MAXIMUM ASSET PROTECTION
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CHOICE OF ENTITY IN ASSET PROTECTION

By Jacob Stein, Esq.

I. Choice of Entity

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With the equalization of the corporate and individual income tax rates, full deductibility of medical expenses by noncorporate taxpayers and with the advent of the limited liability companies and their inherent charging order protection, there has been a considerable shift in the choice of entity analysis.

Practitioners are no longer rushing off to form C or S corporations. As a matter of fact, it is increasingly more difficult to find reasons to form corporations. C corporations are almost entirely out of the picture, unless the taxpayer is planning on taking its business public in the near future or is concerned about an IRS audit. C corporations result in double taxation of profits from operations and gains on liquidation or sale, and do not allow for pass-through of losses.

S corporations are considered for doctors (where in some states, like California, the corporation may be the only entity available by law), and for entertainers (where fees paid to agents would be treated as miscellaneous itemized deductions on individual returns).

There are other unique circumstances where a corporation may be desirable, such as a medical reimbursement plan or bifurcation of gain on sale of real estate, but those are not every day occurrences. Some advocate using C corporations as a mechanism to shift income into a lower bracket. Because a C corporation reaches the 34 percent bracket at $75,000 of income, that is usually not a very viable strategy.

Consequently, today the choice is between the S corporation and the limited liability company taxed as a partnership.[1]

The LLC is the clear front-runner. No tax on liquidation (except to the extent cash is distributed in excess of basis), infinite flexibility in distributions and, to some extent, in allocations, no restriction on identity and number of members, increase in outside basis to the extent of the member's share of the LLC's liabilities, loss pass-through to members, including debt financed losses, liability protection superior to a corporation, and several important business advantages like series LLCs.

LLCs are not subject to the same stiff corporate laws as corporations. There are no requirements for annual meetings, boards, officers, minutes, voting and many more. The members are free to change virtually any default state law provision by agreement. Most importantly, LLCs afford members the protection of the charging order.

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[1] In certain states, a limited partnership with an LLC general partner may be a better choice. For example, the business "friendly" state of California imposes the so-called "gross receipts" tax on LLCs. There is no such tax for limited partnerships. N.B. California also imposes a 1.5 percent income tax on S corporations.

How do S corporations overcome all of these benefits afforded by the LLCs in light of the fact that any taxpayer can now fully deduct medical expenses? The one argument that practitioners continuously make on behalf of S corporations is the self-employment tax, discussed in Section C. below.

B. Check-the-Box Rules

The number of available entities that a business owner may chose is fairly extensive, especially when one factors in the available foreign entities. The available choices for tax purposes are fairly limited: a corporation, taxable either under subchapter C or S, a partnership or a disregarded entity.

Often, both practitioners and lay persons confuse these two entity definitions. For example, a limited liability company is a type of entity that exists under state law, but there is nothing equivalent for tax purposes. A partnership is a type of entity structure that exists for tax purposes, but there is nothing precisely the same under state law.

The check-the-box rules promulgated under Treasury Regulations Section 301.7701-1, -2 and -3 help cut through all the clatter. They tell us the default rules and the elective rules of how a state law entity will be treated for federal income tax purposes. These rules are simple as they apply to state law corporations (these can be taxed only as C or S corporations). The rules are a bit more difficult in their application to LLCs, and by extension there are some choices available with respect to limited and general partnerships.

An LLC with a single owner is treated as a disregarded entity by default. But the owner may elect to treat the LLC as a corporation by making the appropriate election on Form 8832. Once the LLC is taxed as a corporation it can even make an S election. An LLC with more than a single owner is classified as a partnership, by default, but may also elect to be taxed as a corporation. A foreign LLC is by default classified as a corporation, but if it has only a single owner, it can elect to be treated as a disregarded entity by filing Form 8832. An LLC owned by a husband and wife as community property may be treated by them as either a disregarded entity or as a partnership for tax purposes.

A general or limited partnership is usually taxed as a partnership, but not always. Pursuant to Rev. Rul. 2004-77, if an individual and a disregarded LLC owned by such an individual own all of the interests in a general or limited partnership, then such partnership will be disregarded for federal income tax purposes.

C. The Self-Employment Tax

The self-employment tax, at the aggregate rate of 13.3 percent (15.3 percent for 2010 and earlier), is imposed on the "net earnings from self-employment."[2] The net earnings from self-employment include the gross income derived from any trade or business carried on by a sole proprietor or a partner in a partnership.

There are several exceptions from the self-employment tax: (i) rental income;[3] (ii) interest and dividends;[4] (iii) capital gains;[5] and (iv) distributive shares of limited partners.[6]

Thus, limited partners are generally not subject to the self-employment tax. A limited partner will be subject to the self-employment tax if it is receiving guaranteed payments under Code Section 707(c) or payments on account of a general partnership interest.

In 1997, the Service issued revised proposed Regulations which provided that an LLC member was not subject to the self-employment tax if: (i) the member lacked authority to contract on behalf of the LLC; (ii) was not subject to personal liability; or (iii) did not participate in the LLC's trade or business for more than 500 hours during the tax year.[7]

The reasoning behind the proposed Regulations was to exclude income that was demonstratively a partner's return on capital. Congress prevented the Service from finalizing these Regulations in the 1997 Taxpayer Relief Act, and to date these Regulations remain in proposed form.

Because of the uncertainty surrounding the proposed Regulations, practitioners are uncertain as to how to treat distributive shares of LLC members with respect to the self-employment tax. Because there is no clear authority equating LLC members to limited partners for these purposes, and because there is no specific exemption applicable to LLC members, some practitioners take the conservative position that LLC members are subject to the self-employment tax and for that reason opt in favor of forming an S corporation.[8]

Shareholders of S corporations who receive distributions from S corporations are not subject to the self-employment tax on such distributions.[9] Shareholders of S corporations are subject to the self-employment tax on any compensation received by them from the corporation.

This author does not believe that the self-employment taxes that apply to LLC members are any different than the self-employment taxes that would apply in a limited partnership context. The analysis is the same: what is the nature of the income to the LLC member? Did the member

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[2] Code Section 1402(a).
[3] Code Section 1402(a)(1).
[4] Code Section 1402(a)(2).
[5] Code Section 1402(a)(3).
[6] Code Section 1402(a)(13).
[7] Prop. Treas. Reg. Section 1.1402(a)-2(h)(2).
[8] This author takes the position that if the LLC is managed by a manager, members should be treated for self-employment tax purposes similarly to limited partners.
[9] Code Section 1402(a)(2). The self-employment tax rules do not distinguish S corporations from C corporations in this regard.

receive a distribution in their capacity as a passive investor, or did the member receive a payment in some other capacity. All payments to passive investors, in their capacity as passive investors, are not subject to the self-employment tax. As the name implies, the self-employment tax seeks to tax employment-type income. That is why corporate dividends and distributions to limited partners are not subject to this tax.

Example. George is a member of a limited liability company that produces pens. George is also the LLC's best salesman. Last year George received $300,000 as compensation for his sales, and $100,000 as a distribution to a member. Because $300,000 was on account of employment services, it is subject to the self-employment tax. The $100,000 payment had nothing to do with employment, and is not subject to the self-employment tax.

Consequently, forming an S corporation instead of an LLC to avoid the self-employment tax makes little sense.

D. Unreasonable Compensation

Because S corporation shareholders are not subject to the self-employment tax on dividends, but are subject to the tax on salaries, S corporation shareholders can, to an extent, determine whether money received by them from the corporation be subject to the self-employment tax. However, in this analysis, the issue of unreasonable compensation comes up. Generally, unreasonable compensation is limited solely to C corporations, where shareholders attempt to draw down taxable corporate earnings through tax deductible salary payments. In the C corporation arena, the Service usually argues that the compensation paid is unreasonably large.

In the S corporation arena the Service's argument is reversed. It usually argues that the compensation of shareholder-employees is unusually small. While the level of compensation in an S corporation has no impact on the income tax, lowering compensation reduces the self-employment tax.

The inadequate compensation argument is a difficult one for the Service. However, where the employee-shareholders receive no compensation, but do receive distributions, the Service almost always wins.[10]

It is difficult to advise a taxpayer on what amount of compensation would be considered reasonable. If the taxpayer is receiving dividend distributions out of the S corporation to the tune of several hundred thousand dollars a year, the taxpayer should at least max out the FICA compensation limit (approx. $106,000 per year).

For corporations that are converting from C to S, there is a desire on the taxpayer's part to instantly go from a high-level of compensation to a very low level. That is inadvisable, as the Service may treat that as an argument that the compensation during the C years was unreasonably high, resulting in a reclassification of compensation into taxable dividends. Taxpayers should exercise a degree of patience, and slowly dwindle down their salaries when converting to an S.

While "conservative" practitioners may find it more beneficial to form an S corporation as opposed to a partnership, at least with respect to self-employment taxes, several points should be considered. First, the benefit of reducing self-employment taxes for many taxpayers is marginal. It is usually limited to the Medicare hospital tax surcharge, which in turn is offset by the California 1.5 percent income tax on S corporations.

Second, and possibly more importantly, the price paid for reduced self-employment taxes is usually prohibitive: significantly decreased business flexibility, reduced basis and loss pass-through, and significantly less asset protection.

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[10] Rev. Rul. 77-44, 1974-1 C. B. 287; Joseph Radkte v. U.S., 712 F. Supp. 143 (1989).

E. A Structuring Opportunity

Given the unreasonable compensation argument that the Service is likely to advance, taxpayers are unlikely to be able to completely eliminate the self-employment tax. However, some or most of the self-employment tax may be eliminated by using the S corporation.

Is it possible for the taxpayer to obtain the wonderful advantages of the LLC, while minimizing the self-employment tax? A common structure designed to address this question is the LP-S corporation combination.

In this structure the business venture is conducted through the limited partnership form. A limited partnership has the same tax advantages as the LLC, as both are treated as partnerships for tax purposes. The LP has all the business advantages of the LLC, including the charging order protection. The one disadvantage of the limited partnership is the requirement of having a general partner, who would have unlimited liability exposure.

The unlimited liability exposure is usually solved by having an S corporation, which is a sister entity of the LP, act as the general partner. This way, a limited liability entity acts as the general partner eliminating the unlimited liability exposure. The limited partners of the LP are exempt from the self-employment tax, and the income passing through to the S corporation, to the extent not characterized as compensation, will also be exempt from the self-employment tax.

Another alternative structure is to simply use an LLC taxed as a corporation. An LLC retains all of its state law advantages regardless of how it is taxed for federal tax purposes. Accordingly, an LLC that checks the corporate box on Form 8832, retains its charging order protection. For tax purposes the entity is now treated as a corporation, and may even make an S election. To maximize the asset protection of the limited partnership structure, it is advisable to use an LLC taxed as an S corporation as the general partner.

F. Tax Advantages of Partnership-Type Entities

The following is a comparison of the more salient relative advantages of operating in the partnership tax regime of Subchapter K versus the corporate tax regimes of Subchapter C and Subchapter S. References below to partnership are intended to include any type of entity taxed as a partnership, whether that is a general partnership, a limited partnership, an LLC, or even a tenancy-in-common taxed as a partnership.

1. Partnership versus C Corporation

The effective rate of tax on partnership ordinary income or capital gain may be greater or less than the rates imposed on corporate income depending on the prevailing nominal corporate and individual tax rates and the rate brackets into which the owners fall. Apart from any tax rate differential, the advantages of the partnership tax scheme over the scheme that applies to C corporations are numerous and substantial. The major benefits are as follows:

1. Tax losses generally flow through directly to the equity owners as current deductions.
2. No double tax occurs upon the sale or liquidation of the business.
3. Distributions by partnerships of appreciated property generally do not cause the partnerships to recognize gain.
4. Under Code Section 743(b) and 754, a purchaser of a partnership interest can effectively obtain a cost basis in their share of the partnership's assets.

Of course, there continue to be some situations in which it is desirable to operate businesses in the corporate form. For example, the high-bracket owners of a small business that has no real growth potential may find it desirable to form a corporation to take advantage of the low first-tier marginal corporate tax rates. As another example, because limited partners who participate in the management and control of a business are liable as if they were general partners, the risks of operating in partnership form may not be easy to limit if all or most of the owners will be active participants. This deficiency does not exist, however, with respect to LLCs that elect partnership classification. Finally, and most significantly, most publicly held entities must be taxed as corporations because Code Section 7704 requires that most publicly traded entities be taxed as C corporations. Thus, if a business is to be publicly held, partnership tax treatment is not an option.

2. Partnership versus S Corporation

In general, operating as a partnership is preferable to operating as an S corporation, for the following reasons:

1. The 100-shareholder limit, as well as the restrictions on the types of shareholders (and, to a lesser extent, the types of income) that an S corporation may have, prevents an S election in many situations.

2. The ability of S corporation shareholders to deduct entity losses is more limited than that of partners – S corporation shareholder do not get to increase their outside basis by their share of entity debt, whereas partners do.
3. Many states do not at present provide flow-through tax treatment for S corporations, choosing instead to tax S corporations like C corporations.
4. Unlike partnerships, S corporations cannot distribute appreciated property without triggering entity-level gain.
5. S corporations can have only common stock outstanding. In contrast, partnerships can issue multiple classes of equity interests to accommodate virtually any economic sharing arrangement.

G. Charging Order Protection

1. Protecting Assets within Entities

Often, asset protection practitioners will talk about inside out and outside in asset protection. This is a critical distinction.

Example: Dr. Brown is a neurosurgeon. He owns 2 apartment buildings having a combined equity of $10 million. Apartment building "A" is owned by Dr. Brown through a corporation, while apartment building "B" is owned through a limited liability company, taxed as a partnership for income tax purposes.

Assume that two tenants, one residing in a building A and the other in building B, slip, fall and sue, and Dr. Brown's general liability insurance policy is insufficient to cover the claims. Because the buildings are owned by a corporation and a limited liability company, the tenants have to sue these two entities. If the tenants are successful, they will be able to recover against the entities, but, ordinarily, will not be able to pierce the entities and go after the individual owners, namely, Dr. Brown.

Assume now that two of Dr. Brown's patients sue Dr. Brown and the judgment exceeds the limits of Dr. Brown's malpractice policy. The patients will attempt to enforce the judgment against all of Dr. Brown's assets, including his interests in the corporation and the LLC.

The patient-creditor will be able to obtain a writ of execution or a turnover order against Dr. Brown's interest in the corporation, effectively getting apartment building A.

This is an extremely important point to remember. Corporations are often thought of as limited liability entities. The referenced limited liability is that of the shareholder when the corporation is sued. The same limited liability does not apply to the corporation when the shareholder is sued.

2. Charging Order Limitation

Returning to Dr. Brown, what happens to apartment building B, the one owned by the LLC? Fortunately for Dr. Brown, the result is different.

Membership interests in LLCs and partnership interests are afforded a significant level of protection through the charging order mechanism. The charging order limits the creditor of a debtor-partner or a debtor-member to the debtor's share of distributions, without conferring on the creditor any voting or management rights. While that may not seem like much at first glance, in practice, the charging order limitation is a very powerful asset protection tool.

a. The Importance of History

Before the advent of the charging order,[11] a creditor pursuing a partner in a partnership was able to obtain from the court a writ of execution directly against the partnership's assets, which led to the seizure of such assets by the sheriff. This result was possible because the partnership itself was not treated as a juridical person, but simply as an aggregate of its partners.

The seizure of partnership assets was usually carried out by the sheriff, who would go down to the partnership's place of business and shut it down. That caused the non-debtor partners to suffer financial losses, sometimes on par with the debtor partner, and the process was considered to be entirely "clumsy."[12]

To protect the non-debtor partners from the creditor of the debtor-partner it was necessary to keep the creditor from seizing partnership assets (which was also in line with the developing perception of partnerships as legal entities and not simple aggregates of partners) and to keep the creditor out of partnership affairs. These objectives could only be accomplished by limiting the collection remedies that creditors previously enjoyed. Because any limitation on a creditor's remedies is a boon to the debtor, over the years charging orders have come to be perceived as asset protection devices.

The rationale behind the charging order applied initially only to general partnerships, where every partner was involved in carrying on the business of the partnership; it did not apply to corporations because of their centralized management structure.[13] However, over the years the charging order protection was extended to limited partners and LLC members.

b. The Uniform Acts

Both partnership statutes and limited liability company statutes (in most domestic and foreign jurisdictions that have these entity types) provide for charging orders. In almost all the states (including California) partnership and LLC statutes are based on the uniform acts, such as the Revised Uniform Partnership Act of 1994 ("RUPA"), the Uniform Limited Partnership Act of 2001 ("ULPA") or the Uniform Limited Liability Company Act of 1996 ("ULLCA"), or the earlier versions of these acts. California has modified its LLC law and adopted the Revised Uniform Limited Liability Company Act on January 1, 2014.

The very first references to the charging order (in the United States) appeared in Section 28 of the Uniform Partnership Act of 1914 and Section 22 of the Uniform Limited Partnership Act of 1916 and allowed creditors to petition the court for a charging order against the debtor's partnership interest. Both statutes, directly or indirectly, addressed the fact that the charging

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[11] The first charging order statute appeared in Section 23 of the English Partnership Act of 1890, and was later picked up by the Uniform Partnership Act (Section 28) of 1914, and the Uniform Limited Partnership Act (Section 22) of 1916.
[12] Brown, Janson & Co. v. A. Hutchinson & Co., 1895 Q.B. 737 (Eng. C.A.).
[13] Because charging orders do not apply to corporations, a creditor of a shareholder can attach the shares of corporate stock owned by the debtor-shareholder and obtain the entire bundle of rights inherent in those shares, including liquidation and voting rights.

order was not the exclusive remedy of the creditor. Appointment of a receiver and foreclosure of the partnership interest were anticipated.

The subsequent amendment to the Uniform Limited Partnership Act (in 1976), clarified the charging order remedy by stating that the judgment creditor had the rights of an assignee of the partnership interest.

The RUPA, at Section 504, and the ULLCA, at Section 504, introduced the following new concepts: (i) the charging order constitutes a lien on the judgment debtor's transferable interest; (ii) the purchaser at a foreclosure sale has the rights of a transferee; and (iii) the charging order is the exclusive means by which the creditor could pursue the partnership interest.

Both acts also provide that the charging order does not charge the entire partnership or membership interest of the debtor, but only the "transferable" (RUPA) or "distributional" (ULLCA) interest. However, the language providing that the creditor has the rights of an assignee was dropped.

The ULPA (the last act, chronologically), in addition to the new language in the RUPA and the ULLCA provides, further, at Section 703, that (i) the judgment creditor has only the rights of a transferee,[14] and (ii) the court may order a foreclosure only on the transferable interest.[15]

All three most recent acts also provide that the charged interest may be redeemed prior to foreclosure.[16]

There are four important points to take away from the wording of these uniform acts: (1) the charging order is a lien on the judgment debtor's transferable/distributional interest, it is not a levy, (2) the creditor can never exercise any management or voting rights because the creditor has only the rights of an assignee/transferee, (3) the foreclosure of the charged interest does not harm the debtor because the buyer at the foreclosure sale receives no greater right than was possessed by the original creditor, and (4) the creditor, expressly, has no other remedies, but the charging order (and foreclosure on the charging order).

Because the charging order creates a lien and not a levy, and because the creditor is not even a transferee under ULPA, but only has the rights of a transferee, the creditor does not become the owner of the charged interest unless there is foreclosure. This has important tax ramifications (which are discussed below).

By calling the creditor an assignee/transferee, or by stating that the creditor has the rights of an assignee/transferee, the uniform acts deprive the creditor of any voting, management or access to information rights.[17] Let us use ULPA to see how that happens.

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[14] ULPA, Section 703(a).
[15] ULPA, Section 703(b).
[16] RUPA Section 504(c), ULLCA Section 504(c), ULPA Section 703(c).
[17] This is a reflection of two principles: (i) the creditor should be kept out of the entity so that the non-debtor owners are not inconvenienced, and (ii) the so-called "pick your partner" philosophy that allows partners and members to approve any new incoming partner/member. See, for example, RUPA, Section 401(i).

ULPA defines a "transferable interest" as a right to receive distributions.[18] A "transferee" is defined as a person who receives a transferable interest.[19] ULPA defines two bundles of rights that a partner may have in a partnership: economic rights and other rights.[20] While economic rights are freely transferable, other rights (which include management and voting rights) are not transferable at all, unless provided otherwise in the partnership agreement.[21]

ULPA further clarifies that a transferee only has the right to receive distributions, if and when made.[22] This is further elaborated upon by comments to the charging order section of ULPA:

> This section balances the needs of a judgment creditor of a partner or transferee with the needs of the limited partnership and non-debtor partners and transferees. The section achieves that balance by allowing the judgment creditor to collect on the judgment through the transferable interest of the judgment debtor while prohibiting interference in the management and activities of the limited partnership.
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> Under this section, the judgment creditor of a partner or transferee is entitled to a charging order against the relevant transferable interest. While in effect, that order entitles the judgment creditor to whatever distributions would otherwise be due to the partner or transferee whose interest is subject to the order. The creditor has no say in the timing or amount of those distributions. The charging order does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership.
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> Foreclosure of a charging order effects a permanent transfer of the charged transferable interest to the purchaser. The foreclosure does not, however, create any rights to participate in the management and conduct of the limited partnership's activities. The purchaser obtains nothing more than the status of a transferee.[23]

ULLCA has similar provisions that restrict the creditor to a "distributional interest" (identical, except in name, to ULPA "transferable interest") that does not confer on the creditor any voting or management rights.[24]

The creditor's inability to vote the charged interest or participate in the management of the entity is at the heart of the asset protection efficacy of the charging order. If the partnership or the LLC halts all distributions, the creditor has no ability to force the distributions.

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[18] ULPA Section 102(22).
[19] ULPA Section 102(23).
[20] ULPA Section 701.
[21] *Id*.
[22] *Id*.
[23] ULPA Section 703, Comments.
[24] ULLCA Sections 101(6), 501-504.

Much fear has been expressed by some practitioners about the creditor's ability to foreclose.[25] This fear appears to be entirely unfounded – the uniform acts clearly provide that only the charged interest may be foreclosed upon, and further provide that the purchaser at the foreclosure sale has only the rights of a transferee. To grant the purchaser of the foreclosed interest an interest greater than the right to receive distributions would mean granting to the purchaser voting and management rights associated with the debtor's interest in the entity. That would be contrary to the very reason why charging order statutes exist in the first place.

A creditor holding a charging order usually does not know whether any distributions will be forthcoming from the entity. This uncertainty is of little value to most creditors. But it may be possible to find a third party, possibly a collection firm, that may buy the charged interest at a steep discount and then wait to get paid (which may be folly due to possible adverse tax consequences). Consequently, the ability to foreclose affords the creditor some limited value.

The creditor's ability to foreclose is not, in any way, detrimental to the debtor. So long as no one can take away the debtor's management and voting rights, the debtor is not made worse off.

The exclusivity of the charging order (including the ability to foreclose on the charging order), which may be found in each recent uniform act, relates back to the origin of the charging order. The drafters of the uniform acts did not want to allow the creditor any possibility of gaining voting or management rights, and the exclusivity language should be read in that light.

A common point of confusion needs to be addressed with respect to exclusivity. Many cases dealing with charging orders focus on whether the charging order is the exclusive creditor remedy, or whether foreclosure is authorized (see discussion below). The uniform acts, until RUPA in 1994, never made the charging order the exclusive creditor remedy, although it was always understood that the creditor can never gain management rights. Beginning with RUPA, all uniforms acts have introduced the element of exclusivity, but it is not the charging order that is made the exclusive remedy. Instead, the acts make the respective sections of the acts dealing with charging orders the exclusive remedy, and these sections specifically allow foreclosure.

Some practitioners and commentators[26] have suggested that the exclusivity language may mean that fraudulent transfer laws would not apply to transfers of assets to partnerships or limited liability companies. While a strict reading of the exclusivity language may, at first glance, suggest such an outcome, it would be incorrect. The charging order limitation protects the debtor's interest in the legal entity. If a creditor successfully establishes that a transfer of assets to a legal entity is a fraudulent transfer (which would be a separate legal action from the application for a charging order), the creditor no longer needs to pursue the debtor's interest in the entity. With a fraudulent transfer judgment, the creditor gains the ability to pursue the entity itself, in its capacity as the transferee of the assets. Accordingly, if the creditor has the ability to

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[25] See, for example, Elizabeth M. Schurig and Amy P. Jetel, *A Charging Order is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?,* Prob. & Prop. (Nov./Dec. 2003). See also the critique of the above referenced article in the same publication: Daniel S. Kleinberger, Carter G. Bishop and Thomas Earl Geu, *Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, Prob. & Prop. (Jul./Aug. 2004).

[26] See the discussion of the Alaska charging order statute in the Kleinberger, Bishop and Geu article.

pursue the partnership or the LLC, the protection of the debtor's interest in the entity through the charging order becomes a moot point. Several courts have now opined on this subject as well, uniformly holdings that the exclusivity language of the charging order statutes is not a bar to a fraudulent transfer challenge.[27]

c. Charging Order Cases

There are not a great many cases on charging orders, primarily for two reasons. First, many creditors fail to find the charging order to be a useful remedy, and seek to settle with the debtor rather than hoping to get a distribution out of the entity. Second, even when creditors pursue the charging order remedy, the charging order is granted by a trial court and is rarely appealed, so there are few published opinions. Many of the reported cases deal with the creditor's ability to foreclose; most cases authorize the creditor to foreclose but restrict the buyer of the interest to the economic component of the interest. There are also some interesting outliers, readily demonstrating the degree of judicial imagination involved in statutory interpretation.

The California Supreme Court has affirmed that the charging order has replaced levies of execution as the remedy for reaching partnership interests.[28] The two most interesting charging order cases out of California are Crocker Nat. Bank v. Perroton,[29] and Hellman v. Anderson.[30]

In Crocker, the court concluded that a partnership interest may be foreclosed upon if the sale of the interest does not violate the partnership agreement and the other partners consent to the sale.[31] In Hellman, the court confirmed that foreclosure of the charged interest is authorized by the charging order statute, but disagreed with Crocker that consent of non-debtor partners is required. The court concluded that consent from other partners is not required because pursuant to the foreclosure sale the buyer receives only the economic interest in the partnership, but not voting or management rights. Consequently, the buyer will never have ability to interfere with the business of the partnership and inconvenience the non-debtor partners.[32] Going even further, the Hellman court remanded the case back to trial court for a determination whether the foreclosure of the economic interest (limited as that interest may be) would unduly interfere with the partnership business.[33]

In the only reported Florida opinion,[34] the court concluded that the simplicity of the language of the charging order statute - "the judgment creditor has only the rights of an assignee" - "necessarily" precluded foreclosure.[35] Florida statutes were subsequently amended to specifically preclude foreclosure (see above).

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[27] See, for example, Taylor v. S & M Lamp Co., 190 Cal. App. 2d 700, 708 (1961); Chrysler Credit Corp. v. Peterson, 342 N.W. 2d 170, 172 (Minn. 1984); Firmani v. Firmani, 332 N.J. Super. 118, 752 A.2d 854 (N.J. 2000).
[28] Baum v. Baum, 51 Cal. 2d 610, 612, 335 P. 2d 481, 483 (1959).
[29] 208 Cal. App. 3d 1, 255 Cal. Rptr. 794 (1989).
[30] 233 Cal. App. 3d 840, 284 Cal. Rptr. 830 (1991).
[31] Crocker at 9.
[32] Hellman at 852.
[33] *Id*. at 853.
[34] A prior decision in Myrick v. Second National Bank of Clearwater, 335 So. 2d 343 (1976) was made under Florida's version of UPA and has been superseded by the subsequent adoption of RUPA.
[35] Givens v. National Loan Investors L.P., 724 So. 2d 610 (1998).

A Minnesota court held that the "exclusivity" of the charging order must be read in conjunction with the Uniform Fraudulent Conveyances Act.[36] In this case a limited partnership interest subject to a charging order was transferred in a fraudulent conveyance to the debtor's wife and attorney. The creditor was allowed to pursue the limited partnership interest transferred through the fraudulent conveyance and retain its charging order.

In Deutsch v. Wolff,[37] a Missouri court analyzed, in a charging order context, the receiver's right to manage the partnership. The court drew a distinction between a creditor who becomes an assignee of the debtor-partner (no management rights), and a receiver appointed by the court. A receiver may be granted management rights "when manager of a partnership has willfully engaged in a series of illegal activities…"[38] It seems that in this case the court found the ability to appoint the receiver through the Missouri charging order statute, but vested the receiver with management rights using equity arguments unrelated to the charging order (*i.e.*, a receiver could have been appointed simply because the general partner was defrauding the limited partners). A similar conclusion, under similar circumstances, was reached by courts in Nevada, [39] Kansas[40] and Minnesota.[41]

In Baker v. Dorfman,[42] a New York district court assigned 75% of the single-member's interest in an LLC (the assignment was limited to the profits of the LLC) to the judgment creditor (pursuant to the New York LLC charging order statutes) and appointed a receiver. The receiver was empowered by a magistrate not only to collect the profits, but also to participate in the management of the LLC and to work to increase its profitability. The LLC itself was also a debtor of the judgment creditor in its capacity as a successor in liability of the member-debtor.

The magistrate's ability to do anything but collect profits was later affirmed (with minor modifications) by the Second Circuit.[43] By granting the receiver the ability to manage the LLC, the court certainly went far beyond New York's charging order statute (discussed above). Similar to Deutsch, Tupper, Arkansas City and Windom, there were allegations of fraud against the debtor, and appointment of the receiver may have been possible even absent a charging order. These cases seem to reaffirm that a debtor subject to a charging order cannot lose its management rights because of the charging order.

In a different New York decision, the court concluded that the charging order was not the sole remedy authorized by the charging order statute, and that levy of the charged interest was proper.[44] The court did make it apparent that the levy did not confer on the creditor a greater interest than the one obtained through the charging order.

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[36] Chrysler Credit Corp. at 172-173.
[37] 7 S.W. 3d 460 (1999).
[38] *Id*. at 464.
[39] Tupper at 155.
[40] Arkansas City v. Anderson, 242 Kan. 875, 752 P. 2d 673 (Kan. 1988).
[41] Windom Nat'l Bank v. Klein, 254 N.W. 602, 605 (Minn. 1934).
[42] 2000 U.S. Dist. LEXIS 10142 (S.D.N.Y. 2000), affirmed in part and reversed in part in 232 F.3d 121 (2000).
[43] 232 F. 3d 121, 122 (2000).
[44] Princeton Bank and Trust Company v. Berley, 57 A.D. 2d 348, 394 N.Y.S. 2d 714 (1977). See, also, *Beckley v. Speaks*, 240 N.Y.S. 2d 553 (1963).

d. Single-Member LLCs

Single-member LLCs deserve special attention in the charging order analysis. It may be argued that given the historical framework of charging orders, their protection should not extend to single member LLCs (there are no other "partners" to protect from the creditor).

However, neither the uniform acts nor any of the state charging order statutes make any distinction between single-member and multi-member LLCs. Some courts have held that the charging order protection would apply in a case where all of the partners of a limited partnership were the debtors of a single creditor.[45] The creditor had argued to no avail that because there were no "innocent" (non-debtor) partners to protect, the charging order protection should not apply.

One bankruptcy court held that the charging order protection does not apply to single-member LLCs.[46] In Albright, the debtor was the sole member and manager of an LLC. The bankruptcy trustee asserted that it acquired the right to control the LLC and sell its assets, while the debtor sought to deny those rights to the trustee, based on the above discussion of charging orders.

The bankruptcy court concluded that based on the Colorado LLC statutes, a membership interest in an LLC can be assigned, including management rights.[47] The relevant statute provides that if all the other members do not approve of the assignment, then the assignee does not acquire management rights.[48] If all the other members do approve, then the assignee may become a substituted member (and acquire all rights of a member).[49]

Because in a single-member LLC there are no other members that can "not approve," an assignee will always become a substituted member. The statute was obviously never revised following the introduction of single-member LLCs. The bankruptcy court concluded that if the LLC in Albright was a multi-member LLC, a different result would be reached and the bankruptcy trustee would be entitled only to the distributions of profits, but not management and control over the LLC.[50]

The court's application of the Colorado assignability statutes is faulty. These statutes are implicated only when a member dies or assigns its interest, not in the context of bankruptcy.[51]

The Albright case is often interpreted as a case on single-member LLC charging orders. However, the bankruptcy court devoted most of its analysis to the assignability of interests statutes, and only in passing noted that the debtor made a charging order argument. The court dismissed the debtor's charging order argument out of hand, noting that charging orders were

[45] Evans v. Galardi , 16 Cal. 3d 300 (Cal. 1976).
[46] In re Albright, 291 B. R. 538 (Bankr. D. Colo. 2003).
[47] Colo. Rev. Stat. Section 7-80-702.
[48] Colo. Rev. Stat. Section 7-80-702(1).
[49] Colo. Rev. Stat. Section 7-80-702(2).
[50] Albright at 541.
[51] Colo. Rev. Stat. Sections 7-80-702 and 7-80-704.

intended to protect non-debtor "partners," and in single-member LLCs there is no one to protect.[52]

The very limited analysis of charging orders engaged in by the Albright court is troubling. The court analyzes and follows Colorado statutes when dealing with the assignability of interests and determining how the charging order would work in a multi-member context. For an unexplained reason, the court completely abandons the Colorado statutes in determining the applicability of the charging order. The Colorado charging order statute does not exempt single-member LLCs from the protection of the charging order.[53] The court completely ignores that and focuses on the historical framework of charging orders.

When there is a clear statute on point, engaging in the analysis of legislative intent and historical origins of statutes is inappropriate.[54] The Colorado charging order statute clearly limits the creditor to an economic interest in the LLC.[55] When the Colorado legislature introduced the single-member LLC statute it is presumed to have known of the charging order statute.[56] It chose not to make any changes to the latter. The Albright decision conveniently ignores these legal principles.[57]

In Olmstead, 2010 WL 2518106 (July 6, 2010), the debtor was the member of a Florida LLC, which permits single-member LLC's. The creditor – the FTC – sought to obtain an order permitting the attachment and sale of the debtor's membership interest, similar to the attachment of a share of corporate stock. Florida has a charging order statute similar to California's. The key provision in the Florida charging order statute provides that an assignee of a membership interest in an LLC may become a member only if all of the other members consent.

Much to the surprise and chagrin of the debtor-member, the court ruled that this statute did not prevent the seizure of the member's interest. It reasoned that in every LLC where there is only one member, the interest must be assignable, for the simple reason that there is no other member who can possibly object.

To date, with the exception of the Albright and Olmstead cases, there are no cases analyzing the efficacy of charging orders in the single-member LLC context. Attorneys should caution their clients that if they are seeking to maximize their charging order protection, they should be forming multi-member LLCs or adding new members to existing LLCs. These new members would need to have some membership interest in the LLC, but is difficult to gage how large of

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[52] *Id*. at 542-543.
[53] Colorado Revised Statutes Section 7-80-703.
[54] See, e.g., Robert E. v. Justice Court, 99 Nev. 443, 445, 664 P.2d 957, 959 (1983) ("When presented with a question of statutory interpretation, the intent of the legislature is the controlling factor and, if the statute under consideration is clear on its face, a court can not go beyond the statute in determining legislative intent.")
[55] *Id*.
[56] See, *e.g.*, Sutherland, *Statutory Interpretation*, Section 22.33 (C. Sands 4th ed. 1972); Walen v. Department of Corrections, 443 Mich. 240, 248, 505 N.W.2d 519, 522 (1993); McLeod v. Santa Fe Trail Transp. Co., 205 Ark. 225, 230, 168 S.W.2d 413, 416 (1943); Woodson v. State, 95 Wash. 2d 257, 623 P.2d 683 (1980).
[57] For a more in-depth discussion of the Albright decision, see Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 Del. J. Corp. L. 199 (2005); Thomas E. Rutledge and Thomas E. Geu, *The Albright Decision – Why an SMLLC is Not an Appropriate Asset Protection Vehicle*, 5 Business Entities 16 (2003).

an interest would be sufficient, and whether an economic interest would suffice, or are voting rights required as well. In Albright, the court concluded that if the analysis was carried out under the Colorado charging order statute, and there was another member, with a passive interest, of an "infinitesimal" nature, the bankruptcy trustee would not acquire any management or control rights.[58]

In a community property state like California, if an LLC has spouses as the only two members, and the interests in the LLC are community property of the spouses, such an LLC would probably not enjoy the protection of a multi-member LLC. If either spouse is a debtor, then under the community property laws the creditor will be able to charge the LLC interests of both spouses. This would mean that there would be no non-debtor members to protect with the charging order.

e. Reverse Piercing

Because of the charging order limitation, partnerships and LLCs afford a liability shield to its owners, by protecting (to some extent) the assets within these entities from personal liabilities of the owners. Similar to the traditional liability shield commonly associated with limited liability entities, the protection of the charging order may be pierced by a creditor. In that eventually the charging order limitation becomes a moot point, because the entity is no longer considered to have a separate legal identity from its owners.

In Litchfield Asset Management Corp. v. Howell,[59] after the judgment against her, the debtor set up two LLCs and contributed cash to the two LLCs. The LLCs never operated a business, never made distributions or paid salaries, and the debtor used the assets of the LLC to pay her personal expenses and to make interest-free loans to family members.[60] The court found that the debtor used her control over the LLCs to perpetrate a wrong, disregarded corporate formalities and exceeded her management authority (in making interest-free loans), and ordered reverse piercing of the LLCs.

Because there has always been a strong presumption against piercing the corporate veil (including reverse piercing), this threat to the charging order protection should be easily avoidable.[61]

Practitioners using partnerships and LLCs to protect personal property, such as investment accounts and residencies should be wary. While most states allow the formation of partnerships and LLCs for any lawful purpose,[62] other states require a business purpose (profit or non-profit).[63] In a state requiring a business purpose, a partnership or an LLC holding personal

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[58] Albright at 544, fn 9.
[59] 70 Conn. App. 133, 799 A.2d 298 (Conn. 2001). For a similar result, see C.F. Trust, Inc. v. First Flight Limited Partnership, 306 F. 3d 126 (4th Cir. 2002).
[60] For a contrary holding, see 718 Arch St. Assoc. v. Blatstein, 192 F.3d 88 (3rd Cir. 1999), where the corporation paid personal expenses of the shareholder, but the shareholder included these payments as income on his tax return.
[61] Blatstein at 114.
[62] See, *e.g.*, Colorado Revised Statutes Section 7-80-103, Delaware Code Title 6, Section 18-106, Ohio Revised Code Section 1705.02.
[63] See, *e.g.*, California Corporations Code Section 17002(a).

property may be subject to a reverse piercing claim. Entities holding personal assets should be formed in states like Delaware, that allow entities to be formed for any lawful purpose.

f. Tax Consequences

The tax consequences of the charging order, to the creditor and to the debtor, vary before and after foreclosure.

Until the charging order is foreclosed upon, it is a lien on the debtor's transferable interest and can be compared to a garnishment. If the entity makes distributions to the creditor, then the tax consequences to the creditor are determined with reference to the underlying judgment.

The distributions made pursuant to a charging order are made in satisfaction of a judgment. Judgments are taxable based on the underlying cause of action, according to the "origin of the claim" test.[64] For example, if the judgment relates to a personal injury or sickness, it may be entirely exempt from income under Code Section 104(a). If the judgment does not relate to a personal injury or sickness, it will be taxable as either ordinary income or capital gain. Generally, recovery which compensates for harm to capital assets is a capital gain.[65] All other income is ordinary.[66]

While the creditor is being taxed on the distributions it receives, the debtor is also being taxed on the income of the entity. There are three ways to arrive at this conclusion. First, absent foreclosure, the debtor remains the owner of the economic interest in the entity. And whether the entity is taxed as a sole proprietorship, a partnership or a corporation, it is the owner of the economic interest who is properly taxable.[67] Second, paying off the creditor reduces the outstanding liabilities of the debtor, which is an economic benefit to the creditor, and therefore taxable under the Haig-Simons definition of income.[68] Third, the charging order simply forces the debtor (to the extent it works) to pay off its debts. Paying off debts is not always deductible (see following paragraph), and changing the mechanism of debt payment (debtor paying creditor directly after getting taxed on its share of distributions, versus intercepting distributions from the entity) should not alter that result by giving the debtor an equivalent of a deduction.

The debtor may be able to obtain a deduction for any distributions made by the entity to the creditor, if the judgment relates to the debtor's business, and paying it off would be deemed an "ordinary and necessary" business expense.[69]

If there are no distributions being made to a creditor, then (absent foreclosure) the creditor is not taxable on the income of the entity.

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[64] U.S. v. Gilmore, 372 U.S. 39 (1963).
[65] Rev. Rul. 74-251, 1974-1 C.B. 234.
[66] Code Section 61(a).
[67] Blair v. Comr., 300 U.S. 5 (1937) (gross income from property must be included in the gross income of the person who beneficially owns the property). Evans v. Comr., 447 F. 2d 547 (7th Cir. 1971) (the "real ownership" of the partnership interest was vested in the person who exercised dominion and control).
[68] Rutkin v. U.S., 343 U.S. 130, 137 (1952).
[69] Code Secton 162(a).

Once a creditor forecloses on the partnership or membership interest, the charging order lien is converted into an actual economic interest in the entity, now owned by the creditor (or the buyer of the interest at a foreclosure sale). For federal tax purposes, the creditor acquires a property right in the economic interest (compared to the right to income), and is now treated as the owner of such interest.[70]

The tax consequences to the creditor depend, on two factors, (i) whether distributions are being made, and (ii) the federal income tax treatment of the entity.

If distributions are being made, then if the entity is taxed as a sole proprietorship (because it is disregarded for tax purposes)[71] as a partnership, or a subchapter S corporation, both the debtor's share of the income of the entity and the character of the income being generated by the entity will pass through to the creditor. If the entity is a subchapter C corporation, its distributions will be taxed to the debtor as dividends.

If distributions are not being made to the creditor, then if the entity is taxed as a sole proprietorship, partnership or subchapter S corporation, the creditor is still taxed on its share of the income of the entity, causing the creditor to generate phantom income.[72] The creditor will not be taxed on the income of the entity until it is distributed, if the entity is a subchapter C corporation.

g. Bankruptcy

When a partner or a member files for bankruptcy protection, the debtor's interest in the entity is transferred to his bankruptcy estate. The relevant question is whether the interest now owned by the bankruptcy estate includes the debtor's management rights, or solely his economic rights. Pursuant to the uniform acts and state statutes, the bankruptcy trustee should acquire the right to receive the debtor's share of distributions, but not his control over the entity. Bankruptcy laws may provide for a different answer.

Section 541(a) of the Bankruptcy Code provides that the bankruptcy estate will include all legal or equitable interests of the debtor in property. The courts are generally in agreement that Section 541(a) would apply to both economic rights and management rights of partners or members.[73] Section 541(c) provides further that no restriction on the transfer of any interest of a

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[70] Evans v. Comr; Rev. Rul. 77-137, 1977-1 C.B. 178. This Revenue Ruling ruled that an assignee that acquired "dominion and control" over the economic interest was to be taxed as a partner of the partnership.
[71] An entity may be disregarded for tax purposes if it is (i) a single-member LLC, (ii) either a limited partnership or an LLC owned by one person for tax purposes, or (iii) an LLC where only one member holds an economic interest and the rest possess only management rights. An example of a clause (ii) fact pattern is a limited partnership where individual A is the sole limited partner, and an LLC owned entirely by individual A and treated as a disregarded entity is the sole general partner.
[72] Pursuant to Code Section 61(a) if a sole proprietorship, Code Section 704(b) if a partnership, and Code Section 1366(a) if a subchapter S corporation.
[73] In re Garrison-Ashburn, L.C., 253 B.R. 700, 708 (Bankr. E.D. Va., 2000).

debtor (whether the restriction appears in a contract or under state law) prevents the interest from becoming property of the estate.[74]

Section 365(c) of the Bankruptcy Code provides, in turn, that if an executory contract contains transfer restrictions that are valid under state law, the trustee may not assume or assign such a contract. Consequently, if a partnership agreement or an operating agreement constitutes an executory contract, then the restrictions on transferability of interests in such agreements would preclude the trustee from obtaining rights other than economic rights.

In determining whether a partnership or operating agreement is an executory contract, the court in Garrison-Ashburn concluded that the operating agreement was not an executory contract because it only established the management structure of the LLC, but did not create any duties of members to each other or to the LLC.[75] The court noted that in the operating agreement there "is no obligation to provide additional capital; no obligation to participate in management; and no obligation to provide any personal expertise or service to the company."[76]

It appears that in the context of bankruptcy, there is no clear cut answer whether the trustee (standing in the shoes of the creditors), will acquire solely the economic rights of the debtor, or the voting rights as well. If bankruptcy is contemplated, then the partnership agreement or the operating agreement should be drafted to impose various obligations on members – obligations to the entity and to each other. However, even if the contract is deemed to be executory, it is always possible to come across an "Albright" type court that will not even consider the executory nature of the contract.[77]

h. Maximizing the Utility of Charging Orders

Most partnership and operating agreements being drafted today provide that only the economic interest in the LLC may be assigned, but not the entire membership interest. This mirrors the uniform acts and the various state statutes.

A carefully drafted partnership or operating agreement can greatly enhance the charging order protection. As discussed above, the statutes allow partners and members to override the default statutory provision of assignability of interests. In most business dealings it would not be possible for practitioners to make LLC interests entirely non-assignable. Clients want to retain flexibility and ability to dispose of their LLC interests. However, in family settings, or for LLCs set up solely for liability protection purposes, it may be possible to either prevent assignability altogether or to limit it in such a manner so as to make the charging order remedy of little value to the creditor.

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[74] Garrison-Ashburn at 708 ("Section 541(c) [of the Bankruptcy Code] makes plain that no restriction on the transfer of any interest of a debtor -- whether it arises from the operative documents themselves or from applicable nonbankruptcy law -- prevents an interest from becoming property of the estate").
[75] *Id.*
[76] *Id*. at 708-709. A similar conclusion was reached in In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005). For a contrary holding, see, Broyhill v. De Luca, 194 B.R. 65 (Bankr. E.D. Va., 1996) (operating agreement called on the members to provide continuing personal services).
[77] For a more in-depth discussion of charging orders in the context of bankruptcy, see Thomas E. Geu and Thomas E. Rutledge, *Guess Who's Coming to Dinner?*, 7 No. 2 Business Entities 32 (2005).

Because the charging order protection is predicated on the debtor's continued ability to manage the entity and thus control distributions, the distribution clauses of partnership/LLC agreements become critical. If the agreement provides that all distributions must be made to the partners/members on a pro-rata basis, then distributions have to be made either to all partners/members or none. This means that if one partner/member is pursued by a creditor holding a charging order, protecting that partner/member would mean withholding distributions from all other partners/members of that LLC. Consequently, agreements should be drafted to deal with this potential problem.

One possible solution is to allow the general partner or the manager, in the partnership or operating agreement, to make distributions to all other members, and not the debtor-member. The author's preferred solution, is to provide that the debtor vests in the distribution (*i.e.*, cash and assets are distributable to the debtor) but instructing the general partner or the manager to withhold the distribution while the charging order is pending. This allows the entity to allocate taxable income to the creditor (following a foreclosure) without distributing cash to the creditor.

Pursuant to the uniform acts and most state statutes that allow foreclosure, prior to the foreclosure, the debtor may redeem its partnership/membership interest.[78] The statute does not specify that the interest must be redeemed for fair market value. This leaves room for drafters to insert various favorable redemption provisions into the operating agreement, such as a poison pill.

A poison pill provision usually allows either the entity itself or the non-debtor partners/members to buy-out the debtor for a nominal amount of money. The poison pill has the effect of substituting the debtor's interest in the entity with a nominal amount of cash, which limits the assets that a creditor can collect against. If the entity is established well in advance of any creditor challenges, when the partners/members do not know who will benefit from the poison pill and who will find it detrimental, it should be enforceable (although there are no cases on this point). Because the poison pill will kick in automatically, it should not be deemed a fraudulent transfer, although a challenge is likely. Poison pill provisions are usually limited to family-setting LLCs where the family members are on good terms with each other.

i. A Practical Take on Charging Orders

Charging orders generally allow debtors to retain control over partnerships and LLCs and determine the timing of any distributions. There are some exceptions to that general rule, particularly when the following facts are present: (i) there is a fraudulent transfer, and (ii) in the context of bankruptcy. It may be argued that single-member LLCs should also be deemed an exception to this general rule, based on the <u>Albright</u> case and the historical origin of charging orders. This author believes the Albright case to be an outlier, and in direct conflict with the charging order statutes of all states that have adopted single-member LLC provisions. Historical origin is also of little significance in this area. There is no need to interpret statutes that are very clearly drafted to apply to all LLCs.

[78] RUPA Section 504(c), ULLCA Section 504(c), ULPA Section 703(c).

Purchasing a foreclosed partnership interest may be foolhardy when the debtor, or a person friendly to the debtor, remains in control of the entity and can hold up the creditor's share of distributions. This will lead to adverse tax consequences for the creditor.

As a practical matter, creditors rarely chose to pursue charging orders.[79] A charging order is not a very effective debt collection tool. The creditor may find itself holding a charging order, without any ability to determine when the judgment will be paid off. Practitioners should remember that any uncertainty surrounding charging orders is uncertainty for both the debtor and the creditor. This uncertainty forces most creditors to settle the judgment with the debtor, on terms more acceptable to the debtor, rather than pursue the charging order remedy.

[79] This conclusion is based on anecdotal evidence and the author's own experience. There are no available statistics.

H. Series LLCs

Similar to corporations, LLCs generally protect owners from lawsuits directed against the entity. However, the assets within the entity are not protected from such lawsuits and the creditor of the LLC may be able to reach the entity's assets. Accordingly, instead of placing all assets in one LLC, practitioners advise clients to form multiple LLCs, placing a single asset in each LLC. At times, lenders also require borrowers to hold collateral in so-called special purpose (bankruptcy remote) entities, with each entity holding a separate piece of collateral.

For a client that owns a couple pieces of real estate (or other business assets) this structure works well. For a client with a multitude of assets the fees (such as the minimum franchise tax imposed on each entity) and costs of setting up dozens of entities add up quickly. Series LLCs ("Series LLCs") are a creative solution.

The concept of the Series LLC has been adopted from the offshore mutual fund industry where segregated portfolio companies and protected cell companies have been in existence for quite some time. These concepts exist in such countries as Guernsey, British Virgin Islands, Bermuda, the Cayman Islands, Mauritius and Belize.
In the United States, the concept of a Series LLC was first introduced in Delaware in 1996.[80] The Delaware Series LLC statute was initially introduced for the mutual fund industry, as an extension of the series fund concept.[81]

Series LLC legislation have now been adopted in Oklahoma,[82] Iowa,[83] Illinois,[84] Utah,[85] Tennessee[86] and Nevada.[87] All the states with a series LLC statute modeled their laws on the Delaware law, with some deviations in the Illinois legislation (discussed below). Because most series statutes are similar to Delaware, Delaware series laws will be used to frame this analysis.

Title 18, Delaware Code, Section 18-215(a) provides:

A limited liability company agreement may establish or provide for the establishment of 1 or more designated series of members, managers or limited liability company interests having separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any such series may have a separate business purpose or investment objective.

Section 18-215(b) provides:

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[80] 6 Del. Code Section 18-215. It should be noted that Delaware also provides for series limited partnerships, 6 Del. Code Section 17-218(b), and series statutory trusts, 12 Del. Code Section 3804(a).
[81] The concept of a series fund dates back to the Investment Company Act of 1940.
[82] 18 Okla. Stat. Section 18-2054.4.
[83] Iowa Code Section 490A.305.
[84] 805 ILCS 180/37-40.
[85] Utah Code Ann. Section 48-2c-606.
[86] Tenn. Code Ann. Section 48-249-309.
[87] NRS Section 86.291.

…if separate and distinct records are maintained for any such series and the assets associated with any such series are held…and accounted for separately from the other assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the certificate of formation of the limited liability company, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series ***shall be enforceable against the assets of such series only***, and not against the assets of the limited liability company generally or any other series…[Emphasis added.]

Until recently, Delaware treated series as merely a bookkeeping concept, the series were not granted the power to sue, enter into contracts, etc.[88] Delaware legislature passed Senate Bill 96 that went into effect Aug. 1, 2007 and expanded the powers given to a series. For example, a series can now enter into contracts, hold title to assets, grant liens and security interests and sue or be sued.[89]

In several other respects, series are not treated by Delaware as separate entities. For example, series are not separately registered and they cannot merge or consolidate with other entities, convert into other entity types or domesticate to another jurisdiction. The Delaware Division of Corporations will not provide a separate certificate of good standing for each series.

Illinois has taken a much clearer stance on treating series as separate entities. Illinois law specifically states that a series of an LLC "shall be treated as a separate entity to the extent set forth in the articles of organization,"[90] and then also provides that each series may "in its own name, contract, hold title to assets, grant security interests, sue and be sued and otherwise conduct business and exercise the powers of a limited liability company…"[91] Illinois specifically requires that each series of an LLC be designated on the articles of organization and levies an additional $50 filing fee for each registered series.[92]

The other five states that have enacted series legislation do not treat series as separate entities and do not allow series to enter into contracts or sue or be sued.
Delaware further provides that to achieve the liability segregation that the series afford (the "internal shield"), the LLC must keep a separate set of books and records for each series, and to have a series enabling statement in its Certificate of Formation.

The following additional characteristics of a series LLC should be noted:

(i) each series may have different members and managers, and the members of one series may have different rights, powers and duties from members of other series;
(ii) each series may have a different business purpose or investment objective;

[88] See, e.g., H.R. 528, Section 9, 70 Del. Law Ch. 360 (1996) "a limited liability company may provide that such series shall be treated in many important respects **as if** the series were a separate limited liability company…" [Emphasis Added.]
[89] 6 Del. Code Section 18-215(c).
[90] 805 ILCS 180/37-40(b).
[91] Id.
[92] 805 ILCS 180/50-10.

(iii) statutory restrictions on distributions are applied separately to each series;[93]
(iv) if a member redeems an interest in one series, he does not cease being a member of any other series;[94] and
(v) a series may be terminated without dissolving the LLC.[95]

Series LLCs offer the advantages of cost savings and simplified administration. If an owner of multiple parcels of real estate can use one Series LLC instead of multiple LLCs that allows for an effective reduction of filing fees, annual franchise taxes, legal fees connected to drafting operating agreements and possibly accounting fees. Because Series LLCs exist in a few states and there is no case law examining Series LLCs, several open questions remain as to their viability in other states. Here we will focus on the viability of a Series LLC in California.

1. Recognition of the Internal Shield by California

The major argument against the use of Series LLCs is the uncertainly of the recognition of the internal shield by a foreign state (like California) that does not have a Series LLC enabling statute. States that have enacted Series LLCs legislation usually expressly recognize the internal shield of Series LLCs formed in other states.[96]
If a Series LLC registers to do business in California or is involved in litigation in California, will a California court apply Delaware law and limit a creditor's ability to reach all of the assets of the LLC, or will the court apply California law and disregard the internal shield of the series? This question is traditionally known as the "choice of law" analysis and has been codified in California, with respect to LLCs, in Corporations Code Section 17450(a).

Section 17450(a) provides that "the laws of the state…under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members." The statute addresses two distinct subissues of choice of law: (i) when will California follow the laws of a foreign jurisdiction with respect to the internal affairs of an LLC (generally known as the "internal affairs" doctrine); and (ii) when will California follow the laws of a foreign jurisdiction with respect to holding managers and members personally liable.
The internal affairs doctrine has been interpreted to apply only to the internal affairs of a legal entity, its internal structure and workings, and should have no impact on anyone outside of the legal entity.[97] In a recent unpublished opinion, interpreting Cal. Corp. Code Section 17450(a), a federal district court concluded that the internal affairs doctrine, as codified in Section 17450(a), "does not apply to disputes that include people or entities that are not part of the LLC."[98] A similar conclusion was reached by another federal district court when it held that the internal affairs doctrine "recognizes that only one state should have the authority to regulate a[n LLC's]

[93] 6 Del. Code Section 18-215(h).
[94] 6 Del. Code Section 18-215(i).
[95] 6 Del. Code Section 18-215(j).
[96] See, e.g., 6 Del. Code Section 19-215(m).
[97] Bishop and Kleinberg, Limited Liability Companies: Tax and Business Law, 6.08[4] (WGL 2007), citing Restatement (2d) of Conflicts of Laws, Section 302, comment a (1971).
[98] Butler v. Adoption Media, LLC, Not Reported in F. Supp. 2d, 2005 WL 2077484 (N.D. Cal. 2005).

internal affairs. Different conflicts principles apply, however, where the rights of third parties external to the [LLC] are at issue."[99]

The second clause (governing liability of managers and members) is clearly inapplicable in a Series LLC analysis. With a Series LLC, the issue is not whether a plaintiff or a creditor can pierce the LLC and reach the personal assets of the member, but whether a creditor of an LLC should be limited to only some of the assets of the LLC because the rest are sequestered in separate series.

The above analysis of Section 17450(a) suggests that a Series LLC registered to do business in California would not be able to rely on the internal affairs doctrine to retain its internal liability shield in California. The analysis then necessarily reverts back to the traditional common law "choice of law" scrutiny which has been summarized as follows: "The local law of the state of incorporation will be applied unless application of the local law of some other state is required by reason of the overriding interest of that other state in the issue to be decided."[100]

California has never articulated an "overriding interest" or any other public policy grounds to disregard the internal shield of Series LLCs. That, however, does not mean that such an interest or a policy does not exist.

This determination will be made by the courts on a case-by-case basis. The court would weigh the injuries suffered by a California plaintiff, and how disregarding the internal shield would help remedy such injuries, against the interests that members of other (nondebtor series) may have in the assets of the nondebtor series. It is possible to hypothesize a situation that would allow a California court to find an "overriding interest" in applying its own law.

Until this question is litigated in a California courtroom, the viability of Series LLCs for owning California assets or for transaction business in California will remain in question. However, if the choice is between using one LLC to own multiple properties and one Series LLC to own multiple properties, there is no disadvantage in using a Series LLC, and all of the possible liability segregation advantages of a series structure (if upheld in a California courtroom).

2. California Income Taxation

For income tax purposes, California Franchise Tax Board (the "FTB") piggy-backs its treatment of legal entities on the federal income tax rules.[101] Consequently, for income tax purposes California will treat each series as a separate taxpayer only if for federal income tax purposes each series should be treated as a separate taxpayer.

There are no federal cases or rulings dealing with income tax treatment of Series LLCs. Because Series LLCs are conceptually similar to series trusts, some guidance can be gleaned from the tax treatment of series trusts. In one tax court case, the separate series of a trust were each held to be

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[99] Chrysler Corp. V. Ford Motor Co., 972 F. Supp. 1097, 1103-1104 (E.D. Mich. 1997).
[100] Restatement (2d) of Conflicts of Laws Section 302, comment b (1971).
[101] Rev. and Tax. Code Sections 23038(b)(2)(B)(ii) and (iii). See also Sections 17851 and 23800.5.

separate regulated investment companies, and therefore separate entities for income tax purposes.[102] The Internal Revenue Service has adopted this approach to all series trusts.[103]

Comparing a Series LLC to a series trust is somewhat of a fallacy. Trusts and LLCs are taxed differently. For example, a limited liability company, under the check-the-box rules, can be taxed as a disregarded entity, a partnership or a corporation.[104] If the LLC is taxed as a partnership or a corporation, then one could further investigate whether each series should be a separate partnership or corporation for income tax purposes. If the LLC is taxed as a disregarded entity, then the treatment of each series for income tax purposes is a moot point, everything is disregarded.

The proper income tax treatment of Series LLCs may also depend on the underlying state statute. For example, an Illinois Series LLC is more likely to be treated as a composition of multiple tax entities than a Nevada Series LLC. If a Nevada Series LLC has the same exact members and managers in each series, same voting and distribution rights, and solely different assets with liability segregation, arguing for multiple tax-entity status would be difficult. Even under the pre-check-the-box rules, finding separate tax entities solely because of liability segregation seems like a stretch. Under the check-the-box rules, the argument becomes even more difficult.

The check-the-box rules apply to "business entities."[105] The regulations do not define a "business entity" and it is not clear, except in Illinois, whether a series of an LLC would be deemed an entity under the applicable state law.

3. California Franchise Taxes

The FTB has issued instructions to Forms 568 and 3522 directing taxpayers to pay a separate $800 franchise tax for each series of an LLC.[106] Additionally, the FTB included more specific instructions in Publication 3556, Tax Information for Limited Liability Companies:

For purposes of filing in California, each series within a Series LLC must file a separate Form 568, Limited Liability Company Return of Income, and pay its separate LLC annual tax and fee if it is registered or doing business in California, and both of the following apply:

1. The holders of interest in each series are limited to the assets of that series upon redemption, liquidation, or termination, and may share in the income only of that series.
2. Under state law, the payment of the expenses, charges, and liabilities of each series is limited to assets of that series.

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[102] National Securities Series – Industrial Stock Series, 13 T.C. 884 (1949). It is not clear how the analysis of this case fares in light of the later-adopted "check-the-box" rules discussed below.
[103] Rev. Rul. 55-416, 1955-1 C.B. 416; PLRs 9837005, 9847013, 9435015.
[104] Treas. Reg. Section 301.7701-3.
[105] Treas. Reg. Section 301.7701-2.
[106] The $800 annual franchise tax is imposed under the authority of Rev. and Tax. Code Section 17941(a).

Note that Publication 3556 applies only if all of the requirements set above apply. The requirements are actually numerous: members are limited only to the assets of their respective series on a liquidating event, members may not share in the income of the other series, and the payment of expenses of each series is limited to the assets of that series. Many Series LLCs can be structured so as to fail one or several of the above requirements without sacrificing the internal shield.

For example, assume each series of a Series LLC is owned by brothers Abe and Ben. The LLC provides that Abe and Ben share in all of the income of all of the series and share in all of the assets of all of the series on liquidation. So long as Abe and Ben maintain separate books and records for each series, the internal shield survives intact (the separate books and records is the only mandatory requirement for the internal shield, all other provisions are discretionary). Consequently, Abe and Ben are not subject to multiple franchise taxes on their Series LLC.

It is also important to remember that the instructions in these forms merely express the FTB's position and are not a statement of the law. As the below analysis suggests, the position adopted by the FTB is devoid of any legal substance.

The FTB has not publicly disclosed the substance behind its position on Series LLCs. The author, over the past two years, has engaged in written correspondence with various FTB attorneys concerning the franchise tax treatment of Series LLCs. Based on that correspondence, the FTB's position is based on the following arguments:

1. For income tax purposes series may be treated as separate tax entities (see discussion above).
2. A series of an LLC is treated as a separate "limited liability company" pursuant to Rev. and Tax. Code Section 17941(d).
3. Cal. Corp. Code Section 17450(a) does not apply to an LLC's classification for tax purposes.

Let us examine each of the points raised above. The FTB first argues that Rev. and Tax. Code Sections 23038(b)(2)(B)(ii) and (iii) mandates the classification of a business entity for California tax purposes to be in line with the federal entity classification rules. This argument makes no sense as the above Rev. and Tax. Code Sections deal with the classification of a business entity as a corporation v. a partnership v. a disregarded entity. These sections do not address whether a business entity exists in the first place.

The FTB then argues that because for income tax purposes each series may be treated as either a separate tax partnership or a separate corporation (see discussion above), California has the ability to subject each series to a separate franchise tax. This is a wishful leap of reasoning.

Rev. and Tax. Code Section 17941(a) authorizes the $800 on each limited liability company registered with the state. The statute specifically refers to a "limited liability company." There are no references to income tax partnerships, corporations, disregarded entities, etc. The only relevant test is whether a series is a "limited liability company." How it may be taxed for income tax purposes is entirely irrelevant.

To further illustrate this point, compare a series of an LLC to a general partnership. A general partnership is treated as a partnership for income tax purposes and is therefore an entity for income tax purposes. Yet, California does not impose a franchise tax on a general partnership, because it is not an entity chartered by any state.
That brings us to FTB's next contention: a series is a "limited liability company" for purposes of Section 17941(a).

California statutes define a "limited liability company" as an entity that is organized under the California limited liability company act,[107] and a "foreign limited liability company" is defined as an entity organized under the laws of a foreign state or country.[108] The statutes provide, further, that in order to form a limited liability company, articles of organization shall be filed with the Secretary of State. For franchise tax purposes specifically, a limited liability company is defined as an organization "that is formed by one or more persons under the law of [California], any other country, or any other state, as a "limited liability company" and that is not taxable as a corporation for California tax purposes."[109]

If the FTB wants to argue that a series of an LLC is a separate limited liability company, then under the above test the series must be formed as a limited liability company. That is never the case.

A limited liability company cannot be created without the consent of a Secretary of State of some state. The existence of a limited liability company does not commence until the articles are filed and a charter is issued. Because no articles of organization are ever filed for a series of a limited liability company (with the exception of Illinois), a series of an LLC should never be a limited liability company under California law. None of the series jurisdictions include the series within the definition of a limited liability company.
The FTB concludes its arguments by claiming that Corp. Code Section 17450(a) does not apply to classifying an LLC for tax purposes. Which is certainly true. But Section 17450(a) does apply in determining how the state of organization treats the series of an LLC. If, for example, Delaware does not treat a series as a separate limited liability company, California should respect that treatment and under Rev. and Tax. Code Section 17941(d) cannot access the franchise tax.

While Section 17450 is discussed in more detail above, recall that this section forces California to respect the laws of a foreign jurisdiction with respect to the internal affairs of a legal entity. Pursuant to the internal affairs doctrine, the laws of the organizing state control the inner workings of a legal entity. Determining whether a legal entity constitutes one limited liability company or multiple appears to related to the legal entity's structure, and therefore its internal affairs.

In the case of a Series LLC, all the series comprise one limited liability company under the applicable enabling statutes, not multiple limited liability companies (again, with the exception

[107] Corp. Code Section 17001(t).
[108] Corp. Code Section 17001(q).
[109] Rev. and Tax. Code Section 17941(d).

of Illinois). Consequently, the FTB's position that each series is a separate limited liability company appears to be in conflict with the California statutes.
The FTB's position is further weakened in cases when the Series LLC owns only few assets in California and mostly transacts its business elsewhere. Assume an Iowa Series LLC has 50 series in existence. Forty-nine own real estate in France, and one owns a hot dog stand in Los Angeles. Because the hot dog series would not be able to obtain a certificate of good standing from Iowa, it would not be able to register with the California Secretary of State as a foreign entity. The Series LLC itself would need to register, and according to the FTB would then be liable for $40,000 of franchise taxes. This argument is likely to fail on constitutional grounds, but only if a taxpayer litigates. Until then, many taxpayers will continue to follow FTB's instructions and pay unwarranted franchise taxes.

Some commentators have suggested that the FTB's position with respect to the Series LLC franchise tax is not "completely objective."[110] This author believes that the FTB's position is so devoid of legal merit and is so self-serving as to be shameful.

4. Recognition of the Internal Shield

The ability of a series of an LLC to seek bankruptcy protection is an unresolved question. Bankruptcy laws allow individuals, partnerships and corporations (and by extension, LLCs) to seek bankruptcy protection.[111] In series enabling states other than Illinois, series are not treated as separate entities (although Delaware comes close to that). Series appear to be nothing more than a bookkeeping concept, a virtual walled off part of an LLC. That may suggest that only the LLC can file for bankruptcy protection, not one of its series.

This analysis may be different in Illinois, where series are afforded the status of separate entities.

The next relevant question is whether a series of an LLC can transact business in another state without the LLC itself transacting business in such state? The answer to this question depends on whether a series is treated as a separate business entity. Under the Illinois series legislation a series is expressly authorized to transact business on its own: "If a limited liability company with a series does not register to do business in a foreign jurisdiction for itself and certain of its series, a series of a limited liability company may itself register to do business as a limited liability company in the foreign jurisdiction in accordance with the laws of the foreign jurisdiction."[112] In Delaware and other similar Series LLC jurisdictions series are not treated as separate business entities (although Delaware now allows each series to enter into contracts on its own), which would imply that a series on its own may not register in a foreign state.

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[110] Bruce P. Ely and Kelly W. Smith, Series LLCs: Many State Tax Questions Are Raised but Few Answers Are Yet Available, Business Entities (WG&L), Jan/Feb 2007.
[111] 11 U.S.C. Section 109(a), ICLNDS Notes Acquisition, LLC, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001).
[112] 805 ILCS 180/37-40(n).

Registration in a foreign state is available only to those entities that possess a charter (such as Articles of Organization) from their home state. While Illinois issues an equivalent of a charter to each series, Delaware and the other series states do not. Consequently, a series of a Delaware Series LLC would not be able to register with the State of California, the entire LLC would need to register.

Similarly, if one series of a Series LLC transacts business in a foreign state, would that mean that the foreign state would acquire jurisdiction and taxation powers over the entire LLC and all of its series or only those series transacting business? The answer again depends on whether the series is treated as a separate entity.