

Limited Liability Companies: Frequently Asked Questions

Who should form an LLC? Should I choose an LLC or an S corporation? What is an LLC Operating Agreement? Do I need to have an Operating Agreement? Must I hold LLC meetings? These questions and exceptions to limited liability are presented in this guide.

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Who should form an LLC?

You should consider forming an LLC (limited liability company) if you are concerned about personal exposure to lawsuits arising from your business. For example, if you decide to open a store-front business that deals directly with the public, you may worry that your commercial liability insurance won't fully protect your personal assets from potential slip-and-fall lawsuits or claims by your suppliers for unpaid bills. Running your business as an LLC may help you sleep better, because it instantly gives you personal protection against these and other potential claims against your business.

Not all businesses can operate as LLCs, however. Businesses in the banking, trust, and insurance industry, for example, are typically prohibited from forming LLCs.

Should I choose an LLC or an S corporation?

While the S corporation's special tax status eliminates double taxation, it lacks the flexibility of an LLC in allocating income to the owners.

An LLC may offer several classes of membership interests while an S corporation may only have one class of stock.

Any number of individuals or entities may own interests in an LLC. However, ownership interest in an S corporation is limited to no more than 100 shareholders. Also, S corporations cannot be owned by C corporations, other S corporations, many trusts, LLCs, partnerships, or nonresident aliens. Also, LLCs are allowed to have subsidiaries without restriction.

What is an LLC Operating Agreement?

An LLC operating agreement allows you to structure your financial and working relationships with your co-owners in a way that suits your business. In your operating agreement, you and your co-owners establish each owner's percentage of ownership in the LLC, his or her share of profits (or losses), his or her rights and responsibilities, and what will happen to the business if one of you leaves.

Do I need to have an Operating Agreement?

Although most states' LLC laws don't require a written operating agreement, you shouldn't consider starting business without one. Here's why an operating agreement is necessary:

- It helps to ensure that courts will respect your personal liability protection by showing that you have been conscientious about organizing your LLC.
- It sets out rules that govern how profits will be split up, how major business decisions will be made, and the procedures for handling the departure and addition of members.
- It helps to avert misunderstandings between the owners over finances and management.
- It keeps your LLC from being governed by the default rules in your state's LLC laws, which might not be to your benefit.

Must I hold LLC meetings?

Although a corporation's failure to hold shareholder or director meetings may subject the corporation to alter ego liability, this is not the case for LLCs in many states. In California, for example, an LLC's failure to hold meetings of members or managers is not usually considered grounds for imposing the alter ego doctrine where the LLC's Articles of Organization or Operating Agreement do not expressly require such meetings.

Exceptions to Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, it is important to realize that this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he or she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the LLC defaults
- fails to deposit taxes withheld from employees' wages
- intentionally does something fraudulent, illegal, or clearly wrong-headed that causes harm to the company or to someone else, or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

This last exception is the most important. In some circumstances, a court might say that the LLC doesn't really exist and find that its owners are really doing business as individuals, who are personally liable for their acts. To keep this from happening, make sure you and your co-owners:

- **Act fairly and legally.** Do not conceal or misrepresent material facts or the state of your finances to vendors, creditors, or other outsiders.
- **Fund your LLC adequately.** Invest enough cash into the business so that your LLC can meet foreseeable expenses and liabilities.
- **Keep LLC and personal business separate.** Get a federal employer identification number, open up a business-only checking account, and keep your personal finances out of your LLC accounting books.
- **Create an operating agreement.** Having a formal written operating agreement lends credibility to your LLC's separate existence.

A good liability insurance policy can shield your personal assets when limited liability protection does not. For instance, if you are a massage therapist and you accidentally injure a client's back, your liability insurance policy should cover you. Insurance can also protect your personal assets in the event that your limited liability status is ignored by a court.

In addition to protecting your personal assets in such situations, insurance can protect your corporate assets from lawsuits and claims. Be aware, however, that commercial insurance usually does not protect personal or corporate assets from unpaid business debts, whether or not they're personally guaranteed.