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Charging Orders Protection Consideration

Protection of business and investments assets are a significant factor in the choice of the formation of a legal entity. A major consideration is when an outside creditor (a creditor that does not deal with the business entity directly) attempts to levy indirectly on assets that are owned by a limited partnership, corporation or limited liability company by attaching the equity interest of the business owner (partnership, shareholder or membership interest.)

Under the laws of most states, the creditor of a limited partner is unable to seize ownership of the limited partner's interest in the partnership. Instead, the creditor receives an order from the court ("charging order") which instructs the partnership to give the creditor any distributions that would otherwise be paid to the debtor limited partner. The court generally will not have the authority to order that distributions be made. The law in many states also provides that similar protection applies to limited liability company ("LLC") interests. Note, that this is generally not true for corporations, except for certain corporations formed in Nevada.

No Silver Bullet Consideration. As was pointed out in a recent article discussing charging order protection by Alan S. Gassman and Sabrina M. Moravecky, there are not a great number of reported cases on this subject. This is due to the fact that most creditors and debtors negotiate and come to terms when the possibility of a charging order arises. Charging orders are established by courts of equity, and such courts typically have significant discretion in implementing equitable remedies.

In order to be able to achieve a more favorable outcome in negotiations, charging order protection is a fundamental factor in favor of utilizing either a limited partnership or LLC. This does not mean that a charging order is a total silver bullet for asset protection purposes. It means simply that there is another round of negotiations between the parties.

Conflict of Law Consideration. I have often been asked whether or not it is better to form a limited partnership or LLC in states other than California. I often reply that conflict of law jurisprudence determines which state's law should apply, depending on the state of residency of the creditor, the debtor, and the subject LLC or limited partnership. If you reside in California, your assets are located in California as well as the creditor suit, and more often than not California law will apply compared to other states' favorable charging order statutes. I do form limited partnerships and LLC in other states for many different reasons not discussed in this article.

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Tiered Entities Consideration. Rather than having a business owner own an interest in an LLC or limited partnership directly, he or she should consider having a “family” or “intermediary” LLC or FLP hold an owner's partial partnership interest in another such entity. For example, if an owner holds 25% of an LLC and has charging order protection under a judgment, the owner is unable to control whether the remaining members may choose by majority rule to make a distribution that the owner's creditor would receive the owner's share of. However, if the owner holds 95% of an FLP that owns 25% of the above referenced entity, then the 25% distribution would pass from that entity to the FLP and could be re-invested if charging order protection applies at the FLP level.

Fraudulent Transfer Statutes. While fraudulent transfer statutes may commonly permit creditors to unwind transfers made for purposes of creditor avoidance, if a owner holds an interest in a company that becomes an LLC, which simply receives a charging order protective interest in exchange for a non-charging order of protective interest, fraudulent transfer statutes may not apply to such a transition.

LLCs that are owned by individuals in different states may or may not be protective for each owner. The law of the state where each member resides may be controlling as to charging order protection. In many cases, limited partnerships may be preferable because of better established charging order protection rules.

Conclusion More and more sophisticated owners have seen their colleagues, competitors, and family members fall to predatory creditors, and have witnessed the United States court litigation system, leveraged real estate, and industry failures. Informed owners will select entities with reference to incidental creditor protection features, regardless of whether said protection is a primary motivation for implementation and use. As owners grow to expect that charging order protection will be applicable to such entities, they must analyze the specific rules that apply in the jurisdiction of the entity's operation and the jurisdiction of residency of each member/partner in order to determine how to select, design, and operate a given entity arrangement.

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