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LLCs take a backseat to limited partnerships in 2014

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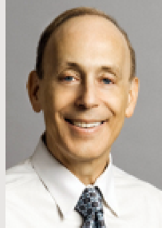

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Asset protection planning is a concern to many clients and professionals. When discussing asset protection planning we need to distinguish among the three types of creditor issues which we refer to, in client meetings, as Up, Down and Sideways. This is best illustrated by assuming that Joe owns a single member LLC which owns two buildings, which is a relatively common current structure. If someone dies in building one, the judgment creditor will want to pierce through the LLC to get to Joe's personal assets; that is the "Up" type of liability (the traditional "piercing the corporate veil"). If Joe gets in a car crash, the judgment creditor will want to seize his valuable interest in the LLC; that is the "Down" type of liability. Finally, if someone dies in building one, the judgment creditor - frustrated at not being able to "piece the corporate veil" - will want to get the equity in building two; that is the "Sideways" type of liability (sometimes called "collateral").

For the first and third types of liability (Up and Sideways), we have good advice. To make it difficult to "pierce the corporate veil," among other steps, the LLC should be adequately capitalized. Unfortunately, on any given set of facts there is no certainty as to how much capital is enough. All we know is that more cash in the LLC's bank account is better than less. For the "Sideways" (collateral) liability, building number two should be in a different LLC than building one, even if both entities are, in turn, owned by the same master LLC.

The problem is the "Down" type of liability. Twenty years ago, before the Sept. 30, 1994, effective date in California for LLCs, we used limited partnerships for this purpose and benefitted from Corporations Code Section 15907.03, titled "Rights of creditor of partner or transferee" (which is still the law). When a judgment creditor wishes to proceed against a partner's interest in a partnership, the first step is to get a charging order, the procedure for which is described in subsection (a): "On application to a court of competent jurisdiction by any judgment creditor of a partner or transferee, the court may charge the transferable interest of a the judgment debtor with payment of the unsatisfied amount of the judgment with interest." So one possible way to protect the partner is to make the partner's interest non-transferable, which can work in a closely held (family) partnership. However, even in those situations the partnership interest is arguably transferable, e.g., at death.

Therefore, we also rely on subsection (c)(2) which reads, in pertinent part, as follows: "At any time before foreclosure, an interest charged may be redeemed ... (2) with property other than limited partnership property, by one or more of the other partners." This is a wonderful provision as it allows the partnership agreement to offer the non-charged partners the opportunity to buy the charged partner's partnership interest for a 30-year, interest only, installment note at an interest rate pegged to prime, with valuations taking into account adjustments for lack of control and lack of marketability. Assume that the partnership's assets are worth $1 million and Joe, the parent, has a 95 percent limited partnership interest, while the trust for Joe's children has a 3 percent limited partnership interest (the LLC, which is the general partner, owned by the children's trust, owns the other 2 percent). What is the value of Joe's limited partnership interest? $1 million *x* 95 percent *x* 80 percent (to allow for a 20 percent lack of marketability adjustment) *x* 80 percent (to allow for a 20 percent lack of control discount) = $608,000. (Of course, the adjustments must be determined by a competent business appraiser.) With this type of provision it was not necessary to have another member, e.g., the children's trust in Joe's case, exercise the option. The mere presence of the option was enough to motivate the creditors to settle in a manner favorable to Joe.

Once LLCs came along in September 1994, we switched from limited partnerships to LLCs since, with an LLC, there is no need to have a separate entity as the general partner. Corporations Code Section 17302(c)(2) for LLCs was modelled on Corporations Code Section 15907.03(c)(2) for limited partnerships, so another member could buy a charged member's interest for terms which would similarly prove unattractive to a creditor.

However, on Jan. 1, 2014, California adopted the Revised Uniform Limited Liability Company Act. Without any discussion, Section 17302(c)(2) was eliminated and replaced with new Section 17705.03(d) which provides: "At any time before foreclosure ... a limited liability company or one or more members whose transferable interests are not subject to the charging order may pay to the judgment creditor the *full amount due under the judgment* and thereby succeed to the rights of the judgment creditor, including the charging order" (emphasis added). Therefore, the operating agreement can no longer allow another member to buy a charged member's interest on terms which will motivate a judgment creditor of the charged member to settle on favorable terms.

Given that change many clients who hold their properties in LLCs have transitioned to using the old LLC as the general partner of a new limited partnership. So they have not had to liquidate (federal tax law) and dissolve (state law) the LLC; they still get use of it while benefitting from the new, improved, limited partnership-based structure.

Accordingly, for clients and professionals interested in the highest degree of protection of their valuable interests in entities, the winning choice is a limited partnership rather than a limited liability company. We are, in 2014, returning to 1994.

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