Originally appeared in Estate Planning, a Thomson Reuters publication.

Why Foreign Limited Liability Companies are Ultimately More Protective than Domestic Limited Liability Companies

Planning considerations when looking at LLCs.

ERIC R. KAPLAN

Over the past few decades, various strategies have been designed and implemented to assist clients with preserving their assets from unforeseen creditors. As asset preservation planning continues to be of increased importance and value to clients, regardless of their overall net worth, estate planning and asset preservation practitioners regularly recommend the use of a limited liability company (LLC) to their clients to convert assets creditors find attractive into one large unattractive asset. A creditor is generally less than thrilled to inherit an LLC in a lawsuit, even if the creditor could successfully take over ownership or control of such LLC.

This article introduces the reader to limited liability companies (both domestic and foreign), and thereafter discusses the reasons why a foreign LLC is ultimately more protective from an asset preservation standpoint as compared to a domestic LLC.

In the United States, the LLC's roots are traced to 1977, when Wyoming enacted the nation's first LLC statute, permitting the formation of a "limited partnership-type" entity wherein there was no flow-through of liability to any owner. This differs from a standard limited partnership in that a limited partnership's general partner has unlimited liability for the limited partnership's debts and obligations. In the same vein that a limited partnership has partners, an LLC has members. Further, as a limited partnership will have one or more general partners and one or more limited partners, an LLC will have one or more managers and one or more members.

From an asset preservation standpoint, the LLC has proven to be highly effective in that it traps liability at the entity level like a corporation, while at the same time is not taxed like a corporation for federal income tax purposes. As such, the LLC is an ideal candidate when it comes to the question of what type of planning vehicle in a client's planning structure should hold assets that themselves have the potential for generating liability. LLCs not only provide protection against a creditor reaching into an LLC and accessing its assets, but any liability that may arise from the assets (known as "hot" assets) themselves in the LLC (e.g., a "slip and fall" at an apartment building owned by the LLC, a distribution from an LLC that can later be clawed back when that LLC goes into bankruptcy)[1] is better contained, as only those assets in the LLC are exposed. A firewall, therefore, exists against having that liability spread to other LLCs (and their assets) that are owned by the client. Limiting liability is a good reason to separate hot assets from other assets, as well as keeping hot assets isolated from "cold" assets.[2] Simply stated, a "hot" asset could be the source of injury to a person, whereas a "cold" asset could not cause injury to another person.

Transferring assets into an LLC provides a layer of asset protection. Protection is provided through what

ERIC R. KAPLAN, Esq., is Senior Counsel in the International Wealth and Asset Planning Group of the Denver, Colorado office of Greenspoon Marder LLP.

is known as the "charging order" restrictions imposed upon a creditor. A charging order is a statutorily created means for a creditor of a judgment debtor who is a member with others to reach the debtor's beneficial interest in an LLC. It is similar in result to an assignment of income because future distributions that would otherwise be made to the debtor-member are instead to be made to the creditor who obtained the charging order. A creditor may be held at bay in getting to an LLC's assets until such time as such assets are distributed to the debtor. If a client is the debtor and the LLC's manager, the client would continue to be in control of when (and if) such a distribution is ever made.[3]

Charging order protection is state specific. For example, Arizona's LLC charging order statute provides that charging order protection is the exclusive remedy that a judgment creditor of a member may use to satisfy a judgment out of the debtor-member's interest in the LLC.[4] Conversely, Colorado's LLC charging order statute provides that a judgment creditor has more than one way to collect against a judgment debtor, namely via a charging order *or* via a court-ordered sale/foreclosure on the debtor's interest.[5] Arizona's charging order statute is clearly more beneficial to a debtor from an asset preservation perspective. The difference in available remedies to judgment creditors in these two states demonstrates how LLC charging order legislation is both state specific as well as multi-faceted. Although Arizona's charging order statute provides a higher level of asset preservation than Colorado's charging order statute, it should be noted that in either of these two states, a creditor cannot simply "step into a manager's shoes" and seize control of an LLC's day-to-day operations. Therefore, it can be difficult for a creditor to be able to seize upon an LLC's assets.

The downside with using an LLC is that a charging order can also prevent a client from receiving distributions from the LLC without having to hand that distribution over to the creditor with the charging order, thereby becoming a waiting game of who can last longer. If the LLC has only one member (e.g., the client), however, the charging order remedy may be less effective. For example, Colorado and Florida courts have previously ruled that in certain situations (such as bankruptcy), the charging order does not act as a shield to the creditors in single-member LLC situations.[6] Additionally, federal law (such as in bankruptcy) can preempt state law charging order protections.

Another plausible scenario that puts a creditor at a disadvantage is if the creditor obtains a charging order from a court, and the creditor is thereafter allowed by such court to exercise additional powers, the creditor could be taxed on the LLC's income *even though that creditor could not force any distributions to be made to the creditor.* If a member is subject to being taxed on an LLC's undistributed profits,[7] then the judgment creditor of such member is also subject to being taxed. In Revenue Ruling 77-137,[8] the IRS provided an example in the context of a limited partnership (as opposed to an LLC) whereby A, a limited partner in a limited partnership, assigned his limited partner interest to B. The partnership agreement provided that assignees of limited partners may not become substituted limited partners without the general partners' written consent. The partnership agreement also provided that a limited partner may, without the general partners' written consent, irrevocably assign to another the right to share in the partnership's profits and losses and to receive all distributions to which the limited partner would have been entitled had the assignment not been made. In his assignment to B, A agreed to exercise any residual powers remaining in A solely in favor and in the interest of B. The IRS held that even though the general partners did not consent to the assignment, because B acquired substantially all control over the limited partner interest, for United States federal income tax purposes, B was to be treated as a substituted limited partner. Therefore, B was required to report the distributed share of partnership items of income, gain, loss, deduction, and credit attributable to the assigned interest on B's federal income tax return in the same manner and in the same amounts that would be required if B was a substituted limited partner. Furthermore, even if a distribution is made, depending on the facts, the creditor may only be able to attach up to 25% of any such distribution.[9] Clearly, these options found in most domestic states may be unattractive for a creditor.

Practitioners would be remiss if they do not present the option of creating and funding an LLC located in a foreign jurisdiction that avails itself of

1 Other examples of "hot" assets include aircrafts, boats, vehicles, stock in a corporation that is open to a "piercing of the corporate veil" ruling, a personal residence, and a general partner interest in a limited partnership that owns hot assets or that engages in activities that could cause liability.

2 "Cold" assets are assets that would not have an inherent source of liability, such as a treasury bond, which, by its nature, does not cause liability.

3 Note, however, that the absence of any distributions being made to the debtor-member is the preferred scenario, as that can result in the overall planning structure being more protective. Any history of distributions to the debtor-member can be argued as evidence of the debtor-member's access to the LLC's assets. It is better to place fewer assets into the overall planning structure than to put in so many assets that the client/debtor-member has a desire or need for distributions. Also, it should be noted that having an independent third party serve as the LLC's manager can be more protective because the client/debtor-member is then unable to easily withdraw funds from the LLC.

4 See Arizona Revised Statutes section 29-3503(E) (2022).

5 See Colorado Revised Statutes section 7-80-703 (2022).

6 See *In re Ashley Albright,* 291 B.R. 538 (Bankr. D. Colo. 2003), and *Federal Trade Commission v. Olmstead,* 44 So.3d 76 (Fla. 2010), both cases of which are beyond the scope of this article.

7 Also known as "phantom income."

8 1977-1 C.B. 178.

9 Note that such attachment percentage varies state-by-state under certain wage garnishment rules.

a potentially even higher level of asset preservation over such contributed assets. Foreign LLCs can offer stronger protections than their domestic counterparts because there are no preemption issues and fewer choice of law risks that could otherwise assist a creditor. Also, a foreign LLC makes it more expensive for a creditor to pursue an action against a client.

LLCs domiciled in Nevis, the Cook Islands, or Belize are highly effective options that can be used by United States clients. For example, to bring any legal action against the assets of a Nevis LLC, the plaintiff/creditor may need to first provide a bond to proceed.[10] Even then, a charging order expires three years after the date the order is entered and is nonrenewable.[11] Additionally, the charging order is the sole remedy available to any creditor of a member's interest, whether the LLC has one or multiple members.[12] In fact, Nevis law also provides that if an individual creates and funds a Nevis LLC, a fraudulent transfer is very difficult to demonstrate because the value of the LLC interest received in return for the assets contributed to the LLC is deemed of equal value under Nevis law, which by definition precludes the transfer from being a fraudulent transfer.[13] Additionally, Nevis law specifically states that no judgment obtained in a foreign domicile shall be recognized or enforced by the Nevis High Court.[14] In Nevis, a creditor's burden of proof is the more stringent "beyond a reasonable doubt" standard as opposed to other jurisdictions that have a lesser burden of proof by "a preponderance of the evidence" standard.[15]

The Cook Islands have similar laws with respect to Cook Islands LLCs.[16] A charging order is the sole and exclusive remedy available to a creditor with respect to a member's membership rights.[17] Similar to Nevis, no member's rights or interest in a Cook Islands LLC are capable of being seized, charged or levied upon, or taken in execution by or under any form of judicial process.[18] Additionally, Cook Islands law specifically states that no judgment obtained in a foreign domicile shall be recognized or enforced by a Cook Islands court.[19] Moreover, the Cook Islands LLC law keeps information confidential on who is manager or owner of such LLC.[20]

Under Belize law, before a plaintiff can pursue a Belize LLC's assets, the plaintiff must deposit cash in the amount of the greater of $50,000 or one-half of the claim being sought.[21]

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Furthermore, Belize has a duress provision that shifts control away from anyone who is being coerced to act against his or her own free will (assuming that affected parties are aware of the duress event).[22] For example, if there are U.S. and Belize persons serving as co-managers, and the U.S. manager is being coerced by a U.S. court, then control of the LLC would automatically shift to the Belize manager. This way, the preservation of the Belize LLC's assets remain under the control of a professional corporate Belize management company that acts in the best interests of the owner of the LLC as opposed to a member's creditors. Additionally, Belize law states that only a judgment issued by a Belizean court is enforceable against a Belize LLC.[23]

The reader should note that using a foreign-domiciled manager that has no presence within the United States can provide strong protection when the LLC's assets are not physically located within the United States. The foreign manager would have control over when to make any distributions from the LLC, assuming that the LLC's operating agreement is properly drafted and cannot be amended without the foreign manager's consent, and if no U.S. person has a power to remove that manager. Alternatively, the client can be the manager (though this could invite added creditor arguments against the client because of control factors), with provisions in place that if a significant creditor action were to begin to surface, a foreign successor manager (which can be located in another foreign jurisdiction) is automatically triggered to replace the client as manager.

If a client has concerns of a foreign manager having the sole authority over an LLC's assets, another approach is to require a third-party "director" or "company protector" or "special manager" of the LLC to be a co-signatory on, for example, an LLC's foreign bank account. This would be solely for the purpose of assuring that any LLC distribution or payment of expenses does not occur in a way that would be without the approval of the third-party director. The director position would be created in the LLC's operating agreement and can provide for successor directors to be appointed in the event of a current director's death, incapacity, or resignation. Directors could be named, removed, or replaced with the unanimous consent of certain designated managers and members of the LLC.

Certain foreign jurisdictions also typically have other additional statu-

tory protections in the event a creditor seeks compensation in the foreign jurisdiction where the LLC was created. For example, a charging order can, in effect, prohibit all members from receiving distributions from an LLC under United States law. Conversely, as stated above, Nevis law provides that a charging order expires after three years and cannot be renewed.[24] As such, funds are no longer subject to garnishment under Nevis law after the three-year period has run its course, and the foreign-domiciled manager is once again free to make distributions as it sees fit. Also, some foreign jurisdictions also have the added benefit of not recognizing punitive or exemplary damage awards or fines.[25]

In practical application, a client can transfer what is known as "low-hanging fruit" (e.g., "cold" assets such as liquid funds, tangible personal property, intangibles, etc.) into a foreign LLC of which the client is also a member. The foreign LLC is more effective if it has at least two members. The foreign LLC is then managed by an offshore management company. The importance of this becomes apparent once you consider that under United States law, a creditor of an LLC's member (the debtor) may succeed in having a court rule that the LLC is either subject to:

- being viewed as a sham;
- being treated as the debtor-member's "alter ego";
- a "reverse piercing" remedy that allows a court to attach and seize the LLC's assets;
- a charging order remedy, which does not cease to garnish LLC distributions until the debt is fully paid; or
- having any United States-based manager of the LLC forced to dissolve the LLC.

If any of the foregoing rulings were to occur, such court ruling would have little enforceable impact over the offshore manager.

Some clients may prefer to be directly involved in the management of the foreign LLC's assets as opposed to relying on a sole manager who is located in a foreign jurisdiction. Although this added control can provide a creditor with more ammunition that the debtor-member has too much control over the foreign LLC's assets and can therefore be ordered by a court to somehow move the foreign LLC's assets away from the protective LLC arrangement, the debtor-member's control as a co-manager can be limited to minimize such risk. This is achieved through a combination of:

- bifurcating the managerial powers so that the offshore manager retains the more creditor-sensitive powers while the debtor has the daily investment decision powers;
- making certain that any high-powered authority that is in the debtor-manager's hands be rendered ineffective in the event the debtor-manager is acting under duress (also known as a "duress clause"); and
- subjecting some of the powers of the foreign manager to certain oversight controls as a checks-and-balances mechanism within the LLC's operations and administration.

Some examples of the foregoing include:

- the power to appoint additional managers can be exercised only with the consent of both the U.S. (debtor) manager and foreign manager;
- the foreign manager may not take instructions or recognize approvals or disapprovals by any persons acting under duress;
- the foreign manager can be removed only through the debtor acting as an act of free will;
- the debtor cannot be removed as manager unless an event of duress (as defined in the governing LLC documents) has occurred;
- the foreign manager retains the sole authority to declare distributions and to enter into certain loans;
- both managers would be required signatories on the LLC's financial accounts, but the foreign manager is authorized to co-sign only if the debtor-manager is co-signing in an act of free will;
- the foreign manager can sign unilaterally on any such account only if the financial institution is made aware that the debtor manager is subject to an event of duress;
- the foreign manager cannot sell any LLC assets without the debtor-manager's voluntary consent; and
- the LLC cannot be dissolved without the foreign manager's consent.

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10 See section 62 of the Nevis Limited Liability Company Ordinance, 2017, entitled "Bond" which states: "(1) Every creditor of a member or a limited liability company, before bringing any legal action to collect on a judgment against any member, limited liability company or property thereof, governed by section 60, shall first deposit with the Permanent Secretary in the Ministry of Finance, a bond in an amount to be determined by the High Court, from a financial institution in Nevis, for securing the payment of all costs as may become payable by the creditor. (2) The High Court may from time to time, increase or vary any bond which has been ordered under subsection (1)."

11 Section 60(15) of the Nevis Limited Liability Company Ordinance, 2017.

12 *Id.* at section 60(5). Further, section 60(6) specifically states that no other legal or equitable remedy, including but not limited to (a) foreclosure; (b) seizure; (c) levy; (d) attachment on a member's interest or rights; or (e) a court order for directions or an accounting is available to a judgment creditor attempting to satisfy a judgment out of the judgment-debtor's interest in the LLC.

13 *Id.* at sections 61(2) and (3).

14 *Id.* at section 61(11).

15 *Id.* at section 61(1).

16 Cook Islands Limited Liability Companies Act 2008.

17 *Id.* at section 45(6).

18 *Id.* at section 45(2).

19 *Id.* at section 45(14).

20 *Id.* at section 72.

21 See section 37(7) of the Belize International Limited Liability Companies Act, 2011.

22 *Id.* at sections 64(3) and 64(4).

23 *Id.* at section 38(1).

24 See section 60(15) of the Nevis Limited Liability Company Ordinance, 2017.

25 See section 45(5) of the Cook Islands Limited Liability Companies Act 2008 and Section 60(3) of the Nevis Limited Liability Company Ordinance, 2017.

Another advantage of using a foreign LLC over a domestic LLC, under certain limited scenarios, includes the foreign LLC's beneficial owners not being subject to the reporting requirements of the federal Corporate Transparency Act, which became effective on January 1, 2021 (the Act) that essentially banned anonymous shell companies in the United States. As a result, the Act requires that domestic LLC beneficial ownership information be disclosed to the Treasury Department's Financial Crimes Enforcement Network (FinCEN) when a new entity is formed or when a change in ownership occurs. The Act requires LLCs to disclose to FinCEN their beneficial owners (including their identities, addresses, dates of birth, copies of government issued identification, etc.). Effective January 1, 2024, all "reporting companies" created or registered prior to January 1, 2024, will have until January 1, 2025, to file an initial Beneficial Ownership Information (BOI) report. Reporting companies created or registered after January 1, 2024, will have thirty days after receiving notice of their creation or registration to file an initial BOI report. Further, reporting companies will have thirty days to report changes to the information in a previously filed BOI report and must correct inaccurate information in previously filed BOI reports within 30 days of becoming aware of such inaccurate information.

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A "foreign reporting company" includes an LLC that is formed pursuant to the laws of a foreign country *and* that is registered to conduct business in any state by filing a document with a domestic Secretary of State or similar office. Therefore, in certain scenarios, using a foreign limited liability company that is *not* registered to conduct business within the United States can avoid being subject to the Act's reporting requirements, allowing the client to retain a high level of privacy.

Note that laws around the world are constantly evolving, and with the Organisation of Economic Cooperation and Development's (OECD) continued pressure for less tax avoidance and more transparency in other jurisdictional laws, practitioners should always research and review the current disclosure and taxation rules of any involved foreign jurisdictions so that no surprise reporting or taxes will occur. That being said, with a properly and timely funded foreign LLC, and strategically located assets, in conjunction with a well-drafted operating agreement that builds in the appropriate provisions such as those mentioned above, a foreign LLC can result in a highly effective planning tool for an asset preservation/estate planning practitioner's client. ■