Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #127
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From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: Forum Shopping for Favorable FLP & LLC Law - Part IV

This is the **fourth** in a special **LISI** series by **Mark Merric** and **William Comer**. Part I was Asset Protection Planning Newsletter # 112, part II was Asset Protection Planning Newsletter # 114, and part III was Asset Protection Planning Newsletter #117.

Here's a quick review:
Installment 1: Asset Protection Planning Newsletter # 112. We provided a chart for both LLCs and FLPs and discussed the asset protection concern when a state provided for the judicial foreclosure sale of a limited partnership or LLC membership interest. We noted that there were eight states whose partnership law provided that a charging order was the sole or exclusive remedy for a creditor attaching the partnership interest. On the other hand, there were sixteen states whose limited liability law provided that a charging order was the sole or exclusive remedy for a creditor attaching an LLC membership interest.

Installment 2: Asset Protection Planning Newsletter # 114 We discussed a charging order that provided for accountings and restricted the partnership from making loans, distributions, capital acquisitions, and a partner from selling his or her interest without debtor or court approval. We concluded that in a state that did not have sole or exclusive remedy language it was most likely that a court could order similar directions against the partnership or limited liability company. We also discussed that the Uniform Limited Partnership Act of 2001 and the Uniform Limited Liability Company Act of 2006 specifically allowed for these directions, with the exception of preventing operating capital acquisitions. We also concluded that there was the possibility that such directions might be ordered by a court in "simple sole remedy states."

Installment 3: Asset Protection Planning Newsletter #117. We discussed the seven states that have distinguished themselves by providing asset protection greater than "sole or exclusive remedy against the partnership interest," hereinafter the "Magnificent Seven." These states are the Alaska prototype; the Delaware prototype; and the South Dakota prototype. The Alaska prototype limits a court from ordering accountings and directions. The Delaware prototype states a court may not order any other legal or equitable remedy. The South Dakota prototype appears to combine both the Alaska and

Delaware model, however, there is a little ambiguity in the last clause of this act.

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EXECUTIVE SUMMARY:

In *this* Part IV article, we discuss what might be "the great equalizer", the Bankruptcy Code. Theoretically, a bankruptcy court is to apply the law of the state that it sits in. If this was the case, would not the words, "sole or exclusive remedy" mean what they say, and a bankruptcy trustee would have no more power than a regular creditor under state law? Unfortunately, this does not appear to be the case. A bankruptcy trustee under federal law appears to have *greater* rights than any other creditor, because a bankruptcy trustee…

"*stands in the shoes of the bankrupt and receives all of the rights of bankrupt/debtor*."[1]

This fourth of a five part series discusses four bankruptcy cases, three that were single member LLC cases, and one against a multi-member LLC. The authors conclude that even in a sole remedy state, or a "Magnificent Seven" state for that matter, there is no charging order protection for a single member LLC. Regarding multi-member LLCs, whether there is any charging order protection in bankruptcy depends on whether the partnership or operating agreement is executory. If it is non-executory, there is no asset protection.

FACTS:

SYNOPSIS:

Single Member LLC: Bankruptcy courts in Colorado, Idaho, and Maryland have all pierced single member LLCs, without any "pierce the veil" or "reverse veil pierce", "constructive trust", "resulting trust" or "alter ego" argument. The Bankruptcy Trustee was able to surpass all charging order protection, solely because the LLC was a single member LLC.

Multimember LLC: Regarding a multi-member LLC, even in the "simple sole remedy"[2] state of Arizona, the bankruptcy trustee "*stood in the shoes of the bankrupt*" and received voting rights. Since the bankrupt originally held more than a majority vote, the bankruptcy trustee was able to vote and liquidate the LLC and reach the underlying assets of the LLC. The result in the Arizona case was dependent upon the Arizona court finding that the operating agreement was not executory.

COMMENT:

SINGLE MEMBER LLC'S

With the score being 3 to 0 and going into the seventh inning, all bankruptcy courts have held that a bankruptcy trustee could reach a single member LLC's interest, regardless of whether it was a sole remedy state or even a Magnificent Seven state for that matter.

The first case was the *Albright* case based on Colorado's LLC statute.

The second case was *In re A-Z Electronics, LLC*[3] based on Idaho's LLC statute.

Richard Shanklin and **Anita Barber**[4], two of Florida's esteemed estate planners, have brought to our attention the third case in the trilogy, *In re Modanlo*[5], which was decided under Delaware law by a Maryland bankruptcy court. It appears that the key thread tying all of these single member LLC cases together is whether the Bankruptcy Trustee succeeds to all of the management rights of the LLC.

In Re Albright[6], Ashley Albright had individual creditors outside of an LLC in

which she was the sole member. Ashley Albright filed for bankruptcy, and she asserted that the bankruptcy trustee was only entitled to a charging order. Ashley Albright's legal argument was technically incorrect, because the Colorado LLC statute specifically provided for the judicial foreclosure sale of the membership interest.[7] However, the bankruptcy trustee was not content with just a judicial foreclosure sale of the 100% LLC interest, he wished to reach the underlying assets of the LLC without an alter ego argument or any type of veil piercing argument.[8]

The *Albright* Court held that because there were no other members, the bankruptcy trustee became a "substituted member." The *Albright* Court stated,

> *"Section 7-80-702 of the Limited Liability Company Act requires the unanimous consent of 'other members' in order to allow a transferee to participate in the management of the LLC. Because there are no 'other members' in the LLC, no written unanimous approval of the transfer was necessary. Consequently, the Debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and the Trustee obtained all her rights, including the right to control the management of the LLC*."

It appears that the Albright court carved out a judicial exception for single member LLCs under § 7-80-702 of the Colorado LLC statute.[9]

After concluding that the bankruptcy trustee succeeded to all of the rights of the debtor as a substituted member, the *Albright* Court explained why the bankruptcy trustee was not limited to a charging order. The Court held,

> *"the charging order, as set forth in Section 703 of the Colorado Limited Liability Company Act, exists to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager. A charging order protects the autonomy of the original members, and their ability to manage their own enterprise. In a single-member entity, there are no non-debtor members to protect. The charging order limitation serves no purpose in a single member limited liability company, because there are no other parties' interests affected*."

In essence, the *Albright Court* appears to have carved out a second judicial

exception. (The first exception was that the bankrupt did not retain voting rights.) The second judicial exception was that the charging order remedy does not apply to the single member LLC. The end result was that the Bankruptcy Trustee succeeded to *all* of the rights of the Bankrupt, including voting rights, and he could liquidate the LLC without any pierce the veil argument or any other legal or equitable theory.

In *A-Z Electronics, LLC*, the debtor individually filed a bankruptcy. Later, the debtor proceeded to file a bankruptcy for his single member LLC. The *A-Z Electronics* Court dismissed the LLC bankruptcy case, noting that when the debtor filed his individual bankruptcy, the bankruptcy trustee succeeded to all the rights in the LLC – including management. Therefore, the individual debtor had no authority to file such an action.

Similar to *Albright,* the key to the court's decision rests on who receives the management rights when a single member LLC files for bankruptcy. The *A-Z Electronics Court* first noted that what becomes property of the estate when a member of an LLC files bankruptcy depends on the facts, in particular whether the LLC was a single member or a multi-member LLC. Citing *Albright,* the A-Z Court held:

> In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003), illustrates the difference between a single-member LLC and a multi-member LLC. It found that where "there are no other members in the LLC, ... the Debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and the Trustee obtained all her rights, including the right to control the management of the LLC." 291 B.R. at 540. The right to control (and not just *891 "participate" in) management is significant. "Because the Trustee became the sole member of [the] LLC upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets." 291 B.R. at 541."

The *A-Z Electronic Court* decision did not state that it was carving out a judicial exception to Idaho's LLC statute for single member LLC's. However, the holding and reliance on *Albright* appears that this is in fact what the Court did.

A recent 2007 Maryland Bankruptcy Court case, applying Delaware law provides the most thorough analysis yet of the single member LLC asset protection issue. The *Mondalo Court* begins its analysis by noting that

> *"The Delaware statute governing LLC's is relatively new, and some of its provisions do not dovetail precisely. Although the definitional section of the Delaware statute indicates that it applies to single member LLCs, some of its operational provisions only make sense when applied to multi-member LLCs*."

Citing *Albright,* the *Mondalo Court* agreed that since there were no other members to protect, the purpose of preventing a creditor from becoming a substituted member does not apply to a single member LLC. The Court later held that "using principles of statutory construction and adopting the reasoning of the Bankruptcy Court in *In re Albright*, sections 18-702 and 18-704 of the Delaware LLC Act were inapplicable to cases concerning single member limited liability companies. In other words, there is little question that the *Mondalo Court* carved out a judicial exception for single member LLCs.

The *Mondalo Court* also gives a second reason for allowing the bankruptcy trustee to be a substituted member and receive voting rights. The Court first asks the simple common sense question, "Who can vote the bankrupt's membership interest once a bankruptcy has been filed?" A literal reading of the statute, with no judicially created exception, would conclude that no one has voting rights. The bankrupt gave up all of his rights when he or she filed bankruptcy, and if the bankruptcy trustee receives only the rights of an "assignee," the bankruptcy trustee has no voting rights. The *Mondalo Court* concluded that such an interpretation would be nonsensical.

SIDE STEPPING THE CHARGING ORDER LANGUAGE.

It is interesting to note that when the Maryland Court applied Delaware law, it side stepped the sole and exclusive remedy language of § 18-703. As noted in our previous article, Delaware is a Magnificent Seven state and its statute provides not only that a charging order is the sole and exclusive remedy of a creditor, but it also states, "No creditor of a partner or of a partner's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership."

MULTI-MEMBER FLPS OR LLCS AND PEPPERCORN PARTNERSHIPS

When reading the above trilogy, one might conclude that the asset protection issues may be easily solved with a multi-member LLC or FLP. While this may be a step in the right direction, it appears further planning and analysis will also be necessary. What if well in advance of any legal crisis, a client creates a FLP and transfers a 1% limited partnership interest to his son, and retains a 98% limited partnership interest and the 1% general partnership interest? Does this structure effectively solve the *Albright, A-Z Electronic, and Mondalo* single member LLC issue?

In a footnote, the *Albright Court* gave the following answer:

> *"The harder question would involve an LLC where one member effectively controls and dominates the membership and management of an LLC that also involves a passive member with a minimal interest. If the dominant member files bankruptcy, would a trustee obtain the right to govern the LLC? Pursuant to Colo. Rev. Stat. § 7-80-702, if the non-debtor member did not consent, even if she held only an infinitesimal interest, the answer would be no. The Trustee would only be entitled to a share of distributions, and would have no role in the voting or governance of the company. Notwithstanding this limitation, 7-80-702 does not create an asset shelter for clever debtors. To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with "peppercorn" co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse. 11 U.S.C. § § 544(b)(1) and 548(a)*."

Planners have come to different views regarding the following footnote. Distinguished estate planner, **Sky Kurlbaum** from Kansas, interprets the above statement as requiring a creditor or bankruptcy trustee to rely on fraudulent conveyance law to reach the underling assets of a multimember partnership or LLC. Some other planners discuss what a "peppercorn" is, and many have concluded that a five percent interest is most likely *not* a peppercorn.

STANDING IN THE SHOES OF THE BANKRUPT

Some planners may wonder, why is there even a discussion of the difference between single member LLCs and multi-member LLCs? Does not the bankruptcy trustee stand in the shoes of the bankrupt for *all* purposes? If so, the bankruptcy trustee would receive the voting rights, and assuming the bankruptcy trustee has a majority interest, he or she would simply vote to liquidate the partnership or the LLC and reach the underlying assets. Under this theory, an LLC or FLP, regardless of charging order, simple sole remedy charging order or even in a Magnificent Seven state, would provide no asset protection when the bankrupt held a controlling vote.

Unfortunately, this is exactly what occurred *In re Ehmann*[10], The *Ehmann* Court held that an operating agreement was not an executory contract under Bankruptcy Code § 365. As a result, the Bankruptcy Court held that the LLC interest was nothing more than a property interest under Bankruptcy Code § 541. Accordingly, the Bankruptcy Trustee succeeded to all interests and rights that the debtor owned.[11] This meant that in addition to receiving voting rights, the Court allowed for the appointment of a receivership as well as allowing the Bankruptcy Trustee the power to take over the management of the LLC.

The *Ehmann* case brings up a split in the courts regarding the interpretation of whether a partnership or operating agreement is executory. If it is executory, then Bankruptcy Code § 365(c) prevents the bankruptcy trustee from assuming the contract and succeeding to all interests and rights of the debtor. Rather, the Bankruptcy Trustee only receives the economic rights of the debtor, but not the management or voting rights.

Conversely, if the partnership or operating agreement is classified by a court as non-executory, then Bankruptcy Code § 541 applies, and the bankruptcy

trustee succeeds to all economic and managerial rights of the debtor.

CONCLUSION:

As to *single* member LLC's, it appears the seventh inning is almost over, and any creditor will be able to reach the underlying assets of these entities without a pierce the veil argument, reverse veil pierce, constructive trust, or any other legal theory. This appears to be true even in the Magnificent Seven states.

Conversely, in *multimember* LLCs or partnerships, whether a bankruptcy trustee will receive both the economic rights as well as the managerial rights (including voting rights) depends on whether the partnership or operating agreement is executory.

- If it is *not* executory, then the bankruptcy trustee succeeds to both economic and managerial rights of the partner or member under Bankruptcy Code § 541.

- If it *is* an executory contract, a further analysis needs to be performed to determine whether the partnership agreement or operating agreement is a personal service contract underBankruptcy Code § 365(c). If so, this prevents the bankruptcy trustee from assuming the partnership or operating agreement contract .

Whether a partnership or operating agreement is executory or non-executory as well as whether a partnership agreement or operating agreement is a personal service contract under Bankruptcy Code § 365(c) will be discussed in the fifth installment of this series.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITES:

[1] While this is a general statement by many practitioners that may be gleaned from Bankruptcy Code § 541, there are some limitations as discussed in this article and our upcoming fifth installment.

[2] In the second installment of this series, we defined a "simple sole remedy" statute as one that provided that a charging order was the sole and exclusive remedy, but did not contain the additional protections that a prevented a court from issuing directions or applying equitable remedies.

[3] 350 B.R. 886 (Bkrtcy. D. Idaho 2006).

[4] Richard and Anita are happily married. However, Mark Merric is working his best to remedy this problem.

[5] 2007 WL 2609470 (Bkrtcy.D.Md. 2007).

[6] 291 B.R. 538 (Bkr. D Colo. 2003)

[7] Colo. Rev. Stat. §7-80-703.

[8] Footnote 2 specifically states, "The Trustee has not asserted any alter ego theory and has not attempted to pierce the veil of the LLC."

[9] Distinguished commentators have different interpretations of the Albright decision. For example Carl Stevens notes the bankruptcy judge contorted the Colorado statute to allow recovery under C.R.S. § 7-80-702. John Sullivan III notes that the *Albright Court* mentioned that the bankruptcy trustee stood in the shoes of the Bankrupt, and received all of the rights of the bankrupt. We prefer the judicial exception theory based on subsequent case law as discussed in this article.

[10] 319 B.R. 200 (Bkr. D. Ariz. 2005).

[11] Also see *Samson v. Prokopf,* 185 B.R. 285 (Bankr. S.D.Ill. 1995); *In re Garrsion-Ashburn, L.C.,* 253 B.R. 700 (Bankr.E.D. Va. 2000).