The Ultimate Guide to LLCs as Asset Protection Tools

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The Ultimate Guide to LLCs as Asset Protection Tools

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Initial Considerations for Using LLCs to Protect Assets

- Generally, the goal of any asset protection strategy is to:
  - Control assets without owning them in your own name, and
  - Make the assets unattractive to a litigator who may be evaluating you or your business as a litigation target.

LLCs and Creditors:
What can they access?

- The remedies available to personal creditors of an LLC owner/member include the following, depending on the state law:
  - Obtaining a charging order, or a right to receive the member's right to distributions;
  - Foreclosing on the member/debtor's LLC ownership interest; or
  - Obtaining a court to order the LLC to be dissolved.

What can they access: Charging Orders

- All states permit personal creditor of an LLC owner to obtain a charging order against the debtor-owner's membership interest.
  - In about ½ the states, the charging order is the exclusive remedy.
- A charging order is an order issued by a court directing an LLC to pay to the member's personal creditor any distributions that would otherwise be distributed to the member.
- In most states, a charging order only transfers "financial rights" and not "governance" or management rights.
- Often, creditors who obtain charging orders end up with nothing because they cannot force the LLC to make any distributions.
- The charging order remedy without any right to order distributions is so weak many creditors don't even try to use it.

What can they access: Foreclosure

- In about half the states, a creditor who obtains a charging order but is not paid by the LLC can have the court order that the debtor-owner's LLC membership interest be foreclosed upon.
- If this occurs, the creditor becomes the permanent owner of all the debtor-member's financial rights, including the right to receive money from the LLC, but not governance rights.
- In Illinois, a creditor who obtains a charging order can have the court order that the debtor-owner's LLC membership interest be foreclosed upon.
- Delaware's LLC law on the other hand says that the charging order is the exclusive legal procedure that personal creditors of Delaware LLC members cannot foreclose.

What can they access: Dissolution

- A few states permit personal creditors of LLC owners to obtain a court order that the LLC be dissolved or the state's LLC statute is silent as to what remedies other than a charging order might be available to creditors.
- If that occurred, the LLC would have to cease doing business and sell all of its assets.
- Like most states, Illinois and Delaware do not permit personal creditors of an LLC member to have a court order that the LLC be dissolved.

Single Member LLCs: Evaluating the risks

- Courts in some states have found that the charging order protection doesn't apply to SMLLCs and have allowed creditors to pursue other remedies, including foreclosing on the member's interest or ordering the LLC dissolved.
  - The logic for limiting personal creditors of individual LLC owners to a charging order is to protect the other members of the LLC.
- In many states, this is an uncertain or Other states, like unresolved issue.
- Nevada and Wyoming law make clear that the charging order protection for debtors applies with all single or multi-member LLCs.
- In Florida, after obtaining a charging order against a SMLLC, the creditor can obtain an order that the LLC be sold in foreclosure.

Single Member LLCs: The solution

- Because of the SMLLC rules in Florida and the uncertainty related to this issue in other states, in order to obtain asset protection for personal debts of the members, an LLC should have at least two members.
- If you have only two members, the second owner must be a legitimate co-owner of the LLC.
  - Co-owner must pay fair market value for the interest acquired and receive financial statements,
  - Participate in decision making, and
  - Received a share of the LLC profits equal to the membership percentage.

Series LLCs

- The reason for using separate limited liability companies ("LLCs") is to compartmentalize risk by segregating assets. Creating a number of different entities does cause additional administrative work. To counteract that additional administrative burden, some asset protection friendly states like Delaware have enacted Series LLC statutes.
- A parent LLC can establish a series of additional sub LLCs within the corporate structure. Each series is compartmentalized, meaning that the assets and liabilities are contained within the sub-LLC. There is only one operating agreement that governs the entire structure and only one annual tax filing. In some states, if different members participate in sub LLCs a separate tax filing is required.
- The series LLC structure is permitted in:
  - Delaware
  - Illinois
  - Iowa
  - Nevada
  - Oklahoma
  - Tennessee
  - Texas
  - Utah

Series LLCs: Delaware

- In 1996, Delaware was the first to authorize series LLCs.
- Each series enjoys limited liability and shields its own assets from those of each other series and the Parent.
  - A series may have a different business purpose from the other series and the Parent LLC.
  - It may have separate members, managers, or voting rights.
- Each series may dictate a separate structure with respect to profits and losses.
- To retain limited liability in Delaware, a series LLC must keep separate records for each series and account for assets separately from each series.
  - However, the assets associates with a series "may be held directly or indirectly, including in the name of such series, in the name of the limited liability company, through a nominee or otherwise.'"

Series LLCs: Illinois

- Illinois law is similar to Delaware law, with several modifications that attempt to improve upon the model.
- A series LLC may be treated as a separate entity able, in its own name, to contract, hold title to assets, grant security interests, and sue and be sued.
- Each series "shall be treated as a separate entity to the extent set forth in the articles of organization.'"
  - Accordingly, the LLC may define the relationship, freeing or binding the series, through the operating agreement or articles of organization.
- Unlike Delaware, Illinois requires that this be provided for in the series' operating agreement.
- These increased formalities support the separate record-keeping requirements and should make the piercing risk easier to evaluate.

Series LLCs: Lingering uncertainty

- Even in Illinois or Delaware, there remains a high degree of uncertainty as to how a court will apply the theoretical separateness between series.
- This uncertainty is most important in the context of a piercing argument.
  - While contracting parties previously had the opportunity to investigate assets, the limited notice requirement in most series LLC jurisdictions may place a contractual claim on the same level as a tort claim.
  - Thus, a plaintiff creditor will seek to not only pierce through to the owner's assets, but also collapse the series to reach the assets of the Parent LLC and other series.
  - Further, it is unclear whether a court will apply the piercing standard from the corporate law analysis, a different analysis, or no analysis.

LLCs vs. Corporations - Overview

- Corporate structure often falls into two categories: a LLC, or a corporation.
- Tax defaults:
  - corporations are taxed as a C corporation (entity level tax)
  - LLCs are taxed as partnerships (disregarded entity)
- Tax election: Corporations and LLCs may elect to be taxed as a S corporation.
- Corporate liability shield: Both corporations and LLCs provide owners corporate liability shield protection from personal liability for the actions/contracts of the business.

LLCs vs. Corporations – Asset Protection

- A personal creditor to an owner of a LLC is limited in most states to a charging order against the membership interest.
- A creditor of a shareholder in a corporation may foreclose upon and take the stock.

LLCs vs. Corporations - Takeaway

- LLCs are preferable from a corporate governance standpoint because:
  - Flexibility in governance structure, fewer corporate formality requirements, default to a pass through.
  - Charging order protection.
- S-Corps are preferable from a tax standpoint because:
  - Pass through tax
  - Savings on self-employment taxes
  - Owners can offset non-business income with losses from the business
- Best of both worlds = LLC taxed as a S-Corp

LLCs vs. FLPs – General Strategy

- A Family Limited Partnership (FLP) is a type of limited partnership that is formed by an official filing with the Secretary of State where it is to be created.
- The FLP is a separate legal entity from its owners, taxed as a partnership.
- Usually family savings/assets are transferred into the FLP, which are organized for the principal objective of transferring wealth from one generation to the next in a tax efficient way while allowing mom and dad to maintain control.
  - GP interest is LLC owned by mom and dad
  - LP interest gifted to children annually (discounted value of gift on initial gift, and incremental gift to stay under annual exclusion)

LLCs vs. FLPs – Asset Protection

- The assets transferred to and owned by the FLP are owned by entity and not the transferor partners.
- Under the Uniform Limited Partnership Act, a *creditor of a partner cannot reach into the partnership and take specific partnership assets.*
- The creditor has no rights to any property which is held by the partnership.
- Since title to the assets is in the name of the partnership the partnership assets may not be taken to satisfy a debt of the partner.
- Creditor of limited partner is limited to a charging order in most states.

LLCs vs. FLPs – Drawbacks of FLPs

- FLPs need at least two members
  - Most LLC's can have 1 member.
- All LLP's are expected to file a K-1065 return; each partner is expected to file a K-1 return.
  - Single member LLC's do not have this requirement.
- Most states require all partners to identify themselves on Secretary of State LLP filings
  - Members can be anonymous on DE LLC filings
- The general partner does not have liability protection.
  - Requires organization of a LLC

Creating LLC Operating Agreements that Strengthen Asset Protections

with Example Provisions

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Introduction

- Asset protection, express or by implication, can be provided for in a skillfully created LLC operating agreement
- In most situations, the specific facts and objectives of the instant LLC member's will determine the importance of asset protection and, of course, there is no "one-size fits all" LLC operating agreement
- The need for asset protection can arise instantly as a result of an accident, divorce, death, decline in business, failure to meet lender covenants, loss, audit, lawsuit, or a myriad of other unfortunate circumstances.

Inside Liability and Outside Liability

- Inside liability shields non-LLC assets from liability exposure for the acts and omissions of the LLC which are not the fault of the LLC's members, individually
- Outside liability protects the LLC assets from liability exposure that is a result of the acts or omissions of the LLC's members but is not related to the acts or omissions of the LLC itself
- The overwhelming focus of this outline will be to focus on protecting the LLC from the outside liability of its members
- As such, the assets inside the LLC may become protected from the outside actions of its members

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- State LLC statutes usually follow the LLC's operating agreement to determine the amount, timing, and identity of distributions and distributees
- We generally break LLC distributions down into four categories: (i) distributions of distributable cash, (ii) tax distributions, (iii) distributions of capital proceeds (i.e. proceeds from refinancing or the sale of capital assets), and (iv) liquidating distributions. This outline will focus on provisions relating to distributions of distributable cash and tax distributions
- The definition of "Distributable Cash" In respect to asset protection, less is more

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- While in many business deals, necessity requires a complex definition of Distributable Cash, we recommend consideration be given to the following definitions:
  - "Distributable Cash" shall mean the amount of cash which the Manager deems available for distribution to the Members, taking into account all debts, liabilities, and obligations of the Company then due, and working capital and other amounts which the Manager deems necessary for the Company's business or to place into reserves for customary and usual claims with respect to such business.

    or
  - "Distributable Cash" shall mean that portion of the Company's cash which the Manager, in the Manager's sole discretion, deems available for distribution to the Members.

  The above definitions expressly empower the Manager to make the determination of amounts available for distribution. Of course, the Members, the Board, or other combinations could be substituted in this role, as the consensus reaching aspect of the limited liability company operating agreement requires.

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Timing of the Distributions
  - Often times, Members require at least annual distributions, if not quarterly or more frequently.
  - At a minimum, many times Members require distributions at least in an amount to satisfy their tax obligations attributable to their ownership of the LLC
  - Stronger negotiating position with the creditor if the Member was not anticipating a distribution
  - If the LLC operating agreement required periodic distributions to members, then a member's creditors may intercept the applicable member's share of the distribution and the Manager would have no opportunity to prevent this unfortunate result
  - We recommend that the Manager be solely responsible for determining when any distributions shall be made from the LLC

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Alter the Default Rule of Proportionate Allocation
  - The LLC operating agreement should permit the Manager to make special allocations and disproportionate distributions to the members
  - With an LLC it is possible, for instance, to permit a member that holds a 60% of percentage interest in the LLC to be allocated 100% of the LLC's profits or losses over a period of time

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Consideration should be given to a distribution provision similar to the following:
  - From time to time, the manager may in the manager's discretion distribute Distributable Cash to the Members on a pro rata or non-pro rata basis, as the Manager deems advisable. If the Manager elects a non-pro rata distribution, such distributions shall be taken into account in re-determining the Capital Account of each Member at the end of the Company's fiscal year
  - Notwithstanding anything to the contrary herein, the Manager is not obligated to make any mandatory distributions to the Members, even though each Member will be taxed on its ratable share of Company income (whether or not such income is distributed)
  - No Right to Demand Return of Capital. No Member has any right to any return of capital or other distribution except as expressly provided in this Agreement

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- A Non-Pro-rata Distribution to the Members
  - If the Manager makes a non-pro-rata distribution to the Members, such distributions will not be respected for tax purposes if they lack "substantial economic effect." IRC §704(b)(2); Treas. Reg. §1.704-1(b)(1)(I)
  - Substantial economic effect requires that two tests be satisfied: (1) the allocation must have economic effect, and (2) the economic effect must be substantial. Treas. Reg. § 1.704-1(b)(2)(I)
  - The first test is satisfied if there is an "economic burden that corresponds to an allocation, the partner to whom an allocation is made must . . . bear such economic burden." Treas. Reg. § 1.704-1(b)(2)(ii)(a)

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Substantiality Requirement
  - The second test is commonly referred to as the "substantiality requirement." This test is satisfied if "the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." Treas. Reg. § 1.704-1(b)(2)(iii)(a)
  - In short, the allocation must have economic effect and the allocation must be substantial

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Safe Harbor Set of Requirements
  - The Treasury Regulations provide a safe harbor set of requirements which if followed permit non-pro-rata distributions. The Safe Harbor provisions are as follows:
    1. The LLC Operating Agreement must satisfy basic requirements for economic effect. IRC§ 704(b) and Treas. Reg. §1.704-2(e)(1)
    2. In year that nonrecourse deductions first arise, allocations must be reasonably consistent with valid allocations of other LLC items. Treas. Reg. § 1.704-2(e)(2)
    3. The LLC Operating Agreement must contain "minimum charge back" provisions. Treas. Reg. §§ 1.704-2(f)(c) and 1.704-2(e)(3)
    4. All other material allocations and capital account adjustments must be valid. IRC §§ 704(b)&(c); Treas. Reg.§ 1.704-2(e)(4))
  - The LLC operating agreement shall further provide that:
    i. The LLC will maintain capital accounts for its members in strict compliance with tax rules;
    ii. The LLC will make liquidating distributions in accordance with capital accounts;
    iii. Members in liquidation who have deficits in their capital accounts will restore those deficits to the LLC; and
    iv. The LLC will make minimum charge backs with respect to their interest in LLC nonrecourse debt.

A. Distribution Clauses to Delete or Include Mandatory, Unequal, Etc.

- Alternate Test
  - Distributions upon liquidation shall be to the Members, ratably in proportion to the credit balances in their respective Capital Accounts, in an amount equal to the aggregate credit balances in the Capital Accounts

  And
  - To the extent a Member shall have a negative capital account balance, there shall be a qualified income offset, as set forth in Treasury Regulation 1.704-l(b)(2)(ii)(d)

B. Poison Pill Provisions

- A provision which would permit its Manager to redeem any LLC Units lost or threatened to be lost to a creditor, and at a substantially reduced price
- A “poison pill” provision designed to intercept and frustrate the creditor of a member from attaching the troubled member’s interest in the LLC
- This is especially important in states where judicial foreclosure may be an alternative remedy to a charging order

B. Poison Pill Provisions

- Charging Order
  - In many states, a charging order is the exclusive remedy to a creditor of a member of an LLC with respect to the LLC
  - The charging order provides such creditor the right to distributions that would otherwise have been paid to that member. However, the judgment creditor does not get the right to manage the LLC or vote the LLC Units of the applicable member
  - Further, the creditor will have no right to compel distributions from the LLC
  - The creditor is only entitled to receive distributions from the LLC when the Manager declares and makes distributions to the applicable member
  - If the manager holds the distributable cash or other assets of the Company in reserve, there is no distribution for the creditor to attach

B. Poison Pill Provisions

- Charging Order
  - In some states, a judge can order the charging order to be foreclosed, forcing the charged membership interest to be sold to the judgment creditor
  - Foreclosing on a charging order makes the judgment creditor the permanent owner of the economic right
  - The creditor may then liquidate its right by selling it in the market place
  - Alternatively, many jurisdictions, including Delaware, Minnesota and Nevada, provide in their LLC Acts that charging orders are the exclusive remedy of a judgment creditor of a member, thus preventing foreclosure of charging orders

B. Poison Pill Provisions

- Charging Order
  - We recommend the LLC operating agreement include poison pill provisions
  - For instance, the operating agreement could provide that when LLC Units are "charged" by a "charging order" the LLC has the right, but not the obligation, to redeem them for $________ or a percentage of their last determined value

B. Poison Pill Provisions

- Troubled Member Receives Only Nominal Benefit
  - The poison pill may protect the LLC and its other members, the troubled member receives only nominal benefit to its application
  - The other members percentage interest in the LLC is augmented for a nominal amount
  - The LLC is free of the creditor
  - The troubled member remains liable to the creditor for the outstanding amount due on its judgment and is out of the LLC
  - Side agreements or “understandings” may give creditors the gumption to challenge the validity of the poison pill

B. Poison Pill Provisions – Sample Clause

- A sample poison pill clause reads as follows:

  Involuntary Transfer of a Membership Interest. A creditor’s charging order or lien on a Member’s Membership Interest, bankruptcy of a Member, or other involuntary transfer of Member’s Membership Interest, shall constitute a material breach of this Agreement by such Member. The creditor, transferee or other claimant, shall only have the rights of an Assignee, and shall have no right to become a Member, or to participate in the management of the business and affairs of the Company as a Member or Manager under any circumstances, and shall be entitled only to receive the share of profits and losses, and the return of capital, to which the Member would otherwise have been entitled. The Manager, including a Manager whose interest is the subject of the charging order, lien, bankruptcy, or involuntary transfer, may elect, by written notice to the Members and the creditor, transferee or other claimant, at any time, to purchase all or any part of Membership Interest that was the subject of the creditor’s charging order, lien, bankruptcy, or other involuntary transfer, at a price of $_________________. The Members agree that such valuation is a good-faith attempt at fixing the value of the interest, after taking into account that the Membership Interest does not include all of the rights of a Member or Manager, and after deducting damages connected therewith and that are due to the material breach of this Agreement.

C. Membership Transfer Restrictions

- The LLC operating agreement restrict a member's ability to freely transfer or assign its interest in the LLC
- Such restrictions are not only important for the smooth ordinary course of daily business but also for the company's long term success and continuity

C. Membership Transfer Restrictions

- Restrict Assignment of Governance Rights
  - A membership interest may be assigned, but such assignment should not include governance rights. To transfer both the financial and governance rights of a membership interest, a member will be required to comply with restrictions on transfer and the LLC operating agreement should further require the managers' consent to the transfer

C. Membership Transfer Restrictions

- Require Consent to Transfers
  - Before a transfer of a membership interest is acknowledged, the LLC operating agreement should set forth whose consent is required; i.e. all of the Members, a percentage of Members, and/or the Manager's consent

C. Membership Transfer Restrictions

- Provide for a Right of First Refusal
  - The LLC and/or other members should have the right for a specific amount of time to match any third party offer to acquire a transferring member's membership interest

C. Membership Transfer Restrictions

- Carve Outs / Permitted Transfers
  - Members can agree to carve out and permit certain transactions from the transfer restrictions contained in the LLC operating agreement. Often times these carve outs are to trusts, family members, other member of the LLC, and controlled entities or affiliates of a member

C. Membership Transfer Restrictions

- Optional Purchase Rights
  - Certain events (such as death, disability, divorce, bankruptcy, termination of employment) may create an opportunity, but not the requirement for the LLC or the other members to purchase such a member's membership interest in the LLC (or a right to the member to be bought out by the company or other members). If the operating agreement has buyout provisions, it is important to describe the procedure of how such buyout will take place, the buyout price and the payout terms (can be over time or perhaps from the proceeds of a key man life insurance)

C. Membership Transfer Restrictions

- Purchase Price Determination
  - The purchase price (and the timing of the payment thereof) of the membership interests should be provided for in the LLC operating agreement. Sometimes that is by annual valuation of the LLC, agreement of the members, book value, or by appraisal

C. Membership Transfer Restrictions

- Bring Along and Tag Along Rights
  - Bring along rights permit the majority member(s) in selling all membership interests to achieve the highest sale price of the LLC and tag along rights permit minority members from being left out of a sale of the LLC. In each case, each member generally receives the same purchase price per LLC Unit

D. Competing Activities

- In the event a Member's interest is charged or a similar threat occurs against a Member, consideration should be given to permitting any and each Member the right to freely pursue activities outside of the LLC without the risk of being considered disloyal or otherwise in breach of a fiduciary duty to the LLC. This may be particularly important if the charged LLC needs to "park" its activities for a while

D. Competing Activities – Sample Clause

A sample clause would be:

Competing Activities. The Managers, Officers, and the Members and their officers, directors, shareholders, partners, members, managers, agents, employees and Affiliates may engage or invest in, independently or with others, any business activity of any type or description, including without limitation those that might be the same as or similar to the Company's business and that might be in direct or indirect competition with the Company. Neither the Company nor any Member shall have any right in or to such other ventures or activities or to the income or proceeds derived therefrom. The Managers, Officers, or Members shall not be obligated to present any investment opportunity or prospective economic advantage to the Company, even if the opportunity is of the character that, if presented to the Company, could be taken by the Company. The Managers, Officers, and Members shall have the right to hold any investment opportunity or prospective economic advantage for their own account or to recommend such opportunity to Persons other than the Company. Each Member acknowledges that the Managers, Officers, and other Members and their Affiliates own and/or manage other businesses, including businesses that may compete with the Company and for their time. Each Member hereby waives any and all rights and claims which they may otherwise have against the Managers, Officers, and other Members and their officers, directors, shareholders, partners, members, managers, agents, employees, and Affiliates as a result of any of such activities.

E. Mandatory Capital Contribution

- Another important feature of an LLC operating agreement tailored to liability protection is an affirmative prohibition against a creditor from calling for a mandatory capital contribution, presumably to solve for its judgment. Likewise, a mandatory capital contribution called for by the Manager of the LLC may force a creditor to contribute funds into the LLC which has no plans to make a distribution. If the creditor fails to make the contribution, its percentage interest will be reduced. We recommend consideration be given to providing only the Manager of the LLC may call for additional capital contributions

E. Mandatory Capital Contribution

- Capital Call

  The Managers may, from time to time, require additional Capital Contributions of the Member or of an Assignee of a Member (a "Capital Call"), and the Member or the Assignee of a Member, as applicable, shall be required to make any such additional Capital Contributions. Upon a Capital Call, the Chief Manager shall notify the Members (or the Assignee of a Member) of the amount of funds required, the use and purpose of such funds, and the Member's or the Assignee's of a Member, required contribution amount. The Members or the Assignee of a Member shall be obligated to contribute such capital and shall fund the amount called for within 15 business days after the Capital Call notice is given. In the event a Member or the Assignee of a Member declines to make an additional capital contribution in response to a Capital Call as described in this Section ___, then the other Members (or the Assignee of a Member) may make additional capital contributions up to the amount the non-contributing Member or the Assignee of a non-contributing Member elected not to contribute, on a pro-rata basis in accordance with the Percentage Interest of each Member (or the Assignee of a Member) electing to make such additional capital contribution. Immediately following such Capital Contributions, the Percentage Interests shall be adjusted by the Manager to reflect the new relative proportions of the Capital Accounts of the Members (or the Assignee of a Member) and thereafter each Member's (or the Assignee's of a Member) Percentage Interest shall be a fraction, the numerator of which represents the aggregate amount of such Member's (or the Assignee's of a Member) Capital Contributions and the denominator of which represents the sum of all Members' (or the Assignee's of a Member) Capital Contribution.

E. Mandatory Capital Contribution

- Equity Protection Technique

  For instance, two investors form a LLC to operate a stable but capital intensive company. Each member delivers to the LLC a subscription agreement which creates a legal obligation of the members to contribute capital to the LLC, upon demand of the Manager, so the LLC may conduct its business. The first member would contribute seed capital to get the LLC up and running, in return for a small percentage interest in the LLC (i.e. 1%-5%). The other second member would subscribe to provide a significant capital contribution as demanded, in return for an initial large percentage interest in the company (95% to 99 %, for instance). Because the first member contributed his, her or its capital upon formation, but the second member was not required to do so, the LLC would place a lien on certain pieces of the second member's property to ensure that the second member fulfills his, her or its obligation to capitalize the LLC upon the Manager's demand. As long as the LLC is not considered an insider under any applicable fraudulent transfer law and the obligation is valid, its fulfillment demonstrable, and it makes sense in a business context, a lien against the second member's personal assets is duly created. As a result, this lien may actually discourage any future creditors of the second member from taking aggressive action as they would be behind the LLC in priority

E. Mandatory Capital Contribution

- Under this approach, the Manager of the LLC could make a good faith capital call, and enforce the second member's subscription method for several reasons including, as applicable:

  (i) Purchasing equipment, inventory, or parts.

  (ii) Purchasing the stock or assets of a business to compliment the LLC.

  (iii) Contribute loans or capital to the LLC's vendors or consumers.

  (iv) Fund employee retirement or profit-sharing plans.

  (v) Satisfying in full all commercial loans of the LLC.

  (vi) Establish reserves for business purposes or to satisfy bank covenants.

  (vii) Satisfy surety bond or similar third party requirements.

F. Removal of Manager

- The LLC operating agreement should provide a very high threshold for removal of the Manager of the LLC
- Determining specific criteria that could trigger the right to remove a Manager
- The Manger committing bad acts or being convicted of crimes
- the Manager intentionally violating the terms of the LLC operating agreement and unable or unwilling to cure any breach
- or the Manager's death, disability, bankruptcy or dissolution (if an entity)
- in the event a removal event occurred, the procedure for removing and appointing a successor manager should be set forth. Often times the bar is set very high (even to the point of requiring unanimous consent) but we recommend a super majority of voting interest it the LLC be sufficient to remove and replace a manager

F. Removal of Manager – Sample Provision

- Removal of Manager. A Manager, or any successor Manager may be removed as Manager by a Voting Interest of the Members only under the following circumstances (a "Removal Event"):
  - (i) The Manager: (1) knowingly, intentionally and deliberately misapplies any funds derived from the Company, including insurance proceeds and condemnation awards, (2) is charged and convicted by any governmental entity or authority with any felony or any other criminal act involving fraud, or (3) intentionally takes or causes to be taken action constituting a Major Decision under this Agreement without any required approval of the other Manager which is not reasonably cured or reversed within sixty (60) days after written notice to such Manager setting forth in detail the circumstances of the alleged action of the Manager constituting a Major Decision; or
  - (ii) The death, Disability, Bankruptcy, or Dissolution of the Manager.

Upon the occurrence of a Removal Event, a Voting Interest of the Members may immediately remove such Manager as a manager of the Company, and appoint a successor Manager of the Company.

G. Partition of Assets

- A LLC operating agreement should provide for the waiver of an action for partition
- It has the power to own property and other assets
- Property belongs to the LLC and not its individual members (or the creditor of a member)
- Holding ownership interests in an LLC is much easier and more efficient than holding fractional interests in real property
- The LLC operating agreement should facilitate the member's indirect ownership interests in real property without the fear of a partition action by a wayward member or the creditor of a member. Therefore we recommend including a provision similar to the following in the LLC operating agreement
- Waiver of Action for Partition. Each Member irrevocably waives during the term of the Company any right that he, she or it may have to maintain any action for partition with respect to the property of the Company

H. Rights of Members in Bankruptcy

- The restrictions on a creditor under the several LLC acts may also be applicable under a federal bankruptcy proceeding
- Federal bankruptcy judges have other options, techniques, and powers that other courts do not necessarily have within their arsenal
- The bankruptcy code does not contain specific provisions that apply to LLCs. This creates non-uniform application of facts and law amongst the bankruptcy court decisions

H. Rights of Members in Bankruptcy

- The LLC operating agreement may be considered an "executory contract" in bankruptcy when "the obligation of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." See *In re Robert L. Helms Constr. and Dev. Co., Inc*, 139 F.3d 702 (9th Cir. 1998). The Bankruptcy Code § 365(e)(2) provides that a trustee in bankruptcy may not assume or assign an "executory contract" if applicable law excuses a party, other than the debtor, to the contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not the contract prohibits or restricts assignment of rights or delegation of duty, and the other party does not consent to such assumption or assignment. Therefore, if an LLC operating agreement were determined to be an "executory contract," teh trustee in bankruptcy should then step in the shoes of any other creditor of the LLC debtor member and be subject to the same terms and conditions of the transfer prohibitions provided in the LLC operating agreement.

H. Rights of Members in Bankruptcy

- The trustee appointed by the bankruptcy court can, under the federal bankruptcy code, exercise powers over the debtor's interests in an executory contract. The trustee in bankruptcy may argue the bankruptcy code gives the trustee the right to step in the shoes of the debtor member before the filing of bankruptcy. Thus, in a state where the LLC statute provides a charging order as an exclusive remedy, then the trustee in bankruptcy should only have the same rights as a creditor with a charging order. This result could work to prevent the bankruptcy trustee from attempting to influence management rights, sale rights, or other privileges of a member in good standing.
- Unfortunately, because of a lack of direct provisions in the bankruptcy code to address LLCs, we cannot definitively opine whether a bankruptcy court would accept this interpretation.
- Accordingly, the drafting of expulsion provisions in an LLC warrants consideration. Such a provision could provide the other members the option to expel a member who files for bankruptcy. The impact of a successfully expulsion would terminate a member from the LLC, and in theory, forever release the remaining members and the LLC from the bankruptcy and the reach of the trustee of the bankruptcy estate.

H. Rights of Members in Bankruptcy

- The expulsion clause could be tailored so that the value of the expelled member's interest is substantially reduced, an attempt to further dissuade the trustee in bankruptcy from contesting the position that the LLC's operating agreement is an executory contract. Like a "poison pill", these provisions provide the debtor member little relief and as such the expulsion provision should be discussed with the LLC members during the creation of the LLC operating agreement.
- It must further be pointed out, bankruptcy courts are all over the map with respect to the expulsion rights of the LLC compared to the rights of the trustee in bankruptcy to step into the shoes of the debtor member. Having said that, the most security one may find with the validity of expulsion provisions in bankruptcy would be within a state that provides a charging order as an exclusive remedy to a creditor of a LLC member.

H. Rights of Members in Bankruptcy – Example Expulsion Provision

An example of an expulsion provision is below.

- OPTIONAL DISSOCIATION UPON MEMBER BANKRUPTCY

The other members shall have the option to dissociate a member if:

(a) The member files for bankruptcy or any similar relief; or

(b) One or more creditors of the member file a petition to have the member declared bankrupt or any similar petition and this petition is not dismissed within 60 days after being filed; and

(c) The non-bankrupt members reasonably determine that the dissociation is in the LLC's best interest.

LLC's As Tax Planning Vehicles

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A. Partnership Taxation vs. Corporate Taxation

For purposes of this Outline, we will presume for comparison purposes the LLC we describe is a two member LLC, subject to default tax classification as a partnership (that is it is neither a disregarded entity taxed as a sole proprietorship nor did its members elect to be taxed as a S or C corporation). Single-member LLCs that choose to be taxed as a sole proprietorship treat business income as personal income to the member. The member reports business income and expenses on Schedule C of his individual income tax return. Whatever is left over after paying taxes belongs to the member, and the member can distribute the profit out of the business in the member's sole discretion.

A. Partnership Taxation vs. Corporate Taxation

- Single Level of Taxation Compared to Double Taxation
  - LLC's are pass-through entities for tax purposes
  - That is, the LLC itself pays no income taxes on its earnings and profits
  - Instead, all of an LLC's profits and losses are passed down to its members and reportable on their respective individual tax returns
  - Corporations are actual legal entities separate and distinct for tax purposes from their shareholders
  - Corporations are required to file state and federal tax returns and C corporations must pay income taxes on their profits. This is the trigger to double taxation
  - The C corporation first pays income tax at its tax rates on its income
  - When the C corporation distributes such profits to its shareholders, the shareholders must report the distributions (dividends) on their individual tax returns

A. Partnership Taxation vs. Corporate Taxation

- Timing and Character of Distributions
  - A member of an LLC or a S corporation is taxed on his, her or its share of income whether or not the profits are distributed. Shareholders of a C corporation are not taxed on their dividends until they are distributed.
  - Unlike an LLC, S – corporations may only have certain persons or certain wholly owned entities as shareholders; all distributions must be pro-rata, and S corporations may only have one class of stock (though differences in voting are permitted if the shares are otherwise identical in every material way).
  - A substantial advantage an LLC has over a C corporation is the fact LLC members who actively participate in the business may deduct the LLC's operating losses on their personal tax return to offset other personal income. C corporation shareholders are not able to deduct the corporation's losses. S corporation shareholders may, however, subject to the same participation requirements as LLC members and different basis rules and regulations, offset S corporations loss against personal income..
  - The LLC has other tax advantages over S corporations. For instance, (i) an LLC can make non-pro-rata distributions and special allocations of profits and losses amongst its members; (ii) its members receive basis in LLC borrowings, (iii) all contributions of property to an LLC are tax free, even for non-controlling members; and (iv) distributions of property out of an LLC are generally not taxed until sold (cash and "hot assets" excepted).

A. Partnership Taxation vs. Corporate Taxation

- Payroll Taxes
  - LLC members are not considered employees of the LLC, and thus, their share of the profit is not subject to social security or Medicare tax. However, LLC members who actively work in the business are required to pay self-employment taxes on their income (including salary and their share of any LLC profits). The rules are different for corporations. For corporations, only the shareholder's salaries are subject to social security and Medicare taxes. Any profit distribution to the shareholders isn't subject to these taxes.
  - With thoughtful planning, shareholders of corporations can allocate the corporation's profits in such a manner to take advantage of lower income tax brackets or to avoid imposition of certain employment taxes.
  - For instance, if a corporation generated $85,000 in profits for the year, the shareholders could pay out a percentage in salary (and thus subject to employment taxes) and take the balance out as a dividend or distribution (subject to income taxes but, if respected, outside of employment taxes). The IRS scrutinizes shareholder owner salaries.

A. Partnership Taxation vs. Corporate Taxation

- Employee Benefits
  - In terms of employer provided perks and fringe benefits, there are some key differences between an LLC and a corporation.
  - Certain retirement plans, stock option and employee stock purchase plans are only available for C corporations. In addition, LLC members (as well as S corporation shareholders who own more than 2 percent of the business) are required to pay taxes on certain employee benefits like health benefits, employer contributions to HSAs or FSAs, life insurance benefits, and parking. Shareholders of a C corporation do not have to pay taxes on these fringe benefits.

B. Taxation of Single Member LLC's

- Single member LLCs generally receive unfortunate treatment with respect to the impact of charging orders. Creditors often times successfully advance the position that charging order protection should not be extended to single member LLCs because there are no other members to protect from the creditor.
- Even though the several LLC Acts make no distinction between single member and multi-member LLCs, courts generally do not extend the same protection as multi-member LLCs. While there is not a lot of case law on this issue and almost no case law to proclaim that charging order protection should not extend to single member LLCs, it is considered good practice to encourage clients who wish to take advantage of charging order protection to form multi-member LLCs or add new members to existing single member LLCs. The new members would need to have some percentage interest in the LLC, how large is uncertain, but even a small interest would support the argument for limitation (or in many states the exclusive remedy) of creditors to charging orders.
- The addition of more than one member to an LLC will increase administrative expenses and cause partnership (or corporate, if elected) taxation and filing requirements.

C. Spousal Partnership Taxation

- An unincorporated business jointly owned by a married couple is generally classified as a partnership for Federal tax purposes. For tax years beginning after December 31, 2006, the Small Business and Work Opportunity Tax Act of 2007 (Public Law 110-28) provides that a "qualified joint venture," whose only members are a husband and a wife filing a joint return, can elect not to be treated as a partnership for Federal tax purposes. However, we do not recommend this election as only businesses that are owned and operated by spouses as co-owners (and not in the name of a state law entity, such as a LLC) qualify for the election. Thus, the married couple would have to conduct business as a sole proprietorship without a liability shield.
- In a community property state, such as Arizona, if the only members of an LLC are a married couple, the spouses' interest in the LLC would generally be considered community property, and 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 likely be able to charge the LLC
- interests of both spouses. In this scenario, the creditor would argue there is no non-debtor member to protect with the charging order. In such an instance, the couple would be advised to 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 a family member.
- See Rev. Proc. 2002-69, 2002-2 C.B. 831, for special rules applicable to spouses in state law entities in community property states.

D. Ensuring Tax Structures Protect Against Charging Orders

- To best position the LLC for charging order protection, the LLC should have multiple members and follow the default rule of partnership taxation. If the LLC has only one member, the debtor member's creditors will likely avoid the exclusive remedy of a charging order since there would be no innocent LLC members to protect.
- Many states LLC laws follow the Revised Uniform Limited Liability Company Act (RULLCA) and passed rules preventing foreclosure of an owner's interest and forced liquidation of the LLC to satisfy a personal liability of a debtor member. The unfavorable outcome that can occur in a corporation--forced dissolution--cannot occur in the LLC because a creditor with a charging order does not become a member of the LLC and, accordingly, the creditor has no rights to insert itself as a member of the LLC or otherwise order a distribution or liquidation.

D. Ensuring Tax Structures Protect Against Charging Orders

- However, not all states follow the RULLCA view with respect to LLC interests. Some are likely to follow the general partnership rules and take the "liquidation view," under which the creditor can, in fact, foreclose on the partnership interest. In short, the creditor can force a liquidation of the partnership, so that the partner's personal debt can be paid from his or her share of the liquidated assets. Note that the Uniform Limited Liability Company Act, which has been adopted in some states, reflects the general partnership view or allowsforeclosure upon a showing that distributions under a charging order would not pay the judgment debt within a reasonable time.
- The following states have LLC statutes that prohibit foreclosure and liquidation: Arizona, Arkansas, Connecticut, Delaware, , Idaho, Illinois, Louisiana, Maryland, Minnesota, Nevada, New Jersey, Oklahoma, Rhode Island, and Virginia.
- For asset protection purposes, owners of LLC should consider organizing their LLC in one of the states just mentioned, even if that is not the state where the LLC will be conducting its business. In these states, the protection afforded to the LLC, against the claims of any personal creditors, is codified or otherwise well recognized. Note that, under the LLC statutes in the states listed above, courts are not given the power to make any orders, except the exclusive remedy of a charging order. Before organizing in any state, the applicable statute should be examined to make certain no changes occurred.

D. Ensuring Tax Structures Protect Against Charging Orders

- Because a person can obtain liability protection from one's personal creditors for assets owned by a multi-member LLC, some business owners will be tempted to convert substantial assets into business assets and contribute them to the LLC. Placing assets within a LLC can provide significant protection from the claims of the member's personal creditors where a charging order is the creditor's exclusive remedy.
- However, the benefits of this approach may be short lived if the LLC suffers a business loss. Businesses are much more likely to face a substantial business liability or judgment than a member is to be burdened with personally. The LLC's property, as opposed to the member's personal assets outside of the LLC, are typically at the greatest risk of loss, which means this strategy could actually increases the risk of loss. A preferred strategy would be to own two LLC's or businesses with a multi-member LLC, taxed as a partnership, acting as a holding company or equipment leasing company. Under this approach, both the business assets and the member's individual assets may be protected assets against the claims of creditors because of the charging order being the creditor's exclusive remedy. Of course, care should be taken and the advice of practicing attorneys should be solicited before any of these techniques are considered or even implemented.

Trouble Shooting Other LLC's Asset Protection Pitfalls

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Not Operating the LLC as an Independent Entity: The dangers of veil piercing

- For a plaintiff to successfully pierce the LLC veil, he or she will usually have to prove:
  - the LLC ignored corporate formalities and
  - otherwise ignored the separateness between the LLC and its members.
- Most states apply one of two tests:
  - Instrumentality Test – DE
  - Alter Ego Theory - NY

Veil Piercing: instrumentality theory

- Prevailing under this theory requires a showing of control over the company in a way that caused harm, either through wrongful acts or fraud.
- Factors that may lead a court to pierce the veil include:
  - failure to follow corporate formalities,
  - overlapping ownership and management,
  - common office space,
  - lack of arm's length dealing,
  - preferences exercised in favor of family owned entities,
  - unity of interest, or lack of independence,
  - injustice/inequity, and
  - insolvency or a lack of sufficient funds for the company to operate, coupled with evidence of intent, at the time of funding, to avoid payment of future debts of the company.

Veil Piercing: alter ego theory

- To establish alter ego liability, New York courts have required evidence of 1) a single economic unit, and 2) injustice.
- Courts have held that a 30% ownership interest is insufficient to make a controlling decision.
- New York case law also integrates the alter ego theory, and may allow for veil piercing "[w]hen a corporation [or limited liability company] has been so dominated by . . . another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego."

Not Maintaining Appropriate Insurance Levels: Advising the clients on what's best

Most businesses need to purchase at least the following three types of insurance:

- Property Insurance
- Liability Insurance
- Business Vehicle Insurance
- Workers Compensation Insurance

The appropriate type and level of coverage depends upon the specific needs and exposures of the business.

Not Maintaining Appropriate Insurance Levels: Advising the clients on what's best

In addition to the basic coverages highlighted above, there are various other policies needed by some businesses. They include:

- umbrella policies
- specialized liability policies
- terrorism insurance

Insurance: Specialized Liability Insurance

Specialized Liability Insurance Policies:

- Errors and Omissions Insurance (E&O)/Professional Liability Insurance
- Employment Practices Liability Insurance (EPLI)
- Directors and Officers Liability Insurance (D&O)
- Business Identity Theft Insurance

Not Putting LLCs Profits in Protected Places: Methods to secure them from creditors

- Placing assets within a LLC exposes these assets to a high risk of loss to the business's creditors.
  - Generally, a business is more likely to be sued than its owners.
- Distribute profits to a member who loans them back to the company.
- Distribute profits to the member, who in turn invests those distributions in exempt investments such as a homestead, a protected retirement account, or even investment grade life insurance.

Not Protecting Key Assets from LLC Creditors: Techniques to keep them safe

- Many business owners mistakenly believe that assets within a LLC are shielded from liability. This is certainly not the case with respect to business debts.
- Generally, two strategies are employed by operating companies to protect the assets that they use to run their business: (1) compartmentalization of assets and exposures, and (2) encumbering assets owned by the at risk entity.

Compartmentalization of Risk

- In most business structures, the entity that runs and manages business operations has the most exposure.
  - This exposure includes potential claims by creditors, vendors, employees, and customers.
- Some business own one or a few assets that represent the majority of the book value of the business.
  - Technology based businesses have a valuable patent or trade secret.
  - Real estate based businesses may own commercial or residential real estate.
  - Manufacturer may own equipment with a significant value.
- It is important to protect these valuable assets from the exposures to the operating company.
  - This is done by compartmentalizing ownership of these assets or holding these assets in entities that are separate from the operating entity.
- The two entities may be commonly owned, but they are only linked by an agreement allowing the operating company to use the assets.
  - This agreement may take the form of a license or a lease with fair payment terms and avoid piercing.

Encumber Assets

- Multi entity structures are not workable for some businesses.
  - Need for debt capitalization that they cannot qualify for unless the operating business owns the valuable assets.
  - Tax purposes.
- In these instances, the operating company can make the valuable assets less attractive to a potential creditor by encumbering these assets with “friendly liens.”
  - Bank revolving line of credit secured by a blanket lien on all assets.
  - Assets offered as collateral for member loans to the company.
- These liens will diminish the value of the property to creditors.

Ensuring All LLC Members cannot Become Personally Obligated to the Same Creditor

- Issue – Charging Order protection
- The theory behind charging order protection for multi-member LLCs is that it is unfair for the other members to have their interests in the business affected by one member’s personal debts.
- In the event that all members are liable to the same creditor, that creditor can argue that this theory and protection does not apply and the creditor should be allowed to foreclose on the LLC interests as if the LLC were a single member LLC.
- Solution – do not give personal guarantees of all owners. An internal agreement can be structured, whereby the company and other owners can contribute to their fellow member for any amount paid on a personal guarantee, but this agreement, if drafted properly, will not give a creditor the right to pursue all owners jointly and severally.

Charging Orders and Member-Creditor Issues

Jay D. Adkisson

History of the charging order

- The U.S. went the path of judgment liens
- The U.K. went the path of charging orders
- Partnership Act of 1890 (UK)
- Uniform Partnership Act of 1914
- Uniform Limited Partnership Act of 1916
- Uniform Limited Liability Company Act of 1996
- The charging order as a vehicle to create a judgment lien

Purpose of charging orders

- Contrast with levy on corporate shareholder
- Creditor cannot interfere with management directly
- Partnerships and LLCs may allow direct management
- Charging orders prevent creditor management
- Faithful to “Pick Your Partner”

Single-member LLCs

- Recall that the purpose of a charging order is to protect the non-debtor partners from a “forced partnership” with a creditor
- Makes no sense in the Single-Member LLC context
- Bankruptcy Law allows the Trustee to take over the SMLLC interest entirely
- No reason for different result under state law
- Late Arriving Members (LAMBs)
- The Peppercorn Issue

Charging order effect

- Creates a lien on the debtor's interest
- Temporarily assigns the debtor's economic rights to the creditor
- Ancillary provisions to prevent "backdoor" distributions
    - Loans
    - Salary
    - Consulting Fees

Charging order effect

- Often bundled with other remedies, such as wage garnishment
- Lien is entitled to priority based on when entered
- Creditor has no greater informational rights than the debtor
- Debtor retains management rights

Charging order procedure - generally

- Most judgment-enforcement orders issued by clerk
- Charging order requires motion
- Only California has a statutory charging order procedure
- Courts of other states must come up with *ad hoc* procedure

Charging order procedure – giving notice

- Notice of motion, the actual motion, brief and proposed order
  - Served on both debtor and entity
  - Service by mail effective
  - Can serve entity's registered agent or all members
- Notice of charging order after entry
  - Personally served on both debtor and entity
  - Serve entity by personally serving registered agent

Charging order procedure - defenses

- The entity probably has no defense, unless debtor not a member
- Debtor's exemption defenses
  - "Wildcard" exemption where available – usually very small
  - Distribution in the nature of wages – Federal Wage Garnishment Restriction to 25% of "disposable earnings" (i.e., after deductions)

Charging order and foreclosure

- Recall that the charging order creates a lien and liens can be foreclosed upon
- Foreclosure is only allowed if the distributions will not timely satisfy the judgment:
  - Judgment is for $10,000 and distributions are $5,000 per year – The distributions will satisfy the judgment timely and thus no foreclosure.
  - Judgment is for $500,000 and distributions are for $5,000 per year – The distributions will not satisfy the judgment timely and thus foreclosure is allowed.
- Numerous states prohibit foreclosure

Charging order and foreclosure

- Foreclosure is of the lien only, which was only on the debtor's distributional rights, but the buyer takes a permanent lien.
- Thus, foreclosure does not give the creditor any management rights.
- Foreclosure is very rare because the creditor gains little.
  - Creditor as permanent assignee responsible for tax liability.
- The Harmonized Acts allow for pre-foreclosure redemption, but for the full amount of the judgment.
- The non-debtor members would prefer the debtor's member to be foreclosed upon, and then purchase it at the foreclosure sale.

Charging orders and conflict of laws

- Creditors not bound by an agreement's choice of laws provision
- External creditor issues are not an "Internal Affair"
- A membership interest is defined as "personal property"
- Intangible personal property is said to exist in the jurisdiction where the debtor is resident
- Roughly analogous to stock share, which does not require the creditor to go to the jurisdiction of formation
- Courts have consistently held that the charging order may be issued by the forum state

Charging order exclusivity

- The Harmonize Acts restrict a creditors “remedies” to a charging order
- Examples of remedies:
  - Garnishment
  - Levy
  - Assignment orders
- Examples of non-remedies:
  - Alter ego
  - Fraudulent transfer

Reverse Veil-Piercing

- Claims that the member and the entity are one and the same
- Veil-Piercing – Creditor of entity to pierce against member
- Reverse Veil-Piercing – Creditor of member to pierce against entity
- Reverse Veil-Piercing widely rejected a separate theory to standard Veil-Piercing

The LLC Member in Bankruptcy

- The Debtor's interest comes into the Bankruptcy Estate under 541
- Executory (something to be done) vs. Non-Executory (vested right)
- If Executory (apply 365)
  - Treated as "open option"
  - Trustee must accept or abandon operating agreement within 60 days
  - Accepts: Takes "whole hog with warts" including voting rights
  - Abandons: Passes back to debtor, but creditors can assert charging order lien
- If Non-Executory (365 doesn't apply)
  - Trustee simply has a right to distributions and may liquidate

The LLC Member in Bankruptcy

- Attempts to restrict a member's interest because of insolvency or bankruptcy is an Ipso Facto clause and is void in bankruptcy
- Post-petition attempts to divest the debtor's interest would violate the automatic stay
- Best solution is to simply cut a deal with the Trustee

Hot Topics

Jay D. Adkisson

Hot Topics - Procedure

- Charging Order Procedural Issues Confronted in Textron Financial -- *Textron Financial Corp. v. Gallegos*, C.D.Cal. Case No. 15cv1678 (Oct. 7, 2015). http://goo.gl/QJC6YF
- Partnership The Violated Charging Order Subject To Contempt (Joslin Brothers) - *Joshlin Bros. Irrigation v. Sunbelt Rental, Inc.,* 2014 WL 248104, 2014 Ark. App. 65 (Ark.App., Unpublished, Jan. 22, 2014). Full Opinion at http://goo.gl/aHI0tk

Hot Topics - Priority

- Questionable Charging Order Priority Decision In Chase Bank Case -- *McClure v. JP Morgan Chase Bank NA*, 2015 WL 4760275 (Colo.App., AAug. 13, 2015). http://goo.gl/Uyv9o8

Hot Topics – Conflict of Laws

- Charging Order Jurisdictional And Foreign LLC Issues Become Clearer In Vision Marketing --*Vision Marketing Resources, Inc. v. McMillin Group, LLC*, 2015 WL 4390071 (D.Kan., July 15, 2015). Full Opinion at http://goo.gl/tvzMwB
- EarthGrains Turns Up The Heat With Utah Charging Order Against Nevada LLC -- *Earthgrains Baking Co. v. Sycamore Family Bakery, Inc.,* D.Utah Case No. 09CV523 (Aug. 21, 2015). Full opinion at http://goo.gl/yxBYv2
- Connecticut Court Applies Own Charging Order Law To Out-Of-State LLCs (Shanghai Real Estate) -- *Shanghai Real Estate Ltd. v. Greenberg*, 2014 WL 660624 (Conn.Super., Jan. 28, 2014). Full Opinion at http://goo.gl/We31u4
- Georgia Court Applies Own Charging Order Law to Out-Of-State LLCs (Mahalo) -- *Mahalo Investments III, LLC v. First Citizens Bank andTrust Co., Inc.,* 2015 WL 687922, ___ S.E.2d _____ (Ga.App., Feb. 19, 2015). Full opinion at http://goo.gl/sFbjRf

Hot Topics – Intra-Member Disputes

- Intra-Member Charging Order Disputes (Wear It's At LLC) – *Young v. Levy*, 2014 WL 2741060 (Fla.App., June 18, 2014). Full Opinion at http://goo.gl/Mb8uT1
- Intra-Member Charging Order Disputes - Auction (MacDaddy) -- *Voll v. Dunn*, 2014 WL 7461644 (Conn.Super., Unpublished, Nov. 10, 2014). Full Opinion at http://goo.gl/nZepWH

Hot Topics – Veil Piercing

- Wyoming Single-Member LLC's Veil Pierced (Greenhunter) -- *Greenhunter Energy, Inc. v. Western Ecosystems Tech., Inc.,* 2014 WY 144, 2014 WL 5794332 (Wyo., Nov. 7, 2014). http://goo.gl/nbte3u

Hot Topics - Bankruptcy

- Albright Relief Applied To Personal Services LLC (Cleveland) -- *In re Cleveland*, 2014 WL 4809924 (D. Nev. Sept. 29, 2014). Full Opinion at http://goo.gl/WC3r1B
- Executory Interest Problem (Denman) -- *In re Denman*, 513 B.R. 720 (W.D.Tenn., July 24, 2014). Full opinion at http://goo.gl/nyy26F

The Ultimate Guide to LLCs as Asset Protection Tools

Ethical Considerations

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ATTORNEYS AT LAW

Legal Ethics

A. Scope of Representation

B. Professional Conduct

C. Conflicts of Interest\

D. Attorney Fees

Scope of Representation

- Who Is Your Client?
- Multiple representations
- Avoiding conflicts of interest

Professional Conduct

a) Model Rules of Professional Conduct

b) Aspirations

c) Your Obligation to Keep the Client Informed

d) Independent Judgment

e) Prudence, Skill and Care

Conflicts of Interest

- Loyalty and conflicts of interest
- Claims
- Impartiality
- Duties to Board, Officers, Employees and Owners
- Conflict Resolution

Attorney Fees

- "Reasonable compensation"

  1. Time and labor required, novelty and difficulty of questions involved, and skill needed to resolve issues.
  2. The likelihood that other employment will be precluded by acceptance of this employment.
  1. The fee customarily charged in the locality.
  2. The amount involved in the results obtained.
  3. The time limitations upon such services.
  4. The experience, reputation, and ability of the worker.

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Initial Considerations for Using LLCs to Protect Assets and Troubleshooting Other LLC Asset Protection Pitfalls

Submitted by Brett M. Larson

I. Initial Considerations for Using LLCs to Protect Assets

A. LLCs and Creditors: What can they access?

In order to understand asset protection benefits and strategies using LLCs as opposed to other vehicles, it is first important to understand the basic foundation of asset protection strategies in general. Generally, the goal of any asset protection strategy is to control assets without owning them in your own name and to make the assets unattractive to a litigator who may be evaluating you or your business as a litigation target. A properly designed asset protection plan and strategy can accomplish both of these goals through the use of LLCs.

The remedies available to personal creditors of an LLC owner/member include the following, depending on the applicable state law:

1. Obtaining a charging order, or a right to receive the member's right to distributions;
2. Foreclosing on the member/debtor's LLC ownership interest, or
3. Obtaining a court to order the LLC to be dissolved.

All states allow personal creditors of an LLC owner to obtain a charging order against the debtor's LLC interest. Some states specify that the charging order is the creditor's exclusive remedy with regards to the debtor's LLC interest. These states are the most "debtor friendly;" they provide the greatest protection for LLC owners against personal creditors. This protection extends to both the debtor/LLC member and any co-owners who would otherwise be at risk of having creditors take more aggressive action against the LLC, including possibly forcing a dissolution of their LLC.

<u>Charging Orders</u>

All states permit personal creditors of an LLC owner to obtain a charging order against the debtor-owner's membership interest. A charging order is an order issued by a court directing an LLC's manager to pay to the debtor-owner's personal creditor any distributions of income or profits that would otherwise be distributed to the debtor-member. However, in most states, creditors with a charging order only obtain the owner-debtor's "financial rights" and cannot participate in management of the LLC. Thus, the creditor cannot order the LLC to make a distribution subject to its charging order. Often, creditors who obtain charging orders end up with nothing because they cannot force the LLC to make any distributions. As a result they are not a very effective collection tool for creditors.

The charging order remedy without any right to order distributions is so weak many creditors don't even try to use it. In about half the states, the charging order is the exclusive legal remedy personal creditors of LLC members have.

Foreclosure

In about half the states, a creditor who obtains a charging order but is not paid by the LLC can have the court order that the debtor-owner's LLC membership interest be foreclosed upon. If this occurs, the creditor becomes the permanent owner of all the debtor-member's financial rights, including the right to receive money from the LLC. However, the creditor cannot participate in the management of the LLC. Thus, it cannot force the LLC to pay money to it or anyone else. A creditor's ability to foreclose upon an LLC membership interest puts LLC owners' personal creditors in a stronger bargaining position than they have under the LLC laws of states that don't permit LLC foreclosures.

In Illinois for example, a creditor who obtains a charging order can have the court order that the debtor-owner's LLC membership interest be foreclosed upon. If this occurs, the creditor becomes the permanent owner of all the debtor-member's financial rights, including the right to receive money from the LLC. However, the creditor cannot participate in the management of the LLC. Thus it can't force the LLC to pay money to it or anyone else. It's quite possible, however, that before any such foreclosure occurred, the debtor-owner and/or other LLC members would settle the debt with the creditor. If they don't, the debtor-owner will never be able to obtain any financial benefits from the LLC--for example, if the LLC is later dissolved, the debtor-owner will not be entitled to any share of the company's assets.

A creditor's ability to foreclose upon an LLC membership interest can put an Illinois creditor in a stronger bargaining position than creditors have under the LLC laws of many other states where their remedies are limited to a charging order.

Delaware's LLC law on the other hand says that the charging order is the exclusive legal procedure that personal creditors of Delaware LLC members can use to get at their LLC ownership interest. Thus, unlike some other states, Delaware does not permit an LLC owner's personal creditors to foreclose on the owner's LLC ownership interest. This makes Delaware a particularly friendly state for people who want to form LLCs to protect assets from personal creditors.

Dissolution

A few states permit personal creditors of LLC owners to obtain a court order that the LLC be dissolved or the state's LLC statute is silent as to what remedies other than a charging order might be available to creditors. In those states, it's possible that a creditor would seek to have the LLC dissolved. If that occurred, the LLC would have to cease doing business and sell all of its assets. This is the most extreme remedy available to personal creditors of LLC owners. Like most states, Illinois and Delaware do not permit personal creditors of an LLC member to have a court order that the LLC be dissolved and its assets sold to pay off the creditor.

B. Single Member LLCs: Evaluating the risks

An LLC provides the same protection as a corporation against creditors of the business. However, there is some uncertainty as to whether a single member LLC ("SMLLC") member will receive the same protection from liability that members of an LLC with multiple members receive. While the law is clear in most states, this is still an evolving issue.

As discussed above, in most states a creditor of an LLC member can only seek a charging order against the member's interest in the LLC. With a charging order, the creditor cannot directly attach the assets of the LLC but instead receives any payments made from that member's distributional interest.

Courts in some states have found that the charging order protection doesn't apply to SMLLCs and have allowed creditors to pursue other remedies, including foreclosing on the member's interest or ordering the LLC dissolved. Other states, like Nevada and Wyoming, have recently changed their laws to make clear that the charging order protection for debtors applies with all LLCs, regardless of whether they are single or multi-member entities.

In most jurisdictions the logic for limiting personal creditors of individual LLC owners to a charging order is to protect the other members of the LLC. It doesn’t seem fair that they should suffer because a member incurred personal debts that had nothing to do with their LLC. This logic is inapplicable when the LLC has only one member (owner). As a result, the LLC laws and court decisions in some states don't limit personal creditors of owners of SMLLCs to the same remedies as multi-member LLCs. In many states, including Minnesota, the LLC acts do not distinguish between single member and multimember LLCs, however, the issue of whether the court would treat them the same in the context of a charging order.

Delaware has not made a distinction in how it handles cases involving single and multi-member LLCs. Thus it appears that under Delaware law, creditors of SMLLCs may be limited to the charging order remedy as described above. However, even when the LLC law states that charging orders are the exclusive remedy, courts in some states have applied a different rule for SMLLCs, particularly in cases where the SMLLC owner has filed for personal bankruptcy. It's possible that a court in Delaware would do the same; this is an unsettled and evolving area of law. In a Maryland bankruptcy case that involved a Delaware SMLLC, the Maryland bankruptcy court held that Delaware LLC charging order protection <u>did not</u> apply to a SMLLC and allowed the creditor to step into the shoes of the sole LLC member. *In re Modanlo*, 2006 WL 4486537 (D. Md. 2006).

Florida is one of the states that has explicitly adopted different rules for single and multi-member LLCs. Florida amended its laws in 2011 to clarify that if the charging order remedy proves ineffective against a SMLLC, the creditor can ask the court to order that the SMLLC be sold in a foreclosure sale. Whoever purchases the SMLLC in a sale acquires all the former owner’s rights and becomes the new sole owner of the SMLLC. To obtain an order foreclosure, the creditor must show that the SMLLC debtor-owner will not be able to pay its debt within a reasonable time. This rule was first adopted by the Florida legislature when it amended Section 608.433 of Florida Statutes in 2011 (the "Olmstead Patch"). This same rule was incorporated in the new Florida LLC Act which is effective for all new LLCs as of July 1, 2014 and for all Florida LLCs starting January 1, 2015.

Because of the SMLLC rules in Florida and the uncertainty related to this issue in other states, in order to obtain asset protection for personal debts of the members, an LLC should have at least two members. If you have only two members, the second owner must be a legitimate co-owner of the LLC. If the second owner is added merely on paper as a sham, the courts will likely treat the LLC as a single-member LLC. To avoid this, the co-owner must pay fair market value for the interest acquired and receive financial statements, participate in decision making, and receive a share of the LLC profits equal to the membership percentage. Exactly how much of an LLC a person must own to be considered a legitimate LLC co-owner is unclear; but a very small ownership interest--such as 1% or less--may not be enough. The second member must also have the full rights of an LLC member, including economic and voting rights. For example, the second member should have the right to receive some share of the LLC profits.

C. Series LLCs for Multiple Assets

The reason for using separate limited liability companies ("LLCs") is to compartmentalize risk by segregating assets. Creating a number of different entities does cause additional administrative work. To counteract that additional administrative burden, some asset protection friendly states like Delaware have enacted Series LLC statutes.

A parent LLC can establish a series of additional sub LLCs within the corporate structure. Each series is compartmentalized, meaning that the assets and liabilities are contained within the sub-LLC. There is only one operating agreement that governs the entire structure and only one annual tax filing. In some states, if different members participate in sub LLCs a separate tax filing is required.

Theoretically, series LLCs solve many of the objections that a client may have to the complexity and cost of maintaining a traditional parent subsidiary structure, however practically many practicing attorneys still shy away from series LLCs because the law regarding these structures is relatively undeveloped in most jurisdictions. Further, only eight states to date have enacted statutes authorizing series LLCs, and the drafters of the recent Revised Uniform Limited Liability Company Act (RULLCA) considered and rejected provisions to the concept of compartmentalization of liability between series. The series LLC structure is permitted in:

1. Delaware
2. Illinois
3. Iowa
4. Nevada
5. Oklahoma
6. Tennessee
7. Texas
8. Utah

In 1996, Delaware passed the first legislation authorizing series LLCs. H.B. 528, 138th Gen. Assem., 2d Sess. (Del. 1996), *amended* by DEL. CODE ANN. tit. 6, § 18-215. The statute allows an LLC to designate one or more series of members, managers, LLC interests, or assets. Once a series is formed, state law outlines the rights, powers, and duties of each series. Each series enjoys limited liability and shields its own assets from those of each other series and the Parent.

DEL. CODE ANN. tit. 6, § 18-215(b). A series may have a different business purpose from the other series and the Parent LLC. *E.g.,* DEL. CODE ANN. tit. *6,* § 18-215(a); OKLA. STAT. tit. 18, § 2054.4. It may have separate members, managers, or voting rights. *E.g.,* OKLA. STAT. tit. 18, § 2054.4. Each series may dictate a separate structure with respect to profits and losses associated with specific property or obligations. *E.g.,* 805 ILL. COMP. STAT. ANN. 180/37-40(a).

However, the limited liability of each series may only be enjoyed if certain guidelines fundamental to the series LLC concept and premised on generally applicable theories of piercing the corporate veil are followed, such as maintaining separate entity records, accounting records, and bank accounts. Also, some states require each series to separate assets (i) from the Parent LLC and (ii) among the other series. Additionally, most states require the articles of organization or operating agreement to state that liability is limited to the assets owned by each series, effectively providing notice to creditors. As a result, the debts, liabilities, obligations, and expenses incurred are only enforceable against the assets of that series. Thus, any series LLC which fails to meet these requirements risks losing the benefits of the series LLC.

Delaware added a new section to its Limited Liability Company Act which authorizes an LLC to designate series of members, managers, or interests. H.B. 528, 138th Gen. Assem., 2d Sess. (Del. 1996), *amended* by DEL. CODE ANN. tit. 6, § 18-215. As all other series LLC state statutes provide, each "series may have a separate business purpose or investment objective."' 144 A Delaware series LLC is formed by filing a Certificate of Formation and drafting a limited liability company agreement which establishes one or more designated series of members, managers, limited liability company interests, or assets. *E.g.,* DEL. CODE ANN. tit. 6, § 18-215(a). By this agreement, series may have separate rights, powers or duties with respect to specified assets. *Id.*

To retain limited liability in Delaware, a series LLC must keep separate records for each series and account for assets separately from each series. *See id.* § 18-215(b). However, the assets associated with a series "may be held directly or indirectly, including in the name of such series, in the name of the limited liability company, through a nominee or otherwise."' *Id.* Thus, a series must keep separate records, but the Parent may hold its assets. Unless otherwise provided in the limited liability company agreement, management is, by default, vested in the members in proportion to their current interest in the profits of the series. *Id.* § 18- 2 15(g).

Illinois law is similar to Delaware law, with several modifications that attempt to improve upon the model created by Delaware in compartmentalizing assets between series. In fact, the Illinois statute states that a series LLC may be treated as a separate entity able, in its own name, to contract, hold title to assets, grant security interests, and sue and be sued. 805 ILL. COMP. STAT. ANN. 180/37-40(b). The language states that the series "shall be treated as a separate entity to the extent set forth in the articles of organization."' *Id.* Accordingly, the LLC may define the relationship, freeing or binding the series, through the operating agreement or articles of organization.

Unlike Delaware, Illinois requires that this be provided for in the series' operating agreement. *Id.* § 37-40(a). The increased formalities like this one, which are prevalent throughout the statute, support the separate record-keeping requirements of each series and should make it easier for a court to determine when it should pierce the series LLC's veil of limited liability.

Even in Illinois or Delaware, two of the more member/creditor friendly states there remains a high degree of uncertainty as to how a court will apply the theoretical separateness between series. This uncertainty is most important in the context of a piercing argument. Assuming each series contains one asset, that asset may not be able to satisfy a judgment against the series. While contracting parties previously had the opportunity to investigate assets, the limited notice requirement in most series LLC jurisdictions may place a contractual claim on the same level as a tort claim. Thus, a plaintiff creditor will seek to not only pierce through to the owner's assets, but also collapse the series to reach the assets of the Parent LLC and other series. Further, it is unclear whether a court will apply the piercing standard from the corporate law analysis, a different analysis, or no analysis. Although widely accepted, piercing is not yet a clear-cut standard for LLCs in many states.

D. LLCs vs. Corporations

Corporate structure often falls into two categories: a limited liability company (LLC), or a corporation. As a default, corporations are taxed as a C corporation and LLCs are taxed as partnerships. Either a corporation or a LLC may file a form 2553 with the IRS to be taxed as a S corporation. Both corporations and LLCs provide their owners corporate liability shield protection, protecting those owners from being held personally liable for the actions of the business entity.

From an asset protection standpoint, the most significant difference between a LLC and a corporation is that a personal creditor to an owner of a LLC is limited in most states to a charging order against the membership interest. A creditor of a shareholder in a corporation, on the other hand, may foreclose upon and take the shareholder’s share including both the governance and financial rights attached to that share. From an asset protection standpoint, the determining factor is the form of the legal entity (either a corporation or a LLC) in determining whether charging order protection will apply. Given this distinction and added protection for LLCs and their owners, and the fact that a LLC can be taxed as an S corporation for tax purposes, most small businesses who desire this tax treatment are much better served by a LLC taxed as a S corporation rather than incorporating a corporation and seeking the same tax treatment through that corporation.

Additional benefits of an LLC include:

- **Flexibility in management.** Corporations have a set management structure where directors oversee the major business decisions and officers are responsible for the day-to-day running of the business. LLCs do not have the same formal management structure. Required formalities for S corporations include: adopting bylaws, issuing stock, holding initial and annual director and shareholder meetings, and keeping meeting minutes with corporate records. Recommended but not required formalities for LLCs include: adopting an operating agreement, issuing membership shares, holding and documenting annual member meetings (and manager meetings, if the LLC is manager-managed), and documenting all major company decisions.

- **Pass-through taxation default.** The default rule is that a LLC is taxed as a partnership, which is a pass-through entity for tax purposes. Accordingly, if a LLC or its members make a decision for estate planning, asset protection, or succession planning purposes that would otherwise compromise the S election, the consequence of reverting back to the default tax structure is generally minimal. The same cannot be said for a corporate structure, which will revert to a C corporation tax structure where the entity will be taxed in addition to the individual tax to the owners. With pass-through taxation, taxes are not paid at the business level. If you choose to become an LLC, income/loss would be reported on your personal tax return. If any taxes were due, they would be paid on the individual level.

The benefits of a S corporation are generally tax driven. The "S corporation advantage," allows business owners to use business losses — like those incurred during the startup phase — on their personal tax returns as deductions. An S corp can also provide savings on self-employment or Social Security/Medicare taxes, and it allows owners to offset non-business income with losses from the business — unlike a C corp which is a completely separate tax entity. With careful planning, a small business can avoid significant employment taxes by electing to become an S-corp.

There are instances where organizing as a corporation is preferred over an LLC. The main benefit of corporations is its stock may be freely transferred without the consent of other shareholders or corporate management. This is essential for any publicly traded company. Companies that plan a public offering should be a corporation. C corps are often the preferred incorporation choice of venture capitalists. Owners can hold different types of stock interests (including preferred and common stock), which allow for different levels of dividends. This is main reason that venture capitalists choose C corporations when they offer funding to a business. Investors are attracted to the prospect of dividends (often higher dividends) if the corporation makes a profit. Furthermore, any company that wants easy transferability of ownership or that has a complex equity structure should prefer the corporate form of organizations.

Finally, some businesses such as banks, insurance companies or public utilities are required by law to be corporations. There are also certain legal concerns to consider when choosing between an LLC and a corporation. Although this issue is less pronounced in most jurisdictions than it was 20 years ago, the law of most states is more developed with regard to corporations than it is with respect to LLCs. The corporate form has been a part of U.S. history from beyond its inception. LLCs were first recognized in the 1970s and 1980s in most states. In many states, the corporate statutes are very similar to the LLC statutes; however, the law governing each jurisdiction is different.

An ownership interest in an LLC has considerably greater creditor-protection than shares in a corporation, which can be easily seized by a stockholder's personal creditors. A member's interest in an LLC is creditor protected in the same way a partner's interest in a limited partnership is protected. A member's personal creditor is limited only to a charging order against the LLC interest. This gives the creditor only the right to receive distributed profits due the debtor partners.

E. LLCs vs. FLPs

A Family Limited Partnership (FLP) is a type of limited partnership that is formed by an official filing with the Secretary of State where it is to be created. The FLP is a separate legal entity from its owners, with its own tax identification number. Any income or loss flows through to the partners and is reported on the owner's tax returns as partnership income. Usually family savings, investments and ownership of business and real estate interests are transferred into the FLP, which are organized for the principal objective of transferring wealth from one generation to the next in a tax efficient way. When properly structured, these assets receive a modicum of protection from potential claims and lawsuits. A plaintiff with a judgment is not permitted to reach into the FLP to seize this property. The ownership of the interests in the FLP is usually protected in a trust designed for this purpose.

A FLP must meet the following criteria:

1) The limited partnership interests in the FLP which the organizer receive must be proportionate to the amount of her contribution. If you form an FLP and contribute $90 and your children contribute $10, you must receive a 90% interest in the FLP. The records of the partnership must properly account for the contributions of each partner.

2) Partnership formalities must be satisfied. The FLP must be properly organized, the FLP Agreement must specify the rights and responsibilities of the partners and assets contributed to the FLP must be properly and legally transferred.

3) The FLP must serve a valid business purpose such as asset protection. However, where there is no legitimate business venture, the Tax Court will likely find that the FLP simply acted as a vehicle for changing the form in which a person holds his property – that is to say, "a mere recycling of value." *See Estate of Harper v. Commissioner*, T.C. Memo 2002-121 (U.S. Tax Court 2002).

4) To avoid weakening the FLP for tax, business and asset protection purposes, assets and income from the FLP should not be used for personal or household living expenses. Use the income from your practice or set aside sufficient other assets to meet recurring expenses. Don't put assets such as your residence, jewelry and personal effects into the FLP.

Kimball v. United States, 371 F.2d 257 (5th Cir. 2004).

When the guidelines offered by the Court are followed and a solid business purpose such as asset protection is the foundation of the plan, the Family Limited Partnership may serve as the cornerstone for most advanced financial plans.

Under the typical arrangement, the FLP is set up so that Husband and/or Wife (or a specially formed Limited Liability Company) is each a general partner. Corporations are not typically used as a general partner if asset protection is a goal. The shares of a corporation can be seized by a creditor, which then effectively transfers to the creditor all management rights over the partnership.

The general partners will typically own only a minimal 1 or 2 percent interest in the partnership. The remaining interests are in the form of limited partnership interests. These interests will be held, directly or indirectly, by one or more other entities or family members, based on the particular tax, estate planning, and asset protection goals to be achieved. The general partners have management over the affairs of the partnership and can buy or sell any assets they wish, subject to the terms of the partnership agreement. The general partners also may have the right to determine what portion of partnership income and assets are retained by the partnership and what amount is to be distributed to the partners.

The assets transferred to and owned by the FLP are owned by the entity and not the transferor partners. Under the provisions of the Uniform Limited Partnership Act, *a creditor of a partner cannot reach into the partnership and take specific partnership assets.* The creditor has no rights to any property which is held by the partnership. Since title to the assets is in the name of the partnership and it is the Husband partner rather than the partnership which is liable for the debt, partnership assets may not be taken to satisfy the judgment. Similar to a LLC, however, a charging order or a foreclosure of a partner's interest in the partnership may be an equally powerful remedy of a creditor.

In some states, including California, Florida, and Colorado, case law and the statutes specifically allow a creditor to foreclose on a limited partnership interest, in addition to the charging order remedy. California Corporations Code Section 17302 (b). See also (*Hellman v. Anderson,* 233 Cal. App. 3d 840; (Foreclosure of partnership interests); Section 17302 (Foreclosure of LLC interests) In Re: *Ashley Albright,* U.S. Bankruptcy Court for the District of Colorado (decided April 4, 2003) *Olmstead, et. al., vs. The Federal Trade Commission,* Supreme Court of Florida. Case No. SC08-1009 June 24, 2010).

Having said all this, the FLP may still be a valuable tool for asset protection. It merely requires that the proper steps be taken to ensure that ownership of the FLP has been correctly established from the beginning so that neither a charging order nor a foreclosure can be applied and the goal of asset protection will be accomplished.

However, limited partnerships have drawbacks when compared to LLCs. First, for a FLP, you need at least two members; most LLC's can have 1 member. Therefore, all LLP's are expected to file a K-1065 return, and each partner individually is expected to file a K-1 return. Single member LLC's do not have this requirement. As was previously noted, the general partner does not have liability protection.

Therefore, an LLC is usually best for an optimal combination of privacy and asset protection. More specifically, a Delaware LLC can be organized without identifying any of the members, managers, or governors on any filing with the Secretary of State. However, if someone is using a domestic LLC to run a business, or a foreign LLC in a manner that requires it to be registered with the members' home state, the LLC may be subject to a franchise tax that a limited partnership would not be subject to. This is the case in Texas, California, Florida, and may be the case in a few other states as well.

IV. Trouble Shooting Other LLCs Asset Protection Pitfalls

A. Not Operating the LLC as an Independent Entity: The damages of veil piercing

For a plaintiff to successfully pierce the LLC veil, he or she will usually have to prove that the LLC ignored corporate formalities and otherwise ignoring the separateness between the LLC and its members. The specific analysis differs by state.

Delaware law imposes a high threshold to pierce the LLC veil. *See Midland Interiors, Inc. v. Burleigh*, No. CIV. A. 18544, 2006 WL 3783476, at *3 (Del. Ch. 2006). Delaware courts have often adopted an "instrumentality" theory in determining whether a corporate veil has been pierced. Generally, prevailing under this theory requires a showing of control over the company in a way that caused harm, either through wrongful acts or fraud. *Connecticut Light & Power Co. v. Westview Carlton Grp., LLC*, 108 Conn. App. 633, 640; 950 A.2d 522, 527 (2008) ("[S]uch control was used by defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or to commit a dishonest or unjust act in contravention of plaintiff's legal rights."); *see also Schultz v. Gen. Elec. Healthcare Fin. Servs. Inc.*, 360 S.W.3d 171, 178 (Ky. 2012). Factors that may lead a court to pierce the veil include failure to follow corporate formalities (comply with operating agreement or statutory requirements for approval by vote of transactions), overlapping ownership and management, common office space, lack of arm's length dealing, preferences exercised in favor of family owned entities, unity of interest, or lack of independence and injustice/inequity. *Tzovolos v. Wiseman*, 16 A.3d 819, 842 (Conn. Super. Ct. 2006). Additionally, the veil may be pierced when the company is insolvent or there exists a lack of sufficient funds for the company to operate, coupled with evidence of intent, at the time of funding, to avoid payment of future debts of the company. *Milk v. Total Pay and HR Solutions, Inc.*, 634 S.E.2d 208, 212 (Ga. App. 2006).

Satisfaction of only one or a few of these factors will not necessarily result in piercing the veil. For example, some courts have stated that any lack of formalities must lead to some misuse of the LLC form to justify piercing. *Advanced Tel. Sys., Inc. v. Com-Net Prof'l Mobile Radio, LLC*, 846 A.2d 1264, 1279 (Pa. Super. 2004). Additionally, even where some formalities are not strictly followed, evidence that other formalities were followed (e.g., filing papers, making loans, having a bank account and operating in the company's name) can help prevent an LLC's corporate veil from being pierced. *F.G. Bruschweiler (Antiques) Ltd. v. GBA Great British Antiques, LLC*, 860 So.2d 644, 651 (La. App. 5th Cir. 2003). Finally, one court has stated that members of an LLC are not personally liable when they follow company rules, refrain from commingling personal funds with company funds, do not borrow or use company assets for their own purposes, and do not exercise greater control than any managing members of a company. *McGovern Capital, LLC v. Papic*, No. CV020190931S, 2003 WL 21267436, at *3 (Conn. Super. Ct. May 21, 2003).

Many states have adopted an alternative theory, referred to as the "alter ego" theory. Typically, this test applies when a corporation (or LLC) is deemed merely a front for another entity. To establish alter ego liability, New York courts have required evidence of 1) a single economic unit and 2) injustice. *NetJets Aviation, Inc. v. LHC Commc'ns, LLC*, 537 F.3d 168, 176 (2d Cir. 2008). Courts have held that a 30% ownership interest is insufficient to make a controlling decision (constituting a single economic unit) in a Delaware company. *Bronstein v. Crowell, Weedon & Co.*, No. B191738, 2007 WL 969559, at *9 (Cal. App. 2d Dist. Apr. 3, 2007). New York case law also integrates the alter ego theory, and may allow for veil piercing "[w]hen a corporation [or limited liability company] has been so dominated by . . . another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego." *Last Time Beverage Corp. v. F & V Distribution Co., LLC*, 951 N.Y.S.2d 77, 81 (2012).

B. Not Maintaining Appropriate Insurance Levels: Advising the clients on what's best

Businesses can hedge much of the risk that they face by securing and maintaining the appropriate insurance at the appropriate levels. Most businesses need to purchase at least the following three types of insurance:

- Property Insurance
- Liability Insurance
- Business Vehicle Insurance
- Workers Compensation Insurance

Property Insurance – Property insurance compensates you if the property you use in your business is lost or damaged as the result of various types of common "perils" such as fire or theft. Property insurance covers not just a building or structure but also personal property, meaning office furnishings, inventory, raw materials, machinery, computers and other items vital to your business operations. Property insurance can do more than protect your physical assets. It may also provide operating funds during a period when the business is forced to close after a catastrophic covered loss. Depending on the type of policy and endorsement, property insurance may include coverage for equipment breakdown, removal of debris after a fire or other destructive event, some types of water damage and other losses.

Liability Insurance – Liability insurance is often packaged with property insurance in the form of a Commercial General Liability Policy or Business Owner Policy. The typical policy may provide coverage for negligence of employees, premises liability, product or manufacturer defects, or an error in providing service. Liability insurance coverages and limits should be tailored to the specific needs of the business based on anticipated exposures and customer requirements.

Workers Compensation Insurance – In all states but Texas an employer must have workers compensation insurance when there are more than a certain number of employees, varying from three to five, depending on the state. Workers comp insurance, as this coverage is generally called, pays for medical care and replaces a portion of lost wages for an employee who is injured in the course of employment, regardless of who was at fault for the injury. When a worker dies as a result of injuries sustained while working, the insurance provides compensation to the employee's family.

In addition to the basic coverages highlighted above, there are various other policies needed by some businesses. They include:

- umbrella policies
- specialized liability policies
- terrorism insurance

Umbrella Policies - An umbrella liability policy provides coverage over and above other liability coverages. It is designed to protect against unusually high losses, when the policy limits of one of the underlying policies have been used up. For the typical business, the umbrella policy would provide protection over and above general liability and auto liability policies. If the business has Employment Practices Liability Insurance, Directors and Officers Liability or other types of liability insurance, the umbrella could provide protection over and above those policy limits as well.

Specialized Liability Insurance Policies - Some businesses need specialized liability policies. They include:

- Errors and Omissions Insurance (E&O)/Professional Liability Insurance
- Employment Practices Liability Insurance (EPLI)
- Directors and Officers Liability Insurance (D&O)
- Business Identity Theft Insurance

Errors and Omissions Insurance/Professional Liability Insurance **-** If a business involves services such as giving advice, making recommendations, designing products, providing physical care or representing the needs of others, it could be sued by customers, clients or patients claiming a negligent failure to perform the service. Errors and Omissions or Professional Liability Insurance covers these situations and provides for both defense costs and payment of damages up to a specified limit.

Employment Practices Liability Insurance **-** Employment Practices Liability Insurance pays, up to the policy limits, damages for which an employer is legally liable for violating an employee's civil or other legal rights. Any business that has a significant number of employees should consider EPLI. In addition to paying a judgment for which the insured is liable, it also provides for legal defense costs, which can be substantial even where there has been no wrongdoing.

Directors and Officers Liability Insurance **-** Directors and Officers Liability Insurance protects directors and officers of corporations or not-for-profit organizations if there is a lawsuit claiming they managed the business or organization without proper regard for the rights of others. The policy will pay any judgment for which the insured is legally liable, up to the policy limit. It also provides for legal defense costs, which can be substantial even where there has been no wrongdoing. For many businesses, especially multiple shareholder close businesses, many sophisticated individuals will require that this type of coverage be in place before they will agree to take on a director or officer position.

Business Identity Insurance **-** Business Identity Theft Insurance provides legal liability coverage to businesses that are victims of data theft. Such policies can also provide coverage to notify customers whose personal identification information may have been compromised and pay for services to provide identity theft recovery services for customers.

The appropriate type and level of coverage depends upon the specific needs and exposures of the business. Some business will choose to self-insure against certain more remote risks and opt for coverage against exposures that are more likely to become an issue.

C. Not Putting LLCs Profits in Protected Places: Methods to secure them from creditors

Placing assets within a LLC is sometimes touted as an asset protection device for personal debts. While this strategy has merit, when used by itself it dangerously and unnecessarily exposes these assets to a high risk of loss to the business's creditors. Generally, a business is more likely to be sued than its owners, and therefore a strategy of retaining earnings within the LLC for “safe keeping” can backfire in the event the company is sued. Even so, many business owners will retain earnings in a company in order to provide needed liquidity. There are a number of strategies for protecting these retained earnings while meeting the goal of providing liquidity. Generally, business owners should invest and maintain as little vulnerable capital as possible within the business form, so that the business’s "limited liability" is further limited. This strategy can backfire and serve as grounds to pierce the corporate veil because the company is not adequately capitalized.

Fortunately, an LLC or a corporation can be adequately capitalized so as to avoid this exception, without exposing business assets to liability. Balancing the initial capital structure is critical in avoiding application of this exception. One strategy is to distribute the profits to the member, who immediately lends the distributed profits back to the company. The promissory note can be drafted to provide protection for the profits by minimizing or eliminating rights of collection in the event of an involuntary creditor assignment or insolvency of the lender and enhance the lender / member’s ability to collect in the event that the company finds itself unable to satisfy its debts. So long as the loan is valid and well documented, it may be paid back to the member without a risk of a claw back action.

Alternatively, a member may receive the financial benefit of the profits generated by the business while protecting this wealth from even personal creditors. This can be accomplished by distributing profits to the member, who in turn invests those distributions in exempt investments such as a homestead, a protected retirement account, or even investment grade life insurance. Many states allow residents to place a homestead exemption on their primary residence within the state up to certain dollar amounts. The state of Florida is particularly generous and largely shields primary residences in total from debts, even if the purchase was made to avoid creditor liability. Tax-qualified retirement plans, like IRAs, 529 college savings plan for children and grandchildren, and the cash value of life insurance policies are also usually protected at varying levels from LLC debts under applicable laws.

D. Not Protecting Key Assets from LLC Creditors: Techniques to keep them safe

Many business owners mistakenly believe that assets within a LLC are shielded from liability. This is certainly not the case with respect to business debts. In fact, as stated above, most business owners face the greatest risk of liability from business transactions, and not personal dealings. Thus, these assets, which can be significant in a successful business, will be exposed to the greatest risk of loss. Yet, a corporation or LLC can be structured, funded and operated so that the business's assets are not exposed to any liability. In order to LLC assets from personal creditors, it is important to maintain corporate formalities and avoid the piercing risks discussed above. Protecting LLC assets from LLC creditors requires a different type of planning and strategy. Generally, two strategies are employed by operating companies to protect the assets that they use to run their business: (1) compartmentalization of assets and exposures and (2) encumbering assets owned by the at risk entity.

In most business structures, the entity that runs and manages business operations has the most exposure. This exposure includes potential claims by creditors, vendors, employees, and customers. Some businesses own one or a few assets that represent the majority of the book value of the business. For instance, many technology based businesses have a valuable patent or trade secret that differentiates the business from its competitors. Real estate based businesses may own commercial or residential real estate. A manufacturer may own equipment with a significant value. It is important to protect these valuable assets from the exposures to the operating company. This is done by compartmentalizing ownership of these assets or holding these assets in entities that are separate from the operating entity. The two entities may be commonly owned, but they are only linked by an agreement allowing the operating company to use the valuable assets owned by its sister company. This agreement may take the form of a license or a lease. So long as both companies observe corporate formalities, are operated as separate businesses, and the operating entity pays the asset holding company a rental or license fee, the assets will be protected from creditors of the operating entity.

This strategy is not workable for all businesses for a variety of reasons. Some businesses may have a need for debt capitalization that they cannot qualify for unless the operating business owns the valuable assets. Some businesses choose to have the operating company own the assets for tax purposes. In these instances, the operating company can make the valuable assets less attractive to a potential creditor by encumbering these assets with “friendly liens.” This could mean having a bank line of credit that is secured by a blanket lien on all assets. This could also mean that the assets are offered as collateral for member loans to the company. These liens will diminish the value of the property to creditors. Of course, this strategy requires that the obligations secured by the valuable property do not themselves present creditor risks themselves.

E. Ensuring All LLC Members cannot Become Personally Obligated to the Same Creditor

One of the purposes of organizing a business as a limited liability company, or LLC, is to separate a business owner's personal and business assets and obligations. Setting up a company that has the legal status of an independent entity effectively limits the ability of an owner's personal creditors to reach into his business assets to collect payment of personal bills.

Ordinarily, the line between business and personal affairs remains intact for regular bills that an LLC owner, known as a member, might incur personally.

An LLC can be set up as a single-member or multi-member LLC. If a personal creditor obtains a judgment against a member in either setup for nonpayment, however, the creditor can attempt to attach the member's interest in the LLC. The theory behind charging order protection for multi-member LLCs is that it is unfair for the other members to have their interests in the business affected by one member's personal debts. In the event that all members are liable to the same creditor, that creditor can argue that this theory and protection does not apply and the creditor should be allowed to foreclose on the LLC interests as if the LLC were a single member LLC. For this purpose, it is important, if possible, to avoid all owners of a LLC becoming personally liable to the same creditor.

Creating LLC Operating Agreements that Strengthen Asset Protections – With Example Provisions

Submitted by Nathan J. Nelson

II. Creating LLC Operating Agreements that Strengthen Asset Protections – With Example Provisions

INTRODUCTION

Whether your approach to asset protection is more akin to a marathon or a sprint, in either case the first step to liability protection begins with a well drafted limited liability company operating agreement. Asset protection, express or by implication, can be provided for in a skillfully created LLC operating agreement. Likewise, in the absence of specific tailoring, the use of a limited liability company operating agreement that generally follows statutory default rules may actually aid a creditor's collection against a member of an LLC who has suffered a judgment or is otherwise under attack by creditors.

In most situations, the specific facts and objectives of the instant LLC member's will determine the importance of asset protection and, of course, there is no "one-size fits all" LLC operating agreement. The need for asset protection can arise instantly as a result of an accident, divorce, death, decline in business, failure to meet lender covenants, loss, audit, lawsuit, or a myriad of other unfortunate circumstances.

Limited liability companies are vulnerable to two types of liabilities, "inside liability" and "outside liability". Inside liability shields non-LLC assets from liability exposure for the acts and omissions of the LLC which are not the fault of the LLC's members, individually. Outside liability protects the LLC assets from liability exposure that is a result of the acts or omissions of the LLC's members but is not related to the acts or omissions of the LLC itself. The overwhelming focus of this outline will be to focus on protecting the LLC from the outside liability of its members. As such, the assets inside the LLC may become protected from the outside actions of its members. Shrewd members who recognize this protection, may become more inclined then to contribute substantial assets to their respective limited liability companies, especially to LLC's who act as holding companies, investment companies or otherwise have low inside liability risks.

The purpose of this outline is to address several drafting techniques that warrant strong consideration for inclusion in one form or another in limited liability company operating agreements where asset protection is a priority concern to the applicable LLC's members.

A. DISTRIBUTION CLAUSES TO DELETE OR INCLUDE MANDATORY, UNEQUAL, ETC.

An important benefit of LLC structure is that state LLC statutes usually follow the LLC's operating agreement to determine the amount, timing, and identity of distributions and distributees. This is an invitation to strategically structure distribution provisions within LLC operating agreements. We generally break LLC distributions down into four categories: (i) distributions of distributable cash, (ii) tax distributions, (iii) distributions of capital proceeds (i.e. proceeds from refinancing or the sale of capital assets), and (iv) liquidating distributions. This outline will focus on provisions relating to distributions of distributable cash and tax distributions.

Central to determining what is distributable to the Members is the definition of "Distributable Cash." In respect to asset protection, less is more. The result, however, may create a tension between the members of the LLC and the party or persons responsible for determining what is distributable. Obviously, the greater the trust or lacking that, the greater the common purpose of the members, the more fluid the definition of Distributable Cash may become. While in many business deals, necessity requires a complex definition of Distributable Cash, for the purposes of this outline we recommend consideration be given to the following definitions:

"Distributable Cash" shall mean the amount of cash which the Manager deems available for distribution to the Members, taking into account all debts, liabilities, and obligations of the Company then due, and working capital and other amounts which the Manager deems necessary for the Company's business or to place into reserves for customary and usual claims with respect to such business.

or

"Distributable Cash" shall mean that portion of the Company's cash which the Manager, in the Manager's sole discretion, deems available for distribution to the Members.

The above definitions expressly empower the Manager to make the determination of amounts available for distribution. Of course, the Members, the Board, or other combinations could be substituted in this role, as the consensus reaching aspect of the limited liability company operating agreement requires.

The limited liability company operating agreement should provide that the Manager shall determine the timing of the distributions to the Members. Often times, Members require at least annual distributions, if not quarterly or more frequently. At a minimum, many times Members require distributions at least in an amount to satisfy their tax obligations attributable to their ownership of the LLC. If an LLC member was being pursued by a creditor, the member would be in a stronger negotiating position with the creditor if the Member was not anticipating a distribution, be it from Distributable Cash or a mandatory tax distribution. However, if the LLC operating agreement required periodic distributions to members, then a member's creditors may intercept the applicable member's share of the distribution and the Manager would have no opportunity to prevent this unfortunate result. Thus, for asset protection purposes we recommend that the Manager be solely responsible for determining when any distributions shall be made from the LLC.

In addition, we recommend the LLC operating agreement allow the Manager to alter the default rule of proportionate allocation of profits, losses, and distributions among members. The LLC operating agreement should permit the Manager to make special allocations and disproportionate distributions to the members. Otherwise, in the event one member were in danger of losing his, her, or its share of the distribution to a creditor, then none of the other members would be able to receive a distribution for their share of Distributable Cash or tax obligations as a result of their respective ownership in the LLC. With an LLC it is possible, for instance, to permit a member that holds a 60% of percentage interest in the LLC to be allocated 100% of the LLC's profits or losses over a period of time.

Accordingly, consideration should be given to a distribution provision similar to the following:

From time to time, the manager may in the manager's discretion distribute Distributable Cash to the Members on a pro rata or non-pro rata basis, as the Manager deems advisable. If the Manager elects a non-pro rata distribution, such distributions shall be taken into account in re-determining the Capital Account of each Member at the end of the Company's fiscal year.

Notwithstanding anything to the contrary herein, the Manager is not obligated to make any mandatory distributions to the Members, even though each Member will be taxed on its ratable share of Company income (whether or not such income is distributed).

No Right to Demand Return of Capital. No Member has any right to any return of capital or other distribution except as expressly provided in this Agreement.

It is important to note, if the Manager makes a non-pro-rata distribution to the Members, such distributions will not be respected for tax purposes if they lack "substantial economic effect." IRC §704(b)(2); Treas. Reg. §1.704-1(b)(1)(I). Substantial economic effect requires that two tests be satisfied: (1) the allocation must have economic effect, and (2) the economic effect must be substantial. Treas. Reg. § 1.704-1(b)(2)(I).

The first test is satisfied if there is an "economic burden that corresponds to an allocation, the partner to whom an allocation is made must . . . bear such economic burden." Treas. Reg. § 1.704-1(b)(2)(ii)(a).

The second test is commonly referred to as the "substantiality requirement." This test is satisfied if "the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." Treas. Reg. § 1.704-1(b)(2)(iii)(a).

In short, the allocation must have economic effect and the allocation must be substantial. The Treasury Regulations provide a safe harbor set of requirements which if followed permit non-pro-rata distributions. The Safe Harbor provisions are as follows:

1. The LLC Operating Agreement must satisfy basic requirements for economic effect. IRC§ 704(b) and Treas. Reg. §1.704-2(e)(1).
2. In year that nonrecourse deductions first arise, allocations must be reasonably consistent with valid allocations of other LLC items. Treas. Reg. § 1.704-2(e)(2).
3. The LLC Operating Agreement must contain "minimum charge back" provisions. Treas. Reg. §§ 1.704-2(f)(c) and 1.704-2(e)(3).
4. All other material allocations and capital account adjustments must be valid. IRC §§ 704(b)&(c); Treas. Reg.§ 1.704-2(e)(4))

The LLC operating agreement shall further provide that:

i. The LLC will maintain capital accounts for its members in strict compliance with tax rules;

ii. The LLC will make liquidating distributions in accordance with capital accounts;

iii. Members in liquidation who have deficits in their capital accounts will restore those deficits to the LLC; and

iv The LLC will make minimum charge backs with respect to their interest in LLC nonrecourse debt.

The Regulations provide an “alternate test” that we generally use to maintain compliance with IRC §704(b) which is to include a qualified income offset provision in the LLC operating agreement. Treas. Reg. §1.704-1(b)(2)(ii)(d). Below is an example of the tax allocation provisions often included in LLC operating agreements designed to satisfy the safe harbor for economic effect including use of the alternate test. These regulations and Code Sections must be reviewed independently and often, operating agreement section references are for illustrative purposes only.

Section 3. Special Allocations. Notwithstanding Section 6.1 and 6.2:

A. Allocations of Distributions. Reserved.

B. Minimum Gain Chargeback. If there is a net decrease in Company Minimum Gain during any Fiscal Year, each Member shall be specially allocated items of Company income and gain for such Fiscal Year (and, if necessary, in subsequent fiscal years) in an amount equal to the portion of such Member's share of the net decrease in Company Minimum Gain that is allocable to the disposition of Company property subject to a Nonrecourse Liability, which share of such net decrease shall be determined in accordance with Regulations Section 1.704-2(g)(2). Allocations pursuant to this Section 6.3B shall be made in proportion to the amounts required to be allocated to each Member under this Section 6.3B. The items to be so allocated shall be determined in accordance with Regulations Section 1.704-2(f). This Section 6.3B is intended to comply with the minimum gain chargeback requirement contained in Regulations Section 1.704-2(f) and shall be interpreted consistently therewith.

C. Chargeback of Minimum Gain Attributable to Member Nonrecourse Debt . If there is a net decrease in Company Minimum Gain attributable to a Member Nonrecourse Debt, during any Fiscal Year, each member who has a share of the Company Minimum Gain attributable to such Member Nonrecourse Debt (which share shall be determined in accordance with Regulations Section 1.704-2(i)(5)) shall be specially allocated items of Company income and gain for such Fiscal Year (and, if necessary, in subsequent Fiscal Years) in an amount equal to that portion of such Member's share of the net decrease in Company Minimum Gain attributable to such Member Nonrecourse Debt that is allocable to the disposition of Company property subject to such Member Nonrecourse Debt (which share of such net decrease shall be determined in accordance with Regulations Section 1.704-2(i)(5)). Allocations pursuant to this Section 6.3C shall be made in proportion to the amounts required to be allocated to each Member under this Section 6.3C. The items to be so allocated shall be determined in accordance with Regulations Section 1.704-2(i)(4). This Section 6.3C is intended to comply with the minimum gain chargeback requirement contained in Regulations Section 1.704-2(i)(4) and shall be interpreted consistently therewith.

D. Nonrecourse Deductions. Any nonrecourse deductions (as defined in Regulations Section 1.704-2(b)(1)) for any Fiscal Year or other period shall be specially allocated to the Members in proportion to their Percentage Interests.

E. Member Nonrecourse Deductions. Those items of Company loss, deduction, or Code Section 705(a)(2)(B) expenditures which are attributable to Member Nonrecourse Debt for any Fiscal Year or other period shall be specially allocated to the Member who bears the economic risk of loss with respect to the Member Nonrecourse Debt to which such items are attributable in accordance with Regulations Section 1.704-2(i).

F. Qualified Income Offset. If a Member unexpectedly receives any adjustments, allocations, or distributions described in Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5) or (6), or any other event creates a deficit balance in such Member's Capital Account in excess of such Member's share of Company Minimum Gain, items of Company income and gain shall be specially allocated to such Member in an amount and manner sufficient to eliminate such excess deficit balance as quickly as possible. Any special allocations of items of income and gain pursuant to this Section 6.3F shall be taken into account in computing subsequent allocations of income and gain pursuant to this Article VI so that the net amount of any item so allocated and the income, gain, and losses allocated to each Member pursuant to this Article VI to the extent possible, shall be equal to the net amount that would have been allocated to each such Member pursuant to the provisions of this Section 6.3F if such unexpected adjustments, allocations, or distributions had not occurred.

6.4 Code Section 704(c) Tax Allocations. Notwithstanding any other provision in this Article VI, in accordance with Code Section 704(c) and the Regulations promulgated thereunder, income, gain, loss, and deduction with respect to any property contributed to the capital of the Company shall, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of such property to the Company for federal income tax purposes and its fair market value on the date of contribution. Allocations pursuant to this Section 6.4 are solely for purposes of federal, state and local taxes. As such, they shall not affect or in any way be taken into account in computing a Member's Capital Account or share of profits, losses, or other items of distributions pursuant to any provision of this Agreement.

6.5 Code Section 754 Adjustments. To the extent an adjustment to the adjusted tax basis of any Company asset under Code Sections 734(b) or 743(b) is required to be taken into account in determining Capital Accounts under Regulations Section 1.704-1(b)(2)(iv)(m), the amount of the adjustment to the Capital Accounts will be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases the basis), and the gain or loss will be specially allocated to the Members in a manner consistent with the manner in which their Capital Accounts are required to be adjusted under Regulations Section 1.704-1(b)(2)(iv)(m).

6.6 Curative Allocations. The allocations set forth in Section 6.3 B-F (the "Regulatory Allocations") are intended to comply with certain requirements of Regulations Sections 1.704-1(b) and 1.704-2. The Regulatory Allocations may effect results which would be inconsistent with the manner in which the Members intend to divide Company distributions. Accordingly, the Manager is authorized to divide other allocations of Profits, Losses, and other items among the Members, to the extent that they exist, so that the net amount of the Regulatory Allocations and the special allocations to each Member is zero. The Manager will have discretion to accomplish this result in any reasonable manner that is consistent with Code Section 704 and the related Regulations.

The LLC Agreement should provide in its section on dissolution something to the effect:

9.5 Distributions on Liquidation Upon dissolution of the Company, the business of the Company shall be wound up, the Manager shall take full account of the Company assets and liabilities, and all assets shall be liquidated as promptly as is consistent with obtaining the fair value thereof. If any assets are not sold, gain or loss shall be allocated to the Members in accordance with Article VI, as if such assets had been sold at their fair market value at the time of the liquidation. If any assets are distributed to a Member, rather than sold, the distribution shall be treated as a distribution equal to the fair market value of the assets at the time of the liquidation. Upon liquidation, the assets of the Company shall be applied and distributed in the following order of priority:

a. To the payment of all debts and liabilities of the Company, including any loans or advances that may have been made by the Members to the Company, in the order of priority as provided by law;

b. To the establishment of any reserves deemed necessary by the Manager or the Person winding up the affairs of the Company for any contingent liabilities or obligations of the Company;

c. To the Members, ratably in proportion to the credit balances in their respective Capital Accounts, in an amount equal to the aggregate credit balances in the Capital Accounts after and including all allocations to the Members under Article VI, including the allocation of any income, gain or loss from the sale, exchange or other disposition (including a deemed sale pursuant to this Section 9.5) of the Company's assets; and

d. To the Members in proportion to their respective Percentage Interests.

B. POISON PILL PROVISIONS.

To further provide liability protection to the LLC and its members who are free of creditors, the LLC operating agreement should contain a provision which would permit its Manager to redeem any LLC Units lost or threatened to be lost to a creditor, and at a substantially reduced price. This is commonly referred to as a “poison pill” provision designed to intercept and frustrate the creditor of a member from attaching the troubled member’s interest in the LLC. This is especially important in states where judicial foreclosure may be an alternative remedy to a charging order. In many states, a charging order is the exclusive remedy to a creditor of a member of an LLC with respect to the LLC. The charging order provides such creditor the right to distributions that would otherwise have been paid to that member. However, the judgment creditor does not get the right to manage the LLC or vote the LLC Units of the applicable member. Further, the creditor will have no right to compel distributions from the LLC. The creditor is only entitled to receive distributions from the LLC when the Manager declares and makes distributions to the applicable member. If the manager holds the distributable cash or other assets of the Company in reserve, there is no distribution for the creditor to attach.

In some states, a judge can order the charging order to be foreclosed, forcing the charged membership interest to be sold to the judgment creditor. Foreclosing on a charging order makes the judgment creditor the permanent owner of the economic right. The creditor may then liquidate its right by selling it in the market place. Alternatively, many jurisdictions, including Delaware, Minnesota and Nevada, provide in their LLC Acts that charging orders are the exclusive remedy of a judgment creditor of a member, thus preventing foreclosure of charging orders.

To avoid situations where a creditor may foreclose on a Member's LLC Units or otherwise receive distributions from the LLC, we recommend the LLC operating agreement include poison pill provisions. For instance, the operating agreement could provide that when LLC Units are "charged" by a "charging order" the LLC has the right, but not the obligation, to redeem them for $________ or a percentage of their last determined value.

It is important to note, while the poison pill may protect the LLC and its other members, the troubled member receives only nominal benefit to its application. The other members percentage interest in the LLC is augmented for a nominal amount and the LLC is free of the creditor. The troubled member remains liable to the creditor for the outstanding amount due on its judgment and is out of the LLC. The LLC, its members, and the former troubled member need to respect the form of the poison pill transaction. Side agreements or "understandings" may give creditors the gumption to challenge the validity of the poison pill.

A sample poison pill clause reads as follows:

Involuntary Transfer of a Membership Interest. A creditor's charging order or lien on a Member's Membership Interest, bankruptcy of a Member, or other involuntary transfer of Member's Membership Interest, shall constitute a material breach of this Agreement by such Member. The creditor, transferee or other claimant, shall only have the rights of an Assignee, and shall have no right to become a Member, or to participate in the management of the business and affairs of the Company as a Member or Manager under any circumstances, and shall be entitled only to receive the share of profits and losses, and the return of capital, to which the Member would otherwise have been entitled. The Manager, including a Manager whose interest is the subject of the charging order, lien, bankruptcy, or involuntary transfer, may elect, by written notice to the Members and the creditor, transferee or other claimant, at any time, to purchase all or any part of Membership Interest that was the subject of the creditor's charging order, lien, bankruptcy, or other involuntary transfer, at a price of $_________________. The Members agree that such valuation is a good-faith attempt at fixing the value of the interest, after taking into account that the Membership Interest does not include all of the rights of a Member or Manager, and after deducting damages connected therewith and that are due to the material breach of this Agreement.

C. MEMBERSHIP TRANSFER RESTRICTIONS.

We recommend the LLC operating agreement restrict a member's ability to freely transfer or assign its interest in the LLC. It is oftentimes important to owner's of closely held businesses to know who their co-owners are and will be in the future. Such restrictions are not only important for the smooth ordinary course of daily business but also for the company's long term success and continuity. Specifically, the following provisions should be considered for incorporation into any LLC operating agreement:

Restrict Assignment of Governance Rights. Provide a restriction on the assignment of LLC membership interests. A membership interest may be assigned, but such assignment should not include governance rights. To transfer both the financial and governance rights of a membership interest, a member will be required to comply with restrictions on transfer and the LLC operating agreement should further require the managers' consent to the transfer.

Require Consent to Transfers. Before a transfer of a membership interest is acknowledged, the LLC operating agreement should set forth whose consent is required; i.e. all of the Members, a percentage of Members, and/or the Manager's consent.

Provide for a Right of first refusal. The LLC and/or other members should have the right for a specific amount of time to match any third party offer to acquire a transferring member's membership interest.

Carve Outs / Permitted transfers. Members can agree to carve out and permit certain transactions from the transfer restrictions contained in the LLC operating agreement. Often times these carve outs are to trusts, family members, other member of the LLC, and controlled entities or affiliates of a member.

Optional Purchase Rights. Certain events (such as death, disability, divorce, bankruptcy, termination of employment) may create an opportunity, but not the requirement for the LLC or the other members to purchase such a member's membership interest in the LLC. (or a right to the member to be bought out by the company or other members). If the operating agreement has buyout provisions, it is important to describe the procedure of how such buyout will take place, the buyout price and the payout terms (can be over time or perhaps from the proceeds of a key man life insurance).

Purchase Price Determination. The purchase price (and the timing of the payment thereof) of the membership interests should be provided for in the LLC operating agreement. Sometimes that is by annual valuation of the LLC, agreement of the members, book value, or by appraisal.

Bring Along and Tag Along Rights. Bring along rights permit the majority member(s) in selling all membership interests to achieve the highest sale price of the LLC and tag along rights permit minority members from being left out of a sale of the LLC. In each case, each member generally receives the same purchase price per LLC Unit.

The following is a sample restriction on transfer section. Note, the poison pill described above could be incorporated into this section.

ARTICLE VII
TRANSFER OF INTERESTS

7.1 Generally. No Member shall be entitled to transfer, assign, gift, convey, sell, encumber or in any way alienate all or any part of his, her or its Membership Interest (collectively, "transfer") except as permitted under this Section 7. A Member may assign the Member's full Membership Interest only by assigning all of the Member's Governance Rights coupled with a simultaneous assignment to the same assignee of all of the Member's Financial Rights, and only if the transfer of both are permitted under this Section 7.

7.2 Transfer of Interests. A Person may freely transfer all or any portion of such Person's Membership Interest, including Governance Rights and/or Financial Rights, whether by sale, gift, devise, or distribution; the death, withdrawal, bankruptcy, divorce, separation, dissolution or termination of such Person; or otherwise (collectively, "transfer"), subject to the restrictions set forth in this Agreement. The transferor of all or any such portion of such Membership Interest shall continue to be a Member of the Company to the extent such transferor retains a Membership Interest having Governance Rights, but shall cease to be the owner of the Governance Rights and/or Financial Rights transferred.

7.3 Pledge Prohibition. No Member shall pledge or encumber a Membership Interest or otherwise subject a Membership Interest to a security interest; provided, however, that this prohibition shall not apply to a security interest securing an obligation to or of the Company (i.e. pursuant to a guarantee by a Member) or a pledge to secure payment for a Membership Interest.

7.4 Options Upon Voluntary Transfer. Notwithstanding any other provision in this Agreement, no Person owning a Membership Interest having Governance Rights and/or Financial Rights shall voluntarily transfer such Membership Interests during such Person's lifetime (except to a Member already party to this Agreement or in trust for the primary benefit of such Person, and upon such transfer the Membership Interests shall remain subject to this Agreement), such Person is referred to as a "Transferor" in this Section 7.4, unless notice shall first have been given to the Company and each Member, as hereinafter provided, for the purpose of commencing the period within which the Company or the Members may purchase such Membership Interest in accordance with this Article. Such notice to the Company and the Members shall be in writing, shall state the number of

Units proposed to be disposed of, the amount of any consideration offered, the payment terms, a copy of all relevant proposed agreements with the proposed transferee, and the name of the bona-fide proposed transferee. Such notice to the Company and the Members shall be delivered personally or be deposited in the United States mail in a sealed envelope with first class mail postage prepaid thereon, addressed to the Chief Managers of the Company at the principal office of the Company with regard to notice given to the Company, and addressed to each of the Members at each of their respective mailing addresses as reflected in the required records of the Company with regard to notice given to the Members.

The Company shall first have an option to purchase such Membership Interest, in whole but not in part, at any time within 90 days after the date of receipt of such notice, at the price and on the other terms provided in this Article. The Company's option shall be exercised by delivery of written notice to the Transferor within the above-prescribed period.

In the event that the Company does not exercise its option to purchase such Membership Interest, each Member (other than the Transferor) shall then have an option to purchase such Membership Interest, in whole but not in part, at any time within 15 days after the expiration of the Company's option to purchase such Membership Interest, at a price and on such other terms as provided in this Article. The Members' option shall be exercised by delivery of written notice to the Transferor within the above-prescribed period. If more than one Member exercises the Members' option to purchase such Membership Interest pursuant to this Section 7.4, each Member exercising such Members' option shall purchase such Membership Interests pro rata based upon a fraction, the numerator of which is such Member's percentage of Membership Interest in the Company, and the denominator of which is the total of the percentages of Membership Interest in the Company of the Members exercising the Members' option to purchase such Membership Interest pursuant to this Section 7.4. Any transfer to be made after the expiration of the Members' option to purchase such Membership Interest must be made within an additional period of three months; otherwise, requisite notice to the Company and each Member must be given again.

7.5 Requirements or Options Upon Involuntary Transfer.

7.5.1 Reserved.

7.5.2 Other Involuntary Transfers. Any other involuntary transfer of a Membership Interest including where the Member dies but the Company does not own life insurance on such Member or where the Member is adjudicated bankrupt or has a judgment entered against such Member and execution is levied thereon or encumbers such Member's Membership Interest and such Membership Interest is foreclosed upon or sold pursuant to the collateral agreement, or in the case of an entity the Member is dissolved or terminated (an "Involuntary Transfer Event") (such Member also is referred to as a "Transferor" in this Section 7.5.2), the Company shall first have an option to purchase all but not part of the Membership Interest owned by such Member as of the date of the Involuntary Transfer Event. The Company's option shall be exercisable at any time for a period of 90 days after the later of (i) the occurrence of an Involuntary Transfer Event, and (ii) the date that the Company has actual notice of the Involuntary Transfer Event. The Company's option shall be exercised by delivery of written notice to the Transferor within the above-prescribed period.

In the event that the Company does not exercise its option to purchase such Membership Interest, each Member (other than the Transferor) shall then have an option to purchase such Membership Interest, in whole but not in part, at any time within 90 days after the expiration of the Company's option to purchase such Membership Interest, at a price and on such other terms as provided in this Article. The Members' option shall be exercised by delivery of written notice to the Transferor within the above-prescribed period. If more than one Member exercises the Members' option to purchase such Membership Interest pursuant to this Section 7.4, each Member exercising such Members' option shall purchase such Membership Interests pro rata based upon a fraction, the numerator of which is such Member's percentage of Membership Interest in the Company, and the denominator of which is the total of the percentages of Membership Interest in the Company of the Members exercising the Members' option to purchase such Membership Interest pursuant to this Section 7.5.

7.6 Exercise of Options. The options granted to the Company by Sections 7.4 and 7.5.2 of this Article shall be exercised by delivery of written notice of the exercise, signed by the Managers of the Company (or, in the event of a purchase by a Member, signed by such Member), to the seller(s) of the Membership Interest. All questions and issues required to be addressed by the Company in connection with the Company exercising any options in this Article and the calculation of payment of the purchase price as provided in this Article shall be made by the Managers. If the seller(s) is a Manager, such seller(s) shall vote in the same manner as a majority of the other Managers may vote. If any question or issue is for any reason submitted to a vote of the Members, the seller(s) of such Membership Interest having Governance Rights entitled to vote shall vote in the same manner as a majority of the other Members owning a majority of Units having Governance Rights entitled to vote.

7.7 Determination of Purchase Price. If an option contained in Article 7 is exercised, the purchase price for the entire Membership Interest of such seller(s) shall be determined as follows:

7.7.1 Governance Rights Only. If the Membership Interest being purchased has only Governance Rights and no Financial Rights, the purchase price for all of such Membership Interest shall be $1.

7.7.2 Financial Rights. If the Membership Interest being purchased has Financial Rights and Governance Rights or only Financial Rights, the purchase price shall be determined by multiplying the number of the seller's Units having Financial Rights by the purchase price per Unit determined as follows.

7.8 Value of Unit. The purchase price per Unit shall be determined as follows:

7.8.1 Agreed Value. The purchase price per Unit shall be that which is then agreed upon by the Transferor and the Company or the Members (as the case may be, and in any case, individually or collectively, the “Buyer”) (the “Agreed Value”). If the Transferor and the Buyer do not agree upon such value within thirty (30) days following the date on which the event giving rise to the purchase option is exercised, the purchase price per Unit shall be determined in the manner provided in the following subsection 7.8.2.

7.8.2 Offered Price vs. Appraised Value. If the Transferor and the Buyer cannot agree on the purchase price per Unit as provided in Section 7.8.1, or if the event giving rise to the purchase option is described in Section 7.5, then the Buyer shall have the option of purchasing the Transferor’s Units for the lesser of (i) the offered price as described in the notice described in Section 7.4, if applicable; or (b) the Appraised Value determined as follows (the “Appraised Value”). For a period of fifteen (15) days following expiration of the period specified in Section 7.8.1, the Transferor and the Buyer shall attempt to mutually agree upon an Appraiser. If the parties agree upon the identity of the Appraiser, the Appraiser shall determine the fair market value excluding any discounts per Unit, and the value determined by such Appraiser shall be the Appraised Value. If the parties are not able to reach agreement within such fifteen (15) day period, each shall identify an Appraiser and the Appraisers identified by the Transferor and Buyer shall select a third Appraiser. The purchase price per Unit determined by each of the three Appraisers shall be averaged to determine the Appraised Value. If the parties agree on the Appraiser or if a third Appraiser is selected, the costs and expense of such Appraiser or third Appraiser (as the case may be) shall be paid one-half by the Transferor and one-half by the Buyer. The parties shall be responsible for the costs and expense of their own Appraisers, respectively. If either the Transferor or the Buyer fail to designate their own Appraiser as set forth herein, or if the Transferor’s and the Buyer’s Appraisers cannot agree on a third Appraiser, the third Appraiser or the Appraiser not selected by Transferor or Buyer (as the case may be) shall, upon petition, be selected by the Chief Judge of the District Court for the County in which the Company then has its registered office. In determining the purchase price per Unit, the Appraisers shall take into account and consideration any bona-fide offer received by any Member pursuant to Section 7.4 (if applicable).

7.9 Payment of Purchase Price. The Buyer shall pay the entire purchase price in cash within ninety (90) days after the earlier of the (i) date of the Transferor’s and the Buyer’s Agreed Value pursuant to Section 7.8.1, or (ii) date of the decision of the Appraised Value pursuant to Section 7.8.2.

7.10 Transferee is an Assignee. Notwithstanding anything otherwise provided herein, the transferee of the Governance Rights and Financial Rights or only Governance Rights may be admitted as a Member only upon the written approval of the Manager and subject to execution of an addendum to this Agreement pursuant to which the transferee agrees to be bound by the terms and conditions hereof. If such transferee has not been admitted as a Member, then such transferee shall be considered an assignee but in no event a Member, and shall have no right to become a Member, or to participate in the management of the business and affairs of the Company as a Member or Manager under any circumstances, and shall be entitled only to receive the share of profits and losses, and the return of capital, to which the transferor would otherwise have been entitled.

D. COMPETING ACTIVITIES.

In the event a Member's interest is charged or a similar threat occurs against a Member, consideration should be given to permitting any and each Member the right to freely pursue activities outside of the LLC without the risk of being considered disloyal or otherwise in breach of a fiduciary duty to the LLC. This may be particularly important if the charged LLC needs to "park" its activities for a while.

A sample clause would be:

<u>Competing Activities</u>. The Managers, Officers, and the Members and their officers, directors, shareholders, partners, members, managers, agents, employees and Affiliates may engage or invest in, independently or with others, any business activity of any type or description, including without limitation those that might be the same as or similar to the Company's business and that might be in direct or indirect competition with the Company. Neither the Company nor any Member shall have any right in or to such other ventures or activities or to the income or proceeds derived therefrom. The Managers, Officers, or Members shall not be obligated to present any investment opportunity or prospective economic advantage to the Company, even if the opportunity is of the character that, if presented to the Company, could be taken by the Company. The Managers, Officers, and Members shall have the right to hold any investment opportunity or prospective economic advantage for their own account or to recommend such opportunity to Persons other than the Company. Each Member acknowledges that the Managers, Officers, and other Members and their Affiliates own and/or manage other businesses, including businesses that may compete with the Company and for their time. Each Member hereby waives any and all rights and claims which they may otherwise have against the Managers, Officers, and other Members and their officers, directors, shareholders, partners, members, managers, agents, employees, and Affiliates as a result of any of such activities.

E. MANDATORY CAPITAL CONTRIBUTION

Another important feature of an LLC operating agreement tailored to liability protection is an affirmative prohibition against a creditor from calling for a mandatory capital contribution, presumably to solve for its judgment. Likewise, a mandatory capital contribution called for by the Manager of the LLC may force a creditor to contribute funds into the LLC which has no plans to make a distribution. If the creditor fails to make the contribution, its percentage interest will be reduced. We recommend consideration be given to providing only the Manager of the LLC may call for additional capital contributions.

Capital Call. The Managers may, from time to time, require additional Capital Contributions of the Member or of an Assignee of a Member (a "Capital Call"), and the Member or the Assignee of a Member, as applicable, shall be required to make any such additional Capital Contributions. Upon a Capital Call, the Chief Manager shall notify the Members (or the Assignee of a Member) of the amount of funds required, the use and purpose of such funds, and the Member's or the Assignee's of a Member, required contribution amount. The Members or the Assignee of a Member shall be obligated to contribute such capital and shall fund the amount called for within 15 business days after the Capital Call notice is given. In the event a Member or the Assignee of a Member declines to make an additional capital contribution in response to a Capital Call as described in this Section ___, then the other Members (or the Assignee of a Member) may make additional capital contributions up to the amount the non-contributing Member or the Assignee of a non-contributing Member elected not to contribute, on a pro-rata basis in accordance with the Percentage Interest of each Member (or the Assignee of a Member) electing to make such additional capital contribution. Immediately following such Capital Contributions, the Percentage Interests shall be adjusted by the Manager to reflect the new relative proportions of the Capital Accounts of the Members (or the Assignee of a Member) and thereafter each Member's (or the Assignee's of a Member) Percentage Interest shall be a fraction, the numerator of which represents the aggregate amount of such Member's (or the Assignee's of a Member) Capital Contributions and the denominator of which represents the sum of all Members' (or the Assignee's of a Member) Capital Contribution.

Another derivative of a capital call is akin to, for lack of a better word, an equity protection technique to virtually cash-strap an LLC member. For instance, two investors form a LLC to operate a stable but capital intensive company. Each member delivers to the LLC a subscription agreement which creates a legal obligation of the members to contribute capital to the LLC, upon demand of the Manager, so the LLC may conduct its business. The first member would contribute seed capital to get the LLC up and running, in return for a small percentage interest in the LLC (i.e. 1%-5%). The other second member would subscribe to provide a significant capital contribution as demanded, in return for an initial large percentage interest in the company (95% to 99 %, for instance). Because the first member contributed his, her or its capital upon formation, but the second member was not required to do so, the LLC would place a lien on certain pieces of the second member's property to ensure that the second member fulfills his, her or its obligation to capitalize the LLC upon the Manager’s demand. As long as the LLC is not considered an insider under any applicable fraudulent transfer law and the obligation is valid, its fulfillment demonstrable, and it makes sense in a business context, a lien against the second member's personal assets is duly created. As a result, this lien may actually discourage any future creditors of the second member from taking aggressive action as they would be behind the LLC in priority.

Under this approach, the Manager of the LLC could make a good faith capital call, and enforce the second member’s subscription method for several reasons including, as applicable:

(i) Purchasing equipment, inventory, or parts.

(ii) Purchasing the stock or assets of a business to compliment the LLC.

(iii) Contribute loans or capital to the LLC’s vendors or consumers.

(iv) Fund employee retirement or profit-sharing plans.

(v) Satisfying in full all commercial loans of the LLC.

(vi) Establish reserves for business purposes or to satisfy bank covenants.

(vii) Satisfy surety bond or similar third party requirements.

F. REMOVAL OF MANAGER.

The LLC operating agreement should provide a very high threshold for removal of the Manager of the LLC. We recommend consideration first be given as to determining specific criteria that could trigger the right to remove a Manager. Often that involves matters such as the Manger committing bad acts or being convicted of crimes; the Manager intentionally violating the terms of the LLC operating agreement and unable or unwilling to cure any breach; or the Manager’s death, disability, bankruptcy or dissolution (if an entity). Liability protection planning requires a balance between not providing the Manager with too much control to the point where a creditor could challenge the Manager and the LLC are one and the same on an alter ego theory; but still providing enough control to the Manager to achieve the objectives of the members.

Next, in the event a removal event occurred, the procedure for removing and appointing a successor manager should be set forth. Often times the bar is set very high (even to the point of requiring unanimous consent) but we recommend a super majority of voting interest it the LLC be sufficient to remove and replace a manager.

An example of such a provision follows.

C. <u>Removal of Manager</u>. A Manager, or any successor Manager may be removed as Manager by a Voting Interest of the Members only under the following circumstances (a "Removal Event"):

(i) The Manager: (1) knowingly, intentionally and deliberately misapplies any funds derived from the Company, including insurance proceeds and condemnation awards, (2) is charged and convicted by any governmental entity or authority with any felony or any other criminal act involving fraud, or (3) intentionally takes or causes to be taken action constituting a Major Decision under this Agreement without any required approval of the other Manager which is not reasonably cured or reversed within sixty (60) days after written notice to such Manager setting forth in detail the circumstances of the alleged action of the Manager constituting a Major Decision; or

(ii) The death, Disability, Bankruptcy, or Dissolution of the Manager.

Upon the occurrence of a Removal Event, a Voting Interest of the Members may immediately remove such Manager as a manager of the Company, and appoint a successor Manager of the Company.

G. PARTITION OF ASSETS

A LLC operating agreement should provide for the waiver of an action for partition. Since an LLC is a legal entity, it has the power to own property and other assets. Accordingly, such property belongs to the LLC and not its individual members (or the creditor of a member). The operating agreement of an asset protection based LLC should be drafted to address property interests or ownership rights in the LLC. Holding ownership interests in an LLC is much easier and more efficient than holding fractional interests in real property. The LLC operating agreement should facilitate the member's indirect ownership interests in real property without the fear of a partition action by a wayward member or the creditor of a member. Therefore we recommend including a provision similar to the following in the LLC operating agreement.

Waiver of Action for Partition. Each Member irrevocably waives during the term of the Company any right that he, she or it may have to maintain any action for partition with respect to the property of the Company.

H. RIGHTS OF MEMBERS IN BANKRUPTCY

The restrictions on a creditor under the several LLC acts may also be applicable under a federal bankruptcy proceeding. It must be noted, though, federal bankruptcy judges have other options, techniques, and powers that other courts do not necessarily have within their arsenal. Moreover, the bankruptcy code does not contain specific provisions that apply to LLCs. This creates non-uniform application of facts and law amongst the bankruptcy court decisions. An exhaustive commentary on the rights of the LLC and its debtor member in bankruptcy is beyond the scope of this outline. Below is a review of some key premises to consider in the event of a bankruptcy of a LLC member.

The LLC operating agreement may be considered an "executory contract" in bankruptcy when "the obligation of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." See *In re Robert L. Helms Constr. and Dev. Co., Inc*, 139 F.3d 702 (9th Cir. 1998). The Bankruptcy Code § 365(e)(2) provides that a trustee in bankruptcy may not assume or assign an "executory contract" if applicable law excuses a party, other than the debtor, to the contract from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not the contract prohibits or restricts assignment of rights or delegation of duty, and the other party does not consent to such assumption or assignment. Therefore, if an LLC operating agreement were determined to be an "executory contract," teh trustee in bankruptcy should then step in the shoes of any other creditor of the LLC debtor member and be subject to the same terms and conditions of the transfer prohibitions provided in the LLC operating agreement.

The trustee appointed by the bankruptcy court can, under the federal bankruptcy code, exercise powers over the debtor's interests in an executory contract. The trustee in bankruptcy may argue the bankruptcy code gives the trustee the right to step in the shoes of the debtor member before the filing of bankruptcy. Thus, in a state where the LLC statute provides a charging order as an exclusive remedy, then the trustee in bankruptcy should only have the same rights as a creditor with a charging order. This result could work to prevent the bankruptcy trustee from attempting to influence management rights, sale rights, or other privileges of a member in good standing.

Unfortunately, because of a lack of direct provisions in the bankruptcy code to address LLCs, we cannot definitively opine whether a bankruptcy court would accept this interpretation.

Accordingly, the drafting of expulsion provisions in an LLC warrants consideration. Such a provision could provide the other members the option to expel a member who files for bankruptcy. The impact of a successfully expulsion would terminate a member from the LLC, and in theory, forever release the remaining members and the LLC from the bankruptcy and the reach of the trustee of the bankruptcy estate.

The expulsion clause could be tailored so that the value of the expelled member's interest is substantially reduced, an attempt to further dissuade the trustee in bankruptcy from contesting the position that the LLC's operating agreement is an executory contract. Like a "poison pill", these provisions provide the debtor member little relief and as such the expulsion provision should be discussed with the LLC members during the creation of the LLC operating agreement. It must further be pointed out, bankruptcy courts are all over the map with respect to the expulsion rights of the LLC compared to the rights of the trustee in bankruptcy to step into the shoes of the debtor member. Having said that, the most security one may find with the validity of expulsion provisions in bankruptcy would be within a state that provides a charging order as an exclusive remedy to a creditor of a LLC member.

An example of an expulsion provision is below.

1.1 OPTIONAL DISSOCIATION UPON MEMBER BANKRUPTCY

The other members shall have the option to dissociate a member if:

(a) The member files for bankruptcy or any similar relief; or

(b) One or more creditors of the member file a petition to have the member declared bankrupt or any similar petition and this petition is not dismissed within 60 days after being filed; and

(c) The non-bankrupt members reasonably determine that the dissociation is in the LLC's best interest.

LLC'S as Tax Planning Vehicles

Submitted by Nathan J. Nelson

III. LLC'S AS TAX PLANNING VEHICLES

A. PARTNERSHIP TAXATION VS. CORPORATE TAXATION

For purposes of this Outline, we will presume for comparison purposes the LLC we describe is a two member LLC, subject to default tax classification as a partnership (that is it is neither a disregarded entity taxed as a sole proprietorship nor did its members elect to be taxed as a S or C corporation). Single-member LLCs that choose to be taxed as a sole proprietorship treat business income as personal income to the member. The member reports business income and expenses on Schedule C of his individual income tax return. Whatever is left over after paying taxes belongs to the member, and the member can distribute the profit out of the business in the member's sole discretion.

I. <u>Single level of taxation compared to Double Taxation</u>.

LLC's are pass-through entities for tax purposes. That is, the LLC itself pays no income taxes on its earnings and profits. Instead, all of an LLC's profits and losses are passed down to its members and reportable on their respective individual tax returns.

Corporations are actual legal entities separate and distinct for tax purposes from their shareholders. Corporations are required to file state and federal tax returns and C corporations must pay income taxes on their profits. This is the trigger to double taxation. The C corporation first pays income tax at its tax rates on its income. When the C corporation distributes such profits to its shareholders, the shareholders must report the distributions (dividends) on their individual tax returns.

In many instances, a small corporation can elect a "S corporation tax treatment" and avoid tax at the corporate level and instead pass the profits and losses down to its shareholders much like, but not identical to an LLC.

II. Timing and Character of Distributions.

A member of an LLC or a S corporation is taxed on his, her or its share of income whether or not the profits are distributed. Shareholders of a C corporation are not taxed on their dividends until they are distributed.

Unlike an LLC, S – corporations may only have certain persons or certain wholly owned entities as shareholders; all distributions must be pro-rata, and S corporations may only have one class of stock (though differences in voting are permitted if the shares are otherwise identical in every material way).

A substantial advantage an LLC has over a C corporation is the fact LLC members who actively participate in the business may deduct the LLC's operating losses on their personal tax return to offset other personal income. C corporation shareholders are not able to deduct the corporation's losses. S corporation shareholders may, however, subject to the same participation requirements as LLC members and different basis rules and regulations, offset S corporations loss against personal income..

The LLC has other tax advantages over S corporations. For instance, (i) an LLC can make non-pro-rata distributions and special allocations of profits and losses amongst its members; (ii) its members receive basis in LLC borrowings, (iii) all contributions of property to an LLC are tax free, even for non-controlling members; and (iv) distributions of property out of an LLC are generally not taxed until sold (cash and "hot assets" excepted).

III. Payroll Taxes.

LLC members are not considered employees of the LLC, and thus, their share of the profit is not subject to social security or Medicare tax. However, LLC members who actively work in the business are required to pay self-employment taxes on their income (including salary and their share of any LLC profits). The rules are different for corporations. For corporations, only the shareholder's salaries are subject to social security and Medicare taxes. Any profit distribution to the shareholders isn't subject to these taxes.

With thoughtful planning, shareholders of corporations can allocate the corporation's profits in such a manner to take advantage of lower income tax brackets or to avoid imposition of certain employment taxes.

For instance, if a corporation generated $85,000 in profits for the year, the shareholders could pay out a percentage in salary (and thus subject to employment taxes) and take the balance out as a dividend or distribution (subject to income taxes but, if respected, outside of employment taxes). The IRS scrutinizes shareholder owner salaries.

IV. Employee Benefits.

In terms of employer provided perks and fringe benefits, there are some key differences between an LLC and a corporation.

Certain retirement plans, stock option and employee stock purchase plans are only available for C corporations. In addition, LLC members (as well as S corporation shareholders who own more than 2 percent of the business) are required to pay taxes on certain employee benefits like health benefits, employer contributions to HSAs or FSAs, life insurance benefits, and parking. Shareholders of a C corporation do not have to pay taxes on these fringe benefits.

B. TAXATION OF SINGLE MEMBER LLC'S

Single member LLCs generally receive unfortunate treatment with respect to the impact of charging orders. Creditors often times successfully advance the position that charging order protection should not be extended to single member LLCs because there are no other members to protect from the creditor.

Even though the several LLC Acts make no distinction between single member and multi-member LLCs, courts generally do not extend the same protection as multi-member LLCs. While there is not a lot of case law on this issue and almost no case law to proclaim that charging order protection should not extend to single member LLCs, it is considered good practice to encourage clients who wish to take advantage of charging order protection to form multi-member LLCs or add new members to existing single member LLCs. The new members would need to have some percentage interest in the LLC, how large is uncertain, but even a small interest would support the argument for limitation (or in many states the exclusive remedy) of creditors to charging orders.

The addition of more than one member to an LLC will increase administrative expenses and cause partnership (or corporate, if elected) taxation and filing requirements.

C. SPOUSAL PARTNERSHIP TAXATION

An unincorporated business jointly owned by a married couple is generally classified as a partnership for Federal tax purposes. For tax years beginning after December 31, 2006, the Small Business and Work Opportunity Tax Act of 2007 (Public Law 110-28) provides that a "qualified joint venture," whose only members are a husband and a wife filing a joint return, can elect not to be treated as a partnership for Federal tax purposes. However, we do not recommend this election as only businesses that are owned and operated by spouses as co-owners (and not in the name of a state law entity, such as a LLC) qualify for the election. Thus, the married couple would have to conduct business as a sole proprietorship without a liability shield.

In a community property state, such as Arizona, if the only members of an LLC are a married couple, the spouses' interest in the LLC would generally be considered community property, and 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 likely be able to charge the LLC interests of both spouses. In this scenario, the creditor would argue there is no non-debtor member to protect with the charging order. In such an instance, the couple would be advised to 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 a family member.

See Rev. Proc. 2002-69, 2002-2 C.B. 831, for special rules applicable to spouses in state law entities in community property states.

D. ENSURING TAX STRUCTURES PROTECT AGAINST CHARGING ORDERS

To best position the LLC for charging order protection, the LLC should have multiple members and follow the default rule of partnership taxation. If the LLC has only one member, the debtor member's creditors will likely avoid the exclusive remedy of a charging order since there would be no innocent LLC members to protect.

Many states LLC laws follow the Revised Uniform Limited Liability Company Act (RULLCA) and passed rules preventing foreclosure of an owner's interest and forced liquidation of the LLC to satisfy a personal liability of a debtor member. The unfavorable outcome that can occur in a corporation--forced dissolution--cannot occur in the LLC because a creditor with a charging order does not become a member of the LLC and, accordingly, the creditor has no rights to insert itself as a member of the LLC or otherwise order a distribution or liquidation.

However, not all states follow the RULLCA view with respect to LLC interests. Some are likely to follow the general partnership rules and take the "liquidation view," under which the creditor can, in fact, foreclose on the partnership interest. In short, the creditor can force a liquidation of the partnership, so that the partner's personal debt can be paid from his or her share of the liquidated assets. Note that the Uniform Limited Liability Company Act, which has been adopted in some states, reflects the general partnership view or allowsforeclosure upon a showing that distributions under a charging order would not pay the judgment debt within a reasonable time

The following states have LLC statutes that prohibit foreclosure and liquidation: Arizona, Arkansas, Connecticut, Delaware, , Idaho, Illinois, Louisiana, Maryland, Minnesota, Nevada, New Jersey, Oklahoma, Rhode Island, and Virginia.

For asset protection purposes, owners of LLC should consider organizing their LLC in one of the states just mentioned, even if that is not the state where the LLC will be conducting its business. In these states, the protection afforded to the LLC, against the claims of any personal creditors, is codified or otherwise well recognized. Note that, under the LLC statutes in the states listed above, courts are not given the power to make any orders, except the exclusive remedy of a charging order. Before organizing in any state, the applicable statute should be examined to make certain no changes occurred.

Because a person can obtain liability protection from one’s personal creditors for assets owned by a multi-member LLC, some business owners will be tempted to convert substantial assets into business assets and contribute them to the LLC. Placing assets within a LLC can provide significant protection from the claims of the member's personal creditors where a charging order is the creditor’s exclusive remedy.

However, the benefits of this approach may be short lived if the LLC suffers a business loss. Businesses are much more likely to face a substantial business liability or judgment than a member is to be burdened with personally. The LLC's property, as opposed to the member's personal assets outside of the LLC, are typically at the greatest risk of loss, which means this strategy could actually increases the risk of loss. A preferred strategy would be to own two LLC’s or businesses with a multi-member LLC, taxed as a partnership, acting as a holding company or equipment leasing company. Under this approach, both the business assets and the member’s individual assets may be protected assets against the claims of creditors because of the charging order being the creditor’s exclusive remedy. Of course, care should be taken and the advice of practicing attorneys should be solicited before any of these techniques are considered or even implemented.

Charging Orders
The Peculiar Mechanism

Submitted by Jay D. Adkisson

Charging Orders

The Peculiar Mechanism

Jay D. Adkisson[1]

Jay D. Adkisson

Contents

[1] The author thanks San Francisco attorney Gerald V. Niesar of NIESAR & VESTAL LLP for his very valuable contributions to this paper.

CHRONOLOGY OF THE ACTS

Acronym	Title	Ch.Ord.§
UKPA 1890	Partnership Act of 1890 (U.K.)	§ 23
UPA 1914	Uniform Partnership Act of 1914	§ 28
RUPA 1997	Uniform Partnership Act (Revised) of 1994 (amended 1997)	§ 504
ULPA 1916	Uniform Limited Partnership Act of 1916	§ 22
RULPA 1976	Uniform Limited Partnership Act (Revised) of 1976	§ 703
ULPA 2001	Uniform Limited Partnership Act of 2001	§ 703
ULLCA 1996	Uniform Limited Liability Company Act of 1996	§ 504
RULLCA 2006	Uniform Limited Liability Company Act (Revised) of 2006	§ 503

HISTORY OF THE "PECULIAR MECHANISM"[2]

The Charging Order is an oddity of American law, sometimes rarely appearing in old opinions pre-dating World War I to address odd situations in garnishment law,

[2] *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) (contrasting "standard execution procedures rather than the peculiar mechanism of the charging order which is subject both to the broad discretion of the trial court and to redemption by the debtor").

but now almost exclusively found in the law of partnerships, and more recently LLCs. Yet, in that area, the Charging Order has taken on a life and aurora of its own, with some states racing each other to have the "best" Charging Order provisions, so as to foster the entity formation and registered agents businesses within those states. Creditors meanwhile, while of course describing the "race" in less than flattering terms, have been developing their own strategies for defeating or circumventing the much-ballyhooed "exclusivity" of the Charging Order remedy.

To understand why this unique remedy even exists, and why it has graced or cursed the area of partnership and LLC law, we must retrace the history of Anglo-American law to where a fork in the road developed in how each country would handle security interests that were created by creditor claims.

The Lien was not a part of the English Common Law. Instead, it was first suggested in 1791 as a "Mechanic's Lien" by Thomas Jefferson as a means to further the construction of the District of Columbia. After adoption by the Maryland legislature that same year, thereafter the concept quickly spread to other states.3 The concept was not a particularly new one; the Romans had centuries before developed the concept of the *obligare rem*, by which a creditor took an interest in a *pignus* (the object of a security interest) to secure a debt. The Roman security interest had survived into the Civil Law of the continental European states, of which the francophile attorney Jefferson was likely aware.

Now we have materialman's liens, tax liens, mortgage liens, attorney's liens, mineral liens, maritime liens, warehouser's liens, HOA liens, municipal liens, UCC liens, judgment liens (of which the Charging Order Lien is but one), the list goes on and on. Thanks to our Third President, America has become the land of the Free and the Brave, and the Lien.

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[3] See generally Charles Emmett Davison, THE MECHANICS LIEN LAW OF ILLINOIS: A LAWYER'S BRIEF UPON THE TOPIC (1922).

While America went the way of the Lien, the United Kingdom instead adopted the notion of the Charging Order to the same effect. That a debtor's interest in shares of stock could be "charged" was formalized in the first two Acts of Queen Victoria.

JUDGMENTS ACT 1838 C. 110 (REGNAL. 1 & 2 VICTORIA)

> XIV Stock and Shares in Public Funds and Public Companies belonging to the Debtor, and standing in his own Name, to be charged by Order of a Judge.
>
> And be it enacted, That if any Person against whom any Judgment shall have been entered up in any of Her , Majesty's Superior Courts at Westminster shall have any Government Stock, Funds, or Annuities, or any Stock or Shares of or in any Public Company in England (whether incorporated or not), standing in his Name in his own Right, or in the Name of any Person in Trust for him, it shall be lawful for a Judge of one of the Superior Courts, on the Application of any Judgment Creditor, to order that such Stock, Funds, Annuities, or Shares, or such of them or such Part thereof respectively as he shall think fit, shall stand charged with the Payment of the Amount for which Judgment shall have been so recovered, and Interest thereon, and such Order shall entitle the Judgment Creditor to all such Remedies as he would have been entitled to if such Charge had been made in his Favour by the Judgment Debtor, provided that no Proceedings shall be taken to have the Benefit of such Charge until after the Expiration of Six Calendar Months from the Date of such Order.

Thus, under U.K. law, the method for a judgment creditor to create and maintain a legal interest on the debtor's property was through the vehicle of the Charging Order. When the U.K. codified its partnership law in 1890, the Charging Order was thus the natural and accepted method of achieving that end.

PARTNERSHIP ACT OF 1890 C. 39 (REGNAL. 53 & 54 VICTORIA)

> 23 Procedure against partnership property for a partner's separate judgment debt
>
> (1)After the commencement of this Act a writ of execution shall not issue against any partnership property except on a judgment against the firm.
>
> (2)The High Court, or a judge thereof, or the Chancery Court of the county palatine of Lancaster, or a county court, may, on the application by summons of any judgment creditor of a partner, make an order charging that partner's interest in the partnership property and profits with payment of the amount of the judgment

> debt and interest thereon, and may by the same or a subsequent order appoint a receiver of that partner's share of profits (whether already declared or accruing), and of any other money which may be coming to him in respect of the partnership, and direct all accounts and inquiries, and give all other orders and directions which might have been directed or given if the charge had been made in favour of the judgment creditor by the partner, or which the circumstances of the case may require.
>
> (3)The other partner or partners shall be at liberty at any time to redeem the interest charged, or in case of a sale being directed, to purchase the same.
>
> (4)This section shall apply in the case of a cost-book company as if the company were a partnership within the meaning of this Act.
>
> (5)This section shall not apply to Scotland.[4]

It would be incorrect to pretend that America had totally ignored the concept of the Charging Order. In *Cross v. Brown*, 19 R.I. 220 (1895), and *Hunter v. Strider's Adm'x*, 41 W.Va. 321 (1895), we find a pair of opinions where charging orders were used to enforce Writs of Garnishment. But, by and large, the procedure was an oddity that was employed in unusual circumstances where no clear remedy existed, and in such a rare case to borrow the concept of the Charging Order from the East side of the Atlantic seemed as good an idea as any other.

The point is that the Charging Order was not wholly alien[5] to American law when it came time for the U.S. to codify its own partnership laws. The Uniform Laws Commission, which at that time had a slavish adoration for the Law Commission in England that bordered on the embarrassing, borrowed heavily from the U.K.'s Partnership Act of 1890, including the concept of the Charging Order,[6] even though

[4] For those curious as to why Scotland was excluded, we find further up in the Partnership Act of 1890 that:

> 4 Meaning of firm.
>
> (2) In Scotland a firm is a legal person distinct from the partners of whom it is composed, but an individual partner may be charged on a decree or diligence directed against the firm, and on payment of the debts is entitled to relief pro ratâ from the firm and its other members.

[5] But see *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("In the United States . . . the 'charging order' procedure was a complete innovation . . ..")

[6] *City of Arkansas City v. Anderson*, 752 P.2d 673 (Kan. 1988) ("[T]he charging order came into being as a part of the English Partnership Act of 1890 [that] was the model for section 28 of the Uniform Partnership Act, which is quite comparable to the original English version.").

the rest of American law had largely chosen and had already been following for just short of a Century, the different path of the Lien beginning in 1791.

Thus, in the Charging Order we unfortunately ended up with an English remedy to accomplish what should have been done directly and simply through an American Lien. The unexplained rumblings heard by the drafters of the Uniform Partnership Act of 1914, was Jefferson rolling in his grave.

UNIFORM PARTNERSHIP ACT OF 1914

> § 28. Partner's Interest Subject to Charging Order
>
> (1) On due application to a competent court by any judgment creditor of a partner, the court which entered the judgment, order, or decree, or any other court, may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts and inquiries which the debtor partner might have made, or which the circumstances of the case may require.
>
> (2) The interest charged may be redeemed at any time before foreclosure, or in case of a sale being directed by the court may be purchased without thereby causing a dissolution:
>
> (a) With separate property, by any one or more of the partners, or
>
> (b) With partnership property, by any one or more of the partners with the consent of all the partners whose interests are not so charged or sold.
>
> (3) Nothing in this act shall be held to deprive a partner of his right, if any, under the exemption laws, as regards his interest in the partnership.

By contrast, the Limited Partnership was first introduced into American law by New York's Limited Partnership Act of 1822, which was itself based on the French *société en commandite* (Jefferson would have been proud). Predictably, since the Charging Order was an English invention, New York's innovation had no charging order provision.[7] Although the Limited Partnership was alien to the English

[7] The author has been unable to identify how creditors of "special partners" (as limited partners were then referred to under the New York LPA and its progeny) were treated prior to the adoption of the ULPA in 1916.

partnership law upon which the UPA of 1914 was based, when the Uniform Law Commission adopted the ULPA in 1916, section 28 providing for the English remedy of the Charging Order was engrafted into the ULPA, apparently to conform the two Acts.

We then wait some 14 years after the 1914 adoption of the UPA before an appellate court finally is presented with a case involving a Charging Order arising under the UPA, the opinion being that in *Rader v. Goldoff*, 223 A.D. 455, 228 N.YS. 453 (N.Y.Super.App.Div., 1928). There the creditor of a partner had obtained an injunction that compelled a bank to freeze partnership assets until they could be executed upon by the creditor. The injunction was vacated, with the Court blandly reciting that the Charging Order provision of New York's UPA must be followed, and also awarding the debtor $10 in costs.

Soon thereafter, the California Court of Appeal then took up the challenge in *Sherwood v. Jackson*, 8 P.2d 943, 121 Cal.App. 354 (1932), and considered the case of one partner who had sued, and obtained a personal injury judgment against the other partner -- and then tried to dissolve the partnership so as to enforce the judgment against the debtor-partner's share of the assets. The California panel nixed this attempt, holding (based upon the New York holding in *Rader*) that the creditor-partner's exclusive remedy was the Charging Order procedure.

The California experience is important to us, for in 1946 it brings us *Hensley v. Popkin,* 171 P.2d 916, 75 Cal.App.2d 852 (1946), which appears to the first opinion to address the effect of a Charging Order as creating not only a Lien on the debtor-partners' interest, but a Lien that was subject to priority as any other Lien. It also brings us *Ribero v. Callaway*, 196 P.2d 109, 87 Cal.App.2d 135 (1948), which recognized the right of the non-debtor partners to appeal a charging order, so as to assert their defense that the debtor whose interest was charged was never actually a partner at all; they lost on the merits.

For nearly 50 years following the New York decision in *Rader*, New York and California case law, often playing off each other's opinions, would dominate the area of charging orders, those states producing nearly as many opinions on the topic as the rest of the states combined.

A Tropical Interlude

Located in the South Pacific, in the vast peaceful ocean somewhat between Hawaii and New Zealand, lie the Cook Islands. First named the Hervy Islands by the famed British explorer who would chance upon them in 1773, and then renamed the Cooks in his honor by an obscure Russian cartographer in 1820, the 15 sparsely populated islands would appear to be a most unlikely candidate for the massive tremor that it was to ultimately generate in the American law of Charging Orders. Even less likely, the tremor would be initiated by a Denver lawyer who was then about as well-known as the Russian cartographer.

As a Protectorate of New Zealand, which itself is a Commonwealth Country, the Cook Islands follow English law, with the highest court of appeals being the Privy Counsel in London. In 1984, looking for sources of revenue other than the occasional National Geographic reader, the Cook Islands enacted their International Trust Law by which they sought trust business from around the globe. There were few takers.

Then, in 1989, Denver lawyer Barry S. Engel persuaded the Cook Islands' Parliament, such as it was in a territory having less than 40,000 inhabitants, to amend the International Trust Law so as to include certain provisions that were very unfriendly to creditors. The settlor-beneficiary of a self-settled trust was given protection as to her beneficial interest, a concept which had to that point been anathema on public policy grounds throughout Anglo-American jurisprudence since at least the reign of Elizabeth. Other features were built in to the ITA to deter creditors from even attempting to challenge a trust formed in the Cook Islands a trust that was formed there, and to make the even mere attempt at a challenge horrendously expensive.

Thus, the fledgling industry known today as "asset protection planning" was given birth, and a few, and then many U.S. tax and estate planning practitioners jumped on the concept as a way of increasing practice revenues. In 1989, there was not a single practitioner nationwide who was listed in Martindale-Hubbel as practicing in the area of asset protection; today, those lawyers hanging out that shingle as one of their practice areas number in the tens-of-thousands. Barry Engel thus forever cemented his legacy as the true "Father of Asset Protection", though not just a few hucksters would later take the title for themselves to try to impress their unfortunate clients.

The effect on American trust law has been similarly dramatic, with Alaska passing the first "Domestic Asset Protection Legislation" in 1997, followed closely on its heels by Delaware later that same year, and as of this writing there are now 15 states that provide some level protection to the settlor-beneficiary of self-settled trusts. The drama would not be confined to trusts.

One of the first beneficiaries, or victim some might lament, of the asset protection craze was the little known Charging Order. Ignoring that the purpose of the Charging Order was to protect the non-debtor partners from being forced into an involuntary partnership with somebody's creditor under the Most Exalted and All Holy[8] *Pick-Your-Partner Principle* that has characterized partnership law since the adoption of the UPA in 1914, asset protection planners quickly realized that these provisions could also be used (or misused, depending on one's point of view) by the debtor-partner to prevent creditors from accessing the debtor-partner's assets that

[8] As if nobody was getting together to do deals before the UPA was adopted in 1914.

had been contributed to the partnership.

Thus, the massive tremor spawned in the Cook Islands now hit partnership law as well -- partnerships would henceforth be formed not just to facilitate commercial enterprises, but would also be formed as the family piggy-bank, and thus the "Family Limited Partnership", originally conceived as an estate planning tax-shelter to take advantage of limited partnership interest discounts, gained its asset protection teeth.

Meanwhile, back in the more mundane area of ordinary business planning, other changes were taking place that would bring partnership law to its current footing.

THE KAISER WILLIAM INVADES WYOMING

If the Cook Islands were an unlikely place for a sea change in trust law, then Wyoming was as an unlikely candidate for a dramatic change in partnership or corporate law. Long known as the place one has to pass through to reach Yellowstone, probably few Americans can name the capital of the state (it is Cheyenne), though in 1977 the state's Devil's Tower briefly became popular for the final scenes in Steven Spielberg's Close Encounters of the Third Kind.

But that year, something else was happening in Wyoming; something that also had its genesis in the reign of Victoria.

Just as America borrowed heavily from the English Partnership Act of 1890, so did the fledgling German Empire of Kaiser William II,[9] though ordinarily following the civil law, borrow heavily from his cousin Queen Victoria's Companies Act of 1862, to create the limited liability company known as the *Gesellschaft mit beschränkter Haftung*, or more popularly and pronounceably its acronym "GmbH".

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[9] Father of the ill-fated Wilhelm who would lead Germany to defeat and financial ruin in the Great War.

The German LLC in the form of the GmbH became, and remains, quite popular, as any owner of an auto manufactured by "BMW GmbH" might attest.

While the U.S. of course had long before adopted limited partnership legislation, that "statutory bastard"[10] suffered from the necessity of having general partners that were generally liable for the debts of the partnership; further, LPs carried various and sometimes undesirable baggage from their partnership heritage.

Thus, in 1977, Wyoming took the plunge and adopted the first LLC act -- and then watched the new entity languish because nobody really knew how it might be treated for tax purposes. Guidance from the IRS had proclaimed that LLC would be taxed as partnerships for tax purposes if the "four factors" test was satisfied. But, it was not until December 18, 1996, when the IRS issued its simplified Check-The-Box regulations to be effective on January 1, 1997,[11] that life was breathed into the LLC.

It couldn't have come at a better time, as the asset protection industry started in the Cook Islands was beginning to break into the mainstream, and Family Limited Partnerships had already become a popular estate planning tool. Now we had an entity that could taxed as either a partnership or corporation, did not require a general partner that was generally liable, did not drag along most of the baggage of partnership law, and was (in theory) easy to manage -- and it had Charging Order protection too.

The Check-The-Box regulations paved the way for the success of the LLC, and indeed in anticipation of those regulations, the Uniform Law Commission had been working on a new Uniform Limited Liability Company Act, which was adopted

[10] *Green v. Bellerive Condominiums LP*., 135 Md.App. 563, 763 A.2d 252 (2000) ("[W]e have characterized a charging order against a limited partnership interest as 'nothing more than a legislative means of providing a creditor some means of getting at a debtor's ill-defined interest in a statutory bastard, surnamed `partnership,' but corporately protecting participants by limiting their liability as are corporate shareholders.'" quoting *Bank of Bethesda v. Koch*, 44 Md. App. 350, 354 (1979)).

[11] 26 CFR 301.7701-2 and 301.7701-3.

in 1996. The ULLCA was revised a decade later to give us the RULLCA that we know today.

THE UNIFORM LIMITED LIABILITY COMPANY ACT (REVISED) 2006

SECTION 503. CHARGING ORDER.

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale obtains only the transferable interest, does not thereby become a member, and is subject to Section 502.

(d) At any time before foreclosure under subsection (c), the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) This [act] does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.

(g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of

> judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.

The Prefatory Note to RULLCA pays appropriate homage to its roots:

> Charging Orders: The charging order mechanism: (i) dates back to the 1914 Uniform Partnership Act and the English Partnership Act of 1890; and (ii) is an essential part of the "pick your partner" approach that is fundamental to the law of unincorporated businesses. The new Act continues the charging order mechanism, but modernizes the statutory language so that the language (and its protections against outside interference in an LLC's activities) can be readily understood.

For reasons largely having to do with perception from a competitive viewpoint, i.e., "We had better make our Charging Order provisions more attractive than those of other states, else we might lose formation business at home," various states have (often irrationally) enacted their own, unique Charging Order provisions. Thus, the sleepy and unusual Charging Order, for which historically there has been little use or controversy, has recently -- with the rise of "asset protection planning" as a popular planning area -- taken on an energetic life of its own.

THE PURPOSE OF THE CHARGING ORDER

To understand the Charging Order, we must first understand what happens when a creditor gets a judgment against a corporate shareholder. A creditor who wins a judgment against the shareholder of a corporation can enforce it by levying on the stock. This means that the Sheriff goes to the shareholder and makes the shareholder turn over the physical share certificates to the Sheriff. Or, if the shareholder refuses to cough up the shares, or if they have never actually been issued, the corporation can be forced to issue new shares to the Sheriff. The shares are then auctioned off by the Sheriff to whoever bids for them.

Sometimes, if no good cash bid has been made by a third-party buyer, the creditor will itself acquire the shares at the auction by bidding part of the creditor's judgment against the shares, what is known as "credit bidding". If the shares are publicly-traded, the creditor can then sell the shares at the market trading price. If the shares are privately-held and the creditor acquires a majority share, the creditor can vote to wind-up the company, and thus access the debtor's share of the company's value.

The benefit of corporations is that they typically have three levels of control that separate the investors from the day-to-day management of the business. First, the Shareholders have a vote, and their vote can make major changes to the Articles and Bylaws of the corporation, as well as elect the Directors. Second, the Directors have a vote, and can make significant decisions on behalf of the corporation, and elect the Officers. Third, the Officers are empowered to run the corporation on a daily basis, and make significant decisions subject to the ratification or approval of the Directors.

Importantly, the Shareholders are divorced from day-to-day decisions. A change in the composition of Shareholders may not immediately affect the operations of the business. The Shareholders will have to wait until their meeting to elect new Directors, and only if new Directors are elected are the Officers likely to change. If the new Creditor-Shareholder holds less than a majority stake, then the business may not change at all. If, for instance, a Creditor levies upon the Debtor's 100 shares in Microsoft Corporation, which had of this writing a paltry 8.26 billion issued and outstanding shares, it is unlikely that there will be many long faces in Redmond.

Contrast[12] this with a partnership or LLC where the owners of business are

[12] *Green v. Bellerive Condominiums LP*, 135 Md.App. 563, 763 A.2d 252 (2000) (Charging orders "are purely statutory tools that judgment creditors use to reach partnership interests of indebted partners * * *[W]e have characterized a charging order against a limited partnership interest as 'nothing more than a legislative means of providing a creditor some means of getting at a debtor's ill-defined interest in a statutory bastard, surnamed 'partnership,' but corporately protecting participants by limiting their liability as are corporate shareholders.'" *quoting Bank of Bethesda v. Koch*, 44 Md. App. 350, 354 (1979)).

usually active in the business. The partners have agreed among themselves that they -- and only they -- will run the business, and their partnership agreement prohibits new partners without unanimous consent. A change of a partner could have a dramatic, and very negative, effect upon the chemistry of the partnership. If Microsoft were a partnership, even a partner holding a 0.01% interest could presumably come into its offices and start tinkering with its Operating System.

Thus, partnerships are treated differently than corporations for judgment collection purposes. The purchaser of corporate shares at a judicial sale will not immediately be able to jump into the management of the company and disrupt its operations. Not so with a partnership, which lacks the legal separation of ownership and management.

A creditor who holds a judgment against a partner in a partnership (or a member in an LLC) is not normally allowed to take the debtor's interest. Instead, the creditor is allowed to take a Lien against the debtor's interest so that any profit distributions that would have been made to the debtor will instead be made to the creditor. It is here that we should realize that a partner's or member's "interest" is in fact really a bundle of several different rights and privileges within the partnership or LLC, or which the right to distributions is just one.[13]

The legal vehicle by which the Lien is placed on the debtor's distributive rights is the Charging Order, which exists primarily to prevent a creditor's enforcement action from disrupting the business of the partnership. The explanation given by the Court in *Taylor v. S & M Lamp Co.,* 190 Cal. App. 2d 700, 12 Cal. Rptr. 323 (1961),

[13] *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991) ("[A] partner's right in specific partnership property is different from his interest in the partnership. The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management. . . . A partner's interest in the partnership is his share of the profits and surplus, and the same is personal property."); *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 35 Conn. App. 81, 1994.CT.11663, 644 A.2d 363 (Conn.App. 1994) ("The partner's interest in the partnership is one of three property rights the partner possesses; the others are the partner's rights in specific partnership property and the right to participate in partnership management.").

is most helpful:

> Lord Justice Lindley gave the following reason for the English rule forbidding execution sale of a partner's interest in the partnership to satisfy his nonpartnership debt:
>
> "When a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a *fiery facias*, and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and caused the execution creditor to bring an action in Chancery in order to get an injunction to take an account and pay over that which was due the execution debtor. A more clumsy method of proceeding could hardly have grown up." (28 Wash. L. Rev. 1; see also 9 Cal. L. Rev. 117.)
>
> It was to prevent such "hold up" of the partnership business and the consequent injustice done the other partners resulting from execution against partnership property that the [California Charging Order] code sections and their counterparts in the Uniform Partnership Act and the English Partnership Act of 1890 were adopted. As we view those code sections they are not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served.[14]

[14] *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("A charging order is the statutory means by which a judgment creditor may reach the partnership interest of a judgment debtor. * * * Prior to its availability, the courts would resort to common law procedures for collection that were ill-suited for reaching partnership interests. * * * Typically, despite the fact that individual partners do not have title in partnership property, partnership property would be seized under writs of execution; the debtor partner's interest in the partnership would be sold, often to the judgment creditor, subject to the payment of partnership debts and prior claims of the partnership against the debtor partner; and the sale of the debtor partner's interest would result in compulsory dissolution and winding up of the partnership. The charging order [is a] solution to this procedural nightmare."); *Green v. Bellerive Condominiums LP,* 135 Md.App. 563, 763 A.2d 252 (2000) ("Charging orders originated as a statutory solution to cumbersome common law collection procedures that were ill-suited for reaching partnership interests."); *Heron v. Kelley West Santa Clara Assoc*., Unpublished No. H024719 (Cal.App. Dist.6 2003) ("[P]rior to California's adoption of the Uniform Partnership Act (Corp. Code, § 15001 et seq., repealed 1996), *fn4 a judgment creditor of a partner whose personal debt gave rise to the judgment could satisfy that judgment by means of an execution levy on partnership assets. That procedure . . . was severely criticized for the "consequent injustice done [to] the other partners resulting from execution against partnership property." (*Taylor v. S & M Lamp Co.* (1961) 190 Cal.App.2d 700, 708.) In response, California adopted the Uniform Partnership Act. To reach a judgment debtor's partnership interests now, the judgment creditor must obtain a court order charging such interests with the amount of the judgment. Thus, "charging orders on partnership interests have replaced levies of execution as the remedy for reaching such interests." (*Baum v. Baum* (1959) 51 Cal.2d 610, 612-613.)"); *Madison Hills Limited Partnership II v. Madison Hills, Inc*., 35 Conn. App. 81, 1994.CT.11663, 644 A.2d 363 (Conn.App. 1994) ("The charging order replaced levies of execution as the remedy for reaching the interest of a partner."); *Windom Nat'l Bank v. Klein*, 254 N.W. 602, 191 Minn. 447 (Minn. 1934) ("Even before the uniform act came into our law, we held that 'the attempted transfer by one partner of his individual interest could not in any manner affect or prejudice any use or disposal of this partnership asset for the legitimate purpose of paying or securing partnership debts.' *National Citizens Bank v. McKinley*, 129 Minn. 481, 485, 152 N.W. 879, 880. The statute goes further and to the extent just stated.").

The purpose of the Charging Order remedy, and its exclusivity as a remedy under RULLCA § 503(g) and the other partnership acts, is to prevent disruption of the partnership's business[15] by keeping the creditor from otherwise enforcing the judgment directly against the debtor-partner's share of the assets,[16] and to prevent a forced "business divorce".[17] It is not meant to protect the debtor-partner's interests,[18] but rather protects the non-debtor partners[19] from being forced into what amounts to

[15] Baybank v. Catamount Construction, 141 N.H. 780, 693 A.2d 1163 (1997) ("The statutory remedy of a charging order was designed to prevent the personal creditors of a limited partner from disrupting the partnership business by seizing partnership assets on execution."); Lauer Construction Inc. v. Schrift, 123 Md.App. 112, 716 A.2d 1096 (1998) (Purpose of charging order "is to protect the partnership business and prevent the disruption that would result if creditors of a partner executed directly on partnership assets."); Nigri v. Lotz, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("The apparent purpose of prohibiting the sale and transfer of a partner's charged interest under the UPA was the fear that it could cause disruption because the creditor-assignee may be able to seek judicial dissolution of the partnership.").

16 Baybank v. Catamount Construction, 141 N.H. 780, 693 A.2d 1163 (1997) ("Such an application of partnership property to pay the personal debts of a partner, however, is precisely what the charging order provisions of the ULPA and the UPA are intended to prevent."); Windom Nat'l Bank v. Klein, 254 N.W. 602, 191 Minn. 447 (Minn. 1934) ("Plain is the purpose that all partnership property is to be kept intact for partnership purposes and creditors."); Keeler v. Academy of American Franciscan History, Inc., 178 Md.App. 648, 943 A.2d 630 (2008) ("The purpose of the charging order is "to protect the partnership business and prevent the disruption that would result if creditors of a partner executed directly on partnership assets."); *Shinn v. Vaughn*, 83 Ore.App. 251, 730 P.2d 1290 (Ore.App. 1986) ("A partner does not own a proportional part of specific partnership property . . .. The value of a partner's interest in specific partnership property is reflected in his 'interest in the partnership,' which is his interest in profits and surplus. * * * Although a partner's interest in profits and surplus is personal property . . . and freely transferable, an interest in specific partnership property 'is not assignable except in connection with the assignment of the rights of all of the partners in the same property.'"); *Beach Park Associates v. Heron*, Unpublished No. H023320 (Cal.App. Dist.6, Aug. 25, 2003) (Neither partnership assets nor personal assets of the partners would be disgorged to satisfy charging order); *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo.App. 1999) ("[C]reditors may not attach or otherwise encumber partnership property to satisfy a partner's individual debt."); *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("The charging order remedy entitles the creditor to receive the profits and surplus of the limited partnership, which the limited partner would otherwise have been entitled to receive, up to the unsatisfied amount of the judgment debt, but gives no direct remedy against specific limited partnership property. "); *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991) ("A partner's right in specific partnership property is not subject to enforcement of a money judgment, except on a claim against the partnership . . ..").

17 *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) (purpose of charging order is not to permit court to facilitate or force upon a debtor a "business divorce").

18 *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991) (Charging order remedy exists to prevent interference in partnership business or with partnership assets to detriment of non-debtor partners, but is not meant to protect interest of debtor partner.)

19 *Union Colony Bank v. United Bank of Greeley Nat'l Assoc*., 832 P.2d 1112 (Colo. 1992) (Charging order "remedy arose in response to the unique issues which confront partnerships, specifically the need to protect the interests of the non-debtor partners."); *Christensen v. Oedekoven*, 888 P2d 228 (Wyo.App. 1995) ("The charging order procedure protects the interests of the nondebtor partners by giving the judge wide latitude to control the creditor's actions against the partnership.").

an involuntary partnership with somebody's creditor.[20]

THE EFFECT OF A CHARGING ORDER

In U.K. law, the Charging Order was the end in itself -- the debtor's interest in the partnership was "charged" with the payment of distributions to the creditor until the debt was satisfied. But in the U.S., the method is different, even if the ultimate result is nearly the same. Under American law, the issuance of a Charging Order has the effect of involuntarily creating a security interest in favor of the creditor, by a Lien on the debtor's right to distributions that requires the LLC to make all future distributions to the creditor[21] until the judgment is satisfied.[22]

One might think of a Charging Order as an aerosol can that sprays the Lien upon the debtor-member's interest, much in the manner that a child might spray-

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20 *Brant v. Krilich*, 835 N.E.2d 582 (Ind.App. 2005) ("[U]nless the operating agreement provides otherwise, an assignee only becomes a member of an LLC if the other members unanimously consent. There is no reason why our courts should disregard the intent of the General Assembly to protect the close-knit structure of a LLC and violate the other members' interests and rights by declaring that they must accept a judgment creditor of a member into full membership with all the rights appurtenant thereto when the judgment debtor could not transfer those rights himself.")

[21] *City of Arkansas City v. Anderson*, 752 P.2d 673 (Kan. 1988) ("[W]e hold that the issuance and service of a proper charging order is sufficient to require the partnership to pay the judgment debtor's share of distributable partnership profits to the judgment creditor or to the court to await further orders of the court."); *Beach Park Associates v. Heron*, Unpublished No. H023320 (Cal.App. Dist.6, Aug. 25, 2003) (Charging orders required each partnership to pay to appellant "any and all income, revenues, distributions, compensation, fees, repayment of debt, or personal property, tangible or intangible, or [sic] whatever sort or nature, that have, at any time from the date of service of the notice of motion herein on the respective partnerships or thereafter, become due, payable, or distributable to any one or more of the judgment debtors, or as to which any one or more of the judgment debtors has become entitled . . .."); *Zavodnick v. Leven*, 340 N.J.Super. 94, 773 A.2d 1170 (2001) ("On due application to a competent court by any judgment creditor of a partner, the court which entered the judgment, order or decree, or any other court, may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts and inquiries which the debtor partner might have made, or which the circumstances of the case may require."); *Keeler v. Academy of American Franciscan History, Inc*., 178 Md.App. 648, 943 A.2d 630 (2008) (Charging Order upheld order requiring that partnership "shall sequester and pay over to the Judgment Creditor all distributions of any kind whatsoever otherwise payable to the Judgment Debtor . . . and to account for said payments to this Court and to the Judgment Creditor, until such time as the judgment entered against the Judgment Debtor has been paid in full and satisfied....").

[22] *Beach Park Associates v. Heron*, Unpublished No. H023320 (Cal.App. Dist.6, Aug. 25, 2003) (Amounts collected from charged partnership interests are credited against the underlying judgment, and in no case would holder of charging order be permitted to collect more than underlying judgment, plus interest, etc.); *City of Arkansas City v. Anderson*, 752 P.2d 673 (Kan. 1988) ("[T]he extent of [payments made pursuant to a charging order] is limited to any amounts due on the unsatisfied judgment.").

paint their bicycle a different color. In the end, it is the paint (the Lien) that is important and lasting, and the Charging Order itself is of as little consequence as the empty can once it has accomplished its task -- with one critically important exception.

The exception does not relate to the Lien, but rather to ancillary provisions in the Charging Order that help to make it truly effective. The typical Charging Order will not just place the lien, but will also command that the debtor-member may not take any loans, salary,[23] fees, etc., or any other actions that would get moneys out of the LLC through the backdoor and thus defeat the Charging Order.

As a matter of procedure, a creditor is not required to throw in these other provisions, but instead could bring a separate Motion for an Order In Aid Of Execution or the like, but it is so much easier to simply bundle these provisions into the Charging Order. This is the (possibly sole) benefit to the creditor of the Charging Order procedure.

Some states follow the California Model, by which the mere filing of a Motion for Charging Order, and service upon the LLC or its members, creates a temporary lien on the debtor-member's interest. The lien then becomes permanent lien until the Judgment is paid once the Motion is granted. *See* California Code of Civil Procedure § 708.320. In states which do not follow the California Model, a creditor must file a Motion for TRO or Preliminary Injunction, etc., to attempt to tie up the debtor-member's distributions pending the hearing on the Motion for Charging Order.

The Lien created by the Charging Order must be accorded priority like any other judgment lien.[24]

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[23] Gerry Niesar pointed out in his editing of the draft of this paper that because a Charging Order only applies to transferrable interests, that it might not reach the salary or wages of the debtor-member at all, and the creditor would instead be required to employ the remedy of garnishment as to such compensation. The author is unaware of any case that addressed this ingenious and possibly novel argument, but cannot presently conceive of an argument as to why it might be incorrect.

[24] *City of Arkansas City v. Anderson*, 752 P.2d 673 (Kan. 1988) ("[A] valid charging order does create a lien upon the

That the creditor who has successfully obtained a Charging Order ends up with a Lien, and only a Lien (although there may be some ancillary provisions to effectuate the Lien in the text of the Charging Order), has certain ramifications, the most important of which is that -- like any other ordinary[25] Lienholder -- the Creditor does not gain any management rights within the LLC.[26] Some decisions have likewise held that the Lien created by the Charging Order does not independently create any right of a creditor to demand information about the LLCs operations and affairs,[27] although a wily creditor may be able to figure out some other method to ferret out this information.

debtor partner's distributive share of present and future profits as of the time of service upon the partnership. The lien or charge thus established has priority over other security interests which are not perfected prior to the date of service of the charging order."); *Union Colony Bank v. United Bank of Greeley Nat'l Assoc.*, 832 P.2d 1112 (Colo. 1992) ("[L]ien [created by the charging order] attaches at the time the order is served upon the partnership. And, upon attachment, the charging order has priority, for full satisfaction of the creditor's judgment, over any other charging order subsequently served upon the partnership, regardless of the order in which the judgments were entered and the previous efforts, if any, made by the creditor to satisfy the judgment by other means.")

[25] *Green v. Bellerive Condominiums LP*, 135 Md.App. 563, 763 A.2d 252 (2000) ("Of course, we recognize that a partnership agreement may 'otherwise provide' for assignment of such management rights.")

[26] *Cadle Co. v. Ginsburg*, Unpublished No. CV950076811S (Conn. 03/28/2002) ("a charging order merely gives the judgment creditor the rights of an assignee of the member's interest in the limited liability company, * * * and does not entitle the assignee to participate in the management and affairs of the limited liability company or to become or exercise any rights of a member"); *Green v. Bellerive Condominiums LP*, 135 Md.App. 563, 763 A.2d 252 (2000) ("In the context of a proposal to purchase partnership debt, the right to consent * * * is essentially a right to participate in the decision regarding whether the partnership should commit its resources to pursue the partnership opportunity. Like the right to information about partnership opportunities, a partner's right to consent to another partner's pursuit of a partnership opportunity is a management right of a partner that remains with the indebted partner after his right to receive distributions in the limited partnership has been transferred via a charging order.").

[27] *Lumbermans Mut. Cas. Co. v. Luciano Enterprises, LLC*, Unpublished, 2005 WL 2340709 (D.Alaska, Sept. 21, 2005) ("Neither the federal discovery rules nor the Alaska discovery rules contemplate regular, monthly disclosure such as plaintiff requests. Plaintiff is not entitled to have a regular, financial disclosure requirement included in the charging order."); *Green v. Bellerive Condominiums LP*, 135 Md.App. 563, 763 A.2d 252 (2000) ("Because the receiver had only the rights of an assignee, and such rights do not include the right to demand or receive information regarding partnership opportunities, the trial court was legally correct in ruling that the receiver was not entitled to separate notice of the opportunity to purchase the Note."); *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo.App. 1999) ("Additional non-economic interests in the partnership include the partners' rights to acquire property, including management powers and co-tenancy in specific partnership property. Also hold certain information rights such as the right to inspect partnership books and demand an accounting."); *Brant v. Krilich*, 835 N.E.2d 582 (Ind.App. 2005) (Creditor holding a charging order does not receive any of the debtor's rights to participate in management nor to inspect the entity's books or records); *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("Although a creditor who obtains a charging order is in a position similar to that of an assignee of the limited partner's interest, in the sense that both have a right to receive the profits and surplus to which the limited partner would otherwise be entitled, neither has the limited partner's information or inspection rights.").

As for our poor downtrodden debtor-member, he retains in an unfettered fashion whatever management rights that he had before the Charging Order was entered, including his own rights as a member to information about the LLC's activity[28] (and this information is usually fair game for a creditor in post-judgment examination proceedings).

THE CHARGING ORDER PROCEDURE

To the surprise of most practitioners who do not regularly practice in the area of creditor-debtor law, most post-judgment enforcement procedures do not implicate the Court directly, but instead work through the Clerk acting in an almost perfunctory role, and the Sheriff. For instance, most post-judgment Writs, such as Writs of Execution, Writs of Attachment, Writs of Garnishment, etc., are normally issued by the Clerk upon the request of the creditor, and often with only the slightest review to make sure that all the paperwork is in good order. Thereafter, the Sheriff simply follows the instructions of whatever Writ the Sheriff is having to deal with that day, and takes possession of property, holds judicial sales, etc. Probably the vast bulk of garden-variety collection cases never require a Judge to make anything approaching an actual decision.

The placing of a Lien on the debtor's property is even easier. For real property, the creditor files an Abstract of Judgment with the local county title clerk or recorder or equivalent office, and -- *Voila!* -- the Lien is thereby instantly created upon the

[28] *Green v. Bellerive Condominiums LP.*, 135 Md.App. 563, 763 A.2d 252 (2000) ("[A] charging order does not prevent indebted partners from participating in partnership affairs, at least to the extent an applicable partnership agreement allows. Nor does it prohibit the indebted partner from keeping the charging creditor informed about partnership affairs."). Contra. *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 35 Conn. App. 81, 1994 CT 11663, 644 A.2d 363 (Conn.App. 1994) ("Under the UPA, however, a charging creditor is entitled to more than just the rights of an assignee. The UPA provides that the charging creditor is entitled to the distributions to which the partner is entitled plus the benefit of all other orders, directions, accounts and inquiries that the partner could make. * * * Assignees under the UPA are denied the latter benefit.").

debtor's real property. Similarly, liens on personal property can be established variously by filing forms with the local Secretary of State, similar to a UCC-1, or by the service upon the debtor of certain Writs. To create a lien on most personal property, the creditor can literally "mail it in".

The same is not true of the Charging Order, which requires that the creditor file a noticed Motion for Charging Order with the Court (*which* Court we will get to presently), serve the debtor and often either the LLC[29] or all its members, and then have a hearing before the Court whereby the merits of the Charging Order are considered. It is a time-consuming, and arguably needless procedure in most cases. Since rare is the case where the debtor will have anything like a viable defense to a Charging Order, by and large the hearing on the Motion only provides the Debtor with an opportunity to show up and annoy everybody with nonsensical arguments, while whining about how unfair it all is.

When granted, the Charging Order by its terms "charges" (creates a Lien[30] upon) the transferrable interest of the Debtor-Member, i.e., the right only to distributions.31 The effect is to divert to the creditor the payments that would otherwise have been made to the debtor,[32] and to create a liability of the LLC to

[29] For the rest of this balance of this paper, unless otherwise indicated, partnerships and LLCs will be collectively referred to as LLCs, and reference will be made to the RULLCA only, although the other partnership and limited partnership Uniform Acts will often have the identical result.

[30] *Madison Hills Limited Partnership II v. Madison Hills, Inc*., 35 Conn. App. 81, 1994.CT.11663, 644 A.2d 363 (Conn.App. 1994) ("The UPA permits a judgment creditor of a partner to place a type of lien known as a charging order on the partner's interest in the partnership."); *Union Colony Bank v. United Bank of Greeley Nat'l Assoc*., 832 P.2d 1112 (Colo. 1992) ("[C]harging order creates a lien upon a debtor partner's interest in the partnership, to wit, his distributive share of partnership's profits and surplus.")

[31] *Cadle Co. v. Bourgeois*, 821 A.2d 1001 (N.H. 2003); *Brant v. Krilich*, 835 N.E.2d 582 (Ind.App. 2005) (Charged "interest is limited to economic interests and nothing more."); *Green v. Bellerive Condominiums LP*., 135 Md.App. 563, 763 A.2d 252 (2000) ("Unless otherwise provided in the partnership agreement, an assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled.")

[32] *Madison Hills Limited Partnership II v. Madison Hills, Inc.,* 35 Conn. App. 81, 1994.CT.11663, 644 A.2d 363 (Conn.App. 1994) ("The charging order leaves the partnership intact but diverts to the judgment creditor the debtor partner's share of the profits."); *MacDonald v. MacDonald*, 1986 DE 412 (1986) (Delaware's charging order statute "provides a form of execution permitting a judgment creditor to divert a flow of payments from the judgment debtor to the party obtaining the charging order."); *91st Street Joint Venture v. Goldstein,* 691 A.2d 272, 114 Md.App. 561 (1997) ("Among the cases we have found that discuss the charging order procedure in any detail, there seems to be at

make those payments.[33]

The Charging Order is similar in many respects to what would be a garnishment proceeding against the debtor-member's right to distributions, but a Charging Order is not a garnishment and is in many ways a more flexible remedy.[34] The Charging Order is also quite similar to an Assignment Order, which is often used to assign to creditors the interests in royalties and other income streams, and to Attachment Order which places an involuntary lien on the debtor's interest in some asset, but it is neither. It is indeed a "peculiar mechanism".[35]

As previously mentioned, the form of the Charging Order will routinely contain detailed ancillary provisions to keep the Debtor-Member from benefitting from the LLC other than by distributions, i.e., taking money out the back door. These provisions typically include prohibiting the LLC from making loans to, paying the personal debts of, or paying wages or salary (if they were not paid before) to the Debtor-Member. But even the absence of such ancillary provisions, the creditor may

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least implicit agreement with Professor Gose's observation that the charging order statute provides two basic collection methods: (1) the diversion of the debtor partner's profits to the judgment creditor; and (2) the ultimate transfer of the debtor partner's interest should the first collection method prove unsatisfactory." [citations omitted]); *Dispensa v. University State Bank*, 1997 TX 2375, Unpublished No. 06-96-00082-CV (Tex.App. Dist.6, Aug. 13, 1997) (charging order is similar to mandatory injunction compelling affected partnership to take affirmative action).

[33] *Keeler v. Academy of American Franciscan History, Inc.*, Unpublished No. DKC 2001-0888 (D.Md., Feb. 14, 2002) (Pre-petition charging order was a liability of the partnership and not the debtor and was not discharged in bankruptcy).

[34] *Beach Park Assoc. v. Heron*, Unpublished No. H023320 (Cal.App. Dist.6, 2003) (charging order "is akin to garnishment"); *Banc One Capital Partners v. Russell*, Unpublished No. 74086 (Ohio App. Dist.8, June 24, 1999) ("[A] judgment creditor who has obtained a charging order against a member's interest in a limited liability company garnishes the financial rights that attach to the interest."); Christensen v. Oedekoven, 888 P2d 228 (Wyo.App. 1995) ("[C]harging orders are remedies different in character from writs of garnishment."); City of Arkansas City v. Anderson, 752 P.2d 673 (Kan. 1988) (A charging order "while similar to garnishment, is separate and apart from the garnishment statutes . . .."); *Union Colony Bank v. United Bank of Greeley Nat'l Assoc.*, 832 P.2d 1112 (Colo. 1992) ("While the charging order may, depending on the circumstances presented, mimic a garnishment proceeding, because of statutory constraints, garnishment cannot mimic the flexible and sustained character of charging orders.").

[35] *Green v. Bellerive Condominiums LP*, 135 Md.App. 563, 763 A.2d 252 (2000) ("A charging order is a unique tool. Although it has some characteristics of both an assignment and an attachment, it is neither."); *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo.App. 1999) ("[A] charging order is not an assignment or attachment of a partnership interest."); *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("A charging order . . . is not an assignment of the limited partner's interest to the creditor, nor does it confer upon the creditor the status of a substituted limited partner."); *Bank of Bethesda v. Koch*, 44 Md. App. 350, 354, 408 A.2d 767 (1979) ("[A] charging order. . . is neither fish nor fowl. It is neither an assignment nor an attachment.").

still have avenues of relief in such cases.[36] Failure of the LLC to abide by these provisions may subject the LLC to contempt.[37]

The RULLCA and the partnership acts only vaguely set out the availability, basic application, and exclusivity of the Charging Order. Some states have adopted implementing statutes in their judgment enforcement laws or court rules to govern the issuance of a Charging Order. Probably the best example is that of California, seemingly always in the forefront of Charging Order law, which has adopted the following in the California Code of Civil Procedure:

> CCP 708.320
>
> (a) A lien on a judgment debtor's interest in a partnership or limited liability company is created by service of a notice of motion for a charging order on the judgment debtor and on either of the following:
>
> (1) All partners or the partnership.
>
> (2) All members or the limited liability company.
>
> (b) If a charging order is issued, the lien created pursuant to subdivision (a) continues under the terms of the order. If issuance of the charging order is denied, the lien is extinguished.

But other states are no so lucky, causing the Courts in those states when faced with a Motion for Charging Order to deal with the "peculiar mechanism" in an *ad hoc* fashion.[38]

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[36] *PB Real Estate, Inc. v. DEM II Properties*, 50 Conn. App. 741, 719 A.2d 73 (1998) (Turnover order against LLC would be granted where LLC had made payments disguised as "legal staff" expenses to debtors in violation of charging order.).

[37] *Joshlin Bros. Irrigation v. Sunbelt Rental, Inc.*, 2014 WL 248104, 2014 Ark. App. 65 (Ark.App., Unpublished, Jan. 22, 2014).

[38] *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("§ 28 of the UPA is drafted in the most general terms and provides courts with very little guidance regarding particular procedures that should be used to further the goals of the charging order. The generality of its terms could be read to sanction the fashioning of charging order procedures on a case-by case basis and without regard to collection procedures already in place with respect to judgment debtors generally." * * * [W]e view it as just an unfortunate circumstance that § 28 was adopted in Maryland and most other jurisdictions without any additional elaboration of procedure.")

EFFECT OF STATE STATUTORY CREDITOR EXEMPTIONS

RULLCA § 503(f) specifically provides that a Charging Order is subject to any applicable exemptions that might exist for the benefit of the debtor-member. An excellent example of this is found in the *Zavodnick*[39] decision, where the Court held that distributions from partnership were "profits due and owing" such as to implicate 10% exemption on execution or other civil process under New Jersey law. The *Zavodnick* court noted that because no exemptions were enumerated in the New Jersey partnership act, it was necessary for the Court to look elsewhere for those exemptions, and then held:

> Moreover, we perceive no reason why the 'exemption laws' that may be invoked in response to an application for a charging order under N.J.S.A. 42:1-28 should exclude the limitation upon executions on 'profits' provided by N.J.S.A. 2A:17-56. A partner's periodic receipt of distributions from a partnership engaged in a professional practice plays substantially the same role in the partner's economic life as an employee's wages. The partner typically depends on such distributions to purchase food, shelter, and other necessities for himself and his family. If [debtor] were an associate rather than a partner in the [partnership] law firm, any wage garnishment clearly would be subject to the limitations of N.J.S.A. 2A:17-56. Similarly, if [debtor] were a sole practitioner, the income that he derived from his practice would constitute 'earnings' within the intent of N.J.S.A. 2A:17-56. Therefore, we conclude that distributions from the partnership through which [debtor] has chosen to practice his profession are subject to the same limitation on executions under N.J.S.A. 2A:17-56 as an employee's wages or a sole proprietor's earnings."

Importantly, the *Zavodnick* court also held that the Charging Order was subject to the $10,000 personal property exemption of New Jersey law, thus indicating that a debtor may properly "stack exemptions" with a Charging Order, as otherwise is a quite common practice in American creditor-debtor law as to

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[39] *Zavodnick v. Leven*, 340 N.J.Super. 94, 773 A.2d 1170 (2001). See also *MacDonald v. MacDonald*, 1986 DE 412 (1986) (charging order statute " does not deprive any partner of the benefit of any exemption laws applicable to his partnership interest"); *Koh v. Inno-Pacific Holdings, Ltd.*, 114 Wash.App. 268, 54 P.3d 1270 (2002) (Charging order statute "does not deprive any member of the benefit of any exemption laws applicable to the member's limited liability company interest.").

exemptions generally.

Note that the *Zavodnick* court required the debtor-partner to prove that the distributions received from the partnership were in the nature of wages, but because the partnership was a professional practice, it was not particularly difficult for the debtor-partner to do so. In other cases where the role played by the debtor-partner is not so clear, consideration of the issue of whether distributions are in the nature of wages might be more difficult, particularly in the case of a largely passive partner who may have a quite difficult time believably arguing that a part of her distributions were anything like wages.

Effect of Federal Wage Garnishment Restrictions

One objection that a Debtor-Member might raise is that the distributions made to the Debtor-Member are in the nature of wages, and thus are protected by the Federal Wage Garnishment Law, 15 U.S.C. §§ 1671 *et seq*., which protects from garnishment the lesser of (1) 25% of the Debtor's "disposable earnings" or (2) 30 times the Federal minimum wage amount.

Section 1672(a) of that Law states that the term "earnings" means "compensation paid or payable for personal services, whether denominated as wages, salary, commission, bonus, or otherwise . . .." This would appear to apply to distributions that were made to the Debtor-Member for his or her services rendered to the LLC.

Although the Act provides protection against "garnishments", that term is defined in § 1672(c) to include "any legal or equitable procedure through which the earnings of any individual are required to be withheld for payment of any debt." The Charging Order would seem to fit that description.

Planners might consider whether to structure an LLC so that working members are paid some level of salary, to better clarify which portion of the members' receipts will be protected by this Federal protection (which of course supersedes any contrary state law), and which portion will be pure distributions which will not be so protected and thus subject to the Lien, as is specifically contemplated by RULLCA § 405(g).

GIVING NOTICE OF THE ISSUED CHARGING ORDER

If the Court issues the Charging Order, then the next step will be for the Creditor to serve a "Notice of Entry of Charging Order" both on the Debtor-Member, and on the LLC (or all its members). In the concept of the Charging Order as placing a Lien on the Debtor-Member's distributive interest, the giving of the Notice of the Charging Order to the LLC has the effect of "perfecting" the Lien. From the date of receipt of the Notice, the LLC will itself henceforth be potentially liable to the Creditor for violating the Lien, and in danger of being held in contempt for violating the Charging Order.[40]

FORECLOSURE & REDEMPTION

Foreclosure of a liened interest means that the Creditor can subject the interest to a judicial sale, *i.e.*, the Sheriff holds an auction at which the interest is sold to the highest bidder.[41] The Creditor is not required to bid at the auction, and in fact hopes that some other party will pay substantial moolah for the interest, which the Creditor will then cheerfully apply (less the costs of the auction) towards satisfaction of the outstanding Judgment.

If the Creditor does bid, then the Creditor will likely make a "credit bid"

[40] *Joshlin Bros. Irrigation v. Sunbelt Rental, Inc.,* 2014 WL 248104, 2014 Ark. App. 65 (Ark.App., Unpublished, Jan. 22, 2014).

[41] *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("[A]ny transfer of the debtor partner's interest is to take place pursuant to the rules governing judicial sales.")

whereby the Creditor treats as satisfied a portion or all of the Judgment, in lieu of a cash bid by the Creditor. Note, however, that the amount that the Creditor applies towards the satisfaction of the outstanding Judgment is the amount of the winning bid, not the value of the interest. Assume that the appraised FMV of the interest is $5 million, but nobody nobody shows up at the auction, and the Creditor bids only $1 American as the winning bid. In that case, the $1 American would be applied towards the satisfaction of the Judgment, even if the Creditor soon thereafter sells the interest for $5 million. This scenario is somewhat tempered by the Court's mandatory review (as with all judicial sales) of the fairness of the auction, but the point is that the Debtor should not blindly presume that she will get full credit towards satisfaction of the Judgment based on the value of her interest which is thereby sold.

Importantly, even if the liened interest is sold at the auction, the only thing the Buyer (whether the Creditor or somebody else) gets is the right to distributions, albeit that right becomes a permanent right whereby distributions will be collected even after the Judgment is satisfied, or even later discharged. But that does not mean that the Buyer obtains any other rights, such as management rights, in the LLC -- that is specifically prohibited by RULLCA § 503(c).

In other words, prior to foreclosure, the Creditor has a temporary right to distributions only until the Judgment is satisfied, after foreclosure, this right becomes permanent to the Buyer regardless of whether the Judgment is ever satisfied. But in either case, the Creditor or Buyer still doesn't become anything like a member or manager of the LLC -- they have a right to distributions only, nothing more.

Under RULLCA § 503(c), and probably the laws of most states whether they have adopted RULLCA or not, the Lien created by the Charging Order can be foreclosed upon. However, the Creditor must first demonstrate to the Court that the distributions from the LLC will not satisfy the Judgment in some reasonable period of time.[42] This is a call entirely within the Court's discretion,[43] and the Court may take into account the possible disruption of the LLC and its effect (if any) on the non-debtor members.[44] However, the consent of the non-debtor members to foreclosure is not required.[45]

To illustrate what this means in practical terms, let's take two situations:

(A) The Creditor's Judgment is for $20,000 and the LLC is a hedge fund that regularly spins off $6,000 per year in distributions to the liened interest. In that case, the Judgment will be satisfied in four years, even counting interest on the Judgment, and so the Court would be unlikely to grant foreclosure.[46]

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[42] *Lauer Construction Inc. v. Schrift*, 123 Md.App. 112, 716 A.2d 1096 (1998) (judgment creditor has the power to force a sale of the debtor's general partner's interest in a limited partnership); *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("In general, a charging order is considered the primary method of satisfying the creditor's judgment, but the further step of ordering a sale may be considered appropriate where it is apparent that distributions under the charging order will not pay the judgment debt within a reasonable period of time."); *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("[T]he primary means of satisfying a judgment from a partnership interest should be the receipt and distribution of any income or profits due the debtor partner, and that, ordinarily, sale of the interest should not be resorted to unless the judgment could not be satisfied in that manner within a reasonable period of time."); *Green v. Bellerive Condominiums LP*., 135 Md.App. 563, 763 A.2d 252 (2000) ("The preferred collection method is to use a charging order to divert the debtor partner's right to partnership profits to the judgment creditor. * * * 'If this method is ineffectual there is another more drastic course of action. * * * That alternative is the ultimate transfer of the debtor partner's interest.'" quoting Gose, The Charging Order Under the Uniform Partnership Act, 28 Wash. L. Rev. 1, 10 (1953)).

[43] *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("[T]he trial court has discretion to determine whether or not a judicial sale of the partnership interest is an appropriate means in aid of the charging order."); *Stewart v. Lanier Park Medical Office Building, Ltd.*, 259 Ga. App. 898;578 S.E.2d 572 (2003) ("The trial court has broad discretion in deciding whether to order a foreclosure and sale of charged interests.")

[44] *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991) ("We conclude that since the interest acquired by the purchaser of a partnership interest is limited by operation of law to the partner's share of profits and surpluses, with no acquisition of interest in partnership property or management participation, the foreclosure and sale of the partnership interest will not always unduly interfere with the partnership business to the extent of requiring consent of the nondebtor partners. In some cases, foreclosure might cause a partner with essential managerial skills to abandon the partnership. In other cases, foreclosure would appear to have no appreciable effect on the conduct of partnership business. Thus, the effect of foreclosure on the partnership should be evaluated on a case-by-case basis by the trial court in connection with its equitable power to order a foreclosure.").

[45] The non-debtor partners must be given prior notice of the foreclosure, *Union Colony Bank v. United Bank of Greeley Nat'l Assoc.*, 832 P.2d 1112 (Colo. 1992), although their consent to foreclosure is not required, *Hellman v. Anderson*, 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991) ("consent of nondebtor partners is not an inflexible requirement").

[46] *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114 Md.App. 561 (1997) ("Ordinarily, the trial court should consider whether the judgment can be satisfied out of the debtor partner's profits prior to resort to the more drastic method of sale of the debtor partner's interest.")

(B) The Creditor's Judgment is for $5 million and the LLC is a closely-held entity with few assets that irregularly spins off distributions, none of which have exceeded $20,000 in years past, and none at all during the time since the Charging Order was granted. In that case, it is unlikely that distributions from the liened interest will ever satisfy the Judgment, and the Court would likely grant foreclosure in such a case.

Note that nothing prevents the Creditor from bringing a "Combined Motion for Charging Order and To Foreclose" and attempting to do both at the same hearing. The case where such a Combined Motion might be successful is the (B) situation above, where it is clear that distributions will never satisfy the Judgment, and there is little sense in making the Creditor wait for a few months just to then tell the Court the obvious.

THE MONSTER UNDER THE BED?

The mere thought of foreclosure has caused many planners to freak out, and demand that their states' legislature amend their partnership and LLC laws so as to prohibit a creditor's foreclosure of a liened interest. This is a concern primarily connected with the marketing competitiveness of partnerships and LLCs between states, as it is not a concern born out by any widespread outbreak of creditors attempting to foreclose on the interest. To the contrary, there have been fewer than a dozen reported opinions nationwide over the entire history of partnership and LLC law where a creditor has even attempted to foreclose upon an interest subject to the Charging Order Lien. In other words, creditors are not exactly falling over themselves to foreclose on liened interests, even in the states where such is plainly sanctioned by statute. There are several reasons for this.

First, there is often painfully little for the Creditor to gain by foreclosing. The Creditor already has a lien on the debtor-member's interest, and if the LLC is making significant distributions, the Creditor will quite likely be satisfied to accept those distributions so long as they continue to be made. If not, *i.e*., the LLC is not making distributions to the liened interest, then an auction of the liened interest will not draw any serious bidders, and all the Creditor will have done would be to have "thrown good money after bad" by of the attorney's fees and expenses of the auction.

Second, where the Charging Order was acquired by the Creditor for the strategic purpose of causing financial pain to the Debtor by cutting off the Debtor's access to funds from the LLC, the lien created by the Charging Order works just as well as a temporary lien until the judgment is satisfied, as it does if the lien were foreclosed upon and purchased either by the Creditor of some third-party Buyer.

Third, the Creditor has a significant tax incentive to not foreclose and risk acquiring the interest. Prior to foreclosure, the Creditor is simply the holder of a lien, and as such is not subject to receiving a K-1 from the LLC (the frequently misinterpreted Rev. Rul. 77-137 and IRS General Counsel Memorandum 36960 (1977) not to the contrary). However, after foreclosure, the Buyer (which might be the Creditor who ends up with it), does then become a transferee of the transferrable interest, and is potentially liable for its distributive share of the LLC's taxes.

Finally, as discussed more fully below, the Creditor has possibly better avenues to explore in attempting to get at the Debtor-Member's share of the assets of the LLC, instead of just seeking a judicial sale of just the transferrable interest.

For all these reasons, the threat of foreclosure is the monster under the bed -- much more bark than bite. The proof is, again, in the utter paucity of reported opinions where creditors have attempted to foreclose on liened interests.

PRE-FORECLOSURE REDEMPTION

RULLCA § 503 para. (d) provides that before foreclosure, the debtor-member may redeem the liened interest, and § 503 para. (e) says that the LLC or any other member may redeem the liened interest.[47]

These two paragraphs raise the specter of a situation where the Creditor moves to foreclose, and simultaneously:

(1) The debtor-member attempts to redeem under para. (d), and offers to pay the Creditor; and

(2) The other members of the LLC vote to have the LLC redeem under para. (e), and the LLC offers to pay the Creditor; and

(3) Another member of the LLC attempts to redeem under para. (e) and offers to pay the Creditor.

Who wins? Section 503 provides no guidance, and thus we are left with a situation where, possession being 9/10ths of the Law, the party whose check is first accepted by the Creditor has actually redeemed, and probably wins -- an unlikely "race to the Creditor".

Unlikely, because of what is required in the way of payment. Most planners would presume that payment would be in some amount tied to the Fair Market Value of the liened interest. Not so, according to the plain text of paras. (d) and (e), which instead require the redeeming party to pay the full amount required to satisfy the Judgment.

Nothing prohibits the non-debtor members from showing up at the judicial sale and themselves bidding on the interest,[48] for a which the amount of the winning bid will in most cases be much less than the full amount of the debtor's outstanding Judgment Common sense thus dictates that where the amount of the outstanding Judgment exceeds the fair market value of the interest, the non-debtors would be smarter to bid than to redeem.

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[47] *Union Colony Bank v. United Bank of Greeley Nat'l Assoc.*, 832 P.2d 1112 (Colo. 1992) (partners may, at any time before foreclosure, redeem or purchase the interest charged or subject to sale.)

[48] *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo.App. 1999) ("Where the court directs sale, the interest charged may be purchased by any one or more of the partners without thereby causing a dissolution.").

Let's say that our debtor-member has suffered a $5 million judgment, and the liened interest is worth on a good day only $10,000. Probably nobody is going to offer to pay the full amount of the $5 million judgment, just to redeem the $10,000 foreclosed interest. This is also why planners should not rely heavily upon redemption to keep the Creditor from foreclosing on the interest, not that, as discussed previously, the Creditor will even want to do that in most cases.

CHOICE OF LAW ISSUES WITH CHARGING ORDERS

There is an old truism among creditors' right counsel that "All collection law is local." This saying reflects that most judgment enforcement actions take place in the local court where the Judgment was rendered, and personal jurisdiction over the debtor survives after the Judgment becomes final, or it takes place in the local court where assets are found. In ordinary judgment enforcement action, local law will apply. As a practical matter, it is very difficult to get a Court to consider that any other law might apply.

Debtors, or the LLC, often argue that the place for the bringing of a Motion for Charging Order, and the law applicable to such proceeding, must be only in the state where the LLC was formed. So far, it has been a losing argument whenever attempted.

The first problem is that an LLC interest is personal property,[49] see, e.g., RULLCA § 501, and intangible personal property at that. For collection purposes, intangible personal property is "located" either with the debtor wherever the debtor

[49] *Koh v. Inno-Pacific Holdings, Ltd.,* 114 Wash.App. 268, 54 P.3d 1270 (2002) ("The interest of a member in a limited liability company is personal property."); *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo.App. 1999) ("A partnership interest is an economic right to share in the profits and surpluses, most accurately characterized as intangible personal property."); *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 35 Conn. App. 81, 1994.CT.11663, 644 A.2d 363 (Conn.App. 1994) ("The charging order affects only the partner's interest in the partnership, which is personal property.").

may be found, or in the debtor's state of domicile.[50] In the vast majority of cases, these are the same since the debtor was originally sued in his place of domicile. But in either event, it is not some distant domicile where the LLC was formed.

The second problem is that for creditor-debtor purposes, an LLC interest may be analogized to a share of stock in a corporation. If a creditor is levying upon a debtor's shares in Microsoft, the creditor doesn't have to go to Washington state or Delaware to accomplish that result -- so why should a Charging Order be treated much differently? It is, after all, only the debtor's rights that are being affected, and not those of the LLC (or corporation).

In several cases, the Courts have held that local law applies to the issuance of a Charging Order, and not the law where the entity is domiciled.[51]

Debtors have attempted to change the forum for the determination of charging orders in at least two cases, Bay Guardian and Fairstar Resources.[52] In both cases, the debtors filed lawsuits for declaratory judgment in Delaware, where the LLCs were domiciled, seeking injunctions to prevent the creditor from pursuing the charging order remedy in California (Bay Guardian) and Utah (Fairstar Resources). The creditors in both of those cases successfully thwarted the debtor's attempt by removing the cases to federal court, and there invoking the Federal Anti-Injunction Act which prevents a federal court from interfering with an ongoing state proceeding

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[50] *See, e.g., Waite v. Waite*, 6 Cal. 3d 461, 467-68, 492 P.2d 13, 17 (1972) (internal quotations and citations omitted):

> An intangible, unlike real or tangible personal property, has no physical characteristics that would serve as a basis for assigning it to a particular locality. The location assigned to it depends on what action is to be taken with reference to it. [...] Thus most cases that place the situs of an intangible asset at the domicile of the owner do so to enable the jurisdiction of the owner's domicile to tax that property or the income derived from it. [...] When, however, the issue, as in this case, involves jurisdiction to compel the obligor to pay one claimant and not a competing claimant, 'the debt or claim is usually regarded as having a situs in any state in which personal jurisdiction of the debtor can be obtained.

51 *Rockstone Capital, LLC v. Marketing Horizons, Ltd.,* 2013 WL 4046597 (Conn.Super., Unpublished, July 17, 2013); *American Institutional Partners, LLC v. Fairstar Resources, Ltd.,* 2011 WL 1230074 (D.Del., Mar. 31, 2011) vacated on other grounds; *Bay Guardian Co. v. New Times Media, LLC*, Cal.Super.San.Fran. Case No. CGC-04-435584 (Charging Order entered Jan. 6, 2010).

[52] These two cases are cited in the immediately-preceding footnote.

(the charging order motions).

The Internal Affairs Doctrine And Outside Creditors

Some planners place a great deal of reliance upon the "Internal Affairs Doctrine" to determine which law will apply to the resolution of a Charging Order dispute. This doctrine is codified in RULLCA in Section 106:

> SECTION 106. GOVERNING LAW. The law of this state governs:
>
> (1) the internal affairs of a limited liability company; and
>
> (2) the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of a limited liability company.

The problem is, the Internal Affairs Doctrine has been almost consistently held to not apply to outside creditors. *McDermott Inc. v. Lewis,* 531 A.2d 206 (Del. 1987); *Petro v. Gold*, 166 Ohio.App.3d 371, 850 N.E.2d 1218 (2006); *In re The Heritage Organization*, 413 B.R. 438 (Bk.N.D.Tex. 2009). "Internal affairs" has been consistently interpreted to mean precisely that, *i.e.*, a dispute between members, or a member and the LLC itself.[53] The Doctrine does not extend to third-party creditors, even if the effect of the Charging Order would be to indirectly interfere somehow (that a Member would not perform if not getting paid distribution being the most common argument) with the "internal affairs" of the LLC.

The Operating Agreement Does Not Apply To Outside Creditors

Similarly, the Operating Agreement does not bind outside creditors, for the simple reason that they are not signatories to the Agreement and did not consent to be bound by its terms. Often, planners will load their Operating Agreements up with a lot of fun, innovative, and sometimes outlandish anti-creditor provisions, but while those

[53] The most common exception is that in alter ego cases, the law of the jurisdiction where the entity has been formed will most typically apply.

provisions might impress their colleagues and clients, they are not worth the proverbial hill of beans in an action involving outside creditors.

However, the Operating Agreement might be somewhat effective as to outside creditors to the extent that it narrowly defines what interest a member has, as a creditor cannot lien or foreclose upon a greater interest than the member actually owns. Here is the place that drafters should be creative, though keeping in mind that the member might not be so happy with such restrictions until a creditor actually appears.

THE FOREIGN COMPANY GLITCH

Article 8 of the RULLCA deals with foreign limited liability companies, but does not speak to the topic of charging orders. Section 102 defines a limited liability company as "except in the phrase 'foreign limited liability company', means an entity formed under this Act." Section 503 relates only to a "limited liability company", without any reference to a foreign limited liability company.

Bootstrapping all of this together, arguments have been made that Section 503 applies only to limited liability companies that are formed in the state, and not to foreign limited liability companies.

The argument first came up in the *Bay Guardian* litigation, where the debtor defensively argued under California's ULLCA that the California Court lacked the authority to place a Charging Order on the debtor's interest in various foreign LLCs. To the debtor's great surprise, the creditor gleefully accepted the argument as valid, and then offensively argued that if the charging order section of the ULLCA did not apply to foreign LLCs, then by like token the statutory restriction to the charging order remedy of that same section similarly did not apply to foreign LLCs -- and thus the creditor could instead levy directly upon and sell the debtor's interests. Whereupon, the debtor attempted to take back its argument, and the Court simply ignored the entire issue on its way to issuing the sought Charging Order (without Opinion) against the foreign LLC interests.

Then, the Minnesota Court of Appeals took up the cudgel in *Fannie Mae v. Heather Apartments LP*, 2013 WL 6223564 (Minn.App., Dec. 2, 2013), where the creditor used the argument offensively to force a debtor to turn over his interests in a Cook Islands LLC. On this issue, the Court held *in toto*:

> C. A charging order was not Fannie Mae's only remedy.
>
> Finally, Grossman argues that Fannie Mae's only remedy is to obtain a charging order under Minn.Stat. sec. 322B.32 (2012). But this argument fails because that statute only applies to Minnesota limited liability companies. Chapter 322B defines a "limited liability company" as "a limited liability company, other than a foreign limited liability company, organized or governed by this chapter." Minn.Stat. sec. 322B.03, subd. 28 (2012). Because LSPG Shoreline was organized in, and is governed by, the laws of the Cook Islands, chapter 322B does not apply.

Certainly, it was not the intent of the ULLCA or RULLCA drafters to exclude a foreign limited liability company from the ambit of the Section 503 charging order procedure, or exclusive remedy limitation. Professor Carter G. Bishop of Suffolk University Law School, a member of the RULLCA Drafting Committee and an expert on American charging order law if there is one,[54] attempted to file an *Amicus Curiae* brief with the Minnesota Supreme Court, to point this out, but the filing of his brief was denied. As of this writing, the appeal in *Heather Apartments* is still pending.

Presumably, this glitch of statutory drafting will someday be corrected in the Uniform Acts, but it may cause some interesting litigation in the meantime.

[54] *See* Bishop, Carter G., LLC CHARGING ORDER CASE TABLE, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1565595

CIRCUMVENTING CHARGING ORDER EXCLUSIVITY

RULLCA § 503(g) provides:

> (g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest. [55]

They key word here is "remedy", which is a legal term-of-art that refers to a number of specific legal devices that a creditor may use to enforce a judgment, devices such as levy, attachment, garnishment, etc., that are defined in a state's remedies statutes.

The word does not mean, as many planners mistakenly believe, that the outcome should be exclusively that as set forth in the charging order procedure of RULLCA § 503 generally. Which is to say that there are a number of legal strategies that a creditor might employ that technically are not "remedies" in the sense of being an enumerated judgment enforcement device under the remedies statutes of the state.[56]

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[55] *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 35 Conn. App. 81, 1994 CT 11663, 644 A.2d 363 (Conn.App. 1994) ("Because the partner's rights in specific property of the partnership cannot be attached or made subject to execution * * * and the partner's management rights cannot be assigned to or conferred on anyone other than a partner * * * the charging order is the sole remedy available to a judgment creditor of a partner."); *Herring v. Keasler*, 563 S.E.2d 614 (N.C.App. 2002) (injunction would be granted to prevent creditor from executing on debtor's LLC interests); *Brant v. Krilich*, 835 N.E.2d 582 (Ind.App. 2005) (Execution upon interest in limited liability company would be construed as charging order on interest); *Tudor Engineering Co. v. Mouw*, 709 P.2d 146 (Idaho 1985) ("Under Idaho law, the interest of a partner in partnership property is not subject to execution absent a charging order. I.C. §§ 53-325(2)(c) and 53-328. See Tom Nakamura, Inc. v. G & G Produce Company, 93 Idaho 183, 457 P.2d 422 (1969)."); *Novak v. Novak*, 513 N.W.2d 303 (Neb. 1994) ("The interest of a partner is not subject to attachment or execution, except on a claim against the partnership.") Contra. *Nigri v. Lotz*, 453 S.E.2d 780, 216 Ga. App. 204 (1995) ("The charging order remedy is not exclusive, and the financial interests of the limited partner may also be reached by the judgment creditor by process of garnishment.").

Charging Order exclusivity is likewise binding on the federal courts. *Lumbermans Mut. Cas. Co. v. Luciano Enterprises, LLC*, Unpublished, 2005 WL 2340709 (D.Alaska, Sept. 21, 2005) (Alaska law making charging order the "exclusive remedy" deemed by federal court to be "a situation in which a state substantive law does in fact limit the court's power to enforce its own judgments . . ..."). It is also effective in divorce cases. *Addis v. Addis*, 288 Ark. 205, 703 S.W.2d 852 (Ark. 1986) ("At divorce, in determining the rights of a husband or wife to a spouse's partnership interest, a court cannot make specific awards of partnership assets. The court must determine the value of the interest in the partnership and then award the spouse an amount equal to one-half of the value of the interest, which may be enforced by a charging order on the partnership interest."); Riegler v. Riegler, 243 Ark. 113, 419 S.W.2d 311 (1967); Warren v. Warren, 675 S.W.2d 371 (Ark.App. 1984).

[56] Some reported decisions have language to the contrary. *91st Street Joint Venture v. Goldstein*, 691 A.2d 272, 114

For instance, California enumerates its list of "remedies" that a creditor in a post-judgment enforcement action might employ in the Enforcement of Judgments Law (EJL), California Code of Civil Procedure § 680 *et seq*., as execution, levy, garnishment, written interrogatories to judgment debtor, examination proceedings, creditors suit, charging orders, lien in pending action or proceeding, assignment order, and receiver to enforce judgment. Everything else is not technically a "remedy" under the California EJL, although certainly the term "remedy" is sometimes loosely applied by the California courts to other theories of relief which are not enumerated "remedies".

There are, in fact, other strategies of relief that creditors may pursue to get at the Debtor-Member's interest, if not of the actual assets of the LLC.[57] A few of those strategies are discussed below.

THE SOLITARY CONUNDRUM OF THE SINGLE-MEMBER LLC

Much as a computer program will terminate when an attempt is made to divide something by zero, so does the so-called Charging Order Protection run into trouble when the LLC has but a single member, i.e., the number of other partners is likewise zero.

We have previously seen that the historical purpose of the charging order is to protect the non-debtor members, and not the debtor member. But where there are no non-debtor members to protect, then we have a situation where the charging order

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Md.App. 561 (1997) ("[T]here is general agreement that the charging order is now the judgment creditor's exclusive method of reaching a partner's interest in a partnership and that the creditor may no longer execute directly on partnership property."); *Dispensa v. University State Bank*, 1997.TX.2375, Unpublished No. 06-96-00082-CV (Tex.App. Dist.6 08/13/1997) ("A charging order is the sole means by which a judgement creditor can reach an individual debtor's partnership interest.").

[57] It may also be that a creditor might employ some ancient form of Writ to circumvent Charging Order exclusivity, *see*, *e.g*., *MacDonald v. MacDonald*, 1986 DE 412 (1986) (declining to address "the question whether a writ of *fieri facias* is effective to seize a limited partnership interest in a Delaware limited partnership").

is not serving its intended purpose, but is instead being misapplied to protect the assets of the single member from her creditors. This is all summarized nicely by Gerry Niesar:

> When considering a charging order in the context of a SMLLC it is very important to remember why the procedure was developed. It was not to protect the debtor-partner. The procedure limiting the creditor of a partner to an economic, but not management or control, right was designed to protect the *other* partners and the *partnership* from interference by a creditor, cum partner, whom the other partners had not invited to the management and control table. Viewed in the light of its history, it is easy to see that in a SMLLC context (where there are no partners other than the debtor) the charging order procedure generally will have no *raison d'etre* and, in fact, it could be used unfairly by debtors to prevent creditors from having a way to collect on their judgments.
>
> In a SMLLC there is no other "partner" to protect, and it would require legerdemain to advance the notion that there is an "entity" that deserves the right to be protected from the creditor. If the judgment creditor is one who obtained a judgment based upon a tort claim, or through an enforcement action relating to the debtor's violation of a law or regulation, it is even more obvious that being limited to a charging order denies the creditor justice. For all of these reasons, the cases addressing this issue of creditors' remedies against a single member are providing scant, if any, reason for debtors to believe that a SMLLC will provide much of a shield against creditors.[58]

In at least two reported bankruptcy cases, *Albright* and *Modanlo*,[59] the Courts held that since the purpose of charging order protection is to protect the interests of the non-debtor members, and there were no non-debtor members to protect, the application of the charging order protection was nonsensical, and the Trustee was allowed to exercise management control over, and sell for the benefit of the bankruptcy estates, the assets of the subject LLCs.

In a third case, the Ninth Circuit BAP, while essentially agreeing that the rationale of *Albright* was correct, instead embarked on a predictably (for those familiar with the Ninth Circuit) circuitous and somewhat tortured theory that

[58] Gerald V. Niesar, Charging Orders and the Single-Member LLC, Consumer Finance Law, Vol. 65 Nos. 3 & 4 (Fall-Winter, 2011).

[59] *In re Ashley Albright*, 291 B.R. 538 (D.Colo. 2003); In re Nader Modanlo, 412 B.R. 715 (D.Md. 2006).

involved the LLC's Operating Agreement as an "executory contract" under Bankruptcy Code § 365(d)(1), and since there were no other parties to the Operating Agreement other than the debtor-members who jointly owned the single interest 100%, the debtor-members had no management or voting rights but instead those were vested upon their bankruptcy filing in the Trustee — effectively the same result as *Albright*, although the BAP had gone from Minneapolis to St. Paul by way of Miami.

Outside of bankruptcy, on a Certified Question from the Eleventh Circuit, the Florida Supreme Court in *Olmstead*[60] answered that a Charging Order was not the exclusive remedy against a SMLLC under the Sunshine State's laws. Although paying their respects to the logic of *Albright* and *Modlano*, the majority in *Olmstead* instead focused on differences in the language between Florida's LLC statute, which did not clearly limit a creditor's remedy to a charging order, and Florida's partnership and limited partnership statutes, which did. After analogizing an LLC interest to a share of corporate stock, the majority concluded that the Florida legislature must not have meant to make the Charging Order the exclusive remedy, at least with respect to a SMLLC. Thereafter, the Florida legislature amended the LLC statute (referred to as the *Olmstead patch*) to provide that the Charging Order was indeed the exclusive remedy in Florida -- but only as to Multiple-Member LLCs. As to SMLLCs, the Olmstead patch expressly allows a creditor to foreclose on the single-member's interest in the SMLLC, with the buyer being able to take management control of the SMLLC, but only if the creditor first shows that her judgment will not be satisfied by distributions from the LLC within a reasonable time.

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[60] *Olmstead v. FTC*, 40 So.3d 76 (Fla. 2010).

STATUTORY PROBLEMS WITH *ALBRIGHT*

Some states have expressly amended their partnership and LLC laws to provide Charging Order exclusivity for entities formed in their states, for the very purpose of making those entities an asset protection vehicle to protect the assets of the single-members who use them. In such a state, where the legislative history can be shown that the legislatures affirmatively did desire that Charging Order exclusivity apply to single-members, an assertion of the *Albright* rationale to circumvent Charging Order exclusivity might not hold water. Whether extending such exclusivity to single-member LLCs, and thus turning them into asset protection vehicles with a super ability to thwart creditors, is anything like a good idea from a public policy standpoint is another matter entirely (certainly, it helps the marketing of the LLCs from those states).

Additionally, we must recall that in *Olmstead*, *supra*., the Florida Supreme Court indicated that the Florida partnership and limited partnership statutes did provide for charging order protection as the exclusive remedy, and thus inferred that if the Florida LLC statute had been similarly drafted, then the charging order protection might have applied in that case despite *Albright*. Indeed, there is nothing like a single-member carve-out in RULLCA § 503, and it may be that future courts could hold that in the absence of such a carve-out, SMLLCs will benefit from Charging order exclusivity just as multiple-member LLCs enjoy. While it is the author's humble opinion that RULLCA should have its own *Olmstead patch*, that of course will be left to the wisdom of future drafting committee members.

LATE-ARRIVING MEMBERS

Another fly-in-the-ointment goes to the issue of just exactly when the status of an LLC as a single-member or multiple-member entity is tested. Theoretically, it might be possible to add a second member to an LLC so as to destroy its single-member status and thus prevent the application of *Albright*, the late-arriving member being the not-so-innocent party crasher who shows up with the intent of spoiling the creditor's party.

Let's consider the following timeline:

January 12	Debtor forms an LLC, contributes assets to it, and is the single-member of LLC
February 13	Debtor negligently causes a car accident with multiple injuries
March 14	Debtor consents to judgment in excess of his net wealth, including Debtor's 100% in the LLC
April 15	Debtor's golf buddy acquires a 5% membership interest in the LLC by contributing the necessary cash
May 16	Creditor files a Motion for Turnover Order for the assets of the LLC and/or full management control of the LLC.
June 17	Court holds hearing on Motion for Turnover Order

On which date do we "test" whether the LLC is single-member or multiple-member? Possibly the right answer is May 16, the date that the Creditor filed the Motion for Turnover Order, since that is the date that the creditor first attempted to take enforcement action against the debtor's interest; analogizing it to other judgment enforcement procedures such as a Writ of Levy, that "hits" the value of an asset on the day that the Writ is served, i.e., a creditor would get whatever shares of corporate stock is owned by the debtor on the day that the Writ of Levy is served, not the most shares of stock that were previously owned by the debtor.

However, to change the timeline slightly, let's say that the Creditor first filed a Motion for Charging Order against the debtor's LLC interest on April 14 -- the day before the debtor attempted to sell the interest to his golf buddy. In that case, the "temporary lien" created by the filing of the Charging Order motion would be created in the debtor's 100% interest, and the attempt of the golf buddy to acquire an interest might be defeated.

There may be fraudulent transfer concerns as well to adding a member late just to thwart collections. In the *Sardis*[61] case, the debtor owned 100% of the interest in a profitable LLC, but just days after she lost an arbitration award, she sold a 10% interest in the LLC to her son. Although the Court never directly reached the issue as to whether the transfer of the 10% interest was a fraudulent transfer, the Court did negatively comment upon it as one in a number of facts that demonstrated the debtor's intent to fraudulently transfer another of her assets to her son:

> Finally, the addition of Michael as a member of Applied Medicals LLC, of which Sofia was formerly the sole member, precludes plaintiffs from obtaining an order from a Florida court directing the surrender of her entire interest in the company to satisfy the award against her.

Implicitly in this statement, the *Sardis* Court was saying that even though the son acquired the 10% interest after the debtor had lost the arbitration proceeding, that would be effective to "bust" the single-member status of the entity and require the creditor to pursue a Charging Order, but it can be implicitly read within the overall context of the case to suggest that the transfer of the 10% interest might be a fraudulent transfer because it had the effect of hindering the creditor.

WHEN IS A PEPPERCORN NOT A PEPPERCORN?

How much interest must another, non-debtor member have so as to defeat a creditor's argument based on *Albright*? The Court addressed the issue, if only to tease us, in Footnote 9 of its Opinion:

> The harder question would involve an LLC where one member effectively controls

[61] *Sardis v. Frankel*, 2014 WL 37870 (N.Y.App., Jan. 7, 2014).

> and dominates the membership and management of an LLC that also involves a passive member with a minimal interest. If the dominant member files bankruptcy, would a trustee obtain the right to govern the LLC? Pursuant to Colo.Rev.Stat. § 7–80–702, if the non-debtor member did not consent, even if she held only an infinitesimal interest, the answer would be no. The Trustee would only be entitled to a share of distributions, and would have no role in the voting or governance of the company. Notwithstanding this limitation, 7–80–702 does not create an asset shelter for clever debtors. To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with "peppercorn" co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse. 11 U.S.C. §§ 544(b)(1) and 548(a).

The truth is that nobody knows, or will likely ever know, what sort of minimal interest is required to change the characterization of a single-member LLC to a multiple-member LLC for *Albright* purposes, since such an issue must fundamentally be resolved on a facts-and-circumstances evaluation in each particular case. Caution must be given, however, that simply putting in another member who is the *de facto* nominee of the debtor-member, risks a Court simply collapsing all the interests together and treating them as the debtor-member's interest for purposes of this analysis.

For example, it is common for planners to give their clients a 99% non-managing interest in an LLC, and then to create a new corporation or trust (often a revocable "living" trust), directly or indirectly controlled by the Client, to act as the 1% managing member. In such a case, it would not be too terribly difficult for a Court to hold that the 1% (or 5% or 10% or even 70%) other member is simply the Client in a different form, and trigger relief under *Albright*. Which is all by way of saying that planners should quit focusing on the *percentage*, and instead focus on the true substance of the situation, since ultimately it is the substance of what is really going on that the Court will cast its focus.

REVERSE VEIL-PIERCING

In an ordinary, often referred to as traditional, veil-piercing case, the LLC has a judgment against it, and the creditor seeks to disregard the LLC's separateness from its member so as to enforce the judgment directly against the member's assets. By contrast, in a *Reverse Veil-Piercing* case, the creditor has a judgment against the member of the LLC, and attempts to disregard the LLC's separateness from its member, so as to enforce the judgment directly against the LLC's assets -- and thereby circumvent Charging Order exclusivity.

Veil-piercing and reverse veil-piercing are of course just different sides of the same coin, with the coin being to disregard the separateness for liability purposes of the LLC and its member.

I use term "member" in the singular, since the vast bulk of veil-piercing and reverse veil-piercing cases either involve one member, or a dominant member. This is a result of the alter ego analysis that goes into a veil-piercing case, which -- despite that there are a lot of factors that may be considered -- usually boils down to the creditor proving two elements:

(1) There exists a *unity of ownership* between the LLC and the member against which veil-piercing is asserted; and

(2) The separateness of the LLC was used to *commit some wrong*.

Assuming the creditor can prove up the commit some wrong element, which is so facts-and-circumstances dependent as to be far beyond the scope of this paper, the creditor will still have to prove the unity of ownership element, which is basically that the LLC and the member against which liability is sought, are so closely intertwined that equity demands that they be treated as one and the same.

In the law of corporations, the unity of ownership element was often met by the creditor proving that the corporate formalities of the entity were not met, often leading to some poor first-year associate having to stay up the night before document production was due, drafting Minutes "memorializing" board meetings from years past. These days, an examination of the corporate documents carries much less weight, with the Court instead examining the totality of the circumstances to make this determination.

But what of the case of the LLC, of which a supposed advantage is its lack of formalities and easy-going management? Here too, the Court will most likely look past the formalities, or lack thereof, and instead look to see whether the member treating the LLC as an independent commercial enterprise, or instead as a personal appendage.

If there are many more-or-less equal members in an LLC, the unity of ownership element will of course be much more difficult for a creditor to prove; by like token, it may be much easier for creditor to prove unity of ownership in the case of the single-member LLC.

But to get back to reverse veil-piercing, creditors in some states were able to convince a few courts that reverse veil-piercing was warranted in some cases, as discussed (but not successfully applied) by the Third Circuit in *Blatstein.*[62]. However, about as quickly as the tide of reverse-piercing cases came in, it went back out, with other courts rejecting the notion and pointing out that the creditor could always get at the entity's assets by enforcing the judgment against the debtor's shares, and then use the power conferred by those shares to do whatever needed to be done with the assets of the entity.[63]

Reverse veil-piercing has thus been widely neutered, but is not quite dead. In the case of a partnership or LLC where the Creditor's remedy is restricted to the Charging Order, it may still be that in a particular case a creditor may be able to

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[62] *In re Blatstein*, 192 F.3d 88 (3rd Cir., 1999).

[63] See, e.g., *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal.App.4th 1510 (Cal.App. Div.4, 2008); *Comm'r of Environmental Protection v. State Five Indus. Park, Inc.,* 304 Conn. 128 (2012).

persuade the Court that the equitable solution of reverse-veil piercing may be warranted. The critical thing is for planners to advise clients that the any protection afforded by their LLC's Charging Order exclusivity may only be as good as they strictly maintain separation between the operations of the LLC and their personal activities, and this should be particularly true with single-member entities where proof of unity of ownership might only be a few seemingly innocuous documents away.

DISTRIBUTION CLAWBACKS

Assume that an LLC has several more-of-less equal members, but one of the members is a debtor, and a Charging Order has been entered thus placing the Lien on the debtor-member's interest. Further assume that the other members decide to distribute the LLCs assets out to themselves, thus leaving the LLC with no assets available to make distributions to the debtor-member's interest.

The theory has gone around in such cases that, similar to theories that have evolved in cases involving corporations, the creditor might be able to bring a derivative suit on behalf of the entity to make the non-debtor members return (which is known as the "clawback") their distributions, so that an equal distribution could be made to the debtor-member's interest for the benefit of the creditor.

The theory was tested in the *CML*[64] case, where the Delaware Court of Chancery held that the creditor lacked standing under Delaware's LLC statute to bring such an action, though commenting that such an action was authorized under Delaware's corporate laws. How the theory will be treated in other states under their

[64] *CML, LLC v. Bax*, 6 A.3d 238 (Del.Ch. 2010) aff'd 28 A.3d 1037 (Del., 2011). Contra. *Beach Park Associates v. Heron*, Unpublished No. H023320 (Cal.App. Dist.6, Aug. 25, 2003) (Non-debtor partners who caused a loan from partnership that reduced the partnership's liquidity such that it could not pay on charging order perpetrated a fraud on the judgment creditor and a breach of their fiduciary duties to the partnership);

LLC statutes remains to be seen.

It should be noted, however, that a creditor might be able to assert a fraudulent transfer theory to obtain relief in such a case, although that theory remains to be tested as well.

EHMANN LIVES!

In the *Ehmann*[65] case, Bankruptcy Trustee brought an adversary action against an LLC in which the debtor-member had filed for personal bankruptcy, seeking an order that he (the Trustee) be allowed to succeed to the debtor-member's interest in the LLC, and to dissolve and liquidate the LLC so as to prevent the waste or diversion of the LLC's assets.

The LLC moved to dismiss the Trustee's complaint, alleging that the Trustee was restricted to the debtor-member's rights under the Operating Agreement which expressly prohibited an involuntary assignee, here being the Trustee, from being allowed to participate in the management of the LLC. The LLC argued that Bankruptcy Code § 365(e)(2) restricts the Trustee's powers to such contractual rights as are afforded by state law and contract law (*i.e.,* the Operating Agreement). The Trustee retorted that § 365(e)(2) only applied to executory contracts, meaning contracts where something remains to be done before a party gains rights to receive the promised consideration, and that the debtor-member here was basically a passive investor who didn't have to do anything to receive distributions. Instead, the Trustee argued, his powers came under Bankruptcy Code § 541(c)(1), which renders state and contact law restrictions invalid to the Trustee in the event of a non-executory contract, which the Trustee claimed was involved in that case.

The Court agreed with the Trustee:

[65] *In re Ehmann*, 319 B.R. 200 (Bk.D.Az., Jan. 13, 2005) *vacated per settlement* 337 B.R. 228 (Jan. 25, 2006).

> In the absence of any obligation on the part of the member, it is difficult to see where an executory contract lies. This is consistent with the whole purpose of Fiesta. It was created simply as a way to reduce the estate tax liabilities that might otherwise have been incurred upon the death of the parents and the distribution of their estate to their heirs. Indeed, as *King Lear*[66] suggests, the irrevocable transfer of the parents' assets to Fiesta and the irrevocable gift of membership interests in Fiesta to their children probably creates even less obligations on the children than the ordinary filial obligations morally felt by most expectant heirs.
>
> Moreover, not only do there not appear to be *any* obligations imposed upon members by the Fiesta Operating Agreement, but there are certainly none with respect to either receipt of a distribution or proper management of the company by its managers. Members do not have to do anything to be entitled to proper management of the company by the managers. The Trustee's complaint does not involve the Debtor's lone arguable obligation not to voluntarily withdraw.
>
> Because there are no obligations imposed on members that bear on the rights the Trustee seeks to assert here, the Trustee's rights are not controlled by the law of executory contracts and Bankruptcy Code § 365. Consequently the Trustee's rights are controlled by the more general provision governing property of the estate, which is Bankruptcy Code § 541.

The *Ehmann* opinion thus sets out a roadmap for another means for creditors to circumvent Charging Order exclusivity, albeit restricted to situations where the debtor-member has landed in bankruptcy.

As a post-script, the LLC settled the adversary action with the Trustee for $85,000 but only on the condition that the Court withdraw its Opinion in the case. The Court reluctantly did so, but felt compelled to comment:[67]

> Here, it is essentially conceded that the general manager of Defendant Fiesta Investments is particularly interested in eliminating any precedential effect this Court's December 7th Opinion might have, because his principal occupation is as a tax lawyer who frequently advises clients in the use of limited liability companies for estate planning purposes. In the balancing of the equities this counts against vacatur because it is in effect the "buy and bury" strategy that the Ninth Circuit has criticized. It also raises the Seventh Circuit's objection to the right of private parties to obtain expungement of a public act of the government.[3]
>
> Nonetheless, in weighing the equities, the Court must be mindful of the interests

[66] A reference to Shakespeare's tragedy and not to any Court opinion of that name.

[67] *In re Ehmann*, 337 B.R. 228, 229-30 (Bankr. D. Ariz. 2006)

> of unsecured creditors in this case who are understandably much more interested in getting their debts paid than in the law of executory contracts as applied to family planning LLCs. Their interests weigh heavily in favor of the settlement and vacating the Opinion. There is little equity on the other side because a bankruptcy court opinion has essentially no precedential value beyond law of the case and the inherent logic of its analysis. And, regardless of what the Court does here, it cannot disagree with Judge Easterbrook's observation that "History cannot be rewritten."

Indeed, even after the *Ehmann* opinion was withdrawn pursuant to the settlement, at least two more courts have picked up the *Ehmann* rationale and reached the same result.[68]

Ehmann lives![69]

END

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[68] *Matter of H&W Food Mart*, 461 B.R. 904 (Bk.N.D.Ga., Aug. 22, 2011); *In re First Protection, Inc.,* 440 B.R. 821 (9th Cir., Nov. 22, 2010).

[69] A reference to the phenomena of the fans of late jazz musician Charlie Parker painting the graffiti "Bird Lives!" as a statement that his innovations had survived him.

Ethical Considerations

Submitted by Scott M. Nelson

VIII. Ethical Considerations

A. Scope of Representation

B. Professional Conduct

C. Conflicts of Interest

D. Attorney Fees

A.

Scope of Representation

Lawyers are governed by the rules of professional conduct in the states where they are licensed. The ABA Model Rules of Professional Conduct ("MRPC") were initially drafted in 1983 and are updated periodically. Each state has adopted its own version of these ethical rules. The MRPC can be found at the ABA website cover page under "Popular Resources." The MRPC are largely based upon the lawyer-client relationship. Identifying your client is the first step in almost every ethical analysis.

Rule l.1 governs Competence, Rule 1.2 covers Scope of Representation, and Rule 1.3 covers Diligence. At the outset of every engagement, the lawyer needs to determine whether they can undertake the representation in a competent matter, and if not, whether they can manage the representation and delegate certain aspects to other legal counsel. A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation. Rule 1.1. A lawyer shall act with reasonable diligence and promptness in representing a client. Rule 1.3.

Who is the Client?

With any entity, there is a question of whether the lawyer represents the entity as a whole, or one of the particular members. Under Rule 1.13, a lawyer employed or retained by an organization represents the organization first and foremost. Rule 1.13(a) states, "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." The comment to Rule 1.13 clarifies the meaning of the words "duly authorized constituents." For corporations, this term refers to "officers, directors, employees, and shareholders." For non-corporate entities, the term encompasses those individuals holding "the position equivalent to officers, directors, employees, and shareholders." In the case of an LLC, the equivalent positions are those of the employees, members, managers, and governors.

Organization as the Client

Under most state statutes, an LLC is a legal entity that is separate and distinct from its partners. Thus, when a lawyer or firm represents a business entity, the client is the entity alone, and not the members, managers, partners, etc. When members of the organization make decisions, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. The organization must make its own decisions concerning policy and operations, including those decisions entailing serious risk. However, there are certain situations where it may be appropriate for a lawyer to take action. If a lawyer for an organization learns that an officer, employee or other person associated with the organization is engaged in action or intends to act in a manner that is a violation of a legal obligation to the organization or a violation of law that can reasonably be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer should give due consideration to (1) the seriousness of the violation and its consequences; (2) the scope and nature of the lawyer's representation; (3) the responsibility in the organization and the apparent motivation of the person involved; (4) the policies of the organization concerning such matters; and (5) any other relevant considerations. Any measures taken by an attorney must be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization, or even persons within the organization.

In addition to informing individuals of the consequences of an adverse action or potential conflicts, measures taken to prevent a member from acting in a manner which could substantially injure the organization may include among others (1) asking for reconsideration of the matters; (2) advising that a separate legal opinion on the matter be sought for presentation to the appropriate authority in the organization; and (3) referring the matter to a higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

The comments to Rule 1.13 indicate that clear justification should exist for seeking review over the head of the member normally responsible in the organization. Care must be taken to assure that the individual understands that when there is such adversity of interest, the lawyer for the organization cannot provide legal representation for the individual. In addition, discussion between the lawyer for the organization and the individual may not be privileged. Whether the lawyer should give a warning to the organization regarding an individual may turn on the facts of each case.

In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer must explain the identity of the client when it appears that the organization's interests are adverse to those of the organization. Nonetheless, a lawyer representing an organization may also represent any of its constituents subject to consent provisions of Rule 1.7. If the organization's consent to dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization, other than the individual who is to be represented, or by the shareholders.

Issues arise when a number of individuals wish to form an entity and one of the individuals is the lawyer's original client. If the lawyer has been selected to draft the entity agreement for all the parties, it is important for the lawyer to clearly identify who is the client and for all parties to have an understanding of whether the lawyer represents the individual or the entity.

Retainer Letter

After identifying the client, it is advisable for the lawyer to prepare a specific retainer letter defining who the lawyer is representing, as well as the scope of the engagement. The scope of representation is covered by MRPC Rule 1.2. If the lawyer's responsibilities are clear to the client at the beginning of the engagement, confusion can be avoided later as to whether the lawyer failed to meet the responsibilities assigned to the lawyer.

B.
Professional Conduct

MRPC

The preamble to the MRPC provides as follows:

"As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system. As a negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealing with others. As intermediary between clients, a lawyer seeks to reconcile their divergent interests as an advisor and, to a limited extent, as a spokesperson for each client. A lawyer acts as evaluator by examining a client's legal affairs and reporting about them to the client or to others."

Aspirations

In 2001, the Minnesota Supreme Court approved "Professionalism Aspirations" for lawyers in Minnesota. The preamble states as follows:

"We, the judges and lawyers of Minnesota, have a special responsibility for the quality of justice. We have taken an oath to conduct ourselves in an upright and courteous manner with fidelity to the court and the client, promising no falsehood or deceit. Commensurate with this responsibility and unique oath is the obligation to conduct our affairs according to the highest standards of professionalism. The following standards reflect our commitment to professionalism. They memorialize our obligations to each other, our clients and to the people of the State of Minnesota. They are designed to raise public confidence in the legal profession and the justice system through the promotion and protection of professionalism and civility. The Professionalism Aspirations are not intended to be used as a basis for discipline by the Lawyers Professional Responsibility Board."

The section dealing with a lawyer's standards of conduct to the client states as follows: "A lawyer owes allegiance, learning, skill, and diligence to a client. As lawyers, we shall employ appropriate legal procedures to protect and advance our clients' legitimate rights, claims, and objectives. In fulfilling our duties to each client, we will be mindful of our obligation to the administration of justice, which is a truth-seeking process designed to resolve human and societal problems in a rational, peaceful, and efficient manner.

i. Independent Judgment

(a) We will be loyal and committed to our clients' lawful objectives, but will not permit that loyalty and commitment to interfere with our duty to provide objective and independent advice.

(b) We will always be conscious of our duty to the system of justice.

(c) We reserve the right to determine whether to grant accommodations to opposing counsel in all matters that do not adversely affect our clients' lawful objectives.

(d) We will advise our clients, if necessary, that they do not have a right to demand that we engage in abusive or offensive conduct and we will not engage in such conduct.

(e) We will neither encourage nor cause clients to do anything that would be unethical or inappropriate if done by us.

ii. Proper Conduct on Behalf of Clients

(a) We will affirm among parties and other lawyers that civility and courtesy are expected and are not a sign of weakness.

(b) We will endeavor to achieve our clients' legitimate objectives in our office practice work and in litigation as expeditiously and economically as possible.

(c) We will not employ tactics that are designed primarily to delay resolution of a matter or to harass or drain the financial resources of the parties.

Rule 2.1 states "in representing a client, a lawyer shall exercise independent professional judgment and render candid advice." In rendering candid advice, a lawyer may refer not only to law but to other considerations such as moral, economic, social, and political factors that may be relevant to the client's situation."

Part of a lawyer's role is to serve as an advisor. As an advisor, a lawyer must provide the client with an informed understanding of his or her legal rights and obligations. The lawyer must also explain the practical implications of these rights and obligations. The comments to Rule 2.1 indicate that "purely technical advice . . . can sometimes be inadequate." In supplying advice to any business entity, it is important to take into account the ultimate goals and direction of the organization. Lawyers who can supplement their legal knowledge with an understanding of the client's business needs and objectives will be more likely to produce positive results for the client. This, in turn, will reinforce the client's confidence and trust in the lawyer and foster a more productive working relationship.

<u>Duty of Confidentiality</u>

The attorney-client privilege protects private information and communications from being made public or from being used in a court proceeding. Similarly, a lawyer has a duty to protect private information gained through representation of a client. Except when permitted under Rule 1.6(b), a lawyer shall not knowingly (1) reveal a confidence or secret of a client; (2) use a confidence or secret of a client to the disadvantage of the client; or (3) use a confidence or secret of a client for the advantage of the lawyer or a third person, unless the client consents after consultation. Rule 1.6(b) indicates that a lawyer may reveal:

(1) Confidences or secrets with the consent of the client or clients affected, but only after consultation with them;

(2) Confidences or secrets when permitted under the Rules of Professional Conduct or required by law or court order;
(3) The intention of a client to commit a crime and the information necessary to prevent a crime;
(4) Confidences or secrets necessary to rectify the consequences of the client's criminal or fraudulent act in the furtherance of which the lawyer's services were used;
(5) Confidences or secrets necessary to establish or collect a fee or to defend the lawyers or employees or associates against an acquisition of wrongful conduct; and
(6) Secrets necessary to inform the Office of Lawyers Professional Responsibility (in Minnesota) of knowledge of another lawyer's violation of The Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness, or fitness as a lawyer in other respects.

A lawyer must exercise reasonable care to prevent employees, associates and others, whose services the lawyer utilizes, from disclosing or using confidences or secrets of a client, except that a lawyer may reveal the information as allowed by Rule.

"Confidence" refers to information protected by the attorney-client privilege under applicable law, and a "secret" refers to other information gained in the professional relationship that the client has requested to be held in confidence, or the disclosure of which would be embarrassing or would be likely detrimental to the client.

When one of the members of an organizational client communicates with the organization's lawyer in that person's organizational capacity, the communication is protected by Rule 1.6. Thus, by way of example, if members of an organization request its lawyer to investigate allegations of wrongdoing, interviews made in the course of that investigation between the lawyer and the client's employees or other constituents are covered by Rule 1.6. This does not mean, however, that constituents of an organization are the client's of the lawyer. The lawyer may not disclose such information relating to the representation except for disclosures explicitly or implicitedly authorized by the organization in order to carry out the representation or as otherwise provided by Rule 1.6.

A lawyer may disclose or use information gained from a client to the advantage of the lawyer in a professional or personal setting. A lawyer may be privy to information that could potentially have adverse effects on the client, or that could provide financial benefits for the lawyer. Such information cannot be used or disclosed by the lawyer or those working with/for the lawyer.

C.
Conflicts of Interest

Rule 1.7 states that a lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless (1) the lawyer reasonably believes that the representation will not adversely affect the relationship with the other clients; and (2) each client consents after consultation. In addition, a lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interest, unless (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation must include explanation of the implications of the common representation and the advantages and risks involved.

Consent of Client

The first step in guarding against conflicts of interest is to identify all of the possible sources. Intake forms are useful to inquire about all related parties related, including adverse parties and their counsel. Further steps are recommended to compare information on new matters with information on matters that the individual attorney, and the firm as a whole have handled for other clients. Also perform a new conflict search whenever additional parties join during representation.

The comments to Rule 1.7 provide that the relevant factors in determining whether there is a potential for adverse consequences include:

(1) The duration and intimacy of the lawyer's relationship with the client or clients involved;
(2) The functions being performed by the lawyer;
(3) The likelihood that actual conflict will arise; and
(4) The likely prejudice to the client from the conflict if it does arise.

Even non-direct conflicts of interest should be recognized if a lawyer's ability to consider, recommend, or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities of interest. Substantial risk that a conflict could interfere with the lawyer's independent professional judgment is the basis for this determination. A client does have the option of consenting to representation notwithstanding the conflict. This consent must be confirmed in writing by each client. A writing by the attorney identifying the conflict does not replace the lawyer's responsibility to talk directly with the client and explain the risks and advantages to the representation, in addition to the burden of the conflict on the client and available alternatives.

A lawyer cannot ask for consent if a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances. Such as situations where the clients are hostile, it is unlikely that the lawyer could be impartial between the clients.

<u>Prohibited Transaction</u>

A lawyer shall not enter into a business transaction with the client, or knowingly acquire an ownership, possessory, security, or pecuniary interest adverse to a client unless:

(1) The transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing to the client in a manner which can be reasonably understood by the client;
(2) The client is given a reasonable opportunity to seek the advice of independent counsel in the transaction; and
(3) The client consents in writing.

Lawyer as Board Member

Ethical issues can arise when a lawyer representing an entity also serves as a member of its Board of Governors or Directors. If the situation does arise, the lawyer should consider carefully the language contained in the Rule 1.7 comment, which reads as follows:

A lawyer for a corporation or other organization who is also a member of the Board of Directors should determine whether the responsibilities of the two roles may conflict. The lawyer may be called upon to advise the corporation on matters involving actions of the directors. Consideration should be given to the frequency with which such situations may arise, the potential degree of the conflict, the effect of the lawyer's resignation from the board, and the possibility of the company obtaining legal advice from another lawyer in such situations. If there is a material risk that the dual role will compromise the lawyer's independence of professional judgment, the lawyer should not serve as director.

Termination of Representation

Conflict of interest concerns also continue after termination of an attorney-client relationship. After termination, a lawyer may not represent another client except in conformity with Rule 1.9. A lawyer who has formally represented a client in a matter shall not thereafter:

(1) Represent another person in the same or a substantially related matter that is materially adverse to the interests of the former client unless the former client consents after consultation; or

(2) Use information relating to the new representation that is to the disadvantage of the former client, except as Rule 1.6 would permit with respect to a client, or when the information has become generally known.

D.

Attorney Fees

Minn. R. Prof Conduct Rule 1.5 provides:

a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:

1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
3) the fee customarily charged in the locality for similar legal services;
4) the amount involved and the results obtained;
5) the time limitations imposed by the client or by the circumstances;
6) the nature and length of the professional relationship with the client;
7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
8) whether the fee is fixed or contingent.

b) The scope of the representation and the basis or rate of the fee and expenses for which the client will be responsible shall be communicated to the client, preferably in writing, before or within a reasonable time after commencing the representation, except when the lawyer will charge a regularly represented client on the same basis or rate. Any changes in the basis or rate of the fee or expenses shall also be communicated to the client. Except as provided below, fee payments received by a lawyer before legal services have been rendered are presumed to be unearned and shall be held in a trust account pursuant to Rule 1.15.

1) A lawyer may charge a flat fee for specified legal services, which constitutes complete payment for those services and may be paid in whole or in part in advance of the lawyer providing the services. If agreed to in advance in a written fee agreement signed by the client, a flat fee shall be considered to be the lawyer's property upon payment of the fee, subject to refund as described in Rule 1.5(b)(3). Such a written fee agreement shall notify the client:

    i. of the nature and scope of the services to be provided;
    ii. of the total amount of the fee and the terms of payment;
    iii. that the fee will not be held in a trust account until earned;
    iv. that the client has the right to terminate the client-lawyer relationship; and
    v. that the client will be entitled to a refund of all or a portion of the fee if the agreed-upon legal services are not provided.

2) A lawyer may charge a fee to ensure the lawyer's availability to the client during a specified period or on a specified matter in addition to and apart from any compensation for legal services performed. Such an availability fee shall be reasonable in amount and communicated in a writing signed by the client. The writing shall clearly state that the fee is for availability only and that fees for legal services will be charged separately. An availability fee may be considered to be the lawyer's property upon

payment of the fee, subject to refund in whole or in part should the lawyer not be available as promised.

3) Fee agreements may not describe any fee as nonrefundable or earned upon receipt but may describe the advance fee payment as the lawyer's property subject to refund. Whenever a client has paid a flat fee or an availability fee pursuant to Rule 1.5(b)(1) or (2) and the lawyer-client relationship is terminated before the fee is fully earned, the lawyer shall refund to the client the unearned portion of the fee. If a client disputes the amount of the fee that has been earned, the lawyer shall take reasonable and prompt action to resolve the dispute.

c) A fee may be contingent on the outcome of the matter for which the service is rendered, except in a matter in which a contingent fee is prohibited by paragraph (d) or other law. A contingent fee agreement shall be in a writing signed by the client and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal; litigation and other expenses to be deducted from the recovery; and whether such expenses are to be deducted before or after the contingent fee is calculated. The agreement must clearly notify the client of any expenses for which the client will be liable whether or not the client is the prevailing party. Upon conclusion of a contingent fee matter, the lawyer shall provide the client with a written statement stating the outcome of the matter and, if there is a recovery, showing the remittance to the client and the method of its determination.

d) A lawyer shall not enter into an arrangement for, charge, or collect:

1) any fee in a domestic relations matter, the payment or amount of which is contingent upon the securing of a divorce or upon the amount of alimony or support, or property settlement in lieu thereof; or
2) a contingent fee for representing a defendant in a criminal case.

e) A division of a fee between lawyers who are not in the same firm may be made only if

1) the division is in proportion to the services performed by each lawyer or each lawyer assumes joint responsibility for the representation;

2) the client agrees to the arrangement, including the share each lawyer will receive, and the agreement is confirmed in writing; and
3) the total fee is reasonable.

The editorial comments suggest:

a. As to the reasonableness of the fees and other charges: Paragraph (a) requires that lawyers charge fees that are reasonable under the circumstances. The factors specified in (1) through (8) are not exclusive. Nor will each factor be relevant in each instance. Paragraph (a) also requires that expenses for which the client will be charged must be reasonable. A lawyer may seek reimbursement for the cost of services performed in-house, such as copying, or for other expenses incurred in-house, such as telephone charges, either by charging a reasonable amount to which the client has agreed in advance or by charging an amount that reasonably reflects the cost incurred by the lawyer.

b. As to the basis or rate of the fee: When the lawyer has regularly represented a client, they ordinarily will have evolved an understanding concerning the basis or rate of the fee and the expenses for which the client will be responsible. In a new client-lawyer relationship, however, an understanding as to fees and expenses must be promptly established. Generally, it is desirable to furnish the client with at least a simple memorandum or copy of the lawyer's customary fee arrangements that states the general nature of the legal services to be provided, the basis, rate or total amount of the fee and whether and to what extent the client will be responsible for any costs, expenses or disbursements in the course of the representation. A written statement concerning the terms of the engagement reduces the possibility of misunderstanding.

c. As to contingent fees: Contingent fees, like any other fees, are subject to the reasonableness standard of paragraph (a) of this rule. In determining whether a particular contingent fee is reasonable, or whether it is reasonable to charge any form of contingent fee, a lawyer must consider the factors that are relevant under the circumstances. Applicable law may impose limitations on contingent fees, such as a ceiling on the percentage allowable, or may require a lawyer to offer clients an alternative basis for the fee. Applicable law also may apply to situations other than a contingent fee, for example, government regulations regarding fees in certain tax matters.

d. As to terms of payment: A lawyer may require advance payment of a fee, but is obliged to return any unearned portion. See Rule 1.16(d). A lawyer may accept property in payment for services, such as an ownership interest in an enterprise, providing this does not involve acquisition of a proprietary interest in the cause of action or subject matter of the litigation contrary to Rule 1.8 (i). However, a fee paid in property instead of money may be subject to the requirements of Rule 1.8(a) because such fees often have the essential qualities of a business transaction with the client.

e. An agreement may not be made whose terms might induce the lawyer improperly to curtail services for the client or perform them in a way contrary to the client's interest. For example, a lawyer should not enter into an agreement whereby services are to be provided only up to a stated amount when it is foreseeable that more extensive services probably will be required, unless the situation is adequately explained to the client. Otherwise, the client might have to bargain for further assistance in the midst of a proceeding or transaction. However, it is proper to define the extent of services in light of the client's ability to pay. A lawyer should not exploit a fee arrangement based primarily on hourly charges by using wasteful procedures.

f. As to division of a fee: A division of fee is a single billing to a client covering the fee of two or more lawyers who are not in the same firm. A division of fee facilitates association of more than one lawyer in a matter in which neither alone could serve the client as well, and most often is used when the fee is contingent and the division is between a referring lawyer and a trial specialist. Paragraph (e) permits the lawyers to divide a fee either on the basis of the proportion of services they render or if each lawyer assumes responsibility for the representation as a whole. In addition, the client must agree to the arrangement, including the share that each lawyer is to receive, and the agreement must be confirmed in writing. Contingent fee agreements must be in a writing signed by the client and must otherwise comply with paragraph (c) of this rule. Joint responsibility for the representation entails financial and ethical responsibility for the representation as if the lawyers were associated in a partnership. A lawyer should only refer a matter to a lawyer whom the referring lawyer reasonably believes is competent to handle the matter. See Rule 1.1.

g. As to dispute over fees: If a procedure has been established for resolution of fee disputes, such as an arbitration or mediation procedure established by the bar, the lawyer must comply with the procedure when it is mandatory, and, even when it is voluntary, the lawyer should conscientiously consider submitting to it. The law may prescribe a procedure for determining a lawyer's fee, for example, in representation of an executor or administrator, a class or a person entitled to a reasonable fee as part of the measure of damages. The lawyer entitled to such a fee and a lawyer representing another party concerned with the fee should comply with the prescribed procedure.

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