REVERSE LIMITED LIABILITY AND THE DESIGN OF BUSINESS ASSOCIATIONS

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ABSTRACT

The proliferation of partnership-type entities raises questions about how these entities relate to corporations and one another. It has also created strains as the use and scope of the statutes has expanded. This article discusses a particular problem that has arisen in the development of partnership-type business forms, "reverse limited liability." Reverse limited liability refers to the use of partnership-type entities as, effectively, asset-protection trusts. This has occurred because of the combination of limitations on creditors' access to debtors' interests in partnership-type firms and provisions permitting use of such firms by non-profit, one-owner entities. The courts have attempted to curtail this unexpected development with fraudulent conveyance, veil-piercing, and bankruptcy rules that do not reach the basic problem. The article suggests a statutory fix. More broadly, the advocates for a greater level of respect for the core functions of business entities and coherence of business association statutory provisions.

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I. INTRODUCTION

The rapid evolution and proliferation of entity forms over the last fifteen years has opened up an unprecedented variety of planning possibilities, but also left some rough edges. This article discusses one particular unexpected problem—what I refer to as "reverse limited liability." Unlike standard limited liability, which protects the personal assets of business owners from their firms' debts, reverse limited liability uses business-type entities to protect owners' personal assets from "personal" debts—that is, debts that arise separately from the liability-protection vehicle.

This article discusses the causes of this peculiar development and how courts have addressed the issue. Courts have pieced together several different types of remedies—veil-piercing, fraudulent conveyance, bankruptcy, and, indirectly, tax law. These remedies, however, are makeshift and inadequate because they do not address the root problem of statutory design.

The design problem arises from the need for coherence in business association statutes. The terms of business associations should functionally interrelate. Indeed, this is a principal rationale for having distinct business association statutes.[1] Political pressures, however, often cause such statutes to diverge from logical perfection. Business people and their lawyers have strong incentives to press for business association statutory provisions that minimize taxation and regulation of businesses even if they are not functionally consistent with other provisions of the statute.

An example of this phenomenon is the family limited partnership. A business owner may want to use a limited partnership to transfer her business to family members without substantial estate or gift tax. The tax value of the transferred interest, in turn, depends on whether family members can cash out of the firm at full market value. Family members cannot avoid receiving full market value simply through a provision restricting fair value transfers in the limited partnership agreement, because the Internal Revenue Code only "counts" for restrictions in applicable state

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[1] *See* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369 (1995).

or federal law.[2] Partly because of this tax rule, the states amended their statutes to eliminate default cash out rights for limited partnerships.[3] The elimination of these rights, however, can be costly. An exit right suits the sort of closely-held firm that likely relies on the default provisions of the limited partnership statute. Exit rights also mesh with restrictions on the transferability of limited partnership interests.[4]

In the case of reverse limited liability, the fundamental problem was the expansion of limited liability partnership-type firms to include single-member and non-profit firms. These specific forms appeared to be logical extensions of the flexibility of the partnership form. These provisions, however, do not mesh with other provisions designed for multi-member firms that produce and distribute earnings. The limitation on the rights of members' creditors to access members' interests through a charging order assumes that firms will make distributions that can be reached by the charging order. Also, the statute needs to reconcile creditors' interests with those of non-debtor partners or members. Neither of those conditions, however, hold in non-profit single-member firms, making these business entities ripe for unexpected exploitation as asset-protection vehicles.

Reverse limited liability teaches statutory drafters to account for the internal logic of business association statutes before making significant changes. Several subsidiary lessons follow from this foundation, and are also evident in the reverse limited liability story. First, since business association statutes do have an internal logic, they should be preserved, not merged, or "rationalized," into hub-and-spokes statutes as some lawyers and academics propose.[5] Second, although courts are tempted to apply corporate cases in deciding issues dealing with novel partnership-type

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[2]*See* 26 U.S.C. § 2704 (2000) (providing that an "applicable restriction" on liquidation rights can be disregarded in valuing the interest for tax purposes). *Id.* § 2704(b)(3)(B) (providing that an "applicable restriction" does not include "any restriction imposed, or required to be imposed, by any Federal or State law"). Treas. Reg. § 25.2704-2(b), 26 C.F.R. § 25.2704-2(b) (2004) (defining "applicable restriction" as one that is "more restrictive than the limitations that would apply under the State law generally applicable to the entity in absence of the restriction").

[3]*See* ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 17.02(d)(3) (2004).

[4]*See* Rev. Unif. Ltd. Partnership Act § 702 (1985) (providing that assignment does not transfer management rights). The tax-driven limited partnership changes arguably affected the "market" for limited partnership, which in turn affects the appropriateness of limited partnership statutory provisions for that market. This process by which business forms evolve may make business association statutes efficient in the long run. In the short run, however, tax and liability driven changes arguably produce a misfit of statutory provisions.

[5]*See* Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023 (2003).

entities, courts should act cautiously because of subtle differences between entities.

This article proceeds as follows. Part II provides a general description of reverse limited liability. Part III puts reverse liability in the more general context of asset-protection vehicles. Part IV discusses the statutory context for reverse limited liability. Part V examines the judicial remedies that have been developed to deal with statutory gaps. Part VI analyzes the broader implications of this analysis in terms of the development of statutory forms.

II. DEFINING REVERSE LIMITED LIABILITY

Business entities, in general, and partnership-type firms, in particular, can be viewed as ways of "partitioning" business assets from the debts of individual owners and individuals' assets from the debts of their businesses. Hansmann & Kraakman have referred to these functions of business associations as affirmative and defensive asset partitioning, respectively.[6] Accordingly, lawmakers constructed default and mandatory rules in business association statutes to achieve this separation. The statutes and cases protect creditors from the abuse that partitioning causes, such as the undercapitalization of firms to minimize the exposure of assets to creditors' claims.

In this broad frame, partnerships and corporations look alike, particularly now that both types of firms can adopt "limited liability," or what Hansmann & Kraakman call "defensive" asset partitioning. In other words, these "essential" features cut across types of firms. The main difference is that traditional general partnerships lack defensive asset partitioning, and have a weaker form of affirmative asset partitioning, in which partners' creditors, unlike those of corporate shareholders, can compel liquidation of the firm.[7]

This article, however, shows that business entity statutes may differ in subtle and possibly surprising ways. Courts, legislators, and commentators may overlook the distinguishing features, with unfortunate results. This article focuses on the differences between partnerships and corporations that made the former available for reverse limited liability. Essentially, rather than partitioning pools of assets from different groups of creditors, thereby providing monitoring and risk-assessment efficiencies, partnerships are being used to protect an individual debtor from the claims

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[6] *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organization Law*, 110 YALE L.J. 387 (2000).

[7] *Id.* at 394-96.

of their personal creditors. I refer to this as "reverse limited liability" because the concept uses a business entity to protect an individual against personal debts instead of protecting the individual against the debts of his firm.

The protection in this situation does not arise from the limited liability feature of modern partnership-type forms like the limited liability company (LLC), limited partnership (LP) or limited liability partnership (LLP). When used as reverse limited liability vehicles, these entities do not generate significant liabilities. Their function, rather, is simply to hold assets. Accordingly, it should make little difference to creditors whether these asset-holding entities have limited liability. The rapid development of these limited liability firms, however, spurred other developments that created reverse limited liability.

Reverse limited liability arises from a little-understood device called the "charging order." The specific statutory provisions dealing with this remedy are discussed below.[8] In general, this is the procedure that a creditor of a partner or member of a partnership-type firm must use to reach the partner or member's interest in the firm. The charging creditor may reach only the debtor-member's interest in the firm's distributions, somewhat like garnishment. In some partnership-type firms, the creditor may "foreclose" on the charging order and become an assignee of the debtor's interest in the firm. Yet, foreclosure gives the creditor little more than a right to the firm's distributions. While Hansmann and Kraakman focus on the assignee-creditor's right to compel liquidation as indicating a lower level of asset partitioning than in corporations, most creditors of partners or LLC members do not have this right.

More importantly, creditors of partners, unlike creditors of shareholders, lack any right to participate in management and thereby cause distributions. Partnership or LLC law, therefore, may force the member's or partner's creditors to wait forever before being able to get any cash out of the firm. By contrast, a creditor of a corporate shareholder can *attach* corporate shares and compel a sale.[9] The purchaser is a full owner of the shares, including its management rights, and rights to share in the control of distributions. This is one reason why the asset protection issue did not emerge in closely-held corporations.

Partnership and partnership-type firms are not the only types of asset protection available to debtors. There are many other ways, including securitization, by which parties can separate assets from liability-generating entities. Many of these vehicles involve the traditional use of business

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[8] *See infra* Part IV.

[9] *See infra* text accompanying note 39.

associations to create separate pools of assets that are exposed to distinct sets of debts. More pertinent to the present discussion, the law has created asset-protection trusts that exist specifically for the purposes of protecting assets.[10]

What is distinct about the use of partnership-type firms for asset protection is that, as discussed below, debtors have, in effect, adapted business entities for a use the law did not originally intend. On the other hand, this gives debtors important flexibility compared to vehicles designed specifically for asset protection. On the other hand, this article shows that reverse limited liability creates problems for creditors and challenges for courts and legislatures.

Creditors have sought relief through general equitable remedies, including fraudulent conveyance, "reverse veil-piercing" and bankruptcy. But these remedies do not provide adequate protection because they were designed to deal with fraud or similar misconduct, and not with an inherent limit on creditors' rights built into business association statutes. Accordingly, the only effective remedy is for legislatures to close the statutory gaps that created the problem.

III. BUSINESS ENTITIES AND ASSET PROTECTION

The story of reverse limited liability begins with a general discussion of the "asset-protection" industry over the last twenty years. Asset-protection schemes allow debtors to avoid liability for their own actions (and not simply as owners of a business) by placing ownership rights in their personal assets in an entity that only they can reach. The classic mechanism used is the "spendthrift trust." Historically such trusts were ineffective if established and funded by the debtor herself.[11] The advent of offshore asset-protection trusts (OAPT), however, was a major breakthrough. Beginning with the Cook Islands in 1984, island nations in the lower latitudes offered asset-protection trusts that not only could be settled by the debtor, but were also subject to limited avoidance under fraudulent conveyance law.[12]

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[10] *See infra* Part III.

[11] *See* RESTATEMENT (SECOND) OF TRUSTS § 156, cmt. c (1959).

[12] *See* James T. Lorenzetti, *The Offshore Trust: A Contemporary Asset Protection Scheme*, 102 COM. L.J. 138 (1997); Lynn M. LoPucki, *The Essential Structure of Judgment Proofing*, 51 STAN. L. REV. 147 (1998); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race To The Bottom?* 85 CORNELL L. REV. 1035 (2000); Thomas O. Wells, *Real Property, Probate And Trust Law: Domestic Asset Protection Trusts—A Viable Estate And Wealth Preservation Alternative*, 77 FLA. B.J. 44 (2003). Limitations on fraudulent conveyance law included requirements of proof of actual fraud and a short statute of limitations running from the

These laws, however, provided imperfect protection for debtors. Some noteworthy bankruptcy cases in the late 1990s indicated hostility towards applying the law under which the trust was created, particularly where the debtor established the trust fraudulently or with clear evasion of existing claims.[13] Moreover, even if U.S. courts recognized the trust, debtors risked placing their assets at the mercy of a foreign legal system and potentially unstable government.[14]

The benefits of asset protection and drawbacks of OAPTs suggested the existence of a market for domestic asset-protection trusts (DAPTs). Beginning in 1997, Alaska, Delaware, Nevada, and Rhode Island have adopted such statutes.[15] These statutes offer debtors the opportunity to put their assets into trusts protected by American law from which they can receive distributions at the trustee's discretion, but whose assets cannot be reached by the settlors' creditors.

These trusts, however, also have limitations. First, the statutes by their terms do not protect the assets from some claims, including those for child support and alimony, and personal injury or wrongful death claims arising prior to the transfer into the trust. Second, DAPTs, like OAPTs, present a risk that a court in a creditor's state, in which the debt is adjudicated, will not enforce the choice of law clause in the trust and apply the traditional rule against self-settled trusts. Debtors may avoid this problem to the extent that the forum lacks a jurisdictional nexus with the trust assets or the trustee. However, intangible property, such as corporate stock may be deemed to be located in the debtor's home state.[16] This is even more likely for an interest in a local partnership or close corporation.[17] Finally, a U.S. bankruptcy court can reach the assets of any DAPT. Although the bankruptcy court must apply "applicable" state law,[18] such law may be forum law if the local choice of law rule disregards the choice of law clause in the trust.[19]

Here is where asset-protection *partnerships* enter the picture. If debtors could protect their assets by placing them in partnership or

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date of the transfer into the trust.

[13]*See* Lawrence v. Chapter 7 Trustee, 251 B.R. 630, 642 (Bankr. S.D. Fla. 2000); Sattin v. Brooks (*In re* Brooks), 217 B.R. 98 (Bankr. D. Conn. 1998); Marine Midland Bank v. Portnoy (*In re* Portnoy), 201 B.R. 685 (Bankr. S.D.N.Y. 1996).

[14]*See* Sterk, *supra* note 12; Wells, *supra* note 12.

[15]*See* Sterk, *supra* note 12; Wells, *supra* note 12.

[16]*See* Sterk, *supra* note 12, at 1099.

[17]*Id.*

[18]*See* 11 U.S.C. § 541 (West 2004).

[19]One author was therefore quite skeptical of the value of DAPTs for asset protection, as distinguished from estate planning, purposes. *See* Wells, *supra* note 12.

partnership-type entities governed by statutes with uniform provisions and obtain APT-like protection, applicable law no longer would pose a problem. Such entities, however, are not designed for asset-protection purposes, as indicated by the fact that these entities traditionally were not available for sole-owner firms or vehicles owning non-business, non-income-producing assets. As shown in the following section, however, those statutory restrictions have disappeared. The absence of these restrictions created an opening for using partnerships as asset-protection vehicles.

Before discussing the statutory mechanisms that created reverse limited liability, it is worth analyzing why it matters. After all, asset protection is available in other forms. The fact that partnerships may have been inadvertently enlisted for asset protection is not necessarily a problem in itself. Numerous features of business entities have evolved in unpredictable ways because legal or economic developments called for old tools to be used in new ways.

It is important, however, to distinguish new solutions to transaction cost problems from devices that evade regulation. Asset-protection devices in general are ways for parties to avoid liability imposed by other law. This liability may be efficient because it addresses externalities that give rise to social costs. To be sure, that is not necessarily the case: liabilities may be imposed by judicial or legislative rules promoted by interest groups and ignorant of the availability of contractual or market internalization devices. Conversely, pro-defendant interest groups can mitigate liability by limiting the scope of liability laws or by promoting escape from those laws. One such escape is enforcement of jurisdictional choice.[20] Another mechanism is the asset-protection trust statutes discussed at the beginning of this Part.

The important point for present purposes is that *inadvertent* escape devices are least likely to be efficient because they do not result from a conscious legislative or administrative effort to balance costs and benefits. This is indicated by the very limitations that partnership-type asset-protection devices avoid, such as exceptions in domestic asset-protection trust statutes for child support and alimony claims. The fact that asset-protection partnerships do not include such exceptions is not attributable to a legislative judgment, but rather to an accident of legislative adaptation. While this does not prove that the provisions are inefficient, it does suggest that the provisions are not entitled to a presumption of efficiency.

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[20]*See* Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363 (2003).

IV. THE STATUTORY BASIS OF REVERSE LIMITED LIABILITY

This Part analyzes the rules in partnership-type firms that enable their use as asset-protection vehicles. Subpart A discusses the partnership charging order device, which has been carried over into all partnership-type firms. The charging order sharply restricts a creditors' ability to reach debtors' interests in partnerships, as compared to the rights of creditors of corporate shareholders. Subparts B and C discuss recent developments in partnership law that made the charging order available in sole-member and non-profit firms for which the remedy was not designed.

A. *Partnership Asset-Protection Rules: The Charging Order*

All partnership-type statutes restrict members' power to transfer their interests in the firm. As in corporations, partnership-type statutes prohibit individual members from transferring the firm's specific property. Partnership-type statutes go further and provide that, in the absence of contrary agreement, members can transfer only their economic rights, and not their management rights. This limitation reflects the traditionally "aggregate" nature of partnerships as an association of individuals who care about the identity of their co-members,[21] which contrasts with the sole owner and passive nature of an asset-protection vehicle.

Economic rights subject to transfer are further limited under most partnership-type statutes to the right to receive distributions. The Uniform Partnership Act (UPA) provides that the transferee is entitled to "the profits to which the assigning partner is entitled."[22] This entitlement, however, does not embrace a right to compel distribution of earnings, since an assignee may not "interfere in the management or administration of the partnership business."[23] The Revised Uniform Partnership Act (RUPA) clarifies that a transferee is permitted to receive only the distributions to which the transferor is entitled.[24] Similarly, the Uniform Limited Liability Company Act (ULLCA) provides that the member's transferable interest includes only the member's right to receive distributions.[25] These

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[21]*See* BROMBERG & RIBSTEIN, *supra* note 3, §§ 3.04(a)(1), 3.49 (1996).

[22]*See* Unif. Partnership Act § 27(1) (1914).

[23]*Id.* This is reinforced in DEL. CODE ANN. tit. 6, § 703(f) (2003), which provides that "[n]o creditor of a member shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company."

[24]*See* Rev. Unif. Partnership Act § 503(b) (1994).

[25]Unif. Ltd. Liability Comp. Act §§ 502, 503(e) (1996). *See also* PB Real Estate, Inc. v. Dem II Properties, 719 A.2d 73 (Conn. App. Ct. 1998) (holding that payments sole owners made to themselves from company assets constituted "distributions" and were subject to turnover

limitations are consistent not only with the assignee's lack of management rights, but also with restrictions on the transfer of specific firm property,[26] including undistributed profits.

Partnership-type statutes permit judgment creditors[27] to obtain attachment or a garnishment-type remedy from the court against the member's interest, which results in a charging order.[28] Whatever the ambiguities about assignees, the charging creditor gets only the right to receive distributions owing to the debtor member to the extent of the court order. Although the creditor gets an assignee's right to distributions, the charging order alone does not necessarily make the creditor the full owner of the debtor member's interest in the firm.[29] The creditor, rather, must proceed through foreclosure on the charging order under general partnership statutes, some LLC statutes,[30] and limited partnership statutes by "linkage" with the general partnership statute.[31]

There is a further question of precisely what rights or powers foreclosure gives the charging creditor. These rights arguably should depend on balancing the creditors' right to payment against the non-debtor

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order after judgment creditor abstained deficiency judgment against them). The court in *PB Real Estate, Inc.* applied the jurisdiction's statutory definition of a member's LLC interest, which includes "a member's share of the profits and losses"). *Id.* at 76 n.6 (citing CONN. GEN. STAT. § 34-101(10)).

[26]*See* Unif. Partnership Act § 25 (1914); Rev. Unif. Partnership Act § 501 (1994); Unif. Ltd. Liability Comp. Act § 501(a) (1996).

[27]The remedy is unavailable to divorced spouses under alimony decrees and others with rights against members other than those of judgment creditors, or to judgment creditors of members' assignees.

[28]*See* Unif. Partnership Act § 28 (1914); Rev. Unif. Partnership Act § 504 (1994); Unif. Ltd. Liability Comp. Act § 504(a) (1996); Rev. Unif. Ltd. Partnership Act § 703 (1985). It is not clear under the LLC statutes whether other remedies, including garnishment, are also available, or whether the charging order is the exclusive remedy. *See* LARRY E. RIBSTEIN & ROBERT KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 7.08 (2d ed. 2004). *See also* Tilcon Capaldi, Inc. v. Feldman, 249 F.3d 54 (1st Cir. 2001) (permitting creditor to execute on trust interests that had become subject to a joint venture agreement under a Massachusetts "reach and apply" statute that permits execution on intangible interests not otherwise subject to execution).

[29]*See* Banc One Capital Partners v. Russell, No. 74,086, 1999 Ohio App. LEXIS 2879 (Ohio App 1999) (holding that the trial court erred in ordering transfer of the charged interest to the creditor).

[30]*See* RIBSTEIN & KEATINGE, *supra* note 28, app. 7-1 (tabulating statutory provisions); Herring v. Keasler, 563 S.E.2d 614 (N.C. Ct. App.), *review denied*, 572 S.E.2d 431 (N.C. 2002) (applying North Carolina statute). *See also* Hopson v. Bank of N. Ga., 574 S.E.2d 411 (Ga. Ct. App. 2002) (permitting foreclosure although not explicitly provided for in the Georgia statute).

[31]*See* Baybank v. Catamount Constr., Inc., 693 A.2d 1163 (N.H. 1997) (holding that the U.P.A's enforcement mechanisms, including foreclosure and the appointment of a receiver, applied to limited partners' interests in a limited partnership).

members' or partners' need to preserve the firm's assets.[32] A general partner's creditor, therefore, cannot foreclose without showing that foreclosure will not "unduly interfere with partnership business of the non-debtor partnership."[33] As discussed above, the assignee does not have a right to interfere in management to the extent of compelling the firm to make distributions.[34] The general partnership statute instead gives an assignee the right to compel judicial dissolution of the firm, thereby to compel liquidating distributions.[35] This right is not available by "linkage" to limited partnerships.[36] In any event, the assignee's right provides a dubious benefit because the assignee holding this right (but not a mere charging creditor) may be taxed on a share of partnership income even if she does not receive distributions.[37]

A creditor of a partner or other member of an unincorporated firm, therefore, has only the right to receive distributions that the non-debtor partners or managers choose to make, not the right to compel the firm to make distributions. This might not seem to be a serious problem for creditors. Because partners are taxed on the firm's earnings whether or not they are distributed, partnerships have strong tax incentives to make distributions.[38] Restrictions on the rights of partners' creditors, however, have become a problem with recent developments in partnership law that permit the use of partnership-type firms to protect assets from creditors.

The charging order remedy available to creditors of partners should be contrasted with the *attachment* remedy available to creditors of corporate shareholders.[39] The executing creditor of a corporate shareholder gets the right to sell off the debtor's full package of management and financial rights rather than only the right to distributions. Accordingly, the purchaser (which could be the executing creditor) acquires the right to

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[32]*See* Hansmann & Kraakman, *supra* note 6.

[33]*See* Hellman v. Anderson, 233 Cal. App. 3d 840, 853 (Cal. Ct. App. 1991) (holding that a creditor can foreclose on charged interest without the consent of co-partner unless co-partner shows that foreclosure would unduly interfere with business). *But see* Madison Hills Ltd. Partnership II v. Madison Hills, Inc., 644 A.2d 363, 370 (Conn. App. Ct. 1994) (permitting strict foreclosure of partnership interest).

[34]*See supra* text accompanying note 22.

[35]*See* Unif. Partnership Act § 32(1) (1914); Rev. Unif. Partnership Act § 801(6) (1994).

[36]*See* Baybank v. Catamount Constr., Inc., 693 A.2d 1163 (N.H. 1997) (discussed *supra* note 31.

[37]*See* Rev. Rul. 77-137, 1977-1 C.B. 178.

[38]To be sure, the firm might decide to order distributions only to non-debtor partners, but this could be deemed an intent to defraud creditors, or might constitute a bankruptcy-only ipso facto provision. *See infra* text accompanying note 78.

[39]*See* Juliet M. Moringiello, *Seizing Domain Names to Enforce Judgments: Looking Back to Look to the Future*, 72 U. CINN. L. REV. 95 (2003).

force distributions. This power reflects the separation of financial and management rights of partners, which contrasts with the unitary nature of a corporate shareholder's interest. This separation may not be worth much in a multi-member firm, but these rights have value in a sole-member firm, where a *partner* would be able to achieve his asset-protection objective.

B. *Limited Liability Sole Proprietorships*

The first stage of the move toward limited liability as personal asset protection was the recognition of limited liability in partnership-based sole proprietorships. This move was a natural progression from recognition of multiple-owner firms, however, this step had unexpected results because the default rules of such firms were designed for multiple owners.

A sole proprietorship is simply a business that has a single owner—that is, one person who exercises control and receives the profits of the business.[40] The idea of limited liability for sole proprietorships is not novel, as sole proprietorship corporations long have been recognized. The recent development is making limited liability available for limited liability companies, and perhaps other types of firms, that are based on a partnership model.

One-person partnership-type firms present conceptual and practical problems. First, partnerships traditionally have been viewed as aggregates of the owners, not corporate-type entities.[41] This distinction makes it difficult to see how a one-member partnership-type firm could differ from an unincorporated sole proprietorship.

Second, partnerships, unlike corporations, always have been regarded as fundamentally based on a contract among the owners. This recognition presents obvious problems where the firm has only one owner. The Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit."[42] The drafters of the Uniform Partnership Act believed that "association" necessarily implied a type of voluntary behavior implicit in contract.[43] LLC statutes allow for the waiver of default provisions by provisions in an

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[40]The term technically could include a subsidiary corporation. The discussion in this Part, however, does not deal with that situation, as it focuses on the use of a sole proprietorship limited liability entity to shield an individual human being from liability.

[41]*See* BROMBERG & RIBSTEIN, *supra* note 3, § 1.03.

[42]*See* Unif. Partnership Act § 6(1) (1914); Rev. Unif. Partnership Act § 101(6) (1944).

[43]*See* Commissioners' Note to Unif. Partnership Act § 6, 6 U.L.A. § 23 (1969) (stating that "[i]n the domain of private law the term association necessarily involves the idea that the association is voluntary").

"operating agreement."[44] This contrasts with corporations because statutory provisions can be varied in the articles of incorporation, which has formalistically been viewed as a document between the firm and the state.[45] It is also not clear how one person can create an "agreement."[46] Several LLC statutes attempt to define away the conceptual problem by explicitly providing for one-member operating agreements.[47] But the statutory focus on an agreement continues to reinforce the inherent multiple-member nature of partnership-type firms.

Third, the *default* provisions of partnership-type statutes are based on a partnership model that implies the existence of two or more owners. These provisions include allocation of management power among members and between members and managers, sharing of profits and distributions, members' and managers' fiduciary duties to the firm or to other members, and dissolution triggered by a member's dissociation from the firm. This is not a significant problem for management and financial provisions that are intended to apply between the members, since the literal effect of the provisions, even in the absence of contractual variation, is simply to allocate all management and money to the sole owner. Problems, however, arise. When the sole or last remaining member dies, for example, the continued existence of the firm remains unclear. Although this scenario can happen in any firm by attrition, the risk is obviously increased by one-member firms. Corporations do not present this problem because the dissociation of owners from a corporation has no effect on the corporate entity. While a corporate shareholder might terminate his agency relationship with the corporation, or vice versa, the party would remain a shareholder.

The practical and conceptual problems with one-owner partnership-type firms are not insurmountable. Legislators solved the one-member operating agreement by fiat, and the last member problem by providing for a procedure whereby the firm continues if the successor to the deceased partner's interest appoints a substitute member.[48] Any remaining problems would appear to be outweighed by the advantages of extending the

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[44]*See, e.g.*, Unif. Ltd. Liability Company Act § 103 (1995).

[45]*See* Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95 (1995).

[46]*See* Mitchell F. Crusto, *Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)*, 2001 COLUM. BUS. L. REV. 381; Larry E. Ribstein, *The Loneliest Number*, 1 J. ASSET PROTECTION 46 (May/June 1996).

[47]*See* RIBSTEIN & KEATINGE, *supra* note 28, app. 4-1. Some states provide that a one-member operating agreement must be in writing, at least in some circumstances. *See id.*

[48]*See, e.g.*, DEL. CODE ANN. tit. 18, § 101 (2003); RIBSTEIN & KEATINGE, *supra* note 28, app. 11-1 (tabulating provisions).

availability of the flexible and relatively informal LLC form. Also, the two-member poses a potential trap for unwary lawyers and business people where the firm accidently fails to have multiple members. That might happen where, for example, a member has not made a required contribution or a member dissociates, causing the liability shield to fail.[49] Moreover, it may be unclear what type of interest is enough to satisfy the multiple-member requirement in other firms.

In moving toward one-member LLCs, however, legislators did not fully consider whether all of the statutory provisions were suitable for such firms. Most importantly, this oversight includes the charging order remedy. Where there are no non-debtor members with interests in continuing distributions, the owner may have no regular distribution policy. The charging creditor, lacking any role in management or power to compel dissolution, theoretically would have no recourse to the member's interest. Nor do these restrictions on creditors' rights serve to protect non-debtor members. Thus, the *combination* of one-member firms and charging orders contributed to creating the anomaly of reverse limited liability.

C. *Non-Business/Non-Profit LLCs*

The asset-protection use of partnership-type firms is enhanced to the extent that statutes permit such firms to be organized for non-business/non-profit purposes. Traditional general partnerships can be used only by a "business for profit."[50] Thus, an entity organized for passive holding of property or non-profit purposes risked being characterized as a common or joint tenancy or some other form, and therefore not subject to charging order protection of the firm's assets.

This distinction, however, has been changed in modern LLC statutes. Many LLC statutes permit an LLC to be organized for any lawful *purpose* or similar language.[51] Other statutes expressly or implicitly permit non-

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[49]*See* Peinado v. Barnett, No. A093928, 2001 Cal. App. Unpub. LEXIS 1924 (Cal. App. 1st Dist. Nov. 6, 2001) (piercing LLC veil partly on ground that firm was formed with one member at a time when statute required two or more members).

[50]*See* Unif. Partnership Act § 6(1) (1914); Rev. Unif. Partnership Act § 101(6) (1994).

[51]*See* RIBSTEIN & KEATINGE, *supra* note 28, § 4:10; ALASKA STAT. § 10.50.010 (Michie 2002); CAL. CORP. CODE § 17002 (West 2004) (lawful business activity); DEL. CODE ANN. tit. 18, § 106 (1999); ILL. COMP. STAT. ANN. § 180/1-25 (West 2004); KY. REV. STAT. ANN. § 275.1 (Banks-Baldin 2003); LA. REV. STAT. ANN. § 12:1302 (West 1994); ME. REV. STAT. ANN. tit 13, § 611 (West 1994); MASS. GEN. LAWS ch. 156C, § 6(a) (West 2004) (any lawful business, trade, profession, purpose, or activity); MISS. CODE ANN. § 79-29-8(1) (1997) (any lawful business, purpose, or activity); MO. REV. STAT. § 347.035 (2001) (lawful businesses or purposes); N.H. REV. STAT. ANN. § 304-C:7 (1995); N.Y. PARTNERSHIP LAW ch. 34 § 201 (McKinney 2004); N.C. GEN. STAT. § 57C-1-03(3) (2002) ("lawful . . . purpose or activity whether or not such trade,

profit firms.[52] These provisions arguably permit passive property-holding of assets safe from creditors, and firms with no possibility of distributions that might be reached by charging creditors. Moreover, LLC statutes limit creditors to the restrictive charging order in situations where limitations on creditor relief are unnecessary to protect ongoing business enterprises. By contrast, corporate statutes include special provisions for non-profit corporations intended to protect the public in firms where there are no owners in the conventional sense.[53]

As with single-member LLCs, a seemingly innocuous change—but one that was out of sync with the other provisions of the statute—led unexpectedly to the creation of reverse limited liability. The new statutory flexibility permitted the creation of entities for the sole purpose of holding personal assets without producing any income that charging creditors could grab. This flexibility was a critical step toward reverse limited liability.

V. JUDICIAL REMEDIES

The statutes for unincorporated firms have quickly evolved to accommodate the interests of debtors forming limited liability firms. This subpart explains how state courts have provided some relief for creditors where the statutes have been abused. These judicial remedies, however, were never designed to deal with an asset-protection device that is clearly authorized by business entity statutes. Accordingly, these remedies provide incomplete relief to creditors, while creating significant ambiguity.

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investment, purpose, or activity is carried on for profit"); OHIO REV. CODE ANN. § 1705.02 (Anderson 2004); OKLA. STAT. tit. 18, § 2002 (West 1999); WASH. REV. CODE § 25.15.70 (Michie 1994) (business or activity); W. VA. CODE § 31B-1-112(a) (Michie 2003); Unif. Ltd. Liability Comp. Act § 112(a) (1996).

[52]*See, e.g.*, Unif. Ltd. Liability Comp. Act § 101(3) (1996); MD. CODE ANN. CORPS. & ASS'NS § 4A-20 (1999); N.C. GEN. STAT. § 57C-1-03(3) (2002); VA. CODE ANN. § 13.1-1008 (Michie 1999). *See also* TENN. CODE ANN. §§ 48-101-701 to -708 (2002) (providing for Nonprofit Limited Liability Company Act).

[53]This principle may bar non-profit LLCs in some states. *See* OHIO REV. CODE ANN. § 1705.02 (Anderson 2004).

> A limited liability company may be formed for any purpose or purposes for which individuals lawfully may associate themselves, except that, if the Revised Code contains special provisions for the formation of any designated type of corporation other than a professional association, a limited liability company shall not be formed for the purpose or purposes for which that type of corporation may be formed.

A. *Fraudulent Conveyance*

Because the rules discussed above hinder creditors' ability to reach owners' assets that are tied up in a partnership-type limited liability firm, a transfer to an LLC might be a fraudulent conveyance. A leading example is *Firmani v. Firmani*.[54] Here, a man who owed his ex-wife $25,000 transferred his residence, in which he had $83,000 in equity, shortly before the debt came due, for a dollar to a family partnership. The partnership agreement gave the husband a one percent interest as the general partner and a ninety-four percent interest as a limited partner, while the debtor's second wife, three children, and stepson owned the remainder. The first wife sued to set aside the conveyance as a fraudulent transfer. The court agreed, reasoning that the conveyance had five of the eleven "badges of fraud" in the New Jersey fraudulent conveyance statute.[55] The court held that the defendants did not rebut the inference of fraudulent intent merely by showing that he established the partnership for "estate planning purposes" other than hindering his creditors.

Most importantly, the court reasoned that "[b]y putting plaintiff in a position where she could only recover the money owed through the Limited Partnership charging process, defendant "removed . . . assets."[56] The husband argued that "the transfer did not deprive Ms. Firmani of assets sufficient to satisfy her judgment. The transfer merely changed the type of asset against which she could assert her lien."[57] The court, however, noted that under the limited partnership act charging order procedure,

> [e]ven if plaintiff were able to secure a charge against Firmani's partnership interest, she would have to wait until a

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[54]752 A.2d 854 (N.J. Super. Ct. App. Div. 2000).

[55]*See* N.J. STAT. ANN. 25:2-26 (West 1997). The following were listed:
a. The transfer or obligation was to an insider; b. The debtor retained possession or control of the property transferred after the transfer; c. The transfer or obligation was disclosed or concealed; d. Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; e. The transfer was of substantially all the debtor's assets; f. The debtor absconded; g. The debtor removed or concealed assets; h. The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred; i. The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; j. The transfer occurred shortly before or shortly after a substantial debt was incurred; and k. The debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

[56]*Firmani*, 752 A.2d at 857.

[57]*Id.* at 858.

> distribution was made before she could collect any money, and Firmani, as the sole general partner, has sole discretion as to distributions. The partnership is not set to terminate until December 31, 2030, and the partnership agreement allows for an extension beyond that date. Moreover, Firmani has sole discretion to dissolve the partnership, and even upon his death, the other partners retain the right to vote to continue the partnership. Consequently, the conveyance of the Haddonfield property from Firmani to the Family Partnership serves to greatly hinder and delay plaintiff's ability to collect the debt Firmani owes her.[58]

Thus, *Firmani* clearly recognized the potential for abuse inherent in the charging order remedy. The relief granted in *Firmani*, however, requires a general assessment of the "badges of fraud," including such factors as concealment and pre-transfer insolvency.

Rather than going through the cumbersome fraudulent conveyance reasoning, the court may strain the interpretation of the charging order statute in order to prevent abuse like that in *Firmani*. Thus, in *Baker v. Dorfman*,[59] the court, purportedly applying the charging order procedure of the New York LLC act, gave a malpractice judgment creditor a seventy-five percent interest in the profits of the defendant's single-member professional LLC formed after plaintiff won the judgment, leaving defendant "an adequate incentive to generate future profits." This holding obviously goes substantially beyond a right in the firm's distributions. The relief was arguably justified on the ground that the post-judgment transfer was a fraudulent conveyance. But this would have necessitated wholly voiding the transfer. Moreover, *Dorfman* leaves it unclear under what other circumstances courts will adjust the charging order procedure to avoid potential abuse.

Given problems like that in *Dorfman*, the court may prefer to apply the charging order remedy literally, and leave any abuse of the statute to the fraudulent conveyance remedy. For example, *Baybank v. Catamount Construction, Inc.*[60] held that any creditor remedy "lies in fraudulent conveyance law, not in a judicially created exception to the partnership statutes."

The fraudulent conveyance remedy does not, however, quite fit the reverse limited liability situation because it covers only the transfer into the

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[58] *Id.*

[59] No. 99Civ.9385(DLC), 2000 WL 1010285 (S.D.N.Y. July 21, 2000).

[60] 693 A.2d 1163, 1168 (N.H. 1997), discussed *supra* note 31.

partnership-type entity, not the structure of the entity itself. Thus, if the debtor in *Dorfman* had the foresight to form the LLC before the judgment—or perhaps even before the claim, knowing only of the general potential for future malpractice claims—fraudulent conveyance law probably would have afforded no basis for voiding the transfer. This future planning would permit doctors and other professionals to shield assets from creditors while continuing to use them. The problem is inherent in the LLC statute rather than in the fraudulent nature of the specific conduct.

B. *Reverse Veil-Piercing*

Fraudulent conveyance law does not necessarily reach an asset-protection vehicle that is set up when the asset-owner is solvent—as where a lawyer or doctor knows there is a risk he might be subject to malpractice liability, but has not yet been hit with a judgment. In other words, there is a distinction between what might be called asset protection that is illegal per se, and moves that are illegal only in certain circumstances.

Assuming that the relevant statutes permit passive, asset-holding non-profit partnership-type entities to effectively block creditor access, there is a question whether the court might invalidate such an entity under certain circumstances. Indeed, a doctrine known as "reverse veil piercing" allows a creditor to reach a business entity of which a debtor is an owner (as distinguished from reaching owners of debtor business entities). While standard veil piercing allows an end run around statutory limited liability, or "defensive asset partitioning," reverse piercing permits an end run around statutory rules protecting business assets against owners' individual creditors, or "affirmative asset partitioning."[61]

Courts have applied reverse veil-piercing to partnership-type firms. In *Litchfield Asset Management Corp. v. Howell*,[62] a ninety-seven percent owner of an LLC who owed plaintiff $657,207.38, contributed $144,679 to the LLC after plaintiff sued. Other owners, including the debtor's daughters, contributed $10 each. Relying on traditional corporate veil-piercing rules, the court pierced the veil, emphasizing the control exercised by the majority owner, the owner's unauthorized use of company funds to pay personal expenses (instead of drawing a regular salary or distributions that a creditor might have reached through a charging order), and the owner's commingling of business and personal affairs and funds.

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[61] *See* Hansmann & Kraakman, *supra* note 6 (describing the quoted concepts).

[62] 799 A.2d 298 (Conn. App. Ct. 2002).

In *C.F. Trust, Inc. v. First Flight Ltd. Partnership*,[63] Peterson owed two creditors over $7 million. The creditors obtained judgments against Peterson and charging orders against First Flight, a limited partnership substantially owned by Peterson as well as against other entities Peterson owned. The limited partnership and other entities made transfers to a wholly-owned corporation, which made separate distributions to Peterson for his living expenses. The limited partnership operated a commercial rental property. Peterson initially owned, directly or indirectly, a ninety-eight percent limited partnership interest with the remaining two percent owned by an entity that was wholly owned by Peterson's son. Shortly after one creditor got its judgment against the debtor and the other obtained its first charging order, Peterson transferred a forty-nine percent partnership interest to his son who then owned fifty-one percent, although Peterson continued to manage the partnership. Father and son amended the partnership agreement to allow the son, as general partner, to decide on distributions. The son claimed that this implicitly eliminated the prior contractual requirement to make pro rata distributions to the owners. The son then distributed limited partnership funds to himself, but used the funds for Peterson's benefit. This arrangement enabled Peterson to get $4.3 million in partnership funds without receiving any chargeable distributions.

The Fourth Circuit observed that limited partnerships, unlike corporations, have a special rule holding limited partners liable for participating in control, and provides for a special charging order procedure for creditors of limited partners.[64] The court noted that discussion of these special limited partnership features in a Virginia veil-piercing opinion (which did not reach the veil-piercing issue)

> [l]eaves us uncertain whether, under Virginia law, the Act provides the exclusive remedy for judgment creditors of individual limited partners. Moreover, even if this constitutes the general rule, we cannot discern whether Virginia courts would allow an exception in circumstances like those in the case at hand, in which the defendant has improperly foiled the plaintiff-creditors in pursuing the remedies provided by the Act.[65]

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[63] 306 F.3d 126 (4th Cir. 2002), *opinion on certified question*, 580 S.E.2d 806 (Va. 2003). For a discussion of the case, see Leslie C. Heilman, Comment, C.F. Trust, Inc. v. First Flight Limited Partnership: *Will the Virginia Supreme Court Permit Outsider Reverse Veil-Piercing Against a Limited Partnership?* 28 DEL. J. CORP. L. 619 (2003).

[64] *C.F. Trust*, 306 F.3d at 140.

[65] *Id.*

The court also noted that *Litchfield* had ordered reverse piercing of an LLC, despite a charging order provision virtually identical to that in the Virginia limited partnership statute. The court found that the debtor had circumvented the charging order procedure by avoiding making distributions. Given these authorities cutting in opposite directions, the court certified to the Virginia Supreme Court the question whether Virginia law would permit reverse piercing against the limited partnership under the facts of this case.

The state court held that Virginia law would permit reverse veil piercing under the general Virginia corporate veil-piercing standard. That test required showing that the limited partnership "has been controlled or used by the debtor to evade a personal obligation, to perpetrate a fraud or a crime, to commit an injustice, or to gain an unfair advantage."[66] The court must consider the impact of piercing on innocent partners and creditors, and "the availability of other remedies the creditor may pursue."[67] The court did not make an explicit exception to veil-piercing for limited partnerships, although it indicated that the creditor's "other remedies," such as the charging order remedy, may be relevant.

C.F. Trust indicates that, while the limited partnership control rule and charging order remedy do not preclude veil-piercing, the creditor will be remitted to these remedies unless it can show some abuse. This abuse might include the debtor's use of control to prevent the creditor's access to distributions, as in both *Litchfield* and *C.F. Trust.* Moreover, *C.F. Trust* shows that a court will reverse-pierce even if the debtor is not the sole owner, at least where the other owner (in this case the son) is complicit in the scheme.

These partnership reverse piercing cases leave significant questions concerning the circumstances in which the court will pierce. Tto begin with, it is not clear whether the courts will follow corporate reverse piercing cases. Some of these cases have refused to apply this remedy because of the need to protect innocent non-debtor owners of the corporation and the availability of other creditor remedies, presumably including attachment.[68] Neither justification for reluctance to pierce may exist in a partnership case, where the asset-holding entity is a sole proprietorship or family-owned non-profit firm, and the charging order blocks the creditor from access to the firm's assets.

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[66]*C.F. Trust, Inc.*, 580 S.E.2d at 811.

[67]*Id.*

[68]*See In re* Blatstein, 192 F.3d 88, 100 (3d Cir. 1999); Cascade Energy & Metals Corp. v. Banks, 896 F.2d 1557, 1576 (10th Cir. 1990); Acree v. McMahan, 585 S.E.2d 873, 875 (Ga. 2003).

On the other hand, reverse piercing arguably ought to be precluded in partnership cases in the absence of fraud because asset protection is built into the partnership statutes. Courts, therefore, should not pierce without a commingling of business and personal funds or other failure to maintain the asset-holding firm as a distinct entity, and where there is no indication of a fraudulent conveyance as in *Litchfield* and *C.F. Trust*. If sole ownership by the debtor or lack of distributions justifies piercing, the court's actions would contradict clear statutory authorization of these structural elements. This situation differs from the type of abuse of established statutory forms that veil-piercing remedies are designed to deal with. Because the statute provides protection, it would seem that debtors will be able to accomplish significant asset protection simply by avoiding blatant misconduct.

C. *Bankruptcy*

When a partner or LLC member becomes a debtor in bankruptcy, his partnership interest becomes part of his bankruptcy estate. It logically follows, applying partnership law as to the nature of this interest, that the bankruptcy trustee does not control specific partnership or LLC property, but simply has financial rights in the firm's distributions.[69] Partnership-type firms can be expected to seek to expel the bankrupt member or to dissolve in this situation because bankruptcy significantly changes the member's incentives and willingness to perform his obligations.[70] This change is particularly evident in a traditional general partnership, where the partners may have to personally shoulder debts created by their bankrupt partners. Likewise, members of limited liability firms rely on co-members' personal guarantees or ability to make continued capital contributions. Thus, on bankruptcy of a partner, the Uniform Partnership Act provides that the partnership is dissolved.[71] RUPA provides for *dissociation* of the bankrupt partner,[72] as well as *dissolution* if the partnership is at will, or if it is for an unexpired term or undertaking and at least half of the non-debtor partners vote to dissolve.[73] The partnership agreement, in either case, may prohibit

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[69]*See, e.g.*, *In re* Buchman, 600 F.2d 160 (8th Cir. 1979); BROMBERG & RIBSTEIN, *supra* note 3, § 7.05(b)(1); RIBSTEIN & KEATINGE, *supra* note 28, § 14:4.

[70]*See* BROMBERG & RIBSTEIN, *supra* note 3, § 7.05.

[71]*See* Unif. Partnership Act § 31(5). This is technically a change in the partners' relationship under Unif. Partnership Act § 29, which that section defines as a dissolution.

[72]*See* Rev. Unif. Partnership Act § 601(6)(i).

[73]*Id.* § 801(1)-(2).

dissolution or dissociation in the event of partner bankruptcy.[74] Many LLC statutes provide for dissociation by a bankrupt member in the absence of contrary agreement,[75] but generally not for dissolution.

The problem with dissolution or dissociation on bankruptcy is that the debtor partner's or member's creditors may rely on the debtor's continued association with the firm to produce income for the bankruptcy estate.[76] Accordingly, they may resist dissociation of the bankrupt debtor partner. A partnership is generally treated as an executory contract under bankruptcy law that the trustee or debtor in possession can assume or reject.[77] State law governs the trustee's right to assume or reject the partnership, unless the applicable state law or agreement is characterized as an "ipso facto" provision that is triggered by bankruptcy and therefore deemed to be an unlawful attempt to avoid the effects of federal law. In this situation, it has been held that the bankrupt partner may be able to continue as such notwithstanding bankruptcy, which might otherwise terminate the interest under the partnership statute or a partnership agreement.[78]

Different issues arise in the case of reaching a debtor partner's interest in an asset-protection partnership. In this situation, there is nothing that can be characterized as an "ipso facto" clause because the debtor seeks to continue operating in bankruptcy. Moreover, unlike in the ipso facto cases, the issue here is between the *debtor* and the creditors, rather than between the creditor and the non-debtor partners. Indeed, there may be no "executory contract" in a single member LLC even if there is an "operating agreement" in this situation[79] because a single member does not have

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[74]*See id.* § 103(a).

[75]*See, e.g.*, Unif. Ltd. Liability Comp. Act § 601(1) (1996).

[76]Where the debtor partner is not receiving continuing income, as through management fees, it may be enough for his creditors that he is cashed out of the firm on becoming bankrupt.

[77]*See, e.g.*, Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 610 (1st Cir. 1995); *In re* Siegal, 190 B.R. 639, 643 (D. Ariz 1996); *In re* Corky Foods Corp., 85 B.R. 903, 904 (S.D. Fla. 1988); *In re* Sunset Developers, 69 B.R. 710, 713 (D. Idaho 1987). *But see In re* Phillips, 966 F.2d 926, 935 (5th Cir. 1992) (holding that a partnership was not an executory contract after dissolution and 90-day winding up period under final judgment).

[78]*See* 11 U.S.C. § 365(e)(1) (2000). *See also id.* §§ 541(c)(1), 363(1) (providing, respectively, that the bankrupt partners' rights are part of the debtor's bankruptcy estate and may be used, sold, or leased by the bankruptcy trustee). *See generally* BROMBERG & RIBSTEIN, *supra* note 3, § 7.05 (noting causes of dissolution); RIBSTEIN & KEATINGE, *supra* note 28, § 14:4 (discussing effect of bankruptcy on LLCs); Larry E. Ribstein, *Partner Bankruptcy and the Federalization of Partnership Law*, 33 WAKE FOREST L. REV. 795 (1998) (discussing the collision of state partnership law with federal bankruptcy law as applciable to bankrupt partners).

[79]*See supra* note 46.

contractual obligations to co-members.[80] The bankruptcy estate, as a result, would simply own the debtor's interest in the partnership, subject to whatever state law rights accrue to that interest. The bankruptcy trustee or debtor in possession may have no greater right to receive distributions from the firm than a charging creditor would outside of bankruptcy.

This analysis sets the stage for the first comprehensive consideration of a bankruptcy court regarding creditors' rights in connection with an asset-protection partnership. In *In re Albright*,[81] the debtor was the sole member and manager of a Colorado LLC that owned real property, but was not itself a debtor in bankruptcy. The trustee claimed that he controlled the LLC and held the right to sell the LLC's property and distribute the proceeds to the estate. The debtor argued, consistent with the above analysis, that the trustee was entitled only to a charging order and the financial rights that entailed, not to management rights in the LLC. Moreover, these financial rights did not embrace any distributions: since the LLC was "'non-profit' pursuant to its operating agreement, no distribution of 'profit' will ever be made and thus the value of this interest is zero."[82] The court accepted the trustee's argument, holding that it "now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets."[83]

Although the court purported to reach its decision under the Colorado LLC act, the court actually stretched or ignored several aspects of LLC law. First, with regard to the nature of the trustee's rights in a "non-profit" LLC, the court observed that the Colorado act defined a membership interest in an LLC, which was part of the bankruptcy estate, to include "a member's share of the profits and losses of a limited liability company."[84] Second, the court held that, as a result of the bankruptcy filing, the trustee became a "substituted member" under the Colorado LLC Act.[85] The court reasoned that the Act requires the unanimous consent of "other members" in order to allow a transferee to participate in the management of the LLC, and, in this case, there were no other members.[86] The trustee, a substituted member, then could exercise the debtor's right to control the management

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[80]*See In re* Smith, 185 B.R. 285 (S.D. Ill. 1995) (holding that a limited partnership is not an executory contract because the limited partner is only a passive capital contributor).

[81]291 B.R. 538 (D. Colo. 2003). For a discussion of the case, see Thomas E. Rutledge & Thomas Earl Geu, *The Albright Decision—Why an SMLLC is Not an Appropriate Asset Protection Vehicle*, 5 BUS. ENT, at 16 (Sept./Oct., 2003).

[82]*Albright*, 291 B.R. at 539 n.3.

[83]*Id.* at 539.

[84]*Id.* (quoting COLO. REV. STAT. § 7-80-102(10) (2003)).

[85]*Id.* at 540.

[86]*Albright*, 291 B.R. at 540 (quoting COLO. REV. STAT. § 7-80-702).

of the LLC.[87] Third, the trustee was not remitted to a charging order under state law because the charging order was intended only to protect other members of the LLC from interference by the debtor's creditors and does not apply where there is only a single member.[88]

There are several problems with the court's analysis of state law. Despite the court's contortions, the trustee was no more than an assignee of the debtor's interest. Applying state law, the trustee was entitled only to a right to the firm's distributions.[89] Moreover, there is no exception under state law that would permit the trustee to exercise management rights in the absence of non-debtor member of the firm. The statutory provision that makes the transfer of management rights subject to an objection by another member of the firm[90] clearly refers only to an assignee who obtained his rights from "a member who has died or has assigned his interest in a limited liability company."[91] The statute's charging order provision applies separately to the rights of a creditor of the debtor member. Similar to other state partnership and LLC charging order provisions, the statute provides that "[t]o the extent so charged, except as provided in this section, the judgment creditor has only the rights of an assignee of the membership interest. The membership interest charged may be redeemed at any time before foreclosure."[92] The statute, therefore, gives "the rights of an assignee" to a judgment creditor who has obtained a charging order. The judgment creditor of a sole member might become an assignee by foreclosure,[93] thereby becoming a full member under the court's analysis.[94] But a debtor partner's creditor, and by inference a trustee exercising the rights of a creditor in bankruptcy, are not assignees under the provision relied upon by the court. That would be the case even if the creditor had obtained a charging order. But in *Albright,* no creditor had done so.

The rights the court gave the trustee in *Albright* could only come from bankruptcy law and not from state law. The court effectively held that

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[87]*Id.*

[88]*Id.* at 541.

[89]*See* COLO. REV. STAT. § 7-80-102(10) (2003). Even assuming that the statutory definition of membership interest controls over the provision specifically dealing with assignees, and therefore entitled the trustee to "profits" (see note 3 of the court's opinion), there were none in this case.

[90]COLO. REV. STAT. § 7-80-702(2).

[91]*Albright*, 291 B.R. at 540 n.5.

[92]*Id.* at 541 n.8.

[93]*See* BROMBERG & RIBSTEIN, *supra* note 3, § 7.05(d)(4).

[94]Alternatively, the statute may provide that assignment of the member's interest causes dissociation of the member and thereby dissolution and liquidation of the firm. *See* Rutledge & Geu, supra note 81, at 20 n.18.

bankruptcy law makes the trustee an assignee with the full rights under state law of an assignee who obtained his rights by voluntary transfer or death. But there appears to be no Bankruptcy Code provision that would have this effect, and no clear federal policy that this result would effectuate. Creditors' interest in enlarging the bankruptcy estate does not necessarily trigger a federal right.[95] To the extent that the debtor is using the partnership to evade creditors, this sounds like the interest underlying state fraudulent conveyance remedies.[96]

The ambiguous basis for the court's decision raises several questions about the application of the case to other facts. First, will the court require equitable grounds for ignoring state law restrictions on creditor rights? It has been noted that *Albright* "seems to allow a 'reverse piercing' of the LLC without the showings usually required for a piercing claim."[97] Yet the court's ruling might have been motivated by the creditor's apparent effort to evade creditors. Would the result have been the same if the LLC had been a for-profit going concern that produced distributions, but not enough proceeds to satisfy the creditors' claims?

Second, the case arose as a result of a voluntary filing, where there had been no creditor effort to obtain a charging order against the LLC. These facts indicate that the debtor may have tried to use bankruptcy to foil creditors, which may or may not be a prerequisite for the relief granted in *Albright*. If the bankruptcy proceeding had been initiated by a charging creditor, or apart from the party who initiated the proceeding there had been a charging order, then the court might have deemed itself bound by the charging order provision of the statute. The charging order provision, as discussed above, is a weaker basis than the assignment provision for the relief the court ordered.

Third, and perhaps most importantly, the case is clearly limited to the single-member situation. The court observed:

> The harder question would involve an LLC where one member effectively controls and dominates the membership and management of an LLC that also involves a passive member with a minimal interest. If the dominant member files bankruptcy, would a trustee obtain the right to govern the

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[95] *See generally* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986) (suggesting a balance between bankruptcy law and other concerns, particularly, limits on creditor access); Ribstein, *supra* note 78 (necessitating the careful weighing of the federal interest against federal interference).

[96] JACKSON, *supra* note 95, at 146-50.

[97] *See* Rutledge & Geu, *supra* note 81, at 20.

> LLC? Pursuant to Colo. Rev. Stat. § 7-80-702, if the non-debtor member did not consent, even if she held only an infinitesimal interest, the answer would be no. The Trustee would only be entitled to a share of distributions, and would have no role in the voting or governance of the company. Notwithstanding this limitation, 7-80-702 does not create an asset shelter for clever debtors. To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with "peppercorn" co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse.[98]

It follows that the result would have been different in a family partnership, even including a situation like *Litchfield* where the non-debtor interest in the firm was nominal. In that case, the creditor would have to fall back on the common law remedies discussed above.

Fourth, under what circumstances will the court ignore state statutory provisions or agreements in favor of some unspecified bankruptcy policy? The court clearly would not respect an operating agreement that explicitly precluded a bankruptcy trustee from exercising the rights and powers of an assignee. What if the agreement simply gave management powers to a different person from the sole owner-debtor, and provided that only the manager could make distributions? Many LLC statutes, in the absence of an explicit agreement, permit only a manager to exercise management rights in a manager-managed LLC.[99] If the debtor is both manager and owner, it is not clear that the bankruptcy trustee would take by assignment the debtor's rights as manager in addition to those as member.

In bankruptcy cases, as with the other remedies discussed in this Part, courts have been forced to adapt a remedy to deal with a situation for which it is ill-suited. The situation in *Albright* theoretically might seem to be better redressed through explicit application of traditional state remedies than by a federal court trying to shoehorn its preferred result into the state LLC statute. The problem, as indicated above in this article, is that no state remedy is appropriate because the asset protection was explicitly permitted

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[98] *Albright*, 291 B.R. at 541 n.9 (citing 11 U.S.C. §§ 544(b)(1), 548(a) (2000)). *See also* Herring v. Keasler, 563 S.E.2d 614 (N.C. Ct. App.), *review denied*, 572 S.E.2d 431 (N.C. 2002) (denying charging creditor's motion to seize and sell the membership interests, relying in part on a North Carolina statutory provision requiring consent of all members to admit a member).

[99] *See* RIBSTEIN & KEATINGE, *supra* note 28, app. 8-1; Rutledge & Geu, *supra* note 81, at 20.

by the applicable statute. The appropriate solution, therefore, lies in fixing the statute.

D. *Tax Rules*

Some creditor protection might be achieved indirectly by denying tax benefits that are sometimes sought through asset-protection vehicles. In *Estate of Strangi v. Commissioner*,[100] the tax court ruled that a family limited partnership set up carefully to minimize the value of a decedent's estate did not have the intended effect. The partnership, because of the decedent's retention of control over the property, was a testamentary disposition.[101]

In *Strangi*, the decedent's attorney, who was also his son-in-law, set up a family limited partnership at a time when decedent was expected to live no more than two years, after learning at a seminar about the use of such vehicles for estate planing and asset protection. Decedent held a ninety-nine percent limited partnership and a corporate general partner, Strangi held the remaining one percent while given full power to manage. The partnership agreement provided for distributions of income at the general partner's discretion after deduction for certain expenses "taking into account the reasonable business needs of the Partnership."[102] This agreement also provided for dissolution under limited circumstances prior to 2014. Decedent, through his attorney, transferred $10 million, approximately ninety-eight percent of his wealth, to the partnership. Decedent purchased forty-seven percent of the corporate general partner and his children purchased fifty-three percent for a combined amount of approximately $100,000. The corporate general partner then bought a one percent general partnership interest. Decedent and his children were the initial five directors of the corporation, while the son-in-law/attorney managed under a management contract. The partnership paid for decedent's health and other expenses. On death the government claimed a deficiency in the amount of the difference between the amount claimed as the value of the partnership interest and the value of the assets in the partnership.

The tax court initially held that the partnership was valid under state law and would be recognized for estate tax purposes, and denied the government's deficiency claim. The Fifth Circuit remanded with

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[100]2003 Tax Ct. Memo LEXIS 144 (May 20, 2003).

[101]For an analysis of the decision, see Susan Kalinka, *Estate of Strangi II: IRS Wins Another Battle in Its War Against, FLPs*, 100 TAX NOTES 4, at 545 (July 28, 2003) (predicting that the case would cause the FLP "to lose much of its attraction as an estate planning tool").

[102]*Estate of Strangi*, 2003 Tax Ct. Memo LEXIS 144, at 7.

instructions to consider the government's claim under Section 2036.[103] That section provides:

> (a) General Rule.—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—
>
> (1) the possession or enjoyment of, or the right to the income from, the property, or
>
> (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.[104]

The court observed that "[t]he general purpose of this section is 'to include in a decedent's gross estate transfers that are essentially testamentary' in nature."[105]

Following the Fifth Circuit remand, the tax court upheld the government's claim. The court first held, despite observing the requisite formalities, that the decedent had retained income under Section § 2036(a)(1), based primarily on transfer of ninety-eight percent of his wealth and continued use of the transferred funds and property. Decedent, pursuant to Section 2036(a)(2), also retained the right to designate those who possess or enjoy the property or its income. Despite the limited partner's lack of control under the limited partnership act, decedent effectively could decide who got distributions. His power was not limited by an independent trustee. Rather, decisions were made by the decedent's attorney in fact, decedent's son-in-law, whom decedent effectively controlled. Moreover, as the partnership held only money and investment assets, distributions were not effectively constrained by business realities. While the manager was technically subject to fiduciary duties to the corporate general partner and the partnership, his main duty was as decedent's personal attorney. The corporate general partner's fiduciary duties were essentially to the decedent as the ninety-nine percent owner.

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[103] I.R.C. § 2036 (West 2004).

[104] *See id.* § 2036(c).

[105] *Strangi*, 2003 Tax Ct. Memo LEXIS 144, at 19 (quoting Ray v. United States, 762 F.2d 1361, 1362 (9th Cir.1985) (quoting United States v. Estate of Grace, 395 U.S. 316, 320 (1969)).

Decedent's duties to his children did not create a realistic constraint, and the charity holding a gratuitous one percent interest did not exercise meaningful oversight. Finally, the court held that, in the absence of meaningful bargaining, the decedent had not engaged in a transfer of his property for consideration.

The important question for present purposes is whether the tax rules applied in *Strangi* should or will be applied by courts in constraining asset-protection partnerships. Some of the principles in this case are relevant to the reverse limited liability problem. In particular, the decedent's transfer of most of his wealth without arm's-length bargaining, his effective control over distributions, and lack of business motivation for making such distributions, relate as much to creditor protection as to whether there has been a delayed testamentary-type transfer.[106] Thus, a byproduct of *Strangi* may be to reduce the more blatant use of partnership-type entities for reverse limited liability to the extent that these entities are asset protection and estate planning devices, as was apparently the case in *Firmani*.[107] A debtor who complies with *Strangi* rules regarding distributions and business purpose, will likely avoid asset recapture for the benefit of creditors unless the transfer to the limited partnership could be considered a fraudulent conveyance—that is, occurred while the debtor was insolvent and was for inadequate consideration. However, it is not clear that a debtor, who sets up an asset-protection partnership for non-business purposes and retains full control over distributions while fully solvent and not under any judgment threat, should be subject to asset recapture for the benefit of creditors merely because the assets would be in his estate for the government's benefit at death. Also, *Strangi* obviously does not apply to a sole member firm without estate planning implications. A remedy adapted from other applications creates ambiguities when applied to straighten out the statutory mess inherent in reverse limited liability.

VI. IMPLICATIONS AND CONCLUSIONS

This article serves two purposes. First, it describes a potentially important emerging phenomenon of reverse limited liability in which conventional business association statutes are used to insulate individual

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[106]Post-*Strangi* cases have emphasized the business motivation for the transfer. *Compare* Kimbell v. United States, 371 F.3d 257 (5th Cir. 2004) (recognizing for estate tax purposes a transfer of working oil and gas interests to a family partnership that provided, among other things, centralized management and protection from liabilities) *with* Estate of Thompson v. C.I.R., 382 F.3d 367 (3d Cir. 2004) (refusing to recognize transfer of assets to family limited partnership where the partnership was not a functioning business enterprise).

[107]*See supra* text accompanying notes 54-58.

owners from their own personal debts. Second, and more broadly, it uses reverse limited liability to illustrate the proper approach to designing business association statutes. Reverse limited liability is created by a flaw in the recent evolution of partnership-type business entities. The scope of these statutes was expanded to include single-member, non-profit firms for which the terms of the statutes were unsuited. The problem arose when the charging order remedy, which was intended to balance the rights of creditors and non-debtor owners of for-profit firms, became an asset-protection mechanism. This device did not have the benefit of the same legislative balancing that was done for devices explicitly designed for asset protection.

The cases discussed in Part V show that judicial remedies for reverse limited liability are inadequate. These remedies require adapting devices intended to fix abuses of an appropriate legislative goal—i.e., limited liability—to undo a structure that clearly complies with applicable law. The courts must apply concepts such as fraud that only touch the edges of the problem. The only effective remedy, therefore, is to revise the statute.

The most direct statutory solution would undo the change that caused the mess. In other words, legislatures arguably should withdraw authorization of single-member non-profit LLCs. This action, however, would be costly because it would either jeopardize the validity of many firms already formed according to law, or require an extensive grandfathering period.

The best approach would address the specific symptom and limit the application of the charging order remedy to the multiple-member for-profit firms for which the remedy was initially designed. This fix would leave some uncertainty concerning the definition of multiple members. Further, the remedy would create the potential for misuse of the charging order in for-profit firms that have multiple members, yet are abused as asset-protection devices. The courts, however, are capable of policing fraud and other misuse of statutory devices.

Reverse limited liability has two broader lessons. First, legislatures should exercise care in adopting provisions or changes to ensure that they mesh with the rest of statute. As this article has emphasized, the basic problem with reverse limited liability is that partnership statutes were never designed to be used in single-member, non-profit firms. Even if the suggested statutory changes fix the immediate problem, other problems may lurk when a statute is stretched beyond its theoretical core.

Second, this discussion has implications for the "entity rationalization" project. Entity rationalization seeks to eliminate separate business association statutes and produce menus of alternative provisions

that can be mixed or matched at will.[108] The problem inherent in reverse limited liability, however, was the poor fit of single-member/non-profit provisions with the charging order. This problem may become endemic if legislatures abandon coherent frameworks in favor of mixing and matching.

[108] *See generally* Ribstein, *supra* note 5 (discussing various rationalization approaches).