

InsideCounsel

Regulatory: Piercing the veil of a single-member LLC

A possible trap for the unwary

BY RANDY JOHNSON

January 11, 2012

The single-member limited liability company is a powerful tool in structuring both simple and complex business relationships. In its simplest form, a sole proprietorship can be structured as a single-member limited liability company to protect the proprietor from liability while maintaining the simple tax and operational flexibility inherent in a sole proprietorship. In more complex business structures, assets or business operations can be segregated into separate, single-member LLCs to compartmentalize risk and build liability firewalls.

Despite its great flexibility and usefulness, the single-member LLC can be a trap for the unwary. A single-member LLC is disregarded as a separate entity for tax purposes, but recognized as a separate legal entity for liability purposes. In some respects, those concepts are at odds.

In the corporate context, courts have been willing to disregard the corporate entity where there exists such unity between the corporation and the individual that the corporation ceases to be separate from its owners and, in effect, becomes disregarded as a separate entity. Because a single-member LLC already is disregarded as a separate entity for tax purposes, it may be especially easy for the LLC owner to treat the LLC as a disregarded entity for liability purposes as well. If a court adopts the corporate standards for piercing the veil, this could cause the LLC owner to lose the liability protection afforded by the LLC structure.

Compared to the corporate structure, the LLC structure is relatively new. Case law dealing with piercing the LLC veil is still developing, and the cases decided so far are neither uniform nor entirely predictable. This is particularly true with single-member LLCs.

A common feature of the LLC statutes in various states is they each expressly provide that an LLC member will not be liable for the debts and obligations of the company by virtue of being a member of the company. Despite the clear language of the LLC statutes that would seem to provide an impenetrable shield to the LLC owners, many courts considering piercing the veil of an LLC have adopted the same analysis used with respect to corporations.

Considering the most significant factor in determining whether to pierce the corporate veil is whether the corporation's separate identity is respected for all purposes by the owner, and because the single-member LLC already is disregarded as a separate entity for tax purposes, a single-member LLC must take extra care to maintain its separate identity.

While each situation is unique, at a minimum, a single-member LLC should:

- Assure it is properly capitalized given the nature of its business operations
- Maintain separate accounting records and bank accounts, and avoid comingling funds with its owner
- Not cause excessive capital to be distributed to the owner
- Be clear in its agreements and communications with third parties that it is acting on its own behalf and not strictly on behalf of its owner

About the Author



Randy Johnson

Randy K. Johnson is a Kirton & McConkie shareholder and member of the firm's Business section. He has extensive experience advising founders and management of start-up and emerging growth companies on entity structure, financing, securities, taxation, intellectual property and mergers and acquisitions as well as drafting and negotiating commercial agreements. He can be reached at rkjohnson@kmclaw.com or (801) 328-3600.

© 2012 InsideCounsel. A Summit Business Media publication. All Rights Reserved.