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For Asset Protection, Use Charging Order Protection Entities: LLCs, LPs, LLPs and LLLPs

Business entities typically have limited liability, which shields the investors from the liabilities of the business. For a business entity, the creditor's relief is limited to the assets of the business. But what about creditors of members of a limited liability company or limited partners of a Limited Partnership?

Theoretically, non-debtor partners of an LP or members of an LLC may be forced into an involuntary partnership with a creditor of a member of an LLC or the partner of a partnership.

Fortunately, many state legislatures have passed laws where creditors may be prohibited from attaching partnership interests and becoming the partners themselves. Instead, such legislatures have limited the recovery of a creditor of a member of an LLC or a partner in partnership to a charging order held against the partner's or member's right to distributions from the entity. A charging order is an order obtained from a court by a judgment creditor where the property of the judgment debtor stands charged with the payment of the judgment amount. Conceptually, a charging order is like an "assignment of income" or as an assignment of the partner's economic right to distribution from the partnership. What types of business entities have this feature of charging order protection? Generally, such entities are known as Charging Order Protected Entities (COPE). The best known COPE entities are the Limited Partnership (LP) and the Limited Liability Company (LLC). However, COPEs also include the Limited Liability Partnership (LLP) and the Limited Liability Limited Partnership (LLLP), as well as the new Series LLC.

What about single member LLCs? The motivation behind legislatures allowing charging order protection for certain entities is to protect the non-debtor members of an LLC or partners of an LP from being involuntarily forced into a partnership or LLC with the debtor member's or partner's creditor. Because this area of law is unsettled, the safe presumption will be that single member LLCs probably do not provide charging order protection.

The key is careful drafting of the operating agreement or partnership agreement that prohibits distributions to the debtor member of the LLC or partner of the partnership as well as forbids a debtor of a partner in a partnership or member of an LLC from becoming an unwanted member of the LLC or partner of the partnership.

Corporations are Not the Optimum

What about corporations? Can somebody take advantage of Asset Protection with a corporation? The sad fact is they can't. A judgment against a stockholder of a corporation can result in judicial foreclosure of the stock of the shareholder/debtor, or "reverse piercing" of the corporate veil so that the corporation's assets can be reached to satisfy the claim against the shareholder/debtor. Other types of business entities are not as exposed as the corporation, and can be subject to the protection of a charging order.

Asset Protection and Estate Planning: Family Limited Partnership

A popular COPE is the Family Limited Partnership (FLP), a Limited Partnership where family members hold most or all of the ownership interest in a Limited Partnership, as it is an important vehicle for Asset Protection and Estate Planning. The FLP can be formed so that a husband and wife are each General Partners that handle the day-to-day operations of the family business or perhaps by a husband and an older son. Furthermore, the FLP has limited partners that invest, perhaps only nominally, in the FLP. Typically, the husband, wife and children are the limited partners as well.

After forming the FLP, all family assets can be transferred into it, including investments and business interests. After the transfers, rather than such assets being owned individually by the husband and wife, etc., the husband and wife will own a controlling interest in a business entity that owns the assets. The family members that are General Partners will have complete management and control over the affairs of the partnership and can buy or sell any assets they wish on behalf of the FLP. Furthermore, as General Partners the family members can decide either to distribute the proceeds from the sale of the assets or to have the FLP keep such proceeds.

The FLP and Asset Protection from Creditors

An important feature of the FLP is Asset Protection. If an individual is sued and the plaintiff gets a judgment against the defendant, the plaintiff/judgment creditor can seize everything owned by the defendant/debtor. If a husband and wife plan wisely and are partners in an FLP where they transferred all their former personal assets to the FLP, the only asset individually owned is the interest in the FLP. A creditor cannot reach into the FLP and seize the investments and bank accounts of the FLP. The creditor has no rights to any property held by the FLP. Since title to the assets is in the name of the FLP and it is an individual that is a partner rather than the partnership itself which is liable for the debt, the partnership assets may not be taken to satisfy the judgment.

A creditor may apply to a court for a charging order against an individual partner's partnership interest. When this happens, in the event of an FLP distribution, instead of the money going to the individual partner, the money goes to the judgment creditor until the amount of the judgment is satisfied. Cash distributions paid to the partner/debtor could, therefore, be taken by the creditor. This doesn't mean that the judgment creditor is a partner in FLP, it means the judgment creditor receives the right to any distributions paid to an individual partner/debtor.

The way to forestall such a scenario where a creditor has obtained a charging order is that the FLP has provisions in its partnership agreement preventing distributions to the debtor partner. Since the partnership would not have any distributions, the judgment creditor won't get paid, at least not from that collection method. Instead, the FLP would retain its funds and continue to invest and reinvest its money.

The Family Limited Partnership is an excellent vehicle for holding interests in other business entities. Because you want to protect your valuable family assets from creditors, you do not want the FLP to actively conduct business, as this will expose such valuable family assets to litigation. Instead, you want the FLP to own shares of corporate stock or membership interests in LLCs. Such corporations or LLCs in turn will hold individual investment properties or conduct business with a specific business purpose. This way, exposure to liability is isolated where litigation concerning one of your businesses will not jeopardize the other businesses and the assets they hold.

Tax Benefits of an FLP

The FLP has tremendous flexibility. To that end, with family assets held by an FLP, it may be possible to obtain income tax savings by spreading income from high tax bracket parents to lower tax bracket children and grandchildren who are fourteen years or older.

The FLP can also be a vehicle for dramatically reducing or eliminating estate taxes by shifting the value of your assets out of your estate without any loss of control through a program of gifting Limited Partnership interests to your children or other family members. This is done with an Estate Plan including an FLP established to hold all of your family assets. Say for example you and your wife are General Partners of the FLP. As such, you would have management and control over your property in the FLP. Initially, you could make a gift of the FLP interests to your children in an amount equal in value to the combined maximum estate tax credit (currently $2 million). Later, you could gift Limited Partnership interests equal to the amount of the annual gift tax exclusion of $22,000 per year, per child.

The value of each gift of a Limited Partnership interest may be discounted in order to account for the lack of marketability and the lack of control associated with those interests. Because the FLP interest cannot be readily sold and because the donee has no right to participate in management of the FLP, many financial advisors recommend discounting the transferred interest to reflect its true market value. Depending on the situation and Estate Planning aggressiveness, discounts in the range of 30 to 50 percent may reduce the estate tax burden.

FLPs versus Family-Owned Dual Class LLCs

Generally speaking, a family-owned Dual Class LLC may achieve the same results as an FLP, insofar as multiple-member LLCs can be taxed as a partnership and the management and investment aspects can be isolated the same way as with an FLP. Also, instead of the General Partner of the FLP either being exposed to liability (if a "plain vanilla" Limited Partnership, rather than a Limited Liability Limited Partnership) or facing the expense of forming a corporation or other entity that intrinsically has limited liability, all managing members will have their liability limited to the extent of the capital they have contributed in exchange for their equity interest. Furthermore, the family-owned Dual Class LLC is considerably less expensive than the FLP. Finally, the Family Owned Dual Class LLC is extremely flexible, as it can be taxed as a partnership or a corporation, depending on what the members elect. However, it should be noted that because Limited Partnerships have been around for years, court cases involving Limited Partnerships allow planning to be more certain compared to the dearth of guidance for LLCs in general and Dual Class LLCs in particular. Thus, you will want to carefully analyze your situation and seek guidance from an attorney or other Estate Planning professional for the entity that best fits your family business situation.

FLP Formalities Are a Must

In order to fully realize the Asset Protection and Estate Planning potential of FLPs, it is essential that all business formalities are followed and documented as if the FLP is a completely independent entity and that there are no family relationships involved, as courts and the Internal Revenue Service will carefully scrutinize the dealings of the FLP in order to disallow the tax benefits claimed by the partners of the FLP (see Kimbell v. U.S.A., Case No. 03-10529 (May 20, 2004)). This means that all the financial and business records should be carefully maintained, that funds are not commingled, that any and all agreements are carefully drafted, that real property and other assets should be treated as FLP assets rather than personal assets, that transactions should be carefully documented and bona fide rather than disguised

gifts or sham transactions, that any price paid for in a FLP transaction is fair market value, that any transaction has a valid business purpose such as Asset Protection or continuity of family ownership rather than tax avoidance and that appraisals used to claim a valuation discount are adequately substantiated.

Careful drafting of FLP documents is crucial, and the partnership agreement of the FLP must contain certain key provisions designed to protect your valuable family assets from creditors of individual partners and that family members maintain control over the FLP.

An Asset Protection Strategy

Now that you've read about the various business entities for Asset Protection, what strategy to use? You may use layers of limited liability to isolate and protect your valuable assets to pass on to future generations, instead of having "all of your eggs in one basket," so to speak. To that end, individuals with appreciated property should place each real estate parcel or business operation into its own Limited Liability Company (let's call them the "Operating LLCs"). For anonymity, you may want land trusts (in the states that permit them)

Furthermore, all of the Operating LLCs should be owned by a Limited Partnership or Family Limited Partnership (let's call it the "Holding Limited Partnership") comprised of a General Partner that is a business entity with limited liability itself, such as a corporation or an LLC (this would not be needed if you are in a state that permits Limited Liability Partnerships or Limited Liability Limited Partnerships), and several limited partners. The reason a Limited Partnership or Family Limited Partnership would be the holding entity is because while Limited Liability Companies are quite flexible, compared to Limited Partnerships or Family Limited Partnerships they are a relatively new type of business entity that does not have the stability and predictability of settled case law like the Limited Partnership or Family Limited Partnership. The initial owner should get Holding Limited Partnership interests in proportion to the value of the real estate parcel or business operation contributed to the LLCs.