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Piercing the LLC Veil: Best Practices to Avoid Member Liability for Business Debts

Protecting the Limited Liability Benefits of LLCs Amid Evolving State Law

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LIMITED LIABILITY COMPANIES

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I. **Series LLCs**

1. The Series LLC is a separate legal entity like a normal LLC, but it also has the ability to partition its assets, debts and other liabilities among two or more distinct "series" or "cells" ("Series") under the umbrella of a "master" LLC. A Series is like a division for maintaining assets and liabilities separate from the assets and liabilities held within other Series of the Series LLC. While Series LLCs are particularly useful for segregating investment shares and apportioning the return or cash flow from several assets or portfolios held by a single entity, this alternate structure has many other applications, particularly when fractionalized ownership would foster liability management and asset protection (for example, separating parcels or components in a real estate development), or dividing economic participation among several businesses or investments that are partially but not wholly-owned in common (such as a manger-sponsor who wishes to market a process or concept in several locations and needs either local capital or services).

2. Series LLCs were first enacted in the State of Delaware in 1996. Other states that have adopted Series LLCs include Illinois, Iowa, Nevada, Oklahoma, Tennessee, Texas and Utah. A Series LLC is an entity that permits the creation of separation series, wherein the assets of one Series are shielded from the liability of another series without having to actually form a separate legal entity.

3. In Florida and the remainder of the states who have not adopted Series LLC, the same result can be accomplished by forming subsidiary LLCs. The key administrative cost differential appears to be that the Series LLC saves in the formation cost of each subsidiary, filing fees, professional fees, and annual renewal fees.

4. Case law has not been developed on Series LLCs yet, and there is much fear in the professional world that the assets may not be as protected as when the entity is formed. What is clear is that the "corporate formalities" must be carefully followed, such that:

   a. Separate books and records should be maintained for each series;

   b. Creditors need to be made specifically aware of the separate existence of each series; and

   c. The assets of each must be unambiguously identified as belonging to that series.

5. One of the most significant issues is whether bankruptcy courts and creditors will be subject to the limited liability standards that would otherwise apply to the Series LLCs by the terms of their organizational statutes, and whether their internal shields will be recognized in states that do not have Series LLC enabling provisions. It is not clear whether a Florida court will uphold liability protection if an out-of-state Series LLC decides to conduct business within Florida. The Florida Department of State is trying to determine the best course of action for allowing out-of-state Series LLCs to register as a foreign LLC doing business in the state. While the Full Faith and Credit Clause of the U.S. constitution requires states to respect transactions governed by the law of another state, the breadth of this protection is limited when the law is against the host state's public policy. There is still some uncertainty as to how bankruptcy courts will treat the separate Series of a Series LLC under its "consolidation" rules.

6. It is still not entirely clear how a Series will be characterized for federal and state income tax purposes. In 2008, the IRS issued the first Private Letter Ruling (PLR 200803004) upholding implicitly that each Series of a Series LLC is a separate entity for federal tax purposes. The ruling was issued to a group of insurance companies that were reorganizing their mutual fund as a Delaware Series LLC, and affirmed that each Series was entitled to choose its own entity classification independent of the classification of the other Series.

While the IRS did not explicitly rule that each Series of the Series LLC is a separate legal entity, the ruling treated each Series as being entitled to elect its classification under the check-the-box regulations, *supra*. Moreover, the IRS allowed multiple entity classifications for the Series within the same Series LLC, which would not be possible unless each Series was treated as a separate entity for classification purposes under the IRC § 7701 regulations. In other words, the IRS ruled that a Series with one member would be treated as a disregarded entity, while the Series with more than one member could elect to be treated as either a partnership or as an association taxable as a corporation.

7. Where the entity is properly set up and the operative documents reflect clearly the series, each LLC in the series should be disregarded for federal income tax purposes. However, there have been analogous cases in the trust area that have held such subsidiaries as separate taxpayers. This may be of particular importance where the ownership percentage is different on a series-by-series basis.

8. Some Uses for a Series LLC:

a. Cell for Captive Insurance Companies, where separate participants utilize the same license insuring company for their individual benefit.

b. Large retail chains with a vast number of business sites, such as fast food restaurants and gas stations.

c. A real estate investor with a large number of properties.

d. Mutual funds.

J. **Disregarded and Hybrid Entities**

1. General

a. Since January 1, 1997, certain eligible entities can choose their classification for federal tax purposes pursuant to the "check-the-box" regulations, Treasury Department Regulations §301.7701-3 promulgated by the Service under IRC §7701. This enlightened concept allows great flexibility in utilizing entities.

b. A disregarded entity is an entity that has a single owner and is treated as a mere extension of its owner. When a disregarded entity is owned directly or indirectly by a single owner, it is a nullity for tax purposes, except for payroll and excise tax purposes. Thus, it operates (a) as if it were a sole proprietorship of a natural person owning the sole interest in the disregarded entity, or (b) as a division of another entity, that is recognized for tax purposes, which owns the sole interest in the disregarded entity.

c. A disregarded entity files no tax return. Income and expenses of a disregarded entity are reported on the owner's tax return. Formerly, a disregarded entity did not need a tax identification number. However, the final regulations under §301.7701 state that for both employment taxes and excise taxes, a disregarded entity will be treated "as a corporation" for tax administration purposes; and thus, must carry its own tax I.D. number and pay its employment taxes and excise taxes. However, the IRS permits an otherwise tax disregarded entity to apply for and use a separate tax identification number solely to calculate, report and pay federal employment taxes on the disregarded entity's employees. The owner must continue to use the tax identification number for non-employment tax purposes.

d. By transferring assets used in a particular profit making activity to a wholly-owned LLC, QSub or trust, the owner may be able to insulate the owner's other assets from liabilities associated with the transferred assets and the operations in which they are used.

e. REMEMBER: The entity is defined under state law regardless of its tax classification. Thus, just because an entity is disregarded for tax purposes, does not mean it is disregarded under state law.

2. Single Member LLCs

a. A single member LLC is an LLC with only one member. There is a surprising amount of misunderstanding about the structure of a single member LLC. Some of this stems from the fact that the original LLC Act required at least two members, similar to the Partnership Acts. When the Act was modified to permit only one member, other provisions of the Act were not corrected, such as the changing order provisions. A single member LLC is an entity (i) which is governed by an LLC statute (as opposed to a corporate statute), (ii) which offers the sole owner the ability to limit his or her responsibility for debts and obligations to the amount of equity committed to the entity, and (iii) which, in most (but not all) cases, is ignored as a separate entity for federal income tax purposes. A single member LLC should have an operating agreement.

b. Single Member Status

(i) QSub - §1361(c)(1) states that spouses (and their estates) shall be treated as one shareholder. Note however, that this rule applies solely for purposes of the 100 shareholder limit, and not for other purposes [e.g., each spouse must consent to the S election under §1362(a)(2)].

(A) Note also that a disregarded entity owned by a person who is a qualified "S" shareholder can own the stock of an "S" corporation. LTR 9739014 (Trust) and LTR 9745017 (merger).

(B) S corporation stock owned by members of a family is treated as one shareholder for purposes of the 100 shareholder limitation. Regs. §1.1361-1(i)(c)(3).

(ii) LLCs - "Check the Box" Regs. (Regs. §301.7701-2(a) and (b). An eligible entity - an LLC with a single owner is disregarded by default unless it elects to be treated as a corporation.

(iii) Tenancy by the Entirety as a Single Member LLC

(A) Reason to use:

(1) Charging Lien Protection

(2) Florida Asset Protection Laws

(B) Under partnership tax law, the issue is whether a husband and wife may be treated as one partner/member, regardless of whether they own their interest separately or through some form of joint ownership. The IRS has not provided guidance as to whether a single member LLC owned by a husband and wife as tenants by the entireties is a disregarded entity or partnership for federal income tax purposes. Query, is there a difference from a tax perspective? Has anyone had a client receive a notice from the IRS requesting a partnership return? *See* Rev. Proc. 2002-69 (2002-2) where the Service ruled that in a community property state, a husband and wife are considered one owner of an LLC and, hence, the LLC would be disregarded. *See* *also* Regs. 301.6231(a) (2)-1T (as narrowly applied to IRC §6223 relating to the single partner exception), which states that "a spouse who files a joint return with an individual holding a separate interest in the partnership shall not be counted as a partner"; *see also* the legislative history of IRC §1041 which states that a "husband and wife are a single economic unit," HR Rep. No. 432, 98th Cong., 2d. Sess, Pt. 2, 1491 (1984).

(C) RUPA §202(a) defines a partnership as "the association of two or more persons to carry on as co-owners of a business for profit..". Furthermore, good support for this contention can be found in the analogous situations of subchapter "S" corporations and trusts (see discussion above). A person is not recognized as a separate member if that person owns no interest (profits, losses, distributions, capital, voting) in the entity. LTR. 199914006. LTR 199911033 held that a two member LLC was a disregarded entity where a trust and a corporation wholly owned by the trust were the only members. The rationale being a corporation was created as a bankruptcy remote vehicle at the request of the lender solely for the purpose of holding title as a nominee to the member's interests, and had no rights to profits, losses or distributions or voting or other management rights other than the right to approve the filing of bankruptcy. In both of these rulings, the Service held that the LLC was not set up to "operate a business and share profits and losses," and thus, should be disregarded.

(D) Florida Law on Tenants by the Entirety:

(1) Florida. Asset protection laws only for "tenants by the entirety".

(2) To qualify, tenants by the entirety must always possess the five Unities of Title (*Sitomer v. Orlan*, 660 So. 2d 1111 Fla. App. 4 Dist. 1995):

(a) Unity of Possession (joint ownership and control)

(b) Unity of Interest (no difference in rights)

(c) Unity of Title (same instrument)

(d) Unity of Time

(e) Unity of Marriage

Note that we must be careful in over-planning situations such as LLC operating agreements where we can separate rights of the spouses (e.g. voting, distributions etc.) that may cause the loss of the unity of interest. Unity of interest generally involves both spouses' joint approval over all activities affecting or involving the property owned as tenants-by-the-entireties. Typically, LLC operating agreements will specify individual rights in members exercisable in either of the spouses' sole discretion. This may cause the loss of Unity of Interest, thus providing potential access to creditors.

PLANNING TIP:

- form LLC and specifically state that it is a single member entity
- issue a single certificate to Husband and Wife as tenants-by-the entireties
- operating agreement - no separation rights - e.g.: voting; profits; capital; distributions; etc.; no services
- report on joint 1040 on Schedule C

(E) CAVEAT: Spouses may be treated as "partners" in some cases. *Commission v. Tower*, 327 US 280 (1946), where each spouse invests significant capital or services. But after Tower, the IRS has only tried and lost twice to argue spousal partnerships. *See Estate of Kjorvestad v. U.S.*, 81-1 USTC (DC ND 1981) and *Grober v. Commissioner*, TCM 1972-240, 31 TCM 1179. In both cases, one of the spouses was found to have failed to contribute either services or capital.

(F) Partnership of Spouses May Elect Out of Partnership Status. The 2007 Tax Act creates IRC § 761(f) which permits a "qualified joint venture" ("QJV") to elect not to be treated as a partnership for tax purposes. A QJV must be engaged in a trade or business and must satisfy the following test:

(1) Husband and Wife are the only members of the QJV;

(2) Material participation in the business by both spouses individually (evaluated under the IRC § 469 passive loss rules, but no attribution of participation from one spouse to the other); and

(3) Election must be made by both spouses to invoke IRC §761(f).

Tax reporting is as if each spouse were running the business as a sole proprietor. The QJV is not treated as a partnership and no Form 1065 is required. The trap is the self-employment tax issue, i.e., the election could wipe out the ability to exclude income from SET as a return on capital. New IRC § 1402(a)(17) expressly provides that spousal shares of QJV income or loss shall be taken into account for purposes of computing net earnings from self employment for each spouse.

PLANNING TIP: the election makes sense if the trade or business is rental real estate (exempt from SET) or if the business is purely a service business where there is no significant "return on capital" element involved. It is important to note that there may be a technical correction pending since Congress did not intend to create a SET issue with the QJV election; that is, they only intended to reduce the compliance burden by saying you do not need to file a Form 1065.

c. Some Uses for Single Member LLCs

(i) Perhaps the simplest, yet most neglected area in which single member LLCs can be of importance is in the creation of "firewalls." That is, the compartmentalization of various discrete economic activities in separate LLC "boxes" to limit the exposure that each type of activity has to liabilities that might arise in other areas of the business. Every new economic venture, no matter how small, entails some degree of risk. LLCs can be used to encapsulate those risks. Creative use of financing between related entities reinforces the walls.

(ii) Creation of Single Purpose Bankruptcy Remote Entities. In the real estate downturn of the late 1980s, lenders were frequently hindered in their efforts to foreclose on collateral when borrowers declared bankruptcy. In reaction, lenders are frequently requiring that borrowers form "single purpose bankruptcy remote entities" to borrow the funds and hold the collateral. These entities are generally restricted in their ability to borrow additional funds, add any assets to their asset base other than collateral, declare voluntary bankruptcy, or take various other actions not in the ordinary course of business. Most significantly, perhaps, is that the lender will require that its nominee be placed on the governing board of the entity and that the entity be prohibited from taking any of the types of actions set forth above without the approval of that nominee. Moreover, a tender may require the nominee be a "springing member" from inception, with no economic interest to preserve SMLLC status. Thus, even if the parent of the entity were to declare bankruptcy, the entity itself would not be in the bankruptcy estate. The concept of a bankruptcy remote entity for the protection of the creditor was sanctioned by a Bankruptcy Court in *In Re: DB Capital Holdings*, U.S. Bankruptcy Appellate Panel of the Tenth Judicial Circuit (10th Cir. BAP (Colo.)). See also *General Growth Properties*, 451 B.R. 323, U.S. Bankruptcy Court, S.D. New York (June 16, 2011), and *Doctors Hospital of Hyde Park*, IN BR 2013 WL 5524696 (Bankruptcy N.D. Ill., 2013).

(iii) Tax free exchanges under I.R.C. §1031. The IRS has ruled that replacement property in a Section 1031 exchange could be conveyed directly by the seller to a single member limited liability company wholly owned by the buyer without jeopardizing non-recognition under Section 1031. PLR 199911033 (Dec. 18, 1998), PLR 9807013 (Nov. 13, 1997) and 9751012 (Sept. 15, 1997). Likewise, the purchase of 100% of the interests in a single member limited liability company which owns the replacement property qualifies for non-recognition treatment under Section 1031. PLR 200118023,2001.

d. These types of entities are most commonly used in structured financings or securitizations to reduce the risk that the financing transaction might be challenged or nullified in a bankruptcy proceeding. In such transactions, the owner of particular assets transfers those assets to the bankruptcy remote entity which then issues financial instruments secured or backed by the assets. The proceeds of the instruments are paid to the asset transferor as compensation for the assets. In such a transaction, the transferred assets must be considered the property of the bankruptcy remote entity, and not the transferor, so that the automatic stay does not apply and the transferor cannot claim that the transferred assets are property of its bankruptcy estate. *See* Truit and Murphy, Bankruptcy Issues in Securitization, appearing in Dolan and Davis, Securitizations: Legal and Regulatory Issues (Law and Journal Press).

e. Can have single member LLCs in Florida, which, unless elect to treat as a corporation on IRS Form 8832, will default into "tax nothing" for federal tax purposes.

f. Compare:

(i) Single Member LLCs Treated as Separate Entities: In Chief Counsel Advice (CCA) 200338012 and 200235023, the IRS ruled that an assessment against single member owner of LLC does not result in IRS having tax lien that it could enforce against assets held by LLC; *see also* CCA 200250012, where the IRS treated disregarded single member LLC as separate entity for purposes of applying small partnership exception to TEFRA audit rules.

(ii) Multi-Member LLCs Treated as Disregarded Entities: In PLRs 200201024, 199911033, and 199914006, IRS treated multi-member LLCs as single member LLCs that were disregarded for tax purposes where second member neither shared in profits and losses of the LLC nor had any management rights in the LLC. For a more detailed discussion of these issues, *See* Jeffrey L. Rubinger, "Making Something Out of Nothing (and Vice Versa) - Inconsistent Treatment of 'Tax Nothings,'" Journal of Taxation (November 2003).

(iii) CAVEAT: While a Single Member LLC may have its own taxpayer ID number and file its own payroll tax returns, the Member is personally liable for 100% of all payroll tax liability, not just the "trust" portion. *See* IRC Notice 99-6, 1999.3 I.R.B. 12, (January 19, 1999), and New Regs. §301.7701-2 effective August 16, 2007. *See also* Stearn & Co., LLC, D.C. Mich., June 29, 2007, 2007-2 USTC.

g. Powers

(i) Litigate under entity name.

(ii) Make business transactions (purchase/sale/lease) within and outside (sometimes) the "forum" state.

(iii) Make business transactions on behalf of other entities where permitted.

(iv) Freely contract.

(v) Operating agreement may be loosely structured and flexible to suit the purpose of the entity.

h. Liabilities/Asset Protection

(i) *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* and *Crocker, infra* at page 24. However, the latest revised Model LLC Act permits foreclosure on a multi-member LLC interest as in *Crocker* and *Nigri*, *supra*.

(ii) In *Olmstead, et al. v. FTC* (Florida Supreme Court June 24, 2010), the Florida Supreme Court ruled that creditors can go after a debtor's assets that are held by a single-member LLC. (See Section II.B.2.e.v. *supra*, for further discussion.) Florida Statutes §605.433 was amended on May 31, 2011 protecting multi-member LLCs by providing that a charging order was the "sole and exclusive remedy" by which a creditor may satisfy a judgment. However, creditors of a debtor owning a single-member LLC may foreclose on the membership interest upon a showing that they cannot otherwise expect to collect within a reasonable period of time.

(iii) *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 LLCs assets were available to the judgment creditor of the LLCs 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.

i. Second Member and Loss of "Single Member" Status. The following problems that can cause there to be a second "Member" and thus loss of "single member" status:

(i) Debt holder re-characterized as another "owner".

(ii) "Deep" options as equity - May be treated as a current ownership interest if the option is substantially likely to be exercised when issued, and it is exercisable at any time.

(iii) Divorce - Spouses become two separate owners.

(iv) QSubs

Qualified Subchapter S Subsidiary (QSub). A corporation that is wholly owned by an S Corp where the subsidiary is treated as a Qualified Subchapter S Subsidiary by the parent corporation filing Form 8869 is a disregarded entity. QSubs are treated as divisions of their parents for federal tax purposes, except for payroll and excise taxes.

3. LLC Classified as an S Corp. Pursuant to the check-the-box regulations, an LLC can elect to be an association taxed as a C Corp. The LLC can also elect to be an S Corp. This type of entity has become, in many instances, the entity of choice (i.e., the entity du jour). An LLC electing to be treated as an S Corp for federal income tax purposes provides the owners of the LLC with the asset protection benefit of the charging order remedy (assuming there are multiple members), yet provides the owners with the possibility of receiving distributions free of self-employment taxes.

a. In order to elect to be treated as a corporation for federal tax purposes, the LLC must file within 75 days of filing of the Articles of Organization Treasury Department Form 8832, Entity Classification Election, electing to be treated for federal tax purposes as an association taxable as a corporation. In the event that "S" status is also desired, the LLC must file by the 15th day of the third month of the filing of its Articles of Organization Treasury Department Form 2553, Election By a Small Business Corporation, electing to be treated for federal tax purposes as an S Corp. Each member of the LLC must consent to such election. The instructions to Form 2553 now indicate the filing of a Form 8832 is not necessary if a Form 2553 is filed.

b. Because of superior asset protection, limited liability, tax savings and self-employment tax benefits, certain Florida businesses may be best served by this type of hybrid entity. This assumes that most f(business owners will value two considerations above all others - namely, more money in their pockets as a result of the wage-reduction tax strategy and asset protection. Notwithstanding the appeal of this hybrid envelope, such an entity may not be appropriate where the business cannot qualify as an S Corp, the one-class-of-stock rule interferes with business terms agreed to or desired by the owners, the business has considerable non-shareholder debt and the owners anticipate significant losses for which they might not have enough basis to allow deduction at the shareholder level, the business owns (or will own) appreciating assets, or the wage-reduction tax strategy will not benefit the owners. In addition, operating agreements for LLCs may be more complicated and expensive than shareholder agreements. Finally, while the conversion of an entity into an LLC envelope can be complex, with careful planning, adverse tax consequences can be either minimized or eliminated.

4. S Corporation Merges/Converts into an LLC. In the case of appreciated property inside a corporation, if the appreciation is so high as to preclude a liquidation and transfer of the assets to a partnership or LLC, other hybrid solutions are available. An "S" corporation can either:

a. Merge into an LLC under IRC §368(a)(i)(F). *See* PLR 200622025; 200718014, so long as the LLC elects under Reg. §301.7701-3 to be treated as an association taxed as a corporation for federal tax purposes, and then the existing "S" corporation is merged under applicable state merger law into the newly formed LLC. PLR 200622025 provides that the existing "S" corporation's "S" election does not terminate as a result of the reorganization, citing Rev. Rul. 64-250. A very important point contained in PLR 200620025 is that the new LLC will not be required to make a new "S" election. This ruling should supersede on earlier letter ruling (PLR 200201005) involving an "F" reorganization of an "S" corporation, which earlier ruling implied that the reorganized S entity must file an S election as part of the reorganization transaction. The point is significant because if the reorganized entity is required to file a new S election to maintain S status in a transaction that qualifies as an "F" reorganization (or may qualify as an "F" reorganization dependent on the maintenance of the reorganized entity's S status), the filing of a new S election gives minority owners significant leverage through their ability to block the transaction by refusing to consent to the S election which requires unanimous consent. Thus, while not entirely clear, based on Rev. Rul. 64-250, an argument can be made that the new LLC will not have to file a new S election. Further, based on Rev. Rul. 73-526, the new LLC will retain the same federal tax ID No. as the existing S corporation.

Problem: All assets of S corporation must be transferred to the LLC causing additional transaction and transfer costs (e.g., documentary stamp tax and title insurance). And there may be assets that are difficult or impossible to transfer, such as licenses, contracts, mortgages, etc.

b. Conversion under Florida Statute §607.1112, et seq. of an S corporation into an LLC for state law purposes has also been approved by the IRS as a "F Reorg" under IRC §368(a)(i)(F) PLR 200528021; 200548021. The rulings provide that the existing "S" corporation's "S" election does not terminate as a result of the reorganization, citing Rev. Rul. 64-250. Based on Rev. Rul. 64-250, the new LLC will not have to file a new S election. Further, based on Rev. Rul. 73-526, the new LLC will retain the same federal tax ID No. as the S corporation. The conversion under the formless conversion statute may be a better plan in Florida, because FS §6114(2) provides that title to real estate becomes automatically vested in the converted entity without the need to transfer the assets. If title to real estate does not have to be transferred into the converted entity, a significant savings can be obtained in documentary stamp taxes and title insurance premiums. Also, since no deed is recorded, the ad valorem tax assessor is not notified of the transfer. However, you should file a copy of the Articles of Correction in any county that the entity owns real estate to put the public on notice.

c. Advantages of an "S" over an LLC:

(i) One level of taxation.

(ii) An existing S corporation owning substantially appreciated assets may find prohibitive the tax cost of converting to an LLC unless the LLC elects to be treated as an S corporation by filing Form 2553 (F Reorganization).

(iii) By transferring the assets used in a particular business to a wholly owned LLC or QSub, an existing S corporation can insulate the corporation's remaining assets from liabilities associated with the transferred assets and the operations in which they are used.

(iv) Some taxpayers may continue to prefer the more straightforward rules of Subchapter S compared to the complexity of Subchapter K.

(v) An S corporation is preferable if it is contemplated that the entity will go public, and there is a desire to avoid the intermediate step of converting the LLC to a corporation. Furthermore, until LLC interests are as easily issued in capital markets as traditional corporate stock, the S corporation may continue to be an attractive vehicle in which to start a business, if it is anticipated that it will later go public.

(vi) An S corporation increases the potential for engaging in nontaxable corporate reorganizations.

(vii) A corporate charter is a prerequisite imposed by regulators for some trades or businesses (e.g., for depository institutions or to hold certain licenses), and LLCs may not meet such regulatory requirements.

(viii) State corporate case law is more clearly defined and understood.

(x) State and federal securities laws may provide exemptions to corporations that are not available to LLCs.

(xi) Simple capital structure.

(xii) Advantages of new healthcare tax.

d. Disadvantages of "S" Corp.

(i) Limit on fringe benefits.

(ii) One class of stock.

(iii) Ownership limits.

(iv) Built-in gain tax.

(v) Limits on passive income.

(vi) Deemed sale rule.

K. **Advantages Of An "S" Corporation Over A Partnership (Or LLC)**

1. *Ability to Reduce Net Employment Taxes*. Owners of S Corps have an ability to decrease the amount of wages received from the S Corp and to correspondingly increase the amount of S Corp distributions. Care must be taken to ensure such distributions are not re-characterized as wages. Must meet the "reasonable salary" requirement. *See Pediatric Surgical infra* and *Renkemeyer infra*.

2. *Can Take Advantage of Reorganization Provisions*. Tax-Free reorganization provisions contained in the Code are only applicable to corporations. IRC § 368(a) permits shareholders of an S Corp to effectively "sell" their company to another corporation in exchange for the stock of that corporation (including preferred stock) without federal income tax consequences.

3. *Insolvency & Cancellation of Indebtedness*. In general, in financial distress situations the owner of an S Corp may be able to obtain more favorable tax treatment than a partner of a tax partnership; that is, for S Corp shareholders under IRC § 108 "insolvency" is determined at the corporate level versus at the partner level for partners. In the event that cancellation of indebtedness income occurs, the exclusion for "insolvency" under IRC § 108(a)(1)(B) is determined at the entity level for corporations as opposed to the partner/member level for partnerships or LLCs.

4. *ESOPs*. Income of the ESOP from an S Corp is not subject to federal income tax because it is a tax exempt entity.

L. **Advantages Of A Partnership (Or LLC)**

1. Non-Tax Advantages Of An LLC Over An "S" Corporation:

a. *Liability Protection*. A creditor of a multi-member LLC is limited to a charging order remedy. Creditors of individual shareholders of an S Corp may be able to foreclose and obtain full ownership of the stock.

b. *Reduction of Duty of Loyalty Via Agreement*. In many jurisdictions, members of an LLC have an opportunity to contract around the duty of loyalty, although they cannot eliminate it entirely, so long as the reduction in the duty of loyalty is not "manifestly unreasonable". This is a key point from a non-compete/misappropriation of company opportunity standpoint where one individual participates in various, potentially competing business ventures through a variety of different business entities. Corporate statutes are generally less forgiving in this regard. For example, on the LLC side, Company A's LLC operating agreement may contain a provision which says Member A of Company A can become a member of Company B, a potential competitor of Company A, without violating Member A's duty of loyalty to Company A (as long as such reduction in duty of loyalty is not *manifestly unreasonable*). On the other hand, a shareholder of Corporation A may not have the ability to contract around the duty of loyalty in this way.

c. *Transfer Restrictions*. An LLC may be a better vehicle for restricting transfers of interests. The assignee concept is embedded in most LLC statutes, which limits non-permitted transferees to economic rights.

d. *Corporate Formalities*. LLC members are generally not subject to the rigorous requirement to observe corporate formalities imposed on corporate shareholders, so LLC members are less likely to inadvertently commit a mistake which could make it easier for a potential plaintiff to pierce the veil.

e. *Operational Issues*:

(i) Operating Agreement (traps for the Unwary).

(A) One class of stock requirement. Can have voting and non-voting, but no liquidation preferences or special allocations.

(B) Loans. Observe straight debt safe harbor.

(ii) State & Local Taxes. Must do homework.

2. Tax Advantages of Partnership (or LLC) over an "S":

a. Anyone can be an owner (No eligibility requirements)

b. Do not have to deal with the subchapter "S" limitations (e.g., limits on number of shareholders and classes of stock)

c. More flexible capital structure:

(i) No limit on number of members

(ii) Can have more than one class of stock

(iii) Allocation of profits and losses extremely flexible

d. No outside basis problems

(i) Partners' basis includes entity debt

(ii) Generally, no taxation on relief of liability upon contribution (e.g. 357(c)).

(iii) Limited partners ability to increase basis under IRC §752 for assumed liabilities

(iv) Distributions of appreciated property usually tax free

(v) Optional basis adjustments. IRC §754

e. Generally, no tax on asset distributions

f. Deemed sale rule does not apply on liquidations and distributions

The ability to disregard an LLC for tax purposes creates the possibility of obtaining IRC §1031 treatment on the exchange of an interest in such entity directly for property which is like kind, or even for the interest in another disregarded entity which owned like kind property. The argument is the assets held by a disregarded entity are deemed to be owned directly by the owner of the disregarded entity. Thus, for federal income tax purposes, the transaction should be reported as a tax-free exchange of property owned by the owners of the disregarded entity. This same argument applies to single-member LLCs, business trusts, and QSubs.

Some additional support for this contention can be found in the proposed Regs on mergers involving disregarded entities (Reg 106186-90), which adopt the position that disregarded entities (even QSubs) do not qualify as a tax-free merger under IRC §368(1)(A). Further, one of our prestigious colleagues has received verbal approval that the contribution of a single member LLC interest to a limited partnership should be treated as the contribution of the assets owned by the LLC.

HOWEVER: Even though the entity is disregarded for reporting purposes, under state law, the ownership interest is still stock or "other security" prohibited under IRC §1031(a)(2). Further, the ownership interest itself may not be the same "class of property" as the property exchanged. *See* Regs. §1.1031-(a)-(b). The Service has determined that a transaction failed to qualify under §1031 where property owned by a partnership was exchanged for replacement property deeded directly to a partner. TAM 9818 003.

M. **Disadvantages of Partnership (or LLC) versus "S"**

1. Very little case law. E.g. *Olmstead* regarding LLCs, *infra* and *supra*.

2. Questionability of limited liability, especially regarding single member LLCs. Not an issue with corporations.

3. Complicated partnership tax rules under Subchapter K.

4. The IRS § 108 insolvency test stops at the entity level for corporations, but not so for partnerships or LLCs.

5. Fringe benefits limitations.

B. **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 personal assets of the entity's owner(s), e.g., shareholders, partners or members, from third-party claims against the entity (inside liabilities). Corporations have been in existence for more than 100 years. However, the limitation on liability provided by incorporation is not without boundaries. There is a large body of case law indicating that under certain circumstances the "corporate veil" can be pierced, in which case, claims against the corporation can reach the shareholders of the corporation and their personal assets. 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 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.

e. LLCs should provide effective insulation from inside liabilities. Section 608.701 of the Florida Limited Liability Company Act expressly provides that the Florida courts shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a Florida corporation may be pierced to Florida limited liability companies and their members. The seminal "corporate veil piercing" case in Florida is *Dania Jai-Alai Palace, Inc. v. Sykes,* 450 So. 2d 1114 (Fla. 1984), which holds that corporations are legal entities distinct from shareholders and the corporate veil will not be pierced either at law or in equity unless the plaintiff proves the corporation was organized or used to mislead creditors or to work fraud upon them. A creditor has a difficult task to convince a Florida court to pierce the corporate veil, and would likely face similar difficulties as a plaintiff in LLC veil piercing litigation.

f. 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.

g. *17315 Collins Avenue, LLC and Waterstone Properties, LLC v. Fortune Development Sales Corp.*, No. 3D09-2056 (Fla. 3d DCA, January 15, 2010). To pierce the veil of a subsidiary, it must be shown that the subsidiary is a mere instrumentality of the parent, <u>and</u> that it was organized and used by the parent to mislead creditors or to perpetrate a fraud on them. *See also Dania Jai-Alai Palace, Inc. v. Sykes,* 450 So. 2d 1114 (Fla. 1984) (must also have "improper conduct"); *Baldwin v. Bill and Carolyn Limited Partnership* (10th Cir. Bankr. Okla. 2006).

h. *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 LLCs assets were available to the judgment creditor of the LLCs 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, disregard corporate formalities, and exceed 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. *See also Klein v. Weidner,* 2010 WL 571800 (E.D. PA) (reverse pierce where LLC was improperly used to perpetrate an injustice against creditor) and *Postal Instant Press, Inc. v. Kaswa Corp.* 162 Cal. App. 4th 1510 (Cal. Ct. App. 2008) (reverse pierce using "alter ego" doctrine but only after available alternate remedies are inadequate).

2. Insulation Against Outside Liabilities

a. 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.

b. In general, LPs and LLCs provide insulation from outside liabilities by limiting outside creditors to a charging order remedy.

c. 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]

d. The Exclusivity of the Charging Order Remedy

(i) RE-FRULPA provides that a charging order is the sole remedy available to a creditor and that the judgment creditor of a Florida limited partnership has only the rights of an assignee to the extent so charged. Fla. Stat. §620.1703 provides a similar protection for LPs.

(ii) 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 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).

(iii) The current Florida LLC Act provides that any judgment creditor of a member is limited to a charging lien against the member's interest in the LLC for the amount of the judgment. Fla. Stat. §608.433(4). To the extent so charged, the judgment creditor has only the rights of an assignee of such interest. The assignee cannot exercise any rights or powers of a member unless the assignee becomes a member. Fla. Stat. §608.432(2)(a). The assignee may become a member with the unanimous consent of all members other than the member assigning the interest. Fla. Stat. §608.433(1). This consent must be in writing. Fla. Stat. §608.4232. Without becoming a member, the assignee is restricted to sharing in such profits and losses, such distribution or distributions, and receiving such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled. Fla. Stat §608.432(2)(b). 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. See new rules for single-member LLCs under F.S. 608.433(6).

(iv) *In re LaHood (Heartland Bank and Trust Company v. Covey)*, Bankruptcy No. 07-81727, Adversary No. 07-8156, 2009 WL 2169879 (Bankr. C.D. Ill. July 16, 2009). In a case upholding the exclusive nature of the charging order remedy as expressly provided for in the Illinois LLC statute, the bankruptcy court in Illinois determined that a lender's judgment lien against an LLC member's distributional interest was not valid because the charging order remedy in the Illinois LLC statute operates to the exclusion of all other remedies. The lender had obtained a pre-petition judgment against the debtor, and the lender served the debtor with a citation that impressed a lien upon the debtor's personal property under Illinois judgment collection provisions. In this opinion, the court addressed the lender's argument that the charging order provision of the LLC statute applies only to a distributional interest and that the lender's judgment lien obtained under the

[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.

general judgment collection provisions applied to the debtor's membership interest. The lender emphasized the statutory distinction between a membership interest and a distributional interest and argued that, although it did not obtain a charging order so as to obtain a lien on the distributional interest, it nevertheless obtained a citation lien on the membership interest. The court stated that the lender's implied argument that it somehow had the right to enforce its lien against the distributional interest, the only interest that mattered at this point, directly contradicted the plain language of the charging order provision. The lender's argument implied that a creditor could bypass the exclusive procedure of the charging order provision and obtain a lien on a member's distributional interest by obtaining a lien on the entire membership interest, which includes the distributional interest. Applying the rule of statutory construction that a specific provision controls over a more general one, the court concluded that the exclusive charging order provision in the LLC statute necessarily controlled over the more general statute providing for a citation lien on personal property.

(v) Some state statutes or case law have provided for the foreclosure and sale of an LLC or LP interest. The buyer is not afforded the rights of a member or partner, but rather, that of an assignee. The predominate cases are:

(A) *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 so long as the business of the partnership is not unduly interfered with.

(B) *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.

(C) Other states that have statutes or case law permitting foreclosure are: California, Colorado, Connecticut, Georgia, Hawaii, Idaho (effective July 1, 2010), Iowa, Kansas, Kentucky, Maryland, Missouri, Montana, Nebraska, New Hampshire, Ohio, South Carolina, Utah, Vermont and West Virginia.

(D) States that do not permit foreclosure include: Alabama, Alaska, Arizona, Delaware, Florida limited partnerships MMLLCs but <u>not</u> SMLLCs, Illinois, Minnesota, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, Virginia and Wyoming.

(vi) Single Member LLCs.

(A) *In re Albright*, a bankruptcy decision from Colorado dealing with a single member LLC, the court interprets a charging order as only existing to protect other members of an LLC from sharing governance responsibilities with a judgment creditor. This finding was based on the commentary in the original LLC Model Act. 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.

(B) 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; <u>but not</u> 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]

(C) In two recent cases, *In Re Modanlo*, 412 BR. 715 (Bankr. D. Md., 2006), *aff'd* 266 Fed. Appx. 272, 2008 and *In Re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. Idaho 2006), involving Chapter 11 bankruptcy filings, the courts relied entirely on the bankruptcy law and held that all of the debtor's interests in a single-member LLC became the property of the bankruptcy estate, and, as such, were subject to the sole and exclusive authority of the Trustee. *See also In Re First Protection, Inc.*, 440 B.R. 821 (Arizona 2010), *In Re Fabian*, 458 B.R. 235, B.R. Md. (2011).

(D) Single Member LLCs Treated as Separate Entities: In Chief Counsel Advice (CCA) 200338012 and 200235023, the IRS ruled that an assessment against a single member owner of an LLC does not result in IRS having a tax lien that it could enforce against assets held by LLC; *see also* CCA 200250012, where the IRS treated disregarded single member LLC as a separate entity for purposes of applying small partnership exception to TEFRA audit rules.

(vii) In *Olmstead et al. v. FTC*, 44 So. 3d 76 (Fla. 2010), the Florida Supreme Court ruled that creditors can go after a debtor's assets that are held by a single-member LLC. *Olmstead* involved two individuals 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."

The majority reasoned that because Section 608.433(4) of the Florida LLC Act did not clearly state that a charging order was the "sole and exclusive remedy," an alternate remedy could be ordered at the court's discretion. The court also concluded that the limitation on assignee rights of LLCs found in Section 608.433(1) does not apply in cases involving transfer of rights in single-member LLCs. In a single-member LLC, the set of "all members other than the member assigning the interest" is empty. Thus, an assignee of a membership interest in a single member LLC becomes a full and legitimate member, taking full right and title to the economic and management interests of the transferor.

However, the *Olmstead* Court fails to address positions previously taken by Florida courts involving partnerships and the charging order remedy. The Court in *Myrick v. Second National Bank*, 335 So. 2d 343 (Fla. 2d DCA 1976), concluded that the charging order is the essential first step and all further proceedings must occur under the supervision of the court to protect the interests of the various parties. The Florida Court of Appeals went even further in *Givens v. National Loan Investors, L.P.*, 724 So. 2d 610 (Fla. 5th

[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).

DCA 1999) and *Atlantic Mobile Homes, Inc. v. LeFever*, 481 So. 2d 1002 (Fla. 4th DCA 1986), concluding that the charging order remedy was the sole remedy available to a judgment creditor.

Instead, *Olmstead* classifies a single-member LLC as merely another form of a corporation, indirectly terminating the single-member LLC as an asset protection vehicle. *While* it appears that *Olmstead* does not necessarily apply to multi-member LLCs, it does create a reasonable fear of similar litigation for owners of multi-member LLCs in the future. As a result, we could begin to see business owners begin forum shopping in search of a safer haven for their assets or even use a different form of entity altogether.

(viii) *The Legislative Fix to Olmstead*. In response to the *Olmstead* decision, House Bill 253, amending Fl. Stat. §608.433, was enacted into law on May 31, 2011. The revisions to Fl. Stat. §608.433 are intended to be clarifying and remedial in nature and apply retroactively. This amended provision has been reviewed and acknowledged by the Federal District Court in a Miami, Florida, bankruptcy case in *Hage* (see below). This legislative fix was enacted verbatim in the new 2013 law effective January 1, 2014 for new LLCs and January 1, 2015 for existing LLCs (which can opt into the new law as of January 1, 2014).

(A) Fl. Stat. § 608.433(4)(a) has been amended to clarify that a court may enter a charging order against the LLC interest of the judgment debtor or the judgment debtor's assignee rights for the unsatisfied amount of the judgment plus interest. Subsection (b) provides that a charging order constitutes a lien on the judgment debtor's LLC interest or assignee rights and that, under a charging order, the judgment creditor has only the rights of an assignee to receive any distribution(s) to which the judgment debtor would otherwise have been entitled from the LLC, to the extent of the judgment plus interest. Subsection (c) clarifies that nothing in Chapter 608 is intended to deprive any member or member's assignee of the benefit of any exemption law otherwise applicable to the member's LLC interest or the assignee's rights to distributions.

(B) Fl. Stat. § 608.433(5) has been added to explicitly provide that "[e]xcept as otherwise provided in subsections 96) and (7), a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's assignee may satisfy a judgment from the judgment debtor's LLC interest or rights to distributions from the LLC."

(C) Fl. Stat. § 608.433(6) has been added to create an exception to the general rule for interests in single-member LLCs that are not either (i) currently making distributions which can be applied towards satisfaction of the charging order within a reasonable time, or (ii) projected to produce sufficient income which can be applied towards satisfaction of the charging order within a reasonable time. Specifically, a charging order will not be the sole and exclusive remedy by which a judgment creditor may satisfy a judgment if the judgment creditor "establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment within a reasonable time." Upon such showing, the court may order the sale of the judgment debtor's interest pursuant to a foreclosure sale.

(1) The judgment creditor may make this showing to the court at any time after the entry of the judgment and may do so at the time that the judgment creditor applies for the entry of a charging order.

(2) This exception prevents a debtor from utilizing a single-member LLC as a depository for non-income producing assets, such as raw land, in order to shield such assets from legitimate creditor claims.

(3) Notwithstanding subsection (6), the charging order should be the exclusive remedy for a single-member LLC operating a business or holding income-producing assets as long as distributions are anticipated.

(D) Fl. Stat. § 608.433(7) has been added to describe the rules for foreclosing on a membership interest in a single-member LLC if so ordered. Specifically, if the court orders a foreclosure sale of a judgment debtor's LLC interest or of a charging order lien pursuant to subsection (6), then (i) the purchaser obtains the judgment debtor's entire interest (not merely an assignee interest), (ii) the purchaser becomes the sole member, and (iii) the judgment debtor ceases to be a member of the LLC.

(E) Fl. Stat. § 608.433(8) has been added to expressly provide that the remedy of foreclosure of a judgment debtor's LLC interest or against assignee rights to distributions in the LLC is not available with respect to interests in a multi-member LLC. This reaffirms the position in Fl. Stat. § 608.433(5) that the charging order is the sole and exclusive remedy with respect to multi-member LLCs.

(F) Fl. Stat. § 688.433(i) is added to clarify that nothing in Fl. Stat. § 608.433 shall be applied to limit:

(1) The remedies otherwise available to secured creditors under applicable law;

(2) The principles of law and equity which affect fraudulent transfers;

(3) The availability of equitable principles of alter ego, equitable lien, or constructive trust, or other equitable principles not inconsistent with Fl. Stat. § 608.433; or

(4) The continuing jurisdiction of the court to enforce a charging order in a manner consistent with Fl. Stat. § 608.433.

(G) Subsection (9) is not intended to grant any additional rights to a judgment creditor that it would not already possession if subsection (9) was not enacted. Instead, subsection (9) was added as a compromise to clarify that certain remedies continue to exist for a judgment creditor under appropriate circumstances.

(1) Secured creditors retain the right to seek redress pursuant to the terms of the security instrument or other law applicable to secured creditors.

(2) Creditors may continue to seek to set aside the fraudulent transfer of assets to an LLC by a debtor pursuant to the Florida Uniform Fraudulent Transfer Act under Chapter 726.

(3) Remedies based on equitable principles, such as alter ego, are not prohibited. This is intended to prevent abuse of the enhanced charging order protection granted under Fl. Stat. § 608.433. It is important to note that the remedy of foreclosure would not be permitted as an equitable remedy against interests in a multi-member LLC under the language of subsection (9)(c) because such remedy would be inconsistent with the explicit language of subsection (8).

(ix) On March 5, 2012, the U.S. District Court, South Florida, upheld the recently amended Florida Statutes §608.433(6) in the case of a SMLLC by remanding it back to the bankruptcy court requiring a showing that distributions under the charging order will not satisfy the judgment within a reasonable time. *Hage v. Salkin*, 2012 WL 718644 (S.D. Fla.). Upon such a showing, the court is restricted to ordering a foreclosure sale only, and had no power to the assets of the SMLLC. It is interesting to note further that defendant alleged the LLC was a multi-member LLC including his brother and his wife, but the court confirmed that the bankruptcy court was correct in finding that the defendant did not provide sufficient evidence to support his claim.

(x) Bottom Line. In Florida, RE-FRULPA currently provides the exclusivity of the charging order as the "sole" remedy Florida courts should be bound by such exclusivity on a going forward basis. Unfortunately, LLCs are not as tightly protected. In 2011, Florida amended Florida Statute 608 to provide full statutory protection for multi-members but did not extend the "sole" remedy protection for single member LLCs. A SMLLC interest may be foreclosed after a determination by the court that the creditor could not otherwise expect to collect its debt within a reasonable time period.

(xi) It is interesting to note in Rev. Rul. 77-137, the Service ruled that a limited partnership entity's K-1 goes to the assignee of a limited partnership interest even though the partnership agreement provided that an assignee may not become a substituted limited partner without the consent of the general partners. It would seem that this ruling would also apply to an LLC. This can be a strong inducement to a creditor not to foreclose if the documents do not provide for minimum tax distributions.

3. Planning Ideas.

While *Olmstead* is still fresh on our minds, consider the following planning thoughts:

a. Issue additional shares of the LLC so that the LLC is a multi-member LLC and not a single member LLC. The only caveat is that the *Olmstead* case does infer that the charging order may not be the sole remedy against a multi-member. The revised statute should resolve this issue. However, there is still some doubt whether or not it is the sole remedy based on the dicta in *Olmstead*.

b. Leave the state. However, the use of single member entities in other states with clearer language such as Delaware or Wyoming may not be as safe as you think. No rulings have been held in these states but it is pretty clear that the bankruptcy courts in *Albright, Ehman's, etc.* are not going to recognize the single member LLC to protect against creditors. With all the discussion going on around the country about *Olmstead*, it may well be that the courts are not going to recognize a single member LLC under state law either, so if you are going to leave, leave the country or consider an asset protection trust in another state.

c. Hold the interest in a single member LLC as tenants by the entirety between husband and spouse. It is strongly recommended that you issue a single certificate, labeled husband and wife as tenants by the entirety, and draft an operating agreement that clearly states the entity as a single member entity and there is no distinguishment between voting, profits and losses or capital as between the spouses. Lastly, the personal tax returns of the spouses should be filed jointly disregarding the entity and recognizing all the income as if the entity were disregarded. In Florida, this should protect the assets against the creditor of one of the spouses and should be disregarded for tax purposes. However, you still have the following problems that occur:

(i) Client is single;

(ii) Prenuptial or client may simply not want to share the ownership with his or her spouse;

(iii) The judgment is against both spouses;

(iv) If the wrong spouse dies;

(v) Divorce; or

(vi) This arrangement may not fit with your estate planning goals, where you are trying to set up separate assets in each spouse's name to fund the unified credit shelter trust. Of course, if you have enough to fund that trust for each spouse with other assets, it is not as much of a problem.

d. The safest alternative seems to be to use a Limited Liability Limited Partnership ("LLLP"). Convert to or begin with a LLLP. The *Olmstead* court indicated that the "sole and exclusive" language of the LLLP statute was sufficient to protect the entity against debtors. This entity is a little more expensive and requires a partnership tax return. The only problems here are: (a) that you must have a real second member; and (b) who will be the general partner? The first problem is mostly a business question. As for the second, it can be a corporation, an LLC or an individual. The creditor can take any of these, but the LLC stands out because the creditor must go through the "can't get my money within reasonable time" test. After that, the creditor is a mere "assignee" and cannot affect the company business without the consent of the other partners. And, the other partners can replace the general partner unless restricted by the partnership agreement, so in drafting the agreements, make sure to provide for the remaining partners to do so in the event of such an assignment. However, for married couples, consideration should be given to owning a portion of the limited partnership interests as tenants by the entirety.

e. Another method is to create a creditor - proof trust and put the LLC into it. This goes for all entities discussed herein.

4. Continued Uses for Single Member LLCs.

The following uses presume that there is little or no need for protection against outside creditors:

a. As firewalls between the shareholder and another interest. For instance, in a tenancy in common ("TIC"), rather than taking the owner's undivided interest in the name of the individual and subjecting the person to liability, it is better to hold the interest in a single member LLC so that not only provides for protection from liability coming from the property, but the entity is disregarded so it can use the entity to effect a tax free exchange under Section 1031. This LLC can also be held jointly as tenants by the entirety as discussed above. While this does not obviate *Olmstead*, it is better than holding the TIC in the individual's name.

b. When used as subsidiaries of a parent holding company, LLCs sometimes are used to create firewalls between the subsidiaries and the parent. The only time the *Olmstead* issue would arise would be debt at the parent level, which if the parent is a simple holding company holding the subsidiaries, should be manageable.

c. Bankruptcy remote entities. The LLC is a good choice to serve as a bankruptcy remote entity. This means that the interest in capital and profits would be owned by the borrower, but a non-profit/capital interest is owned by a lender or its nominee. That interest is a second class of membership interest which only has the right to vote against such things as: bankruptcy, lawsuits, adding additional debt, etc. which the lender would like to prevent.

Piercing the Corporate Veil

If a company acts as the alter ego of an individual, courts can "pierce the corporate veil" and go after your personal assets. If enough of the following factors exist and there is "injustice", courts will pierce the corporate veil and your personal assets will be at risk:

(1) Diversion of assets from the company by or to a stockholder or other person or entity to the detriment of creditors. If the company is doing poorly, do not make preferential payments to shareholders.

(2) Failure to maintain arm's-length relationships among related entities. Do not give preferential treatment to individuals or related entities. For example, charge a fair market rental rate for leased real estate and a fair market interest rate on loans.

(3) Inadequate capitalization. The amount of initial capitalization should be sufficient to meet the anticipated needs of the business. The courts frown on flimsy organizations set up solely to escape personal liability.

(4) Failure to observe corporate formalities. Always sign your title after your name when signing contracts. Have annual corporate minutes appointing directors and officers, plus corporate minutes documenting other major transactions, including loans/payments from/to shareholders. Hold annual and other meetings of the shareholders and board of directors as necessary. Keep the company registered with the Secretary of State. Maintain a company record book to keep official documents in one place.

(5) Commingling of funds. Keep separate bank accounts. Do not use company funds to pay personal expenses and do not transfer money to an individual account without proper resolutions.

(6) Absence of corporate records. Document everything – especially the flow of money. Use promissory notes to document loans and specify terms in detail. Use written contracts – this also makes business sense.

(7) Nonpayment of dividends. Show how money flows from the company to individuals/shareholders. This is usually via a salary, bonus, dividend, distribution or repayment of a shareholder loan. Avoid just transferring money into an account without a company resolution stating what the transfer is for.

(8) Nonfunctioning officers or directors. Only appoint functioning officers and directors.

(9) Failure to issue stock. Make sure stock is properly issued and recorded in your corporate book.

(10) Insolvency of the debtor company. If the company is doing poorly, be extra careful where the money goes and document all transactions.

(11) Whether, in fact, the company is a mere facade for the operation of the dominant stockholders. Ultimately, look at all the facts and decide if the company is just the alter ego of another entity or entities.

Helping Business Owners Avoid Personal Liability

A recent case gives detailed guidance about how business owners should run their companies as separate entities from themselves to avoid personal liability under the "piercing the corporate veil" doctrine.

By Markus May

Business owners risk losing their personal assets if they do not properly operate their businesses. An Illinois second district appellate case reminds business owners, and attorneys advising business owners, on how to operate businesses to avoid personal liability for corporate actions. In *Fontana v TLD Builders, Inc*[1] the court performed a detailed analysis of the "piercing the corporate veil" doctrine and ultimately held an individual liable for a corporate debt exceeding $1 million.

This article reviews the *Fontana* analysis and suggests ways to help business owners avoid personal liability for business debts and torts. Much of the *Fontana* logic applies not only to individual shareholders but also to shareholders in a parent-subsidiary or affiliated entity relationship.[2]

The "piercing the corporate veil" doctrine

A corporation is a separate and distinct legal entity from its shareholders, officers, and directors and a limited liability company is separate from its members. The general rule is that such individuals are not liable for the entity's debts.[3]

In fact, one reason many individuals use corporations or other limited liability entities to transact business is to avoid personal liability for the corporation's actions.[4] By creating a limited liability entity to do business, an individual can generally engage in business without worrying about losing personal assets such as the family home or bank accounts in the event of a business loss or liability not covered by insurance.

However, there are exceptions to the general rule. One deals with piercing the corporate veil. Courts have held that when a business operates as the alter ego or business conduit of an individual or other entity, the corporate veil shielding the individual from liability can be pierced.[5] Generally, courts are reluctant to pierce the corporate veil. Therefore, the burden is on the party seeking to do so to make a substantial showing that the corporation is really a dummy or sham for another entity or individual.[6]

To pierce a corporate veil, the movant must prove a two prong test: (1) there is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, i.e., the corporation is the alter ego for the individual; and (2) adherence to the fiction of a separate corporate existence allows a fraud or promotes injustice or inequitable consequences.[7] The piercing doctrine is therefore an equitable remedy used to impose liability for an underlying cause of action, such as a tort or breach of contract.[8]

Factual background of *Fontana*

TLD Builders Inc. was a company owned by Nicola DiCosola's wife Theresa as the sole shareholder. On September 24, 1999, Joseph and Angela Fontana hired TLD to construct a single-family home on some property the Fontanas owned in Clarendon Hills.

When the home was not completed, the Fontanas brought suit against TLD for breach of contract. The Fontanas also sued Mr. DiCosola as an individual for the contract breach and asked the court to pierce the corporate veil. He argued that since he was not a shareholder of TLD he could not be held liable for TLD's breach of contract. He further argued that the facts were insufficient to support a piercing claim even if a non-shareholder individual could be held liable.

Piercing the corporate veil against a nonshareholder

As a matter of first impression, the *Fontana* court examined whether the piercing doctrine could be used to hold a non-shareholder, such as Mr. DiCosola, liable for a for-profit corporation's acts.[9] The closest Illinois case on point was *Macaluso v Jenkins*,[10] where the corporate veil was pierced against a nonprofit corporation that did not have shareholders. Most of the language in cases and commentaries regarding the piercing doctrine references shareholders and does not specifically address non-shareholder individuals. The court also examined out-of-state law.

As a result of its analysis, the second district held that where a nonshareholder individual exercises ownership control over a corporation such that their separate personalities do not exist and the corporation is a business conduit of the individual, the corporate veil can be pierced.[11] Therefore, a non-shareholder individual can be personally liable for a corporation's debts if the two-prong test for piercing the corporate veil is met.[12] Similarly, the veil between affiliated "sister" companies can also be pierced.[13]

Analysis of the factors used to determine if an alter ego exists

In determining whether a corporation is merely the alter ego of an individual, a court will look at a number of factors. It is important to remember that no single factor will generally be determinative and the cases that explain this doctrine tend to look at the totality of the circumstances.

The factors listed by the *Fontana* court are among the most expansive and include (1) inadequate capitalization, (2) failure to issue stock, (3) failure to observe corporate formalities, (4) nonpayment of dividends, (5) insolvency of the debtor corporation, (6) nonfunctioning of the other officers or directors, (7) absence of corporate records, (8) commingling of funds, (9) diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of

1. 362 Ill App 3d 491, 840 NE2d 767 (2d D 2005).
2. For recent cases dealing with piercing the corporate veil against affiliates or parents, see: *Laborers' Pension Fund v Lay-Com, Inc*, 455 F Supp 2d 773 (ND Ill 2006); *K. C. Pharmaceuticals, Inc v Strieter*, 2006 WL 741383 (SD Ill 2006); *Judson Atkinson Candies, Inc v Latini-Hohberger Dhimantec*, 2007 WL 674662 (ND Ill 2007).
3. *Fontana* at 500, 840 NE2d at 775.
4. Id.
5. Id.
6. Id.
7. Id at 500, 840 NE2d at 776.
8. Id.
9. Though Mr. DiCosola was the company president, the court did not address the piercing doctrine with respect to his position as an officer of the corporation.
10. 95 Ill App 3d 461, 420 NE2d 251 (2d D 1981).
11. *Fontana* at 502, 840 NE2d at 777.
12. An in-depth analysis of the court's reasoning is beyond the scope of this article.
13. *Laborers' Pension Fund*, 455 F Supp 2d at 786.

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creditors, (10) failure to maintain arm's-length relationships among related entities, and (11) whether, in fact, the corporation is a mere facade for the operation of the dominant stockholders.[14]

The *Fontana* court's analysis of these factors and practice pointers for the business advisor are set forth below.

Inadequate capitalization. Generally, a corporation should be properly capitalized at its inception to meet expected expenses.[15] In determining whether TLD was adequately capitalized, the *Fontana* court relied heavily upon *Fiumetto v Garrett Enterprises, Inc.*[16]

As in *Fiumetto*, the *Fontana* court noted that shareholders need to put at risk reasonably adequate unencumbered capital to cover the corporation's prospective liabilities.[17] It is inequitable to allow shareholders to set up flimsy organizations just to escape personal liability.[18] To determine whether a corporation is adequately capitalized you must compare (1) the amount of capital to (2) the amount of business to be conducted and the obligations to be fulfilled. Note this is generally the amount of capitalization at the time the business was formed and not the amount of capitalization as the business has grown.[19]

With respect to initial capitalization, Theresa DiCosola did not demonstrate she wrote a $1,000 check for an initial capital contribution to the company. Mr. DiCosola argued that personal loans to the company by Mr. and Mrs. DiCosola, a $4 million line of credit and some encumbered homes held by the company as inventory showed TLD was adequately capitalized. The court disagreed and found the loans and line of credit were evidence the company was actually undercapitalized.[20]

There is some uncertainty in the definition of what constitutes capitalization of a company. Some courts may recognize inventory, equipment, and lines of credit as part of the capitalization structure[21] while other courts may not. If debt structure and inventory are considered as a part of capitalization, this will help a closely held company which started with $1,000 capital and a large amount of debt.

In actual business practice, many small business owners provide an initial capitalization of a minimal amount such as one thousand dollars. Subsequently, the owners pay themselves salaries or dividends equal to the income of the company each year and retain very little in earnings. Under the *Fontana* and *Fiumetto* analysis, a small initial capitalization would not be enough to prevent this factor from being construed against the owner.

A lawyer defending such a claim would be wise to look at other authority such as *In re Estate of Wallen*,[22] which states that you must look closely at the nature of the business to determine whether it is undercapitalized and whether the company intended to minimize its assets to the detriment of its creditors. Additionally, *Browning-Ferris Industries of Illinois, Inc v Ter Maat*, provides that where a company is able to function on its own for many years, this is evidence the company is not undercapitalized.[23]

Lawyers need to emphasize to their clients the importance of maintaining the corporate formalities and documenting material transactions.

As preventive steps, practitioners should advise clients about the danger of undercapitalization. However, many small business owners will want to take money out of the business as opposed to allowing it to sit in a corporate capital account for a rainy day. If that's the case with your client, remember that all the piercing factors need to be examined and try to ensure that as many of the remaining factors as possible fall in your client's favor.

Failure to issue stock. The stock was issued to Theresa DiCosola and therefore this factor was not addressed by the *Fontana* court. Clearly if the company does not issue stock that bears some weight in determining whether it is a separate entity from the individual alleged to be the alter ego; however this factor is usually not heavily relied upon.[24] This is one of the easiest factors to meet. Therefore, you should see to it that your client has properly issued stock certificates.

Failure to observe corporate formalities. The *Fontana* trial court found that TLD failed to observe the corporate formalities by (1) failing to attach legal descriptions of properties sold to the corporate resolutions approving the sale of those properties and (2) failing to adopt corporate resolutions authorizing payments on loans the DiCosolas made to TLD. The appellate court held that because Mr. DiCosola did not challenge the second basis of the trial court's finding, it alone was sufficient to support the finding that corporate formalities were not followed.[25]

This is a troublesome finding for lawyers and corporations who maintain very streamlined corporate minutes. In *Fontana*, corporate resolutions were adopted each year appointing the directors and officers of the company. Further there were corporate resolutions specifically approving the purchase of various properties. The only failure of corporate formalities was the failure of the corporate resolutions to approve loan payments to the DiCosolas.

Though other courts may not be as strict as the *Fontana* court, *Fontana* is a warning that companies must be diligent in documenting and approving all material transactions of a corporation, especially loans and payments from and to shareholders or other entities. Attorneys who prepare annual minutes for their clients should take special note and advise clients to create minutes approving all material actions taken by the corporation.

Further, though ratifying corporate actions after the fact is not *per se* im-

14. *Fontana* at 503, 840 NE2d at 778.
15. Charles W. Murdock, *Piercing the corporate veil – In general*, 7 Ill Prac, Business Organizations § 8.9 (West 1996).
16. 321 Ill App 3d 946, 749 NE2d 992 (2d D 2001). In *Fiumetto* summary judgment on a piercing claim was disallowed because the record needed to be construed in the plaintiff's favor.
17. *Fontana* at 504, 840 NE2d at 779, relying on *Fiumetto* at 959, 749 NE2d at 1005.
18. Id.
19. Murdock, *Piercing the corporate veil* – (cited in note 15).
20. *Fontana* at 504-505, 840 NE2d at 779.
21. See the following cases where financing arrangements and inventory were considered in the amount of capitalization: *Jacobson v Buffalo Rock Shooters Supply, Inc*, 278 Ill App 3d 1084, 1089-1090, 664 NE2d 328, 332 (3d D 1996) (inventory and equipment considered); *Bankers Trust Co v Chicago Title & Trust Co*, 89 Ill App 3d 1014, 1020, 412 NE2d 660, 664-65(1st D 1980) (successful refinancing considered); *Gallagher v Reconco Builders, Inc*, 91 Ill App 3d 999, 1006, 415 NE2d 560, 564-65 (1st D 1980) (no credit line is a factor in inadequate capitalization).
22. 262 Ill App 3d 61, 71, 633 NE2d 1350, 1359 (2d D 1994).
23. 13 F Supp 2d 756, 766 (ND Ill 1998).
24. *Strieter*, 2006 WL 741383 (SD Ill 2006).
25. *Fontana* at 505, 840 NE2d at 780.

proper, *Fiumetto* indicates this could at least be a possible indication of neglect of the necessary corporate formalities.[26] Therefore, the best practice is for corporate boards to approve corporate actions before they occur or at the time they occur.

As for limited liability companies, Illinois statutes provide that the corporate formalities need not be followed. This provides some protection to the limited liability company members when it comes to this factor. However, limited liability company managers or members may wish to approve all company actions in writing as a matter of good business practice in any event. This would especially be true for anything that could be construed as self dealing.

Nonpayment of dividends. TLD paid no dividends to Theresa DiCosola.[27] The corporation generally operated at a loss and appears to have existed solely because of the infusion of cash from the loans by the DiCosola's as well as the line of credit from the bank. However, money flowed from the corporation into the DiCosola's personal checking account and this weighed heavily in the court's decision.[28]

Note that in small companies, dividends are often not paid and this factor has been held not to be determinative where other countervailing facts are present.[29] In *Fontana*, if there were corporate resolutions authorizing the money transfers, whether as salary, dividends, or loan repayments, this factor probably would not have been construed against Mr. DiCosola.

The practice pointer here is that companies need to ensure that income is properly distributed in the form of dividends, salaries, loan repayments, or some other approved form of compensation.[30] Documentation about the rationale for the payment should be maintained in the corporate records.

Insolvency of the debtor corporation. The *Fontana* court did not explicitly address this factor. A corporation will often be insolvent when a piercing the corporate veil claim is brought.

If a corporation is solvent (assets exceed liabilities), it could presumably pay its debts and the plaintiff could proceed directly against the corporation's assets without piercing the corporate veil. Therefore, this factor seems to be stacked against the debtor corporation whenever a piercing claim is brought. However, when the corporation is insolvent solely due to the underlying claim which leads to the piercing claim, this factor should not be construed against the individual.[31] There is not much a practitioner can do in advising a client with respect to this factor.

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26. *Fiumetto* at 960, 749 NE2d at 1006. Note: clients need to be advised to follow other corporate formalities such as signing a title next to their name in order to avoid other forms of potential personal liability.

27. *Fontana* at 507, 840 NE2d at 781.

28. Id.

29. *Browning-Ferris*, 13 F Supp 2d at 766.

30. Additionally, there may be Internal Revenue Service issues if a corporation never pays dividends yet continues to operate for years on end with bonuses to owners. The company's accountant or tax attorney should be consulted with respect to this issue.

31. *Browning-Ferris*, 13 F Supp 2d at 766.

Nonfunctioning of the other officers or directors. The trial court found that Theresa DiCosola was not an active director of the corporation. Though she apparently performed some actions on the corporation's behalf, the trial court found she did not have the real decision-making role in TLD. There was not enough evidence to overcome the trial court's findings in this regard and therefore the appellate court affirmed the finding.[32]

The lesson here is that companies should not appoint board members or officers who are not actively engaged in making decisions for the company. Be especially wary of this issue when a client desires to obtain a minority or woman owned business designation and no person fitting that description is active in the management of the company.

Absence of corporate records. TLD filed corporate bylaws, prepared resolutions and shareholder actions and filed all necessary paperwork with the secretary of state, filed all tax returns, and maintained a separate bank account and financial records. However, the company failed to document the terms of personal loans from the DiCosolas; the corporate tax returns did not document those loans; and there was no evidence of repayment of any indebtedness. There were no corporate records showing the amounts borrowed by TLD to purchase the properties.

Additionally, there were no written contracts with subcontractors, no written bids, no written change orders, no written work schedules, and no written record of any payments TLD made to subcontractors.[33] Based on these facts, the appellate court found the trial court's determination that TLD failed to keep and maintain corporate records was not against the manifest weight of the evidence.

If the trial court had made a contrary finding on the facts, the appellate court may not have overturned that ruling. However, the practice pointer here is that merely maintaining a corporation is not enough. There must be other written documentation regarding corporate actions and contracts with third parties.

Further, it is good business practice to document an entity's relationship with third parties to clarify responsibilities between the parties. Given the importance of this factor in many courts' rulings, clients should be advised to document all corporate actions and contracts in writing.

Commingling of funds. The *Fontana* court found that commingling of funds occurred because Theresa never received any wages, salary, compensation of any kind, or any dividends. However, funds were transferred from the business account into the DiCosola's personal checking account. The court held "[t]his money was not salary, wages, dividends, or distributions and, therefore, demonstrates the commingling of TLD's funds with DiCosola and Theresa's personal funds."[34]

As is mentioned above, companies need to clearly document, preferably in the form of corporate resolutions, the payment of any funds to shareholders or other controlling individuals. Clients need to be informed of the necessity of maintaining separate bank accounts and not paying personal expenses from the business account. If business expenses are paid from a personal account, there should be documentation supporting the expense and any subsequent expense reimbursement to the individual.

Diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors. This factor was not specifically addressed by the court in its analysis, but it did play a part in the second prong analysis discussed below. Not much needs to be said here – if this factor exists, it will obviously have a strong bearing on a court's decision in piercing the corporate veil. Clients should be advised to not make preferential payments.

Failure to maintain arm's-length relationships among related entities. This factor was not directly addressed by the *Fontana* court. Just as with the diversion of assets, the failure to maintain arm's-length relationships indicates some form of sharp dealing or preferential treatment and has a strong bearing upon a court's decision to pierce the corporate veil.

However, merely operating several businesses out of the same location,[35] using a sweep banking account between related entities,[36] or using another company's trademark[37] is not necessarily enough to fail this test. Generally speaking, a corporation should not receive a benefit that it could not obtain on the market. For example, charging nonmarket rent under a real property lease may be seen as self dealing and not maintaining an arms-length relationship.

Using the corporation as a facade for the operation of dominant stockholders. This factor was not addressed by the *Fontana* court, because Mr. DiCosola was not a shareholder. The courts will generally look at all the factors as evidence to determine whether the corporation is a mere facade for the dominant shareholder.[38]

If a corporate ship is sinking, the company's shareholders must avoid any form of self dealing or risk having their personal assets sink along with the business assets.

This factor allows a court to find that a company is the alter ego for another entity when other factors are not met and a court determines it is appropriate to pierce the corporate veil. Generally, cases seem to hold this as the catch-all summation of the evidence showing that the corporate veil may be pierced.

Analysis of fraud, injustice, or inequitable consequences

The second prong of the piercing analysis requires a showing that the separate company existence allows a fraud, promotes injustice, or promotes inequitable consequences.[39] The *Fontana* court found that though the trial court did not address the second prong of the piercing test, this prong was satisfied.

After the Fontanas filed suit, TLD sold assets worth $1.8 million and paid off various creditors. One of those creditors was Theresa DiCosola who was paid $91,783 on an undocumented share-

32. *Fontana* at 505, 840 NE2d at 780.
33. Id at 506, 840 NE2d at 781.
34. Id at 507, 840 NE2d at 781.
35. *Jacobson v Buffalo Rock Shooters Supply, Inc*, 278 Ill App 3d 1084, 1089-1090, 664 NE2d 328, 332 (3d D 1996).
36. *Judson*, 2007 WL 674662 at 17.
37. *Logal v Inland Steel Industries, Inc*, 209 Ill App 3d 304, 310-311, 568 NE2d 152, 157 (1st D 1991).
38. *People v V & M Industries, Inc*, 298 Ill App 3d 733, 741-742, 700 NE2d 746, 752 (5th D 1998).
39. *Fontana* at 507, 840 NE2d at 781.

holder loan.[40] The DiCosolas also created a new business which began building homes after the lawsuit was filed. The DiCosolas did not perform any additional work with TLD after the lawsuit was filed.[41] Based primarily on these facts, the court held that Mr. DiCosola reduced the assets of the company to the detriment of the Fontanas.

One troubling aspect of the case is the mention of the creation of a second corporation. There is an implication in *Fontana* that the DiCosola's should have continued working with TLD indefinitely after the suit was filed.

If, however, a corporation is failing with no chance of success, it makes business sense from a shareholder perspective to wrap up the old and begin a new corporation. Many business owners own more than one corporation. Setting up a new corporation, in and of itself, where no assets are diverted from the preexisting corporation, should not constitute fraud or an injustice.

Perhaps if TLD had been placed in bankruptcy, the court would not have mentioned the creation of a new company.[42] However, where individuals set up flimsy corporations with limited chances of success, the corporate veil will be pierced.

For the attorney, the lesson is to advise clients to consult their legal advisor if in doubt about whether an action results in an injustice or inequitable result. Generally, clients should be advised to avoid giving related entities or shareholders preferential treatment in repaying loans or other monetary transfers after a lawsuit has been filed or if the company is not doing well.

Conclusion

The *Fontana* case provides a few surprises. Perhaps if TLD were in a different industry or had been in existence for a longer period, the result would have been different. If the payment to Mrs. DiCosola had been made to an unrelated third party owner, perhaps there would have been no personal liability for Mr. DiCosola. The overall take-away from this case is that self-dealing when a company is going under will result in a court being more likely to construe the facts to pierce the corporate veil.

For the attorney representing an ongoing closely held business, the lessons from *Fontana* do not depend on whether the court was right or wrong. The importance of documenting corporate transactions, especially those between a company and its shareholders or other individuals exercising some control over corporate actions, cannot be overemphasized.

Attorneys need to communicate to their clients the importance of maintaining the corporate formalities and documenting material transactions. If a corporate ship is sinking, the company's shareholders need to avoid any form of self dealing or risk having their personal assets sink along with the business assets. In corporate governance, an ounce of prevention is worth more than a pound of cure. ■

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40. The payment was to Theresa and not to Mr. DiCosola. The court did not explicitly address why Mr. DiCosola could be held personally liable on a piercing claim when the payment was to Mrs. DiCosola.

41. *Fontana* at 508, 840 NE2d at 782.

42. Contemplating bankruptcy in and of itself is not a fraudulent or improper scheme. *Judson*, 2007 WL 674662 at 28.

Pierce the Veil

Uphold your personal liability protection in the face of a corporate downturn.

By Markus May

A word of advice: Operate businesses as separate entities, or else risk losing everything…literally.

A corporation is a separate entity, distinct from its shareholders, officers and directors. Similarly, an LLC is separate from its members. By setting up your business as a corporation or other limited liability entity, you avoid personal liability—and therefore the risk of losing your personal assets should business turn sour.

That said, the courts have held that, when a business operates as an individual's or another entity's "alterego" or business conduit, then the protective veil is pierced. In order for this to happen, a two-part test has to be met: (1) There is such unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist, and (2) The "fiction" of a separate corporate entity allows a fraud or promotes injustice or inequitable consequences.

To determine whether a corporation is merely an alter-ego of another entity, Illinois courts look at the following 11 factors, none of which is determinative on its own:

1. Inadequate capitalization. Courts consider it inequitable to allow shareholders to set up flimsy organizations just to escape personal liability. You need to compare the amount of capital to the amount of business to be conducted and the obligations to be fulfilled. You can then determine whether a corporation is adequately capitalized.

There is some uncertainty, however, regarding what constitutes company capitalization. Some courts recognize inventory, equipment and lines of credit as part of the capitalization structure. Some look closely at the nature of the business to determine whether it is undercapitalized and whether the company intended to minimize its assets to the detriment of its creditors. What's more, courts have held that a company's ability to function on its own for many years is evidence that it is not undercapitalized.

In actual business practice, many small-business owners provide an initial capitalization of a minimal amount such as $1,000. Some courts likely would find this inadequate capitalization in defending against a piercing claim. Others may look more closely at the way the business was run before determining it was undercapitalized. In any event, as a preventative step, accountants should advise clients about the potential danger of undercapitalization so they can make an informed decision about how much capital to contribute to an entity.

2. Failure to issue stock. If stock isn't issued, it will bear some weight in determining whether a company is a separate entity from the individual alleged to be the alter-ego. However, this factor isn't heavily relied upon. Wise practitioners ensure the company is set up properly. For instance, too many clients use form documents and "DIY" services, and neglect to issue stock and create a stock ledger. Accountants and attorneys should work together to determine who does what in the formation stage toprevent anything from slipping through the cracks. ⏩

3. Failure to observe corporate formalities. These formalities—which are essential if the business is to be seen as a separate entity—include keeping the company registered with the Secretary of State, holding annual meetings, maintaining annual minutes, and signing corporate documents with the individual's title.

A recent Illinois court opinion found that a company failed to observe the corporate formalities by not attaching legal descriptions of properties sold to the corporate resolutions approving the property sale, and not adopting corporate resolutions authorizing payments on loans to shareholders. Ratifying corporate actions after the fact is not improper, per se, but could be considered an indication of neglect. The best policy is for corporate boards to approve corporate actions before or at the time they occur. For LLCs, Illinois law provides that the corporate formalities need not be followed. That said, LLC managers or members may opt to approve all LLC actions in writing, since the case law in this area is not yet developed.

4. Absence of company records. Does the client file proper tax returns that reflect the proper entity? Are bank accounts listed in the entity's—not the individual's—name? Are contracts, bids, work schedules, etc. in writing? Are there financial records that show the flow of money into and out of the organization, as well as proper balance sheets and income statements? Are all personal loans to owners and other individuals documented not only with a promissory note, but also in the corporate tax returns?

The absence of these and any other company records that could be deemed necessary to transacting business as a separate entity is an important factor that courts consider in determining whether to pierce the corporate veil.

5. Nonpayment of dividends. If they're not paid, this could indicate that a corporation is the shareholders' alter-ego. However, this factor is not determinative where other countervailing facts exist. The point is, when an accountant advises a client on monetary distributions out of the company, he or she should advise them to create the appropriate documentation and keep it in the company books.

6. Insolvency of the debtor company. If the company was solvent, it presumably would pay its debts and the plaintiff would proceed directly against the company without piercing the corporate veil. It therefore follows that this factor is often construed in favor of piercing liability protection. When the company is insolvent solely due to the underlying claim, however, this factor should not be construed against the shareholders.

7. Division of assets from the corporation by or to a stockholder, other person or entity to the creditors' detriment. If payments are made to an owner, and creditors are harmed as a result, this will have a strong bearing on the court's decision.

8. Nonfunctioning of the other officers or directors. Companies should not appoint board members or officers who are not actively engaged in making company decisions. Advisors need to be especially wary of this issue when a client wants to obtain a minority or woman-owned business designation, and no such person is active in the company's management.

9. Commingling of funds. This occurs when company funds are transferred into a personal bank account or into another business's bank account, or when personal funds are placed in a business account. If company records don't indicate that money was paid to an owner as compensation or dividends, and money shows up in the owner's bank account, courts may find that there has been an improper commingling of funds.

Companies need to clearly document the payment of any funds to shareholders or other controlling individuals—preferably in the form of corporate resolutions. Inform clients of the need to maintain separate bank accounts and to avoid paying personal expenses from the business account. If business expenses are paid from a personal account, there should be documentation supporting the expense and any later expense reimbursement to the individual.

10. Failure to maintain arm's–length relationships. Failing to maintain arm's-length relationships among related entities may indicate some form of sharp dealing or preferential treatment. This has a strong bearing on a court's decision to pierce liability protection. However, merely operating several businesses out of the same location or the use of one company's trademark by another is not enough to determine that this factor has been met. Generally speaking, a company should not receive a benefit that it could not obtain on the market. For example, charging below market rent under a real property lease may be seen as self-dealing and a failure to maintain an arm's-length relationship.

11. The corporation is a façade for the dominant stockholders. This catch-all factor allows a court to find that a company is the alter-ego of another entity when, even though some of the above factors are not met, it is believed that the corporate veil should be pierced.

The second prong of the "piercing" analysis involves showing that, by allowing the separate corporate entity, fraud, injustice or inequitable consequences occur. Generally speaking, if the 11 major factors are met and there is any type of self-dealing, then this second prong will be met.

For example, in a recent case, a home builder sold assets worth $1.8 million and paid off various creditors. One of those creditors was a shareholder who was paid $91,783 on an undocumented shareholder loan. Other creditors were not paid in full. The shareholder also created a new business which began building homes after the lawsuit was filed. Based primarily on these facts, and after an analysis of the 11 factors, the court removed liability protection based on its determination that the company's assets were reduced to the creditors' detriment.

The practice pointer here is to advise clients to avoid any type of self-dealing that could be perceived as promoting an inequitable result, injustice or fraud. This includes repaying individual shareholder loans after a potential lawsuit has been filed. Clients should continue operating the business without payments to owners outside the normal course of business when the business is not doing well.

For the professional advising an ongoing business, the importance of documenting business transactions, especially those between a company and its owners or other individuals exercising control over company actions, cannot be emphasized enough. Accountants need to reiterate the importance of maintaining corporate formalities and documenting material transactions. If a company is failing, the company's owners should avoid any form of self-dealing or else risk losing their personal as well as their business assets. □

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CHINKS IN ARMOR: UPDATE ON LIMITED LIABILITY CASE LAW

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Presented To: ____

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Time: _______________ to _______________

Date: _______________

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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 personal assets of the entity's owner(s), e.g., shareholders, partners or members, from third-party claims against the entity (inside liabilities). Corporations have been in existence for more than 100 years. However, the limitation on liability provided by incorporation is not without boundaries. There is a large body of case law indicating that under certain circumstances the "corporate veil" can be pierced, in which case, claims against the corporation can reach the shareholders of the corporation and their personal assets. 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 the later 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.

e. LLCs should provide effective insulation from inside liabilities. Section 608.701 of the Florida Limited Liability Company Act expressly provides that the Florida courts shall apply the case law which interprets the conditions and circumstances under which the corporate veil of a Florida corporation may be pierced to Florida limited liability companies and their members. The seminal "corporate veil piercing" case in Florida is *Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So.2d 1114 (Fla. 1984), which holds that corporations are legal entities distinct from shareholders and the corporate veil will not be pierced either at law or in equity unless the plaintiff proves the corporation was organized or used to mislead creditors or to work fraud upon them. A creditor has a difficult task to convince a Florida court to pierce the corporate veil, and would likely face similar difficulties as a plaintiff in LLC veil piercing litigation.

f. 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.

g. *17315 Collins Avenue, LLC and Waterstone Properties, LLC v. Fortune Development Sales Corp.*, No. 3D09-2056 (Fla. 3d DCA, January 15, 2010). To pierce the veil of a subsidiary, it must be shown that the subsidiary is a mere instrumentality of the parent, <u>and</u> that it was organized and used by the parent to mislead creditors or to perpetrate a fraud on them. *See also Dania Jai-Alai Palace, Inc. v. Sykes*, 450 So. 2d 1114 (Fla. 1984) (must also have "improper conduct"); *Baldwin v. Bill and Carolyn Limited Partnership* (10th Cir. Bankr. Okla. 2006).

h. *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. *See also Klein v. Weidner*, 2010 WL 571800 (E.D. PA) (reverse pierce where LLC was improperly used to perpetrate an injustice against creditor) and *Postal Instant Press, Inc. v. Kaswa Corp.*, 162 Cal. App. 4th 1510 (Cal. Ct. App. 2008) (reverse pierce using "alter ego" doctrine but only after available alternate remedies are inadequate).

2. <u>Insulation Against Outside Liabilities</u>.

a. 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.

b. In general, LPs and LLCs provide insulation from outside liabilities by limiting outside creditors to a charging order remedy.

c. 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]

d. The Exclusivity of the Charging Order Remedy

(i) RE-FRULPA provides that a charging order is the sole remedy available to a creditor of a Florida limited partnership and that the judgment creditor has only the rights of an assignee to the extent so charged.

(ii) Fla. Stat. §620.1703 provides a similar protection for LPs. 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 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).

(iii) The current Florida LLC Act provides that any judgment creditor of a member is limited to a charging lien against the member's interest in the LLC for the amount of the judgment. Fla. Stat. §608.433(4). To the extent so charged, the judgment creditor has only the rights of an assignee of such interest. The assignee cannot exercise any rights or powers of a member unless the assignee becomes a member. Fla. Stat. §608.432(2)(a). The assignee may become a member with the unanimous consent of all members other than the member assigning the interest. Fla. Stat. §608.433(1). This consent must be in writing. Fla. Stat. §608.4232. Without becoming a member, the assignee is restricted to sharing in such profits and losses, such distribution or distributions, and receiving such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled. Fla. Stat §608.432(2)(b). 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.

(iv) *In re LaHood (Heartland Bank and Trust Company v. Covey)*, Bankruptcy No. 07-81727, Adversary No. 07-8156, 2009 WL 2169879 (Bankr. C.D. Ill. July 16, 2009). In a case upholding the exclusive nature of the charging order remedy as expressly provided for in the Illinois LLC statute, the bankruptcy court in Illinois determined that a

[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.

lender's judgment lien against an LLC member's distributional interest was not valid because the charging order remedy in the Illinois LLC statute operates to the exclusion of all other remedies. The lender had obtained a pre-petition judgment against the debtor, and the lender served the debtor with a citation that impressed a lien upon the debtor's personal property under Illinois judgment collection provisions. In this opinion, the court addressed the lender's argument that the charging order provision of the LLC statute applies only to a distributional interest and that the lender's judgment lien obtained under the general judgment collection provisions applied to the debtor's membership interest. The lender emphasized the statutory distinction between a membership interest and a distributional interest and argued that, although it did not obtain a charging order so as to obtain a lien on the distributional interest, it nevertheless obtained a citation lien on the membership interest. The court stated that the lender's implied argument that it somehow had the right to enforce its lien against the distributional interest, the only interest that mattered at this point, directly contradicted the plain language of the charging order provision. The lender's argument implied that a creditor could bypass the exclusive procedure of the charging order provision and obtain a lien on a member's distributional interest by obtaining a lien on the entire membership interest, which includes the distributional interest. Applying the rule of statutory construction that a specific provision controls over a more general one, the court concluded that the exclusive charging order provision in the LLC statute necessarily controlled over the more general statute providing for a citation lien on personal property.

(iv) Some state statutes or case law have provided for the foreclosure and sale of an LLC or LP interest. The buyer is not afforded the rights of a member or partner, but rather, that of an assign. The predominate cases are:

(a) *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 so long as the business of the partnership is not unduly interfered with.

(b) *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.

(c) Other states that have statutes or case law permitting foreclosure are: California, Colorado, Connecticut, Georgia, Hawaii, Idaho (effective July 1, 2010), Iowa, Kansas, Kentucky, Maryland, Missouri, Montana, Nebraska, New Hampshire, Ohio, South Carolina, Utah, Vermont and West Virginia.

(d) States that do not permit foreclosure include: Alabama, Alaska, Arizona, Delaware, Florida, Illinois, Minnesota, New Jersey, North Carolina, North Dakota, Oklahoma, South Dakota, Tennessee, Texas, Virginia and Wyoming.

(v) Single Member LLC's

(a) *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.

(b) 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]

(c) In two recent cases, *In Re Modanlo*, 412 BR. 715 (Bankr. D. Md., 2006), *aff'd* 266 Fed. Appx. 272, 2008 and *In Re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. Idaho 2006), involving Chapter 11 bankruptcy filings, the courts, relying entirely on the bankruptcy law that all of the debtor's interests in a single-member LLC became the property of the bankruptcy estate, and, as such, were subject to the sole and exclusive authority of the Trustee.

(d) Single Member LLCs Treated as Separate Entities: In Chief Counsel Advice (CCA) 200338012 and 200235023, the IRS ruled that an assessment against single member owner of LLC does not result in IRS having tax lien that it could enforce against assets held by LLC; *see also* CCA 200250012, where the IRS treated disregarded single member

[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 a judgment against the debtor spouse. It is significant to note that this particular exemption has been the most fragile over time, although today, except in the case of a fraudulent transfer or asset conversion, the “tenants by the entirety” exemption is probably the strongest it has ever been (see, for example, *Bank of Beal* and *Kossow* which create presumptions in favor of a Tenancy by the Entirety).

LLC as separate entity for purposes of applying small partnership exception to TEFRA audit rules.

(vi) In *Olmstead, et al v. FTC*, 35 Fla**.** L**.** Weekly S 357 (Fla. 2010), the Florida Supreme Court ruled that creditors can go after a debtor's assets that are held by a single-member LLC. *Olmstead* involved two individuals 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."

The majority reasoned that because Section 608.433(4) of the Florida LLC Act did not clearly state that a charging order was the "sole and exclusive remedy," an alternate remedy could be ordered at the court's discretion. The court also concluded that the limitation on assignee rights of LLCs found in Section 608.433(1) does not apply in cases involving transfer of rights in single-member LLCs. In a single-member LLC, the set of "all members other than the member assigning the interest" is empty. Thus, an assignee of a membership interest in a single member LLC becomes a full and legitimate member, taking full right and title to the economic and management interests of the transferor.

However, the *Olmstead* Court and fails to address positions previously taken by Florida courts involving partnerships and the charging order remedy. The Court in *Myrick v. Second National Bank*, 335 So. 2d 343 (Fla. 2d DCA 1976), concluded that the charging order is the essential first step and all further proceedings must occur under the supervision of the court to protect the interests of the various parties. The Florida Court of Appeals went even further in *Givens v. National Loan Investors, L.P.*, 724 So. 2d 610 (Fla. 5th DCA 1999) and *Atlantic Mobile Homes, Inc. v. LeFever*, 481 So. 2d 1002 (Fla. 4th DCA 1986), concluding that the charging order remedy was the <u>sole remedy available</u> to a judgment creditor.

Instead, *Olmstead* classifies a single-member LLC as merely another form of a corporation, indirectly terminating the single-member LLC as an asset protection vehicle. While it appears that *Olmstead* does not necessarily apply to multi-member LLCs, it does create a reasonable fear of similar litigation for owners of multi-member LLCs in the future. As a result, we could begin to see business owners begin forum shopping in search of a safer haven for their assets or even use a different form of entity altogether.

(vii) It is interesting to note in Rev. Rul. 77-137, the Service ruled that a limited partnership entity's K-I goes to the assignee of a limited partnership interest even though the partnership agreement provided that an assignee may not become a substituted limited partner without the consent of the general partners. It would seem that this ruling would also apply to an LLC. This can be a strong inducement to a creditor not to foreclose if the documents do not provide for minimum tax distributions.

(viii) Bottom Line. In Florida, RE-FRULPA currently provides the exclusivity of the charging order as the "sole" remedy Florida courts should be bound by such exclusivity on a going forward basis. Unfortunately, LLCs are not as tightly protected. The new Florida Bar Task Force redrafting the LLC statute is carefully reviewing this difference. Until the LLC law is changed, chinks exist in the armor of the LLC and if outside creditors are the main issue, a limited liability limited partnership it is probably the safer course of action to follow.