

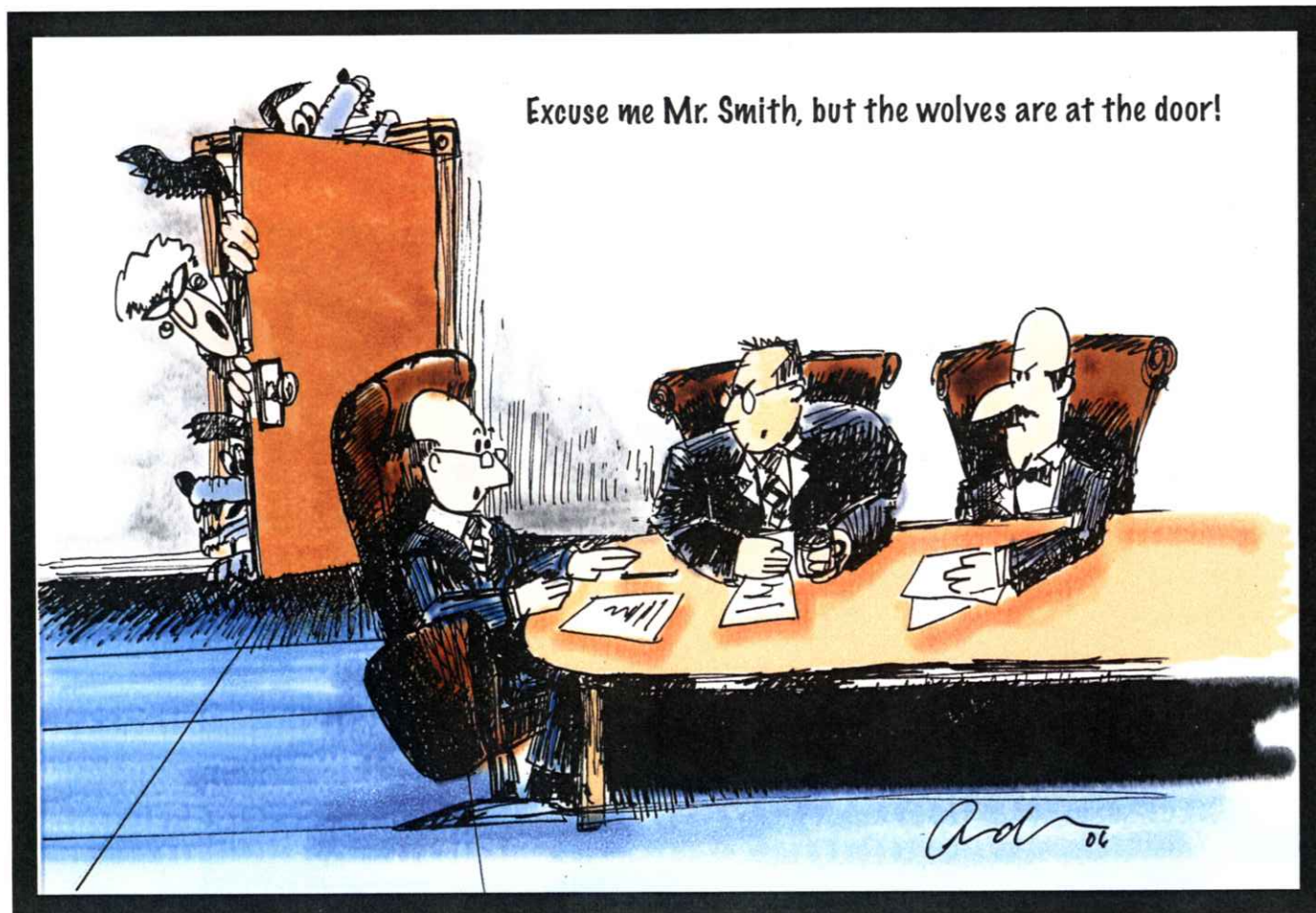
The Alarming Potential for Foreclosure and Dissolution by an LLC Member's Personal Creditors

By Elizabeth M. Schurig and Amy P. Jetel

Limited liability entities (such as limited partnerships, limited liability companies, and corporations) were originally conceived as a way to encourage investment by insulating the entity's owners from the entity's debts and from debts of the other owners. But recently, limited partnership (LP) and limited liability company (LLC) ownership interests have themselves come to be viewed as "quasi-exempt" assets.

In the November/December 2003 issue of this magazine, however, the authors published an article that warned practitioners against making a blanket assumption that an LP interest is a protected asset. Whether or not this is true depends on each individual state's limited partnership laws. Elizabeth M. Schurig & Amy P. Jetel, *A Charging Order Is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?*, Prob. & Prop. 57, Nov./Dec. 2003. Because the previous article was intended to spur discourse, and possibly encourage legislative change, the authors were pleased with both the response from practitioners (whether in the form of horrified phone calls or rebutting prose, see Daniel S. Kleinberger et al., *Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, Prob. & Prop. 30, July/Aug. 2004), and the legislative response from states like Delaware.

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Table 1: Comparison of Creditor's Rights Provisions of the Uniform LP Act and the Uniform LLC Act

Given the resulting heightened focus on the issue of personal asset protection in the context of LP interests, it is timely to write this article on LLC interests as an extension of the discussion started with the authors' previous article.

After providing a brief summary of the interesting history of LLCs in the United States, this article will discuss the various creditor remedies against an individual member's ownership interest (outside of a bankruptcy or secured-creditor context). This article will reveal that, much like the limited partners in a limited partnership, members of an LLC are, in many states, subject to being divested of their ownership interest to satisfy a creditor's claim. But a more severe remedy is available to creditors in the LLC context than in the LP context—in seven states, a member's creditor can actually reach the LLC's assets through judicial dissolution of the company.

The Evolution of Limited Liability Companies in the United States

The LLC has existed in one form or another in Europe, Central and South America, and Japan since the end of the 19th century. In June 1977, Wyoming became the first state in the United States to enact an LLC statute, which provided for an entity that gave its owners limited liability from business debts, like a corporation, but was taxed like a partnership. See, e.g., generally Nicholas G. Karambelas, *Limited Liability Companies: Law, Practice, and Forms* § 3:01 (2d ed. 2004); Wayne A. Hagedorf, *The Complete Guide to Limited Liability Companies* ch. 1 (1995). Hamilton Brothers Oil Company formed a Wyoming LLC in 1977 and immediately applied to the IRS for an administrative ruling that it qualified as a partnership for federal income tax purposes. The IRS granted the ruling on a private basis in 1980, but then changed its position in 1982. PLR 8106082 (Nov. 18, 1980); PLR 8304138 (Oct. 29, 1982). Finally, the IRS settled the matter in 1988 by ruling that an LLC is taxable as a partnership for federal income tax purposes. Rev. Rul. 88-

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| <p>Creditor's rights statute derived from § 703 of the Revised Uniform Limited Partnership Act (1976)</p> | <p>On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's limited liability company interest with the payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's limited liability company interest. [This Act] does not deprive any member of the benefit of any exemption laws applicable to his limited liability company interest.</p> |
| <p>Uniform Limited Liability Company Act (1996)</p> | <p>§ 504. Rights of creditor. (a) On application by a judgment creditor of a member of a limited liability company or of a member's transferee, a court having jurisdiction may charge the distributional interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order. (b) A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee. (c) At any time before foreclosure, a distributional interest in a limited liability company which is charged may be redeemed: (1) by the judgment debtor; (2) with property other than the company's property, by one or more of the other members; or (3) with the company's property, but only if permitted by the operating agreement. (d) This [Act] does not affect a member's right under exemption laws with respect to the member's distributional interest in a limited liability company. (e) This section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.</p> <p>§ 503. Rights of transferee. . . . (e) A transferee who does not become a member is entitled to: . . . (3) seek . . . a judicial determination that it is equitable to dissolve and wind up the company's business.</p> |

76, 1988-2 C.B. 360 (Sept. 2, 1988). By 1996, every state had enacted a limited liability company act, and most states had modeled their LLC acts on partnership statutes to ensure that LLCs would be taxed as partnerships. But because the IRS issued its "check the box" regulations in 1997, which provide absolute certainty for the taxation

of LLCs, certain partnership characteristics of LLC acts are no longer necessary and are therefore being removed from state statutes (such as the requirements that an LLC not have "continuity of life" or "centralized management"). See, e.g., Rev. Proc. 95-10, 1995-1 C.B. 501.

Currently, all state LLC laws derive

from either the Uniform Limited Partnership Act (1976) (the "Uniform LP Act") or the Uniform Limited Liability Company Act (1996) (the "Uniform LLC Act"). Because states first formulated their LLC statutes at a time when no Uniform LLC Act existed, the majority of current state LLC statutes are based on the Uniform LP Act. There is, however, a movement in state legislatures to adopt a version of the Uniform LLC Act, some provisions of which are a concern from the standpoint of protecting the entity from disruption by an owner's creditor. (The creditor's rights provisions of these two uniform acts are compared in Table 1 on page 43.)

Asset Protection and Limited Liability Companies— Defining the Issue

When advising clients on asset protection in the context of LLCs, it is important for practitioners to differentiate between the two primary sources of threats: (1) creditors of the entity and (2) creditors of the individual members.

Creditors of the *entity* (for instance, a lender to the entity or a person who is injured on property owned by the entity) can absolutely reach the LLC's assets to satisfy a claim, but their claim may not generally be satisfied with assets owned by the entity's individual members. In particularly egregious cases, however, a creditor could argue that he should be allowed to "pierce the veil" of the LLC because the entity is either a "sham" or the "alter ego" of the sole owner of a single-member LLC. (In addition to veil piercing, members also can be held personally liable by statute or under common-law principles. For a list of the various exceptions to limited liability for LLC members, see Hagedorf, *supra*, ch. 13.) If a creditor prevailed with this type of argument, then the liability would not belong to the entity but would instead belong to the individual owners of the entity, thereby making the owners personally liable for the claim.

The more difficult and relevant question for purposes of this article is whether a creditor of an individual

**Table 2: States with Creditor's Rights Provisions
Based on Uniform LLC Act, with Dissolution Provision**

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|---|--|
| Hawaii Haw. Rev. Stat. § 428-504 Haw. Rev. Stat. § 428-503 | Hawaii's LLC Act deletes the last part of the second sentence of subsection (a), which allows a court to "make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order." |
| Illinois 805 Ill. Comp. Stat. § 180/30-20 805 Ill. Comp. Stat. § 180/30-10 | There is pending legislation to delete the "exclusive remedy" language of subsection (e) from Illinois's statute. |
| Montana Mont. Code Ann. § 35-8-705 Mont. Code Ann. § 35-8-902 | Substantially similar to Uniform LLC Act provision. |
| South Carolina S.C. Code § 33-44-504 S.C. Code § 33-44-503 | Same as Uniform LLC Act provision. |
| South Dakota S.D. Codified Laws § 47-34A-504 S.D. Codified Laws § 47-34A-503 | Same as Uniform LLC Act provision. |
| Vermont 11 Vt. Stat. Ann. § 3074 11 Vt. Stat. Ann. § 3073 | Substantially similar to Uniform LLC Act provision. |
| West Virginia W. Va. Code § 31B-5-504 W. Va. Code § 31B-5-503 | Same as Uniform LLC Act provision. |

member can reach the member's interest in the LLC—or even reach the underlying LLC assets—to satisfy the member's personal debts. To that end, the three primary remedies available to creditors against an LLC membership interest (primarily under the Uniform LLC Act) will be discussed: (1) a charging order against the debtor-member's LLC interest, (2) foreclosure on the LLC interest that is subject to the charging order, and (3) forced dissolution of the LLC. (Charging orders and foreclosure are also available in the limited partnership context, but dissolution of the entity is not.)

Charging Order

A charging order is an order issued by a court that charges the debtor's interest in the LLC with the amount due to

the judgment creditor. Under a charging order, the creditor can get distributions from the entity only to the extent of the debt. The debtor keeps his membership interest, is taxable on his pro rata share of LLC income, and, once the debt is paid, is freed from the order and life goes on as before.

Foreclosure

Unlike a charging order, a foreclosure results in the debtor's being permanently divested of his LLC membership interest. Section 504 of the Uniform LLC Act explicitly classifies a charging order as a "lien" on the member's "distributional interest" in the LLC. This lien can be foreclosed upon by a creditor who succeeds in convincing a court that the previously issued charging order is not sufficient to satis-

fy the debt (for instance, because the company's earnings are continually withheld for reinvestment rather than distributed to its members).

A member's "distributional interest" is defined as "all of a member's interest in distributions by the limited liability company," and the transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. Uniform LLC Act §§ 101, 502. Although the use of the term "distributional interest" gives the impression that the lien is no real concern from the member-debtor's perspective, the reality is that, if a creditor successfully forecloses on the distributional interest, the debtor will lose all of the economic benefit of his membership interest forever, including a right to his pro rata share of the LLC's assets at liquidation. The fact that the Uniform LLC Act allows the judgment debtor to "redeem" his interest before foreclosure (that is, sell

his interest back to the LLC) protects other members of the company from having a creditor participate in the company's affairs, but it does not have any positive effect on the end result to the debtor—he has still lost his interest in the LLC forever.

Despite the availability of foreclosure as a creditor remedy in those states that have adopted the Uniform LLC Act, some practitioners might still argue that the mere possibility of foreclosure is no "real" threat because of the fact that either the applicable LLC laws or the individual company's governing documents make the purchaser at a foreclosure sale a mere "transferee" of that interest. Further, because a transferee cannot exercise managerial functions and does not have the right to become a member—so the argument goes—foreclosure is not an "attractive" remedy, and, therefore, creditors will not actually seek foreclosure.

**Table 3: States with Creditor's Rights Provisions
Based on Uniform LLC Act, without Dissolution Provision**

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|---|---|
| California Cal. Corp. Code § 17302 | Substantially similar to Uniform LLC Act provision. |
| Colorado Colo. Rev. Stat. Ann. § 7-80-703 | Colorado's LLC Act does not include the language providing that "this section provides the exclusive remedy by which a judgment creditor of a member . . . may satisfy a judgment out of the judgment debtor's [LLC interest]." |
| Delaware 6 Del. Code Ann. § 18-703 | In 2005, Delaware amended its LLC statute to make a charging order the "exclusive remedy" against an LLC interest and to delete the statute's references to foreclosure. The legislature, however, preserved the portion of subsection (b) of the statute that makes a charging order a "lien on the judgment debtor's limited liability company interest." This ambiguity makes it possible that a creditor could argue that foreclosure is still a remedy in Delaware. Although the legislative history to Delaware's statute shows that the legislature intended to preclude foreclosure, the statute would be better without the "lien" language. |
| Utah Utah Code Ann. § 48-2c-1103 | Alters various sections and adds a final subsection: "No creditor of a member shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the company." |
| Virginia Va. Code Ann. § 13.1-1041.1 | Same as Uniform LLC Act provision. There is legislation pending that would attempt to make a charging order the "exclusive remedy." Va. S.B. 547. However, the proposed changes have the same ambiguity as Delaware's statute. |

Nonetheless, foreclosure's permanent nature gives a creditor a better bargaining position in settlement discussions than a bare charging order would.

As an aside, it must be mentioned that some statutes use the term "assignee," rather than "transferee." Many practitioners believe that there is a substantive difference between an "assignee" and a "transferee" in that one has more or less rights than the other. The authors' research, however, has not revealed such a difference. Rather, a state's use of the term "assignee" or "transferee" is just a matter of whether the legislature preferred one word over the other.

Dissolution

As can be seen, the availability of foreclosure as a remedy means that a membership interest in an LLC is not as protected (from the individual member's

perspective) as many practitioners may think. But foreclosure may not be the greatest threat. Section 503 of the Uniform LLC Act allows a transferee who has not become a member to seek a judicial determination that it is equitable to dissolve the LLC and wind up its affairs. In the bankruptcy context, creditors have been allowed to dissolve LLCs under the reasoning that there are no other owners to protect (in the case of a single-member LLC), or the owners have no true duties toward one another to be performed under the company's governing documents. See, e.g., *In re Ehmman*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003). But outside the bankruptcy context, a creditor could use the Uniform LLC Act provisions to not only foreclose on the lien created by a charging order but also to force dissolution of the company and

**Table 4: States with Creditor's Rights Provisions
Based on the Uniform LP Act**

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
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| Alabama Ala. Code §10-12-35 | Adds a sentence before the final sentence: "This section shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." |
| Alaska Alaska Stat. § 10.50.380 | Adds a subsection before the final sentence: "This section provides the exclusive remedy that a judgment creditor of a member or a member's assignee may use to satisfy a judgment out of the judgment debtor's interest in the limited liability company. Other remedies, including foreclosure on the member's limited liability company interest and a court order for directions, accounts, and inquiries that the debtor member might have made, are not available to the judgment creditor attempting to satisfy a judgment out of the judgment debtor's interest in the limited liability company and may not be ordered by a court." |
| Arizona Ariz. Rev. Stat. § 29-655 | Adds a final subsection: "This section provides the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the judgment debtor's interest in the limited liability company." |
| Arkansas Ark. Code Ann. § 4-32-705 | Same as Uniform LP Act provision. |
| Connecticut Conn. Gen. Stat. Ann. § 34-171 | Same as Uniform LP Act provision. |
| Florida Fla. Stat. Ann. § 608.433(4) | Same as Uniform LP Act provision. |

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|---|---|
| Georgia Ga. Code Ann. § 14-11-504 | Adds a final sentence: "The remedy conferred by this Code section shall not be deemed exclusive of others which may exist, including, without limitation, the right of a judgment creditor to reach the limited liability company interest of the member by process of garnishment served on the limited liability company." |
| Idaho Idaho Code § 53-637 | Adds a sentence before final sentence: "The charging order is the exclusive remedy by which a judgment creditor of the member or transferee may satisfy a judgment against the member's interest in a limited liability company." |
| Indiana Ind. Code § 23-18-6-7 | Same as Uniform LP Act provision. |
| Iowa Iowa Code Ann. § 490A.904 | Same as Uniform LP Act provision. |
| Kansas Kan. Stat. Ann. § 17-76,113 | Adds a final sentence: "The rights provided by this section to the judgment creditor shall be the sole and exclusive remedy of a judgment creditor with respect to the member's limited liability company interest." |
| Kentucky Ky. Rev. Stat. § 275.260 | Same as Uniform LP Act provision. |
| Louisiana La. Rev. Stat. Ann. § 12:1331 | Same as Uniform LP Act provision. |
| Maine 31 Me. Rev. Stat. Ann. § 686 | Same as Uniform LP Act provision. |

receive a pro rata share of the LLC's assets on dissolution (which could greatly exceed the individual member's debt). For most individuals forming LLCs as their operational entity, this potential for dissolution in the hands of a co-owner's creditor may dissuade them from using this type of entity.

Overview of State LLC Acts

Tables 2, 3, and 4 separate the state LLC laws into three separate categories. Table 2 on page 44 lists those states whose LLC legislation is based on the Uniform LLC Act, including the dissolution provision, and Table 3 on page 45 lists the states with Uniform LLC Act-derived statutes that do not

include the dissolution provision. Finally, Table 4 on pages 46-48 shows the states with LLC legislation based on the Uniform LP Act. Any noteworthy changes that a particular state has made to the applicable Uniform Act are described in the appropriate table. Note that neither Nebraska's nor Pennsylvania's limited liability compa-

**Table 4: States with Creditor's Rights Provisions
Based on the Uniform LP Act (continued)**

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|--|---|
| Maryland Md. Code Ann., Corps. & Ass'ns § 4A-607 | Same as Uniform LP Act provision. |
| Massachusetts Mass. Gen. Laws. Ann. ch. 156C, § 40 | Same as Uniform LP Act provision. |
| Michigan Mich. Comp. Laws Ann. § 450.4507 | Adds a final subsection: "Unless otherwise provided in an operating agreement, the member remains a member and retains all rights and powers of membership except the right to receive distributions to the extent charged." |
| Minnesota Minn. Stat. Ann. § 322B.32 | Adds a final sentence: "This section is the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." Further, section 322B.31 of Minnesota's LLC Act explicitly disallows a transferee's ability to cause a dissolution of the company. |
| Mississippi Miss. Code § 79-29-703 | Same as Uniform LP Act provision. |
| Missouri Mo. Ann. Stat § 347.119 | Same as Uniform LP Act provision. |
| Nevada Nev. Rev. Stat. § 86.401 | Adds a subsection: "This section . . . Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor." |
| New Hampshire N.H. Rev. Stat. § 304-C:47 | Same as Uniform LP Act provision. |

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|--|---|
| New Jersey N.J. Stat. Ann. § 42:2B-45 | Adds a final sentence: "A court order charging the limited liability company interest of a member pursuant to this section shall be the sole remedy of a judgment creditor, who shall have no right under [this Act] or any other State law to interfere with the management or force dissolution of a limited liability company or to seek an order of the court requiring a foreclosure sale of the limited liability company interest. Nothing in this section shall be construed to affect in any way the rights of a judgment creditor of a member under federal bankruptcy or reorganization laws." Further, section 42:2B-44(e) of New Jersey's LLC Act explicitly disallows a transferee's ability to cause a dissolution of the company. |
| New Mexico N.M. Stat. Ann. § 53-19-35 | Same as Uniform LP Act provision. |
| New York N.Y. Ltd. Liab. Co. Law § 607 | Adds a subsection: "No creditor of a member shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company." |
| North Carolina N.C. Gen. Stat. Ann. § 57C-5-03 | Same as Uniform LP Act provision. |
| North Dakota N.D. Cent. Code § 10-32-34 | Adds a subsection: "This section is the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." |
| Ohio Ohio Rev. Code § 1705.19 | Same as Uniform LP Act provision. |

ny laws address creditor remedies against a judgment debtor's membership interest, and, because of this, neither of these states is shown in the tables. (These tables are current as of March 2006.)

In those states that have statutes derived from the Uniform LLC Act (Tables 2 and 3), a creditor's charging

order can clearly lead to foreclosure because it is explicitly allowed by the statute. Similarly, in the states whose laws are based on the Uniform LP Act (Table 4), although they do not explicitly mention foreclosure, it may still be possible for a creditor to argue that the charging order is a lien that can be foreclosed on—and some states have civil

practice and remedies statutes that allow courts to order foreclosure on a lien to satisfy a judgment. For example, Tex. Civ. Prac. & Rem. Code § 31.002(b) provides that when a judgment lien has been placed on non-exempt property, "[t]he court may . . . (2) otherwise apply the property to the satisfaction of the judgment; or (3) appoint a receiver

**Table 4: States with Creditor's Rights Provisions
Based on the Uniform LP Act (continued)**

| State/Statutory Citation | Noteworthy Differences from Uniform LLC Act | State/Statutory Citation | Noteworthy Differences from Uniform LLC Act |
|--|--|--|--|
| Oklahoma 18 Okla. Stat. Ann. § 2034 | Adds a sentence before the final sentence: "A charging order entered by a court pursuant to this section shall in no event be convertible into a membership interest through foreclosure or other action. . . . This section shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." There is legislation pending that would make Oklahoma's statute substantially similar to the Uniform LLC Act (without the dissolution provision). Okla. S.B. 560. | Texas Tex. Bus. Orgs. Code § 101.112 | Same as Uniform LP Act provision. |
| Oregon Or. Rev. Stat. § 63.259 | Same as Uniform LP Act provision. | Washington Wash. Rev. Code § 25.15.255 | Same as Uniform LP Act provision. |
| Rhode Island R.I. Gen. Laws § 7-16-37 | Same as Uniform LP Act provision. | Wisconsin Wis. Stat. Ann. § 183.0705 | Same as Uniform LP Act provision. |
| Tennessee Tenn. Code Ann. § 48-218-105 | Adds a final sentence: "This section is the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." Further, section 48-218-101 of Tennessee's LLC Act explicitly disallows a transferee's ability to cause a dissolution of the company. | Wyoming Wyo. Stat. § 17-15-145 | Adds a sentence before the final sentence: "The charging order is the exclusive remedy by which a judgment creditor of the member or transferee may satisfy a judgment against the member's interest in a limited liability company." |
| | | District of Columbia D.C. Code § 29-1038 | Same as Uniform LP Act provision. |

with the authority to take possession of the nonexempt property, sell it, and pay the proceeds to the judgment creditor to the extent required to satisfy the judgment." Seeing this possibility, many states with Uniform LP Act legislation have added provisions that provide that the charging order is the "exclusive remedy" against an LLC membership interest.

As for dissolution, this remedy is not statutorily available in states with LLC laws based on the Uniform LP Act. Furthermore, Minnesota, New Jersey, and Tennessee have each added a provision to their respective versions of the Uniform LP Act that explicitly disallows a transferee's ability to cause a dissolution of the company (possibly in response to the concern that a court could still order dissolution under

those states' civil practice and remedies statutes, as discussed above).

Because of the relatively recent passage of the Uniform LLC Act and the fact that only seven states have adopted a version of it, it is not surprising that there are no cases construing the uniform law's dissolution provisions. Nonetheless, given the explicit statutory allowance for dissolution contained in the Uniform LLC Act, it is important for each state that enacts a version of the Uniform LLC Act to evaluate this aspect of the uniform law and determine whether to include it in its state legislation, and it is especially important for each practitioner to carefully evaluate the statutory provisions of each potential jurisdiction before forming an LLC in that jurisdiction.

Conclusion

In conclusion, just like limited partnerships, LLCs can be very useful tools in an estate planning practitioner's tool box. But like any tool, they have their practical limitations. If personal asset protection is the client's primary goal in placing assets in an LLC, it is important for the practitioner to realize that the protection provided by most state LLC statutes is inadequate because of the availability of foreclosure as a remedy against a debtor's membership interest. More frightening, however, is the possibility in some states that a third-party creditor could halt the LLC's business and disrupt the lives of nondebtor members by obtaining a judicial dissolution of the company. ■