

NON-TAX PURPOSES OF FLPS AND LLCs

Discussion Materials

**Business Planning Group Meeting
May 2, 2008**

**AMERICAN BAR ASSOCIATION
Section of Real Property, Trust & Estate Law
19th ANNUAL SPRING SYMPOSIA
Washington, DC**

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**PRACTICAL NON-TAX BENEFITS OF
LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES**

Benjamin H. Pruett¹

Letter to Ward and June Cleaver

The first attachment is a letter (actually an excerpt from a letter) that I wrote to a client discussing ways in which a family LLC might be useful to them. The letter was the result of extensive conversations with the parents and their concerns regarding their two sons, age 17 and 19. Each child was the beneficiary of a UTMA custodial account valued in excess of \$1,000,000, and each child was also the beneficiary of a Section 2503(c) minor's trust, also valued at approximately \$1,000,000 each. The parents were concerned about the fact that the UTMA accounts and minor's trusts would fall into their children's hands at age 21, and while both of their sons are very responsible and mature for their ages, they are still teenagers. The parents also inquired about when the appropriate time might be to inform the children about the nature and extent of the family wealth, because the parents wanted to get them involved as soon as possible. Accordingly, this letter discusses the following uses of LLCs:

- LLC as a vehicle by which to get the children involved, in a participatory way, in management of the family wealth.
- Investment fee savings enjoyed by pooling children's investments with parents' investments
- Opportunity to invest in investments otherwise beyond the children's reach, as a result of their inability to meet minimum investment requirements, "qualified purchaser" status under the securities laws, or both.
- Asset Protection benefits; and
- Facilitation of future gifts (*Bigelow*, et al. notwithstanding)

The primary purpose of this letter was to educate the client, but I also wanted to help to document, from the outset, the many reasons the clients were motivated to create the LLC, and valuation discounts truly were at the bottom of the priority list in this case. I welcome any comments from the committee as to whether, and the extent to which, this type of communication would be helpful in the event of a dispute or, preferably, helpful in avoiding a dispute.

As a follow-up for the subsequent history of this particular client, the following steps have been taken:

- The family's financial cash flow needs were carefully analyzed in light of their expected income and consumption needs, to make sure that they retained sufficient assets outside the partnership to meet any needs not met from current income. This included not only the parents, but the portion of the children's future education needs that they would be contributing from their assets. We now have memos in the file showing the analysis of future cash needs to demonstrate that no distributions will be needed from the LLC, for the foreseeable future, to meet cash flow needs.

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- The assets to be contributed by all of the members of the LLC have been carefully analyzed to prevent any “diversification” issue under IRC § 721(b).
- The mutual fund investments contributed by the children’s UTMA’s and Minor’s Trusts were liquidated so that the proceeds could be reinvested in “managed accounts” holding individual securities within the same asset class. Fortunately, there was not significant gain in any of the liquidated mutual funds, so capital gains recognition was not an impediment to moving forward with the funding plan.
- Private equity investments were contributed to the partnership by the parents, after we confirmed with securities counsel that the partnership qualified as a “qualified purchaser” under the federal securities laws, even though the children were not, individually, qualified purchasers.
- The children’s shares each totaled slightly less than 25%, and each parents’ shares each totaled slightly more than 25%.

Howard Cunningham Letter

Next, I have included a recent letter to a client discussing several other benefits of holding investments in an FLP/LLC. Once again, this letter originated from the client’s desire to make gifts to his children, and all of the goals and considerations set forth in the letter came primarily from the client himself. My goal was to take the client’s thoughts and intentions and articulate them in a way that would demonstrate the reasons for using the entity, should the need ever arise. As with the other client, valuation discounts were at the bottom of the priority list. Again, I welcome any comments or discussion.

Forum Shopping for Favorable FLP and LLC Legislation, Parts I - III

Finally, since the asset protection benefits of FLPs and LLCs are often cited, I have included three recent and excellent articles, reprinted with Steve Leimberg’s permission, from his e-mail newsletter service. These articles discuss the fact that not all state LP and LLC statutes limit a judgment creditor’s remedy to a charging order, and even among states that do so limit remedies, there is wide variance as to the real protection offered by the statute. These three newsletters authored by Messrs. Merric and Comer include a state by state table that is very useful tool in choosing a situs for an FLP or LLC.

My thought when reading these articles is that if asset protection is truly a purpose of the FLP, that purpose may be better served in another state. Moreover, the act of going to another state to form an entity (or the act of determining, after researching the laws of other jurisdictions, that organizing under the laws of another state is *not* necessary), should help to demonstrate that asset protection truly was a motivating factor in forming the entity, rather than a mere afterthought raised in the course of litigation.

Disclaimer

Needless to say, no warranty of any kind is given as to the suitability of any of the materials presented for any particular client.

September 6, 2007

Mr. and Mrs. Ward Cleaver
Re: Estate Planning

Personal and Confidential

Dear June and Ward:

* * *

[The first part of this letter explains that we do not act as legal counsel to the client and that all of the planning comments or suggestions are solely for the purpose of further discussion with the client's counsel.]

Family Limited Liability Company

When we met, you both expressed a particular interest in getting Wally and the Beaver involved in the family wealth as soon as it was reasonably prudent to do so. We also discussed what to do about their respective UTMA accounts and Minor's Trusts when those assets come into their control at the age of 21.

The Minor's Trusts already provide that if they do not withdraw the assets from the trusts within 60 days of their 21st birthdays, the property will remain in the trusts for their benefit until they attain age 25, when they will receive ½ the property, and age 30, when they receive the remainder. The purpose of the *continuation trusts* would be to protect the children from their own youth and inexperience in dealing with financial matters. There are, however, drawbacks to this structure, most notably that the assets in the self-settled trusts would continue to be fully vulnerable to claims by their creditors, most likely as the result of a divorce.

A better option may be for them to contribute their assets, or at least a portion of them, to a ***Limited Liability Company (LLC)***, to which the two of you can also contribute assets. An LLC can provide many benefits to the entire family that may be attractive to you. Such family entities are also sometimes called ***Family LLCs*** and are sometimes structured as *family limited partnerships*, but family limited partnerships require the creation of two new entities, rather than just one, so unless there is some legal or tax reason to use a limited partnership instead of an LLC, the LLC is probably less cumbersome.

- **Participation in Family Venture.** The LLC can provide an excellent opportunity for Wally and the Beaver to get involved in the family finances, because as Members of the LLC, they can participate in meetings in which investments, distributions, etc. are discussed. Since they would have a very real stake in the LLC, they should have a commensurate level of genuine interest. Moreover, being a voting member in the LLC, albeit a minority voting member, would likely give each of them a much greater sense of empowerment and real participation than they would get from being the beneficiary of Minor's Trusts after their 21st birthdays. In his book, *Family Wealth-Keeping It In The Family*, Jay Hughes discusses at length the importance of a family having a sense of common purpose, which could be well served by an

LLC. Consider the following quote from Sam Walton, founder of Wal Mart, from his book, *Sam Walton: Made in America*:

Helen's [i.e., Mrs. Sam Walton's] father organized his ranch and family businesses as a partnership, and Helen and her brothers were all partners. They all took turns doing the ranch books and things like that. Helen has a B.S. degree in finance, which back then was really unusual for a woman. Anyway, Mr. Robson advised us to do the same thing with our family, and we did, way back in 1953. What little we had at the time, we put into a partnership with our kids, which was later incorporated into Walton Enterprises.

Over the years, our Wal-Mart stock has gone into that partnership. Then the board of Walton Enterprises, which is us, the family, makes decisions on a consensus basis. Sometimes we argue, and sometimes we don't. But we control the amount we pay out to each of us, and everybody gets the same. The kids got as much over the years as Helen and I did, except I got a salary, which my son, Jim, now draws as head of Walton Enterprises. That way, we accumulated funds in Enterprises rather than throwing it all over the place to live high. And we certainly drew all we needed, probably more, in my opinion.

The partnership works in a number of different ways. First, it enables us to control Wal-Mart through the family and keep it together, rather than having it sold off in pieces haphazardly. We still own 38 percent of the company's stock today, which is an unusually large stake for anyone to hold in an outfit the size of Wal-Mart, and that's the best protection there is against the take-over raiders. It's something that any family who has faith in its strength as a unit and in the growth potential of its business can do. The transfer of ownership was made so long ago that we didn't have to pay substantial gift or inheritance taxes on it. The principle behind this is simple: the best way to reduce paying estate taxes is to give your assets away before they appreciate.

It turned out to be a great philosophy and a great strategy, and I certainly wouldn't have figured it out way back then without the advice of Helen's father. It wasn't lavish or exorbitant, and that was part of the plan—to keep the family together as well as maintain a sense of balance in our standards.
S. Walton, Sam Walton: Made In America 6-7 (1992)

- **Reduced Investment Cost.** Some of your children's UTMA and Minor's Trust investments in our various investment portfolios are held in the form of *mutual funds*, rather than *managed accounts*, in which the account actually owns all of the individual securities making up the portfolio, because the investment does not meet the minimum level of investment required to efficiently assemble and maintain the portfolio for the account. The investment management fees for mutual funds (which are charged to the funds themselves, and not to the individual client account), are slightly higher than the fees for a managed account in the same portfolio, due to the additional record keeping and legal compliance that is required for a mutual fund. If you and your children pooled your assets in a single investment vehicle, such as an LLC, then the LLC would likely be able to meet the investment minimums for a managed account in

every portfolio for which managed accounts are an option, thus reducing the investment fees paid by your children.

- **Alternative Assets.** Additionally, should your children ever be interested in investing in any *alternative asset* categories, such as hedge funds and private equity funds, they would have to satisfy the requirements for *qualified purchaser* status under the securities laws. The requirements for qualification include ownership of net investment assets of at least \$5,000,000, which they would not be able to satisfy at this time. Moreover, the private equity funds also have minimum investments, which may be more than a child would want to invest in that category. Finally, the interests in the private equity funds may not be fractionalized, except in very limited circumstances, under the rules of the private equity funds themselves. An LLC, on the other hand, can qualify as an accredited investor and qualified purchaser, even if each of the individual members cannot, as long as the members are related to each other and the LLC was not formed for the specific purpose of making the particular investment in question. Therefore, the LLC could offer future investment opportunities to your children that would not otherwise be available to them at all.
- **Asset Protection for All Members.** Once the assets are contributed to the LLC, they will enjoy significant protection from all of the Members' future creditors, because the contributed assets will thereafter belong to the LLC, not to the individual Members. Moreover, Virginia law provides that a judgment creditor of a Member in an LLC may not seize a Member's LLC interest in satisfaction of a debt. Instead, the creditor's *sole remedy* against the Member is to obtain a *charging order* from a court, which essentially gives the creditor the right to any distributions to the Member, up to the amount of the debt, *if* and *when* such distributions are actually made. However, the judgment creditor does *not* have the power to compel the LLC to make any distributions at any time, so the creditor may be forced to wait for payment indefinitely, if the LLC does not vote to make distributions to Members. When faced with a charging order as the sole remedy, judgment creditors tend to be willing to settle the matter on terms more favorable to the debtor. The rights of a judgment creditor of an LLC Member are not so limited under the laws of all states, but Virginia has one of the most powerful LLC statutes in the country in this regard.
- **Separate Property Status.** In the divorce context, the laws of many states provide that an individual's "separate" assets brought to a marriage or acquired through gift or inheritance are not subject to "equitable division" in the event of a divorce, but as soon as those separate assets are commingled with the spouse's assets or joint assets, they lose their status as separate assets, and become subject to equitable division. It is deceptively easy to inadvertently commingle separate property in the form of cash or marketable securities with marital property. It is not, however, very easy to inadvertently commingle an LLC interest with anything.
- **Future Gift Facilitation.** Another advantage of a LLC is that it can help facilitate future gifts you may wish to make to your children, especially annual exclusion gifts, because you can give them interests in the LLC, rather than cash. Any gift of an LLC interest carries all of the advantages of an LLC interest, such as creditor protection, as well as the fact that it would be a gift of a well diversified and managed portfolio, even though you can control the value of the gift because you control what percentage of your interest in the LLC you choose to transfer.

Mr. and Mrs. Ward Cleaver

September 6, 2007

Page 4

- **Control.** Presumably, if both of you and both children contributed assets to the LLC, neither child would hold a majority interest in the LLC, so neither child would have the unilateral ability to control the investment of or distribution of LLC assets, including a liquidation of the company (assuming, of course, that the operating agreement for the company so provided). If the two of you each own equal shares, then neither of you would own a controlling interest either (which can be beneficial), but the two of you together would likely hold a controlling interest.
- **Valuation Discounts for Tax Efficiency.** LLCs offer estate planning benefits, in that for gift, estate, and GST tax purposes, the fair market value of a minority interest in an illiquid, closely held entity like an LLC is substantially less than the pro-rata value of the LLC's assets represented by the interest. Such valuation discounts resulting from the lack of control and the lack of marketability associated with minority LLC interests can often total as much as 25% to 45%, depending upon the circumstances, thus allowing for larger economic benefit to pass at a reduced estate tax cost.

The LLC would be formed under Virginia law, and each member would receive a Membership interest that is commensurate with his or her contribution to the LLC. All of the LLC's taxable income would "pass through" the LLC to the Members, pro rata, irrespective of whether distributions are made from the LLC to the Members during that year.

* * *

Conclusion

If you have any questions or need anything further, please do not hesitate to call.

Sincerely,

Benjamin H. Pruett

BHP

cc: [Client's Counsel]

September 19, 2007

Mr. Howard Cunningham

Personal and Confidential

Washington, DC 20007

Re: HappyDays, LLC and Subsidiary Real Estate Partnership Interests

Dear Howard:

I am writing to convey my thoughts about your proposal to transfer, by gift, a ten percent (10%) Member interest in HappyDays, LLC, a Virginia limited liability company (the "Company") of which you serve as Manager, to each of your four children. You believe that the future prospects of the real estate ventures, interests in which are currently held in the Company, to be very good, and by transferring Member interests to your children, you will give them the economic benefit of the interests in the ventures, while at the same time removing those interests, and the future increases in the values of the interests, from your gross estate for estate tax purposes which is, of course, very sound estate planning.

As a reminder, all comments or suggestions in this letter are intended solely as points of discussion with your legal counsel, since Bessemer Trust does not practice law. Accordingly, no part of this letter is intended as legal or tax advice, nor may it be relied upon as such for any purpose, and we have agreed that you will look solely to your counsel for such advice.

The Operating Entity Interests

I understand that each of the operating entities in which the Company holds an interest is a limited liability entity holding real property for development and eventual sale (or rental) or current income production. The Company's interest in each operating entity is a minority interest, both with respect to voting rights and economic interests, such as distribution rights on liquidation. Some of the operating entities are subject to future capital calls to the owners, and some are not. You are not related to the other owners in the operating entities, but the other owners are persons with whom you have a very long term and productive working relationship.

Children's Lack of Experience in Industry

While you would like for the children to enjoy the economic benefits of the operating entities, you do not want for them to have to be involved in the day to day operations, since none of your children have much experience in this industry.

Relationships with Current and Potential Partners

Moreover, while the operating entity interests are transferable to family members and trusts for family members, the other owners would likely prefer to continue dealing only with you with respect to these ventures. Additionally, you are in negotiations with some potential new owners, either for additional investments into some of the ventures, or with respect to new ventures, and their interest is based upon their knowledge of you and the other owners in the ventures. Accordingly, you feel that those potential new owners would be more inclined to join the venture if they knew that the persons with whom they were going into business were limited to the existing "core" group, rather than numerous new owners with little or no experience in the business.

Future Capital Calls

You are concerned about transferring to your children operating entity interests for which they may be called upon to make additional capital contributions, due to the economic burdens that could create for them.

Creditor Issues

Finally, you are concerned about protecting the interests, as much as possible, from any future claims of creditors especially, in the case of your children, claims incident to divorce.

Purpose of Holding Company Structure

I understand that, for several years, you have held your interests in the operating entities in the Company's predecessor, which was a Maryland limited liability limited partnership, for several reasons, and that the use of a holding company structure is even more important now, in light of your planned transfers to your children.

- Administratively, it is much simpler for you to transfer interests in the holding company than it would be to transfer interests in each individual operating entity, especially since the operating entity interests are already in the holding company.
- By holding the operating entity interests in a single holding company, of which you serve as the Manager, you can transfer the *economic benefits* to your children, without imposing upon them the burdens of participating in the business of each of the operating entities, including attending meetings, signing documents, voting, etc.
- Given the accounting that is necessary whenever there is a change of ownership in the middle of a tax year, it will be much easier to confine those accounting issues to the single holding company, rather than having to recalculate capital accounts, percentage interests, etc. in each operating entity.
- You will maintain better relations with the other owners, since they will continue to deal with you rather than having to deal with more numerous, but less experienced, new owners.
- Potential new owners in the operating entities also should be more comfortable in knowing that irrespective of who the beneficial owners of the interests are, the person with whom they will be dealing will be you.

- Cash flow from the operating entities that produce cash flow can be retained by the holding company for later use in meeting capital calls from other operating entities. Of course, this *could* be accomplished on an individual basis as well, but it is in everyone's best interests to take any action that will better assure that the capital calls will be met in a timely manner, without concern about whether each child continues to maintain the ready liquidity that will be necessary. Moreover, cash distributions from one operating entity could be seized by a creditor before they can be used to meet capital calls in another entity, but are better protected if retained in the holding company.

Virginia Residency for Company

Among other benefits of relocating the holding company from Maryland to Virginia is the superior asset protection offered by a Virginia LLC as compared to a Maryland LLLP. The sole remedy of a judgment creditor of a Virginia LLC Member is a *charging order* against the Member's interest, meaning that if, and when, distributions are made from the LLC, the creditor can seize the distribution, but the creditor cannot compel a distribution, nor can the creditor obtain judicial foreclosure of the Member's interest or any assets of the LLC. In Maryland, by contrast, a judgment creditor can obtain foreclosure against the interest of an owner in an LLLP.

Valuation

Since it appears that the interests you will be giving to the children will be worth far more than the current gift tax annual exclusion amount of \$12,000, you will need to report these gifts on a federal gift tax return, even though you should incur no actual gift tax liability until your cumulative lifetime taxable gifts exceed \$1,000,000 for each of you and Marion. Determining the value of the gifts for reporting purposes presents a challenge, however, since determining the "fair market value" of real estate is not an exact science, but, to the contrary, is a very *inexact* art. Compounding the difficulty is the fact that the real estate ventures are held in entities in which you hold an illiquid, minority interest, and those operating entity interests are, in turn, held in another entity as well. Therefore, not only will the ventures have to be valued, but the illiquid minority interests in the operating entities will also have to be valued, as will the interests in the holding company.

The concern, from a tax standpoint, is that the IRS may determine that the value of the interests given away is higher than the value you have determined, which could result in an unanticipated gift tax liability or, at least, a greater than anticipated use of your available gift and estate tax exclusions. This uncertainty can be greatly mitigated, however, if you adequately disclose the value of the interests transferred, including your method for determining that value, on a federal gift tax return. Assuming that you have adequately disclosed the gift and your valuation method, the IRS will, in most cases, be foreclosed from challenging the value if no challenge is brought within three years of the filing of the gift tax return. Accordingly, within three or four years, you will either know that the value of the gift has been "fixed" or you will have initiated the process of settling the issue of value, whether by negotiation or (heaven forbid) litigation.

When you do obtain an appraisal, don't be surprised if the value of each operating entity interest is determined to be significantly less than the pro-rata value of the assets of the operating entity represented by the interest, since the illiquidity of the interest and the fact that the interest is a minority interest will reduce the overall fair market value of the interest. Moreover, the 10%

Mr. Howard Cunningham
September 19, 2007
Page 4

Personal and Confidential

interests in the Company may be further “discounted,” owing to the fact that the 10% interests will also be illiquid minority interests. Whether you wish to obtain appraisals at the holding company level, as well as at the operating entity level, will depend upon the additional discount that might be determined, as offset against the additional time and expense involved in the second appraisal.

The positive aspect of “valuation discounts” is that they theoretically allow you to transfer more value at less gift tax “cost.” I say “theoretically” because the discounts are quite real until the operating entities are liquidated, which may not happen for a very long time.

Conclusion

I think that the transfers of the interests in the Company are an excellent idea. If there is any way in which I might be of further assistance in the process, please do not hesitate to call.

Sincerely,

Benjamin H. Pruett

BHP

cc: [Client’s Counsel]

Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #112

Date: 08-Aug-07
From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: **Forum Shopping For Favorable FLP and LLC Legislation**

Mark Merric is the principal in **Merric Law Firm**, a boutique firm emphasizing active in the areas of estate planning, international tax, and asset protection planning and specializing in co-counsel arrangements with other attorneys.

Mark is a national speaker on estate and asset protection planning and co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*.

William Comer is a financial consultant specializing in estate preservation, asset protection and privacy. He is a certified senior advisor, a long-time member of the Offshore Institute and has spoken on these issues throughout the U.S., Costa Rica and the Bahamas. He is the author of *Freedom, Asset Protection & You* <http://www.offshorepress.com/fapy.htm>, a complete encyclopedia of asset protection and estate preservation.

EXECUTIVE SUMMARY:

The race for states to attract trust business is not the only race with big dollars at stake. Many states seek to attract corporate, limited partnership, and limited liability company business. One of the primary factors an estate planner should consider when forum shopping for favorable limited partnership law or limited liability law is “sole remedy charging order protection.”

This LISI commentary provides a chart regarding the law of each state, and whether such state provides for sole remedy charging order, allows the judicial foreclosure sale of an limited partnership interest or member interest, or is silent on the issue leaving the decision to future case law. In our next LISI, we will discuss whether “sole remedy” actually means “sole remedy?”

FACTS:

Regarding limited partnerships, nine states provide for “sole remedy” charging order. On the other hand, twenty-one states provide for the judicial foreclosure sale of the limited partnership interest, and nineteen states are silent on the issue. One state, Louisiana does not have any “charging order” language within its statute.

In the case of limited liability companies, sixteen states provide for “sole remedy” charging order, while only twelve states provide for the judicial foreclosure sale of the membership interest. Also, two states, Nebraska and Pennsylvania, do not have any “charging order” language within their statutes.

COMMENT:

WHAT'S CHARGING ORDER PROTECTION?

Partnership law (and subsequently LLC law) developed differently than corporate law. Rather than allowing a creditor to attach all of the rights of a partnership interest, a charging order allows a creditor only to attach a right to distributions.

The creditor does not receive any voting rights.

In layman's terms, a charging order may be defined as a right to a distribution, when and if ever made.

With a charging order, a creditor is left with a right to distributions, however, the creditor has no method (i.e., voting rights) to force a distribution.

If a charging order is the sole remedy of the creditor, the result is a waiting game, with the question being who can wait the longest - the client or the creditor? If the client can out-wait the creditor, typically the creditor will settle for less than the judgment amount.

WHAT HAPPENS IF THERE IS A JUDICIAL FORECLOSURE SALE?

It is easier to illustrate a judicial foreclosure sale by example rather than provide a technical explanation.

Let's assume that we have Dr. Anne who has a \$2 million medical malpractice judgment against her.

Many years ago, she created an FLP that holds \$3 million of assets. Dr. Anne owns a ninety-five percent limited partnership interest and her husband Ray is the general partner.

The creditor obtains a charging order over Dr. Anne's ninety-five percent interest, but does not receive any voting rights and no distributions are made.

The creditor complains to the court that no distributions are being made from the partnership.

As an additional remedy, the court, and the judge orders the judicial foreclosure sale of Dr. Anne's limited partnership interest.

At the sheriff's auction, Dr. Anne's ninety-five percent limited partnership interest is sold to a speculative investor for a fraction of the underlying value, let's say \$250,000. The speculative investor's proceeds are transferred to Dr. Anne's creditor. Dr. Anne still owes the original creditor \$1.75 million, plus interest and attorney fees.

Now Dr. Anne has two parties she must negotiate a settlement with. The original creditor has not gone away, and Dr. Anne still owes the original creditor \$1.75 million, plus interest.

Also, some time in the future, Dr. Anne must also negotiate a separate deal with the speculative investor to purchase back her limited partnership interest.

Worse yet, the speculative investor received more rights than the original creditor. The original creditor had a right to distributions until the charging order was paid.

However, this is not what the speculative investor purchased. At the sheriff's auction, the speculative investor purchased Dr. Anne's partnership interest, not the charging order. After the purchase of Dr. Anne's partnership interest, the speculative investor has the right to distributions forever.

Fortunately, the partnership agreement is properly drafted, the speculative investor does not become a substituted partner with voting rights and cannot force a liquidation of the partnership.

Regarding the effectiveness of an FLP or LLC in a non-sole remedy state, one of the authors contacted the debtor and creditor attorneys on almost all of the judicial foreclosure reported cases and learned that when the court ordered this remedy, the cases settled almost immediately on relatively unfavorable terms.

**THE LIMITED PARTNERSHIP/LIMITED LIABILITY COMPANY SOLE
REMEDY/JUDICIAL FORECLOSURE LAW TABLE:**

The following table lists each state and is divided in the middle between the state's limited partnership and limited liability company law.

If the two columns under either limited partnership or limited liability company are blank, this means that the state has language substantially similar to the Revised Uniform Limited Partnership Act of 1976, which states that a charging order is a remedy, but the statute does not specifically state that it is the sole remedy.

Otherwise, one of the two columns will denote the states that are either a "sole remedy state" or a "judicial foreclosure state."

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| State | Limited Partnership | | Limited Liability Company | |
|----------------------|--|------------------------------|--|------------------------------|
| | Sole Remedy | Permits Judicial Foreclosure | Sole Remedy | Permits Judicial Foreclosure |
| Alabama | | Pending Legis ¹ | Statute ² | |
| Alaska | Statute ³ | | Statute ⁴ | |
| Arizona | Statute ⁵ | | Statute ⁶ | |
| Arkansas | | Statute ⁷ | | |
| California | | Statute ⁸ | | Case Law ⁹ |
| Colorado | | | | Statute ¹⁰ |
| Connecticut | | Case Law ¹¹ | | Implied ¹² |
| Delaware | Statute ¹³ | | Statute ¹⁴ | |
| District of Columbia | | | | |
| Florida | Statute ¹⁵ | | | |
| Georgia | | Case Law ¹⁶ | | Implied ¹⁷ |
| Hawaii | | Statute ¹⁸ | | Statute ¹⁹ |
| Idaho | | Statute ²⁰ | | |
| Illinois | | Statute ²¹ | | Statute ²² |
| Indiana | | | | |
| Iowa | | Statute ²³ | | |
| Kansas | | | Statute ²⁴ | |
| Kentucky | | Statute ²⁵ | | |
| Louisiana | No charging order language ²⁶ | | | |
| Maine | | Statute ²⁷ | | |
| Maryland | | Case Law ²⁸ | | |
| Massachusetts | | | | |
| Michigan | | Statute ²⁹ | | |
| Minnesota | | Statute ³⁰ | Statute ³¹ | |
| Mississippi | | | | |
| Missouri | | ??? ³² | | |
| Montana | | | | Statute ³³ |
| Nebraska | | | No charging order language ³⁴ | |

| State | Limited Partnership | | Limited Liability Company | |
|----------------|-----------------------|------------------------------|--|------------------------------|
| | Sole Remedy | Permits Judicial Foreclosure | Sole Remedy | Permits Judicial Foreclosure |
| Nevada | Statute ³⁵ | Statute ³⁵ | Statute ³⁶ | |
| New Hampshire | | Case Law ³⁷ | | |
| New Jersey | | | Statute ³⁸ | |
| New Mexico | | Case Law ³⁹ | | |
| New York | | | | |
| North Carolina | | | Case Law ⁴⁰ | |
| North Dakota | | Statute ⁴¹ | Statute ⁴² | |
| Ohio | | Statute ⁴³ | | |
| Oklahoma | Statute ⁴⁴ | | Statute ⁴⁵ | |
| Oregon | | | | |
| Pennsylvania | | Case Law ⁴⁶ | No charging order language ⁴⁷ | |
| Rhode Island | | | | Statute ⁴⁸ |
| South Carolina | | | | Statute ⁴⁹ |
| South Dakota | Statute ⁵⁰ | | Statute ⁵¹ | |
| Tennessee | | | Statute ⁵² | |
| Texas | Statute ⁵³ | | Statute ⁵⁴ | |
| Utah | | | | Statute ⁵⁵ |
| Vermont | | Statute ⁵⁶ | | Statute ⁵⁷ |
| Virginia | Statute ⁵⁸ | | Statute ⁵⁹ | |
| Washington | | | | |
| West Virginia | | | | Statute ⁶⁰ |
| Wisconsin | | | | |
| Wyoming | | | Statute ⁶¹ | |

UNEXPECTED REVERSAL OF STATE LAW

The Uniform Limited Partnership Act of 2001 specifically provides for the judicial foreclosure sale of a limited partnership interest. Minnesota previously provided sole remedy charging order protection by case law and Nevada previously provided sole remedy charging order protection by statute.

Both of these state laws were unexpectedly reversed when the Uniform Limited Partnership Act was passed. (However, Nevada provides a method to elect out of the ULPA (2001) and be governed by the prior sole remedy statute.)

Also, Oklahoma currently has sole remedy charging order, however HB 1361, adopting the ULPA (2001), passed the Oklahoma House and is currently pending in the Senate Judiciary Committee.

NO CHARGING ORDER LANGUAGE

As noted in the charts above, three states (one under a limited partnership act and two under limited liability company acts) do not have any charging order language.

Does this mean that any creditor can attach the partner's or member's interest and vote the partnership interest or membership interest similar to corporate stock? If so, there is little, if any asset protection in these three states provided by charging order.

On the other hand, it is also possible that a court in these three states would look to other state law and adopt charging order protection by case law.

CONCLUSION:

The race continues as many estate planners forum shop for sole remedy charging order protection. Several lead trust jurisdictions have also designed lead limited partnership and limited liability company laws. Some of these states have actually added a turbo charge to the words “sole remedy.” In our next LISI, we will discuss whether a charging order is really the sole remedy?

On the other hand, if you cannot wait until then, you may wish to join us at **Professor Regis Campfield’s Notre Dame Tax and Estate Planning Institute** for a discussion of this issue.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mark Merric

Bill Comer

Technical Editor - **Duncan Osborne**

CITE AS:

Steve Leimberg's Asset Protection Planning Newsletter # 112 (August 8, 2007) at <http://www.leimbergservices.com>

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CITES:

Proposed legislation in committee adopting ULPA(2001) – HB 940

¹ The ULPA 2001 specifically provides for the judicial foreclosure sale of limited partnership interests.

² Ala. Code §10-12-35

³ Alaska Stat. §32.11.340

⁴ Alaska Stat. §10.50.380

⁵ Ariz. Rev. Stat. §29-341

⁶ Ariz. Rev. Stat. §29-655

⁷ Arkansas HB 1009 (2006-2007) legislature, which should be codified as Ark. Code § 4-47-703.

⁸ Cal. Corp. Code §15907.03 adapting ULPA 2001, previously judicial foreclosure sale was allowed by the following cases *Hellman v. Anderson*, 233 Cal. App. 3d 840 (1991); *Crocker Nat. Bank v Perroton*, 208 Cal. App. 3d 1 (1989).

⁹ *Severson v. Superior Ct.*, 2006 WL 1495309 (unreported)

¹⁰ Colo. Rev. Stat. §7-80-703

- ¹¹ *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363 (Conn. App. Ct. 1994). Noting that the ULPA(1976) provides that the remedies of the UPA may be imported. The UPA provides for the judicial foreclosure sale of partnership interests.
- ¹² *PB Real Estate, Inc. v. Dem II Properties*, 1997 WL 625465 – dictum regarding that an LLC statute should also be able to import the remedies of the UPA, including the judicial foreclosure sale of the LLC interest.
- ¹³ Del. Code 6 § 17-703
- ¹⁴ Del. Code 6 § 18-703
- ¹⁵ Fla. Stat. ch. 620.1703; also previously by case law *In re Stocks*, 110 B.R. 65 (Bankr. N.D. Fla. 1989); *Givens v. National Loan Investors, L.P.*, 724 So.2d 610 (Fla. App. 1998).
- ¹⁶ Ga. Code Ann. §14-9-703, which specifically states a charging order is not a creditor’s exclusive remedy; *Nigri v. Lotz*, 453 S.E. 2d 780 (Ga. App. 1995); *Stewart v. Lanier Medical Office Building, Ltd.* 578 S.E. 2d 572 (Ga. App. 2003)
- ¹⁷ Ga. Code Ann. §14-11-504(b), similar to the limited partnership statute above states that a charging order is not a creditor’s exclusive remedy.
- ¹⁸ Haw. Rev. Stat. §425D-703, which adopted ULPA (2001)
- ¹⁹ Haw. Rev. Stat. §428-504
- ²⁰ Idaho Code § 53-42-703, which adopted the ULPA (2001)
- ²¹ 805 ILCS 206/504, which adopted ULPA (2001)
- ²² 805 Ill. Comp. Stat. § 206/504
- ²³ Idaho Code § 53-42-703, which adopted the ULPA (2001)
- ²⁴ Kan. Stat. Ann. §17-76, 113
- ²⁵ Ky. Rev. Stat. §362.2-703, which adopted the ULPA (2001)
- ²⁶ The Louisiana statute has no charging order language. Query: Does this mean if the creditor attaches the member’s interest, the creditor may vote the member’s interest? If so, a Louisiana LLC provides very little, if any, asset protection.
- ²⁷ 31 M.R.S.A. §1383, which adopted the ULPA (2001)
- ²⁸ *Lauer Construction, Inc. v. Claude Schrift*, 716 A.2d 1096 (Md.App. 1998); *Gibson’s Lodging v. Lauer*, 721 A.2d 989 (Md. 1989).
- ²⁹ M.C.L.A. §449.28
- ³⁰ Minn. Stat. Ann. §322A.0504 adopting ULPA(2001) and reversing prior case law regarding sole remedy under *Chrysler Credit Corp. v. Peterson*, 342 N.W. 2d 170 (Minn. Ct. 1984).
- ³¹ Minn. Stat. §322B.32
- ³² *Deutsch v. Wolf*, 7 S.W. 3d 460 (Mo. App. 1999). It is uncertain whether Missouri allows for the judicial foreclosure sale of a limited partnership interest. While the *Deutsch* Court states that the

debtor/partner held “general and limited partnership interests,” this statement is incorrect. The authors discussed the issue with Brad Stevens who is a member Spencer and Fane, the Plaintiff’s attorney. Brad confirmed that *Wolf* held only a general partnership interest and the court ordered a foreclosure of only his general partnership interest. Therefore, it is uncertain whether *Deutsch* provides authority for the judicial foreclosure sale of a limited partnership interest in Missouri. For a more detailed discussion of this issue between Steven Gorin and Mark Merric, please see Part II of this series.

³³ Mont. Code Ann §35-8-705

³⁴ The Nebraska LLC statute has no charging order language, similar to the Louisiana statute. Again, does this mean a creditor can attach and vote the limited partnership interest similar to corporate stock.

³⁵ Previously, Nevada was a sole remedy state and for these limited partnerships sole remedy protection remains. However, N.R.S. §88.535 adopted the ULPA (2001) and, for all limited partnerships formed after October 1, 2007 that do not elect out of the statute, provides for the judicial foreclosure sale of the limited partnership interest. Therefore, limited partnerships formed before October 1, 2007, and those that elect out of ULPA (2001) are subject to the previous statute that provides for sole remedy asset protection.

³⁶ N.R.S. §86.401

³⁷ *Baybank v. Catamount Construction, Inc.*, 693 A.2d 1163 (N.H. 1997) stating that a court may look to the UPA for remedies not mentioned in the ULPA (1976), including the judicial foreclosure sale of the limited partnership interest.

³⁸ N.J. Stat. Ann. § 42:25-45

³⁹ *In re Priestley*, 93 B.R. 253 (D.N.M. 1988)

⁴⁰ *Herring v. Keasler*, 563 S.E.2d 614 (N.C. App. 2002)

⁴¹ N.D. Code § 45-10.2-64

⁴² N.D. Code §10-32-34

⁴³ Ohio Rev. Code §1775.27 adopting ULPA (2001). Previously, Ohio allowed judicial foreclosure sale by case law – *Larson v. Larson*, 2000 WL 1566522 (Ohio App. 11. Dist.) unreported.

⁴⁴ Okla. Stat. tit. 54, §342

⁴⁵ Okla. Stat. tit. 18, §2034

⁴⁶ *In re Allen*, 228 B.R. 115 (Bankr. W.D. Pa. 1998); *Auburn Steel Company v. American Steel Engineering Co.*, 1993 WL 257379 unreported case.

⁴⁷ No charging order language contained in the statute. Similar to Louisiana and Nebraska, does this mean that a creditor may attach and vote the limited partnership interest.

⁴⁸ R.I. Gen. Laws § 7-16-37.

⁴⁹ S.C. Code Ann. § 33-44-504

⁵⁰ S.D. Code §48-7-703; 2007 Legislative Session SB 77

⁵¹ S.D. Code §47-34A-504; 2007 Legislative Session SB 78

⁵² Tenn. Code Ann. §48-218-105

⁵³ 2007 Texas Session Laws H.B. 1737

⁵⁴ 2007 Texas Session Laws H.B. 1737

⁵⁵ Utah Code § 48-2c-1103

⁶ Vt. Stat. Ann. Tit. 11, §3244

⁵⁷ Vt. Stat. Ann. Tit. 11, §3074

⁵⁸ Va. Code § 50-73.46:1 also prior to statutory law, *In re Piske*, 1 B.R. 913 (Bankr. E.D. Va. 1981) held that a charging order was the sole remedy.

⁵⁹ Va. Code § 13.1-1041.1

⁶⁰ W. Va. Code § 31B-5-504

⁶¹ W.S. § 17-15-145

Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #114

Date: 28-Aug-07

From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Forum Shopping For Favorable FLP and LLC Legislation--Part II

A Charging Order Affecting Management of the Entity

This is the *second* in a series by **Mark Merric** and **William Comer** on this topic.

Mark, a principal in the Merric Law Firm, is co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Many of his numerous articles on asset protection planning can be downloaded at www.InternationalCounselor.com.

William Comer is a financial consultant specializing in estate preservation, asset protection and privacy. He is a certified senior advisor, a long-time member of the Offshore Institute and has spoken on these issues throughout the U.S., Costa Rica and the Bahamas and author of Freedom, Asset Protection & You <http://www.offshorepress.com/fapy.htm>, a complete encyclopedia of asset protection and estate preservation.

EDITOR'S NOTE & BACKGROUND:

After "Forum Shopping For Favorable FLP and LLC Legislation" was published, we received many praises, some comments, and a few questions. One of the key questions revolved around how so many courts came to the conclusion that RULPA (1976) allowed the judicial foreclosure sale of the limited partnership interest. In fact, this became the subject of a one and a half hour discussion between **Steven Gorin**, a LISI editor and a distinguished estate planner from St. Louis, and Mark Merric, one of the authors - whether Missouri allowed for judicial foreclosure sale by case law under *Deutsch v. Wolf*⁴¹. They agreed to disagree, but each agreed that the other made some good points.

The nature of the disagreement primarily centers around an often overlooked area of charging order protection and the judicial foreclosure sale of a limited partnership interest – the "import" and "export" clauses of the Revised Uniform Limited Partnership Act (1976) and Uniform Partnership Act ("UPA 1914"), respectively.

The RULPA (1976) was never written to be a stand alone statute. Rather, it was designed to borrow from the Uniform Partnership Act (1914) ("UPA (1914)"). Section 6(2) of the UPA (1914) provides the export clause that export's the UPA provisions into RULPA (1976) and states,

"this chapter shall apply to limited partnerships except insofar as the statutes relating to such partnerships are inconsistent herewith."

At the same time, RULPA § 1105 provides the import clause and states,

"in any case not provided for in this [Act], the provisions of the Uniform Partnership Act [UPA 1914] govern."

Both Messrs. Gorin and Merric agree that the case *Deutsch v. Wolf* is not a model of clarity, and both agree that the Missouri Appellate Court borrowed from the UPA (1914) to order the judicial foreclosure sale of the debtor's partnership interest.

The primary nature of the *disagreement* is whether it is inconsistent to order the judicial foreclosure sale against a limited partnership interest when importing the judicial foreclosure remedy from the UPA

(1914). Both Messrs. Gorin and Merric agree that RULPA (1976), by importation from UPA (1914), allows for the judicial foreclosure of a general partnership interest.

Mark Merric takes the position that it is not inconsistent to import from the UPA the judicial foreclosure sale of a limited partnership interest. He cites cases from California, Connecticut, Georgia, Maryland, New Hampshire, Ohio, and Pennsylvania,^[2] that all hold a limited partnership interest may be judicially foreclosed by importing the UPA judicial foreclosure remedy. Mark notes that the *Deutsch* court specifically mentioned that the debtor was "the sole general partner and active limited partner."^[3]

However, after Steve and Mark discussed the case, Mark Merric consulted with the Plaintiff's attorney regarding the case, and discovered that the debtor only held a general partnership interest, and only a general partnership interest was foreclosed.

Steve Gorin notes that *Deutsch* may well be a bad fact case that justified an extreme result. The court did not clarify *why* it looked to Missouri's version of the UPA. Was it RSMo § 359.251.1, which states that the UPA applies to general partners if the partnership agreement and RULPA do not cover the situation? Or did it rely on RSMo § 359.671, which applies the UPA when RULPA does not "provide for" a situation? Steve notes that RULPA provides a remedy for attaching a partnership interest – a charging order. Shouldn't the doctrine of *expressio unius est exclusio alterius* preclude application of RSMo § 359.671 here?

Steve views the application of RSMo § 359.251.1 to be more appropriate here. He would limit the application of judicial foreclosure to general partners. Regarding the bad facts, the general partners blatantly over billed the partnership for well over \$1 million, and the court was so upset, it even allowed the highly unusual remedy of a court receiver to assume the management of the FLP.^[4]

Steve notes that this remedy was warranted, because the other partners were the ones bringing the action, as they clearly did not want this wrongdoer to be in charge of their investment in the partnership. Applying the foreclosure to the general partner's entire partnership interest made sense, because the court should not require them to do business with someone who had violated their trust.

In conclusion, Mark sees this as one of a number of cases allowing judicial foreclosure for limited partnership interests - general or limited. Steve views it as an extraordinary case that involved an extraordinary remedy that generally should not be read as definitively allowing judicial foreclosure when attaching a limited partner's interest in a limited partnership. In view of the court's failure to explain its view of this issue, Mark and Steve agree that each has reasonable views and that this case's significance is unclear.

On another note, the Nevada ULPA (2001) should be interpreted in light of the legislative digest that states that you may *elect out* of the statute.^[5] For all FLPs created in Nevada after October 1, 2007 that wish to retain Nevada's sole remedy charging order, planners *must affirmatively* elect out of the ULPA (2001).

The sole remedy/judicial foreclosure sale chart has been updated to reflect the comments above, and may be downloaded by Leimberg Subscribers at .

Now we shift our focus from the judicial foreclosure sale of a limited partnership interest to the primary purpose of this LISI article – "How broadly may a judge issue a charging order and affect the management of the partnership?"

EXECUTIVE SUMMARY:

In general, a creditor may bring a variety of actions against a limited partnership or limited liability company. Our previous LISI article discussed one of the most common remedies in addition to the charging order, the judicial foreclosure sale of the limited partnership interest. Sole remedy statutes preclude the judicial foreclosure sale of the debtor's interest. However, charging order language may be very broad and many times actually control some of the management activities of the partnership. This LISI article discusses the Revised Uniform Limited Partnership Act of 1976 ("RULPA (1976)"), the Uniform Limited Partnership Act of 2001 ("ULPA (2001)"), the Uniform Limited Liability Company Act of (2006), and how various sole remedy statutes deal with a broad charging order.

FACTS:

Many planners are of the opinion that a charging order statute prevents a court from issuing a charging order that controls some of the management activities of the partnership by preventing the entity from engaging in the following actions without either court or debtor approval:

- ◆ Make no loans;
- ◆ Make no capital acquisitions;
- ◆ Make no distributions;
- ◆ Sell any partnership interest; and
- ◆ Provide full accounting of the partnership activities.

Below is the specific language of a Colorado District court charging order:

The partnership is directed to pay to the [plaintiff's] law firm, as for the Petitioner's receiver, present and future shares of any and all distributions, credits, drawings, or payments to said law firm until the judgment is satisfied in full, including interest and costs.

Until said judgment is satisfied in full, including interest and costs, the partnership shall make no loans to any partner or anyone else.

Until said judgment is satisfied in full, including interests and costs, the partnership shall make no capital acquisitions without either Court approval or approval of the Judgment Creditor herein.

Until said judgment is satisfied in full, including interests and costs, neither the partnership nor its members shall under take, enter into, or consummate any sale, encumbrance, hypothecation, or modification of any partnership interest without either Court approval or approval of the Judgment Creditors herein.

Within ten days of service of a certified copy of this Order upon the registered agent of the partnership, the partnership shall supply to the Judgment Creditors, a full, complete, and accurate copy of the Partnership Agreement, including any and all amendments or modifications thereto; true, complete and accurate copies of any and all federal and state income tax or informational income tax returns filed within the past three years; balance sheets and profit and loss statements for the past three years; and balance sheet and profit and loss statement for the most recent present period for which same has been completed. Further, upon 10 day notice from Petitioners to the partnership, all books

and records shall be produced for inspection, copying, and examination in the Petitioner's office.

Until said judgment is satisfied in full, including all costs and interest thereon, all future statements reflecting cash position, balance sheet position, and profit and loss shall be supplied to Petitioners within thirty days of the close of the respective accounting period for which said data is or may be generated.^[6]

At first blush, one might think that a charging order relates *only* to the debtor's partnership interest, and a charging order should not be able to control the management activities of the partnership.

However, playing the devil's advocate, the following questions support the position that a court may issue a broad charging order to the extent that it prevents the *partners* from circumventing the intent of the charging order:

- ◆ What if the partnership makes distributions to all non-debtor partners, and a loan to the debtor partner? The loan would not be subject to the charging order.
- ◆ What if the debtor/partners sells his or her partnership interest to another partner or a related entity or trust well below fair market value?
- ◆ What if the partnership attempts to pay out management fees in lieu of distributions?[7] Without receiving accountings from the partnership, this may be difficult to determine whether such activities are taking place.

The issue behind a broad charging order is whether or not it is needed to effect the charging order itself. An order restricting the sale of the debtor partner's interest and preventing the partnership from making loans to the debtor partner would be much less intrusive than the above charging order.

On the other hand, the accounting issue is more complicated. One might argue that any management fees would be disclosed on the K-1 of the partnership return.

However, when one is dealing with a dishonest debtor, he or she tends may well seek to hide such management fees through related entities.^[8]

COMMENT:

Charging order statutes primarily take one of the following five methods to defining the creditor's remedies for a charging order:

- ◆ Revised Uniform Limited Partnership Act of 1976 ("RULPA (1976)") approach;
- ◆ Uniform Limited Partnership Act of 2001 ("ULPA (2001)") approach;
- ◆ Uniform Limited Liability Company Act of 2001 ("ULLC (2006)");
- ◆ Simple sole remedy approach; and
- ◆ Magnificent seven approaches

RULPA (1976) APPROACH

The charging order reproduced above was written under the Colorado statute that follows the RULPA (1976) statute.

Section 703 – Rights of a Creditor

On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This Act does not deprive any partner of the benefit of any exemption laws applicable to his partnership interest.

Regarding the broad charging order language granted by the Colorado court under the RULPA (1976), as a transferee one may imply that the creditor has rights to copies of the books and records.

However, there is a much more subtle issue that deals with the import and export clauses of RULPA (1976) and the UPA (1914). UPA (1914) § 28(1) states,

"On due application to a competent court by any judgment creditor of a partner, the court . . . may charge the interest of the debtor partner . . . , and make all other orders, directions, accounts, and inquiries which the debtor partner might have made, or which the circumstances of the case may require."

Worse yet, the official comment to ULPA § 703 states,

"Section 703 is derived from Section 22 [which is now Section 28] of the 1916 Act but has not carried over some provisions that were thought to be superfluous. For example, references in Section 22(1) to specific remedies have been omitted . . ."

In other words, the *"make all other orders . . . which the circumstances of the case may require"* was deemed to be such an obvious power of the court that there was no need to mention it in the statute.

This being the case, all of a sudden the Colorado Court's charging order does not appear to be as broad as many readers initially might have thought.

ULPA (2001) APPROACH

The ULPA (2001) was written to be a stand alone statute.^[9] The ULPA (2001) provides:

SECTION 703. RIGHTS OF CREDITOR OF PARTNER OR TRANSFEREE

(a) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of the judgment debtor with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of a transferee. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require to give effect to the charging order.

(b) A charging order constitutes a lien on the judgment debtor's transferable interest. The court may order a foreclosure upon the interest subject to the charging order at any time. The purchaser at the foreclosure sale has the rights of a transferee.

(c) At any time before foreclosure, an interest charged may be redeemed:

(1) by the judgment debtor;

(2) with property other than limited partnership property, by one or more of the other partners; or

(3) with limited partnership property, by the limited partnership with the consent of all partners whose interests are not so charged.

(d) This [Act] does not deprive any partner or transferee of the benefit of any exemption laws applicable to the partner's or transferee's transferable interest.

(e) This section provides the exclusive remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of the judgment debtor's transferable interest.

In one small area, the comments to the ULPA (2001) are helpful. They prevent a court from issuing an order that would restrict the limited partnership from making future capital acquisitions "for operations."

Unfortunately, the comments do not explain whether "for operations" mean only capital improvements for a business limited partnership, or also includes the reinvestment of the sales proceeds of liquid assets (e.g. securities). If the ULPA (2001) includes both, this is a small asset protection improvement.¹⁰¹

Under Section 703(a), as well as the comment, a court may issue whatever order that is necessary to give effect to the charging order. The UPA (1914) language that was omitted from RULPA (1976), because the drafters thought it was superfluous, has been added to the ULPA (2001). The "balancing" reference between creditor's and debtor's rights provides no restriction and virtually no guidance on what limits a court's authority as applied to the broad charging order language discussed at the beginning of this LISI article.

In a second area some might feel that RULPA (2001) is *less* favorable to creditors. The ULPA (2001) allows a partnership interest to be redeemed anytime prior to foreclosure. While this is a benefit, there are the following issues that surround such a proposed redemption:

1. Does the court or the debtor need to approve the redemption price or will an appraisal considering any minority interests be sufficient?
2. Can part of the partnership interest be redeemed?
3. Can the purchase price include an installment note? If so,
 - (a) Does the note need to be amortized within some period of time or is a 30 year balloon note acceptable?
 - (b) Does the note need to be secured, and if so who decides what is adequate security?
 - (c) Can the note be non-negotiable?

The authors are aware that some estate planners propose that in a judicial foreclosure sale state, they will solve the problem by redeeming the partnership interest at a minority/discount valuation (or below minority/discount formula contained in the partnership) payable with an unsecured interest only balloon note over 30 years. The authors find it hard to believe that such a redemption would be respected by the court issuing the charging order.

The remaining comments as well as the statute itself add little help to the protection of a partnership interest. In fact when compared to the ULPA (1976), since the ULPA (2001) specifically allows for the judicial foreclosure sale of a partner's interest, they appear to be more creditor favorable.^{[111](#)}

In our prior LISI article, we covered the detrimental effects of a judicial foreclosure sale of the partner or member interest. Finally, Section 703(e), which provides that Section 703 is the exclusive remedy to reach a "*a partner's interest*," does not address the equitable and legal remedies that attack the *partnership itself* such as reverse veil piercing, constructive trust, resulting trust, alter ego, and sole purpose.

However, the comments to the ULLC (2006) discussed immediately below, which is similar to the ULPA (2001), specifically allow for reverse veil piercing. This issue, as well as direct equitable remedies that attack the partnership, will be discussed in part III of this series.

In summary, compared to the ULPA (1976), the ULPA (2001) *broadens* creditor rights and, for the most part, grants a judicial blank check to issue a broad charging order.

UNIFORM LIMITED LIABILITY COMPANY OF 2006

The creditor protection under the ULLC (2006) is weaker than both ULPA (1976) and ULPA (2001). The ULLC (2006) allows the judicial foreclosure sale of the member's interest,

"upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time."^{[121](#)}

The ULLC (2006) does not allow the possible added protection by allowing the redemption of a member's interest before foreclosure. Instead, the debtor member, the other member(s), or the LLC may satisfy the judgment before judicial foreclosure sale.

Further, the comments to the ULLC (2006) make it clear that a creditor may bring a reverse veil piercing action. Similar to the ULPA (2001), there may be a slight benefit that a charging order may not require court approval for the purchase of capital acquisitions for operations. Since the ULLC (2006) has only recently been finalized, at this point no states have adopted the ULLC (2006).

SIMPLE SOLE REMEDY CHARGING ORDER

The simple sole remedy approach typically adds a sentence to the RULPA (1976) language such as,

"This section shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest."

For example, Alabama: §10-12-35 states,

"(a) On application to a court of competent jurisdiction by any judgment creditor of a member or assignee, the court may charge the interest of the member or assignee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of financial rights. This section

shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest."

States using the simple sole remedy approach are:

Family Limited Partnerships:

| | |
|----------------------------|--|
| ♦ Arizona – A.R.S. §29-341 | ♦ Oklahoma – Okla. Stat. tit. 54, §342 |
|----------------------------|--|

Limited Liability Companies:

| | |
|----------------------------------|---------------------------------------|
| ♦ Alabama Ala. Code §10-12-35 | ♦ N. Dakota N.D. Code §10-32-34 |
| ♦ Arizona A.R.S. §29-655 | ♦ Oklahoma Okla. Stat. tit. 18, §2034 |
| ♦ Kansas Kan. St. §17-76, 113 | ♦ Tennessee Ten Code §48-218-105 |
| ♦ Nevada N.R.S. §86.401 | ♦ Wyoming W.S. §17-15-145 |
| ♦ Minnesota Minn. Stat. §322B.32 | |

The addition of language that states a charging order is the "sole and exclusive" creditor remedy precludes the judicial foreclosure sale of the limited partnership or membership interest.

Unfortunately, it is uncertain whether the sole remedy language would prevent a court from issuing a broad charging order similar to the one above.

Further, there is another fine distinction that an estate planner must differentiate. The sentence referring to sole and exclusive remedy is limited to the judgment debtor's "membership interest." For this reason, most likely the remedies directly attacking the partnership such as reverse veil piercing, constructive trust, resulting trust, alter ego, and sole purpose are *also* available in simple sole remedy states.

THE MAGNIFICENT SEVEN APPROACHES:

Seven states have added much more clarity in their sole remedy statutes by providing some, but not all of, the following enhancements:

- ♦ Preventing a creditor from affecting the management of the LP or LLC (i.e., an order for directions);
- ♦ Preventing a creditor from receiving accountings from the LP or LLC;
- ♦ Allowing a redemption of the charged interest; and
- ♦ Denying legal or equitable remedies with respect to the partnership property.

The seven states and their relevant LP or LLC statutes are as follows:

Family Limited Partnerships:

| | |
|----------------------------------|---------------------------------|
| ♦ Alaska Ala. Stat. §32.11.340 | ♦ S. Dakota N.D. Code §48-7-703 |
| ♦ Delaware Del. Code 6 §17-703 | ♦ Texas 2007 – HB 1737 |
| ♦ Florida Fla. Stat. Ch 620.1703 | ♦ Virginia Va. Code §50-73.46:1 |

Limited Liability Companies

| | |
|-----------------------------------|-----------------------------------|
| ♦ Alaska Ala. Stat. §10.50.380 | ♦ S. Dakota S.D. Code §47-34A-504 |
| ♦ Delaware Del. Code §29-655 | ♦ Texas 2007 – HB 1737 |
| ♦ New Jersey N.J. Stat. §42:2B-45 | ♦ Virginia Va. Code §13.1-1041.1 |

These state statutes may be divided into three separate approaches: (1) the Alaska approach; (2) the Delaware approach; and (3) the South Dakota approach. These approaches as well as remedies directly attacking the partnership or LLC will be discussed in detail in our upcoming Forum Shopping for Favorable FLP and LLC legislation – Part III.

CONCLUSION:

Our first LISI article detailed the issues associated with judicial foreclosure of a limited partnership or membership interest. This LISI article divided the five major types of charging order statutes, and provided a detailed analysis of the ULPA (2001). This LISI article also discussed that it is unclear whether a simple sole remedy statute will be effective in protecting against a broad charging order.

For most situations, the ULPA (1976), the ULPA (2001), and ULLC (2006) all grant a court the ability to issue a broad charging order. There is a good chance the same is true in simple sole remedy states.

Our third part to this series discusses how the magnificent seven states have added additional protections to help preclude a broad charging order, and some of these states have also drafted statutory language to address legal and equitable remedies asserted directly against the limited partnership or LLC.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mark Merric

Bill Comer

Duncan Osborne - Technical Editor

CITE AS:

Steve Leimberg's Asset Protection Planning Newsletter #114 (August 28, 2007) at <http://www.leimbergservices.com>

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CITES:

^[1] *Deutsch v. Wolff*, 7 S.W.3d 460 (MO App. 1999).

^[2] *Hellman v. Anderson*, 223 Cal. App. 3d 840 (1991); *Crocker Nat. Bank v Perroton*, 208 Cal. App. 3d 1 (1989); *Madison Hill Limited Partnership II v Madison Hills, Inc* , 644 A.2d 363 (Conn. App. 1994); *Nigri v. Lotz*, 453 S.E. 2d 780 (Ga. App. 1995); *Lauer Construction, Inc. v. Schrift* , 716 A.2d 1096 (Md. App. 1998); *Baybank v. Catamount Construction, Inc.* ,693 A.2d 1163 (NH 1997);

Larson v. Larson, 2000 WL 1566522 (Ohio App. 11 Dist) unreported; *Auburn Steel Company v. American Steel Engineering Co.*, 1993 WL 257379 (E.D. Pa. 1993) unreported, aff'd 22 F.3d 300 (3rd Cir).

- [3] *Deutsch* second paragraph under the "factual background".
- [4] Mark notes that, except in very egregious facts, courts have generally not allowed this remedy. See *Tupper v. Kroc*, 88 Nev. 146 (1972); *City of Arkansas v. Anderson*, 242 Kan. 875 (Kan. 1988); and *Widom Nat'l Bank v. Klein*, 254 N.W. 602 (Minn. 1934).
- [5] Section 30 mentioned the ability to elect in or out is internally inconsistent. It appears that this will be amended at Nevada's next legislative session.
- [6] *E.J. and Muriel Rothwell v. Lisa Fertman*, Order re Motion and Application to Charge Partnership Interest. Civil Action 92 Z 1881, District Ct Colo. 1994.
- [7] *PB Real Estate, Inc. v. Dem II Properties*, 719 A.2d 73 (Conn. App. 1998)
- [8] *C.F. Trust, Incorporated v. First Flight Limited Partnership*, 580 S.E. 2d 806 (Va. 2003).
- [9] Therefore, unlike the RULPA (1976), there is no need to look to the UPA act to provide for the judicial foreclosure sale of the limited partnership interest. It is contained within the ULPA (2001).
- [10] A problem with the drafting of some Uniform Acts is the inclusion of substantive law that are included in the comments. Courts are not obligated to follow comments. Further, comments may be changed by NCCUSL without legislative approval, and at the same time change substantive law.
- [11] ULPA (2001) §703(b). Subject to the Export/Import Clause discussion in this LISI article, RULPA (1976) was silent regarding the judicial foreclosure sale of a partner's interest.
- [12] ULLC (2006) Section 503(c).

Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #117

Date: 19-Dec-07

From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: Searching for Favorable FLP & LLC Law - Part III

This is the third in a series by **Mark Merric** and **William Comer**. Part I was Asset Protection Planning Newsletter # 112 and part II was Asset Protection Planning Newsletter # 114

Mark Merric is a principal in the Merric Law Firm. He is co-author of CCH's treatise on asset protection – first edition, *The Asset Protection Planning Guide*, and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Many of his numerous articles on asset protection planning can be downloaded at <http://www.internationalcounselor.com/>.

William Comer is a financial consultant specializing in estate preservation, asset protection and privacy. He is a certified senior advisor, a long-time member of the Offshore Institute and has spoken on these issues throughout the U.S., Costa Rica and the Bahamas and author of *Freedom, Asset Protection & You* <http://www.offshorepress.com/fapy.htm>, a complete encyclopedia of asset protection and estate preservation.

Special thanks to **Duncan Osborne**, our Asset Protection Planning Newsletter Technical Editor.

EXECUTIVE SUMMARY:

In the second installment of this LISI^[1], we noted that there were many states that, either by case law or by statute, had adopted "simple sole remedy statutes." A "simple sole remedy statute" within one sentence states that the charging order is the "sole" and/or "exclusive" remedy against a debtor's "partnership interest" or "membership interest."^[2]

The "simple sole remedy" language prevents a creditor from judicially foreclosing on a partnership or membership interest and was discussed in detail in the first installment of this series. We also noted that seven states, Alaska, Delaware, Florida, New Jersey, South Dakota, Texas, and Virginia (hereinafter referred to as the "Magnificent Seven") have provided additional asset protection features above the simple sole remedy language. Depending on which of these states are being discussed, these seven states have added some, but not all, of the following additional creditor restrictions:

- ◆ Preventing a creditor from affecting the management of the LP or LLC (i.e., an order for directions);
- ◆ Preventing a creditor from receiving accountings from the LP or LLC;
- ◆ Denying legal or equitable remedies with respect to the partnership property.

It is at this point that asset protection planning experts differ over whether these additional protections are necessary. One camp notes that to date there is no case where a creditor has pierced a sole remedy case outside of bankruptcy.^[3] The other camp agrees that there is no case yet on point, however, there is a difference between an action that only attacks a partner's or member's interest and an action that attacks both the partner's or member's interest as well as the partnership or LLC directly.

This LISI compares the Magnificent Seven statutes, and concludes that these seven states may well have an asset protection edge over the other jurisdictions.

FACTS:

The seven states may be generally divided into the following three classifications:

- ♦ Alaska prototype – that includes Florida and New Jersey
- ♦ Delaware prototype – that includes Texas and Virginia; and
- ♦ South Dakota's prototype.

COMMENT:

Alaska Prototype:

Regarding limited partnerships, Ala. Stat. §32.11.340 states:

- (a) On application to a court of competent jurisdiction by a judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent charged, the judgment creditor has only the rights of an assignee of the partnership interest. This chapter does not deprive a partner of the benefit of an exemption law applicable to the partner's partnership interest.
- (b) This section provides the exclusive remedy that a judgment creditor of a general or limited partner or of the general or limited partner's assignee may use to satisfy a judgment out of the judgment debtor's interest in the partnership. Other remedies, including foreclosure on the general or limited partner's partnership interest and a court order for directions, accounts, and inquiries that the debtor general or limited partner might have made, are not available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited partnership and may not be ordered by a court.^[4]

The Alaska statute has the advantage of protecting the limited partnership from a charging order that attempts to restrict the management of the limited partnership. In other words, a charging order could not require the limited partnership to obtain court approval to make a loan to a limited partner, prevent capital acquisitions, or the sale of a partnership interest.

Further, the Alaska statute also prevents the disclosure of financial information to a creditor. If an estate planner believes that the additional protections are necessary, the Alaska prototype provisions are an improvement over the sole remedy provisions provided by the simple sole remedy statutes.

Unfortunately, there are other remedies which a creditor may utilize to directly attack the partnership instead of the partnership interest.

REMEDIES ATTACKING THE PARTNERSHIP OR LLC:

Simple sole remedy charging order protection protects the debtor's interest from attack by a creditor. Some estate planners as well as some of the lead debtor/creditor attorneys, such as **John Sullivan, III** and **Harvey Levin**, note that a simple sole remedy charging order may not protect the debtor from a direct attack against the partnership or LLC itself.

There are at least five major direct theories of attack against the partnership or LLC: (1) reverse veil piercing; (2) constructive trust; (3) resulting trust; (4) alter ego; or (5) sole purpose.

1. Reverse Veil Piercing

"In the usual veil piercing case, a court is asked to disregard a corporate entity so as to make available the personal assets of its owners to satisfy a liability of the entity. In this case, an instance of what is known as "reverse piercing," the plaintiff argues the opposite, that the assets of the corporate entities should be made available to pay the personal debts of the owner." Litchfield Asset Management Corporation v. Howell, 799 A.2d 298 (Conn. App. 2002).

In many cases, reverse piercing allows the bypassing of the normal collection procedures, such as obtaining a charging order.^[5] The recently created legal theory of a "reverse pierce" is rapidly being adopted by many federal and state courts.^[6]

Unfortunately, the case law is new and different courts use different tests to determine whether a creditor may use a reverse pierce argument.^[7]

Connecticut allows a creditor outside of the corporation to reach the entity's assets if *both* of the following tests are met:

1. Domination over the LLC so that it had no separate mind of its own; and
2. Such control must be used by the defendant to commit fraud or wrong, or a dishonest or unjust act in contravention of the plaintiff's legal rights.

The domination test starts with the standard veil piercing elements such as

- (1) the absence of corporate formalities;
- (2) inadequate capitalization;
- (3) whether the funds are put in and taken out of the corporation for personal rather than entity purposes; and
- (4) whether the parties dealt with each other at arms length;

However, the domination test adds the following factors that many times will be present in closely held entities

- (5) overlapping ownership, directors, and personnel;
- (6) common office space;
- (7) the amount of business discretion by the allegedly dominated entity;
- (8) whether the entities are treated as independent profit centers;
- (9) payment or guarantee of the debts of the dominated entity;
- (10) whether the corporation in question had property that was used by other entities or corporations as if it were its own.

In *Litchfield Asset Management Corporation v. Howell et. al.*,^[8] a Texas court entered a default judgment against Howell and her corporation, Mary Ann Howell Interiors, Inc. ("Interiors") The default judgment was brought to Connecticut. Mary Ann Howell ("Howell") ceased operations with Interiors and created two new LLCs to continue her interior design business. She borrowed \$144,679 from her life insurance policy to begin the operations of these two new LLCs. Howell did not respect the separate nature of the entity and herself and met many of the above factors, so she met the first prong of the reverse pierce.

The second test is that the debtor used that control and dominance to perpetuate a wrong. Here the court noted that Howell formed the LLCs eighteen months after the default judgment had been entered. The court then mentions that personal expenses were paid from the LLC instead of making distributions or providing her a salary. From this, the Appellate Court concluded the second prong was met. The court then noted that the plaintiff need not prove fraud, and stated, a reverse pierce "merely requires the trial court to find that the defendants committed an unjust act in contravention of the plaintiff's legal rights."

In *Litchfield*, the debtor let her old business go dormant and moved the clientele to the newly formed LLCs. Fraudulent conveyance law should have provided an ample remedy for reaching the assets and income of the corporation. Adding the recent remedy of reverse piercing provides many situations where a court may use very subjective tests to reach a properly structured FLP or LLC.

The authors have classified the reverse pierce as a direct attack against the partnership. The comments to the ULLC (2006) appear to agree with the authors' classification.^[9] Therefore, states adopting RULPA (1976); ULPA (2001); ULLC (2006) are not protected against a reverse pierce attack.^[10]

Harvey Levin of **Thompson Coburn, LLP** was one of the first attorneys to bring a successful reverse veil piercing action against an LLC.^[11] Harvey notes and John Sullivan III agrees that such an action is made by directly naming the partnership as a party, and seeks to reach the underlying assets of the partnership.

This is a distinguishing point. A simple sole remedy statute states that a creditor's sole remedy against the debtor's "partnership interest" is a charging order. A simple sole remedy statute does not state that a creditor cannot seek to reach the underlying assets of the partnership by directly naming the partnership.

2. Constructive Trust

A constructive trust is an equitable creature that arises by operation of a law against one who holds the legal right to property that in equity and good conscience belongs to another.^[12] "A constructive trust, is in the main, the appropriate remedy against unjust enrichment."^[13]

A constructive trust is typically used in cases where property has been acquired by fraud. However, a constructive trust may also be imposed where it is against the principles of law and equity that the property be retained by a certain person even though the property was acquired without fraud.^[14]

Constructive trusts are imposed irrespective of intention.^[15] In other words, a creditor need not prove intent to defraud to invoke a constructive trust remedy. Rather, a creditor need only assert that it is unfair for the limited partnership or LLC to prevent the creditor from accessing the entity's property.

In essence, the constructive trust remedy has the possibility of opening the limited partnership and the LLC to many reasons that it is unfair for the partnership to prevent the creditor from recovering their assets. For example, a creditor may allege that the family limited partnership or LLC is merely a passive company holding investment assets. As noted by several cases,^[16] the legislative purpose of "charging order protection" was originally to protect operating businesses from being liquidated when the claim originated outside the partnership at the individual partner level. In essence, a court could declare that the general partner (or manager of an LLC) is the constructive trustee in favor of the creditor. If so, the creditor would be able to directly access the assets of the family limited partnership or a LLC.

Fortunately, to date, the authors are aware of only one court directly applying a constructive trust analysis to defeat charging order protection and this case is replete with fraud by the debtor partner. In *Delta Development and Investment Co. v. Hsiyuan*^[17] (unreported case), Yeh usurped business opportunities and profits from a joint venture with a partner and then deposited the ill-gotten gains into his own limited

liability company. The Washington Appellate Court quotes RCW § 25.15.255 which states:

"On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company interest of the member with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the limited liability company interest. . . ."

The Court then concluded that the above charging order language only prevented a monetary judgment and that a constructive trust was not a monetary judgment for a particular amount and not subject to the above charging order restriction.

While not using a constructive trust analysis, *In re Ehmann* provides some analogous authority for a court using a constructive trust to pierce at the entity level a partnership or LLC.

In the vacated decision of the Bankruptcy Court, the Court held that, *"The conduct of Fiesta [the LLC] and its manager since the Trustee's appointment demonstrates an unequivocal intent to operate Fiesta as if it were a revocable living spendthrift trust. . . . Utilizing a legitimate business structure for the sole purpose of shielding assets from creditors borders on a fraud on creditors, especially when the Legislature has provided another mechanism [A.R.S. §§ 14-7701 to 7710 codifying the laws of spendthrift trusts] for accomplishing the same purpose that would put creditors on notice that they cannot rely on the value of the debtor's assets."*^[18]

3. Resulting Trust

"A resulting trust has been defined as one which the court of equity declares to exist where the legal estate in the property is transferred or acquired by one under facts and circumstances which indicate that the beneficial interest is not intended to be enjoyed by the holder of the legal title."^[19]

The resulting trust theory is based on the notion that the donee is really holding property for the benefit of the donor, either in whole or in part, and that such was the intent of the transaction from the beginning. In other words, the parties intended a trust relationship even though it was not reduced to writing.

Under this theory, the creditor would argue that the limited partnership or the LLC has no business purpose, other than asset protection, and is really functioning as a trust for the benefit of the limited partners or members.

Unfortunately, in many cases, if a limited partnership or LLC is primarily being used for asset protection purposes without any significant gifts of limited partnership interests for estate planning purposes, this is exactly what is happening – the limited partnership or LLC is being used as a trust for the benefit of its members.

4&5. Sole Purpose Asset Protection & Alter Ego

In *In re Turner*^[20], the bankrupt and his wife had transferred his home into a Nevada LLC. As dictum in a fraudulent conveyance action, the Bankruptcy Court concluded,

"'Asset protection' is not illegal and is honored by the law if done for a legitimate purpose. For example, an individual may do business through a corporation or LLC and will not be held personally liable for the debts of the entity. The assets of the corporation are not to be considered the assets of the individual interest holder.

However, an entity or series of entities may not be created with no business purpose and personal assets transferred to them with no relationship to any business purpose, simply as a means of

shielding them from creditors. Under such circumstances, the law views the entity as the alter ego of the individual debtor and will disregard it to prevent injustice."

Several states have responded to the concerns regarding the equitable remedies directly attacking the partnership or LLC. Below is a discussion of the Delaware and South Dakota approach.

Delaware Prototype

Regarding limited partnerships Del. Code 6 §17-703 states:

- (a) On application by a judgment creditor of a partner or of a partner's assignee, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment. To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such partnership interest.
- (b) A charging order constitutes a lien on the judgment debtor's partnership interest.
- (c) This chapter does not deprive a partner or partner's assignee of a right under exemption laws with respect to the judgment debtor's partnership interest.
- (d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of a partner's assignee may satisfy a judgment out of the judgment debtor's partnership interest.
- (e) No creditor of a partner or of a partner's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.
- (f) The Court of Chancery shall have jurisdiction to hear and determine any matter relating to any such charging order.^[21]

The Delaware prototype adds another layer of asset protection. It specifically provides that

"no creditor . . . have any right . . . or otherwise exercise legal or equitable remedies to the property of a limited partnership."

While the authors would suggest that the drafters may wish to be a little more specific, the authors would interpret that, in addition to protecting the management of the limited partnership, the Delaware statute protects against reverse veil piercing, constructive trust, resulting trust, sole purpose and alter ego theories.

However, the Delaware statute may be inadvertently too broad. For example, "legal or equitable" remedies could not mean that a creditor could not bring a blatant fraudulent conveyance claim? Also, assume the limited partnership is a real estate development company. There is a tort accident on the partnership property. Unfortunately, the limited partners did not keep proper books, commingled partnership and individual property, purchased some partnership property in their individual names, have no minutes, and frequently paid personal expenses from the partnership account. The authors are not certain whether the Delaware legislature intended to prevent a standard "pierce the veil" argument.

Finally, it is uncertain whether an accounting is a "legal remedy." So, it's uncertain whether a creditor holding a charging order is entitled to an accounting in Delaware.

South Dakota Prototype

Regarding limited partnerships South Dakota § 48-7-703 states

On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This chapter does not deprive any partner of the benefit of any exemption laws applicable to the partner's partnership interest.

This section provides the exclusive remedy that a judgment creditor of a general or limited partner or of the general or limited partner's assignee may use to satisfy a judgment out of the judgment debtor's interest in the partnership. No other remedy, including foreclosure on the general or limited partner's partnership interest or a court order for directions, accounts, and inquiries that the debtor, general or limited partner might have made, is available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited partnership, and no other remedy may be ordered by a court.

The South Dakota act has the benefits of the Alaska charging order statute that prevents accountings and orders affecting the management of the partnership. The last clause of subparagraph (e) appears to give the same effect as Delaware's no "legal or equitable" remedies. In this respect, we would suggest the same clarifications of South Dakota law as mentioned regarding Delaware above.

California:

On a side note, an esteemed estate planner, Steve Halper, has brought to our attention that California's limited partnership act also prevents equitable remedies.

Unfortunately, the same protection from equitable remedies does not appear in California's LLC statute. We thank Steve Halper for bringing this fine point to our attention and agree that this is an improvement to California's limited partnership statute. We did not include California in the Magnificent Seven since the limited partnership statute specifically allowed the judicial foreclosure sale of the limited partnership interest^[22] and the limited liability company statute had been interpreted in the same manner by case law.^[23]

CONCLUSION:

Seven states have provided protections in addition to simple sole remedy. One camp of estate planners take the position that sole remedy protection by itself should be sufficient, and the additional protections are unnecessary.

Conversely, the other camp notes that an equitable remedy is an action directly against the partnership or LLC, rather than simply the debtor's interest.

Only time will tell whether the additional protections are necessary or not. However, as discussed in the fourth installment of this series, time has already voiced considerable concerns to the protection of a partner's or member's interest in the bankruptcy situation.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mark Merric

Bill Comer

TECHNICAL EDITOR - DUNCAN OSBORNE

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Steve Leimberg's Asset Protection Planning Newsletter # 117 (December 19, 2007) at <http://www.leimbergservices.com/>

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CITES:

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- [1] *Forum Shopping For Favorable FLP and LLC Legislation Part II*, Merric & Comer, Steve Leimberg's Asset Protection Newsletter #114, August 28, 2007.
 - [2] The issue of judicial foreclosure sale and the law of each state regarding this issue was discussed in *Forum Shopping For Favorable FLP and LLC Legislation Part I*, Merric & Comer, Steve Leimberg's Asset Protection Newsletter #112, August 4, 2007.
 - [3] One might take the position that while *In re Turner*, 345 B.R. 674 (N.D. Calif. 2005) allowed the bankruptcy trustee to reach the assets of a Nevada LLC, which is a simple sole remedy state, the outcome of the case did not depend on bankruptcy law. The authors take the position that the transfer by the wife of the family residence into the FLP was a fraudulent conveyance and that the dictum that the FLP was the alter ego of the bankrupt was not necessary to pierce the Nevada, simple sole remedy, statute. On the other hand, some planners may take the position that the "alter ego" language part of the decision was not dictum, and a court has already pierced a simple sole remedy statute for an equitable remedy.
 - [4] Ala. Stat. §10.50.380 provides the same protection for an LLC.
 - [5] Concerns have been expressed regarding this bypass of other remedies. *Cascade Energy & Metal Corp. v. Banks*, 896 F.2d 1557 (10th Cir. 1990). However, some courts have attempted to mitigate these concerns by stating that a reverse pierce is an extraordinary measure, and the availability of other remedies must be considered by the court. *In re Phillip*, 139 P.3d 639 (Colo. 2006).
 - [6] Concerns have developed regarding the application of a "reverse pierce" where independent shareholders may be unfairly prejudiced when assets in which they have an interest are attached by the outsider to satisfy its claim against the wrongdoer insider. *Cascade Energy & Metal Corp. v. Banks*, 896 F.2d 1557 (10th Cir. 1990).
 - [7] Colorado uses a three prong test: (1) the controlling insider and the corporation are alter egos; (2) justice requires recognizing the substance of the relationship over the form because the corporate fiction is utilized to perpetuate a fraud or defeat a rightful claim; (3) an equitable result is achieved by piercing.
 - [8] 799 A.2d 298 (Ct. App. 2002)
 - [9] ULLC (2006) § 503(g) regarding charging order states that "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 debtor's transferable interest." However, the comment specifically states that § 503 does not prevent a "reverse pierce" action. In

order to distinguish the "exclusive remedy" of § 503(g), one must conclude that the "reverse pierce" is directly against the LLC, not the "debtor's transferable interest."

[10] See Footnote 1.

[11] *C.F. Trust, Inc. v. First Flight Ltd. Partnership*, 140 F.Supp. 2d 628 (E.D. Vir. 2001); *C.F. Trust, Inc. v. First Flight L.P.*, 580 S.E.2d 806 (VA 2003); *C.F. Trust, Inc. v. First Flight Ltd. Partnership*, 338 F.3d 316 (C.A.4 (Va.),2003).

[12] *American Diabetes Ass'n v. Diabetes Soc.*, 509 N.E. 2d 84, 89 (OH app. 1986).

[13] *Ferguson v. Owens*, 459 N.E. 2d 1293, 1295 (OH 1984).

[14] *Ferguson v. Owens*, 459 N.E. 2d 1293, 1295 (OH 1984).

[15] *Peterson v. Teodosio*, 297 N.E.2d 113, 120 (OH); *Bivolocki v. Marimberga*, 405 N.E. 2d 337, 341 (OH App. 1979).

[16] See, e.g., *Brown, Janson & Co.l v. Hutchinson & Co.*, [1895]], 2 Q.B. 126, 130 (referring to the "inconvenient mode by which partnership property was taken in execution for a partner's separate debt); *In re Stocks*, 110 B.R. 65, 67 (Bkrtcy. N.D. Fla. 1989) ("The reason for this assignment rather than allowing a direct levy on the partnership assets is to prevent the disruption of the partnership business and the resulting injustice to the other partners."); *Baybank v. Catamount Const., Inc.*, 693 A.2d. 1163 ("charging order was designed to prevent the personal creditors of a limited partner from disrupting the partnership business by seizing the partnership assets upon execution.")

[17] 2002 WL 31748937 (Wash.App. 2002).

[18] *In re Ehmman*, 334 B.R. 437 (D. Ariz. Dec 2005) withdrawn by *In re Ehmman*, 337 B.R. 228 (D. Ariz. Jan 2006). When withdrawing the case discussed above, the Bankruptcy Judge noted that the debtor's reason for settlement and request to withdraw the order was that the debtor was a "tax lawyer who frequently advises clients in the use of limited liability companies for estate planning purposes."

[19] *Bilovocki, supra; In re Bushey*, 210 B.R. 95, 104 (6th Cir. 1997)

[20] 335 B.R. 140 (N.D. Cal. 2005), modified 345 B.R. 674 (N.D. Cal. 2006)

[21] Del. Code §29-655 provides the same protection for limited liability companies.

[22] Cal. Corp. Code §15907.03 adapting ULPA 2001.

[23] *Severson v. Superior Ct.*, 2006 WL 1495309 (unreported)

