

# How to **DOUBLE** Your Asset Protection



By Lee R. Phillips, JD  
US Supreme Court Counselor

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## Protect What You Own

Asset protection is a major issue today for anyone who has managed to successfully acquire some wealth. With the “I’m entitled” attitude in the country, there are a ton of people who will try to take whatever you own away from you.

If it’s not the people who have made a profession out of suing other people they think have money, it’s the professionals themselves, or the government coming after your money. You’re a target! In today’s society, keeping your money is just as important as making it. If you don’t protect it, somebody is going to take it away from you. That’s a given.

You’ve probably got a security system in your office or at your house. You’ve put up fences and lights to keep thieves out. You’ve got extra secure locks on your doors. You’ve done everything you can to keep a thief from taking your property. But chances are you haven’t done anything to protect yourself and your assets from some sort of a legal or financial attack.

You just hope you don’t get sued, get audited, have your

identity taken, get sick, get divorced, or have a family member die. Actually, even if you don’t do anything wrong, you can still lose everything you’ve worked your whole life for. Your spouse, kid, business partner, or tenant can do something, and you’re the one who loses.

You’ve got a better chance today of losing money in a legal or financial attack than you do to the common thief. You can do a lot of easy and simple things to protect yourself from a legal or financial attack. Let’s double your asset protection.

## Traditional Asset Protection

One thing you can take advantage of is a legal concept called “charging order protection.” Your advisors probably haven’t ever explained it or given you the steps you need to follow to take advantage of it. But it will double your asset protection.

This ebook will first overview general asset protection techniques and how you can use “business entities” to beef up your asset protection. There are lots of ways a business entity (LLC, corporation, or limited partnership) can give you asset protection that can’t be provided any other way. Understanding what you can do with a business entity will help set the stage for charging order protection. Then we’ll get deep into the ways you can use charging order protection.



One of the reasons you may not have done much “general asset protection” is you have been turned off by some of the “professionals” that want to protect your wealth. They want you to set up elaborate legal structures that cost tens of thousands of dollars to design. For an extra \$50,000 they’ll even include “offshore” protection.

They talk a good story, and everything sounds great, but when push comes to shove, most of the structures they sell collapse under their own weight. In all my years doing asset protection, I’ve never met anyone who actually did the elaborate structure and offshore deals say it was great and they were happy they had done it. I have met a lot of people who are wringing their hands, because they can’t afford to “maintain” their asset protection plan.

I have also never met anyone who said that they were grateful they set up their company in Wyoming, Nevada, Delaware, or some state other than the state where they were doing business or owned property. The pitch is no taxes or privacy. Privacy is the poor man’s asset protection plan, and it doesn’t work.

Years ago I was hired to do an asset protection plan for a man. He vetoed everything I suggested saying he had spent his life making sure he was totally anonymous and “off the grid.” I finally said give me an address. I didn’t care if it was in a land trust, LLC, or whatever. Does your tenant know the address where they live?

With nothing more than an address I came back with a 40-page printout on this guy. I had every property he had had an interest in, wife he had ever had, bank account, business partner, place he had lived, and phone number he had ever had. I had it all. I sent it to him.



After three days, he called and his simple statement was “Ok, anonymity doesn’t work. Now what do we do?”

Of course, keep a low profile, but the pitch for a Wyoming LLC and privacy in general is nothing more than a sales pitch.

Over the past 30 years, I have helped over 50,000 people protect their assets. There are lots of relatively simple and inexpensive legal tools you can use to get some good asset protection. Most people do nothing, so if you do even a little bit of asset protection, you’re ahead of the rest of the pack.

Why should the legal and financial attackers come after you if you’ve got some protection, when there are a lot of people who don’t have any protection? You should start with the simple techniques before you jump into the deep end of the asset protection pool.

First of all, you need to understand some of the basic asset protection tools an attorney has available to use for your protection. The corporations, limited liability companies (LLC), limited partnerships, trusts, benefit plans, retirement plans, and even contracts can be used as asset protection tools. The tools can be used in conjunction with each other to give you even better asset protection.

## Don’t Go Overboard

There are a lot of advisors and attorneys that try to “set you up” with layer after layer of asset protection. They use the common tools and stack them on top of each other. Part of the problem is there’s a common feeling that if one is good, ten is better.

Usually, the push for complexity is just a way for the attorney to make more money.

A number of years ago, I had two doctors from California come to me for help. They were distraught, because one of the big-time marketing-promoting-asset-protection attorneys in the US had gotten a hold of them. They had 53 properties that they wanted to protect. This particular attorney's answer to all asset protection problems was the family limited partnership (FLP).

California is an expensive state to set up a limited partnership in. It costs about \$800 just for the state filing fees each year. The attorney told the doctors to form a limited partnership for each property. Because California was so expensive, he suggested that they set up the limited partnerships in his state. Of course, the attorney would set up each of the 53 partnerships for them in the attorney's state, and because there had to be a registered agent in the state for each limited partnership, he volunteered to act as the registered agent.

This attorney gave these doctors a deal. He only charged them \$5,000 for each of the 53 limited partnerships he set up for them. He set it up so he not only acted as registered agent, but also paid all the annual fees and "maintained" the limited partnerships. For those services, he only charged the doctors \$1,500 per year per limited partnership.

After three or four years of this asset protection plan, these poor doctors heard about me and called me up. They asked if there was anything they could do to get out of the mess that they were in. They stated that they weren't worried about asset protection anymore. Their lawyer had all their money. There wasn't anything left to protect. I did help them out of their mess, and we did something a lot more "sane" for them.

## Understand the Corporate Shield

I have given thousands of lectures on asset protection over the years. A man who heard me speak at one event called me after the speech and stated that he had solved all his asset protection problems. He was sure he had found the holy grail of asset protection.

He was going to establish a C corporation and then put everything he had into the corporation. He stated that if everything was owned by the corporation, then when somebody sued him, they couldn't get anything. I had to do a little explaining to convince him his plan wouldn't work. He didn't understand the "corporate shield."



Corporations were created to protect the investors (stockholders) and managers (officers and directors) from liabilities that might occur because the corporation was doing business. Corporations were not created to protect your stock in the corporation from being taken away from you when YOU get sued personally or have big problems.

Congress created corporate protection to encourage people to fund and run companies. If you'll take the risk of setting up a corporation and starting your little business, or if you'll invest in the company, Congress has agreed to protect your personal assets from the disasters that might happen inside of the corporation.

You certainly wouldn't want to be liable for the stupid things Enron did, just because you had purchased stock in Enron. (Actually, you were liable, but only up to the amount of money you invested in the stock.) You're safe from the creditors and liabilities of Enron and all the big companies you invest in, but what about your own little company? Are you safe from the little company's creditors and liabilities?

The laws won't protect you from everything that happens in the corporation, unless everything associated with the corporate structure and maintenance is done just right. Most corporations fail when they are really challenged. Corporations and LLCs are often set up wrong. For example, only half the paperwork is done. They are seldom "managed" correctly. There are 16 main "corporate formalities," plus a bunch of other things you have to do routinely in order to ensure that your corporation or LLC will actually protect you when there is a problem.

In many respects, the corporations and LLCs you are dealing with when you set up your small company are different than the Wall Street companies. When you set up a corporation or LLC, you'll probably own it alone, or maybe you will own it along with a couple of other people. That means it is "closely held" and the courts will look at it very carefully to make sure you treat it as a real entity rather than just your alter ego. Technically, the legal structure is the same as the big corporations, but the care and feeding of your closely-held company feels very different.

If you do it right, your closely held corporation will give you a liability shield and protect you from the activities of the corporation, just like a big corporation protects its officers, directors and shareholders. Yes, in your corporation you will not only be a shareholder, you will be an officer (president) and director of the company. That means you may be exposed to a lot more liabilities than the Average Joe shareholder of a big corporation, because if somebody can "pierce the corporate veil," the officers and directors become liable.

For our purposes, we will assume that you have taken care of all the corporate and LLC formalities, and the "corporate veil" will hold

when you are sued. Yes, your LLC will give you the same "corporate shield" as a corporation. Make sure you know how to take care of these important matters to "protect the veil." You need to pay attention to the "corporate" formalities, or the corporation or LLC won't protect you. The fact is a high percentage (well over 50%) of the corporations and LLCs in the United States will not protect the officers and directors, because the owners haven't followed the formalities.

If you get sued, they will always sue you and your corporation or LLC. When you get to court, you will ask the judge to dismiss the suit against you personally. The judge has the list of formalities the corporation has to follow. He will start down the list. If you can't establish that you have followed the formalities, then he will simply say how sorry he is that he can't use the corporate shield to protect you. If you haven't done what the law requires you to do to have the shield and get its protection, the judge can't use the law to protect you. He will have no choice but to "pierce the corporate veil" of your corporation or LLC.

By the way, it doesn't matter whether you have a C corporation (a corporation taxed under chapter C of the IRS Code), an S corporation (a corporation taxed under chapter S of the IRS Code), or an LLC, the asset protection shielding for each individual owner (shareholder or member) will be the same. It's all the same "corporate shield," aka, limited liability protection. (Note: corporations have stockholders and LLCs have members.)

## Another Universe of Asset Protection

All the asset protection theory we have been talking about hinges on protecting you from things that happen within the realm of the





company. That's what all the attorneys and everybody you have ever worked with concentrate on — giving you the liability shield against problems within the company. There is another entire universe of asset protection independent of the corporate shield world. Nobody has ever really discussed that universe with you.

What happens to your company when you get divorced or one of your company co-owners gets divorced, is sued, goes bankrupt, or suffers some other personal disaster? How do the personal disasters of one shareholder/member affect the other shareholders/members? It's likely none of your advisors have ever discussed these issues with you. The outcome of your personal disasters or those of your "partners" will be very different depending on how you structure your company.

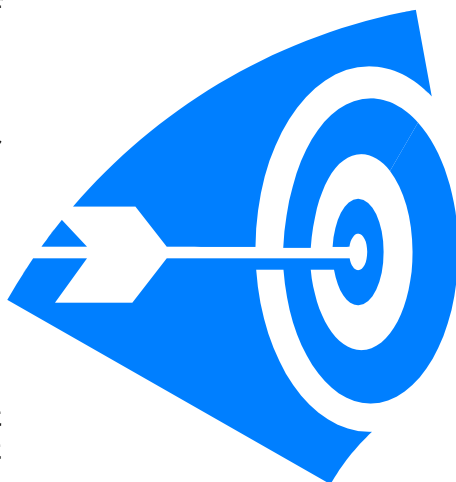
We're not talking about the corporate shield in this case. We're in the other universe. My asset protection student who was going to protect everything by putting his assets into a corporation didn't understand the purpose of the corporation. The corporation is only designed to put up a corporate shield and protect the people behind the shield (officers, directors, and stockholders) from liabilities that occur as a result of the corporation doing business.

Stated another way, in a corporation, if the attack comes from the company side of the shield, then the people behind the shield are protected. However, if the attack comes from behind, i.e., the personal side of the shield, the corporate shield doesn't protect the individual under attack. It also doesn't protect the company or any of the other co-owners of the company from your personal disasters.

A shield only protects you from arrows shot at you from the front where the shield is be-

tween you and the shooter. Arrows shot from the rear will not be stopped by the shield. Business or corporate activities are occurring out in front of the shield, personal activities are occurring behind the shield. If the attack comes from the personal side of the shield, all of your assets are at risk, including your ownership in the corporation or LLC. If you have a successful business, your business is probably your most valuable asset. **YOUR BUSINESS NEEDS TO BE PROTECTED FROM YOU!**

To belabor and expand on this point, if somebody slips and falls at the business office, the shield will protect you. The attack (lawsuit) will come from the corporate side of the shield. The corporate assets will be exposed, but your personal assets will be protected. If a kid breaks his neck on the trampoline in your backyard, the corporate shield won't protect you. The kid jumping on the trampoline isn't a business activity of the corporation. The attack is coming from behind the shield, and everything you own — including your stock in the corporation — is vulnerable.



## Strengthen Your Rear Guard

Congress has never given us a shield to protect us against our personal problems. One way to protect yourself against an attack from the back of the shield is to carry a lot of insurance. Look at beefing up your homeowner's policy, health insurance, and auto insurance. Make sure you have a big umbrella policy. The cost of beefing up your insurance protection may be less than the corporate filing fees in some states, so effectively it doesn't cost any more to protect your back side than it does your front side.

The problem with insurance is the coverage. Insurance companies love to limit their coverage. There are tons of exceptions and addendums. When it works, insurance is great. But

the insurance company's job is to get out of paying your claim, so there are lots of holes in insurance coverage.

If the attack comes from the back, i.e., you are personally sued or go bankrupt, what happens to the assets you own? Obviously, they are all open to your creditor. A revocable trust (land trust or estate planning trust) won't help. What happens if the attack is made on one of the other owners of your closely held business? (Those owners are often your children or other family members.) Will you lose your business assets, just because they are attacked? Advanced planning can help protect your company's assets from an attack that comes from the back of the shield.

## A Note to Real Estate Investors

It is a common asset protection technique for real estate investors to hold assets in a land trust. If you are attacked personally, the land trust will not give you any protection. Actually, the land trust won't give you any asset protection from any attack. It is also common to hold one or more properties in a corporate or LLC entity. Holding a property in an entity will protect you and your other properties from problems associated with the property that is owned by the specific entity. If the tenant slips and falls, their claim will be contained within the corporation or LLC.

For asset protection purposes, it is a good idea to hold each property in a separate entity rather than your own name or a land trust. Obviously, there is a limit to the number of entities you can afford and manage. (Most people can't effectively manage any more than 3 to 6 entities.) If you have a lot of properties, logically group them into a limited number of entities. The question is: what entity should you

use to hold the properties? You should probably never use a C corporation because of the adverse tax consequences. That leaves limited partnerships, limited liability companies, and S corporations.

## The Corporate vs. LLC Difference: The Charging Order

Let's assume that you own two apartment buildings. One apartment building is held in an LLC taxed as a partnership (sole proprietorship if you are the only member) and the second apartment building is held in an S corporation. (Actually, the membership interests in the LLC and the stock in the corporation should be owned by your living revocable trust to avoid probate problems when you die.)



In either case, if a tenant slips and falls, the tenant will have to sue the entity that owns the building. The attack is coming from the front (company) side of the shield.

Assuming the corporate/LLC shield holds, the most the tenant can get is the assets of the entity that owns the building. Your other assets, including your ownership of the entity that owns the other apartment building, will be safe. (Even though your trust owns both entities, for lawsuit, creditor, and tax purposes, you are considered to be the owner. The trust only gives you probate and possibly estate tax protection.)

What happens if the attack comes from the back (personal) side of the shield against you or one of the other owners of the LLC or corporation? Let's assume the attack is successful. The spoils of the suit will include your stock in the corporation that owns one apartment building, and your membership interest in the

LLC that owns the other apartment building.

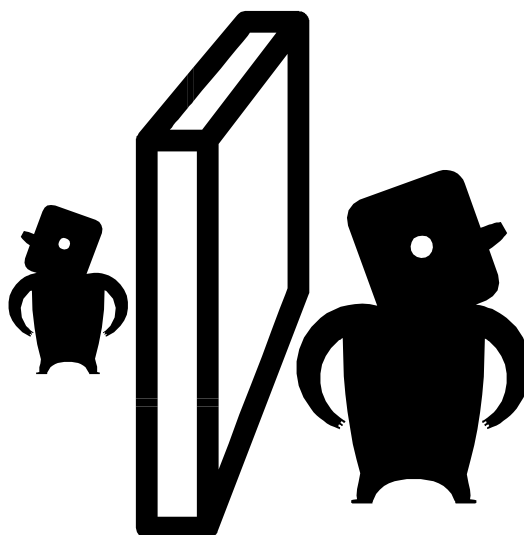
When the lawsuit winner (creditor) takes over your assets, he gets your stock in the S corporation. Effectively the creditor now owns the apartment building. The creditor has all the stock (assuming you are the only owner of the corporation). He will throw you out as officer and director, elect new officers and directors (himself), and he now runs the show. The creditor now has a new apartment building. The creditor will also get your membership interests (same as stock) in the LLC — sort of. What does “sort of” mean?

When the creditor gets a membership interest in an LLC or a partner interest in a limited partnership, including a family limited partnership (FLP), the creditor has to get what is called a “charging order” to come against the entity. The charging order limits the creditor to only being able to receive the financial benefit of the owner’s interest in the LLC or limited partnership.

When the creditor gets an LLC membership interest, he can’t just hold an election and put in new “officers and directors” (managers). He can’t just take over the LLC. By definition of law, a charging order **does not** give the creditor any voting or management rights.

This is very different from being able to seize the stock in a corporation and have all the voting rights and management rights. If the LLC document is written properly, the management of the LLC is intact and free from the creditor’s influence. In fact, the managers of the LLC can basically make life miserable for the new member.

The bottom line is you are still in control of your LLC. You can siphon off all of the income



and tax benefits before the creditor gets anything as a result of his “ownership” in the LLC. In some cases, you can shift tax burdens to the creditor without ever giving the creditor any money. Basically, you still have the apartment building held in the LLC as an asset. You still call all the shots, get all the rents and make all the money.

Using the corporation structure, you lost the building. Using the LLC structure, you still have all the benefits of the building. That’s a very different outcome than you get with a corporation.

It is subtle, but the charging order concept is a powerful asset protection tool. Can you see the difference in the corporate outcome and the LLC outcome? The attack on the personal side of the shield may come from someone piercing the corporate veil of one of your companies, personal lawsuit, illness, divorce, or any one of a dozen other disasters. You need to plan for the personal attacks from behind the shield, as well as the business-related attacks from the front of the shield.

## Why Charging Orders?

Historically, when a creditor took a partner’s interest (either in a general partnership or a limited partnership), the creditor became a partner. As a partner, the creditor could bind the partnership, sell assets of the partnership, conduct business in the partnership, and do anything he wanted without any approval or consideration of any other partners.

Take the case where three partners spent 20 years building a business. One of the partners got in trouble (divorce, bankrupt, lawsuit,



whatever) and got a judgment against himself. The creditor would simply take the partner's interest in the partnership, and the creditor had free rein of all the partnership assets and activities. The other two partners just lost everything, because the third partner "screwed up."

That's not fair to the other partners. In the early 1800s, British laws changed to protect the other two partners. The charging order concepts were born.

Instead of having the creditor come in as a partner, the laws have evolved to where the creditor just gets the benefit of the debtor partner's "economic interest" in the partnership. The creditor is forced to get a charging order which allows him to collect the debt owed by the debtor partner by standing in the shoes of the debtor partner and getting any "distributions" made from the partnership which would have gone to the debtor partner.

The charging order basically gives the creditor a "lien" against the debtor partner's interest in the partnership. The creditor doesn't have direct access to the partnership assets, can't bind the partnership or participate in the partnership management, and is unable to control the partnership in any way. There is simply a lien against the partner's interest, and when money intended to go to the partner is distributed, the creditor gets his share standing in the shoes of the debtor partner.

## Uniform Laws

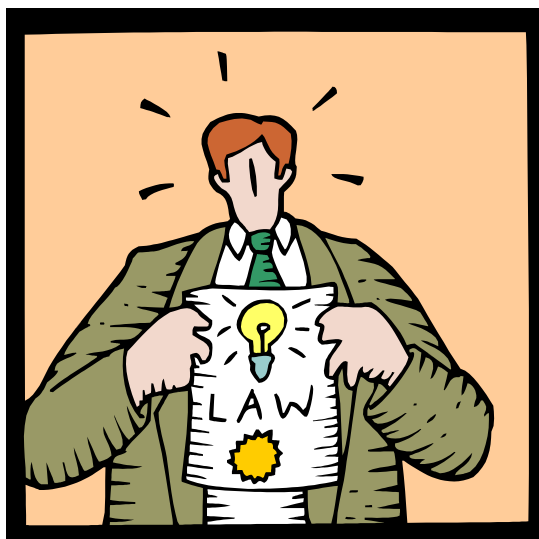
Charging order protection applies to general partnerships, limited partnerships and limited liability companies (LLCs). It does not apply to corporations. LLCs can be thought of as a

cross between partnerships and corporations. They have some elements of both entities.

The charging order laws in the United States have evolved to the point where "uniform acts" have been established which influence the laws in every state and give a consistent foundation for each state to draft their laws on. There are variations in state laws concerning LLCs and partnerships, but the state laws are all very similar, with the exception of Utah.

The national Uniform Limited Partnership Act was updated in 2001. The Uniform Limited Liability Company Act was enacted in 1996

and then updated in 2006. They both clearly make the creditor's only remedy a charging order. There isn't any transfer of rights other than the economic interest, i.e., the expectation of a distribution of profits. That protects the company from the attacks that come against the individual partners and members.



## An Application of Charging Orders in Today's Economy

Fifteen years ago, I was getting a lot of calls from people that had bought a number of pieces of property, and due to the rotten real estate markets in some states, they were losing one or more of their properties. They were ending up as a debtor with large foreclosure (deficiency) judgments against them. Some of these were individuals who had heard me speak, and purchased one of my business or estate planning courses. We are able to keep an ongoing dialogue, and I will answer their questions without additional fees. Also, if I know what problems are out there, I can refine my courses to meet the needs of more

people, so I encourage my students to talk to me.

This is important. If you own a little business and you decide to use the LLC for your structure, you need to become familiar with every part of the process. You need to know the state requirements for filing the Articles of Organization, how to do the operating agreement to get the beefed up charging order protection, what the options are for dealing with the taxes, how to do the maintenance formalities, and how to minimize your taxes. (The tax treatment alone can save you thousands of dollars a year!) This is a big deal, because the IRS is coming after you if you meet certain income thresholds.

And now let me share a scenario I have seen all too often, and a possible solution to the problem. Many people are upside down in a couple of properties that are going into foreclosure. The problem is they have some “good” properties that they could keep, if they could isolate them from the bad properties.

When your bad properties go into foreclosure, the mortgage company (creditor) gets a judgment. If there is a deficiency, the creditor will try to collect from your assets, including all the good property you “own.” You don’t want to “own” the properties. You (the debtor) can hold the properties in land trusts, LLCs, family limited partnerships (FLPs) or corporations.

If the properties are held in different land trusts, the foreclosure judgment creditors will simply go from land trust to land trust until they can satisfy their judgment. Land trusts are

supposed to “hide” ownership of assets, and they do, to some degree. The fact that a creditor can’t see your assets may stop them from filing a lawsuit, but a foreclosure creditor never even considers your “other assets” when it institutes a foreclosure action against you.

Once a deficiency judgment or another judgment is entered against you, the game changes. You will be required by the court to disclose all of the land trust properties. If you don’t, it is jail time. Any “anonymity” the land trust offered is gone, and it doesn’t give you any asset protection.

Another factor to consider is what was on the application for the mortgage when you bought the property. The application had a full list of your assets at the time. They already know where the land trust properties are, because you have personally signed a mortgage for every property.

If the properties are held in corporations, the mortgage company “creditor” will simply get the stock you own in

each corporation to satisfy their deficiency judgment. Once the creditor gets your stocks as part of the deficiency judgment, they then effectively own all the properties and can do whatever they want.

If however, the properties are held in a limited partnership or LLC, the creditors can only obtain a charging order against the debtor’s limited partnership interest in the limited partnership or their membership interest in the LLC.

But wait, you say. The property being foreclosed on is held in a corporation or LLC, and the creditors can only attack the assets of the single entity holding the property. You are correct, if the loan was given to the entity, but



even when loans were easy to come by, more than likely your mortgage company required personal signatures from the “owners” of the entity, i.e., you. That means the foreclosure creditor can not only look to the entity for satisfaction, but also look to all of your other assets for satisfaction as well. Your assets include your stock in all of your other corporations or your interests in partnerships and LLCs.

As an aside, hopefully only one spouse signed the loan. If at all possible, never have both spouses sign the loan. If only one spouse signed, then the assets of the spouse that didn't sign the loan should be outside the creditor's grasp. You should always clearly separate ownership of assets between husband and wife. If you are in a community property state, that's hard to do. If you are in a common law state, it is very easy to do. If you don't know what type of property state your state is, you are in a common law state.

When the assets are separated between husband and wife, then all of the family assets may not be at risk when disaster strikes. (In a community property state, spouses are considered to be one ownership unit.) Hold the separated assets in living revocable trusts, a “his trust” and a “her trust,” so that the surviving spouse doesn't have to probate the assets when the other spouse dies. Let me say it again, whenever possible, separate assets between husband and wife. Don't hold all your eggs in one basket.

When the foreclosure creditor starts to collect his debts from you, if all you have to offer is an interest in a limited partnership or LLC, the creditor has a problem. The creditor can't come directly against the assets in the limited partnership or LLC. The creditor has to get a charging order. The bottom line is that assets

held in your LLC or FLP are largely protected from your creditors (attacks from the back side of the shield).



## If You Are Already in Trouble, Can You Use an LLC?

If you are already in trouble, basically your asset protection options are nonexistent. That's why you do your asset protection planning NOW before the problems arise. All states have “fraudulent conveyance laws.” These laws prevent you from moving assets away from yourself to try and protect them, if you are already in trouble.

If you move assets for less than fair market value (give them to the kids or another creditor), the courts use the fraudulent conveyance laws to get the assets back. If you move assets and become insolvent (your debts are more than your assets), the courts can get the assets back using the fraudulent conveyance laws.

You could put the assets in a corporation and get stock back in exchange for contributing the assets to the corporation. When you give IBM \$100 and get \$100 worth of IBM stock back in exchange, that's simply changing the nature of the asset. That is not a fraudulent conveyance. You still “own” \$100 in assets, i.e., stock.

Let's say you have one bad property and two good properties. (You are going to lose one of the properties because of a loan default and the other two properties you want to keep, because they give you a positive cash flow.) If you move the two properties into a corporation and get stock back, what happens?

Moving the two good properties into the corporation won't be a fraudulent conveyance, but it won't do you any good. Note that if you want to keep the corporate shield in place,

you have to recognize transfer of the properties to the corporation, and the corporation had better issue more stock to you. When the judgment comes, the creditor will get control of your stock in the corporation, and effectively own the two good properties. You didn't gain any advantage.

If you put the properties into an LLC and get membership interests back in exchange, then the transfer into the LLC may or may not be considered a fraudulent transfer. It mostly depends on when you put the properties into the LLC.

Technically, it won't be a fraudulent conveyance, because you got equal value worth of membership interests back in exchange for the property you put into the LLC. Yes, you had better do all the paperwork and issue new membership interest, if you want the corporate shield of the LLC to stay intact.

If you intend to defraud a creditor, you're in trouble.

## Can You Make Life Bad for Your Creditors?

Let's get cute with the law. If you are the manager of the LLC and have just lost your rights to all distributions from the LLC, how often are you going to make distributions of the profit? I am sure you will figure out a way to "eat all of the profits" in wages for yourself and other LLC members or in general expenses. The other members are usually your family members, so it's still "all in the family."

Any successful litigating attorney will tell you that if you get too cute with the law, you are going to lose. There is the law, and there is equity (what's fair). If you get cute, the judge is going to exercise his "wiggle room" and figure

out a way to get "equitable relief" for the creditor. The judge will figure out a way to get those two good properties for the creditor.

If you have done your asset protection long before the problem arises with the creditor, and you haven't been "cute" with the law, the law of charging orders allows the judge to protect your two good properties. But, remember, if you have signed the mortgages for each property and used the other properties as collateral, the mortgage company has you between a rock and a hard spot no matter what you try to do — that's their job.



## Erosion of Charging Order Protection

There have been cases where the courts have flat out denied the charging order protection for an LLC. In the two highest profile cases, the LLCs were "single member" LLCs. (All the membership interests were owned by one individual — a single member.) In both cases, the single member was a despicable dude that really deserved to be nailed.

In a Colorado court (*Albright*, 291 B.R. 538, 540 (D. Colo. 2003)) the judge addressed a bankruptcy of the owner of a single-member LLC. The judge gave the bankruptcy creditor the right to take both the economic interest and the management interest of the member. Basically, the court ignored the charging order protection the LLC was supposed to give its member.

The *Albright* court reasoned that charging orders were developed to protect the other members/partners in the business activity. Since there was only one member, there wasn't any need to protect anyone else, so the court gave the creditor everything. The court

was wrong and no other bankruptcy court has followed, but it has raised a concern about single-member LLCs.

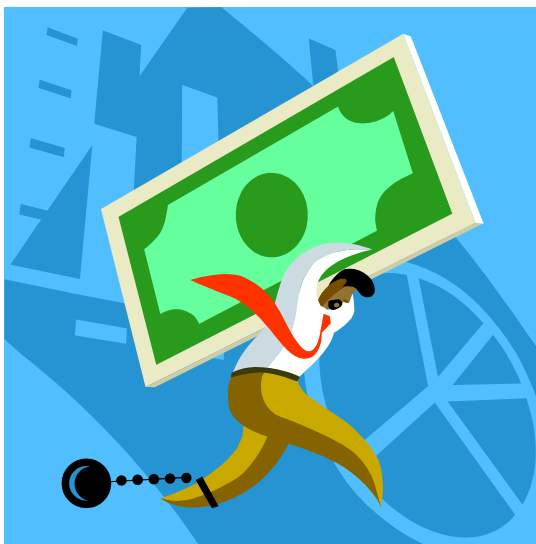
In a Florida Supreme Court case (No. SC08-1009 *Shaun Olmstead vs. FEDERAL TRADE COMMISSION*, [June 24, 2010]) the court “set aside” a single-member LLC and let the personal creditors of the LLC owner come directly against the LLC assets. The creditor (FTC) in the *Olmstead* case was simply given the assets of the LLC to satisfy the LLC owner’s debt. Olmstead was a bad dude. So, the good guy won, even though it was the government. This means Florida has come out against the charging order protection that the Revised Uniform LLC Act says single-member LLCs should enjoy. The *Olmstead* case may be a tipping point against single-member LLCs.

Utah and Idaho have legislatively stripped single-member LLC charging order protection. The bottom line is single-member LLC charging order protection is under attack today. Note, this does not mean an LLC doesn’t offer the “corporate shield” protection for its single member owner from activities of the LLC. It simply means the personal creditors of the single member owner can use assets of the LLC to satisfy the debts of the sole owner of the LLC.

You should also note that charging order protection is alive and well in every state if there are multiple members (owners) in the LLC. It is only single-member LLCs that have this problem. In a way, the logic of the *Olmstead* case is sound, because the original intent of the charging order laws was to protect the

“other partners” from the creditors of the partner that got in trouble.

You need to seriously consider having someone else own some of your LLC. I would say at least 5%, because that is the threshold the IRS uses for “significant” ownership of an LLC. You could use less than the 5% for a second member, because there is no set amount, but to be safe, I think 5% is a good number. Just be reasonable and treat the second member with all the respect of a full “partner.” However, remember in a community property state you should use a child or someone other than the spouse, because the spouses in community property states are considered to be a single owner-



ship unit.

Don’t panic if you have a single-member LLC already, because in most states a single-member LLC still enjoys charging order protection from its owner’s debts. You do need to be aware that the cases are starting to stack up against single-member LLCs, and plan accordingly. Check and see if your state requires more than one member for charging order protection.

## Give the Creditor the Income Tax, but NO Income

Yes, when a creditor gets a charging order, it is possible to shift income tax burdens to the creditor without ever making an actual distribution of cash to the creditor. Having said that, you need to know that the income tax trick won’t work in most situations.

It is quite clear that when the creditor gets a charging order, he simply gets the expectation



of an economic benefit. In this situation he does not “stand in the shoes of the member economically.” The creditor has basically a lien.

If however, the creditor “forecloses” on his charging order, then he does stand in the shoes of the member, and he does have to recognize the tax consequences of being in the member’s shoes. It is entirely possible that the LLC could force a tax burden on the creditor and never transfer any cash to the creditor.

Most creditors who get charging orders do not foreclose on the charging order. If the creditor does not foreclose, his lien can be satisfied by having the LLC pay out enough money to get rid of the lien. Once the debt is satisfied, the charging order is rescinded.

If the creditor “forecloses” on the charging order, the lien becomes permanent. The creditor doesn’t get any more rights to management of the LLC, but the lien is good forever. The creditor gets the economic benefit forever.

If the creditor forecloses, he can be in an unpleasant situation. With no right to ever force a distribution, no right to manage or vote, and the possibility of getting phantom income that creates a tax liability, most creditors simply don’t try to foreclose on a charging order. In fact most creditors don’t try to collect through a charging order. This gives you a great advantage over your creditor.

Often the creditor will settle their dispute with you and walk away with next to nothing, because that’s as good as they can get. The LLC and charging order has done its job. It has

given you the opportunity to “settle” with your creditor for pennies on the dollar and have the situation “go away.” That’s great asset protection.

Real life asset protection doesn’t prevent all losses and pain. The real goal of asset protection is to put you on the high ground, where you can deal with the creditors and get a “good result.”

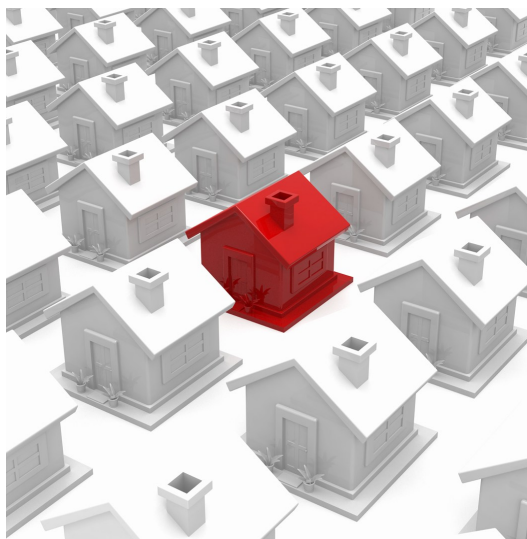
## How Do You Get Charging Order Protection?

Obviously, you need to consider an LLC or limited partnership as the basis for your business structure. But that’s just the beginning. Many advisors don’t concentrate on charging order protection and don’t write the LLC or limited partnership documents to provide good charging order protection.

When you set up an LLC, the Articles of Organization are simply the papers the state requires. The operating agreement is something some people forget about — or you get the attorney’s latest generic “boilerplate” version. However, the operating agree-

ment is critical. You basically get to define what charging order protection you’ll get out of your LLC.

If you write your operating agreement with the nuggets that beef up charging order protection, the courts will honor those documents in almost every situation. If the operating agreement says that no distributions will be made to an “assignee” or “transferee” of a member’s interest, many of the state courts



will honor that. You may have just eliminated the creditor's possibility of ever getting a distribution of profit. Without the possibility for a distribution, a creditor basically has nothing. The economic interest the creditor gets is worthless.

Your operating agreement should have language that restricts the assignment of a member's interest. Such as: "No interests may be assigned," or "Any assignment of an interest requires approval of all other members/partners or the consent of the LLC manager." These types of little changes in an operating agreement make a huge difference. There are a number of subtle things you can do to increase your front and backside asset protection. Most attorneys and the Legal Beagle websites never address many of the asset protection issues. I have addressed them in detail in my course on operating agreements.

Your advisors have probably never thought much about charging order protection, but you need to. The charging order aspect of limited partnerships and LLCs is one of your most powerful asset protection strategies. Learn how to use them, and you can sleep a lot better at night, because your assets are protected from the business liabilities and many of your personal liabilities. This means you can get protection from both the front and the back side of your shield.

My operating agreement tutorial walks you through every part of forming and using an LLC operating agreement, so you get the beefed-up corporate shield and charging order protection.



Your little business (LLC) is your most important tax shelter. I also have a tax tutorial that gives you ten tax tips you can use to get more money. If you can't make thousands of extra dollars a year out of your little company using my tax tutorial, you're not using your LLC to its max. Your LLC will help reduce your adjusted gross income. The tax tutorial gives you ten tax tips you can use. Your LLC is one of the best tax tools you can use. Use it effectively and that means more money in your pocket.

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