

Understanding the Liquidation Value of Membership Interests in Limited Liability Companies

Before relying on a borrower or guarantor's membership interest in a limited liability company ("LLC") to enter a lending relationship, a lender should first understand how those LLC interests will be "liquidated" in the case of a default.

While LLC interests and cash flows may appear valuable on paper (i.e. financial statements, etc.), proper due diligence into the LLC's structure and the rights granted to LLC members – and their creditors – can paint a different picture.

LLC Structure and Charging Orders¹

An LLC is a business-friendly entity choice; it offers the benefit of shielding the LLC's members from liability for company debts and provides potential tax advantages. Although direct creditors of the LLC may attach a levy on the LLC's assets to satisfy a judgment or debt, individual members of the LLC are normally immune from liability for the LLC's debts. Likewise, LLC laws are designed to prevent the debts of the LLC's members from becoming liabilities of the LLC.

As a general rule, an LLC member's creditors may only execute against that member's "economic" interest in the LLC to satisfy that individual's debts. Unless there is an agreement to assign or a pledge of the member's interest, a lender must first obtain a judgment against the LLC member/obligor and then can execute on the membership interest by way of a charging order. However, the member's "non-economic" interests – i.e. rights to vote, inspect company records, manage, etc. – are not typically subject to execution through a charging order.

Charging orders are creatures of state law and, as such, vary from jurisdiction to jurisdiction. However, charging order statutes and procedures are basically the same in most jurisdictions throughout the United States. The creditor obtains an order from the court and, once properly served, the charging order acts as a lien on the economic interest of the debtor – requiring that any LLC distributions be made to or for the benefit of the judgment creditor until the judgment is satisfied.

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For the third consecutive year, Shapiro Sher Guinot & Sandler has been named the top medium-size law firm in Maryland for Business & Transactions by Super Lawyers, a division of Thomson Reuters. The firm represents clients in numerous practice areas, including banking, bankruptcy, corporate, real estate, and commercial litigation.

The firm's banking lawyers provide experienced counsel in connection with all aspects of commercial loans. Chaired by **Scott W. Foley**, the firm's **Banking & Financial Services Group** represents regional and community banks, credit unions, finance companies, pension funds, and other financial institutions in Maryland and throughout the Mid Atlantic.

The banking group advises financial institutions in commercial lending transactions; it also advocates for financial institutions in commercial loan workouts, restructurings, and bankruptcy proceedings. Because the group has extensive experience in the origination of loans and in workout situations, it is prepared to provide efficient representation at every stage in the commercial lending process. With decades of experience in the banking industry, Mr. Foley and the firm's other seasoned banking attorneys appreciate the potential hazards facing clients in the commercial loan process, and strive to protect lenders' interests throughout the lifecycle of the loan.

For more information, contact Mr. Foley at SWF@ShapiroSher.com.

Common Problems and Pitfalls with Charging Orders

The purpose of the charging order can be subverted by managing members of an LLC who neglect (willfully or otherwise) to make distributions while the charging order is in place. This practice – and similar tactics – are more common in closely-held LLCs. Given that the judgment creditor only has the rights of an assignee to the judgment debtor's economic interest in the LLC, the creditor may not be able to force distributions and can effectively be left without a remedy.

The amount of pressure the judgment creditor is able to exert – within the guidelines of the applicable state charging order statute or rule of procedure – is left to the court's discretion. Some courts may provide the judgment creditor the ability to obtain financial information from the LLC even though the charging order only attaches to economic rights. However, absent some type of fraudulent conduct, courts are hesitant to allow any direct action against the LLC's assets.

In order to force a resolution to charging orders where the amounts being distributed will not satisfy the judgment in a reasonable span of time, some LLC statutes provide that the member's economic interest is subject to foreclosure sale. However, as previously discussed, the member's transfer/forfeiture of their economic interest will not necessarily result in the purchaser receiving the non-economic interests too. Because the assignee/foreclosure purchaser does not receive the member's non-economic rights, there is often a limited pool of potential purchasers willing to pay for only the economic membership rights in the LLC. Even if the LLC is financially strong, it is difficult to value a membership interest when you have no guarantee that the LLC will make timely distributions.

Depending on the state charging order statute, and the language in the LLC operating agreement, a lender can determine in advance what issues may arise if it is forced to resort to a charging order, and can modify expectations of value associated with a membership interest accordingly. For example, Maryland passed legislation allowing LLC's to modify their operating agreements to prevent a judgment creditor from foreclosing on a member's economic interest in an LLC. Such intricacies can create complications for lenders.

Alternatives to Charging Orders

If potential complications associated with charging orders are identified in advance, lenders can strategize around them. Obtaining a pledge or assignment from the obligor prior to closing, together with consent from the LLC members to this assignment, is a viable alternative to avoid the uncertainty attendant with charging an LLC membership interest.

In most instances, applicable law and a well-drafted LLC operating agreement will prevent an LLC member from transferring anything greater than the member's economic rights without consent of all of the members. Obtaining the required consents should be relatively simple in single members LLCs, but can be problematic in multi-member LLCs. Even if the obligor is willing to pledge all of his or her rights in the LLC, many LLC members are leery of giving voting, inspection or management rights to a third party. Unless the borrower/member has sufficient clout within the LLC or is able to provide some value to the LLC members, a full economic and non-economic rights assignment may not be possible.

The potential for such problems should be identified and dealt with pre-closing. Given the many contingencies involved in obtaining funds from economic interests in an LLC, lenders are prudent to review LLC operating agreements and relevant state laws in advance when relying on the value associated with LLCs in making a loan.

For more information about this or other banking law matters, please contact Scott W. Foley, Chair of the Shapiro Sher Banking & Financial Services Group, at swf@shapirosher.com.

¹Though the focus of this newsletter is on charging orders and LLCs, it is worth noting that many states have similar laws in place regarding other limited liability entities, such as limited partnerships.