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Does Your Limited Liability Company Provide You With As Much Liability Protection As You Believe?

By Marc Maher, Esq.



The limited liability company ("LLC") is an ideal vehicle through which to own your real estate investments because of, amongst other things, the personal liability protection it affords you (as a member) from and against the claims of judgment creditors. However, the mere fact that your particular asset is owned by your LLC does not necessarily mean that your personal liability protection is impregnable.

What Liability Protection Is Afforded by an Arizona LLC?

A.R.S. § 29-651 provides, in part, that a member of an LLC is not liable, *solely by reason of being a member* (emphasis added), for the debts, obligations and liabilities of the LLC whether arising in contract or tort, under a judgment, decree or order of a court or otherwise. While this veil of protection is broad, it is not exhaustive. The statute does not serve to protect a member from personal liability arising from his own (in)action(s) or negligence. In instances where a court of competent jurisdiction determines that a member's own (in)action(s) or negligence caused harm to a third party, such court may award a judgment to that third party, regardless of the fact that the asset on which the harm arose was owned by an LLC.

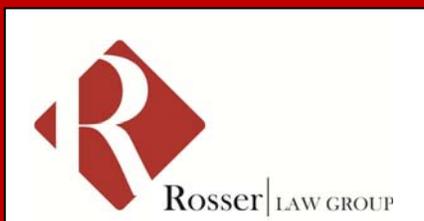
Can the Veil Be Pierced?

"Piercing the veil" is a concept that is associated with the law of corporations. Generally, a corporation will be treated as a legal entity unless or until sufficient reason appears to disregard the corporate form. When the veil is pierced a creditor is able to pursue the person behind the corporate veil for damages. Yes, you concluded correctly. This means that the individual shareholder's personal property would then be at risk of being taken.

Although there is no statute or precedential case law in Arizona that extends the "piercing the veil" concept to LLC's, there is an unreported case in the Arizona Court of Appeals that extends the "piercing the veil" concept to LLC's. Additionally, there is persuasive authority from courts outside of Arizona that extend this concept to LLC's. Thus, the mindset that you should adopt as an investor, and member of an Arizona LLC, is that the veil of your Arizona LLC can be pierced by an injured party, whether that injured party is a tenant, guest of a tenant, service provider, or member of the public.

How is the Veil Pierced?

Arizona has a two pronged test to determine whether the corporate fiction should be disregarded and the corporate veil should be pierced. The first prong is when the corporation is the "alter ego" or "business



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conduit” of a person; the second prong is when observing the corporation would work an injustice. The “alter ego” status is said to exist when “there is such unity of interest and ownership that the separate personalities of the corporation and owners cease to exist.” As a member of an LLC it is critical that you take those steps necessary to ensure that your LLC is not the alter ego of yourself, lest you risk dissolving the liability protections that your LLC affords you. The following are some steps that you can take to lessen the possibility that your LLC’s fiction is disregarded, and merely treated as an alter ego of yourself:

1. Maintain formalities of the LLC, even if you are the sole member. This includes using an operating agreement, and actions in writing.
2. Acknowledge, through your actions, that your LLC is distinct from you. An example is signing LLC documents, service contracts, leases, and other business documents related to the LLC as “John Smith, Member of Cash Flow Apartments, LLC” as opposed to “John Smith [a natural person]”.
3. Do not undercapitalize your LLC. Do not siphon off profits. Ensure that the LLC has enough money to cover its reasonably foreseeable liabilities.
4. Do not commingle the LLC’s funds and your personal funds. For example, keep a separate bank account for your LLC; and ensure it is distinct from your own personal bank accounts. Do not write a personal check to pay the debts of the LLC, and vice-versa. Document any money you lend to the LLC through the formalities of a properly drafted and executed promissory note. Ensure that the LLC is paying rent to the property owner for that property at which the LLC declared as its domestic address.
5. Do not allow the LLC to use your assets (e.g. office equipment) or the assets of other companies (including those in which you hold an ownership interest) without having the LLC pay rent for use of those assets.

To help you keep the above in mind, simply follow this simple rule of thumb; treat the LLC like it is a stranger. Would you lend money to a stranger without memorializing the loan in a promissory note? No. Therefore, do not lend money to the LLC unless you go through the property formalities. Would you allow a stranger to share your office space without signing a lease and paying you rent? No. Therefore, and again, go through the property formalities. Although honoring the separate formalities of the LLC may seem to be an additional administrative task, particularly if you have a single-member LLC, doing so will help to preserve the integrity of the LLC and will lessen the possibility that the clever lawyer for the party suing your LLC will be able to pierce your LLC’s veil of liability protection.

As transactional real estate attorneys, we are equipped to review the structure of your LLC’s and help you (re)establish their integrity. Please do not hesitate to contact us if you would like to schedule a consultation to discuss how we may be of service.

This article is of a general nature and reflects current statutory and case law as of the date of first publication. Further, this article reflects only the opinion of the author, and is not intended as definitive legal advice; you should not act upon it without seeking independent legal counsel.

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