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

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From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: **Forum Shopping For Favorable FLP and LLC Legislation Part III – Prohibiting Directions and/or Equitable Remedies**

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.

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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 attack's 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.

Discussion:

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 <u>debtor's interest</u> 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.

(a) 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 "<u>partnership interest</u>" is a charging order. A simple sole remedy statute does <u>not</u> state that a creditor cannot seek to reach the underlying assets of the partnership by directly naming the partnership.

(b) 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] Finally, 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 <u>operating businesses</u> 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, the defendant, 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]

c. 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.

d. *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, would "legal or equitable" remedies mean that a creditor could not bring a blatant fraudulent conveyance claim? Also, assume the limited partnership is a real estate development company, and 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, its 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. On the other hand, 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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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); *Bivolvocki 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 Ehmann,* 334 B.R. 437 (D. Ariz. Dec 2005) withdrawn by *In re Ehmann,* 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)