Are Business Entities a Viable Option for Personal Asset Protection?

by Amy P. Jetel

Introduction

The explosive litigation industry in the United States, capricious legislative bodies, and the volatility of financial markets and economies have evoked a powerful response. The buzz word among lawyers representing clients at risk is "asset protection." More than at any time in our legal history, attorneys are scrambling to find ways to protect and preserve the wealth of their clients. High net worth individuals perceive new and potentially devastating threats to their wealth, and creative lawyers must conceive and render more protective solutions. Traditional asset protection includes the use of state exemptions for homesteads and retirement accounts, while more cutting edge approaches include the use of offshore trusts and entities.

Background: Threats to Individual Wealth[1]

After outlining the various threats to individual wealth and describing the role of fraudulent transfer law in asset protection planning, this paper will focus on the use of domestic business entities for personal asset protection. We will focus primarily on limited partnerships and limited liability companies and the remedies available to creditors to satisfy a claim out of an individual partners'/member's ownership interest in such entities. Finally, we will provide an overview of various entities available in non-U.S. jurisdictions that offer protection of assets from third-party creditors.

Legal Threats. Threats to individual wealth from litigation arise across the spectrum of contract and tort law. The plaintiff's bar in the United States has been marvelously creative in its practice, contriving new theories of liability in the malpractice, products liability, contract, securities, ultra vires, and employment areas, and judges have accepted many such theories. The measures of damages (compensatory, punitive, and exemplary) for psychological, emotional, and other highly subjective injuries have also expanded tremendously.

Some causes of action stem from legitimate and expected contract creditors, such as those occasioned by consumer and bank debt or the breach of an obligation to perform. Less easily anticipated claims arise from guaranties, contingent liabilities, and joint and several partnership obligations. Debtors often can be surprised by the extent of this exposure and the reaches of creditors. For example, unexpected risks can derive from the financial failure of a partner or business associate, the judicial interpretation of a guaranty beyond its intended scope, or simply from the size and amount of damages awarded in business litigation judgments.

[1] The materials in this section were taken, in part, with permission from the white paper, "Offshore Asset Protection for United States Clients," by Leslie C. Giordani and Elizabeth M. Schurig.

The extension of corporate liability to officers and directors also results in unpleasant surprises and economic losses. Shareholders, governmental entities, and business associates have successfully sued under theories of liability that render the corporate veil of limited usefulness. While perhaps justified, the government's success in achieving personal liability judgments against former officers and directors of failed financial institutions dramatically exemplifies this trend.

Beyond the contract creditor and business claimant is the tort creditor. Numerous publications describe the unrestrained growth in tort litigation. Media headlines continuously report new theories of liability and astronomical damage awards. The United States enjoys the dubious reputation as the world's most litigious society, and the prospects of meaningful tort reform appear bleak.

While liability insurance once provided the trusted shield from potential economic devastation resulting from a civil judgment, individuals with "deep pockets" are increasingly susceptible, regardless of their insurance coverage. The escalating cost of premiums, the unavailability of coverage for some risks, and the routine denial of coverage by some insurance companies detract from the utility of traditional insurance.

In addition to the potentially disastrous effect of tort, contract, and business liability, there is increasing concern about what might be called regulatory (or legislative) liability, evidenced over the years primarily in the form of the United States environmental statutes. Landowners, whether individuals or businesses, may be liable under federal law (e.g., CERCLA, the Comprehensive Environmental Response, Compensation and Liability Act[2]) or state law for environmental hazards on land that they own. This liability can apply regardless of whether present owners created the hazard or whether they acquired the land with knowledge of the hazard. Furthermore, liability can be imposed under such laws on former landowners or, in the instance of corporate landowners, on directors or shareholders if they had substantial "control" over the land.[3]

Business owners perceive other legislative liabilities in the form of the Americans with Disabilities Act[4] and the Family Medical Leave Act.[5] While motivated by praiseworthy aspirations, these acts have an economic impact on business and create additional causes of action.

Another contemporary concern in the area of claims on wealth comes from the divorce court, not because divorce claims are new, but because they are so prevalent. Judges and legislators are understandably eager to protect a non-working spouse, but even carefully planned premarital arrangements (with both spouses represented by counsel) often fail to withstand judicial scrutiny. Moreover, the evolution of inter-spousal tort liability claims (e.g., intentional infliction of emotional distress) in some cases effectively renders premarital agreements meaningless.[6] Lawyers find planning in this area very challenging, and concern is not necessarily limited to the client or even the actions of the client's spouse, but often includes concern for children whose inheritance the client wishes to protect from loss upon divorce.

Compulsory dispositions, whether inter vivos or testamentary, present a more familiar asset protection problem. However, our highly mobile society and the related fact that clients increasingly have assets in more than one jurisdiction have generated a new awareness of this issue. Most civil and common-law jurisdictions have statutory provisions for forced dispositions at death or upon the termination of marriage. Common law legal systems recognize dower and curtesy rights, and civil law systems usually incorporate forced heirship concepts. In community property states, these battle lines are drawn along the character of the property, that is, the determination of whether it is separate or community property. Movement by a married couple from one jurisdiction to another complicates the nature of property and marital rights as well as rights of heirs and legatees. Today, clients seek to ensure that property passes to the intended beneficiary rather than to a claimant under these various theories.

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[2] 42 USC §9601.

[3] S*ee Michigan Natural Resources Comm'n v. ARCO Indust. Corp.*, 723 F. Supp. 1214, 1219 (WD Mich. 1989) (using "position in the corporate hierarchy and percentage of shares owned" as consideration in determining individuals' liability). *See also United States v. Northeastern Pharmaceutical & Chem. Co.*, 579 F. Supp. 823, 848 (WD Mo. 1984), aff'd, 810 F.2d 726 (8th Cir.1986), cert. denied, 484 U.S. 848 (1987) ("An employee of a corporation can be personally liable for activities over which he had direct control and supervision.").

[4] 42 USC §12101.

[5] 5 USC § 6381.

[6] *See, e.g., Geyelin, Divorcing Couples Wage War with Domestic Torts*, Wall St. J., Feb. 2, 1994, at Bl. *See also Moran v. Beyer*, 734 F.2d 1245 (7th Cir.1984).

Many wealthy individuals view the United States legal system as facilitating the capricious redistribution of wealth. At a minimum, its judicial and legislative branches operate unpredictably and can have dramatic economic consequences to an individual's net worth.

Economic Threats. The preceding section examined contemporary legal threats to wealth. In a different, but in a no less modern or serious, vein there exist what might be classified as "economic threats." Concerns about the United States economy are high. Troubling issues include weaknesses in the social security and health care systems, the interest on the federal debt, and the United States government's propensity, albeit high-minded, for throwing money at a current crisis without proper oversight on the efficient use of the funds. In addition, despite reform efforts, the foreign trade imbalance also continues to haunt the economy.[7]

Prominent investment strategists believe that meeting the primary goal of investment (high return with acceptable risk) requires international investment. By mixing foreign and domestic investments, United States investors can achieve superior diversification, thereby lowering risk.

And the ever-weakening U.S. Dollar against other currencies suggests that long-term investments in other currencies would be prudent. The existing risks would be exacerbated by potential foreign exchange controls or related legislation. Early planning potentially allows an investor to achieve diversification and minimize the consequences of possible currency devaluations.

Political Threats. Citizens of countries in Latin America and the Middle East have a long history of using asset-protective planning to deal with revolution, governmental expropriation, and other attacks on private wealth occasioned by unstable governments or civil unrest. While such political extremes are less likely to occur in the United States, concern about the domestic economy and its tax structure has caused individuals to consider expatriation (or perhaps repatriation, for foreigners living in this country).

There has been a sharp increase in clients seeking expatriation advice. Anecdotal reports among lawyers in this field suggest that citizens are increasingly discouraged about the United States' inability to solve its domestic problems, the readiness with which Congress adopts a "tax-the-rich" approach, and the confiscatory nature of the wealth transfer tax system. Business owners express frustration at the cost of operating in a litigation-prone society with a government that is antagonistic to their needs. Congress, concerned about the economic impact of this trend, has tightened the tax rules governing tax motivated expatriates[8] and has also passed immigration laws prohibiting re-entry by such expatriates into the United States.[9]

While forfeiture of citizenship carries a profound emotional price for some citizens, others view it as just another business decision. Political threats, whether real or perceived, drive personal and economic decisions. Reconsideration of citizenship is becoming a reality in the United States.

Background: Methods to Achieve Asset Protection

Statutory Exemption Planning. In the United States, each state provides exemptions for assets against the claims of a debtor's creditors. Although the extent of the protection offered by the various states' laws differs significantly, all states provide some statutory protection for homesteads, retirement plans, life insurance, and annuities. Subject to fraudulent transfer law, these protections are probably the most air-tight method of achieving asset protection given their long history and general acceptance by creditors and courts. However, what is protected in one state may be exposed in another.[10] Additionally, statutory exemption planning can be somewhat inflexible due to the fact that the exempt assets must be maintained in a particular form (e.g., a qualified retirement plan, which is subject to early withdrawal penalties) which limits the debtor's ability to access the funds if needed.

[7] *See www.census.gov/foreign-trade/*

[8] IRC §877A.

[9] 8 USC §1182 (a)(10)(E).

[10] For example, Texas provides unlimited protection for a debtor's homestead (TX Prop. Code §41.001), while Illinois exempts only $15,000 in a debtor's homestead (735 Ill. Comp. Stat. Ann. 5/12-901). For a comprehensive discussion of the various states' exemptions, see *Asset Protection: Domestic and International Law and Tactics*, Duncan Osborne and Elizabeth Schurig, ed. (Thomson/West Group, updated quarterly). Also accessible on www.westlaw.com.

Gifting. Another method of achieving protection for assets is to simply give those assets away, either outright or in trust. Because creditors can reach only what the debtor owns (subject, of course, to fraudulent transfer law), assets gifted to someone other than the debtor cannot be reached by his creditors. Clearly, assets gifted outright will be no less exposed to the donee's creditors.

Protective Trust Planning. As mentioned above, statutory exemptions, although very strong, carry practical limitations that prevent the debtor from being able to access protected wealth (and in some states, the exemptions are practically useless due to low dollar limitations). And gifting, while a good method of protecting assets against unknown future claimants, doesn't allow the debtor to retain any benefit from the gifted property. Therefore, practitioners are always looking for ways to allow their clients to place funds in a protected vehicle that gives the client the option of easily accessing those funds in the future. One of the more sophisticated methods to achieve this goal is through the use of a trust sitused in an offshore jurisdiction that allows a settlor to transfer assets to a protective trust for his own benefit, subject only to fraudulent transfer law.[11] Fifteen U.S. states have also passed some form of protective trust legislation, but their viability remains largely untested.[12]

Entity Planning. Another method of achieving the goal of providing protection for assets that gives the client the option to access those assets involves interposing a legal entity between the assets and the client. The theory behind the use of an entity in achieving asset protection is that, although an individual's interest in a limited liability entity can typically be reached by that individual's personal creditors (i.e., "outside" creditors who have claims that are unrelated to the assets held by the entity), that interest will often be a poor substitute for the underlying assets. The most common types of entities used by clients are limited partnerships and limited liability companies, which are the focus of this paper.

Fraudulent Transfer Considerations[13]

Before we look more closely at business entities as asset protection vehicles, it is important to discuss fraudulent transfer law because it is so tightly intertwined with asset protection planning. In general, a "fraudulent transfer" is a transfer of assets made with the intent to defeat the rights of creditors. If a creditor prevails on a fraudulent transfer claim, the transfer (even to a protected vehicle) can be voided, and the creditor can thus reach the transferred assets to satisfy a debt.

Modern fraudulent transfer law has its origins in the Statute of Elizabeth, a 16th Century, seven-paragraph act, which provided that conveyances designed to "delay, hinder, or defraud creditors" were "utterly void."[14] In addition to voiding fraudulent conveyances, the Statute of Elizabeth also provided for criminal and civil penalties. With nearly four and a half centuries of tradition, is it any wonder that "asset protection" can stir the emotions of creditors and their lawyers? Yet those who righteously criticize asset protection as an estate-planning goal should consider the environment of the late twentieth century and early twenty-first century juxtaposed against the environment that produced the Statute of Elizabeth and its modern equivalent, the Uniform Fraudulent Transfer Act.

In the 16th Century, it was extremely difficult to secure detailed information about a borrower or a prospective business associate. Lacking were the Dunn & Bradstreet and TRW services with computer-database power that can furnish extensive business, personal, and financial information, not to mention the modern practice (or requirement, in some cases) of due diligence. Also lacking were laws that provide penalties for supplying false financial data.[15] A strong

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[11] For a comprehensive discussion of the use of offshore trusts and a comparison of various foreign trust jurisdictions, see *Asset Protection: Domestic and International Law and Tactics*, Duncan Osborne and Elizabeth Schurig, ed. (Thomson/West Group, updated quarterly). Also accessible on www.westlaw.com.

[12] Alaska, Colorado, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, Wyoming.

[13] The materials in this section are taken, in part, with permission from the white paper, "An Overview of Asset Protection in Texas," by Elizabeth Morgan Schurig, Amy P. Jetel, and Eric J. Carter, presented by Elizabeth M. Schurig as part of her speech, "Tools of the Asset Protection Trade: A Necessary Component of the Estate Planner's Toolbox," at the Texas Bar CLE Advanced Estate Planning and Probate Course in Houston, Texas, June 8, 2006.

[14] 13 Eliz 1 c.5 (1571).

[15] *See, e.g.,* 18 USC §1014.

argument can be made that the modern variants of the Statute of Elizabeth should be interpreted and applied in the current financial atmosphere, which abounds with safeguards for creditors.

Without question, known and reasonably foreseeable creditors should be protected from fraudulent transfers. But is a creditor who is remote in time and events from the moment of a transfer also entitled to such unlimited, broad-based protection? Historically, courts have not so interpreted the statutes. Rather, they have focused on the relative proximity to known, or at least reasonably knowable, creditors. Unknown future creditors removed in years and in events from the transfer have not been protected by the courts and, indeed, should not be. The law simply does not require one to put all of one's assets at risk. Furthermore, if a client passes the "balance sheet test" prior to implementing a wealth-protective estate planning vehicle (i.e., the transfer does not render the transferor insolvent), and there is no claimant on the horizon and no misrepresentation to creditors or claimants, the client is merely prudently positioning assets. The United States Supreme Court recognized this as a fundamental policy of U.S. law in the landmark case, Nichols v. Eaton:

"[T]he doctrine that the owner of property, in the free exercise of his will in disposing of it, cannot dispose of it, but that the object of his bounty . . . must hold it subject to the debts due his creditors . . . is one which we are not prepared to announce as the doctrine of this court. . . . [E]very State in this Union has passed statutes by which a part of the property of the debtor is exempt from seizure [for] the payment of his debts. . . . To property so exempted the creditor has no right to look . . . as a means of payment when his debt is created [and] this court has steadily held that [such exemptions are] invalid as to debts then in existence [but] as to contracts made thereafter, the exemptions [are] valid. This distinction is well founded in the sound and unanswerable reason, that the creditor is neither defrauded nor injured by the application of the law to his case, as he knows, when he parts with the consideration of his debt, that the property so exempt can never be made liable to its payment."[16]

Needless to say, the legal debate on this issue resonates with more than usual emotion.

Currently, most U.S. jurisdictions have enacted some form of the Uniform Fraudulent Transfer Act ("UFTA") by statute or have adopted its general concepts by case law. Texas' version of the UFTA is found in Title 3, Chapter 24 of the Texas Business and Commerce Code, and is substantially similar to the uniform law. As will be shown below, creditors' interests are very well protected under the UFTA. Therefore, the debate over asset protection as an estate-planning goal has become unduly heated because creditors are not focused on the strong legal protections afforded them by fraudulent transfer law.

For the purpose of determining what must be proved in court, the UFTA divides creditors into two categories: (1) present creditors (those whose claims arose before the transfer); and (2) future creditors (those whose claims arose concurrent with or after the transfer). Both present and future creditors can void transfers made with "actual intent to hinder, delay, or defraud."[17] This intent, however, does not have to be proven with regard to the specific creditor making the claim. A creditor can void a transfer as long as he can show that it was made with the intent to hinder, delay, or defraud any creditor.[18] Furthermore, a creditor does not have to prove actual fraudulent intent—the UFTA lists "badges of fraud" from which the court can infer that the debtor made the transfer with the intent to defraud creditors.[19] These badges of fraud include insolvency, transfers to insiders, retention of possession or control by the debtor, and transfer of substantially all of the debtor's assets.[20]

Both present and future creditors are also allowed to void transfers on a "constructive" fraud theory (i.e., without having to either prove actual intent to defraud or to rely on the presence of badges of fraud) if the debtor made the transfer in exchange for less than "reasonably equivalent value," and the debtor was either left with an unreasonably small amount of assets for the business or transaction in which she was engaged (or in which she was about to engage), or the debtor intended to incur debts beyond her ability to pay them when they came due.[21]

In addition to the methods for present and future creditors to void transfers described above, the UFTA gives present

[16] *Nichols v. Eaton,* 91 U.S. 716, 725-26 (1875).
[17] UFTA §4(a)(1).
[18] *Id.*
[19] UFTA §4(b)(1)-(11).
[20] *Id.*
[21] UFTA §4(a)(2).

creditors even greater protection. Without having to show any intent, a present creditor can void transfers made for less than "a reasonably equivalent value" by debtors who are actually insolvent before the transfer is made, or who are made insolvent by the transfer.[22] The UFTA defines insolvency as either the inability of a debtor to pay debts as they become due ("the income test"), or the circumstance in which the value of a debtor's overall debts exceed the overall value of her assets ("the balance sheet test").[23] Present creditors may also void transfers made by insolvent debtors in respect of antecedent debts to insiders who have reason to know of the debtor's insolvency.[24] For individual debtors, "insiders" specifically include (but are not limited to) relatives, partnerships of which the debtor is a general partner, and corporations of which the debtor is a "director, officer, or person in control."[25] Because the definition of "insider" is not limited to the above-named persons or entities, a creditor could argue that the trustee of a spendthrift trust is an insider and should know that the settlor was insolvent at the time of the transfer.

It must be emphasized that a fraudulent transfer of assets to a protected vehicle is voidable by creditors under fraudulent transfer law. Accordingly, the public outcry over the injustice of wealthy individuals protecting millions of dollars by purchasing exempt homesteads on the eve of judgment is unwarranted. Clearly, such a transfer can be voided by present and future creditors under the UFTA. However, it seems that creditors have not properly focused on fraudulent transfer as a strong remedy. If they did, perhaps the debate over whether asset protection is a valid goal in estate planning wouldn't take on such a controversial tone.

Types of Domestic Business Entities

Limited Partnership. A limited partnership is an entity consisting of two or more owners, at least one of which is a general partner and at least one of which is a limited partner. The general partners exercise management and control over the business and assets of the limited partnership, but they are also jointly and severally liable for the debts of the partnership and for the acts of other general partners with respect to partnership activities. As a shield against this liability, another limited liability entity (such as an LLC or corporation) is typically used to hold the general partner interest. The limited partners, on the other hand, are normally liable for partnership debts only to the extent of their investment and their committed investment, but they may not participate in the management and control of partnership assets.

Limited Liability Company. Unlike limited partnerships, all members of an LLC are typically protected from the debts and obligations of the company in the absence of a contrary provision in the company regulations or a written promise of contribution. Members may choose to be involved in the management of the company or may instead elect nonmember managers to exercise management authority in much the same manner as corporate officers and directors.

Corporation. The corporate form is the oldest of the three types of entities discussed in this section and is therefore bolstered by the most established body of legal precedent regarding issues such as managerial standards and relations among owners. As is the case with an LLC, the liability of each owner of a corporation is generally limited to the amount of his or her investment in the entity.

The major drawback to the corporation, particularly in the context of investment vehicles, is the fact that, unlike limited partnerships and LLCs, it is automatically treated as a separate entity for federal income tax purposes. Thus, earnings of the corporation are taxed once at the entity level and then again at the owner level when they are distributed. Partnerships and LLCs, on the other hand, are generally treated as pass-through entities for federal income tax purposes, unless they elect otherwise, meaning that earnings flow through to the owners (whether or not distributed) and therefore are taxed only at the owner level. Although certain closely held domestic corporations can largely avoid the double taxation scheme by electing pass-through treatment under Subchapter S of the Internal Revenue Code, such election entails restrictions on the types of eligible shareholders, the type of stock that may be issued, and the ability to pass through losses in certain circumstances.

[22] UFTA §5(a).
[23] UFTA §2.
[24] UFTA §5(b).
[25] UFTA §1(7)(i).

History of Limited Partnerships and Limited Liability Companies

Given the negative tax attributes of the corporate form, pass-through entities such as limited partnerships and limited liability companies have become the most popular forms of entities for business and investment. Limited partnerships and limited liability companies, although not new concepts, are relatively new to U.S. law. A brief overview of their evolution is set forth below.

History of Limited Partnerships.[26] Partnership as a cooperative business arrangement has existed since ancient times—there is evidence of its use in Babylon, classical Greece, and Rome. As the use of partnership became increasingly common in the United States and in England in the 19th Century, a body of common law applicable to partnership began to develop, which drew from established common law concepts such as joint property and joint obligations. The increased use of partnership gave rise to a general call for certainty in the area of partnership law, which lead eventually to The English Partnership Act of 1890, and in the United States, the Uniform Partnership Act (1914), and more recently, the Uniform Partnership Act (1997).

Limited Partnership law in the U.S. draws heavily on the law of general partnerships, but has its source in the need for a form of business that permits capital investment without management responsibility or liability beyond the amount invested. This need clearly gave rise to the corporation, but in the context of limited partnerships, it was seen much earlier. As early as the 12th Century in parts of continental Europe, was the commenda, in which the investor received a profits interest, but no liability for losses or other debts of the trade. In the U.S., limited partnership is a statutory creation whose uniform-law counterparts (upon which most states' laws are based) are the Revised Uniform Limited Partnership Act (1976) (the "1976 LP Act") and the Uniform Limited Partnership Act (2001) (the "2001 LP Act").

History of Limited Liability Companies.[27] The limited liability company ("LLC"), a much newer form of business entity than the corporation and the limited partnership, has existed in one form or another in Europe, Central and South America, and Japan since the end of the 19th Century. In the U.S., Wyoming became the first state to enact an LLC statute in June of 1977, which provided for an entity that gave its owners limited liability from business debts like a corporation but was taxed like a partnership. Hamilton Brothers Oil Company formed a Wyoming LLC in 1977 and immediately applied to the IRS for an administrative ruling that it qualified as a partnership for federal income tax purposes. The IRS granted the ruling on a private basis in 1980,[28] but then changed its position in 1982.[29] Finally, the IRS settled the matter in 1988 by ruling that an LLC is taxable as a partnership for federal income tax purposes.[30] By 1996, every state had enacted a limited liability company act, and most states modeled their LLC legislation on partnership statutes to ensure that LLCs would be taxed as partnerships. However, since the IRS issued its "check the box" regulations in 1997, which provide absolute certainty as to the taxation of LLCs, certain partnership characteristics of state LLC acts (e.g., the requirements that an LLC not have "continuity of life" and that it not have "centralized management")[31] are no longer necessary and are therefore being removed from state statutes.

Currently, all state LLC laws derive from either the 1976 LP Act or the Uniform Limited Liability Company Act (1996) (the "1996 LLC Act"), amended in 2006 as the Revised Uniform Limited Liability Company Act (2006) (the "2006 Revised LLC Act"). Because states first formulated their LLC statutes at a time when there was no Uniform LLC Act, the majority of current state LLC statutes are based upon the 1976 LP Act, but there is a fast-moving trend in the past few years in state legislatures to adopt a version of the 1996 LLC Act. Seven states have now adopted versions of the 2006 Revised LLC Act.

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[26] See, generally, *Bromberg & Ribstein on Partnership*, §1.02 and §11.02.
[27] See, generally, Wayne A. Hagendorf, *The Complete Guide to Limited Liability Companies*, Ch. 1.
[28] PLR 8106082 (Nov. 18, 1980).
[29] PLR 8304138 (Oct. 29, 1982).
[30] Rev. Rul. 88-76, 1988-2 C.B. 360 (Sept. 2, 1988).
[31] See, e.g., Rev. Proc 95-10, 1995-1 C.B. 501 (Dec. 28, 1994).

Defining the Issue: Creditors of the Entity vs. Creditors of the Owners

When thinking about asset protection in the context of limited liability entities, it is important to differentiate between the two sources of threats: (1) those that are a result of liabilities associated with the entity's assets (for example, a slip-and-fall accident on real estate owned by the entity); and (2) those that are associated with the actions of the owners themselves (such as a third-party lawsuit against an owner).

In general, all legislation governing "limited liability" entities will protect individual owners from the entity's debts. However, not all such legislation will protect the entity and its assets from the creditors of its owners. That is, an owner's creditor (i.e., the lawsuit plaintiff) might be able to satisfy its debt by divesting the owner of its interest in the entity, and from there, attempt to assert control over, and possibly liquidate, the entity in satisfaction of its claim. Some U.S. jurisdictions (such as Alaska) and some foreign jurisdictions (such as Nevis) have recognized this possibility and have passed limited partnership and limited liability company legislation that clearly prevents creditors from satisfying their claims in this way.

Types of Creditors' Remedies Against Entities and their Owners

Veil-Piercing. The issue of piercing the entity's protective veil arises in the context of creditors of the entity. Creditors of the entity can absolutely reach the entity's assets to satisfy a claim, but they may not generally reach assets owned by the entity's individual owners. In particularly egregious cases, however, a creditor could argue that he should be allowed to "pierce the veil" of the entity because the entity is either a "sham" or is the "alter ego" of the sole owner of a closely-held entity. If a creditor prevailed with this type of argument, then the liability would not belong to the entity but would instead belong to the individual owners of the entity, thereby making the owners personally liable for the claim.

As stated above, veil-piercing is a concern primarily in the context of protecting an entity's owners against the entity's liabilities. The primary focus of this paper, however, is on creditors' remedies against the individual owners of a limited liability company or a limited partnership. In this context, there are three primary remedies to be aware of: (1) a charging order against the debtor's ownership interest; (2) foreclosure upon the interest that is subject to the charging order; and (3) forced dissolution of the entity.

Charging Order. A charging order is an order issued by a court that charges the debtor's interest in the entity with the amount due to the judgment creditor. Under a charging order, the creditor can get distributions from the entity only to the extent of the debt. The debtor keeps his membership interest, is taxable on his pro rata share of the company's income, and once the debt is paid, the debtor is freed from the order and life goes on as before.

Foreclosure. Unlike a charging order, a foreclosure results in the debtor being permanently divested of his interest in the entity. In the limited partnership context, Section 703(b) of the 2001 LP Act explicitly classifies a charging order as a "lien" on the debtor's "transferable interest" in the partnership (whereas the 1976 LP Act is silent). And with regard to limited liability companies, Section 504 of the 1996 LLC Act and Section 503 of the 2006 Revised LLC Act explicitly classify a charging order as a "lien" on the member's "distributional interest" in the LLC (whereas state LLC statutes based on the 1976 LP Act are silent).

This "lien" can be foreclosed upon by a creditor who succeeds in convincing a court that the previously issued charging order is not sufficient to satisfy the debt (for instance, because the company's earnings are continually withheld for reinvestment rather than distributed to its owners). Additionally, even if the creditors' rights provision of a statute does not explicitly classify a charging order as a lien, the civil practice and remedies codes of many states may still allow foreclosure upon an interest subject to a charging order. For example, Texas' Civil Practice and Remedies Code §31.002(b) provides that when a judgment has been placed on non-exempt property, "[t]he court may . . . (2) otherwise apply the property to the satisfaction of the judgment; or (3) appoint a receiver with the authority to take possession of the nonexempt property, sell it, and pay the proceeds to the judgment creditor to the extent required to satisfy the judgment."

The language of the 2001 LP Act and the 1996 LLC Act also gives rise to the question of what the creditor is getting when he forecloses upon a partner's "transferable interest" or a member's "distributional interest." For limited

partnerships, a partner's "transferable interest" is defined as "a partner's right to receive distributions,"[32] and the transfer of a transferable interest does not entitle the transferee to become or exercise any rights of a partner.[33] For LLCs, a member's "distributional interest" is defined as "all of a member's interest in distributions by the limited liability company," and the transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member.[34] Although these provisions, which limit the creditor's status in the entity upon foreclosure, give the impression that the lien is no real concern from the partner/member's perspective, the reality is that, if a creditor successfully forecloses upon a transferable interest or distributional interest, the debtor will lose all of the economic benefit of his ownership interest forever, including a right to his pro rata share of the entity's assets at liquidation. The fact that the 2001 LP Act and the 1996 LLC Act allow the judgment debtor to "redeem" his interest before foreclosure (i.e., sell his interest back to the entity) protects other members of the company from having a creditor participate in the company's affairs, but it does not have any positive effect on the end result to the debtor—he has still lost his interest in the limited partnership or LLC forever.

Despite the explicit availability of foreclosure as a creditor remedy in those states that have adopted the 2001 LP Act or the 1996 LLC Act, some practitioners might still argue that the mere possibility of foreclosure is not a genuine threat due to the fact that either the applicable LP/LLC laws or the individual company's governing documents make the purchaser at a foreclosure sale a mere "transferee" with respect to that interest.[35] Because a transferee cannot exercise managerial functions and does not have the right to become a member—so the argument goes—foreclosure is not an "attractive" remedy; therefore, creditors will not actually seek foreclosure. Nonetheless, foreclosure's permanent nature gives a creditor a better bargaining position in settlement discussions than a bare charging order would.

Dissolution. A more worrisome remedy is the creditor-transferee's ability to seek a judicial dissolution of the entity to satisfy a claim. This remedy is not available in the limited partnership context, but in the context of LLCs, dissolution is available. Section 503 of the 1996 LLC Act allows a transferee who has not become a member (i.e., a creditor who has successfully foreclosed upon an LLC interest subject to a charging order) to seek a judicial determination that it is equitable to dissolve the LLC and wind up its affairs (the 2006 Revised LLC Act does not contain such a provision).[36] The result is that a creditor could not only foreclose upon the lien created by a charging order, but it could also force dissolution of the company and receive a pro rata share of the LLC's assets upon dissolution (which could greatly exceed the individual member's debt). For most individuals forming LLCs as their operational entity, this potential for dissolution in the hands of a co-owner's creditor may dissuade them from using this type of entity.

Choice of Domestic Entity: Jurisdictional Considerations

Limited Partnerships. In states that have adopted a version of the 2001 LP Act, foreclosure is clearly a creditor remedy. But in those states that have adopted a version of the 1976 LP Act, it will be necessary to be familiar with any applicable case law construing the statute before determining whether a charging order truly is the "exclusive remedy" in that state.

Limited Liability Companies. In states that have statutes derived from the 1996 LLC Act, a creditor's charging order can clearly lead to foreclosure because it is explicitly allowed by the statute. Similarly, in the states whose laws are based on the 1976 LP Act, although they do not explicitly mention foreclosure, it may still be possible for a creditor to argue that the charging order is a lien that can be foreclosed upon under the state's civil practice and remedies statutes. Seeing this possibility, many states with 1976 LP Act legislation have added provisions expressly providing that a charging order is the "exclusive remedy" against an LLC membership interest, although some states do it better

[32] Uniform Limited Partnership Act (2001) §102(22)
[33] Uniform Limited Partnership Act (2001) §702; Revised Uniform Limited Partnership Act (1976) §702.
[34] Uniform Limited Liability Company Act (1996) §§101(6); 502.
[35] Some statutes use the term "assignee," rather than "transferee." Many practitioners believe that there is a substantive difference between an "assignee" and a "transferee" in that one has more or less rights than the other. However, our research has not revealed such a difference. Rather, a state's use of the term "assignee" or "transferee" is just a matter of whether the legislature preferred one word over the other.
[36] In the bankruptcy context, creditors have been allowed to dissolve LLCs under the reasoning that there are no other owners to protect (in the case of a single-member LLC), or the owners have no true duties toward one another to be performed under the company's governing documents. See, e.g., *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003).

than others. As for dissolution, this remedy is not statutorily available in states with LLC laws based on the 1976 LP Act, or in states that have attempted to make a charging order the exclusive remedy.

Entities in Non-U.S. Jurisdictions

In addition to domestic limited partnerships and limited liability companies, a number of other entity options exist in foreign jurisdictions.

Foreign LLCs. The Island of Nevis[37] has LLC legislation that provides that a creditor's sole remedy against an owner's LLC interest is a charging order. The Marshall Islands[38] also amended its LLC legislation to provide that a charging order is the exclusive remedy against an LLC interest. The Cook Islands[39] has also passed LLC legislation that provides exclusive charging order protection.

The benefit of a foreign LLC is that it is jurisdictionally severed from the United States, and therefore would generally not be within the reach of U.S. courts. However, if the company's assets are physically located within the United States, it would be possible for a U.S. court to obtain jurisdiction over the company's assets and possibly over the company itself. Furthermore, given the pro-plaintiff environment in the U.S. in recent years, a U.S. court could conceivably refuse to apply the law of the foreign jurisdiction, or even decide to disregard the entity all together, for "public policy" reasons.

Isle of Man Hybrid Company. An Isle of Man hybrid company is a cross between a company "limited by shares" (one in which the shareholders' liability is limited to the amount of capital contributed) and a company "limited by guarantee" (one in which there are no shares, but the owners guarantee the company's liabilities; the guarantee can be as low as $1).

An Isle of Man hybrid company has two classes of membership: ordinary shareholders and guarantee members. Ordinary shareholders are not entitled to dividends or other distributions, and upon liquidation, they are entitled only to the amount that they paid into the company. The guarantee members have no voting rights other than the right to vote to wind up the company. They may receive distributions out of the company reserves at the directors' discretion, and upon liquidation, they are entitled to any assets remaining after satisfying the company's debts.

The asset protection aspect of a hybrid company is based on the fact that control and management of a company draws liability. Therefore, the guarantee members, who are entitled to all of the value of the company, have no control. And the ordinary shareholders, who have control over the company, do not hold any value. For instance, a protective trust could hold the guarantee membership (which has rights to distributions from the company's earnings), and the ordinary shares (and control) could be placed in the hands of a third party.

Samoa Section 228B Company. A Samoa International Company that provides in its Articles of Association that it is subject to Section 228B of the Samoa International Companies Act 1987 ("ICA") is referred to as a "Section 228B Company." Section 228B of the Samoa ICA provides that a company's shares will automatically vest in certain specified persons (such as family members or a trust) upon the happening of a specified event or events set forth in the company's Articles. A "specified event" could be, for instance, the issue of a writ, order, decree, or judgment, or an action for bankruptcy, against a shareholder of the company. It could also include the death of the shareholder, a divorce, or a child reaching a certain age.

There are many ways in which shares can be vested in the "specified persons," and a Section 228B Company can issue various classes of shares with different voting and distribution rights. The Samoa ICA also authorizes a company to hold shares as treasury stock, so upon the happening of a specified event, the voting stock could be reabsorbed into

[37] Nevis, together with St. Kitts, comprises a small sovereign nation in the eastern Caribbean.
[38] The Marshall Islands is an independent U.S.-protectorate nation consisting of a gathering of 29 coral atolls, thousands of tiny islets, and hundreds of very small low-lying islands scattered over a wide area of the Pacific Ocean about midway between Australia and Hawaii.
[39] The Cook Islands is a self-governing parliamentary democracy in free association with New Zealand. It consists of 15 small islands in the South Pacific widely scattered across nearly a million square miles of ocean.

the entity, and the other classes of stock (which could be held by a protective trust) would be elevated to voting stock. Additionally, the Articles of a Section 228B Company can provide for a succession of directors upon the happening of specified events. In short, there is a wide array of planning options (both asset protection and succession) available with a Section 228B Company.

Cell Company. A cell company is a corporation that is composed of assets contained in structurally separate parts called "cells." The cells are legally independent and separate from each other (as if they were separate entities), and the assets designated to a specific cell are not liable for the obligations, commitments, or liabilities of the other cells. Thus, the insolvency of one cell should not affect the business of the whole entity or the assets of other cells. In order to segregate the liabilities associated with assets owned by a traditional business entity, the assets must be dropped into separate subsidiary companies, which could become administratively cumbersome—accordingly, it's easy to see the advantage of using one cell company rather than a parent and numerous subsidiaries. Cell companies are offered by a number of jurisdictions, such as the Cayman Islands, Bermuda, Panama, Samoa, Jersey, Guernsey, Anguilla, Mauritius, and St. Vincent and the Grenadines.

Liechtenstein Establishment. A Liechtenstein Establishment is a structure that is unique to the Principality of Liechtenstein, a tiny country nestled between Switzerland and Austria. In many ways, an Establishment is like a common-law trust, but unlike a trust, which is simply a relationship between the settlor, trustee, and beneficiary, an Establishment has its own separate legal existence like a corporation.

One of the ways an Establishment is like a trust is that it holds legal title to any property contributed to it, and it has beneficiaries who have the right to enjoy the property and receive earnings generated within the Establishment. Accordingly, separation of legal and beneficial ownership (and therefore the virtual elimination of liabilities to the beneficiaries) is possible with an Establishment, much like a trust. However, there are some increased asset protection benefits that an Establishment has over a trust due to the fact that, unlike a trust, it is a recognized legal entity and so some of the arguments available to creditors against a trust would not be available against an Establishment. In addition, the assets in an Establishment are explicitly protected from the beneficiaries' creditors by statute, and because Establishments are typically not divided into shares, there would be no members, partners, or shareholders to reach under any sort of corporate veil-piercing theory.

The purpose of an Establishment can be as specific or as general as the founder wants, and it can operate commercial enterprises as well as provide for the beneficiaries' support. It can also be organized to look more like a stock company or more like a trust. In short, an Establishment is an endlessly flexible vehicle in which to conduct a business.

A possible disadvantage to an Establishment is that their taxation is not completely settled under U.S. law. Although an Establishment has many corporation-like features, it also looks somewhat like a trust, and there is precedent that it should be treated as a trust for U.S. tax purposes (which means that transfers to the trust are subject to gift tax, and the U.S. person who creates the Establishment would be taxed on all of the income of the trust regardless of whether he receives any distributions). However, the significant flexibility and asset protection available through an Establishment tend to outweigh these possible disadvantages.

Summary

Asset protection has always been at the heart of estate planning, and the protection of assets against future creditors is a foundational principle of U.S. law. The current legal environment presents new, and perhaps more dangerous, threats to wealth, causing planners to look for innovative ways to protect their clients' assets. As long as the implementation of an asset protective structure precedes creditor problems, and as long as practitioners are aware of the limitations inherent in certain structures, a full range of opportunities exists, including the use of business entities such as limited partnerships and LLCs.