LIMITING LIABILITY

A presentation by Domenick R. Lioce at the January 21, 2010 JOINT meeting of the East Coast Estate Planning Council and Planned Giving Council of Palm Beach County.

Abstract:

One of the primary benefits of utilizing an entity to own assets or operate a business is that the entity shields the owners' other assets from third-party claims against the entity (inside liabilities). Corporations have been in existence more than 100 years. There is a large body of case law indicating when the "corporate veil" can be pierced such that claims against the corporation can reach the shareholders of the corporation.

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LIMITING LIABILITY

1. Insulation Against Inside Liabilities

a. One of the primary benefits of utilizing an entity to own assets or operate a business is that the entity shields the owners' other assets from third-party claims against the entity (inside liabilities). Corporations have been in existence more than 100 years. There is a large body of case law indicating when the "corporate veil" can be pierced such that claims against the corporation can reach the shareholders of the corporation. The limitation on liability provided by incorporation is not without boundaries. Two rules, the "instrumentality rule" and "identity rule" have been developed to determine when a court can pierce the corporate veil.

b. The instrumentality rule requires proof of three elements: (i) complete dominion and control of both the entity's policy and business practices; (ii) use of such control to commit fraud or wrong, breach of a legal duty, or a dishonest or unjust act (such as using such control to avoid personal liability previously assumed by an individual); and (iii) the aforesaid control and breach of duty proximately caused the injustice or loss.

c. The identity rule is generally employed in a situation where two corporations are, in reality, controlled as one entity because of common owners, officers, directors, or shareholders, and because of a lack of observance or corporate formalities between the two entities.

d. LLCs have only become popular in Florida following the 1999 repeal of the application of the Florida Corporation Income Tax to the income of LLCs and later the repeal of the Florida Intangible Tax on LLC interests. LLPs became more popular when the Florida legislature amended the LLP statute to provide for unlimited liability rather than the partial limitation of liability that was available prior to the change. There are no cases in Florida that determine the extent the "corporate veil" extends to LLCs. The liability shield referred to sometimes as a "veil" may be more complete, less complete, or the same as the "veil" of a corporation. It is believed that LLCs provide effective insulation from inside liabilities.

e. In an unreported decision, one court has held that under the appropriate circumstances, it may "pierce the corporate veil" of an LLC and hold the members personally liable for wrongs done to third parties. In *Stone v. Frederick Hobby Associates II, LLC*, 2001 Conn. Super. LEXIS 1853, Superior Court, Judicial District of Stamford-Norwalk, at Stamford, Docket No. CV000181620S (July 10, 2001), the court found that the "instrumentality and identity rules" could be applied, under the facts of the case, to "pierce the corporate veil" of an LLC and hold the individual members personally liable.

f. *Litchfield Asset Management Corp. v. Howell*, 799 A2d 298 (Conn., 2001). Although it would seem that the charging order remedy should have been vigorously advanced as a defense and at least discussed in some detail by the court, the *Litchfield* case was argued and decided purely as a reverse veil piercing case. In *Litchfield,* the court affirmed a reverse pierce of the LLC veil, so that the LLC's assets were available to the judgment creditor of the LLC's sole member. According to the record evidence, after a judgment was entered against the debtor in her individual capacity, she set up two LLCs and contributed cash to both.

The *Litchfield* court found that the LLCs never operated a business, never made distributions or paid salaries, and the debtor used the assets of the LLC to pay her personal expenses and make interest-free loans to family members. In applying the veil-piercing standard, the court held that the debtor used her control over the LLCs to perpetrate a wrong, disregarded corporate formalities, and exceeded her management authority (in making interest-free loans). Accordingly, it ordered reverse piercing of the LLCs. *Litchfield* provides additional support for the proposition that a single member LLC may be flawed as an asset protection vehicle; that is, in situations where the facts resemble those in *Litchfield*, counsel for a creditor can simply file a complaint grounded in fraud and invoke the veil-piercing remedy, which will likely enable the judgment creditor to circumvent the normal judgment collection procedures codified in the relevant LLC Act, *i.e.,* the charging of the member's interest in the LLC.

INSULATION AGAINST OUTSIDE LIABILITIES

1. A key asset protection feature of an LP and LLC is that, if a limited partner is unable to satisfy a creditor (an outside liability), that creditor's only remedy may be to receive a "charging order" against the income of that partner's limited partnership interest or membership interest. The protection of the charging order concept should extend to LLCs in Florida.

2. An LP and LLPs provide insulation from outside liabilities by limiting outside creditors to a charging order remedy.

3. The Florida Task Force successfully submitted to the legislature a revised FRULPA statute based upon RE-RULPA ("RE-FRULPA"). As a result, RE-FRULPA currently provides that the charging order is the exclusive remedy for a judgment creditor of a limited partner.[1]

4. The Exclusivity of the Charging Order Remedy

   a. RE-FRULPA provides that a charging order is the sole remedy available to a creditor and that the judgment creditor has only the rights of an assignee to the extent so charged. Fla. Stat. §620.1703 provides a similar protection for LLCs. However, Fla. Stat. §608.433 does not provide that the charging order is the "sole" remedy against an LLC interest as is the rule for LPs. This issue is currently being addressed by the Florida Bar Task Force.

   b. The recipient of a charging order has only the rights of a transferee and, therefore, does not acquire management and other rights of partners. Instead, it has only the rights that the judgment debtor/partner had to distributions. In this regard, the holder of a charging order is analogous to the garnishor of wages. The charging order represents a lien on the judgment-debtor's right to distributions. That right is the judgment-debtor's transferable interest. Other remedies, including foreclosure on the partner's interest in the limited partnership or a transferee's transferable interest and a court order for directions, accounts, and inquiries that

[1] The Delaware legislature amended Delaware LP and LLC law, effective August 1, 2005, to expressly provide and emphasize that the charging order is a creditor's sole recourse for both LPs and LLCs. Foreclosure of an LLC or LP interest is expressly not allowed if all the creditor has is a charging order.

the debtor general or limited partner might have made, are not available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited partnership and may not be ordered by a court. Fla. Stat. §620.1703(3).

c. *Crocker Nat. Bank v. Perroton*, 208 Cal. App. 3d 1 (Cal. App. 1st Dist. 1989) - Court of Appeals of California addressed the question whether a charged limited partnership interest was subject to foreclosure and sale. Held, the court can authorize a sale of the debtor's partnership interest where (1) creditor had a charging order, (2) all partners other than the debtor agree to the sale, and (3) the judgment remained unsatisfied. *See also Hellman v. Anderson*, 233 Cal. App. 3d 840 (1991), where the court went further and stated that the consent of non-debtor partners is not always required.

d. *Nigri v. Lotz*, (1995, GA App) 453 SE2d 780 – In the charging order remedy context, the *Nigri* decision illustrates the importance of choosing the state of incorporation in the choice of entity process. As was the case in *Nigri*, if the applicable limited partnership statute and pertinent case law does not provide that the charging order is the sole remedy, the court may provide for enforcement of the charging order by means such as foreclosure of a partner's interest. The Court of Appeals of Georgia addressed the question whether a charged limited partnership interest was subject to foreclosure and sale. The Court of Appeals in *Nigri* held that a court may provide for enforcement of the charging order by means such as foreclosure of a partner's interest, especially when it is apparent that distributions under the charging order will not pay off the judgment debt within a reasonable period of time. The Court reasoned that the trial court should have discretion to determine whether or not a judicial sale of the charged partnership interest is an appropriate means in aid of the charging order.

A cautionary note: The Court in *Nigri* made an argument in Footnote 3 of the opinion which bears a disturbing resemblance to the argument made by the Bankruptcy Court in Albright. In *Albright*, the now bankrupt sole member sought to thwart the trustee's ability to reach the assets of the LLC and to use them to satisfy her obligations by arguing that the trustee was limited to the relief afforded by a charging order, namely receipt of distributions as made. The court, in rejecting her charging order defense, reasoned based on the legislative history that the charging order remedy was designed to protect non-debtor members of a multi-member LLC from judgments against a debtor member. Thus, reasoned the Bankruptcy Court, in a single member entity such as Albright's LLC, there are no non-debtor members to protect and so it was proper for the trustee to take on a managerial position in the LLC in place of Albright. Similarly, in *Nigri*, noting that the partnership was a limited partnership governed by both ULPA and UPA, the Court of Appeals noted that UPA contains a provision specifically prohibiting the sale of a charged interest, while the ULPA does not. The Court of Appeals reasoned, based on the legislative history, that the apparent purpose of prohibiting the sale and transfer of a partner's charged interest under the UPA was the fear that it could cause disruption because the creditor-assignee may be able to seek judicial dissolution of the partnership. However, concluded the court, this reasoning does not apply to foreclosure of limited partnership interests since the assignee of a limited partnership interest cannot seek judicial dissolution under the ULPA.

e. *In re Albright*, a bankruptcy decision from Colorado dealing with a single member LLC, where the court interprets a charging order as only existing to protect

other members of an LLC from sharing governance responsibilities with a judgment creditor. Therefore, the court decided that single member LLCs, having only one managing member are not protected in that there are no other members to protect (allowing for judgment creditor to also obtain governance rights). *In re Albright*, 291 B.R. 538 (Bankr., 2003).

It is important to note, however, that *Albright* involved a Chapter 7 (liquidation) bankruptcy. As stated by the court, upon the debtor's bankruptcy filing, the debtor "effectively transferred her membership interest to the estate." Since there were no other members, the bankruptcy trustee became a "Substituted Member". Thus, the same result would not necessarily occur in favor of a creditor.

The *Albright* court found that certain elements of the statutory structure of LLCs, including the charging order and the requirement of approval by the current owners for the admission of new members, lost their rational support when viewed in the context of a single member LLC. The Albright case should not be applicable to multi-member LLCs. See also *In Re Ehmann supra* at page 26 and *Crocker, infra* at page 28. However, the latest revised Model LLC Act permits foreclosure on a multi-member LLC interest as in *Crocker* and *Nigri*, *supra*. The Florida Bar Task Force which is drafting the new Florida LLC Act is currently reviewing these issues.

f. In *Florida Federal Trade Commission v. Olmstead*, Eleventh Circuit Court of the U.S. Court of Appeals, (2008 Fed. Ct. of App.) 528 F.3d 1310, is currently being reviewed by the Florida Supreme Court, involves two women who operated a credit card scam, using an "S" Corp and a single member LLC. A receiver was appointed over the LLC, to which the defendants consented, the receiver was directed to "conserve, hold and manage, preserve the value of, and prevent the unauthorized transfer, withdrawal, or misapplication of the entities' assets. FTC later obtained a $10,000,000 judgment against the individuals. The FTC then moved to compel the defendants to surrender their single member LLC interests to the receiver. The District Court granted the motion, and the receiver sold the LLCs assets and paid the proceeds to the FTC.

The appellate court certified the following question to the Florida Supreme Court: "Whether, pursuant to Fla. Stat. §608.433(4), a court may order a judgment-debtor to surrender all "right, title and interest" in the debtor's single-member limited liability company to satisfy an outstanding judgment."

g. Current "*Ehmann*" Issue. A more recent Bankruptcy Court decision decided in Arizona (*In re Ehmann*, 319 Bankr. D. Ariz. 2005) allowed a Chapter 7 Bankruptcy Trustee to step into the shoes of the bankrupt member of an Arizona LLC as a "full member", not burdened by the "assignee" status of a transferee as mandated by state law or the operating agreement. *Ehmann* involved a multi-member family LLC that was set up by the debtor's parents. Arizona law provides that a charging lien is the sole remedy for the creditors. However, as in *Albright*, the debtor filed for a Chapter 7 bankruptcy liquidation. Additionally, the debtor's parents were distributing significant funds out to themselves and other children; but not to the debtor (the bankruptcy trustee).

Recent discussions among tax planners have given rise to the following recommendations to mitigate the *Ehmann* issue: i) make the FLP agreement or operating agreement an "executory contract" for bankruptcy law purposes by providing for ongoing obligations by entity and owners; ii) mandatory capital calls; iii) service obligations; iv) non-competition obligations; and v) have partnership interest or membership interest owned by a trust or as tenants by the entirety.[2]

h. It is interesting to note in Rev. Rul. 77-137, the Service decided that the entity's K-I goes to the holder of a charging order. This can be a strong inducement to a creditor to settle.

i. Bottom Line. In Florida, RE-FRULPA currently provides the exclusivity of the charging order as a remedy Florida courts should be bound by such exclusivity on a going forward basis. As a practical matter, the creditor will receive a K-1 from the partnership and will have to complain to the IRS and convince them that it should not be subject to taxation. Since no one really enjoys requesting an IRS audit, a creditor holding a charging order should likely be willing to settle for less than the value of the claim. Even if a court were to fly in the face of RE-FRULPA's new legislative mandate (unlikely) and impose the foreclosure sale remedy, the creditor is still sitting there as transferee with absolutely no voting rights (*i.e.,* no way to ever compel a distribution). At the end of the day, the creditor is really "K-Oed by the K-1." *See* Tax Consequences of Charging Orders: Is the K.O. by K-1 K.O.'d by the Code by Christopher M. Riser. Unfortunately, LLCs are not as tightly protected.

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[2] In Florida, significant asset protection is accorded property owned as "tenants by the entirety" whereby each of husband and wife are considered to own 100% of the asset thereby theoretically forbidding a creditor of only one spouse from seizing the property. Exceptions to this are "joint debt" and if the non-debtor spouse dies while the debtor spouse has an action against them. However, it is significant to note that this particular exemption has been the most fragile over time, although recent case Musolino makes the exemption strong presently (bolstered by recent cases of Bank of Beal and Kossow which create presumptions in favor of Tenancy by the Entirety).