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The Uncertain Viability of a Single Member Limited Liability Company as a Choice of Entity

John A. Pearce II and Ilya A. Lipin***

The Single Member Limited Liability Company (“SMLLC”) is a corporate entity with favorable tax treatment and liability protection. It plays a significant role in transactions such as forming an LLC for a sole proprietor, corporate reorganizations, like-kind exchanges, or asset protection. An SMLLC permits its solvent owners to retain full management and control rights, and practitioners believe that the use of SMLLC as an entity will continue to grow.

However, recent legal developments show pitfalls and existing uncertainty associated with utilizing SMLLCs as an operating business entity. Specifically, courts have demonstrated that creditors of SMLLC can go beyond the traditional remedies of obtaining a charging order or piercing the corporate veil to satisfy an existing judgment. Therefore, for single-owners to take full advantage of the SMLLC form, they need to heed the cautions implicit in recent legal developments and enact operating agreement and bylaws that can help prevent their loss of control and management rights if faced with a severe financial reversal.

This article reports on an investigation of the SMLLC as a corporate structure and offers innovative solutions to enhance protection of owner’s assets in the SMLLC, including safeguards in the event of bankruptcy.

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I. INTRODUCTION

The Single Member Limited Liability Company (“SMLLC”) is thought to provide small business owners with favorable and flexible tax treatment, limited liability protection from torts and incurred business debt, management control, capability to file for business bankruptcy protection without declaring personal bankruptcy, and ability to transfer assets and ownership interest.¹ Many entrepreneurs looking to formalize their businesses often turn to SMLLC structure as their entity of choice. In the last decade,² the popularity of SMLLCs has “skyrocketed” and their use has steadily risen.³

However, recent legal developments have raised shortcomings of the SMLLC as a corporate structure and uncertainty as to its long-term viability. Florida Supreme Court’s decision in *Olmstead v. FTC* permits courts to order debtors to surrender all rights, title, and interests in their SMLLC to satisfy an outstanding judgment, which raises serious questions about an SMLLC’s ability to provide asset protection from creditors. Other findings in *In re Albright*, *In re A-Z Electronics*, *In re Modanlo*, *Cognex Corp. v. VCode Holdings, Inc.*, and *In re Desmond*, suggest that the SMLLC may fail to protect its owner from judgment creditors who aggressively pursue the SMLLC’s assets. The cases also suggest that it is not a bankruptcy-remote entity, thus being less advantageous than originally envisioned by investors.

This article consists of six parts. After this brief introduction describing the importance and use of SMLLC, Part II describes the benefits and shortcomings of the SMLLC as a legal entity. Part III describes traditional remedies employed against the SMLLC to guide creditors’ recovery. Part IV and associated Table 1 summarize the recent developments and highlight the consequences of courts’ rulings pertaining to the SMLLC. Part V offers practical insights as to how SMLLC can continue to be utilized and how their owners may increase their protection against creditors. Part VI concludes the article.

1. Beat U. Steiner, *Remembering When the Single-Member LLC Is and When It Isn’t*, PRAC. REAL ESTATE LAW., Mar. 2002, at 35–37.

2. See Ryan H. Pace, *The Rising Popularity of SMLLCs in Tax and Business Planning*, 38 TAX ADVISER 466, 466 †Aug. 2007) (“Single-member limited liability companies (SMLLCs) have become popular in the past decade as taxpayers take advantage of opportunities presented by the check-the-box regulations.”).

3. See Mary Fitzsimons, *Have Disparities in State Tax Treatment of Single Member Limited Liability Companies Created a Tax Overlap for Interstate Business?*, 3 ENTREPRENEURIAL BUS. L.J. 19, 23 (2008).

II. SINGLE MEMBER LIMITED LIABILITY COMPANIES

The SMLLC is a legal entity that is separate from its single-member owner, and offers the member owner protection from debts, obligations, and acts of the SMLLC.⁴ It is an offshoot of the limited liability company (“LLC”)⁵ and emerged from the statutes originally written for a multi-owner structure.⁶ The SMLLC is a popular structure with tax-exempt organizations and solely owned businesses.⁷ It is permitted in all 50 states of the United States as an entity choice.⁸ Individuals and businesses have used the SMLLC structure to form real estate investment transactions, invest in foreign currency options,⁹ conduct like-kind exchanges and corporate reorganizations, create special purpose entities and separate corporate divisions,¹⁰ establish partnerships and joint ventures,¹¹ and isolate liability from property contributions to charities.¹²

4. Minn. Dep’t of Emp’t & Econ. Dev., *The Single Member Limited Liability Company (SMLLC) as an Alternative to the Sole Proprietorship* (Feb. 2010), available at [www.positivelyminnesota.com/Data_Publications/Publications/All_Other_DEED_Publications/Small_Business_Assistance_Office_Publications/Single_Member_Limited_Liability_Company_\(SMLLC\).pdf](http://www.positivelyminnesota.com/Data_Publications/Publications/All_Other_DEED_Publications/Small_Business_Assistance_Office_Publications/Single_Member_Limited_Liability_Company_(SMLLC).pdf).

5. See *United States v. Feng Juan Lu*, 248 Fed. Appx. 806, 808 (9th Cir. 2007) (“[S]ingle-member LLCs are hybrids of both corporations and sole proprietorships.”); See also *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 287 (Del. 1998) (stating that a limited liability company (“LLC”) is a business entity, which was created to provide tax benefits of a partnership and a limited liability of a corporation); *In re A-Z Elecs., LLC*, 350 B.R. 886, 890 (Bankr. D. Idaho 2006) (“[LLCs] are legal entities, created by and under state law, blending attributes of corporations and partnerships.”).

6. Thomas E. Rutledge & Thomas Earl Geu, *The Albright Decision: Why an SMLLC is not an Appropriate Asset Protection Vehicle*, 5 No. 5 BUS. ENTITIES 16, 21 (Sept./Oct. 2003) (“A single-member LLC is a curious entity that exists under statutes initially contemplated for multiple owner structures.”).

7. Alistair M. Nevius, *New Single-Member LLC Reporting Requirements*, J. ACCT. (Mar. 2009), <http://www.journalofaccountancy.com/Issues/2009/Mar/FTTA.htm> (“Many tax-exempt organizations have formed single-member limited liability companies (SMLLCs) as integral parts of their entity structure.”). See *Pace*, *supra* note 2, at 466 (“[SMLLCs] have become popular in the past decade as taxpayers take advantage of opportunities presented by the check-the-box regulations.”).

8. *Fitzsimons*, *supra* note 3, at 22–23. See also *One Communs. Corp. v. Sprint Nextel Corp.*, 495 F. Supp. 2d 219, 224 n.5 (D. Mass. 2007) (“Most states permit ‘single member’ LLC’s, those have only one owner.”); *Stearn & Co., L.L.C. v. United States*, 499 F. Supp. 2d 899, 902 (E.D. Mich. 2007) (“[S]ingle-member LLCs are entitled to whatever advantages state law may extend . . .”).

9. See *Stobie Creek Invs. LLC v. United States*, 608 F.3d 1366, 1370 (Fed. Cir. 2010) (citing the use of SMLLCs for foreign currency investments).

10. See *Feng Juan Lu*, 248 Fed. Appx. at 808 (where the owner created SMLLC to “obtain asset-protection advantages”).

11. See *Rogel v. Dubrinsky*, 337 Fed. Appx. 465, 466 (6th Cir. 2009) (noting the use of SMLLC in a business venture developing economy hotels).

12. *Pace*, *supra* note 2, at 466.

A. SMLLC BENEFITS

The SMLLC is a legal entity separate from its owner, which is treated as a sole proprietorship disregarded for tax purposes,¹³ unless its member elects the SMLLC to be classified as a corporation.¹⁴ The SMLLC is the only type of business entity that “can be owned and operated by one natural person” and receive disregarded entity tax treatment.¹⁵ It became a viable entity option after the check-the-box regulations in 1997, which allows individuals to elect to have SMLLC treated as a pass-through entity for tax purposes. This disregarded entity tax status is achieved automatically even if SMLLC’s only member is an existing corporation.¹⁶ Due to its disregarded status, there is no federal tax consequence to forming an SMLLC.¹⁷ For purposes of reporting, the disregarded entity status means that the SMLLC’s member will report the entity’s revenue and other tax effects on his tax return¹⁸ and other necessary returns.¹⁹ The SMLLC

13. See *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 541 (5th Cir. 2009) (noting that SMLLC are disregarded for tax purposes). See *United States v. Roe*, No. 10-cv-01049-PAB, 2010 U.S. Dist. LEXIS 101286 (D. Colo. Sept. 8, 2010). See also Carter G. Bishop & Daniel S. Kleinberger, *An SMLLC Conundrum: Disregarded for Tax Purposes But Not in Federal Court*, 12 No. 1 BUS. ENTITIES 4, 6 (Jan./Feb. 2010).

14. Treas. Reg. § 301.7701-3(b)(1)(iii) (2012). See Bishop & Kleingberger, *supra* note 13, at 7 (“An SMLLC, like a sole proprietorship, is disregarded as an entity separate from its owner unless it elects to be classified as a corporation.”). See also *Litriello v. United States*, 484 F.3d 372, 378 (6th Cir. 2007) (noting that because the owner of the SMLLC elected to be treated as a corporation, it could not be taxed as a partnership); *Seymour v. United States*, No. 4:06-CV-116, 2008 U.S. Dist. LEXIS 47674, 7–8 (W.D. Ky. 2008) (“If a sole-owner, single-member limited liability company (“LLC”) does not elect to be treated as a corporation, the owner is personally liable for the employment taxes due and owing from the LLC.”). An owner may desire to elect SMLLC to be taxed as a corporation if the owner wants the earnings to stay in the corporation and be distributed in the form of dividends potentially receiving preferential tax treatment.

15. Bishop & Kleingberger, *supra* note 13, at 48 (“[U]nlike partnerships, which have two or more partners, and unlike a corporation with only one owner, an SMLLC is the only business entity that can be owned and operated by one natural person and be totally disregarded as an entity for federal tax purposes.”).

16. See *Kandi v. United States*, No. C05-0840C, 2006 U.S. Dist. LEXIS 2687 (W.D. Wash. 2006) (“A single-member LLC may elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity, resulting in pass through taxation of its sole member. Treas. Reg. § 301.7701-3(a). If no election is made, a single-member LLC is disregarded as an entity separate from the owner for federal tax purposes. Treas. Reg. § 301.7701-3(b)(1)(ii). If the single-member LLC is disregarded as an entity for federal tax purposes, ‘its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.’ Treas. Reg. § 301.7701-2(a).”).

17. Dominic L. Daher & Barry M. Brents, *Achieving Enhanced Liability Protection Through SMLLCs*, TAX’N OF EXEMPTS, at 137, 138, Nov./Dec. 2006 (“Because [SMLLC] does not exist for federal tax purposes, there are no federal tax income tax consequences to forming a disregarded SMLLC.”).

18. Pace, *supra* note 2, at 471 (noting that SMLLC’s business activity is considered to be a sole proprietorship, thus requiring “items of income, gain, loss, expense etc., [to be] reported directly on the individual owner’s income tax return”).

is responsible for payment of employment taxes²⁰ as if its member was considered a responsible party under section 6672 of the Code.

The SMLLC is a legal structure that allows for an “enhanced level of liability protection with a minimum cost.”²¹ When a corporation owns an SMLLC, its activities are treated as if the SMLLC was a corporate branch or division.²² The SMLLC structure helps tax-exempt organizations, such as colleges and hospitals, to limit their liability by transferring their separate valuable assets and real estate property into SMLLCs.²³ By separating its assets into separate SMLLCs, the institutional owner can limit its liability exposure.²⁴

The SMLLC benefits its member by freely allowing the transfer of ownership rights through an assignment to another party or a merger with another entity.²⁵ As the sole owner of a legal entity, the SMLLC member can make exclusive decisions about any fundamental changes and avoid the complex process associated with the voting requirements generally mandated by other corporate structures. This lack of complexity is an attractive benefit to entrepreneurs seeking interstate expansion.²⁶ A merger between a corporate owned SMLLC and another entity is treated as “a merger between the parent corporation and the other merger target participant.”²⁷

19. Nevius, *supra* note 7, at 86 (notifying of new laws requiring SMLLCs with employees to filing separate reports for federal employment tax purposes).

20. Treas. Reg. § 301.7701-2(c)(2)(iv) (2012). *See also* McNamee v. Dep’t of the Treasury, 488 F.3d 100, 111 (2d Cir. 2007).

21. Daher & Brents, *supra* note 17, at 140.

22. Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters’ Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223, 258 n.160 (2000) (“If the SMLLC is corporate-owned, activities are treated in the same manner as a branch or division.”).

23. Daher & Brents, *supra* note 17, at 138 (“[T]hrough proper utilization of an SMLCC, tax-exempt entities can achieve limited liability for state law purposes while not affecting their exempt status for federal tax purposes.”).

24. *Id.*

25. *Olmstead v. FTC*, 44 So. 3d 76, 80 (Fla. 2010) (“[S]ole member in a single-member LLC may freely transfer the owner’s entire interest in the LLC.”).

26. Fitzsimons, *supra* note 5, at 20.

27. Bishop & Kleingberger, *supra* note 13, at 7.

B. SMLLC LIMITATIONS

The SMLLC form has limitations. Because the SMLLC's owner may be deemed by the court as acting in representative capacity of the entity,²⁸ the SMLLC may not protect its member from debts and obligations incurred prior to its formation, member's personal negligence and misconduct, violation of laws and regulations, environmental torts caused by the business, or unclean hands in business transactions.²⁹ Unless the member of the SMLLC is a lawyer, the member cannot represent SMLLC in federal court.³⁰ While SMLLC is considered a disregarded tax entity for federal tax purposes, it may be subject to tax on the state level.³¹ Depending on the factual circumstances surrounding the single-member ownership, states may impose state level income tax on an SMLLC.³² Ownership of SMLLCs in multiple jurisdictions may subject the member to state tax nexus and expose the owner to numerous tax obligations and liabilities.³³

The viability of the SMLLC structure is affected by how certain elements of LLC statutory law are interpreted in light of single-member ownership.³⁴ Although each state's LLC law indicates its application to SMLLCs, some of the statutory operation provisions only make practical sense when they are used in the context of multi-member LLCs.³⁵

Two types of evidence contest the viability of the SMLLC as an entity choice: (1) the overall absence of case law that might support the SMLLC as an independent corporate structure that is separate from its single-member owner,³⁶ and (2) the holdings in *In re Albright*, *In re A-Z Electronics*, *In re Modanlo*, *Cognex Corp. v. VCode Holdings, Inc.*, and *In re Desmond*, and *Olmstead*. The case law summarized in Table 1 suggests that a single-member's assets are

28. See *United States v. Feng Juan Lu*, 248 Fed. Appx. 806, 808 (holding SMLLC owners can act in entity's representative capacity).

29. Steiner, *supra* note 1, at 39.

30. *United States v. Hagerman*, 545 F.3d 579 (7th Cir. 2008). See also Thomas E. Rutledge, *State Law & State Taxation Corner: Regarding the Disregarded Entity*, 14 J. OF PASSTHROUGH ENTITIES 39 (Mar.-Apr. 2011) (citing *Collier v. Cobalt LLC*, 2002 WL 726640 (E.D. La. 2002) and stating that "an LLC could not be represented by its sole member").

31. Fitzsimons, *supra* note 5, at 20.

32. Patrick Henry Smith, *Taxation by States of Single-Member Limited Liability Companies*, 9 NO. 5 BUS. ENTITIES 50 (Sept./Oct. 2007) (noting that Kentucky, Tennessee, and Massachusetts may impose state level income tax on SMLLC).

33. Fitzsimons, *supra* note 5, at 20.

34. Rutledge & Geu, *supra* note 6, at 21.

35. *In re Modanlo*, 412 B.R. 715, 716 (Bankr. D. Md. 2006).

36. *In re Modanlo*, 412 B.R. at 727.

not protected and that an SMLLC is not a foolproof corporate structure.

III. TRADITIONAL REMEDIES AGAINST AN SMLLC

Despite its described benefits, the SMLLC can be subject to lawsuits by third parties. When the single-member owner fails to implement the SMLLC form comprehensively, case law shows that the court may not support the SMLLC as an independent corporate structure that is separate from its single-member owner. Historically, the charging orders and piercing of the corporate veil have been used by creditors to satisfy judgments against an SMLLC debtor.

Charging orders and piercing of the corporate veil have been traditionally used by creditors to satisfy judgments against an SMLLC debtor. The charging order originated in partnership law and has been adopted and applied to limited partnerships and LLCs.³⁷ The purpose of the charging order is to allow creditors to protect their rights in the distributions from the corporate entity.³⁸ A judgment creditor established through a charging order receives a right to the debtor's profits and distributions from a business entity where the debtor has an ownership interest.³⁹ The entry of the charging order does not mandate that the LLC must declare and pay distributions; however, any distributions that are made to the debtor member will be redirected to a judgment creditor in accordance with the court's order.⁴⁰ As a remedy, the charging order provides the creditor with special means to "seek satisfaction when a debtor's membership interest is not freely transferable but is subject to the right of other LLC members to object to a transferee becoming a member and exercising the management rights attendant to membership status."⁴¹ However, a creditor who obtains a charging order against the LLC debtor does not automatically obtain management rights over the company.⁴² For a creditor to have management rights, members of an LLC must unanimously agree to admit creditor as a member.⁴³

37. Rutledge & Geu, *supra* note 6, at 18.

38. *Id.*

39. *Olmstead v. F.T.C.*, 44 So. 3d 76, 79 (Fla. 2010).

40. Carter G. Bishop, *LLC Charging Orders: A Jurisdictional and Governing Law Quagmire*, 12 No. 3 BUS. ENTITIES 14, 17 (May/June 2010).

41. *Olmstead*, 44 So. 3d at 81.

42. *Cadle Co. v. Ginsburg*, No. CV950076811S, 2002 Conn. Super. LEXIS 994 (Conn. Super. Ct. Mar. 28, 2002) (noting what occurs under Connecticut law) ("[A] charging order merely gives the judgment creditor the rights of an assignee of the member's interest in the limited liability company . . . and does not entitle the assignee to participate in the management and affairs of the limited liability company or to become or exercise any rights of a member."). See *B.A.S.S. Group, LLC v. Coastal Supply Co.*, No. 3743-VCP, 2009 Del. Ch. LEXIS 166 (Del.

For the purposes of piercing of the corporate veil, the SMLLC is treated as if it were a corporation.⁴⁴ The basis for piercing of the veil is to protect entity's creditors from the damage caused by debtor's self-serving actions.⁴⁵ Existing case law on the piercing of the corporate veil suggests that because the SMLLC is a tax-disregarded entity, judges are persuaded "to pierce the veil more readily with an SMLLC than other limited liability companies."⁴⁶ The courts are willing to pierce the corporate veil "when doing so would achieve an equitable result."⁴⁷ The courts generally consider multiple factors to determine if it should pierce the corporate veil: (1) presence of intermingling of corporate and personal funds; (2) undercapitalization; (3) failure to maintain separate records or other legal corporate requirements; and (4) diversion of funds by majority shareholders.⁴⁸ After the SMLLC's corporate veil is pierced, its debts are treated as personal obligations of its single-member owner.⁴⁹ This requirement allows creditors to pursue the personal assets of the SMLLC's single member to satisfy their judgments.

IV. CHANGING LANDSCAPE OF REMEDIES AGAINST SMLLCs

Major case findings have clarified some important shortcomings of the SMLLC. First, they have signaled that an SMLLC is not a bankruptcy-remote entity and that creditors can sidestep the limitations of a charging order. Creditors' remedies include a lien

Ch. June 19, 2009) (stating same under Delaware law). *See* Rutledge & Geu, *supra* note 6, at 18 (stating what occurs in the context of a partnership) ("While the holder of a charging order, to the extent of the order, would be treated as an assignee of the partnership interest, such person would not succeed a right to participate in the management of the partnership.").

43. Bishop, *supra* note 40, at 14 ("Under state law, a purchaser of an LLC membership interest does not become a member of the LLC with the right to vote and participate in management unless the other members unanimously agree to admit the purchaser as a member.").

44. Hollowell v. Orleans Reg'l Hosp. LLC, 217 F.3d 379, 390 (5th Cir. 2000). *See* Eric Fox, *Piercing the Veil of Limited Liability Companies*, 62 GEO. WASH. L. REV. 1143, 1167-68 (1994) (noting that most commentators assume that doctrine of piercing the corporate veil applies to LLCs).

45. Rogel v. Dubrinsky, 337 Fed. Appx. 465, 469 (6th Cir. 2009).

46. Steiner, *supra* note 1, at 36.

47. William Wrigley Jr. Co. v. Waters, 890 F.2d 594, 601 (2d Cir. 1989).

48. Williamson v. Recovery L.P., 542 F.3d 43, 53 (2d Cir. 2008). *See* Itel Containers Int'l Corp. v. Atlantrafik Express Serv. Ltd., 909 F.2d 698, 703 (2d Cir. 1990) (noting what occurs under the New York law) ("[The court] allows the corporate veil to be pierced either when there is fraud or when the corporation has been used as an alter ego.").

49. *See* Rogel, 337 Fed. Appx. at 470 (considering application of piercing of corporate veil doctrine against SMLLC).

against SMLLC's distributions to its single member and the right to access SMLLC's assets. Second, the courts have ruled that the SMLLC as an entity is not protected from creditors after its single-owner files for bankruptcy. Third, an SMLLC may lose the option of Chapter 11 reorganization if its owner has filed for individual bankruptcy. Fourth, the courts certified the ability of a bankruptcy trustee to revive a dissolved SMLLC and become its controlling member. The option may predispose creditors to force the SMLLC owner into bankruptcy to maximize their return of assets. Fifth, the courts may treat an SMLLC as an alter ego of its owner by applying its own test, and disregard SMLLC's corporate form for the benefit of the creditors. Finally, some legislation specifies options to a charging order that may be obtained against a SMLLC, which threaten the SMLLC owner's interest in the legal form. The following case overviews explain how these shortcomings were identified.

A. IN RE ALBRIGHT

Ashley Albright, the sole member and manager of Western Blue Sky LLC ("SMLLC"), filed for Chapter 7 Bankruptcy protection in 2001.⁵⁰ SMLLC owned real estate property located in Colorado.⁵¹ The SMLLC formed under Colorado law was not a debtor in the bankruptcy proceedings associated with its sole member Albright.⁵² Based on Albright's sole ownership and management of the SMLLC at the time bankruptcy petition was filed, the Chapter 7 trustee alleged that he had the right to sell SMLLC's real estate and distribute the proceeds to creditors.⁵³ Conversely, Albright claimed that the trustee was only entitled to seek a charging order and cannot assume any management rights in SMLLC or cause it to sell its real estate.⁵⁴

The court disagreed with Albright and held for the trustee. The court stated that the charging order as set forth by the Colorado law was enacted to "protect other members of an LLC from having involuntarily to share governance responsibilities with someone they

50. *In re Albright*, 291 B.R. 538, 539 (Bankr. D. Colo. 2003) ("[Albright, the Debtor,] initiated this case on February 9, 2001, under Chapter 13. It was converted to Chapter 7 by the Debtor on July 19, 2001.")

51. *In re Albright*, 291 B.R. at 539.

52. *Id.*

53. *Id.* at 539 n.2 ("If the Trustee is entitled to control of the LLC, he could, presumably, as an alternative, dissolve the LLC, distribute its property to his bankruptcy estate, and then sell the property himself." However, in this bankruptcy proceeding "[t]he Trustee has not asserted any alter ego theory and has not attempted to pierce the veil of the LLC.")

54. *Id.* at 539.

did not choose, or having to accept a creditor of another member as a co-manager.”⁵⁵ The court held that a “charging order serves no purpose” in a SMLLC, because it is a single-member entity with no other parties’ interests affected and “no non-debtors to protect.”⁵⁶

The Colorado LLC statute treats the debtor’s membership interest in the SMLLC as personal property, which upon debtor’s bankruptcy filing becomes interest of the estate.⁵⁷ Since a SMLLC is solely owned by one member, the entire interest of SMLLC is passed to the bankruptcy estate where the trustee becomes a “substituted member.”⁵⁸ Thus, the court ruled that Albright assigned his entire membership in SMLLC to the bankruptcy estate, permitting the trustee to obtain all of the rights to SMLLC, including management rights.⁵⁹ The court stated that after Albright filed for Chapter 7 bankruptcy, the trustee became the sole member of Albright’s SMLLC and therefore controlled “all governance of that entity, including decisions regarding liquidation of the entity’s assets.”⁶⁰

The *In re* Albright holding demonstrates an often fatal consequence when an SMLLC’s owner files for bankruptcy. According to the holding, by filing bankruptcy the owner loses all control and management rights in its business to a bankruptcy trustee.⁶¹ The likelihood of a continued existence for an SMLLC is bleak after this transfer since the bankruptcy trustee is not interested in running the company but rather in gathering and liquidating its assets for the benefit of the SMLLC owner’s creditors. After obtaining exclusive control of the SMLLC, the bankruptcy trustee can vote to sell the entity’s assets and distribute the profits to the bankruptcy estate.⁶² Even if the SMLLC has not filed for bankruptcy as a separate entity, the trustee upon the receiving control and

55. *In re* Albright, 291 B.R. at 541.

56. *Id.*

57. *Id.* at 539–40.

58. *Id.* See COLO. REV. STAT. § 7-80-702 (2003).

59. *In re Albright*, 291 B.R. at 540.

60. *Id.* at 541. Although the Debtor did not assert a claim, the court stated that the “Debtor may be entitled to a claim for her contributions made to preserve an asset of this bankruptcy estate based on post-petition mortgage payments on the Real Property.” *Id.*

61. *Robucci v. Comm’r*, 101 T.C.M. (CCH) 1060, at 21 (2011) (citing and summarizing *In re* Albright, 291 B.R. at 540–41) (“The court reasoned that (1) the absence of other members in the LLC meant that ‘the entire membership interest passed to the bankruptcy estate, and the Trustee became a “substituted member” under Colo. Rev. Stat. sec. 7-80-702 governing the transferability of LLC interests, and (2) as the sole member of the LLC, ‘the Trustee now controls * * * all governance of that entity, including decisions regarding liquidation of the entity’s assets.’”).

62. See Gary A. Goodman & Lisa J. Teich, *Protecting the Assets of Single-Member Limited Liability Companies in the Event of Bankruptcy*, 20 REAL EST. FIN. 21, 21–22 (Aug. 2003) (stating that the bankruptcy trustee could elect to distribute the SMLLC’s property to the bankruptcy estate and then liquidate the property himself).

management rights may sell the SMLLC's assets to satisfy the debts of the judgment creditors.⁶³

The ability of the bankruptcy trustee to neglect corporate form and list an SMLLC as an asset of its owner's bankruptcy signifies that SMLLC is not a bankruptcy-remote entity.⁶⁴ In effect, *In re Albright* suggests that the bankruptcy trustee may liquidate a separate solvent business entity for the benefit of the creditors of the SMLLC's owner creditors who may not otherwise have any interest in the SMLLC's assets.⁶⁵

The *In re Albright* holding also has a negative implication for any investor who holds assets in an SMLLC because it allows the creditors to circumvent the limitations of the charging order remedy.⁶⁶ Prior to this holding, the creditors' remedies were limited to a lien against the SMLLC's distributions to its single member, and they did not have the right to access the SMLLC's assets. However, as of *In re Albright*, if an SMLLC is used to hold property for a like-kind exchange under section 1031 of the Internal Revenue Code, the bankruptcy trustee can ignore the corporate form and sell that property when its SMLLC's owner files for bankruptcy.⁶⁷ The same neglect of the corporate form would not be allowed if multiple individuals owned an LLC because the bankruptcy trustee would not have sole voting, control, and management rights.⁶⁸

63. Goodman & Teich, *supra* note 62.

64. See *Robucci*, T.C.M. (CCH) 1060, at 21 (interpreting *In re Albright*, 291 B.R. at 541) (“[A]ll of the LLC's assets are available to satisfy the claims of the sole member's creditors (and not that the sole member's assets are available to the LLC's creditors).”).

65. See James J. Wheaton, *Current Status Of Bankruptcy Issues*, VMF0317 ALI-ABA 305, 314 (Mar. 2005) (noting the court's holding in *In re Albright*) (“[The court] concluded that it could disregard statutory provisions requiring approval for the admission of an assignee as a member because the LLC at issue was a single-member LLC, and there were no other members whose approval was required before the chapter 7 trustee could be substituted as a member for the bankrupt debtor-member.”).

66. See Susan Kalinka, *Individuals and Passthrough Entities: What, if Anything, Does the Bankruptcy Court's Decision to Vacate Its Opinion in In Re Ehmann Mean for LLC Members?*, 86 TAXES 13, 16 (Jan. 2007) (“In *Albright*, the court disregarded the charging order provisions of the Colorado LLC Act, holding that a trustee in bankruptcy had the authority to control the management of, liquidate, and sell property of an LLC to satisfy claims of creditors of the LLC's only member.”).

67. *Id.* See also *Fursman v. Ulrich (In re First Prot., Inc.)*, 440 B.R. 821, 829–30 (B.A.P. 9th Cir. 2010) (citing *In Re Albright* 291 B.R. at 541) (“[T]he *Albright* court observed that the purpose of the charging order was not served in single-member LLCs because it was to protect other members of an LLC from being forced to involuntarily share governance responsibilities with someone they did not choose, or from being forced to accept a creditor of another member as a co-manager.”).

68. See Susan Kalinka, *In re Albright: Bankruptcy Court Decision Portends Problems for Single-Member LLCs*, 81 TAXES 15, 20 (July 2003).

B. *DESMOND V. U.S. ASSET FUNDING, LP (IN RE DESMOND)*

Bob Desmond (“Debtor”) was a sole owner of a Delaware LLC, Weaver Cove LLC (“SMLLC”).⁶⁹ Desmond filed for Chapter 11 bankruptcy and listed SMLLC as an asset, which was not a debtor or a party in Desmond’s bankruptcy case.⁷⁰ At the time of the bankruptcy petition, the SMLLC had an option agreement to purchase land in Rhode Island for construction of a marina.⁷¹ After Chapter 11 was filed, Debtor, acting as an individual and as SMLLC’s sole manager, entered into transactions with the U.S. Asset Funding, LP and Vladimir Pave and Gary Pave (“Creditors,” or “Defendants”).⁷² In these transactions, Debtor transferred interest in the SMLLC and collaterally assigned SMLLC’s interest in the option agreement for Defendants in exchange for a \$275,000 note.⁷³ Neither party sought or obtained the approval of the bankruptcy court for this transaction.⁷⁴ The Creditors notified the Debtor that they planned to sell the collateral, and the Debtor filed and obtained an *ex parte* temporary restraining order (“TRO”) for himself and the SMLLC.⁷⁵ Thereafter, the Creditors moved the court to dissolve the TRO. After the motions were filed, the court was faced with a question of whether to extend the injunctive relief it granted the Debtor after it obtained the TRO.⁷⁶

The court held that it was certain that “on the date of the bankruptcy filing, the Debtor’s membership interests [in SMLLC] were personal properties under Delaware law and property of the Chapter 11 estate.”⁷⁷ As a result, the court held that as a sole owner of the SMLLC, the Debtor did not have the right to manage and control SMLLC and was subject to the court’s approval “for actions taken outside the ordinary course of business.”⁷⁸ The court found that since the SMLLC was not a debtor in bankruptcy, “nothing about the [Debtor’s] individual bankruptcy deprived him of the right

69. *Desmond v. U.S. Asset Funding, LP (In re Desmond)*, 316 B.R. 593, 594 (Bankr. D.N.H. 2004).

70. *Id.* The petition for Chapter 11 bankruptcy was filed on November 13, 2003. The schedules were filed on December 29, 2003, and were amended on January 7, 2004. *Id.*

71. *Id.* (noting that this option agreement has never been filed with this bankruptcy court).

72. *Id.*

73. *Id.*

74. *Id.* (noting that the Defendants argued that “they had no knowledge of the plaintiff’s bankruptcy when the documents were signed”; however, the court found Defendants to have such knowledge by early January 2004).

75. *Id.* at 595.

76. *Id.*

77. *Id.*

78. *Id.*

to take actions on behalf of [SMLLC]).⁷⁹ Accordingly, the court held that it would not prevent creditors from pursuing their rights against the non-debtor SMLLC.⁸⁰

In re Desmond followed the precedent established in *In re Albright*. *In re Desmond* interpreted *In re 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.”⁸¹ Again, the court disregarded the corporate formalities and viewed the SMLLC as an entity that was not protected from creditors after its single-owner filed for bankruptcy.⁸²

C. *IN RE A-Z ELECTRONICS*

Ron Ryan was a sole owner and manager of A-Z Electronics, LLC (“SMLLC” or “Debtor”) organized under the laws of Idaho.⁸³ With his wife, Ryan filed for Chapter 7 bankruptcy, listing an SMLLC as one of its assets.⁸⁴ Subsequently, the SMLLC filed for Chapter 11 bankruptcy. The SMLLC’s petition was signed under the penalties of perjury by Ryan as its “managing member” and a single owner of a 100 percent membership interest.⁸⁵

After the SMLLC filed for Chapter 11 bankruptcy, the Office of the U.S. Trustee (“UST”) moved to convert or dismiss the Chapter 11 case because it was unauthorized by the Chapter 7 trustee.⁸⁶ The court looked to the state law to determine if Ryan had the authority to sign the SMLLC petition for Chapter 11 bankruptcy.⁸⁷ The Idaho statutory law stated that unless an operating agreement vests management and decisional authority to a manager, it belongs to the

79. Lawrence A. Goodman et al., *The Crossroad of Alternative Entities and Bankruptcy - A Treacherous Intersection*, 2010 A.B.A. BUS. LAW SECTION, COMM. ON LLCs, P'SHIPS & UNINCORPORATED ENTITIES, COMM. ON MIDDLE MKT. & SMALL BUS., COMM. ON BUS. BANKR., Aug. 6, 2010, at 17, available at <http://www.abanet.org/buslaw/blt/content/2010/10/0003b.pdf>.

80. *In re Desmond*, 316 B.R. at 595.

81. *Id.*

82. *Id.*

83. *In re A-Z Elecs., LLC*, 350 B.R. 886, 888 (Bankr. D. Idaho 2006).

84. *Id.* at 888. Ryan ascribed the value to SMLLC of \$0.00. *Id.* After Ryan’s case was converted to Chapter 13 bankruptcy, it was reverted to Chapter 7. *Id.*

85. *Id.* (“Ryan also signed the list of the 20 largest unsecured creditors and the statement of financial affairs.”).

86. *Id.* at 887.

87. *Id.* at 889 (“State law, not bankruptcy law, is used to determine whether the party signing the entity petition had the authority to do so.”).

LLC's member.⁸⁸ As SMLLC's operating agreement was not provided, the court concluded that because Ryan filed the petition citing its 100 percent membership interest in the SMLLC under the penalties of perjury, he had the authority to act on behalf of the entity as its sole owner and manager.⁸⁹

Under Idaho law, sole owner's membership in an SMLLC is personal property,⁹⁰ which becomes property of the estate after the debtor files for bankruptcy.⁹¹ The court held that at the time of Ryan's bankruptcy filing he was the sole owner and manager of the SMLLC, which made the SMLLC the property of the bankruptcy estate.⁹² Thus, the trustee of the Ryan's estate had "the sole and exclusive authority" over the SMLLC, was "the only one entitled to manage" the SMLLC or to decide whether the SMLLC "would or would not file bankruptcy."⁹³ As a result, the court concluded that the SMLLC's petition to file for bankruptcy lacked authority and was not properly "executed under applicable nonbankruptcy law."⁹⁴ Further, the court held that Ryan lacked the legal authority to file Chapter 11 bankruptcy for SMLLC since at the time of the filing it was already property of the Chapter 7 bankruptcy estate.⁹⁵

In re A-Z Electronics upheld the application of *In re Albright* and signified that the bankruptcy trustee has the power to control and manage SMLLC after its single-owner files for individual bankruptcy.⁹⁶ This case holds that after a single owner files for bankruptcy, he will lose all control and management rights over the SMLLC, which may include the ability to file Chapter 11 bankruptcy on behalf of the SMLLC.⁹⁷ As a result of the *In re A-Z Electronics* holding, the SMLLC may lose any chance for Chapter 11 reorganization generally allowed for businesses that petition for

88. *In re Desmond*, 316 B.R. at 890.

89. *In re A-Z Elecs., LLC*, 350 B.R. at 890.

90. *Id.*

91. *Id.* (citing 11 U.S.C. § 541(a)(1) (2006)).

92. *Id.* at 891.

93. *Id.*

94. *Id.*

95. *Id.*

96. See Elizabeth S. Miller, *Symposium-Limited Liability Companies At 20: Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms?*, 42 SUFFOLK U. L. REV. 617, 653 n.117 (2009) (noting the court's decision in *In re A-Z Electronics*) ("[A] managing member of single member LLC had no authority to file Chapter 11 bankruptcy petition for LLC because interests of member and member's spouse in LLC had become property of their Chapter 7 estate and, relying on *In re Albright*, were subject to sole and exclusive authority of Chapter 7 trustee who was only one entitled to manage LLC and decide whether LLC would file bankruptcy.").

97. *In re A-Z Elecs., LLC*, 350 B.R. at 891.

bankruptcy, if its owner has previously filed for individual bankruptcy.

D. *IN RE MODANLO*

Nader Modanlo held a 100 percent ownership interest in a Delaware LLC company called NYSI (“SMLLC”), which owned approximately 65 percent equity and 85 percent voting interest in a Maryland corporation called FACS.⁹⁸ When FACS obtained a verdict from litigation in the amount of \$11.87 million plus interest, Modanlo’s interest in FACS through the SMLLC became financially valuable.⁹⁹

After Modanlo filed for Chapter 11 bankruptcy, the appointed trustee to manage the case voluntarily filed a Chapter 11 petition for SMLLC to be jointly administered with Modanlo’s case.¹⁰⁰ The trustee’s motive for bringing SMLLC into the bankruptcy proceedings was to motion the bankruptcy court to become SMLLC’s manager and to receive authorization through SMLLC to direct the FACS’s Secretary to call a special shareholder meeting.¹⁰¹ The trustee admitted that he wished to remove Modanlo and his associates from the FACS board of directors.¹⁰² Modanlo opposed and stated that he was not obligated to call a special shareholder meeting, that the trustee’s attempt to replace him or anyone else on FACS’s board of directors was unlawful, and that the trustee did not have any legal authority to cause SMLLC to do anything.¹⁰³

Under the Delaware law, the filing of bankruptcy petition of Delaware SMLLC causes its automatic dissolution.¹⁰⁴ Thus, after Modanlo filed for bankruptcy, SMLLC was deemed dissolved as per Delaware law. The actions of the trustee to join SMLLC in the Chapter 11 proceeding raised a question of law: Was the trustee able to revive the SMLLC after its dissolution under the Delaware law?¹⁰⁵ Ultimately, the court held that the trustee had the legal authority to revive the SMLLC as a personal representative of the bankruptcy

98. *In re Modanlo*, 412 B.R. 715, 717 (Bankr. D. Md. 2006).

99. *Id.* at 718.

100. *Id.* at 717.

101. *Id.* at 718.

102. *Id.* at 719.

103. *Id.* at 718–19.

104. DEL. CODE ANN. tit. 6, § 18-304 (2006); DEL. CODE ANN. tit. 6, § 18-801(a)(4) (2006).

105. *In re Modanlo*, 412 B.R. at 723.

estate.¹⁰⁶ Further, the court stated that when SMLLC was placed in bankruptcy, the trustee, “standing in the shoes of the Debtor and complying with the mandates” of the Delaware law, was authorized to have economic and governance rights over SMLLC that its single-member owner had prior to his bankruptcy filing.¹⁰⁷

In re Modanlo is another example of courts disregarding the corporate form for the benefit of its creditors. The case demonstrates that the bankruptcy trustee can revive a dissolved SMLLC to become its controlling member, as shown in Table 1.¹⁰⁸ Once in control, the bankruptcy trustee can collect property and assets that the SMLLC possessed prior to the dissolution to satisfy creditors’ interests.¹⁰⁹ Judgments obtained from litigation by the SMLLC are treated as an asset that can be distributed to the debtor’s creditors. The ability of the bankruptcy trustee to control contingent receivables, such as a large settlement or judgment payments from litigation, makes an SMLLC an appealing target for creditor recovery. Knowing of a possible payout, creditors will be interested in forcing the SMLLC owner into bankruptcy so that the bankruptcy trustee can obtain control of the SMLLC assets and thereafter distribute them to the creditors.

E. *COGNEX CORP. V. VCODE HOLDINGS, INC.*

Cognex Corporation (“Cognex”) filed a declaratory judgment against Acadia Research Corporation (“Acadia”) and its subsidiaries, VData LLC (“VData”), and VCode Holdings, Inc. (“VCode”), to determine the validity of their patent.¹¹⁰ Cognex manufactured a product that read and interpreted two-dimensional bar codes used in tracking merchandise. The defendants owned and controlled a patent that enabled a device to read these two-dimensional bar codes.

106. *In re Modanlo*, 412 B.R. at 724–25 (“Trustee is the personal/legal representative of the Debtor (Mr. Modanlo), that the Trustee has effectively revived the LLC, and that he had the authority to place [SMLLC] into voluntary bankruptcy.”).

107. *Id.* at 731.

108. *Id.* at 724–25. See T. Randall Wright & Joyce A. Dixon, *Bankruptcy Issues in Partnership and Limited Liability Company Cases*, 32 ALI-ABA BUS. L. COURSE MATERIALS J. 43, 49 (2008) (citing *In re Modanlo*) (“[The court] determined that the filing of bankruptcy by the sole member of a Delaware Limited Liability Company dissolved the LLC by operation of law, but the Chapter 7 trustee of the Debtor was able to ‘resuscitate’ the LLC by filing an amendment to the LLC operating agreement appointing himself as the new manager, pursuant to a provision of the Delaware LLC law. The court found that this action was effective, and the LLC therefore had new life.”).

109. *Id.* at 730.

110. *Cognex Corp. v. VCode Holdings, Inc.*, 2006 WL 3043129, *1–2 (D.Minn. 2006).

Acadia and its subsidiaries contacted some of Cognex's clients requesting them to purchase licenses for the patent. Cognex's clients who refused to pay were sued by VCode and VData for patent infringement.¹¹¹ The law states that the vendor is liable for inducing patent infringement, where it sells a product and "its purchasers can only use the product for activities that directly infringe a patent."¹¹² Cognex claimed that it sustained financial damage from being forced to provide indemnification of one or more of its clients for patent infringement and its inability to solicit and retain customers because of this litigation.¹¹³

In its motion, Cognex alleged that VData, an Illinois SMLLC, was Acadia's alter ego.¹¹⁴ Under Illinois law, as in most states, the court will impute subsidiaries' actions to the parent if the subsidiary serves as the parent's alter ego.¹¹⁵ In determining if the subsidiary is the parent's alter ego, the court employed a multiple-factor test, which examined whether the subsidiary: "(1) is adequately capitalized; (2) issues stock; (3) observes corporate formalities; (4) pays dividends; (5) lacks functioning officers or directors; (6) maintains corporate records; (7) commingles funds with its parent; (8) diverts assets from its parent to evade creditors; (9) fails to maintain an arm's-length relationship with related entities; or (10) is a facade for the interests of dominant stakeholders."¹¹⁶

In applying this multiple factor test, the court found that VData was wholly owned by Acadia, had no employees of its own, filed consolidated return with Acadia, and handled all of its affairs through Acadia's holding company, called Acadia Acquisitions.¹¹⁷ The court found that the officers of Acadia and its holding company were "nearly identical" and performed "identical duties."¹¹⁸ All of VData's operational decisions were made by Acadia Acquisitions.¹¹⁹ While VData had substantial capital reserves, it failed to pay dividends to Acadia or its holding company.¹²⁰ The court found that the only two

111. *Cognex Corp.*, 2006 W.L. 3043129, at *2.

112. *Id.* at *8 (citing *Moba, B.V. v. Diamond Automation, Inc.*, 325 F.3d 1306, 1318 (Fed. Cir. 2003)).

113. *Id.* at *2.

114. *Id.* at *9.

115. *Id.* (citing *In re Rehabilitation of Centaur Ins. Co.*, 632 N.E. 2d 1015, 1017-18 (Ill.1994)) (noting that subsidiary's actions are imputed to the parent where it is necessary to prevent fraud or injustice).

116. *Id.* (citing *Taylor v. Standard Gas & Elec. Co.* 96 F.2d 693, 704-05 (10th Cir. 1938); *CM Corp. v. Oberer Dev. Co.*, 631 F.2d 536, 538-39 (7th Cir.1980); *United States v. Advance Machine Co.*, 547 F.Supp. 1085, 1093 (D.Minn.1982)).

117. *Id.* at *10.

118. *Id.* at *11.

119. *Id.*

120. *Id.* at *10.

persons involved in decisions about licensing of patents and enforcement of patent rights through litigation were essentially employed by Acadia.¹²¹ Settlement agreements indicated that Acadia's general counsel appeared in his capacity as COO of Acadia Acquisitions, the sole member of VData.¹²² When cases were settled, Acadia issued press releases announcing, "VData has settled patent litigation with other parties."¹²³ As a result, the court held that Acadia had full control over VData, the two entities were indistinguishable, and VData was a mere alter ego of Acadia.¹²⁴

Cognex Corp. v. VCode Holdings, Inc. demonstrates the uncertainty in the law pertaining to SMLLC's relationship to a corporate parent. It signifies that the courts may treat an SMLLC as an alter ego of its owner by examining the facts surrounding SMLLC ownership and operation through factor tests.¹²⁵ As demonstrated in this case, the court may avoid employing the traditional corporate alter ego analysis and apply its own test.¹²⁶ If the court determines that an SMLLC is merely an alter ego its corporate parent, it will disregard SMLLC's corporate form for the benefit of the creditors.

F. *OLMSTEAD V. FTC*

The Florida LLC Act ("Act") governs the formation and operation of Florida LLCs as well as SMLLCs. The Act allows one or more persons to form an LLC¹²⁷ and have ownership interest in an LLC as members.¹²⁸ A member's ownership interest in the LLC

121. *Cognex Corp.*, 2006 W.L. 3043129, at *10 ("Only two identified persons are involved in its decisions about patent licensing and litigation. One is Robert Berman, general counsel and chief operations officer for both Acacia Research and Acacia Acquisitions. The other is Tisha DeRaimo, identified on the letterhead of Acacia Technologies Group as Vice President of Licensing, but who may evidently be employed by a separate entity, Acacia Employment Services Corporation.").

122. *Id.*

123. *Id.*

124. *Id.* at *11.

125. See Jay D. Adkisson & Christopher M. Riser, *Single-Member LLCs and Charging Orders*, ASSETPROTECTIONTHEORY.COM, 2007, (stating why the SMLLC is a problematic entity) ("[I]t is comparatively easy to successfully claim that the LLC is the alter ego of its owner . . . The courts are now starting to recognize the absurdity of apply formality tests against an entity that is intended by the legislature to be informal in its structure and management . . . [which] leaves planners guessing at just what the courts might look at to determine alter ego.").

126. *Id.*

127. FLA. STAT. § 608.405 (2008).

128. FLA. STAT. § 608.402(21) (2008) (A member is "any person who has been admitted to a limited liability company as a member in accordance with this chapter and has an economic interest in a limited liability company which may, but need not, be represented by a capital account.").

entitles the owner to a share of LLC's profits and losses, right to receive distributions of LLC's assets, right to vote and participate in management, and any other right allowed by the Florida law, the LLC's articles of organization, or its operating agreement.¹²⁹ A member's interest in a Florida LLC is personal property,¹³⁰ which can be assigned in whole or in part in accordance with the LLC's articles of organization or operating agreement.¹³¹ A transfer of the member's interest to an assignee permits the assignee to share profits and losses, receive distributions and other economic benefits of assignor¹³², but does not automatically transfer the rights associated with management of an LLC.¹³³

The Act authorizes a court to issue the charging order remedy for a member's judgment creditor. Specifically, the Act says that:

“[o]n application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company 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 such interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to the member's interest.”¹³⁴

Florida law provides creditors with remedies of levy and sale under execution.¹³⁵ It states that the debtor's real and personal property, goods, chattels, and corporate stock are subject to levy and sale under execution.¹³⁶ An ownership interest in an LLC is considered corporate stock and personal property that falls within the scope of the statute allowing it to be used to pay debts.¹³⁷

Shaun Olmstead and Julie Connell, the Appellants, through use of SMLLCs, ran a fraudulent credit card scheme that advanced fees

129. FLA. STAT. § 608.402(23) (2008).

130. FLA. STAT. § 608.431 (2008).

131. FLA. STAT. § 608.432(1) (2008).

132. FLA. STAT. § 608.432(2)(b) (2008). See FLA. STAT. § 608.433(1) (2008) (“Unless otherwise provided in the articles of organization or operating agreement, an assignee of a limited liability company interest may become a member only if all members other than the member assigning the interest consent.”).

133. *Olmstead v. FTC*, 44 So. 3d 76, 79 (Fla. 2010). See FLA. STAT. § 608.432(1) (2008) (“The assignee of a member's interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in the articles of organization or operating agreement and upon . . . [either] [t]he approval of all of the members of the limited liability company other than the member assigning the limited liability company interest . . . or [c]ompliance with any procedure provided for in the articles of organization or operating agreement.”).

134. FLA. STAT. § 608.433(4) (2008).

135. FLA. STAT. § 56.061 (2008).

136. *Id.*

137. *Olmstead*, 44 So. 3d at 80.

to the users.¹³⁸ The Federal Trade Commission sued the Appellants and their SMLLCs for unfair or deceptive trade practices.¹³⁹ During litigation, Appellants' assets and the SMLLCs, where either Olmstead or Connell had sole membership, were placed in receivership.¹⁴⁰ The FTC prevailed in litigation and obtained a judgment for injunctive relief of more than \$10 million in restitution, and an order compelling Appellants to relinquish all of their rights, title, and interests in the SMLLCs.¹⁴¹ On appeal, the Appellants argued that the sole available remedy against their SMLLCs' ownership interests is a charging order.¹⁴²

Conversely, the FTC argued that a statutory charging order remedy is not the sole remedy available to the judgment creditor of the owner of an SMLLC.¹⁴³ Faced with two statutory provisions allowing creditors to recover, the Florida Supreme Court had to decide if the charging order provision of the Act was an exclusive judgment remedy for creditors that always displaced other remedies available under the Florida law.¹⁴⁴ The court stated that the Act's charging order provision would be considered an exclusive remedy if it limited the application scope of prior Florida law.¹⁴⁵ By employing the laws of statutory interpretation, the court found that the Act's charging order was not an exclusive remedy.¹⁴⁶ The court found that nothing in the statutory language stated that the charging order was an exclusive remedy that creditors are allowed to utilize.¹⁴⁷ As a result, the Supreme Court of Florida held that under the Florida law it has the authority to order a debtor to surrender all of its right, title, and interest in the SMLLC to pay an outstanding judgment.¹⁴⁸

The *Olmstead* ruling again questions the ability of an SMLLC to

138. *Id.* at 78.

139. *Olmstead*, 44 So. 3d at 78.

140. *Id.*

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.* at 80 (stating that the court had to “decide whether section 608.433(4) establishes the exclusive judgment creditor’s remedy—and thus displaces section 56.061—with respect to a judgment debtor’s ownership interest in a single-member LLC.”).

145. *Id.* at 80–81 (“Since such an interest is freely and fully alienable by its owner, section 56.061 authorizes a judgment creditor with a judgment for an amount equaling or exceeding the value of the membership interest to levy on that interest and to obtain full title to it, including all the rights of membership—that is, unless the operation of section 56.061 has been limited by section 608.433(4).”).

146. *Id.* at 81.

147. *Id.* at 81–82 (stating that language of section 608.433(4) “does not in any way suggest that the charging order is an exclusive remedy”).

148. *Id.* at 83. See *FTC v. Peoples Credit First, LLC*, 621 F.3d 1327, 1330 (11th Cir. Fla. 2010) (holding “[w]here an LLC has only one member, no need exists to protect the interests of other members by restricting judgment-creditors to a charging-order remedy”).

protect its investor's assets. The *Olmstead* decision, which was upheld by the Eleventh Circuit Court of Appeals in *FTC v. Peoples Credit First, LLC*,¹⁴⁹ holds that a judgment creditor is not limited to a charging order to collect from the debtor's assets held in his SMLLC, and thus proposing creditors attempt new ways to go after the SMLLC's assets.¹⁵⁰ Effectively this means that an SMLLC's assets are subject to the claims of its owner's non-SMLLC creditors. SMLLC owners are worried because other courts may follow the *Olmstead* precedent.¹⁵¹

The *Olmstead* decision may have resulted from the fact that the SMLLC concept was created from multi-member LLC state legislation without considering its effect on the charging order provisions.¹⁵² As a result, *Olmstead* may have an unexpected consequence on owners of multi-member LLCs in the future because a judgment creditor may be able to assume their LLC membership interest rather than be limited to a charging order remedy.¹⁵³

V. SAFEGUARDING THE PROTECTIONS PROFFERED BY THE SMLLCS

Viewed together, the court rulings suggest that unless the owner takes proper safeguard measures, an SMLLC may fail to provide the intended protections for the debtor's assets,¹⁵⁴ and may not be a bankruptcy-remote entity. As indicated by the case law summarized in Table 1, the courts tend to treat an SMLLC as an asset of the

149. *FTC*, 621 F.3d at 1330 (stating “[w]here an LLC has only one member, no need exists to protect the interests of other members by restricting judgment-creditors to a charging-order remedy”).

150. Gardner F. Davis & Mary F. Kendrick, *Single-Member LLC Will Not Shield Debtor's Assets from Judgment Creditor*, FOLEY & LARDNER LLP, <http://www.foley.com/files/publication/ea1efec4-6da7-430f-9a2acbde0a85b18f/presentation/publicationattachment/182846ac-53ac-4e62-9948-d2395ff83078/americanbankruptcyinstitutejournal.pdf> (last visited Mar. 13, 2013).

151. *Id.* (noting that “[t]he Florida Supreme Court's majority decision in *Olmstead* that a judgment creditor of the sole member of an LLC is not limited to a charging order and may levy on the debtor's interest in the LLC will presumably lead to similar rulings in other courts”).

152. See Memorandum from Carter G. Bishop for Drafting Committee on the Harmonization of Business Entity Statutes (Sept. 23, 2010), available at http://www.law.upenn.edu/bll/archives/ulc/hobe/2010sept23_memo.pdf.

153. Alan S. Gassman, Christopher J. Denicolo & Thomas O. Wells, *Florida Supreme Court Surprises Practitioners With LLC Charging Order Opinion* (2010), available at <http://twellsawcom.web.siteprotect.net/wp-content/uploads/2010/11/FL-Supreme-Court-LLC-Opinion-Article-Nov.-2010.pdf>.

154. Davis & Kendrick, *supra* note 150, at 99 (noting that *Olmstead's* holding leaves SMLLC's questions the viability as an asset protection).

debtor that during the bankruptcy proceedings becomes property of the estate that a trustee can obtain, manage, and thereafter liquidate to satisfy judgment creditors. As demonstrated by *Olmstead*, traditional remedies may be expanded to accommodate creditors' interests and ability to recover their loans from the owner of an SMLLC.

Creditors will find the trend of court decisions favorable to pursue an SMLLC's assets. Because creditors know that SMLLC assets become property of the bankruptcy estate, thus improving chances of payment, they have an incentive to force an SMLLC's owners into bankruptcy. When uncertain about obtaining full recovery from a single-owner, creditors can also target single-owners' separate SMLLCs to enhance their repayments. Thus, investors should consider whether to use an SMLLC as their choice of entity as long as the law remains contradictory with some courts disregarding the corporate formalities of an SMLLC, and some courts treating their assets as property of the SMLLC's owner. Investors should also consider their financial viability and leverage with respect to the assets in the SMLLC. When bankruptcy is imminent, the owners can anticipate potential loss of control and management rights over their SMLLC and thereafter the sale of the SMLLC's assets by the court appointed trustee to satisfy creditor interests.

Investors who decide to use an SMLLC can adopt measures to safeguard their entity from a bankruptcy trustee's takeover. This can be achieved by enacting specific protection measures in the SMLLC's operating agreement or bylaws (together "operating documents"). The operating documents should adopt separateness covenants that mandate that the single-owner and SMLLC keep separate books and records at all times, maintain separate financial statements, prohibit commingling of any funds and documents, pay any liabilities from separate accounts, observe all organization formalities, always conduct business in own name, represent self and SMLLC as separate and distinct entities, conduct transactions at arm's length with any affiliates and third parties, and avoid lending and borrowing transactions between each other.¹⁵⁵

To enhance its protection, the sole owner should also prepare the SMLLC's operating documents to prohibit any bankruptcy trustee from obtaining control and management rights over the SMLLC.¹⁵⁶ This can be accomplished by adding a section to the SMLLC's operating documents specifying that control and management rights over the SMLLC solely belong to its existing and identified member.

155. Goodman & Teich, *supra* note 62, at 22.

156. *Id.*

The operating documents should expressly state that the single-owner's bankruptcy filing has no effect on the SMLLC as an independent entity and provide for an exclusionary section stating that the bankruptcy trustee may never assume the control and management of the company, under any circumstances. In the event that an SMLLC files for Chapter 11 bankruptcy, the operating documents must explain that the SMLLC's member has a right to become its debtor in possession. This provision will require the bankruptcy courts to disregard or rewrite the SMLLC internal operating documents if it desires to hold for the bankruptcy trustee.

SMLLC may also increase its protection by having an option in its operating agreement to sell some of its interest for bona fide consideration to a non-debtor third party.¹⁵⁷ However, under the Uniform Commercial Code, the bankruptcy trustee has the authority to re-obtain property that was disposed because of custodial arrangement, preferential transfer, or fraudulent conveyance.¹⁵⁸ Thus, to minimize the risk of having the sale be reclassified by the trustee and thereafter rescinded by the bankruptcy court, the single member should conduct this transaction prior to court's rendering of charging order against SMLLC's owner and in advance of the bankruptcy filing.¹⁵⁹

Finally, a single owner can receive additional protection by converting an existing SMLLC to another state where the law expressly limits creditor's "exclusive remedy" to a charging order.¹⁶⁰ By forming an SMLLC in an owner-favorable jurisdiction where a charging order is the creditor's sole statutory remedy, the single-owner enhances protection against judiciary created remedies.¹⁶¹ Similarly, an SMLLC's operating documents may be amended to add a choice of law provision that will select the jurisdiction with law favorable to the single-owner.¹⁶²

157. Jacob Stein, *Building Stumbling Blocks: A Practical Joke on Charging Orders*, BUS. ENT. 28, 35 (Sep./Oct. 2006) (noting that "[a]ttorneys should caution their clients that if they are seeking to maximize their charging order protection, they should be forming multi-member LLCs or adding new members to existing LLCs").

158. See *United States v. Whiting Pools*, 462 U.S. 198, 205 n. 10 (U.S. 1983) (citing 11 U.S.C. §§ 543, 547, 548).

159. Jeffrey A. Zaluda, *Asset Protection for Professionals and Business Executives Tax Management Estates*, GIFTS & TRUSTS J. 125, 129 (Mar. 2005) (noting that addition of new members or transfer of assets should occur before bankruptcy avoidance provisions and fraudulent transfer laws become applicable).

160. Gassman, Denicolo & Wells, *supra* note 153, at 231.

161. *Id.*

162. Goodman & Teich, *supra* note 62, at 22.

VI. CONCLUSION

In conclusion, the SMLLC legal form is a useful corporate entity with favorable tax treatment and liability protection. It plays a significant role in transactions such as forming an LLC for a sole proprietor, corporate reorganizations, like-kind exchanges, or asset protection.¹⁶³ An SMLLC permits its solvent owners to retain full management and control rights, and practitioners believe that the use of SMLLC as an entity will continue to grow.¹⁶⁴ However, for single-owners to take full advantage of the SMLLC form, they need to heed the cautions implicit in recent legal developments and enact operating agreements and bylaws that can help prevent their loss of control and management rights if faced with a severe financial reversal.

163. See Pace, *supra* note 2, at 1–3, 8–9.

164. Pace, *supra* note 2, at 1.

Table 1: Summary of SMLLC Case Law

CASE	RESULT	CONSEQUENCE
<i>In re</i> Albright, 291 B.R. 538 (Bankr. D. Colo. 2003)	In Chapter 7 bankruptcy, the debtor's interest and rights in SMLLC passed to the bankruptcy estate where the Trustee became a substituted member and obtained the management rights.	A SMLLC is not a bankruptcy-remote entity. The bankruptcy trustee obtains control and management rights of SMLLC and thus has the authority to sell SMLLC's assets and distribute the proceeds to the creditors of SMLLC's owner.
<i>In re</i> Desmond, 316 B.R. 593 (Bankr. D.N.H. 2004)	On the date of Debtor's filing for Chapter 11 bankruptcy, his SMLLC became property of the bankruptcy estate. Court did not recognize that Debtor had the right to manage or control SMLLC after the bankruptcy filing.	A SMLLC becomes property of its owner's Chapter 11 bankruptcy estate allowing creditors to pursue its assets for recovery.
<i>In re</i> A-Z Electronics, 350 B.R. 886 (Bankr. D. Idaho 2006)	Debtor in Chapter 7 bankruptcy lacked the authority to file Chapter 11 bankruptcy on behalf of his SMLLC because as personal property it was part of the Chapter 7 bankruptcy estate.	A SMLLC becomes property of its owner's Chapter 7 bankruptcy estate allowing creditors to pursue its assets for recovery.
<i>In re</i> Modanlo, 412 B.R. 715 (Bankr. D. Md. 2006)	Trustee had the power to revive previously dissolved SMLLC, to file Chapter 11 bankruptcy on its behalf, and to obtain management rights over SMLLC.	A dissolved SMLLC may be revived by the bankruptcy trustee to accommodate creditor ability to recover against the single-owner.

Case	Result	Consequence
Cognex Corp. v. VCode Holdings, Inc., 2006 WL 3043129 (D.Minn. 2006).	Held that the parent corporation and SMLLC subsidiary had essentially the same management. In applying the multi-factor test under Illinois law, the court found that SMLLC was its parent's alter ego and allowed the plaintiff to pursue its claims against SMLLC.	Uncertainty in the law permits courts to design its own alter ego tests. If the court determines that an SMLLC is merely an alter ego its corporate parent, it may disregard SMLLC's corporate form for the benefit of the creditors.
Olmstead v. FTC, 44 So. 3d 76, 2010 Fla. LEXIS 990 (Fla. 2010)	Charging order was not an exclusive creditor remedy. Court found that it had the authority to order a debtor to surrender all of its right, title, and interest in the SMLLC to pay an outstanding judgment.	Judgment creditor is not limited to a charging order to collect from the debtor's assets held in his SMLLC. SMLLC's assets are subject to the claims of its owner's non-SMLLC creditors. Allows creditors to apply new legal grounds besides the charging order to recover payments from SMLLC's owner.