

CHARGING ORDER LANDMINES

Prepared by:
Jeffrey M. Grieff
Miller Nash Graham & Dunn LLP

INTRODUCING

Lorman's New Approach to Continuing Education

ALL-ACCESS PASS

The All-Access Pass grants you **UNLIMITED** access to Lorman's ever-growing library of training resources:

- ☑ Unlimited Live Webinars - 120 live webinars added every month
- ☑ Unlimited OnDemand and MP3 Downloads - Over 1,500 courses available
- ☑ Videos - More than 700 available
- ☑ Slide Decks - More than 1700 available
- ☑ White Papers
- ☑ Reports
- ☑ Articles
- ☑ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.



Get Your All-Access Pass Today!

SAVE 20%

Learn more: www.lorman.com/pass/?s=special20

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

*Discount cannot be combined with any other discounts.

CHARGING ORDER LANDMINES.

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

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

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

A. JUDGMENT CREDITOR OF A MEMBER

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

- **Uniform Business Organization’s Code (2011-ABA) (UBOC) Article 5, Section 502**

- i. Right of assignee to become member.**

- a.** An assignee of a limited liability company interest may become a member upon:

- 1.** The approval of all of the members of the limited liability company other than the member assigning his or her limited liability company interest; or

2. Compliance with any procedure provided for in the limited liability company agreement.

b. An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under an LLC agreement. An assignee who becomes a member is liable for the obligations of his or her assignor to make contributions to the LLC in accordance with the Operating Agreement and for the obligations of his or her assignor.

c. Whether or not an assignee of an LLC interest becomes a member, the assignor is not released from his or her liability to a limited liability company.

B. STATUTORY CHARGING ORDERS

If your member's objective is to keep the LLC closely held and limit the membership of the LLC to only those parties acceptable, draft the operating agreement to provide that membership interests are not "Transferable Interests" or "Assignable Interests" I have provided an example of a provision in the operating agreement that serves this objective. Don't fall into the trap of allowing a membership interest to become a "Transferable Interest."

Under **UBOC Article 5, Section 503(a)**, the majority of state LLC statutes, on application by a judgment creditor, a member's transferable interest in a partnership may be subjected to a charging order. The partner's transferable interest is his economic interest; management rights are not transferable unless all other partners approve or the partnership agreement otherwise provides.

"A charging order constitutes a lien on the judgment debtor's transferable interest in the partnership." (**UBOC Article 5, Section 503(a)**). The court may order a foreclosure of the interest subject to the charging order at any time if the jurisdictional state statute provides. (**UBOC Article 5, Section 503(c)**). Such a foreclosure would foreclose only the economic interest subject to the charging order.

Under **UBOC Article 5, Section 503**, a member's LLC interest may be charged with payment of the unsatisfied amount of a judgment with interest. Use of the word "may" places issuance of a charging order within the court's

discretion. To the extent charged, the judgment creditor “has only the rights of an assignee of the limited liability company interest.” **UBOC Article 5, Section 503**

As assignee has not right to participate in management of the LLC. Under **UBOC Article 5, Section 503(b)**, the assignee of a member’s LLC interest “shall have no right to participate in the management of the business and affairs” of the LLC except upon approval of all of the members of the LLC other than the member assigning his interest, or as provided in the LLC Operating Agreement.

C. ASSIGNABLE INTEREST IN THE LLC

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

Upon assignment of the member’s LLC interest in accordance with the Operating Agreement, the member ceases to be a member and no longer has the right to exercise any rights or powers of a member, unless otherwise provided in the LLC agreement. **UBOC Article 5, Section 502**. In the case of a single-member LLC, this would effectively freeze the LLC as there would be no one authorized to manage it unless the LLC Operating Agreement provided otherwise, creating a need to appoint a receiver.

An assignee of a member’s LLC interest can become a member if all other members (except the assigning member) approve, or if allowed by the LLC Operating Agreement. **UBOC Article 5, Section 502**.

- **The Relevant Statutes:**

- i. **UBOC Article 5, Section 501 and Section 502**

- a. **Nature of limited liability company interest – Certificate of interest.**

1. A limited liability company interest is personal property. A member has no interest in specific limited liability company property. (UBOC Section 501)

2. A limited liability company agreement may provide that a member's interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company. (UBOC Section 502(d))

ii. UBOC Article 5, Section 501 and Section 503

a. Rights of judgment creditor.

1. 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. (UBOC Section 502(a)(3) and Section 503)

D. LLC OPERATING AGREEMENT PROVISIONS

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

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

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

- i. Without first notifying each Member, in writing, thirty (30) days in advance of any proposed transfer;

ii. Unless and until the Company has received an opinion of counsel for the Company, prepared at the transferring Member's expense, stating that the proposed transfer will not cause the termination of the Company under this Agreement or the Act;

iii. Unless and until the Company has received an opinion of counsel satisfactory to the Members, prepared at the expense of the Member proposing the transfer, stating that the proposed transfer (a) may be effective without registration of the Percentage Interest under the Securities Act of 1933, as amended, and (b) will not violate any applicable state securities law (including investor suitability standards);

iv. Unless and until the transferor has made all required contributions to the capital of the Company;

v. The transfer or assignment of the Member's Percentage Interest is approved unanimously by all the other Member(s); and

vi. The transferee or assignee is unanimously approved by all the other Member(s) to be admitted as a Member and participate in the management of the Company.

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

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

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

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

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

- **Purchase/Redemption Special Formula ("Poison Pill")**

- i. In the event any member's transferable Percentage Interest in the Company becomes subject to a charging order to satisfy a judgment lien by a third party creditor pursuant to **UBOC Article 5, Section 503** or an ordered foreclosure of the charging order by a third party creditor pursuant to **UBOC Article 5, Section 503**, the purchase/redemption price of the member's interest charged shall equal five (5) times the agreed value of the Company set by the members in accordance with this Agreement multiplied by the transferred Percentage Interest to satisfy a judgment lien or foreclosure of the interest charged by a third party creditor.

- ii. Upon the occurrence of such an event set forth in Section 1.1 herein, the member whose Percentage Transferable Interest is charged to satisfy a judgment lien by a third party creditor shall give notice of such event to the Company in writing.

In a single member LLC, the court could decide that the protection of the sole member would not apply and could disregard the charging order restrictions

and allow the judgment creditor, assignee, or bankruptcy trustee to replace the sole member in the management of the LLC. There are no other members to protect! You need to inform and discuss with your client seeking to form a single member LLC.

