

LIMITED LIABILITY COMPANIES IN UTAH

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Using and LLC as an Asset Protection Tool. An oft stated estate planning goal of clients is to obtain some measure of protection from creditor claims for their assets. Limited partnerships and LLCs have often been touted, usually inappropriately or in an exaggerated sense, as a tool to provide some asset protection benefit. Here's how.

In order to avoid the corporate characteristic of free transferability of interests in order to qualify the LLC as a partnership for tax purposes under the pre-check the box classification regime, drafters of LLC documents would typically incorporate a provision much like the following:

No new member shall be admitted to the LLC without the prior written consent of a majority of the other members. In the event a majority of the other members do not consent to the proposed transfer or assignment the transferee of the interest of the member has no right to participate in the management of the business and affairs of the LLC or to become a member. In that event, the transferee is entitled to receive only the share of profits, losses and distributions to which its transferor would otherwise be entitled.

The documentary and statutory provisions have an unexpected, but seemingly effective, beneficial effect from an asset protection standpoint. Assume, for example, that a couple place their home and other tangible personal property into a family LLC. Further assume that the husband gets into financial difficulties in his business and a creditor obtains a substantial judgment against him personally. The creditor then attempts to execute on the husband's assets. The creditor then learns that the husband's assets are held in the family LLC. At this point, the creditor has a distinct problem. The creditor can execute upon and take the husband's interest in the LLC. However, if the husband's wife and children do not consent to the creditor being a full-voting participating substitute member in the family LLC, that creditor's interest will have a severely limited value from a practical standpoint. The creditor, for example, will not be able to force or influence any management decision. The creditor will also not be able to compel a dissolution of the family LLC or any distribution of its assets. All the creditor will hold is a "charge order" which will entitle the creditor to a pro rata share of any actual distributions of income or assets when and as the other family members decide to make such distributions. In the interim, if the assets are income-producing assets, the creditor will be in the unfortunate position of getting a K-1 form each year reporting the creditor's pro rata share of LLC income. The creditor will have to report and pay taxes on that income even though that creditor gets no distribution of assets out of the LLC to help it pay the tax liability.

The prospect of acquiring phantom income with no foreseeable distribution of assets out of the

LLC seems to be, as a practical matter, an effective asset protection method to keep the creditor from executing on specific family assets or from obtaining any benefit therefrom.

Usually, the asset protection benefit of limited partnerships and LLCs is misplaced or exaggerated. In implementing any asset protection plan, for example, care must be given to relevant fraudulent transfer statutes. Under such statutes, a creditor can effectively undo any transfer of assets to an LLC made within the previous four years if that transfer was made for less than fair market value consideration. In addition, if a transfer is made with actual intent to hinder, delay, or defraud a creditor, the transfer is voidable.

Similarly, where the LLC has been structured to allow annual exclusion gifts, the creditor transferee may have a right to obtain a withdrawal of the former member's capital account or liquidate the LLC. To the extent the creditor may do so, the LLC provides no shield from creditor claims.

Finally, recall that where the managing member has been given certain fiduciary duties in order to avoid the applicability of I.R.C. Sections 2036 and 2038, the creditor may be able to force the managing member to make distributions that are objectively reasonable in light of the then existing business circumstances of the LLC. If a manager refuses to make distributions to a creditor holding a charge order, the creditor may very well prevail in a breach of fiduciary duty claim against the manager for unreasonably withholding distributions. Breaches of fiduciary duty are serious matters, for which the violating manager can be punished with the imposition of punitive damages.

Great care must therefore be taken in advising clients about the availability of asset protection benefits under LLCs.