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REPORT FROM COUNSEL

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LIMITED LIABILITY COMPANIES—THE BEST OF ALL WORLDS?

A limited liability company (LLC) is a business structure that combines some of the best features of sole proprietorships, partnerships, and corporations. LLC owners, like their counterparts for partnerships or sole proprietorships, report profits or losses on their personal income tax returns. Like a corporation, however, the owners of an LLC have "limited liability," that is, they are shielded from personal liability for debts and claims arising from the business.

Limited Liability

The limited liability for LLC owners is not absolute. Owners still can be held liable if they (1) personally and directly injure someone; (2) personally guarantee a loan or business debt on which the LLC defaults; (3) fail to deposit taxes withheld from employees' wages; (4) intentionally commit a fraudulent or illegal act that harms the company or someone else; or (5) treat the LLC as an extension of their personal affairs rather than as a separate legal entity.

The last exception to limited liability is the most significant. It carries the potential for complete removal of the protections for individual owners. If the line between LLC business and personal business becomes too blurred, a court could find that a true LLC does not exist, leaving the owners personally liable for their actions.

Ownership

Most states allow a single individual to be the sole owner of an LLC. An LLC makes the most sense in circumstances where there is a concern about personal exposure to lawsuits stemming from operation of the business. Most laws prohibit establishment of an LLC in the banking, trust, and insurance fields.

Unlike corporations, LLCs can carry on their business without holding regular ownership or management meetings. Of course, formal meetings backed up by written minutes still may be advisable to document important decisions, such as a change in membership or a major expenditure.

Formation

Setting up an LLC is relatively simple. Articles of organization must be filed with the appropriate state office, usually the Secretary of State. The articles of organization include the name and principal office for the LLC, the names and addresses of its owners, and the name and address of the person or company that agrees to accept legal papers on behalf of the LLC.

Even if it is not legally required, the owners should prepare an operating agreement that spells out the owners' rights and responsibilities. The absence of an operating agreement will mean that state statutes will govern the operation of the LLC by default. An operating agreement acts as a guide for resolving common issues that an LLC will face, and thereby helps to avert misunderstandings between the owners. It also underscores the authenticity of the LLC itself, which can be helpful when a judge is deciding whether the owners are protected from personal liability.

A standard operating agreement includes the members' percentage interests in the business; the members' rights and responsibilities; the members' voting power; allocation of profits and losses; how the LLC will be managed; rules for holding meetings and taking votes; and "buy-sell" provisions that control what happens when a member wants to sell his interest, becomes disabled, or dies. Although it is frequently overlooked when an LLC is created, a buy-sell agreement is important as a sort of "premarital agreement" among the owners. The buy-sell provisions can clarify and ease the transition when the inevitable changes come to the members of the LLC.

Taxes

Since an LLC is not considered separate from its owners for tax purposes, the LLC pays no income taxes itself. Like a partnership or sole proprietorship, an LLC is a “pass-through entity.” Each owner pays taxes on a share of profits, or deducts a share of losses, on a personal tax return. The IRS regards each member as a self-employed business owner, not an employee of the LLC. There is no tax withholding, and owners must estimate taxes owed for the year, then make quarterly payments to the IRS.

Conversion

By converting to the LLC business structure, sole proprietors and partnerships can gain the protection afforded to LLC owners without changing the way their business income is taxed. Conversion usually can be accomplished either by filling out a simple form or filing regular articles of organization. Federal and state employer identification numbers will have to be transferred to the name of the new LLC, as will such items as sales tax permits, business licenses, and professional licenses or permits.

The process for creating an LLC is streamlined and free of highly technical considerations. However, there is an important place for professional advice concerning such matters as choosing an LLC over other business structures, preparing or reviewing the operating agreement, and setting up accounting systems.

EMPLOYEES ARE RESPONSIBLE FOR BENEFICIARY DESIGNATIONS

The Federal Employees’ Group Life Insurance Act of 1954 (FEGLIA) establishes an $824 billion program providing low-cost life insurance for hundreds of thousands of federal employees. FEGLIA allows an employee to name a beneficiary of life insurance proceeds, and specifies an “order of precedence” providing that the employee’s death benefits accrue first to that beneficiary ahead of other potential recipients.

In 1996, when he was one of those federal employees who could participate in the FEGLIA program, Warren named Judy, his wife at the time, as the named beneficiary on his life insurance policy. In 1998, the couple divorced. In 2002, Warren married Jacqueline. Warren died suddenly in 2008, without ever having changed the named beneficiary from Judy to Jacqueline. As a result, the ex-wife Judy filed a claim for the $125,000 in life insurance proceeds, and was paid them.

Jacqueline sued Judy in a state court to recover the life insurance proceeds, and she had more to support her claim than just a supposition that Warren would have wanted it that way. In short, she claimed with some justification to have state law on her side.

A state statute revokes a beneficiary designation in any contract that provides a death benefit to a former spouse where there has been a change in the decedent’s marital status. In addition, in the event that this provision is pre-empted by federal law, a separate provision of the state law provides a cause of action making the former spouse liable for the principal amount of the proceeds to the party who would have received them if the first provision was not preempted.

The U.S. Supreme Court sided with Judy, the former wife, notwithstanding that there was a certain logic to the position that Warren most likely would have preferred that the proceeds go to his wife at the time of his death. The unassailable fact was that, though he had ten years after his divorce from Judy and six years after his remarriage to Jacqueline to do so, Warren never changed the named beneficiary on his policy.

Most importantly from a legal standpoint, his selection of a named beneficiary could not be overridden by operation of any state law. Such a result was foreclosed by the doctrine that federal law preempts state law where the two conflict. Thus, even the state statute that sought to foresee the possibility of federal preemption and accomplish an end-run around it could not do so.

Simply put, if a beneficiary, Judy in this case, is properly named for a FEGLIA policy, the insurance proceeds owed to that person cannot be allocated to another person, in this case Jacqueline, by operation of state law. Apart from the legal precedent it set, the case is an object lesson in the importance of keeping one's estate plans, including beneficiary designations, current. Had Warren taken the simple step of filling out the form to change beneficiaries on his policy sometime before he died, assuming that was his wish, the protracted litigation that ensued after his death could have been avoided.

PROTECT YOUR PLASTIC

As new technologies change the way we pay for things, criminals are managing to keep pace as they devise ways to separate you from your money. Doing what you can to protect yourself is one part understanding the technology and at least equal portions of vigilance and common sense. Still, we can all benefit from some reminders.

"Phishing" refers to out-of-the-blue e-mails, text messages, or phone calls from superficially legitimate sources, often couched in urgent tones, asking for your credit card or debit card information. The thieves then set up counterfeit cards and run up charges on your accounts. Don't take the bait. You might think that these appeals are too brazen to work, but obviously they work often enough to be a tool in the con artists' toolbox. Follow this rule: Never give out your payment card information in response to an unsolicited communication, no matter its apparent source.

Be careful and attentive when using payment cards at ATMs, shops, and gas stations, and not just because of suspicious-looking characters. The bad guys sometimes steal account information by attaching their own devices over legitimate card readers. Beware of plastic sleeves inside the slot where you swipe a card. Another sign of potential trouble arises when the person you are paying swipes your card on two different devices. One of those swipes may be taking your account information for later fraudulent use.

Don't stick your account statements in the pile of bills to be paid without scanning them closely for discrepancies or suspicious items, such as unauthorized withdrawals. Today you can usually do this online, or even on a mobile phone. Even small bogus transactions are worth reporting to your bank, as thieves sometimes hope to escape the consumer's notice with many small transactions.

Recently, thieves allegedly racked up over $25 million in charges, all in small individual amounts, from hundreds of thousands of cardholders. Let your financial institution know right away if a statement or bill is unusually late. That can signify theft of your information that may be used to commit fraud.

Periodically review your credit reports from the three major credit bureaus. If an unfamiliar card or transaction shows up, you may already be a victim of identity theft. You get one free report from each of the credit bureaus in a year, so, to maximize your monitoring, get one free report from one of the bureaus every four months.

If, despite your best efforts, you fall prey to the thieves, all is not lost, but neither should you be complacent. As a rule, the federal Truth in Lending Act puts a $50 cap on the consumer's liability for unauthorized charges on a credit card. However, for lost or stolen debit cards and ATM cards, or unauthorized transactions in your checking or savings accounts, the $50 cap is imposed by law (the federal Electronic Fund Transfer Act) *only* if you notify the institution within two business days. Wait longer than that, and the ceiling rises to $500, or even more in some cases. The policies of individual institutions may further limit losses beyond those imposed by statute, so it is a good idea to ask your card issuer about any such limits it uses.

HOA CAN REGULATE COMMON AREA

Kirk owned a home in a residential community that was overseen by a homeowners association. His property abutted one of a handful of lakes in the community. Legally, the lakes were regarded as common areas controlled by the association. When Kirk bought his home many years ago, the only recorded document imposing restrictions on his use of the property was a two-page document with general restrictions for all homeowners in the community. The only mention of the lakes was an irrelevant limit on how far a boat pier could extend into a lake.

The association amended its rules to prohibit the use of pontoon boats having more than two pontoons on the lake next to Kirk's property. As it happened, Kirk had planned to use just such a vessel, called a “tritoon boat,” on that lake. When the association expressed its determination to enforce its regulation, litigation ensued.

Kirk’s strategy, which, with the benefit of hindsight, may have been flawed, was to argue that the association did not have the power to impose the ban on tritoon boats, because there was nothing in the recorded covenants that referred to or authorized such a restriction. The court that ruled against him at least intimated that his lawsuit may have gained more traction had he challenged the regulation as unreasonable, even if it was within the association’s powers.

It is a legal truism that restrictive covenants should be strictly construed in favor of full and unlimited use of property by the property owner and that restrictions against the free use of property are generally not favored. However, these brakes on the power of homeowners associations usually are applied to restrictions that are imposed on a homeowner’s use of his own property.

In this case, the lake was common property for the benefit of all in the community and subject to management by the association; it was not Kirk’s property. The absence of any explicit references to pontoon or tritoon boats in the recorded covenants was not fatal to the association’s position. The homeowners association had the responsibility of administering the lakes for the common good of the members, and with that responsibility came the implicit power to make reasonable regulations regarding the use of that common property. Kirk would have to settle for the usual two pontoons on his boat.

IDENTITY THEFT POLICIES FOR BUSINESSES

The Federal Trade Commission (FTC) has revised and clarified its “Red Flags Rule” to help covered businesses comply with requirements for preventing and responding to identity theft directed at their customers. The Rule requires many businesses and organizations to implement a written Identity Theft Prevention Program designed to detect the warning signs (or “red flags”) of identity theft in their day-to-day operations.

The ultimate goal is to make businesses better able to spot suspicious patterns that may arise and to thwart identity theft. Obviously this is good for customer relations, but it also may avoid the necessity for the stressful and costly process of cleaning up the mess once thieves have struck.

The FTC describes an Identity Theft Prevention Program as a “playbook” that must include reasonable policies and procedures for detecting, preventing, and mitigating identity theft. With such a program in place, an organization should be able to (1) identify relevant patterns, practices, and specific forms of activity—the “red flags”—that signal possible identity theft; (2) incorporate business practices to detect red flags; (3) detail appropriate responses to any uncovered red flags, to prevent and mitigate identity theft; and (4) update the program periodically to reflect changes in risks from identity theft.

The Red Flags Rule includes guidelines to help financial institutions and creditors develop and implement a program, including a supplement that offers examples of red flags.

Some general categories of red flags are notifications or warnings from a consumer reporting agency or from the customer himself; suspicious-looking documents or personal identifying information; and unusual use of, or suspicious activity related to, a covered account. The FTC and the federal financial agencies also have issued Frequently Asked Questions and answers to help businesses comply with the Rule.

The Rule requires “financial institutions” and “creditors” that hold consumer accounts designed to permit multiple payments or transactions—or any other account for which there is a reasonably foreseeable risk of identity theft—to develop and implement an Identity Theft Prevention Program for new and existing accounts. The definition of “financial institution” includes all banks, savings associations, and credit unions, regardless of whether they hold a transaction account belonging to a consumer; and anyone else who directly or indirectly holds a transaction account belonging to a consumer.

A 2010 change in the law amended the definition of “creditor” and limits the circumstances under which creditors are covered. The previous definition of “creditor” was so broad in its language and interpretation that it swept too many within the Rule’s reach.

The new law covers creditors who regularly, and in the ordinary course of business, meet one of three general criteria. They must (1) obtain or use consumer reports in connection with a credit transaction; (2) furnish information to consumer reporting agencies in connection with a credit transaction; or (3) advance funds to, or on behalf of, someone, except for funds for expenses incidental to a service provided by the creditor to that person.