Steve Leimberg's Asset Protection Planning Email Newsletter - Archive Message #107

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From: Steve Leimberg's Asset Protection Planning Newsletter

Subject: **Corporate Stock Asset Protection No Longer Based on Perjury**

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EXECUTIVE SUMMARY:

For many years, certain promoters claimed there were great asset protection benefits with Nevada corporations. Unfortunately, until this year, these asset protection claims regarding Nevada corporations were far from the truth. However, through the persistence of Derek Rowley, President of the Nevada Resident Agent Association, Richard and Steve Oshins' Nevada has taken the lead with SB 242 that becomes effective July 1, 2007. Under this statute, for any corporation that has two to seventy-five shareholders, the statute provides that a creditor's sole remedy is a "charging order."

FACTS:

Asset Protection Based on Perjury:

Prior to SB 252, some proponents of Nevada Corporations alleged that since shareholder information is not public and Nevada does not report to other states, that a creditor is less likely to discover your assets through an asset search with a Nevada corporation. It is true that, if title is not in your individual name, vehicles such as the Nevada Corporation, the Illinois land trust, or any revocable trust for that matter provide – at least a negligible degree of asset protection. However, almost all creditors proceed to discovery regardless of whether an initial asset review revealed a debtor's assets.

As a second element of protection, some less than scrupulous promoters previously claimed that, since Nevada law allows for bearer shares, this feature provides for asset protection. But whether an asset is in bearer share or registered format is immaterial. The client/debtor still owns the shares in the Nevada Corporation. Therefore, when the client responds to the interrogatories or in a deposition, is the estate planning attorney going to advise his or her client to commit perjury in court? Unless a client commits perjury,[1] the bearer share attribute of a Nevada Corporation provides little, if any, asset protection.

Prior to SB 252, if one was to rely on asset protection of a Nevada Corporation, the protection was based on having your client commit perjury or the negligible asset protection provided by titling the assets in the name of an entity.

COMMENT:

Why Does a Corporation Generally Provide No Asset Protection?

Typically, a shareholder has the following three rights regarding his or her stock in a corporation:

1. Right to share in the profits (i.e., dividends);
2. Right to share in the liquidation proceeds; and
3. Right to vote the directors of the corporation.

When a creditor attaches the shares of a corporation, the creditor stands in the shoes of the client/debtor and receives all three rights. If the creditor attaches to more than a majority vote, which is usually fifty percent, then the creditor votes itself as the director(s), and the creditor/directors vote to liquidate the corporation and distribute all of the assets to the creditor/shareholder. The result is that, unless a client owned less than fifty percent of the stock, there was almost no asset protection with a Nevada corporation, an offshore corporation, or any corporation for that matter.

What's Charging Order Protection?

Partnership law (and subsequently LLC law) developed differently than corporate law.[2] 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.[3] With a charging order, a creditor is left with a right to distributions when made ... but the creditor has no method (i.e., voting rights) to force a distribution.

So 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.

Is a Charging Order the Sole Remedy of A Creditor?

The general answer is no. A charging order is not a creditor's only right. Most states have not decided the issue, and if a court decides the issue based on the type of statutory language contained in the Revised Uniform Limited Partnership Act of 1976, there is a substantially better than even chance that a court will allow the judicial foreclosure sale of the limited partnership interest.[4] Also, the 2001 version of the Uniform Limited Partnership Act specifically allows for the judicial foreclosure sale of the limited partnership interest.[5] Finally, ten states allow the judicial foreclosure sale of a member's interest in an LLC.[6]

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 FLP 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.

What's A Sole Remedy State?

A sole remedy state, preferably by statute or by case law, holds that a charging order is a creditor's sole or exclusive remedy. In other words, a creditor would not be allowed to judicially foreclose on the limited partnership or membership interest. For limited partnerships, six states[7] provide that a charging order is the sole remedy. Virginia provides that it is the sole remedy for FLPs by case law. For limited liability companies, twelve states[8] provide that a charging order is the sole remedy by statute, and North Carolina does this by case law.

While this is not in the scope of this article, there is a debate among professionals whether the "sole and exclusive" language of most states will be effective against direct remedies against the partnership such as reverse veil piercing, creditor's bills, constructive trust, and alter ego arguments.

The distinguishing point here is that the "sole and exclusive" language protects the partner's or member's interest, it may well not apply to a direct remedy against the partnership or limited liability company.[9] In this respect, Dick Nenno's Delaware may have the competitive edge over most of the other sole remedy states.[10] Further, in bankruptcy there are even further complications where in some cases, the Bankruptcy Trustee may step into the debtor's shoes and vote the debtor's interest.[11]

Nevada's Corporate Sole Remedy Statute

Similar to the above states that have provided sole remedy charging order by statute to FLPs and LLCs, Nevada is the first state as well as the first nation[12] to provide charging order protection for corporate shares of stock.

SB 242 Section 43.5 states:

> "On application to a court of competent jurisdiction by a judgment creditor of a stockholder, the court may charge the stockholder's stock 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 stockholder's stock.
>
> This section:
>
> (a) Applies only to a corporation that:
>
> (1) Has more than 1 but fewer than 75 stockholders of record at any time.
>
> (2) Is not a subsidiary of a publicly traded corporation, either in whole or in part.
>
> (3) Is not a professional corporation, as defined in NRS 89.020.
>
> (b) Does not apply to any liability of a stockholder that exists as the result of an action filed before July 1, 2007.

(c) Provides the exclusive remedy by which a judgment creditor of a stockholder or an assignee of a stockholder may satisfy a judgment out of the 5 stockholder's stock of the corporation.

(d) Does not deprive any stockholder of the benefit of any exemption applicable to the stockholder's stock.

(e) Does not supersede any private agreement between a stockholder and a creditor."

Conflict of Law Issues:

For those of us who do not live in Nevada, may we forum shop and come under Nevada's state-of-the-art charging order protection for a closely held corporation?[13] Some might say at first, "Of course you can." Conflicts of law cases strongly support that the place of incorporation governs shareholder rights. However, is a charging order a shareholder right or a creditor right? To date in the FLP and LLC area, the authors are not aware of any reported cases, dealing with this conflict of law issue and would suggest that a creditor is not bound by the same conflict of law rules as a shareholder.

An analogous issue is debated regarding whether a person who does not live in a Domestic Asset Protection Trust ("DAPT") state (e.g., someone who lives in California) settles a trust in a DAPT state (e.g., Nevada). Will a California court apply the governing law of Nevada as stated in the trust, or will the California court apply California law?

When making this decision, a court may apply any one or combination of the following factors:

(1) the choice of law designated in the trust;

(2) the situs of the trustee;

(3) the situs of the trust property;

(4) the residence of the settlor;

(5) the residence of the beneficiary;

(6) any other factor.

With a trust, by moving all of the trust assets to the DAPT state and not using an out of state trustee, the first three of the five specific factors may be weighted in favor of Nevada law. This might be enough evidence for a California court to hold that Nevada law governs the DAPT under conflict of law principles.[14]

Unfortunately, it is harder to get a majority of the factors in favor of a corporation, FLP, or LLC. The table below depicts this comparison modifying the above factors for a statutory entity instead of a trust.

		Nevada	California
(1)	place of organization	X	
(2)	the situs of the G.P., manager, president		X
(3)	the situs of the FLP or LLC property		X
(4)	the residence of the partners or members		X
(5)	any other factor.		

Regrettably, clients forum shopping for FLPs and LLCs generally hold the underlying partnership assets or LLC assets outside of the state of organization. Further, there is no forum state trustee with an FLP, LLC, or a corporation, and the client usually demands to hold the position of general partner, manager, or president. If this is the case, only one of the four specific factors is in favor of applying Nevada law, and whether a California court will apply Nevada law for a creditor claim is highly uncertain.

In order to equalize the above factors in favor of Nevada, the authors would suggest that a sizable part of the FLP's, LLC's, or now Nevada Corporation's assets be held in the sole remedy state.

Cost/Benefit Issues:

Even if forum shopping proves not to be successful, what is the cost/benefit to present this legal hurdle to a creditor? Typically, it is the annual cost of the registered agent and sometimes there are dual annual filing fees for the entity: one in Nevada in the above example and the other in California. If the cost is only the registered agent, the cost/benefit amount is typically from $250 to $350 a year. If there is a dual annual filing fee, the incremental cost is typically from $50 to $100 a year. The authors find the above annual costs relatively small compared with the possible benefits of a court applying the law of the forum jurisdiction.

Conclusion:

The Nevada corporate charging order statute is truly a state-of the art statute. For the first time, corporate stock may now be protected by a charging order. However, there are a few limitations. Remember that the following are NOT protected under SB 242:

(1) single owner corporate stock

(2) corporations that have seventy-five or more shareholders

(3) professional corporations

Outside of Nevada, there is always the question of whether an out of state judge will apply Nevada's state-of-the-art law. However, at a minimum, forum shopping for favorable sole remedy charging order protection at least presents a legal hurdle for a creditor to surmount at a fairly inexpensive cost.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Mark Merric *William Comer*

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[1] Most likely if a client committed perjury, they would be easily discovered. This is because almost all closely held corporations are S corporations. The K-1 from the S corporation is reported on the client's tax return under schedule E.

[2] John E. Sullivan III, LLCs and LPs – Charging Orders, Creditors Rights, and Other Issues, Ohio Bar Association outline on asset protection 2006 citing the comments to Section 28 of the Uniform Partnership Act that states that charging order stemmed from English taken from section 23(2) of the English Partnership statute.

[3] Revised Uniform Limited Partnership Act of 1976 with 1985 amendments provides:

Section 702: " . . . An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled."

Section 703: "On application to a court of competent jurisdiction by any judgment creditor, 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. . . .

Nowhere in the 1976 RULPA does it state that a charging order is the sole remedy. Rather, it leaves this issue to state case law.

[4] Florida, North Carolina (with regard to an LLC interest) and Virginia have all ruled that a charging order is the sole remedy. However, California, Connecticut, Georgia, Maryland, Missouri, New Hampshire, New Mexico, Ohio, Pennsylvania, Texas and Georgia have followed the trend and allowed the judicial foreclosure sale of the limited partnership interest. Please note that other than Florida, in the last 20 years only one state court (North Carolina) did not allow the judicial foreclosure sale of a limited partnership interest. For a detailed list of all state statutes and case cites regarding this issue, see Merric, Gillen, and M. Osborne, After the Uniform Partnership

Act, Does an FLP Provide More Asset Protection Than a Non-Self Settled Trust?, Journal of Pass Through Entities, April-May 2005. This article may be downloaded at www. InternationalCounselor.com. Also, note that since its publication, both Delaware and South Dakota have become sole remedy states.

[5] Hawaii, Illinois, Iowa and Minnesota have adopted the new 2001 version of the Uniform Limited Partnership Act (ULPA 2001)

[6] Colorado, Hawaii, Illinois, Montana, Rhode Island, South Dakota, Vermont, Virginia, and West Virginia.

[7] Alaska, Arizona, Delaware, Florida, Nevada, and Oklahoma.

[8] Alabama, Alaska, Arizona, Delaware, Kansas, Minnesota, Nevada, New Jersey, North Dakota, Oklahoma, Tennessee, and Wyoming.

[9] John E. Sullivan III, LLCs and LPs – Charging Orders, Creditors Rights, and Other Issues, Chicago Bar Association outline on asset protection 2007

[10] 6 Del. C. § 17-703(e) provides "(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." Also, see 6 Del.C. § 18-703(e) regarding LLCs.

[11] In re Ehmann, 319 B.R. 200 (Bkr. D. Ariz. 2005)

[12] Yes, it is true that Nevada, similar to Texas, thinks that it is its own nation.

[13] For purposes of this article, the term "closely held" means greater than one shareholder but less than seventy-five.

[14] The authors are aware that some DAPT trust companies cite Hanson v. Denkla, 357 US 235, reh'g denied, 358 US 858 (1958).as authority that the governing law of the trust will be applied. The authors disagree that the U.S. Supreme court decided this case under conflict of law principles and would note that it was decided under the jurisdictional issues of *International Shoe*.