

OUTSIDE COUNSEL

Expert Analysis

Look Before You Lend: Creditors' Rights Against Single-Member LLC Owners

Commercial lenders understandably spend significant effort assessing the value of a borrower's or guarantor's assets to ensure that, if a borrower fails to repay and the lender obtains a judgment against the borrower or guarantor, those assets may be used to satisfy the amount owed by the borrower. But lenders and their counsel also need to consider how they will be able to enforce a prospective judgment, as applicable enforcement mechanisms may frustrate a creditor's efforts to collect against assets presumed to be available at the time a loan or other credit transaction is originated.

These considerations are especially warranted when the relevant assets are comprised of a borrower's or guarantor's interests in one or more limited liability companies (LLC). Under New York's Limited Liability Company Law (LLC Law), a judgment creditor is generally limited to enforcing against a debtor's economic rights in an LLC and cannot, unless permitted by the relevant operating agreement, assume ownership and control of the debtor's voting or managerial rights. See *Boyce v. Willner*, No. 650210/09, 2013 WL 358604, at *4-5 (Sup. Ct. N.Y. County 2013).

This restriction is primarily based on the "pick your partner" principle, which protects LLC members from being forced to share management rights with another member's creditor. Creditors seeking to enforce judgments against an obligor's interests in an LLC may be unable to force the sale of the LLC's assets or to control whether or when the LLC will make distributions to members. Thus, particularly in the case of multi-member LLCs, lenders should not assume that an obligor's interests in an LLC are equivalent to a proportionate share of the LLC's asset valuation.

The situation is somewhat different when the

MATTHEW OLSEN is a partner in the *Katten Muchin Rosenman's insolvency and restructuring practice group*. GREGORY JOHNSON is an associate in the firm's *litigation and dispute resolution practice group*.



By
**Matthew
Olsen**



And
**Gregory
Johnson**

relevant LLC is owned entirely by the judgment debtor. For one thing, single-member LLCs do not have multiple members and therefore the "pick your partner" principle is not implicated. Thus, there may be an expectation on the part of a lender that its recourse to assets held by its obligor's single-member LLC is substantially the same as its recourse to assets owned directly by the obligor. But whether a lender will in fact be able to reach the assets owned by its borrower's or guarantor's single-member LLC under New York law is uncertain.

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Although no other members would be affected by enforcement efforts against a single-member LLC owner, the LLC Law does not expressly permit creditors to acquire all the rights of their debtors in single-member LLCs, and New York case law provides little guidance. An examination of the LLC Law, recent commentary, and decisions from other jurisdictions suggests that a judgment creditor should be able to enforce against a judgment debtor's entire membership interest in a single-member LLC, but lenders should nonetheless take protective measures where practical to ensure that all enforcement options are available.

New York's LLC Law

New York's enforcement statutes permit judgment creditors to enforce against virtually any property "which could be assigned or transferred." CPLR 5201(b). An LLC member's interest is considered personal property of the member, but the member has no interest in the property of the LLC. LLC Law §601. There are also statutory limits to the transferability of LLC interests. Under LLC Law §603, unless the operating agreement provides otherwise, the assignment of an LLC membership interest gives the assignee the right to receive allocated distributions but does not "entitle the assignee to participate in the management and affairs of the limited liability company or to become or to exercise any rights or powers of a member." Assignees can only become full-fledged LLC members upon the consent of "at least a majority in interest of the members, other than the member who assigned or proposes to assign such membership interests." LLC Law §604(a).

In a consistent provision, LLC Law §607 permits the judgment creditor of an LLC member to seek a "charging order" against the member's LLC interest, but restricts the creditor's rights in the LLC to those of an assignee.

The LLC Law does not address the assignment of interests in single-member LLCs or enforcement efforts against their owners, though the plain language of LLC Law §604 suggests it does not apply to single-member LLCs because there would be no members to give consent other than the assigning member, whose consent is expressly not required. Furthermore, LLC Law §607 does not state that charging orders are the exclusive remedy available to creditors of LLC members, and the accompanying practice commentaries indicate that creditors should be able to exercise broader enforcement rights against single-member LLC owners:

[U]nlike the LLC statutes of many other states, Section 607 does not expressly say the charging order is the exclusive remedy of the judgment creditor....In certain situations a judgment creditor may instead

seek [for] the member [to] turn over his entire membership interest, such as against a debtor who is the sole member of a [single-member LLC] on the theory that the sole member has control over when and if future distributions would be made.

Bruce A. Rich, Practice Commentaries, McKinney's Cons. Laws of NY, Book 32A, Limited Liability Company Law, 2015 Pamph., at §6.6.

No judicial authority is cited in support of the above commentary, however. Further, the practice commentaries elsewhere state that the non-exclusive nature of the charging order statute "leaves open" the question of whether the creditor of a single-member LLC owner can enforce against the debtor's entire membership interest under New York law. *Id.* at §1.4.

Other Jurisdictions

Decisions from other jurisdictions with LLC statutes similar to New York's suggest that creditors should have recourse to broader enforcement measures against single-member LLC owners. In *Olmstead v. FTC*, 44 So.3d 76 (Fla. 2010), the Federal Trade Commission obtained a judgment against the owners of several single-member LLCs and sought an order directing the owners to surrender all of their membership interests. The owners asserted that Florida's LLC law limited the FTC's enforcement rights to those of an assignee, and that the FTC could only obtain a charging order against the owners' economic interests. *Id.* at 78.

The Supreme Court of Florida, to which the case was referred by the U.S. Court of Appeals for the Eleventh Circuit, held that charging orders were "*nonexclusive* remedial mechanism[s]" under Florida law, and that "a court may order a judgment debtor to surrender all right, title, and interest in the debtor's single-member LLC to satisfy an outstanding judgment." *Id.* at 81, 83 (emphasis in original).

While not binding in New York, the *Olmstead* decision suggests that New York courts may reach a similar conclusion. Florida's charging order statute at the time, F.S.A. §608.433, was consistent with New York's current statute in that it did not make charging orders the exclusive remedy for creditors, and Florida law also permitted a judgment creditor to enforce against any alienable property. *Id.* at 80-81.

In an instructive decision analyzing Colorado's LLC law, the court in *In re Albright*, 291 B.R. 538, 541 (Bankr. D. Colo. 2003), held that a trustee in bankruptcy succeeded to all of the rights of the debtor, including voting and management rights, as 100 percent member of an LLC. Addressing a Colorado statute similar to LLC Law §604, which required the unanimous consent of "other members" to permit an assignee to participate in the management of

the LLC, the court reasoned that "[b]ecause there are no other members in the LLC, no written unanimous approval of the transfer was necessary." 291 B.R. at 540. Accordingly, the court entered an order declaring that the trustee controlled the LLC and could cause the LLC to sell its assets for the benefit of the debtor's creditors. *Id.* at 542.

Whether a New York court will follow *Olmstead* and *Albright* cannot be predicted with certainty. Indeed, the majority decision in *Olmstead* was accompanied by a vigorous dissent, which stated that the majority had re-written Florida's LLC law. See 44 So.3d at 87-88. In response, the Florida Legislature amended its LLC law to include a provision specifically stating that a creditor can foreclose on a single-member LLC interest and that the purchaser becomes the full-fledged owner of the single-member LLC. See 2011 Fla. Sess. Law Serv. Ch. 2011-77 (C.S.H.B. 253).

Until New York courts resolve this issue, or the New York Legislature adopts a similar revision to New York's LLC Law, a judgment creditor's ability to enforce against the full interests of a single-member LLC owner will remain uncertain.

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Impact of Bankruptcy

Although the LLC member in *Albright* was a debtor in bankruptcy, the court based its decision on Colorado LLC law, apparently overlooking an overriding provision of federal bankruptcy law. When a bankruptcy case is commenced, the debtor's "legal or equitable interests" in property are contributed to an estate by operation of law. See 11 U.S.C. §541(a). Of course, "bankruptcy courts must look to state law to determine whether and to what extent the debtor has any legal or equitable interests in property as of the commencement of the case." *In re First Protection*, 440 B.R. 821, 828 (B.A.P. 9th Cir. 2010). And so it would seem that applicable LLC law, including statutory restrictions on membership assignments, controls the outcome even in bankruptcy.

However, Section 541(c)(1) of the Bankruptcy Code provides that "an interest of the debtor in property becomes property of the estate... notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law... that restricts or conditions transfer of such interest by the debtor." (Emphasis added.) In *In*

re First Protection, the court held that Section 541(c)(1) "overrides both contract and state law restrictions" on the transfer of a debtor's 100 percent membership interest in an LLC. As a result, the court determined, a bankruptcy trustee "was not a mere assignee, but stepped into [the] debtors' shoes, succeeding to all of their rights, including the right to control [the LLC]."

Notably, the debtors in *First Protection* were the 100 percent owners of the subject LLC but the court's interpretation of Section 541(c)(1) of the Bankruptcy Code would not appear to be limited to single-member LLCs and may imply that Section 541(c)(1) overrides state law restrictions on the transfer of membership interests even in multi-member LLCs.

If courts follow *First Protection*, which appears to be correctly decided, creditors may find their ability to recover against the assets of a judgment debtor's single-member LLC to be significantly enhanced in bankruptcy. Of course, creditors would have to rely on a trustee, where one is appointed, to liquidate the single-member LLC's assets, and the resulting proceeds will be distributed ratably to creditors of the debtor. Nonetheless, bankruptcy law may prevent a judgment debtor from shielding a single-member LLC's assets from his or her creditors.

Prophylactic Steps

Lenders should take precautionary measures so they can fully monetize their borrower's or guarantor's assets if judicial enforcement becomes necessary. Ideally, a lender should obtain a pledge of its obligor's membership interests entitling the lender to exercise remedies, including non-judicial foreclosure, following the borrower's default. In the case of multi-member LLCs, a lender should also seek to obtain the requisite consents of the LLC's other members to permit the lender to step into the shoes of its obligor as a member of the LLC following a default. Alternatively, lenders may seek to make their borrower's or guarantor's single-member LLC itself a guarantor of the underlying transaction.

If judgment enforcement becomes seriously frustrated, a creditor could seek to place the debtor into an involuntary bankruptcy case, which generally requires three creditors holding undisputed, unsecured claims totaling at least \$15,325. See 11 U.S.C. §303(b). Although bankruptcy adds some complexity and expense and entails sharing recoveries with other creditors, it may prove useful in avoiding transfer restrictions imposed by the LLC law and help creditors unlock the value of assets held by a debtor's single-member LLC.