

Overview of How an LLC Protects your Personal Assets

Let's more closely consider the LLC's inside protection. Creditors of a limited liability company member cannot seize or force a sale of the member's interest. Nor can the member's creditor vote the interest of the debtor-member. The member's creditors can only obtain a court charging order remedy to direct the limited liability company to pay to the creditor any income distributions that would otherwise flow to the debtor-member. This is the same charging order remedy that a limited partner's creditor has against an interest in a family limited partnership. The creditor gains only the financial rights of the debtor-member, not control or ownership rights.

Note that the charging order will not 1) give your creditor voting rights or 2) force the limited liability company manager to pay distributions to a member or his creditor. The charging order only directs distributions to the creditor rather than the debtor-member.

The charging order may thus be as futile a creditor remedy with the limited liability company as it is with a family limited partnership. If you manage your limited liability company, you will decide if and when you will make distributions. Your judgment creditor cannot replace you as the manager because your creditor cannot vote. And for as long as your creditor has a charging order against you, you can refuse to pay distributions. Nevertheless, you can pay yourself a salary for services and salaries cannot be seized through the charging order. Also, your creditor is not able to garnish loans or other forms of compensation that you may pay to yourself as a manager or member.

You also have the same tax liability (poison pill) opportunities with the charging order against a limited liability company interest. The charging order creditor may be required to pay your income tax on LLC profits. Since a limited liability company is ordinarily taxed as a partnership, its tax liability automatically passes to its members. The charging order creditor then, under certain circumstances, gets the tax bill for the debtor-member's share of LLC profits. This forces the member's creditor to pay taxes on the member's earnings, even if the creditor has not received any distributions. That's a losing proposition for any creditor.

Some professionals argue that the tax bill wouldn't apply to a charging order creditor unless he or she also had the voting rights of the assigned membership interest. A carefully drafted operating agreement, however, will allow for an assignment of voting rights, while also ensuring that these voting rights do not allow the creditor to replace the manager, force distributions, or in any other way compromise the LLC's protection. In this case, there is little doubt that the creditor will have a tax bill and no distribution to pay it.

Some states view the charging order as a remedy that is inadequate from a creditor perspective. And it is. As a result, they have passed legislation allowing for the foreclosure of a member's LLC interest, wherein the assignment (charging order) could vest in perpetuity, even after the judgment debt has been settled. In response to this, other business-friendly states, such as Alaska, Arizona, and Oklahoma, have passed legislation that forbids such foreclosure.

In reality, the ability to foreclose membership interests is a remedy with a lot of bark and little bite, provided that your LLC is set up properly. A foreclosure will still not allow for a creditor to receive anything more than a right to distributions from the LLC, which the creditor will likely never receive. Furthermore, the receiver of a foreclosed interest will certainly be liable for the taxes on a distribution he will probably never see. This in turn will probably lead to a settlement where the foreclosure is set aside as if it had never happened. Despite this fact, the possibility of a problem that won't go away makes the avoidance of LLC membership foreclosures desirable. Thus, you should form your LLC in a state that forbids such foreclosure.

These charging order's limitations encourage most creditors to settle rather than fight. Why would a creditor elect a remedy that gives them no money, no control, and only a tax bill? When your assets are safely titled to a limited liability company, you may reach a faster settlement and avoid the expense, time, and hassle of defending the lawsuit.

Unfortunately, the limited liability company also has the same protective deficiencies as the family limited partnership. For example, if you transfer your assets to the limited liability company after you have a creditor, your creditor may possibly recover the assets as a fraudulent transfer.

Profits may be distributed to you (and hence your creditor) when you do not control the manager. You would then not rely on the limited liability company, though your membership interest may then be owned by another LLC that you do control.

And as an LLC member in bankruptcy, your bankruptcy trustee may have greater rights to claim your limited liability company ownership interest than could a judgment creditor holding a charging order.

Should a member file bankruptcy, recent case law has demonstrated that the bankruptcy trustee may also have considerably greater rights to claim the member's limited liability company ownership interest than could be obtained by a judgment creditor holding a charging order. A meticulously drafted operating agreement may curb these greater powers by giving each member an ongoing obligation to render certain services to the company. Such obligations make the operating agreement an executory contract, which in turn subjects the LLC to more favorable bankruptcy law. Nonetheless, bankruptcy is the ultimate test of any asset protection plan, and even an immaculately structured LLC is no guarantee that the member declaring bankruptcy will retain his LLC interest.

Aside from bankruptcy, we can improve your protection as a limited liability company member by using the same strategies as we would use to maximize protection for your corporate shares or limited partnership interests. For example, we can assess your membership interest, issue voting proxies, or grant the LLC options to redeem your membership interest. You may also encumber or lien your membership interest or dilute your membership control having the LLC sell additional ownership interests.

We can also comparably protectively title a membership interest. For instance, limited liability company interests owned by a married couple may title their ownership as tenants-by-the-

entirety in those states where this form of marital ownership is creditor-protected. Or an offshore trust can own the membership interests, much as we use offshore trusts as limited partner in a limited partnership. Or a limited partnership may be the member of a limited liability company. This is a particularly good arrangement in those states that better protect a limited partnership interest than a limited liability company membership. We can also use the limited partnership to own a limited liability company to reduce estate taxes as we explain later.

Finally, for protection, your LLC should have one or more members in addition to the one who is a lawsuit defendant. The courts are more hesitant to expand upon a creditor's remedy when other LLC members would be affected. Some courts will liquidate an LLC for the benefit of a creditor when the debtor is the only member and no other members would be affected.