

## OLMSTEAD: THE BIGGEST CHINK IN THE ARMOR

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Since its introduction into the Florida Limited Liability Company Act in 1993, the “charging order” provision has served as a key asset protection feature of a Limited Liability Company (“LLC”). If a member of a LLC is unable to satisfy the debts owed to a personal creditor (outside liability), that judgment creditor's remedy against the member is usually limited to receiving a "charging order" against the economic income of that member's share of an LLC's distributions.<sup>1</sup> However, after the Florida Supreme Court's decision in *Olmstead, et al v. FTC*, 35 Fla. L. Weekly S357 (Fla. 2010), this may no longer be true.

As the current statute reads, "the Court may charge the LLC membership interest with payment of the unsatisfied amount of the judgment with interest."<sup>2</sup> 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. The rights of the "charging order" holder extend only to the debtor's rights to income distributions from the LLC.<sup>3</sup> This provision protects non-debtor members by keeping creditors from obtaining interests in the management and operations of the company. It can be inferred from the statute and legal precedent that the “charging order” provision was created to protect non-debtor members in a multimember LLC, but what if a LLC has but a single member?

The elimination of Florida's corporate income tax in 1998 coupled with the repeal of the Florida intangible tax on LLC interests sparked increased usage of LLCs as asset protection vehicles. In 1999, the Florida Legislature revised the LLC Act again by constructing Section 608.471, which established single-member LLCs in the State of Florida.<sup>4</sup> However, there was neither a revision to the charging order provision nor any amendment discussing application of alternative judicial remedies against the single member LLC.

The treatment of debts owed by members of LLCs and the application of the charging provision has been addressed recently in noteworthy bankruptcy court decisions. The Colorado bankruptcy court addressed an issue involving the application of the charging order provision on a single-member LLC in the case of *In re Albright*. The *Albright* Court granted the Chapter 7 bankruptcy trustee full membership power in a LLC despite objections by the debtor that the trustee was only entitled to a charging order.<sup>5</sup> The court determined that a charging order exists only to protect other members of an LLC from having to involuntarily share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. This provision protects the autonomy of the original members, and their ability to manage their own enterprise. However, in a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose as no other parties' interests are affected. Therefore, *Albright* found that in single-member LLCs, the trustee can assume a managerial position in the company in place of the debtor.

The Chapter 7 liquidation case of *In re Ehmman* involved a debtor with membership in a multi-member LLC. Section 541 of the Bankruptcy Code states that upon the filing of a Chapter 7 petition, an estate is created which encompasses all legal and equitable property of the debtor.<sup>6</sup>

Upon filing for Chapter 7 protection, the debtor's membership interest in the LLC was voluntarily transferred to the trustee.<sup>7</sup> The *Ehmann* court ruled that Chapter 7 status allowed the bankruptcy trustee to step in as a "full member" of the LLC without assuming the "assignee" status of a transferee which state law and the operating agreement required.

Cases such as *Albright* and *Ehmann* prompted the Legislature to enact the new Florida Revised Uniform Limited Partnership Act ("RE-FRULPA"). This statute clarified the language surrounding charging order provisions by making a charging order the "exclusive" remedy for a creditor against a member of a limited partnership.<sup>8</sup> Limited partnerships require two or more partners, which always leaves someone to protect. But what about single-member entities? *Albright* addressed flaws surrounding the structure of single-member LLCs. The statutory provisions surrounding the "charging order" and the restrictions pertaining to assignment of membership lose their rational support when viewed in the context of single-member LLCs. It wasn't until the decision in *Olmstead*, that these flaws were thoroughly exposed.

After two years of deliberation, the Florida Supreme Court issued its ruling in *Olmstead* in favor of the creditor, the Federal Trade Commission ("FTC").<sup>9</sup> Through the usage of two limited liability entities, Peoples Credit First, LLC ("PCF") and Consumer Preferred, LLC ("CP"), *Olmstead* and his partner, Connell, defrauded people out of money using an advance-fee credit card scam. The Federal Trade Commission sued the appellants and the corporate entities under Section 5(a) of the Federal Trade Commission Act, 15 U.S.C. § 45(a), for unfair and deceptive trade practices. The district court immediately froze the assets of the appellants. As a result of not adhering to the court ordered asset freeze, the FTC obtained a court order compelling appellants to endorse and surrender all of their right, title, and interest in the LLCs to a receiver. The appellants did not object to the surrender of PCF and CP, acknowledging that there was very little money in the two companies. However, among those assets listed in the surrender order was several single-member LLCs in which either *Olmstead* or his partner, Connell, was the sole member. The FTC asserts that two of these LLCs, Product Dynamics and Dynamic Fulfillment & Services, assisted PCF and CP; and were an integral part of the scam as they provided mailing lists and trained employees to deal with consumer complaints. The appellants strongly opposed the surrender of their single-member LLCs, and argued that they were protected by the Florida LLC Act's "charging order" provision. The underlying premise for the argument was the appellants' desire to protect the proceeds of their credit card scam which were transferred into the single-member LLCs to escape judgment. The assets were ultimately placed in receivership. The FTC sought to liquidate the assets, including all of their LLCs, after being granted \$10 million in a summary judgment.

The landmark decision in *Olmstead* reiterates the need for clarified statutory language regarding LLCs and the "charging" order provision. The majority in *Olmstead* reasoned that because Section 608.433(4) of the Florida Statute for LLCs did not clearly state that a charging order was the "sole and exclusive remedy," an alternate remedy could be ordered at the court's discretion. The Court opined that the legislature deliberately left the softer language surrounding the charging order provision after its last revision of the statute and, affirmed the district court's ruling that allowed the assets from the LLCs be liquidated to pay the FTC judgment. However, the *Olmstead* Court fails to discuss positions previously taken by Florida courts involving partnerships and the charging order remedy in adopting their position. In *Myrick v. Second*

*National Bank*, the Florida District Court of Appeals considered whether the partnership charging order statute, which at the time was substantially similar to the Florida LLC Act, furnished the creditor with an additional remedy or whether it limited the remedy to strictly a charging order.<sup>10</sup> The court concluded that the charging order is the essential first step, and all further proceedings must occur under the supervision of the court, which may take all appropriate actions, including the appointment of a receiver if necessary, to protect the interests of the various parties. The Florida Court of Appeals went even further in *Atlantic Mobile Homes, Inc. v. LeFever* and *Givens v. National Loan Investors, L.P.*, concluding that the charging order remedy was the sole remedy available to a judgment creditor.<sup>11</sup> All of these cases were decided prior to the 2005 Amendment of FRULPA and FRUPA and ultimately, were the driving points towards adding the “sole and exclusive” language to the respective statutes.

The *Olmstead* majority views single-member LLCs as merely another form of corporation, not a partnership. The opinion refers to an LLC as a type of corporate entity and an ownership interest in an LLC as transferable personal property that is reasonably understood to be “common stock.” However, a corporation is structurally different from an LLC. Nowhere in the Florida corporate statute does it mention charging orders as even a potential remedy for a creditor judgment. LLCs are substantially more akin to partnerships in both structure and substance. The majority’s decision to levy and sell *Olmstead*’s single-member LLCs under Section 56.061 implies a material similarity between corporations and LLCs that simply does not exist.

Citing *Bradshaw v. Am. Advent Christian Home & Orphanage*, the majority claims that where a debtor has an “interest in property which he may alien or assign, that ‘interest, whether legal or equitable, is liable for the payment of his debts.’”<sup>12</sup> Section 608.432(1) provides that a member may freely transfer or assign his LLC interest in whole or in part. However, an assignment of a membership interest will not necessarily transfer the right to participate in the LLC’s management. The Florida LLC act provides that an assignee cannot participate in the management of the LLC unless he obtains “approval of all of the members of the LLC other than the member assigning a LLC interest...” According to the majority, the limitation on the assignee rights of LLCs found in Section 608.433(1) does not apply in cases involving transfer of rights in single-member LLCs. *Albright*’s analysis shows that in a single-member LLC, the set of “all members other than the member assigning the interest” is empty. Thus, an assignee of a membership interest in a single member LLC becomes a full and legitimate member, taking full right and title to the economic and management interests of the transferor. This opens the door for application of the levy and sale remedy afforded by Section 56.061 over the standard Section 608.433(4) charging order.

Because a sole member may freely transfer his entire interest in a single member LLC, the majority felt that Section 56.061 authorizes a creditor with a judgment for an amount equaling or exceeding the value of the membership to levy upon that interest and take full title of it. Due to the size of the FTC’s judgment and the diminished value of the PCF and CP entities, a charging order would provide little recourse for the creditor. Therefore, the creditor is justified in its actions to seek liquidation of the LLCs. Had the value of the judgment been significantly lower than the overall value of the LLCs, liquidation of the LLCs assets would be unjust as a charging order would provide sufficient satisfaction of the creditor’s judgment.

The scary part about this decision is that if the Supreme Court is correct in its position that the statute does not provide for the charging order as an exclusive remedy against an LLC interest, then it would appear that the Supreme Court could ultimately revisit this decision and come to the same conclusion with multi-member LLCs involved in similar litigation. The asset protection value of the LLC certainly has come into question as a result of *Olmstead*. The dissent suggests future legislative intervention to prevent this problem.

While substantially longer, the dissenting opinion appears more rational. The dissent feels that the majority was incorrect in its decision to rewrite the LLC statute regarding the charging order remedy. When amending the LLC Act in 1999 to permit the creation of single member LLCs, the Legislature did not amend the assignment of interests and charging order provisions to provide separate remedies for single-member LLCs and multi-member LLCs. As a result of *Olmstead*, significant future exposure to multi-member LLCs was created.

The majority may be misinterpreting the true intent of the legislature. As evidenced by the legislative revisions to RE-FRULPA and RE-FRUPA after *Albright* and *Ehmann*, lawmakers were seemingly unaware of the potential judicial repercussions that could arise from the absence of the “sole and exclusive remedy” clause from the charging provision in the FLLCA statute. However, rather than judicially rewriting the LLC statute to provide restitution for creditors, the dissent provides a roadmap of alternative methods that can be used while adhering to the language of the “charging order” provision.

If a creditor is concerned that the economic interest charged is insufficient to satisfy their judgment, that creditor may move through additional judicial proceedings to seek dissolution of the LLC and liquidation of its assets. The circuit court can order dissolution of a LLC if it is not reasonably practicable to carry on the business in conformity with the articles of organization or the operating agreement.

If the LLC’s single member owner became insolvent, the creditor could file an involuntary bankruptcy petition. By filing the petition, the creditor could initiate a Chapter 7 proceeding, thus allowing the bankruptcy court to possess and, ultimately, dissolve the LLC and liquidate company the assets.

Another method involves the court “reverse piercing” the LLC, but only under the right circumstances. A creditor can use the reverse-piercing remedy to hold a corporation liable for the debts of the member where the member/debtor formed or used the LLC to hide assets and avoid pre-existing personal liability. For instance, if an individual facing a possible judgment creates a LLC and transfers assets into the controlled entity so that the assets would be protected from civil judgment, then the individual’s creditors could levy upon the company assets under the reverse-piercing theory. This is an interesting remedy and could possibly have been applied in *Olmstead*. If the FTC could establish that the “fees” sent to PCF were transferred into the single member LLC’s to take advantage of the liability shield, they could pierce the veil of the LLCs.

The current Florida Bar Task Force has spent the last two years working on a new LLC statute for Florida based on the latest Model Act. One of the hottest topics on their agenda is dealing with the charging order language as it relates to both single member and multi-member

LLCs. It remains to be seen whether the Florida Legislature will decide to adopt any proposed amendments to the LLC Act and whether or not the Supreme Court will honor them in the future. The biggest concern, however, lies with existing multi-member LLCs which are at risk because of language contained in the majority decision. While it appears that *Olmstead* does not necessarily apply to multi-member LLCs, it does create a reasonable fear of similar litigation for owners of multi-member LLCs in the future. As a result, we could begin to see business owners begin forum shopping in search of a safer haven for their assets or even use a different form of entity altogether. *Olmstead* serves as a big “chink in the armor” for the LLC as an asset protection vehicle; one which we hope is addressed by legislation in the near future.

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<sup>1</sup> Florida Limited Liability Company Act § 608.433(4) (2009).

<sup>2</sup> Fla. Stat. § 608.433(4) (2009).

<sup>3</sup> Fla. Stat. § 608.432(2)(b) (2009).

<sup>4</sup> Fla. Stat. § 608.471 (1999).

<sup>5</sup> In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003).

<sup>6</sup> 11 U.S.C. §541(a)(1) (2006).

<sup>7</sup> In re Ehmman, 319 B.R. 200 (Bankr. D. Ariz. 2005).

<sup>8</sup> Florida Revised Uniform Limited Partnership Act, §620.1703(3) (2005), *eff. Jan. 1, 2006*.

<sup>9</sup> Olmstead, et al v. FTC, 35 Fla. L. Weekly S357 (Fla. 2010).

<sup>10</sup> Myrick v. Second National Bank, 335 So. 2d 343 (Fla. 2d DCA 1976).

<sup>11</sup> Givens v. National Loan Investors, L.P., 724 So. 2d 610 (Fla. 5<sup>th</sup> DCA 1999); *See also Atlantic Mobile Homes, Inc. v. LeFever*, 481 So. 2d 1002 (Fla. 4<sup>th</sup> DCA 1986).

<sup>12</sup> Bradshaw v. Am. Advent Christian Home & Orphanage, 199 So. 329 (Fla. 1940).