Asset Protection with Limited Liability Companies

Earl H. Cohen and Jeffrey C. O'Brien

Since 1997, when the Internal Revenue Service first allowed single member limited liability companies, the burning question in terms of choice of entity has been whether to select the LLC or Subchapter S corporation? As time passed, the LLC has clearly become the dominant entity type, with S corporations used when a self-employment tax rationale can be made.

A lesser-known benefit of LLCs has attracted more attention in the midst of the current economic climate; namely, its asset protection benefits. Beyond the fact that an LLC (like an S corporation) shields an owner's personal assets from business liabilities, the nature of an LLC membership interest contains additional asset protection benefits that should be considered by the business owner vis a vis the business owner's creditors. That benefit is the LLC charging order.

In a corporation, a creditor may attach the shares of the debtor's stock to gain all the rights that the debtor had in the corporation, including rights to sell the shares, voting rights, the right to view books and records, and rights to bring derivative actions against errant corporate officers and directors. In other words, a creditor holding a debtor's stock could wreak havoc on the ordinary course of the corporation's business operations. Even worse, S corporation stock winding up in the hands of a non-individual, the "S" election will be terminated.

An LLC, on the other hand, differs from the corporation in ways that impact creditors' rights significantly. Recall that in an LLC, in contrast to the S corporation, the entity can be created with separate classes of membership interests with different rights. For example, the holders of one class of membership interest may hold governance rights (i.e., voting rights) and financial rights (i.e., a share of profits and losses), while another class may hold only financial rights. This bifurcation results in a profound difference in terms of creditors' rights as to the member's interest in the LLC; namely, that a creditor is limited to a "charging order" against the debtor's LLC membership interest. The charging order could be classified as a "business garnishment" in that the creditor is limited to receive any income the debtor becomes entitled to through the debtor's ownership in the LLC. It does not, however, permit the creditor to control the debtor's governance rights in the LLC.

The process to obtain a charging order requires the creditor to first obtain a judgment against the LLC member, as a charging order is only available to "judgment creditors." After obtaining the judgment, the creditor must then obtain the charging order against the debtor's economic rights to distribution from the LLC.

Alternatively, the creditor could attempt to foreclose on the debtor's membership interest, but such foreclosure merely makes the assignment of income permanent (whereas with the charging order, the assignment lasts only so long as the judgment remains unsatisfied). The creditor may seek to sell the interest (which is permitted), but practically speaking the creditor may find only a limited market, if any, for the interest. Even worse for the foreclosing creditor, such creditor will become liable for any tax liabilities generated to the members by the LLC.

In short, the LLC entity type offers powerful asset protection to its members beyond the obvious liability shield. This protection is yet another motivation towards the use of an LLC over a corporation.