UPDATE ON CALIFORNIA

LIMITED LIABILITY COMPANIES

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TO WHAT EXTENT DO LLCS PROVIDE LIABILITY PROTECTION?

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February 24, 2010

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1. *Chicago Title Company v. Metropolitan Property Holdings*, LLC, No. B206217, 2009 WL 711767 (Cal. App. 2 Dist. March 19, 2009). "Reverse piercing" claim (attempt to apply use entity's assets to satisfy a liability of a shareholder or member). Legend stamped on deed said that grantor (98% member) and grantee (LLC) where "comprised of the same persons," so no documentary tax was due. In effort to collect tax from the grantor, the FTB asserted that this statement was evidence that grantor and grantee should be treated as the same person for other California tax purposes. Held: the statement did not constitute substantial evidence that the individual and the LLC were "one and the same" for other purposes.

2. *Stone v. Advance America*, *Cash Advance Centers, Inc.*, No. 08CV1549 WQH (WMc), 2009 WL 765665 (S.D. Cal. March 20, 2009). Plaintiff asserted that San Diego court should have jurisdiction in class action over parent

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[1] *This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.*

[2] I am indebted to Elizabeth S. Miller at Baylor Law School in Waco, Texas for her periodic surveys *Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships* in the PUBOGRAM, a publication of the Committee on LLCs, Partnerships and Unincorporated Entities of the Business Law Section of the American Bar Association. The most recent survey is in the October, 2009 edition at page 20.

corporation, based in South Carolina, because the California-based subsidiary LLC was the alter ego of the parent corporation. Parent submitted an officers declaration supporting its position that it had no direct contacts with California. Plaintiff failed to submit any evidence in rebuttal. Held: Subsidiary LLC was not the alter ego of its parent corporation for purposes of exercising jurisdiction over the parent.

3. In re LmcD, LLC (Schwab v. Damenti's, Inc.), 405 B.R. 555 (Bankr. M.D. Pa. 2009). Master ice carver and restaurateur McDonald formed a Pennsylvania LLC to showcase the work of various ice artists. The LLC failed financially and filed a Chapter 7 bankruptcy.

The trustee sought to pierce the LLC veil and to hold McDonald liable for the LLC's debts. The trustee also sought to use "reverse piecing" to hold a restaurant corporation owned by McDonald liable for the LLC's debts. The trustee argued that McDonald and the LLC were alter egos of each other. The trustee also asserted that McDonald and the two entities were really a "single entity."

The court held that that the Pennsylvania LLC statute makes the equitable remedy of "piercing" available with respect to an LLC. To determine whether McDonald should be held liable for the LLC's debts, the court analyzed the issues of undercapitalization, adherence to company formalities, intermingling of business affairs, and use of the corporate form to perpetrate fraud. The court found that:

- The LLC was slightly undercapitalized, but undercapitalization was not alone dispositive;

- The LLC properly documented its dealings with government agencies.

- There was some intermingling of McDonald's personal and corporate affairs, but no evidence of commingling of assets, financial records, or employees. The court held that failing to run the businesses on a strictly separate basis did not amount to fraud that would overcome the presumption against piercing.

The trustee asserted that the same factors supported reverse piercing of the restaurant corporation. But the court held that the evidence did not overcome the presumption against piercing.

The trustee argued that the restaurant corporation was liable for the LLC's debts because in equity they were a single entity. The theory had not been adopted in Pennsylvania, and the court predicted that the Pennsylvania Supreme Court would be reluctant to adopt the theory. The court concluded, however, that the evidence did not satisfy the elements of the single entity theory so as to hold the restaurant liable for the LLC's debts.

4. *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003). The court allowed a Chapter 7 bankruptcy trustee to reach the assets in the debtor's single-member LLC. The court reasoned – without any citations -- that there were no other members for the charging order to protect. Compare *Evans v. Galardi*, summarized below. The court also held that under the Bankruptcy Code, the trustee became the substituted member of the LLC, replacing the debtor.

5. *In re Bob Desmond*, 316 B.R. 593 (Bankr. D. New Hampshire, 2004). Bob (the Debtor) owned a single-member LLC, which was not a debtor in a bankruptcy case and not a party in Bob's case. The LLC owned an option to purchase a marina. After Bob's Chapter 11 bankruptcy proceeding commenced, the LLC allowed a creditor of the LLC to foreclose on the option. Creditors of Bob argued that Bob's "right to manage and control the [the LLC] as its sole member is an asset of [the bankruptcy] estate and subject to the [Bankruptcy] Court's approval for actions taken outside the ordinary course of business." The court refused to exercise its powers over the LLC, because the LLC was not a debtor in the bankruptcy proceeding. The court read Albright to stand "for the proposition that a Chapter 7 trustee succeeds to the rights of a debtor who is a sole member of an LLC, absent an operating agreement to manage and control the LLC." Because there was no trustee, the court refused to interfere in the sale of the LLC's assets.

6. *In re A-Z Electronics*, 350 B.R. 886 (Bankr. D. Idaho, 2006). U.S. Trustee moved to dismiss a Chapter 11 case because the sole member of the LLC was in a Chapter 7 case and the sole member had signed the petition for the LLC's Chapter 11 case. The U.S. Trustee asserted that the Chapter 7 trustee -- and not the debtor -- had the right to initiate the LLC's proceeding. The court agreed, relying on both *Albright* and *In re Garrison-Ashburn*, 253 B.R. 700 (Bankr. E.D. Va. 2000), which held that a member/debtor's bankruptcy

estate includes the rights to receive distributions from the LLC, as well as the right to vote and to control the LLC. (The parties did not submit briefs, so the judge did all of the research for this one.)

7. *Evans v. Galardi,* 16 C. 3d 300 (1976). Three investors formed a limited partnership with a corporate general partner. The limited partnership operated a motel. They each owned equal LP interests and shares.

Two investors bought out the position of the third. The buyers did not pay their notes and the seller got judgments against them. The buyer asked for an order to tap the till of the motel.

The limited partnership objected because it was not bound by the judgment and the seller did not get a charging order. The seller responded that there was no partner to protect with a charging order, since both partners had the same creditor. The trial court sided with the motel.

The California Supreme Court noted that general partners of a limited partnership had rights in specific partnership property, but limited partners did not have such rights. So the court reversed the order allowing the levy on assets of the limited partnership. "We are not persuaded by plaintiff's argument that a contrary conclusion is compelled simply because defendants were entitled to 100 percent of the net partnership profits in their capacities as limited partners. The ... Act does not distinguish ... depending on the extent of their ownership interest." And later "We decline plaintiff's invitation to recognize ... an implied exception to the required use of the statutory [charging order] procedure."

In dictum, the court noted that its decision might have been different if the plaintiff/seller had claimed that he would not be able to satisfy his claim by charging orders or by levying on the sellers' other assets.

Cal. Corp. Code

§ 17001. Definitions

Unless the context otherwise indicates, the following definitions govern the construction of [the California LLC Act]:

...

(n) "**Economic interest**" means a person's right to share in the income, gains, losses, deductions, credit, or similar items of, and to receive distributions from, the limited liability company, but does not include any other rights of a member, including, without limitation, the right to vote or to participate in management, or, except as provided in Section 17106 [rights of members to information about the LLC], any right to information concerning the business and affairs of the limited liability company.

…

(z) "**Membership interest**" means a member's rights in the limited liability company, collectively, including the member's economic interest, any right to vote or participate in management, and any right to information concerning the business and affairs of the limited liability company provided by this title.…

§ 17301. Assignment of membership interest or economic interest; Pledge or lien against membership interest

(a) Except as provided in the articles of organization or the operating agreement:

(1) A membership interest or an economic interest is assignable in whole or in part, provided, however, that no membership interest may be assigned without the consent of a majority in interest of the members not transferring their interests, as required pursuant to Section 17303.

(2) An assignment of an economic interest does not of itself dissolve the limited liability company or, other than as set forth in the articles of organization or operating agreement, entitle the assignee to vote or participate in the management and affairs of the limited liability company or to become or exercise any rights of a member.

(3) An assignment of an economic interest merely entitles the assignee to receive, to the extent assigned, the distributions and the allocations of income, gains, losses, deductions, credit, or similar items to which the assignor would be entitled.

(4) Upon the assignment of all or part of an economic interest, the assignor shall provide the manager or member of the limited liability company responsible for maintaining its books and records with the name and address of the assignee, together with details of the interest assigned. Upon receipt of that notice, the limited liability company shall amend the list required by paragraph (1) of subdivision (a) of Section 17058 accordingly. Until the assignee of that

interest becomes a member, the assignor continues to be a member and to have the power to exercise any rights and powers of a member, including the right to vote which, in the case of a member who has assigned his or her or its entire economic interest in the limited liability company, shall include the right to vote in proportion to the interest in current profits that the assigning member would have, had the assignment not been made.

(b) Except to the extent assumed by agreement, until an assignee of an economic interest in a limited liability company becomes a member, the assignee shall have no liability to the limited liability company under Chapter 5 (commencing with Section 17200) and Chapter 6 (commencing with Section 17250) solely as a result of the assignment. The assignor of a membership interest is not released from liability as a member solely as a result of the assignment.

(c) The pledge of, or granting of, a security interest, lien, or other encumbrance in or against any or all of the membership interest of a member shall not cause the member to cease to be a member or to grant to anyone else the power to exercise any rights or powers of a member.

§ 17302. Unsatisfied amount of judgment to be charged against membership interest; Foreclosure

(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the assignable membership interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect to the limited liability company and may make all other orders, directions, accounts, and inquiries that the judgment debtor might have made or that the circumstances of the case may require.

(b) A charging order constitutes a lien on the judgment debtor's assignable membership interest. The court may order a foreclosure on the membership interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of an assignee.

(c) At any time before foreclosure, a membership interest charged may be redeemed in any of the following manners:

(1) By the judgment debtor.

(2) With property other than property of the limited liability company by one or more of the other members.

(3) With property of the limited liability company by one or more of the other members with the consent of all of the members whose membership interests are not so charged.

(d) This section does not deprive any member or assignee of a membership interest of the benefit of any exemption laws applicable to the membership interest in the limited liability company.

(e) This section provides the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's membership interest in the limited liability company.

HISTORY:

Amended by Stats. 2002 ch. 451 § 3 (AB 2355). The 2002 Amendment substituted the section above for the former section which read: "On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the membership interest of the member 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 membership interest. This section does not deprive any member of the benefit of any exemption laws applicable to the member's membership interest."

[End of outline.]