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The Limitations of Limited Liability

Often the primary purpose—and sometimes the only purpose—of forming a limited liability company (LLC) is to achieve "limited liability" protection for the members and managers. Just as with corporations, "limited liability" is one of the defining characteristics of the entity. Thus protected, the members may feel that they can hide behind the LLC's shield. Perhaps, like actor-turned-singer Jamie Foxx, they will enjoy the refrain, "It ain't my, it ain't my fault." Such a feeling would be correct, most of the time. Generally, the LLC form will protect members and managers from personal liability for any debts or wrongful actions of the company. The flexibility of the LLC form combined with its built-in protection from personal liability has contributed significantly to its huge growth since its adoption in Alabama in the early 1990s.

However, compared to corporations and their significantly longer history in this state, there has been a relative dearth of case law and legislation relating to breaking through the limited liability protections of an LLC to attach liability to an LLC's members or managers. Piercing the corporate veil and other longtime corporate doctrines that permit a finding of personal liability for shareholders or directors have not been as well established or litigated in the realm of LLCs to date in most jurisdictions, including Alabama.

Slowly, this has been changing, based in large part on the similarities of the corporate and LLC form, and in part based on statutory provisions in state codes. In Alabama, there is a statutory exception to the limited liability offered by LLCs. There have been court rulings applying the doctrine of piercing the corporate veil to LLCs. Finally, under certain circumstances, the participation theory and traditional doctrine of agency may also impose personal liability on LLC members and managers.

The Statutory Limitation of Limited Liability

Most members of LLCs will rely on the black letter of the LLC statute to claim their limited liability. Indeed, Alabama's Limited Liability Company Law of 2014, in Section 3.01, specifically states that: "[a] member of a limited liability company is not liable, solely by reason of being a member, for a debt, obligation, or liability of the limited liability company or a series thereof, whether arising in contract, tort, or otherwise or for the acts or omissions of any other member, agent, or employee of the limited liability company or a series thereof."

While the statute's "limited liability" protection is the general rule, the word "solely" is important. The comment to this section specifically exempts certain types of behavior from the provided limited liability protection. The comment states that Section 3.01 was "not intended to relieve a member from liability arising out of the member's own acts or omissions to the extent such actions or omissions would be actionable, either in contract or in tort, against the member if the member were acting in an individual capacity." The comment even gives examples of when members of limited liability companies may be personally liable, and provides that a member will be "responsible for the member's own actions which may result in tort claims against the member, much like owners in other entities." This, in essence, is the codification of the "participation theory," as discussed in this article.

In analogous reasoning, a federal bankruptcy court in Alabama has held that while not generally liable, a member "may be held li-

able to the extent that their participation in a tortious act results in harm to a third-party." In this case, the member withheld lease payments that were to be made by his LLC, knowing that the failure to make the payments would cause significant harm to the entity to which they were due.

Any action, when an LLC member is acting individually, would enable claims against him by a wronged plaintiff, and permit claims against that member despite his membership in the LLC. The fact that a member undertook any such actions on behalf of, and while a member of, an LLC, does not permit him to avoid liability for such actions. As the comment indicates, § 3.01 is certainly not, and was not intended to be, so broad a shield. Alabama Code section 10A-5A-3.01 specifically permits actions against an individual when that individual acts wrongly, even if doing so for a limited liability company.

The "Veil Piercing" Limitation of Limited Liability

A further limitation on the limited liability of LLC members is the doctrine of "veil piercing." Well recognized in Alabama in corporate contexts, veil piercing permits bypassing the liability protections of a corporation (or LLC) to allow claims against individuals owning or participating in the entity.

Veil piercing began, and is most associated, with corporation law. Despite the usual rule that the liability of the corporation will not be imposed upon a stockholder, under specific circumstances the corporate entity and its protections will be disregarded and the liability protections will no longer be available to a stockholder. While veil piercing is disfavored and is the exception rather than the rule, many factors can be used to determine when veil piercing should be used, and include "1) inadequacy of capital; 2) fraudulent purpose in conception or operation of the business; 3) operation of the corporation as an instrumentality or alter ego."

One such method for piercing the corporate (company) veil is if a plaintiff can show either fraud in asserting the corporate existence or that recognition of the corporate existence will result in injustice or inequitable consequences; if shown, the plaintiff may utilize veil piercing to claim against a stockholder defendant personally. Veil piercing is also utilized "where an individual drains funds from the corporation." Additionally, "the corporate entity will be disregarded when it is used solely to avoid a personal liability of the owner while reserving to the owner the benefits gained through use of the corporate name." If a plaintiff can "show fraud in asserting the corporate existence or show that recognition of the corporate existence will result in injustice or inequitable consequences," a court will allow the plaintiff to pierce the veil of the entity.

Importantly, the concept of veil piercing is not limited solely to the corporate form. Multiple Alabama federal district courts have found that veil piercing is as applicable to the limited liability company as it is to the corporation. The Middle District of Alabama has held that "under Alabama law, it is possible to 'pierce the veil' of an LLC," and that "Alabama law... allows veil-piercing of a limited liability company." Recognizing the differences between limited liability companies and corporations, the Southern District of Alabama still found veil piercing applicable to the limited liability companies, stating that while "limited liability law is more relaxed than corporate law, the ability to pierce the corporate veil extends to limited liability companies."

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Even though the body of law applying veil piercing to corporations is much greater than it is for applying the doctrine to LLCs, applying veil piercing to limited liability companies is not a new idea and has been applied in other jurisdictions.

Even the Alabama Civil Court of Appeals has found that piercing the veil can be appropriate with regard to an LLC. In that case, the court allowed the use of reverse piercing when the LLC in question was a sham for purposes of evading a creditor. The court specifically stated that the purpose of the formation of the company was to evade a creditor, and that such a "purpose was fraudulent and illegal." Despite the lack of discussion surrounding veil piercing in the opinion, this situation represents exactly one of the rationales for permitting piercing, and was so applied. While it appears that the Alabama Supreme Court has not yet ruled on the issue of applying the doctrine

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of veil piercing to LLCs, other Alabama courts have done so, and with significant legal support from a growing variety of other jurisdictions. It is likely that the Alabama Supreme Court would follow, especially in light of the fact that, according to the Alabama Code, an LLC has the same kind of limited liability as does a corporation.

The "Participation" & "Agency" Limitations of Limited Liability

In addition to the statutory exemption and doctrine of veil piercing discussed above, a member, manager, or agent's personal participation in wrongful tortious or other conduct can cause the limited liability protections of an LLC to fall away. Under the participation theory and traditional agency doctrine, members, managers, and agents can be personally liable for wrongful acts committed by them while acting for an LLC.

The participation theory means that an officer or employee of a corporation who takes part in the commission of a tort by the company is liable for that tort. Similarly, and relatedly, under traditional agency law, when an agent or director of an entity acts in a tortious manner, that person is not relieved from liability by the fact that he acted at the command or on account or on behalf of the entity or principal. Liability under these theories does not depend on the same grounds as the doctrine of piercing the veil because the agent, manager, director, or officer is liable as an actor, not as an owner of the entity.

The Alabama Supreme Court has adopted the participation theory, holding that "the general rule is that officers or employees of a corporation are liable for torts in which they have personally participated, irrespective of whether they were acting in a corporate capacity." Likewise, Alabama has adopted the Restatement (Second) of Agency, which states, "An agent who does an act otherwise a tort is not relieved from liability by the fact that he acted at the command of the principal or on account of the principal."

The "participation" and "agency" theories of personal liability can apply to the LLC, just as to the corporation. As discussed above, the very statutory section which creates "limited liability" protection also limits the protection. The Comment tells us the LLC statute is "not intended to relieve a member from liability arising out of the member's own acts or omissions to the extent such actions or omissions would be actionable, either in contract or in tort, against the member if the member were acting in an individual capacity." Again, this is essentially the codification of the participation theory. Further bolstering this is the language contained in Alabama's new LLC Act, which states that "[u]nless displaced by particular provisions of this chapter, the principles of law and equity supplement this chapter. Since the participation theory and agency are principles of law and equity, there is no bar to their application to LLCs.

The "Guaranty" Limitation of Limited Liability

There is another situation in which members or managers of an LLC can be held liable for the debts or actions of the LLC: a guaranty. The guaranty can be differentiated from the limitations discussed above because it requires members or managers to affirmatively accept the limitation.

A guaranty is "a promise to answer for the payment of some debt, or the performance of some duty, in the case of the failure of another who is liable in the first instance." However, to be liable for a guaranty, a member or manager must agree to and execute a guaranty contract or agreement in writing. This is quite commonly required as security for loan agreements and other credit obligations.

Without such a contract, a member or manager cannot be liable as a guarantor. Therefore, while members or managers of an LLC may be personally liable under a guaranty contract, it is not because of their status or position within the LLC, but because they signed a contract promising to pay the debt or perform the action. Doing so requires affirmative action on the part of the member or manager to agree to be liable. Unlike the above limitations, this limitation is one with which the member or manager burdens himself.

Conclusion

"Limited liability" is a significant (sometimes only) reason for choosing to form an LLC. It is an inherent protection for the company's members and managers, and it can be a formidable obstacle for third parties who have been wronged by an LLC. However, the protection of "limited liability" is not something that can, or should be, taken for granted. As the reader has seen, "limited liability" is itself subject to several limitations. ⚖

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