



THE LAW OFFICE OF

**CHARLES H. McCLENAGHAN**

ATTORNEYS AND COUNSELORS AT LAW

Charles H. McClenaghan, Esq.  
\*Licensed in Ohio and Florida  
Phillip S. Haer, Esq.

---

## **BASIC ISSUES REGARDING A LIMITED LIABILITY COMPANY**

By Charles H. McClenaghan

### **1. What is a Limited Liability Company?**

A limited liability company or “LLC” is a business entity that is authorized by specific legislation in most States and in many foreign countries. It is designed to offer co-owners of an unincorporated business who make a proper filing with the state freedom from personal liability for the debts of the business, the option to manage the business, and the tax advantages of partnership status. The owners enjoy limited liability, and are not vicariously liable for the contract or tort obligations of the business. The LLC can be member-managed or manager-managed. Simply put, the LLC combines the best attributes of a corporation and a partnership

### **2. How do you form an LLC?**

An LLC is formed upon the filing of a document, generally called “articles of organization,” with the secretary of state or some other designated state office. The articles of organization are normally very simple providing only basic information with respect to the name of the company, the agent for service of process, the company’s address, and its manager(s) or member(s). Once the filing is approved by the Secretary of State, the Organizer sells Membership interests to future Members, a Meeting of Members is held to establish the manner in which the LLC will be managed and an Operating Agreement is adopted. This Operating Agreement is critical to the success of any multi-Member LLC. It establishes the “rules” of ownership and how decisions will be made.

### **3. How is a LLC Structured?**

An LLC is structured much like a partnership, with the co-owners being referred to as members instead of partners. The LLC can be member-managed in a manner similar to a general partnership or it can be manager-managed like a general partner does in a limited partnership. If the LLC is member-managed all members will typically have an equal vote and collectively make decisions. This includes not only major business and

financial policies, but also the everyday operations. If the LLC is manager-managed, the members only decide on major financial and business decisions and the manager handles the day-to-day business operations.

#### **4. How is the structure of the LLC determined?**

The founding members or promoters of the LLC determine the structure by means of an operating agreement which is similar to a partnership agreement. Typically, when the articles of organization are filed, the state requires the articles to include the management structure. That is, whether the LLC is member-managed or manager-managed. The members have an experienced attorney draft an operating agreement which sets forth the different rights and responsibilities of the members and covers matters such as capital contributions, division of profits, management, member meetings, and transferability of ownership interests, dissolution, and indemnification. An LLC is a contractual entity, with only a few mandatory, non-waivable provisions.

#### **5. What are fees for establishing and operating a LLC?**

Costs to form an LLC will vary from state to state. In Ohio, the costs of setting up an LLC will include a registration fee with the Ohio Secretary of State (currently \$99.00) and may include attorney fees, paying an accountant, and deed preparation among others. The total cost of establishing an LLC is totally dependent upon each situation and the professionals that are involved. An Ohio limited liability company does not pay an annual fee to the State to maintain its status. However, a *foreign* LLC registered in Ohio must pay an annual fee.

#### **6. Tax and Accounting Treatment**

Recent changes in federal tax law, known as the “check-the-box” regulations, allow Member(s) of the LLC to choose the way the LLC will be taxed. For example, it may be advantageous for the LLC to be taxed as a partnership. When electing to be taxed as a partnership the LLC files an Information Return and issues K-1 statements to its members. The K-1 shows the member’s share of the income or loss that the LLC incurs. The members then report this amount on their individual returns. The LLC, if taxed like a partnership, does not pay any income tax. If the LLC is a single member LLC, the owner may treat it as a disregarded entity for tax purposes and report the tax and related accounting on the individual tax return of the member. This eliminates the necessity of a tax return for the LLC.

#### **7. Separation of Personal and LLC Assets**

It is important for any company to respect the difference between the *company’s* bank accounts, property, equipment, and other assets and *personal assets* owned by the company’s owners. An LLC, like a corporation or other legal “person,” is a separate

legal entity with assets that are owned by the LLC. Any attempt by an LLC member to dispose of or use LLC property would be no more proper than an attempt by that member to dispose of or use another member's personal property. Members must respect the fact that the LLC's assets are the property of the LLC, not the members. Similarly, an LLC member should not co-mingle such member's personal assets with the company assets of the LLC.

The Company's books, records, and financial statements should be maintained clearly to reflect the separation of the Company's assets from the personal assets of the members. The Company must conduct business in its own name (not in the individual name of any Manager or member). All letterhead, business card, bills, checks, invoices, and other Company forms should show the Company's full legal name (and fictitious business name, if any), and the Company's current address, telephone number and facsimile number.

As a statement of sound business practice the observations made about separation of personal assets from company assets are fairly obvious. There is an additional, less obvious reason to follow those rules.

Creation of an LLC shields from liability for LLC members inevitably gives rise to attempts to pierce that shield by creditors of the LLC. This has long been the case for the liability shield of corporations. As long as there have been corporations, there have been attempts to "pierce the corporate veil." Published cases in which such attempts have been successful usually involve a recitation by the court of a dozen or so factors in support of the court's ruling that the shareholders of the corporation should be held personally liable for the debts, obligations, or other liabilities of the corporation. At the top of this list of factors are (i) failure by the shareholders to respect the corporation's separate identity (by intermingling corporate and personal assets); and (ii) some other form of misconduct by the shareholders with respect to the corporation.

Although the failure of an LLC to respect corporate formalities generally cannot be considered a factor "tending to establish that the members have personal liability" for any LLC debt, obligation or liability (see "Observance of Corporate Formalities Not Required" above), this is not to say that LLC members can ignore the many years of corporations law development in this area. LLC members and Managers are well advised to bear in mind the foregoing observations about "piercing the corporate veil."

## **8. Charging Order Protection**

Creditors of members of an LLC can obtain relief through what is known as a charging order. This means that the creditor can get an order requiring the LLC to remit to the creditor any distributions that would otherwise be made by the LLC to the judgment debtor whose interest is being charged. This remedy precludes a judgment creditor of a member from obtaining a seizure and forced sale of the debtor-member's interest in the

LLC while at the same time providing the creditor some relief relative to distributions from the entity to the member. The charging order remedy is often times the exclusive remedy available to the creditor and provides substantial asset protection for the LLC owner.

The charging order limits the creditor exclusively to collection of the income or distributions which the LLC assets might engender, but which under some circumstances can be withheld from distribution at the discretion of the LLC manager. Stated another way, a creditor who has obtained a charging order only has the right to receive distributions from the entity when and if such distributions are made even though the entity itself may have substantial income.

## 9. Holding Real Estate in the LLC.

If the primary purpose of the LLC is to hold title to real estate investments, the members will need to deed or convey the real property to the LLC by means of a formal, recorded deed. All of the rents with respect to the real property should be deposited in the LLC bank account and all expenses with respect to the property should be paid from the LLC bank account. All contracts with respect to the real property and service arrangements should be exclusively in the name of the LLC.

## 10. Examples.

The following are some examples of when and why a LLC might be wisely selected:

**a. Margaret** is a widow, who, in addition to her personal residence, owns a four-unit in the Ohio State University area of Columbus, Ohio. She is concerned about potential liability beyond her insurance coverage and has elected to place the four-unit into a single member LLC. She treats it as a disregarded entity for tax purposes. She has all the personal liability protection of a corporation and has the simplicity of tax and accounting reported on her personal individual return. No company tax return is required.

**b. Kurt**, his brother Steve and their friend, Robert, each own a one-third interest in a small shopping center in New Albany, Ohio. They have created an LLC in which to hold title to the shopping center so as to protect their respective personal assets from any claims with respect to the shopping center. All three of them participate equally in the LLC which is member-managed by the three of them and treat it as a partnership for tax purposes. The LLC files a partnership return; Kurt, Steve and Robert each receive a K-1, which they use to prepare their individual tax returns.

**c. Ryan** owns a 25% interest in a 76 unit apartment building which he manages in Newark, Ohio. The other 75% is owned by various members of Ryan's family and by some friends. Ryan and the other members have placed the apartment complex into a manager-managed LLC to provide Ryan greater flexibility in his management duties and responsibilities. The LLC reports its taxes as a partnership and Ryan and all the other

3956 Brown Park Drive, Suite B | Hilliard, Ohio 43026

Tel: (614) 429.1053 | Fax: (614) 319.3746

Charles@LawDublin.com | Phillip@Lawdublin.com

members receive K-1s for their shares of profits. Ryan also receives a salary or guaranteed payment as manager which is paid to him as an expense before there is a division of profits.

**11. Business and Professional Application. LLCs can be used to operate any retail or other business or professional situations where limited liability is desirable, but the flexibility of the LLC is required.**

I hope this is helpful. Please let me know if you have questions or if you would like me to begin the LLC formation process.

Sincerely,  
*Charles H. McClenaghan*

Charles H. McClenaghan