

CHARGING ORDERS: OUTSIDE-IN V. INSIDE-OUT ASSET PROTECTION

Since 1994, when the Beverly-Killea Limited Liability Company Act was adopted by the California legislature, LLCs have quickly become the entity of choice for most entrepreneurs. In addition to shielding their owners (i. e., members) from entity-level liabilities ("inside-out protection"), LLCs also offer the managerial flexibility and pass-through taxation of partnerships. However, to what extent can assets held by the LLC be protected from lawsuits and claims of the members? Specifically, when a member is involved in an unrelated lawsuit (i.e., a lawsuit that is not related to the business or actions of the LLC), how does this event affect the LLC and the remaining members? As we will see, a properly structured LLC can offer members with "outside-in protection", that is, protection of the LLC assets and business from the claims of a member's creditors.

To better understand the concept of "outside-in protection," it is best if one compared the consequences of operating in the LLC form with those of operating in a corporate and partnership format.

Corporation: In a corporation, ownership interest (i.e., stock) is generally freely transferable. As such, a creditor of a debtor-shareholder may attach the shares of the debtor's stock to gain all the rights that the debtor had in the corporation, including rights to transfer the shares, the right to vote on corporate matters, the right to view books and records, and rights to bring derivative actions against errant corporate officers and directors. Furthermore, if the debtor-shareholder's interest is sufficiently significant, the creditor may cause the liquidation of the corporation and obtain access to its assets.

Partnerships: Historically, a creditor pursuing a debtor who happened to be a partner in a partnership was able to petition a court for a writ of fieri facias asking the court to direct a levy officer (usually a sheriff) to go down to the partnership's place of business in order to seize sufficient partnership property in order to satisfy the debtor-partner's obligation. Needless to say, the process frustrated the operation of the partnership business as well as the solvent partners' intentions. Due to various policy objectives (e.g. preventing disruption of partnership business), legislatures and courts have been largely unwilling to convert a partner's creditors into full-fledged partners. Nevertheless, in order to provide some degree of creditor protection, both legislatures and courts have been more receptive to establishing and implementing "charging orders."

Briefly, a charging order is an affirmative, but temporary, creditor remedy (i.e., it is actually sought by the creditor). Generally, a creditor is required to first obtain a judgment against a partner. Next, the creditor petitions for a charging order which is an action against the partner's distributional interest partnership. The creditor is only entitled to distributed profits. The debtor retains his partnership interest and is taxable on his pro rata share of partnership income. The partnership is directed to distribute all profits due to the debtor-partner to the creditor. However, if the other partners decide not to distribute profits of the partnership, nothing is due to the debtor partner and the creditor cannot compel a distribution. Therefore, the creditor may seek to foreclose on the debtor's partnership interest whereby the creditor ordinarily becomes the owner of the partner's transferable interest. The creditor may then attempt to sell the interest to an outside buyer in order to recoup some of his costs. Nevertheless, if the partnership has relatively few partners or is controlled by relatives or friends of the debtor, the creditor attempting to sell the foreclosed interest may not be able to obtain a desired purchase price for the interest in the partnership.

In reality, although some regard the charging order limitation as a form of "asset protection", the limitation may be best described best as "creditor frustration" simply because a creditor may not be willing to invest significant resources (i.e., litigation costs) in order to obtain something of relatively insignificant value (i.e., debtor's transferable interest in the partnership).

In California, the charging order limitation has been extended to LLCs. Under California law, the charging order constitutes a lien on a debtor's transferable membership interest. Whether a membership interest is assignable depends on the provisions of the operating agreement (which may specify that a new member may be accepted by all or significant portion of the members) or, in the alternative, provisions of state law applicable to LLCs. If a well-drafted operating agreement restricts the transferability of the interest, or couples such transferability with buy/sell or redemption provisions (for nominal amount), the charging order remedy may be of little or no value to an outside creditor.

It is important to note that creditors of single-member LLC investors might not be limited to the charging order remedy. From a policy point of view, charging orders have been adopted in order to protect solvent partners (or members). In a single-member LLC, this concern is non-existent. Nevertheless, the presence of at least one unrelated capital-interest holding member may be sufficient, in some

circumstances, to make the charging order remedy applicable to the LLC.

In sum, properly-structured charging order protected entities (e.g. LLCs) protect the investment of the original members, and their ability to manage their own business. Thus, the charging order concept is simply another factor that must be considered when structuring a California business entity.