Pass-Through Entities Have Protections in Charging Order Law

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Most states have laws providing that the creditor of a limited partner of a partnership may not seize any portion of the partner's ownership interest, if the limited partner individually has a creditor. The creditor may instead receive a court order (a "charging order") that forces the partnership to redirect distributions that would normally be paid to the debtor limited partner instead to go to the creditor to the extent of the limited partner's debt to the creditor. Typically, the court lacks authority to mandate if or when the limited partnership would make such distributions. Many states also have similar laws that protect debtors with limited liability company (LLC) interests in many states; Nevada legislation even protects some corporations that have fewer than 75 shareholders in this manner.[1]

As stated above, a charging order prohibits a creditor from exercising any rights otherwise held by the debtor, such as management, alienation, and governance rights, but does permit the creditor to receive distributions that would normally go to the debtor-limited partner. The discussion that follows focuses mainly on Florida law in pointing out issues to consider when advising clients.

Florida limited partnerships

Charging order protection for limited partnerships in Florida follows the rules under Fla. Stat. § 620.1703, which provides as follows:

> (1) On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the partnership interest of the partner or transferable interest of a transferee 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 of the partnership interest.
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> (2) This act shall not deprive any partner or transferee of the benefit of an exemption law applicable to the partner's partnership or transferee's transferable interest.
>
> (3) This section provides the exclusive remedy which a judgment creditor of a partner or transferee may use to satisfy a judgment out of the judgment debtor's interest in the limited partnership or transferable interest. Other remedies, including foreclosure on the partner's interest in the limited partnership or a transferee's transferable 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 attempt-

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ing to satisfy the judgment out of the judgment debtor's interest in the limited partnership and may not be ordered by a court.

As stated in subsection (3) of the statute, the charging order is the "exclusive remedy" for a creditor seeking to satisfy a judgment from the debtor's limited partnership interest. Some states similarly use the "exclusive remedy" approach,[2] but Florida provides that other remedies, such as foreclosure of the partner's interest and order for directions and accountings, are explicitly unavailable to the judgment creditor under the statute. This legislative action is meant to prevent the management of a limited partnership from being affected by the creditor. Similar laws exist in a few other states to provide additional protection for limited partnerships.[3]

Furthermore, according to some state statutes, no creditor of a partner has the right to exercise any legal or equitable remedies with respect to property of the limited partnership.[4] Rather than protecting solely the debtor's interest, this additional provision seems to directly protect the limited partnership itself. The limited partnership is "safe" from reverse veil piercing, constructive trust, resulting trusts, alter ego, and sole purpose theories that might otherwise apply to allow a creditor to reach the assets of the limited partnership. These remedies, which creditors may seek to use to circumvent the Florida limited partnership statute, are discussed in more detail below.[5]

Florida LLCs

Charging order protection for LLCs in Florida was thought by many commentators to be, for most purposes, the same as for limited partnerships, although it was provided for under case law as opposed to clear statutory law.

Recent court decision. The perception of charging order protection for Florida LLCs changed in June 2010, when the Florida Supreme Court released its opinion in *Olmstead v. The Federal Trade Commission*.[6] This long-awaited opinion held that single-member Florida LLCs are not afforded charging order protection under Florida law, and raised the question as to whether multiple-member Florida LLCs will continue to have charging order protection.

Olmstead involved debtors who "operated an advanced-fee credit card scam," and were sued by the Federal Trade Commission (FTC) for unfair or deceptive trade practices. The FTC received a judgment against the debtors and obtained an order compelling them to surrender to a receiver "all right, title and interest" in their LLCs, many of which were single-member LLCs that comprised a substantial portion of their assets. The Florida Supreme Court, in response to a question certified to it by the Eleventh Circuit, reaffirmed the United States District Court for the Middle District of Florida's order that compelled the debtors to surrender all "right, title and interest" in their single-member LLCs.

While many commentators and practitioners expected the Florida Supreme Court to find that charging order protection would not apply to single-member LLCs, the court's reasoning opened up the possibility that charging order protection might not apply to multiple-member LLCs as well.

The court, in its analysis, seemingly did not realize that the Florida LLC charging order statute was based on the Florida limited partnership charging order statute, and was intended to be consistent therewith.

Recent legislation. When the Florida legislature updated the limited partnership charging order rules as part of the overhaul of Florida's limited partnership statute in 2005, it left the LLC statute intact. The LLC statute was identical to the limited partnership statute prior to the 2005 revisions to the limited partnership statute. Since 1997, the limited partnership statute had been unchanged, and appellate court decisions in the fifth,[7] fourth,[8] and second[9] district courts of appeal, along with published bankruptcy court decisions, found that a charging order was the sole remedy of a judgment creditor under the former limited partnership statute. In 1993, when the LLC statute[10] was passed, the following language from the limited partnership statute was taken verbatim:

> (4) On application to a court of competent jurisdiction by any judgment creditor of a member, the

1 N.R.S. § 78.756(2)(a).

2 See Ala. Code § 10-12-35 (1975) (Alabama); A.R.S. § 29-341 (2007) (Arizona); Okla. Stat. tit. 54, § 342 (1998) (Oklahoma).

3 See Ala. Stat. § 32.11.340 (2004) (Alaska); S.D. Code § 48-7-703 (2007) (South Dakota); Del. Code 6 § 17-703 (2007) (Delaware); Tex. Bus. Org. Code § 153.256 (2007) (Texas); Va. Code § 50-73.46:1 (2006) (Virginia).

4 See S.D. Codified Laws § 48-7-703 (2007) (South Dakota).

5 The author thanks Mark Merric for excellent writings on this subject, and commends the reader to review Mr. Merric's series of LISI Newsletters numbered 112, 114, 117, and 127 on 8/8/2007, 8/28/2007, 12/19/2007, and 4/17/2008 respectively. Steve Leimberg's Asset Protection Planning Newsletter can be found at http://www.leimbergservices.com.

6 44 So.3d 76 (Fla., 2010).

7 Givens v. National Loan Investors, L.P., 724 So. 2d 610 (Fla. 5th Dist. App., 1998).

8 Krauth v. First Continental Dev-Con, Inc., 351 So. 2d 1106 (Fla. 4th Dist. App., 1977).

9 Myrick v. Second National Bank of Clearwater, 335 So. 2d 343 (Fla. 2d Dist. App., 1976).

10 Fla. Stat. § 608.433(4).

11 Wells, "Asset Protection Provided With Florida Business Entities," published in *Asset Protection in Florida* ¶ 4.36 (Florida Bar Real Property, Probate, and Trust Law Section, 2008).

12 See Bankruptcy Code section 541(c) (stating that a provision—either contractual or statutory—that modifies or terminates the debtor's interest in property because of "the insolvency or financial condition of the debtor" or the filing of a bankruptcy case, will be unenforceable in bankruptcy).

court may charge the limited liability company membership 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 such interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to the member's interest.

Fortunately, the Florida legislature has passed House Bill 253 as a "patch amendment" to clarify Florida charging order law with respect to LLCs in light of the *Olmstead* opinion. This bill amends Fla. Stat. § 608.433 to explicitly provide that "a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member's assignee may satisfy a judgment from the judgment debtor's interest in a limited liability company or rights to distributions from the limited liability company," and explicitly precludes the availability of the foreclosure of the debtor's LLC interest as a remedy to the judgment creditor.

However, the amended statute also states that a charging order is not the sole and exclusive remedy in the context of a single-member LLC, if the judgment creditor establishes to the satisfaction of a court of competent jurisdiction that distributions under a charging order will not satisfy the judgment within a reasonable time. In this event, a court may, therefore, order the foreclosure sale of a debtor's single-member LLC interest, and the creditor obtains the member's entire LLC interest and becomes a member of the LLC. Furthermore, the amended statute does not limit the availability of equitable remedies that are not inconsistent with the statute.

The bill was signed by Florida Governor Rick Scott on 5/31/2011, and the above changes to Fla. Stat. § 608.433 are now effective under Florida law.

Planning considerations. The authors tell clients that on a scale of one to ten, if Florida limited partnerships score a ten for charging order protection, Florida LLCs score a nine. Some lawyers, however, strongly favor limited partnerships for their clients because of their extra statutory protections.

One commentator has indicated that under the Florida Law, a trustee in bankruptcy of a bankrupt LLC member could force that member's interest to be redeemed, unless the LLC's Articles of Organization or Operating Agreement explicitly prohibit such action.[11]

The relevant portion of Fla. Stat. § 608.4237 reads as follows:

> A person ceases to be a member of a limited liability company upon the occurrence of any of the following:
>
> (a) Makes an assignment for the benefit of creditors;
>
> (b) Files a voluntary petition in bankruptcy;
>
> (c) Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding;
>
> (d) Files a petition or answer seeking for herself or himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;
>
> (e) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any proceeding of this nature; or
>
> (f) Seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the member or of all or any substantial part of the member's properties;

Subsection (2) of Fla. Stat. § 608.427 reads as follows:

> (2) Except as provided in subsection (3), upon withdrawal, a withdrawing member is entitled to receive any distribution to which he or she is entitled under the articles of organization or regulations, and, if not otherwise provided in the articles of organization and regulations, he or she is entitled to receive, within a reasonable time after withdrawal, the balance of his or her capital account.

Apparently, the legislature intended that a bankrupt or insolvent LLC member would be bought out of the LLC. However, the enactment of the changes to the Florida LLC charging order statute (Fla. Stat. § 608.433(4)), which strengthen charging order protection for Florida LLCs, would indicate to the contrary. Fortunately, the concept of *ipso facto* would probably cause the Bankruptcy Code to invalidate the effect of the Florida Statutes for bankrupt debtors.[12] Until the legislature modifies the statute, however, there is still a problem for insolvent debtors. To prevent this issue; an LLC's Articles of Organization or the Operating Agreement of the LLC must contain language that overrides the undesired result that the Florida Statutes contemplate. If an LLC is established by an accountant or friend with office store form operating agreements, LLC members may find themselves in an inescapable trap.

Charging order may be more restrictive than commonly thought

When a charging order is entered by a court, most creditors and debtors negotiate and come to terms, leaving little case law on the actual terms and conditions that can apply when a charging order is put into place. However, a creditor that has obtained a charging order may seek additional action rather than waiting for a potential distribution. Courts of equity establish charging orders, and typically, these courts have significant discretion in implementing equitable remedies.

The following is language from a broadly written Colorado district court charging order. This charging order required the partnership to obtain court approval

before making capital acquisitions, selling, encumbering, or modifying any partnership interests. Additionally, the creditor was entitled to receive periodic tax and financial information on the partnership.

> 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 undertake, 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.[13]

Tax reporting issues

Whether a creditor with a charging order will be considered the owner of the partnership interest held by the debtor for federal income tax reporting purposes remains unclear. This position is not directly supported, although many lawyers promoting limited partnerships believe this to be the case. Rev. Rul. 77-137[14] reached this conclusion when the debtor limited partner voluntarily gave the creditor an assignment of his limited partnership interest. A common belief is that a creditor who merely holds a charging order is not subject to federal income tax on the interests under the charging order.[15] Distributions from the entity to the creditor should be treated as a reduction in the debt owed to the creditor, so the owner of the interest in the entity would have to recognize the income under general tax principles.[16] If the income was allocated but not distributed, the creditor could potentially be taxed on income that would never be received.

A creditor who is concerned about sustaining income tax liability through a charging order could set up a C corporation or a complex trust and assign the judgment to that entity. The entity, rather than the creditor directly, could then obtain the charging order and would owe any income tax, but the IRS might then pursue the creditor-entity and the LLC for the tax.

Additional creditor remedies

Creditors may be able to obtain assets held under a limited partnership or LLC using any of the following four theories:

1. Reverse veil piercing.
2. Constructive trust.
3. Resulting trust.
4. Alter ego/sole purpose.[17]

These equitable theories of entity attack are discussed below.

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."[18] However, when the corporate entity acts as a shell for asset protection purposes without an actual business purpose, and when the debtor is showing abuse, creditors are not limited solely to a charging order. The creditor may be able to apply the equitable remedy of reverse veil piercing instead, which would place

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13 Rothwell v. Fertman, Order re Motion and Application to Charge Partnership Interest. Civil Action 92 Z 1881 (DC Colo., 1994).

14 1977-1 CB 178.

15 812-2nd Tax Mgmt. Est., Gifts & Tr. J. IX.D.2 (2006).

16 *Id.*; Fla. Stat. § 608.4237.

17 Steve Leimberg's Asset Protection Planning Newsletter #177 (12/19/2007) at www.leimbergservices.com.

18 Litchfield Asset Management Corp. v. Howell, 799 A.2d 298 (Conn. App., 2002).

19 812-2nd Tax Mgmt. Est., Gifts & Tr. J. IX.D.2 (2006); C.F. Trust, Inc. v. First Flight Ltd. Partnership, 306 F.3d 126 (CA-4, 2002).

20 EPICA v. Swiss Bank Corp., 507 So.2d 1119 (Fla. 3d Dist. App., 1987).

21 812-2nd Tax Mgmt. Est., Gifts & Tr. J. IX.D.2 (2006).

22 *Id.*

23 Delta Development and Investment Co. v. Hsiyuan, 2002 WL 31748937 (Wash. App. Div. 1, 12/9/2002).

24 In re Turner, 335 B.R. 140 (Bkrptcy. DC Calif., 2005), *modified* 345 B.R. 674 (Bkrptcy. DC Calif., 2006).

25 Kassuba v. Hemmerle, 10 B.R. 309 (Bkrptcy. DC Fla., 1981).

26 Movitz v. Fiesta Investments, LLC (In re Ehmann), 319 B.R. 200 (Bkrptcy. DC Ariz., 2005).

liability for the debtor's personal debts under the entity.[19]

This theory is most often applicable to situations where a "fraudulent transfer" appears to have been made when an asset was transferred into the entity. The courts use various reverse piercing tests. Florida courts, for instance, have laid out two basic criteria to determine if a creditor may seek a reverse piercing action:

1. Whether the debtor had ownership and control of the corporation.
2. Whether the debtor used the corporation to secrete personal assets as a means to deceive, defraud, or mislead his personal creditors.[20]

The reverse piercing test does not require a creditor to prove that the debtor committed actual fraud; it "merely requires the trial court to find that the defendants committed an unjust act in contravention of the plaintiffs legal rights."[21] In order for the creditor to show that an unjust act in contravention of their legal rights occurred, and therefore for the reverse piercing action to be successful, the creditor must directly name the entity as a party.

Constructive trust. An alternate equitable remedy is a constructive trust; it becomes available when someone legally holds the rights to property that should "in equity and good conscience" belong to another party. The property does not have to be acquired fraudulently, nor does the creditor need to prove that there was *intent* to defraud.[22] Essentially, the creditor must prove only that the current ownership of the property is unfairly preventing the creditor from accessing the entity's property.

The authors are aware of only one case in which the constructive trust analysis was used to defeat charging order protection.[23] In the relevant case, the debtor was shown to have committed significant fraud, including funding personal ventures and opportunities with company assets, commingling personal and company funds, receiving extended credit from banks based on company funds, and transferring company funds into a personal account. Ultimately, the court decided that the constructive trust could defeat the charging order limitation because the judgment was not monetary, and only monetary judgments are protected by charging order limitation statutes. Therefore, although infrequently used as a remedy, a constructive trust may be an alternative for a creditor seeking to bypass a charging order and attack a limited partnership or an LLC.

Resulting trust. A third alternative is a resulting trust, which may be used if a person with legal title to property is holding it for the benefit of a person holding equitable title and further, if the facts and circumstances demonstrate that the holder of the legal title is not enjoying the beneficial interest of the property. In such circumstances, the implication is that the parties entered into an agreement where a trust relationship exists, without formally declaring as such in writing. As a result, a creditor has cause to argue that the title holder is acting as a trust, whose sole purpose is asset protection rather than a business purpose. If the creditor can prove this assertion, the creditor may be able to overcome the charging order exclusive remedy, thereby obtaining an equitable resulting trust.

Alter ego/sole purpose. The alter ego/sole purpose theory is yet another method to potentially bypass a charging order and have the entity considered "disregarded." An entity must have a business purpose, in the opinion of many courts, and an entity may not be safe from creditors if it is set up only to shield the assets from creditors, or to house personal assets that are not intended for business purposes.[24] At this point, the entity is considered to be only the debtor's alter ego. In this instance, the creditor may have other options available as a remedy besides the charging order, including the court's potential decision to disregard completely the corporate entity to prevent an injustice from occurring.

Examining one of these Florida cases, where the corporation *was* found to be the alter ego of the debtor,[25] reveals the following relevant facts:

- Control of the corporation was in the hands of the debtor, rather than the shareholders.
- The debtor's personal expenses, including those of his wife and children, were directly paid by the corporation.
- There had been no stockholder or directors meeting held since the inception of the corporation.
- Record keeping was poor, including missing records.
- Fraudulent transfers made up all of the corporation's assets.

In the case of *In re Ehmann*,[26] an analogous case, the bankruptcy court warned against using a limited partnership or an LLC as a trust for holding personal assets. The court also cautioned entities to remember that business entities are for fulfilling economic ventures, and not to hold personal assets. The entity may not stand up to creditors if the members' real intention in setting up the entity is to operate the entity like a revocable trust, disguised as a business entity but containing purely personal assets. In *Ehmann*, the court eventually withdrew this decision when the

parties settled, partially because this outcome is so difficult for people who have set up family funding vehicles using their limited partnerships and LLCs.[27]

Because the decision was withdrawn, it cannot be relied on as a precedent, but it may still act as guidance in future court decisions. Clients should, therefore, be careful to establish and confirm the business purposes of their entities when setting up and funding an LLC or a limited partnership. This case is the only example of a non-traditional "alter ego" case of which the authors are aware.

Conflict of law issues

Conflict-of-law issues (i.e., which state's law should apply in a case) may arise in a variety of circumstances, including the state of residency of the creditor, the debtor, and the subject LLC or limited partnership. In Washington State, a court determined that for purposes of levy or attachment, the adjudication of personal property is typically based on the physical location of the property or where the owner resides, and that the interest of a member in an LLC can fall under the definition of personal property. An interest in a limited partnership or LLC would be "subject to the jurisdiction of a state if the relationship of that state to the thing and to the parties makes the exercise of such jurisdiction reasonable." [28] Therefore, if an individual resides in one state but has a personal property interest in a limited partnership or LLC located in another state, he or she may be held to the law of the state where the entity is located. The courts have consistently leaned toward finding that the controlling law with respect to the entity is the state law where the entity was formed, although the Revised Uniform Limited Partnership Act (RULPA) or the Revised Uniform Limited Liability Company Act (RULLCA) have yet to address this issue.

In this Washington State case, *Koh v. Inno Pacific Holdings Ltd.*,[29] a creditor wanted to obtain a charging order after being awarded a monetary judgment against a debtor with a 50% interest in an LLC formed under Washington state law. The creditor was seeking this charging order in California, and the LLC's principal place of business was in Malaysia. Initially, the Washington trial court quashed the charging order; it claimed that because the LLC's primary interest with respect to the debtor was outside of Washington, the court did not have jurisdiction over the debtor's membership interest in the LLC. This decision was later reversed by the appellate court, which found that a limited partnership's or an LLC's interest is considered to be located within the state under the laws of which the entity is organized.

It may be permissible, therefore, for a creditor to register a judgment and obtain a charging order under the state law where the entity was formed, provided there is also a valid foreign judgment. In *Koh*, the creditor registered his foreign judgment and thereby obtained a charging order against the debtor's LLC interest under Washington law.

Executory v. non-executory agreements

Under bankruptcy law, an "executory" contract is a contract where both sides have unperformed obligations, and where in order to receive a benefit, a party must execute certain duties. A "non-executory" contract, on the other hand, is a contract where an employee has already completed work, and is now merely awaiting compensation for services rendered. A non-executory member contract may be "abandoned" by a trustee in bankruptcy, but this does not apply to executory contracts under the current Bankruptcy Code.

In January 2007, the *Florida Bar Journal* published an article[30] which indicated that LLC operating agreements and limited partnership agreements should be made executory contracts, with affirmative obligations imposed on members and partners to make future capital calls, comply with fiduciary duties, and be involved in the entity's management. The article reached this conclusion as a result of the Bankruptcy Court's decision in *Ehmann*,[31] whereby the judge concluded that charging order protection does not apply once a limited partnership interest is subjected to the Bankruptcy Court's jurisdiction, either by the debtor limited partner filing or being forced into bankruptcy, if the partnership agreement is non-executory. The agreements may further state that they are intended to be executory contracts, and may also state the business purpose of the partnership, along with the other affirmative obligations mentioned above, if clients have concerns about the potential perception of these agreements by a Bankruptcy Court.

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27 Order Withdrawing This Court's Opinion and Order Dated December 7, 2005 (1/25/2006). Order can be found at: www.assetprotectionbook.com/AZ_Ehmann_2005.htm.

28 Koh v. Inno-Pacific Holdings Ltd., 54 P.3d 1270 (Wash. App. Div. 1, 2002).

29 *Id.*

30 Wells and Guso, "Business Law: Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member," 81 Fla. Bar J. 34 (2007).

31 Note 26, *supra*.

32 2006 WL 2034217 (10th Cir. BAP, 7/11/2006).

33 See *supra* note 30.

34 291 B.R. 538 (Bkrptcy. DC Colo., 2003).

35 528 F.3d 1310 (CA-11, 2008).

Will bankruptcy law trump state law?

An ownership contract that is deemed non-executory is not binding on the trustee in bankruptcy. The contract may be non-executory if a debtor is a limited partner in a limited partnership but has no affirmative duties to the partnership. As such, the trustee may even be able to become a full member of the entity, owning all the rights associated with the interest. *In re Baldwin*,[32] an unpublished case, concluded in addressing this issue that where federal law applies in determining the extent of the trustee's interest, the trustee's rights with respect to that interest are determined by state law and the partnership agreement itself.

As a result, the trustee could dissolve the partnership, if the right to vote to dissolve the partnership existed under state law or the entity's operating agreement. However, similar to the *Baldwin* case, if the right to dissolve was not granted to the debtor, the trustee could obtain a general interest, but would not be permitted to force dissolution of the entity.

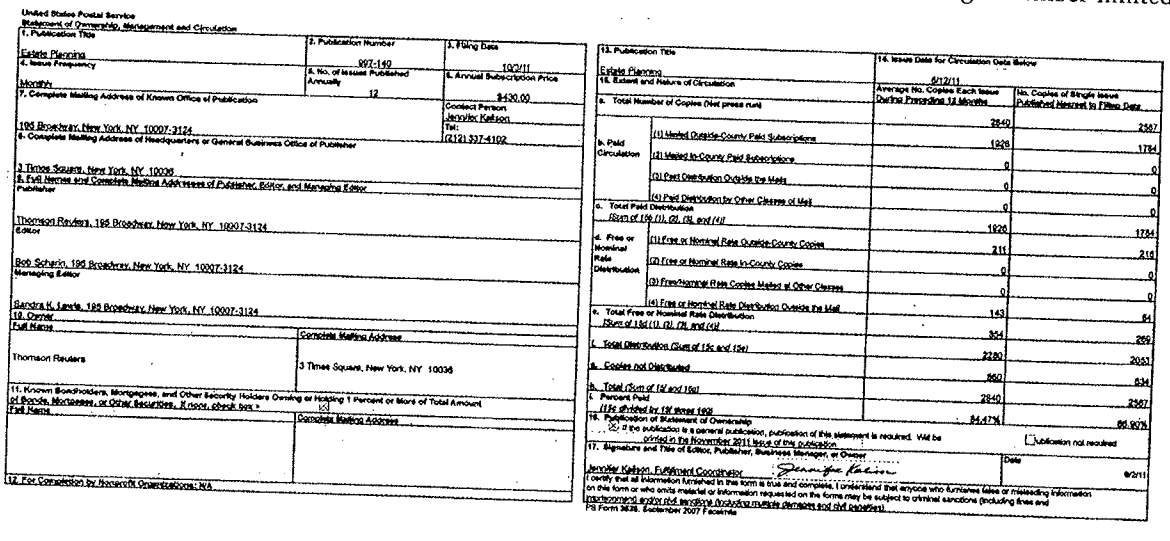
However, if a debtor has affirmative duties as a limited partner, including to contribute money and perform services for the partnership, the partnership agreement may receive charging order protection in the event of bankruptcy, because it would be considered an executory contract, as defined above. Furthermore, entity management should be an active and engaging role for members and partners. Recent modifications to the Florida limited partnership statute not only no longer prohibit limited partners from participation in entity management, they also allow limited partners to participate without a loss of limited liability that is inherent to a limited partnership interest.[33]

Also of note is that under Bankruptcy Code section 541(c), an agreement or provision that modifies or terminates the debtor's interest in property because of "the insolvency or financial condition of the debtor" or the filing of a bankruptcy case is not enforceable in the event of bankruptcy.

Multiple members needed?

In re Albright[34] also provides an example of bankruptcy court interjection in this area. In 2003, a Colorado bankruptcy court held that as the successor of an LLC previously owned by the debtor, the trustee in bankruptcy could exercise management control over the LLC and liquidate the LLC's assets, in order to realize the value as the sole member. The purpose of the Colorado charging order statute, according to the Colorado judge, was primarily to protect *other* members, although there is no mention of limiting the application of charging order protection to a multiple-member situation in the statute language. As a result, many planners suggest that a limited liability company have multiple members, so that the presence of other members would strengthen the possibility of charging order application should one member end up in bankruptcy.

As described above, the ultimate decision in June 2010 by the Florida Supreme Court in *Federal Trade Commission v. Olmstead*[35] created certainty as to the charging order protection available with respect to a single-member LLC in Florida, and simultaneously created uncertainty as to the charging order protection available with respect to a multiple-member LLC in Florida. The court affirmatively answered the following question certified to it by the Eleventh Circuit Court of Appeal: "Whether ... a court may order a judgment-debtor to surrender all 'right, title, and interest' in the debtor's single-member limited lia-



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Jennifer Kelson, Fulfillment Coordinator — Date: 9/2/11

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bility company to satisfy an outstanding judgment," and awarded the creditor all right, title and interest in the debtor's single-member LLC interest. Nevertheless, the Florida legislature has addressed the outcome of this case, and has passed an amendment to the Florida LLC statute, as described in greater detail above.

Judgment creditors' rights

Under a limited partnership, a judgment creditor only has the rights of an assignee of the partnership interest, and therefore does not have the right to foreclose against a debtor partner's interest. This is supported by the case of *Givens v. National Loan Investors, L.P.*,[36] where National Loan Investors procured a deficiency judgment against Givens with respect to a mortgage, and eventually obtained charging orders charging Givens' interests in two limited partnerships. National Loan Investors then asked the court for an order to transfer Givens' interest so that it could be liquidated. The Fifth District Court of Appeals, however, stated that the Florida Revised Uniform Limited Partnership Act does not authorize foreclosure of the charged interest, because the statute permits the rights of only an assignee to a judgment creditor; the court subsequently refused to issue the order. Unless explicitly provided in the partnership agreement, assignees are not, therefore, entitled to a partnership interest.

First come, first served

In *Krauth v. First Continental Dev-Con, Inc.*,[37] the court held that when a single debtor has multiple unsecured judgment creditors, the policy is essentially "first come, first served." The first creditor that applies for a charging order against the debtor's partnership interests to a court of proper jurisdiction has top priority for the full satisfaction of his or her judgment. The sequence in which the judgments were entered is not relevant, and furthermore, the notion of a pro rata apportionment of the debtor's partnership interest was rejected. Because charging orders are considered less disruptive substitutes for judgments typically executed by sheriffs, which are enforced in the order in which they were put in the hands of the sheriff, the court found that the enforcement of charging orders should also be enforced one at a time, with priority given to the order of filing.

Lien holder comes before charging order holder

In *Blosam Contractors, Inc. v. Luycx*,[38] the issue is the order of priority for the payment of final judgments. Blosam obtained a final judgment against Cooper and executed a financing statement covering her interest in a limited partnership. Luycx obtained a final judgment against Cooper as well, and was the first to file an application for a charging order. The lower court held that a charging order held priority over a perfected security interest, and therefore pursuant to Fla. Stat. § 620.695, Lucyx had priority for judgment. However, the court in this instance reversed the lower court's decision, holding that a perfected security interest was superior to the rights of a subsequent lien creditor, so Blosam's judgment had higher priority.

Does LLC have to be party or the creditor an eligible owner?

In *Cadle C. v. Ginsburg*,[39] the plaintiff tried to obtain a charging order against the defendant's interest in a Jai Alai Limited Liability Company. The defendant opposed this action for two reasons:

1. The defendant claimed that the LLC must be made a party to the case.
2. The defendant claimed that plaintiff's charging order would violate a Connecticut statute forbidding an unlicensed person from operating a jai alai company.

Connecticut law provides for a charging order against an LLC member's interest to secure payment of an unsatisfied judgment. The court determined that making the LLC a party to the action was unnecessary, because the "charging order merely gives the judgment creditor the rights of an assignee" of the LLC member's interest, but it does not give the assignee the right to manage the LLC. The court also found that an assignee's right to the LLC member's interest is not equivalent to the right to manage or participate in the LLC, based on the same reasoning; therefore, the statute that forbids an unlicensed person from running a jai alai company was not violated.

New Nevada law development

The authors have seen charging order protection for debtors granted by the states to only limited partnerships or LLCs thus far. Nevada, however, passed a statute[40] effective 11/1/2007, extending charging order protection to certain corporations; it is the first state to grant this protection to corporate shares of stock. However, a Nevada corporation must meet certain requirements in order for this protection to apply,

[36] 724 So. 2d 610 (Fla. 5th Dist. App., 1998).
[37] 351 So. 2d 1106 (Fla. 4th Dist. App., 1977); *supra* note 9.
[38] 535 So. 2d 352 (Fla. 1st Dist. App., 1988).
[39] CV 950076811s (Superior Ct. Conn., 2002).
[40] N.R.S. § 78.746 (2007).
[41] N.R.S. § 78.746(2)(a) (applies only to a corporation that: (1) has fewer than 100 stockholders of record at any time, (2) is not a publicly traded corporation or a subsidiary of a publicly traded corporation, either in whole or in part, and (3) is not a professional corporation as defined in N.R.S. 89.020).
[42] N.R.S. § 78.746 (2011).

including that it must have less than 100 shareholders.[41]

Nevada further enhanced its charging order protection with the passage of SB405,[42] effective 10/1/2011. The new legislation establishes the charging order remedy as the sole remedy for LLCs, limited partnerships, and corporations, regardless of whether an LLC or corporation has only one member. The legislation also specifies that no equitable remedies would be applicable with respect to an LLC or limited partnership although the alter-ego equitable remedy may apply to corporations. Only time will tell if other states will follow suit and begin extending charging order protection in this manner.

Other planning considerations

An assortment of other planning considerations are relevant with respect to charging orders and LLCs.

Selection of jurisdiction. Life insurance and annuity structuring are similar to asset protection trusts, in that the laws of many offshore jurisdictions have been adapted specifically for creditor protection purposes, to encourage the use of such entities in these jurisdictions. These statutes have clear, protective language, as well as rigid and supportive judicial systems. Furthermore, lawyers in these jurisdictions are not permitted to take cases on a contingency basis. These factors have led many planners to promote offshore entities as planning vehicles for their clients. Such entities may be disregarded or treated as partnerships for federal income tax purposes, and are often extremely useful if a client has significant activities or investments offshore. Offshore entities may also be useful because foreign institutions often prefer not to work directly with U.S. persons or entities, because of governmental and regulatory issues.

Estate tax planning implications. No court decision explicitly enumerates creditor protection as a valid business purpose for a "discount planning" estate tax situation. However, neither has any court case involved a situation where creditor protection was highly important to the taxpayer. Inevitably Tax Court cases will arise in situations where debtors with significant liability exposure have established family entities, primarily for the purpose of avoiding potential predatory creditor confiscation. The IRS may be purposely choosing not to litigate such cases, potentially because of concerns that creditor protection will become a recognized legitimate business purpose.

Tiered entities. Instead of a client owning an ownership interest in an LLC or limited partnership directly, planners may wish to set up a "family" or "intermediary" LLC or limited partnership, which could hold a client's partial partnership interest in another such entity.

Suppose, for example, a client owns 25% of an LLC and has charging order protection with respect to his or her interest in the entity. The client cannot control whether the remaining members may vote, by majority rule, to make a distribution. Then, the client's creditor would receive the client's share of the distribution. If instead the client owns 95% of a family limited partnership owning 25% of the above-referenced entity, the 25% distribution would pass from that entity to the family limited partnership. If charging order protection applies at the family limited partnership level, the ownership percentage could later be re-invested.

Fraudulent transfer statutes. Fraudulent transfer statutes often allow creditors to unwind transfers made for the purposes of creditor avoidance, but if a client owns an interest in a company that becomes an LLC, which simply receives a charging order protective interest of equivalent fair market value in exchange for a non-charging order of protective interest, the transition may not fall under the fraudulent transfer statutes.

LLCs owned by individuals in different states may or may not be protected for each individual owner. The controlling law for charging order protection may differ for each individual, depending on the law of the state where each member resides, as discussed above. Limited partnerships may be preferable in many situations because they are governed by better-established charging order protection law (at least in many jurisdictions, such as Florida).

Conclusion

As sophisticated clients see their colleagues and competitors fall more and more frequently to predatory creditors, the U.S.'s court litigation system, leveraged real estate, and industry failures, these clients will seek out entities that offer the potential for incidental creditor protection, although this protection may not be the primary motivation for use or selection of a particular entity. Planners must keep up with their clients' demands and expectations, and must continually analyze the applicable rules in a given jurisdiction of operation and the jurisdiction of residency of each member/partner, and select, design, and operate entity arrangements that will ensure their clients' security and protection. ■