

When It Comes to LLCs, Pay Attention to Liability Direction

By Paul Chmielecki

Limited liability companies (“LLCs”) have become popular entities for conducting a wide variety of business and investment activities. Most people understand that LLCs shield an LLC member’s personal assets from liability arising from the conduct of LLC business activities. For example, if a supplier successfully sues an LLC, the vendor is generally limited to collecting from the assets owned by the LLC. In other words, the vendor cannot go after the non-LLC assets owned by the LLC members. This can be referred to as upward liability protection because it shields a creditor from going up through the entity to the individual owner.

Unfortunately, many business owners never consider the impact that their personal actions can have on their business operations and assets. If a business owner is sued due to actions arising from his or her personal activities, the business owner’s creditors may be entitled to attach the assets of the business and/or the owner’s interest in the business to satisfy their judgment. This type of liability can be referred to as downward liability because creditors may be able to reach down into the owner’s unrelated business assets to satisfy the judgement.

Both S corporations and C corporations provide upward liability protection to a business. However, with one limited exception, these entities do not provide downward liability protection.¹ In many states, the same is true of single member limited liability companies (“SMLLCs”).² As a result, a business owner that utilizes these entities to conduct business operations can lose his or her business assets to creditors for liability arising from personal actions.

Fortunately, there is an alternative. A multimember limited liability company (“MMLLC”) can be used to provide a shield from both upward liability and downward liability.³ Although the downward liability protection afforded by these entities is significant, the protection is not absolute. When an MMLLC is involved, creditors are generally only entitled to receive a “charging order” to satisfy their personal claims against the business owners. A charging order does not allow creditors to seize assets owned by a member’s LLC interest. Instead, a charging order merely enables a judgment creditor to receive distributions, if any, made from these entities to the individual owner who is liable to creditors. Because a charging order cannot be used to force distributions to be made from an MMLLC, creditors of the members of MMLLCs are not able to obtain control of the entity’s business operations or assets. Thus, in contrast to creditors of S corporations, C corporations, and SMLLCs, a charging order provides limited relief to a creditor. Creditors holding charging orders may also be subject to negative tax consequences, which provides further disincentive to pursue that option.

Despite the ability of SMLLCs to provide downward liability in most states, SMLLCs are often used in conjunction with MMLLCs as part of an overall plan that segregates liability to assets of a specific SMLLC while achieving downward liability protection through the overlying MMLLC. This is accomplished by creating an MMLLC, which in turn is the sole owner of one or more SMLLCs. For example, a person may create separate SMLLCs to own each separate piece of rental real estate he or she owns. This segregates the liability of each SMLLC to the single piece of real estate owned by that SMLLC. Creditors of one SMLLC will not be able to obtain control of the assets of any of the other SMLLCs (i.e., segregated upward and lateral liability protection). At the same time, the overlying MMLLC provides downward liability protection for the members owning the MMLLC.

Another benefit to using SMLLCs in conjunction with MMLLCs is because, for tax purposes, SMLLCs are disregarded and do not have to file their own tax return. Instead, all income from SMLLCs is reported on the tax returns of the

overlying MMLLC. As a result, only one single tax return is required to be filed regardless of the number of SMLLCs owned by the overlying MMLLC. In contrast, every MMLLC is required to file its own separate tax return.

When properly structured, the use of SMLLCs in conjunction with an MMLLC provides important upward and downward liability protection benefits while reducing the number of tax returns that need to be prepared.

If you would like to have a conversation about your asset protection strategies, or review whether your LLCs are properly structured, click [here](#) to contact us.

¹ Nevada has enacted legislation extending downward liability protection to corporations.

² Some states have enacted legislation providing downward liability protection to SMLLCs. These states include Wyoming, Alaska, Delaware, South Dakota, and Nevada.

³ An MMLLC is simply an LLC with two or more members.

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