

# Keeping Limited Liability Limited: It's All About the Details

Generally, limited liability is the primary reason business entities are formed. The comfort of limiting liability keeps many business owners warm at night. Limited liability is granted automatically by the state with the formation of certain business entities and most business owners would consider it a right. However, most business owners don't know that limited liability can become "un"limited, *i.e.*, lost, if you fail to follow simple formalities and guidelines. In other words, it's all about the details.

## What is limited liability?

Limited liability restricts your legal responsibility for the company's obligations to the capital contributions or investments you are required to make. Basically, creditors of the company can only look to the assets of the company to satisfy the company's obligations. Limited liability shields your personal assets from the obligations of the company.

Limited liability is an excellent supplement, but is not a replacement for insurance. Limited liability will not protect you from liability from your own individual acts.

## How does a company get limited liability?

Limited liability is granted by the state (*i.e.*, the State of Oregon) in the formation of certain entities. Corporations, limited liability companies, limited partnerships and limited liability partnerships are all granted limited liability on formation. Limited partnerships and limited liability partnerships have limited liability only for the limited partners. General partners of limited partnerships and limited liability partnerships generally do not receive limited liability unless the general partner is already an entity with limited liability. Owners of sole proprietorships and general partnerships also do not receive limited liability protection from the state.

## How does a company "lose" limited liability?

A company can lose limited liability through some form of a theory called "piercing the veil." Piercing the veil is a legal term used to describe an action to have the entity set aside for purposes of the litigation such that personal liability attaches to you, and your personal assets can be reached. The theory is usually used in litigation, where the company is believed to have inadequate assets to cover its liabilities, and the plaintiff alleges that the company is actually a sham, *i.e.*, the company is not really a distinct business, but is merely an extension or alter ego of you, being used to advance your private interests or to perpetrate a fraud.

## How does a company keep limited liability limited?

The short answer is to follow all formalities and treat the company as a separate and distinct entity. Paying attention to the details is very important.

## **Keep the Company Separate**

- Do not commingle assets. You should not use the business assets of the company for personal use and should not use personal assets for business use. Do not borrow the company car to shop for groceries. Do not write checks from the company bank account to pay the mortgage on your home or use your personal checking account to buy supplies for the company.
- Carefully document all transactions between you and the company. All contributions, loans, sales, etc. should be in writing.
- Make sure all transactions between you and the company are at arm's length. Basically, treat transactions between you and your company as if you were transacting with an unrelated third-party. Charge interest on loans, buy or sell assets at fair market value, and do not give any special deals you would not give to an unrelated third-party.

## **Follow the Formalities**

- Operate the business of the company as the business of the company. The company should borrow money, enter into leases and engage in other business transactions, where possible, without the individual endorsements of the owners of the company or of employees. The owners and employees should sign documents on behalf of the company in a representative capacity. Sign the documents as president, shareholder, member, limited partner, etc.
- All meetings of the owners, shareholders, members, partners, directors, managers, etc. should be recorded in writing. If the entity is a corporation, make sure annual meetings are held and the minutes are recorded. Other entities should consider holding similar meetings, even though it may not be required, in order to show the company is following the formalities. If you hold a meeting, write it down.
- Operate the company administratively as separate. Set up separate checking accounts in the name of the company, use the company's employer identification number for all tax purposes, insurance policies of the company should be purchased in the name of the company, taxes on wages paid to employees of the company should be withheld by the company, etc.
- Assets used in the business of the company should generally be owned in the name of the company. If the company uses it, it should own it. There are exceptions such as assets leased or rented by the company. For larger assets such as real property, you should consult with an attorney to determine the best ownership.

Follow the formalities and treat your company as a separate and distinct entity so you can sleep well at night knowing that your limited liability shield is keeping your personal assets safe from creditors of your company.

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