FINANCIER WORLDWIDE corporatefinanceintelligence

Freeborn & Peters LLP

# Asset Protection Using LLCs And Limited Partnerships

BY WILLIAM RUSSELL

PROOF ONLY

In the current distressed economic environment, asset protection planning takes on heightened importance. Businesses and their owners who formerly had little concern for asset protection strategies now view them as essential. Financial calamities that were remote possibilities and only happened to the 'other guy' are now a hard reality for many. Similarly, financiers find it more important to understand the protection devices their borrowers may be using.

Much of asset protection planning has been focused on individuals who own closely-held businesses or guarantee their debt. Depending upon the jurisdiction, there are a variety of techniques and exemptions that individuals may use to shelter their assets. Businesses, however, have not always focused on how to structure their assets to make them less attractive to creditors, particularly unsecured general creditors. While the concepts that are discussed may apply in many different jurisdictions, the focus of this article is investment in US limited partnerships or limited liability companies (LLCs), whether by US or foreign companies.

Sophisticated business people are aware of the use of limited liability entities to protect owners from direct general liabilities of a business.

In the US, a corporation, limited liability company or limited partnership affords such protection (subject to certain exceptions). With respect to limited partnerships, only the limited partners have limited liability. The general partner will have unlimited liability for the obligations of the partnership.

Businesses also need protection from the attachment of assets by creditors. Given the existence of potential existence of claims against a business, how may such business reduce the exposure of various assets? Subject to the discussion of fraudulent conveyance, below, assets may be transferred into a partnership or limited liability company with a third-party partner. Such structures may substantially limit the remedies that a creditor of a partner may use to reach the assets within those entities.

For example, Company A forms a limited partnership (LP) with B with respect to its US operations. Company A owns 95 percent of LP and B owns 5 percent. Company A controls the appointment of the general partner. However, Company A may not cause the liquidation of LP without the consent of B. Furthermore, Company A may not sell or assign its interest in LP without the consent of Company B.

As a result of this structure, a judgment creditor of Company A will be unable to cause the liquidation or sale of the LP or Company A's ownership in LP. The creditor may obtain a 'charging order' directing any distributions with respect to A's partnership interest in LP be paid to the creditor. However, the creditor is not a partner and has no other rights as a partner. While the charging order is outstanding, the LP may make little or no distributions. At the end of the judgment period (typically seven years), the charging order lapses.

In order to obtain the result in the foregoing example, there are several critical assumptions. First, the LP is not a direct obligor or guarantor of the debts of Company A. Second, the appropriate jurisdiction is chosen for the formation of the LP (Delaware is assumed in this example). Laws governing partnerships and LLCs vary from state to state. The state of governance will generally control the rights of creditors to reach the assets of the LP or LLC. Third, the creation and funding of the LP does not run afoul of the fraudulent conveyance issues discussed below.

Given these assumptions, the LP affords the following protections. First, a creditor has limited rights in foreclosing and attaching a partner's interest. For example, under Delaware law, a charging order is the sole remedy with respect to any levy on a limited partnership interest. The creditor has no right to become the partner, has no voting or management rights, and will only have rights to distributions. At the end of the judgment period, the right to distributions lapses. Second, a creditor with a charging order has no rights to cause the liquidation of the partnership or its assets.

It should be noted that limited partnerships and limited liability companies afford such limitations on creditor remedies. Corporations generally do not. Under the traditional law of corporations, capital stock is transferable. Consequently, shareholder agreements which restrict transfer of corporate stock are intrinsically more susceptible to creditor attack, particularly in bankruptcy.

Fraudulent conveyance principles are a limitation on any asset protection technique. This is a civil concept, not a criminal one. At its most simple level, when a transaction is found to be a fraudulent conveyance, the transaction is set aside. The creditor may undo the conveyance and recover the transferred assets.

There are variations of this legal prohibition, including the US Bankruptcy code and statutes in every US state. Generally, there are two types of fraudulent conveyance: (i) actual, and (ii) constructive.

Actual fraudulent intent is a transfer with actual intent to hinder, delay or defraud present or future creditors. Actual intent is based upon a factual finding of subjective intent as evidenced by events which are 'badges of fraud'. While there are numerous potential acts which may provide evidence of such intent, the key is that debtors should not take actions which are a patent effort to avoid an existing debt and have no other legitimate purpose. Well designed asset protection incorporates other legitimate purposes, making actual intent harder to prove. Debtors should avoid blatant and indefensible transactions, as they will only serve to prove the actual intent to hinder creditors.

Because actual fraudulent conveyance requires that a party prove subjective intent, creditors often rely upon the constructive fraudulent conveyance test. A constructive fraudulent transfer is one that is for less ▸▸

This article first appeared in Financier Worldwide's *September 2009 Issue.*
© 2009 Financier Worldwide Limited. Permission to use this reprint has been granted by the publisher.
For further information on Financier Worldwide and its publications, please contact James Lowe on +44 (0)845 345 0456 or by email: james.lowe@financierworldwide.com

than reasonably equivalent value and is made when (i) insolvent, (ii) a debtor is unable to pay obligations when due, or (ii) with respect to a business, is made by an undercapitalised business.

The key to avoiding a fraudulent conveyance is to engage in asset protection planning well in advance and while one is fully solvent. As one moves closer to a 'zone of insolvency', it is then critical to make transfer for adequate equivalent value that makes the assets less attractive to creditors. There are still opportunities to increase one's protection posture, but careful and balanced planning is required.

In creating asset protection structures, debtors must be cognisant of the following additional issues that may arise: (i) there is no substitute for accurate financial disclosures to banks and others, where required. Inaccurate financial statements may attract separate criminal or civil claims based upon banking law, as well as serve as a 'badge of fraud' to show actual intent for a fraudulent conveyance; (ii) creation of certain structures may cause defaults under loan agreements. For example, the transfer of assets into a partnership may be prohibited under one's loan document; (iii) securities law and public accounting requirements create special issues that, if applicable, must be addressed in advance; and (iv) when a lender has a direct secured interest in the collateral transferred, or has a direct guarantee of the new LP, putting assets with the LP will obviously not protect against foreclosure on the transferred assets by the creditor.

In a nutshell, LP and LLCs may serve as protection devices for a business operating in the US.

Many businesses already may have investments in LLCs or limited partnerships, but have failed to consider asset protection in the structure of agreements for those companies. The governing document of those entities should be reviewed and consideration given to changes which will enhance protection.

William Russell is a partner at Freeborn & Peters. He can be contacted on +1 (312) 360 6373 or by email: brussell@freebornpeters.com

PROOF ONLY

**William E. Russell**
Partner
**T:** 312.360.6373
**E:** brussell@freebornpeters.com
www.freebornpeters.com

William E. Russell is a Partner in the Business Law Practice Group and his areas of focus include: International, Tax Planning for Real Estate Transactions and Taxation and Estate Planning.

Mr. Russell advises closely-held businesses and professionals on business and tax matters. His practice consists of (i) real estate development structure and investment, (ii) corporate transactions and business consulting, and (iii) advanced estate planning and probate.

Mr. Russell has represented a number of real estate investors and developers in the financing and development of both commercial and residential properties, including specialized mezzanine financing and the structuring of real estate investment and development entities. Mr. Russell is the relationship partner for Shelbourne Development Group, Inc. in its acquisition and development of the Chicago Spire, as well as other properties.

As to business matters, Mr. Russell has handled the purchase and sale of numerous private equity business and joint ventures. He has significant expertise in the structuring of business entities, including limited liability companies, partnerships, S corporations, buy-sell agreements, deferred compensation arrangements, and general corporate transactional agreements.

Mr. Russell's experience in advanced estate planning includes the restructuring of businesses or real estate to minimize estate taxes, family partnerships, grantor annuity trusts, qualified personal residence trusts, charitable trusts, trusts for children, insurance trusts, generation-skipping trusts, and retirement distribution planning as well as basic estate planning for all individuals. Additionally, Mr. Russell's practice includes estate administration and post-mortem planning to minimize taxes.