

Asset Protection of Single Member LLC's-Fact or Fiction?

Limited liability companies (LLCs) developed in the 1990s as a very popular form of business in the United States. This form of business is a hybrid of components of partnerships and corporations. Like partnerships, LLCs can be managed completely by owners of the business, who are called members. These businesses are now generally taxed in the same category as partnerships, rather than corporations. Owners of an LLC also enjoy limited liability similar to that of a corporation. The LLC business form provides flexibility that is not generally available in other types of business forms, thus making the LLC a favorite of many business owners. Though the tax status of an S Corp is similar to that of an LLC, the LLC can offer small business owners advantages over the Subchapter S Corporation:

- **An LLC is typically easier to form.** The state requirements for forming a corporation, and then electing to have it be taxed as an S corporation, are more complex and time-consuming than the simple filing of a Certificate of Formation or Articles of Organization needed to form an LLC. Unless they elect to do otherwise, single-member LLCs are automatically taxed as sole proprietors by the IRS. Similarly, LLCs with multiple owners are automatically taxed as partnerships at the federal level. No separate filing is required to elect pass-through taxation for an LLC. In contrast, after a corporation is formed it must file IRS Form 2553, "Election by a Small Business Corporation," within 75 days of the corporation's formation to obtain pass-through status as an S corporation.
- **LLCs are not required to hold annual meetings or keep formal meeting minutes.** Corporations, including Subchapter S Corporations, have a formal annual meeting and record-keeping requirement that LLCs do not.
- **LLC owners don't need to worry about the formalities of issuing stock.** A corporation must issue shares of stock as evidence of ownership, but an LLC does not issue stock.
- **There is no limit to the number of members who may own an LLC.** In contrast, Subchapter S Corporations are limited to a total of 100 shareholders.
- **Members of an LLC do not need to be U.S. citizens or permanent residents.** In contrast, all S Corp owners must be U.S. citizens or permanent residents.
- **A company may be listed as the owner of an LLC.** In contrast, all shareholders in a Subchapter S corporation must be individuals, so another company may not be a shareholder in an S Corporation. In an LLC there is no such requirement. An owner/member can be another LLC or other entity.
- **An LLC does not need to distribute income in proportion to ownership.** The shareholders of a Subchapter S corporation must receive dividends according to the number of shares they own. In contrast, LLC members may split profit and loss in any way they choose as long as they follow IRS guidelines for special allocations.

Recall that with a corporation, shareholders are twice removed from the operations of the corporation because the shareholders elect the directors, and the directors elect the officers who actually run the corporation. Thus, if the creditor attaches shares of a corporation, the creditor will not directly influence operations until there has been at least one meeting of directors at which new officers can be elected.

In a limited partnership or LLC, however, the change of ownership from the debtor to a creditor could directly impact the operations of the entity and affect the remaining non-debtor members. The primary purpose of the charging order is thus to protect the non-debtor members from being involuntarily forced into a partnership with a the debtor member's creditor.

However, there is only one member in a SMLLC, so there are no non-debtor members to protect. It also defies common sense that a creditor would not be able to get at the assets of an entity where the debtor is the only owner.

Some planners argue that even though it may not make any sense to have charging order protection where there is only one member, the language of the statute is nonetheless protective. Some states, such as Arizona, have modified their LLC acts in such a manner that suggests protection of the debtor's indirect interest in the assets of the entity, even if the creditor has charging order.

Planners who believe that SMLLCs are protected by charging orders in the same manner as other LLCs and partnerships argue that, unless it is apparent that the creditor's judgment may never be satisfied by distributions from the SMLLC, the creditor should not be allowed to invade the LLC.

After years of speculation and the lack of any solid case law, the issue of whether SMLLCs are afforded the protections of the charging order was finally addressed by a U.S. bankruptcy court, [In re Albright](#), No. 01-11367 (Colo. Bkrpt. April 4, 2003). The judge in Albright held that charging order protection does not exist for a SMLLC because there are no non-debtor members to protect. The court granted full economic and non-economic rights to the trustee, allowing the bankruptcy trustee to manage the debtor's LLC. The trustee subsequently sold the LLC's property and distributed the net proceeds to the bankruptcy estate for satisfaction of creditors' claims.

Thus, until Albright is overturned or rejected by other courts, the safe presumption will be that SMLLCs probably do not provide charging order protection.

Based on Albright, sometimes I hear planners blurt out, "Single Member LLCs provide no asset protection!" This is wrong. The lack of charging order protection is a far cry from concluding that SMLLCs are "worthless" as asset protection vehicles. SMLLCs may still provide substantial protection for owners against the liabilities of the entity itself, which are so-called "internal liabilities".

For example: SMLLC owns a strip mall and is successfully sued by one of the tenants. If the SMLLC is adequately capitalized, is not the alter ego of the sole member, and is not used to perpetuate a fraud, the tenant may not assert liability against the member.

There is no reason that a SMLLC should be treated much differently from a sole shareholder corporation. Historically, sole shareholder corporations have contained liability within the entity and shielded the liability away from its owners.

To summarize, even if SMLLCs do not offer the same charging order protection as multiple-member LLCs, they can still be very valuable business planning vehicles. Certainly, it is preferable from a liability standpoint to own one's business in a SMLLC than to run it as a sole proprietorship. But of course, where external liability is a concern and it is feasible to add another member, that should be done so that charging order protection arises.

The prudent planner will try to find at least one other member to add to the sole member LLC so that charging order protection can then be provided under the statute. For example, a grantor trust for the benefit of children, other family members or other persons that are near and dear to the client would also be permitted. When combined with a sole owner of a single member LLC, the LLC now receives charging order protection due to the multi-member arrangement.

Michigan law provides, in pertinent part:

450.4507 Charging membership interest with payment of judgment; rights of judgment creditor; rights and powers of member.

(1) On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the membership interest of the member with payment of the unsatisfied amount of judgment with interest. To the extent the membership interest is so charged, the judgment creditor has only the rights of an assignee of the membership interest. This act does not deprive any member of the benefit of any exemption laws applicable to his or her membership interest.

(2) Unless otherwise provided in an operating agreement, the member remains a member and retains all rights and powers of membership except the right to receive distributions to the extent charged.

The prudent approach is to try to find at least one other member (however nominal the percentage ownership) so that the general charging order statute applies.