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

Date: 28-Aug-07
From: Steve Leimberg's Asset Protection Planning Newsletter
Subject: Forum Shopping For Favorable FLP and LLC Legislation – Part II

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Editor's Note & Background:

After "Forum Shopping For Favorable FLP and LLC Legislation" was published, we received many praises, some comments, and a few questions. One of the key questions revolved around how so many courts came to the conclusion that RULPA (1976) allowed the judicial foreclosure sale of the limited partnership interest. In fact, this became the subject of a one and a half hour discussion between Steve Gorin, a LISI editor and a distinguished estate planner from St. Louis, and Mark Merric, one of the authors - whether Missouri allowed for judicial foreclosure sale by case law under *Deutsch v. Wolf*[1]. They agreed to disagree, but each agreed that the other made some good points.

The nature of the disagreement primarily centers around an often overlooked area of charging order protection and the judicial foreclosure sale of a limited partnership interest – the "import" and "export" clauses of the Revised Uniform Limited Partnership Act (1976) and Uniform Partnership Act ("UPA 1914"), respectively. The RULPA (1976) was never written to be a stand alone statute. Rather, it was designed to borrow

from the Uniform Partnership Act (1914) ("UPA (1914)"). Section 6(2) of the UPA (1914) provides the export clause that export's the UPA provisions into RULPA (1976) and states, "this chapter shall apply to limited partnerships **except insofar** as the statutes relating to such partnerships are inconsistent herewith." At the same time, RULPA § 1105 provides the import clause and states, "any case not provided for in this [Act] the provisions of the Uniform Partnership Act [UPA 1914] govern." Both Mssrs. Gorin and Merric agree that the case *Deutsch v.Wolf* is not a model of clarity, and both agree that the Missouri Appellate Court borrowed from the UPA (1914) to order the judicial foreclosure sale of the debtor's partnership interest. The primary nature of the disagreement is whether it is inconsistent to order the judicial foreclosure sale against a limited partnership interest when importing the judicial foreclosure remedy from the UPA (1914). Both Mssrs. Gorin and Merric agree that RULPA (1976), by importation from UPA (1914), allows for the judicial foreclosure of a general partnership interest.

Mark Merric takes the position that it is not inconsistent to import from the UPA the judicial foreclosure sale of a limited partnership interest. He cites cases from California, Connecticut, Georgia, Maryland, New Hampshire, Ohio, and Pennsylvania,[2] that all hold a limited partnership interest may be judicially foreclosed by importing the UPA judicial foreclosure remedy. Mark notes that the *Deutsch* court specifically mentioned that the debtor was "the sole general partner and active limited partner."[3] However, after Steve and Mark discussed the case, Mark Merric consulted with the Plaintiff's attorney regarding the case, and discovered that the debtor only held a general partnership interest, and only a general partnership interest was foreclosed.

Steve Gorin notes that *Deustch* may well be a bad fact case that justified an extreme result. The court did not clarify why it looked to Missouri's version of the UPA. Was it RSMo § 359.251.1, which states that the UPA applies to general partners if the partnership agreement and RULPA do not cover the situation? Or did it rely on RSMo § 359.671, which applies the UPA when RULPA does not "provide for" a situation? Steve notes that RULPA provides a remedy for attaching a partnership interest – a charging order. Shouldn't the doctrine of *expressio unius est exclusion alterious* preclude application of RSMo § 359.671 here? Steve views the application of RSMo § 359.251.1 to be more appropriate here. He would limit the application of judicial foreclosure to general partners. Regarding the bad facts, the general partners blatantly over billed the partnership for well over $1 million, and the court was so upset, it even allowed the highly unusual remedy of a court receiver to assume the management of the FLP.[4] Steve notes that this remedy was warranted, because the other partners were the ones bringing the action, as they clearly did not want this wrongdoer to be in charge of their investment in the partnership. Applying the foreclosure to the general partner's entire partnership interest made sense, because the court should not require them to do business with someone who had violated their trust.

In conclusion, Mark sees this as one of a number cases allowing judicial foreclosure for limited partnership interests - general or limited. Steve views it as an extraordinary case that involved an extraordinary remedy that generally should not be read as definitively allowing judicial foreclosure when attaching a limited partner's

interest in a limited partnership. In view of the court's failure to explain its view of this issue, Mark and Steve agree that each other has reasonable views and that this case's significance is unclear.

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

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

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

Executive Summary:

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

Facts:

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

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

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

> The partnership is directed to pay to the [plaintiff's] law firm, as for the Petitioner's receiver, present and future shares of any and all distributions, credits, drawings, or payments to said law firm until the judgment is satisfied in full, including interest and costs.
>
> Until said judgment is satisfied in full, including interest and costs, the partnership shall make no loans to any partner or anyone else.
>
> Until said judgment is satisfied in full, including interests and costs, the partnership shall make no capital acquisitions without either Court approval or approval of the Judgment Creditor herein.
>
> Until said judgment is satisfied in full, including interests and costs, neither the partnership nor its members shall under take, enter into, or consummate any sale, encumbrance, hypothecation, or modification of any partnership interest without either Court approval or approval of the Judgment Creditors herein.
>
> Within ten days of service of a certified copy of this Order upon the registered agent of the partnership, the partnership shall supply to the Judgment Creditors, a full, complete, and accurate copy of the Partnership Agreement, including any and all amendments or modifications thereto; true, complete and accurate copies of any and all federal and state income tax or informational income tax returns filed within the past three years; balance sheets and profit and loss statements for the past three years; and balance sheet and profit and loss statement for the most recent present period for which same has been completed. Further, upon 10 day notice from Petitioners to the partnership, all books and records shall be produced for inspection, copying, and examination in the Petitioner's office.
>
> Until said judgment is satisfied in full, including all costs and interest thereon, all future statements reflecting cash position, balance sheet position, and profit and loss shall be supplied to Petitioners within thirty days of the close of the respective accounting period for which said data is or may be generated.[6]

At first blush, one might think that a charging order only relates to the debtor's partnership interest, and a charging order should not be able to control the management activities of the partnership. However, playing the devil's advocate, the following questions support the position that a court may issue a broad charging order to the extent that it prevents the partners from circumventing the intent of the charging order:

- What if the partnership makes distributions to all non-debtor partners, and a loan to the debtor partner? The loan would not be subject to the charging order.
- What if the debtor/partners sells his or her partnership interest to another partner or a related entity or trust well below fair market value?

- What if the partnership attempts to pay out management fees in lieu of distributions?[7] Without receiving accountings from the partnership, this may be difficult to determine whether such activities are taking place.

The issue behind a broad charging order is whether or not it is needed to effect the charging order itself. An order restricting the sale of the debtor partner's interest and preventing the partnership from making loans to the debtor partner would be much less intrusive than the above charging order. On the other hand, the accounting issue is more complicated. One might argue that any management fees would be disclosed on the K-1 of the partnership return. However, when one is dealing with a dishonest debtor, he or she tends may well seek to hide such management fees through related entities.[8]

Discussion:

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

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

RULPA (1976) Approach

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

> Section 703 – Rights of a Creditor
>
> On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This Act does not deprive any partner of the benefit of any exemption laws applicable to his partnership interest.

Regarding the broad charging order language granted by the Colorado court under the RULPA (1976), as a transferee one may imply that the creditor has rights to copies of the books and records. However, there is a much more subtle issue that deals with the import and export clauses of RULPA (1976) and the UPA (1914). UPA (1914) § 28(1) states,

"On due application to a competent court by any judgment creditor of a partner, the court . . . may charge the interest of the debtor partner . . . , *and make all other orders*,

directions, accounts, and inquiries which the debtor partner might have made, or which the circumstances of the case may require."

Worse yet, the official comment to ULPA § 703 states, "Section 703 is derived from Section 22 [which is now Section 28] of the 1916 Act but has not carried over some provisions that were thought to be superfluous. For example, references in Section 22(1) to specific remedies have been omitted . . . " In other words, the "make all other orders . . . which the circumstances of the case may require" was deemed to be such an obvious power of the court that there was no need to mention it in the statute. This being the case, all of a sudden the Colorado Court's charging order does not appear to be as broad as many readers initially might have thought.

ULPA (2001) Approach

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

SECTION 703. RIGHTS OF CREDITOR OF PARTNER OR TRANSFEREE

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

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

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

(1) by the judgment debtor;

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

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

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

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

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In one small area, the comments to the ULPA (2001) are helpful. They prevent a court from issuing an order that would restrict the limited partnership from making future capital acquisitions "for operations." Unfortunately, the comments do not explain whether "for operations" mean only capital improvements for a business limited partnership, or also includes the reinvestment of the sales proceeds of liquid assets (e.g. securities). If the ULPA (2001) includes both, this is a small asset protection improvement.[10]

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

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

(1) Does the court or the debtor need to approve the redemption price or will an appraisal considering any minority interests be sufficient?

(2) Can part of the partnership interest be redeemed?

(3) Can the purchase price include an installment note? If so,

  (a) Does the note need to be amortized within some period of time or is a 30 year balloon note acceptable?

  (b) Does the note need to be secured, and if so who decides what is adequate security?

  (c) Can the note be non-negotiable?

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

The remaining comments as well as the statute itself add little help to the protection of a partnership interest. In fact when compared to the ULPA (1976), since the ULPA (2001) specifically allows for the judicial foreclosure sale of a partner's interest, they appear to be more creditor favorable.[11] In our prior LISI article, we covered the detrimental effects of a judicial foreclosure sale of the partner or member interest. Finally, Section 703(e), which provides that Section 703 is the exclusive remedy to reach

a "a partner's interest," does not address the equitable and legal remedies that attack the partnership itself such as reverse veil piercing, constructive trust, resulting trust, alter ego, and sole purpose. However, the comments to the ULLC (2006) discussed immediately below, which is similar to the ULPA (2001), specifically allow for reverse veil piercing. This issue, as well as direct equitable remedies that attack the partnership, will be discussed in part III of this series. In summary, compared to the ULPA (1976), the ULPA (2001) broadens creditor rights and, for the most part, grants a judicial blank check to issue a broad charging order.

Uniform Limited Liability Company of 2006

The creditor protection under the ULLC (2006) is weaker than both ULPA (1976) and ULPA (2001). The ULLC (2006) allows the judicial foreclosure sale of the member's interest, "upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time."[12] The ULLC (2006) does not allow the possible added protection by allowing the redemption of a member's interest before foreclosure. Instead, the debtor member, the other member(s), or the LLC may satisfy the judgment before judicial foreclosure sale. Further, the comments to the ULLC (2006) make it clear that a creditor may bring a reverse veil piercing action. Similar to the ULPA (2001), there may be a slight benefit that a charging order may not require court approval for the purchase of capital acquisitions for operations. Since the ULLC (2006) has only recently been finalized, at this point no states have adopted the ULLC (2006).

Simple Sole Remedy Charging Order

The simple sole remedy approach typically adds a sentence to the RULPA (1976) language such as, "This section shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest." For example, Alabama: §10-12-35 states,

"(a) On application to a court of competent jurisdiction by any judgment creditor of a member or assignee, the court may charge the interest of the member or assignee with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of financial rights. This section shall be the sole and exclusive remedy of a judgment creditor with respect to the judgment debtor's membership interest."

States using the simple sole remedy approach are:

Family Limited Partnerships:

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

Limited Liability Companies:

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

The addition of language that states a charging order is the "sole and exclusive" creditor remedy precludes the judicial foreclosure sale of the limited partnership or membership interest. Unfortunately, it is uncertain whether the sole remedy language would prevent a court from issuing a broad charging order similar to the one above. Further, there is another fine distinction that an estate planner must differentiate. The sentence referring to sole and exclusive remedy is limited to the judgment debtor's "membership interest." For this reason, most likely the remedies directly attacking the partnership such as reverse veil piercing, constructive trust, resulting trust, alter ego, and sole purpose are also available in simple sole remedy states.

The Magnificent Seven Approaches:

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

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

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

Family Limited Partnerships:

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

Limited Liability Companies

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

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

Conclusion:

Our first LISI article detailed the issues associated with judicial foreclosure of a limited partnership or membership interest. This LISI article divided the five major types of charging order statutes, and provided a detailed analysis of the ULPA (2001). This LISI article also discussed that it is unclear whether a simple sole remedy statute will be affective in protecting against a broad charging order. For most situations, the ULPA (1976), the ULPA (2001), and ULLC (2006) all grant a court the ability to issue a broad charging order. There is a good chance the same is true in simple sole remedy states. Our third part to this series discusses how the magnificent seven states have added additional protections to help preclude a broad charging order, and some of these states have also drafted statutory language to address legal and equitable remedies asserted directly against the limited partnership or LLC.

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

[2] *Hellman v. Anderson,* 223 Cal. App. 3d 840 (1991); *Crocker Nat. Bank v Perroton,* 208 Cal. App. 3d 1 (1989); *Madison Hill Limited Partnership II v Madison Hills, Inc* , 644 A.2d 363 (Conn. App. 1994); *Nigri v. Lotz,* 453 S.E. 2d 780 (Ga. App. 1995); *Lauer Construction, Inc. v. Schrift* , 716 A.2d 1096 (Md. App. 1998); *Baybank v. Catamount Construction, Inc.* ,693 A.2d 1163 (NH 1997); *Larson v. Larson,* 2000 WL 1566522 (Ohio App. 11 Dist) unreported; *Auburn Steel Company v. American Steel Engineering Co.*, 1993 WL 257379 (E.D. Pa. 1993) unreported, aff'd 22 F.3d 300 (3rd Cir).

[3] *Deutsch* second paragraph under the "factual background".

[4] Mark notes that, except in very egregious facts, courts have generally not allowed this remedy. *See Tupper v. Kroc.*, 88 Nev. 146 (1972); *City of Arkansas v. Anderson,* 242 Kan. 875 (Kan. 1988); and *Widom Nat'l Bank v. Klein,* 254 N.W. 602 (Minn. 1934).

[5] Section 30 mentioned the ability to elect in or out is internally inconsistent. It appears that this will be amended at Nevada's next legislative session.

[6] *E.J. and Muriel Rothwell v. Lisa Fertman,* Order re Motion and Application to Charge Partnership Interest. Civil Action 92 Z 1881, District Ct Colo. 1994.

[7] *PB Real Estate, Inc. v. Dem II Properties*, 719 A.2d 73 (Conn. App. 1998)

[8] *C.F. Trust, Incorporated v. First Flight Limited Partnership,* 580 S.E. 2d 806 (Va. 2003).

[9] Therefore, unlike the RULPA (1976), there is no need to look to the UPA act to provide for the judicial foreclosure sale of the limited partnership interest. It is contained within the ULPA (2001).

[10] A problem with the drafting of some Uniform Acts is the inclusion of substantive law that are included in the comments. Courts are not obligated to follow comments. Further, comments may be changed by NCCUSL without legislative approval, and at the same time change substantive law.

[11] ULPA (2001) §703(b). Subject to the Export/Import Clause discussion in this LISI article, RULPA (1976) was silent regarding the judicial foreclosure sale of a partner's interest.

[12] ULLC (2006) Section 503(c).