Foreclosure and Dissolution Rights of a Member’s Creditors: No Cause for Alarm

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A recent article in this magazine by Elizabeth M. Schurig and Amy P. Jetel entitled The Alarming Potential for Foreclosure and Dissolution by an LLC Member's Personal Creditors, Prob. & Prop., May/June 2006, at 42, raised the specter that a judgment creditor of a member of a limited liability company (LLC) might apply for a charging order, obtain it, persuade the court to order foreclosure on the membership interest subject to the charging order before the charging order is redeemed, be the successful bidder at the foreclosure sale thereby becoming a transferee, petition the court for involuntary judicial dissolution of the LLC, and, finally, persuade the court to order an involuntary dissolution in conformance with the statutory prerequisites—all without regard to the consequences of such an order on a potentially successful business, its other members, employees, and creditors.

Even the threat of judicial dissolution could force a sale of the entity's assets or require the other members to purchase the interest at the foreclosure sale or from the purchaser at the sale at an inflated price. Any realistic possibility of judicial dissolution would therefore represent a serious threat to the "asset protection" goals of using an entity's separate existence to insulate personal assets from the reach of that member's creditors. Moreover, either event would be highly disruptive to the successful continuation of the LLC's business. If the consequences of the threat are more than a theoretical

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risk, they represent a serious impediment to the use of the LLC entity form.

The central difficulty with the previous article is that consummation of the threat requires the completion of multiple events, each with independent significance. The sequence of events becomes increasingly unlikely as they cascade toward the rarely granted remedy of judicial dissolution of an otherwise successful business simply because a member incurred an unrelated debt.

Statutory and equitable judicial dissolution remedies exist for all business entity forms and for good reason; they protect an owner from the fraudulent or nefarious behavior of other owners. Judicial dissolution remedies for owners (shareholders or partners, for example) have existed for over a century and yet are asserted rather sparingly by full owners and, further, rarely granted by a court to disrupt a profitable business enterprise. See Alan R. Bromberg & Larry Ribstein, *IV Bromberg and Ribstein on Partnership* § 17.06(e)(3), at 17.70.

Although judicial dissolution rights of business owners are rarely granted, similar rights of an owner’s transferee are even more constrained. Generally speaking, unincorporated entity law uniformly provides that a member’s transferee may not exercise any of the member’s rights to participate in management including, under many statutes, the statutory right to petition for judicial dissolution. Accordingly, there is, in fact, no cause for alarm.

**Rights: A Comparative Introduction Across Entities**

The place to start the analysis is the rights of members themselves. Every form of business entity permits the owners to agree unanimously to dissolve the entity, sell the assets, and distribute the net proceeds. See, e.g., RULLCA §§ 404, 701, 702. The motives of the owners are irrelevant because they act in concert and without oppression. A disquieting opportunity of menace, however, lurks in this unanimous sanctuary. A malcontent or obstreperous owner could cause harm and heartache to the other owners but withhold its consent to dissolution, trapping the other owners on a sinking ship. As a result, first equity and then law granted the trapped and aggrieved owners the sanctity of an involuntary dissolution of the entity ordered by a court, but only after a fair hearing to determine whether the business should continue under the circumstances. See Model Business Corporations Act (MBCA) § 14.30, off. cmt. (b).

In the corporate context, and absent contrary agreement, a shareholder can transfer stock to any person it chooses, and the transferee of the shares is a shareholder, has all of the rights of any other shareholder, and may petition a court to dissolve the entity. If an individual shareholder’s judgment creditor receives the shares in satisfaction of a debt, the creditor becomes a shareholder and, as such, has the ability to move for dissolution.

An unincorporated entity is different. Absent contrary agreement, an owner of an unincorporated entity may not transfer the full ownership right to another without the approval of the other owners. The law of these organizations presumes a close personal association from conception, and state statutes provide that economic rights are freely transferable but that governance rights are nontransferable. Uniform Partnership Act (UPA) § 27(1); RUPA § 503(a)(3); Uniform Limited Partnership Act (ULPA) (1985) § 702; Uniform Limited Liability Company Act (ULLCA) § 502; ULPA (2001) § 702(a)(3); RULLCA § 502(a)(3)(A).
LLCs and other unincorporated entities, therefore, have an initial advantage over corporations in the entity selection calculus in the closely held or asset protection context because the transfer of an ownership interest does not make the transferee a member by operation of law. For the purposes of this article, that difference is most important when the transfer is to satisfy the judgment debt of an individual member. See Jay Adkisson & Christopher Riser, Asset Protection 217 (2004).

The table on page 36 contains comparative information about the rights of creditors and transferees across business organizational statutes. In using the table, recall that transferees of corporate shareholders become shareholders themselves. As a result, corporate law is referenced only in a limited way. Determining whether the menu of rights is entirely rational as it varies across business forms is beyond the scope of this article. The chart serves only as background for the limited purposes of this article.

As the table suggests, both creditors of the entity and transferees of ownership interests have a limited menu of statutory rights. These limited rights of creditors and assignees seem reasonable in the broad context of the different types of unincorporated entities. Illustratively, creditor enforcement of contribution obligations is understandable when one considers that “paid in capital” forms a basis on which credit is extended and, in part, on which credit is priced. Transferee rights for oversight of winding up protect the reasonable expectation of receipt of liquidating distributions.

None of the uniform acts provides assignees interim oversight or accounting rights for interim distributions. As such, during the period the partnership/LLC is operating, the transferee is not provided information on the operations leading to the distributions. Restricted information rights do exist for transferees but only when active business operations have terminated and the partnership/LLC is in the winding up phase. See, e.g., RUPA § 802(a); ULPa § 803(a); RULLCA § 502(a)(3)(B).

Further, under most current unincorporated entity statutes, the transferee of an owner, unlike the owner, does not at law have the statutory right to petition for judicial dissolution of the entity. For example, in a limited partnership, only general and limited partners typically have the right to apply for judicial dissolution, and transferees do not have a similar statutory right. RULPA § 802; ULPa (2001) § 802. Likewise, in a term (but only in a term) general partnership, only partners have the statutory right to apply for judicial dissolution. UPA § 32(1); RUPA § 801(5). There is an exception to the “partners only” rule for a term general partnership when it extends beyond its term. Under those circumstances a transferee has the right to seek judicial dissolution. UPA § 31(2)(a); RUPA § 801(6)(i). More importantly, however, transferees of an interest in an at-will general partnership have the statutory right to seek judicial dissolution only when it is “equitable” to dissolve the partnership. UPA § 31(2)(b); RUPA § 801(6)(ii).

ULLCA (1996) carried over the at-will and term distinction from the law of general partnerships, including the rights of transferees to apply for judicial dissolution (as constrained by the equitable standard). ULLCA § 801(5). It is important to note, however, that ULLCA (1996) was adopted in eight states, and there was departure from the at-will and perpetual distinction; thus, it is arguable that criticisms relating specifically to ULLCA (1996) should form the primary basis for the larger debate.

Even under UPA, RUPA, and ULLCA (1996), the application of the dissolution provisions requires equitable reasons. UPA was silent on this point, but the context of the grounds for granting judicial dissolution clearly implied the necessity of equitable grounds in that RUPA § 801(6) and ULLCA § 801(5) expressly limit a transferee’s right to obtain judicial dissolution subject to a showing of equitable grounds.

ULLCA (2006) places a greater limitation on the right to seek judicial dissolution than ULLCA (1996). Judicial dissolution may only be sought by a “member” and, for these purposes, “member” does not include a “dissociated member.” ULLCA § 701(a)(5). The order to dissolve is limited to circumstances that are similar to those for judicial dissolution of a corporation; that is, when the conduct of the entity is unlawful (ULLCA § 701(a)(4)(A)); it is not reasonably practicable to carry on the entity’s activities in conformity with the certificate or the operating agreement (ULLCA § 701(a)(4)(B)); the managers or members in control have, are, or will act in an illegal or fraudulent manner (ULLCA § 701(a)(5)(A)); or the managers or members in control have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant (ULLCA § 701(a)(5)(B)). In all cases, the court is granted authority to enter a remedy other than dissolution (ULLCA § 701(b)).

Moreover, ULLCA deleted the “equitable” language of ULLCA. Do transferees have such an extra-statutory right to obtain dissolution in equity? And, if so, is such an equitable right so destabilizing to entity continuance that this particular entity form is undesirable? The possibilities are troubling, particularly when the creditor of an owner can foreclose on the ownership interest and petition for involuntary judicial dissolution like under the old ULLCA. After all, a creditor is uniquely disinterested in the prospect of rewards.
attributable to risk sharing and particularly interested in the entity's assets as a liquid resource of repayment of its loan. First, the concern is not unique to RULLCA. Second, even under these troubling circumstances, there is need only for caution, and not alarm, because the judgment creditor's journey is long and tortured, and the risk is neither a new nor novel one to LLCs. After all, the general equity power of courts would apply consistently to all types of entities.

More Than One Concern: Beware of Unintended Consequences

The primary "alarm" identified in the previous article to which this article responds is that a member's creditors may move for judicial dissolution of the LLC. It may be helpful to recall where the former judgment creditor stands at the time it seeks this outcome. It is not a transferee by reason solely of being a creditor of a member and, to the extent the interest is purchased by the creditor at a foreclosure sale, it is no longer a creditor of the member/partner (or former member/partner). Thus, the issue needs to be considered in the light of all transferees. Should the unique case of the plaintiff transferee (who is a former holder of a charging order, the foreclosure purchaser, and who is seeking judicial dissolution) be used to justify a "no judicial dissolution by transferee rule" in all cases? Transferee status arises, after all, in other contexts such as (1) the interest of the surviving spouse of a member of a two-member LLC who finds all of the income diverted to the remaining member or (2) a family member who has "gifted" transferee rights in a family business. These other contexts raise concerns beyond pure asset protection. For example, without some rights, whatever they may be, what is the current value of an interest for a member or a transferee for wealth transfer planning purposes?

The idea of "cabining" creditor rights within the charging order remedy nonetheless is an important one for operational certainty and for asset protection planning. The statutory language stating that charging orders and foreclosures are the "exclusive remedy" for the judgment creditor plus the existence of the careful and limited statutory scheme for foreclosure and redemption may be helpful and necessary to cabin the rights of a creditor of a member in an ascertainable way. See, e.g., RULLCA § 503.

Indeed, one reason for providing a comprehensive statutory scheme is that, absent such limitations (or alternatives), courts are left with the creditors' remedies under general creditor rights statutes or are invited to fashion unique remedies under the true power in equity. For example, a real property mortgage treatise published in 1904 stated: "When [statutory] provisions in detail are made on this subject, they are generally founded on principles and rules of practice already established by courts of equity under the general jurisdiction they have always exercised on the subject; and the powers of these courts are only enlarged and defined by the statutes." Leonard A. Jones, 3 Jones on Mortgages § 1443, at 1 (7th ed. 1904). The same treatise stated that the appointment of a "receiver of the rents and profits," too, is a matter of equity. A treatise on British real and personal property mortgages, published in 1857, stated that the right of redemption is "an equitable process." William Richard Fisher, The Law of Mortgage (1857), at 32. Thus, the fact that the acts address details like redemption and the appointment of receivers helps to define and cabin those traditionally equitable concepts within the statute and to avoid the greater uncertainty caused by a court's recourse to its general equitable powers outside the statute.

This seems particularly relevant because it appears to be an open question (at minimum) whether the grant of general equity power in a given state's constitution is necessarily or constitutionally limited even by the "exclusive" language of a statute that may be, in fact, an attempt to strip a court of that power. To reiterate, it may be important for a court to be able to find a statutory procedure that provides a comprehensive statutory structure lest it be tempted to engage its general equitable powers. Moreover, restricting the rights of a judgment creditor "too much" may have the unintended consequence of increasing the pressure to use equitable orders. Use of such power may cause an undesirable and unpalatable result for the judgment debtor member but one with possibly catastrophic consequences for the entity and the other members.

A different negative scenario that might result from pushing and paring charging order remedies "too far" at the level of policy is that it might lead to the judicial expansion of other remedial doctrines, like notions of fraud, that are not as statutorily cabined or even as certain as the statutory provisions on charging orders and foreclosures. Finally, some small risk probably exists that judgment creditors and their allied interests could push back politically and champion legislation far less restrictive than that which currently exists. All these reasons suggest that the single-minded pursuit of maximizing asset protection goals in an unincorporated entity act might create a larger problem than it seeks to solve.

Back to the Sequence of Events: Creditor "Ownership," Charging Order to Foreclosure, and Beyond

The pathway to foreclosure in unincorporated business organizations is sequentially ordered through the charging order. Stated in the negative: no charging order, no foreclosure, at least
by a judgment creditor. In turn, no fore-
closure sale, no transferee.

The charging order affords the judg-
ment creditor of a partner/member
(not the creditor of the entity) the right
to receive the distributions made to
that partner/member until such time
as the judgment is satisfied. As origi-
nally crafted, this limited right served
to protect the business organization
from the disruption that would follow
from the judgment creditor seeking to
take possession of that portion of the
business organization’s property that
“belonged” to the judgment debtor. See
J. Gordon Gose, The Charging Order
Under the Uniform Partnership Act, 28
Wash. L. Rev. 1 (1953). It continues to
provide certainty for what are (and are
not) the rights of a partner’s/member’s
judgment creditor today even with the
entity treatment of unincorporated busi-
ness organizations and the effec-
tive elimination of any argument that
the partner/member owns a portion of
the organization’s assets. See, e.g.,
RUPA §§ 201(a), 203; ULLCA § 703;
ULLCA § 501(a); RULLCA § 503.

In addition, unincorporated entity
law has long contemplated that follow-
ing the entry of a charging order that
was left unsatisfied, a judgment credi-
tor could statutorily foreclose on the
interest. Early statutes were admittedly
oblique on foreclosure, stating only
that an interest could be “redeemed at any
time before foreclosure.” See, e.g., UPA
§ 28(2). Although, for limited part-
nerships, RULP § 703 did not expressly
contemplately foreclose, RULP § 1105
“linked” RULP to UPA for situations
not expressly covered in RULP. See
Elizabeth S. Miller, Linkage and
Delinkage: A Funny Thing Happened to
Limited Partnerships When the Revised
Uniform Partnership Act Came Along, 37
Suffolk L. Rev. 891 (2004); RUPA
§ 504(b); ULLCA § 504(b); ULP (2001)
§ 703(b); RULLCA § 503(c). Current
uniform acts all expressly authorize
foreclosure. In particular, RULLCA
§ 503(c) provides that a condition of
foreclosure is a showing that the charg-
ing order will not pay the judgment
within a reasonable time, demonstrat-
ing that foreclosure is an extraordinary
 equitable remedy. (A few states—
Delaware and Florida, for example—
have eliminated the right to foreclose
following issuance of a charging order,
but this elimination might increase
pressure on the court to expand the
judgment creditors’ rights under the
charging order itself. See, e.g., Jacob
Stein, Building Stumbling Blocks: A
Practical Take on Charging Orders, 8 Bus.
Entities 28 (Sept./Oct. 2006).)

The purchaser at foreclosure
acquires the member’s transferable
interest. Foreclosure and the creation of
a new transferee are not, however, fore-
gone conclusions when an owner finds
her interest subject to a charging order.
Foreclosure is not a unilateral right of
the judgment creditor; it must apply to
the court for foreclosure, and the court
may order foreclosure. Foreclosure is
ordered if and only if the judgment
creditor is able to demonstrate that
doing so is appropriate; for example,
when the interest in question yields lit-
tle current income and the judgment
will not otherwise be satisfied in a rea-
sonable period. See, e.g., FDIC v.
Birchwood Builders, Inc., 573 A.2d 182

Even when a court determines that
foreclosure is appropriate, the judg-
ment debtor, another member, or the
LLC may redeem the charged interest
before the foreclosure sale. UPA § 28(2);
ULLCA §§ 703, 1105; RUPA § 504(c);
ULLCA § 504(c); ULP (2001) § 703(c);
ULLCA § 503(d)–(e). In the typical
case, the reasonable economic expecta-
tion would be that, if the intrinsic value
of the interest exceeds the value of the
judgment, the interest will be
redeemed, and proceeds of the
redemption will be paid over to the
judgment creditor and the charging
order will be discharged.

When there is an order of foreclo-
sure and no redemption, the proceeds
of the foreclosure sale are paid first to
the judgment creditor in satisfaction of
the judgment, and any excess is paid to
the prior holder of the interest.

The purchaser at foreclosure
becomes a transferee (RUPA § 504(b);
ULLCA § 703(b)) and because the debtor
partner/member no longer owns an
economic stake in the business enter-
tprise, the member may be expelled or

problem comes dangerously close to
writing indirect and informal “put”
rights into the acts similar to those
provided by statute in RULPA (1976)/
(1985). Put rights were roundly rejected
on other policy grounds in, for exam-
ple, RULLCA (2006). Further, giving
nonmembers such “informal rights”
would give them greater rights than
members; or the suggestion of a valua-
tion mechanism for an interest might
provide an indirect two-step mecha-
nism for members themselves to exer-
cise put-like rights simply by becoming
friendly with a prospective judgment
creditor.

Though imperfect, redemption
under a limited set of circumstances does represent an opportunity for the entity or other members to “clean out” charging order holders and avoid future dealings with the member’s creditor. Moreover, the mere existence of a statutory redemption scheme may discourage courts from applying equitable redemption doctrines from other debtor-creditor relationships. Similarly, disfavoring the partnership or operating agreement even if those modifications have a negative effect on the transferees. See generally Bauer v. Blomfield Company/Holden Joint Venture, 849 P.2d 1365 (Alaska 1993). This reality prevents a transferee’s static rights from “freezing the deal” at the time a person becomes a transferee under the modern acts. Cf. RULLCA § 502, § 112(b) cmt.

A transferee is not in an enviable economic or legal position. There are good reasons for the holder of a charging order not to seek foreclosure and thereby become a transferee. For example, having foreclosed and purchased, the holder turned transferee will almost certainly be treated as a partner for federal income tax purposes and, as such, will be forced to recognize phantom income to the extent of partnership allocations irrespective of distributions. See, e.g., Thomas E. Rutledge, Charging Orders: Some of What You Ought to Know (Part II), 8 J. Passthrough Entities 21, at 21–22 (July/Aug. 2006). According to RUPA and ULLCA (1996), a transferee may only apply for judicial dissolution on showing that a term entity has extended business beyond the agreed term or it is “equitable” to wind up an at-will entity. RUPA § 801(6); ULLCA § 801(5); RULLCA § 112(b) cmt. Although it may be possible that a transferee could file such an application on general equitable grounds, this is not likely given that partners and members do not owe such persons any fiduciary duties. E.g., Bane v. Ferguson, 890 F.2d 11 (7th Cir. 1989). Even for partners and members, the statutory “equitable” threshold is high. For example, the fact that a particular entity may not generate sufficient distributions to satisfy a particular judgment does not evidence that it is impracticable to operate the partnership in accordance with its partnership agreement. Baybank v. Catamount Const. Co., Inc., 693 A.2d 1163 (N.H. 1997).

Further, the purchase of a transferable interest at a foreclosure sale and the determination of the purchase price are volitional acts of the purchaser with full knowledge of the limited rights afforded a transferee. It is the purchaser’s own pricing error if it pays too much for the interest at the sale. It is illogical that such volitional pricing decisions should implicate equitable remedies against the entity absent other material facts.

The remaining question therefore begins to sound rhetorical: given that partners and members do not owe transferees any fiduciary duties, under what, if any, facts may a transferee of a partner or member seek judicial dissolution? Even in the “full rights” corporate context of shareholder (owner) “oppression,” dissolution is not without limits. Indeed, a leading treatise states it is unlikely dissolution will be granted solely because the complaining shareholder has individual and personal financial problems. F. Hodge O’Neal & Robert B. Thompson, 2 O’Neal & Thompson’s Oppression of Minority Shareholders and LLC Members § 7.13 (rev. 2d ed. 2004) (Cum. Supp. 2006), at 35.

Theory May Be Instructive: The Two Sides of Limited Liability

Limited liability is a two-sided coin. The first side, and the one most often examined, provides that the owners, qua owners, are not liable for the debts and obligations of the business organization beyond their agreed investments therein. See, e.g., ULLCA § 303(a); RULLCA § 304(a)(2); MBCA § 6.22. This follows from the understanding that the business organization is a separate legal debtor. A counterbalance to the latter rule is the possibility of “piercing the veil” and holding the owners liable for the obligations of an impecunious business under certain circumstances. “Piercing” is based on equitable principles, though it is channelled by statute in some states.

The other side of the coin is that of asset partitioning, namely that the assets of the business organization are dedicated to its purposes and generally are not available to satisfy the creditors of the owners. This second side of limited liability exists for the benefit of the business organization’s creditors, assisting them in the pricing of credit through...
the knowledge that absent distributions (which may by contract be limited); capital, whether paid in or in accumulated earnings, will not be applied to satisfy creditors of the individual owners. A counterbalance to this rule is the “reverse pierce” wherein the assets of the entity are made available to meet the personal debts of an owner. See, e.g., Gregory S. Crespi, The Reverse Pierce Doctrine: Applying Appropriate Standards, 16 J. Corp. L. 33 (1991).

(Efforts to provide bulletproof asset protection may be frustrated through “reverse piercing,” especially if the asset transfer to the entity occurs after the judgment is secured and if the entity is a single-member LLC. See, e.g., Litchfield Asset Management Corp. v. Howell, 799 A.2d 298 (Conn. App. Ct. 2001).)

Both sides of the limited liability coin encourage efficient capital formation and economic activity through the formation of operating business entities. One side encourages equity investment while the other undergirds the availability of debt capital to the entity and, to a lesser extent, to the individual owner. Charging order schemes and remedies are at the edge between the two sides of limited liability and act as policy-switching mechanisms. As this article has implied, both “sides” need to be considered before proposing any changes solely to maximize one of many features of the existing comprehensive schemes.

**No Cause for Alarm: No Perfect Solution**

Any asset protection benefit enjoyed by the partner/member by reason of the charging order as it was originally crafted is entirely derivative of the asset partitioning that it supports. The holder of a charging order is not a transferee of the charged interest, and it does not have even the limited rights of a transferee under the latest versions of the uniform laws. Entry of a judgment against a partner/member does not automatically lead to the entry of a charging order. Even if the statute in question affords a transferee the right to petition for judicial dissolution, the holder of a charging order is not automatically a transferee and therefore does not have the right to petition for dissolution. And, as a practical matter, of course, other assets owned by the debtor-member (including insurance in the case of some tort liability) that can be immediately accessed and transferred to the judgment creditor will be preferred to the charging order and the consequent delay in receipt of satisfaction of the judgment.

The authors can find no published or unpublished court decisions involving a third-party judgment creditor who obtained a charging order, sought and obtained foreclosure, purchased the interest at foreclosure, applied for judicial dissolution, and was granted dissolution. Leventhal v. Five Seasons Partnership, 581 A.2d 449 (Md. Ct. Spec. App. 1990), is not such a case. The Five Seasons Partnership was dissolved in the course of the litigation between the partners. Furthermore, Maryland’s charging order provision at the time expressly allowed the holder of a charging order to seek judicial dissolution; it was not necessary that there be a foreclosure first. Moreover, with greater familiarity, courts seem to be interpreting the provisions more correctly. Prof. Daniel S. Kleinberger has brought to the authors’ attention the decision of Goldberg v. Winogradow, No. CV000993186S (Conn. Super. Ct. Oct. 12, 2006).

Finally, state law cannot preclude a bankruptcy trustee from stepping into the member’s shoes for purposes of administering the bankruptcy estate of the member and attempting to exercise the member’s right to seek judicial dissolution. Thus, state law alone cannot reduce the risks associated with federal bankruptcy law. See, e.g., Thomas Earl Geu & Thomas E. Rutledge, Guess Who’s Coming to Dinner?: The Bankruptcy Trustee’s Ability to Become a Member and the Ehmann Decision, 7 Bus. Entities 32 (Mar./Apr. 2005).

In summary, it is difficult for even a member to force dissolution of an LLC under RULLCA. There are real hurdles, both practical and legal, for a judgment creditor to become a transferee under RULLCA. Most importantly, RULLCA does not contain an explicit right for transferees to move for dissolution because the broad and vague “equitable” language in ULLCA was completely revised to provide greater clarity and direction to courts. Thus, LLC statutes generally, but particularly under the new RULLCA, provide workable and practical rules for the multiple goals of entities used in a variety of contexts.

Simply, there seems to be no cause for “alarm” concerning the choice of an LLC in the entity selection calculus, though care in reviewing any specific state act for entity selection choices is certainly warranted.