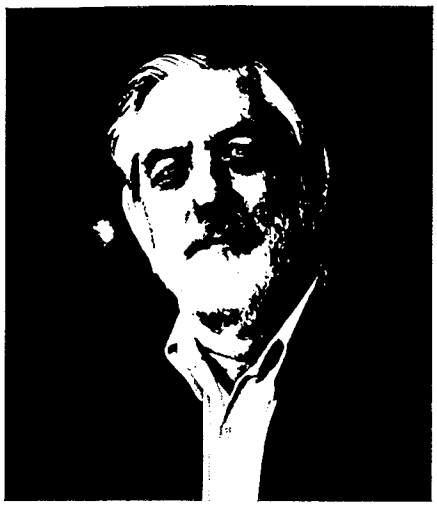
Charging Orders and the Single Member LLC

By Gerald V. Niesar



Gerald V. Niesar is a partner with Niesar & Vestal, LLP in San Francisco, Ca. He concentrates his practice in transactions and securities law matters involving businesses, usually as outside general counsel to closely held and smaller public companies. Mr. Niesar lectures annually for California Continuing Education of the Bar on recent law developments affecting businesses. He is also an author of the widely used *California Limited Liability Company Forms and Practice Manual*, published by Data Trace Publishing Company covering California and Nevada law and practice in the LLC and LLP entity forms.

A regular speaker at American Bar Association (ABA) programs, Mr. Niesar recently chaired a program at an ABA Annual Meeting addressing "speed bumps in California law that trip up out of state lawyers." His activities at the ABA have included past chair positions on the Partnership Committee as well as the Task Force on Private Placement Broker Dealers, which grew out of his original proposal to the ABA Small Business Committee.

Mr. Niesar graduated from the University of Pennsylvania Law School, *cum laude*, in 1969 where he was also admitted to Order of the Coif. His undergraduate studies were at the Wharton School at the University of Pennsylvania.

I. Introduction

Single Member LLCs (SMLLCs) are sometimes used as asset protection devices. What makes the SMLLC attractive for this purpose is the fact that in most states a creditor of an LLC member, having obtained a judgment against the debtor-member, is relegated to a charging order when the creditor attempts to enforce his or her judgment.

II. Charging Orders

Since this procedure is a relative rarity, it is most likely useful to describe what a charging order is before proceeding further with this discussion. Long ago in the days of Merry Old England it was recognized by the courts that, if a member of a partnership owes money, it would be inequitable to allow the partner's creditor to replace the partner in the partnership because that would force the other partners to be in business with someone they did not choose. This seemed especially inappropriate when one considers that a general partner can incur liabilities on behalf of the partnership, and all partners have joint and several liability for those debts; it seemed that under those circumstances a partner should have the right to choose the persons who will be his or her partners.

To prevent the unjust imposition of an unwanted partner, the English courts developed the concept of a charging order. This procedure entitles the creditor of the judgment debtor-partner to have a court order the partnership to pay to the creditor any and all amounts that would be payable to the debtor-partner until the creditor is paid in full. In our modern partnership/LLC lexicon, we would say the issuance of charging order is much like the court directing the transfer to the creditor of an economic interest in the LLC. This is because the charging order only gives the creditor the right to be paid distributions; the creditor has no voting or other management rights in the partnership. As a consequence, the judgment creditor has essentially no power to force any payment, and generally will have to wait until the partners decide to make a distribution to the partners to receive any real economic benefit from the judgment.

III. The Context of a SMLLC

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'être* 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.

IV. *Olmstead v. Federal Trade Commission*[1]

In *Olmstead,* the Florida Supreme Court addressed a question certified to it by the United States Court of Appeals for the Eleventh Circuit: Under Florida law, is a charging order the sole remedy for a judgment creditor whose debtor is the single member of an LLC? Olmstead and Connell had been sued by the Federal Trade Commission (FTC) for unfair and deceptive trade practices. The FTC had obtained a judgment for restitution in an amount in excess of $10,000,000. Olmstead and Connell had, between them, several SMLLCs organized under Florida law. In the federal proceedings, Olmstead and Connell argued that the FTC was limited to obtaining a charging order with respect to the SMLLCs, while the FTC argued that because they were SMLLCs the FTC should be entitled to all of the respective owner's right, title and interest in each SMLLC that was a target of its judgment enforcement action.

The majority opinion in *Olmstead* (four justices concurring) ultimately concluded that, under Florida law, a charging order is not the exclusive remedy available to the creditor of a person with respect to that person's interest in a SMLLC. The majority opinion apparently rested on the difference between the Florida LLC statute provision concerning charging orders[2] and the Florida partnership and limited partnership statutes' charging order provisions. These latter two statutes specifically state that the charging order is the exclusive remedy a creditor has when attempting to satisfy a claim against the debtor's interest in a partnership or limited partnership. The Florida LLC statute, on the other hand, does not say a charging order would be the exclusive remedy, thus allowing the majority to conclude that the legislature intended that a creditor could pursue remedies other than charging orders, specifically under Florida Statute section 56.061 which provides that properties of a debtor, including "stock in corporations," "shall be subject to levy and sale under execution."[3] The majority then says: "An LLC is a type of corporate entity, and an ownership interest in an LLC is personal property that is reasonably understood to fall within the scope of 'corporate stock'."[4] In the view of the majority: "Since the charging order remedy clearly does not authorize the transfer to a judgment creditor of all an LLC member's 'right, title and interest' in an LLC, while section 56.061clearly does authorize such a transfer, the answer to the [certified] question at issue in this case turns on whether the charging order provision in section 608.433(4) always displaces the remedy available under section 56.601."[5]

It is by no means clear that the majority would have come to the same conclusion if the LLC in question had multiple members. And it is equally questionable whether the absence of the "exclusive remedy" language in the LLC statute dictated the result. It appears that the majority, in fact, focused on the anomaly of allowing the owner of a SMLLC to hide behind the charging order statute. For instance:

> The limitation on assignee rights in section 608.433(1) has no application to the transfer of rights in a SMLLC. In such an entity, the set of "all members other than the member assigning the interest" is empty. Accordingly, an assignee of the membership interest of the sole member in a SMLLC becomes a member-and takes the full right, title, and interest of the transferor-without the consent of anyone other than the transferor.[6]

The majority opinion in *Olmstead* also cited two bankruptcy court cases that rejected the argument that the bankruptcy trustee was only entitled to a charging order with respect to the debtor's interest in a SMLLC (see discussion below).

Two Justices of the Florida Supreme Court joined in an extensive dissent. The main concern expressed by the minority appears to be that the reasoning of the majority could apply in the multi-member LLC context as well as the SMLLC context: "The Florida statute simply does not create a different mechanism for obtaining the assets of a SMLLC as opposed to a multimember LLC and, therefore, there is no room in the statutory language for different rules."[7] In addition, the dissent expressed concern for the situation where the value of the LLC property exceeds the amount of the judgment, pointing out that the Florida LLC statue provides remedies that could be taken by a creditor with a judgment against the single member where the judgment is equal to or in excess of the value of the LLC's underlying assets.

V. The Bankruptcy Cases

A. The *Ashley Albright* Case

The *Olmstead* majority cited two bankruptcy court decisions in support of its argument that making a distinction between the voting and management rights, and the economic interest of the single member of a SMLLC, is a distinction that should not be recognized by the courts. *In re Ashley Albright*[8] concerned a SMLLC owned by Albright who was in a Chapter 7 bankruptcy case. The trustee in bankruptcy (Trustee) sought to sell the real property assets of the SMLLC but the debtor argued that the Trustee only had the right to a charging order and would not enjoy management and control rights unless and until admitted as a member of the SMLLC, which would require the unanimous consent or approval of the members. And, of course, the debtor claiming to be the one member refused

1. 40 So. 3d 76 (Fla. S. Ct. 2010).
2. Fla. Stat. § 608.433.
3. Fla. Stat. § 56.061.
4. 40 So. 3d at 80.
5. *Id.*
6. *Id.* at 81.
7. *Id.* at 87.
8. 291 B.R. 538 (D. Colo. 2003).

to give her consent. The bankruptcy court made short shrift of that argument:

> The Debtor argues that the Trustee acts merely for her creditors and is only entitled to a charging order against distributions made on account of her LLC member interest.[9] However, the charging order, as set forth in Section 703 of the Colorado Limited Liability Company Act, exists to protect **other** members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a SMLLC because there are no other parties' interests affected.[10]

B. The *Nader Modanlo* Case

In re Nader Modanlo[11] presented a similar issue in the context of a Chapter 11 bankruptcy case. The debtor was the owner of a SMLLC and asserted reasons why the bankruptcy Trustee could not take over the manager role because there was no member vote to admit the Trustee as a member. In her opinion, Judge Alquist cited the *Albright* opinion, finding it persuasive, and spent quite some time reviewing the reasons for the charging order procedure, *i.e.*, to protect the non-debtor, solvent LLC members from becoming involuntary "partners" with a Trustee or other creditor. She then concluded that a single-member debtor is not entitled to assert the charging order limitations as protection from a bankruptcy Trustee's assertion of management and other control rights over the debtor's SMLLC.

C. The *First Protection* Case

The Ninth Circuit Bankruptcy Appellate Panel (BAP), in an opinion issued in November 2010, concluded that a debtor who is the member in a SMLLC has no retained management or voting rights when he or she files for bankruptcy protection. In *In re First Protection, Inc.*,[12] debtors David and Laura Fursman filed a Chapter 11 petition at a time when they owned 100 percent of the member interests of Redux, LLC, a limited liability company formed under Arizona law. Six months after filing the Chapter 11 petition, the Fursmans transferred fifty percent of their interest in Redux to Thompson, Laura Fursman's mother. Five months after that transfer, the Fursmans converted their Chapter 11 case to a Chapter 7 case.

The Chapter 7 Trustee commenced an adversary proceeding against the Fursmans seeking to avoid the Fursman's postpetition transfer of fifty percent of their interest in Redux to Thompson. The bankruptcy court found that when the Fursmans filed for Chapter 11 protection, their entire interest in Redux became property of the Chapter 11 estate; thus they had no interest to transfer to Thompson at the time they attempted to transfer the fifty percent interest to her.

On appeal, the Fursmans argued, among other things, that the Trustee had no right to control Redux or participate in management because he was simply "an assignee of the Fursmans' rights under Arizona law and the operating agreement." This is essentially the "charging order" argument. They also argued that their "transfer" was not really a transfer because what actually happened was that Redux expanded the members to include Thompson. The BAP made short shrift of the "no-transfer" contention, basing its decision on Bankruptcy Code section 101(54)(D).[13] Section 101(54) defines the term "transfer," providing that, for purposes of bankruptcy proceedings, a transfer includes "each mode, direct or indirect,...of disposing of or parting with (i) property; or(ii) an interest in property."[14] "There is no question that a 'transfer' of Debtor's property occurred by the transaction between the Fursmans and Thompson even though the transfer may have been effected by Redux, an entity which was 100% owned and controlled by Debtors."[15] This sentence of the opinion is incorrect because, since the "transfer" occurred during the Chapter 11 phase of Redux's life, at the time of the transfer the Fursmans controlled Redux, but the bankruptcy estate, not the Fursmans, owned it.[16] However, that error does not change the result of the examination of the "transfer" issue.

The more important analysis in the *First Protection* case, for purposes of this article, concerns the BAP's treatment of the Fursmans' argument that the Trustee (*i.e.*, the estate) only came into possession of the Fursmans' economic (ownership) interests in Redux, not their non-economic rights such as management and control. They claimed that the Trustee's rights were only as an assignee under Arizona Statute section 29-732(a), that is, essentially the rights of a judgment creditor with a charging order under Arizona law. The Arizona

9. Colo. Rev. Stat. § 7-80-703 provides:

> Rights of Creditor against a member. On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the membership interest of the member with payment of the unsatisfied amount of the judgment with interest thereon and may then or later appoint a receiver of the member's share of the profits and of any other money due or to become due to the member in respect of the limited liability company and make all other orders, directions, accounts, and inquiries which the debtor member might have made, or which the circumstances of the case may require. To the extent so charged, except as provided in this section, the judgment creditor has only the rights of an assignee of the membership interest. The membership interest charged may be redeemed at any time before foreclosure. If the sale is directed by the court, the membership may be purchased without causing a dissolution with separate property by any one or more of the members. With the consent of all members whose membership interests are not being charged or sold, the membership may be purchased without causing a dissolution with property of the limited liability company. This article shall not deprive any member of the benefit of any exemption laws applicable to the member's membership interest.

10. *Ashley Albright*, 291 B.R. 538 at 541 (emphasis and footnote in original).

11. 412 B.R. 715 (D. Md. 2006).

12. 440 B.R. 821 (9th Cir. BAP 2010).

13. Bankruptcy Code, 11 U.S.C. § 101(54)(D).

14. *Id.*

15. *First Protection*, 440 B.R. at 828.

16. *See* Bankruptcy Code, 11 U.S.C. § 541 (property of the estate).

statute provides that a charging order is the exclusive remedy for a creditor of a member of an LLC with respect to the debtor's interest in the LLC.[17]

In answer to these contentions, the BAP referred to *Albright* as well as *Olmstead*. The BAP agreed with the outcome in *Albright*, but said it reached "the same conclusion by way of another path."[18] The Fursmans had attempted to bar the Trustee from becoming a "full member" of Redux because he had not accepted the operating agreement, claimed by them to be an executory contract, within sixty days of the order for relief, as required by Bankruptcy Code section 365(d)(1).[19] The court rejected the Fursmans' assertion that the operating agreement was an executory contract. The court noted that for a contract to be executory there must be other parties to the contract. Since the Fursmans were the sole members of Redux "there are essentially no 'other parties' to the operating agreement,"[20] so the application of an executory contract analysis in a SMLLC context is illusory.

In its opinion, the court noted that the purpose of the executory contract sections of the Bankruptcy Code is to protect non-debtor third parties who should not be required to accept performance from someone (*e.g.*, a bankruptcy Trustee) with whom they did not contract. Thus, in a SMLLC situation, where there are no third parties to the claimed executory contract (the operating agreement) there is no third person to protect. This is a very strong echo of the analysis used in the other cases noted above, to explain why the charging order exclusive remedy cannot be applied in the SMLLC context, as there are no other "partners" to protect from the transfer of management rights to the Bankruptcy Trustee. Therefore, it appears that in a bankruptcy proceeding in the jurisdiction of the Ninth Circuit, neither the "charging order exclusive remedy" argument, nor the "executory contract" argument will prevent the bankruptcy Trustee from asserting full and complete control over the SMLLC assets where the single member is the debtor.

VI. California Statutory Provisions

Unlike Florida, but like Nevada and Delaware, the California LLC Act specifically declares the charging order to be the exclusive remedy a creditor has when attempting to enforce a judgment against the interest of a Limited Liability Company Member. This is in section 17302(c):

> This section [dealing with charging orders] provides the exclusive remedy by which a judgment creditor of a member or a member's assignee may satisfy a judgment out of the judgment debtor's membership interest in the limited liability company.[21]

Your author has been unable to find any case law under any of these three acts that examines whether the "exclusive remedy" provision will be enforced where the LLC member-judgment debtor is the single member of a SMLLC. As discussed with respect to the cases noted above, neither the three bankruptcy courts, nor the Florida Supreme Court in dicta, found the charging order "exclusive remedy" doctrine to be a barrier to allowing the creditor to take over full powers with respect to the SMLLC owned by the debtors in those cases. Their analyses can best be summarized as a refusal to respect the fiction that the single member of the SMLLC had voting and control rights that were not a unity of interest with their economic interests in the SMLLCs. In other words, it would be illogical and inequitable for a court to respect the distinction when there is no other person to "vote" with respect to "admitting" a new Member to the SMLLC.

An interesting unanimous opinion by the United States Court of Appeals for the Ninth Circuit addressed the same question in a very different setting. In *Jules Jordan Video, Inc., et al. v. 144942 Canada Inc., et al.*,[22] the court found, in a case involving copyright issues, that it would make no sense to find a distinction between the sole shareholder of a corporation and the corporation with regard to the issue of ownership of the copyright. Gasper was the owner, officer, director and employee of the corporation, JJV. Gasper was asserting claims under a copyright that was owned by JJV. When the work at issue was created, Gasper was an employee of JJV. The copyright law specifically provides that a work created by an employee is a "work for hire" meaning that the copyright was the corporation's and not Gasper's to assert. Hence, the defendants claimed that Gasper had no standing to enforce the copyright. The Ninth Circuit's unanimous opinion reversed the district court finding that Gasper had no standing to assert the copyright claim. The Ninth Circuit concluded:

> The problem with the district court's analysis is that JJV was a one-man shop. Gasper was the sole officer, director, and shareholder of JJV, exercised complete control over it, and made all decisions concerning JJV and production of the films. It was all Gasper all the time. JJV as employer and Gasper as employee could certainly agree as to the scope of the employee's employment, and could agree that Gasper should retain all copyrights. Since JJV was Gasper, JJV intended whatever Gasper intended, and if Gasper intended that his creative work be outside the scope of his employment with JJV, there was no one to disagree.[23]

So, here is the Ninth Circuit conflating the identities of the sole shareholder

17. Ariz. Rev. Stat. § 29-655.

18. *First Protection*, 440 B.R. at 830.

19. Bankruptcy Code, 11 U.S.C. § 365(d)(1).

20. *First Protection*, 440 B.R. at 831.

21. CA Corp § 17302(c). *See also* Nev. Rev. Stat. § 86.401(2(a), and Delaware Limited Liability Company Act § 18-703(d).

22. 617 F. 3d 1146 (9th Cir. 2010).

23. *Id.* at 1156.

and the corporation when it makes no sense to distinguish between the two. This, as in the SMLLC situation, goes beyond a typical "piercing of the veil" where the assets, liabilities, activities, etc. of the owner and the entity are so indistinguishable that it would be inequitable to respect the distinction between owner and entity. The courts are taking a practical approach in the interests of justice to say that if respecting the entity as a separate being, notwithstanding the sole Member's (shareholder's) absolute and complete control rights, would lead to an inequitable result, the distinction between the two will be ignored.

VII. Conclusion

Whether California, Nevada and Delaware Courts, or any of them, or other states will follow and apply the same reasoning when a single member debtor tries to assert that a charging order is the exclusive remedy available to his or her creditor in an SMLLC context, is yet to be seen. Until either a definitive court decision or a legislative answer is available in each state, it would seem prudent not to put too much reliance on a SMLLC as an asset shield against liabilities of the single member. Note that, even if the state court would respect the "exclusivity" of the remedy, that court's opinion would not necessarily be a barrier to a bankruptcy court deciding to follow the *Albright* and *Modanlo* rulings.

A careful reading of the cases discussed here will not give one any reason to believe that the courts will respect a statutory mandate that a charging order is the exclusive remedy available to a SMLLC member's creditor. Of course, this could be different in Florida where the statute does not specifically say charging orders are exclusive remedies. In any case, it would seem prudent to conclude that if one is seriously contemplating use of a limited liability company for asset protection purposes, one better get used to the idea of having a "partner." If the entity is owned by two or more members, and the other member(s) are not sham members, one would think that the court would have no right to ignore the statute's direction that the charging order is the exclusive creditor remedy. In fact, even in the *Olmstead* opinion analyzing the non-exclusive Florida law, the court appears to rely on the injustice of respecting the fiction of separate interests enjoyed by a single member of an LLC, as much as the statutory interpretation based on the difference between the Florida partnership statutes and the LLC statute.

Update on Mortgagee Liability...

(Continued from page 472)

possession; (2) has charge, care or control of the property as owner or agent of the owner or an executor, administrator, trustee, or guardian of the estate of the owner; (3) is the agent of the owner for the purpose of managing, controlling the property or collecting rents, or is any other person managing or controlling the property; or (4) is any person entitled to the control or direction of the management or disposition of the property.[26]

The Cook County Vacant Building Ordinance applies to all areas of unincorporated Cook County, but its reach is expected to be significantly greater because municipalities can enter into agreements with the county to enforce the ordinance within their own boundaries. The Cook County Vacant Building Ordinance took effect thirty days after adoption by the Cook County Board of Commissioners.[27]

V. Federal Housing Finance Agency Lawsuit Against City of Chicago

As noted, the City of Springfield, Massachusetts ordinance and Cook County Vacant Building Ordinance, described above, largely follow the Chicago Ordinance described above at Part I., in holding mortgagees and servicers responsible for maintaining vacant or abandoned properties even before the mortgagee obtains ownership or possession of the property through the foreclosure process.

The Chicago Ordinance is being challenged by the Federal Housing Finance Agency (FHFA), which oversees Fannie Mae and Freddie Mac, on grounds that the Ordinance encroaches on the FHFA's role as the sole regulator and supervisor of Fannie Mae and Freddie Mac, which own approximately 258,000 mortgages within the City of Chicago.[28] In addition, the FHFA lawsuit argues that the registration provisions and continuing obligations under the law constitute regulation of Fannie Mae and Freddie Mac, which are not subject to supervision or regulation by any other agency.

In the complaint, the FHFA makes the argument that the $500 registration fee amounts to a tax that would be unlawfully applied to servicers of loans acting on behalf of Fannie Mae and Freddie Mac and, therefore, federal law preempts the Chicago Ordinance. Additionally, the FHFA argues, Congress granted Fannie Mae and Freddie Mac immunity from state and local taxes. Accordingly, the lawsuit seeks to exempt all Fannie Mae and Freddie Mac mortgages from the Ordinance. It should be noted, however, that the narrow preemption grounds for this lawsuit mean that its resolution may not provide relief for other, private parties.

VI. Conclusion

It has been common for decades to hear arguments that imposing increasing costs and compliance burdens on mortgagees does not adversely affect the availability of mortgage credit. The consequences of this miscalculation have become widely apparent over the past five years, and many of the subsequent policy responses seem designed to make matters worse.[29] For those who may wonder how far this downward policy spiral can go, the ordinances noted here do not provide encouragement.

26. Cook County Vacant Building Ord. § 102-4. *See also supra* note 23.

27. Cook County Vacant Building Ord. § 102-24.

28. Federal Housing Finance Agency v. City of Chicago, Case No. 1:11-cv-08795 (N.D. Ill. Dec. 12, 2011). *See also* Review & Outlook, *supra* note 3.

29. *See generally* Review & Outlook, *Badly Written Bad Rules*, Wall Str. J., Dec. 27, 2011, at A12 ("New studies show the quality of regulation is plummeting").

Dodd-Frank Act Appraisal...

(Continued from page 277)

loan production function, is directly or indirectly involved in selecting, retaining, recommending or influencing the selection of the person to prepare a valuation or perform valuation management functions, or to be included in or excluded from a list of approved persons who prepare valuations or perform valuation management functions.

4. Employees and Affiliates of Creditors with Assets of $250 Million or Less

With respect to any covered transaction in which the creditor had assets of $250 million or less as of December 31 for either of the past two calendar years, a person who is employed by or affiliated with the creditor will not be deemed to have a conflict of interest based on the person's employment or affiliate relationship with the creditor if:

(Continued on page 290)