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## LEGAL ALERT

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### **Nevada Expands Debtor Protections for Members of Limited Liability Companies**

by Pat Curtis and Michael Keller

#### **Recent Developments**

Judgment debtors, whose assets include Nevada Limited Liability Company memberships, received significantly expanded protections as a result of a recent Nevada Supreme Court decision and recently enacted Nevada legislature amendments. Generally, a judgment creditor, who desires to execute on its judgment with respect to a membership interest its judgment debtor may hold in a Nevada LLC has, as its sole remedy under Nevada law, the right to obtain a "charging order" against the debtor's membership interest. If granted by a Nevada court, the charging order permits the judgment creditor to receive only current and liquidating distributions made by the LLC to the member. Recent developments in Nevada law have clarified that the charging order remedy may not be granted to a judgment creditor with respect to a member's managerial interest in an LLC and is the exclusive remedy available against debtors holding membership interests in both single-member and

multi-member LLCs.

The Nevada Supreme Court expanded the scope of debtor protections available to members and managers of LLCs in a recent decision limiting the application of the charging order remedy.<sup>[1]</sup> In *Weddell v. H2O, Inc.*, 128 Nev. Adv. Op. No. 9 (March 1, 2012), the court overturned a district court's charging order granted to a creditor of a person who was both a member and manager of a Nevada LLC. The district court's charging order allowed the member/manager's creditor to become not only the assignee of the debtor's rights as a member of the LLC to receive disbursements and distributions from the LLC, but also allowed the creditor to become the assignee of the debtor's managerial rights as a manager of the LLC.

The court reversed the district court's entry of the charging order, holding that pursuant to Nevada's LLC statute, "a judgment creditor may obtain the rights of an assignee of the member's interest, receiving only a share of the economic interests in a limited-liability company, including profits, losses, and distributions of assets. Thus, the charging order does not entitle the creditor to the [member/manager's] managerial rights in the [LLC]."

The Supreme Court's decision follows a 2011 amendment to Nevada's LLC statute providing that the charging order remedy is applicable to single-member LLCs as well as multi-member LLCs. Prior to this legislative amendment, Nevada's LLC statute provided that the charging order was the exclusive remedy available to judgment creditors of any debtor member of Nevada LLCs. Courts in several jurisdictions, including Colorado, have held that the rationale for the charging order, namely protecting the continuing operational viability and integrity of the contractual relationship among members of the LLC, simply does not exist when judgment creditors are trying to enforce judgments against single-member LLCs.<sup>[2]</sup> Such courts have generally held that when pursuing judgments against members of

single-member LLCs, judgment creditors should be able to pursue remedies other than the charging order, including executing a judgment against the assets owned by the LLC.

One such court, the Florida Supreme Court, ruled in a 2010 case that Florida's charging order statute was not intended to be an exclusive remedy of a judgment creditor against a judgment debtor's interest in a single-member LLC; thus, in addition to issuing a charging order, a Florida Court could order a judgment debtor to surrender its complete right, title and interest in the debtor's single-member LLC to satisfy a judgment.<sup>[3]</sup> Based on Florida's LLC Act and the reasoning of the majority opinion, many commentators argued that the holding of the court, which would allow a judgment creditor to pursue remedies other than just a charging order with respect to a debtor's interest in a single-member Florida LLC, could apply equally to multi-member Florida LLCs.<sup>[4]</sup> In response, the Florida Legislature amended its LLC charging order statute in 2011 to make it clear that only judgment creditors of members of single-member LLCs can exercise remedies other than a charging order if the charging order remedy initially sought proves to be unsatisfactory.<sup>[5]</sup>

The 2011 amendment to Nevada's LLC statute will preclude Nevada courts from following decisions from other jurisdictions that distinguish between single- and multi-member LLCs in determining whether the charging order should be the exclusive remedy available to judgment creditors of such members. As amended, Nevada's statutory charging order remedy for judgment creditors of members of LLCs makes Nevada's protection of debtors, who are members of LLCs, one of the strongest debtor protection legal schemes in the country. Conversely, the charging order remedy significantly frustrates the ability of judgment creditors to obtain meaningful recovery from debtors whose interests in valuable assets or income streams are owned or generated by Nevada LLCs.

## Background

The key provisions of Nevada's LLC statute that limit a judgment creditor's rights to reach a debtor's interest in assets owned by an LLC of which the debtor is a member are as follows:

1. On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's interest with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest.

2. This section:

- (a) Provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor, whether the limited-liability company has one member or more than one member. No other remedy, including, without limitation, foreclosure on the member's interest or a court order for directions, accounts and inquiries that the debtor or member might have made, is available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited-liability company, and no other remedy may be ordered by a court.<sup>[6]</sup>

The conceptual basis of the charging order remedy is to balance the interests of a creditor of an LLC member against the interests of the other non-creditor members in the continued existence and functioning of the LLC as an entity without a forced dissolution. The charging order therefore allows a creditor to reach only the interest of the debtor-member in the member's rights to receive current and liquidating distributions made by the LLC. A

creditor who obtains a charging order against a debtor's membership interest in a Nevada LLC is not entitled to participate in any non-economic interests of the debtor (such as voting rights), any managerial interest of the debtor in the LLC and, most importantly, is not entitled to obtain any interest whatsoever in the assets owned by the LLC.

In effect, a judgment creditor of a member in a Nevada LLC may become only an assignee of the member's rights to receive distributions from the LLC. In contrast, judgment creditors of debtors who are shareholders in Nevada corporate entities that have more than 99 stockholders at any time, are publicly traded, or are professional corporations as defined in Nevada Revised Statutes Section 89.020, may foreclose on the shares of stock owned by the debtor and succeed to all of the interests of the debtor-stockholder.<sup>[7]</sup> In effect, judgment creditors of debtor-shareholders of these types of Nevada corporate entities may become shareholders in the corporate entity with full rights to receive any dividends or other distributions issued with respect to such stock and to exercise any voting rights with respect to such stock. If the shares of stock are marketable, the foreclosing creditor may also sell some or all of the stock and thus monetize its judgment.

The judgment creditor of a Nevada LLC member may not, by obtaining a charging order, displace the member and itself become a member of the LLC or exercise any rights of membership, including any voting or managerial rights. If the LLC for any reason ceases to make or significantly reduces the amount of monetary or liquidating distributions to its members, the charging order obtained by the judgment creditor may indeed prove to be a remedy without teeth. An LLC may intentionally cease to make distributions, particularly in the case of a single member LLC or an LLC over which the debtor-member has sufficient control in order to prevent the LLC from making distributions altogether, or economic conditions may prevent an LLC from generating sufficient operating cash from its business

operations to make distributions to its members.

To compound the ineffectiveness of the charging order remedy under Nevada's LLC statutes, the judgment creditor has no other remedy or legal recourse to enforce its judgment in a manner that will allow the creditor to reach any assets or other value held in or generated by an LLC of which the debtor is a member, as made clear by the Nevada Supreme Court in the *Weddell* case. The 2011 amendment to Nevada's LLC charging order statute and the *Weddell* case arguably preclude a judgment creditor of an LLC member from successfully asserting remedies based on fraudulent transfer principles and equitable principles such as alter ego, equitable lien and constructive trust.

### **Implications to Lender Creditors**

Lenders to LLC members in particular are frequently frustrated and sometimes surprised to learn that the exclusive charging order remedy under Nevada's LLC statutes prevent them from reaching the assets of an LLC to monetize personal judgments obtained against LLC members (be they individuals or non-corporate entities) who are liable to the lenders as defaulting borrowers or guarantors of loans. Time and again, lenders underwrite loans to borrowers by analyzing to some degree the financial strength of the borrower and any guarantor based on the value of assets owned by non-corporate entities in which the borrower or guarantor obligors hold ownership interests. Attributing financing strength to an obligor, who is a member in a Nevada LLC based on the interest of such member in the value of the assets or income stream owned or generated by such LLC, is fundamentally flawed and underscores the importance of understanding the full implications of Nevada's debtor protective LLC charging order statute.

For a variety of legal and tax reasons, the LLC entity is a popular choice for operating businesses and borrowing money. Lenders and their counsel are well acquainted with the LLC as an entity but are

frequently unaware of the charging order mechanism and its consequences. In structuring loans and drafting loan documents, lenders and their counsel primarily focus on how an LLC is structured (is it manager- or member-managed, does it have one or more members, what are members' economic and non-economic rights and interests, etc.) and who has authority to bind the LLC.

Although lenders and their counsel carefully draft default and remedial provisions in loan documents and usually close loans with documentation that have fully enforceable and effective rights and remedies for pursuing foreclosure of assets (for secured loans) and obtaining judgments against obligors (either directly for unsecured loans or, following foreclosure of secured assets, deficiency judgments), they typically give little thought to the legal issues that may arise in the process of enforcing those judgments against members of Nevada LLCs. As discussed above, if the lender successfully obtains a personal or deficiency judgment against an obligor who is a member of a Nevada LLC and then attempts to recover some or all of that judgment from such an obligor by obtaining a charging order, the lender may belatedly understand that its reliance for credit support purposes on such obligor's interest in valuable assets or income stream from a Nevada LLC was misplaced.

A hard lesson learned from the long-term adverse effects of the Great Recession on Nevada's economy should be that reliance by a creditor on a member's interest in a Nevada LLC for collateral or other credit support in any loan or business transaction may, because of the limitations of the charging order remedy, yield little value to creditors who ultimately are forced to attempt to recover that value as a judgment creditor.

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## End notes

[1] Although the focus of this Alert is on protections for LLC members, charging orders are also the typical remedies available to creditors of

partners in general and limited partnerships. As with charging orders against LLC members, state statutes must be carefully reviewed to determine the applicable parameters of the charging order remedy against partnership entities. [\[back\]](#)

[2] See *In re Ashley Albright*, 291 B.R. 538 (Bankr. D. Colorado, 2003). [\[back\]](#)

[3] *Olmstead v. Fed. Trade Comm'n*, 44 So. 3d 76, 83 (2010). [\[back\]](#)

[4] Alan S. Gassman, Christopher J. Denicolo, David L. Koche, and Thomas O. Wells, *After Olmstead: Will a Multiple-Member LLC Continue to Have Charging Order Protection?*, 84 Fla. Bar J. 8 (2010); and Elizabeth N. Kozlow, *A Charging Order Conundrum: Is it Really the "Exclusive Remedy" of an LLC Member Judgment Creditor*, 63 Baylor L. Rev. 884 (2011). [\[back\]](#)

[5] See *Fla. Stat. Ann. § 608.433(5)-(7)* (West 2011). [\[back\]](#)

[6] Nevada Revised Statutes Section 86.401 (Rights and remedies of creditor of member). [\[back\]](#)

[7] Nevada's corporation statutes were amended in 2007 to extend the charging order protection to creditors of stockholders of corporations with fewer than 75 shareholders at any time (this number was increased to 100 pursuant to a 2009 amendment), privately held corporations and non-professional corporations. As with the charging order remedy applicable to Nevada LLCs, in 2011, the Nevada Legislature amended the corporate charging order statute so that the charging order remedy available against judgment debtors who are stockholders of the types of corporate entities described in the foregoing sentence is the exclusive remedy available to judgment creditors, except in cases where the creditor successfully asserts liability under theories of piercing the corporate veil, alter ego or fraud. Nevada Revised Statutes Sections 78.746 and 78.747. [\[back\]](#)

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