

# Limits on Limited Liability Company Protections

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Since its inception, the limited liability company ("LLC") business form has provided owners with protection from the actions and the debts of the LLC and, to a point, a convenient shelter for storing particular assets out of the reach of their personal creditors. As a result, a creditor holding a valid judgment against an individual owner of an LLC (the latter being referred to in this article as a "Member- Debtor") often finds itself in a difficult position: the Member-Debtor's assets are titled in the name of the Member-Debtor's LLC and cannot be subjected to typical collection efforts. As creditors face more difficulty recovering on judgments, additional methods of collecting debts continue to arise under the law. Based upon those alternative collection methods, some of the asset protections afforded members by an LLC have been substantially weakened.

## Charging Orders

More and more, creditors are resorting to "charging orders" and other remedies to collect their debts from individuals who have attempted to shelter their personal assets in an LLC. Charging orders provide creditors of the Member-Debtor with a right to collect distributions, not from the individual assets the Member-Debtor has placed in the LLC, but based on the Member-Debtor's membership interest in the LLC. To obtain a charging order, the creditor first must obtain a judgment against the member personally. After that judgment is entered, the creditor then must apply to a court for an order charging the Member-Debtor's membership interest with payment of all amounts due under the judgment.

Once the charging order is entered, the creditor is entitled to receive and recover all distributions from the LLC to which the Member-Debtor would otherwise be entitled. Similar to corporate dividends paid to shareholders, LLC distributions are transfers of cash or other property to members of an LLC on account of their membership interests. If a distribution is made, the LLC must pay the creditor who has been granted a charging order all funds that would otherwise have gone to the Member-Debtor. Failure of the LLC to pay those funds directly to the creditor is a violation of the charging order and can result in varying degrees of liability being assessed to the LLC, including monetary fines.

A charging order does not, however, entitle the creditor to collect all funds paid by the LLC to the Member-Debtor. Funds paid as compensation for employment or for personal services rendered in the operation of the LLC are arguably off limits from collection via a charging order. Instead, the charging order allows the creditor to collect only those amounts paid by the LLC on account of the Member-Debtor's membership interest in the LLC. Stated differently, only those "profits" paid to owners of the LLC are subject to the creditor's charging order. If the LLC makes no distribution of profits to its members, the charging order is rendered an ineffective collection tool. However, there are exceptions to this potential defense to a charging order.

## Single-Member Limited Liability Companies

Typically, following entry of a judgment, creditors can "execute" upon the debtor's property, force a sale of that property, and recover the sale proceeds up to the amount of their judgment. Charging orders, however,

are different. Many courts have expressly forbidden attempts by creditors to force the sale of a member's interest in an LLC to recover on a judgment against the member only. Courts have reasoned that to do so would prejudice the rights of other members of the LLC. However, where LLCs are owned solely by one person – dubbed "single-member LLCs" – the old rules are beginning to change.

Although the issue has not been addressed directly in North Carolina, several courts across the country have ruled that the prohibition on forced sales of LLC membership interests to satisfy personal judgments of members is available only where there are two or more members in the LLC. Where the creditor obtains a charging order against the member of a single-member LLC, many courts have begun to allow the creditor to sell the member's membership interest and apply the proceeds toward satisfaction of the underlying judgment. Practically speaking, the sale of the ownership interest in that LLC produces a sale of the assets owned by that LLC.

The reason for this change is relatively obvious. Where there is only one owner of the LLC, there are no other ownership interests that need to be protected. Because that one owner is liable on the underlying judgment and owns all interests in the LLC, courts are willing to lower the shield of protection flowing from the separate legal identity of the owner and the entity. Through effective advocacy, creditors of individuals who own single-member LLCs have created an acceptable avenue for recovering debts from assets previously ruled off limits.

### **The Flip-Side: Planning Ahead by Member-Debtors**

Although effective under certain scenarios, successful collection efforts through charging orders and the single-member LLC issue described above are confined to a relatively narrow set of circumstances. Prudent planning by LLC members can often help to avoid a loss of assets. There are several inexpensive solutions that can be enacted in a short period of time. These may include paying the LLC members a reasonable salary and/or wage for their services rendered to the daily operation of the LLC or expanding the ownership base of the LLC to two or more persons. However, it is important to remember that there is no "one size fits all" solution when faced with these types of issues.

### **Conclusion**

By virtue of charging orders, creditors now are sometimes successful in collecting personal debts from the distributions from, or even the assets of, unobligated LLCs owned, in whole or in part, by their debtors. But, with some planning, the effectiveness of charging orders can be blunted. Both the effectiveness of a creditor's charging order and the asset protection of the Member-Debtor will rest on specific factual conditions. Through careful planning and the assistance of knowledgeable legal advisors, it is possible for a creditor to reach heretofore unavailable assets, and for members of LLCs to avoid potential liability and to continue to enjoy the asset protection afforded by LLCs.

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*For further information regarding the issues described above, please contact Tyler J. Russell.*

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