

# Client Alert

July 2015

## Virginia LLC Update: Charging Orders Against Membership Interests in Professional LLCs

On April 20, 2015, the Circuit Court for the City of Norfolk, Virginia, issued an opinion that may be of interest to members of Virginia professional limited liability companies (PLCs) and creditors of such members. The court held that a judgment creditor of a member of a PLC may obtain a charging order against the member's interest in the PLC to satisfy the judgment, regardless of whether the judgment creditor is eligible to be a member of the PLC. The decision confirms that a judgment creditor may extract economic value from a member of a PLC by obtaining a lien on the member's interest that entitles the judgment creditor to receive any distributions to which the member would otherwise be entitled.

### Background

*Southern Bank & Trust Co. v. Joshi*<sup>1</sup> involved a motion for summary judgment filed by Southern Bank against Ramesh C. Joshi. Mr. Joshi was the sole member of Ramesh Joshi, CPA, PLLC, an accounting firm. Southern Bank held a judgment against Mr. Joshi and, pursuant to the Virginia Limited Liability Company Act (the Virginia LLC Act), sought to obtain a charging order against Mr. Joshi's interest in the PLC to satisfy the judgment. A charging order is a lien on a member's transferable interest that entitles the judgment creditor to receive any distributions from the PLC to which the member would otherwise be entitled.<sup>2</sup>

Mr. Joshi argued that the charging order would constitute an impermissible transfer of his interest in the PLC to Southern Bank under the Virginia Professional Limited Liability Company Act (the Virginia PLC Act). The Virginia PLC Act supplements the Virginia LLC Act and applies to limited liability companies (LLCs) that have opted to be PLCs in their articles of organization by limiting their purpose to rendering certain types of professional services. The Virginia PLC Act generally requires that all members of a PLC be licensed to render the same professional services as the PLC. Southern Bank was not licensed to engage in the practice of accounting and was not eligible to be a member of the PLC.

There were no issues of fact. The only issue before the court was a legal one — whether the court could issue a charging order against a member's interest in a PLC in favor of a judgment creditor that was not a member of the profession engaged in by the PLC.

### Court's Decision

The court analyzed Mr. Joshi's argument that the issuance of a charging order by the court would constitute an impermissible transfer of his interest in the PLC to Southern Bank under the Virginia PLC Act since Southern Bank was not engaged in the accounting profession. Mr. Joshi argued that the

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<sup>1</sup> *S. Bank & Trust Co. v. Joshi*, No. CL14-5435, 2015 BL 170167 (Va. Cir. Ct. Apr. 20, 2015).

<sup>2</sup> Va. Code § 13.1-1038 provides that the only "transferable interest" of a member of an LLC is the member's share of profits and losses of the LLC and the member's right to receive distributions. Va. Code § 13.1-1002 defines "membership interest" or "interest" as a member's share of the profits and losses of the LLC and the member's right to receive distributions of the LLC's assets. Thus, the terms "transferable interest," "membership interest" and "interest" are synonymous under the Virginia LLC Act.

Virginia General Assembly intended for the transfer restriction contained in the Virginia PLC Act to distinguish a PLC from an LLC by prohibiting persons not engaged in the PLC's profession from interfering in the management and function of the PLC.

The court rejected Mr. Joshi's position for two reasons. First, the court pointed out that Mr. Joshi's argument that a charging order would give Southern Bank the ability to interfere with the management and function of the PLC was incorrect. The Virginia LLC Act provides that a judgment creditor with a charging order receives only the right to receive distributions from the LLC and not management rights. Second, the court rejected Mr. Joshi's position on policy grounds. The court noted that Mr. Joshi's argument would afford a member of a PLC special protection from creditors that are not engaged in the same profession as the member, and such protection was not a logical statutory purpose of the Virginia PLC Act.

The court granted Southern Bank's motion for summary judgment, holding that the charging order provisions of the Virginia LLC Act apply to a member's interest in a PLC, regardless of whether a judgment creditor is eligible to become a member of the PLC.

### **Key Observations and Takeaways**

The court's opinion in *Southern Bank & Trust Co. v. Joshi* is only two pages in length, and the decision is not surprising. However, the case raises a few issues about charging orders against membership interests in Virginia LLCs and Virginia PLCs that may be worth noting:

- ***A Charging Order is a Lien on — And Not a Transfer of — a Membership Interest.*** The court could have been clearer on this point. The Virginia LLC Act states that a charging order constitutes a lien on a member's transferable interest in an LLC. A transfer would not occur, though, unless and until a judgment creditor is able to foreclose on its lien. Although the Virginia PLC Act prohibits a member of a PLC from selling, assigning or otherwise transferring such member's interest to a person who is not eligible to be a member of the PLC,<sup>3</sup> the Virginia PLC Act is silent on charging orders and liens. The *Southern Bank* decision is consistent with the charging order provisions of the Virginia LLC Act and does not conflict with the transfer restrictions in the Virginia PLC Act.
- ***A Judgment Creditor May Not be Able to Foreclose on a Membership Interest Subject to a Charging Order.*** The Virginia LLC Act is silent on foreclosure. When the charging order provisions of the Virginia LLC Act were first enacted in 2004, they expressly provided that a court may order a foreclosure of an interest subject to a charging order at any time and that the purchaser at a foreclosure sale has the rights of an assignee (i.e., economic rights, not management rights). In 2006, the Virginia LLC Act was amended to delete all references to foreclosure and provide that the entry of a charging order is the exclusive remedy by which a judgment creditor may satisfy a judgment out of a member's transferable interest. The Virginia LLC Act has remained silent on foreclosure since that time. Does this mean that a court may not order a foreclosure? That may have been the intent of the "charging order is the exclusivity remedy" language in the 2006 amendments to the charging order provisions of the Virginia LLC Act, but the answer is not entirely clear. The 2006 amendments were modeled after similar amendments to the Delaware LLC Act in 2005. The synopsis to Delaware's 2005 amendments explained that their intent was to clarify that attachment, garnishment, foreclosure or like remedies were not available to a judgment creditor. The Delaware LLC Act remained silent on foreclosure until 2014, when the charging order provisions of the Delaware LLC Act were further amended to expressly provide that attachment, garnishment, foreclosure or other legal or

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<sup>3</sup> Va. Code § 13.1-1115 does permit a member of a PLC to transfer such member's membership interest to the PLC itself or to certain charitable remainder trusts.

equitable remedies were not available to a judgment creditor. The Virginia LLC Act's continued silence on foreclosure leaves the issue open to interpretation.<sup>4</sup>

- ***Foreclosure of a PLC Interest Subject to a Charging Order May Violate the Transfer Restrictions in the Virginia PLC Act and Cause Licensed Professionals to Hold Less than the Required Minimum Percentage of the PLC's Interests.*** If a judgment creditor of a member of a PLC is able to foreclose on the member's interest, then the foreclosure would violate the transfer restrictions in the Virginia PLC Act if the transferee was not eligible to be a member of the PLC. For a PLC rendering professional services of accountants, architects, engineers, land surveyors and landscape architects, the Virginia PLC Act requires that a minimum percentage of the interests be held by persons who are licensed to provide such professional services. For a PLC like the one in the *Southern Bank* case that is engaged in accounting, the minimum percentage is 51%, and the remainder of the interests may be held only by individuals who are employees of the PLC. If Southern Bank were able to foreclose on the interest of the sole member of a PLC engaged in accounting, then the PLC would no longer comply with the Virginia PLC Act's statutory ownership requirements.<sup>5</sup> As a result, the PLC would need to convert to a regular LLC.
- ***Should a Single-Member LLC or PLC be Treated Differently Than a Multi-Member LLC or PLC With Respect to Foreclosure of an Interest Subject to a Charging Order?*** The *Southern Bank* case highlights a more general issue regarding charging orders and single-member LLCs and PLCs. The charging order mechanism dates back more than a century and is rooted in the "pick your partner" principle. This principle is irrelevant when an LLC or a PLC has only one member. The reason the charging order mechanism was intended to be an exclusive remedy for judgment creditors was to protect the judgment debtor's co-owners from being forced to be partners with someone they did not choose. The charging order mechanism was never intended to provide an asset protection device for the judgment debtor. In the case of a single-member LLC, there are no co-owners to protect. The drafters of the Uniform Limited Liability Company Act recognized this distinction and provided that, when a charging order against an LLC's sole member is foreclosed, the member's entire ownership interest is transferred to the judgment debtor, who becomes the sole member of the LLC with both economic and management rights. If a Virginia court were to allow foreclosure of a sole member's interest subject to a charging order as a remedy, then the court might be justified in applying equitable principles to hold that the transferee receives both economic and management rights.

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<sup>4</sup> Since the charging order provisions of the Virginia LLC Act were last amended in 2006, two bills have been introduced in the Virginia General Assembly that addressed foreclosure. Both bills were defeated. In 2012, SB 165 proposed amending the charging order provisions of the Virginia LLC Act to (i) entitle a judgment creditor to foreclose on the assets of an LLC when the judgment debtor is the 100% owner of the LLC and (ii) delete the "charging order is the exclusive remedy" language in the statute and specify that a charging order does not preclude the judgment debtor from seeking other available legal and equitable remedies by which to execute the judgment against the judgment debtor's interest. In 2013, SB 735 proposed an amendment that would have entitled a judgment creditor to foreclose on the interest of a judgment debtor when the LLC is operating as an instrumentality to defraud creditors.

<sup>5</sup> In addition, if the PLC has a Virginia license to provide attest or compilation services, then the PLC would no longer meet the minimum statutory ownership requirements set forth in Va. Code § 54.1-4412.1D.