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Charging Order Protection for Nevada Corporations

A White Paper by the Nevada Resident Agent Association

2005 Legislature

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Executive Summary

The right of a judgment creditor to collect against the assets of a judgment debtor varies depending upon the nature of the assets. Some asset types – primarily liquid assets - can be directly attached, while other asset types have limitations on attachment by the judgment creditor. Assets that cannot generally be directly taken by a judgment creditor usually provide for other recourse, such as potential foreclosure and forced sale of assets, or the imposition of a “charging order” against future income of assets.

When the assets of a judgment debtor include ownership interest in business entities, the rights of the creditor have also traditionally varied, depending upon the specific type of business entity owned. This variance creates inconsistencies in the application of creditors’ remedies against different types of business interests.

The Nevada Resident Agent Association (NRAA) proposes to the Nevada Legislature that charging order protection be provided as the judgment creditor remedy against the ownership of corporate stock of small business corporations, consistent with the application of the charging order as it currently applies to limited partnerships and limited liability companies.

This paper discusses the use of the charging order in support of legislative changes which would standardize the remedies of creditors under Nevada law. Additionally, the changes proposed in this paper would create a significant advantage for the State of Nevada in attracting additional commercial recordings and associated revenues, particularly in the area of promoting new corporate filings.

Introduction

Background

A charging order is an order by a court of proper jurisdiction which places a "charge" in the amount owed against the property of a judgment debtor. While the charging order does not normally provide immediate relief to the creditor, it may safeguard the value of the asset in the future.

Currently, charging order relief in Nevada is provided as a creditor's remedy against a debtor's ownership interest in either a limited partnership (LP) or limited liability company (LLC). The charging order generally prevents the creditor from foreclosing upon the ownership interest in the LP or LLC, and from forcing a sale of the entity's interest or assets to satisfy the judgment.

The purpose and theory behind the charging order limitation is to protect innocent partners (in the case of an LP) or members (in the case of an LLC) from being forced to inherit potentially hostile parties as partners/members in a partnership-type arrangement as the result of creditor foreclosure or forced sale. Such a consequence would likely have serious and significant negative economic impact on innocent partner/members.

The charging order remedy protects the value of the creditor's interest, while also protecting the innocent partner/member. The creditor becomes an "assignee" of any income that the debtor would derive from the ownership interest. As a result, any amounts that would normally be paid to the debtor/owner, whether as distribution of profit or by virtue of the unforced, market-value sale of the entity ownership interest – which could include the exercise of internal partnership/LLC agreement provisions allowing existing innocent partner/members to exercise buy-out options to divest the interest of debtor/owner.

In most states, the charging order remedy is one of several alternatives available to the judgment creditor and the court. However, the 2003 Nevada Legislature amended the Nevada Revised Statutes to join 8 other states in making the charging order the sole remedy available to creditors. This change has had a significant impact, particularly in LLC filings. Several legal newsletters and websites have discussed the 2003 changes in Nevada's charging order application.¹

¹ For a sampling of these discussions, see Commerce Clearing House Business Owner's Toolkit: http://www.toolkit.cch.com/text/P12_4476.asp; American Bar Association Magazine, May 2004: <http://www.abanet.org/rppt/publications/magazine/2004/ma/letters.html>; Asset Protection Corp.:

Charging Order Protection for Corporate Stock

Charging order protection for corporations is not currently available in any jurisdiction that we can identify. This places the stock of a corporation, including closely-held or family owned companies, in jeopardy of potential foreclosure and forced sale to satisfy judgment creditors. The legal theory behind for this distinction between ownership of corporate stock as compared with ownership of LP or LLC interests is that stockholders are traditionally thought to be insulated and blind from one another; they are not generally considered to have a relationship or commitment to each other comparable to the partnership.

CCH Business Owner's Toolkit, published by Commerce Clearing House, one of the world's leading legal publishers offers the following analysis:

*"In theory, the relationship among corporate shareholders is an impersonal one (as opposed to that in a partnership or limited liability company). Therefore, when satisfying an owner's personal debt liability, the law allows a creditor who has acquired the shares through attachment to participate in management of the corporation. Thus, the creditor may vote the shares in favor of liquidation or in other ways unfavorable to the debtor's interests. In a small, closely held corporation, this is a real possibility. When you hold a majority interest in the corporation, and this interest is attached by a creditor with a charging order, your creditor may vote to liquidate the business to satisfy the debt. Even setting up your corporation as a statutory close corporation does not eliminate the risk that personal creditors of the owner will be able to attach and then vote the shares in favor of a liquidation of the business."*²

However, this legal concept does not reflect the reality of the business world, particularly in Nevada, where corporate statutes have been specifically drafted over time to attract small business corporate filings, as opposed to publicly-traded entities. The typical Nevada corporate filing is a micro-business with shareholders numbering from one to several. The relationship of these shareholders can be closely compared to that of partners, both in terms of their exercise of ownership and management rights.

Likewise, the potential of foreclosure or liquidation of the stock of a judgment debtor can have the same serious and negative economic impact on innocent shareholders as the charging order seeks to forestall where the entity is an LP or LLC.

By providing charging order protection for small business corporations, Nevada can take a tremendous step toward protecting existing shareholders of Nevada corporate entities. Further, by breaking this new ground in the area of corporate law, Nevada will see significant increase in its market share for new corporate filings and enhance its reputation as an international incorporation center.

<http://www.assetprotectioncorp.com/assetprotectionunderRULPAandLLC.html>; and dozens of websites by Nevada resident agents.

² http://www.toolkit.cch.com/text/P12_4471.asp

Limitations of Corporate Charging Order Protection

The Nevada Resident Agent Association has carefully considered the ramifications of adding charging order protection to small business corporations. This protection, as proposed by NRAA, is intended to comply with the generally accepted legal theories currently governing charging order legislation:

1. It is intended to protect stockholders who have a partnership-type relationship with other stockholders in a small business, and who have potential to suffer economic loss in the event of foreclosure or liquidation by judgment creditors of other stockholders.
2. It is intended to comply with existing legal developments in the area of charging order application pertaining to single-member LLC's.³
3. It does not protect the corporation or corporate assets from judgments against the corporation directly. Thus, the charging order would not be used to insulate the corporation from risk associated with product liability, defects, errors and omissions, etc. that result from the corporation carrying on its business. The charging order only provides innocent party protection from outside judgments against owners.

Single Owner Corporations

In 2003, a federal judge in Colorado denied charging order protection for single member LLC and allowed the bankruptcy trustee to take possession of the single member LLC's assets to benefit creditors. This determination was made due to the fact that no innocent third-party member of the LLC existed, and thus there was no economic interest to protect.

NRAA assumes that this legal standard would also apply to single shareholder corporations. As a result, our proposal requires that more than one shareholder is required for charging order protection to be an available remedy.

Conformity to Federal Sub-Chapter S Status Qualifications

Because the intent of this proposal is to provide charging order protection in circumstances related to small business where stockholders are likely to have partnership-type relationships, it was necessary to consider an appropriate cap on the number of stockholders in order to ensure that this measure provides

³ Ashley Albright, Bkrptc. (2003)

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small business benefits. After considerable discussion, NRAA determined that the federal qualification guidelines for S Corporation eligibility provided an appropriate cap inasmuch as the S corporation election is provided for the intent of providing partnership-type taxation to small business corporation. Clearly, the Internal Revenue Service considers corporations with fewer than 75 shareholders to be a small business.

Publicly Traded Corporations

Stock of a publicly traded Nevada corporation would not be eligible for charging order protection under the NRAA proposal, due to the fact the corporation's status as a public entity removes the partnership/owner relationship that the charging order is designed to protect. In a publicly traded company, stockholders truly are "impersonal" and blind to one another. In addition, stockholders of publicly traded corporations have already assumed the risk associated with potentially hostile stockholders; and statutory and case law pertaining to hostile takeovers are already provided.

Subsidiary Corporations

It is not the intention of the NRAA that charging order protection should be available to corporations that exist as subsidiaries of publicly traded companies, for the same reasons outlined above.

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The Declining Market of Corporate Filings

According to the Annual Report of Jurisdictions published at the 2004 conference of the International Association of Commercial Administrators (IACA), 19 of the 41 states reporting indicated that corporate filings had declined in those states in the period 2002 to 2003. The combined total of all reporting states indicated that corporate filings rose a mere 2.44% overall. This compares with only 2 of 41 states reporting a decline in LLC filing during the same period, with a combined growth in LLC filings of 21.97% nationally.

	<u>2002</u>	<u>2003</u>	<u>% Growth</u>
	<u>Corps</u>	<u>Corps</u>	
Alabama	6,273	6,037	-3.76%
Alaska	844	870	3.08%
Arizona	10,806	11,515	6.56%
Arkansas	5,956	5,897	-0.99%
California	78,935	83,763	6.12%
Colorado	19,144	16,976	-11.32%
Connecticut	2,532	2,498	-1.34%
Delaware	36,256	32,180	-11.24%
Florida	135,578	161,559	19.16%
Georgia	31,797	32,311	1.65%
Hawaii	3,030	3,195	5.45%
Iowa	4,338	4,384	1.06%
Indiana	11,237	11,184	-0.47%
Kansas	4,547	4,419	-2.82%
Louisiana	6,267	5,694	-9.14%
Maine	2,592	2,639	1.81%
Maryland	16,867	17,031	0.97%
Massachusetts	12,544	11,941	-4.81%
Minnesota	13,254	13,545	2.20%
Mississippi	4,375	4,170	-4.69%
Missouri	12,550	12,132	-3.33%
Nebraska	2,966	3,017	1.72%
Nevada	28,612	29,120	1.78%
New Hampshire	1,680	1,737	3.39%
New Jersey	25,543	22,198	-13.10%
New Mexico	2,259	2,370	4.91%
New York	77,650	78,104	0.58%
North Carolina	20,975	21,841	4.13%
Ohio	15,095	13,866	-8.14%
Oregon	8,710	8,912	2.32%
Pennsylvania	18,159	17,888	-1.49%
Rhode Island	2,403	2,337	-2.75%
South Dakota	14,954	15,379	2.84%
Tennessee	7,143	7,209	0.92%
Texas	48,188	46,694	-3.10%
Utah	10,303	7,785	-24.44%

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Virginia	19,232	19,337	0.55%
Washington	12,069	12,394	2.69%
West Virginia	1,320	1,455	10.23%
Wisconsin	5,780	5,643	-2.37%
Wyoming	2,269	1,977	-12.87%
TOTALS	745,022	763,203	2.44%

For 2003, the report shows a total of 763,203 new corporate filings, compared with 748,083 new LLC filings. Based on those numbers and the trends reported in the 2004 IACA report, we expect that when the 2005 is released with final 2004 figures, it will show that new LLC filings will have surpassed total new corporate filings for the first time.

While the growth in LLC filings is a healthy trend for the economy, as well as for the Commercial Recordings Division and resident agents, the lack of growth or decline in corporate filings is cause for some concern. Since corporate filings have always been a historical staple revenue source generated by the Secretary of State's office and resident agent marketing efforts, any decline in corporate filing numbers will likewise be reflected in a decline in commercial recording fees generated by future new corporate filings.

The NRAA believes that the proposal to provide charging order protection to the stock of Nevada small business corporations will reinvigorate corporate filings in Nevada. Of particular interest to the NRAA is in positioning Nevada to capture a greater share of the market that is currently filing corporate entities in Florida – at a rate, we note, that far exceeds the baseline incorporation level that is supported by the population of the state. A large proportion of Florida corporate filings are generated by law firms who are attracted to Florida's general climate for asset protection (as evidenced by Florida's unlimited homestead exemption on the value of residential real estate).

We feel that the addition of charging order protection for Nevada corporate entities will provide the state with a significant tool to gain national market share in the incorporation market, and to continue to aggressively compete with states such as Florida, Delaware, Wyoming and South Dakota for the importation of corporate filings and its associated revenues and economic development impacts.

Possible Objections

It is difficult for our Association to fully anticipate all of the possible objections that might arise from our proposal. As groups raise legitimate concerns, we are prepared to sit down with these parties and discuss these concerns rationally in the pursuit of resolving problem issues or reaching workable compromises wherever possible. Nevertheless, as we have discussed this issue at the level of our Executive Board, we have identified the following possible objections:

Unreasonable Protection for Debtors

Clearly, the proposal to add charging order protection to small business corporation stock provides a degree of additional protection from judgment creditors that are not now present. Some, particularly those involved in seeking and collecting judgments, may perceive that this charging order protection may prevent or hinder the collection on legal judgments, or that the charging order has potential for abuse in creditor/debtor relationships.

We would argue that the current law - where foreclosure and forced sale of corporate stock can result - may provide less protection to creditor than the charging order proposal. If stock of a closely-held corporation is liquidated in an auction on the steps of the county courthouse under foreclosure proceedings, the creditor is unlikely to receive anything close to full value for corporate stock or assets because the forced sale does not take place in an environment that enables the stock to be sold at its highest value.

In preparation for bringing this proposal to the legislature, we have discussed this concept with several Nevada attorneys who practice in the area of business law. It was universally noted that the forced liquidation of closely-held corporate stock is rare due to the fact that the creditor is unable to receive sufficient value to justify the expense of the proceedings in such a circumstance.

While the charging order on corporate stock may delay the creditor's ability to collect on the judgment, the likelihood may be much greater that the creditor is able to collect on the full amount, either through the attachment of future dividend distributions or at some future point of sale or transfer of corporate stock.

Potential for Abuse

Some may argue that the charging order has potential for abuse and fraud. Those who would attempt to use the corporation as a tool for fraud are also likely to attempt to hide behind the protection of the corporate veil and any connected charging order limits.

In the event of criminal fraud (and related sanctions and penalties), the charging order would have no application. In civil actions or suits, the charging order would generally apply to judgments obtained against individual shareholders UNLESS the entity is also named as a party to the action, and the court finds that fraud or "manifest injustice" is present in the corporation's involvement or activity. In the presence of fraud or manifest injustice, the corporation veil can be pierced and individuals can be held personally liable.⁴ The court has wide latitude to deal with matters of fraud and abuse.

Unreasonable Protection from Liability for Corporate Actions

If the charging order is not properly understood, it may seem to the uninformed that we propose to create additional barriers to legitimate claims against the corporation. Such is not the case. The charging order does not apply to actions against the corporation. Any injured party with a legitimate claim or action against a corporate entity may pursue that action in the courts. If a judgment is obtained against the corporation itself, all assets of the corporation are potentially availability for satisfaction of the judgment. In other words, a corporation cannot use a charging order to prevent satisfaction of claims against the entity for any reason.

⁴ NRS 78.747

Conclusions

Providing charging order protection to Nevada small business corporations will give Nevada a significant competitive edge that will have reap tremendous economic benefits for many years. This proposal breaks new legal ground in the area of corporate law in a manner that no other state can currently match. While the Nevada Resident Agent Association is unable to predict the specific impact these changes will have on Nevada filings, we do predict that the consequences will be substantial. If passed, the addition of charging order protection for Nevada corporations will catch the attention of the entire legal community, and will become the subject of a tremendous amount of technical "buzz" and publicity for Nevada's advantages.

This proposal represents an attempt to provide equal treatment among the available business entity types regarding the protection of the economic interests of innocent partner/stockholders of Nevada corporations. However, the charging order also provides important protections to ensure that creditors will receive full value remedies, and thus protects their economic interests as well.

Further, the proposal seeks to provide long-term protection and reinforcement of Nevada's commercial filing staple: the corporation. As Nevada competes with many other states for market share in the corporate filing world, it will be poised to attract a large number of filings that currently go elsewhere.

Impacted NRS Sections

- NRS 78 Private Corporations
- NRS 78A Close Corporations
- NRS 21 Enforcement of Judgments

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