LIMITED LIABILITY COMPANIES (LLCs): RISKS AND ADVANTAGES

By: Majda Barazzutti 1

When confronted with the choice between a corporation and a limited liability company, clients are sometimes inclined to choose a limited liability company (or LLC). Limited liability companies are perceived as an appropriate business vehicle for smaller ventures and to manage real estate investments in a very informal and flexible manner. Limited liability companies are often compared with S.r.l.’s in Italy or GmbH’s in Germany, which require a smaller capitalization and are thus perceived as less costly. The comparison, however, is not always appropriate, especially because LLC laws in the United States are largely based on the law of partnerships. A limited liability company is first of all a contract among members, rather than a rigid statutory creation with specific structures and provisions created by law. If this allows more flexibility, it also leaves the door open to uncertainties and ambiguities.

From an operational standpoint, limited liability companies are indeed more flexible. An LLC can be managed directly by the members as “member-managers”, thus eliminating the various levels of corporate bodies (shareholders, board of directors, officers), typical of a corporation. The shares (units or membership interests) are usually not represented by certificates and can be linked to specific initiatives or investments of the company, thus segregating rights, obligations and risks of certain members from other initiatives or investments of the company. Each member has a capital account reflecting contributions and withdrawals, which is much more flexible than contributions and distributions on shares. The main reason why LLCs are adopted is, however, its tax treatment: LLCs can elect to be treated as “pass-through entities” in which profits are only taxed at the members’ level, thus avoiding double taxation at the company and the members’ level. A foreign member, however, should avoid forming a “pass-through” LLCs because that would require the non-U.S. member to file tax returns in the United States and be subject to reporting in the United States2.

In a limited liability company, similarly to a corporation, the members are shielded from, and are not responsible for, the liabilities of the company. However, under the legal theory commonly named “piercing the corporate

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2 LLCs can also be taxed as corporations.
veil”, a judge could hold the member responsible for the liabilities of the company if certain practices occur, including commingling of company’s and member’s assets, failure to document company actions, failure to maintain separate records for separate entities, and inadequate capitalization in relation to the activities carried out by the company. This theory applies both to corporations and to limited liability companies, whatever the management structure of the company. Hence, even member-managed limited liability companies are required to follow formalities to reflect company decisions, if the operating agreement provides for formalities such as holding of meetings.

Another form of piercing the corporate veil is the so-called “reverse piercing”, which occurs when a creditor of a member can reach the company’s assets to satisfy the member’s debts. In general, courts will not allow a creditor to seize and sell the debtor’s membership interest in an LLC: Since the LLC is treated more like a partnership, courts will not force the other members of the LLC to be “partners” with a party not of their choosing, such as the creditor. As a result, the creditor’s remedy against a limited liability company is usually limited to obtaining a “charging order” from the court.

A charging order is a legal mechanism by which a creditor of an LLC member may obtain an order from the judge and make a claim on LLC distributions to its members as the sole recourse to satisfy the debtor’s obligation. It’s a temporary remedy, in that it assigns any profits or distributions owed to the debtor member to the creditor until the creditor’s judgment is satisfied. It does not confer to the creditor any management or voting rights, such as the right to order distributions. If no distributions are made, the member creditor has no rights to force distribution. In many states, a creditor cannot foreclose on the membership interest, cannot “step into the shoes” of the member debtor, cannot exercise managerial rights of the limited liability company and cannot decide to dissolve the company, sell its assets, etc. Its effectiveness is therefore limited.

However, there are variations from state to state as to what a creditor can do. While still a majority of the States expressly provide that a “charging order” is the sole and exclusive remedy by which a creditor of a member may satisfy a judgment against a member, those protections are being eroded.

For example, personal creditors of a member of a New York limited liability company, in addition to obtaining a charging order may be able to foreclose on the member’s interest, thus becoming the permanent owner of all the debtor-member’s rights. As such, the creditor could attempt to sell its assets, manage the company, force dissolution, etc. Comparable provisions apply in Ohio, Connecticut, New Jersey, and Washington State.

Consequently, before forming a limited liability company as a personal investment vehicle, the investor would be well advised to seek legal advice as to the rights that a personal creditor could exercise in a specific state.
Moreover, certain other states have taken the position that, since the reason for screening the member’s creditors from the assets of the LLC is the need for protection of the other members, in those states a distinction is made between a single member LLC (SMLLC) and a multi-member LLC (MMLLC).

For example, the Florida legislature recently amended the Florida LLC Act\textsuperscript{3} by introducing the distinction between single-member limited liability companies and multi-member limited liability companies. While the creditor of a multi-member LLC can only apply to the court for a charging order for the payment of the unsatisfied amount of the judgment, in a single-member LLC if a creditor of a member can prove that distributions under a charging order will not satisfy the judgment within a reasonable time, the court may order the sale of that interest in the limited liability company pursuant to a foreclosure sale. Thus, the purchaser at the court-ordered foreclosure sale would obtain the member’s entire limited liability company interest, not merely the rights of a transferee, and would become a full member of the limited liability company, while the debtor-member would cease to be a member of the limited liability company. Similar provisions, either implemented by the legislature or judicially enforced, apply in other states, such as Maryland, Utah, Idaho, Colorado and Kansas.

This issue must be carefully considered when planning for an investment in the United States. Florida and New York are popular destinations for real estate investments, which are often held through single-member limited liability companies. In order to avoid the “reverse piercing the corporate veil” risk described above, the investor should inquire as to the specific provisions applicable in the specific state, and should avoid single-member limited liability companies by admitting other members. Note, however, that the other member must pay a fair price for its membership interest and participate in decisions and profit distributions, and not be merely a sham member.

Requests for information or insights on the issue discussed in this article may be addressed to majda.barazzutti@vallalaw.com.

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\textsuperscript{3} Fla. Stat. Ann. § 605.0503 (West)