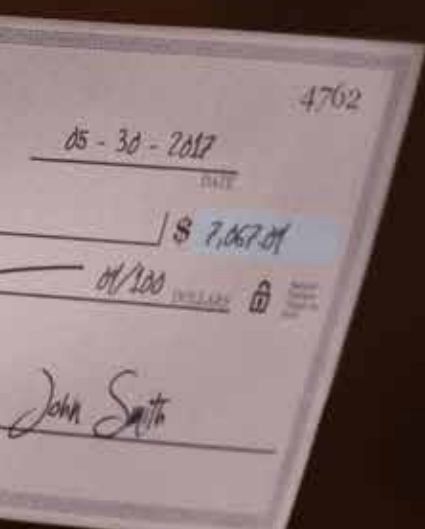






Charging Orders

You Better Get Used To Them

By Shawn M. Flanagan

A “charging order” allows a judgment creditor to receive a debtor’s share of distributions from a limited liability company (LLC) or a partnership. With the proliferation of LLCs in the last 20 years, understanding “charging order” concepts has taken on increased importance. The focus of this article is to discuss charging orders and issues arising from charging orders in the context of LLCs.

Illustration of a charging order

Assume a creditor obtains a judgment against a person (the debtor). The creditor knows or discovers that the person owns an interest in a limited liability company (LLC) or a partnership. The creditor can obtain a “charging order” from a court and deliver the order to the debtor and the LLC/partnership.

A charging order constitutes a lien on the debtor’s distributional interest in the LLC or partnership. If the LLC or partnership makes a distribution to its owners, the share that would have been paid to the debtor will instead be paid to the creditor toward satisfaction of the judgment. A “distribution” from an LLC or partnership is akin to a “dividend” from a corporation. S.C. Code Ann. Section 33-44-504 “provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor’s distributional interest in a limited liability company.”¹

History of charging orders

It is easier to understand charging orders if you understand the policy reasons behind the law.

PHOTO BY GEORGE FULTON

The following synopsis from the Maryland Court of Special Appeals provides some helpful background:

A charging order is the statutory means by which a judgment creditor may reach the partnership interest of a judgment debtor. Prior to its availability, the courts would resort to common law procedures for collection that were ill-suited for reaching partnership interests. Typically, despite the fact that individual partners do not have title in partnership property, partnership property would be seized under writs of execution; the debtor partner's interest in the partnership would be sold, often to the judgment creditor ...; and the sale of the debtor partner's interest would result in compulsory dissolution and winding up of the partnership. As noted by at least one jurist, '[a] more clumsy method of proceeding could hardly have grown up.' ... The charging order solution to this procedural nightmare appeared first in the Partnership Act adopted in England in 1890, and then in the 1914 Uniform Partnership Act (UPA) at § 28.²

As noted in the Prefatory Note to the Uniform Limited Liability Company Act (2013): "The charging order mechanism ... is an essential part of the "pick your partner" approach that is fundamental to the law of unincorporated businesses."

Charging orders have been available in South Carolina for a long time. Limited research indicates that the South Carolina Uniform Partnership Act (SCUPA) has contained a charging order statute since at least 1950.³ Having compared the current Section 33-41-750 with the SCUPA statutes in effect in 1950, 1952 and 1962, the language has remained the same for over 60 years. S.C. Code Section 33-42-1230 is the current charging order statute applicable to limited partnerships. The application of charging orders to limited partnerships in South Carolina was traced

by this author back to 1960.⁴

The LLC: The most popular choice of entity

It is no longer possible for charging orders to exist in obscurity, living in the shadows. Everything changed with the adoption of the South Carolina Uniform Limited Liability Company Act of 1996 (the Act). The number of domestic legal entities formed with the South Carolina Secretary of State's Office from July 1, 2015 to June 30, 2016 were as follows:

Corporations	1,784
Limited Liability Companies	31,019
Limited Partnerships	106
Limited Liability Partnerships	190

These statistics lead to an obvious conclusion. Over the last 20 years, limited liability companies have become the legal entity of choice in this state. It is because of this fact that charging orders have become increasingly relevant to the practice of law. (Note: Charging orders only apply to LLCs and partnerships. Charging orders do not apply to corporations.) To see a sample charging order, your attention is directed to the following form: § 18:4. Charging order, 11 West's Legal Forms, Debtor & Creditor Non-Bankruptcy Rights and Remedies, Part III. Judicial Collection, Chapter 18. Charging Orders.

Foreclosure of lien on distributional interest

Prior to a foreclosure, a creditor with a charging order is only entitled to share in distributions from the LLC in an amount equal to the judgment. If, however, the creditor purchases the distributional interest at a foreclosure sale, the creditor is entitled to share in any and all distributions from the LLC after the purchase (including distributions made in liquidation of the LLC). Where the charging order grants the creditor a lien, the purchase of a distributional interest at a fore-

closure sale makes the creditor an economic owner in the LLC (albeit an owner without voting rights).

Under the Act, the equitable remedy of foreclosure is an option with respect to a charging order lien on a distributional interest in an LLC. The Act provides that a "court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time."⁵

The purchaser at the foreclosure sale has the "rights of a transferee."⁶ A foreclosure of a lien on a distributional interest entitles the purchaser to receive the debtor-member's pro rata share of all distributions from the LLC. However, except for the right to receive a pro rata share of all distributions (if any), a "transferee" has almost no rights in an LLC.

Whether it is in the best interest of a judgment creditor to seek foreclosure is going to be based on the facts and circumstances of each case. If a creditor is already a "member" in the subject LLC, a purchase at a foreclosure sale is more likely to be to the advantage of the creditor. If a creditor is not already a member, foreclosing is less likely to be advantageous, unless the LLC owns valuable assets and the purchase price is not significant in comparison. Foreclosure is more likely advantageous in the case of a single-member LLC than it is in the case of a multiple member LLC.

Single-member LLCs

Foreclosing on a single-member LLC in South Carolina is likely to be different from foreclosing on an interest in a multiple-member LLC. The following is from the Comment to §503 of the Uniform Limited Liability Company Act (2013): "**Subsection (f)**—The charging order remedy—and, more particularly, the exclusiveness of the remedy—protect the "pick your partner" principle. That principle is inapposite when a limited liability company has only one member.

The exclusivity of the charging order remedy was never intended to protect a judgment debtor, but rather only to protect the interests of the judgment debtor's co-own-

ers” (emphasis added). Put another way, the charging order remedy was never intended as an “asset protection” device for judgment debtors.⁷ Accordingly, when a charging order against an LLC’s sole member is foreclosed, the member’s entire ownership interest is sold and the buyer replaces the judgment debtor as the LLC’s sole member.”

Tax issues and LLC charging orders

An LLC can elect to be taxed as a “C” corporation or an “S” corporation via IRS Form 8832, Entity Classification Election (known as “check the box”) and Form 2553, Election by a Small Business Corporation. If an LLC does not elect corporate tax status, there are two alternatives. First, a single-member LLC is disregarded for tax purposes, is considered a sole proprietorship, and files a Schedule C or E with the taxpayer’s Individual Income Tax Return (Form 1040). Second, a multiple-member LLC is considered a partnership for tax purposes and each member receives a Schedule K-1 when the Partnership Return

of Income (Form 1065) is filed. This section focuses on multiple-member LLCs taxed as partnerships.

If a creditor obtains a charging order, the debtor continues to be the tax partner. With a charging order in place, the debtor continues to be responsible for reporting the pass-thru partnership items and the LLC should continue to issue the Schedule K-1 to the debtor. A payment toward a loan (or a judgment) is made with after-tax money. If a creditor receives a distribution from an LLC pursuant to a charging order, the creditor is merely receiving a debt payment. The debtor pays the tax attributable to the distribution to the creditor.⁸

A purchaser of a debtor’s interest at a foreclosure sale (whether that person is the judgment creditor who initiated the action or an unrelated third party) becomes a tax partner and starts receiving the Schedule K-1. Purchase at a foreclosure sale can be problematic for a creditor as a result of the creditor becoming a “transferee.” As a transferee, income may pass-thru to the

creditor (on which taxes must be paid) regardless of whether the LLC distributes any cash to the creditor.

What if the debtor continues to hold “residual rights” in the LLC after the foreclosure sale? For example, what if after the creditor becomes a transferee, the debtor continues to hold a right to participate in the management of the LLC and inspect the books? In that event, there is some 40-year-old guidance from the IRS that suggests that the debtor should continue to be the “partner” for tax purposes after the foreclosure sale.⁹ Tax law is not always logical.

Bankruptcy and LLC charging orders

Assume a judgment creditor purchases a debtor’s LLC interest at a foreclosure sale. The creditor under this scenario becomes a “transferee” or “assignee” (the two terms being synonymous). The creditor is not admitted as a “member” of the LLC. As merely a transferee, the creditor has no say in the management of the LLC (and, therefore,

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no right to compel distributions). This typical result may be different in the event of a bankruptcy. It is possible for a bankruptcy trustee to become a “member” of the LLC with “voting rights” (also known as the right to participate in management). If a bankruptcy trustee has management rights, the trustee might be able to force a dissolution of the LLC.¹⁰ The resolution of this issue typically turns on whether an operating agreement is an “executory contract.” Though the case law is split on the matter, courts finding that an operating agreement was not an executory contract typically have allowed the bankruptcy trustee to succeed to all of the rights of the debtor as a “member” of the LLC.¹¹ In the case of single-member LLCs, the bankruptcy trustee will become a “member” whether or not the operating agreement is an executory contract.¹²

The consequences of this distinction (“member” vs. “assignee”) are material. The Act provides that “a member or a dissociated member” of an LLC may apply for dissolution via judicial decree under certain circumstances.¹³ This dissolution provision is one of the special provisions that the Act does not allow the operating agreement to waive or vary.¹⁴ Therefore, a practitioner may seek to have an operating agreement qualify as an executory contract, so as to prevent a bankruptcy trustee from becoming a member. To be an executory contract, there should be ongoing material obligations between the LLC and its members.¹⁵ Including one or more of the following in your operating agreement should help achieve that result: (1) adding fiduciary obligations of loyalty for all members via non-compete provisions; (2) adding an advisory board that “advises” the manager and requires the participation of all members; and (3) adding additional capital contribution obligations for all members.¹⁶

Limited South Carolina case law

Historically, there has been a lack of case law involving charging orders. As one Maryland court had

to say, “despite its lengthy existence in Maryland law, we have been able to uncover only six published opinions that even mention the charging order.”¹⁷

Although South Carolina has had “charging order” statutes on the books for more than 60 years, *Kriti Ripley, LLC v. Emerald Investments, LLC*, 746 S.E.2d 26, 404 S.C. 367 (2013), is the first known published decision in South Carolina to discuss charging orders.¹⁸ The two known cases in South Carolina offer helpful guidance on some of the issues that can arise in the context of LLC charging orders.

Kriti Ripley, LLC v. Emerald Investments, LLC

The following is a summary of the central facts in *Kriti*. Ashley River Properties II, LLC (Ashley II LLC) was formed by Kriti Ripley, LLC (Kriti LLC) and Emerald Investments, LLC (Emerald LLC). Emerald LLC contributed real property and permits valued at \$2.5 million for a 70 percent interest in Ashley II LLC. Kriti LLC contributed \$1.25 million in cash for a 30 percent interest in Ashley II LLC. Immediately after the \$1.25 million in cash was contributed to Ashley II LLC, Emerald LLC and its sole member, Stuart Longman, diverted and misappropriated the cash. Kriti LLC first procured a judgment against Emerald LLC and then obtained a charging order against Emerald LLC’s interest in Ashley II LLC. Kriti LLC moved to foreclose on Emerald LLC’s interest in Ashley II LLC. The circuit court denied foreclosure. The Supreme Court of South Carolina reversed the circuit court and allowed foreclosure.

The following are points of law addressed in the *Kriti* opinion. (1) An operating agreement cannot vary a creditor’s right to obtain a charging order and foreclose on it. S.C. Code Ann §33-44-103(b). (2) The circuit court’s denial of Kriti LLC’s motion for foreclosure was “immediately appealable.”¹⁹ (3) S.C. Code Ann §33-44-504 “provides the exclusive remedy by which a **judgment creditor** of a member or a transferee may satisfy a judg-

ment out of the judgment debtor’s distributional interest in a limited liability company” (emphasis added). (4) “[T]he decision to grant or deny foreclosure under section 33-44-504(b) is equitable (citation omitted). Accordingly, an appellate court reviewing a decision to grant or deny foreclosure under section 33-44-504(b) may find facts in accordance with its own view of the preponderance of the evidence.”²⁰

Among other things, the Supreme Court of South Carolina held that: Kriti LLC and Ashley II LLC “sought foreclosure not as members of an LLC, but as judgment creditors.” Foreclosure “is a remedy commonly used around the country when a charging order on a debtor’s interest in an entity alone will not result in payment of a judgment ... A judgment creditor has a right to collect on his judgment.” Foreclosure is not “drastic,” not “a form of forfeiture” and not “a penalty.”²¹ The ability of Ashley River Properties II, LLC to sell assets to pay the judgment was not a factor the circuit court should have considered. “Kriti and Ashley River II bear no obligation to forego what they believe to be a potentially profitable business venture in order to aid Emerald and Longman in paying their debt. If Kriti and Ashley River II believe the development of the property can still be made to turn a profit, they are free to pursue that goal.”²²

The SC Supreme Court discussed the totality of the circumstances test to be applied in deciding whether foreclosure is appropriate in a given case. “As an equitable matter, the decision whether to grant foreclosure under section 33-44-504 requires consideration of the totality of the circumstances in each individual case (citation omitted). **However, the primary, and usually determinative, factor for a circuit court to consider is whether the judgment will be paid within a reasonable amount of time through distributions** (emphasis added; citations omitted). In short, if a judgment will not be paid through distributions in the reasonably foreseeable future, then foreclosure

usually should be ordered.”²³

Levy v. Carolinian, LLC

Following hot on the heels of Kriti was the SC Supreme Court’s decision in *Levy v. Carolinian, LLC*, 763 S.E.2d 594, 410 S.C. 140 (2014). For those of us who organize LLCs, the importance of a written operating agreement cannot be overstated. *Levy* reaffirms this understanding as it pertains to charging orders.

The following is a summary of the facts in *Levy*. In February 2010, Shaul and Meir Levy (the Levys) obtained a \$2.5 million judgment against Bhupendra Patel (Patel) and thereafter obtained a charging order against Patel’s distributional interest in Carolinian, LLC. In April 2012, the Levys purchased Patel’s distributional interest in Carolinian, LLC at a foreclosure sale for \$215,000. Carolinian, LLC unsuccessfully bid \$190,000 at the foreclosure sale for Patel’s interest. Invoking its operating agreement, Carolinian, LLC then attempted to redeem the interest the Levys had purchased at the foreclosure sale.

The Levys objected to Carolinian, LLC’s attempt to redeem their interest since it did not occur prior to foreclosure. The circuit court found that Carolinian, LLC could compel the judgment creditors to sell their distributional interest after the foreclosure sale. The Supreme Court reversed the circuit court.

The LLC Act is a default statute. As such, the LLC Act only applies in cases where an operating agreement does not provide guidance.²⁴ The following provisions of Carolinian, LLC’s operating agreement were material to the outcome of the case.

Section 3.5 of Carolinian, LLC’s operating agreement provided that if a member’s interest became subject to a charging order, Carolinian, LLC could redeem such member’s interest at any time prior to foreclosure.

Section 11.1 of Carolinian, LLC’s operating agreement provided that “No Member may ... involuntarily ... transfer ... his Membership Share to any Person without the prior written consent of [the] Mem-

bers ...” Section 11.2 of Carolinian, LLC’s operating agreement provided that “If a Member attempts to transfer all or a portion of his Membership Share without obtaining the other Members’ consent as required in SECTION 11.1, ... such Member is deemed to have offered to the Company all of his Member Share ...”

Carolinian, LLC did not exercise its right of redemption prior to the foreclosure sale per Section 3.5 of the operating agreement. Carolinian, LLC attempted to purchase the Levys’ interest under Section 11.2 of the operating agreement. The trial court found that Sections 11.1 and 11.2 of the operating agreement applied to the Levys. The SC Supreme Court reversed the trial court.

The SC Supreme Court found that the Levys did not attempt to transfer their interest after they became transferees and, therefore, Sections 11.1 and 11.2 of the operating agreement never applied to them. An operating agreement can have a buy-out provision applicable after a judgment creditor becomes a transferee, but the Carolinian, LLC’s Operating Agreement did not contain such a provision.

The SC Supreme Court applied the following analysis:

First, the transfer restrictions of Section 11.1, by their express and unambiguous terms, apply only to “members,” and unquestionably, the Levys have never been or sought to be members of Carolinian; they merely became transferees of Patel’s distributional interest by virtue of the foreclosure sale. Further, the Levys did not attain the status of transferees until *after the foreclosure sale*; thus, Carolinian could not, through its Operating Agreement, restrict the statutory rights of the Levys by requiring consent from Carolinian or its members *before the foreclosure sale*, as the Levys were mere judgment creditors at that time. See S.C. Code Ann. § 33-44-103(b)(7) (prohibiting an operating agreement from restricting

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the rights of a person other than managers, members, and transferees of a member's distributional interest). Thus, the Levys were not subject to the transfer restrictions of Section 11.1 at the time they foreclosed their charging lien.

Moreover, because the Levys were not required under Section 11.1 to obtain consent from Carolinian or its members prior to the foreclosure sale, we find Carolinian may not now invoke the right to purchase under Section 11.2, as that section, by its terms, applies only where consent under Section 11.1 is required and not obtained prior to the transfer. We hold that Carolinian's ability to purchase Patel's interest is not controlled by any part of Article 11, but rather by Section 3.5 of the Operating Agreement, which provided Carolinian the opportunity to purchase Patel's interest before the foreclosure sale, not after.²⁵

Conclusion

Black's Law Dictionary has included a "charging order" definition since 1904. Charging orders are not new. LLCs, on the other hand, are relatively new. The advent of LLCs has increased the need to understand charging orders. Keep in mind that the law governing LLCs is still evolving. This article provides some guidance in just one area, charging orders. If you are interested in keeping a watch on this changing area of "corporate law," you may want to view the annual compilation of LLC case law in the United States prepared by Professor Elizabeth S. Miller of the Baylor University School of Law (including charging order cases) that is available on that school's website, under her name. Stay tuned. More change is on the way.

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Endnotes

¹ S.C. Code Ann. Section 33-44-504(e).

² 91st Street Joint Venture v. Goldstein, 691 A.2d 272, 275 (Md. Ct. Spec. App. 1997). For another description of the law in effect before charging order statutes, see Asset Protection And The Limited Liability Company: Not The Panacea Of Creditor Protection That You Might Think! by William S. Forsberg, 23 Prob. & Prop. 39 (Nov/Dec 2009).

³ See "HISTORY" after S.C. Code Section 33-41-750.

⁴ See 1962 Code Sec. 52-123 and 1960 (51) 1970.

⁵ S.C. Code Ann. Section 33-44-504(b).

⁶ S.C. Code Ann. Section 33-44-504(b).

⁷ See *Olmstead v. F.T.C.*, 44 So. 3d 76, 83 (Fla. 2010) (recognizing "the full scope of a judgment creditor's rights with respect to a judgment debtor's freely alienable membership interest in a single-member LLC"); *In re Albright*, 291 B.R. 538, 540 (Bankr. D. Colo. 2003) (holding that, "[b]ecause there are no other members in the LLC, . . . the Debtor's bankruptcy filing effectively assigned her entire membership interest in the LLC to the bankruptcy estate, and the Trustee obtained all her rights, including the right to control the management of the LLC").

⁸ Carter Bishop & Daniel Kleinberger, Limited Liability Companies: Tax and Business Law, § 8.07[1][a][i] ("Member" status for tax purposes) and § 8.07[1][a][ii] (Taxation where a charging order exists: assignees vs. creditors) (WG&L).

⁹ See Revenue Ruling 77-137, 1977-1 C.B. 178; Internal Revenue Service General Counsel Memorandum (IRS GCM) 36960 (December 20, 1976), 1976 WL 39195; and *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971).

¹⁰ See *Can an Estate Effectively Liquidate a Fractional Interest in an LLC?*, by Richard J. Mason and Patricia K. Smoots, *ABI Journal* (October 2015).

¹¹ See, e.g., *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000); *In re Tsiaoushis*, 383 B.R. 616, 619 (Bankr. E.D. Va. 2007); *In re Klingerman*, 388 B.R. 677 (Bankr. E.D.N.C. 2008); and *In re Hanckel*, No. 2:14-cv-2898, 2015 WL 7251714 (D.S.C. 3/10/15). See also *What Your LLC Operating Agreement Can Do for You*, by Paul R. Hage and Patrick R. Mohan, *ABI Journal* (July 2012).

¹² See *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003); *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006); *In re Frumusa*, 2010 WL 1509291 (Bankr. W.D.N.Y. 2010); *In re Pavilack*, Case No. 10-06503-jw (Bankr. D.S.C. November 2, 2012); *In re Cleveland*, 519 B.R. 304 (D. Nev. 2004); *In re First Protection, Inc.*, 440 B.R. 821, 830 (9th Cir. BAP 2010); *In re B & M Land & Livestock, LLC*, 498 B.R. 262, 267 (Bankr.D.Nev.2013); and *In re Penn*, 2010 WL 9445533 (Bankr. N.D. Ga. 2010).

¹³ S.C. Code Ann. Section 33-44-801(4).

¹⁴ S.C. Code Ann. Section 33-44-103(b)(6).

¹⁵ See, for example, *In re DeLuca, L.C.*, 194 B.R. 65 (Bankr. E.D. Va. 1996) (the operating agreement was held to be executory because the members were required to provide continuing personal services); *In re Allentown Ambassadors, Inc.*, 361 B.R. 422 (E.D. Pa. 2007) (the members had duty to manage the LLC and make additional cash contributions as necessary); and *Matter of*

Daugherty Construction, Inc., 188 B.R. 607, 612 (Bankr. D. Neb. 1995).

¹⁶ *Partnership, LLC & S Corporation Tax Planning Forums*, by Charles R. Levun and Michael Cohen (CCH).

¹⁷ 91st Street Joint Venture v. Goldstein, 691 A.2d 272, 276, 114 Md.App. 561, 569 (Md. App. 1997).

¹⁸ Over the last twenty years there has been a significant increase in case law in all jurisdictions involving charging orders, as well as more scholarly discussions of the subject.

¹⁹ 746 S.E.2d at 32.

²⁰ 746 S.E.2d at 33.

²¹ 746 S.E.2d at 33-34.

²² 746 S.E.2d at 34-35.

²³ 746 S.E.2d at 34.

²⁴ For the few things in the Act that an operating agreement cannot change, see S.C. Code Ann. Section 33-44-103(b). **Practice tip:** Section 33-44-103(b)(6) references Section 33-44-801(4). Section 33-44-801 sets forth events causing dissolution and winding up of an LLC's business. Section 33-44-801(4)(d) references Section 33-44-701 (which sets forth instances when an LLC must purchase a distributional interest of a dissociated member). Failure to purchase an interest when required can result in dissolution. By making your LLC a "term company" via your articles of organization and/or in your operating agreement, a mandatory purchase of a dissociated member's interest does not have to occur until the end of the term.

²⁵ 763 S.E.2d at 597.

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