

NBI SEMINAR

TOP LLC MISTAKES TO AVOID IN EVERYDAY BUSINESS PRACTICES

SECTION 3: CHARGING ORDER AND PICK-YOUR-PARTNER PROVISION LANDMINES

(MAY 21, 2015)

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INTRODUCTION

Sections 3 and 4 are related liability topics. Section 3 “Charging Orders” topic focuses on a judgment lien against a member, to the extent that the operating agreement provides that the member’s debt cannot be satisfied from the member’s interest in the limited liability company (LLC). The judgment creditor will have to satisfy themselves with a charging order which limits the creditor to any distribution made by the LLC to that member or the foreclosure of the charging order to reach the member debtor’s assignable company interest.

Section 4 “LLC Veil Piercing” focuses on a judgment lien against the LLC. The LLC’s property is seized or sold in payment (same as a corporation) with the result that the judgment is not fully satisfied. In this case, the judgment creditor forces collection against the LLC members personally by piercing the LLC veil to obtain personal liability of the members to satisfy the judgment.

A member can also face personal liability under contract law and statutory provisions for claims against the LLC if, for example, the member signed personally and not in representative capacity or outside the scope of the member’s authority or the member’s act or omission constituted fraud, misconduct, bad faith or gross negligence.

JUDGMENT CREDITOR OF A MEMBER

A judgment creditor’s best practice to collect the member’s debt is to become an assignee of the member debtor assignable company interest and step into the shoes of the member as an assignee who has become a member.

RCW 25.15.260

Right of assignee to become member.

(1) An assignee of a limited liability company interest may become a member upon:

(a) The approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or

(b) Compliance with any procedure provided for in the limited liability company agreement.

(2) An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under a limited liability company agreement and this chapter. An assignee who becomes a member is liable for the obligations of his or her assignor to make contributions as provided in RCW 25.15.195, and for the obligations of his or her assignor under article VI of this chapter.

(3) Whether or not an assignee of a limited liability company interest becomes a member, the assignor is not released from his or her liability to a limited liability company under articles V and VI of this chapter.

CHARGING ORDERS

Under RCW 25.05.215, on application by a judgment creditor, a member's transferable interest in a partnership may be subjected to a charging order. The partner's transferable interest is his economic interest; management rights are not transferable unless all other partners approve or the partnership agreement otherwise provides.

"A charging order constitutes a lien on the judgment debtor's transferable interest in the partnership." RCW 25.05.215(2). The court may order a foreclosure of the interest subject to the charging order at any time. RCW 25.05.215(2). Such a foreclosure would foreclose only the economic interest subject to the charging order.

Under RCW 25.15.255, a member's LLC interest may be charged with payment of the unsatisfied amount of a judgment with interest. Use of the word "may" places issuance of a charging order within the court's discretion. To the extent charged, the judgment creditor "has only the rights of an assignee of the limited liability company interest." RCW 25.15.255.

As assignee has not right to participate in management of the LLC. Under RCW 25.15.250(1), the assignee of a member's LLC interest "shall have no right to participate in the management of the business and affairs" of the LLC except upon approval of all of the members of the LLC other than the member assigning his interest, or as provided in the LLC agreement.

FORECLOSURE

RCW 25.15.250(3)(a) suggests that all of the member's LLC interest may be sold by foreclosure or execution sale. However, this does not appear to mean that foreclosure or execution would provide a way around the charging order procedure or allow proceeding against a member's management rights. Rather, this section appears to say that although a pledge or granting of a security interest against all of the member's LLC interest is not deemed to be an assignment, a foreclosure or execution sale with respect to all of the member's LLC interest "shall be deemed to be an assignment of the member's limited liability company interest to the transferee pursuant to such foreclosure or execution sale or exercise of similar rights." An assignment, as provided in RCW 25.15.250(1), confers no right to participate in management of the LLC unless all other members approve or as provided in the LLC agreement.

ASSIGNMENT

Only an assignable interest in the entity may be charged by the creditor, and the lien attaches to only the assignable interest. The assignability of an interest is governed by the agreement of the members. Consequently, to thwart creditors, operating agreement commonly provide provisions which will be included in the following section, either (1) make membership interest (or just economic interest) non-assignable, or (2) make the assignment subject to the prior approval of the manager or a majority of the members. I have included specific provisions in a later section that accomplish this purpose.

Upon assignment of the member's LLC interest in accordance with the Operating Agreement, the member ceases to be a member and no longer has the right to exercise any rights or powers of a member, unless otherwise provided in the LLC agreement. RCW 25.15.250(2)(b). In the case of a single-member LLC, this would effectively freeze the LLC as there would be no one authorized to manage it unless the LLC agreement provided otherwise, creating a need to appoint a receiver.

An assignee of a member's LLC interest can become a member if all other members (except the assigning member) approve, or if allowed by the LLC agreement. RCW 25.15.260(1).

THE RELEVANT STATUTES:

RCW 25.15.245.

Nature of limited liability company interest – Certificate of interest.

- (1) A limited liability company interest is personal property. A member has no interest in specific limited liability company property.
- (2) A limited liability company agreement may provide that a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company.

RCW 25.05.215

Partner's transferable interest subject to charging order.

- (1) On application by a judgment creditor of a partner or of a partner's transferee, a court having jurisdiction may charge the transferable interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require.
- (2) A charging order constitutes a lien on the judgment debtor's transferable interest in the partnership. The court may order a foreclosure of the interest subject to the charging

order at any time. The purchaser at the foreclosure sale has the rights of a transferee.

(3) At any time before foreclosure, an interest charged may be redeemed:

(a) By the judgment debtor;

(b) With property other than partnership property, by one or more of the other partners; or

(c) With partnership property, by one or more of the other partners with the consent of all of the partners whose interests are not so charged.

(4) This chapter does not deprive a partner of a right under exemption laws with respect to the interest in the partnership.

(5) This section provides the exclusive remedy by which a judgment creditor of a partner or partner's transferee may satisfy a judgment out of the judgment debtor's transferable interest in the partnership.

RCW 25.15.250.

Assignment of limited liability company interest.

(1) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except:

(a) Upon the approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or

(b) As provided in a limited liability company agreement.

(2) Unless otherwise provided in a limited liability company agreement:

(a) An assignment entitles the assignee to share in such profits and losses, to receive such distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and

(b) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of his or her limited liability company interest.

RCW 25.15.255

Rights of judgment creditor.

On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited liability company interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to the member's limited liability company interest.

REVIEW

To review, in Washington, "Charging Orders" are governed by the following RCWs: (1) RCW 25.15.245 (a limited liability company interest is personal property); (2) RCW 25.05.215 (charging the transferable of the judgment debtor to satisfy the judgment and may appoint a receiver); (3) RCW 25.15.250 (a limited liability company interest is assignable as provided in

the company operating agreement); (4) RCW 25.15.255 (any judgment creditor of a member may charge the LLC interest with payment of the unsatisfied judgment – the “Charging Order”); and (5) RCW 25.15.260 (limitation of an assignee (judgment creditor) to become a member of the LLC).

SINGLE MEMBER LLCs.

Supported by a number of published opinions, as to whether the member’s management rights in a single member LLC or even the single member LLC form itself needs to be respected is in question. There are no Washington cases discussing the rights and protections of members and creditors with respect to a single member LLC. In several bankruptcy court decisions from other jurisdictions and a Florida Supreme Court decisions, courts have treated single member LLCs differently than they would have been treated if the LLCs had multiple members.

In *Olmstead v. FTC*, 44 So.3d 76 (Fla. 2010), 528 F.3d 1310 (11th Cir. 2008), the Eleventh Circuit Court of Appeals decision ignored the rights of the single member in an SMLLC. The decision was highly convoluted. The FTC obtained a \$10,000,000 judgment against Shawn and Julie Olmstead and sought to collect the funds from the Olmsteads’ Florida SMLLC. The Florida LLC Act (similar to Washington State’s) allows an LLC member’s creditors to reach only the member’s interest in the LLC derived from partnership law called a “charging order.” See RCW 25.15.255 and RCW 25.15.260. The debtor, as the sole member, controls whether distributions of the LLC are made that would be subject to the charging order, but not the actual assets of the SMLLC or membership as a “member.” The charging order was intended to protect the member’s governance rights. The Florida court reviewed Florida’s charging-order statute as an invitation to the Olmsteads to frustrate the debtor’s creditors. Since the Florida legislature did not fix this perceived problem, the Florida Supreme Court chose to stay with its decision.

The court started out by rejecting the certified question! Finding itself unduly constrained by the charging-order provision, the court asked whether “Florida law” requires the surrender of all membership rights. The majority noted the policy issue that co-member consent to transfer of governance rights was not called for in single-member LLCs. But that still left the clear statutory language. The court dealt with this by reasoning that applying the charging-order provision would effectively abrogate the general execution statute, which makes various types of

property, including corporate stock, subject to attachment and execution. The LLC, said the court without any basis or citation, is “a type of corporate entity.” (Charging orders are not applicable in a corporate setting.) The LLC statute, while specifying the charging-order remedy, didn’t say explicitly that was the “exclusive” remedy (as it had in other corporation statutes). This gave the court enough of a legal basis to apply the Florida general attachment statute and disregard the LLC charging order statute.

The dissenters also discussed, among other things, the obvious problem that the majority had usurped the legislature’s role regarding the Florida LLC Act; that by relying on non-exclusivity it had unsettled creditor remedies for all LLCs and not just the single-member ones that they were worried about; that exclusivity is the only reasonable reading if the statute applies only one remedy; and that the court’s remedy could support transferring management rights even if the judgment is for less than the value of the LLC interest.

The Albright Case. The unpublished opinion on *In Re Ashley Albright*, No. 01-11367 (Bankr. D. Colo. Apr. 4, 2003), illustrates the maxim “bad facts make bad law.” The sole member of an SMLLC membership interest was transferred to the bankruptcy estate. Col. Rev. Stat. §§ 7-80-702 and 7-80-108(3)(a) are Colorado’s “charging order” statutes similar to RCW 25.15.250, .255, and .260. The court disregarded the SMLLC entity on a technical reading of the charging order statute and held that the Trustee now controls the SMLLC and may cause the SMLLC to sell the assets of the SMLLC and distribute the net sale proceeds to the bankruptcy estate.

The court states in footnote 9 that this result would be different (i.e., the Trustee would not have the “right to govern the LLC”) if the entity were an LLC of two or more members (the minimal membership interest); of course, if the debtor were a holder with another in a closely held corporation, the debtor’s shares would be considered an asset of the debtor’s estate which in this case would trigger the terms and conditions of a shareholder-type “buy-sell” agreement. In a sole-shareholder corporation, the shares would be transferred to the Trustee with full powers of corporate governance.

RCW 25.10.410 is the charging statute for limited partnerships and is identical to RCW 25.15.255.

I want to emphasize that the effect of the *Albright* and *Olmstead* cases is currently limited to single-member LLC/PLLCs allowed by RCW 25.15.005, though multimember LLCs

could also be at risk under the *Olmstead* decision. A comparison of entity risk of personal liability as well as advising your client for full disclosure purposes is whether a single-member corporation electing Subchapter S or a single-member LLC/PLLC is more preferable for the client. Such factors would include but not be limited to whether your client is risk-adverse, its business plan, financial strength and stability, experience and expertise in the business, debt-to-equity leverage, and tax consequences between entity choices.

Many planners contend that a single member LLC should provide no worse protection than that of a sole-shareholder corporation. Until the law is settled, I advise that your client be warned in writing that single member LLCs should be considered with caution until their effectiveness against inside liabilities is validated by case law, notwithstanding RCW 25.15.255.

Accordingly, the bankruptcy court allowed the Trustee, standing in the shoes of the debtor as a hypothetical judgment creditor and, thus, the sole member of the LLC, to cause the LLC to sell its property and distribute net proceeds to his bankruptcy estate, or distribute the LLC's property to himself and liquidate the property himself. The court further noted:

The Limited Liability Company Act requires the unanimous consent of "other members" in order to allow a transferee to participate in the management of the LLC. Because there are no other members of the LLC, no written unanimous approval of the transfer was necessary...

The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected.

Albright, 291 B.R. at 540, 514. See also *In re Modanlo*, 412 B.R. 715 (D. MD. 2006) and *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006). The case decisions are attached as Exhibits following this outline.

LLC OPERATING AGREEMENT PROVISIONS

A properly drafted LLC operating agreement is necessary to limit the devices a judgment creditor can use to disregard the LLC and allow the judgment creditor to satisfy the judgment to the detriment of the other members. I would include, as examples, in a LLC operating agreement the following provisions:

- (a) **Limitation of Member Authority.** Unless authorized to do so by this Agreement or by the Members, no Member, employee or other agent of the Company shall have any power or authority to bind the Company in any way, to pledge its credit or to render it liable for any purpose.

(b) Conditions Precedent to Any Transfer. Notwithstanding any contrary provision contained in this Agreement, no Member may transfer or assign his/her/its Percentage Interest:

- (i) Without first notifying each Member, in writing, thirty (30) days in advance of any proposed transfer;
- (ii) Unless and until the Company has received an opinion of counsel for the Company, prepared at the transferring Member's expense, stating that the proposed transfer will not cause the termination of the Company under this Agreement or the Act;
- (iii) Unless and until the Company has received an opinion of counsel satisfactory to the Members, prepared at the expense of the Member proposing the transfer, stating that the proposed transfer (a) may be effective without registration of the Percentage Interest under the Securities Act of 1933, as amended, and (b) will not violate any applicable state securities law (including investor suitability standards);
- (iv) Unless and until the transferor has made all required contributions to the capital of the Company;
- (v) The transfer or assignment of the Member's Percentage Interest is approved unanimously by all the other Member(s); and
- (vi) The transferee or assignee is unanimously approved by all the other Member(s) to be admitted as a Member and participate in the management of the Company.

(c) Effect of Transfer. If any purported transfer of a Member's Percentage Interest does not comply with the various requirements and restrictions contained in this Article, it will be void and of no force or effect. If any such purported transfer complies with the various requirements and restrictions contained in this Article, on the effective on the date of the transfer, the transferor will cease to be a Member with respect to the transferred Percentage Interest and, whether or not the transferee is admitted to the Company as a substitute Member pursuant to the provisions of this Agreement, the transferee will be entitled to receive all future distributions to which the transferor would otherwise be entitled. In the case of a transfer of an interest, the transferee shall succeed to the Capital Account of the transferor, or, in the case of a partial transfer, a proportionate share thereof. The Company will be entitled to treat the transferor as the record owner of the Percentage Interest until the effective date, and no Member will incur liability for distributions made in good faith to the transferor prior to the effective date. No such transfer will relieve the transferor of its existing obligations under this Agreement.

(d) Substitute Members. A transferee of a Member's Percentage Interest will not be admitted to the Company as a substitute Member unless:

- (i) The transfer complies with all requirements of this Article;
- (ii) The transferor give the transferee the right to be substituted in its place; and
- (iii) The transferee has agreed, in writing, to be bound by all of the terms and conditions of this Agreement, and has paid all expenses of the Company incurred in connections with the transfer.

Upon admission to the Company as a substitute Member, a transferee shall succeed to all rights and obligations of its transferor under this Agreement.

(e) **Admission of New Member.** New Subscribers who take their interest directly from the Company will be admitted as Members. The new Member must be approved by all Members in order to be admitted as a Member and participate in management of the Company.

(f) **No Obligation to Restore Negative Capital Account Balance on Liquidation.** Notwithstanding anything to the contrary in this Agreement, upon a liquidation within the meaning of Regulation Section 1.704-1(b)(2)(ii)(g), if any Member has a negative Capital Account balance (after giving effect to all contributions, distributions, allocations and other Capital Account adjustments for all taxable years, including the year during which such liquidation occurs), such Member shall have no obligation to make any Capital Contribution to the Company, and the negative balance of such Member's Capital Account shall not be considered a debt owed by such Member to the Company or to any other Person for any purpose whatsoever.

(g) **Return of Contribution Nonrecourse to Other Members.** Except as provided by law or as expressly provided in this Agreement, upon dissolution each Member shall look solely to the assets of the Company for the return of his/her/its Capital Contribution. If the property remaining after the payment or discharge of liabilities of the Company is insufficient to return the contributions of Members, no Member shall have recourse against any other Member.

(h) **Purchase/Redemption Special Formula (“Poison Pill”)**

- (i) In the event any member's transferable Percentage Interest in the Company becomes subject to a charging order to satisfy a judgment lien by a third party creditor pursuant to RCW 2.5.05.215(1) or an ordered foreclosure of the charging order by a third party creditor pursuant to RCW 25.05.215(2), the purchase/redemption price of the member's interest charged shall equal five (5) times the agreed value of the Company set by the members in accordance with this Agreement multiplied by the transferred Percentage Interest to satisfy a judgment lien or foreclosure of the interest charged by a third party creditor.
- (ii) Upon the occurrence of such an event set forth in Section 1.1 herein, the member whose Percentage transferable Interest is charged to satisfy a judgment lien by a third party creditor shall give notice of such event to the Company in writing.

In a single member LLC, the court could decide that the protection of the sole member would not apply and could disregard the charging order restrictions and allow the judgment creditor, assignee, or bankruptcy trustee to replace the sole member in the management of the LLC. There are no other members to protect! You need to inform and discuss with your client seeking to form a single member LLC.

LIST OF EXHIBITS

- Exhibit 1 *Olmstead v. FTC*, 44 So. 3d 76 (Fla. 2010), 528 F.3d 1310 (11th Cir. 2008)
- Exhibit 2 *Ashley Albright*, No. **01-11367** (Bankr. D. Colo. Apr. 4, 2003)
- Exhibit 3 *A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006)
- Exhibit 4 *Modanlo*, 412 B.R. 715 (D. MD. 2006)