

SINGLE MEMBER LIMITED LIABILITY COMPANIES AND FINANCIAL DISTRESS¹

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Many small business owners form a limited liability company (“LLC”) as the structure of their business as it provides the tax benefits of a partnership with the liability protection of a corporation. Creation of an LLC occurs by drafting, approving and filing articles of organization. The powers and duties of the LLC and its members are established by an operating agreement. Kentucky law broad discretion in establishing how an LLC operates through its treatment of operating agreements, specifically that the “maximum effect” should be given to the right of freedom to contract and enforcing the terms of operating agreements. KRS 275.003(1).

But what happens when the owner of a single member LLC encounters financial hard times? Most operating agreements don’t specifically address such circumstances, and while Kentucky law provides some rules, individuals should “plan for the worst” and consider including provisions in an operating agreement which would help a single member LLC survive hard times, or wind down its business in an orderly fashion.

First, some basic concepts about LLCs which are often overlooked. Property transferred to or acquired by the LLC is not owned by the member, but by the LLC. KRS 275.240. Take the time to document whether the individual or the company owns property. If an individual owns property that is used by his or her LLC, create a lease or other document to establish the terms of use. Avoid the risk that a creditor will claim your property belongs to the LLC (or vice versa) when they attempt to collect a delinquent debt.

The owner of an LLC has an “interest,” instead of stock (for a corporation). An interest in an LLC is personal property. KRS 275.250. Regardless of what type of property the LLC may own, your interest in the LLC is personal property, which has consequences if financial distress knocks on your door.

Owners of single member LLCs often pay personal expenses directly from LLC income. If times get tight and creditors discover company income went to pay living expenses instead of company debts, they are more likely to make a claim against the member, not just the LLC. Kentucky law imposes restrictions on making distributions from an LLC. If a distribution would result in the LLC not being able to pay its debts as they become due or cause its assets to be less than its debts, the distribution is prohibited. KRS 275.225(1). However, the same law provides that “reasonable compensation for present or past services” is not a distribution. KRS 275.225(7). Insulate yourself from allegations of illegal distributions by paying yourself a salary or other reasonable compensation for your work.

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Can you sell some or all of the assets of an LLC to satisfy creditor claims? Property which is subject to a lien in favor of a creditor cannot be sold without that creditor's consent (exceptions may exist for the regular sale of inventory or the use of receivables to pay operating expenses). Otherwise, Kentucky law allows for such sales on terms established by the member(s). KRS 275.247(1). It is not unusual for a business owner to forget exactly what a creditor has a lien against a few years after a loan was made and if there are more debts than assets, how you spend the sale proceeds could create more problems than it solves. Consult an attorney or financial restructuring expert to assist with such issues.

May a creditor can try and satisfy a judgment against the member of an LLC by selling the member's interest in the LLC? Ultimately, yes. While most operating agreements restrict the ability of anyone who tries to voluntarily sell or transfer an interest in an LLC, Kentucky law provides that the exclusive remedy for the creditor of a member in an LLC is a charging order against the member's interest. KRS 275.260. A charging order allows the creditor to receive any distributions the member would normally get, but doesn't give the creditor the right to vote or exercise any other rights that accompany an interest. A court may also allow a creditor to foreclose upon, or sell, the interest of a member to satisfy the creditor's judgment. Such a sale would result in the new owner of the interest being in control a single member LLC.

Should you consider bankruptcy for your LLC? Or maybe you need to consider a personal bankruptcy? The answer to these questions depends on many factors, including how effectively you have separated the debts and assets of the LLC from your individual debts and assets. Most lenders who will make a loan to a single member LLC will insist on a personal guarantee so the owner ends up with the debt, even though the LLC owns the assets.

Even though you own 100% of an LLC, the law treats it as a separate person. An LLC will have to have an attorney represent it in court. *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289 (Bankr. N.D. Ohio 2001). If you decide to file bankruptcy personally, the LLC is not protected, and creditors could choose to continue collection attempts against the LLC. *In re Calhoun*, 312 B.R. 380 (Bankr. N.D. Iowa, 2004).

What happens to a single member LLC when its owner files for bankruptcy? Any property an individual owns becomes part of a bankruptcy "estate" when a case is filed. In most cases, a trustee is appointed who has the right to control what happens with property of the estate. That includes whatever rights you have as a member of the LLC. *In re Albright*, 291 B.R. 538 (Bankr. D. Colorado 2003). So, a bankruptcy trustee could become involved in operating a single member LLC, decide to sell its assets, or otherwise take control of the LLC from the individual member.