ASSET PROTECTION BASICS: USING PARTNERSHIPS AND LLCS

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Outside Liability & Charging Orders

LLC and LP owners can be protected from the "inside liabilities" of the business entity itself where they are not also personally liable. But what about "outside liabilities," that is, liabilities of the owners from which the owners wish to protect the assets of the business? There is an often overlooked but very important difference between being a shareholder of a corporation and a member of an LLC in this situation.

The shares of a shareholder of a corporation are vulnerable to claims of the shareholder's judgment creditors. In many small businesses, this vulnerability could allow the creditor to control the business by reaching the stock of a controlling shareholder.

The membership interests of an LLC are more protected. A creditor of a member of an LLC is entitled only to a charging order, rather than being entitled to execute directly against LLC assets. A charging order gives a creditor the right to receive any distributions that the owner of the interest would have received. A charging order is simply a court document that directs the manager(s) of the LLC to divert distributions that would otherwise go to the debtor member to the creditor to the extent of the unpaid judgment plus interest.

At first glance, the charging order may not seem like much protection. However, the economic rights to distributions are all that the creditor gets. The creditor does not get the management and voting rights that may go along with the LLC membership interest. The LLC's managers determine if and when distributions are made. It may be that distributions will not be made or that distributions will be significantly delayed. Some tax professionals believe that the creditor may be taxable on the debtor-member's income, even if the creditor never receives any distributions in respect of the charging order. This belief is suspect, but the uncertainty in this area can make a creditor contemplating a charging order very uneasy.

The charging order is not an attractive remedy to most creditors. As a result, the prospect of a charging order can often convince a creditor to settle on more reasonable terms than might otherwise be possible. Shareholders of a corporation have little such leverage. Thus, in addition to being a very useful business tool, the LLC can be a valuable personal asset protection tool.

North Carolina Charging Order Law

North Carolina is one of the few states with a reported appeals court case involving a charging order against an LLC member's interest. Studying North Carolina charging order law is instructive as it is similar to that of most other states.

A North Carolina LLC membership interest cannot be seized and sold to satisfy a creditor's judgment. The creditor is limited to an order charging the debtor's LLC membership interest with payment of the unsatisfied amount of the judgment with interest. *Herring v. Keasler,* 150 N.C. App. 598 (2002). Although this is almost certainly the law in every state, North Carolina is one of only a few states with an appellate case directly on point.

The creditor obtained a writ of execution for the seizure and sale of the debtor's LLC membership interests and, pending sale, requested a charging order directing any distributions with respect to the debtor's LLC interests to be applied towards the satisfaction of the creditor's judgment. The trial court granted the charging order, but denied the creditor's request for the seizure or sale of the debtor's LLC membership interests. The court's charging order provided that:

- the LLCs must deliver to the creditor any distributions and allocations that the debtor would be entitled to receive on account of his membership interests in the LLCs;
- that the debtor must deliver to the creditor any distributions he would receive from the LLCs; and
- that the creditor would not obtain any rights in the LLCs, except those of an assignee under LLC Act and the respective operating agreements.

Generally under N.C. Gen. Stat. § 1-362 a trial court may order any of the debtor's property (except the homestead and personal property exemptions of the judgment debtor) in the hands of the judgment debtor or of any other person or due to the judgment debtor to be applied towards the satisfaction of a judgment.

However, N.C. Gen. Stat. § 57C-5-03, provides that with respect to a judgment debtor's membership interest in a LLC, a trial court "may charge the membership interest of the member with payment of the unsatisfied amount of the judgment with interest." Under N.C. Gen. Stat. § 57C-5-02, the charge entitles the judgment creditor "to receive … the distributions and allocations to which the [judgment debtor] would be entitled." The charge "does not dissolve the limited liability company or entitle the [judgment creditor] to become or exercise any rights of a member."

The Court of Appeals said that because the forced sale of a membership interest in a LLC to satisfy a debt "would necessarily entail the transfer of a member's ownership interest to another, thus permitting the purchaser to become a member," forced sales are prohibited under North Carolina law. The court cited N.C. Gen. Stat. § 57C-3-03, which provides that except as provided in the operating agreement or articles of organization, consent of all the members of a LLC is required to admit any person as a member.

Finally, the court affirmed the trial court's ruling and held that the plaintiff's only remedy is to have the defendant's LLC interests charged with payment of the judgment under N.C. Gen. Stat. § 57C-5-03.

Herring v. Keasler was a case of first impression in North Carolina. Not only had there been no such case involving LLC interests, but there also have been no similar cases in North Carolina involving partnership interests.

While the result is desirable from an asset protection perspective, the court's analysis is a bit flawed. Although the court reasoned that a forced sale of a membership interest in an LLC "would necessarily entail the transfer of a member's ownership interest to another, thus permitting the purchaser to become a member," that is simply not the case under the North Carolina LLC Act (nor under the LLC acts of most other jurisdictions).

A purchaser of an LLC interest simply gets the economic rights of an assignee – sort of a "permanent charging order." Under N.C. Gen. Stat. § 57C-5-04, the purchaser becomes a member only if admitted by the consent of all of the members (or as otherwise provided in an operating agreement). If the purchaser is not admitted, he has no rights to participate in LLC business in any way. He can only wait and hope for operating or liquidating distributions.

The position of a purchaser is not much better than that of a creditor with a charging order, except that while the charging order will expire with the judgment (but may be renewed along with the judgment), the rights of an assignee continue indefinitely.

Apparently, however, the plaintiff thought that a purchaser at a forced sale would pay considerably more for assignee rights than a charging order is worth. In the June 10, 2002 edition of *North Carolina Lawyer's Weekly*, the plaintiff's attorney said:

> The bad thing about having a charging order is that, at most, you get your principal and interest – but only if the LLC works out until your judgment is paid. The charging order is worth less than selling the interest because you bear all the risk that the business will go bust before the judgment is paid. So it's worth much less than what you could get by selling it under an order.
>
> The real problem with this decision is that it enables defendants to hide their assets from judgment creditors basically forever…. The decision takes assets that are potentially subject to execution and turns them into something you cannot get to. If you're a member and manager of an LLC, you never have to give yourself a distribution or you don't have to do it until the judgment runs out. [The defendant] owns at least seven or eight LLCs that were formed years after the judgment with his assets and I can't get to them. If they were shares in a corporation, we could sell them.

However, while the holder of a charging order bears the risk that the LLC will go bust or that the manager will withhold distributions, the purchaser of an assignee interest bears essentially the same risk. Furthermore, while the holder of a charging order likely will not be taxable on his allocable share of LLC income, an assignee is likely to be taxable.[1] Foreclosure and true assignee status sets up a potential ambush for a creditor to be "K.O.'d by the K-1". The tax liability (of which a creditor's attorney may be unaware) sometimes can facilitate a quick and cheap redemption of the foreclosed interest from the creditor. The mouse no longer wants the cheese; he just wants out of the trap. Depending on the tax circumstances of the LLCs involved, the creditor's failure to attach directly the debtor's LLC membership interests may have been a blessing in disguise for the creditor. After all, the creditor can pursue other assets. The judgment in this case was not large. It is likely that non-exempt, unprotected assets would appear at some point.

The fact that the debtor's LLCs were organized after the judgment was not mentioned in the court's opinion. An online search of the North Carolina Secretary of State's Corporations Division database shows that they were in fact organized *3½ years* after the judgment was obtained. Also not mentioned in the opinion is the fact that within days of the issuance of the trial court's charging order, each of the LLCs filed articles of correction stating that the articles of organization filed for each LLC about two years earlier incorrectly manifested the intent of the organizers to create member-managed LLCs; in fact, the intent was to create manager managed LLCs, thus the articles of correction were filed changing them to manager-managed LLCs. Although the first conclusion that could be drawn from the fact that these facts do not appear in the opinion is that they weren't alleged by the plaintiff, one might also speculate that these facts were irrelevant to the court's analysis.

As for the post-judgment formation of the LLCs, it appears that the defendant had a legitimate business purpose for investing in the LLCs that was clearly separate from the protection afforded by the charging order. Assuming that a transfer to an LLC in exchange for membership interests is for reasonably equivalent value, then under the North Carolina Uniform

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[1] *See* Riser, Christopher M., "Tax Consequences of Charging Orders: Is the K.O. by K-1 K.O'd by the Code?" *Asset Protection Journal*, Winter 2000, Vol. 1 No. 4, online at http://www.riserlaw.com/publications/ap/credtax.htm)

Fraudulent Transfer Act, the plaintiff would be required to prove actual or constructive intent to defraud creditors in order to void the transfer. Although certain badges of fraud were present (transfer to insider, transfer occurred after debt incurred), the fact that equivalent value was received in the form of LLC interests and that the transfer was made for legitimate business purposes likely would have outweighed them in a constructive fraud analysis (assuming that there was no actual-intent "smoking gun").

Converting the LLCs from member-managed to manager-managed probably was intended to prevent the plaintiff from obtaining a court order requiring the defendant, as a member-manager, to make distributions. Going the route of filing articles of correction seems a little fishy in that it attempts to make it seem like that was what was intended regardless of the judgment and charging order against the defendant. It also would seem to open the door to a veil-piercing claim, e.g., "these LLCs are so loosely run, the members didn't even know how they were organized; they just did this to keep me from collecting on my judgment." In fact, simple articles of amendment changing the LLCs to manager-managed LLCs as of the time of filing would have served the purpose just as well.

The favorable position of an LLC member regarding a fraudulent transfer challenge is another reason to consider the LLC as an asset protection tool. The fact that the exchange of property for LLC interests is generally considered a transaction for reasonably equivalent value can make an asset protection structure based on an LLC preferable to a structure that requires the gratuitous transfer of a large amount of assets, such as an asset protection trust.

Caution is advised, however, when using LLCs or any other asset protection tool in a post-judgment environment. Careful badges of fraud and solvency analyses must be made where fraudulent transfer may be an issue. However, as a practical matter, transfers for which reasonably equivalent value is received can be difficult to challenge under the fraudulent transfer laws of most jurisdictions, which require proof of a transferor's actual or constructive fraudulent intent to set aside a transfer.

On the other hand, there is little doubt that a creditor who forecloses on a charging order is treated as an owner of the charged entity for tax purposes. Foreclosure becomes a potential trap for a creditor to be "K.O.'d by the K-1". The tax liability (which is not something that creditors' attorneys are typically even aware of) can sometimes facilitate a quick and cheap redemption of the foreclosed interest from the creditor. Or as we litigators say, "They no longer want the cheese; they just want out of the trap."

From the asset protection perspective, foreclosure is sometimes good, and the states that have eliminated the foreclosure remedy in order to attract asset protection work may have unwittingly taken a step backwards.[2] However, some would argue that the fact that the creditor is stopped at the charging order stage may facilitate settlement by the creditor even without the surprise leverage of the "thank you for foreclosing, here's your K-1".

Single Member LLCs

The single-member LLC is something of an anomaly. LLC law is largely based on the law of partnerships and, of course, there have never been single-member partnerships. The anomalous nature of single-member LLCs extends to the taxation of single-member LLCs as well.

[2] For an excellent overview of charging orders and foreclosure, *see* Bishop, Kleinberger and Geu, "Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster," Probate & Property, July/August 2004, at 30.

Tax Classification of Single Member LLCs

In December 1996, the IRS issued check-the-box regulations,[3] which allow an LLC simply to choose whether to be taxed as a partnership or as a corporation. Under the check-the-box regulations, a single-member LLC may elect to be classified as a corporation or to be disregarded for tax purposes as an entity separate from its owner—and thus to be taxed as a sole proprietorship. If a newly-formed single-member LLC fails to elect classification, it is classified under a set of default rules generally providing that domestic single-member entities are disregarded as entities separate from their owners. Basically, the regulations really are that simple. If the owner of a single-member domestic LLC wants pass-through sole proprietorship taxation, she simply does nothing. In such a case, the entity classification system more precisely might be called the "don't-check-the-box" rules.

If the member of a single-member domestic LLC wants the LLC to be taxed as a corporation, the LLC simply files a one-page IRS Form 8832, Entity Classification Election, within seventy-five days after the date the election is to be effective, literally checking a box to elect to be taxed as a corporation. Once an LLC elects to be taxed as a corporation, it is a corporation for all federal tax purposes. So, a domestic LLC that has elected to be taxed as a corporation can elect to be taxed under Subchapter S as an S corporation as well (assuming it otherwise qualifies under the Subchapter S rules).

Single-member entities that do not elect to be taxed as corporations are completely disregarded for tax purposes. The simplest example is an LLC with one member, an individual person. In such a case, the tax items of the LLC are the tax items of the individual. The individual simply reports the tax items of the LLC on her own personal income tax return: business activity on Form 1040 Schedule C, capital gains and losses on Schedule D, rental activity on Schedule E, and the like.

In the case that an entity is the single member of an LLC, the LLC's tax items are reported on the underlying entity's tax return, just as with an individual owner. The tax items of an LLC wholly owned by a corporation, for example, will be reported on the corporation's Form 1120 along with the corporation's other tax items.

Multi-Member Disregarded LLCs

Consider an LLC that is owned by more than one legal person, all of whom are treated as one for tax purposes. This type of LLC may also be disregarded under the check-the-box regulations. This concept is best illustrated by example.

> A decides to do some estate planning by establishing up a trust for A's children. A's estate planning advisor recommends that the trust be a grantor trust for income tax purposes such that the income of the trust is taxable to A directly. A's sister is the trustee. A funded the trust for several years and the trust principal has grown to about $1 million.
>
> A has $100,000 that A would like to invest in a rental property. A's sister, as trustee of the trust, thinks it would be a good investment for the trust as well, and she decides that the trust will invest $100,000 as well.
>
> A and A's sister, as trustee, form an LLC, with each as a 50 percent member. The members choose not to have the LLC taxed as a corporation, so no check-the-box election is filed. The LLC is taxed as a disregarded entity with respect to A. A is

[3] Treas. Regs. 301.7701-3.

> treated as the owner of the assets of the grantor trust and A is, of course, the owner of A's LLC interests. So, A is treated as the owner of 100 percent of the LLC interests, even though A does not legally own or even control 100 percent of the LLC interests.

Why would someone want a multi-member disregarded LLC when a single-member disregarded LLC might do?

Single Member LLCs and Charging Order Protection[4]

An LLC provides protection to its owners for debts unrelated to the business in that LLC property and LLC interests themselves generally cannot be directly seized or attached by creditors of debtor members. Instead, such creditors are limited to a "charging order" issued by a court requiring the LLC to divert payments to the debtor member to the creditor. However, the charging order does not provide the creditor with voting rights, such as the right to vote for a distribution. If no distributions are made to the debtor member, neither are distributions made to the creditor. Furthermore, in some cases, the creditor may be taxable on the debtor member's share of LLC income, whether he receives a distribution or not.[5] Thus the charging order is not a particularly attractive remedy for a creditor.

Nothing in any LLC act, foreign or domestic, indicates that the charging order remedy is not the preferred or sole remedy available to a creditor of a member of a single-member LLC. The original policy reason for the charging order, however, does not exist with a single-member LLC. There is no other LLC member who would be unfairly affected by the seizure of LLC assets or of the LLC interest itself in its entirety.

If asset protection via the charging order is a major concern, single-member LLCs should be used with caution. When possible, an additional member should be included to bolster the charging order protection. An additional member often can be added without changing the treatment of the LLC as a disregarded entity for tax purposes —for example, by using a grantor trust or another disregarded entity.

The issue of the member of a single-member LLC in bankruptcy is yet another potential problem area. In a 2003 Colorado bankruptcy case, *In re Ashley Albright,*[6] the court held that the bankruptcy trustee succeeded not only to the economic rights of the member-manager of a Colorado single-member LLC, but also to her management rights because there were no other members of the LLC.

The Colorado LLC Act provides that a member's membership interest in an LLC consists only of the member's economic rights.[7] Only this economic interest is freely transferable under the Act. The Colorado LLC Act permits the transfer of a member's management rights only with the consent of "other members."[8] However, the court also concluded that this restriction on transfers of management rights makes no sense in the case of single-member LLCs and thus can reasonably be disregarded in such a case.[9] As a result, the bankruptcy trustee, exercising its management rights in the LLC, was able to cause the LLC to sell its sole asset, certain real estate, and to distribute the proceeds to the bankruptcy trustee to be used to satisfy debts of the bankruptcy estate.

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[4] The author is indebted to his friend and colleague John M. Cunningham, Esq. for his input on this topic.
[5] *See* Rev.Rul. 77-137, 1977-1 CB 178. *But see* Riser, note 1, *supra*.
[6] *In re Ashley Albright*, 291 BR 538 (Bankr. D. Colo. 2003).
[7] Colo. Rev. Stat. § 7-80-702
[8] Colo. Rev. Stat. § 7-80-102(1)
[9] *Id* at 538.

Although perhaps the result is logically correct, from a legal perspective it is subject to criticism. In essence, the court said that by succeeding to the debtor-member's membership interest, the bankruptcy trustee thereby succeeded to the member's control of the LLC. This contravenes the definition of the term membership interest in the Colorado LLC Act as meaning only the member's right to receive allocations and distributions.[10] The decision thus rests on a fundamental misapplication (albeit intentional) of statutory LLC law — namely, a failure to distinguish between an LLC member's economic rights and her management rights.

The court also stated, and rightly so, that the charging order limitation serves no purpose in a single-member LLC, because there are no other parties' interests affected. Yet, the court entirely failed to address the strongest argument in support of LLC charging order protection, even for single-member LLCs—namely, the plain meaning of the charging order statute.

The court discussed what might happen if the LLC had two members and the dominant member filed for bankruptcy. In such an event, the court said that if the nondebtor member did not consent to the admission of the bankruptcy trustee as a substituted member, even if that nondebtor member held only an infinitesimal interest, the bankruptcy trustee would not gain management rights. The trustee would only be entitled to a share of distributions and would have no role in the voting or governance of the company.

The *Albright* decision powerfully supports the asset protection afforded by multimember LLCs. Although the court is basically incorrect in its stated rationale for denying charging order protection to members of single-member LLCs, its result is logical. This outcome is likely to be repeated throughout the country as similar cases arise. Despite the fact that the Albright case is binding precedent only before the judge who decided the case, it is likely to be persuasive in bankruptcy cases in other jurisdictions where similar single-member LLC charging order questions are raised. Furthermore, it is likely to be cited as persuasive precedent by courts in non-bankruptcy cases.

Most importantly perhaps, we should not ignore the dicta of the court regarding the ability of a second member to avoid the Albright outcome. If charging order protection is important to the owner of a single-member LLC, the owner's advisors should recommend adding a second member. This advice applies in the case of new LLC formations and conversions as well as in the case of existing single-member LLCs. For individuals who own single-member LLCs, the simplest fix is normally to add a spouse or child as a second member. Another alternative would be to add a trust as a second member. If the trust is a grantor trust with respect to the LLC's original single member, the resulting two-member LLC would remain for tax purposes a disregarded entity with respect to the original single member. This could be advantageous to the member, administratively and otherwise, as it would avoid the requirement to file a partnership return and may provide other tax benefits as well. For entities that own single-member LLCs, the issue can be more complicated. However, if the entity already has other subsidiaries or sister companies, these may make good second members.

How much of a second membership interest is enough? At the end of the Albright opinion, the court noted that if Ms. Albright's LLC had had even a "peppercorn" second member – i.e., another member with even an "infinitesimal" interest in the LLC – the court would have ruled in her favor and would not have allowed the bankruptcy trustee to succeed to her management rights. However, in a case with facts more sympathetic to a creditor – for example, imagine a personal injury case with a horrific injury caused by an intoxicated defendant – a court may be persuaded to ignore the "peppercorn" second member, particularly if the member is a spouse, perhaps easily overlooked as a member of the same economic unit as the debtor. The right

[10] Colo. Rev. Stat. § 7-80-702

minimum amount will vary from case to case, but a second membership interest of at least one percent interest is recommended. A five-percent or ten-percent is even better.

The Albright case should have been no surprise to asset protection planners. To me, the surprise is that it has taken so long for such a case to be reported. The case merely confirms what many of us have long believed – namely, that few courts are likely to rule that single-member LLCs provide charging order protection.

The outcome of the Albright case does not mean, however, that single-member LLCs are without utility in asset protection planning. As subsidiary LLCs of holding entities, they are still quite useful in segregating liabilities resulting from different sources, such as separate parcels of real estate and separate lines of business. In such cases, it is not the charging order upon which the protection relies, but rather the limited liability nature of the LLC. In other words, there is no reason to suspect that the liability shield afforded to "internal" liabilities of the LLC will be any less than that of sole-shareholder corporations.

Subsidiary single-member LLCs owned by a holding structure taxed as a disregarded entity can be excellent means of protecting S corporation ownership interests, which are often difficult to protect. Tax rules prohibit partnerships (that is, entities taxed as partnerships) from owning shares of S corporation stock. So, S corporation shares cannot be owned in an LLC holding company structure if the LLC holding company is taxed as a partnership. However, tax rules permit S corporation shares to be owned in an LLC holding company if the LLC holding company is taxed as a disregarded entity and if the LLC owner is a U.S. individual (or other eligible S corporation shareholder).. So, a dual strategy is often best for S corporation shares. First, convert the corporation to an LLC taxed as an S corporation to obtain the administrative advantages of the legal form of the LLC over the legal form of the corporation. Then, contribute the membership interests of the LLC taxed as an S corporation to an LLC holding company structured as a disregarded entity.

Conflicts of Laws and Charging Orders

Speaking of charging orders, in which jurisdiction should a creditor apply for a charging order? Consider the following hypothetical:

> Timbuktu LLC is formed in Delaware, has its offices and principal place of business in Kansas, is qualified to do business and owns real property in Oregon. Timbuktu does not do business or hold assets in North Carolina. However, a member of Timbuktu LLC lives in North Carolina, where he is successfully sued. The North Carolina creditor seeks to charge the debtor's interest in Timbuktu LLC to satisfy the North Carolina judgment.

In which jurisdiction should the North Carolina creditor apply for the charging order?

Uniform act drafters have left this question unanswered for 80+ years, simply providing that a court of "competent" jurisdiction may issue the order. Thus the issue of jurisdiction can be a contested matter in a charging order case. While a North Carolina court can issue a charging order, Timbuktu LLC has no minimum contacts in North Carolina; thus, North Carolina has no personal jurisdiction over Timbuktu LLC. If Timbuktu LLC ignores the North Carolina court's order, the court does not have jurisdiction if Timbuktu is not within its borders.

In order to obtain a charging order, the North Carolina creditor should register the judgment in (1) Delaware, where the LLC was organized; or (2) Kansas or Oregon, where Timbuktu LLC has minimum contacts, and should obtain the charging order against Timbuktu under that state's laws. This issue was addressed by the Washington Court of Appeals recently.[11] The court concluded that a California creditor did not violate due process by bringing an application for a charging order in the state in which the LLC was organized, holding that, although the LLC's principal place of business was in Malaysia:

> where a partnership organizes under the laws of a state, the partnership interest is located within that state. Here, [the LLC] is registered under the laws of the State of Washington, maintains an office and registered agent in Washington, and owns a parcel of property in Washington. Therefore, the partnership interest is located here.[12]

In the case of attachment and levy upon corporate stock, the stock must be located in the jurisdiction in which the sheriff is charged with finding the property. In the case of stock, the property is reified in the stock certificate. The court does not get jurisdiction over the property by service of a notice in the attachment proceedings upon an officer or agent of the foreign corporation, but obtains jurisdiction over the property, namely, the stock, by serving an attachment upon the person in whose possession the stock actually is and who is a resident of the state.

If a charging order proceeding is an *in rem* proceeding, then the property must be found within the state. One might argue that the property consists of the right to receive distributions, and as such, that right exists wherever the member is located. In any case, the issue is one sure to cause increasing problems for creditors' attorneys. Secured creditors' attorneys whose clients obtain security interests in LLC and partnership interests should require that the interests be certificated in order to eliminate the issue of the location of the interest. In such a case, the interest will be located where the certificate is located.

Series LLCs

Segregating "dangerous" assets and businesses into separate entities away from other assets, especially "safe" assets, is always a good idea from an asset protection point of view. For example, an individual who owns a gas station and a rental home should not own both within the same entity. Further, an individual with a large amount of liquid assets (cash, securities, etc.) to protect should not hold those assets in the same entity as a business.

Best practices would dictate that every distinct business or major business asset be segregated into a different limited liability entity. In an ideal situation, someone with 25 rental properties would have 25 separate LLCs, one for each property. However, this is not always practical because of administrative costs and government fees that must be paid for each LLC. What can such a business owner do to protect his assets from liabilities unrelated to those assets in a cost-effective way?

Enter the series LLC. The LLC acts of Delaware, Iowa, Illinois, Tennessee, Nevada, and Oklahoma provide for the creation of separate protected "cells" ('series') within one limited liability "container" (the series LLC) without the need to create separate entities, thus avoiding the inefficiencies associated with multiple related entities. The Delaware LLC Act is the LLC act most often used for series LLCs and is the act used for discussion purposes in this article.

The Delaware LLC Act provides that the liabilities of a particular series are enforceable only against the assets of that series. The Act also provides that classes or groups of members can be established, having whatever rights the LLC agreement says they have.

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[11] *Koh v. Inno Pacific Holdings Ltd,* 54 P.3d 1270 (Wash. Ct. App. 2002).
[12] *Id.*, at 1272.

The combination of these two provisions allows a series to function in many ways as a separate entity for practical purposes. The series LLC concept is similar in function to segregated portfolio companies and protected cell companies designed for the mutual fund and captive insurance industries in a number of offshore and onshore jurisdictions.

The Act allows an LLC agreement to designate series of members, managers or LLC interests that have separate rights and duties with respect to specific LLC property or obligations. So, each series can be tied to specific assets and can also have different members and managers.

Each series can have its own separate business purposes. A series can be terminated without affecting the other series of the LLC. A series can make distributions to its own members without regard to the financial condition of the other series.

Most importantly, the Act provides that debts, liabilities and obligations incurred, contracted for or otherwise existing with respect to a particular series are enforceable against that series only, and not against the assets of the LLC generally or any other series of the LLC.

In order to obtain inter-series liability protection, each series must be treated separately and the public must be put on notice of the liability limitation by the inclusion of the series limitations in the LLC's Certificate of Formation filed with the Delaware Secretary of State. Records must be kept for each series and the assets of each series must be held and accounted for separately. The separate holding and accounting required may be in the LLC's records, so long as separate and distinct records are maintained for each series. However, the safest practice would be to segregate and separately hold series assets titled, to the extent possible, in the name of each series (e.g., "ABC LLC, Series X").

Federal tax law rather than state law determines the existence of an entity for tax purposes. In many cases, the members of each series of an LLC will be identical. In such cases, it is fairly certain that the series LLC as a whole will be treated as a single tax entity for federal tax purposes. On the other hand, if the series of an LLC have the same members, or identical or similar membership rights, or similar business purposes, each series may be treated as a separate LLC for income tax purposes.

In both cases, however, there should be only one filing with a state's secretary of state for the LLC (rather than for the individual series). Furthermore, in most cases, there should be only one state franchise (or similar) tax filing.

The most obvious use for the series LLC is to hold multiple parcels of real property in liability-segregated cells. Owners of small commercial or residential properties may find the series LLC particularly appealing. This is especially true in states with high minimum franchise taxes. Forming and maintaining a number of separate LLCs may cost several thousand dollars in the year of formation and several thousand dollars each subsequent year. Using a series LLC with each property held by a separate series may save several thousand dollars in startup costs and another several thousand dollars a year in ongoing administrative and state tax costs.

Another use for the series LLC is to facilitate the combination of business operations of distinct businesses. For example, rather than undertaking a traditional merger, two companies wishing to join forces might form a series LLC, with each company contributing its assets to a separate series, or with the owners of each company contributing their ownership interests to a separate series. The LLC agreement and series agreements could be drafted to determine exactly which rights and responsibilities are shared and which are maintained separately. The series LLC provides a unique and very flexible framework for this sort of business combination.

Reverse Veil Piercing / Alter Ego

By combining the most attractive characteristics of partnerships and corporations, legislatures have granted the owners of limited liability companies broad business powers and personal liability protection while avoiding the double taxation (or the "S corporation straitjacket") traditionally associated with full-shield limited liability protection. The protection afforded by the corporate "veil" of limited liability may be pierced when a court disregards the corporate entity and extends liability to an owner if the entity is a mere instrumentality for an owner to escape liability, commit fraud, or engage in some other activity that is in violation of public policy or statutory law.

Another form of piercing the corporate veil is known as "reverse piercing." Reverse piercing occurs when a creditor of an individual pierces through the corporate entity in order to use the corporation's assets to satisfy the individual's debts.

Courts have applied reverse veil-piercing to LLCs and partnerships in rare circumstances. In *Litchfield Asset Management Corp. v. Howell,*[13] the debtor, a 97% owner of an LLC, contributed assets to the LLC after the plaintiff sued. Other owners, including the debtor's daughters, contributed $10 each. Relying on traditional corporate veil-piercing rules, the court reverse-pierced the LLC veil, allowing the creditor to reach LLC assets. The court emphasized the control exercised by the debtor, the debtor's unauthorized use of LLC funds to pay personal expenses, and the owner's commingling of business and personal affairs and funds.

In *C.F. Trust, Inc. v. First Flight Ltd. Partnership,*[14] a similar result was reached under Virginia law. Applying general principles of Virginia law for corporate veil-piercing, the Virginia Supreme Court held that reverse-veil piercing a limited partnership requires a showing that "the limited partnership "has been controlled or used by the debtor to evade a personal obligation, to perpetrate a fraud or a crime, to commit an injustice, or to gain an unfair advantage."[15] The court must consider the impact of piercing on innocent partners and creditors, and "the availability of other remedies the creditor may pursue."[16] In other words, the court did not make an explicit exception to veil-piercing for limited partnerships, although it indicated that the creditor's "other remedies," which would include the charging order remedy, may be relevant.

What Not to Do…

As an easy rule of thumb, a prudent business owner should simply avoid fraudulent and unjust practices, even when he is receiving the protections of an LLC, in order to avoid exposure of liability through the doctrine of piercing the corporate veil. Courts do not apply the doctrine lightly and emphasize the value of substance over form. However, if the court recognizes that a business owner is using the LLC in order to perpetuate injustice or fraud, it will not hesitate to ignore the usual protections of and LLC to hold the owner liable.

So, businesses should avoid these potential pitfalls to the extent possible (this is not an exhaustive list, but is merely indicative of the types of factors to which courts look in veil-piercing cases)

- Inadequate capitalization (not just a lack of available funds, but an deceptive capital structure (e.g., debt misrepresented as equity)
- Failure to document company action or the failure to maintain separate records for separate entities
- Excessive compartmentalization of business units into separate entities without reasonable business justification
- Commingling business and personal assets

[13] 799 A.2d 298 (Conn. App. 2002).
[14] 306 F. 3d 126 (4th Cir. 2002), opinion on certified question, 580 S.E.2d 806 (Va. 2003).
[15] 580 S.E. 2d at 811.
[16] *Ibid.*

- Commingling the assets of separate entities
- Treating business assets as personal assets
- Failure to document dealings among related businesses and/or owners on arms-length terms
- Overlapping and dominating ownership and control
- Multiple entities with the same address and employees
- Use of single-purpose entities
- Concealment or misrepresentation of the identity of owners and management
- Concentration of liabilities in an entity where the assets used in the business are concentrated in others
- Transferring existing liabilities to a newly formed entity

Considered individually, many of the foregoing factors are not indicative of the type of situation calling for the extraordinary measure of piercing the liability veil of an entity. In fact, some — such as the use of single-purpose entities and compartmentalization of assets — are accepted means of doing business. It is not difficult, however, for a conscientious business owner or her attorney to ascertain the difference between sound asset protection planning and recklessness and abuse. If it doesn't feel right, it's probably not right.

So, if a potential client shows up in your office with a complaint and summons recently served upon him in a consumer fraud case and:

- he's got five Nevada LLCs
- none have operating agreements or other books and records
- each LLC purportedly owns or operates the various components of an internet marketing business
- each LLC has the same Reno post office box address
- each LLC has a nominee member and a nominee manager
- each LLC is minimally funded by what the owner considers a "loan" to the LLC (though nothing is documented)
- bills for the overall business are paid by whichever LLC has funds at the time, or sometimes out of his pocket; and
- the SUV he just drove to Colorado for a month-long fly-fishing vacation is owned by one of his LLCs

… you might want to decline the engagement.

What to Do…

- Capitalize the company with a reasonable amount of initial equity
- Hold meetings or at least keep records of consideration of significant business decisions
- Conduct regular, documented planning and reviews of business operations and finances are never a bad idea. Annual budgets and reviews are a practical minimum necessity for a business to function anywhere near smoothly. Semi-annual, quarterly or monthly planning and review are better, of course.
- Execute entity documents in the name of the entity.
- Open and maintain bank accounts for the entity and keep them and funds in them separate from other business and personal bank accounts.
- Undertake "insider" transactions on arm's-length terms and document them
- Maintain reasonable (at least!!) levels of insurance that are reflective of the risks the business faces.

The LLC Member or Limited Partner in Bankruptcy

In bankruptcy, all bets are off. If an LLC member or limited partner is a debtor in a bankruptcy proceeding, a bankruptcy trustee may be able to exercise all of the powers of the member or partner, depending on whether the law and agreements governing the relationship between the member or partner and the LLC or partnership creates an "executory" interest under bankruptcy law.

Executory interests involve some sort of substantial ongoing affirmative obligation of the partner the partner or member. One might define executory interests as generally "active" interests. Non-executory interests generally require the partner or member to do little. Non-executory interests are generally "passive" interests.

The nature of a partner's or member's interest as executory or non-executory determines the parameters of the bankruptcy trustee's powers with respect to that interest. If the interest is non-executory, then the trustee has all of the rights of the partner or member under state law, often including the right to withdraw and receive payment, the right to request judicial dissolution, and, if the trustee has voting control, the right to dissolve and liquidate the partnership or LLC.[17] The effect can be to allow the trustee to reach partnership or LLC assets via a forced dissolution or forced redemption.

On the other hand, if the partner's or member's interest is executory, the trustee's rights would be limited to those of an assignee, who generally does not have any of the "dangerous" rights mentioned above. So, where asset protection is important, drafting an operating agreement or partnership agreement to ensure treatment of ownership interests as executory interests is crucial. Among the provisions that should move an interest toward being an executory interest would be requiring some participation in management and capital call provisions.

[17] *Movitz v. Fiesta Investments, LLC (In re Ehmann),* 319 B.R. 200, 206 (Bankr. D. Ariz. 2005).