Using Ohio LLCs

Nuts & Bolts Considerations
And
Planning Issues

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LLC Issues:

Ohio's New LLC Act:
The Basics,
A Statutory Upgrade, and Series LLCs

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Introduction

Ohio's New LLC Act

- New ORC Ch. 1706
  - Ohio Revised Limited Liability Company Act
    - ORC § 1706.02
- Effective Date of 2022 February 11
    - See ORC § 1706.83
- Applies to All OH LLCs On/After Effective Date
  - No Transition Rules
  - Just.. BANG!! It Applies!

Carries Over Prior Act's Key Features

- The Old LLC Act's Key Provisions Carried Over into New LLC Act
  - See, e.g., Conversion Table
    - Provided in Written Materials
  - **NOTE:** Quotes from OH LLC Act are from New Rev'd LLC Act Unless Indicated
- What of Existing LLCs?
  - Existing LLCs Should Not be Adversely Affected
  - Might Care to Revise Old Operating Agreements To Fully Utilize New Statute

LLCs – A Flexible Tool

- New to US Starting with 1977 WY Act
  - Cottam, et al., *The 2010 Wyoming Limited Liability Company Act: A Uniform Recipe*, 11 Wyo. Law Rev. 49, 51 (2011)
- Originally Intended to Allow:
  - Corporate Veil
  - Fewer Formalities
  - Charging Order Protection
  - Flexible Management Structure
  - Potentially Favorable Tax Treatment

Favorable Tax Rules → Δ↑ Popularity

- For Many Years, WY Was Only LLC State
- LLCs Become Popular After IRS Allows Taxation as Partnership
  - Cottam, et al., *The 2010 Wyoming Limited Liability Company Act: A Uniform Recipe*, 11 Wyo. Law Rev. 49, 51 (2011)
  - See Rev. Rul. 88-76, 1988-2 C.B. 360, applying old "Kintner Regs"
  - For More on Kintner Regs, see Brown, *Taxability of Unincorporated Medical Associations – The Kintner Regulations,* 12 W. Res. L. Rev. 777 (1961)
- Really Popularized After IRS Adopts its "Check the Box" Entity Classification Rules in 1997
  - See 26 CFR § 301.7701-1 et seq.

Effect of Check-the-Box Regs

- IRS's Check the Box Regs Allowed for Tax-Planning Certainty
- LLCs Can Choose How They're Taxed
  - Multi-Member LLC Tax Options:
    - Partnership
    - C Corp
    - S Corp
  - Single Member LLC ("SM LLC") Tax Options:
    - Disregarded Entity
    - C Corp
    - S Corp
- Tax Certainty ➔ Planners Can Plan!
- LLC Statutes Proliferate Across USA and Globe

Traditional Reasons to Use LLCs

- Insulate Owners from Business Liability
  - Only Cuts Off Vicarious Liability
  - A Person is Always Liable for His Own Acts
  - See Uniform LLC Act, § 304, cmt. to Subsection (a) (Collecting Cases)
- Separate Ownership from Control
  - Allow for Professional Management
- Provide Continuity of Existence
  - Perpetual Existence of Entity Allowed
- Centralize Ownership of Assets
  - Parcel Out Membership Interests, not Bits and Pieces of Underlying Assets
- Generate Estate and Gift Tax Discounts
- Etc.

Issues List

- Reasons for Choosing Ohio
- Comparing LLC Jurisdictions
- Formation Mechanics
- Converting into LLC Form
- Annual "Care and Feeding" of LLC
- Choosing LLC Tax Status
- Business Planning with LLCs
- Asset Protection Planning with LLCs
- Phantom Income Issue
- Charging Order Protection: Pros and Cons
- Charging Orders and Conflicts of Law
- Weaknesses of SMLLCs
- Tiered LLCs
- LLC Planning With Trusts
- Series LLCs

Reasons For Choosing Ohio

Sidebar Note: Syllabi in Ohio Judicial Opinions

- Syllabus by the Ohio Supreme Court is Law
- Syllabus by an Ohio Appellate Court is Merely for Convenience
- Authorities:
  - *Smith v. Klem,* 6 Ohio St.3d 16, 18 (1983)
  - Ohio Rep. Op. R. 2.2
  - *Parkview Hosp. v. Hosp. Serv. Assn. of Toledo,* 8 Ohio App.2d 315 (10th Dist. 1966)
  - *State v. Sager,* 131 N.E.3d 335, ¶ 22 (Ohio App. 1st 2019)

Brief Ohio History

- Ohio Used to Have Weak LLC Statute
- Multiple Amendments Starting in 2012 ➔ Ohio Has Very Good LLC Act
  - As a Legal Matter
- It's Also a "User Friendly" Jurisdiction
  - As an Administrative Matter

Key Legal Features of Ohio LLCs: Slide 1

- OH Has Narrow Charging Order Rules
  - Old Ohio Rev. Code §§ 1705.19, 1705.18
  - New Ohio Rev. Code § 1706.342
  - "If and When, Wait and See" Rule re: Distributions
  - Exclusive Remedy
  - No Other Legal or Equitable Remedies
    - No Foreclosure, Receivership, Judicial Blank Check
- Ohio Allows Maximum Freedom of Contract
  - Can Even Waive Duties of Care and Loyalty
  - Can't Waive Duty of Good Faith & Fair Dealing
    - Old Ohio Rev. Code §§ 1705.081(C), (D)
    - New Ohio Rev. Code § 1706.06(A)

Key Legal Features of Ohio LLCs: Slide 2

- Default Duties of Care and Loyalty are Modest
  - Old Ohio Rev. Code § 1705.281
  - New Ohio Rev. Code § 1706.31
- Duty of Care Now Hard to Breach
  - Expressly "Limited to Refraining From Engaging In Grossly Negligent or Reckless Conduct, Intentional Misconduct, or a Knowing Violation of Law"
- Duty of Loyalty Restricted to:
  - Accounting for Misappropriated Profits or Opportunities
  - Disclose Material Facts re: Self-Dealing

Key Legal Features of Ohio LLCs: Slide 3

- Lack of Formalities Not Fatal
  - Ohio Rev. Code § 1705.48(C)
  - New Ohio Rev. Code § 1706.26

"***The Failure*** of a Limited Liability Company or Any of Its Members ***to Observe Any Formalities Relating to the Exercise of*** the Limited Liability Company's ***Powers or the Management of Its Activities Is Not a Factor to Consider In, or a Ground for, Imposing Liability On the Members***, for the Debts, Obligations, or Liability of the Limited Liability Company."

- This Will Make Veil Piercing Much Harder in Many Cases
- It Protects LLC Owners Against Major Harm Due to Minor Lapses
- Consistent with Uniform LLC Act (Amd. 2013), § 304(b)
  - See Also Related Official Comments to 304(b)

Key Legal Features of Ohio LLCs: Slide 4

- Assignee Bound by Operating Agreement
  - Ohio Rev. Code § 1705.18(B)
  - New Ohio Rev. Code § 1706.082(C)
- Charging Order Rules Apply to SMLLCs
  - Ohio LLC Act Expressly States that Most LLC Act Provisions Apply to All OH LLCs, Even SMLLCs
    - Old Ohio Rev. Code § 1705.031
    - New Ohio Rev. Code § 1706.06(E)
    - Only Exception: Limited Application of OH LLC Act to Foreign LLCs
  - Official Comments Also ➔ SMLLCs Covered by OH Charging Order Rules
    - Comments on 129th General Assembly, HB 48, by OSBA Corp. Law Committee (2012)
    - Was Available On-line at Old LAWriter Site

Key Administrative Features of OH LLC Law

- "One and Done" Filing System
  - No Annual Reports or Fees
  - No Administrative Dissolution for Forgetting Reports or Fees
- Cheap and Easy to File
  - $99 One Time Filing Fee
  - Electronic Filing
- Quick
  - Routine Filing Usually Clears in 48 – 72 Hours

Comparing LLC Jurisdictions

Other "Good" LLC States vs. OH and DE

	Exclusive *	Lien Only †	No Direct Action ‡	Assignees Bound ≟	Privacy	One & Done
OH [1]	X	X [2]	X	X	X	X
DE	X	X	X	X	X	
TX	X	X	X	X		
MS	X	X [3]	X	X		
SD	X	X	X [4]	?? [5]		
ME	X	X	X [6]	?? [7]		
VA	X	X	X			
AK	X	X	?? [8]			
NV	X	X [9]				
AZ	X	?? [10]				

* Charging order remedy is "exclusive" way to get value out of an ownership interest.
† Charging order remedy is "lien only," no foreclosures, etc. allowed.
‡ Creditor can sue LLC for its own wrongs, but can't proceed against LLC or its property merely to collect on judgment against debtor-member.
≟ Assignee automatically bound to operating agreement by law, even if he doesn't sign.

Notes to LLC Comparison Table

[1] Ohio's Revised LLC Act takes effect on 2922 February 11 and applies to all Ohio LLCs from that date forward. However, the traits of Ohio LLCs cited in this Table also applied under Ohio's old LLC Act as well as the its new LLC Act.

[2] See Ohio Rev. Code §§ 1705.19(A), (giving creditors "only" rights of assignee per § 1705.18), 1705.18 (foreclosure not listed), 1706.342 (OH Rev'd LLC Acct). See also *Knollman-Wade Holdings, L.L.C. v. Platinum Ridge Properties, L.L.C.*, 2015-Ohio-1619 (Ohio App. 10th Dist.)

[3] Similar statutory method as Ohio. See Miss. Code §§ 79-29-705, 79-29-703.

[4] See SD Cod. Laws § 47-34A-504(f).

[5] Probable. See SD Cod. Laws §§ 47-34A-103(b)(7) (allowing restrictions on "transferee"), 47-34A-101(18) (defining "transfer").

[6] UFTA claims expressly allowed. Maine Rev. Stat. 31 § 1573(6).

[7] Maine Rev. Stat. § 1522(1)(D) suggests that "transferees" are bound.

[8] Statute's limits only apply to actions against a membership interest, not LLC or its assets. See Alaska Stat. § 10.50.380(c).

[9] Based on legislative history and express repealed terms, not express current terms.

[10] AZ probably "lien only" due to "creditor has only assignee's rights" and "exclusivity" rules of Ariz. Rev. Stat. § 29-655(A) and (C).

In General: OH Charging Orders vs. Others

- OH Has Member-Friendly Charging Order Rules
  - Old Act: ORC §§ 1705.19, 1705.18
  - New Act: ORC § 1706.342
- OH Like Other Jurisdictions, e.g.,
  - DE – 6 Del. Code § 18-703
  - TX – Tex. Bus. Org. Code § 101.112
  - SD – SDCL § 47-34A-504
  - NV – NRS § 86.401
- OH Unlike Creditor-Friendly States, e.g.,
  - IL – 805 ILCS 180/30-20
  - CO – CRS § 7-80-703
  - CA – Cal. Corp. Code § 17705.03

Formation Mechanics

Getting Started: Articles & Certificates

- Most States ➔ LLC Formed Upon Filing of Articles of Organization
  - See, e.g., ORC §§ 1705.04(A), 1706.16(B)
- Some States ➔ Filing Certificate of Formation
  - See, e.g., 6 Del. Code § 18-201(b)
  - Same as "Articles," Just a Different Name
- Usually Have Option to Postpone Formation Date to a Time After Filing
  - ORC §§ 1705.04(A), 1706.16(B)
    - Delay of up to 90 Days Post-Filing
  - 6 Del. Code § 18-201(b)
    - No Time Limit on Delayed Formation Date

Other Optional Initial Steps

- Organizers Can Take Various Optional Steps
  - These Are Not Required, but Still a Good Idea
  - Show Observance of Formalities
- Optional Organizational Documents
  - Minutes of Organizational Meeting
  - Operating Agreement
    - No Operating Agreement ➔ Company Governed by Statutory Default Rules
    - *Germano v. Beaujean*, 997 N.E.2d 1238, ¶ 16 (Ohio App. 6th Dist. 2013) (LLC "may" have an operating agreement, but statute controls in the absence of an operating agreement).
    - ORC § 1706.08(A)(2)
  - Resignation of Organizer Rights
    - Makes Clear that Organizer Has No Stake in LLC Solely Due to Organizer's Role

Converting into LLC Form

Conversion Statutes

- Many States Have "Conversion" Statutes
- These Allow:
  - Non-LLC to Convert to LLC
  - Out-of-State Entity to Convert to LLC
    - Typically Applies to Any Entity
    - Partnership, Corporation, etc.
- To Convert, Must Have
  - "Outbound" Conversion OK Under Old State's Law
  - "Inbound" Conversion OK Under New State's Law

Sample Conversion Statutes

- Ohio Rules – Inbound and Outbound
  - Old ORC §§ 1705.361, 1705.371
  - New ORC §§ 1706.72 – 1706.723
- 6 Del. Code §§ 18-214, 18-216
  - Inbound and Outbound
- Mass. Gen. Laws Ch. 156C, § 69
  - Inbound Only

Effects of Conversion

- New LLC is Deemed a Continuation of Prior Entity
- New LLC Holds All Rights, and is Subject to All Liabilities, of the Old Entity
- See:
  - ORC §§ 1705.391, 1706.723
  - 6 Del. Code § 18-214(d) – (g)
  - *YF Bethanny Inc. v. 16 Bethany Station LLC,* Case No. 1 CA-CV 18-0183 (Ariz. App. Div. 1 – 2019 Feb. 19), ¶ 16
    - "Under both Florida and Arizona law, an entity that converts from a corporation to an LLC remains the same entity with the same rights as obligations it had before the conversion."

Procedure for Converting

- File a Certificate of Conversion (or Analogue)
  - File in Both Inbound and Outbound Jurisdictions
    - ORC §§ 1705.381, 1706.722
    - 6 Del. Code §§ 18-214(b), 18-216(e), 18-204
  - Can't Convert Unless OK Under Both Sets of Laws
  - Alternative: Old-Fashioned Merger
- Adopt a Plan, Declaration, or Resolution of Conversion
  - ORC §§ 1705.361(A), 1705.371(A), 1706.72, 1706.721
  - 6 Del. Code §§ 18-214(h), 18-216(b)
- Must Have Both Plan and Filed Certificate
  - One Without the Other ➔ Botched Attempt to Convert

Conversion Can Be Tax Neutral

- No Tax Changes if Immediately After Conversion:
  - Continue Same Method of Taxation
    - Whether as Partnership, Disregarded Entity, or Corp
  - Same Owners
    - Including Same Ownership Percentages
  - Same Voting Rights and Management Structure
- Treated as a Tax-Free IRC § 368(a)(1)(F) Reorg
  - Can Even Keep Same Tax ID Number and Tax Year
    - Check-the-Box Election May be Needed in Some Cases
    - See Sullivan & Loeffler, *Ohio LLC Update: HB 48 Ushers Ohio Into the Modern Age*, *22* Prob. L. J. of Ohio 153, 155 (March/April 2012) (collecting authorities)

What if You Also Want to Change Ownership, etc?

- Trade-Off
- Tax Neutral Conversion ➔ Less Room to Change
- BUT… Avoid Adverse Tax Results
  - Possible Deemed Distributions, etc.
- AND… Get Benefits of LLC Act
  - Fewer Formalities
  - Asset Protection (Charging Order, No Attachment, etc.)
  - Waivable Duties of Care and Loyalty
  - Etc.

Possible Solutions

- Solution 1
  - Convert Today with No Changes
  - Wait a While… At Least Into Next Tax Year
  - Then Revisit Restructuring Issues
    - Maybe Change is Still Desired, Maybe it's Not
- Solution 2
  - Make All Changes Before Conversion
  - Carry Over Changes into New LLC

Annual "Care and Feeding" of LLC

Most States ➔ Annual Fees and Reports

- Delaware
  - Annual Franchise Tax of $300
- Massachusetts
  - Annual Report re: Managers, etc.
  - Annual Filing Fee of $500
- California
  - Annual Franchise Tax of $800
  - Annual Tax Returns
    - Could ➔ More Taxes Beyond $800 Franchise Tax

Ohio's "One and Done" Filing System

- Ohio LLCs Not Required to:
  - File Annual Reports
  - Pay Annual Fees
- One Filing Only
  - Initial Ohio Sec. of State Form 533A
  - $99 Filing Fee
- NOTE:
  - Annual "CAT Tax" Filings May Still be Required, Depending Upon Nature, Source, and Amount of Income
  - Still… No Need to Annually Renew Charter

Benefits of Ohio System: Slide 1

- No Recurring Annual Fees
  - This Can Add Up for Small Firms
- No Recurring Annual Reports
  - Less Time Spent on Paperwork
  - More Time Spent on Business
- Privacy
  - Form 533A Does Not Require ID of Members or Managers

Benefits of Ohio System: Slide 2

- No Surprise Loss of LLC Status
  - In Other States, LLC's Failure to Pay Annual Fees ➔ Administrative Dissolution
- Can Usually Reinstate or "Revive" Retroactive to Dissolution Date
  - 6 Del. Code § 18-1109
  - *Elite Destinations, Ltd. v. JD&T Enters., Inc.*, Case No. B269315 (Cal. App. 2017 June 27), FastCase pg. 16 - 17
- However:
  - Time and Energy Wasted
  - Additional Filing Fees for Reinstatement Papers
  - Possible Other Fees, Depending Upon State Law

How Bad is Inadvertent Dissolution?

- If Caught in Time, It's a Disruptive Headache
- If Not Caught in Time, Could be Really Bad
  - LLC Contracts Could be Challenged
    - See, e.g., *Great Plains Royalty Corp. v. Earl Schwartz Co.*, 927 N.W.2d 880 (N.D. 2019), ¶¶ 39 – 45
  - Members Might Lose Protection of LLC Veil
    - No LLC ➔ No LLC Veil Exists
  - LLC's Standing to Sue Open to Challenge
  - Etc.
- The Moral
  - Save the Hassle, File in Ohio

What About Doing Business in Other States?

- Out-of-State LLCs Usually Must Register if "Doing Business" in Another State

- Sample Statutes
  - OH: ORC §§ 1705.54, 1706.511
  - MA: MGL Ch. 156C, § 48
  - IL: 805 ILCS 180/45-5

What = "Doing Business" – Slide 1

- No Need to Register if Not "Doing Business"
  - Often Phrased as "Conducting" or "Transacting" Business
- Some States Don't Define "Doing Business"
  - Example: Old ORC §§ 1705.53 – 1705.58
- Other States Provide Guidance
  - IL: 805 ILCS 180/45-47
  - DE: 6 Del. Code § 18-912
  - CA: Cal. Corp. Code § 17708.03.
  - OH New ORC § 1706.512

What = "Doing Business" – Slide 2

- Statutory Lists of "Not Doing Biz" are Non-Exhaustive
- Specific In-State Activities That ≠ Doing Business
  - Carrying on Litigation
  - Meetings of Managers or Members
  - Maintaining Financial Accounts
  - Selling In-State via Independent Contractors
  - Soliciting or Taking Orders from In-State if Orders Require Acceptance by Offeror Out-of-State
  - Conducting "Isolated Transactions"
  - Holding Assets for LLC's Own Account
  - Creating or Acquiring Debt
    - As Either Borrower or Lender
    - With or Without a Mortgage or Security Interest
  - Etc.

Test for "Doing Business"

- Caselaw Standards can Vary State-by-State
- Often Come Down to Something Like This:

[A] foreign corporation transacts business within a state when it has entered the state by its agents and is there engaged in carrying on and transacting through them ***some substantial part of its ordinary or customary business,*** usually continuous in the sense that it may be distinguished from merely casual, sporadic, or occasional transactions and isolated acts… [A] foreign corporation's activities must be ***permanent, continuous, and regular*** to constitute "doing business".

State ex rel. v. OSU Bd. of Trustees, 108 Ohio St.3d 288, ¶ 21 (2006) (brackets, ellipses, emphasis added; internal cites, quotes omitted)

The Constitution & "Doing Business"

- Commerce Clause, U.S. Const., Art. I, § 8
- Interstate Commerce ≠ Doing Biz In a Specific State
  - Statutes Frequently Exempt Interstate Commerce from "Doing Business" and Related Registration
    - 6 Del. Code § 18-912(a)(11)
    - New ORC § 1706.52(A)(11)
  - Consistent with Case Law
    - Clear Law: States Cannot Regulate Interstate Commerce
    - Fuzzy Facts: What = Interstate Commerce?

Example of Exemption: California

- Cal. Corp. Code § 17708.03(a) states (emphasis added):

A foreign limited liability company that enters into repeated and successive transactions of business in this state, ***other than in interstate or foreign commerce,*** is considered to be transacting intrastate business in this state within the meaning of this article.

Sample Interstate Commerce Cases – No. 1

- *Allenberg Cotton Co., Inc v. Pittman*, 419 U.S. 20 (1974)
  - Registration In MS Not Required of TN Buyer of MS Cotton Even Though Contract was to be Performed in MS. Cotton Purchase was Part of a Broader Set of Related Interstate Transactions by TN Buyer
- *Charter Finance Co. v. Henderson*, 326 N.E.2d 372, 375 (Ill. 1975)
  - "[S]tatutes relative to foreign corporations cannot be given effect in such a way as to impede the Federal authority and responsibility to insure the free flow of interstate commerce." (Internal cites, quotes omitted.)

Sample Interstate Commerce Cases – No. 2

- *CK Franchising v. Alice Home Servs. Inc.*, Case No. 11 CV 7421 (N.D. Ill. 2011 Dec. 5)
  - Ohio Corporation Not Required to Register in Illinois Even Though its Franchisees Provided In-Home Elder Care in Illinois
- *Harbin Yinhai Tech. Dev. Co. v. Greentree Fin. Group Inc.*, 677 S.E.2d 854, 860 (N.C. App. 2009)
  - "Every negotiation, contract, trade and dealing between citizens of different states whether it be of goods, persons or information, is a transaction of interstate commerce." (Internal cites, quotes, ellipses, brackets omitted.)

Consequences of Not Registering - 1

- Local Sec. of State ➔Agent for Service of Process
  - A Potential "Black Hole" Risk
  - Who Knows if/when SOS Will Tell You of Suits
- Example: Cal. Corp. Code § 17708.07(d), which states:

> If a foreign limited liability company transacts intrastate business in this state without a certificate of registration or cancels its certificate of registration, it shall be deemed to have appointed the Secretary of State as its agent for service of process for rights of action arising out of the transaction of intrastate business in this state.

Consequences of Not Registering - 2

- Time and Expense of Bringing LLC into Compliance
  - Filing Fees
  - Possible Back-Fees, Fines, Penalties, etc.
    - Tex. Bus. & Com. Code § 9.052
    - 805 ILCS 180/45-45(d)
- Not Fatal, but Still a Disruptive Nuisance

Consequences of Not Registering - 3

- Injunction Barring Further In-State Business
  - Cal. Corp. Code § 17708.09
  - Tex. Bus. & Com. Code § 9.052(b)
- Obviously Not Good for Business

Consequences of Not Registering - 4

- "Door Closing" Statutes
- These Bar Foreign LLC from Suing
  - Can Still Defend
- Can be Grounds for Dismissing a Suit
- Usually Can Remedy the Problem by Bringing Entity Back into Compliance
  - Do This Before Final Judgment
  - After Final Judgment May be Too Late to Preserve Rights

Sample Door Closing Statutes

- Ohio:
  - Old ORC § 1705.58(A) – (B)
  - New ORC § 515(A)
    - Statute Bans Only Suits to Collect Debts
    - This Suggests Injunctive Suits & Dec Actions OK
- 805 ILCS 180/45-45(a) – (b)
- Cal. Corp. Code § 17708.07(a) – (b)

Sample Door Closing Cases

- *Allenberg Cotton Co., Inc v. Pittman*, 419 U.S. 20 (1974)
- *Maryland Digital Copier v. Litig. Logistics, Inc.*, 394 F.Supp.3d 80 (D. D.C. 2019)
- *Wausau Dev. Corp. v. Natural Gas & Oil, Inc.*, 144 So.3d 309 (Ala. 2013)
  - Noting that Failure to Register is a Capacity Defense that Defendant Must Affirmatively Plead
- *Douglas Landscape & Design, L.L.C. v. Miles*, 355 P.3d 700 (Kan. App. 2015)
  - Also Noting "Capacity" Nature of Door Closing Defense
- *Resort At Summerlin v. Dist. Ct.*, 118 Nev. 110 (2002)
  - NV Door-Closing Statute Does Not Apply to Foreign Corporation that Initially Registered but Fail to Renew

Choosing LLC Tax Status

Federal Tax Planning Options

- As Noted, LLCs Have IRS Tax Options
  - Multi-Member LLC Tax Options:
    - Partnership
    - C Corp
    - S Corp
  - Single Member LLC ("SM LLC") Tax Options:
    - Disregarded Entity
    - C Corp
    - S Corp
- Each Option Has Different Consequences

Sidebar Note: IRS Terminology

- IRS Regs Often Refer to "Association" Instead of "Corporation"
  - See 26 CFR §§ 301.7701-1 thru 301.7701-3
- This Term Covers Entities That Are Like Corporations but Not Technically Corporations Under Local Law
  - Especially True with Foreign Entities
- "Association" Usually ➔ Default Corporate Tax Status

Flow Through Options

- SM LLC ➔
  - Disregarded Entity
    - "Disregarded" for Tax Purposes Only
    - See 26 CRF § 301.7701-1(a)(1) (noting that entity classification is "for federal tax purposes" and "is a matter of federal tax law" that is not dependent on "local law")
  - S Corp
- Multi-Member LLC ➔
  - Partnership
  - S Corp

Flow-Thru Tax Rules Are Attractive – Slide 1

- Avoid "Double Taxation" of C Corp
  - Less of a Problem with C Corp Tax Rate of 21%
    - See IRC § 11(b)
  - NOTE: Biden Proposes Δ↑ to 28%
- S Corp ➔ Possible Δ↓ Self-Employment Tax
  - S/H is Paid Only "Reasonable Salary"
  - Balance of Entity Income can be Paid as a "Non-Wage Distribution" Not Subject to SE Tax
    - See IRS Summary at:
      - https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-compensation-and-medical-insurance-issues#Reasonable%20Compensation

Flow-Thru Tax Rules Are Attractive – Slide 2

- LLC Members Often Get IRC § 199A Benefit
  - Basically Excludes 20% of Profits from Taxable Income
  - Intent: Equalize Partnership Tax Treatment with C Corps After C Corp Tax Rate Δ↓ to Max of 21%
    - See, e.g., Dalton, *ICYMI: Proposed Regulations Clarify the IRC Section 199A Deduction*, CPA Journal (Jan. 2020), available at:
      - https://www.cpajournal.com/2020/01/30/proposed-regulations-clarify-the-irc-section-199a-deduction/
  - NOTE:
    - IRC § 199A Rules are Complex
    - Pres. Biden Proposed Reducing 199A Benefits
    - Unclear What Congress & Pres. Biden Will Finally Do

Default IRC Entity Classifications

- Domestic LLC
  - SM LLC ➔ Defaults to Disregarded Status
  - MM LLC ➔ Defaults to Partnership Status
  - Source:
    - 26 CFR § 301.7701-3(b)(1)
- Foreign LLC
  - Defaults to Corporate Status
    - True for SM LLC or MM LLC
    - Subject to Members Having Limited Liability
  - Source:
    - 26 CFR § 301.7701-3(b)(2)

Sidebar: Foreign LLCs Taxed as Foreign Corps

- Foreign LLC that Defaults to Corporate Status Will be Taxed as a Foreign Corporation
- Generally Very Bad News
  - Highly Intricate Foreign Corp. Reporting Rules
    - Form 1120-F
    - Form 5471
    - FATCA Form 8938
    - Potential PFIC Rules
      - Passive Foreign Investment Company ➔ Mark-to-Market Taxation
    - Subpart F Rules re: Controlled Foreign Corp & Passive Income
  - Big Compliance Costs
  - Big Penalties for Non-Compliance
- OK if Intended, but…
- Beware Unintentional Default Classification

How to Opt Out of Default Status

- In General
  - LLC Files IRS Form 8832
    - See 26 CFR § 301.7701-3(c)(1)
- For S Elections
  - LLC Files IRS Form 2553
  - Do Not File Form 8832
    - See Instructions, Form 8832 (Rev. 12-2013), Pg. 5, Col. 1, under "Who Must File"
  - Foreign LLC Not Eligible to be S Corp
    - IRC § 1341(b)(1) (Requiring a "Domestic Corporation")

Exceptions to Form 8832 Filing ("Deemed Elections")

- The Following are Deemed to Have Opted for Corporate Status and Need Not File Form 832
  - S Corporations
    - As Noted in Prior Slide, File Only Form 2553
  - REITs
    - File Only the IRC § 856(c)(1) Election
  - IRC 501(a) Tax Exempt Organizations
    - Treated as Corporation as of First Day on Which Exemption Claimed or Exempt Determination Made
- See 16 CFR § 301.7701-3(c)(1)(v)

Business Planning with LLCs

Management Structure

- Member-Managed vs. Manager-Managed
  - Big Differences Between the Two
  - Member-Managed is Typical Default Rule
  - Choice is Made Available by Statute
    - Old ORC §§ 1705.24 - 1705.25, 1705.29
    - New ORC § 1706.01(O)
    - 6 Del. Code § 18-402
- Officers are Optional for LLCs
    - Old ORC § 1705.291
    - 6 Del. Code § 18-407
- New OH LLC Act ➔ Officer or Director = Manager
  - ORC § 1706.01(O)

Manager-Managed Usually Preferred

- Manager-Managed Allows Separation of Management and Ownership
  - Can Have Independent Professional Managers
  - LLC Management Not Disrupted Simply Because Member is Sued, Gets Divorced, Goes Senile, etc.
- Members Can Also be Managers
  - ORC § 1705.282 (re: Member-Managers)
  - ORC § 1706.311(H) (Similar)
- Member Legal Problems ➔ Can Change Management Without Changing Owners
  - Need Op. Agr. Clauses re: Manager Removal

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Ownership Certificates Not Needed

- Nothing Requires Certificates
  - No Need for "Unit" Certs, "Member" Certs, etc.
- Membership Rights are Contractual
  - Rights Established by Operating Agreement
- Membership may be Uncertificated
  - **Sidebar:** Some States also Allow Uncertificated Stock in Corporations
    - ORC § 1701.24(F)
    - 8 Del. Code § 158

Cites re: Contractual Nature of Membership Rights

- Ohio
  - Old ORC § 1705.081
  - New ORC § 1706 .08(A)(1), (B)(1)
    - (A)(1) ➔ Subject to certain statutory exceptions, "[a]n operating agreement governs relations among the members as members and between the members and the limited liability company"
- *MPT of Hoboken TRS, LLC v. Humc Holdco, LLC*, Case No. 8442-VCN (Del. Ch. 2014 July 22)
  - "It is axiomatic under Delaware law that a Delaware LLC is governed by its operating agreement"
- *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 at *8 (Del. Ch. 2008 May 7), aff'd 984 A.2d 124, n. 33
  - LLCs "are creatures of contract, designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved." (Internal cites, quotes omitted.)

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Ownership Certificates – A Bad Idea

- Certificates Create Risk of Attachment
- General UCC Rules
  - Stock Certificates Attachable
  - Interests in Privately Held LLCs and Partnerships Are Not Attachable
    - ORC §§ 1308.02(C), 1308.32 (UCC §§ 8-103(c), 8-112)
- The Risk of Having Certificates
  - Court Might Say, "If You Think These Certs Are Valuable, Then I Do, Too. Sheriff: Attach!"
- If There's No Certificate, There's Nothing To Attach

What's The Bottom Line on Certificates?

- Don't Issue Certificates
- They Aren't Necessary
- They Invite Trouble

What if Client Insists on Certificates?

- I Always Want One!
  - Load Up Certificate With Disclaimers
    - "This Cert is Totally Worthless, Dude! It Merely Shows That, as of the Date Hereof, the Person Named Herein Had Membership Rights as Set Forth in Operating Agreement. All Rights and Duties are Totally Governed by and Subject to the Operating Agreement."
    - "PS – This Cert is Totally 100% Non-Transferable, Dude! All Transfers of Membership Interests are Governed by the Operating Agreement. Don't Even Think About it! "
- How Do I Pledge My Units?
  - Don't Pledge Units… "Assign" Economic Benefits

"Assignment" is Term of Art

- For LLCs and Partnerships, Assignment **Is Not**:
  - Transfer of Membership Interest
  - Substitution of Member
  - Admission of New Member
- Unless Operating Agreement Provides Otherwise, Assignment Transfers Only Economic Benefits
  - Rights to Distributions, Credits, Deductions, etc.
  - Akin to Assignment of Income
  - Sample Cites
    - Old ORC § 1705.18
    - 6 Del. Code § 18-702

New ORC § 1706.341(B) a Bit Different?

- § 1706.341(B) ➔ Assignment Covers Only "Distributions"
  - "Distribution" = "Money or Other Property"
    - ORC § 1706.01(J)
- Statutory Rules May Not Cover Deductions, Credits, or Similar Tax Benefits
- For More, See Below re: "Phantom Income"

Waivable Duties of Loyalty & Care

- Best Statutes Allow Op. Agree. to Modify, Waive, or Eliminate Duties of Care and Loyalty
  - Considered to be a Matter of Free Contract
    - Old ORC § 1705.081(C), (D)
    - New ORC §§ 1706.06(A), 1706.08(B)(1), (2)
    - 6 Del. Code § 18-1101(b), (c)
- Can't Waive Duty of Good Faith & Fair Dealing
  - Old OH ➔ Could Set Standards to Measure Performance
    - Old ORC § 1705.081(B)(5)
  - New OH (Like DE) ➔ Can "Restrict," Not "Eliminate"
    - New ORC § 1706.08(B)(1), (2)
    - 6 Del. Code § 18-1101(c)

Old Law Bad for Big Investors

- Old Law ➔ Minority Owners Protected, Majority Owners Burdened
  - See, e.g., Crosby v. Beam, 47 Ohio St.3d 105, (Ohio 1989), Syl. ¶ 2, stating:

Where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders with an equal opportunity to benefit, such breach, absent any legitimate business purpose, is actionable.

Waivable Duties ➔ Protecting Investment

- Operating Agreements Can Include Safeguards for Majority Investors
  - Waive Duties of Loyalty and Care to Other Members
  - Allow Competing Ventures
  - Limit Duty to Spend Time on LLC Affairs
  - Clauses re: Control or Takeover of Management
  - Waive Need to Consult
  - Fee-Shifting Rules re: Inter-Member Litigation
  - Preferential Indemnification and Advancement Rules for Majority Owner
  - Etc.
- Impair Ability of Minority Owners to Cause Trouble
  - Translate: $\Delta\downarrow$ Risks for Major Investors

Overview:

Using LLCs for Asset Protection

APP with LLCs: A Two-Prong Theory

- Many Clients Use Family LLCs as Stand-Alone APP Tools
  - Holding Companies for Family Assets
  - Thought to Provide Some "Judgment Proofing"
  - A "Poor Man's" Asset Protection Trust Substitute
- Big Reliance on Two Factors:
  - The Charging Order
  - The Threat of Phantom Income

The Theory May Not Be Sound

- Limits to Charging Order Protection
  - Charging Order Rules Can Vary
    - "Broad" vs. "Narrow"
  - Pressure from Other Members for Distributions
  - Inapplicable to Bankruptcy Trustees or Receivers
  - Possible "Direct Action" Theories
- The Phantom Income Threat May Be Hollow
  - Judgment Creditors Don't Get Anything Until they Actually Collect
  - IRS "Economic Substance" Rules
- Some People Still Opt for LLCs Over Other Tools
  - Pass on APTs, Exempt Property, More Insurance, etc.

Phantom Income Issue

Phantom Income: The Theory

- Rev. Rul. 77-137 Dealt With an LP Assignee
  - Assignee Deemed Liable for Income Associated With Assigned LP Interest
- Many Planners Interpret 77-137 Broadly:
  - Argue That ***Any*** Assignee of a Partner is Liable for Income
  - Also Argue That Judgment Creditors with Charging Orders ***Are*** Assignees

Rev. Rul. 77-137 Is Distinguishable

- LP Assignment Was Voluntary
- Assignor Promised To Use Residual Management Powers for Assignee
- Assignee Got Full Economic Benefit of LP Interest
- Made Sense to Tag Assignee With Income

IRC Probably Precludes "Phantom Income"

- Partnership Allocations Must Have Substantial Economic Effect
  - IRC § 704(b)(2)
- IRS May Disallow "Phantom" K-1
- Issuing a "Phantom" K-1 May Create New, Additional Liability

Many Statutes ➔ Creditors ≠ Assignees

- Creditor with a Charging Order Typically "Has **Only the Rights** of an Assignee"
  - See, e.g., Old ORC § 17.05.19(A) (Emphasis Added)
- Having "Only the Rights of an Assignee" is Very Different from Being an Assignee
  - Among Other Things… No Duties or Liabilities
- If Creditor with a Charging Order ≠ Assignee, then the Phantom Income Argument Fails

Reminder: New ORC § 1706.341(B)

- § 1706.341(B) ➔ Assignment Covers Only "Distributions"
  - "Distribution" = "Money or Other Property"
    - ORC § 1706.01(J)
- Statutory Rules May Not Cover Deductions, Credits, or Similar Tax Benefits
- Two-Edged Sword
  - Assignor Can Keep Tax Deductions, Credits, etc., But…
  - Op. Agmt. May Need to Attribute Income to Assignee to Get Phantom Income Effect

Charging Order Protection:

Pros and Cons

"Narrow" v. "Broad" Charging Order Rules

- Different States Have Different Charging Order Rules
- Some Have "Narrow" Rules
- Some Have "Broad" Rules

Narrow Charging Order Rules

- Charging Order is a Lien on Distributions
  - Distributions If and When Made
- It's a "Sole and Exclusive" Remedy
  - Exclusive vis-à-vis Getting Value Out of a Debtor's Membership Interest
- No Escalating Remedies
  - The "If and When" Waiting Game is Everything
- No Other Remedies vis-à-vis LLC Assets
  - No Other Legal or Equitable Remedies

Examples of Narrow Charging Order

- Ohio
  - Old Ohio Rev. Code § 1705.19(A)
  - New Ohio Rev. Code § 1706.342
  - *Knollman-Wade Holdings, L.L.C. v. Platinum Ridge Properties, L.L.C.*, 2015-Ohio-1619 (Ohio App. 10th Dist.)
- Delaware
  - 6 Del. Code § 18-703
- South Dakota
  - SDCL §§ 47-34A-504

Broad Charging Order Rules

- Broad Charging Order Rules Allow Escalating Remedies
  - Not Just an "If and When" System
- Other Potential Remedies
  - Foreclosure
  - Receivership
  - The Judicial Blank Check
    - "All Other Orders, Directions, Accounts, and Inquiries the Judgment Debtor Might Have Made or Which the Circumstances May Require to Give Effect to the Charging Order"

Examples of Broad Charging Order

- Colorado
  - C.R.S. § 7-80-703
- Illinois
  - 805 ILCS 180/30-20 (Using Updated ULLC Act Language)
- Uniform LLC Act (Amd. 2013)
  - ULLC § 503
  - Language Not Quite as Broad as Colorado's or Prior Uniform Act
  - Still Very Broad

Things to Look For

- Avoid Broad Charging Order Systems
- Look for Narrow Charging Order Systems
- Look for Other Attractive Features

Big Controversy:

Do Charging Order Rules Apply to Single Member LLCs?

- Courts and Commentators Split on This
- Arguments for "No" and "Yes" Positions

The "No" Argument

- Charging Orders Meant to Protect Co-Owners from Problems of Debtor-Member
  - In Old Pre-Charging Order World of General Partnerships, Creditors Could Seize Debtor-Partner's Pro Rata Share of Partnership Property
    - Profits, Assets, Receivables, Equipment, etc.
  - Charging Order Protected Innocent Co-Owners
    - Lien on Debtor Share of Distributions If/When Made
    - Maybe Foreclosure on Debtor's Partnership Interest
    - But… Partnership and Other Partners Undisturbed
- No Concerns re: Other Partners if Just 1 Member

The "Yes" Argument

- Charging Order Protects More than Just Innocent Co-Owners
  - Innocent Vendors, Employees, Customers, etc.
  - They Exist Even if Just 1 Owner
- SMLLC Exception Encourages Games
  - Smart Planners Would Include Small Co-Members
- SMLLC Exception Risks Unfairness
  - What if Single Member Sued Between Buy-Out of Prior Co-Member and Sale to New Co-Member?

Examples of "Yes" and "No" States

- Yes: Charging Order Rules Apply to SM LLCs
  - DE – 6 Del. Code § 18-703
  - SD – SDCL § 47-34A-504
  - NV – NRS § 86.401
- No: They Don't Apply
  - FL – *Olmstead v. FTC*, 44 So. 3d 76 (2010)
  - FL – Fl. Stats. § 605.0503
- Many Other States Unclear

OH Now Clearly a "No Exception" State

- This Was Already OH Law… ARGUABLY
  - No SMLLC Exceptions in Prior Ohio LLC Act
  - Prior Corp. Law Comments to ORC § 1705.19
    - Lawriter Anno. Added Along with HB 48 (2012) Changes
    - "The ***Charging Order Is the Only Remedy***, Whether the Membership Interest Is or Is Not Evidenced by a Certificate, or Whether It Is a Membership Interest of a ***Single Member*** Limited Liability Company."
- Now Clearly OH Law
  - Old ORC § 1705.031 ➔ Express Statutory Text
    - Not Just Comments and Construction
  - New ORC § 1706.06(E)

New ORC § 1706.06(E)

"This Chapter ***Applies to All Limited Liability Companies Equally*** Regardless of ***Whether the Limited Liability Company Has One or More Members*** or Whether it is Formed by a Filing Under Section 1706.16 of the Revised Code or by Merger, Consolidation, Conversion, or Otherwise."

Old ORC § 1705.031

"The Provisions of Sections 1705.01 to 1705.52 and Section 1705.61 of The Revised Code ***Apply to All Limited Liability Companies*** Formed Under this Chapter ***Whether the Limited Liability Company Has One or More Members*** or Whether It Is Formed by a Filing Under Section 1705.04 of the Revised Code or by Merger, Consolidation, or Conversion."

NOTE:
ORC §§ 1705.53 – 1705.58 Apply to Foreign LLCs, Not OH LLCs.
ORC §§ 1705.59 – 1705.60 are Reserved for Expansion.

Charging Orders & Conflicts of Law

Situs of Formation Controls Charging Order

- At Least 3 Cases ➔ Use Charging Order of State of LLC Formation
  - *Wells Fargo Equip. Fin., Inc. v. Retterath*, 928 N.W.2d 1 (Iowa 2019)
  - *JPMorgan Chase Bank, N.A. v. McClure*, 393 P.3d 955, (Colo. 2017) (en banc)
  - *Peach REO, LLC v. Rice*, 2017 WL 2963511, Case No. 2:12-cv-02752-SHM (W.D. Tenn. 2017 July 11)
- These Cases Endorse 3 Theories for this Result

The 3 Theories

- Situs of Membership Interests
  - Charge is a Lien on Membership Interests
  - Membership Interests Located in Situs of LLC Formation
  - This Promotes Predictability and Avoids Uncertainty Caused by Mobile Members
- Internal Affairs Doctrine
  - Charge is Essentially an Order to the LLC to Redirect Distributions Away from Debtor-Member
  - This Implicates the LLC's Internal Affairs
- Contractual Choice of Law
  - Operating Agreement's Choice of Law is Presumed AOK
  - This Choice Will be Honored Absent Rare Circumstances

Should Still Choose Narrow LLC State Even if Different Conflicts Rule Applies

- "Inside" Creditors Bound by Op. Agmt.'s Choice of Law and Charging Order Rules
  - Inside Creditors = Members, Manager, the LLC, Assignees
- Creditor Might Sue in Another Narrow Remedy State
  - Forming LLC in Broad Remedy State ➔ Creditor Might Still be Able to Argue for Broad Relief
- Don't Concede the Conflicts Fight in Advance
  - Court Might Buy Into Narrow Remedy

Weaknesses of SMLLCs

Unique Issues of SMLLCs

- Some People Think SMLLCs Don't Deserve Charging Order Protection
  - See, *Olmstead v F.T.C.*, 44 So.3d 76 (Fla. 2010)
- SMLLCs More Prone to Certain Problems
  - Examples
    - "Direct Action" Theories
    - Bankruptcy & Insolvency Problems
  - Multi-Member LLCs Susceptible, Too, But Less So

Five "Direct Action" Theories

- The Five Direct Action Theories
  - Veil Piercing and Reverse Pierces
  - Fraudulent Transfers Law
  - Constructive Trust
  - Resulting Trust Plus RASST
    - "RASST" is the Rule Against Self-Settled Trusts
  - Creditor's Bill
- What Are They Targeting?
  - None Target a Debtor's Share of Distributions
  - All Target:
    - The LP or LLC; and/or,
    - The Assets Titled in the Entity

Some States Bar "Direct Actions"

- DE, TX, OH, MS, SD, ME, VA
  - All Say Creditors Have "No Other Legal or Equitable Remedy" Against LLC or its Property
    - Caveat: Maine Expressly Allows UFTA Claims
      - Maine Rev. Stat. 31 § 1573(6)
  - This ➔ Creditors Can't Proceed Against LLC or its Property Merely To Collect From Judgment Debtor-Member
  - Caveats
    - State Law
      - Creditors Can Still Sue LLC for Its Own Wrongs
      - Has to be More than an End-Run Around "No Other Remedy" Rule
    - Federal Law
      - Federal Remedies Still Available, if Applicable
      - U.S. Constitution, Art. VI (Supremacy Clause)

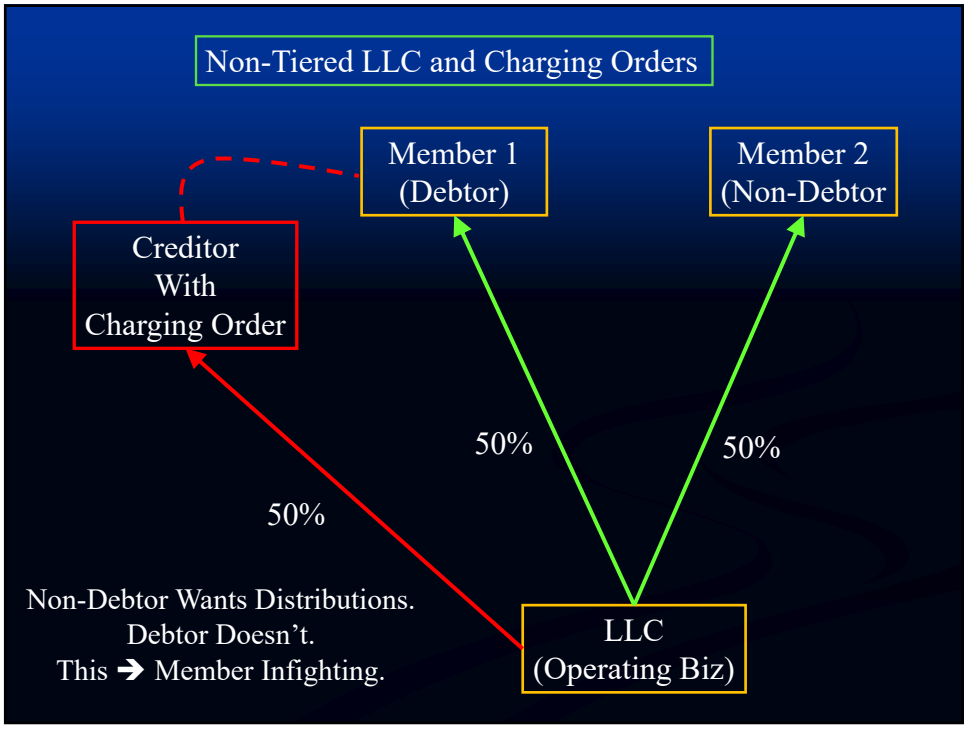
"Direct Action" Is Not Synonymous With Disregarding an Entity

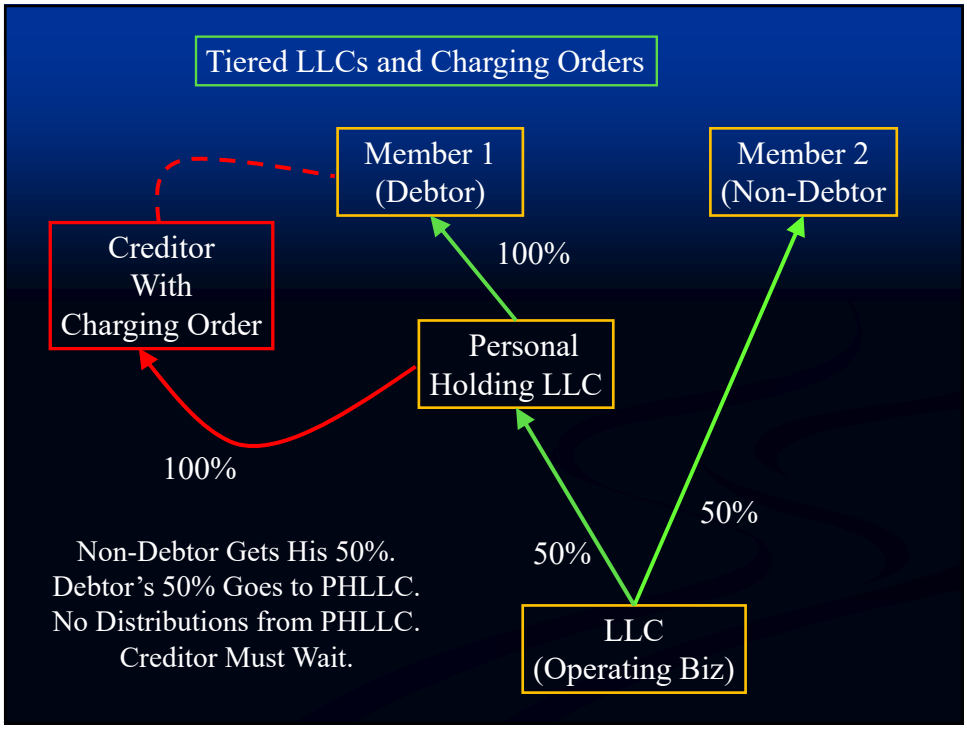
- Only "Veil Pierces" Disregard the LLC or LP
- All Other Theories Assume the Entity is Valid
- Instead of Attacking the Entity, These Theories Attack How the Entity is Used

Bankruptcy & Insolvency Issues

- Bankruptcy Trustee Takes a Debtor's Property, Including LLC Interests
  - *In re Albright,* Case No. 01-11367 ABC, Ch. 7, U.S. Bankr. Ct., D. Colo., 2003 Bankr. LEXIS 291 (Decided April 4, 2003), Relying on 11 USC § 541
- Receivers "Step Into Shoes" of a Debtor
  - *Leventhal v. Five Seasons,* 581 A.2d 449 (Md. Spec. App. 1990)
  - *Wuliger v. Owens,* 365 F.Supp.2d 838, 841 (N.D. Ohio 2005)
- If Sole Owner of LLC is Bankrupt or Insolvent, Then Trustee or Receiver Fully Controls LLC
  - *In re Albright,* supra
- Multi-Member LLC ➔ Solvent Members and/or Manager Still Have Some Say-So

Tiered LLCs


Non-Tiered LLC and Charging Orders
Member 1
(Debtor)
Member 2
(Non-Debtor
Creditor
With
Charging Order
50%
50%
50%
Non-Debtor Wants Distributions.
Debtor Doesn't.
This ➔ Member Infighting.
LLC
(Operating Biz)



Caution re: Use of PH LLC – No. 1

- Be Careful re: Inserting PH LLC Into Existing Structure **After** Claim Arises
- Doing So ➔ Risk of Fraudulent Transfer Claim
- Argument:
  - You Disposed of an Exposed Membership Interest in Exchange for a 100% Share of a PH LLC
  - The PH LLC Membership Interest Has No Value to Creditors
    - This Due to "Narrow" Charging Order Rules
    - May Not be so Worthless if LLC is Organized in a "Broad Remedy" State
  - Ergo, Disposition Was Made With Intent to Hinder, Delay, or Defraud Creditors

Caution re: Use of PH LLC – No. 2

- May Insert PH LLC Into:
  - **Existing** Structure **Before** Claim Arises
  - **Existing** Structure **After** Claim Arises if Sufficient Reserves Created to Cover Likely Value of Claim
    - See, e.g., Sullivan, *Future Creditors and Fraudulent Transfers... Important Limits to Fraudulent Transfers Law for the Asset Protection Planner*, 22 Del. J. Corp. Law 955, 988 – 1024 (1997)
  - **New Unfunded** Structure **After** Claim Arises
    - If Unfunded, then No Skin Off of Creditor's Nose
    - This Means No UFTA Violation as No Transfer
  - New Structure Can Fund Later With:
    - Co-Owner Capital Contributions (i.e., 3rd Party Equity)
    - Loans (i.e., Debt)

Corporate Transparency Act

- New 31 USC § 5336
  - Effective Sometime Soon… Probably Early 2022
  - Exact Date TBD
    - Effective Date Pegged to Date on Which Regs Issued
- CTA Adopted as Part of H.R. 6395 (2020)
  - National Defense Authorization Act for FY 2021
- CTA ➔ New Federal Registry of "Beneficial Owners" of "Reporting Companies"
  - Generally Applies to All Entities, Including LLCs
  - Certain Classes of Entities Exempt from Reporting
  - Many Details TBD
  - Non-Compliance is Potentially a Crime

LLC Planning With Trusts

Using LLCs to Fix "Traditional" Trusts – 1A

- Hypo: First-to-Die Spouse in A/B Plan Puts Assets in Trust for Spouse, Remainder 50/50 to 2 Kids ***Outright***
  - Kid 1 – Stable, Prosperous, Dependable, etc.
  - Kid 2 – A Total Mess (Drugs, Unemployable, etc.)
- Original Plan: Flawed Sense of Fairness re Kids
  - Giving Kid 2 Outright Assets Risks it All Quickly Going up Her Nose
  - That's a Crazy, Ill Considered (but Parentally Sentimental) Bequest

Using LLCs to Fix "Traditional" Trusts – 1B

- LLCs Offer a Solution
- The Basics
  - Trustees Drop All Assets into a Manager-Managed LLC
  - Give Kids 50% Membership Interests Upon Second Death
  - Include Suitable Distribution Rules
- Distribution & Allocation Rules Can Allow for:
  - Getting All Income for Life to Surviving Spouse
  - Controlled Distributions F/B/O Kid 2 after Second Death
    - Manager Pays Legitimate Creditors/Bills
    - Kid 2 Can't Easily Waste Assets

Using LLCs to Fix "Traditional" Trusts – 2A

- Hypo: Parent Leaves Cash, Securities, etc., in Trust for Child
- Trust Has "Age-Vesting" Schedule for **Outright** Distributions to Child
  - 1/3 to Child at Age 30
  - 1/2 Balance at Age 35
  - 100% Balance at Age 40
- At Age 39, Child Incurs Serious Debt Problems
  - Divorce, Business Problems, Tort Claims, etc.
- Outright Distribution ➔ Easy Attachment by Creditors

Using LLCs to Fix "Traditional" Trusts – 2B

- LLCs Offer Solution
- Trust Invests in New LLC
  - All Cash, Securities, etc. into LLC
  - Get Membership Interest in Exchange
  - LLC is from a "Narrow Remedy" State
- Mom Co-Invests with Her Own Money
  - This ➔ Multi-Member LLC with Approx. 50/50 Membership
- LLC is Manager-Managed, Mom is Manager
  - Son is Passive Non-Managing Member
- Outright Distribution ➔ Problems For Creditors
  - Son Gets a Membership Interest, Not Cash, Securities, etc.

Authority for Such Fixes?

- Trust Terms
  - Trust Documents Often Give Trustee Broad Investment Authority
    - "Trustee May Invest in Any Company or Partnership…"
- Statutory Authority
  - Ohio Rev. Code § 5808.16(C), UTC § 816(3)
    - "Trustee May… Exchange, Partition, Or Otherwise ***Change The Character*** Of Trust Property"
  - Local Non-UTC Statutory Authority
    - Can Vary State to State

LLCs Can Also Be Integrated With Asset Protection Trusts

- These Trusts Originated Offshore
- They Are Now Available in Many US States, Including Ohio
  - Ohio Legacy Trust Act, ORC § 5816.01 et seq.
- Domestic APTs Have Been Upheld as Valid
  - At Least by a DAPT State's Supreme Court
    - *Klabacka v. Nelson,* 394 P.3d 940, 950 – 951 (Nev. 2017)

What is an APT?

In A Nutshell:

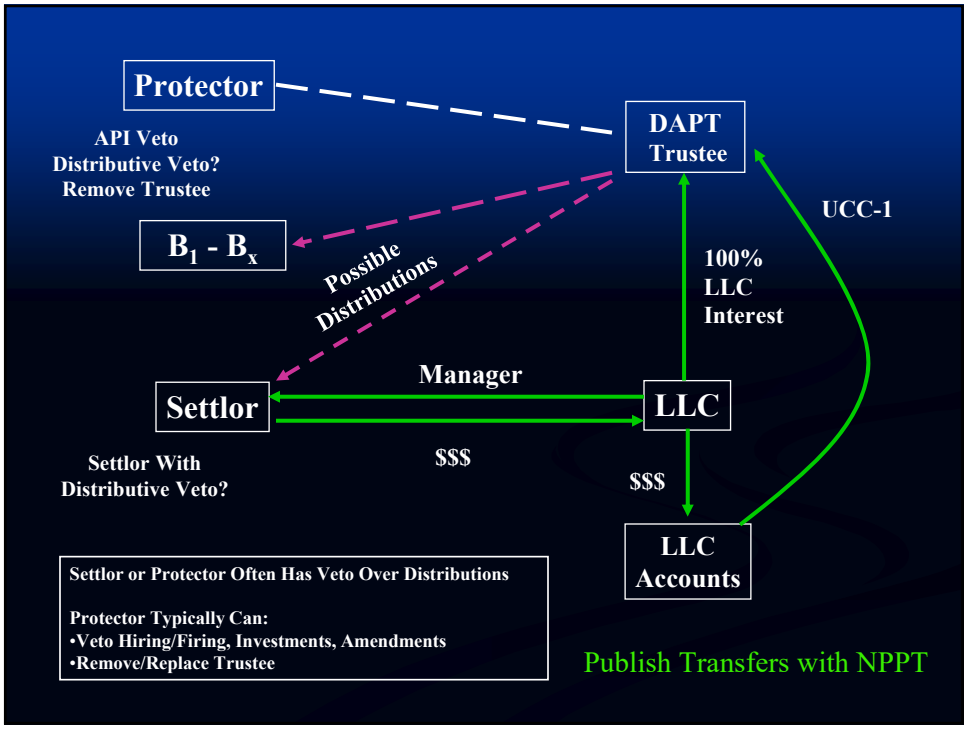
A Self-Settled Spendthrift Trust That Is Effective Against the Settlor's Own Creditors As Well As the Creditors of Other Beneficiaries

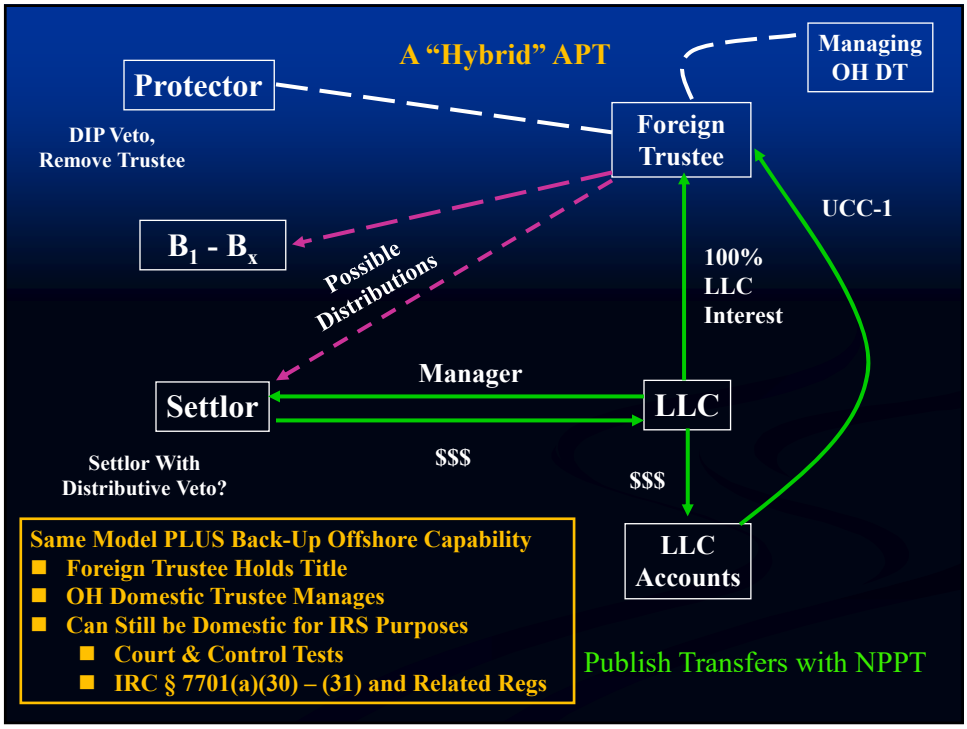
The Crux and the Caveat

- The Crux: In General, a Settlor's Creditors Can't Attach Trust Property, Even If a Settlor:
  - Is a Trust Beneficiary
  - Has Retained Powers Over the Trust Fund
- Repeals the "Rule Against Self-Settled Trusts"
  - See Restatement 2d, Trusts, § 156 and Related Cases
- The Catch:
  - Trust Settlement Must Not Be a Fraudulent Transfer

Domestic APTs

- Available in 19 States
  - AK, CT, DE, HI, IN, MI, MO, MS, NH, NV, OH, OK, RI, SD, TN, UT, VA, WV, WY
- Settlor Can Receive or Retain at Least:
  - Discretionary Distributions of Income or Principal
  - Ltd. Testamentary POA
  - Veto Over Distributions
    - NOTE: OK Law is Quirky and Doesn't Fit Above Pattern
- Some States Allow Broader Retained Rights


Protector
API Veto
Distributive Veto?
Remove Trustee
DAPT
Trustee
UCC-1
B_1 - B_x
Possible
Distributions
100%
LLC
Interest
Manager
Settlor
LLC
Settlor With
Distributive Veto?
$$$
$$$
LLC
Accounts
Settlor or Protector Often Has Veto Over Distributions
Protector Typically Can:
•Veto Hiring/Firing, Investments, Amendments
•Remove/Replace Trustee
Publish Transfers with NPPT


A "Hybrid" APT
Managing
OH DT
Protector
DIP Veto,
Remove Trustee
Foreign
Trustee
UCC-1
B_1 - B_x
Possible
Distributions
100%
LLC
Interest
Manager
Settlor
LLC
Settlor With
Distributive Veto?
$$$
$$$
LLC
Accounts
Same Model PLUS Back-Up Offshore Capability
Foreign Trustee Holds Title
OH Domestic Trustee Manages
Can Still be Domestic for IRS Purposes
Court & Control Tests
IRC § 7701(a)(30) – (31) and Related Regs
Publish Transfers with NPPT

Series LLCs
a/k/a
"Protected Cell" LLCs

Series LLCs – Basic Traits

- One Parent Umbrella LLC
- With Discrete "Series" or "Cells" Underneath
- Each Series or Cell:
  - Can Have Different Members
  - Treated as a Separate Entity
    - At Least in Theory

Examples of Series or Cell LLC Statutes

- Ohio Rev. Code § 1706.76, et seq.
- 6 Del. Code § 18-215
- Companies (Jersey) Law 1991 127YA, et seq.

What's the Attraction? Cost Savings

- Series LLCs ➔ No Multiple Fees… In Theory
- Just 1 of Each of the Following… In Theory:
  - 1 LLC Formation Fee
  - 1 Statutory Agent ➔ 1 Annual Agent Fee
  - 1 Annual Report (if Reports Required)
  - 1 Annual Franchise Tax
  - 1 Annual Renewal Fee
  - Etc.

But….

Series or Cell LLCs Carry Potential Problems

And the Problems Might Outweigh The Benefits

Legally Untested

- We Don't Really Know How Series LLC States Will Treat Their Own Series LLCs
- Things Could Be Even More Dicey in Non-Series States
  - Judges in Those States May Be Totally Clueless

Difficult to Administer

- Easy for Staff to Screw Up Governance Docs, Accounting, Banking, etc.
  - Risk of Commingling, Veil Piercing, etc.
  - Risk of Confusing Docs
    - Example: Transposition… Cell "12" Becomes "21"
- Difficulties Reported in Getting TINs
  - This Ties in With IRS's Uncertainty re: Series LLCs
    - See Below

Try Explaining it to a Bank or Broker

- Financial Houses Are **Notorious** for Botching Customer Legal Needs
  - They Can't Even Handle Basic Powers of Attorney
  - Think They'll Get This Straight?
  - They'll Botch Account Opening Papers, Statements, EIN Assignments, etc.
- Imagine the Headaches from This!

Tax Treatment Unclear

- Not Sure if State and Federal Tax Authorities Will Treat Each Cell as Separate or Part of One Big Group
- IRS ***Suggests*** it Will Give Separate Treatment
  - PLR 200803004
  - Proposed Regs, 75 Fed. Reg. 55699 et seq. (2010 Sept. 14)
- But… We Don't Really Know

Separate Treatment ➔ Fewer Cost Savings

- The Whole Point of Series LLCs is to Cut Costs
- But… Separate Treatment of Series ➔ Δ↓ Savings
- Example: Cal. Franchise Tax Board
  - Each LLC Series Treated as Separate Entity
  - Each Series Doing Biz in California Must File and Pay Separate Annual Reports, Fees, and Taxes. See:
    - https://www.ftb.ca.gov/file/business/types/limited-liability-company/series-limited-liability-company.html
- Other Tax-Hungry States Likely to Do Same

Bankruptcy Treatment Unclear

- Unclear if a Single Cell or Series Can be a Petitioning Debtor
- "No" ➔ Whole Umbrella Series Must File
  - Mass Filing ➔ Chaos for Solvent Cells
  - Non-Filing ➔ Chaos for Insolvent Cell
- Potentially Ugly Choices!!

UCC-1 Treatment Unclear

- Not Clear if Single Series Can be Debtor for UCC-1 Financing Statement Purposes
- Less of a Problem in OH… ***Maybe!!!***
  - Separate Debt Treatment for Each Cell
    - ORC § 1706.761(A)
  - BUT… Contingent on Separate Bookkeeping
    - ORC § 1706.761(B)(1)
  - What if Staff Botches Accounting or Banking?
    - Try Untangling Lien Rights Then

So… Why Bother, Especially in Ohio?

- Series LLCs Carry a Lot of Risk
  - For Minimal Upside
- Simpler to Form Separate LLC for Each Biz
- "1 LLC per Biz" Especially Attractive in Ohio
  - Easy to Form
  - Cheap… $99
  - "One and Done" Filing System

Conversion Table: Key Ohio LLC Act Provisions

ORC Ch. 1705 (Old Ohio LLC Act) vs. **ORC Ch. 1706** (Ohio Rev'd LLC Act)

Ch. 1706 supersedes Ch. 1705 vis-à-vis all LLCs as of 2022 February 11.
See ORC § 1706.83.

Unannotated Conversion Table

Issue	***Ch. 1705***	***Ch. 1706***
Assignees: Automatically Bound by Operating Agreement	1705.18(B)	1706.082(C)
Assignees: Exposed to Fines, Penalties, etc. for Misconduct	1705.18(B)	1706.08(B)(4), (5)
Charging Order: Sole and Exclusive Remedy	1705.19(B)	1706.342(F)
Charging Order: Only Remedy is Redirection of Distributions	1705.19(A), 1705.18(A), 1705.19(C)	1706.342(A)
Charging Order: Only a Non-Foreclosable Lien on Distributions	1705.19(A), 1705.18(A)	1706.342(C), 1706.342(F)
Charging Order: No Creditor Right to LLC Property	1705.19(C)	1706.342(F)
Single Member LLCs: Allowed	1705.04(A)	1706.16(A)
Single Member LLCs: Treated the Same as Multi-Member LLCs	1705.031	1706.06(E)
Contract Issues: Waivable Duties of Care and Loyalty	1705.081(C)	1706.08(B)(1), (2)
Contract Issues: Unwaivable Duty of Good Faith and Fair Dealing	1705.081(B)(5)	1706.08(B)(1), (2)
Contract Issues: Policy to Maximize Freedom of Contract	1705.081(D)	1706.06(A)
LLC Powers: Exercisable Without Following Formalities	1705.48(C)	1706.26

[Annotated Conversion Table Follows]

Annotated Conversion Table

Issue	*Ch. 1705*	*Ch. 1706*
Assignees: Automatically Bound by Operating Agreement	1705.18(B)[1]	1706.082(C) [2]
Assignees: Exposed to Fines, Penalties, etc. for Misconduct	1705.18(B) [3]	1706.08(B)(4), (5) [4]
Charging Order: Sole and Exclusive Remedy	1705.19(B) [5]	1706.342(F) [6]
Charging Order: Only Remedy is Redirection of Distributions	1705.19(A), 1705.18(A), 1705.19(C) [7]	1706.342(A) [8]

[1] "A substitute member of a limited liability company or an assignee of a membership interest in a limited liability company is bound by the operating agreement whether or not the substitute member or assignee executes the operating agreement." ORC § 1705.18(B).

[2] "An assignee… [is] bound by the operating agreement."

[3] This power is implied because: i.) Assignees are bound by operating agreements, and, ii.) Ohio's policy of maximum free contract rights does not prohibit the imposition of contractual fines and penalties on assignees. See ORC §§ 1705.18(B), quoted in n. 1, supra (assignee bound by operating agreement), 1705.081(D), quoted in n. 21, infra (regarding Ohio's policy of maximizing rights of free contract).

[4] ORC § 1706.08(B)(4) – (5) state in their entirety as follows:

> (4) An operating agreement may provide either or both of the following:
>
> > (a) That, a member or assignee who fails to perform in accordance with, or to comply with the terms and conditions of, the operating agreement shall be subject to specified penalties or specified consequences;
> >
> > (b) That at the time or upon the happening of events specified in the operating agreement, a member or assignee may be subject to specified penalties or consequences.
>
> (5) A penalty or consequence that may be specified under division (B)(4) of this section may include any of the following:
>
> > (a) Reducing or eliminating the defaulting member's or assignee's proportionate interest in a limited liability company;
> >
> > (b) Subordinating the member's or assignee's membership interest to that of nondefaulting members or assignees;
> >
> > (c) Forcing a sale of the member's or assignee's membership interest;
> >
> > (d) Forfeiting the defaulting member's or assignee's membership interest;
> >
> > (e) The lending by other members or assignees of the amount necessary to meet the defaulting member's or assignee's commitment;
> >
> > (f) A fixing of the value of the defaulting member's or assignee's membership interest by appraisal or by formula and redemption or sale of the membership interest at that value;
> >
> > (g) Any other penalty or consequence.

[5] "An order charging the membership interest of a member of a limited liability company is the sole and exclusive remedy that a judgment creditor may seek to satisfy a judgment against the membership interest of a member or a member's assignee." ORC § 1705.19(B).

[6] "This section provides the sole and exclusive remedy by which a judgment creditor of a member or assignee may satisfy a judgment out of the judgment debtor's membership interest…" ORC § 1706.342(F).

[7] "To the extent the membership interest is so charged, the judgment creditor has only the rights of an assignee of the membership interest as set forth in section 1705.18 of the Revised Code." ORC § 1705.19(A). "An assignment entitles the assignee only to receive, to the extent assigned, the distributions of cash and other property and the allocations of profits, losses, income, gains, deductions, credits, or similar items to which the assignee's assignor would have been entitled." ORC § 1705.18(A). "No creditor of a member of a limited liability company or a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company." ORC § 1705.19(C).

[8] "To the extent so charged and after the limited liability company has been served with the charging order, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise be entitled in respect of the membership interest." ORC § 1706.342(A).

Issue	*Ch. 1705*	*Ch. 1706*
Charging Order: Only a Non-Foreclosable Lien on Distributions	1705.19(A), 1705.18(A) [9]	1706.342(C), 1706.342(F) [10]
Charging Order: No Creditor Right to LLC Property	1705.19(C) [11]	1706.342(F) [12]
Single Member LLCs: Allowed	1705.04(A) [13]	1706.16(A) [14]
Single Member LLCs: Treated the Same as Multi-Member LLCs	1705.031 [15]	1706.06(E) [16]
Contract Issues: Waivable Duties of Care and Loyalty	1705.081(C) [17]	1706.08(B)(1), (2) [18]

[9] The old Ohio LLC Act does not explicitly bar a creditor with a charging order from foreclosing on a membership interest. However, this bar is implied by the other provisions that limit the scope of a creditor's charging order remedy. See n. 7, supra.

Note also the following:

A charging order is widely recognized to constitutes a lien. See, e.g., *Union Colony Bank v. United Bank*, 832 P.2d 1112 (Colo. App. 1992); *First Mid-Illinois Bank v. Parker*, 403 Ill. App. 3d 784, 794 – 795, 933 N.E.2d 1215 (2010) (discussing priority of lien rights); *LaSalle Bank, N.A. v. Tuke*, Case No. C-090444 (Ohio Ct. App. Hamilton 2010 March 31); *First Mid-Illinois Bank v. Parker*, 403 Ill. App. 3d 784, 789, 933 N.E.2d 1215 (2010) (noting the trial court reserve for later determination the question of priority among competing charging order liens and other liens).

Further, while some earlier cases held that a charging order allowed foreclosure on a debtor's ownership interest in an entity, the more recent trend is to find that a charging order lien is not on a debtor's ownership interest in an entity, but is instead on a debtor-owner's "economic benefits" or "transferable interest," which usually means a debtor's right to receive distributions, profits, losses, deductions, or credits. See, e.g., *In re Foos*, 405 B.R. 604, 609 (Bankr. N.D. Ohio 2009) (citing Ohio Revised Uniform Partnership Act for proposition that a charging order constitutes a lien on the judgment debtor's economic interest in the partnership); *Berns Custom Homes, Inc. v. Johnson*, 2021-Ohio-3033, ¶13 (Ohio App. 8th Dist. 2021) (similar); *In re: Talbut*, Case No. 08-34763, (Bankr. N.D. Ohio 2016 March 10 (construing Virginia LLC statute). Under this newer theory, a creditor should not be allowed to foreclose on an ownership interest because the charging order lien does not attach to that ownership stake.

As indicated in n. 10, infra, Ohio's Revised LLC Act expressly states that the charging order lien is on a debtor's membership interest, rather than a lien on "economic benefits" or a "transferable interest." However, Ohio's Revised LLC Act also explicitly bars foreclosure on membership interests. As a result, Ohio adheres to the older view about what a charging order lien encumbers while simultaneously embracing the more contemporary view against foreclosure of membership interests.

[10] "A charging order constitutes a lien on the judgment debtor's membership interest." ORC § 1706.342(C). "[A] judgment creditor shall have no right to foreclose, under this chapter or any other law, upon the charging order, the charging order lien, or the judgment debtor's membership interest." ORC § 1706.342(F).

[11] See n. 7, supra.

[12] "A judgment creditor of a member or assignee has no right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the judgment debtor's membership interest or the property of a limited liability company." ORC § 1706.342(F).

[13] "One or more persons, without regard to residence, domicile, or state of organization, may form a limited liability company." ORC § 1705.04 (A).

[14] "In order to form a limited liability company, one or more persons shall execute articles of organization and deliver the articles to the secretary of state for filing." ORC § 1706.16(A).

[15] "The provisions of sections 1705.01 to 1705.52 and section 1705.61 of the Revised Code apply to all limited liability companies formed under this chapter whether the limited liability company has one or more members or whether it is formed by a filing under section 1705.04 of the Revised Code or by merger, consolidation, or conversion." ORC § 1705.031.

[16] "This chapter applies to all limited liability companies equally regardless of whether the limited liability company has one or more members or whether it is formed by a filing under section 1706.16 of the Revised Code or by merger, consolidation, conversion, or otherwise." ORC § 1706.06(E).

[17] "A written agreement, including a written operating agreement, that modifies, waives, or eliminates the duty of loyalty, the duty of care, or both for one or more members, managers, or officers shall be given effect." ORC § 1705.081(C).

[18] "To the extent that, at law or in equity, a member, manager, or other person has duties, including fiduciary duties, to the limited liability company, or to another member or to another person that is a party to or is otherwise bound by an operating agreement, those duties may be expanded or restricted or eliminated by a written operating agreement." ORC § 1706.08(B)(1). "A written operating agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties, including breach of fiduciary duties, of a member, manager, or other person to a limited liability company or to another member or to another person that is a party to or is otherwise bound by an operating agreement." ORC § 1706.08(B)(2).

Issue	*Ch. 1705*	*Ch. 1706*
Contract Issues: Unwaivable Duty of Good Faith and Fair Dealing	1705.081(B)(5) [19]	1706.08(B)(1), (2) [20]
Contract Issues: Policy to Maximize Freedom of Contract	1705.081(D) [21]	1706.06(A) [22]
LLC Powers: Exercisable Without Following Formalities	1705.48(C) [23]	1706.26 [24]

[19] "[T]he operating agreement may not… [e]liminate the obligation of good faith and fair dealing…but the operating agreement may prescribe the standards by which the performance of the obligation is to be measured." ORC § 1705.081(B)(5).

[20] "[A]n operating agreement may not eliminate the implied covenant of good faith and fair dealing." ORC § 1706.08(B)(1). "[A]n operating agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied covenant of good faith and fair dealing." ORC § 1706.08(B)(2).

[21] "It is the policy of this chapter…to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements." ORC § 1705.081(D).

[22] "This chapter shall be construed to give maximum effect to the principles of freedom of contract and to the enforceability of operating agreements." ORC § 1706.06(A).

[23] "The failure of a limited liability company or any of its members, managers, or officers to observe any formalities relating to the exercise of the limited liability company's powers or the management of its activities is not a factor to consider in, or a ground for, imposing liability on the members, managers, or officers for the debts, obligations, or other liabilities of the company." ORC § 1705.48(C).

[24] "The failure of a limited liability company or any of its members to observe any formalities relating to the exercise of the limited liability company's powers or the management of its activities is not a factor to consider in, or a ground for, imposing liability on the members for the debts, obligations, or liability of the limited liability company." ORC § 1706.26.

LLCs and LPs – Charging Orders, Creditors Rights, and Other Issues

2019 Version

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I. Charging Orders: An Overview

A. Virtually all general partnership, limited partnership, and LLC statutes contain charging order provisions.

1. Example: Ohio

a. General Partnerships: Ohio Rev. Code §§ 1775.25 - 1775.27.

b. Limited Partnerships: Ohio Rev. Code §§ 1782.39 - 1782.42.

c. LLCs: Ohio Rev. Code §§ 1705.17 - 1705.20.

B. In general, a charging order remedy gives creditors of partners in a general partnership relatively broad rights, while conferring at least arguably narrower rights on the creditors of LLC members and limited partners.

C. The charging order is derived from English law. *See infra*.

D. The charging order is generally thought to be an exclusive remedy for creditors trying to reach a partnership or LLC interest. *See infra.*

E. The charging order's fundamental remedy is to allow a creditor to "charge" a debtor-partner's interests in the partnership, but does not, in general, allow attachment of underlying partnership property.

1. A charging order is "neither an assignment nor an attachment. It serves only the precise purpose statutorily indicated, *i.e.*, to 'charge' an interest with a debt." *Rector v. Azzato*, 539 A.2d 1162, 1165 (Md. App. 1998) (internal quotes, cites, bracket and ellipses omitted).

F. For a general partnership, the charging order starts as an "if and when" remedy, meaning that the judgment creditor can exercise his charge if and when the GP makes distributions to the debtor-partner.

1. However, the Uniform Partnership Act enables creditors to seek additional, stronger relief if the "if and when" charge does not yield attachments. *See infra*.

G. For LLCs and LPs, the traditional analysis was that the charging order was an "if and when" remedy that did not allow for any other creditor remedies. However, that view has become suspect, and broader remedies may be available, as analyzed below.

H. The charging order approach contrasts with the prior approach, which allowed judgment creditors to attach partnership property when a partner was subject to a judgment debt.

I. The historically "new" charging order approach is common throughout the Anglo-American world. See, e.g.:

1. U.S. - Cases: "The charging order leaves the partnership intact; it merely entitles the creditor to receive the debtor partner's share of any distribution of partnership profits or capital." *Rector v. Azzato*, 539 A.2d 1162, 1165 (Md. App. 1998).

2. U.K. - Cases: "The object of the [the charging order] section is to get rid of the cumbrous and inconvenient mode by which partnership property was taken in execution for a partner's separate debt. A fi. fa. [*i.e.,* a fieri facias execution writ] founded on a judgment obtained against one partner can no longer be executed against the goods of the firm." *Brown, Janson & Co. v. Hutchinson & Co.* [1895], 2 Q.B. 126, 130.

3. U.K.: Partnership Act 1890, as amended, §§ 90 - 93, 35 Halsbury's Laws of England (4th Ed. 1981, as supplemented).

J. The original historical purposes of the charging order are:

1. Insulate a going concern (and its non-debtor partners, employees, creditors, etc.) from the adversity that might afflict a single partner.

a. *See, e.g., Brown, Janson & Co. v. Hutchinson & Co.* [1895], 2 Q.B. 126, 130 (referring to the "inconvenient mode by which partnership property was taken in execution for a partner's separate debt."); *id.*, 131 (purpose was "to get rid of such inconveniences as arose under the old law in cases where the partnership property was seized to satisfy the separate judgment debt of one of the partners").

b. *In re Stocks,* 110 B.R. 65, 67 (Bankr. N.D. Fla. 1989) ("The reason for this assignment rather than allowing a direct levy on the partnership assets is to prevent disruption of the partnership business and the resulting injustice to other partners").

c. *Hellman v. Anderson,* 284 Cal. Rptr. 830, 833 (Cal. App. 1991).

d. *BayBank v. Catamount Const., Inc.*, 693 A.2d 1163, 1165 (N.H.

1997) ("charging order was designed to prevent the personal creditors of a limited partner from disrupting the partnership business by seizing the partnership assets on execution").

e. *See also Schultz v. Ziegenfuss,* 253 A.2d 180, 183 (N.J. App. 1969) ("the uniform law is consistent with the entity approach for the purposes of... protecting the business operation against the immediate impact of personal involvements of the partners") (internals quotes and cites omitted).

f. *Union Colony Bank v. United Bank,* 832 P.2d 1112, 1114 – 1115 (Colo. App. 1992) (citations omitted):

> The charging order represents, essentially, an outgrowth of the more disruptive post-judgment remedy of execution against partnership assets to satisfy a personal debt of a partner. In short, the common law had no procedure to seize a partner's interest in the partnership, that is, his intangible share in the business of the firm or, as later defined under the UPA, his distributive share of the partnership's profits and surplus. In order to reach this valuable interest, tangible partnership property was seized and sold, disrupting the partnership and forcing it into dissolution.
>
> These consequences were unfair to the non-debtor partners. And, because it impaired intangible aspects of the partnership such as good will, the consequences were, in addition, harmful to the value of the partnership interest which the creditor sought to reach. Thus, the charging order evolved as a way to divert the debtor partner's share of the partnership profits and surplus to his creditor without disrupting the on-going partnership.
>
> Accordingly, the charging order operates, in effect, as a substitute for execution.

2. Preserve the voluntary nature of partnership relations by disallowing partnership status to unwelcome intruders.

a. *See, e.g.*, the following:

i. *Farmers State Bank v. Mikesell,* 51 Ohio App. 3d 69, 75, 554 N.E.2d 900, 906 (Darke 1988) ("partnership is a voluntary relation").

ii. *Temple v. White Lakes Plaza Associates, Ltd.,* 816 P.2d 399, 405-406 (Kan. App. 1991).

b. This rationale (*i.e.*, preserving the voluntariness of relations) applies with equal force to LLCs, especially small LLCs and/or member-managed LLCs.

II. Charging Orders: Conflicts of Law Issues – Which State's Rules Apply?

A. As discussed below, there different jurisdictions can have different charging order rules, and the rule differences can be considerable.

1. Some jurisdictions can have very pro-creditor charging order rules, some can have very pro-debtor charging order rules, and some fall somewhere in between.

B. What if an LP or LLC is formed in a very pro-debtor jurisdiction, but a judgment is entered against a debtor-partner or debtor-member in another jurisdiction, which might have very pro-creditor rules?

1. Which jurisdiction's charging order rules apply?

C. One line of thought opined that post-judgment collection remedies, including a charging order, are procedural in nature, and that the forum court could apply its own collection rules as a matter of local practice and procedure. See, e.g., the following:

1. *GE Capital Corp v JLT Aircraft,* 2010 US Dist. LEXIS 76384 (D Minn.).

a. In this case, the U.S. District Court applied Minnesota charging order rules to Delaware LLC interests pursuant to Fed. R. Civ. Pro. 69's mandate to apply post-judgment collection procedures that "accord with the procedure of the state where the court is located" in the absence of a controlling federal statute.

b. However, the court implicitly assumed that Minnesota would apply

its own charging order rules to a Delaware LLC regardless of any conflicts of law concerns.

D. However, we now have several cases that apply the charging order rules of the jurisdiction of formation, and that did so various grounds.

E. **Theory 1:** Situs of Membership Interests

1. Under this theory: i.) LLC membership interests are intangible property interests located in the jurisdiction in which the LLC is formed; and, ii.) Charging orders should be governed by the law of the LLC's formation, particularly since the charging order is ultimately a turnover order directed against the LLC, and also because unpredictability of remedies would ensue if and when members move from one state to another. *Wells Fargo Equip. Fin., Inc. v. Retterath*, 928 N.W.2d 1, 6 – 8 (Iowa 2019); *JPMorgan Chase Bank, N.A. v. McClure,* 393 P.3d 955, 958-59 (Colo. 2017) (en banc).

2. In *Retterath,* the Court dealt with membership interests held by debtor Floridians in an Iowa LLC. The debtors argued that: i.) Florida law should govern the judgment creditor's efforts to attach their membership interests, and, ii.) The creditor could not reach the membership interest because it was protected by Florida's tenancy-by-the-entireties rules. The Court rejected that argument and applied Iowa charging order rules to the membership interest. The Court stated:

> The Retteraths challenge the district court's conclusion that Iowa law applies to their dispute with WFEFI… [T]he Retteraths argue Iowa law governing personal property applies to their membership interests in [the Iowa LLC]. Thus, the Retteraths claim the situs of their [LLC] membership units is the Retteraths' domicile, which is Florida. The Retteraths also contend the district court erred in relying on the choice-of-law clause in [the LLC's] operating agreement.
>
> Courts are divided in determining where the intangible property interest in an LLC lies, and this is an issue of first impression in Iowa. We have previously held the situs of similar forms of intangible personal property, such as corporate stock, is governed by the law of the owner's domicile, and not by the law of the corporate domicile… However, an individual's interest in an LLC is unlike other forms of intangible personal property since the typical levying procedures available to creditors for similar forms of intangible personal property are unavailable to creditors

seeking to levy an individual's interest in an LLC. Iowa and Florida both have adopted forms of the Revised Uniform Limited Liability Company Act (RULLCA). Under the RULLCA in Iowa, a charging order is the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest. Likewise, in Florida, a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's transferee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company unless the limited liability has only one member.

Charging orders provide a judgment creditor with the ability to satisfy a judgment from the judgment debtor's transferable interest in an LLC while simultaneously allowing the LLC to protect its other members' interests and continue operating. A charging order allows a judgment creditor to obtain a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor… This remedy is unique to an interest in an LLC, as it is premised upon the distinct ability to separate the individual's economic interest in an LLC from the LLC's operations and the interests of its other members.

Charging orders are not available for other forms of intangible personal property. Moreover, both Iowa and Florida law concerning a transferable interest in an LLC characterizes the LLC as the core of the interest. Specifically, Iowa law defines a transferable interest in an LLC as the right, as originally associated with a person's capacity as a member, to receive distributions from a limited liability company in accordance with the operating agreement, whether or not the person remains a member or continues to own any part of the right. Florida similarly defines a transferable interest as the right, as initially owned by a person in the person's capacity as a member, to receive distributions from a limited liability in accordance with the operating agreement, whether the person remains a member

> or continues to own a part of the right. The individual LLC member, and thus the location of the member, is secondary to the member's transferable interest in the LLC. Consequently, while the Retteraths are correct to note their [LLC] interests are personal property under the law, there are unique attributes of a membership interest in an LLC that render our traditional debtor-domicile analysis applied to other forms of intangible personal property inadequate with regard to the situs of a membership interest in an LLC.
>
> For the purposes of determining the enforceability of a charging order, we hold that a member's membership interest is located where the LLC was formed. Our holding aligns with the anomalous characteristics of a membership interest in an LLC, particularly because a charging order is directed to the LLC rather than the individual member since it requires the LLC to redirect the debtor-member's distributions to the creditor. Additionally, Iowa law governs an LLC's internal affairs and the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the LLC. Locating the membership interest in the state in which the LLC was formed recognizes this authority and promotes uniformity. To conclude otherwise (i.e., that the interest lies wherever the debtor happens to be domiciled) could result in substantial uncertainty and confusion, as an LLC could become subject to various and competing charging orders from differing foreign jurisdictions. Likewise, our holding creates certainty for creditors because it provides them with a fixed jurisdiction to pursue charging orders.
>
> In this case, the Retteraths' interests in [the LLC] exist under Iowa law, and their creditor's remedies are also limited by Iowa law. Accordingly, we hold membership interests in an LLC are located in the state where the LLC is formed. The district court correctly concluded Iowa law applies to this case.

Retterath, 928 N.W.2d at 6 – 8 (internal cites, quotes, brackets, original ellipses omitted; new ellipses and bracketed material added).

F. **Theory 2:** Internal Affairs Doctrine

1. As indicated in *Retterath*, using the formation state's LLC charging order rules is justified by the internal affairs doctrine.

    a. "Additionally, Iowa law governs an LLC's internal affairs and the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the LLC. Locating the membership interest in the state in which the LLC was formed recognizes this authority and promotes uniformity." *Retterath*, 928 N.W.2d at 8.

2. This analysis is predicated on the notion that the charging order is really a turnover order issued to the LLC, and it therefore affects the LLC's relations with a debtor-member by altering distribution patterns, i.e., the charging order rearranges the internal affairs of the LLC.

    a. "Our holding aligns with the anomalous characteristics of a membership interest in an LLC, particularly because a charging order is directed to the LLC rather than the individual member since it requires the LLC to redirect the debtor-member's distributions to the creditor." *Retterath*, 928 N.W.2d at 7.

3. This analysis is contrary to the commonly held view of collections lawyers that the internal affairs doctrine is irrelevant because a charging order is really an order against a debtor-member in favor of a judgment creditor.

G. **Theory 3:** Contractual Choice of Law

1. Under this theory, an operating agreement's choice of law is presumptively valid. Consequently, when an operating agreement provides that the law of "State X" governs, that choice extends to charging order matters absent extenuating circumstances.

a. See, e.g., *Peach REO, LLC v. Rice*, 2017 WL 2963511, Case No. 2:12-cv-02752-SHM (W.D. Tenn. 2017 July 11).

i. In this case, a federal district court sitting in Tennessee applied Tennessee, Mississippi, and Delaware charging order rules to Tennessee, Mississippi, and Delaware LLCs, respectively.

ii. After first noting Fed. R. Civ. Pro. 69's mandate to apply local collections procedures in the absence of a contrary federal statute, the court stated:

> No relevant federal statute governs the Court's execution

procedure. Therefore, Tennessee law controls. Because Tennessee courts apply Tennessee choice-of-law rules, this Court applies those rules. Each Relevant LLC has its own operating agreement; each contains a choice-of-law provision. Tennessee choice-of-law rules generally honor contractual choice-of-law provisions:

> Tennessee follows the rule of lex loci contractus. This rule provides that a contract is presumed to be governed by the law of the jurisdiction in which it was executed absent a contrary intent. If the parties manifest an intent to instead apply the laws of another jurisdiction, then that intent will be honored provided certain requirements are met. The choice of law provision must be executed in good faith. The jurisdiction whose law is chosen must bear a material connection to the transaction. The basis for the choice of another jurisdiction's law must be reasonable and not merely a sham or subterfuge. Finally, the parties' choice of another jurisdiction's law must not be contrary to a fundamental policy' of a state having a materially greater interest and whose law would otherwise govern.

[These] requirements are met here. There has been no showing that the members of the Relevant LLCs executed the various choice-of-law provisions in bad faith. For each LLC, the choice-of-law provision selects the law of the state of its formation; that state has an obvious material connection to the LLC. There has been no showing that the choice-of-law provisions were unreasonable, shams, or subterfuges. There has also been no showing that the choice-of-law preferences of the members of the Relevant LLCs were contrary to a fundamental policy of another state's law.

Because [these] requirements have been met, the Court will apply the choice-of-law provisions in the Relevant LLC operating agreements. Tennessee law applies to [the Tennessee LLCs], Mississippi law applies to [the Mississippi LLCs], and CDTLM, and Delaware law applies to [the Delaware LLCs].

Peach REO at FastCase p. 7 – 9 (internal cites, quotes, footnotes omitted; brackets added)

III. Charging Orders: Detailed Analysis of General Partnerships

A. For a detailed discussion of various issues related to charging orders, see Loeffler & Sullivan, *Ohio LLCs After Florida's Olmstead Decision: Why Ohio LLCs are No Good Anymore, How to Fix Them, and What To Do Until They're Fixed*, Probate Law Journal of Ohio, Vol. 21, No. 2, p. 66 (November/December 2010) (regarding LLC and LP charging order issues in wake of Florida's controversial *Olmstead* decision).

B. Genesis of the charging order:

1. American authority for the charging order is found in § 28 of the Uniform Partnership Act ("UPA"),6 ULA 125, *et seq*. (1995) and state law counterparts.

2. The UPA remedy is expressly modeled on English law. The Official Comment to UPA § 28 states:

> "This provision... is taken from section 23(2) of the English Partnership Act. The operation of the provision has given great satisfaction. The judgment creditor does not acquire any greater rights than the debtor is entitled to for his own benefit. [Sutton v. English, etc., Produce Co., [1902] 2 Ch. 502; Howard v. Sadler, [1893] 1 Q.B. 740; Scott v. Hastings, (1858) 4 Kay & J. 633]."

Note: By limiting the creditor who holds a charging order to no "greater rights than the debtor is entitled to for his own benefit," this carries the implication that the creditor may ultimately claim up to all the rights that the debtor has in the partnership. Consequently, be careful about what rights are conferred by a partnership agreement.

C. UPA § 28, as codified at Ohio Rev. Code § 1775.27, states:

> (A) On due application to a competent court by any judgment creditor of a partner, the court which entered the judgment, order, or decree, or any other court, may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership, and make all other orders, directions, accounts, and inquiries which the debtor partner might have made, or which the circumstances of the case may require.

(B) The interest charged may be redeemed at any time before foreclosure, or in case of a sale being directed by the court may be purchased without thereby causing a dissolution:

(1) With separate property, by any one or more of the partners;

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

Note: Other examples of UPA § 28 in other states includes:

Cal. Corp. Code § 16504

Colo. Rev. Stat. Anno. § 7-60-128

Mass. General Laws Ch. 108A, § 28

D. This creates a cumulative remedy in connection with general partnerships:

1. If a mere charge does not yield revenue for the judgment creditor, then a creditor may go back and ask for more relief:

a. Receivership

b. Accounting

c. Broad catch-all relief as "circumstances.... may require," including:

i. Broad discretion over orders

ii. Issuing directions that the debtor-partner could have ordered (presumably including anything allowable under the general partnership agreement).

d. Foreclosure on the general partner's interest. *See, e.g.*:

i. Revised UPA ("RUPA") (1994):

(a) § 504, Cmt. 1, 6 ULA 71, notes the existence of lien and foreclosure rights under the UPA.

(b) Cmt. 1 states, "Subsection (b) is new and codifies the case law under the UPA holding that a charging order constitutes a lien on the debtor's transferable interest. The lien may be foreclosed by the court at any time."

ii. *Deutsch v. Wolff,* 7 S.W.3d 460, 463 (Mo. App. 1999) ("A partner's individual interest is not partnership property and therefore may be sold to satisfy that partner's individual debts") (construing Missouri UPA in case in which foreclosed partner had both limited and general partnership interests).

iii. *Lauer Const., Inc. v. Schrift,* 716 A.2d 1096 (Md. Spec. App. 1998) (allowing sale of general partner's interest in a limited partnership pursuant to Maryland UPA rules).

iv. *Tupper v. Kroc,* 494 P.2d 1275 (Nev. 1972) (allowing sale of general partner's interest in a limited partnership pursuant to Nevada UPA rules).

v. *BayBank v. Catamount Const., Inc.,* 693 A.2d 1163, 1166 (N.H. 1997) (noting that UPA authorizes foreclosure on general partnership interests, and also holding that such foreclosure is sometimes available against limited partnership interests).

vi. *Hellman v. Anderson,* 284 Cal. Rptr. 830, 836-838 (Cal. App. 1991) (collecting cases and discussing effects of foreclosure on general partnership interest).

vii. *But see Buckman v. Goldblatt,* 39 Ohio App. 2d 1, 314 N.E.2d 188, at n. 7 (Cuyahoga 1974) (construing "foreclosure" language in UPA to mean "foreclosure in support of a judgment against the partnership").

(a) *Buckman* is contrary to the weight of authority, including the Commissioners on Uniform Laws, as indicated above by the Commissioners' Cmt. 1 to RUPA § 504.

e. Possible dissolution of the partnership and an associated distribution of general partnership property.

i. Pursuant to a receivership:

(a) *See, e.g., Leventhal v. Five Seasons*, 581 A.2d 449 (Md. Spec. App. 1990) (receiver of general partner appointed pursuant to a charging order stands in the debtor's shoes and may do whatever the debtor-partner could do, including ask for dissolution of the partnership).

ii. RUPA jurisdictions:

(a) Under RUPA § 504, the purchaser of a foreclosed interest "has the Section 503(b) rights of a transferee." RUPA § 504, Cmt. 1.

(b) A § 503(b) transferee may seek dissolution and winding up of a partnership, which, if allowed, would entail a distribution of partnership property.

iii. **Note:** If dissolution occurs and proceeds to the winding up phase, the general partners are liable for all outstanding partnership debts. Ohio Rev. Code § 1775.39, UPA §40.

E. The court traditionally has had discretion to enter these other orders but has typically reserved such orders for "special circumstances." *See, e.g., Brown, Janson & Co. v. Hutchinson & Co.* [1895], 2 Q.B. 126, 130-131, 132.

IV. Charging Orders: Detailed Analysis of LLCs and LPs

A. Creditors of LLC members and limited partners may "charge" a debtor's LP or LLC interests.

B. For limited partnerships, the charging order is based on § 703 of Revised Uniform Limited Partnership Act ("RULPA"), 6A ULA 59 (1976), and state law counterparts:

1. RULPA § 703 states in pertinent part:

> On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner 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 partnership interest.

2. Some state-law counterparts:

a. Ohio Rev. Code §§ 1782.41, 1782.40.

b. 6 Del. Code § 17-703.

Note: Not all states have adopted RULPA § 703 verbatim, and potentially significant state-by-state variations can exist.

C. There is no uniform LLC statute in effect in most states.

1. Although the Commissioners on Uniform State Laws have proposed a Uniform Limited Liability Company Act, most states have adopted their own version of an LLC statute.

a. There are, however, a small but growing number of states that have adopted the Uniform LLC Act. (See below.)

b. Some states sometimes adopt part of the Uniform LLC Act, but ignore other parts.

2. Many, but not all, state LLC laws have adopted LLC charging order provisions that are substantially similar to RULPA § 703.

3. However, state-by-state variations exist and can be very significant.

4. Further, these state-by-state variations seem to be increasing on an annual basis.

5. Consequently, each state's LLC statute must be individually analyzed to determine if the local statute has deviated from RULPA § 703.

D. A charge, at least initially, creates an "if and when" situation, whereby the creditor gets distributions that would otherwise go to the debtor if and when those distributions are made.

1. This puts the creditor in the position of having to wait for a distribution that might never materialize.

E. The statutory basis for the "if and when" regime is as follows:

1. Creditors who obtain charging orders get "only the rights of an assignee." RULPA § 703.

2. An "assignee" is entitled to receive distributions. RULPA § 702 states:

> "An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled."

3. An assignee has no right to participate in the business or affairs of the entity. See RULPA § 702 ("An assignment... does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner.")

   a. **Note:** An assignee may become a member if all other members consent or the partnership or operating agreement gives the assignor written authority to admit an assignee in his stead. See, e.g., RULPA § 704.

4. Likewise, an assignee cannot force a dissolution of the entity.

   a. *See, e.g.,* RULPA § 702 ("An assignment... does not dissolve a limited partnership"); Ohio Rev. Code § 1705.18 (similar language re: LLCs).

F. For supporting interpretive cases, *see:*

1. *Temple v. White Lakes Plaza Associates, Ltd.,* 816 P.2d 399 (Kan. App. 1991) (limited partnership).

2. *In re Stocks,* 110 B.R. 65 (Bankr. N.D. Fla. 1989) (limited partnership).

3. *Herring v. Keasler,* 150 N.C. App. 598 (Wake County 2002)

G. The "if and when" right is often said to be the end of creditor's rights against the LP or LLC interest itself. However:

1. Foreclosure and other UPA style remedies against a limited partnership interest are now available in some states ***as part of*** RULPA's charging order system.

   a. This arises from the operation of RULPA § 1105 and it's "gap

clause." *See infra.*

2. LLC statutes don't have gap clauses but, in some instances, are replicating UPA remedies as part of the LLC statute itself.

3. At least one state - Ohio - had an LLC statute that fails to state that holder of a charging order "only" has the rights of an assignee.

   a. This old provision, which is analyzed further below, was repealed pursuant to Ohio Am. Sub. H.B. 301 (2006), which took effect October 12, 2006.

   b. The prior version of the statute suggested that Ohio's LLC charging order relief was cumulative of other creditor's remedies.

      i. This suggestion of cumulative relief existed even before the bizarre *Olmstead* decision discussed below in connection with single member LLCs.

         (a) See *Olmstead v F.T.C.*, 44 So.3d 76, (Fla. 2010), rehearing den'd (Fla. S. Ct. 2010 August 31).

      ii. This suggestion was negated as of October 12, 2006, but would have been revived due *Olmstead* but for the changes in Ohio LLC charging order law arising from Amd. Sub. H.B. 48 (2012), which gave Ohio a "state of the art" set of charging order rules.

      iii. In any event, this history highlights the need to check specific state statutes for:

         (a) State-by-state variations.

         (b) Periodic changes within a state.

V. Charging Orders: The General View on Exclusivity of Remedies

A. The General Proposition - "Exclusive Remedy"

1. The attraction of the charging order is that it is widely considered to be a judgment creditor's exclusive remedy against judgment debtor's

partnership interest.

a. **Note:** Under § 22(3) of the old Uniform Limited Partnership Act (1916) ("ULPA"), the charging order was not exclusive and was instead cumulative in connection with limited partnership interests.

2. Note that membership and partnership interests are personal property belonging to the member or limited partner. See, e.g., Ohio Rev. Code §§ 1705.17 (LLC), 1782.39 (LP), 1775.25 (GP).

3. This personal property interest would be subject to attachment in the absence of any special legislation to the contrary. However, the charging order legislation and related case law bars a creditor from simply seizing or attaching these interests.

a. *See In re Stocks,* 110 B.R. 65, 66 (Bankr. N.D. Fla. 1989) (partnership interests are personal property; personal property was subject to levy, execution and sale at common law; but the UPA and ULPA have made the charging order "the only means by which a judgment creditor can legally command payment from" a bankrupt limited partner's partnership interest).

b. *Atlantic Mobile Homes, Inc. v. LeFever,* 481 So. 2d 1002 (Fla. App. 1986) (similar).

4. As a result of the exclusive nature of the remedy, creditors seeking to get value out of an LLC or partnership interest cannot simply levy and execute. They must instead go through the charging order process, which is cumbersome and affords limited relief.

a. With LPs and LLCs, a creditor may be confronted with an "if and when" situation where the creditor may need to wait forever.

b. With a GP interest, the charging order expressly gives creditors various cumulative remedies, but anything beyond the normal "if and when" charge is traditionally left for unusual circumstances, which at least slows a creditor. *See, e.g., Brown, Janson & Co. v. Hutchinson & Co.* [1895], 2 Q.B. 126, 130-131, 132.

5. Examples of this "exclusivity" view:

a. *Farmers State Bank v. Mikesell,* 51 Ohio App. 3d 69, 77, 554 N.E.2d 900, 907, n. 10 (Darke 1988) ("there is agreement among states that

have adopted the Uniform Partnership Act that the charging order is virtually the exclusive remedy for a creditor who wishes to attach the partner's interest in the partnership," but "there is some confusion as to how a charging order, once obtained, is to be applied").

b. *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363, 366 (Conn. App. Ct. 1994).

c. *Chrysler Credit Corp. v. Peterson,* 342 N.W.2d 170, 172 (Minn. App. 1984) (similar).

d. *In re Stocks,* 110 B.R. 65, 66 (Bankr. N.D. Fla. 1989).

e. Revised Uniform Partnership Act (1994) ("RUPA"), 6 ULA 1 *et seq.*, § 504(e) ("This section provides the exclusive remedy by which a judgment creditor of a partner or a partner's transferee may satisfy a judgment out of the judgment debtor's transferable interest in the partnership").

f. RUPA § 504, Cmt. 5, stating, "Subsection (e) provides that the charging order is the judgment creditor's exclusive remedy. Although the UPA nowhere states that a charging order is the exclusive process for a partner's individual judgment creditor, the courts have uniformly so interpreted it."

g. RUPA § 504, Cmt. 5, citing:

i. *Matter of Pischke,* 11 B.R. 913 (E.D. Va. 1981).

ii. *Baum v. Baum,* 51 Cal. 2d 610, 335 P.2d 481 (1959).

iii. *Atlantic Mobile Homes, Inc. v. LeFever,* 481 So. 2d 1002 (Fla. App. 1986).

6. Consequently, many people favor LLCs and LPs over corporations because their creditors cannot attach and sell their ownership interest.

B. State by State Variations on Exclusivity

1. While most states have charging order protection, not all state statutes make the charging order remedy "exclusive."

a. Much depends on case law, as noted by the Commissioner's Cmt. 5 to RUPA § 504, quoted *supra*.

2. Some statutes expressly state that the remedy is exclusive. See, e.g., Ariz. Rev. Stat. § 29-655(C).

VI. Ohio's View on Exclusivity in Connection with LLCs

A. Before May 2012, Ohio ***seemed*** to be an "exclusive remedy" state, at least for ***partnership*** interests.

1. *Farmers State Bank v. Mikesell*, 51 Ohio App. 3d 69, 77, 554 N.E.2d 900, 907 (Darke 1988) ("If the creditor of an individual partner has obtained a judgment against a partner, his sole means of attaching the partner's interest in the partnership is the charging order") (construing Uniform Partnership Act).

2. Ohio RULPA, Ohio Rev. Code § 1782.41(A) ("To the extent so charged, the judgment creditor shall have ***only*** the rights of an assignee of the partnership interest") (emphasis added).

B. Before May 2012, it also ***seemed*** that way for LLC interests

1. See, e.g., *FirstMerit Bank, N.A. v. Washington Square Enterprises*, 2007 WL 2206545 (Ohio App. Cuyahoga) (discussing the rights of creditors as assignees of LLC member under ORC §§ 1705.18 and 1705.19 and strongly suggesting that Ohio's pre-2012 statute, which used "only" when referring to the rights of creditors under the charging order, created a narrow and exclusive remedy).

C. As of May 2012, Ohio is ***definitely*** an "exclusive" remedy state for LLCs.

1. See Ohio Amd. Sub. H.B. 48 (2012), which clearly and explicitly made Ohio an "sole and exclusive remedy" state pursuant to changes to Ohio Rev. Code § 1705.19.

2. See also *Knollman-Wade Holdings, L.L.C. v. Platinum Ridge Properties, L.L.C.*, 2015-Ohio-1619 (Ohio App. 10th Dist.) (discussing exclusive and limited nature of Ohio's LLC charging order remedy).

3. For details of Ohio's law as of May 2012, see below in § XI, "Special Recognition."

D. Previously, though, things were a little unclear under Ohio LLC law.

1. Ohio Until October 12, 2006, Ohio's LLC charging order statute was arguably cumulative, not exclusive.

a. Until October 12, 2006, Ohio's LLC statute did not say that the creditor of an LLC member had "only" the rights of an assignee. Instead, Ohio Rev. Code 1705.19 stated:

> "If any judgment creditor of a member of a limited liability company applies to a court of common pleas to charge the membership interest of the member with payment of the unsatisfied amount of the judgment with interest, the court may so charge the membership interest. To the extent the membership interest is so charged, ***the judgment creditor has the rights of an assignee*** of the membership interest."

(Emphasis added.)

b. The omission of "only" from the LLC statute may have been a legislative oversight, but it may also have been an intentional omission meant to give creditors additional rights against LLC members.

c. Therefore, a court dealing with an Ohio LLC operating under the pre-October 2006 law might have had more latitude to look to other remedies on the grounds that the "if and when a distribution is made" theory is not the "only" approach allowed under Ohio law.

2. However, under the October 2006 Ohio LLC law, the word "only" was inserted, and the key sentence stated:

> To the extent the membership interest is so charged, the judgment creditor has ***only*** the rights of an assignee of the membership interest.

(Emphasis added.)

a. As a result of the 2006 change, it seemed unlikely that Ohio's charging order allowed cumulative remedies in relation to LLC membership interests.

b. Thus, after the 2006 changes, and even before the 2012 changes, Ohio was probably an "exclusive" remedy state, at least insofar as a creditor wants to "get" a debtor's membership interest.

   i. See, e.g., *FirstMerit Bank, N.A. v. Washington Square Enterprises*, 2007 WL 2206545 (Ohio App. Cuyahoga) (discussing the rights of creditors as assignees of LLC member under ORC §§ 1705.18 and 1705.19 and strongly suggesting that Ohio's "only" style statute creates a narrow and exclusive remedy).

c. However:

   i. Because Ohio's pre-2012 law did not expressly bar creditors from exercising other legal or remedies against an LLC or its property, Ohio's old and arguable "exclusivity" probably did not bar other attacks that aimed at something besides a membership interest per se. See infra regarding "Direct Action" theories.

   ii. The pre-2012 exclusivity might not have extended to single member LLCs in the wake of Florida's controversial *Olmstead* decision.

      (a) See Loeffler & Sullivan, *Ohio LLCs After Florida's Olmstead Decision: Why Ohio LLCs are No Good Anymore, How to Fix Them, and What to Do Until They're Fixed*, Probate Law Journal of Ohio, Vol. 21, No. 2, p. 66 (November/December 2010).

VII. Foreclosure on LP Interests: RULPA (1976) Charging Order Rules

A. Many states still function under the 1976 version of RULPA.

B. A growing number of RULPA (1976) states allow for foreclosure and sale of an LP interest. This seems to be the emerging trend.

1. Cases allowing foreclosure:

    a. *BayBank v. Catamount Const., Inc.,* 693 A.2d 1163 (N.H. 1997).

    b. *Centurion Corp. v. Crocker Nat. Bank,* 255 Cal. Rep. 794, 208 Cal.App.3d 1 (App. 1st Dist. 1989).

    c. *Deutsch v. Wolff,* 7 S.W.3d 460, 463 (Mo. App. 1999) (partner foreclosed on held both general and limited partner interests).

2. Cases disapproving of foreclosure:

    a. *In re Stocks,* 110 B.R. 65 (Bankr. N.D. Fla. 1989).

    b. *See also Chrysler Credit Corp. v. Peterson,* 342 N.W.2d 170 (Minn. App. 1984).

C. The courts allowing LP foreclosure rationalize that foreclosure is not separate or distinct from the charging order system.

1. Instead, these courts claim that foreclosure is an allowed part of the charging order system, and is in fact necessary if a creditor is to have any meaningful recourse in many cases. *See, e.g., BayBank, v. Catamount Const., Inc.,* 693 A.2d 1163, 1166 (N.H. 1997).

2. These courts allow foreclosure even though RULPA gives holders of charging orders "only" the rights of an assignee. *See, e.g., Lauer Const., Inc. v. Schrift,* 716 A.2d 1096, 1099 (Md. Spec. App. 1998) (reviewing Maryland RULPA); *BayBank v. Catamount Const., Inc.,* 693 A.2d 1163, 1166 (N.H. 1997) (quoting New Hampshire RULPA).

D. Foreclosure is often justified as a remedy in LP cases by means of the gap clause of RULPA, which incorporates UPA into RULPA "in any case not provided for" by RULPA.

1. See RULPA § 1105.

E. As a result, the foreclosure option that is plainly available under UPA's charging order system is said to also be available (by means of importation) under RULPA.

F. *See, e.g.* the following cases as examples of the "import" logic:

1. *BayBank v. Catamount Const., Inc.,* 693 A.2d 1163 (N.H. 1997).

2. *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363 (Conn. App. Ct. 1994).

3. *Lauer Const., Inc. v. Schrift*, 716 A.2d 1096 (Md. Spec. App. 1998) (allowing sale of general partner's interest in a limited partnership pursuant to Maryland UPA rules).

4. *Tupper v. Kroc*, 494 P.2d 1275 (Nev. 1972) (allowing sale of general partner's interest in a limited partnership pursuant to UPA rules).

5. *Deutsch v. Wolff*, 7 S.W.3d 460, 463 (Mo. App. 1999) (construing Missouri UPA in case in which foreclosed partner had both limited and general partnership interests).

6. *See also Major Real Estate & Investment Corp. v. Republic Financial*, 695 P.2d 893, 894 (Okla. App. 1985).

G. Note that, technically, the courts are applying the RULPA charging order, not the UPA charging order, even when foreclosing on a general partner's interest in a limited partnership.

1. *See, e.g., Lauer Const., Inc. v. Schrift*, 716 A.2d 1096, 1098 (Md. Spec. App. 1998); *cf.* Ohio Rev. Code §§ 1782.41(A) (Ohio RULPA's charging order is available to judgment creditor of "a" partner, and not just limited partners); *id.* (holder of a charging order treated as an assignee); 1782.42(A) (giving assignees of general partners same treatment as assignees of limited partners)

2. *But see Tupper v. Kroc*, 494 P.2d 1275 (Nev. 1972) (relying on UPA rules without referring to RULPA when upholding sale of general partner's interest in a limited partnership).

H. The "import" courts reason, however, that UPA charging order rules are made part of RULPA under the gap clause.

1. Note that this "importation" logic does not violate the exclusivity premise that underlies most charging order analysis. It merely expands the scope of the RULPA charging order

I. Either way, however, the emerging trend allows foreclosure on interests in a limited partnership.

1. The foreclosure option undermines the "if and when" concept and gives creditors a more powerful collections tool.

2. However, Still, on the rationale adopted by the courts allowing foreclosure, the charging order is still exclusive, albeit much broader than initially thought.

VIII. Foreclosure on LP Interests: RULPA (2001) Charging Order Rules

A. A small but growing number of states are adopting the 2001 version of RULPA.

1. As of June 2004, the NCCUSL website notes that 3 states (HI, IA, and MN) have adopted RULPA (2001) and 2 states (KY and IL) are considering RULPA (2001).

B. RULPA (2001) expressly allows foreclosure and all other UPA-style remedies that are impliedly allowed under the "importing" theory adopted by many RULPA (1976) courts.

1. These UPA-style remedies are expressly set forth in RULPA (2001) § 703.

C. Consequently, RULPA (2001) portends the end of charging order protection for many FLPs.

D. Note, however, that many states, when enacting a Uniform Act like RULPA (2001), will often apply it prospectively with an "opt in" clause for pre-existing entities. Ergo:

1. FLPs formed before "new" RULPA takes effect may still be very protective, depending upon whether the state of organization follows "old" RULPA's "importing" theory.

IX. Foreclosure on LLC Interests

A. LLC membership interests may not be exposed to the same risk of foreclosure as interests in a limited partnership.

B. LLC statutes typically do not have gap clauses that incorporate UPA.

1. Therefore, a court would need to resort to other means of statutory construction to justify entry of a foreclosure order in an LLC case.

C. The lack of a statutory basis to import UPA-style charging orders may slow the march to foreclosure as part of the LLC charging order system.

D. However, some courts might just simply say that the omission of specific charging order enforcement mechanisms, such as foreclosure or receivership, was merely the omission of "superfluous" language, and that these unmentioned enforcement mechanisms are implicit in the statute. This is the approach taken by several courts analyzing RULPA:

1. *Lauer Const., Inc. v. Schrift*, 716 A.2d 1096, 1099 (Md. Spec. App. 1998) (noting that Commissioners on Uniform Laws expressly described certain omitted verbiage as "superfluous").

2. *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363, 368 (Conn. App. Ct. 1994) (similar).

E. However, at least one recent LLC case suggest that this "superfluous language" analysis will not prevail, and that "if and when" logic will control in the absence of specific statutory language to the contrary. *See Herring v. Keasler*, 150 N.C. App. 598 (Wake County 2002).

F. In contrast, at least two states have, as of 2005, expressly allowed foreclosure, receiverships, and other broad UPA-style relief in connection with their LLC charging order systems:

1. Colorado: C.R.S. § 7-80-703 (court has broad authority to enter orders).

2. Illinois: 805 ILCS 180/30-20 (near-verbatim replication of UPA § 28).

G. Also, according to the website for the National Conference of Commissioners on Uniform State Laws, as of November 2019, at least 21 jurisdictions (including Illinois, noted above), have adopted the Uniform LLC Act.

1. Section 504 of the model Uniform LLC Act allows broad UPA-style relief for creditors:

a. Foreclosure

b. Receivership

c. The Judicial Blank Check

i. Sec. 504 authorizes the court to enter "all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order."

2. However, some states, like South Dakota, have adopted the model Act with significant revisions to its charging order rules.

X. What Is Being Foreclosed Upon?

A. A partnership or membership interest carries two (LLC) or three (partnership) basic "sticks" in the "bundle" of ownership rights:

1. An interest in the partnership or LLC itself.

a. This is personal property.

2. An interest in specific partnership property.

a. Partnerships and LLCs differ in this regard.

i. In a partnership, this is held as a "cotenant in partnership."

ii. In an LLC, the company property is usually just that – company property in which the member has no ownership interest. See Ohio Rev. Code § 1705.34.

b. In the absence of authority conferred by the partnership or operating agreement, such property cannot be sold or assigned without the consent of all other partners or members.

3. The right to participate in management of the entity.

a. This right is usually a very limited one in connection with limited partnerships and manager-managed LLCs.

Representative cases and authorities: Ohio Rev. Code § 1705.34 (regarding titling of LLC property); *Deutsch v. Wolff,* 7 S.W.3d 460 (Mo. App. 1999) (partnership attributes); *Madison Hills Limited Partnership II v. Madison Hills, Inc.,* 644 A.2d

363 (Conn. App. Ct. 1994) (same); *Rector v. Azzato*, 539 A.2d 1162 (Md. App. 1988) (same).

B. Foreclosure affects only the first attribute – the interest in the entity, which is the right to distributions.

1. Charging order entitles a creditor to receive the debtor's distributions. *Rector*, 539 A.2d at 1165.

2. Charging order affects only a partner's interest in the partnership. *Madison Hills*, 644 A.2d at 366.

3. Foreclosure on the partnership interest is permissible. Id., 368 - 371; *Deutsch*,7 S.W.3d at 463.

4. The interest in the entity is the right to share in the profits and surpluses. See Id.

5. "[A] charging creditor does not become a full partner, is not entitled to manage the partnership, and has no right to attach specific partnership property." *Madison Hills*, 644 A.2d at 367.

a. Note, however, the following:

i. The same "gap" argument that entitles creditors to foreclose may allow creditors to exercise other rights as well, including management rights.

ii. Gap clause imports UPA-style charging order rights into RULPA setting, hence allowing foreclosure. *Id.*, 644 A.2d at 367 - 371.

iii. UPA allows for receivership. See, e.g., Ohio Rev. Code § 1775.27.

iv. A charging order receiver of a general partner stands in the debtor's shoes and may do whatever the debtor-partner could do, including ask for dissolution of the partnership. See, e.g., *Leventhal v. Five Seasons*, 581 A.2d 449 (Md. Spec. App. 1990).

v. See also *Deutsch*,7 S.W.3d at 462 (noting that trial court gave receiver management duties held by debtor partner);

463 - 465 (upholding trial court).

C. Courts sometimes disagree on precisely what foreclosure method to follow:

1. Foreclosure by Sale

a. This is a simple sale to the highest bidder without regard to market value and has been allowed for some time.

b. See, e.g., *Madison Hills,* 644 A.2d at 369 - 370 (defining procedure), 368 (collecting cases approving foreclosure by sale); *Deutsch,*7 S.W.3d at 462 - 463 (approving foreclosure by sale).

c. **NOTE:** Under foreclosure by sale, "fire sale" syndrome may result.

2. Strict foreclosure:

a. This cuts off the equity of redemption held but also appraises the foreclosed interest at fair market value.

b. This is more potentially protective of the debtor if he decides to let the strict foreclosure proceed, as FMV could be higher than fire sale prices, thus getting more value applied against the outstanding judgment debt.

c. However, strict foreclosure could be costlier if he wants to redeem, as FMV could be much more than "fire sale" prices.

d. See *Madison Hills,* 644 A.2d at 369 - 370.

D. The emerging trend seems to be that both types of foreclosure are available, and that either party may ask for either type of foreclosure. Id.

E. The effect of foreclosure is very simple: "[A]fter the sale, the... partner had no rights to the profits, surplus, or any equity in the partnership property although the sale of his interest did not divest the... partner of his other partnership rights." *Deutsch,* 7 S.W.3d at 463 (discussing foreclosure on a general partnership interest).

XI. Special Recognition - DE, OH, SD, TX, VA, AK, and NV

A. Certain states have developed very clear – and very narrow – forms of charging order relief for creditors.

B. **Delaware** has flipped and flopped and flipped again.

1. Delaware's LLC charging order appears at 6 Del. Code § 18-703.

2. Under its initial version, Delaware's charging order provisions were could be read as providing "if and when" relief, for reasons similar to those set forth in *Herring v. Keasler*, 150 N.C. App. 598 (Wake County 2002).

3. Delaware then went to "broad relief" by expressly allowing foreclosures, accountings, receiverships, and the "judicial blank check" that allowed courts broad discretion to enter orders that they deemed appropriate on the circumstances of the case.

4. However, effective August 2005, Delaware has amended its statute (again) and now very explicitly and expressly:

a. Adopts the "if and when," "narrow remedy" approach to the charging order.

i. See generally 6 Del. Code § 18-703 (2013).

b. Deprives creditors of any other legal or equitable remedy to attach or reach LLC assets. See revised 6 Del. Code § 18-703 (2013).

c. Provides that the narrow charging order rules apply to single member LLCs as well as to multi-member LLCs.

i. See 6 Del. Code § 18-703(d) ("The entry of a charging order is the exclusive remedy... whether the limited liability company has 1 member or more than 1 member").

d. Binds assignees to the terms and conditions of an operating agreement, even if the assignee didn't sign the agreement.

i. See 6 Del. Code § 18-101(7) (2013).

ii. This clears up a major uncertainty as to the effect of operating agreements on creditors who become, or who are

treated as, assignees.

iii. This also gives clients and planners a chance to:

(a) Eliminate any creditors' rights other than the narrow "if and when" remedy; and,

(b) Load up an LLC agreement with "poison pills." Cf. *In re Ehman,* 319 B.R. 200, 205 (Bankr. D. Ariz. 2005) (discussing effect of capital call provisions on a bankruptcy trustee).

5. **Note:** Delaware has also adopted comparable provisions in connection with its limited partnership statute.

6. Delaware also has a clear, and explicit, policies of maximizing parties' freedom of contract and enforcing those agreements upon the parties.

a. See 6 Del. Code § Section 18-1101(b) of the Delaware LLC Act, which states, "It is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

b. See also *Elf Atochem N. America, Inc. v. Jaffari,* 727 A.2d 286 (Del. 1999).

7. There is essentially only one restriction on the parties' right to fashion their own operating agreement: "[T]he limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." 6 Del. Code § 18-1101(c).

a. Note, though, that even this is not necessarily a very strict or onerous burden, and in general it's very, very difficult to show a breach of the implied covenant if the parties are simply acting pursuant to the written terms of their agreement.

b. Delaware has clearly articulated this view, as shown by *Dunlap v. State Farm Fire & Cas. Co.,* 878 A.2d 434, 440 – 442 (Del. 2005), which states (internal quotes, ellipses, brackets, and footnotes omitted; emphasis added):

> By the twentieth century, courts and commentators clarified the doctrine, steadily referring to the newly-

> coined implied covenant of good faith and fair dealing. Despite its evolution, the term good faith has no set meaning, serving only to exclude a wide range of heterogeneous forms of bad faith. The covenant is best understood as a way of implying terms in the agreement, whether employed to analyze unanticipated developments or to fill gaps in the contract's provisions. ***Existing contract terms control, however, such that implied good faith cannot be used to circumvent the parties' bargain, or to create a free-floating duty unattached to the underlying legal document. Thus, one generally cannot base a claim for breach of the implied covenant on conduct authorized by the terms of the agreement.*** Recognized in many areas of the law, the implied covenant attaches to every contract, including contracts of insurance.
>
> Stated in its most general terms, the implied covenant requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain. Thus, parties are liable for breaching the covenant when their conduct frustrates the overarching purpose of the contract by taking advantage of their position to control implementation of the agreement's terms. This Court has recognized the occasional necessity of implying contract terms to ensure the parties' reasonable expectations are fulfilled. ***This quasi-reformation, however, should be a rare and fact-intensive exercise, governed solely by issues of compelling fairness. Only when it is clear from the writing that the contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate with respect to that matter may a party invoke the covenant's protections.***

c. Ohio shares Delaware's view on these matters:

   i. Ohio Rev. Code § 1705.081, pursuant to amendments effective 2016 July 7, expressly allows parties to an LLC

operating agreement to modify and even outright waive all duties of care and loyalty.

(a) Ohio Rev. Code § 1705.081(B)(5) also made the duty of good faith and fair dealing non-waivable, but it allows the parties to "prescribe the standards by which the performance of the obligation is to be measured."

ii. See, e.g., also *Ed Schory & Sons, Inc. v. Soc. Natl. Bank*, 75 Ohio St.3d 433, 443 – 444, 662 N.E.2d 1074 (1996), quoting *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357-1358 (7th Cir 1990) (internal ellipses omitted):

> Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of 'good faith.' Although courts often refer to the obligation of good faith that exists in every contractual relation, this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. 'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.

8. *Elf* provides an in-depth discussion of the origins and development of Delaware's LLC Act, and of the fact that is a preferred model for other States and their statutory draftsmen. For example, *Elf*, 727 A.2d at 289 – 291 (footnotes omitted) states:

> The phenomenon of business arrangements using "alternative entities" has been developing rapidly over the past several years. Long gone are the days when business planners were confined to corporate or partnership structures.
>
> Limited partnerships date back to the 19th Century. They

became an important and popular vehicle with the adoption of the Uniform Limited Partnership Act in 1916. Sixty years later, in 1976, the National Conference of Commissioners on Uniform State Laws approved and recommended to the states a Revised Uniform Limited Partnership Act ("RULPA"), many provisions of which were modeled after the innovative 1973 Delaware Limited Partnership (LP) Act. Difficulties with the workability of the 1976 RULPA prompted the Commissioners to amend RULPA in 1985.

To date, 48 states and the District of Columbia have adopted the RULPA in either its 1976 or 1985 form. Delaware adopted the RULPA with innovations designed to improve upon the Commissioners' product. Since 1983, the General Assembly has amended the LP Act eleven times, with a view to continuing Delaware's status as an innovative leader in the field of limited partnerships.

The Delaware Act was adopted in October 1992. The Act is codified in Chapter 18 of Title 6 of the Delaware Code. To date, the Act has been amended six times with a view to modernization. The LLC is an attractive form of business entity because it combines corporate-type limited liability with partnership-type flexibility and tax advantages. The Act can be characterized as a "flexible statute" because it generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act. Indeed, the LLC has been characterized as the "best of both worlds."

The Delaware Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act. Under the Act, a member of an LLC is treated much like a limited partner under the LP Act. The policy of freedom of contract underlies both the Act and the LP Act.

In August 1994, nearly two years after the enactment of the Delaware LLC Act, the Uniform Law Commissioners promulgated the Uniform Limited Liability Company Act (ULLCA). To coordinate with later developments in

> federal tax guidelines regarding manager-managed LLCS, the Commissioners adopted minor changes in 1995. The Commissioners further amended the ULLCA in 1996. Despite its purpose to promote uniformity and consistency, the ULLCA has not been widely popular. In fact, only seven jurisdictions have adopted the ULLCA since its creation in 1994. A notable commentator on LLCs has argued that legislatures should look to either the Delaware Act or the Prototype Act created by the ABA when drafting state statutes.

C. **Ohio,** pursuant to Amd. Sub. H.B. 48 (2012), and effective as of May 2012, has adopted very good LLC legislation (but there are no similar counterpart rules for LPs). Specifically, LLC law will be very "Delaware-like" and will provide as follows:

1. Charging order rules will apply in the same fashion to both multi-member and single member LLCs.

   a. See Ohio Rev. Code § 1705.031, effective 2016 July 6

      i. This Code section expressly makes all provisions of the Ohio LLC Act, other than those provisions dealing with foreign LLCs, applicable to "to all limited liability companies formed under [Ohio law] whether the limited liability company has one or more members or whether it is formed by a filing under section 1705.04 of the Revised Code [i.e., by an original filing in Ohio] or by merger, consolidation, or conversion."

   b. The new statutory rule is consistent with earlier official comments from the Corporation Law Committee of the Ohio State Bar Association, which also gave similar charging order treatment to single member and multi-member LLCs.

      i. See Comments on 129th General Assembly, HB 48, from the Ohio State Bar Association Corporation Law Committee (2012), stating (emphasis added):

         > New [ORC § 1705.19] divisions (B) and (C) have been added to state that a judgment creditor's sole and exclusive remedy with respect to a membership interest in a limited

liability company is a charging order. ***The charging order is the only remedy, whether the membership interest is or is not evidenced by a certificate, or whether it is a membership interest of a single member limited liability company.***

2. Charging orders are narrow, limited, and exclusive.

   a. Creditors of a debtor-member may get a charging order. Ohio Rev. Code § 1705.19(A). See also *Knollman-Wade Holdings, L.L.C. v. Platinum Ridge Properties, L.L.C.,* 2015-Ohio-1619 (Ohio App. 10th Dist.) (establishing exclusive and narrow nature of Ohio's charging order remedy).

   b. Creditors with a charging order have "only" the rights of an assignee. Ohio Rev. Code § 1705.19(A).

      i. Ohio Rev. Code § 1705.18(A) basically makes assignees wait for distributions if and when they are made, and bars assignees from exercising any other rights.

   c. This limited relief is a creditor's "sole and exclusive remedy." Ohio Rev. Code § 1705.19(B).

   d. Creditors are expressly barred from exercising any other legal or equitable remedy vis-a-vis the LLC or its property. Ohio Rev. Code § 1705.19(C).

   e. The LLC or other non-debtor members may buy the charged interest at any time by paying the judgment creditor the amount then due under the judgment. Ohio Rev. Code § 1705.19(D).

      i. This could be valuable if the membership interest has appreciated to being worth more than the balance owed on the judgment.

3. Assignees are bound to the terms of an operating agreement by operation of law, even if they didn't sign the agreement. Ohio Rev. Code § 1705.18(B).

D. **South Dakota** also has Delaware-like LLC law:

1. See SDCL §§ 47-34A-504 (LLCs) and 48-7-703 (LPs).

2. These statutes were last upgraded in 2009, as part of a conscious and ongoing effort by South Dakota to keep its jurisdiction as competitive as possible.

E. **Texas,** is very similar to Delaware for both LLC and LP purposes:

1. Texas LLCs

a. Texas LLCs now have Delaware-style charging order remedies, including a clause eliminating any other legal or equitable remedies to or against the LLC's property. See Tx. Bus. Org. Code § 101.112

b. Like Delaware, Texas distinguishes between assignees and judgment creditors. See Id.

i. Consequently, judgment creditors are just creditors, and aren't assignees.

c. Texas LLC operating agreements are also binding on assignees (although Texas is not quite as resoundingly explicit as Delaware).

i. See Tx. Bus. Org. Code § 101.052(a)(1) ("operating agreement "governs... relations among members, ...assignees..., and the company itself").

2. Texas LPs

a. Texas LPs also have Delaware-style charging order remedies. See Tx. Bus. Org. Code § 153.256.

b. Judgment creditors are not assignees. Id.

c. Assignees are bound by partnership agreements. Tex. Bus. Org. Code § 153.253(b).

F. **Virginia** is also good.

1. Under Va. § 13.1-1041-1 (LLCs) and § 50-73.46:1 (LPs), charging order rules in Virginia:

a. Outline the remedies of judgment creditors as such, and do not

equate judgment creditors with assignees.

b. Give creditors a charging order lien on distributions attributable to a member's or partner's ownership interest.

c. Prevent any other remedies vis-a-vis the ownership interest (e.g., no foreclosures).

d. And, significantly, expressly state that creditors have no other legal or equitable remedies vis-a-vis LLC or LP property.

2. Unlike Delaware, Virginia operating agreements can ***give rights*** to any third party (which necessarily includes assignees), but does not expressly provide that assignees are bound by these agreements.

i. See Va. § 13.1-1023(A)(1) (explaining effect of LLC operating agreements and allowing conferment of rights but not providing for automatic binding of assignees) and § 13.1-1001.2 (definition of operating agreement silent on this point).

b. The Virginia limited partnership statute has even less to say on this matter than does the Virginia LLC statute.

c. Hence, the "poison pill" effect against assignees may be much weaker in Virginia than in Delaware or Texas.

3. Virginia does follow Delaware's lead and expressly endorses the principle of maximizing the parties' right to freely contract, at least for LLCs.

a. See Virginia § 13.1-1001.1(C).

G. **Alaska** also has a debtor-friendly, creditor-hostile LLC and LP charging order provision.

1. See A.S. §§ 10.50.375, 10.50.380 (LLCs), 32.11.330, 32.11.340 (LPs) (providing that the charging order lien on distributions is the exclusive way to get value out of a debtor's partnership or membership interest, and prohibiting foreclosures and other remedies vis-a-vis those interests).

2. However, unlike Delaware, Texas, and Virginia, Alaska does not clearly or expressly prohibit other actions by creditors directed against the company/partnership itself or its assets.

a. The relevant statutory charging order language, which clearly limits the remedies and relief available with a charging order per se, might also be construed to prohibit "direct actions" that are supplemental to a charging order.

i. See, e.g., A.S. § 10.50.380(c).

3. And, unlike Delaware LLCs and LPs, and also unlike Texas LLCs, Alaska does not clearly bind assignees to operating agreements by operation of law.

H. **Nevada** rules are similar to the Alaska rules.

1. See N.R.S. §§ 86.401, 86.351 (LLCs), 87A.475, 87A.480 (LPs).

2. Unlike Delaware, Nevada does not expressly bind assignees to operating agreements.

3. Nevada also has a history of "flip-flopping" from a narrow "if and when" approach to an UPA style, broad creditors' rights approach in 2001, and then in a special session in July 2003 went back to the "if and when" approach.

a. See N.R.S. § 86.401 (2004) (espousing the narrow rule of creditor's rights under the charging order).

b. For legislative change from UPA-style remedies back to narrow creditor remedies, see 2003 Statutes of Nevada, 20th Special Session, p. 71.

i. The short-lived UPA style relief was a near verbatim duplicate of Delaware's "old" UPA-style statute.

XII. Priority Among Competing Charging Orders

A. A charging order creates a lien.

1. According to case law, this lien is, in effect, "perfected" when the papers creating the charging order are served on the entity in which the debtor holds an ownership interest.

a. See, e.g., *Union Colony Bank v. United Bank,* 832 P.2d 1112 (Colo. App. 1992).

B. If more than one creditor has a charging order, the general rule is "first in time, first in line," i.e., earlier "perfected" charging order liens take priority over subsequently "perfected" charging order liens, even if the subsequently perfected lien arises from a charging order that was entered before the order creating the earlier-perfected lien. Examples include:

1. *Union Colony Bank v. United Bank,* 832 P.2d 1112 (Colo. App. 1992).

2. *First Mid-Illinois Bank v. Parker,* 403 Ill. App. 3d 784, 794 – 795, 933 N.E.2d 1215 (2010), stating:

> Although the Limited Liability Company Act does not detail the priorities to be given to multiple judgment creditors that obtain charging orders directed to the same limited liability company interest, generally, a lien that is first in time has priority and is entitled to prior satisfaction out of the property it binds.

C. A court can issue a charging order and create a lien but reserve for later determination the question of priority among liens. See, e.g., the following:

1. *LaSalle Bank, N.A. v. Tuke,* Case No. C-090444 (Ohio Ct. App. Hamilton 2010 March 31).

2. *First Mid-Illinois Bank v. Parker,* 403 Ill. App. 3d 784, 789, 933 N.E.2d 1215 (2010) (noting the trial court reserve for later determination the question of priority among competing charging order liens and other liens).

D. A defective charging order will not be effective and thus will not gain lien priority over any other charging order lien, even ones created by subsequent charging orders.

1. See, e.g., *JPMorgan Chase Bank, N.A. v. McClure,* 393 P.3d 955, 960 – 961, (Colo. 2017) (en banc), stating, "[D]etermining the relative priorities of the competing charging orders requires us to ascertain when each order became effective or enforceable. This is because any assessment of the relative priorities of competing charging orders mandates comparing only effective and enforceable orders to one another (assuredly, an unenforceable or ineffective order could not take priority over an enforceable, effective one)." (Internal cites omitted.)

XIII. Possible Creditor Attacks on FLLCs or FLPs

Note: As of August 2005, the following discussion does not apply to LLCs in Alaska and Delaware, nor does it apply to Delaware LPs.

Other states have also adopted more debtor-friendly, creditor-hostile laws, since 2005, thus rendering these arguments wholly or partially inapplicable under the charging order rules of such states.

See, e.g., **Section XI, Special Recognition - DE, OH, SD, TX, VA, AK, and NV**

A. Some planners advocate using the family limited partnership ("FLP") or family limited liability company ("FLLC") as a personal holding company for asset protection purposes.

1. Provides charging order protection.

a. Presumed to be "exclusive" remedy.

i. No attachment of underlying assets because they are company assets and not those of the members.

2. Phantom income threat. See Rev. Rule 77-137, 1977-1 C.B. 178.

3. Cheaper than a trust:

a. No trustee fees, less complicated to set up, etc.

4. Allows for direct client control of assets:

a. Client can act as manager (FLLC) or general partner (FLP).

B. Note that these considerations all lead many planners and clients to regard FLLCs as a "trust substitute."

C. However:

1. The risk of phantom income may be more bark than bite due to the economic substance rules of the tax code. See IRC § 704(b)(2).

2. The "if and when" aspect of the charging order remedy may be just the first

level of relief afforded to creditors under the charging order.

a. Foreclosure and other UPA-style relief is emerging as a real risk in connection with charging orders.

3. The charging order may not be really exclusive in any event.

a. If the client uses the tool as a trust substitute, don't be surprised if the FLLC or FLP is held to trust standards, as shown *infra.*

b. There are other potential remedies besides trust-based theories. *See infra.*

D. The exact language of the charging order provision shows that it is exclusive, if at all, only as to claims against the debtor's interest in the LLC or LP. For example:

1. RULPA § 703 addresses the rights held by "any judgment creditor of a partner."

2. Ohio Rev. Code § 1705.19 addresses the rights held by "any judgment creditor of a member."

E. ***Key point:*** The charging order statute is ***usually*** inapplicable to any direct claims brought against an LLC.

1. ***Exception:*** Certain states, like Delaware, Virginia, and Texas, have charging order provisions that bar creditors of members or partners from taking direct actions to seize the entity's property. See above.

F. Thus, the charging order provision does not bar attachment of the LLC assets if there is a legal theory that allows a direct action against the LLC.

1. *See Baum v. Baum,* 51 Cal. 2d 610, 335 P.2d 481 (1959), at n. 2, in which the court, when discussing the charging order, expressly noted the distinction between "a creditor of an individual partner as distinguished from a creditor of the partnership."

2. *Schultz v. Ziegenfuss,* 253 A.2d 180, 183 (N.J. App. 1969) (partnership property may be attached only on actions against the partnership).

XIV. Direct Action Theories: What and Who are Creditors Targeting?

A. Charging order remedies typically effect how a creditor can get to a debtor's membership or limited partnership interest.

1. See, e.g., RULPA (2001) § 703(e) ("This section provides the exclusive remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of the judgment debtor's transferable interest").

2. Apart from Delaware, the charging order provisions of an LP or LLC statute do not preclude any "direct action" against the entity itself of the assets transferred to the entity.

a. The Delaware Difference:

i. In addition to making the charging order the exclusive way of reaching a debtor's membership or limited partnership interest, see 6 Del. Code §§ 18-703(d), 17-703(d), Delaware also expressly limits a creditor's rights to invoke other remedies:

(a) LLCs – 6 Del. Code § 18-703(e) states, "No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."

(b) LPs – 6 Del. Code § 17-703(e) (similar).

ii. A creditor's rights are therefore substantially limited by the Delaware statutory rules.

B. Consequently, under the LLC and LP laws of most states, creditors can maintain "direct actions" against LLCs, LPs, and their assets if the facts will support such a claim.

C. There are at least 5 possible ways for creditors to mount a "direct action" against an asset protection plan based on a FLLC or FLP:

1. Fraudulent transfers law

2. Veil piercing and reverse pierces

3. Constructive trust

4. Resulting trust plus the rule against self-settled trust ("RASST")

5. Creditor's bill

D. Put differently, "direct actions" raise questions of who and what a creditor is targeting.

1. Who is the target?

a. The target defendant is the entity itself (i.e., the LP or LLC), and is not the judgment debtor.

2. What is being targeted?

a. The target assets are the assets owned by the entity, and not any proceeds attributable to the judgment debtor's ownership interest.

E. See below for more regarding "when" and "who," i.e., when exactly is a creditor acting and who exactly is he (and what is the status) at that time.

XV. The Uniform Fraudulent Transfers Act ("UFTA")

A. If a transfer to an LLC is actually or constructively fraudulent, it can be unravelled.

1. *See BayBank v. Catamount Const., Inc.*, 693 A.2d 1163, 1168 (N.H. 1997) (creditor's "recourse lies in fraudulent conveyance law" in connection with allegedly fraudulent transfer of realty to a limited partnership).

2. *Interpool Ltd. v. Patterson,* 890 F.Supp. 259 (S.D. N.Y. 1995).

3. *Firmani v. Firmani,* 332 N.J. Super. 118, 752 A.2d 854 (2000).

B. Transfers to a limited partnership or LLC can be fraudulent if, under the charging order law governing the entity, the transferred assets are essentially unreachable by partner's or member's creditors. *See Interpool Ltd. v. Patterson,* 890 F.Supp. 259 (S.D. N.Y. 1995).

1. Hence, transfers to an entity formed in a true "if and when" charging order jurisdiction may raise a fraudulent transfers issue.

C. However, if the prevailing charging order system is pro-creditor, then the transfer of assets into an LLC in exchange for a membership interest might be deemed an exchange for reasonably equivalent value. See, e.g., Georgia, which provides the following example:

1. The LLC charging order system is expressly non-exclusive, and expressly allows creditors to garnish (i.e., seize) a membership interest. See, e.g., the following:

a. O.C.G.A. § 14-11-504, and especially sub-section (b), which states:

> The remedy conferred by this Code section shall not be deemed exclusive of others which may exist, including, without limitation, the right of a judgment creditor to reach the limited liability company interest of the member by process of garnishment served on the limited liability company.

b. *Word v. Stidham*, 271 Ga. App. 435, 437, 609 S.E.2d 651 (2004), reconsideration denied, in which the court stated (emphasis added):

> Certainly, Mr. Word's transfer of the subject property to the limited liability company made it more difficult for the Stidhams to satisfy their judgment from the property and, therefore, may have been done with the intent to hinder or delay them. As recognized by the trial court and the parties, however, there is a material issue of fact on that question. There is also a material issue of fact on the question of whether Word's interest in the limited liability company is reasonably equivalent in value to the interest he had in the property he transferred to the company. The record contradicts the trial court's finding that the limited liability company is without any assets. Without dispute, the property previously owned by Word and Pyron is the company's sole asset. It does not appear from the record that the company has any countervailing liabilities. ***The record would thus support a finding that Word's one-half interest in the company is reasonably equivalent in value to the one-half interest he had in the property conveyed to the company.*** Therefore, the Stidhams were not

entitled to summary judgment.

2. See also *Venables v. Smith,* 2003 WL 1903779, 2003 Del. Super. LEXIS 131, Case No. 02C-09-126-JOH (Del. Super.), which was decided when Delaware's old pro-creditor charging order statute was still in effect.

   a. In *Venables*, a client sued an attorney for malpractice, alleging that he took too long to fund a new LLC, which was formed as part of a partnership reorganization, and thereby exposed the client to avoidable collection efforts by her creditors.

   b. The attorney sought summary judgment against the client and her malpractice claim on the grounds that the unperformed funding would have been a fraudulent transfer and thus voidable by creditors in any event.

   c. The court denied summary judgment, noting that:

      i. "Insolvency is but one factor to be considered while determining actual intent under [UFTA]." 2003 Del. Super. LEXIS 131 at *9.

      ii. "The fact that the transfer of the property [to the LLC] would make it more difficult for creditors to reach does not lessen the value of the LLC interest..." received by the client in exchange. 2003 Del. Super. LEXIS 131 at *12.

      iii. "If Venables were to receive a one-third interest in a LLC in exchange for her one-third interest in partnership property, that constitutes reasonably equivalent value." 2003 Del. Super. LEXIS 131 at *12.

      iv. "According to Venables, her subjective intent was to avoid personal injury liability, not to hinder, delay or defraud. In short, Venables' subjective intent is a genuine issue of material fact, such that summary judgment is inappropriate." 2003 Del. Super. LEXIS 131 at *10.

3. Of course, if a state's charging order system is very pro-creditor, then why would an asset protection planner form entities in that jurisdiction in the first place?

4. Consequently, in a pro-debtor LLC jurisdiction, it's much less likely that

the membership interest received by a debtor in exchange for his LLC contributions will count as REV.

D. Note also the tension between estate and gift tax discounting techniques and UFTA:

1. The client wants to get as much of discount as possible when transferring assets to a family LP or LLC.

2. However, these deep discounts will deplete his estate *vis-a-vis* his lifetime creditors, thus raising UFTA concerns about transfers that prejudice creditors.

E. In addition to avoiding transfers ***to a partnership***, a court can avoid a fraudulent transfer ***of a partnership interest*** by a debtor partner. *Interpool Ltd. v. Patterson,* 890 F.Supp. 259 (S.D. N.Y. 1995). However, upon avoidance, the creditor is still limited to a charging order against the interest so transferred. *Chrysler Credit Corp. v. Peterson,* 342 N.W.2d 170 (Minn. App. 1984).

XVI. Veil Piercing & Reverse Pierces

A. Cases recognize both "veil piercing" and "reverse veil piercing."

B. The difference between the two is straightforward:

1. In a piercing case, an entity's creditor tries to seize or attach the assets of an entity owner (e.g., a shareholder or member) in satisfaction of the entity's debt.

2. In a reverse piercing case, an individual's creditor tries to seize or attach assets belonging to an entity that is wholly or partially owned by the individual debtor.

3. See, e.g., the following:

a. *CF Trust, Inc. v. First Flight LP,* 580 S.E.2d 806, 810 (Va. 2003), stating:

> Traditionally, a litigant who seeks to pierce a veil requests that a court disregard the existence of a corporate entity so that the litigant can reach the assets of a corporate insider, usually a majority

> shareholder. In a reverse piercing action, however, the claimant seeks to reach the assets of a corporation or some other business entity, as in this instance the assets of a limited partnership, to satisfy claims or a judgment obtained against a corporate insider. This proceeding, often referred to as "outsider reverse piercing," is designed to achieve goals similar to those served by traditional corporate piercing proceedings.

b. Richardson, *The Helter Skelter Application of The Reverse Piercing Doctrine*, 79 U. Cin. L. Rev. 1605 at 1605 - 1606 (2011) (footnotes omitted), stating:

> This continuing conflict between debtors hiding behind the shield of the corporate form and their creditors has resulted in substantial case law on piercing the corporate veil. In the prototypical case, a creditor with a right to the assets of an undercapitalized corporation seeks to execute against the assets of the party who owns and controls the corporation. If the owner has intentionally abused the corporate form to profit excessively and shield himself from loss while disregarding the possibility of harm to third parties, the theory holds that this creditor should collect from the owner as if he and the corporation were one. This practice, while tightly regulated, is widely accepted.
>
> Less frequently, parties will try to pierce the corporate veil "in reverse." "Outsider" reverse piercing occurs when a party with a claim against an individual or corporation attempts to be repaid with assets of a corporation owned or substantially controlled by the defendant. In doing so, plaintiffs attempt to increase the ease of collecting on their judgment by skipping the intermediary step of seizing the defendant's interest in the corporation. Outsider reverse piercing flips the traditional doctrine on its head by contemplating the seizure of corporate assets in a suit against an owner.

C. Veil piercing, which is available in a corporate law setting, is commonly thought to

be available as a remedy in an LP or LLC context as well.

D. This is sometimes expressly confirmed by statute.

1. See, e.g., Minnesota Stat. § 322C.0304(3), which states:

> "Except as relates to the failure of a limited liability company to observe any formalities relating exclusively to the management of its internal affairs, the case law that states the conditions and circumstances under which the corporate veil of a corporation may be pierced under Minnesota law also applies to limited liability companies."

E. Sometimes, this is established by case law.

1. See, e.g., *Serio v. Baystate Properties, LLC*, 39 A.3d 131, 139 (Md. App. 2012), which states:

> "Our case law has recognized the availability of an action to disregard a limited liability entity congruent with the equitable remedy of piercing the corporate veil."

F. Usually, the elements of veil piercing are fairly well established within a particular state, and often are similar from state-to-state.

1. However, elements or judicial attitudes can vary from state to state. See, e.g., the following:

a. *Serio v. Baystate Properties, LLC*, 39 A.3d 131, 140 (Md. App. 2012), in which the court favorably quoted authority supporting the view that "Maryland is more restrictive than other jurisdictions in allowing a plaintiff to pierce a corporation's veil."

b. *CF Trust, Inc. v. First Flight LP*, 580 S.E.2d 806, 809 – 810 (Va. 2003), stating:

> This Court has been very reluctant to permit veil piercing. We have consistently held, and we do not depart from our precedent, that only 'an extraordinary exception' justifies disregarding the corporate entity and piercing the veil.

i. See also *id.*, 580 S.E.2d at 811, stating:

> In Virginia, unlike in some states, the standards for veil piercing are very stringent, and piercing is an extraordinary measure that is permitted only in the most egregious circumstances, such as under the facts before this Court. The piercing of a veil is justified when the unity of interest and ownership is such that the separate personalities of the corporation and/or limited partnership and the individual no longer exist, and adherence to that separateness would create an injustice.

2. Attitudes can even change within a state over time.

G. For instance, Ohio at one point allowed fairly liberal veil piercing, and thus often allowed creditors to pierce the corporate veil in order to get to assets titled in the name of a shareholder. However, Ohio has become more restrictive about veil piercing in recent years.

1. The old "liberal" view was usually justified on the grounds that the corporation is merely the shareholder's alter ego, that the corporate vehicle was used to commit some sort of dastardly deed, and that the shareholder should therefore be liable for corporate debts:

2. In *Link v. Leadworks Corp.*,79 Ohio App.3d 735, 744, 607 N.E.2d 1140, 1146 (Cuyahoga 1992), the court stated:

> The basic principles of the alter ego doctrine in Ohio were set forth in *Bucyrus-Erie Co. v. Gen. Products Corp.* (C.A. 6, 1981), 643 F.2d 413. The corporate fiction should be disregarded when "(1) domination and control over the corporation by those to be held liable is so complete that the corporation has no separate mind, will, or existence of its own; (2) that domination and control was used to commit fraud or wrong or other dishonest or unjust act, and (3) injury or unjust loss resulted to the plaintiff from such control and wrong." *Id.* at 418. The factors to be considered in determining when the above principles should be applied include the observance of corporate formalities, undercapitalization, fraud, and the result of unjust or inequitable consequences in the event the corporate fiction were retained. *Id.* at 418-419.

3. In *Belvedere Condo. Owners v. R.E. Roark*, 67 Ohio St. 3d 274, 289, 617 N.E.2d 1075, 1078 (1993), the Ohio Supreme Court approved of *Bucyrus-Erie* by stating:

> We feel the Sixth Circuit's approach to piercing the corporate veil strikes the correct balance between the principle of limited shareholder liability and the reality that the corporate fiction is sometimes used by shareholders to protect themselves from liability for their own misdeeds.

4. However, in recent years, Ohio has become less indulgent of veil piercing.

   a. For example, in *Dombroski v. WellPoint, Inc.*, 119 Ohio St.3d 506, 895 N.E.2d 538 (2008), the Ohio Supreme Court modified the second prong of *Bucyrus-Erie* by requiring that the wrongful act in question must amount to "fraud, an illegal act, or a similarly unlawful act." Id., ¶ 2.

      i. *Dombroski* also held that "unjust or inequitable acts that do not rise to the level of fraud or an illegal act" are insufficient to satisfy the second prong of *Bucyrus-Erie.* See *Dombroski*, ¶¶ 1 – 2.

      ii. The court further said, "Courts should apply this limited expansion cautiously toward the goal of piercing the corporate veil only in instances of extreme shareholder misconduct." *Dombroski*, ¶ 29.

      iii. The court still further said, "piercing the corporate veil is the "rare exception" that should only be applied in the case of fraud or certain other exceptional circumstances." *Dombroski*, ¶ 26 (internal cites, quotes omitted.)

      iv. In other words, it takes a really bad act before veil piercing is even plausible.

   b. Similarly, in *Minno v. Pro-Fab, Inc.*, 121 Ohio St.3d 464, 905 N.E.2d 613 (2009), the Ohio Supreme Court significantly limited the ability of courts to commit inter-corporate veil pierces between sister corporations. The court stated at ¶ 13:

      > Thus, we hold that a plaintiff cannot pierce the

> corporate veil of one corporation to reach its sister corporation. A corporation's veil may not be pierced in order to hold a second corporation liable for the corporate misdeeds of the first when the two corporations have common individual shareholders but neither corporation has any ownership interest in the other corporation. Despite the element of common shareholder identity, sister corporations are separate corporations and are unable to exercise control over each other in the manner that a controlling shareholder can. This lack of ability of one corporation to control the conduct of its sister corporation precludes application of the piercing-the-corporate-veil doctrine.

H. Many jurisdictions also allow a "reverse pierce," which uses the same principles to enable the owner's creditors to pierce the veil to get to assets titled in the entity's name. See, e.g., the following:

1. *CF Trust, Inc. v. First Flight LP*, 580 S.E.2d 806, 809 – 819 (Va. 2003) (considering certified question from a federal court, allowing reverse piercing, and collecting cases).

2. See, e.g., *Zahra Spiritual Trust v. United States*, 910 F.2d 240, 244 (5th Cir. 1990) (applying Texas law):

   a. "A reverse piercing case requires the creditor to establish an alter ego relationship between the individual debtor and corporation to treat them as one and the same," *Id.*, 244.

   b. "In determining whether an alter ego relationship exists... [t]he factors relevant to the court's inquiry include... ***whether the corporation has been used for personal purposes.***" *Id.*, 245 (emphasis added).

3. 1 Fletcher, *Cyclopedia of the Law of Private Corporations* (1999 Perm. Ed.), §§ 41 - 41.95 (discussing general principles of "piercing" and "reverse piercing").

4. *IBF Corp. v. Alpern*, 487 A.2d 593, 596, n. 8 (D.C. App. 1985) (collecting tax court cases allowing reverse pierce).

5. *718 Arch Street Associates, Ltd. v. Blatstein (In re Blatstein)*, 92 F.3d 88,

100 – 101 (3rd Cir. 1999) (collecting cases and explaining standards for reverse pierce).

6. *Litchfield Asset Management Corp. v. Howell,* 70 Conn. App. 133, 147 - 159, 799 A.2d 298 (2002), cert. denied, 261 Conn. 911 (2002), partially overruled on other grounds, *Robinson v. Coughlin,* 266 Conn. 1,9 (Conn. 2003). In particular, *Litchfield Asset Management* stated:

> A corporation is a separate legal entity, separate and apart from its stockholders. It is an elementary principle of corporate law that a corporation and its stockholders are separate entities and that corporate property is vested in the corporation and not in the owner of the corporate stock. That principle also is applicable to limited liability companies and their members. The assets of a corporation or limited liability company, therefore, typically are not available to creditors seeking to recover amounts owed by a stockholder or member of that corporation or limited liability company. Nonetheless, courts will disregard the fiction of a separate legal entity to pierce the shield of immunity afforded by the corporate structure in a situation in which the corporate entity has been so controlled and dominated that justice requires liability to be imposed.

70 Conn. App. At 147 (internal cites, quotes, ellipses, brackets, emphasis omitted).

7. *In re Schimmelpenninck,* 183 F.3d 347, 357, n. 21 (5th Cir. 1999), collecting cases from numerous jurisdictions and stating:

> "Piercing the corporate veil in 'reverse' has been recognized in many jurisdictions as an equitable doctrine used to prevent injustice by corporate principals."

I. *Braswell v. Ryan Investments, Ltd.,* Case No. 3D06-2827 (Fla. App. 3 Dist. 7-9-2008) (collecting cases).

J. It is presently unclear whether all states allow the reverse pierce, but there is no logical reason why not.

1. But see, e.g., *Geiger v. King,* 158 Ohio. App.3d 288, (Ohio App. Franklin 2004); *Mathias v. Rosser,* 2002 WL 1066937, 02-LW-6370 (Ohio App. Franklin 2002), indicating that Ohio and other jurisdictions may not accept

the reverse pierce doctrine. In *Mathias,* a case involving a debtor named Rosser who was the sole owner of an entity, the court stated:

> "[I]n recent years a number of courts have discussed a 'reverse' corporate veil piercing doctrine which would permit a corporation to be held liable for the debts of an individual where the corporation is so controlled by the individual that it amounts to the individual's alter ego. See *In re Blatstein* (C.A.3 1999), 192 F.3d 88, 100; *Scholes v. Lehmann* (C.A.7 1995), 56 F.3d 750, 758; *Century Hotels v. United States* (C.A.5 1992), 952 F.2d 107, 110, fn. 6; *Zahra Spiritual Trust v. United States* (C.A.5 1990), 910 F.2d 240, 243-244; *Thomsen Family Trust, 1990 v. Peterson Family Ent. Inc.* (Ark. App. 1999), 989 S.W.2d 934, 937. It is apparently upon this reverse corporate veil piercing doctrine that the trial court relied in imposing liability upon the nursing home defendants because they were the alter egos of Rosser.
>
> "Although reverse corporate veil piercing has been widely discussed, only a few jurisdictions have actually adopted the doctrine. See, e.g., *LiButti v. U.S.* (C.A.2 1997), 107 F.3d 110, 119; *State v. Easton* (1995), N.Y.S.2d 904, 908-909, and Ohio is not among them. In fact, we have located only one Ohio case which discusses reverse corporate veil piercing, *Humitsch v. Collier* (2000), Lake App. No. 99-L-099, and none in which liability has been imposed on the basis of the doctrine. See *Winston v. Leak* (S.D. Oh 2001), 159 F.Supp.2d 1012, 1017-1018 (noting that reverse corporate veil piercing has not been embraced by Ohio courts). Even if Ohio had adopted the doctrine of reverse corporate veil piercing, it would be inapplicable to the facts of the instant case because plaintiff can obtain virtually the identical result by attaching Rosser's interests in the nursing home defendants. See *Scholes,* at 758 (commenting that the application of reverse corporate veil piercing even to "one-man" corporations will be rare "because a simple transfer of the indebted shareholder's stock to his creditors will usually give them all they could get from seizing the assets directly."); *Cascade Energy and Metals Corp. v. Banks* (C.A.10 1990), 896 F.2d 1557 (stating that reverse corporate veil piercing is problematic because it allows a judgment creditor to bypass the normal judgment collection procedure

> of attaching the judgment debtor's shares in the corporation, and attach the corporate assets directly). Therefore, the trial court erred in concluding that the nursing home defendants are liable on the five promissory notes because they are Rosser's alter egos."

2. This rationale against reverse pierces seems to be based on the notion that a creditor can attach a debtor's interest in stock.

3. However, LPs and LLCs don't have stock, and LLC and LP interests are typically unattachable as a matter of law. See, e.g., Most LLC and partnership interests are not "securities" under the UCC. UCC §§ 8-103(c), 8-112.

4. Accordingly, the judicial reluctance to allow reverse pierces in corporation cases may not exist in LLC or LP cases.

K. The factors that allow for piercing are malleable and elastic.

1. Whether a claim succeeds will ultimately depend upon the fact-finder's view of the evidence. Consequently, this theory carries the potential to sustain claims against an entity that is allegedly being used to hide an individual's assets from his creditors.

L. Key Point: Reverse piercing is most appropriately used when an entity is formed to shelter a debtor's assets from the ***pre-existing*** claims of the debtor's creditors.

1. This is established by various authorities. See, e.g., the following:

a. *Braswell v. Ryan Investments, Ltd.*, Case No. 3D06-2827 (Fla. App. 3 Dist. 7-9-2008) (collecting cases and applying Florida law).

b. *Select Creations, Inc. v. Paliafito Am., Inc.*, 852 F. Supp. 740 (E.D. Wisc. 1994), applying Wisconsin law, *id.* at 767, citing 1 Fletcher Cyclopedia Corporations § 41.70 at 707 (1990), and stating at 774:

> It is particularly appropriate to apply the alter ego doctrine in "reverse" when the controlling party uses the controlled entity to hide assets or secretly to conduct business to avoid the pre-existing liability of the controlling party.

M. While a case involving pre-existing debts and present creditors is more ripe for

reverse piercing, it's possible that future creditors can use reverse piercing to attack a structure in connection with efforts to satisfy judgment based on post-transfer claims. This will vary from jurisdiction to jurisdiction.

1. In Florida it appears as if reverse pierces may be used only in connection with pre-existing debts. See *Braswell v. Ryan Investments, Ltd.,* Case No. 3D06-2827 (Fla. App. 3 Dist. 7-9-2008) (collecting cases and applying Florida law).

2. In Connecticut, the law is very broad and malleable, and the relevant judicial language broadly refers to reaching equitable results. See, e.g., *Litchfield Asset Management Corp. v. Howell,* 70 Conn. App. 133, 147 - 159, 799 A.2d 298 (2002). In particular:

    a. Id. at 151, stating, "A guiding concept behind both standard and reverse veil piercing cases is the need for the court to avoid an over-rigid preoccupation with questions of structure and apply the preexisting and overarching principle that liability is imposed to reach an equitable result." (Internal quotes, ellipses omitted.)

    b. Id. at 152 (setting forth elements of a veil piercing claim, which conspicuously omit reference to pre-existing debts and which have broader application).

3. Note, however, that a future creditor may have a hard time satisfying the elements of a reverse pierce. For example, as shown by *Litchfield,* supra, the elements for a reverse pierce in Connecticut include:

    a. ***Loss causation.*** It may be hard to show how an ancient transfer proximately caused loss to a future creditor, particularly if the future creditor never treated the LLC's assets as the debtor's, and instead made the decision to extend credit based on other factors.

    b. ***Fraud.*** It may be hard for a future creditor to prove fraud vis-a-vis him if he wasn't even "on the debtor's radar screen" at the time the transfer was made. This difficulty is compounded if the debtor was left solvent immediately after the disputed transfer to the LLC. Cf. *Braswell v. Ryan Investments, Ltd.,* Case No. 3D06-2827 (Fla. App. 3 Dist. 7-9-2008), which states:

> Looking at the "piercing the veil" doctrines from a broader perspective which may serve to explain the narrower problem with which we are now concerned,

> it seems to us that the rule is, perhaps *sub silentio*, based on the idea that when one enters into an agreement with another entity, whether individual or corporate, which calls for future performance, it is in presumed reliance on the ability to look to all of that party's existing assets to satisfy any damage caused by his failure to perform and to require this reliance. The direct and reverse piercing doctrines are respectively designed to prevent a fraudulent breach of that understanding which occurs when a contracting individual later fraudulently transfers his assets to a controlled corporation or a contracting corporation does so to a controlling individual. Obviously the considerations do not exist when the contracting party (in this case Mr. Braswell) did not have title to the asset in question (Ryan Investments did) when he made the promises sued upon.

N. Even if reverse piercing is allowed as a matter of law, courts will be proceed carefully as a factual matter, first to determine whether the reverse pierce is, in general, appropriate for the case in question, and second, to assure that a reverse pierce will not harm innocent third parties with an interest in the entity that might have assets seized pursuant to a reverse pierce.

1. While both concerns are important, this second factual concern, i.e., the potential for harm to innocent third parties, is especially so.

2. For example, a seizure of LLC assets pursuant to a reverse pierce could impair or injure the rights of other members or arms-length LLC creditors.

   a. See, e.g., *CF Trust, Inc. v. First Flight LP*, 580 S.E.2d 806, 811 (Va. 2003), stating (footnotes omitted):

      > Additionally, a court considering reverse veil piercing must weigh the impact of such action upon innocent investors, in this instance, innocent limited partners or innocent general partners. A court considering reverse veil piercing must also consider the impact of such an act upon innocent secured and unsecured creditors. The court must also consider the availability of other remedies the creditor may pursue.

b. See also Richardson, *The Helter Skelter Application of The Reverse Piercing Doctrine*, 79 U. Cin. L. Rev. 1605 at 1614, 1619, and 1624 – 1627 (2011) (collecting cases and arguing against the use of reverse piercing due to its potential to harm innocent third parties and its potential adverse impact on investing and lending patterns, particularly in connection with small and mid-sized businesses).

O. In some states, specific LLC or LP charging order statutes have rules that expressly: i.) Limit creditors to narrow charging order relief; and, ii.) Prohibit creditors from using any other legal or equitable remedy to satisfy their judgment out of LLC or LP assets.

1. Such statutes probably eliminate the possibility of reverse piercing in connection with the entity type in question.

2. Examples of such state statutes are set forth in **Section X,** below, which gives "**Special Recognition"** to Ohio, Delaware, and various other jurisdictions

XVII. Constructive Trusts

A. Ohio, like most states, recognizes at least two types of equitable trusts:

1. Constructive trusts

2. Resulting trusts.

See In re Bushey, 210 B.R. 95, 104 (6th Cir. BAP 1997).

B. Constructive trust principles:

1. Equitable remedy:

a. "A constructive trust is an equitable creature which arises by operation of law against one who holds the legal right to property which in equity and good conscience belongs to another." *American Diabetes Ass'n v. Diabetes Soc.*, 31 Ohio App.3d 136, 141, 509 N.E.2d 84, 89 (Clinton 1986).

2. Purpose is to prevent unjust enrichment:

a. "A constructive trust is, in the main, an appropriate remedy against unjust enrichment." *Ferguson v. Owens*, 9 Ohio St.3d 223, 226, 459 N.E.2d 1293, 1295 (1984). *See also Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 171, 405 N.E.2d 337, 340 (Cuyahoga 1979); *id.*, Syl. ¶ 1; *Dixon v. Dixon*, 4 Ohio St.3d 160, 447 N.E.2d 756 at n. 4 (1983).

3. Typically used in cases of fraud, but can be used whenever deemed equitable:

   a. "This type of trust is usually invoked when property has been acquired by fraud. However, a constructive trust may also be imposed where it is against the principles of equity that the property be retained by a certain person even though the property was acquired without fraud." *Ferguson v. Owens*, 9 Ohio St.3d 223, 226, 459 N.E.2d 1293, 1295 (1984).

4. Constructive trusts may be used in many different settings:

   a. A constructive trust is "a trust by operation of law which arises... against one who, by fraud, actual or constructive, by duress or abuse of confidence, by commission of wrong, or by any form of unconscionable conduct, artifice, concealment, or questionable means, or who in any way against equity and good conscience, either has obtained or holds the legal right to property which he ought not, in equity and good conscience, hold and enjoy." *Ferguson v. Owens*, 9 Ohio St.3d 223, 225, 459 N.E.2d 1293, 1295 (1984) (internal quotes and cites omitted).

5. A constructive trust is a flexible remedy.

   a. In determining whether a constructive trust arises, the Court "is bound by no unyielding formula." *Ferguson v. Owens*, 459 N.E.2d at 1295 (quoting Justice Cardozo).

6. The remedy may not be available until a judgment is rendered. *See In re Omegas Group*, 16 F.3d 1443, 1451 (6th Cir. 1994).

7. Intent is irrelevant.

   a. "Constructive trusts are imposed irrespective of intention." *Peterson v. Teodosio*, 34 Ohio St.2d 161, 172, 297 N.E.2d 113, 120. *Accord*, *Ferguson*, 459 N.E.2d at 1295 ("arises contrary to intention");

Bilovocki, Syl. Par. 1 ("arises without regard to the intention of the person who transferred the property"); *id.*, 62 Ohio App.2d at 172, 405 N.E.2d at 340 ("impressed without regard to intention") (emphasis original).

8. BFPs are protected from constructive trusts.

   a. *Union Sav. & Loan Ass'n v. McDonough*, 101 Ohio App.3d 273, 276, 655N.E.2d 426, 428 (Butler 1995), *appeal not allowed* 72 Ohio St.3d 1551, 650 N.E.2d 1370 ("[a] constructive trust will not attach to property acquired by a bona fide purchaser-one who acquires title to property for value and without notice of another's equitable interest in that property").

9. "Actual fraud" (*i.e.*, a fraudulent transfer made with intent to hinder, delay or defraud creditors) is not an element of a constructive trust.

   a. *In re Bushey*, 210 B.R. 95, 105 (6th Cir. BAP 1997) ("[a]ctual fraud is not a prerequisite to the imposition of an equitable trust under Ohio law").

10. The primary purpose of a constructive trustee is to turn over property to its rightful owner.

    a. "In the case of an express trust the trustee ordinarily has active duties of management. In the case of a constructive trust, the duty is merely to surrender the property." *In re Benefit Association*, 72 S.D. 23, 36, 29 N.W.2d 81 (1947).

C. A court could conclude that use of an LLC to insulate property for the sake of a contributing member might "unjustly enrich" the debtor-members of an FLLC.

   1. The FLLC has no business purpose, but is a passive holding company.

   2. One of its primary uses is asset protection, *i.e.*, how to avoid creditors.

   3. Accordingly, a court might declare that the LLC is a constructive trustee.

D. Case law supports the use of a constructive trust as a creditor remedy:

   1. *In re Elliott*, 83 F. Supp. 771 (E.D. Pa. 1948):

      a. This case involved a husband who arranged for a homestead title to

be placed in his wife's name. Wife made the initial modest down payment, but then the husband made all future mortgage payments.

b. General principle announced:

"Another common instance of defrauding creditors arises when a debtor purchases property and takes the title in the name of another. If his purpose in so doing is to conceal the property from his creditors, the grantee holds the property upon a constructive trust for the creditors." *Elliott*, 83 F.Supp. at 773, n. 6 (internal quotes omitted).

c. Specific holding:

"Although she made the initial payment on the property, it is quite apparent that at that time she could not pay the installments on the mortgage as they became due without the financial assistance of her husband. As was to be expected, his funds were used to that end. Consequently, subject to her equity therein, the bankrupt's wife holds the property upon a constructive trust for his creditors." *Elliott*, 83 F.Supp. at 773.

2. *In re Bushey*, 210 B.R. 95 (6th Cir. BAP 1997).

3. Note that a constructive trust is not the appropriate remedy if the parties intend a trust to arise. Instead, a resulting trust should be imposed.

a. *See Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 171 - 173, 405 N.E.2d 337, 340 (Cuyahoga 1979).

E. Note also the rather unusual unreported case of *Delta Development and Investment Co. v. Hsiyuan*, 2002 WL 31748937 (Wash. App. 2002), petition for review denied 49 Wash.2d 1027 (2003), which, among other things, held as follows:

1. A judgment for a constructive trust against an LLC member differs from a money judgment against that member.

2. The plaintiff who gets a constructive trust is therefore not a "judgment creditor" within the meaning of the Washington LLC Act's charging order provision.

a. The Washington charging order provision appears at RCW § 25.15.255.

b. The Washington statute is fairly representative of many others, and states:

> 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.

3. The successful plaintiff can therefore step into the shoes of the defendant-member who is subject to the constructive trust... and this includes even the defendant's managerial rights!!!!!

4. NOTE: *Delta Development* may have limited precedential value because it unpublished. See old Wash. R. App. Pro. 10.4(h) (since repealed but applicable at time of decision) and new Wash. Gen. Rule 14.1 (replacing RAP 10.4(h)), both of which strictly limit citations to unpublished opinions.

F. Constructive trusts are internationally recognized, albeit with some possible wrinkles that arguably make non-U.S. constructive trusts slightly different from their U.S. counterparts. See, e.g., the following small sampling:

1. Isle of Man:

a. *Cusack & Cotter v. Scroop Ltd.,* 1 O.F.L.R. 68 (1997/98) (Isle of Man High Court) (collecting cases from British Commonwealth).

2. England:

a. *Hussey v. Palmer* [1972] 1 WLR 1286 at 1290, [1972] EWCA Civ 1 (per Lord Denning M.R.).

b. *Eves v. Eves* [1975] 1 WLR 1338, [1975] EWCA Civ 3 (per Lord Denning M.R.).

3. Ireland:

a. *Varko Ltd (In Liquidation)* [2012] IEHC 278.

4. Jersey:

a. Bagus Inv Ltd v Kastening [2010] JRC 144 (Jersey Royal Court), ¶¶ 20 – 21, stating:

> Mr James argued that, under English law, it is clear that section 21(1) does not apply to claims for knowing receipt. Underlying this assertion is the fact that, in English law, the expression "constructive trustee" covers two completely different types of situation. The first is where the defendant acquired the property as a trustee or other fiduciary in an unimpeached arrangement before the conduct complained of when he abused the trust and confidence that reposed in him; the second is where the wrongful conduct of the defendant in asserting his interests leads to an equitable obligation being placed upon him. This distinction has been touched upon in a number of cases but has perhaps been most clearly articulated by Millett LJ in the case of *Paragon Finance plc-v-D B Thackerar & Co* [1999] 1 All ER 400 at 408-414. I would refer in particular to the following passage of his judgment beginning at 408:-
>
> > "The explanation for the rule [that a claim against an express trustee was never barred by lapse of time] was that the possession of an express trustee is never in virtue of any right of his own but is taken from the first for and on behalf of the beneficiaries. His possession was consequently treated as the possession of the beneficiaries, with the result that time did not run in his favour against them: see the classic judgment of Lord Redesdale in *Hovenden-v-Lord Annesley* (1806) 2 Sch & Lef 607 at 633-634.
> >
> > The rule did not depend upon the nature of the trustee's appointment, and it was applied to trustees de son tort and to directors and other fiduciaries who, though not strictly trustees, were in an analogous position and

who abused the trust and confidence reposed in them to obtain their principal's property for themselves. Such persons are properly described as constructive trustees.

Regrettably, however, the expressions 'constructive trust' and 'constructive trustee' have been used by equity lawyers to describe two entirely different situations. The first covers those cases already mentioned, where the defendant, though not expressly appointed as trustee, has assumed the duties of a trustee by a lawful transaction which was independent of and preceded the breach of trust and is not impeached by the plaintiff. The second covers those cases where the trust obligation arises as a direct consequence of the unlawful transaction which is impeached by the plaintiff.

A constructive trust arises by operation of law whenever the circumstances are such that it would be unconscionable for the owner of property (usually but not necessarily the legal estate) to assert his own beneficial interest in the property and deny the beneficial interest of another. In the first class of case, however, the constructive trustee really is a trustee. He does not receive the trust property in his own right but by a transaction by which both parties intend to create a trust from the outset and which is not impugned by the plaintiff. His possession of the property is coloured from the first by the trust and confidence by means of which he obtained it, and his subsequent appropriation of the property to his own use is a breach of that trust. Well known examples of such a constructive trust are *McCormick-v-Grogan* [1869] LR 4 HL 82 (a case of a secret trust) and *Rochefoucald-v-Boustead* [1897] 1 Ch 196 (where the defendant agreed to buy the property for the plaintiff but the trust was

> imperfectly recorded). *Pallant-v-Morgan* [1952] 2 All ER 951, [1953] Ch 43 (where the defendant sought to keep for himself the property which the plaintiff trusted him to buy for both parties) is another. In these cases the plaintiff does not impugn the transaction by which the defendant obtained control of the property. He alleges that the circumstances in which the defendant obtained control make it unconscionable for him thereafter to assert a beneficial interest in the property.
>
> The second class of case is different. It arises when the defendant is implicated in a fraud. Equity has always given relief against fraud by making any person sufficiently implicated in the fraud accountable in equity. In such a case he is traditionally though I think unfortunately described as a constructive trustee and said to be 'liable to account as constructive trustee'. Such a person is not in fact a trustee at all, even though he may be liable to account as if he were. He never assumes the position of a trustee, and if he receives the trust property at all it is adversely to the plaintiff by an unlawful transaction which is impugned by the plaintiff. In such a case the expressions 'constructive trust' and 'constructive trustee' are misleading, for there is no trust and usually no possibility of a proprietary remedy; they are 'nothing more than a formula for equitable relief': *Selangor United Rubber Estates Ltd-v-Cradock (no 3)* [1968] 2 All ER 1073 at 1097, [1968] 1 WLR 1555 at 1582 per Ungoed-Thomas J."

In a number of cases the first type of constructive trustee has been referred to as a class 1 constructive trustee and the second as a class 2 constructive trustee.

XVIII. Resulting Trust plus the Rule Against Self-Settled Trusts ("RASST")

A. Resulting trusts are historically applied in three situations:

1. Purchase money trusts.

2. An express trust fails for any reason.

3. The terms of the express trust do not exhaust the trust fund.

Bilovocki v. Marimberga, 62 Ohio App.2d 169, 172, 405 N.E.2d 337, 341 (Cuyahoga 1979).

Note: Situations 1 and 2 are most relevant to this discussion. Situation 3 is not addressed below.

B. Key Issue - Intent:

1. "A resulting trust has been defined as one which the court of equity declares to exist where the legal estate in property is transferred or acquired by one under facts and circumstances which indicate that the beneficial interest is not intended to be enjoyed by the holder of the legal title." *Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 172, 405 N.E.2d 337, 341 (Cuyahoga 1979) (internal quotes omitted), quoting *The First National Bank of Cincinnati v. Tenney*, 165 Ohio St. 513, 515-516, 138 N.E.2d 15, 17 (1956); *accord, In re Bushey*, 210 B.R. 95, 104 (6th Cir. BAP 1997).

2. "In this class of trusts, the courts seek to enforce the intention of the parties." *Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 172, 405 N.E.2d 337, 341 (Cuyahoga 1979); *accord, In re Bushey*, 210 B.R. 95, 104 (6th Cir. BAP 1997).

3. An expression of intent to settle a trust can be manifested by an act, or expression, or both, of the settlor. 91 O Jur 3d, Trusts, § 37, p. 57 (1989).

a. In Ohio, express trusts need not be in writing and can instead be founded upon verbal declarations, even in connection with real estate. 91 O Jur 3d, Trusts, §§ 57 (in general), 78 - 79 (in detail) (1989).

b. Circumstantial evidence may also be considered, such as the parties conduct and the surrounding circumstances. 91 O Jur 3d, Trusts, §§ 80, 85 (1989).

i. Potentially relevant circumstances include the fact that one person controlled the disposition of funds or directed another regarding the method and manner of using funds. *See Gooley v. DeWitt,* 70 Ohio Law Abs. 338, 122 N.E.2d 123 (Com. Pls. Fayette 1954); *Alkire v. Alkire,* 22 Ohio Law Abs. 419 (Ohio App. Madison 1936).

C. Purchase money trusts:

1. Property held by a transferee will generally be subject to a resulting trust if the transferor paid the purchase price for property.

2. This is a "purchase money trust."

3. "Where a transfer of property is made to one person and the purchase price is paid by another, a resulting trust arises in favor of the person by whom the purchase price is paid, except as stated in §§ 441, 442, and 444." *John Deere Indus. Equip. Co. v. Gentile*, 9 Ohio App.3d 251, 255, 459 N.E.2d 611, 616 (Cuyahoga 1983), quoting Restatement of the Law, Trusts 2d (1959), § 440, p. 393.

4. Exceptions to general rule imposing resulting trust in purchase money situations:

a. § 441 - No resulting trust arises in favor of the purchaser if he manifests an intent that no trust should arise. *See* Restatement of the Law, Trusts 2d (1959), § 441.

b. § 442 - No resulting trust arises in favor of the purchaser in connection with gifts to children or other "natural objects of bounty," unless the purchaser manifests an intent that the transferee should not have a beneficial interest (*i.e.*, a sham gift).Restatement of the Law, Trusts 2d (1959), § 442.

(a) "Natural objects of bounty" can potentially include spouses.

i) This exception may therefore be relevant to cases involving transfers to spouses.

(b) Cf. 26 U.S.C. § 2036 (regarding inclusion in a decedent's taxable estate) and cases and materials

thereunder, which sometimes hold that no implied agreement as to retained possession and enjoyment can be inferred simply because the donor and donee are spouses. Examples include:

i) Rev. Rul. 70-155, 1970-1 C.B. 189.

ii) PLR 9735035

iii) *Estate of Gutchess v. Commissioner*, 46 T.C. 554 (1966), acq. 1967-1 C.B. 2.

However, estate and gift tax holdings may not be readily transferrable into the realm of debtor-creditor litigation, so these tax precedents must be viewed cautiously.

c. § 444 - No resulting trust arises in favor of the purchaser if he vested title in a putative trustee in order to accomplish an illegal end, such as defrauding creditors. *See* Restatement of the Law, Trusts 2d (1959), § 444, and Reporter's Notes in Appendix (1959).

5. Part of a transfer may be subject to a purchase money trust; there is no need to subject all of the transferred property to a purchase money trust:

a. Purchase money trusts may be imposed on a pro rata basis if the transferor paid only part of the purchase price for the property held by the transferee.

b. "'Where a transfer of property is made to one person and a part of the purchase price is paid by another, a resulting trust arises in favor of the person by whom such payment is made in such proportion as the part paid by him bears to the total purchase price, unless he manifests an intention that no resulting trust should arise or that a resulting trust to that extent should not arise.' Thus, the equitable owner has an interest in such proportion as the amount he paid bears to the total purchase price." *Glick v. Dolin*, 80 Ohio App.3d 592, 597, 609 N.E.2d 1338, 1341 - 1342 (Cuyahoga1992), quoting Restatement of the Law 2d, Trusts (1959) § 454.

6. Timing issues: A purchase money trust can be created with post-transfer payments as well as pre-transfer payments.

a. Paying bills owed by another can create a purchase money trust.

b. "A resulting trust also arises... where a person other than the transferee undertakes an obligation to pay the purchase price on credit." *John Deere Indus. Equip. Co. v. Gentile,* 9 Ohio App.3d 251, 255, 459 N.E.2d 611, 616 (Cuyahoga 1983), citing Restatement of the Law, Trusts 2d (1959), § 456.

c. **Note:** For a similar holding in connection with constructive trusts, *see In re Elliott,* 83 F. Supp. 771 (E.D. Pa. 1948), quoted in § X(D), *supra.*

D. Failure of express trusts:

1. Resulting trusts can be imposed whenever an express trust fails.

a. *See Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 172, 405 N.E.2d 337, 341 (Cuyahoga 1979).

b. Example: Resulting trusts may be imposed in transactions where the transferor intended herself to be the sole beneficiary of an intended but defective trust. *See Bilovocki v. Marimberga*, 62 Ohio App.2d 169, 171 - 173, 405 N.E.2d 337, 340 - 341 (Cuyahoga 1979).

c. Note that defects can arise by error (*i.e.*, forgetting to execute trust papers) or by design (*i.e.*, choosing not to execute trust papers to prevent evidence of a trust relationship).

E. RASST – Application & Principles:

1. If a FLLC or FLP is found to be a resulting trustee for the family, it will almost always be a self-settled trust to one degree or another.

a. In most FLLC or FLP situations, the overwhelming bulk of the assets held by the entity are contributed by one or both spouses and held for the benefit of all the family, including the contributing spouses.

b. Put differently, the client has "settled the trust" (*i.e.,* funded the LLC) for his own use, benefit, and control.

2. If the LLC is deemed a self-settled trust, then the assets are readily

attachable under the "rule against self-settled trusts" ("RASST").

3. RASST Principles:

   a. A creditor can take anything that the transferor gave to the trustee up to the maximum amount that might be distributed to or for the benefit of the transferor. This is true even if:

      i. Other beneficiaries exist.

      ii. All distributions are wholly in the trustee's discretion.

   b. Intent to defraud is irrelevant.

   c. There is no statute of limitations.

4. RASST citations to authority:

   a. In General: Sullivan *Gutting the Rule Against Self-Settled Trusts: How the New Delaware Trust Law Competes with Offshore Trusts,* 23 Delaware J. Corp. Law 423, 425 - 428 (1998) (detailed review).

   b. Ohio: 91 O Jur 3d, Trusts, § 194 (1989) (regarding self-settled spendthrift trusts).

F. Consequently, if a resulting trust arises, then creditors will be able to attach the property held by the FLLC for the "settlor" (*i.e.*, the property transferred to the FLLC and held for the sake of the contributing member).

G. ***Special Note 1:*** Judicial Criticism of LLCs or LPs Acting as De Facto Trusts

1. In the *Ehman* trilogy of cases, the debtor unsuccessfully tried to use an LLC to stave off collections by the bankruptcy trustee. The court rejected virtually every argument made by debtor's counsel. In so holding, the court also expressly criticized and rejected the planning effort to use LLCs and LPs as a trust substitute. See the following:

   a. *Ehman I – In re Ehman,* 319 B.R. 200 (Bankr. D. Ariz. 2005) (general background and distinguishing between regular creditors and a trustee in bankruptcy, who succeeds to the debtor's rights).

   b. *Ehman II – In re Ehman,* Case No. 2-00-05708-RJH, Adv. Pro. No.

04-00956 (Bankr. D. Ariz. – Dec. 7, 2005) (available via PACER/ECF system) (the "Pearl Harbor Day" Order).

i. In this opinion, the court stated:

> In this case, however, Anthony Ehmann and Fiesta have engaged in such transactions after the Trustee was appointed and succeeded to the Debtor's interest, and after the Trustee put them on notice of his intent to enforce the Trustee's rights under the operating agreement. The Trustee's requests and demands were not simply ignored, they were defied. The conduct of Fiesta and its manager since the Trustee's appointment demonstrates an unequivocal intent to operate Fiesta as if it were a revocable living spendthrift trust. Their reargument of the limitations imposed by the law of executory contracts, notwithstanding this Court's previous ruling that the operating agreement is governed solely by § 541, demonstrates an unequivocal determination to utilize executory contract law to shield assets from the members' creditors. Neither intent is sanctioned by either bankruptcy law or Arizona's law of LLCs. ***Utilizing a legitimate business structure for the sole purpose of shielding assets from creditors borders on a fraud on creditors, especially when the Legislature has provided another mechanism for accomplishing those same purposes that would put creditors on notice that they cannot rely on the value of the debtor's asset.***
>
> (Emphasis added.)

c. *Ehman III – In re Ehman*, Case No. 2-00-05708-RJH, Adv. Pro. No. 04-00956 (Bankr. D. Ariz. – Jan 25, 2006) (available via PACER/ECF system) (the "Let's Pretend This Didn't Happen" Order).

i. In this opinion, the court vacated its Pearl Harbor Day order pursuant to a settlement agreement between the parties. The court expressly noted that the debtor's faction included an LLC manager whose principal livelihood was as a tax

lawyer who frequently advised clients on the use of LLC's for estate planning, and that the attorney didn't want the bad precedent of the Pearl Harbor Day order.

The court granted the motion as it was in the best interests of creditors to collect the $85,000 settlement payment being offered by the debtor's faction. In so doing basically ridiculed the estate planner's motives, and noted that nothing would undo the fact that he had already entered the Pearl Harbor Day Order for the reasons he stated therein.

XIX. Creditors' Bill

A. A creditor's bill statute may allow a creditor to simply step into the shoes of a debtor partner and exercise all rights of the partner.

B. For example, in Ohio, the creditor's bill statute is ORC § 2333.01, which states:

> "When a judgment debtor does not have sufficient personal or real property subject to levy on execution to satisfy the judgment, any equitable interest which he has in real estate as mortgagor, mortgagee, or otherwise, or any interest he has in a banking, turnpike, bridge, or other joint-stock company, or in a money contract, claim, or chose in action, due or to become due to him, or in a judgment or order, or money, goods, or effects which he has in the possession of any person or body politic or corporate, shall be subject to the payment of the judgment by action."

C. A creditor's bill is a whole new lawsuit filed by the judgment creditor against the debtor's debtors.

1. Objective is to make the debtor's debtors to pay directly to the creditor instead of the judgment debtor.

D. A creditor's bill is an equitable remedy, and courts may not employ this remedy only if the judgment creditor's remedies at law "are ineffectual to reach the property of the debtor, or the enforcement of the legal remedy is obstructed by some incumbrance upon the debtor's property, or some fraudulent transfer of it." *Graybar Elec. Co. v. Keller Elec. Co.,* 113 Ohio App. 3d 172, 176, 680 N.E.2d 687, 689 (Summit 1996), quoting *Jones v. Green,* 68 U.S. (1 Wall.) 330, 331 - 332 (1864).

1. The targets of a creditor's bill could therefore conceivably include an LLC that is withholding distributions otherwise due to a judgment debtor-member in order to frustrate the member's creditors.

E. Under the creditor's bill statute, it is generally held that the judgment creditor steps into shoes of the judgment debtor, and thus may enforce any rights and remedies that the judgment debtor has against third parties.

1. *Terry v. Claypool*, 77 Ohio App. 87, 65 N.E.2d 889, 892 (Ohio App. Hancock 1945), stated:

> "As the suit is in the nature of an equitable execution the judgment creditor to such suit subjects to the payment of his judgment only such right as the judgment debtor has in the property involved, and in enforcing such right against third parties, he is entitled to such remedies and securities as the judgment debtor would be entitled to in the premises, and is subject to the same defenses as the judgment debtor would be subject to."

2. *Edgarton & Wilcox v. Hana & Co.*, 11 Ohio St. 323, 324 (1860) (remedies of creditor's bill plaintiff "must be in analogy, as to claims against third persons, to the remedies to which the debtor himself might resort").

3. *Beavis v. Sharwell.* Case No. 255140 (Ohio Com. Pls. Cuyahoga), Judge Corrigan (Journalized 4 March 1994) (plaintiff granted all rights previously held by defendant against third parties pursuant to judgments obtained by defendant against those third parties).

Note: Not all courts agree, and occasionally some opinions limit the judgment creditor's right to proceed. *See, e.g., Alms v. Doepke Co. v. Johnson,* 98 Ohio App. 78, 128 N.E.2d 250 (Ohio App. Hamilton 1954), which held that "'a debt due to a debtor of the debtor is not subject to a creditors' bill.'"

F. There is also out-of-state authority indicating that a creditor might step into a debtor's shoes:

1. *Bressler v. Averbuck*, 76 N.E.2d 146, 148 (Mass. 1947), in which the court said of creditors' bills:

> "This statute... combines in a single proceeding two different matters or steps in procedure, one at law and the other in equity. The first is the establishment of an indebtedness on the part of the principal defendant to the plaintiff. The second is the process for

collecting the debt, when established, ***out of property rights that cannot be reached on an execution.***" (Emphasis added.)

a. The court also held that a partnership interest was subject to a creditor's bill, but noted that the Massachusetts creditor's bill act made express reference to reaching partnership interests.

b. Ohio's statute refers to "joint stock compan[ies]," ORC § 2333.01, not partnerships.

i. However, a court interested in effectuating legislative intent might be willing to interpret the Ohio statute to include a right against partnership interests.

G. Creditor's bills have been used in some rather flexible ways, such as compelling a debtor to use his powers over a trust fund to help pay off a creditor.

1. *Great American Ins. Co. v. Thompson Trust,* 2006-Ohio-304 [Lawriter] (Hamilton App. 2006) (creditor's bill entitled creditor to priority lien on proceeds of debtor's "5 or 5" power).

2. *Great American,* supra, n. 2 ("where the beneficiary could force the trustee to pay him, the court could likewise force the trustee to pay the creditor") (internal cites, quotes omitted);

H. If a creditor can step into a debtor's shoes *vis-a-vis* the LLC and its distributions, then the creditor could presumably compel a distribution or dissolution if such rights are available to members.

1. *Cf. Leventhal v. Five Seasons,* 581 A.2d 449 (Md. Spec. App. 1990) (receiver of general partner appointed pursuant to a charging order stands in the debtor's shoes and may do whatever the debtor-partner could do, including ask for dissolution of the partnership).

I. This theory is untested and could involve a question of statutory interpretation, *i.e.*, which statute takes precedence: The charging order statute, which might allow a creditor many rights in an LLC, or the more specific LLC charging order provision, which might limit the creditor's rights to those of a mere "assignee" (*i.e.,* the right to receive distributions if and when they are made).

1. *Cf. Matter of Pischke,* 11 B.R. 913, 917 (E.D. Va. 1981), which indicates that charging order statutes displace other remedies, but only insofar as those remedies are "designed to reach a partner's interest in a partnership."

(Internal quotes and cites omitted).

a. The creditor's bill method is not just an attempt to reach a partnership interest.

b. Instead, it is an effort to step into the partner's shoes, to get the benefits of being a partner, and exercise rights in the partnership, including dissolution rights, demand-for-distribution rights, management rights, *etc.*

J. Further, the potential problems associated with a creditor's bill can be limited by proper drafting.

1. Even if the creditor steps into the shoes of the debtor-member, that is of little consolation if the member's rights are limited by the operating agreement and do not include the right to force a distribution, oust the manager, dissolve the company, etc.

XX. Aside: Direct Action Theories vs. Other Transferees (Spouses, etc.)

A. A creditor can use the "direct action" theories noted above against transferees other than LLCs or LPs.

B. For example, as suggested above, resulting trusts can be used against a debtor's spouse.

1. However, there may be a strong presumption in favor of finding that transfers to spouses or children are valid gifts.

2. In many instances, this presumption can be overcome only by showing an elevated quantum of evidence of intent to entrust, e.g., proof by clear and convincing evidence.

3. For more on this point, see:

a. Materials cited above in connection with purchase money resulting trusts.

b. *In re O'Malley*, 252 B.R. 451, 457 - 458 (Bankr. N.D. Ill. 1999).

c. *In re Medlock*, 272 B.R. 360, 363 - 365 (Bankr. M.D. Fla. 2001) (applying Georgia law).

d. *In re True,* 285 B.R. 405, 417-418 (Bankr. W.D. Mo. 2002).

e. *In re Blackwell,* 1998 WL 2017334 (Bankr. D. S.C.).

C. While the theory may be difficult to prove in connection with intra-family transfers, it is nonetheless legally valid and can be an effective pro-creditor tool, particularly if the facts show that the alleged donor maintained full use and benefit of the property in question.

XXI. Possible Non-Exclusivity of Charging Order Pre-Judgment

A. A charging order may be exclusive only during the post-judgment phase, and does not bar pre-judgment attachments or other routine pre-judgment remedies. The reasoning is as follows:

1. Under the express language of most charging order statutes, a charging order is a remedy made available to a "judgment creditor."

2. However, a pre-judgment plaintiff is not yet even a judgment creditor.

3. Therefore, nothing in the charging order statute addresses, much less prohibits or restricts, pre-judgment remedies.

4. See *First Mid-Illinois Bank v. Parker,* 403 Ill. App. 3d 784, 933 N.E.2d 1215 (2010).

B. The foregoing theory clearly implicates the "when" and "who" aspects of charging orders.

1. When?

a. The charging order and its exclusivity rules apply only during the post-judgment phase.

2. Who?

a. The charging order only targets members or partners who are subject to judgments.

b. As corollaries:

i. The only creditors bound by the charging order's exclusivity rules are judgment creditors.

ii. Pre-judgment plaintiffs are not restricted by the charging order's exclusivity rules.

C. What about priorities arising from pre-judgment attachments?

1. If a pre-judgment attachment creates a pre-judgment lien, and if the plaintiff ultimately prevails and procures a judgment against the debtor-member/partner, then:

a. "[T]he doctrine of relation back merges an attachment lien in the judgment and relates the judgment lien back to the date of the attachment." *First Mid-Illinois Bank v. Parker,* 403 Ill. App. 3d 784, 795, 933 N.E.2d 1215 (2010).

b. This "relation back" means that the lien created by a post-judgment charging order will be deemed to exist and take priority as of the date on which the pre-judgment attachment lien arose.

i. See generally *First Mid-Illinois Bank v. Parker,* 403 Ill. App. 3d 784, 933 N.E.2d 1215 (2010).

2. However, if the plaintiff loses on the merits, then the pre-judgment attachment lien presumably dissolves just like any other pre-judgment attachment lien held by a losing plaintiff.

D. Although there is currently no authority directly on point, *First Mid-Illinois Bank's* logic regarding pre-judgment attachments and related pre-judgment liens could easily be applied to other pre-judgment remedies that create pre-judgment liens under local law (e.g., a creditor's bill).

XXII. Operating Agreements May Not Bind Non-Parties, e.g., Assignees

A. An operating agreement may not bind a non-party.

1. This can be a significant issue in connection with assignees.

2. It can also be an issue if a judgment creditor with a charging order is legally equated with an assignee.

    a. Note, though, that charging order statutes frequently say that "[a] judgment creditor has only the rights of an assignee," Ohio Rev. Code § 1705.19(A), not that a judgment creditor with a charging order "is" an assignee.

3. Either way, this can be potential source of trouble if an assignee somehow gets more rights than the member or partner who made or who is deemed to have made an assignment.

B. A growing number of states now deal with this issue by statute. For example:

1. Delaware:

    a. 6 Del. Code § 18-101(7) expressly provides that LLC operating agreements are binding on assignees, whether or not they sign the agreement.

    b. Counterpart provisions exist for Delaware LPs. See 6 Del. Code § 17-101(12).

2. Ohio's LLC Act, Ohio Rev. Code § 1705.18(B), which states:

> A substitute member of a limited liability company or an assignee of a membership interest in a limited liability company is bound by the operating agreement whether or not the substitute member or assignee executes the operating agreement.

C. In states that don't expressly address this issue, there is a risk that operating agreements or limited partnership agreements are not binding on assignees of interests.

XXIII. The Asset Protection Problems of Single Member LLCs

A. Many jurisdictions, especially inside the U.S., authorize single member "one man" LLCs, making them a globally recognized phenomenon. Examples include:

1. Ohio: ORC § 1705.04(A)

2. Delaware: 6 Del. Code18-201(a)

3. California: 2.5 Cal. Code § 17050

4. Texas: Art. 3.01(A), Title 32 Tex. Civ. Stat., Ch. 18, Art. 1528n

5. New York: Ch. 34 McKinney's Cons. Laws of NY, § 203(a)

6. Nevis: Nevis Limited Liability Company Act 1995, § 21.

7. Cook Islands: Statute currently being drafted.

B. Many people do, in fact, have one-man LLCs whose only or predominant purpose is to hold assets for the sake of a single member.

1. Under these circumstances, the LLC is essentially a trust substitute for the single member.

C. If there is a single owner of a holding company, this raises the odds that the LLC may be exposed to some type of direct action argument (*i.e.*, UFTA, veil piercing, equitable trusts, etc.) unless there is some sort of statutory mandate to the contrary.

1. This type of direct action approach against a one-man LLC would probably conflict with the "exclusivity" notion associated with charging orders.

2. Moreover, if the relevant LLC statute contains an exclusivity clause, and does not distinguish between multi-member and single member LLCs, then one can very reasonably argue that: i.) The legislature has spoken; ii.) The charging order is the exclusive means of satisfying a judgment out of a debtor's membership interest; and, iii.) Claims against the debtor-member's LLC interest do not allow direct seizure of LLC assets, even if there is just one owner of the LLC.

3. Nonetheless, a court might allow a direct action claim, especially if the court thinks that the "exclusivity" rule is limited to ways to squeeze value out of a debtor's membership interest, and has no bearing on attempts to squeeze value out of the LLC entity itself.

D. Additionally, some commentators argue that a one-man LLC that acts as a passive holding company does not warrant the protection of an exclusive charging order regime. They reason as follows:

1. Charging order regimes were meant to protect ongoing business from seizure of partnership assets to satisfy the debts of an individual member, and also to preserve the voluntariness of a partnership relation.

2. These reasons do not apply to one-man LLCs that are passive holding companies because: i.) There is no real business to disrupt, and the only impact is on the title of assets; ii.) With a single owner, there are no other "innocent" co-owners who will have an involuntary partner thrust upon them.

3. Accordingly, courts should allow direct seizure of assets held by a one-man LLC that is merely a passive holding company owned solely by a debtor.

4. Sometimes, courts agree with this pro-creditor argument. See, e.g., See *Olmstead v F.T.C.*, 44 So.3d 76, (Fla. 2010), rehearing den'd (Fla. S. Ct. 2010 August 31).

    a. The court basically reasoned that the absence of the word "exclusive" from Florida's LLC charging order statute meant that charging orders were cumulative rather than exclusive.

        i. Accordingly, this case turned on some rather unusual statutory phrasing.

        ii. Nonetheless, this case indicates that some courts will look for ways to get around a charging order unless there is clear precedent and/or statutory language to the contrary.

    b. *Olmstead* has been roundly criticized, starting with the dissenting opinion issued in *Olmstead* itself, as well as by some professional literature. See, e.g., Loeffler & Sullivan, *Ohio LLCs After Florida's Olmstead Decision: Why Ohio LLCs are No Good Anymore, How to Fix Them, and What to Do Until They're Fixed*, Probate Law Journal of Ohio, Vol. 21, No. 2, p. 66 (November/December 2010).

        i. NOTE: This article pre-dated some significant changes to Ohio's LLC law.

E. However, in some states, there is a clear statutory rule that protects single-member LLCs from singling out by courts, and in many cases the statutory rule in favor of SMLLCs is combined with a "narrow remedy" LLC charging order statute that also

protects against other legal and equitable remedies.

1. In such states, the members of SMLLCs should get the same charging order protections that are available to members of multi-member LLCs.

2. Examples:

    a. Ohio

        i. Ohio Rev. Code § 1705.031 (making various provisions of the Ohio LLC Act, including its charging order rules, "apply to all limited liability companies formed under this chapter whether the limited liability company has one or more members…"

        ii. Ohio State Bar Association's Corporations Committee cmt. to ORC § 1705.19 (online LAWriter version), which states, "New divisions (B) and (C) have been added to state that a judgment creditor's sole and exclusive remedy with respect to a membership interest in a limited liability company is a charging order. The charging order is the only remedy, whether the membership interest is or is not evidenced by a certificate, or whether it is a membership interest of a single member limited liability company."

        iii. See also Ohio Rev. Code § 1705.19 and *Knollman-Wade Holdings, L.L.C. v. Platinum Ridge Properties, L.L.C.*, 2015-Ohio-1619 (Ohio App. 10th Dist.) (establishing exclusive and narrow nature of Ohio's charging order remedy).

    b. Delaware

        i. Charging order rules at 6 Del. Code § § 18-703(d), which states, "The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member."

c. South Dakota

i. Charging order rules at SDCL § 47-34A-504(g), which states, "This section applies to single member limited liability companies in addition to limited liability companies with more than one member."

ii. See also SDCL § 47-34A-504(e), (f) (establishing exclusive and narrow nature of South Dakota's charging order remedy).

d. Nevada

i. Charging order rules at NRS § 86.401(2)(a), which states, "This section: (a) Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor, whether the limited-liability company has one member or more than one member."

ii. See also the balance of NRS § 86.401(2)(a) (establishing exclusive nature of Nevada's charging order remedies).

iii. Note, however, that Nevada does not bar a member's creditors from exercising other legal or equitable remedies vis-à-vis the LLC's property.

(a) This contrasts sharply with the statutes in Ohio, Delaware, and South Dakota, all of which expressly bar creditors from exercising such remedies.

(b) This also means that creditors might have another route to the pot of gold, i.e., the assets held by the LLC, by pursuing a direct action against the LLC in addition to seeking a charging order against the debtor-member.

(c) Quaere: Does this mean that Nevada is overrated?

e. Alaska

i. Charging order rules at AS § 10.50.380(e), which states, "This section applies to limited liability companies with only

one member as well as to limited liability companies with more than one member."

ii. See also AS § 10.50.380(c) (establishing exclusive nature of Alaska's charging order remedies).

iii. Note, however, that Alaska, like Nevada, does not bar a member's creditors from exercising other legal or equitable remedies vis-à-vis the LLC's property.

iv. Quaere: Does this mean that Alaska is also overrated?

F. Further, at least in the bankruptcy context, a debtor-member's interest in a single member LLC is vulnerable to creditor claims, no matter how broad, narrow, exclusive, or non-exclusive the applicable charging order rules might be.

1. See, e.g., *In re Albright,* Case No. 01-11367 ABC, Ch. 7, U.S. Bankr. Ct., D. Colo., 2003 Bankr. LEXIS 291 (Decided April 4, 2003).

2. In *Albright,* the debtor was the sole owner and sole manager of a Colorado LLC.

3. The court concluded that the debtor's interest in the LLC was property of the bankruptcy estate pursuant to 11 U.S.C. § 541, and that consequently:

a. The trustee in bankruptcy was not limited to a "wait and see" charging order situation.

b. Instead, the trustee could assume sole ownership and control of the LLC on behalf of the bankruptcy estate.

G. Even outside the bankruptcy context, a truly exclusive charging order rules for one-man LLCs do not end the matter:

1. An "exclusive" charging order might still allow foreclosure and other UPA style relief.

2. The charging order concerns itself with what relief is available when trying to get at a member's ownership interest. It does not address direct actions against the LLC itself.

a. Hence, constructive and resulting trust theories are potentially still available unless there is a statutory bar against such theories.

i. See, e.g., the bars available in Ohio, Delaware, and South Dakota, noted above.

b. In the absence of such bars, someone who is not an alter ego can still be treated as *de facto* trustee, thus potentially enabling creditors to take assets directly from the LLC.

3. One-man passive holding company LLCs are, as noted, more exposed to direct action theories than multi-member entities that are an operating, going concern.

H. Thus, one-man LLCs are potentially a rather limited asset protection tool.

1. They may be weak as trust substitutes or as a "stand alone" tool.

2. One-man LLCs may be a useful element of a broader plan that also combines a trust.

a. The trustee can be the sole owner. *See, e.g.*, Merric, *Comparison of the FLP versus the LLC as a Component to the Foreign Asset Protection Trust,* Asset Protection Journal, Autumn 2000, Vol. 2, No. 3, p. 31.

b. The client can still be the manager. *Id.*

c. The trustee can encumber his interest in the FLLC assets to secure his right to distributions upon liquidation, withdrawal, etc. This also cuts off the rights of future creditors. Sullivan, *The Often Overlooked Role of Disclosure in Asset Protection Planning: Part II,* The Asset Protection Journal, Summer 2000, Vol. 2, No. 2

3. Single member LLCs are still the vehicle of choice, however, for many small businesses.