

In these troubled economic times, protecting one's assets from creditor attack is as important as—maybe even more important than—saving estate taxes. The limited liability company has long been touted as one of the best entity choices available to hold a client's business (or nonbusiness) assets because of its asset protection benefits. The LLC is also a very common estate planning tool for other reasons, including a streamlined and flexible management structure, favorable income tax treatment, and ease of transferability of interests. But as explained below, the asset protection benefits of the LLC structure should not be overestimated or oversold. This article will examine the genesis and history of the LLC as an asset protection vehicle under state law. It also will explore some of the federal bankruptcy laws and cases in which the asset protection benefits of the LLC under state law were questioned or, worse yet, simply stripped away.

The Charging Order— A Creditor Roadblock

The general rule under most state LLC statutes is that if a judgment creditor of an LLC member attempts to seize the LLC member's membership interest, or the LLC assets, the judgment creditor's only remedy is a "charging order." The charging order limits a judgment creditor's remedies against the LLC member by prohibiting the creditor from seizing or selling the LLC member's membership interest and also—and equally as important—from seizing or selling the LLC's assets. The judgment creditor simply becomes an "assignee" of the LLC. The charging order remedy is therefore a significant collection roadblock to the judgment creditor. It is also a very important roadblock in preventing a wholesale disruption of the LLC's business operations. If the judgment creditor could sell LLC assets to satisfy its judgment, LLC operations would quickly come to a halt. Therefore, most state LLC statutes give a judgment creditor with a charging order few options or rights. The primary right the judgment creditor has is to receive any distributions that might otherwise be made by the LLC to the LLC member. Note that these limitations on a judgment creditor's rights presume there has not been a fraudulent transfer under state or federal law.

History and Genesis of the Charging Order Under State Law

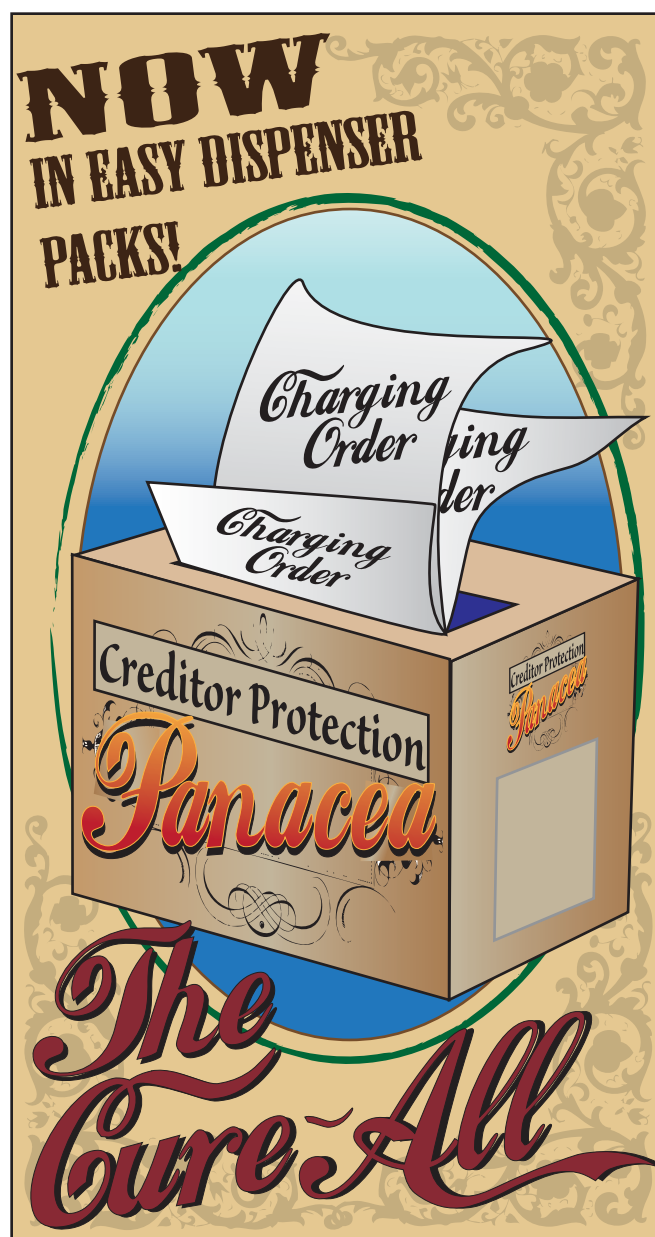
Today, the charging order remedy is found in most state LLC statutes and derives from section 503 of the Revised Uniform Limited Liability Company Act (RULLCA (2006)), which also provides for judicial foreclosure of an LLC member's interest as an alternative remedy. Some states have opted to exclude judicial foreclosure as an alternative remedy in their LLC statutes. See, for example, the Texas Revised Uniform Limited Partnership Act. It should be pointed out that the LLC charging order remedy originated from the charging order remedy found in most state limited partnership statutes. This remedy derives from section 703 of the Uniform Limited Partnership Act (ULPA (2001)). Before the charging order remedy (and before LLC state statutes), a judgment creditor of

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ASSET PROTECTION AND THE LIMITED LIABILITY COMPANY

NOT THE PANACEA OF
CREDITOR PROTECTION
THAT YOU MIGHT THINK!

By William S. Forsberg



a partner in a partnership (limited or general) could effect a sale by foreclosure of specific partnership assets to satisfy the partner's debt. The procedure was for the sheriff to go to the partnership's place of business and seize and liquidate partnership assets, which, in many cases, effectively put the partnership out of business. The charging order remedy was created to enable partnerships to prevent this type of draconian creditor action and the corresponding business disruption. The charging order was a way to satisfy the creditor's claims with the partner debtor's share of partnership distributions while preserving the ongoing business operations of the partnership. The charging order operates as a substitution for execution on a partner's interest in the partnership, or a liquidation of the partnership. These same public policy considerations were later incorporated into the charging order provisions of most state LLC statutes. Each state's LLC statute is different, so it is important to review each relevant state's LLC statute regarding asset protection in general and the charging order in particular. This is particularly true today because of the frequency with which practitioners form LLCs in states other than their own home state. For example, the author is aware (at least anecdotally) that there is uncertainty about whether other states will honor Delaware's "series" LLC statute. Below are the relevant provisions of RULLCA (2006), which provide that the charging order is the exclusive remedy of a judgment creditor. These provisions are similar to, if not exactly the same as, those contained in many state LLC statutes.

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.

...
(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.

RULLCA (2006) § 503 (emphasis added).

Rights of a Judgment Creditor with a Charging Order

The rights of a judgment creditor with a charging order under state law are few. The judgment creditor has only the rights of an "assignee." An assignee has only the right to receive any LLC distributions to which the LLC debtor member was entitled. The judgment creditor as assignee does not have the right to become a member in the LLC. In most cases, an assignee can become a substitute member only if all other LLC members (or some percentage of LLC members as stated in the LLC operating agreement) consent. Most important, the judgment creditor as assignee does not have a right to vote on LLC matters. The judgment creditor as assignee cannot inspect the books and records of the LLC, nor can the judgment creditor obtain business and tax information from the LLC. And if all the LLC members are related to each other (that is, a "Family LLC"), it is unlikely that family members will "vote in" a judgment creditor as an LLC member, provide LLC information, or make distributions from the LLC that could be attached by the debtor (family) LLC member's judgment creditors. These LLC charging order protections and limitations can put settlement negotiations with the judgment creditor on a fast track. This may be particularly true if the judgment creditor must report, and is taxable on, its pro rata share of taxable income from the LLC, whether or not the LLC makes a distribution. This fact alone may be enough leverage for a quick and favorable settlement.

Federal Bankruptcy Law and the LLC

The charging order under state law gives LLC members a powerful weapon against judgment creditor attack. But

what if the LLC member files for protection under the federal bankruptcy laws? Are state law asset protection benefits still as helpful under federal law? Does it matter if the LLC is a single or multiple member LLC? As noted above, the public policy behind the charging order was to balance the judgment creditor's rights against the desire to avoid a disruption or liquidation of the LLC's business. In *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003), a debtor owning an interest in a single member LLC filed for federal bankruptcy protection. The bankruptcy court held that, on filing, the debtor assigned her LLC membership interest to the trustee in bankruptcy under Bankruptcy Code § 541, which afforded the trustee all of the debtor's rights in the LLC, including the right to liquidate the LLC. The court in *Albright* noted that the result would have been different if there had been more than one member in the LLC. But compare *Albright* to *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005), in which a debtor who owned an interest (less than all) in an Arizona LLC filed for Chapter 7 bankruptcy—liquidation. The trustee in bankruptcy brought a lawsuit against the LLC claiming that the trustee was a substitute LLC member and that the assets of the LLC were being wasted, misapplied, and diverted for improper purposes. The trustee sought an order to dissolve and liquidate the LLC. The LLC sought to dismiss the lawsuit, asserting that the trustee was a mere assignee and that the restrictions on transfer in the LLC operating agreement were "executory" in nature. The court sided with the bankruptcy trustee. It held that the bankruptcy trustee has all the rights and powers regarding the LLC that the debtor held at the commencement of the case. One alarming aspect of the holding in *Ehmann* is that the bankruptcy trustee took the LLC member/debtor's full membership interest in the LLC. And the bankruptcy court went a step further—it held that Bankruptcy Code § 541(c)(1) effectively stripped away all provisions of Arizona law and the LLC operating agreement that otherwise provided that an assignee does not succeed to non-economic rights (voting rights, for example) of an LLC member, implying that the bankruptcy trustee gained all of the

rights and powers, economic and non-economic, of the LLC member/debtor. Finally, it should be pointed out that the court in *Ehmann* granted the bankruptcy trustee's motion for summary judgment and ordered the appointment of a receiver with the admonition that the receiver could, if necessary, cause the dissolution and liquidation of the LLC to satisfy the creditors of the LLC member/debtor.

Executory Contracts and Ipso Facto Clauses in Bankruptcy

In the Bankruptcy Code, the term "executory contract" is not defined, so the courts have adopted the "Countryman" definition, derived from the work of Prof. Vern Countryman in *Executory Contracts in Bankruptcy*, 57 Minn. L. Rev. 439 (1973): a contract is "executory" 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). 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," the transfer restrictions contained in the agreement would be binding on the bankruptcy trustee. The bankruptcy court in *Ehmann* found that the LLC operating agreement *was not* executory because the LLC members had no binding unfulfilled obligations to the LLC, that Bankruptcy Code § 541(c)(1) controlled, and that the trustee stepped into the shoes of the debtor LLC member. Bankruptcy Code § 541(c)(1) provides:

Except as provided in paragraph (2) of this subsection, *an interest of the debtor*

in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—
(A) *that restricts or conditions transfer of such interest by the debtor; or . . .*

Bankruptcy Code § 541(c)(1) (emphasis added).

A provision that terminates an agreement on the filing of bankruptcy is called an ipso facto clause (Latin for "by the fact itself"). The fact of bankruptcy itself is enough to trigger the termination of the agreement. Bankruptcy Code § 541(c)(1) prohibits these ipso facto clauses from being operative. It provides that an interest of the debtor in property becomes "property of the estate,"

meaning that the debtor does not lose the property or contract right, despite an ipso facto provision in an agreement. Many LLC member control or operating agreements provide that, on an involuntary transfer (such as the filing of a petition in bankruptcy by an LLC member), the LLC member's interest converts to that of any assignee, or triggers a buy-out, or both. Will they be upheld? The general rule is no, unless the LLC operating agreement is an "executory" contract. In *In re The IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003), a default provision in an operating agreement for an LLC was held to be an ipso facto clause that was unenforceable under the provision of the Bankruptcy Code barring termination or modification of executory contracts or unexpired leases, or rights or obligations thereunder, because of the debtor's commencement of a bankruptcy case, such that one of the remaining members of the LLC was precluded from exercising its buyout rights under the agreement based on the debtor's bankruptcy petition filing.

In *In re Smith*, 185 B.R. 285 (Bankr. S.D. Ill. 1995), a Chapter 7 trustee filed an adversary proceeding seeking to dissolve a limited partnership formed by the debtor and her brother or, alternatively, to have the debtor's interest in the partnership property "re-conveyed" to the bankruptcy estate. The brother and the limited partnership moved for summary judgment. The bankruptcy court held that (1) the debtor's right, as a limited partner, to seek judicial dissolution of the partnership was estate property over which the bankruptcy court had jurisdiction; (2) the restrictions on transfer contained in the limited partnership agreement did not preclude the bankruptcy trustee from seeking dissolution; (3) the limited partnership agreement was not an "executory contract" and thus the bankruptcy trustee did not relinquish its right to seek dissolution by failing to timely assume the contract; (4) it was a question of fact as to whether the limited partnership by conducting business precluded summary judgment on the merits of the dissolution issue; (5) the venue provision in the Illinois Revised Uniform Limited Partnership Act

(RULPA) did not preclude the bankruptcy court from exercising jurisdiction; and (6) the Bankruptcy Court would not abstain from hearing the dissolution proceeding.

In *In re Garrison-Ashburn, LC*, 253 B.R. 700 (Bankr. E.D. Va. 2000), a member of a Virginia LLC filed for bankruptcy and the bankruptcy court concluded that the LLC operating agreement was not an executory contract and thus not within Bankruptcy Code §§ 365(c) and 365(e), thereby preventing enforcement of certain ipso facto clauses.

Finally, in *In re Cutler*, 165 B.R. 275 (Bankr. D. Ariz. 1994), a Chapter 7 debtor's partners brought an adversary proceeding for an order compelling the bankruptcy trustee to allow them to buy back the debtor's partnership interest in accordance with a buyout clause in the partnership agreement. The bankruptcy trustee answered and counter-claimed, seeking an order vesting in the bankruptcy estate an undivided 25% interest in each asset of the partnership. The bankruptcy court held that (1) the debtor-partner's one-quarter interest in profits and surplus of the partnership was included in the property of his Chapter 7 estate, free and clear of restrictions in the partnership agreement granting other partners the option to purchase his interest at book value, but (2) the bankruptcy trustee could not assume the debtor-partner's management function under the partnership agreement and could not compel sale of partnership assets themselves, which were not included in debtor's estate.

Agreement Executory in Bankruptcy?

Can one make the LLC member control or operating agreement executory in bankruptcy? Bankruptcy case law suggests it is very difficult to accomplish. In *In re Garrison-Ashburn*, 253 B.R. 700, the bankruptcy court held that once a member of the LLC filed for bankruptcy, a bankruptcy estate was created that encompassed all of the LLC member's interest in the LLC, whatever that interest was, whether economic or non-economic. No restriction on transfer of any interest of a debtor/LLC member,

whether it arises from operative documents themselves (an LLC operating agreement, for example) or from applicable nonbankruptcy law (that is, state law), prevents that interest from becoming property of the estate under the Bankruptcy Code. The LLC operating agreement was not an executory contract but merely provided structure for management of the LLC and did not impose any additional duties or responsibilities on the LLC members. But the court, in dicta, suggested that an obligation to provide additional capital, to participate in management, or to provide personal expertise or services to the LLC (contained in the LLC operating agreement) might make it an executory contract.

In *In re DeLuca*, 194 B.R. 65 (Bankr. E.D. Va. 1996), the operating agreement was held to be executory and not assumable. The operating agreement was determined to be executory because it required continuing personal services by the members, and, thus, the services were executory under the Bankruptcy Code. Therefore, the bankruptcy trustee could not substitute himself for the members as the managing members in the face of objections of the other members.

Whether or not one can craft an LLC operating agreement so it is executory is an open question. Also, in most cases business considerations and exigencies dictate the provisions of an LLC operating agreement, not asset protection planning.

Conclusion

Although the LLC remains a formidable estate and asset protection tool under state law, it is not the panacea of creditor protection that one might think. This is especially true if the judgment debtor owns an interest in a single member LLC, or the LLC is a multiple member LLC and the judgment debtor LLC member files for federal bankruptcy protection. Due diligence must be exercised by all members of an LLC when the LLC is formed. Not all LLC members are created equal, and caution in the selection of one's business partners is always prudent. ■