CHINKS IN THE ARMOR:
CURRENT TRENDS IN LIMITED LIABILITY COMPANY STRUCTURE AFTER OLMSTEAD

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From corporations to limited partnerships and limited liability companies, developing trends in the law shape the dynamics of an entities' limited liability. Certain corporate forms provide more protection from outside creditors than others. This writing will examine a few of these entities and see where Chinks in the Armor exist-- allowing outside creditors to reach seemingly protected assets.

Insulation Against Inside Liabilities

For over 100 years, we witnessed the existence of corporations. One of the main benefits of a corporation, is to use an entity to own assets or operate a business and shield corporate owner(s)' other assets from third-party claims against the entity. We call this insulation against inside liabilities. When can we go beyond this infrastructure and "pierce the corporate veil" the following question arises - whether such claims against the corporation reach its shareholders? The answers lie in the "Instrumentality Rule" and "Identity Rule."

The "Instrumentality Rule" requires a plaintiff to prove the following three elements against shareholders: (1) complete dominion and control of the entity's policy and business practices; (2) use of such control to commit fraud or wrongdoing, breach of a legal duty, or a dishonest or unjust act; and (3) such control and breach of duty proximately caused injustice or loss.[1] One example of a dishonest or unjust act for proof of the second element occurs when shareholders use control to avoid personal liability which an individual previously assumed.[2] Where two corporations are really controlled as an entity due to common owners, officers, directors or shareholders, the "Identity Rule" generally governs.[3] A court will also use the "Identity Rule" to "pierce the corporate veil" where two corporate entities fail to observe corporate formalities.[4]

Limited liability companies ("LLCs"), which have only been around since 1982, gained popularity in Florida after the 1999 repeal of the Florida Corporation Income Tax on an LLC's income and later repeal of the Florida Intangible Tax on an LLC's interests. Limited liability limited partnerships ("LLLPs") arose when the legislature amended the LLLP statute to provide for *limited* liability protected for all partners including general partners rather than partial limited liability formerly available.[5] A Connecticut court held under the appropriate circumstances, it could "pierce the corporate veil" of an LLC and hold members personally liable to third parties. In *Stone v. Frederick Hobby Associates II, LLC*, No. CV 000181620S, 2001 WL 861822, at *10 (Conn. Super. Ct. July 10, 2001), the court found based on the facts the "instrumentality and identity rules" allowed the court to "pierce the veil" of an LLC and hold individual members personally liable.

When one considers the big picture of "piercing the veil" of a corporation, LLC or LLLP, a secondary question arises: how does a court "pierce the veil" of a subsidiary? A recent Florida case held that to "pierce the veil" of a subsidiary, a plaintiff must prove the subsidiary is a mere instrumentality of the parent company *and* the parent company organized and used its subsidiary to mislead or perpetrate a fraud on creditors.[6]

The court in *Litchfield Asset Management Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2001), allowed "reverse veil piercing" or "piercing the veil" against a subsidiary. The court in *Litchfield*, determined a judgment creditor could access an LLC's assets against the LLC's sole member.[7] After the

court entered judgment against the debtor in her individual capacity, she set up two LLCs and contributed cash to both. The *Litchfield* court noted the LLCs never operated a business, made distributions or paid salaries. Moreover, the debtor used the LLC's assets to pay personal expenses and make interest-free loans to family members. The court held the debtor used control over the LLC to perpetrate a wrong-doing against creditors, disregarded corporate formalities, and exceeded her management authority (via loans to family members). The court ordered reverse piercing of the LLCs.

Litchfield demonstrates certain flaws inherent in use of a single member LLC as an asset protection vehicle. For example, in situations like *Litchfield*, a creditor's attorney may file a complaint alleging fraud and invoke the veil-piercing remedy allowing the judgment creditor to circumvent normal judgment collection procedures codified in the LLC Act.[8] One such procedure is charging of the member's interest in the LLC.[9]

Insulation Against Outside Liabilities

Limited partnerships and LLCs share certain asset protection features against outside liabilities such as a creditor. One key feature occurs where a limited partner cannot satisfy a creditor. The creditor's only available remedy may be to secure a "charging order" against a partner's limited partnership or membership interest income.[10] A "charging order" gives the creditor the right to receive all distributions from the LLC related to the debtor's interest thereon until such time as the debt is satisfied. Because limited partnerships and LLCs similarly insulate debtors from outside liabilities, the protection of the "charging order" concept should extend to LLCs in Florida.

In 2005, the Florida Bar Task Force successfully provided the Florida Legislature with a Revised form of the Florida Revised Uniform Limited Partnership Act of 2005. Under RE-FRULPA, the exclusive remedy for a judgment creditor of a limited partnership is a "charging order."[11] LLCs currently enjoy the protection of "charging orders" but not as an exclusive remedy.

The Exclusivity of the Charging Order Remedy

Under RE-FRULPA, in an action against a limited partnership, "charging orders" provide an exclusive remedy where a judgment creditor's rights equal those of an assignee to the extent charged.[12] Florida Statute Section 608.433 provides similar protection for LLCs. However, unlike limited partnerships, under Florida Statute Section 620.1703, a "charging order" is not the *sole* remedy against an LLC interest.[13]

In an LLC, the rights of a creditor under a "charging order" equal those of a transferee and cannot reach management and other partners' rights.[14] The rights of the "charging order" holder extend only to the judgment debtor/partner's rights to distributions.[15] In this scenario, the rights of the "charging order" holder are analogous to those of a wage garnishor. The "charging order" represents a lien on the judgment-debtor's distribution rights. Such a right is the judgment-debtor's transferrable interest. A court cannot order other remedies for a judgment creditor who attempts to satisfy a judgment out of the judgment debtor's interest in the limited partnership.[16] This includes remedies of foreclosure on the partner's interest in the limited partnership or a transferee's transferable interest and a court order for directions, accounts and inquires that the debtor general or limited partner might have made.[17]

Certain state statutes and precedent provide for the foreclosure and sale of an LLC or limited partnership interest. In such a situation, the buyer takes the position of an assignee and shares no member or partner rights. For example in *Crocker National Bank v. Perroton,* 208 Cal. App. 3d 1 (Cal. Dist. Ct.

App. 1989), the California District Court of Appeal considered whether a charged pimited partnership interest was subject to foreclosure and sale. The court determined where the creditor has a "charging order," all partners other than debtor agree to sale and the judgment remains unsatisfied, a court can authorize sale of the debtor's partnership interest.[18] The *Nigri v. Lotz*, 453 S.E.2d 780 (Ga. Ct. App. 1995) decision illustrates the importance of the incorporation state in the entity selection process. As in *Nigri*, if the applicable limited partnership statute and case precedent do not make the "charging order" the sole remedy, the court may use other means to enforce the "charging order" such as foreclosure of a partner's interest.[19] In *Nigri*, the Georgia Court of Appeals considered whether a charged limited partnership interest was subject to foreclosure and sale.[20] The court held a trial court may enforce a "charging order" through foreclosure of a partner's interest, especially where it appears distributions under the "charging order" will not pay off the judgment debt within a reasonable period of time.[21] The court concluded whether or not a judicial sale of the charged partnership interest is appropriate in aid of a "charging order" lies within a trial court's discretion.[22]

Despite the ultimate decision in *Nigri*, the court raised an argument of concern. Noting the Uniform Limited Partnership Act ("ULPA") and the Uniform Partnership Act ("UPA") governed the limited partnership in *Nigri*, the Court of Appeals stated the UPA contained a provision which prohibited the sale of a charged interest, while the ULPA did not.[23] The court determined the purpose underlying the inability to sell and transfer a partner's charged interest under the UPA was fear of disruption as the creditor-assignee could seek judicial dissolution of the partnership.[24] The court distinguished foreclosures of limited partnership interests since the assignee of a limited partnership interest cannot seek judicial dissolution under the ULPA.[25] The Bankruptcy Court in *In re Albright*, 291 B.R. 538 (Bankr. D. Co. 2003), advanced the same argument. The bankrupt sole member in *Albright* sought to thwart the trustee's ability to reach the LLC's assets and use them for her own obligations.[26] The LLC member argued according to the "charging order" the only relief available to the trustee was receipt of distributions.[27] The court rejected the "charging order" defense on grounds that the remedy served to protect non-debtor members of a multi-member LLC from judgments against a debtor member.[28] Thus, in a single member entity, where no non-debtor members existed, the trustee could take on a managerial position in the LLC in place of Albright.[29]**Single Member LLCs**

In a single member LLC, different considerations shape how a court applies liability rules. For example, in *Albright, supra,* the court concluded a "charging order's" purpose was to protect other LLC members from sharing governance responsibilities with a judgment creditor.[30]
The court found single member LLCs with only one managing member were not protected as no other members existed.[31] In *Albright*, a judgment creditor could thus obtain governance rights.[32]

The *Albright* caveat—a Chapter 7 Liquidated Bankruptcy. Upon the debtor's bankruptcy filing, she effectively transferred her membership interest to the estate.[33] With no other existing members, the bankruptcy trustee became a "Substituted Member."[34] Thus, the same result would not necessarily occur in favor of a creditor.[35] Certain elements of the LLCs' statutory structure, including the "charging order" and requirement that the current owner approve new members, lose their rational support when viewed in the single member LLC context.[36] Thus, *Albright* should not apply to multi-member LLCs.[37]

The case of *In re Ehmann,* 319 B.R. 200 (Bankr. D. Ariz. 2005), involved a recent Bankruptcy Court decision where the court allowed a Chapter 7 Bankruptcy Trustee to step in the shoes of a bankrupt member of an Arizona LLC as a "full member" without assuming the "assignee" status of a transferee which state law and the operating agreement required. There the debtor's parents set up a multi-member family LLC and distributed significant funds to themselves and their children *but not* the debtor/bankruptcy trustee.[38]

In order to mitigate the *Ehmann* issue, tax planners recommend: (1) drafting the LLC operating agreement or operating agreement as an "executory contract" for bankruptcy law purposes and provide entity owners' ongoing obligations; (2) mandatory capital calls; (3) service obligations; (4) non-competition obligations; and (5) partnership or membership interests with owners of a trust or "tenants by the entirety."[39]

In the single member LLC context, how does a Chapter 11 bankruptcy proceeding differ from a Chapter 7? Recent court decisions involving pending Chapter 11 bankruptcy actions relied entirely on bankruptcy law and held in a single member LLC, all debtor's interests became the bankruptcy estate's property and subject to the trustee's sole and exclusive authority.[40]

The Florida Supreme Court case of *Federal Trade Commission v. Olmstead*, 528 F.3d 1310 (11th Cir. 2008), provides an interesting analysis of how to reach single member LLC assets in a fraud scenario. *Olmstead* involved two people who used an "S" Corporation and single member LLC to run a credit card scam.[41] The defendant agreed to appointment of a receiver over the LLC who was directed to "conserve, hold and manage, preserve the value of, and prevent the unauthorized transfer, withdrawal, or misapplication of the entities' assets."[42] The Federal Trade Commission ("FTC") later obtained a $10,000,000.00 judgment against the individuals and their original company.[43] The FTC then moved to compel defendants to surrender their single member LLC interests to the receiver.[44] The district court granted the motion and the receiver sold the LLCs' assets and paid the FTC the proceeds.[45] The appellate court in *Olmstead* certified the following question, currently under review, to the Florida Supreme Court: "[w]hether, pursuant to Florida Statute section 608.433(4), a court may order a judgment-debtor to surrender all 'right title and interest' in the debtor's single-member limited liability company to satisfy an outstanding judgment?"[46]

The Florida Supreme Court held that a charging lien is not the sole remedy against a single member LLC. It cited the "emptiness" of the charging lien where there are no other members to protect and/or obtain the approval to become a member. More importantly, the decision stated that the LLC statute did not have the "sole and exclusive" language that the LP statute contained. Although the opinion spoke only to single-member LLC's, this last line of reasoning does not bode well for multimember LLC's but it does indicate that charging orders against limited partnership interests are the creditors sole remedy.

On September 29, 2010, the U.S. District Court of Appeals for the 11th Circuit concluded that, based on the Florida Supreme Court's decision in *Olmstead*, a court may order a judgment-debtor to surrender all "right, title and interest" in the debtor's single member LLC to satisfy a judgment creditor's claims.[47] Now we have Federal Appellate Law to add to the Florida Supreme Court and the four bankruptcy cases that all do away with the "soleness" of the charging order as a remedy for creditors against single member LLCs.

Single Member LLCs Treated as Separate Entities

Can the IRS get a tax lien against a single member LLC? An assessment against a single member owner of an LLC does not result in an enforceable IRS tax lien against the LLC's assets.[48] In one case, the IRS treated a disregarded single member LLC as a separate entity in order to apply the small partnership exception to TEFRA audit rules.[49]

As an interesting aside, in Revenue Ruling 77-137, the Internal Revenue Service ruled that a limited partnership entity's K-1 must be reported by a limited partnership interest assignee even where the

partnership agreement provided an assignee may not become a substituted limited partner without the general partners' consent.[50] This rule, applied to an LLC, gives a creditor a strong inducement against foreclose, if documents fail to provide for minimum tax distributions.

A final thought regarding Florida law. RE-FRULPA currently provides the "charging order" as a *sole* remedy. Such exclusivity binds Florida courts as we move into the future. Unfortunately, LLCs do not share such tight protection. The new Florida Bar Task Force redrafting the LLC statute will review this inconsistency. But until a change takes place in the law, enough Chinks in the Armor of the LLC exist to allow outside creditors through. Thus, the safer structure in such a situation is a limited liability limited partnership.

Planning Ideas

While *Olmstead* is still fresh on our minds, consider the following planning thoughts:

1. Issue additional shares of the LLC so that the LLC is a multi-member LLC and not a single member LLC. The only caveat is that the *Olmstead* case does infer that the charging order is not the sole remedy against a multi-member either because the statute is improperly drafted. Assuming that the new statute goes through as currently drafted, it should be resolved by the middle of next year. However, in the meantime, you still have the question of whether or not it is the sole remedy based on the dicta in *Olmstead*.

2. Leave the state. However, the use of single member entities in other states with clearer language such as Delaware or Wyoming may not be as safe as you think. No rulings have been held in these states, but it is pretty clear that the bankruptcy courts in *Albright, Ehman's, etc.* are not going to recognize the single member LLC to protect against creditors. With all the discussion going on around the country about *Olmstead*, it may well be that the courts are not going to recognize a single member LLC under state law either, so if you are going to leave, leave the country.

3. Hold the interest in a single member LLC as tenants by the entirety between husband and spouse. It is strongly recommended that you issue a single certificate, labeled husband and wife as tenants by the entirety, and draft an operating agreement that clearly states the entity as a single member entity and there is no distinguishment between voting, profits and losses or capital as between the spouses. Lastly, the personal tax returns of the spouses should be filed jointly disregarding the entity and recognizing all the income as if the entity were disregarded. In Florida, this should protect the assets against the creditor of one of the spouses and should be disregarded for tax purposes. However, you still have the following problems that occur:

a. Client is single;

b. Prenuptial or client may simply not want to share the ownership with his or her spouse;

c. The judgment is against both spouses;

d. If the wrong spouse dies;

e. Divorce; or

f. This arrangement may not fit with your estate planning goals, where you are trying to set up separate assets in each spouse's name to fund the unified credit shelter trust. Of course, if you have enough to fund that trust for each spouse with other assets, it is not as much of a problem.

4. The best alternative seems to be to use an "LLLP". Convert to or begin with an LLLP. The *Olmstead* court indicated that the "sole and exclusive" language of the LLLP statute was sufficient to protect the entity against debtors. This entity is a little more expensive and requires a partnership tax return. The only problems here are: (a) that you must have a real second member; and (b) who will be the general partner? The first problem is mostly a business question. As for the second, it can be a corporation, an LLC, or an individual. The creditor can take the interest of a corporation or an LLC, and thereby own the general partner's interest , but an individual general partner may be best because the creditor can only obtain a charging lien against his interest and the individual is protected from inside liability by electing to become an LLLP. Further, if the individual is married, the general partner interest could be held as tenants-by-the-entireties which should avoid the charging lien entirely. After that, the creditor is a mere "assignee" and cannot affect the company business without the consent of the other partners. And, the other partners can replace the general partner unless restricted by the partnership agreement, so in drafting the agreements, make sure to provide for the remaining partners to do so in the event of such an assignment.

Continued Uses for Single Member LLCs

The following uses presume that there is little or no need for protection against outside creditors:

1. As firewalls between the shareholder and another interest. For instance, in a tenancy in common ("TIC"), rather than taking the owner's undivided interest in the name of the individual and subjecting the person to liability, it is better to hold the interest in a single member LLC so that it not only provides for protection from liability coming from the property, but the entity is disregarded so it can use the entity to effect a tax free exchange under Section 1031. This LLC can also be held jointly as tenants by the entirety as discussed above. While this does not obviate *Olmstead*, it is better than holding the TIC in the individual's name.

2. When used as subsidiaries of a parent holding company, LLCs sometimes are used to create firewalls between the subsidiaries and the parent. The only time the *Olmstead* issue would arise would be debt at the parent level, which if the parent is a simple holding company holding the subsidiaries, should be manageable.

3. Bankruptcy remote entities. The LLC is a good choice to serve as a bankruptcy remote entity. This means that the interest in capital and profits would be owned by the borrower, but a non-profit/capital interest is owned by a lender or its nominee. That interest is a second class of membership interest which only has the right to vote against such things as: bankruptcy, lawsuits, adding additional debt, etc. which the lender would like to prevent.

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[1] *See Stone v. Frederick Hobby Assocs. II, LLC*, No. CV 000181620S, 2001 WL 861822, at *8 (Conn. Super. Ct. July 10, 2001).
[2] *Id.*
[3] *Id.* at *9.
[4] *Id.*
[5] § 620.81002, Fla. Stat. (2010).
[6] *17315 Collins Ave., LLC v. Fortune Dev. Sales Corp.*, 34 So. 3d 166 (Fla. 3d DCA 2010); *see also Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So. 2d 1114 (Fla. 1984) ("improper conduct" also required); *Baldwin v. Bill & Carolyn Ltd. P'ship*, No. BAP.NO. EO-05-114, 2006 WL 2034217, at *1 (B.A.P. 10th Cir. 2006).
[7] *Litchfield Asset Mgmt. Corp. v. Howell*, 799 A.2d 298 (Conn. App. Ct. 2001).
[8] § 621.02, Fla. Stat. (2010), Professional Service Corporations and Limited Liability Company Act, ch. 621, sec. 621.02 (2010); *see* § 608.701, Fla. Stat. (2010).
[9] § 608.433, Fla. Stat. (2010). Professional Services Corporations & Limited Liability Companies, ch. 621 sec. 621.8504 (2010); *see also Klein v. Weidner*, No. 08-3798, 2010 WL 571800, at *8 (E.D. Pa. Feb. 17, 2010) (reverse pierce where LLC improperly used to perpetrate injustice against creditor); *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal. App. 4th 1510 (Cal. Ct. App. 2008) (reverse pierce allowed with "alter ego" doctrine after alternative available remedies found inadequate).
[10] § 620.1703, Fla. Stat. (2005).
[11] *See* Rights of Creditor of Partner or Transferee. § 620.1703, Fla. Stat. (2010).
[12] § 620.1703(3), Fla. Stat. (2010), RE-FRULPA section citation providing judgment creditor exclusive remedy is charging order and rights are of an assignee to extent charged. § 620.8504, Fla. Stat. (2010).
[13] *See* Right of an Assignee to Become Member. § 608.433, Fla. Stat. (2010).
[14] § 608.432 and § 608.433(4), Fla. Stat. (2010).
[15] § 608.433(4), Fla. Stat. (2010).
[16] § 620.1703(3), Fla. Stat. (2010).
[17] *Id.*
[18] *Id. see also Hellman v. Anderson*, 233 Cal. App. 3d 840 (Cal. Ct. App. 1991) (consent of non-debtor partners not always required where no undue interference with partnership business exists).
[19] *Nigri v. Lotz*, 453 S.E.2d 780, 782-783 (Ga. Ct. App. 1995).
[20] *See Nigri, supra.*
[21] *Nigri, supra.*
[22] *Nigri, supra.*
[23] *Nigri, supra.*
[24] *Nigri, supra.*
[25] *Nigri, supra*. Similarly, other states with statutes or precedent allowing foreclosures include California, Colorado, Connecticut, Georgia, Hawaii, Idaho (effective July 1,2010), Illinois, Iowa, Kansas, Kentucky, Maryland, Missouri, Montana, Nebraska, New Hampshire, Ohio, South Carolina, Utah, Vermont and West Virginia. States not allowing foreclosure include Alabama, Alaska, Arizona,

Delaware, Florida, Minnesota, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, Virginia and Wyoming.

[26] *In re Albright*, 291 B.R. 538 (Bankr. D. Co. 2003).

[27] *In re Albright, supra.*

[28] *In re Albright, supra.*

[29] *In re Albright, supra.*

[30] *In re Albright, supra.*

[31] *In re Albright, supra.*

[32] *In re Albright, supra.*

[33] *In re Albright, supra.*

[34] *In re Albright, supra.*

[35] *In re Albright, supra.*

[36] *In re Albright, supra.*

[37] *See also In re Ehmann,* 319 B.R. 200 (Bankr. D. Ariz. 2005); *Crocker Nat'l Bank v. Perroton,* 208 Cal. App. 3d 1 (Cal. Dist. Ct. App. 1989); *cf.* Revised Model LLC Act, § 621.02, Fla. Stat. (2010) (permits foreclosure on multi-member LLC interest as in *Perroton* and *Nigri*, 453 S.E.2d 780 at 782-783); *see also* The Florida Bar Task Force drafting the new Florida LLC Act & reviewing single and multi-member issues.

[38] *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005).

[39] In Florida, "tenants by the entirety" gives property owners significant asset protection as husband and wife theoretically own one hundred percent of the asset which forbids one spouse's creditor from seizing the property. Exceptions are "joint debt" and where a non-debtor spouse dies with an action pending against the debtor spouse.

[40] *In re Modanlo*, 412 B.R. 715 (Bankr. D. Md. 2006), *aff'd* 266 Fed. Appx. 272 (2008); *In re A-Z Electronics, LLC,* 350 B.R. 886 (Bankr. D. Idaho 2006).

[41] *Federal Trade Comm'n v. Olmstead,* 528 F.3d 1310 (11th Cir. 2008).

[42] *Olmstead, supra.*

[43] *Olmstead, supra.*

[44] *Olmstead, supra.*

[45] *Olmstead, supra.*

[46] *Olmstead, supra.*

[47] *Federal Trade Comm'n v. Olmstead*, 621 F.3d 1327 (11th Circuit 2010).

[48] IRS CCA 200338012, 2003 WL 22208688, § 82.01.00-00 Trust Fund Taxes: Collection (Sept. 19, 2003); IRS CCA 200235023, WL 1999524, § 6331 Levy and Distraint (Aug. 30, 2002).

[49] *See IRS CCA* 200250012, 2002 WL 31781355, § 6231 Definitions and Special Rules (December 13, 2002).

[50] Rev. Rul. 77-137, 1977-1 CB 178

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