Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1637

Date: 06-May-10
From: Steve Leimberg's Estate Planning Newsletter
Subject: **Forum Shopping For Favorable FLP and LLC Law – Part V**

Three years ago, **Mark Merric** suggested that **LISI** run a series of newsletters on limited partnerships. I was a bit leery at first, because many times a reader's interest diminishes after the first or second installment. However, this has not been the case with any of Mark's series of newsletters (reciprocal trusts, spousal access trusts, self-settled estate planning trusts, or who can be a trustee), and I receive many e-mails asking when the next installment will be published.

Related to the topic of charging order protection, there is an excellent article by **Mark Merric**, **Bill Comer**, and **Dan Worthington** published in the April issue of **Trusts and Estates**, "Charging Order, What Does Exclusive Remedy Mean? "

The authors' current commentary discusses the great many interpretations regarding what different planners refer to as "sole remedy." The authors would like to thank esteemed estate planning attorney **Randall Borkus** for bringing this case to the authors' attention.

Merric Law Firm is a boutique practice emphasizing activity in the areas of estate planning, international tax, and asset protection planning. **Mark Merric** is co-author of CCH's treatise on asset protection – first edition, The Asset Protection Planning Guide (first edition), and the ABA's treatises on asset protection, *Asset Protection Strategies Volume I*, and *Asset Protection Strategies Volume II*. Mark's articles have been published in Trusts & Estates, Estate Planning Magazine, Journal of Practical Estate Planning, Lawyers Weekly – Heckerling Edition, Journal of Taxation, and the Asset Protection Journal. Mark speaks nationally on estate planning and asset protection.

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Now, here is their commentary:

EXECUTIVE SUMMARY:

Many state laws or case law allow a creditor to judicially foreclose on a debtor's limited partnership (LP) or limited liability company (LLC) interest. The authors find that the judicial foreclosure sale is a separate and additional remedy to a charging order.[1] This article discusses the effectiveness of this judicial foreclosure sale remedy to a third party or by a bankruptcy trustee.

There are two different camps regarding the effectiveness of such a remedy:

- One camp finds that the judicial foreclosure sale to a third person is a strong remedy, often forcing a debtor/partner (or member) to settle on unfavorable terms.

- The other camp advocates the "porcupine theory" that a creditor will never pursue the judicial foreclosure sale of a partner's or member's interest due to the phantom income generated by the LP or LLC.

In general, the authors would lean toward the camp that believes a judicial foreclosure sale is an effective remedy for a creditor. A small amount of light is cast toward this view with the recent bankruptcy case, *In re Adams*[2]. In *Adams,* the debtor's member's interest was sold for 12% of the underlying fair market value of the debtor's pro rata share of the LLC's assets.

At first blush, the porcupine theory seems to have had no effect at deterring a creditor. However, the specific facts of *Adams* may provide guidance as to why in this case the porcupine theory had little, to no, effect in preventing a judicial foreclosure sale. Therefore, this commentary discusses different fact patterns where the porcupine theory will probably not be too effective to prevent a judicial foreclosure sale as well as a fact pattern where it should be effective.

FACTS:

Types of Judicial Foreclosure Sales

There are primarily two types of state judicial foreclosure sales[3]:

One is where the creditor receives the LP or LLC interest at its appraised value in satisfaction of part of the creditor's claims. This type of judicial foreclosure sale is known as "strict foreclosure," there is no bidding by third parties or by the creditor.

For example, assume an LLC owns $1 million of marketable securities. The debtor owns 50% of the LLC and the debtor's spouse owns the other 50%. The underlying value of 50% of the LLC assets is ½ million dollars.

The 50% interest would most likely be valued similar to a minority/marketability discount. In this example, let's assume the appraised value results in a 35% discount so that a 50% interest with ½ million dollars of underlying assets is valued at $325,000 ($500,000 x 65%). Further assume that the creditor is owed $1 million.

With a strict foreclosure, the creditor would receive the 50% LLC interest and the amount owing the creditor would be reduced from $1 million to $675,000. When state law requires that the creditor receive the appraised value under a strict foreclosure, the effectiveness of a creditor pursuing judicial foreclosure remedy is substantially reduced.

Conversely, a creditor may seek to circumvent a strict foreclosure sale by filing an involuntary bankruptcy. In such a case, depending on state law and whether the operating agreement is executory[4], the sale by a bankruptcy trustee is similar to the judicial foreclosure sale to a third party.

While the procedures of a third party judicial foreclosure sale, which is commonly referred to as a "sale by foreclosure," may vary from one state to another, in general the LP or LLC interest is auctioned to the highest bidder. In many states, the creditor may also bid at a sale by foreclosure. It is the sale by foreclosure the authors find to be an effective creditors remedy, and in this situation the authors find the porcupine theory problematic.[5]

What is a Third Party Judicial Foreclosure Sale To a Third Person?

It's easier to illustrate a third party 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 a LP that holds $3 million of assets. Dr. Anne owns a 95 percent LP interest and her husband Ray is the general partner. Assume that a creditor obtains a charging order over Dr. Anne's 95 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 LP. As an additional remedy, the court orders the judicial foreclosure sale of Dr. Anne's LP interest. At the sheriff's auction, Dr. Anne's 95 percent LP 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 LP 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 LP interest, not the charging order. After the purchase of Dr. Anne's LP interest, the speculative investor has the right to distributions forever. Also, the speculative investor has standing to bring an action for a judicial dissolution of the LP, which is discussed below. Fortunately if the LP agreement is properly drafted, the speculative investor does not become a substituted partner with voting rights and generally cannot force a liquidation of the LP.[6]

What Will the Amount of the Discount Be?

As of March 12, 2010 with the case of *In re Adams*, we have a recorded bankruptcy sale of an LLC interest. In this case, the underlying value of Adam's 20% interest was estimated to be $294,000, and Adam's LLC interest was sold to another member for $36,000, which is approximately 12% of the underlying value.[7]

One cannot rely on the results of one case to establish a statistic. Also, this one case was a bankruptcy sale, not a sale by foreclosure. Finally, some commentators take the position of whether someone would purchase an LLC interest in bankruptcy or at a sale by foreclosure may well depend on the amount of income being generated by the LLC that is not distributed and which, thus, creates phantom income to the purchaser.

PORCUPINE THEORY:

Under the porcupine theory, some planners take the position that a creditor would not pursue the judicial foreclosure sale, because as the purchaser and owner of the LP or membership interest he or she would receive phantom income.[8] This is because the purchaser becomes the legal owner**.** However, assuming the partnership or operating agreement is drafted properly, he or she does not become a substituted partner or substituted member with any voting rights. Without voting rights, the purchasing partner or member cannot force a distribution and**,** instead, receives phantom income through the K-1 each year.

DOES A JUDICIAL FORECLOSURE SALE CAUSE MORE DAMAGE THAN GOOD?

One of the reasons that some commentators have advocated the porcupine theory is that they believe the judicial foreclosure sale will put the creditor in a worse position than he or she was before the judicial foreclosure sale. In the strict foreclosure case where the creditor receives the LP or LLC interest based on an appraised value, this view has more substance than the sale by foreclosure or bankruptcy sale discussed below.

The first remedy a creditor receives is a charging order. At this time, the creditor and debtor may reach a settlement that involves a payment plan. Distributions may continue to be made from the LP or LLC, and these distributions could have been incorporated into a payment agreement with the creditor. Should the debtor have been able to negotiate a reduced settlement and/or payment plan, then the LP or LLC has provided some degree of asset protection.

Conversely, this is not what is advocated by asset protection planners relying on LPs or LLCs as a stand alone asset protection tool.[9] Rather, the asset protection plan calls for the LP or LLC to terminate any distributions leaving the debtor with an inability to meet any payment plan. Then, hopefully, the creditor will settle for a much smaller amount, which most likely will be satisfied by a large distribution from the LP or LLC.

At this point, the creditor becomes frustrated. The creditor is asked to settle a judgment for a fraction of the amount owed. At the same time, the creditor is advised that if he or she pursues a sale by foreclosure, the debtor will not be able to work out any settlement because the debtor's

LP or LLC interest has been sold. While the threat of not being able to come to a settlement may be able to deter some creditors, for the following reasons the authors in most situations do not think it will have much bite.

First, the creditor has already attempted to negotiate some type of settlement and has been unsuccessful. In this respect, the creditor may conclude that there is little lost by pursing a judicial foreclosure sale. So, while the original threat may have had some deterrent effect, at this point in time the creditor may well view that there is little lost and possibly much more to gain by pursuing a sale by foreclosure.

Second, as noted in the published cases where Merric contacted the attorneys who represented the debtors and creditors in the judicial foreclosure sales, the sale was never concluded. The issuance of the judicial foreclosure sale order resulted in the debtor settling on unfavorable terms. In these cases, the creditor lost nothing by virtue of the threatened judicial foreclosure sale, but instead gained substantially from its original position.

Third, in most states, the creditor can bid at the third party judicial foreclosure sale. In this case, if no one else is willing to bid, what is to stop the creditor from bidding only 1% of the underlying value, instead of 12% as in *In re Adams.* Further, if no one bids anything no harm is done to the creditor by using the threat as a method to negotiate a more favorable settlement.

EXAMPLES WHERE THE PORCUPINE THEORY WILL PROBABLY BE INEFFECTIVE:

In addition to the above circumstances that may well put a creditor in a no worse position for pursuing a third party judicial foreclosure sale, the authors find that the porcupine theory may not be effective in the following circumstances:

1. Bankruptcy;
2. When persons unrelated to the debtor own significant interests in the LP or LLC;
3. When a member of the debtor's family or trusts created by

the debtor hold significant LP or LLC interests;

4. The LP or LLC is not generating much phantom income; or
5. Possibly when the LP or LLC only holds marketable securities;

In re Adams is a bankruptcy case, not a sale by foreclosure. In the event the bankruptcy trustee can sell the debtor's interest,[10] the bankruptcy trustee only cares that he or she maximizes the recovery for all of the creditors. He or she is not worried regarding any implications of phantom income to the purchaser.

In fact the original sales price that was acceptable to the bankruptcy trustee for Adam's 20% interest was $20,000, which is 7% of the pro rata underlying assets. Adams protested the sale because he had non-dischargeable debts such as taxes and the underlying value of his pro rata share of the LLC's assets was $294,000.

The Bankruptcy Court agreed with the third party purchaser's second offer of $36,000, which is 12.3% of the underlying value. Conversely, proponents of the porcupine theory will point out that the purchaser would still need to worry about the possibility of phantom income. In this respect, *In re Adams* may only give us limited guidance as to the sales price as opposed to under what situations a purchaser would buy the LP or LLC interest from the bankruptcy trustee.

A second situation where the porcupine theory will probably be ineffective is if significant interests are owned by partners or members unrelated to the debtor. In this case, the debtor may not have voting control in the first place, as was the situation in Adams where he owned 20%, and the other members will vote to receive their share of the distributions.

A third situation where the porcupine theory will probably not be very effective is when the debtor's family members or trusts own a significant percentage of the LP or LLC. For example, assume that that the LLC owned $ 1 million of marketable securities.

Further, assume that husband and wife owned 100% of the LLC.

Husband's ½ million dollar interest was attached by his creditors and sold at a judicial foreclosure sale for 12% of the underlying value or $60,000.

For sake of this fairy tale, assume stocks are doing very well and the rate of return is approximately 12% or $120,000. Assuming ¼ of the 12% is appreciation that is non-taxable until a security is sold, ½ is long term capital gain or qualifying dividends, ¼ is short term capital gain and interest, then the amount of tax owed on the $60,000 of phantom income would be approximately $12,000 assuming federal tax and a five percent state tax.

In this example, both the debtor's spouse and the purchaser receive phantom income. However, it is much more likely that the purchaser will be able to absorb the tax on the phantom income each year than the debtor's spouse. In this respect, the phantom income causes as much, if not more, damage to the client's family than to the purchaser.

There is a fourth situation where the porcupine theory will probably do little to deter a creditor. This is where the LP or LLC is not generating significant phantom income. Adams involved an LLC that owned commercial real estate. The facts do not state whether it was a rental building or land, but in either case, the phantom income would probably be small. This is because if the commercial real estate is a building, the depreciation will reduce the operating income of the LP or LLC. If the commercial real estate is land, it generates no income unless it is rented such as in a farming situation.

EXAMPLES WHERE THE PORCUPINE THEORY SHOULD BE EFECTIVE

While, generally, the authors find many situations that do not support the porcupine theory, the following fact pattern should provide some support for the porcupine theory. Assume that the debtor owns a 90% interest in an LLC. The other 10% is owned by irrevocable trusts created by the debtor many years before there was any financial crisis.

The LLC is an operating business generating a 10% rate of return before taxes. The fair market value of the LLC is $5,000,000, after reducing the assets and goodwill by $2,000,000 of debt. In this case, the ordinary income generated per year is $500,000 of which $450,000 is allocated to the debtor.

If a third person purchases the debtor's membership interest at a judicial foreclosure sale and the debtor uses all of the income to reduce the debt in the LLC, the purchaser will have phantom income of $450,000 and will pay ordinary income tax on it in the amount of $180,000. Further, assume that the irrevocable estate planning trusts have enough income from other assets to easily cover any phantom income that they receive.

In this case, a few of the factors have changed from the previous examples. There is a large amount of phantom income, and it is ordinary income taxed at a higher rate. The manager of the LLC is using the excess cash for a proper business purpose to pay down the debt of the LLC.

In this respect, it is hard for the purchaser to argue that it is impractical to carry on the business of the LLC or that funds are being improperly diverted to other purposes, rather than making a distribution. Finally, a spouse or irrevocable trust does not have such a great interest that the phantom income hurts the spouse or trust to the same degree as the purchaser.

However, playing devil's advocate, what if a creditor purchased the debtor's 90% interest at a 12% value as in the case of *Adams*. The purchase price would be $540,000.

In four years, the debt of the LLC would be paid off and the purchaser would have paid $720,000 in federal and state taxes. Therefore, the purchaser's total investment in the 90% LLC would be $1,260,000 at this point in time.

The value of the LLC would have increased from $5 million to at least $ 7 million. The purchaser's interest in the underlying assets is $6.3 million and, when compared to the total amount invested, it is now 18% of the fair market value of the assets instead of 12%.

At this point, the debtor who is managing the LLC may spend the excess cash on capital acquisitions to further justify denying distributions. Except in a handful of states, an "assignee" or "transferee," instead of being a member, some commentators take the position that an assignee does not have standing to seek a judicial dissolution.[11]

PRAGMATIC ISSUE WITH STAND-ALONE LPs OR LLCs

There is another practical issue regarding asset protection which involves the charging order, a judicial foreclosure sale, and possibly an involuntary bankruptcy. Once a creditor is granted a charging order, distributions to the limited partners or members cease.

Somewhere the debtor must have access to funds to pay for protracted litigation regarding the judicial foreclosure sale. Further, after the judicial foreclosure sale, then there may be further litigation regarding a judicial dissolution of the LP or LLC. For this as well as many other reasons, the authors recommend that an LP or LLC should be combined with a domestic or offshore asset protection trust. With a domestic or offshore asset protection trust, the trust may always pay expenses on behalf of the debtor/beneficiary.

COMMENT:

One case demonstrating a discounted sales value of 12% of the pro rata value of the underlying assets is not a valid statistic to draw many conclusions. Further, the sale was to a third party member of the LLC and it was in the bankruptcy setting.

Conversely, one case showing the judicial foreclosure sale combined with other cases settling on unfavorable terms, such as a court granting a judicial foreclosure sale, is a bit worrisome. Further, while some planners take the firm position that the porcupine theory will prevent a creditor from seeking a third party judicial foreclosure sale, the authors find that this generally will not be the case.

A bankruptcy trustee will have little hesitation in selling the LP or LLC interest. Second, as in *Adams,* if third parties own significant interests in the LP or LLC they may easily become the purchaser at a sale by foreclosure. Third, if the debtor's family or trusts created by the debtor own significant interests in the LP or LLC the debtor also receives phantom income and, generally, the debtor's family will have less staying power than a third party purchaser. Fourth, phantom income is only a threat if the LP or LLC is generating significant income.

On the other hand, when an operating business owned almost entirely by the debtor with a small fraction owned by a family member (or trust created by the debtor) is generating strong profits, in this situation the porcupine has a good chance of being effective. Also, where state law does not allow a third party judicial foreclosure sale, but rather allows the creditor to only receive the LP or LLC interest at a minority/marketability discount appraised value, this also should have some deterrent effect.

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

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[1] **Mark Merric, Bill Comer, and Dan Worthington**, *Charging Order – What Does Sole Remedy Mean?*, Trusts and Estates, April 2010. This article may be downloaded at www.InternationalCounselor.com, then go to "publications," then "articles," then "asset protection."

[2] *In re Adams*, Bkr. No. 08 B 20217 (Bkr. N.D. Ill. 2010)**.**

[3] The differences between a "strict foreclosure" and a "sale by foreclose" was pointed out by **John Sullivan, III** at the first through the sixth Annual Asset Protection Symposium that has traditionally been hosted by the Chicago Bar Association.

[4] The intricacies in bankruptcy law and how they relate to state law are beyond the scope of this article. For example, in *Ehman*, 319 B.R. 200 (Bkr. D. Ariz. 2005) the Bankruptcy Court found that since the operating agreement was not executory, the bankruptcy trustee could sell the interest as well as receive voting rights. This was so even though Arizona has a sole remedy statute.

[5] Both the ULPA (2001) and the ULLC (2006) authorized the judicial foreclosure sale of the limited partnership interest and seem to strongly imply that they provide for a sale by foreclosure remedy.

[6] *See* **Elizabeth M. Schurig and Amy P. Jetel**, *The Alarming Potential For Foreclosure by an LLC Member's Personal Creditors*, Probate and Property, May/June 2006 discussing Section 503 of the ULLC (1996). This issue was corrected shortly after this article under the ULLC (2006). However, the following states adopted the ULLC (1996) and still allow a transferee to request a judicial dissolution: Hawaii, Illinois, and Vermont. On the other hand, the authors are unaware of any reported case where a judicial dissolution has been requested under these circumstances.

[7] It should be noted that Merric rounded the 12.3% down to 12% to further emphasize the hypocrisy of the Irish and English positions.

[8] While asset protection planners disagree on whether or not a creditor who obtains a charging order should report the income, there is no disagreement that a purchaser of an LP or LLC interest reports his or her share of the pro rata income. **Chris Riser**, *Tax Consequences of Charging Orders: Is the "K.O. by the K-1" K.O.'d by the Code*, Asset Protection Journal, Winter 2000, Volume I, Number 4.

[9] While the authors in general do not find a stand alone LP or LLC as too effective against a creditor attack, when the LP or LLC is combined with a domestic or offshore asset protection trust, the asset protection is greatly increased.

[10] See Endnote 2.

[11] In response to the Schurig and Jetel article cited in endnote 6, Thomas E. Rutledge, Carter G. Bishop, and Thomas Earl Geu wrote a rebuttal article titled, *Foreclosure and Dissolution Rights of a Member's Creditor – No Need for Alarm*, Probate and Property – May and June 2007. The table in the article noted an assignee or transferee could pursue a judicial dissolution under ULLC (1996), but not the ULLC (2006). Schurig and Jetel's article only addressed the ULLC (1996) act, and the ULLC (2006) that was promulgated after their article seems to have addressed the judicial dissolution issue that they raised. However, as noted in endnote 6, a handful of states still have the ULLC (1996) provision allowing for an assignee (i.e. transferee) to seek a judicial dissolution.