

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND FINANCIAL PROFESSIONALS**

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***THE THREE "SECTION 47 PROTECTIONS" –
THE KEY DISTINGUISHING FACTORS
BETWEEN LLCs AND CORPORATIONS***

A Plain-English Explanation for Non-lawyers

Dear Colleagues:

I want to devote this issue of my LLC newsletter to certain critically important LLC legal features provided by the New Hampshire LLC Act. (Similar features are provided by all other LLC acts except those of Nebraska and Pennsylvania.) In my experience, these features are understood by almost no New Hampshire business people, by relatively few New Hampshire CPAs and other New Hampshire financial professionals, and indeed, by only a small portion of New Hampshire business lawyers.

I'm referring to the three protections provided under Section 47 of the New Hampshire LLC Act.

Section 47 provides, in essence, that if an LLC member in his or her personal capacity incurs a judgment on a debt incurred outside the LLC's business and fails to satisfy the judgment by paying the debt, the judgment creditor can obtain from a court a "charging order" that will require the LLC to pay to the creditor any distributions that it would otherwise pay to the debtor-member. (Distributions mean amounts paid to LLC members simply because they are members and not because of any services they render to or on behalf of their LLC.)

EXAMPLE. John Doe is the 51% owner of Doe Construction, LLC, a construction company with receivables, equipment and other assets worth \$5 million. John's wife Mary has a 49% ownership interest in John's LLC. On February 1, 2004, John is driving his car on purely personal business when, accidentally but negligently, he runs over and kills Bob Smith, M.D., a brain surgeon. Bob's estate obtains a judgment of \$10 million against John, which vastly exceeds John's automobile insurance coverage. In these circumstances, Section 47 authorizes Bob's estate to obtain a charging order against the Doe LLC. If, after it has obtained this order, John's LLC makes any distributions intended for John, these distributions must go instead to Bob's estate.

However, Section 47 provides not only that judgment creditors of members of multi-member LLCs can obtain charging orders against these LLCs. It also implicitly provides that

these charging orders are the ONLY relief that the creditors can obtain with respect to the LLC. Thus, as explained in the bullet points below, Section 47 implicitly provides three quite separate and but closely related types of protection for members of multi-member LLCs. And each of these types of protection can be of tremendous practical importance to these owners.

- Protection of debtor-member's ownership of his or her LLC management rights. First, Section 47 protects LLC debtor-members from losing their LLC management rights to judgment creditors. This means, in the above example, that John Doe will retain his LLC voting rights, information rights, agency right (i.e., his right to sign LLC contracts) and dispute resolution rights, and that all of these rights will be beyond the reach of Bob's estate.
- Protection of non-debtor members from unwanted new co-member. Second, Section 47 protects the non-debtor members of multi-member LLCs in which one of the members is in default on a personal debt from having to accept the debtor-member's creditor as a new and unwanted member of their LLC. In the above example, this means that Mary will not have to accept Bob's estate as a new (and controlling) member of the Doe LLC.
- Protection of LLC business assets. Third, assuming – as in the above example - that the LLC debtor-member in default is the controlling member, Section 47 protects all of the members (including both the debtor-member and the NON-debtor members) from the judgment creditor's being able to force the sale of the LLC's assets in satisfaction of the debtor-member's debt. This means that the debtor-member and the non-debtor members can continue to operate the LLC's business as a going concern. It also means that although the debtor-member will no longer be able to obtain a share of LLC distributions, he or she can still obtain a salary or guaranteed payment for services rendered to or on behalf of the LLC. Under the right circumstances, this salary or guaranteed payment can be a substantial equivalent of the debtor-member's LLC distributions.

In seminars that I teach to CPAs, EAs, lawyers and business people, I often make the statement that most new corporations are mistakes – they should have been LLCs. And I routinely assert in these seminars that many existing corporations should convert to LLCs.

There are many legal and tax reasons why I believe these statements are true. However, for most business owners, the biggest reason of all is Section 47. There is no provision in the New Hampshire Business Corporation Act or in any other corporate statute that provides any of the three legal protections provided by Section 47. This fact alone (not to mention other legal reasons and a host of tax reasons) makes LLCs preferable to corporations for most business owners.

If you have any questions about Section 47 or about any other LLC legal or tax features, please feel free to contact me by phone at (603) 228-0125 or by e-mail at lawjmc@comcast.net.