

Rise of the small corporation

Changes in law mean that a limited liability company may not be the best option



MY VOICE
Stephen R. Harris

Over a 19-year period (beginning with Wyoming in 1977 and ending with Hawaii in 1996), all 50 states have adopted limited liability company (LLC) laws. Nevada adopted its LLC laws in 1991, which are contained in NRS Chapter 86.

Generally, an LLC is more like a Subchapter S corporation than a regular Subchapter C corporation in that it provides limited liability protection to its owners, but taxable income or loss is passed through to its owners. Unlike the partners in a general partnership, or the general partners in a limited partnership, the owners of an LLC have limited liability, which is not lost if the owners actively participate in the management of the LLC.

More importantly, the owners or members of an LLC have the advantage of a statutory charging order to shield their membership interests. A charging order is basically a lien against a judgment debtor's membership interest, and it does not allow the judgment creditor to foreclose or unilaterally execute against the judgment debtor's membership interest. Specifically, a charging order allows a judgment creditor to receive from an LLC only those distributions a judgment debtor would have received. Thus, a judgment creditor would have no access to the LLC's assets, and would have no management or voting rights in the LLC; a judgment creditor would not be able to exercise any management or voting rights, because the creditor would have "only the rights of an assignee of the member's interest," pursuant to the provisions of NRS 86.401(1); and a judgment

creditor would have no other remedies available but the charging order, pursuant to the provisions of NRS 86.401(2)(a).

The traditional advantages of operating a small business in Nevada as an LLC generally have included limited liability protection to its owners, simplicity of operation (normal corporate formalities are not required for an LLC), and ease of conversion from a sole proprietorship to an LLC. Indeed, since the enactment of Nevada's LLC laws in 1991, LLCs have enjoyed increasing popularity as a small business planning tool in Nevada, with no end in sight ... until now!

Effective July 1, 2007, with the passage of Senate Bill 242, Nevada became the first state in the nation to provide small business corporations, including small, closely-held, family corporations, with the same charging order protection previously enjoyed only by Nevada partnerships and LLCs. The new 2007 Nevada legislation, which is codified as NRS 21.090 and NRS 78.746, now generally makes a charging order a creditor's exclusive remedy in actions against debtors' interests in small business corporations in Nevada. This allows the business to remain in operation despite the creditor's claim against the individual business owner. Thus, a judgment creditor must wait for distribution from the corporation in order to satisfy its judgment against the business owner.

An individual who files bankruptcy now may claim that his small business stock is an exempt asset.

As a result of the new 2007 Nevada legislation, the stock of small business corporations in Nevada now is exempt from execution under Nevada state law, so

long as the small business corporation meets the following four requirements:

1. The corporation has more than one but fewer than 100 stockholders of record at any time.
2. The corporation is not a subsidiary of a publicly traded corporation, either in whole or in part.
3. The corporation is not a professional corporation, as defined in NRS Chapter 89.
4. This charging order protection does not apply to any liabilities of a stockholder that existed as the result of an action filed before July 1, 2007.

As a result of the enactment of the new 2007 Nevada legislation, small businesses in Nevada, including small, closely-held, family-owned businesses in Nevada, currently stand to benefit *hugely* from Nevada's extension of charging order protection to small business corporations. Significantly, the above-quoted provisions of NRS 21.090(1)(bb), pertaining to "[p]roperty exempt from execution," now explicitly provide an exemption from execution for the "[s]tock of a corporation described in subsection 2 of NRS 78.746 except as set forth in that section." This means that Nevada now expressly provides a Nevada state bankruptcy exemption for the stock of small business corporations, including the stock of small, closely-held, family corporations in Nevada. No corresponding Nevada state bankruptcy exemption presently is available for LLCs in Nevada.

Thus, when deciding whether a small Nevada business should operate as an LLC or a corporation, the ready availability of a Nevada state bankruptcy exemption for the stock of small Nevada business corporations, and the absence of a countervailing Nevada state bankruptcy exemption for membership interest in Nevada LLCs, militates strongly

in favor of a corporate form, as opposed to an LLC form, as the preferred form of doing business for small Nevada businesses, including small, closely-held, family businesses. In addition, the existence of charging order protection for small Nevada corporations now provides a powerful incentive for judgment debtors to seek the corporate format for doing business.

Therefore, all things being equal, and as a direct result of the new 2007 Nevada legislation, it may well be anticipated that the increasing popularity currently enjoyed by LLCs as a small business planning tool in Nevada, will diminish greatly in the years to come, due primarily to the lopsided legal advantages now enjoyed by small corporations in Nevada, as opposed to LLCs in Nevada.

This exemption is not without challenge by the bankruptcy trustee, so your lawyer must be ready to aggressively pursue this exemption, which, in essence, keeps the stock completely out of the bankrupt estate and free from the control of the trustee, other than to receive corporate distributions.

A planning tool for potential judgment debtors: Have your attorney adopt bylaws or operating agreement language that restricts a stockholder or LLC member from transferring their voting rights. Without this restriction, a bankruptcy trustee might garner enough votes to liquidate the corporation or LLC.

Stephen R. Harris, a member of the law firm of Harris & Petroni, Ltd. in Reno, has been practicing bankruptcy law for more than 30 years in Reno. Contact him at 786-7600 or www.beldingharrispetroni.com.