

USE OF LLCs IN ASSET PROTECTION AND ESTATE PLANNING

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1. Why Are LLCs so Special?

a. What do LLCs offer over other entities? Why are we focusing on LLCs?

i. Revocable Trusts

1. Pros:

- a. Probate avoidance
- b. Incapacity of the grantor
- c. Privacy
- d. Flexible vehicle

2. Cons:

- a. No liability protection

ii. Irrevocable Trusts

1. Pros:

- a. Only vehicle that completely removes an asset from your estate

2. Cons:

- a. Loss of flexibility and control
- b. Cannot easily modify, alter, or amend
- c. Cannot easily terminate

iii. Limited Partnerships

1. Pros:

- a. Many of the same benefits as LLCs
- b. Flexible
- c. Pass-through taxation

2. Cons:

- a. General Partners have potential liability

- i. Use of corporate general partners allows you to limited liability exposure, but increases the expense of operating your entity and you must follow corporate formalities.
- iv. Corporations
 - 1. Pros:
 - a. Strong limited liability
 - 2. Cons:
 - a. Must respect and follow corporate formalities
 - b. Double taxation

2. Management of LLCs.

- a. Management of LLCs occurs in two ways.
 - i. Member-Managed
 - ii. Manager-Managed
- b. Under a manager-managed structure, management is completely segregated from ownership.
- c. A manager-managed structure is the most common form of management for LLCs used in estate planning.
 - i. This structure may be very useful where families have a “head” owner or where generation 1 (“G1”) wants to bring in other owners but are not ready to relinquish control to the next generation.

3. Using LLCs in Estate Planning.

- a. Transferring assets from one generation to the next.
 - i. Ability to Retain Control
 - 1. LLC operating agreements are very flexible.
 - 2. Members may be given voting or non-voting interests.
Therefore, children (“G2”) or grandchildren (“G3”) may be

given non-voting interests which account for a majority of the value of the LLC, but provide for no voting or operational control.

3. Management may be left in the hands of G1, while transferring a majority of the units (and value of the assets) to G2 or G3.

ii. Transfer Restrictions

1. The LLC operating agreement may restrict a member's right to sell their membership interest or unilaterally withdrawal from the LLC.
2. Placing transfer restrictions in the LLC operating agreement may help to protect assets from creditors as well as from children or other heirs who may not make the best financial decisions.

iii. Ease of Transferring Hard to Divide Assets

1. LLCs may simplify the process of dividing assets.
2. For example, if you had a family vacation home, rather than deeding the property as joint tenants or tenants-in-common to your children, you may transfer an equal number of LLC units to your children.

iv. Out-of-State Property

1. Ancillary Probate

- a. When you hold property in more than one state, you will have to probate your will in each state in which you are not domiciled.
- b. Time-consuming
- c. Extra expenses
- d. May require court intervention

2. If you had transferred the property to an LLC prior to death, upon your death, the LLC would continue to hold the property. The decedent's LLC units will pass to the next generation or heirs, with no ancillary probate necessary.

4. Using LLCs for Asset Protection.

- a. Business owners who desire additional liability protection
 - i. Worried about lawsuits in excess of insurance limits
 - ii. Worried about a piercing of the corporate veil
- b. Individuals desiring to preserve and protect wealth for themselves and the next generation

5. What Types of Assets Should be Transferred to an LLC?

- a. Marketable securities
- b. Real property
- c. Personal property- vehicles, artwork, etc.
- d. ***Proceed with Caution:***
 - i. If an asset requires registration, you must actually register or retitle assets in the name of the LLC.
 - ii. If you are transferring real estate,
 1. Be sure to check with your lender to see if consent is required. A transfer without lender consent may be an event of default under the terms of your mortgage.
 2. Be sure to check with your insurance broker as a transfer of real property to an LLC may require a change to your insurance policy.

6. Valuation Discounts.

- a. Application of discounts will allow you to transfer a larger percentage of assets to the next generation tax-free.
- b. Valuation discounts may result in a significant decrease in value—sometimes up to 50%, although typically discounts range from 20-40%.
- c. Discount for Lack of Control
 - i. The minority interest discount.
 - ii. There should be a reduction in an LLC's unit value due to a member's lack of ability to exercise his or her control over the LLC.
 - iii. Therefore, a discount should apply when transferring units from a managing member or a member with a majority interest to a non-managing, minority member.
- d. Discount for Lack of Marketability
 - i. Closely-held companies should sell at a discount to actual value because of the additional costs, increased uncertainty and longer time horizons required to sell such interests.
 - ii. Therefore, an additional discount may apply when transferring privately-held company interests that are subject to transfer restrictions.
- e. ***Proceed with Caution:***
 - i. With large transfer tax exemptions now available, you must compare the estate tax savings of utilizing valuation discounts against the option of preserving the income tax basis of an asset.
 - 1. Transfer Tax Exemptions are now at:
 - a. \$11,400,000 for single persons
 - b. \$22,800,000 for married couples
 - ii. Would a step up in basis at death be more valuable to you than a valuation discount?

7. Mistakes to Avoid & Precautions to Take When Establishing LLCs.

- a. Internal Liability Protection v. External Liability Protection.
 - i. Internal Liability
 - 1. The goal of using an LLC is to trap business or asset liabilities inside the entity, so that the member does not become personally liable for such liabilities.
 - ii. External Liability
 - 1. The goal of using an LLC is to insulate and protect its assets from the creditors of individual members.
- b. You over-estimate the internal asset protection and limited liability protection provided by your LLC.
 - i. Your lender demands a personal guarantee.
 - ii. A lawsuit is filed against the LLC and its member(s) individually.
 - iii. An accident occurs on personal use property.
 - 1. In such instances, you must use a multi-layered approach to asset protection, such as ensuring that you have appropriate insurance to achieve adequate asset protection.
- c. You formed your LLC in the wrong state and, consequently, have over-estimated the external asset protection and limited liability protection provided by your LLC.
 - i. Charging Order Protection
 - 1. Provides protection against creditors of a debtor member who are seeking assets, including those of the LLC, to satisfy a debt or judgment.
 - 2. The protection is based on state statute.
 - 3. Generally, all statutes provide that the assignee judgment creditor is only entitled to receive distributions to which the debtor member would have been entitled.

4. Generally, with charging order protection, assignment does not dissolve the entity or entitle the creditor or assignee to become a member or exercise any rights of a member.
5. The Benefits of Charging Order Protection:
 - a. The creditor is only an assignee of the debtor member's interest and has no right to participate in the management of the entity or to vote the debtor member's interest.
 - b. The creditor will only receive LLC distributions which, absent the charging order, would have been distributed to the debtor member.
 - i. In a family or closely-held LLC the debtor member or a relative may have control over distributions.
 - ii. Distributions may be made infrequently or in insignificant amounts making the charging order an unattractive remedy to the creditor.
 - c. The charging order only creates a lien on LLC distributions.
 - i. The debtor member may still be able to benefit from the LLC through loans or guaranteed payments.
 - d. The creditor shall be liable for the membership interest's share of the LLC income, even if no distributions are actually made by the LLC.
 - e. The operating agreement for the LLC may contain provisions for a purchase option when a member's

interest becomes subject to a charging order or if a member is forced into or declares bankruptcy.

6. Issues that May Arise with Charging Orders:
 - a. May disrupt plans for significant distributions or even distributions for tax payments.
 - b. If the creditor is a federal government agency it may not feel compelled to negotiate a quick settlement and it will not be deterred by negative income tax consequences.
 - c. The frequent use of loans (or disproportionate distributions) may negate one's ability to use valuation discounts.
 - d. If there is a purchase option provision, the LLC may have to liquidate assets to buy-back the debtor member's interest.

ii. ***Proceed with Caution:***

1. Not all statutes are alike!
2. Foreclosure Remedy:
 - a. Foreclosure is usually a remedy that is granted by statute under the applicable LLC act.
 - b. In some states, the judgment creditor may obtain a court order that the debtor-member's LLC membership interest be foreclosed upon resulting in the creditor becoming the permanent owner of all the debtor-member's financial rights. *Madison Hills Limited Partnership II v. Madison Hills, Inc.*, 644 A.2d 363 (Conn. App. 1994).
 - c. Some states take this a step further and, if a foreclosure remedy is available, allow the judgment

creditor to force a sale. *Crocker National Bank v. Perroton*, 208 Cal. App. 3d 311, 255 Cal. Rptr. 794 (Cal. App. 1st Dist. 1989).

- d. Note, however, that some courts have allowed foreclosure even where the remedy was not specifically provided for by statute. *Id.*
- e. Certain states, including Delaware, have eliminated foreclosure as a remedy under its statute:
 - i. Section 18-703(d) of Title 6 of the Delaware LLC Act provides that:

“The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member’s assignee may satisfy a judgment out of the judgment debtor’s limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.”

3. Single-Member LLCs

- a. The public policy behind the charging order remedy is to balance a judgment creditor’s rights against a need to avoid a disruption or liquidation of the LLC’s business.

- b. Many courts have argued that this public policy factor is not present in the case of a single member LLC.
 - i. The seminal case on this issue is *Olmstead v. Federal Trade Commission*, 44 So. 3d 76 (Fla. 2010), where the Florida Supreme Court determined that a charging order was not the exclusive remedy for the judgment creditor of the owner of a single member LLC.
 - ii. The Eleventh Circuit Court of Appeals, certified the following question to the Florida Supreme Court: “Whether, pursuant to F.S. §608.433(4) [the then-current charging order statute], a court may order a judgment-debtor to surrender all ‘right, title and interest’ in a debtor’s single member limited liability company to satisfy an outstanding judgment?”
 - iii. The Florida Supreme Court broadened the question and asked whether Florida law allowed such actions.
 - 1. The Florida Supreme Court concluded that the Florida LLC Act had not specifically displaced other remedies available to judgment creditors.
 - 2. The Florida Supreme Court focused on the lack of exclusivity language in

the Florida LLC statute and compared it to both the Florida Revised Uniform Partnership Act and Florida Revised Uniform Limited Partnership Act which did contain exclusive remedy language.

3. The Florida Supreme Court stated that this discrepancy showed that the legislature's failure to include such language in the LLC statute was not inadvertent.
- iv. After the decision in *Olmstead*, the Florida legislature modified §608.433 to make clear that the holding in *Olmstead* does not apply to multiple-member LLCs, and that the sole and exclusive remedy for a judgment creditor of a member of a multiple-member LLC is a charging order.
- v. Florida House Bill 253—The “*Olmstead* Patch”
 1. In 2011, a new subsection (5) was added to §608.433, which provides:

“Except as provided in subsections (6) and (7), a charging order is the sole and exclusive remedy by which a judgment creditor of a member or member’s assignee may satisfy a judgment from the judgment debtor’s

interest in a limited liability company or rights to distributions from the limited liability company.”

2. The intended purpose of subsection (5) was to eliminate any question about the scope of the remedies available to judgment creditors and the exclusive remedy language of the revised charging order provision was to apply to all Florida LLCs, not just multiple-member LLCs.
 3. However, the statute also carved out exceptions to the general rule of charging order exclusivity in §608.433 subsections (6) and (7), which applied only to single-member LLCs.
- vi. In 2013, the Florida legislature enacted the new Florida Revised Limited Liability Company Act codified in Chapter 605 of the Florida Statutes and, as of January 1, 2015, repealed the LLC Act under Chapter 608.
 - vii. However, the Revised Act under Chapter 605 did not change the rules relating to charging orders and the changes made under the *Olmstead* Patch remain unchanged.
- c. In response to *Olmstead*, certain states, including Delaware, amended their statutes to make clear that

a charging order is the sole remedy available to judgment creditor regardless of whether there is one or more members in an LLC.

- i. Again, compare the language of Section 18-703(d) of Title 6 of the Delaware LLC Act to that of the *Olmstead* Patch:

1. “The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member’s assignee may satisfy a judgment out of the judgment debtor’s limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.”

- d. The best practice if you are establishing a single-member LLC is to form the entity in a state where the charging order statute expressly applies to single-member LLCs.

4. Husband and Wife Owned LLCs

- a. Some commentators have expressed concern that a charging order statute would be ignored in the case of an LLC owned by a husband and wife, especially if the judgment is entered against both spouses.

- b. The concern is that a husband and wife may be treated as one economic unit—or a single-member.
- c. When forming an LLC to be owned by a husband and wife, you should perform an analysis similar to that of a single-member LLC.
- d. Again, the best practices would be to add additional members (children, for example) or to form your LLC in a state where the charging order statute expressly applies to single-member LLCs.

5. Bankruptcy

- a. Section 541(c)(1) of the Bankruptcy Code provides as follows:

“Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2) or (a)(5) of this section, notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —

(A) that restricts or conditions transfer of such interest by the debtor;”

- b. Courts have held that section 541(c)(1) of the Bankruptcy Code negates the provisions of the charging order statute that would treat the bankruptcy trustee as an assignee and not a member. *In re Ehmman*, 319 B.R. 200 (Bankr. D. Ariz. 2005).

- c. Courts have even gone as far as granting the receiver or trustee the right to dissolve and liquidate the LLC in order to satisfy creditor claims. *In re Smith*, 185 B.R. 285 (Bankr. S.D. Ill. 1995).
- d. Section 541(c)(1) of the Bankruptcy Code may even negate a provision in the LLC operating agreement requiring the purchase of the debtor member's interest.
 - i. This determination hinges on whether the LLC operating agreement is an executory agreement.
 - ii. The purchase option provisions in the LLC operating agreement may be negated unless the operating agreement is an executory contract.
 - 1. Under federal bankruptcy laws, executory contracts are those where the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and excuse the performance of the other.
 - 2. Unfortunately, most courts have held that LLC operating agreements are not executory. *Id.*; *In re Garrison-Ashburn, LC*, 253 B.R. 700 (Bankr. E.D. Va. 2000); and *In re the IT*

Group, Inc., 302 B.R. 483 (D. Del.
2003).