

Limited Liability Company May Protect Your Assets from Creditors

Careful Planning Can Minimize Your Risk

By: [Beth S. Cohn](#)

A large component of asset protection planning is designed to help protect your business and investment assets from claims by your personal creditors. If you have a corporation and a creditor gets a personal judgment against you, the creditor can seize the stock of your corporation. If you are the sole owner and your business is held in a corporation, it can be taken over and operated, managed or dismantled by your personal creditors.

Because of these risks, some business owners have both their business and/or investment assets held in a limited liability company (“**LLC**”). Under Arizona law, your personal creditors may not be able to seize your membership interest in the LLC, which will be discussed in detail in this article. Additionally, there are substantive matters to consider before your LLC is structured that could further limit a creditor’s ability to reach your assets.

Why is a LLC preferred over a Corporation?

Under Arizona law, if a creditor gets a judgment against you personally, instead of seizing your membership interest in the LLC the creditor is required to obtain a charging order, which designates the creditor as an “assignee” of the member’s membership interest. This means that the creditor’s interest is **only** an economic interest. The creditor must wait for either the member(s) or the manager(s) of the LLC to make distributions to apply towards satisfaction of its judgment. With a properly drafted operating agreement for the LLC, the following are likely scenarios of what would occur:

- The member(s) or the manager(s) of the LLC are given the absolute discretion to make or not to make distributions from the LLC.
- Distributions are not made and the money is kept in the LLC for operations of the business or to acquire additional investments in the LLC. For this to be an effective strategy, the member(s) need to have other assets outside of the LLC so they do not rely on income from the LLC to pay their personal expenses.
- The creditor has incentive to settle for either a reduced amount or collection may be indefinitely delayed.
- The creditor gets nothing from the LLC while it is waiting for the distributions. However the creditor can be taxed on the net income allocated to the member whose interest is subject to the charging order.
- The creditor does not get a charging order as it neither wants to wait for payment nor does it want to be taxed on its debtor’s share of the net income from the LLC.

While this would appear to be a green light to immediately form a LLC, there are theories of law that can benefit creditors. The concept of charging orders comes from old English common law governing partnerships. The theory is that when a partnership owns an asset, if a creditor of one of the creditors can attach the asset of the partnership in satisfaction of its claim against only one partner, it would adversely impact the rights of the other partner in that partnership asset. For equitable purposes, the courts followed this principle and established the charging order to protect the interest of the non-debtor partner in the partnership’s property.

Caution – Recent Florida Supreme Court Ruling

These same concepts have been adopted by many states including Arizona. There is a minority of states that do not provide that the charging order is the exclusive remedy for a creditor to proceed against the assets and interests of a member in a single member LLC. These states include Colorado and Florida. In a recent case, the Florida Supreme Court distinguished Florida law from Arizona law in allowing creditors to proceed directly against the assets of a single member LLC, rather than obtaining a charging order. The Arizona law states that the charging order is an exclusive remedy for the creditor. We do not believe that the Arizona courts will follow the Florida Supreme Court. If a creditor obtains a judgment against you in a state where the Courts follow the law set by the Florida Supreme Court, the creditor may claim that it can proceed against the assets of your single member LLC.

Bankruptcy Courts May Be Able to Reach Assets of a Single Member LLC

Even in states that have laws similar to Arizona's statute, there needs to be caution. In the Bankruptcy Courts, there have been a series of cases where the judges do not follow the applicable state law where a member in a **single member LLC files personal bankruptcy** and claims that the only remedy available to the creditor is a charging order. In these cases, the bankruptcy trustee has attacked the LLC claiming that the assets of the LLC belong to the individual member's bankruptcy estate to pay its creditors, rejecting the claim that the charging order should be exclusive. The Bankruptcy Courts have ignored the principles from the old English common law to rule that the assets of the single member LLC belong to the member's bankruptcy estate and the member's creditors can proceed against the assets of the LLC. The Bankruptcy Courts have reasoned that because there is only one member, there is no other party's interest that will be impacted by a creditor proceeding against the assets of the LLC.

It is my opinion that the result would not be the same if there was another member in the LLC. Wherever possible, my recommendation is to have more than one member in a LLC. If there are two or more members, it is possible to tax the LLC as a partnership for federal income tax purposes. The IRS has ruled that a creditor of an entity that has a charging order against a member of a LLC that is taxed as a partnership is taxed on that "partner's" share of the net profits. Although we believe that this theory applies to a creditor that obtains a charging order against a member in a single member LLC, the IRS has not definitively ruled that for this purpose a creditor of a single member LLC is taxed the same as a creditor of a LLC that is taxed as a partnership by the IRS.

Other legal theories may allow creditors to proceed against the assets of a LLC, including successor liability and fraudulent transfer. The discussion of these theories in detail is beyond the scope of this article, other than to say that it is difficult to successfully transfer assets from one entity to another or from an individual to an entity for the sole purpose of avoiding creditors' claims. If you have a situation where you are considering transferring assets, you will need to consult with an attorney to properly plan your transaction to minimize your risk.

None of these techniques are completely fail safe to protect one LLC member from the attack of the other member's creditors. Using a properly structured LLC in your planning can be a significant deterrent to creditors attacking your net worth. Although a LLC cannot eliminate all of your risk, it certainly can limit a large part of the risk.

About the author: [Beth S. Cohn](#) is a shareholder at the Phoenix law firm of [Jaburg Wilk](#). She chairs the [business law](#) department and is a State Bar of Arizona certified tax specialist and a CPA. Beth can be reached at bsc@jaburgwilk.com or 602.248.1030

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