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(DOES THE LLC LIVE UP TO ITS PROMISES?)

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Some of us remember the days when a corporation was the entity of choice whenever a client wanted to start a business. After all, everyone knew that if liability arose within a properly run corporation's activities, the personal assets of the shareholder/client would be protected. Many failed to consider, however, that if the client herself was exposed to liability, not only would her personal assets be at risk, but the corporation's assets as well, because the client's creditors could reach the corporate shares owned by the client, and if they constituted control, the creditors could liquidate the corporation to satisfy the client's debt. Although a limited partnership offered some protection against this possibility, the general partner of the partnership still had full personal exposure, and a corporate general partner was also exposed to the creditor control risk. Enter the now ubiquitous Massachusetts limited liability company (LLC), which not only offered its members/owners protection from liabilities arising from business activities, but also offered protection of the business assets from the owner's "personal activities"- the best of both worlds, or so we are led to believe.

The LLC protection of the business is based on over a hundred years old English partnership law which holds that it would be unfair and against the public interest to allow a creditor of one

partner to reach partnership assets and thereby upset the business of the non-debtor partners. A partnership was considered a very personal endeavor: you went into business with your partners, not the world. This is very unlike statutory-based corporate ownership with its typically freely transferable interests absent an agreement otherwise among the shareholders. Since LLC law is largely fashioned after partnership law, this position was readily incorporated, along with the protection of the members individual wealth from "inside" liability, which comes from the corporation model.

While there are many considerations to explore when counseling a client on entity selection, for the client who articulates asset protection as the chief goal, just about every advisor recommends the LLC. The problem is that the protective aspect of the LLC may be somewhat overrated if not misunderstood.

When we say that an LLC member's personal creditor generally cannot reach the assets within the LLC, that does not mean that either the debt or the creditor goes away. The LLC assets may stay in place and the business may carry on, but the remedy of a judgement creditor of the member will be to have the court issue a "charging order" against the debtor/member's interest. This is a judicial lien on the member's interest that causes any distributions (other than bona fide salary) that are to be paid to the debtor/member to be paid instead to the creditor to satisfy the debt – including liquidating distribution. In other words, the debtor/member can take no further distributions until the debt is paid. In many instances, this may prove quite a problem to the member, though some see it as a means of forcing the creditor to a settlement. If the LLC, however, simply accumulates cash and makes no distributions so as to avoid payment to the

creditor within a reasonable time, a Massachusetts court may react to this by ordering a "strict foreclosure" of the debtor/member's interest. In this case, the interest would be foreclosed as with a mortgage, and the buyer, presumably the creditor, would own the debtor/member's interest outright. Although this does not get money to the creditor, the debtor/member is permanently parted with her financial interest in the LLC, a high price to pay for temporary protection. And what if the judgment creditor did purchase the interest? Some have argued that as an assignee or transferee the creditor might have the right to petition the court to dissolve the LLC, appoint a liquidating trustee, and receive its share of the dissolved LLC. To the authors' knowledge this has not happened in Massachusetts, and there are strong arguments that such a creditor-forced dissolution would fail, but it is raised as another possible problem with the ability to foreclose on a charging order.

In light of such a potentially bad result, 13 states as of March 2016 have revised their LLC statutes to provide that the charging order will be the sole remedy of the creditor, eliminating the exposure to a strict foreclosure - Massachusetts is not one of them. And although the courts do not take the strict foreclosure lightly, one has to think hard about whether the theory of protecting the other members or the "going business" makes any sense when we have an LLC which contains only publicly traded investments or passive income-producing real estate. Would it really be against the public interest to order a sale or liquidation in such cases?

Another serious risk is where the LLC has only one member. Again, applying the philosophy behind the English rule that the non-debtor members should not have their livelihood upset because of the personal debt of one member, here there are no other members, so the principal

doesn't apply. In one landmark case, a bankruptcy court in Colorado involving a single member LLC held that the trustee in bankruptcy could "stand in the shoes" of the single member and liquidate the LLC to pay the member's debts, despite Colorado's charging order statute. Our firm strongly discourages the formation of single member LLC's for the above reasons when asset protection planning is the chief concern (unless coupled with other protective structures such as an asset protection trust). If the client has no good candidate for additional partner/members, a trust created for the client's children, for example, could be the other member.

As noted above, although Massachusetts has an LLC statue, it is not regarded as "state of the art" protective, the main reason being that the charging order is not stated as the exclusive remedy of a creditor and foreclosure is not specifically prohibited, leaving the court with many options to help a creditor recover. For this reason, many Massachusetts clients and their advisors will establish the LLC in a more favorable jurisdiction such as Delaware or Florida or Nevada. The problem is, we don't know for sure whether a Massachusetts court will apply another state's law to an LLC whose members(s) and operations are entirely in Massachusetts. Choice of law issues are extremely complex in this area. In a recent Florida case involving a Nevis LLC, for example the Florida court issued a charging order against and foreclosure of the Nevis LLC membership interest.

Despite the risks involved with the LLC, it must be noted that under normal business and operating circumstances, it remains and perhaps should remain the entity of choice in many cases, because, at the very least, the LLC provides legal obstacles for creditors and in fact can be

effective in preventing a creditor from attacking or levying directly against LLC assets. But as with any of the tools we use, they should not be used in isolation.