

Consumer Track

Protection of Retirement
and Business Assets in
Consumer Cases: Interests
in Trusts, Inherited Assets,
Annuities, LLC and
Corporate Interests

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Spendthrift Trusts in Bankruptcy-

- Traditionally a spendthrift trust is a trust created pursuant to state law, where the trust indenture contains express language preventing the beneficiary from alienating any beneficial interest in the trust. The policy behind spendthrift trusts was to allow an individual to provide for the maintenance and support of another while protecting the res against the “improvidence of a spendthrift or the incompetence or incapacity of a beneficiary.”
- In Bankruptcy, spendthrift trusts are exempted under 11 U.S.C. 541(c)(2) which states, “[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable non-bankruptcy law is enforceable in a case under this title.”
- According to the Supreme Court in *Patterson v. Shumate*, 504 U.S. 753 (1992), “applicable non-bankruptcy law” includes federal, as well as state law. *Id.* at 759. The inclusion of non-bankruptcy federal law expands the scope of spendthrift trusts to include ERISA qualified retirement plans, as the statute under which these plans are created contains an anti-alienation provision, satisfying 541(c)(2).
- If the spendthrift trust is validly created pursuant to the applicable state or federal law under which it was created than the spendthrift trust will be exempt from bankruptcy estate.

Invalidating a Spendthrift Trust

- The anti-alienation provision of a spendthrift trust does not automatically render the assets held by the trust exempt. The spendthrift trust can be invalidated in whole or in part, and under applicable law may not be valid against certain creditors.
- Some of the creditors with interests that prevail over the state law recognition of spendthrift trusts, include:
 - Child and Spousal support obligations
 - Claims arising from servicing of the trust
 - Claims arising from the personal or medical support of the beneficiary
 - Federal law claims, under the Supremacy Clause of the U.S. Constitution
- The biggest issue with regard to spendthrift trusts is the area of self-settled spendthrift trusts. In a majority of states and under federal law, spendthrift trusts are not valid, if the settlor is also the beneficiary. These trusts are known as self-settled spendthrift

trusts. These trusts are invalid because they do not fall in line with the policy in which spendthrift trusts are historically rooted, and would allow a debtor to defraud his creditors by shielding his assets from their claims while retaining full use and enjoyment for himself.

- These trusts can be invalidated in whole, if the settlor is the sole contributor and sole beneficiary of the trust; or where there are multiple settlors and multiple beneficiaries of a spendthrift trust, the spendthrift provision can be invalidated to the extent that settlor/beneficiary's interest in the trust.

- Example: A and B set up a spendthrift trust, each contributing \$50,000 to the res of the trust and naming B and C as beneficiaries of the spendthrift trust. A creditor of B may recover against the \$50,000 interest of B, because B's interest is invalid.

- A corollary to self-settled spendthrift trusts, are what are known as "sham" trusts. These trusts are invalid for reasons similar to self-settled spendthrift trusts, except here the beneficiary is not the settlor, but the settlor retains such control over and access to the assets held in the trust that the court's determine them to be a sham. The courts have set forth three elements to determine whether a spendthrift trust is a "sham," the three elements are:

- whether the trust will terminate upon the debtor's death;
- whether the debtor is to serve as trustee; and
- whether the debtor is to retain the use, possession, and enjoyment of the property.

- A few states, however, have enacted legislation recognizing self-settled spendthrift trusts as valid. The rationale was to capture some of the Offshore Asset Protection Trust market.

- This creates a conflict for debtors in Bankruptcy holding these self-settled spendthrift trusts. Congress in response to the ever growing Offshore Asset Protection Trust market and the newly forming "Domestic Asset Protection Trust" market enacted subsection (e) to Section 548 of the Bankruptcy Code in 2005.

- This newly enacted 548(e) gives the trustee the power to avoid transfers "made by the debtor" to "self-settled trusts or similar devices" "with the intent to hinder, delay or defraud creditors" for a period of 10 years prior to the filing of the debtor's petition.

- Section 548(e) has yet to be thoroughly analyzed in case law, however, two cases have dealt with this new section, *In re Potter* and *In re Combes*. These cases, along with the near identical fraud language used in other "fraudulent transfer" statutes, which have been examined in numerous cases, tend to show the "intent to defraud" analysis will be applying the badges of fraud.

GENERAL WORDING ASSOCIATED WITH A VALID SPENDTHRIFT PROVISION

No beneficial interest under this Trust Agreement may be voluntarily or involuntarily anticipated, assigned, encumbered, pledged, sold or otherwise transferred, except pursuant to the exercise of the powers granted in this Trust Agreement to disclaim, appoint, and release. No beneficial interest under this Trust Agreement shall be capable of being taken or reached by any attachment, levy, writ, or other legal or equitable process to satisfy any claim against, or obligation of, the person having that interest. No such interest shall be subject to control or interference by any other person. Any attempt to dispose of, or to take or reach, any interest in violation of this spendthrift provision shall be invalid and given no effect by any Trustee.

Spendthrift trust provision—*Direct prohibition against alienation*—Except exercise of power to disclaim, appoint and release, 16B Am. Jur. Legal Forms 2d § 237:9 (West 2010).

RECOGNITION OF SPENDTHRIFT TRUSTS BY JURISDICTION

Jurisdictions that recognize spendthrift trusts under the Uniform Trust Code	Jurisdictions that recognize spendthrift trusts by statute	Jurisdictions that recognize self-settled spendthrift trusts	Jurisdictions that recognize spendthrift trusts under the common law
Alabama	California	Alaska	Colorado
Arizona	Connecticut	Delaware	Hawaii
Arkansas	Georgia	Nevada	Maryland
District of Columbia	Idaho	Rhode Island	Massachusetts
Florida	Illinois	Utah	Michigan
Kansas	Indiana	Oklahoma	Minnesota
Maine	Iowa	South Dakota	
Missouri	Kentucky	Missouri	
Nebraska	Louisiana	Tennessee	
New Hampshire	Mississippi	Wyoming	
New Mexico	New Jersey	New Hampshire	
North Carolina	New York		
North Dakota	Oklahoma		
Ohio	South Dakota		
Oregon	Texas		
Pennsylvania	Washington		
South Carolina	West Virginia		
Tennessee			
Utah			
Virginia			
Wyoming			

CALIFORNIA

- California law is unique among the jurisdictions that recognize spendthrift trusts as valid. Under the California Probate Code despite valid restraints only alienation a creditor may obtain an “order directing the trustee to satisfy all or part of the judgment out of the payment to which the beneficiary is entitled under the trust instrument,” so long as the payment does not “exceed[] 25% of the payment that otherwise would be made to ... the beneficiary.” Cal.Prob.Code § 15306.5. See also, *In re Newton*, 922 F.2d 1379 (9th Cir. 1990).

INTERVIVOS VS. TESTAMENTARY UNDER SECTION 541

- **Intervivos Trusts**

- To the extent a trust is established intervivos a debtor’s interest generally will not be property of the bankruptcy estate, except when:
 - The trust is an invalid spendthrift trust; or
 - The debtor is entitled to a pre-petition disbursement in which the trustee does not have discretion in making that disbursement;

- **Testamentary Trusts**

- Where a debtor obtains a beneficial interest in a trust by bequest, devise, or inheritance, then section 541(a)(5)(A) may apply.
- Section 541(a)(5)(A) states:

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date--

(A) by bequest, devise, or inheritance;

- When a beneficiary has received funds from a spendthrift trust upon the death of a testator, a three-prong analysis is used to determine whether the funds are part of the bankruptcy estate.
 - The first prong is whether the spendthrift trust is valid in accord with the applicable law.
 - The second prong is when was the trust established, was it inter-vivos or testamentary?

- If the spendthrift trust is an inter-vivos trust then the benefit is excluded from the bankruptcy estate under 541(c)(2) and not 541(a)(5)(A). If the spendthrift trust established pursuant to a will, or other testamentary instrument, it may bring distributions received by the debtor-beneficiary into the bankruptcy estate.
- The third-prong of the analysis that must be undertaken to determine from where the distribution came
 - A distribution of assets comprising the corpus of the spendthrift trust does not constitute a “bequest, devise, or inheritance.” The logic is that the validly created spendthrift trust is excluded from the estate under section 541(c)(2) and is not listed under section 541(a)(5)(A). If the distribution is in the form of income derived from the corpus of the trust will become property of the estate.

ANNUITIES

- The exemption of annuities from property of the estate depends on the applicable law. State law will determine first whether the debtor can exempt property under state law only, or if they can choose state or federal exemptions pursuant to section 522(b)(2) of the bankruptcy code.
- Where the debtor elects to take federal exemptions, an annuity is exempt under 522(d)(10)(E) to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless—
 - (i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;
 - (ii) such payment is on account of age or length of service; and
 - (iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), or 408 of the Internal Revenue Code of 1986.
- Where the debtor resides in an “opt-out” state or elects to take the state law exemptions, annuities will be exempt according to the applicable state law in the following manner:

State	Exemption for (Non-IRA / Non-ERISA) Annuity Cash Value and Payments from Claims of Owner's Creditors	Source of Law
Alabama	\$250/mo annuity payments in the aggregate.	Ala. Code §§ 27-14-30, 27-14-32
Alaska	\$12,500 cash value	Ak. Stat. § 09.38.017
Arizona	100%	Ariz. Rev. Stat. § 33-1126A7

23RD ANNUAL WINTER LEADERSHIP CONFERENCE

Arkansas	None	
California	Same as life insurance if annuity contract considered "life insurance" and not "investment." \$9,700-single/\$19,400 married	<i>In re Payne</i> , 323 B.R. 723 (9th Cir. BAP 2005); Cal. Civ. Proc. Code § 704.100
Colorado	None	
Connecticut	None	
Delaware	\$350/mo, plus amount needed for reasonable requirements of debtor and dependents	18 Del Code Ann. § 6708
District of Columbia	\$200/mo for prior two months	§ 15-503(a)
Florida	100% for beneficiary (including owner-beneficiary).	Fla. Stat. Ann. §222.14
Georgia	Georgia Code provides that annuity proceeds are protected from creditors of beneficiary, without specifying whether this includes owner-beneficiary	Ga. Code Ann. § 33-28-7
Hawaii	100%	Hawaii Rev. Stat. § 431-10-232
Idaho	\$1,250/month	Idaho Code § 41-1836
Illinois	100% for annuity payable to dependent	I.L.C.S. § 5/12-1001(f)
Indiana	100% for policy payable to spouse, child, dependent or creditor.	Ind. Code Ann. § 27-2-5-1(b)
Iowa	None.	
Kansas	100% if policy held for more than 1 year.	Kan. Stat. Ann. § § 60-2313(a)(7), 40-414.
Kentucky	\$350/month	Ky. Rev. Stat. Ann. § 304.14-330
Louisiana	100% protected, but limited to \$35,000 if issued within 9 months.	La. Rev. Stat Ann. § 22:647(B)
Maine	\$450/month	24-A Me. Rev. Stat. Ann. §§ 2428 and 2431
Maryland	100%	Md. Code Ann. Ins. § 16-111(a)
Massachusetts	None	

Michigan	100%	Mich. Comp. Laws Ann. § 500.2207
Minnesota	Interest of beneficiary in proceeds 100% protected	Minn. Rev. Stat. Ann. § 61A.12
Mississippi	None	
Missouri	None	
Montana	None	
Nebraska	\$100,000 for cash value attributable to premiums paid at least three years prior.	Neb. Rev. Stat. § 44-371
Nevada	\$350/month	Nev. Rev. Stat. § 687B.290
New Hampshire	None	
New Jersey	\$500/month	N.J. Stat. Ann. § 17B-24-7
New Mexico	100%	N.M. Stat. Ann. § 42-10-3
New York	100%, however, court may order that debtor pay creditor "just and proper amount" with "due regard for the reasonable requirements" of the debtor and dependents.	N.Y. Ins. Law § 3212(d)
North Carolina	None	
North Dakota	\$100,000 per policy / \$200,000 max. for contracts payable to a dependent and which have been in effect for at least one year.	N.D. Cent. Code § 28-22-04.1(3)
Ohio	100% for contracts payable to spouse, children or dependent.	Ohio Rev. Code Ann. §§ 2329.66(A)(6)(b), 3911.10
Oklahoma	100%	36 Okla. St. Ann. § 3631.1
Oregon	\$500/mo aggregate	Ore. Rev. Stat. § 743.049
Pennsylvania	\$100/month	42 Pa. C.S. § 8124(c)(3)
Puerto Rico	\$250/month	26 P.R. Laws Ann. § 1135
Rhode Island	None	
South Carolina	None	
South Dakota	\$250/month	S.D. Cod. Laws § 58-12-8

23RD ANNUAL WINTER LEADERSHIP CONFERENCE

Tennessee	100% for net amounts payable to spouse, child or dependents.	Tenn. Code Ann. § 56-7-203
Texas	100%	Tex. Ins. Code § 1108.051
Utah	None	
Vermont	\$350/month	8 Vt. Stat. Ann. §3709
Virginia	None	
Virgin Islands	None	
Washington	\$2,500/month	Wash. Rev. Code § 48.18.430
West Virginia	None	
Wisconsin	\$150,000 cash value (but \$4000 for contracts issued within 2 years)	Wisc. Stat. § 815.18(3)(f)
Wyoming	\$350/month	Wy. Stat. Ann. § 15-5-132(a)

The Debtor's Interest in and Exemption of Retirement Plans

Hon. Susan V. Kelley
Judge, U.S. Bankruptcy Court
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Prior to BAPCPA, some controversy swirled over whether a debtor's interest in a pension plan qualified as property of the bankruptcy estate. In *Patterson v. Shumate*, the Supreme Court held that a debtor's interest in an “ERISA-qualified pension plan” may be excluded from the property of the bankruptcy estate pursuant to §541(c)(2) of the Bankruptcy Code.¹ That section provides that a restriction on the transfer of the debtor's interest in property that is enforceable under applicable non-bankruptcy law is enforceable in a bankruptcy case. In other words, spendthrift trusts and similar arrangements are excluded from the bankruptcy estate and the creditors' reach.

In *Patterson*, the Supreme Court held that “ERISA-qualified plans” contain enforceable anti-alienation language, and accordingly are excluded from the bankruptcy estate. *Patterson* did not end the discussion, as explained by the Seventh Circuit Court of Appeals: “In its opinion, however, the Court inadvertently opened another jurisprudential Pandora's Box when, for reasons that are not apparent to us, it coined the phrase ‘ERISA-qualified pension plan’ which appears nowhere in ERISA's statutory language. The phrase is neither a term of art nor a defined term for purposes of ERISA. Moreover, §541(c)(2) makes no reference to ERISA, much less to an ERISA-qualified plan. Nevertheless, one line of *Patterson* progeny comprises a body of jurisprudence concerning a question not answered in *Patterson*: Whether, to be ‘ERISA-qualified,’ the plan must be ‘qualified’ for tax purposes. For present purposes, it suffices to note that bankruptcy courts and district courts have answered that question both ways.”²

¹ 504 U.S. 753 (1992).

² *Baker v. LaSalle (In re Baker)*, 114 F.3d 636, 638 (7th Cir. 1997). *See also* *Traina v. Sewell (In re Sewell)*, 180 F.3d 707 (5th Cir. 1999). *Compare In re Hall*, 151 B.R. 412 (Bankr. W.D.

IRAs may not have qualified for exclusion from the estate, but in *Rousey v. Jacoway*, the Supreme Court held that the debtor's interest in an IRA qualified as a “right to receive ... a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of ... age” and came within the federal exemption statute of §522(d)(10) of the Bankruptcy Code.³

BAPCPA amended §§541 and 522 of the Bankruptcy Code to resolve some of these issues. First, excluded from property of the bankruptcy estate under §541(b)(5) are funds placed in an education IRA (defined by I.R.C. §530(b)(1)) over one year before the bankruptcy petition, if the designated beneficiary is the debtor's child, stepchild, grandchild or step grandchild. If the funds were deposited into the education IRA within two years of the petition, the exclusion is limited to \$5,850 per beneficiary.⁴ Similarly, funds used to purchase a tuition credit or contributed to a §529 account under a qualified state tuition program over one year before bankruptcy are excluded from the bankruptcy estate, if the designated beneficiary is the debtor's child, stepchild, grandchild or step grandchild, and the aggregate amount having the same designated beneficiary does not exceed the total contributions permitted under I.R.C. §529(b)(7).⁵ If the funds were

Mich. 1993) (plan must be “tax-qualified” under 26 U.S.C. §401(a), in addition to containing an anti-alienation provision that is enforceable under ERISA), *with In re Bennett*, 185 B.R. 4 (Bankr. E.D.N.Y. 1995) (a plan is “ERISA-qualified” for purposes of §541(c)(2) if it is (1) governed by ERISA and (2) includes an anti-alienation provision that is (3) enforceable under ERISA); *In re Hanes*, 162 B.R. 733 (Bankr. E.D. Va. 1994) (if a restriction on alienation is enforceable under ERISA, 26 U.S.C. §401(a) qualification is irrelevant to exclusion of the debtor's beneficial interest in an ERISA plan from the estate under §541(c)(2)). *See also In re Goldschein*, 244 B.R. 595, 600-601 (Bankr. D. Md. 2000) (declining to hold that every plan governed by ERISA and containing an anti-alienation provision must also obtain tax qualification under 26 U.S.C. §401(a), but holding that “where a tax qualified plan is involved, Congress intended the provisions of ERISA and the provisions of the Internal Revenue Code to work in consort.... In order to be entitled to the exclusion of benefits from the bankruptcy estate, the plan must comply with the provisions of both statutes.”); *and In re Handel*, 301 B.R. 421 (Bankr. S.D.N.Y. 2003) (collecting cases).

³ 544 U.S. 320 (2005).

⁴ 11 U.S.C. §541(b)(5)(C). This dollar limit is adjusted every three years; the amount stated is current for cases filed on and after April 1, 2010. The funds will not qualify for exclusion if they were used as collateral or if they constitute an “excess contribution” under 26 U.S.C. §4973(e).

⁵ 11 U.S.C. §541(b)(6).

deposited into the §529 account within two years of the petition, the exclusion is limited to \$5,850 per beneficiary.

New §541(a)(7) excludes from property of the estate any amount withheld by an employer from the wages of employees for payment as a contribution to (1) an employee benefit plan that is subject to the ERISA; (2) a government plan under I.R.C. §414(d); (3) a deferred compensation plan of a state or local government unit under §457 of the I.R.C.; (4) a deferred compensation plan of a tax-exempt employer; or (5) a health insurance plan regulated by state law. The change does not appear to include church plans, except to the extent they are health insurance plans under state law.

New federal exemptions for retirement funds were created by BAPCPA. Section 522(d)(12) of the Bankruptcy Code provides that retirement funds in a fund or account that is exempt from tax under specified sections of the Internal Revenue Code may be claimed as exempt in the bankruptcy case. The following sections of the I.R.C. are identified: (1) §401 (qualified plans); (2) §403 (annuities); §408 (IRAs);⁶ §408A (Roth IRAs); §414 (hybrid plans); §457 (deferred compensation plans for government and tax-exempt organizations); and §501(a) (plans funded

⁶ Courts remain divided over whether an IRA or similar plan that is not in “pay status” qualifies for the exemption. *Compare* *Skiba v. Auman*, 2006 U.S. Dist. LEXIS 4261 (W.D. Pa. Feb. 3, 2006) *with* *Frank v. Wiggins (In re Wiggins)*, 341 B.R. 506 (M.D. Pa. 2006). *See also In re Krebs*, 527 F.3d 82, 87 (3d Cir. Pa. 2008) (pre-BAPCPA case suggesting that IRA qualifies if and to the extent it is necessary for support). Another issue is whether an inherited IRA qualifies for the exemption, and some, but not all, courts have determined that post-BAPCPA, an inherited IRA qualifies as exempt. *See Doeling v. Nessa (In re Nessa)*, 426 B.R. 312 (B.A.P. 8th Cir. 2010) (exempt under Bankruptcy Code § 522(d)(12)); *In re Weilhammer*, 2010 Bankr. LEXIS 2935 (Bankr. S.D. Cal. Aug. 30, 2010) (as a result of BAPCPA, exempt under Bankruptcy Code § 522(b)(3)(C)); *In re Kuchta*, 434 B.R. 837 (Bankr. N.D. Ohio 2010) (same); *Bierbach v. Tabor (In re Tabor)*, 433 B.R. 469 (Bankr. M.D. Pa. 2010) (same); *but see In re Klipsch*, 435 B.R. 586 (Bankr. S.D. Ind. 2010) (not exempt under Indiana law); *In re Ard*, 435 B.R. 719 (Bankr. M.D. Fla. 2010) (not exempt under Florida law); *In re Chilton*, 426 B.R. 612 (Bankr. E.D. Tex. 2010) (not exempt, even after BAPCPA); *In re Jarboe*, 365 B.R. 717 (Bankr. S.D. Tex. 2007) (not exempt under Texas law); *In re Kirchen*, 344 B.R. 908 (Bankr. E.D. Wis. 2006) (pre-BAPCPA, not exempt under Wisconsin law). *See also In re Green*, 2007 Bankr. LEXIS 1182 (Bankr. E.D. Tenn. Apr. 2, 2007) (annuity purchased as structured settlement due to wrongful death of debtor's son did not qualify for a similar state exemption).

with employee contributions only).⁷ This exemption should clarify the debtor's ability to exempt retirement accounts whether or not they are "ERISA-qualified." The debtor need not prove that the funds in the account are "reasonably necessary for the support" of the debtor or debtor's dependents, as required by the exemption in Bankruptcy Code §522(d)(10)(e). However, §522(n) provides a \$1 million cap on the exemption of an IRA, but the cap does not apply to amounts rolled over from a qualified plan or §403(b) annuity. The cap may be increased if the interests of justice so require. Even if the debtor's state has "opted out" of the federal exemption scheme, the debtor may still claim an exemption of the retirement accounts under §522(b)(3).

⁷ 11 U.S.C. §522(b)(4) defines "exempt from taxation," and covers rollovers and transfers of retirement funds.

THE “INHERITED” IRA: EXEMPT OR NOT??

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INTRODUCTION.

In 1974, when the Employee Retirement Income Security Act (“ERISA”) was passed, some taxpayers (those with no other retirement programs) were allowed to contribute up to \$1,500.00 per year into what was termed an “individual retirement account”, which everyone now knows to be an IRA. By the end of 2009, over \$4 Trillion had been invested in the now various forms of IRAs. Few of those reading these seminar materials, if any there are, would have envisioned that when our parents’ generation was originally given the opportunity to make those investments in 1974, that the demise of their generation would result in what has become a very key bankruptcy issue – who gets the money when the beneficiary of an IRA goes bankrupt?

This issue has been addressed, under BAPCPA, by no less than eight Courts in the last year and a half. When Bankruptcy Judge Brenda T. Rhoades authored *In re Chilton* on March 5, 2010, 426 B.R. 612 (Bankr.E.D.Tex.2010) *rev’d*, 444 B.R. 548 (E.D.Tex.2010), finding an inherited IRA not to be exempt, she noted there were no published cases under BAPCPA addressing the issue. (For clarity, the Bankruptcy Court Opinion will be referred to as *Chilton I*, the reversal as *Chilton II*) *See, Chilton I* at 619. When Judge Rhoades was reversed, slightly more than a year later, the District Court noted five cases all issued since the Bankruptcy Court’s original opinion, that have been decided in that year. Even since Messieurs Lassman and Cymrot wrote on the subject in the *ABI Journal* for its May, 2011 issue, several other cases have been published, including *In re Clark*, 450 B.R. 858 (Bkrcty.W.D.Wis. 2011)¹ (inherited IRA not

¹ Seminar attendee Claire Ann Resop, Trustee and prevailing counsel.

exempt), *In re Kalso*, 2011 WL 3678326 (Bkrcty.E.D. Mich) (inherited IRA exempt) and *In re Cutignola*, 450 B.R. 445 (Bkrcty.S.D. NY 2011) (Inherited IRA exempt even if acquired within 180 days after Petition). Moreover, it is this writer's understanding that the issue is winding its way through the Courts in at least two Circuits. Given the congressional intent of establishing uniform treatment of retirement vehicles in Chapter 7, as discussed below, it is probable that this matter will go to the Supreme Court. In the meantime, the issue is one that the bankruptcy practitioner advising an individual needs to be wary as, at least for the time being, the outcome is jurisdiction dependent and will almost certainly be decided at a high appellate level.

WHAT EXACTLY IS AN "INHERITED" IRA?

An inherited IRA is exactly that – an IRA that was inherited by a non-spouse after the death of the original holder². When the original account holder dies, the Internal Revenue Code allows the “contents” of the IRA to be passed to a beneficiary who is not the spouse of the account holder. The beneficiary has certain options whereby they may avoid immediately paying taxes on the full amount of the distribution by making what is referred to as a “direct trustee to trustee transfer”, i.e., the money goes from the decedent's IRA account into an inherited IRA account owned by the beneficiary. *See*, 26 U.S.C. §402(c)(11)(A). *Also see*, *Chilton I* at 617. The beneficiary cannot make any contributions into the account, but is not taxed until distributions are made, i.e., the money withdrawn. Distributions are not governed by the rules of a “regular” IRA but must be taken on a different basis. *See*, 26 U.S.C. §401(a)(9)(B)(ii). *Also see*, IRS Publication 590 at 37. For all intents and purposes, an inherited IRA is an account that, when received by the beneficiary, is not taxed until withdrawn by him/her. However, it is required to be withdrawn on an accelerated basis, i.e., not commencing at age 59 ½, as a regular

² When the decedent's spouse inherits an IRA, different IRS regulations attach. The IRA is exempt. Treatment of such IRAs is not the subject of this article.

IRA. See also, *Inherited IRAs: Exemption Issues under the Code*, ABI Journal 1, 66-67 (May 2011). The above being said, when a Debtor arrives in Bankruptcy Court with an inherited IRA, is it exempt?

SOME NOT IRRELEVANT HISTORY AND THE CURRENT STATUTORY SCHEME.

Prior to BAPCPA, a Debtor's right to exempt an IRA was generally governed by 11 U.S.C. §522(d)(10)(E), which provided an exemption of the Debtor's right to receive payment "under a stock bonus, pension, profit sharing, annuity or other similar plan" but only to the extent that such funds are reasonably necessary for the support of the Debtor or the Debtor's dependents. There was a split of opinion in the Courts regarding whether or not that section allowed an exception for IRAs, discussion of which is no longer relevant. In *Patterson v. Shumate*, 504 U.S. 753, 112 S.Ct. 2242, 119 L.Ed.2d 519 (1992), the Supreme Court, in the context of a retirement plan, "suggested" but did not hold, that a Debtor's right to receive payments in an IRA could be exempted from the bankruptcy estate under §522(d)(10)(E). Later, in *Rousey v. Jacoway*, 544 U.S. 320, 125 S.Ct. 1561, 161 L.Ed.2d. 563 (2005), the Supreme Court, as stated by Judge Robert D. Martin in *In re Clark*, 450 B.R. 858 (Bkrtcy.W.D.Wis 2011), "followed its suggestion in *Patterson*", holding that IRAs cannot be marshaled by the Bankruptcy Trustee. Subsequent to *Rousey*, BAPCPA, which confused our lives, actually clarified treatment of IRAs by enacting 11 U.S.C. §522(d)(12) which, for all intents and purposes, exempts them. That section allows the Debtor to exempt:

(12) Retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408(A), 414, 457, or 501(a) of the Internal Revenue Code of 1986.

Moreover, in a rare attempt to create uniformity between States that adopted the Federal Exemptions and those that "opted out" of the Federal Bankruptcy Exemption scheme treatment,

BAPCPA also provided that Debtors who chose their respective State Exemptions, would also be entitled to exempt IRA retirement funds under 11 U.S.C. §522(b)(4)(C). That section allowed an exemption in IRAs consistent with that provided for under 11 U.S.C. §522(d)(12). This statute makes the IRA issue a Federal Exemption issue, except in the rare circumstances where a State IRA exemption might be more “liberally” written than §522(d)(12). *See, e.g. In re McClelland*, 2008 WL 89901 (Bankr.D.Idaho).

HOW THE STATUTE IS APPLIED.

All of the cases that have addressed the issue have pointed out, the issue as to whether or not an inherited IRA account (or any IRA account) is exempt is a two-prong question:

- First, is the amount that the Debtor seeks to exempt “retirement funds” within the meaning of 11 U.S.C. §522(d)(12)?
- Second, are the funds exempt from taxation under the Internal Revenue Code?

The clear majority of the Courts that have addressed the second prong, above, since BAPCPA, have concluded that the second criteria has been met. *See, Kalso; In re Mathusa*, 446 B.R. 601 (Bkrty.M.D. FL 2011); *Chilton II; In re Thiem*, 443 B.R. 835 (Bkrty.D.AZ 2011); *In re Nessa*, 426 B.R. 312;; *In re Tabor*, 433 B.R. 470 (Bkrty.M.D.Penn. 2010); *In re Weilhammer*, 2010 WL 3431465 (Bkrty.S.D.Cal.). Cf., *Chilton I; Clark*. The issue most Courts grapple with is first prong - whether or not the funds in the account are “retirement funds” within the meaning of the statute.

TWO APPROACHES, TWO RESULTS.

As stated, the key issue in whether or not an inherited IRA is exempt is whether or not the money in it can be characterized as “retirement funds”. If they ain’t, they are not exempt. If they is, they are exempt. Judge Martin, in *Clark*, while observing that the term “retirement

funds” is not a defined term within the meaning of the Code, did conclude, using his copy of the Webster’s Ninth New Collegiate Dictionary 1007 (9th ed. 1986³), that since “retirement” was defined as “withdrawal from one’s position or occupation from active working life”, that the funds in the inherited IRA were not there for that particular purpose. The funds were in the account for the purpose of the decedent’s retirement, not the retirement of the Debtor. With that distinction, the first prong of the test was not met and the funds were not exempt. Judge Martin, distinguished his decision from other opinions that have found the opposite (discussed below) noting that none of those cases controlled in his District and that they dealt with smaller dollar amounts than that which was before him,⁴ Judge Martin felt he had to make an “independent analysis” to determine whether or not the inherited IRA fell within the exception.

Judge Martin found simply that the funds in an inherited IRA are not “retirement funds” because they were not the retirement funds of the Debtor, but rather the retirement funds of Mrs. Clark’s mother, who, as Judge Martin aptly pointed out, had died and was “incapable of retiring further or using the funds during her retirement”. See, *Clark* at 863. The first prong was not met. As to the second prong, in a much less confident manner, Judge Martin found, based upon authority reviewed, he could not conclude that an inherited IRA was tax exempt. Therefore, the second prong was not met. This case, published in May of 2011, seems to be the most articulate for the argument that the retirement funds are not exempt.

In a recent opinion on the same issue, in *Kalso*, Judge Walter Shapero addressed the matter in a short but direct Opinion, following the two lead cases on point, *Chilton II* and *Nessa* which is the lead case pro-exemption. In those cases, the Courts simply ruled, as to the first

³ Other than the “Gutenberg Bible”, the oldest printed non-electronic book in existence.

⁴ *Chilton I*, \$170,000.00; *Tabor*, \$105,000.00; *Thiem*, \$10,000.00, all apparently chump change in Wisconsin. In *Clark*, the amount in controversy was \$293,000.00.

prong – whether the funds are retirement funds, that they had to be retirement funds because the statute (11 U.S.C. §522(d)(12)) does not in any fashion require or even state whose retirement funds had to be in the account. That they were retirement funds of a now dead retiree, was irrelevant. It is never disputed in any of the cases that the funds in question were, when deposited by the now deceased IRA holder, retirement funds. As such, *Nessa*, *Chilton II* and *Kalso* point out that there is no requirement that those funds must be the Debtor's retirement **funds**. *See, Nessa*. As such, these cases conclude that the funds are exempt, qualifying under both prongs of the test but, most aptly, qualifying because they were put in the account for someone's retirement. *Nessa*, in particular, points out that §522(d)(12) requires that the account be comprised of retirement funds, but it does not specify that they must be the Debtor's retirement funds. Trustee's argument limits the statute "beyond its plain language". *See, Nessa* at 314 quoting *U.S. v. Ron Pair Enterprises*, 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989). The Court concluded that even though the contents of the Debtor's inherited account were that of the Debtor's father, "they remain in form and substance, retirement funds". *See also, Thiem; Chilton II*.

As we await higher authority we wait in doubt, depending on jurisdiction.

THE DEBTOR'S LLC INTEREST IN BANKRUPTCY - WHAT DID THE TRUSTEE GET HERSELF INTO?

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A DEBTOR'S INTEREST IN LLC IS PROPERTY OF THE ESTATE.

As a general proposition, the Debtor's interest in the LLC becomes part of the bankruptcy estate. *See*, 11 U.S.C. §541(a). *In re Albright*, 291 B.R. 538, 540 (Bkrcty.D.Colo.,2003). ("Upon the Debtor's bankruptcy filing, she effectively transferred her membership interest to the estate. *See*, 11 U.S.C. § 541(a)"). Trustees take the interest of the Debtor, including the Debtor's duties to the LLC and restrictions (if any) on the sale or liquidation of the assets. *Id.* This is consistent with the general proposition expressed by the Supreme Court in *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1979). Of course, the Trustee would, as discussed further, also take on the responsibilities of that membership interest, including those found in the LLC's operating agreement. In fact, pursuant to the Revised Uniform Limited Liability Company Act (RULLCA)⁵ §17701.12 (b), "A person that becomes a member of a limited liability company is deemed to assent to the operating agreement."

EXEMPTION OF AN LLC INTEREST.

There is no specified exemption for the Debtor's ownership of interests in LLCs under the federal exemption scheme. *See*, 11 U.S.C. §522. The Debtor may, of course, claim an exemption utilizing the "wild-card" exemption of §522(d)(5). Other than similar "wild-card" exemptions at the state level, this author was unable to locate any specific exemptions for the Debtor's interests in business entities. However, practitioners should be careful to distinguish

⁵ Portions of the RULLCA are attached as Exhibit "A".

between the Debtor's property (the LLC membership interest) and the property of his business (the LLC assets), as property used by the LLC, may in fact be owned by the Debtor, and as such qualify for other exemptions. (See, *In re Schwab*, 378 BR 854 (Bankr. D. Minn. 2007) (equipment qualified for tools of the trade exemption under Minnesota law).

Furthermore, some states that recognize entirety property do so not just for real estate but for personal property. In those states, husbands and wives may hold their membership interests as tenants by the entirety. Of course, not all states that recognize entirety property for real estate also recognize it for personal property, but many do. See, 41 Am. Jur. 2d Husband and Wife §26 (citing *In re Shader*, 90 B.R. 85 (Bankr. D. Del. 1988) (applying Delaware law); *Bostic by Holmes v. Bostic Estate*, 281 Ark. 167, 662 S.W.2d 815 (1984); *Morrison v. Potter*, 764 A.2d 234 (D.C. 2000); *Tingle v. Hornsby*, 111 So. 2d 274 (Fla. Dist. Ct. App. 1st Dist. 1959); *Regnante v. Baldassare*, 15 Mass. App. Ct. 718, 448 N.E.2d 775 (1983); *Clingerman v. Sadowski*, 513 Pa. 179, 519 A.2d 378 (1986); *Grahl v. Davis*, 971 S.W.2d 373 (Tenn. 1998); *Preston v. Burmeister*, 52 S.W.3d 386 (Tex. App. Fort Worth 2001); *George v. Dutton's Estate*, 94 Vt. 76, 108 A. 515, 8 A.L.R. 1014 (1920); *Oliver v. Givens*, 204 Va. 123, 129 S.E.2d 661 (1963).) For states that allow ownership of personal property as tenants by the entirety, and if there was proper planning, this may be an excellent way for Debtors to protect their business interests from creditors. Any transfer of an LLC interest from one spouse to both spouses during the time that the Debtor was insolvent or, if the transfer would render the Debtor insolvent, would be a fraudulent transfer.

WHAT DOES THE TRUSTEE REALLY GET?

As stated earlier, the Trustee takes the Debtor's membership interest subject to its rights, privileges and its duties and restrictions. The operating agreement and the RULLCA often create

obstacles for the Trustee. Many of the operating agreements and RULLCA, itself, provide that upon the filing of a bankruptcy, the bankrupt member becomes what is referred by the Act as “disassociated”. There are two provisions of RULLCA which provide for this disassociation as a result of a bankruptcy. The two provisions are found in §17706.02 of the Act. The first provides that: “A person is dissociated as a member from a limited liability company when . . . (4) the person is expelled as a member by the unanimous consent of the other member because: . . . (B) there has been a transfer of all the person’s transferable interest in the limited liability company . . .”. The second provides that “A person is dissociated as a member from a limited liability company when . . . (7) in a member-managed liability company, the person becomes a debtor in bankruptcy.”

Courts have generally enforced these provisions in bankruptcy. The Court in *In re Garrison-Ashburn, LLC* 253 B.R. 700, 708 (Bankr. E.D. Va. 2000) held that all of the interest of the Debtor in an LLC, whether economic or non-economic, became property of the bankruptcy estate and that these “rights and benefits were burdened with all of the duties and obligations that came with them.” Under Virginia law, a member of an LLC could only assign a member’s interest in the share of profits, losses and distributions, and not the rights to participate in management. *Id.* at 705. Virginia Law also provided that a member was “disassociated” from the LLC upon filing of the bankruptcy. The Court further held that since the operating agreement was not an executory contract, the *ipso facto* provisions of 11 U.S.C. § 365(c) and (e) were not applicable and the Trustee only had the economic rights of the Debtor - that is the estate had the right to share in the profits, losses and distributions.

The Court in *Albright* came to the opposite conclusion in a single member LLC, but seemed to indicate it would find differently in a multi-member LLC. *Id.* at 541. (*See also, In re*

Modanlo, 412 B.R. 715 (Bankr. MD. 2006). Similarly, the Delaware Court of Chancery held that the *ipso facto* clause which required a bankrupt member to assign his interest in the LLC to the other members for no consideration was enforceable as to non-economic rights but not as to economic rights. See, *Milford Power Co. v. PDC Milford Power, LLC*, 866A.2d 738 (Del. CH. 2004).

In addition to the hurdles found in the operating agreement and RULLCA, the Trustee may also be faced with the prospect that the operating agreement is an executory contract if the Debtor has continuing duties, for instance. See, generally *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005). The *Ehmann* Court applied the so called “Countryman Test” which is “[A] contract is executory if ‘the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.’ ” (Citing *Unsecured Creditors’ Comm. v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co., Inc.)*, 139 F.3d 702, 705 (9th Cir.1998), quoting *Griffel v. Murphy (In re Wegner)*, 839 F.2d 533, 536 (9th Cir.1988), and citing Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L.REV. 439, 460 (1973). From the Court’s review of the operating agreement, it concluded that the operating agreement was not an executory contract. Other Courts have, of course, found that the operating agreements in their cases were, in fact, executory contracts. See *In re Daugherty Const. Inc.*, 188 B.R 607 (Bankr. D. Neb 1995). If the operating agreement is an executory contract, the Trustee may be forced to cure any defaults (which since it involves a Debtor in bankruptcy, the likelihood of default is high) the Trustee would have to cure the default promptly. See, 11 U.S.C. §365(b)⁶.

⁶ This may cause the Debtor’s interest to be forfeited or simply be to impractical to pursue absent a motion to obtain credit under 11 U.S. C. §364, which is clearly beyond the scope of this article.

WHAT IS A TRUSTEE TO DO?

The Trustee's first and best option is to sell the Debtor's membership interest in an LLC. No matter if the LLC is a single member LLC or a multi-member LLC, the Trustee may sell the Debtor's interest in the same pursuant to 11 U.S.C. §363. *See, Albright, In re Strickland*, 2010 WL 5238645 (Bkrcty.E.D.N.C.); and *In re Rosbottom*, 2010 WL 3294313 (Bkrcty.W.D.La.).

The Trustee (at least in single member LLCs) can operate the LLC. While operating the LLC, the Trustee has all the rights that the Debtor had when it was in control of the Debtor. *See, Albright* and *In re Fursman*, 440 B.R. 821. Of course, pursuant to RULLCA §17701.12 (b), "A person that becomes a member of a limited liability company is deemed to assent to the operating agreement". As a member and potential manager of the LLC, the Debtor (now operating Trustee) may owe others (including creditors of the LLC) duties. These concerns may have caused the Trustee in *Albright*, to vote to liquidate the LLC.

The Trustee can also enforce the estate's economic rights. Pursuant to RULLCA §17704.04 (d): "if a member or transferee becomes entitled to receive a distribution, the member or transferee has the same status as, and is entitled to all remedies available to a creditor of the limited liability company with respect to the distribution." The Trustee could then, as a creditor of the LLC, pursue assets of the LLC as any other LLC creditor would.

Last, the Trustee has the rights of a lien creditor against the Debtor, and the Trustee may obtain the classic charging order against the Debtor's interest. Specifically, RULLCA §17705.03 provides "(a) on application by a judgment creditor of a member or a transferee, a court may enter a charging order against the transferable interest . . . A charging order constitutes a lien on a judgment debtor's transferable interests." RULLCA further provides that the Court may "(1) appoint a receiver of the distributions subject to the charging order, with the

power to make all inquires the judgment debtor may have made; and (2) make all other orders necessary to give effect to the charging order. *Id.* at § 17705.03(b). Further, if such charging order is not sufficient to pay the debt “the court may foreclose the lien and order the sale of the transferable interest.” §17705.03(c). The purchaser only obtains the transferable interest and does not become a member. *Id.*

As a practical matter, future Trustees administering LLC assets will do what Trustee’s do with other types of jointly held property, pressure the partners/co-owners to pay something for the Debtor’s interest and hope, with all their brain power, there is an antagonized creditor of the Debtor around to push up the price.

WHAT IS THE DEBTOR’S COUNSEL TO DO?

Plan ahead and tell your business partners to do likewise. Include language in operating agreements which reinforce the hurdles imposed by RULLCA. Some examples include:

Involuntary Transfers.

The Members’ Membership Interest shall not be subject to any involuntary transfer whatsoever. If any Member suffers an involuntary transfer or purported involuntary transfer (including, but not limited to, divorce, any bankruptcy, or professional disqualification), then the Company shall have the exclusive right and option for a period of 60 days after the occurrence of such an event to elect to purchase and liquidate the Membership Interest for the proportional sale of the Company’s book value.

And

Participation in Profits and Losses.

In cases of a Member’s Membership Interest subject to an Involuntary Transfer as contemplated in §7.5, the participation in profits and losses shall be according to the terms and conditions as specified by a majority vote of the remaining Members not subject to such Involuntary Transfer.

However, since most Debtors do not plan ahead at all, the Debtor may have to be more reactive than pro-active. Whether or not a Trustee will take interest in a Debtor’s LLC will of

course depend upon its value. The valuation of a Debtor's interest in an LLC can be simple, if it is a single member LLC which owns only vacant real estate worth \$1,000,000.00 and against which there is a single mortgage of \$500,000.00. The Debtor's membership interest is worth \$500,000.00 on a good day. The valuation of a Debtor's interest in an LLC can be extremely difficult. To aid the Trustee in his valuation, it is typical and customary to provide the panel trustee with financial data regarding the financial condition of the Debtor's LLC. This typically consists of a (i) balance sheet as of the date of the bankruptcy; (ii) profit and loss for the calendar/fiscal year prior to the bankruptcy (and year-to-date); and (iii) the tax returns for the previous years.

For many businesses the timing of the bankruptcy could change the Trustee's perceived value of the Debtor's business. As examples, let's review two separate seasonal businesses. The first is a trendy new restaurant in a summer resort. As a restaurant, regardless of when the Debtor files the bankruptcy, the LLC balance sheet will rarely show any equity. However, if the petition date was October 1 (after summer) your Debtor's restaurant will appear to be profitable⁷. If the petition date is March 1, the Debtor's restaurant will appear to be going out of business, having used up all of its summer cash and holiday cash. If you file the bankruptcy in October, your client's Trustee will have more incentive to try to sell your Debtor's interest to the chef who will mistakenly believe that the restaurant is profitable.

The second example is the classic farmer, operating his/her farm as an LLC. As the typical farmer has lost money 30 out of the last 32 years, no matter when you file the case, the profit and loss statement will typically show a loss. However, the farmer's balance sheet would look dramatically different depending upon the timing of the filing. If you file the bankruptcy in

⁷ Please note that even with its excess cash, the restaurant's balance sheet will still be in the negative.

early May (after the Debtor has planted) the Debtor will have little to no cash, with a great deal of time and expense now required to generate any cash. However, if the owner of the farm was to file in mid November (after harvest), the LLC will have a very strong cash position. If the farmer files in November, the Trustee may be able to liquidate the LLC and obtain its equity.

As the Trustee's best and easiest approach to market the LLC membership to the Debtor's "partners", perhaps the best piece of advice a lawyer can give a client in this situation to tell them to be nice to their partners, just this once.

consequences. The penalty or consequence may include and take the form of reducing or eliminating the defaulting member's or transferee's proportionate interest in a limited liability company, subordinating the member's or transferee's membership interest to that of nondefaulting members or transferees, forcing a sale of that membership interest, forfeiting the defaulting member's or transferee's membership interest, the lending by other members or transferees of the amount necessary to meet the defaulting member's or transferee's commitment, a fixing of the value of the defaulting member's or transferee's membership interest by appraisal or by formula and redemption or sale of the membership interest at that value, or other penalty or consequence.

SECTION 17701.11 OPERATING AGREEMENT; EFFECT ON LIMITED LIABILITY COMPANY AND PERSONS BECOMING MEMBERS; PREFORMATION AGREEMENT.

(a) A limited liability company is bound by and may enforce the operating agreement, whether or not the limited liability company has itself manifested assent to the operating agreement.

(b) A person that becomes a member of a limited liability company is deemed to assent to the operating agreement.

(c) Two or more persons intending to become the initial members of a limited liability company may make an agreement providing that upon the formation of the limited liability company the agreement will become the operating agreement. One person intending to become the initial member of a limited liability company may assent to terms providing that upon the formation of the limited liability company the terms will become the operating agreement.

SECTION 17701.12 OPERATING AGREEMENT; EFFECT ON THIRD PARTIES AND RELATIONSHIP TO RECORDS EFFECTIVE ON BEHALF OF LIMITED LIABILITY COMPANY.

(a) An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.

EXHIBIT

(b) The obligations of a limited liability company and its members to a person in the person's capacity as a transferee or dissociated member are governed by the operating agreement. Subject only to any court order issued under Section 17705.03(b)(2) to effectuate a charging order, an amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person's capacity as a transferee or dissociated member.

(c) If a record that has been delivered by a limited liability company to the Secretary of State for filing and has become effective under this title contains a provision that would be ineffective under Section 17701.10(c) if contained in the operating agreement, the provision is likewise ineffective in the record.

(d) Subject to subsection (c), if a record that has been delivered by a limited liability company to the Secretary of State for filing and has become effective under this title conflicts with a provision of the operating agreement:

- (1) the operating agreement prevails as to members, dissociated members, transferees, and managers; and
- (2) the record prevails as to other persons to the extent they reasonably rely on the record.

SECTION 17701.13 OFFICE AND AGENT FOR SERVICE OF PROCESS.

(a) A limited liability company shall designate and continuously maintain in this state:

- (1) an office, which need not be a place of its activity in this state; and
- (2) an agent for service of process.

(b) A foreign limited liability company that has a certificate of authority under Section 17708.02 shall designate and continuously maintain in this state an agent for service of process.

(c) An agent for service of process of a limited liability company or foreign limited liability company shall be an individual who is a resident of this state or other person with authority to transact business in this state.

(D) in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person is expelled or otherwise dissociated as a member because it dissolved or terminated.

(c) A person that wrongfully dissociates as a member is liable to the limited liability company and, subject to Section 17709.01, to the other members for damages caused by the dissociation. The liability is in addition to any other debt, obligation, or other liability of the member to the limited liability company or the other members.

SECTION 17706.02 EVENTS CAUSING DISSOCIATION. A person is dissociated as a member from a limited liability company when:

- (1) the limited liability company has notice of the person's express will to withdraw as a member, but, if the person specified a withdrawal date later than the date the limited liability company had notice, on that later date;
- (2) an event stated in the operating agreement as causing the person's dissociation occurs;
- (3) the person is expelled as a member pursuant to the operating agreement;
- (4) the person is expelled as a member by the unanimous consent of the other members because:
 - (A) it is unlawful to carry on the limited liability company's activities with the person as a member;
 - (B) there has been a transfer of all of the person's transferable interest in the limited liability company, other than:
 - (i) a transfer for security purposes; or
 - (ii) a charging order in effect under Section 17705.03 which has not been foreclosed;
 - (C) the person is a corporation and, within 90 days after the limited liability company notifies the person that it will be expelled as a member because the person has filed a certificate of dissolution or the equivalent, its charter has been revoked, or its right to conduct business has been suspended by the jurisdiction of its incorporation and the certificate of dissolution has not been revoked or its charter or right to conduct business has not been reinstated; or

(D) the person is a limited liability company or partnership that has been dissolved and whose business is being wound up;

(5) on application by the limited liability company, the person is expelled as a member by judicial order because the person:

(A) has engaged, or is engaging, in wrongful conduct that has adversely and materially affected, or will adversely and materially affect, the limited liability company's activities;

(B) has willfully or persistently committed, or is willfully and persistently committing, a material breach of the operating agreement or the person's duties or obligations under Section 17704.09; or

(C) has engaged in, or is engaging, in conduct relating to the limited liability company's activities which makes it not reasonably practicable to carry on the activities with the person as a member;

(6) in the case of a person who is an individual:

(A) the person dies; or

(B) in a member-managed limited liability company:

(i) a guardian or general conservator for the person is appointed; or

(ii) there is a judicial order that the person has otherwise become incapable of performing the person's duties as a member under this title or the operating agreement;

(7) in a member-managed limited liability company, the person becomes a debtor in bankruptcy;

(8) in the case of a person that is a trust or is acting as a member by virtue of being a trustee of a trust, the trust's entire transferable interest in the limited liability company is distributed but not solely by reason of a substitution of a successor trustee;

(9) in the case of a person that is an estate or is acting as a member by virtue of being a personal representative of an estate, the estate's entire transferable interest in the limited liability company is distributed but not solely by reason of a substitution of a successor personal representative;

- (10) in the case of a member that is not an individual, partnership, limited liability company, corporation, trust, or estate, the termination of the member;
- (11) the limited liability company participates in a merger under Article 10, if:
 - (A) the limited liability company is not the surviving entity; or,
 - (B) otherwise as a result of the merger, the person ceases to be a member; or
- (12) the limited liability company terminates.

SECTION 17706.03 EFFECT OF PERSON'S DISSOCIATION AS MEMBER.

- (a) When a person is dissociated as a member of a limited liability company:
 - (1) the person's right to participate as a member in the management and conduct of the limited liability company's activities terminates;
 - (2) if the limited liability company is member-managed, the person's fiduciary duties as a member end with regard to matters arising and events occurring after the person's dissociation; and
 - (3) subject to Section 17705.04 and Article 10, any transferable interest owned by the person immediately before dissociation in the person's capacity as a member is owned by the person solely as a transferee.
- (b) A person's dissociation as a member of a limited liability company does not of itself discharge the person from any debt, obligation, or other liability to the limited liability company or the other members which the person incurred while a member.

ARTICLE 7

DISSOLUTION AND WINDING UP

SECTION 17707.01 EVENTS CAUSING DISSOLUTION. A limited liability company, or a series thereof, is dissolved, and its activities shall be wound up, upon the happening of the first to occur of the following:

- (a) On the happening of an event set forth in a written operating agreement or the certificate of organization;
- (b) By the vote of a majority in interest of the members of the limited liability company, or a series thereof, or a greater percentage of the voting interests of members as may be specified in the certificate of organization or a written operating agreement;

obligation have been satisfied or waived as to or by that member. Conditional obligations include contributions payable upon a discretionary call of that series before the time the call occurs.

(3) Subsection (b)(1) shall not apply to a member's obligation to make a contribution to a series of a limited liability company.

(c) A creditor of a limited liability company which extends credit or otherwise acts in reliance on an obligation described in subsection (a) may enforce the obligation.

SECTION 17704.04 SHARING OF AND RIGHT TO DISTRIBUTIONS BEFORE DISSOLUTION.

(a) Any distributions made by a limited liability company before its dissolution and winding up shall be in equal shares among members and dissociated members, except to the extent necessary to comply with any transfer effective under Section 17705.02 and any charging order in effect under Section 17705.03.

(b) A person has a right to a distribution before the dissolution and winding up of a limited liability company only if the limited liability company decides to make an interim distribution. A person's dissociation does not entitle the person to a distribution.

(c) A person does not have a right to demand or receive a distribution from a limited liability company in any form other than money. A limited liability company may distribute an asset in kind if each part of the asset is fungible with each other part and each person receives a percentage of the asset equal in value to the person's share of distributions.

(d) If a member or transferee becomes entitled to receive a distribution, the member or transferee has the status of, and is entitled to all remedies available to, a creditor of the limited liability company with respect to the distribution.

(e) (1) All members of a series shall share equally in any distributions made by the series before its dissolution and winding up.

(2) A member of a series has a right to a distribution before the dissolution and winding up of the series as provided in the operating agreement. A decision of the series to make a distribution before the dissolution and winding up of the series is a decision in the ordinary course of activities of the series. A member's dissociation from a series with which the member is associated does not entitle the dissociated member to a distribution from the series.

(3) A member of a series does not have a right to demand and receive a distribution from the series in any form other than money. A series may distribute an asset in kind if each member of the series receives a percentage of the asset in proportion to the member's share of distributions from the series.

(4) If a member of a series becomes entitled to receive a distribution from the series, the member has the status of, and is entitled to all remedies available to, a creditor of the series with respect to the distribution.

(f) Subsection (a) shall not apply to a distribution made by a series.

SECTION 17704.05 LIMITATIONS ON DISTRIBUTION.

(a) A limited liability company may not make a distribution if after the distribution:

(1) the limited liability company would not be able to pay its debts as they become due in the ordinary course of the limited liability company's activities; or

(2) the limited liability company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the limited liability company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those of persons receiving the distribution.

(b) A limited liability company may base a determination that a distribution is not prohibited under subsection (a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subsection (f), the effect of a distribution under subsection (a) is measured:

(1) in the case of a distribution by purchase, redemption, or other acquisition of a transferable interest in the limited liability company, as of the date money or other property is transferred or debt incurred by the limited liability company; and

(2) in all other cases, as of the date:

(A) the distribution is authorized, if the payment occurs within 120 days after that date; or

(B) the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(e) A limited liability company, or a series thereof, need not give effect to a transferee's rights under this section until the limited liability company, or a series thereof, has notice of the transfer.

(f) A transfer of a transferable interest in violation of a restriction on transfer contained in the operating agreement is ineffective as to a person having notice of the restriction at the time of transfer.

(g) Except as otherwise provided in Section 17706.02(4)(B), when a member transfers a transferable interest, the transferor retains the rights of a member other than the interest in distributions transferred and retains all duties and obligations of a member.

(h) When a member transfers a transferable interest to a person that becomes a member with respect to the transferred interest, the transferee is liable for the member's obligations under Sections 17704.03 and 17704.06(c) known to the transferee when the transferee becomes a member.

SECTION 17705.03 CHARGING ORDER.

(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor.

(b) To the extent necessary to effectuate the collection of distributions pursuant to a charging order in effect under subsection (a), the court may:

(1) appoint a receiver of the distributions subject to the charging order, with the power to make all inquiries the judgment debtor might have made; and

(2) make all other orders necessary to give effect to the charging order.

(c) Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest. The purchaser at the foreclosure sale only obtains the transferable interest, does not thereby become a member, and is subject to Section 17705.02.

(d) At any time before foreclosure under subsection (c), the member or transferee whose transferable interest is subject to a charging order under subsection (a) may extinguish the

charging order by satisfying the judgment and filing a certified copy of the satisfaction with the court that issued the charging order.

(e) At any time before foreclosure under subsection (c), a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the full amount due under the judgment and thereby succeed to the rights of the judgment creditor, including the charging order.

(f) This title does not deprive any member or transferee of the benefit of any exemption laws applicable to the member's or transferee's transferable interest.

(g) This section provides the exclusive remedy by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment from the judgment debtor's transferable interest.

SECTION 17705.04 POWER OF PERSONAL REPRESENTATIVE OF DECEASED MEMBER.

(a) If a member dies, the deceased member's personal representative or other legal representative may exercise the rights of a transferee provided in Section 17705.02(c) and, for the purposes of settling the estate, the rights of a current member under Section 17704.10.

ARTICLE 6

MEMBER'S DISSOCIATION

SECTION 17706.01 MEMBER'S POWER TO DISSOCIATE; WRONGFUL DISSOCIATION.

(a) A person has the power to dissociate as a member at any time, rightfully or wrongfully, by withdrawing as a member by express will under Section 17706.02(a)(1).

(b) A person's dissociation from a limited liability company is wrongful only if the dissociation:

(1) is in breach of an express provision of the operating agreement; or

(2) occurs before the termination of the limited liability company and:

(A) the person withdraws as a member by express will;

(B) the person is expelled as a member by judicial order under

Section 17706.02(a)(5);

(C) the person is dissociated under Section 17706.02(a)(7)(A) by becoming a debtor in bankruptcy; or