

LLC Asset Protection Strategies

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Inside-Out Liability

As far as inside-out liability, members of an LLC have the same level of personal liability protection as the shareholders of a corporation. That is, creditors of the entity, whether corporation or LLC, cannot get thru to the owners, shareholders or members, unless the shareholders/members have personally guaranteed a corporation/LLC debt, have received an improper distribution or a court allows a piercing of the corporate/LLC veil because of alter-ego theories or other theories. Likewise, managers and officers of an LLC have a liability shield similar to that of officers and directors of a corporation. Corp C §204(a)(10) and 17158(a). This entity shield protects owners, officers, managers and directors from contractual liability and tortuous acts of agents and employees of the entity. However, managers and officers of these entities are not protected from their own intentional and tortuous actions.

Outside-In Liability

LLCs are a much better entity than corporations for purposes of protection against outside-in liability, or what we might call reverse alter-ego liability. In these situations, a creditor or third party claimant is suing a shareholder of a corporation or a member of an LLC, to obtain a judgment against the individual shareholder/member and then seeking to collect that judgment by attaching the shares in a corporation and the membership interests in the case of an LLC. The significant difference between corporations and LLCs is that a creditor of a shareholder can in fact levy upon the shareholder's shares in the corporation and acquire all of the shareholder's rights and interest in those shares, including all voting rights that attach to the shares. Whereas, in the case of a member of an LLC, because of the historical precedent of partnerships under common law, as carried over into the Uniform Acts such as the Revised Uniform Partnership Act ("RUPA") the Uniform Limited Partnership Act ("ULPA") or the Uniform Limited Liability Company

Act (“ULLCA”), creditors are limited to charging orders, a lien on the member’s transferable (economic) interest in an LLC. The historical rationale for this policy is that allowing a partner’s creditor to lien/levy on the assets of the partnership would be grossly unfair to the other partners. Under the Uniform acts, and as incorporated in the Act, the charging order (or foreclosure on a charging order), does not give the creditor voting or management rights associated with the membership interest, the charging order only gives the judgment creditor a claim upon the economic interest element of a membership interest in the LLC. Therefore, because the charging order creates a lien and not a levy on the membership interest, and because the creditor is not a transferee of the entire membership interest, but only has the rights of an assignee, the creditor can never become the owner of the voting and management rights attached to the membership interest. The California code sections to support this position are contained at CCP §708.310; Corp Code §§ 15673, 15672, 17302(a), 17301, 17001(z) and 17001(n). Since the members of the LLC may enter into an Operating Agreement that defines their respective rights and relationships, the members can agree to provisions in the operating agreement that establish that no interest in the LLC may be assigned without the unanimous written consent (or some other level of consent) of other members. This leaves the creditor of a member of an LLC with access to the economic interests attached to a membership interest but unable to control the non-economic interests attached to that membership interest, such as the right to vote and to control management of the LLC. For this and other reasons, an LLC is an effective asset protection device. Limiting the creditor of a member to a charging order on the membership interest prevents the creditor from ever reaching the LLC assets or obtaining the power to dictate distributions and/or dissolution of the LLC entity.

California Case Law and Charging Orders

The California Supreme Court has confirmed that the charging order has replaced levies of execution as the remedy for reaching partnership interests. See Baum v Baum, 51 Cal 2d 610 (1959); Crocker National Bank v. Perroton, 208 Cal App 3d 1 (1989); and Hellman v. Anderson, 233 Cal App 3d 840 (1991).

Single Member LLCs

Single member LLCs deserve special attention in analyzing the impact of California law on charging orders. The argument used by creditors of a single member LLC is that the charging order protection should not be extended to single member LLCs because there are no other “partners” to protect from the creditor. Even though the Uniform Acts and the LLC Statutory Acts such as that in California make no distinction between single member and multi-member LLCs, there is some concern that a court may decide that single member LLCs are not entitled to the same protection as multi-member LLCs. However, there is little case law on this issue and almost no case law to suggest that the charging order protection should not extend to single member LLCs. A California court has held that the charging order protection would apply in a case where all of the partners of a limited partnership were debtors of a single creditor. See Evans v. Galardi, 16 Cal 3d 300 (Cal 1976). In Evans, the creditor had argued that because there were “no innocent” non-debtor partners to protect, the charging order protection should not apply. The court rejected that argument. However, attorneys should be cautioning their clients that if they are seeking to maximize their charging order protection, they should be forming multi-member LLCs or adding new members to existing LLCs. The new members would need to have some interest in the LLC, how large is uncertain, but even a small interest would preserve the argument for limitation of creditors to charging orders.

Community Property States

In a community property state, such as California, if an LLC has spouses as the only two members and the spouses’ interest in the LLC is community property, such an entity would probably not be treated as a multi-member LLC. If either spouse were a debtor, then under community property laws the creditor would be able to charge the LLC interests of both spouses. In this fact situation, there would be no non-debtor member to protect with the charging order. A better strategy would be to clearly establish separate property membership interests of each spouse in the LLC and/or add member(s) to the LLC, even if the added member was family or a child.

Bankruptcy Situations

When a member of an LLC files for bankruptcy protections, the debtor's interests in the LLC is transferred to the debtor's bankruptcy estate. The question here is whether the LLC interests now owned by the bankruptcy estate includes the debtor's non-economic management interests in the entity as well as the debtor's economic rights under the LLC. Under the Uniform Acts and California statutes the bankruptcy trustee would be treated like another creditor whom would receive the right to receive the debtor's economic interests in the LLC but not the debtor's non-economic interests, i.e. control over the entity. However, bankruptcy laws, which will override state law, may provide for a different answer. Under §541(a) of the Bankruptcy Code, the bankruptcy estate will include all legal or equitable interests of the debtor in the property. And courts are generally in agreement that §541(a) would apply to both economic rights and non-economic rights of partners or members. See re Garrison-Ashburn L.P.C., 253 B.R. 700, 708 (Bankr.E.D. Va. 2000). Note that §365(c) of the Bankruptcy Code provides that if an executory contract contains transfer restrictions that are valid under state law, the transferee cannot assume or assign such a contract. Therefore, if a partnership or LLC operating agreement constitutes an executory contract, then the restrictions on transferability of the interests in such agreements would preclude the transferee (trustee in bankruptcy) from obtaining rights other than economic rights.

Executory Rights in Bankruptcy

In determining whether an operating agreement is an executory contract, the bankruptcy court will look to the operating agreement to determine whether or not the operating agreement creates additional duties for members to each other or to the LLC. If the operating agreement provides for no unfulfilled obligation to provide additional capital or to participate in management or to provide any personal expertise or service the company, the operating agreement may not be an executory contract because it does not require any additional duties for members to each other or to the LLC that have not already been completed. If bankruptcy is contemplated, the operating agreement should

be drafted to impose various obligations on the members to the entity and to each other. For LLCs used in family settings or when used primarily for liability protection purposes, it may be possible to prevent assignment of membership interests or to limit it in such manner as to make the charging order remedy of little value to the creditor. For example, if the operating agreement provides that all distributions must be made to the members on a pro rata basis, then distributions have to be made to all members or to none. This would prevent the LLC management from making distributions to some members but withholding distributions to members whose interests are held by creditors. One possible solution would be to allow the manager of the LLC to make distributions to members but not to debtor assignees.

Buy-Outs

The LLC operating agreement could also provide that upon levy of a member's interest in the LLC, that member's interest would be subject to a buy-out provision for substantially less than fair market value. If the entity is established well in advance of any creditor claims and before any members know of any situation which might result in creditor use of a charging order, it would seem that such provision would be enforceable, although there are no cases on this point. And since the poison pill would kick in automatically it would not seem to be a fraudulent transfer.