

## **HAVE RECENT COURT DECISIONS SOUNDED THE DEATH KNELL FOR SINGLE-MEMBER LLCs IN AN ASSET PROTECTION PLAN?**

As LLCs are creatures of state law, any analysis of an LLC's role in an asset protection strategy must consider the relevant state's LLC act as well as case law that interprets it. The Revised Uniform Limited Liability Company Act, on which most state LLC legislation, including Wyoming's, is based, provides in Section 304(b):

“The failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not ground for imposing liability on the members or managers for the debts, obligations or other liabilities of the company.”

In other words, failure to observe corporate formalities is not a reason to pierce an LLC's veil.

Or is it?

A recent case out of the Supreme Court of Wyoming, *Greenhunter Energy, Inc. v. Western Ecosystems Technology, Inc.* (2014 WY 144), left many wondering (1) if the death knell had sounded on the use of Wyoming single-member LLCs in an asset protection strategy, and (2) if other states like New Mexico would follow suit in liberally piercing the veil of a single-member LLC. The case serves as a sobering reminder of the vulnerability of single-member LLCs even in a traditionally LLC-favorable jurisdiction such as Wyoming.

*Greenhunter Energy* involved a contract for consulting services between GreenHunter Wind Energy, LLC (the “Debtor LLC”) and Western Ecosystems Technology, Inc. (the “Consultant”). The Consultant provided services to the Debtor over the course of a year and never received payment. The Consultant sought to obtain judgment against the Debtor LLC only to learn that the Debtor LLC had no assets. The Consultant then sought judgment against the Debtor LLC's sole member, GreenHunter Energy, Inc. (the “Sole Member”).

The primary issue before the Court was whether the Debtor LLC's veil of limited liability should be pierced, subjecting the Sole Member to liability. In analyzing this issue, the Court outlined a new test:

The veil of a limited liability company may be pierced under exceptional circumstances when:

- (1) the limited liability company is not only owned, influenced and governed by its members, but the required separateness has ceased to exist due to misuse of the limited liability company; and
- (2) the facts are such that an adherence to the fiction of its separate existence would, under the particular circumstances, lead to injustice, fundamental unfairness, or inequity.

In considering whether both prongs of its “fact-driven and flexible” test had been met, the Court applied the following non-exhaustive factors:

- (1) presence of fraud,
- (2) inadequate capitalization,
- (3) the degree to which the business and finances of the LLC and its member are intermingled, and

(4) manipulation of assets and liabilities between the LLC and its member to concentrate the assets in the member and the liabilities in the LLC.

The Court repeated that the analysis is fact-driven and clarified that no one factor, except fraud, alone justifies piercing an LLC's veil of limited liability.

Additionally, to pierce the veil, "an injustice or unfairness must always be proven."

Despite reiterating that "limited liability is the rule, and piercing is the rare exception to be applied only in cases involving exceptional circumstances," the Court affirmed the district court's judgment piercing the LLC's veil and holding the Sole Member liable for the debt to the Consultant. The Court cited the following facts to support its holding:

(1) Undercapitalization: During the period that the Consultant provided services to the Debtor LLC, the Debtor LLC often had \$0 in its operating account and received periodic transfers from the Sole Member who had sole discretion in how the money was used. The Consultant submitted seven invoices to the Debtor LLC over time, yet never received payment. The Court held that these facts indicated that the Debtor LLC was inadequately capitalized due to manipulation by the Sole Member.

(2) Inter-mingling: Although the Sole Member and Debtor LLC had separate bank accounts and business records, the Court nonetheless found evidence of improper intermingling. The Sole Member and the Debtor LLC had: (a) overlapping ownership, membership and management; (b) the same business address; and (c) the same accountants, who consolidated the entities' tax returns. Funds were passed through the Debtor LLC by periodic transfers from the Sole Member to pay selected expenses.

(3) Misuse of the Debtor LLC: The Court pointed out that the Sole Member "enjoyed significant tax breaks attributable to the LLC's losses, without bearing any responsibility for the LLC's debt and obligations that contributed to such losses" and held that the "disparity in the risks and rewards resulting from this manipulation would lead to injustice." The Court recognized that filing a consolidated tax return was permitted by federal tax law, and concluded that the tax filings were only one of many relevant pieces of evidence that the Sole Member had improperly directed benefits from the Debtor LLC to itself.

As the Sole Member argued in *Greenhunter Energy*, the holding is troubling from a policy perspective.

Federal tax law permits the consolidated tax filing. To identify this fact as supporting veil piercing puts single-member LLCs in the position of having to choose between the tax and asset protection benefits of an LLC. Furthermore, LLCs are defined by their flexibility and lack of corporate formalities. The minimal requirements of forming and operating a single-member LLC are part of the entity's attractiveness, and it is not inconceivable that such informality and flexibility would lead to some degree of overlap between the business and its owner. No fraud was proven, yet the veil was still pierced, leading many to question whether LLC veil piercing, particularly in the case of single-member LLCs, truly is reserved for exceptional circumstances.

As case law continues to develop around this issue, business owners and their advisors should be cautious about the potential dangers of using a single-member LLC where asset protection is a primary objective.

After Greenhunter Energy, it would be prudent to (1) keep adequate funds in the LLC's operating account, allowing it to pay all debts as they come due, (2) consider using a separate accountant for the LLC's bookkeeping, (3) establish separate mailing addresses for the entities, (4) acknowledge and prioritize ongoing LLC compliance responsibilities, and (5) ensure that all liabilities associated with any tax benefits derived from an LLC are satisfied in full in a timely manner.

*For more information on this issue and other matters related to the proper formation and administration of limited liability companies, please contact THOMAS LAW FIRM, Chartered, PO Box 21580, Albuquerque, NM 87154-1580 Telephone: 505-837-2344 Email: Attorneys@ThomasLaw.US.*