Is Your LLC Protecting Your Personal Assets?

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So you have decided to start your own business, and being the prudent entrepreneur that you are, you've followed your attorney's advice and formed a limited liability company to run your business and hold its assets. So all of your personal assets are sure to be protected from the company's creditors, right? Well, not in all cases.

The general rule is that a company's shareholders or members are not personally liable for their company's debts. As the theory goes, this incentivizes investment by capping an owner's risk at the amount they have invested. The concept of limited personal liability has been referred to by many legal scholars as the "most important legal development of the nineteenth century."

However, there are exceptions to the general rule of limited personal liability. This is known as "piercing the corporate veil," and most often occurs when a court finds that a company is the owner's "alter ego," and is merely being used as a sham to bypass regulations or defraud third-parties.

The Wisconsin Supreme Court has explained that personal liability may be imposed when a company is a mere "instrumentality" of the owner, and the owner is hiding behind the company to "evade an obligation, to gain an unjust advantage, or to commit an injustice." In order to satisfy the elements of the "alter ego" doctrine, there must be proof of the following elements:

(1) The owner must have absolute control of and dominion over the company to the extent it has no separate mind, will or existence of its own;

(2) Such control must be used by the owner to commit a fraud or a wrong, to perpetrate the violation of a statutory or other legal duty, or to commit a dishonest and unjust act in contravention of a third-party's legal rights; and

(3) The aforementioned control and breach of duty must proximately cause the injury or unjust loss complained of.

In regard to the first element, the court will look at whether or not the company has followed corporate formalities, i.e. whether it has organizational documents like articles or organization, by-laws or an operating agreement, whether it has conducted meetings and maintained records, and whether the owner is using the company as his or her own personal piggy bank.

As to the second element, the court will look at whether the control was used to commit the wrong or the injustice that occurred. Whether or not a company is "adequately capitalized" at formation is often a factor that is analyzed.

For the third element to be proven, it must be shown that there is a link between the control, the injustice, and the harm that occurred. Practically speaking, this means that the third-party alleging the wrongdoing must have relied on the controlling owner's misrepresentations or fraudulent documents.

Finally, the veil piercing doctrine is not just a one way street: the "reverse alter ego doctrine" can also be used by creditors to reach the corporate assets held by a company owned by an individual judgment debtor. This is usually invoked when a shareholder or member uses the company to hide assets or secretly conduct business to avoid some pre-existing liability.

While it is undoubtedly good practice to form a corporate entity like an LLC to run your business, owners must still be diligent in order to maintain corporate formalities, adequately capitalize their companies, and make third-parties aware that they are dealing with a separate corporate entity.