LAWSUIT

and

ASSET PROTECTION

Complete Guide to Protecting and Insulating Your Hard-Earned Assets from Lawsuits, Judgment Liabilities and IRS

For Homeowners, Businessmen, Professionals, Consumers, Creditors or Debtors - and Their Attorneys, Accountants and Financial Planners

VIJAY FADIA

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Protecting Jointly-Held Property from Creditors 1

Joint ownership is probably the most popular form of family ownership of property, while at the same time the least understood. It is estimated that more than three-fourths of all the real estate owned by married couples in the United States is held in joint tenancy. When you consider joint bank accounts, joint ownership of stocks and bonds, and joint safe deposit boxes it becomes apparent that joint ownership of property is by far the most prevalent form of ownership.

More important, such joint ownership of property is not limited to husbands and wives. It is quite common to see homes, bank accounts, even an automobile owned in joint tenancy by a mother and daughter, or by parents and a teenage son, or by two business partners.

When more than one person own the same property at the same time, they're said to be "co-tenants" of that property. Co-tenancy can be in several forms: joint tenancy, tenancy by the entirety, tenancy in common, and tenancy by partnership.

The problems often arise when a creditor of one owner tries to collect the debt owed by levying on the jointly-owned property. Can the creditor of one joint tenant reach the whole property? Can he at least reach his debtor's share of the property? Can he force a sale or a division of the property to satisfy the debt? In other words, do you have to worry about the creditors of your co-tenant or joint tenant? Can his creditors reach your money in the bank account or your share of the residence?

In this chapter we'll examine the rights of one co-tenant or joint tenant against the creditors of another, and the problems a creditor may encounter when he tries to levy the jointly-owned property of his debtor.

Joint Tenancy

A joint tenancy is a joint interest owned by two or more persons in equal shares with the express declaration that the title is held in joint tenancy. A joint tenancy may be created by the owner's conveying to two or more persons, as joint tenants, or by one of the owners conveying to himself and one or more persons as joint tenants.

Simultaneous Deaths

A joint tenancy in most jurisdictions must, however, be created by a written instrument and not by an oral agreement. In the event of simultaneous deaths, the joint tenancy is severed and the undivided interest of each tenant is divided as if he or she had survived the other. For instance, the joint property of husband and wife would be divided equally, so that one-half passes through the husband's estate and the other half through the wife's estate.

Illustration: A and B who own an asset as joint tenants die simultaneously. The right of survivorship is inoperative. One-half of the asset will be distributed in the estate of A as if A were the surviving joint tenant and the other half will be distributed similarly in the estate of B.

Joint tenancy conveys to each tenant equal and undivided interest in the property. However, if any one joint tenant conveys his interest, the joint tenancy is severed and the parties become tenants in common as to the conveyed interest.

Right of Survivorship

Joint tenancy has one feature that distinguishes it from all other forms of ownership: Upon the death of one of the joint tenants, the surviving tenant or tenants become the sole owners of the entire property by operation of law. The decedent's will has no effect on the disposition of a jointly-held property.

In some states, a joint tenancy between a husband and wife is presumed to be tenancy by the entirety. This form of ownership is similar to joint tenancy with a right of survivorship, except neither spouse may sever the tenancy without the other's consent.

Disadvantages

The principal disadvantage of joint tenancy lies in its general inflexibility and the inability of the tenants to dispose of the property by will, except upon the death of the survivor. In addition, since the entire interest in the property passes to the surviving tenant outright, all of it is subject to inclusion in the survivor's estate.

Joint tenancy form of ownership is not a will substitute and should not be used as such. It is almost invariably necessary for the joint tenants to have wills to dispose of other assets and the joint tenancy asset, if the testator is the survivor. A will is also necessary to appoint guardians for minor children.

Many individuals with small estates may own all of their assets in joint tenancy, and often married couples own their residences and checking accounts in joint tenancy. If the bulk of the family assets are held in joint ownership, they will pass to the survivor outright. The survivor, as absolute owner of the property, may dissipate it, reinvest it unwisely, or make injudicious gifts.

If the surviving spouse later remarries, some or all of the property may pass to his or her second spouse to the exclusion of the children of the first marriage. It's possible, for example, that the surviving spouse may put all the property received as the surviving co-owner into a new co-ownership with the spouse of the second marriage, or may leave all the property by will to such spouse.

Tenancy by the Entirety

A tenancy by the entirety is a special form of joint tenancy which may be used only by a husband and wife. Its origins can be traced to the English common law when property was transferred to husband and wife together. In early days, man and woman as a result of marriage, for legal purposes, were treated as a unification of the two people, so that their ownership of property (usually real estate) was not regarded as being owned by the two individually, but by the "unity," or by the "entirety."

Under this concept the whole of the property is owned not by two people but rather by the unity created when the parties are married, and the two take title as a single person.

Because of this entirety concept, neither party, acting alone, could transfer his or her interest in the property held by the entirety, and on the death of either party, the survivor would own the whole property. In this respect, tenancy by the entirety works in the same fashion as a joint tenancy. The tenancy in the entirety operates until both parties agree to a transfer or until the marriage is dissolved by law or by the death of one of the parties.

Presently, twenty four jurisdictions recognize tenancy by the entirety in some form. The laws applicable to this form of ownership vary from state to state with certain basic similarity in concept and elements. Many states, however, have actually abolished tenancy by the entirety on the theory that it is out-moded and does not reflect the present-day attitude that husband and wife are individuals, notwithstanding their marriage relationship.

In many states that recognize tenancy by the entirety, there's often a presumption that when husband and wife take property as joint tenants, they're actually taking ownership as tenants by the entirety. To eliminate this presumption, if your intentions are to own the property in true joint tenancy, the title should read as "joint tenants and not as tenants by the entirety." It is important to consult your local state law to determine the full implications of various forms of property ownerships.

Comparing Tenancy by the Entirety with Joint Tenancy

The tenancy by the entirety has a common characteristic with joint tenancy in that there is a right of survivorship in both. That is, on the death of either owner, the survivor owns the whole property. However, there are important differences between the two.

First, a joint tenancy may be held by any number of persons, while a tenancy by the entirety may be held only by husband and wife.

Second, any one of the joint tenants by transferring his ownership to a third party can sever or terminate the joint tenancy, whereas a tenancy by the entirety may not be transferred unless both parties agree, and may not be severed except by dissolution of marriage, or by the death of one of the parties, or by agreement between husband and wife.

The right of a surviving spouse to own the whole property on the death of a spouse is one of the major advantages of holding property by the entirety. Such property passing to the surviving spouse becomes hers or his alone without going through probate, and without being subject to the claims of creditors of the deceased person (unless the property itself was pledged as collateral or security, such as a mortgage signed by both parties.) The surviving spouse may then dispose of the property as her or his own, regardless of any provision to the contrary in the will of the deceased spouse.

In the event of a simultaneous death of both spouses, the property would be distributed as if it was owned by them as tenants in common. In other words, one-half of the property would pass to the husband's estate and the other half to the wife's estate.

Different Types of Co-Tenancies and Their Characteristics - An Overview

Question	Joint Tenancy	Tenancy by the Entirety	Tenancy in Common
Survivorship rights?	Yes	Yes	No
Right to sell share?	Yes	No	Yes
Right to divide?	Yes	No	Yes
Can creditors reach share?	Yes	Maybe	Yes
Included in estate?	Yes (unless w/ spouse, then one-half)	Yes (one-half)	Only your share

Joint Tenancy vs. Trust

Question	Joint Tenancy	Trust
Avoids probate?	Probably	Yes
Can save estate taxes?	No	Yes
Protection from creditors' attack?	No	Yes
Provides for the unexpected?	No	Yes
Affected by disability of owner?	Yes	No
Affected by simultaneous death?	Yes	No
Affected by divorce?	Yes	No
Easy to contest?	Yes	No
Can provide for spouse, children and grandchildren?	No	Yes
Can protect from creditors of beneficiaries?	No	Yes
Can predict outcome?	No	Yes
Reduces overall costs and expenses?	No	Yes

Factors Affecting Creditors' Rights

Whether a creditor will be able to reach jointly-owned property depends primarily on three factors:

1. Whether the debtor (joint tenant or co-tenant) is alive or deceased at the time the creditor attempts to levy on the property.

2. Whether the property is held in a joint tenancy, a tenancy-in-common, or a tenancy by the entirety.

3. Applicable state law.

These factors will largely determine whether the creditor can reach the property in satisfaction of his debt.

While the Debtor Is Alive

Joint Tenancy

A creditor seeking to satisfy a debt owed to him may attach his debtor's interest in property held in a joint tenancy if the debtor/joint tenant is alive at the time of the attachment. (An attachment is a legal securing of property to satisfy a debt.)

The general rule followed by the courts is that during the life of a joint tenant, that joint tenant's undivided interest can be reached by his creditors. The theory behind this is that each joint tenant is able to sell or transfer his interest during his life, thus severing the joint tenancy between himself and his co-tenants and creating a tenancy in common between his buyer and the other co-tenants. Since each joint tenant can sell or otherwise freely transfer his interest, his creditor should be able to reach that same interest to satisfy a debt owed by the joint tenant to the creditor.

The creditor's attachment on the joint tenancy creates a result similar to when a joint tenant's interest is sold. The joint tenancy between the debtor and his co-tenants is destroyed and the creditor becomes a tenant in common with the other co-tenants. The other co-tenants remain joint tenants among themselves.

Case: The case of *Frederick v. Shorman* provides a good illustration of this result. In that case Hilda Bjornsen bought a piece of residential property in Cedar Rapids, Iowa, and had the deed state that she and her son, Robert, were joint tenants in the property with full rights of survivorship. Robert later married Yvonne and they had a daughter, Roberta. Robert and Yvonne were subsequently divorced and a judgment for child support was entered against Robert. When Robert failed to pay, Yvonne went to court and obtained an order that if Robert did not pay immediately, his property would be attached and sold to satisfy his obligations.

Hilda then brought an action in Lynn District Court in Iowa seeking to have the court declare that Yvonne could not attach the jointly-held property. She argued that when she added Robert as a joint tenant she had only intended to create a future right of survivorship in her son and not a present interest that could be attached by his creditors. "I was unmarried at the time I purchased the property," she told the court, "and he was my only child, my only heir, so naturally I put the house in his name, only if something happened to me, he would get the house."

Hilda also argued that she and Robert had agreed that Robert was to pay her one-half of the purchase price and maintenance on the property, but he never did. Since he never paid anything toward the property, he had no real interest in it and his creditors should not be able to touch it.

The district court agreed with Hilda's arguments and held that Yvonne was restrained from proceeding with her attachment and levy on the property. Yvonne appealed to the Supreme Court of Iowa.

The Iowa Supreme Court reversed the lower court's decision. It agreed with Yvonne that Robert and Hilda did indeed hold the property as joint tenants because the deed on the property clearly reflected this intent. It reached this conclusion despite the fact that Robert never paid for any of the property's cost. Since Yvonne brought her action while Robert was still alive, she had the right, as Robert's judgment creditor, to proceed with her sale of Robert's one-half undivided interest in the property.

Tenancy in Common

A creditor of a tenant in common may clearly attach the interest which his debtor owns in the tenancy in common. This is a well-settled principle in the law. It must be remembered, however, that the creditor stands in the shoes of his debtor, and therefore he can only take the interest which his debtor owned. In this event the creditor becomes a tenant in common with the other co-tenants.

Case: In a Colorado case, C.V. James and his family were tenants in common in a parcel of land in El Paso County, Colorado. Mr. James owned a three-fourths interest and his wife and children owned the other one-fourth interest in the property (tenants in common needn't have equal shares).

In 1931, William J. Fallon won a judgment against Mr. James in the district court of Boulder County. An order for collection on the judgment was subsequently issued, and the sheriff of El Paso County was ordered to collect the money owed. The sheriff levied upon the land and put the land up for sale so that the proceeds could be given to Fallon and the judgment could be satisfied. Mr. Fallon himself purchased the property at the sheriff's sale, and he received the sheriff's deed. The sheriff's deed, however, appeared to convey all the interest in the land. It made no mention of the three-fourths interest of Mr. James. Mr. Fallon went into possession of the land assuming he was owner of the whole property.

It was not until eighteen years later that Mr. James' wife and children claimed their one-fourth share of the property. Mr. Fallon resisted but the El Paso County District Court agreed with the wife and children. Fallon appealed.

The Supreme Court of Colorado also agreed with the wife and children and held that despite the fact that the sheriff's deed purported to convey all the interest in the land, the only interest the sheriff could levy upon was that of the debtor, C.V. James, and not upon the interest of the co-tenants. Only Mr. James' three-fourths interest could be reached by Fallon. Therefore, when Mr. Fallon bought the land, he stepped into the shoes of Mr. James, his debtor, and became a tenant in common in the land with Mr. James' wife and children. The wife and children were allowed to claim their interest in the land, even though so much time had elapsed.

Tenancy by the Entirety

Tenancy by the entirety is a special form of joint tenancy that can be used only by a husband and wife. Under this form of ownership, the whole of the property is owned not by two individual spouses but rather by the unity created by the marriage partners; the two married partners take title as a single person.

In the states that recognize tenancy by the entirety, neither spouse, acting alone, can sever such a tenancy. This creates unique problems for creditors who attempt to attach the husband's or wife's interest in the property (except in the case of a bankruptcy.)

As a general rule, if the husband wife are jointly liable on a debt, the property they hold as tenants by the entirety may be attached during their lifetime and sold for satisfaction of their debt. However, if only the husband or only the wife is individually liable on a debt, the creditor will usually not be allowed to seize that property.

Except for those states where tenancy by the entirety has been abolished or modified, creditors of the wife may not attach the property and have it sold. Since the wife herself is not allowed to sell her interest in a tenancy by the entirety, her creditors could gain no greater rights and therefore will likewise not be allowed to sell it. In effect, the wife's interest in the property is insulated from the claims of her individual creditors during her lifetime.

Except in those states (such as Massachusetts) where special protection is given by law to a principal residence or other property held under a tenancy by the entirety, a creditor of the husband may place a lien or attachment on the property since the husband has the sole right to possession during his life. However, as a general rule, the property will not be sold to satisfy the husband's debt so long as the wife is alive.

After the Death of the Debtor

Joint Tenancy

One of the essential characteristics of the joint tenancy with a right of survivorship is that the surviving tenant becomes owner of the whole property after the death of his joint tenant. In other words, by operation of law, the joint tenancy ceases to exist upon the death of the joint tenant.

One consequence of this characteristic of joint tenancy is that the creditors of a deceased joint tenant may not satisfy their debts from the jointly-held property. The theory behind this is that the property no longer belongs to the joint tenant's estate, but passes as the sole property of the surviving joint tenants. In other words, the creditors cannot reach the joint property because there's "nothing" to reach.

The creation of joint tenancy is deceptively simple. And as we've seen before, a very large portion of property owned by more than one person in the United States is held in joint tenancy with right of survivorship. But before you rush out to put all your property into joint tenancy, so as to put it out of reach of creditors after your death, you should carefully examine the tax and legal implications of joint tenancy, as well as exceptions to the rules. Consult a professional for proper guidance.

Exceptions

Although, as a general rule, a creditor cannot reach the jointly-owned property on the death of a debtor/joint tenant, there are two recognized exceptions to this rule:

First, if the joint tenancy was created to defraud the creditors it would be deemed a fraudulent conveyance and would be set aside.

Second, jointly-held funds are generally subject to the payment of federal or state taxes. In other words, you'll not be able to avoid the taxman by forming a joint tenancy.

A third exception would apply in those states that have specific laws regarding creditors' rights against joint property. South Dakota, for example, has a law that allows a creditor to sue a surviving joint tenant for the debts of a deceased joint tenant, and the creditor may reach the joint property to the extent of the deceased joint owner's contribution. And Washington seems to take the position that a joint tenancy shall not cause a creditor to lose his rights. But these states are definitely in the minority.

To the extent that the jointly-held property is subject to federal or state taxes, the surviving joint tenant (or tenant by the entirety) will still own the property but be subject to the payment of taxes. In fact, a lien (a legal attachment) automatically attaches to all property that is subject to tax in the deceased's estate. If there's not enough money to pay the tax out of other property, the jointly-held property may be sold to pay the tax.

Creditors and Joint Bank Accounts

Joint bank accounts between husband and wife or other members of the family or even between two unrelated parties engaged in a common business venture are quite common. It is important to realize the rights of creditors of one of the joint tenants in the event the creditor obtains a judgment against that joint tenant.

Can a creditor of one of the account holders attach the funds in the jointly-held account to satisfy the debt? Is he entitled to only one-half of the funds in the account or can he attach the entire account? Can he do so if the debtor is the non-contributing co-tenant (in other words, if the debtor is only an account holder in name without having contributed any money to the account)?

The answers to these questions depend upon the applicable state law and specific circumstances of the case.

In some states the law provides that each tenant of a joint bank account has a "vested" interest in the account. A vested interest is one which legally belongs to a person, giving him in effect an absolute ownership. Even in the absence of a specific state law, a court may rule that a creditor who has obtained a judgment against one of the joint tenants now stands in the shoes of the joint tenant and is able to withdraw the funds in the account just as the joint tenant himself is able to do. The following case illustrates the complications that arise with joint bank accounts.

Case: Benedict Track and his wife, Dorothy, opened a joint account at the Northwestern National Bank of Minneapolis. The account card they signed stated that all funds deposited would be the property of the depositors jointly with right of survivorship in each, and that each party had complete and absolute authority over the account and that either could withdraw any part, or all of the funds.

Benedict owed rent to an organization called Park Enterprises. Park sued Benedict and obtained a judgment against him, and went on to attach Benedict's bank account. Wife, of course, protested that the joint account was not attachable for her husband's debts. Further, she contended that some of the funds in the account were contributed by her and were her separate property, and therefore should not be reachable by Park. The lower court ruled that Benedict's creditor could reach what was Benedict's and allowed Park to reach one-half of the account. Benedict and Dorothy appealed.

The Supreme Court of Minnesota looked at things differently. The high court said that Park Enterprises not only could reach one-half of the account, but was entitled to recover all of the funds in the account up to the full amount necessary to satisfy the judgment against Benedict. The court reasoned that the contract covering the joint account allowed either of the account holders to withdraw the full balance without accounting to the other.

As this case shows, ownership of the funds in a joint bank account may or may not end up the way the parties intend, depending upon the actual circumstances and the applicable state law. Some states have laws establishing a presumption of a certain intent on the part of the joint tenants, while the laws of other states may establish conclusively that the parties intended a true joint tenancy. In short, ownership of funds in a joint bank account is somewhat unpredictable and the results may or may not be to your liking.

Protecting the Tenancy-by-the-Entirety Property from the Claims of Creditors

Does ownership of a property in tenancy by the entirety afford any protection against the claims of creditors of one of the spouses? Many people are under the impression that if they own a property in tenancy by the entirety, the property would be insulated against the claims of creditors.

The fact is this may or may not be true, depending upon the circumstances.

The determining factor is whether the creditors are creditors of husband or wife, or both, and more importantly, whether the applicable state law recognizes tenancy by the entirety and the extent to which it allows a creditor to reach such property.

Generally speaking, if a husband and wife are jointly liable on a debt, that is, if they both have signed the promissory note and/or both agreed to pay the debt, then any property they own, whether individually, jointly, or as tenants by the entirety may be subject to attachment by their creditors and sale for non-payment of the debt. On the other hand, if the debt is incurred by either husband or wife individually, then the property owned as tenants by the entirety is usually not subject to attachment and sale to satisfy the debt of one of the spouses.

Of course, if the property is pledged as security for the debt (such as on a mortgage), then that property may clearly be sold to satisfy non-payment of the debt.

Fraudulent Conveyance

Most states have adopted the Uniform Fraudulent Conveyance Act (or similar act), which states that a party may not gratuitously transfer property to another (including a transfer into a co-tenancy) if his intent in doing so is to defraud his creditors. The Uniform Act says that such an intent is presumed if the transfer thereby renders the party insolvent.

Some cases have held that if a party puts his property in a joint tenancy in order to defraud a creditor, then that creditor may reach the jointly-held property on his debtor's death. For example, the New York Court of Appeals in 1967 decided in a case that if mutual funds were placed in joint accounts to defraud a creditor, that creditor could reach the funds at the debtor's death.

Creditors' Rights in a Bankruptcy

The right of a creditor to reach a jointly-held property is generally more restrictive as long as the debtor has not filed for bankruptcy. Once in bankruptcy, the creditor may be able to go farther. The federal Bankruptcy Code has established some special rules for joint tenancy when one of the joint tenants is declared bankrupt by a federal court.

When a person is the subject of bankruptcy proceedings, all his property is under the jurisdiction of the court and becomes the property of the "trustee" in bankruptcy. This will include his interest as a joint tenant, tenant in common, or tenant by the entirety.

Under the Bankruptcy Code, the trustee in bankruptcy may sell the property of the bankrupt co-tenant under any of the various forms of co-tenancy and apply the proceeds of the share of the bankrupt co-tenant to satisfy the bankrupt co-tenant's debts. It is up to the non-bankrupt co-tenant to properly claim his share of the proceeds of the commonly-held property before they are applied to satisfy the debts.

If a non-bankrupt co-tenant is the true "owner" of jointly-held property in which the bankrupt is his co-tenant, he must prove to the court that none (or only a part) of the commonly-held property should be subject to the bankruptcy proceedings. This could prove quite difficult and, even if successful, could result in considerable expense.

Illustration: Father creates a joint bank account with his Son. Father contributes all the money and lists his Son as a joint tenant only as a matter of convenience. Later Son files for personal bankruptcy and, as the law requires, lists the joint bank account with his Father as an asset. Under the Bankruptcy Code Father must prove to the court that he contributed all the funds in the account before he can recover them.

If instead of a bank account he had opened a brokerage account, registered jointly with his bankrupt Son, he would be able to recover only one-half the value of the securities, since the other half would have been considered a completed gift to his Son. The Son or his creditors would be entitled to that one-half regardless of the fact that Son had made no contribution.

In some states, exception against a bankruptcy sale is provided for certain property. For example, principal residence held in tenancy by the entirety may be protected against a bankruptcy sale. Remember, however, that this is more of an exception than the rule. You should check the laws of your state to see if you're entitled to any special protection.

The manner in which you own a property may have the moat significant impact on your asset protection and estate planning strategies. It will determine the disposition of the property upon your death, it may affect the claims of creditors and it definitely will have federal estate, income and gift tax implications.

Agreement to Convert Joint Tenancy to Tenancy in Common

Agreement made, effective ________________ [date], by and between __________ ________________________________, of ____ [address], County of __________________, State of ___________________, and _______ _________________________________, of __________________________________ _______, [address], County of __________________, State of ____________________.

RECITAL

The parties to this agreement desire that the property, both real and personal, now owned by them in joint tenancy and not as tenants in common be converted and held by them as tenants in common, and not as joint tenants with right of survivorship.

SECTION ONE

OWNERSHIP RIGHTS

It is agreed that from and after the effective date of this agreement all the real and personal property owned by the parties to this agreement, whether presently held in joint tenancy by the parties, or presently owned by either of the parties in that party's own name, shall be owned by each of the parties as follows:

An undivided ____________ percent (______%) interest therein shall be the separate property of ____, and _____________ _________________________________ assigns and transfers to _________________ _________________________________ all of such transferor's right, title, and interest in and to such undivided ____________ percent (______%) interest in the same.

An undivided ____________ percent (______%) interest therein shall be the separate property of ____, and _____________ _________________________________ assigns and transfers to _________________ _________________________________ all of such transferor's right, title, and interest in and to such undivided ____________ percent (______%) interest in the same.

SECTION TWO

CONVEYANCES

The parties further agree to execute and deliver any deed or other instrument, and to do any act, necessary to effectuate this agreement.

SECTION THREE

GOVERNING LAW

This agreement shall be governed by, construed, and enforced in accordance with the laws of the State of ________________________.

SECTION FOUR

ASSIGNMENT OF RIGHTS

The rights of each party under this agreement are personal to that party and may not be assigned or transferred to any other person, firm, corporation, or other entity without the prior express and written consent of the other party.

In witness whereof, each party to this agreement has caused it to be executed at ________________________________ *[place of execution]* on the date indicated below.

____

____

Signatures and date(s) of signing

[Acknowledgments]

Creditors' Rights in Community Property States

2

The system of community property ownership prevailing in the United States today is essentially an inheritance from the Spanish and can be traced in written form to the Visi Gothic Code of 690 A.D. The community property system was originally adopted by eight states: Louisiana, Washington, Texas, New Mexico, Nevada, California, Idaho and Arizona. Wisconsin became the latest state to adopt community property system in 1985.

History

The community property system, as originally brought from Spain or Mexico, has undergone varying degree of development in these states and the laws in these states are far from uniform.

Husband Controlled All Property

Over the years, husband, as a rule, was the domineering partner in the community. Husband more or less exercised complete control of his separate property, of the community property, and of the wife's separate property. In many cases, wife had no capacity to contract debts. The community was generally subject to debts of the husband but rarely subject to debts of the wife.

Starting from the early to mid-19th century, state legislatures made periodic changes in the community property laws, a result of which was to increase the rights of married women. For example, in 1913 married women in Texas were given control of the separate property which they had brought into the marriage or acquired later by gift or inheritance. California, in 1917, provided that the wife had to join in any instrument by which the husband conveyed, encumbered, or leased for more than one year any community real property.

For the most part, however, the general rule of inequality between sexes prevailed. The right of a married woman to enter into contracts and to manage community property was substantially restricted across the board.

Equality between Spouses

Major reform toward bringing sexual equality into community property did not take place until the 1960's. The effect of these new reforms has been to equalize the rights and responsibilities of partners in marriage. Now, women have equal power to manage community property, just as they have the full power to contract and manage their separate property. Community property is now subject to debts of the wife under the same principles that made property subject to the husband's debts.

Creditors' Rights in General

Common Law States

In non-community property states, also known as common law states, the question of what property a creditor of the husband or wife may reach to satisfy the creditor's debt is relatively simple. If the debt is owed by the husband, his property may be reached. If the debt is owed by the wife, her property may be reached. Thus, if a husband was indebted to the creditor, creditor would obtain a judgment against the husband and then execute on the husband's property.

If both husband and wife are liable on the debt, and the liability is joint and several as it usually is, judgment can be obtained against either or both and the property of either or both, may be reached by execution. In other words, the fact that two individuals are married does not directly affect either their liability for obligations incurred or the property that may be reached by their creditors.

Community Property States

In contrast, in a community property state, the fact that two individuals are married is of paramount importance in determining, first, who is liable for the debt, and second, what property may be reached after a judgment has been obtained by a creditor.

When a married person in a community property state incurs a debt, it needs to be determined whether the debt is of that particular individual's separate obligation, a community obligation, an obligation of the other spouse because the contracting party was acting as the spouse's agent, or any combination of the above.

Thus, for example, if a wife enters into a contract to purchase an automobile, she may be purchasing it on her own and not purchasing it either on behalf of her husband or the community. On the other hand, it is also possible that she is purchasing the automobile for the community and thus obligating the community for the debt. In the event that she is purchasing the vehicle as an agent for her husband, she is obligating only him and his property.

While analyzing a creditor's claim against a specific property of a married couple, the following questions need to be answered:

1. Does the creditor have a claim sounding in contract or in tort?

2. Is the debt a separate debt of one of the spouses or a community debt?

3. Is the creditor attempting to reach community property or the separate property of one or both spouses?

4. Does the property the creditor is attempting to reach represent earnings of one of the spouses?

5. If the property is community property, is the creditor attempting to reach all of it or only the interest of one of the spouses in it?

6. Is the claim one that arose before or after the marriage?

7. What is the statutory and case law of the jurisdiction? There's little uniformity among the laws of various community property states.

Separate and Community Property

In general, property that one of the spouses brings to the marriage continues to be his or her separate property during marriage. Gifts and bequests of property to one spouse during the marriage are also the separate property of that spouse, as is property inherited under the intestacy laws.

All other property is community property, including that which is earned by either spouse during the marriage and profits from community property accumulated by the couple. Commingling of separate property generally transmutes it to community property, and there is a general presumption that property obtained by either spouse during the marriage is community property.

Two aspects of community property deserve mention in the context of creditors' rights. Earnings of a spouse during the marriage are generally community property, but are sometimes treated differently than other community property when creditors of the other spouse are attempting to reach them to satisfy a separate debt.

More complex is the question of whether a spouse's interest in the community property is liable for the spouse's separate debts. A spouse does not have the right to withdraw his or her interest in the community and to make it separate property, and, in absence of divorce or separation, there is no right to have the community property partitioned. However, this does

not necessarily mean that a creditor should not be able to reach a spouse's interest in the community in order to satisfy that spouse's separate debt.

Separate and Community Debts

The distinction between separate and community property is fairly clear from the statutes and case law of all community property jurisdictions. The same cannot be said of community debts and separate debts. Except for New Mexico, no other jurisdiction has a statutory provision defining separate and community debts.

Obligations incurred prior to the marriage or after a separation or divorce are universally denominated as the separate obligation of the spouse incurring the debt. On the other hand, debts incurred during the marriage are generally community obligations.

If the resulting debt was from a contract made on behalf of the community or if the activity giving rise to a tort obligation was designed to benefit the community, the presumption again is that, if that was incurred during marriage by either spouse, it is a community obligation.

The law in New Mexico is more definite. By statute, it defines separate debts as those incurred prior to the marriage or after either a divorce or separation, and as those debts "contracted by a spouse during the marriage, which are identified by a spouse to the creditor in writing at the time of its creation as a separate debt of the contracting spouse," or which are obligations resulting from a "separate tort committed during marriage." In New Mexico, the statute also provides for a judicial decree that a debt is a separate debt. Community debts are defined simply as all debts incurred by either spouse during marriage that are not separate debts.

Liability of Marital Community

The concept of marital community discussed in this chapter, a concept common to Texas and California, must be distinguished from that found in other community property states, such as Arizona, New Mexico or Washington, for example.

Law in Arizona, New Mexico and Washington

In the latter states, the marital community might be viewed as an independent or quasi-independent entity capable of incurring obligations or debts, and for which husband and wife may at times act as agents. Under this system, the intent with which a spouse contracts is relevant in determining the extent of liability; if a spouse contracts for the benefit of the community, or contracts as an agent of the community, then the community property may be liable, but not otherwise.

	Community Debts	Separate Debts
Arizona	Must be satisfied first from community property, then from separate property of contracting spouse. Separate property of non-contracting spouse not liable.	If contracted before 9/1/73, may be satisfied only from separate property of contracting spouse. If contracted after 9/1/73, may be satisfied from separate property of contracting spouse and from community property to the extent of contracting spouse's contribution thereto.
New Mexico	May be satisfied from community property and from separate property of contracting spouse. Separate property of non-contracting spouse not liable.	May be satisfied from separate property of contracting spouse and from one-half of the community property.
Washington	May be satisfied first from community property and from separate property of contracting spouse. Separate property of non-contracting spouse not liable.	May be satisfied only from the separate property of the debtor spouse. Pre-nuptial credtors of a spouse may also reach that spouse's community property earnings.

Law in California, Texas and Idaho

This approach to community property law, commonly called the "community debt" doctrine, is rejected in California and Texas, which provide by statute that at least some of the community property will be liable for the debts of either spouse regardless of the purpose for which the spouse incurred them.

In California, Texas and possibly in Idaho, proper analysis requires that marital obligations not be analyzed in terms of "community" and "separate" debts. In those jurisdictions, obligations are attributed to the husband or the wife, or to both of them jointly.

The "marital community," a concept common to California and Texas, is not an entity separate and distinct from husband and wife. It neither acts nor contracts as principal or through agents.

In Texas and California, the community of marriage owes nothing and owns nothing. A spouse's efforts during marriage are community efforts but not the community's efforts; property earned by a spouse during marriage is community property but not the community's property. The "community" does not own property or incur obligations; husband and wife do, either individually or jointly.

The liability of marital property is not affected by the purpose for which a spouse contracts; whether a spouse contracts for the benefit of himself or herself individually, or for the benefit of both marital partners, is irrelevant in determining the liability of marital property for debts of either spouse.

Summary

1. Generally, a community debt is a debt incurred by either spouse for the purpose of benefiting the community, as distinguished from a debt incurred for the benefit of a contracting spouse's separate estate only. If a spouse and the third party with whom the spouse deals agree that any obligations are those of the contracting spouse alone, any resulting debt is separate.

2. California, Texas and Idaho do not recognize the community/separate debt distinction. In those states debts are attributed to spouses individually or jointly, as the case may be. "Community debt" and "separate debt" are inappropriate analytical categories in those jurisdictions.

3. Louisiana and Nevada are community property jurisdictions whose community property laws may differ significantly from those of the other states. Therefore, they are omitted from the chart above.

A basic concept of community property law is that of marital effort. Property acquired by the efforts of either spouse during marriage is community property. Property acquired before marriage or that acquired afterward by gift or inheritance is the separate property of that spouse.

The separate property of a spouse is generally liable for all contracts of that spouse.

How to Avoid Joint Liability on Your Spouse's Debts

Under the modern community property statutes, both spouses now have the power to obligate the community property for their contracts. On the other hand, with the exception of the "necessaries" of life, neither spouse may unilaterally obligate the separate property of a non-contracting spouse for debts of a contracting spouse.

Where a debt is a joint obligation of husband and wife, all of the community property together with the separate property of the respective spouses, will be liable for the debt.

Generally speaking, joint liability is readily established in the context of marriage. For example, where one spouse pays bills of the other spouse, that spouse would be held jointly liable for subsequent debts incurred by the other spouse. In one case, by making even a single payment, one spouse is said to have clothed the other contracting spouse with apparent authority to contract joint debts.

Steps to Take

Spouses seeking to avoid joint liability on marital debts should take precautionary measures. For example, a wife who wishes to avoid liability for her husband's purchases should make clear to the husband, and immediately to the seller if she is billed for the debt, that her husband acted without her authority or consent. If she desires to pay that debt in full or in part, she should inform the seller that payment by her does not constitute a regular practice and that her husband does not have authority to make future purchases for which she will make payment.

Alternatively, she might make a gift of funds to the husband, or execute a partition agreement with him, so that he may pay the debt with his separate property.

Spouses should avoid making loans to the other spouse to enable the other spouse to pay debts or to start a separate business in which the other spouse might contract debts; such a practice has rendered the lending spouse liable for subsequent debts of the borrowing spouse. Again, a partition or gift of property may accomplish the same results without risking joint liability.

Overview of Rules and Exceptions

The following general statements illustrate the complexity of rules surrounding separate or community property and rights of creditors to reach it to satisfy either the separate or joint debts of marital partners. Keep in mind that these statements are entirely general, and for every categorization, there is a host of exceptions, and rules and exceptions vary from state to state. The statements are provided here only as a very general overview of property laws in community states.

✓ The general presumption in community property states is that all property acquired during marriage is community property.

✓ Separate property is property acquired before marriage and that property acquired afterward by gift, device, descent or bequest; community property is all other property acquired during marriage.

✓ Property traceable to separate property is separate property.

✓ The separate property of a spouse is ordinarily not subject to the liabilities of the other spouse.

✓ The separate property of a spouse is liable for the payment of debts contracted by either spouse for the necessaries of life.

✓ Specific items of separate property of a non-contracting spouse may be reached on a theory of fraud or constructive fraud.

✓ Generally, spouses are free to alter the status or ownership rights of marital property by contract, partition agreement or gift, but such transactions may not prejudice the rights of pre-existing creditors, and creditors of a contracting spouse may reach specific separate property in the hands of the non-contracting spouse, if that property can be traced to the contracting spouse's fraud.

For example, if a debt-ridden spouse transfers half the cash receipts from the sale of a community property car to his wife by gift with an intent to defraud the creditors, the creditors of that spouse would be able to reach the cash in the hands of the other spouse even though the transaction was effective as a gift between the spouses.

✓ The California rule is that community property is subject to the debts of either spouse contracted before or after marriage, except that neither spouse's earnings are liable for premarital debts of the other spouse.

✓ The Texas rule is that community property which is subject to the joint control of the spouses is liable for the debts of either which were contracted before or during marriage, or that community property, subject to the sole control of a spouse, is not subject to any non-tortuous liabilities of the other spouse.

✓ The form in which record title to real property is held is conclusive in favor of good faith purchasers for value, without notice of contrary claims.

✓ If for some reason record title to real property is in the name of the spouse not having actual authority to convey any interest therein, third party purchasers and creditors may nevertheless rely upon the form of title. For instance, in Texas the unilateral conveyance is conclusively valid in favor of third parties acting in good faith without notice.

✓ Judgments for or against one spouse in actions involving community property are not necessarily binding upon the other spouse.

✓ Agreements between spouses determining or altering the status of property are generally valid.

✓ Antenuptial contracts are generally valid in California and Texas.

✓ Marital partners may alter the status of property by postnuptial partition or contract.

✓ Marital partners may alter the status of property by conduct creating an inference that a gift has been made.

Community Property Laws in Individual States

Here we'll briefly examine the statutes that delineate the liability of separate or community property for the satisfaction of separate or community debts in various community property states.

Arizona

A. The separate property of a spouse shall not be liable for the separate debts or obligations of the other spouse, absent agreement of the property owner to the contrary.

B. The community property is liable for the premarital separate debts or other liabilities of a spouse, incurred after September 1, 1973 but only to the extent of the value of that spouse's contribution to the community property which would have been such spouse's separate property if single.

D. Except [when joinder of both spouses is required] in § 25-214, either spouse may contract debts and otherwise act for the benefit of the community. In an action on such a debt or obligation the spouses shall be sued jointly and the debt or obligation shall be satisfied: first, from the community property, and second, from the separate property of the spouse contracting the debt or obligation.

California

A. Except as otherwise expressly provided by statute, the community property is liable for a debt incurred by either spouse before or after marriage, regardless which spouse has the management and control of the property and regardless whether one or both spouses are parties to the debt or to a judgment for the debt.

B. The earnings of a married person during marriage are not liable for a debt incurred by the person's spouse before marriage... they remain not liable so long as they are held in a deposit account in which the person's spouse has no right of withdrawal and are uncommingled with other community property, except property insignificant in amount...

Calif. Civ. Code § **5122** provides in part:

A. A married person is not liable for any injury or damage caused by the other spouse except in cases where he or she would be liable therefor if the marriage did not exist.

B. The liability of a married person for death or injury to person or property shall be satisfied as follows:

1. If the liability of the married person is based upon an act or omission which occurred while the married person was performing an activity for the benefit of the community, the liability shall first be satisfied from the community property and second from the separate property of the married person.

2. If the liability of the married person is not based upon an act or omission which occurred while the married person was performing an activity for the benefit of the community, the liability shall first be satisfied from the separate property of the married person and second from the community property.

Idaho

The major statutory provision is Idaho Code § 32-912, set forth in Chapter 7, which provides that either husband or wife may bind the community property by contract with an exception for the sale, conveyance or encumbrance of realty, joint action is then required.

Idaho exempts some separate property from liability for certain community obligations. Idaho Code § 32-912 provides, in part: "any community obligation incurred by either the husband or the wife without the consent in writing of the other shall not obligate the separate property of the spouse who did not consent."

Louisiana

La. Stat. Ann. -Civ. Code art. 2360 as follows:

An obligation incurred by a spouse during the existence of a communitypropertyregime for the common interest of the spouses or for the interest of the other spouse is a community obligation.

A separate obligation of a spouse is one incurred by that spouse prior to the establishment or after termination of a community property regime, or one incurred during the existence of a community property regime though not for the common interest of the spouses or for the interest of the other spouse. An obligation resulting from an intentional wrong not perpetrated for the benefit of the community, or an obligation incurred for the separate property benefit of a spouse to the extent that it does not benefit the community, the family, or the other spouse, is likewise a separate obligation.

Reimbursement may only be made to the extent of community assets, unless the community obligation was incurred for the ordinary and customary expenses of the marriage, or for the support, maintenance, and education of children of either spouse in keeping with the economic condition of the community. In the last case, the spouse is entitled to reimbursement from the other spouse even if there are no community assets.

Nevada

Nev. Rev. Stat. 123.050:

Neither the separate property of a spouse nor his share of the community property is liable for the debts of the other spouse contracted before the marriage.

New Mexico

N. Mex. Stat. 1978 § 40-3-9:

A. "Separate debt" means:

(1) a debt contracted or incurred by a spouse before marriage or after entry of a decree of dissolution of marriage; [or legal separation].

. . .

(3) a debt designated as a separate debt of a spouse by a judgment or decree of any court having jurisdiction;

(4) a debt contracted by a spouse during marriage which is identified by a spouse to the creditor in writing at the time of its creation as the separate debt of the contracting spouse; or

(5) a debt which arises from a tort committed by a spouse before marriage or after entry of a decree of dissolution of marriage or a separate tort committed during marriage.

B. "Community debt" means a debt contracted or incurred by either both spouses during marriage which is not a separate debt.

§40-3-10: A. The separate debt of a spouse shall be satisfied first from the debtor spouse's separate property, excluding that spouse's interest in property in which each of the spouses owns an undivided equal interest as a joint tenant or tenant in common. Should such property be insufficient, then the debt shall be satisfied from the debtor spouse's one-half interest in the community property or in property in which each spouse owns an undivided equal interest as a joint tenant or tenant in common, excluding the residence of the spouses. Should such property be insufficient, then the debt shall be satisfied from the debtor spouse's interest in the residence of the spouses .... Neither spouse's interest in community property or separate property shall be liable for the separate debt of the other spouse.

B. The priorities or exemptions established in this section for the satisfaction of a separate debt must be claimed by either spouse under the procedure set forth in Section 42-10-13 NMSA 1978, or the right to claim such priorities or exemptions is waived as between a spouse and the creditor.

C. This section shall apply only while both spouses are living, and shall not apply to the satisfaction of debts after the death of one or both spouses.

§ 40-3-11: A. Community debts shall be satisfied first from all community property and all property in which each spouse owns an undivided equal interest as a joint tenant or tenant in common, excluding the residence of the spouses. Should such property be insufficient, community debts shall then be satisfied from the residence of the spouses, except as provided in Section 42-10-9 NMSA 1978. Should such property be insufficient, only the separate property of the spouse who contracted or incurred the debt shall be liable for its satisfaction. If

both spouses contracted or incurred the debt, the separate property of both spouses is jointly and severally liable for its satisfaction.

B. The priorities or exemptions established in this section for the satisfaction of community debts must be claimed by either spouse under the procedure set forth in Section 42-10-13 NMSA 1978 or the right to claim such priorities or exemptions is waived as between a spouse and the creditor.

C. This section shall apply only while both spouses are living, and shall not apply to the satisfaction of debts after the death of one or both spouses.

Texas

The text of **Vernon's Ann. Tex. Stat. Family Code § 5.61** is as follows:

(a) A spouse's separate property is not subject to liabilities of the other spouse unless both spouses are liable by other rules of law.

(b) Unless both spouses are liable by other rules of law, the community property subject to a spouse's sole management, control, and disposition is not subject to:

(1) any liabilities that the other spouse incurred before marriage; or

(2) any nontortious liabilities that the other spouse incurs during marriage.

(c) The community property subject to a spouse's sole or joint management, control, and disposition is subject to the liabilities incurred by him or her before or during marriage.

(d) All the community property is subject to tortious liability of either spouse incurred during marriage.

The Texas approach to marshaling is also unique; it is left to the discretion of the judge by **Vernon's Ann. Tex. Stat. Family Code § 5.62:**

(a) A judge may determine, as he deems just and equitable, the order in which particular separate or community property will be subject to

execution and sale to satisfy a judgment, if the property subject to liability for a judgment includes any combination of:

(1) a spouse's separate property;

(2) community property subject to a spouse's sole management, control, and disposition;

(3) community property subject to the other spouse's sole management, control, and disposition; and

(4) community property subject to the spouses' joint management, control, and disposition.

(b) In determining the order in which particular property will be subject to execution and sale, the judge shall consider the facts surrounding the transaction or occurrence upon which the suit is based.

Washington

Washington has been unusual in making community property responsible for the payment of only community liabilities and certain premarital debts. Because most separate debts could not be collected from community property and most community debts could not be collected from separate property, the distinction between community and separate liabilities was more important (and more frequently litigated) than in other community property states.

The separate property of a spouse is not liable for the separate debt of the other spouse.

Wisconsin

Wis. Stat. 1985-86 § 766.55 provides in part:

(1) An obligation incurred by a spouse during marriage, including one attributable to an act or omission during marriage, is presumed to be incurred in the interest of the marriage or the family. A statement separately signed by the obligated or incurring spouse at or before the time the obligation is incurred stating that the obligation is or will be incurred in the interest of the marriage or the family is conclusive

evidence that the obligation to which the statement refers is an obligation in the interest of the marriage or family, except that the existence of that statement does not affect any interspousal right or remedy.

(2) After the determination date all of the following apply:

(a) A spouse's obligation to satisfy a duty of support owed to the other spouse or to a child of the marriage may be satisfied only from all marital property and all other property of the obligated spouse.

(b) An obligation incurred by a spouse in the interest of the marriage or the family may be satisfied only from all marital property and all other property of the incurring spouse.

(c) 1. An obligation incurred by a spouse before or during marriage that is attributable to an obligation arising before marriage or to an act or omission occurring before marriage may be satisfied only from property of that spouse that is not marital property and from that part of marital property which would have been the property of that spouse but for the marriage.

2. An obligation incurred by a spouse before, on or after January 1, 1986, that is attributable to an obligation arising before January 1, 1986, or to an act or omission occurring before January 1, 1986, may be satisfied only from property of that spouse that is not marital property and from that part of marital property which would have been the property of that spouse but for the enactment of this chapter.

(cm) An obligation incurred by a spouse during marriage, resulting from a tort committed by the spouse during marriage, may be satisfied from the property of that spouse that is not marital property and from that spouse's interest in marital property.

(d) Any other obligation incurred by a spouse during marriage, including one attributable to an act or omission during marriage, may be satisfied only from property of that spouse that is not marital property and from that spouse's interest in marital property, in that order.

(2m) Unless the dissolution decree or any amendment to the decree so provides, no income of a nonincurring spouse is available for satisfaction of an obligation under sub. (2)(b) after entry of the decree. Marital property assigned to each spouse under that decree is available for satisfaction of such an obligation to the extent of the value of the marital property at the date of the decree. If a dissolution decree provides that the nonincurring spouse is responsible for satisfaction of the obligation, the obligation may be satisfied as if both spouses had incurred the obligation.

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Your Legal Rights as a Consumer 3

The Fair Debt Collection Practices Act of 1978 (FDCPA) offers to consumers some of the most comprehensive benefits and protections provided by any federal or state law regulating the activities of debt collectors. Although the Act applies to a relatively small portion of the debt collection industry, its influence is wide-spread and significant. Several states have adopted regulations and statutes fashioned on the broad standards and detailed proscriptions of the Act, and have brought all collectors of debt under their coverage.

Introduction

The FDCPA became law on March 30, 1978. It establishes general standards of proscribed conduct for debt collectors in detail, restricts abusive collection practices, and provides specific rights and remedies for consumers. In particular, consumer is protected from invasion of privacy, harassment, abuse, false or deceptive representations and unfair or unconscionable collection methods. Specific debt collection acts prohibited include late night or repetitive phone calls and false threats of legal action.

The Act gives consumer the right to require a collector to stop all collection contacts. It requires a collector to deal with consumer's attorney when consumer has one. It gives consumer the right to require a collector to verify the existence, legality or amount of the debt it's attempting to collect.

Who Is a "Debt Collector?"

In order to fully understand the protections afforded by the Fair Debt Collection Practices Act, it is necessary to determine if the person or agency is in fact a "debt collector" as defined by the Act. If the person is not a debt collector, then the protections of the Act would not apply. So let's look at the definition of the term "debt collector" and exclusions from that term.

1. Any Person Whose Principal Business Is Collecting Debts Is a "Debt Collector"

Under this definition most debt collection agencies are covered by the FDCPA, whether or not they own the debts they collect. The definition covers flat-rate debt collectors which are "companies hired by a creditor for a flat fee simply to mail debtors letters requesting

payment directly to the creditor," and credit counselors who, for a profit, arrange for payment of a consumer's debts.

Creditors are expressly excluded from the definition of "debt collector." There are, however, many creditors whose primary business is collecting debts, both delinquent and non-delinquent. Sales finance companies, such as General Motors Acceptance Corporation and General Electric Credit Corporation, whose principal business is purchasing and collecting consumer transactions, generated by a retailer clearly come within the scope of the Act, although they may appear to be excluded at first glance.

An attorney, if acting as an agent of a collection agency and not a creditor, would be covered under the Act. Conversely, a collection agency's employees may be excluded from coverage as the creditor's agents where they collect on a creditor's premises, in the creditor's name, and with the creditor's supervision.

2. Any Person Who Regularly Collects Debts Owed to Another Is a "Debt Collector"

The phrase covers the collection of delinquent debts by one creditor for another. Many creditors enter into "reciprocal collection agreements" to collect each other's debts in areas where one is located and the other is not.

For example, if a bank's debtor moves to a distant state, the bank may enlist the aid of a bank in the distant state to collect the debt, while agreeing to perform similar services for the distant bank.

3. Creditors Using False Names Are "Debt Collectors"

Under this phrase, a creditor not otherwise covered would be subject to the Act if it uses a name other than its own which suggests the involvement of a third-party collector, or poses as a collection agency, or uses a third party's name in its collection efforts. This would include, for instance, a creditor who mails letters written by a debt collection agency using the agency's letterhead. A creditor mailing collection letters on an attorney's letterhead is also covered under this definition.

This section was designed to cover principally companies in the business of "flat-rating," and also persons who incidentally design or supply deceptive collection forms. "Flat-rating" is the practice of designing or selling to creditors form letters with the flat-rater's name on the letterhead, thereby falsely suggesting the flat-rater's active participation in the collection process.

4. Repossession Companies Are Treated as "Debt Collectors" Under Certain Circumstances

The Act is aimed at companies that principally repossess automobiles.

5. Lawyers Regularly Collecting Consumer Debts Are Now Covered by All FDCPA Provisions

Effective July 9, 1986 the limited attorney exemption in the Fair Debt Collection Practices Act was eliminated. An attorney who regularly collects consumer debts is now subject to all provisions of the FDCPA.

Who Is Not a "Debt Collector?"

As we've seen above, the requirements of the Fair Debt Collection Practices Act apply only to "debt collectors" as defined by the Act. It is necessary to know who is not a debt collector. The law specifically provides for ten exceptions.

1. Creditor's Employees Collecting in the Name of the Creditor Are Specifically Excluded

This section excludes from most FDCPA requirements creditor's in-house collectors who use a creditor's true business name. By implication, creditor corporations collecting their own debts in their own name are also excluded because they can only act through their employees and officers.

2. A Commonly-Owned or Affiliated Corporate Collector Collecting Only for Its Affiliates Is Specifically Excluded If It Is Not Principally a Debt Collector

This exception applies to debts transferred from one corporate affiliate or commonly-owned organization to another, so long as the transferee is not principally a debt collector and collects transferred debts only for corporate affiliates. For example, one finance company branch may transfer a debt to a corporate affiliate in another city or state because the consumer owing the debt has moved.

3. State and Federal Officials Performing Their Duties Are Specifically Excluded

This exception applies to marshals and sheriffs who are attempting to collect particular debts in their official capacities. The exception does not apply to a private collection agency hired to collect debts for a state or federal agency.

4. Process Servers Are Specifically Excluded

This exclusion applies, for example, to a sheriff serving a subpoena upon a witness to appear in an action for debt.

5. Bona Fide Non-Profit Consumer Credit Counselors Are Specifically Excluded

Most cities have non-profit counseling services or adjustment bureaus established and maintained by major credit extenders. Their principal function is to accept referrals of financially distressed consumers and help them arrange out-of-court plans to pay their creditors in an orderly fashion. To qualify for the exclusion, the counseling agency must be non-profit, must engage in such service in good faith, and must receive and distribute payments, as well as provide financial counseling.

6. Attorneys Acting as Attorneys for Clients in the Clients' Names Were Specifically Excluded Before 1986

This exclusion was repealed in 1986.

7. Persons Collecting Debts as Part of Bona Fide Fiduciary or Escrow Arrangements Are Specifically Excluded

As a fiduciary, a bank trust department may hold notes, accounts receivable and judgments owed trusts, estates and guardian accounts. In its capacity as trustee, executor or guardian, the trust department has legal ownership of such obligations as well as the legal duty to collect them. The specific exemption applies to activities carried out by bank trust departments, escrow companies, and other bona fide fiduciaries.

8. An Extender of Credit Collecting on Behalf of Another a Debt It Originally Extended Is Specifically Excluded

This section excludes from the general coverage of the Act a credit extender's collection in its own name of a debt that it originally extended and then sold or assigned to another creditor while remaining responsible for some or all aspects of collection.

For example, a retailer may assign its retail credit contracts to a bank but retain responsibility for collecting delinquent assigned accounts. He would be exempted from the provisions of the FDCPA. Similarly, a mortgage servicing company that remains responsible for collecting a mortgage it originated but no longer owns would be exempted too.

9. Persons Collecting Debts Not in Default When Obtained Are Specifically Excluded

This exclusion applies to mortgage service companies and others who service outstanding debts for others, so long as the debts were not in default when taken for servicing.

10. Enforcer of a Security Interest in an Account Used as Collateral for a Commercial Loan Is Specifically Excluded

Retailers and lenders sometimes use consumer accounts receivable as collateral for their own commercial loans. Upon default by the retailer or lender, the secured party collects the payments due on the retailer's or lender's consumer accounts receivable. In such situations, the secured party may not be considered a debt collector under this section.

What Transactions Are Covered?

Under the FDCPA Only Consumer Debts Are Covered

This definition limits the application of the Act to activities involved in the collection of consumer debts, incurred primarily for personal, family or household purposes, whether or not such obligations have been reduced to judgment. Commercial debts are not within the scope of the Act.

Debts such as rent, medical expenses, utility, insurance, claims under student loans, parking tickets and credit cards are covered under the provisions of the FDCPA. It also includes dishonored checks if such checks were used for consumer purposes.

FDCPA Covers Only Debts Allegedly Owed by a Natural Person

The term "consumer" means any natural person obligated to pay any debt. Artificial entities, such as corporations, cannot be consumers.

The private remedies provided by the Act are available to "any person." This would include employers, creditors, relatives, friends and neighbors affected by violations connected with consumer transactions.

For example, if a collector calls a consumer's friend asking him or her to talk to the consumer about a debt, both the consumer and friend have a standing to sue under the provisions of the Act prohibiting third-party contacts.

Restrictions on Abusive Debt Collection Practices

The FDCPA restricts the times and places a debt collector may contact a consumer; limits third-party contacts and prohibits contacting a consumer represented by an attorney. These restrictions, along with others, protect the consumer's right to privacy and the security of the consumer's relationships with third parties, including attorneys, co-workers and employers. This was considered an "extremely important protection" when Congress passed the Act.

1. FDCPA Prohibits Contacts at Unusual or Inconvenient Times or Places

Without the prior consent of the consumer given directly to the debt collector, or order from court, a debt collector may not communicate with a consumer in connection with the collection of any debt at any unusual time or place or a time or place known or which should be known as inconvenient to the consumer.

In the absence of any knowledge to the contrary, a debt collector is obliged to assume that the convenient time for communicating with a consumer is after 8 a.m. and before 9 p.m. local time at the consumer's location. Under this section, a collector may not contact a consumer during daytime hours if he has knowledge that the consumer works at night.

Collection contacts could be inconvenient for the consumer for many other reasons: the consumer might be entertaining friends, eating a meal, or attending to an illness in the family. According to the FDCPA, Sunday is an inconvenient or unusual time.

Inconvenient or unusual places to contact a consumer about a debt would include a neighbor's home, hospital or funeral parlor. Work places seem inherently inconvenient places to contact many types of workers, such as assembly line workers, restaurant workers or nurses.

As a general rule, the following types of telephone calls may be illegal:

- calls at odd hours of the day and night;
- repeated calls;
- calls to friends, neighbors, relatives, children, employers, and places of employment;
- threatening calls; and
- calls asserting falsely that legal process is about to be served.

2. A Collector May Not Contact a Consumer It Knows to Be Represented by an Attorney

This prohibits consumer contacts by a collector who knows the consumer is represented by an attorney with respect to the debt. Once the collector learns that the consumer is

represented by an attorney, the collector must deal exclusively with the attorney and should not contact the consumer even to confirm the attorney's retention.

If the attorney fails to respond to the collector's communications within a reasonable amount of time, the consumer forfeits the protection against collector contacts.

3. Collectors Are Restricted in Contacting Consumers Who Are at Work

This section protects consumers from interference on their jobs. Collectors are held responsible for general knowledge that workers in certain occupations do not receive mail, phone calls or visits at work except in emergencies; such occupations include factory, construction, school, hospital and retail jobs.

Additional Restrictions on the Activities of a Debt Collector

In addition to the restrictions placed on the times and places a debt collector may contact a consumer, the FDCPA places additional restrictions on the activities of a debt collector.

1. Informing Most Third Parties Including Consumer's Employer, Friends, and Relatives of Consumer's Indebtedness Is Prohibited

This is one of the most important protections of the FDCPA accorded to the consumer. Other than to obtain location information of a consumer, a debt collector may not phone, write, or visit a consumer's employer, relatives (except spouse), friends, or neighbors about a debt, except with the consumer's direct prior consent, with court permission, or to enforce a post-judgment judicial remedy.

A debt collector is permitted to contact third parties in order to learn the consumer's residential address and phone number or his or her work address. Even when obtaining this limited information, however, the debt collector is not permitted to reveal the indebtedness of the consumer and cannot reveal the collection agency name unless it is requested.

While communicating with a consumer by mail, a collector may not use a name or other information on the envelope indicating that its contents pertain to debt collection, since other people may see the envelope addressed to the consumer.

2. Obtaining Location Information About a Consumer from Third Parties Is Strictly Regulated

The Act strives to protect the consumer's right to privacy, by prohibiting a debt collector from communicating the consumer's personal affairs to third parties. It nonetheless recognizes the debt collector's legitimate need to seek the whereabouts of missing debtors. Accordingly, this section permits a debt collector to contact third persons for the purpose of obtaining the consumer's location under certain guidelines.

- While contacting a consumer, the debt collector's employees must use their own individual names or consistently-used and recorded aliases. The employee may not reveal the collector's trade name except upon request and then must reveal the true legal name.

- When contacting a third party, the collector may state only that "he is confirming or correcting location information concerning the consumer;" the collector may not state that the consumer owes a debt.

- The collector may contact a third party for location information only once unless the collector reasonably believes that the third party's information was erroneous or incomplete and that the third party now has correct or complete information. According to the FDCPA, the collector may only once leave word with the consumer's friend or relative to have the consumer contact the collector.

- The collector may not use postcards to obtain location information. He may not use any name, language, or symbol in any communication or on any envelope indicating that it is in the collection business, or indicating the communication relates to debt collection.

- Once the collector knows that the consumer is represented by an attorney, and can determine the attorney's name and address, it may contact only the attorney for location information, unless the attorney fails to respond to the collector's contact within a reasonable time.

If a debt collector uses harassment, trickery or other deceptive means to obtain location information, it would be violating other provisions of the Fair Debt Collection Practices Act.

3. Consumer May Waive by Direct Prior Consent Protections from Collection Contacts

By direct prior consent, a consumer may waive the protections of the Act and allow a collector to communicate with him or her at inconvenient or unusual times or places, when represented by an attorney, or at his or her place of employment. The consumer may also give prior consent to the collector to make third-party contacts.

4. FDCPA Prohibits Conduct Serving to Harass, Oppress or Abuse

The Act generally prohibits harassing, oppressive and abusive conduct by debt collectors. The following case points out what constitutes such proscribed conduct.

In *Rutyna v. Collection Accounts Terminal, Inc.*, the collector sent the consumer a letter stating:

You have shown that you are unwilling to work out a friendly settlement with us to clear the above debt.

Our field investigator has been instructed to make an investigation in your neighborhood and to personally call on your employer.

The immediate payment of the full amount or a personal visit to this office will spare you this embarrassment.

In ruling against the collector, the court held:

Without doubt defendant's letter has the natural (and intended) consequence of harassing, oppressing, and abusing the recipient. The tone of the letter is one of intimidation, and was intended as such in order to effect collection. The threat of an investigation and resulting embarrassment to the alleged debtor is clear....Defendant's violation of (Section) is clear.

(a) Debt Collectors May Not Use or Threaten Violence or Criminal Conduct

The Act prohibits violent and criminal collection activities, directed not only against the consumer, but also against the consumer's children, friends and other third parties.

(b) Collectors May Not Use Obscene, Profane or Abusive Language

The prohibition against abusive, profane and obscene language would include name-calling, racial or ethnic slurs and other derogatory remarks.

(c) The Act Generally Prohibits Publishing a List of Allegedly Defaulting Debtors

This section prohibits, among other acts, posting of "deadbeat lists" or "shame lists" in the window of a collection agency or publishing such lists in local newspapers.

(d) FDCPA Prohibits Advertising a Debt for Sale in Order to Coerce Payment

This provision prohibits advertising a list of accounts for sale; this prevents shaming the debtor by listing his or her name publicly in the advertisement.

(e) FDCPA Prohibits Repeated or Continuous Telephone Calls Intended to Annoy, Abuse or Harass

This provision limits the frequency and duration of telephone calls a debt collector may place. It applies not only to actual telephone conversations, but also to causing a telephone to ring; for example, redialing after a consumer has hung up the telephone. The protection is available not only to the consumer but also to other persons such as the consumer's babysitter.

How many phone calls would constitute too many calls? A debt collector is almost certainly within his rights to call the debtor more than once. For example, he may call on the day before and on the day after a promised payment. But six phone calls in an hour or a day probably would violate this section.

Incidentally, Massachusetts restricts debt collection calls to two per week at home and one per month at work.

(f) An Employee of a Collector Must Provide Meaningful Disclosure of His or Her Identity When Telephoning

This provision prohibits anonymous phone calls by requiring collection employees to disclose their personal identities and the employer for whom they work.

FDCPA Prohibits False, Deceptive or Misleading Representations and Collection Methods

Under this section the Act prohibits a variety of conducts which would be branded as false, deceptive or misleading. The following is a summary of such conducts.

1. Collectors May Not Use False, Deceptive or Misleading Representations or Collection Means

An example of a deceptive collection practice may be a threat of a lawsuit, because either the suit is not intended by the collector when the threat was made, or was not as imminent as represented, or was beyond the collector's present contractual or legal authority.

Threats of actions other than a lawsuit may also be deceptive. Such deceptive threats include threat of referral to the creditor for legal action, referral to an attorney, referral to a credit reporting agency, or other harm to the consumer's credit rating. Contacting third parties, adding charges to the collector's claim, pursuing post-judgment remedies before suit is filed, etc. may also be deceptive.

2. Collectors May Not Falsely Imply That They Are Vouched for, Bonded by, or Affiliated with the Government

This provision is intended to prohibit a collector from impersonating a government official, such as a law enforcement officer. It also prohibits using a business name that implies governmental affiliation.

3. Collectors May Not Falsely Represent the Character, Amount or Legal Status of Any Debt

This section prohibits a false representation that a debt exists. Such misrepresentations may occur, for example, when:

- Debts are alleged to arise out of unordered mail merchandise (which is treated as a gift under federal law);
- Debts are claimed for which the statute of limitations has expired;
- Debts are claimed against individuals not legally obligated for them, such as a consumer's unobligated relative;
- Debts are claimed which have been discharged in bankruptcy.

A collector misrepresents the "amount" of a debt when it fails to give a consumer credit for payments received or adds illegal, unauthorized or unapproved charges to the balance of the debt.

A collector misrepresents the "legal status" of a debt by attempting to collect money on a non-existent judgment, by threatening immediate garnishment of a consumer's wages when judgment has not been taken, or by claiming that a debt is due after expiration of the statute of limitations.

4. Collectors May Not Falsely Represent Any Services Rendered or Compensation to Which They Are Entitled to for the Collection of a Debt

When a "flat-rate" collector falsely represents that he'll engage in collection activities beyond mailing a series of dunning letters, he has indulged in a prohibited practice.

5. FDCPA Prohibits Falsely Implying That a Person Is an Attorney or That a Communication Comes from an Attorney

This provision prohibits a collector from actually or implicitly impersonating an attorney by mailing form letters carrying an attorney's letterhead and signature.

6. FDCPA Prohibits Implying That Non-payment of Any Debt Will Result in the Arrest or Imprisonment of Any Person or the Seizure, Garnishment, Attachment or Sale of Any Property or Wages of Any Person Unless Such Action Is Lawful and the Debt Collector or Creditor Intends to Take Such Action

7. FDCPA Prohibits Threatening Illegal or Unintended Action

This important provision prohibits the use of threats by a collector that he does not intend to carry out or that are illegal. For example, a creditor is unlikely to follow through with a lawsuit or repossession if:

- The debt is relatively small;
- There is a dispute involving the debt;
- The creditor in the past has exhibited a policy or tendency not to pursue such action;
- The appropriate court is too far away from the collector or creditor so as to make it cost ineffective or impractical for legal action; or
- The collector does not have the authority to sue either under state law or under the collector's agreement with the creditor.

Under these circumstances a threat by the collector would be prohibited since the threatened action would be either unlawful or unintended.

8. FDCPA Prohibits Falsely Implying That Transfer of a Debt Will Preclude a Consumer's Claim or Defense or Will Subject the Consumer to a Practice Prohibited by the Act

This provision was designed to prohibit a covered creditor or a collector from making direct or implied false threats to transfer a consumer's account to another, harsher collector or to an attorney or to a repossession agency.

9. FDCPA Prohibits Misrepresenting That the Consumer Committed a Crime or Engaged in Other Misconduct in Order to Disgrace the Consumer

An example of such a prohibited action would be a statement by a collector to the consumer that it is a crime merely to write a dishonored check, because bad check laws usually have other prerequisites, such as a specific intent by the consumer to write such a check.

10. FDCPA Prohibits Communicating or Threatening to Communicate False Credit Information Regarding a Consumer

This provision prohibits, for example, threats to tell third parties without explanation that a consumer refuses to pay a debt when either the consumer is unobligated or the debt is in dispute.

11. FDCPA Prohibits Using or Distributing Written Material That Gives a False Impression of a Source, Authorization or Approval

This provision prohibits such common debt collection practices as simulating legal process, and using false legal documents that may imply governmental affiliation. In general, the types of form letters prohibited are:

- letters creating false impression that they were approved by the collector's state licenser;
- letters sent by a collector using an attorney's letterhead stationery;
- letters representing the collector to be a credit reporting agency;
- letters sent by a creditor on a collection agency's stationery.

12. FDCPA Prohibits Using False Representations or Deceptive Means to Collect or Attempt to Collect a Debt or to Obtain Information About a Consumer

Under this section even unsuccessful attempts to collect debts by deceptive means are prohibited. Some examples of the violations are:

- misrepresentation by a collector that he only has authority to accept payment in full;
- use of a letter that resembles telegram to create a false sense of urgency and expense;
- false implication that the collector is providing legal advice to the creditor;
- failure to reveal the collector's close association with the creditor.

13. Except When Acquiring Location Information from a Third Party, the Collector Must Clearly Disclose in All Communications That the Debt Collector Is Attempting to Collect a Debt and That Any Information Obtained Will Be Used for That Purpose

A collector may not disclose the debt collection purpose of a phone call to most third parties when leaving messages for the consumer. The collector must, however, disclose the collection purpose to the consumer when the consumer returns the phone call.

14. FDCPA Prohibits Falsely Implying That Accounts Have Been Transferred to Innocent Purchasers for Value

This provision prohibits a debt collector from misrepresenting, among other things, that it purchased an account when in fact it was paid a flat rate for its collection activities or a contingent fee for its accounts. Such misrepresentations may suggest to the consumer that the collector has already paid the consumer's debt and now the collector is innocently collecting an account for the overreaching creditor.

15. Falsely Implying That Documents Are Legal Process Is Prohibited

A collection letter closely resembling the format, words, and type size and style of a court summons or complaint simulates legal process and is proscribed.

16. FDCPA Prohibits Using Any Business Name Other Than the True Name of the Debt Collector's Business

This provision does not require that an affirmative disclosure be made of the collector's name; it only requires that a business use its true name if one is used at all.

17. Falsely Implying That Documents Are Not Legal Process Is Prohibited

This provision prohibits a collector from representing that a consumer need only send in payments upon being sued, when in fact legal inaction by the consumer will result in a default judgment.

18. FDCPA Prohibits Falsely Implying That the Collector Operates or Is Employed by a Credit Reporting Agency

FDCPA Prohibits the Use of Unfair or Unconscionable Means in Debt Collecting

There is a general prohibition against unfair or unconscionable collection practices not covered under other sections. A practice may be unfair without being harassing, abusive or sharp. Under this section vulnerable consumers, such as the illiterate and infirm, are given particular protection.

The following practices are specifically prohibited.

1. Collecting Any Amount Not Permitted by Law Is Prohibited

This provision prohibits collection of any amount (including interest, dishonored check charges, service charges, litigation costs, late or other expenses incidental to the principal obligation) unless such amount is expressly authorized by the agreement creating the debt or permitted by law.

2. Soliciting, Accepting and Depositing Post-Dated Checks Are Restricted

The purpose of this section is to prevent a common abusive debt collection practice of forcing a consumer to write a postdated check and then pressuring him to make it good under the threat of criminal prosecution.

3. Causing Expenses to a Person by Concealing the Collection Purpose of a Communication Is Prohibited

This section prohibits a collector from placing a collect telephone call or telegram to a consumer without having first notified the consumer to expect it and without having announced its collection purpose.

4. Repossession or Threats of Repossession Are Prohibited When There Is No Right or Intent to Repossess or When the Property Is Exempt from Repossession

5. Using a Postcard to Communicate with a Consumer Regarding a Debt Is Prohibited

6. FDCPA Prohibits Using Any Language or Symbol, Other Than the Debt Collector's Address on Any Envelope When Communicating with a Consumer by Use of the Mails or by Telegram, Except That a Debt Collector May Use His Business Name If Such Name Does Not Indicate That He Is in the Debt Collection Business

Asserting Your Rights against a Bill Collector 4

The Fair Debt Collection Practices Act (FDCPA) encourages consumers to exercise their rights against possibly abusive debt collection practices. In most cases they can exercise their rights without the assistance of a lawyer. There are basically three rights:

Right to Stop Collection Contacts

This provision requires a debt collector to halt its routine collection efforts upon receiving either a written request from a consumer to seize collection efforts or a written refusal to pay the debt. After receiving the notice, the collector may contact the consumer only to advise that its collection efforts are being terminated and that it or the creditor intends to invoke specified remedies.

Under the Act, the collector or creditor can specify only those remedies that are ordinarily invoked by such debt collector or creditor. Remedies not ordinarily pursued by the collector may be specified, but only if they are intended to be pursued in the particular case. When a collector falsely threatens a consumer with an extraordinary action, a violation of this section may have occurred.

Verification of a Debt

The FDCPA gives consumers the right to obtain verification of a debt from the collector. This is intended to minimize instances of mistaken identity of a debtor, or mistake over the amount or existence of a debt.

Within 5 days after the initial communication with a consumer in connection with the collection of a debt, a debt collector is required to send to the consumer a written notice containing the amount of the debt; the name of the creditor to whom the debt is owed; a statement that unless the consumer, within 30 days after receipt of the notice, disputes the validity of the debt, the debt will be assumed to be valid by the debt collector; a statement that upon written demand within 30 days by the consumer, the debt collector will obtain verification of the debt or a copy of the judgment against the consumer and that such verification will be mailed to the consumer by the debt collector; and finally, a statement that upon the consumer's written request within the 30-day period the debt collector will provide the consumer with the name and address of the original creditor, if different from the current creditor.

Additionally, if the consumer notifies the debt collector in writing within the above 30-day period disputing the debt, or requesting the name and address of the original creditor, then the debt collector must cease collection of the debt until the consumer is supplied with the verification of the debt, or a copy of the judgment, or the name and address of the original creditor.

Consumer May Direct Application of Payments When a Collector Holds Multiple Accounts

If a consumer owes multiple debts and makes a single payment to any debt collector holding multiple accounts, such debt collector must apply the payment in accordance with the consumer's directions, and may not apply such payment to any debt which is disputed by the consumer.

This provision gives consumer the right to decide how to allocate payments among multiple debts being collected by the same collector. For instance, he may wish to give preference to a secured debt over an unsecured debt.

In addition to the above rights, the FDCPA also places certain restrictions on the activities of a debt collector.

Restrictions against Bringing Suits in Inconvenient Forums

A debt collector who brings a legal action on a debt against a consumer must bring such action only in the judicial district in which such consumer signed the contract sued upon or in which the consumer resides. In a case involving real property, such action can be brought only in a judicial district in which such real property is located.

How to Protect Yourself against Abusive Medical Bill Collection Practices

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More than any other kind of debt, debts incurred for medical services are probably the most debilitating to a consumer's financial well-being. It is a matter of national disgrace that a large segment of our population is neither covered by private medical insurance, nor is eligible for public assistance programs, such as Medicare or Medicaid. An unexpected mishap or a minor emergency requiring a short stay in a hospital would wipe out most families' savings.

What are the common defenses available to a consumer against abusive medical bill collectors?

Fortunately, consumers have a variety of health and consumer law defenses to debt collection efforts by doctors, hospitals, and their collection agencies. Federal and state laws place significant restrictions on abusive debt collection practices.

Federal Law

The Fair Debt Collection Practices Act (FDCPA) prohibits abusive, deceptive and unfair debt collection practices. For example, it provides consumers with the right to:

- obtain verification of the debt;
- terminate collection efforts; and
- be sued in a convenient forum.

In addition to generally prohibiting abusive, deceptive, and unfair debt collection practices, the FDCPA also specifies that certain conduct is a *per se* violation of the FDCPA. For example, sending of post cards to debtors, late night phone calls, false threats of suit, and most third-party contacts to collect a debt are violations of the Act.

Although the FDCPA applies primarily to collection agencies and usually not to creditors, from a practical standpoint, most health care providers, such as hospitals and doctors, typically employ collection agencies in their debt collection efforts. In all likelihood, a consumer would be dealing with an outside collection agency employed by the health care provider.

Moreover, while hospitals and doctors are generally "creditors" not subject to the FDCPA, there are a number of instances in which these creditors and affiliated collection entities may be subject to the Act. For example, if a hospital's internal bill collector misrepresents that he or she is calling from a collection agency, both the employee and hospital would be subject to the provisions of the FDCPA.

Federal Trade Commission, mindful of the potential for misrepresentation and deceptive practices in the health care field, has adopted several rules to safeguard the consumer. For instance, a hospital staff attorney's plan to send collection letters on his letterhead, which indicates he is a private practitioner and does not disclose his hospital employment, is a violation of the FDCPA, and subjects both the hospital and attorney to FDCPA sanctions.

In another case, where a non-profit hospital created a separate collection organization to collect debts for itself and other health care providers, the use of an attorney letterhead by the collector's staff attorney, without indicating the attorney's employment by the collector violated the FDCPA, subjecting the collector and attorney to a liability. If a hospital hires a debt collection agency and holds a common ownership interest, the agency should indicate its affiliation with the hospital when collecting the hospital's debts, unless the agency is actually independent of the hospital.

A creditor violating the FDCPA is liable for actual damages (which include damages for emotional distress), statutory damages, attorney's fees and court costs. Most courts have also granted class junctive relief.

State Remedies for Medical Debt Harassment

In the consumer's arsenal, there is even a more effective weapon than the FDCPA. State laws as opposed to federal statutes or FTC actions provide a broader line of defense for a besieged consumer.

State debt collection statutes were passed in the 1960's and 1970's to protect consumers against abusive debt collection practices. State remedies for health debt collection harassment often utilize state debt collection statutes, state unfair and deceptive acts and practices (UDAP) statutes, the tort of intentional infliction of emotional distress and other remedies.

The advantage of state action over federal enforcement is that state laws generally allow a consumer to proceed directly against the health care provider as well as against the collection agency for abusive collection tactics. The consumer in a private action can recover attorney's fees, actual damages and sometimes statutory damages.

In some states, unfair and deceptive action practices statutes provide for recovery of double or treble actual damages as well as attorney's fees. Thus, a harassed consumer with substantial actual damages might be well advised to proceed under the UDAP statute than the FDCPA.

If a debt collector is dealing with a person known to be handicapped or convalescing, the court is likely to impose a greater duty of care. An aggrieved consumer in these circumstances would be able to assert the claim of tort of infliction of emotional distress - a cause of action very commonly used in abusive debt collection practices. The advantage of this tort is the likelihood of recovery of punitive damages in an egregious case where the collector's malice is readily apparent.

Duress as a Defense to a Hospital Collection Action

A debtor facing a hospital collection action can assert an important contractual defense, that the hospital's contract was extracted from the consumer under duress. For example, a hospital's requirement that the patient (or a relative or friend of a patient) agree to pay the patient's medical bills in order for the patient to be admitted or discharged may give rise to the complete contractual defense of duress.

There are three basic elements of duress:

Creditor's Exercise of Coercion

There can be no duress unless there is a threat to do some act which the party threatening has no legal right to do. For example, hospitals are generally not required to admit emergency patients. In order to assert the defense of duress, there must be county or state or other governmental regulations that call for compulsory emergency admittance.

Similarly, the act or threat of a hospital detaining a person by refusing to discharge the patient until a bill is paid is improper since it amounts to false imprisonment. Such an act would clearly fall under coercion.

Debtor's Loss of Volition as a Result of the Coercion

This is the second element of duress. For example, a patient initially refuses to sign a note, but then relents under a threat of detention and signs the note. The threat has resulted in the debtor's loss of volition.

A Promissory Note or Contract Must Be Executed as a Result of the Wrongful Coercion

This element rounds out the claim of duress. The patient must have been forced to execute a contract or promissory note that he or she would otherwise not have done.

A few years ago, Washington Post had reported an instance where a hospital had brought a $56,000 suit against a patient's widow who had signed an agreement believing it was necessary to gain admittance for her husband, who was in great pain and vomiting while waiting for emergency treatment. He later died in the hospital of cancer. The jury voided the bill.

Your Guide to Protection From Harassment by Bill Collectors

6

The following summary of the protections afforded by the Fair Debt Collection Practices Act is excerpted from a publication put out by the Bureau of Consumer Protection in the Federal Trade Commission.

If you use credit cards, owe money on a loan, or are paying off a home mortgage, you are a "debtor." Most Americans are.

You may never come in contact with a debt collector. But if you do, you should know that there is a law to make sure you are treated fairly. The Fair Debt Collection Practices Act was passed by Congress in 1977 to prohibit certain methods of debt collection. Of course, the law does not erase any legitimate debt you owe.

The following questions and answers may help you understand your rights under the Debt Collection Act.

What debts are covered?

Personal, family, and household debts are covered under the Act. This includes money owed for the purchase of a car, for medical care, or for charge accounts.

Who is a debt collector?

A debt collector is any person, other than the creditor, who regularly collects debts owed to others. Under a 1986 amendment to the Fair Debt Collection Practices Act, this includes attorneys who collect debts on a regular basis. The Act does not apply to attorneys who only handle debt collection matters a few times a year.

How may a debt collector contact you?

A debt collector may contact you in person, by mail, telephone, or telegram. However, a debt collector may not contact you at inconvenient or unusual times or places, such as before

8 a.m. or after 9 p.m., unless you agree. A debt collector may not contact you at work if the debt collector has reason to know that your employer disapproves.

Can you stop a debt collector from contacting you?

You may stop a debt collector from contacting you by writing a letter to the collection agency telling them to stop. Once the agency receives your letter, they may not contact you again except to say there will be no further contact or to notify you that some specific action will be taken, if the debt collector or the creditor intends to take such action.

May a debt collector contact any other person concerning your debt?

If you have an attorney, the collector may not contact anyone but the attorney. If you do not have an attorney, a debt collector may contact other people, but only to find out where you live or work. In most cases, the collector is not allowed to tell anyone other than you or your attorney that you owe money. Collectors are usually prohibited from contacting any person more than once.

What is the debt collector required to tell you about the debt?

Within five days after you are first contacted, the debt collector must send you a written notice telling you the amount of money you owe; the name of the creditor to whom you owe the money; and what to do if you believe you do not owe the money.

If you believe you do not owe the money, may a debt collector continue to contact you?

The debt collector may not contact you if, within 30 days after you are first contacted, you send the collector a letter saying you do not owe the money. However, a debt collector can begin collection activities again if you are sent proof of the debt, such as a copy of the bill.

What types of debt collection practices are prohibited?

Harassment. Debt collectors may not harass, oppress, or abuse any person. For example, debt collectors may not:

- use threats of violence of harm to the person, property, or reputation;
- publish a list of consumers who refuse to pay their debts (except to a credit bureau);
- use obscene or profane language;

- repeatedly use the telephone to annoy someone;
- telephone people without identifying themselves;
- advertise your debt.

False Statements. Debt collectors may not use any false statements when collecting a debt. For example, debt collectors may not:

- falsely imply that they are an attorney or government representative;
- falsely imply that you have committed a crime;
- falsely represent that they operate or work for a credit bureau;
- misrepresent the amount of the debt;
- indicate that papers being sent are legal forms when they are not.

Also, debt collectors may not say that:

- you will be arrested if you do not pay your debt;
- they will seize, garnish, attach, or sell your property or wages, unless the collection agency or the creditor intends to do so, and it is legal;
- actions will be taken against you which legally may not be taken.

Debt collectors may not:

- give false credit information about you to anyone;
- send you anything that resembles an official document from a court or government agency;
- use a false name.

Unfair Practices. Debt collectors may not engage in unfair practices in attempting to collect a debt. For example, debt collectors may not:

- collect any amount greater than your debt, unless allowed by law;

- deposit a post-dated check before the date on the check;
- make you accept collect calls or pay for telegrams;
- take or threaten to take your property unless this can be done legally;
- contact you by postcard.

What control do you have over payment of debts?

If you owe several debts, any payment you make must be applied to the debt you choose. A debt collector may not apply a payment to any debt you believe you do not owe.

What can you do if you believe a debt collector broke the law?

You have the right to sue a debt collector in a state or federal court within one year from the date you believe the law was violated. If you win, you may recover money for the damage you suffered. Court costs and attorney's fees also can be recovered. A group of people may sue a debt collector and recover money for damages up to $500,000, or one percent of the collector's net worth, whichever is less.

Where can you report a debt collector for an alleged violation of the law?

Report any problems with a debt collector to your state Attorney General's office. Many states also have their own debt collection laws and your Attorney General's office can help you to determine your rights.

If you have a question about your rights under the Fair Debt Collection Practices Act, the Federal Trade Commission may be able to assist you. While the FTC cannot intervene in individual disputes, information from consumers about their experiences is vital to the enforcement of the Act. Contact any of the FTC offices listed below.

6th & Pennsylvania Avenue, N.W.
Washington, D.C. 20580
(202) 326-2222

1718 Peachtree Street, N.W.
Atlanta, Georgia 30367
(404) 347-4836

10 Causeway Street
Boston, Massachusetts 02222
(617) 565-7240

55 East Monroe Street
Chicago, Illinois 60603
(312) 353-4423

118 St. Clair Avenue
Cleveland, Ohio 44114
(216) 522-4210

8303 Elmbrook Drive
Dallas, Texas 75247
(214) 767-7053

1405 Curtis Street
Denver, Colorado 80202
(303) 844-2271

11000 Wilshire Boulevard
Los Angeles, California 90024
(213) 209-7890

26 Federal Plaza
New York, New York 10278
(212) 264-1207

901 Market Street
San Francisco, California 94103
(415) 995-5220

915 Second Avenue
Seattle, Washington 98174
(206) 442-4655

How to Stop Debt Collection Harassment without Litigation or Bankruptcy 7

Debt collection harassment can take an enormous toll on the financially-strapped consumer in more ways than one. Abusive collection efforts and outrageous conduct by the collector can result in severe emotional distress for the consumer and his family. The consumer, without exception, is already in dire financial straits when he's subjected to the abuse and humiliation by the debt collector.

The emotional stress and anxiety created as a result of abusive debt collection can manifest itself in the form of many physical ailments: loss of appetite, nausea, loss of weight, ulcers, headaches, impotence, frigidity, hysteria, irritability, heart attack, angina, etc. The embarrassment, humiliation and intimidation can also affect the consumer's family life and job performance.

What can you, as a consumer, do to avoid being the victim of abusive debt collection practices?

Strategies to Stop Debt Collection Harassment

Litigation is a definite possibility in certain egregious debt collection cases. A successful lawsuit may not only result in a recovery of actual and statutory damages but also in punitive damages which will have a general deterrence on the future conduct of the collector.

However, litigation is not a practical solution in many instances. For example, the conduct may not be sufficiently outrageous, the requirement of legal proof may be lacking, the consumer may not have maintained proper documentation to support the allegations of misconduct and, finally, legal counsel may be hard and expensive to obtain. In other words, litigation at best is a costly and uncertain weapon and beyond the reach of most consumers.

Bankruptcy, by definition, is a weapon of last resort. It will stop all collection efforts immediately, but the cost of bankruptcy in terms of future credit and emotional trauma is high and is not an acceptable solution for many consumers.

However, there are strategies that can help alleviate a consumer's distress from debt collection abuses without resorting to a lawsuit or bankruptcy. All of these strategies are predicated on the number of important rights afforded to consumers under the Fair Debt Collection Practices Act (FDCPA). These rights include:

- **The right to terminate future collection contacts;**
- **The right to stop contacts at work if the employer prohibits them;**
- **The right to stop contacts at work if they are inconvenient;**
- **The right to obtain verification of a debt;**
- **The right to direct application of payments to a specific debt being collected by the debt collector.**

Strategy 1: Ask Collector to Terminate Contacts

The federal Fair Debt Collection Practices Act requires collection agencies to terminate collection contacts once the consumer notifies the debt collector in writing that the consumer refuses to pay a debt or that the consumer wishes the debt collector to cease further communications with the consumer. The Act generally does not cover creditors collecting their own debts, and thus they do not have to honor such requests. Nevertheless, in practice most creditors do comply with such requests.

The actual implementation of this strategy would require the consumer to write the collector detailing his present financial inability to pay the debt, a reasonable assessment of his future outlook and realistic repayment schedule, the abusive tactics of the collector's employees and the distress such tactics have caused the consumer and his family. The letter should then request the collector to terminate all future collection contacts.

A copy of the letter should also be sent to the creditor making him aware of its collection agency's abusive practices. In an egregious case, a copy should also be sent to the local Better Business Bureau which would precipitate an investigation if there was a history of repeated misconduct.

Sample Letter to Debt Collector Requesting Termination of Collection Contacts

John Smith
123 Main Street
Los Angeles, CA 90015

March 10, 1989

ABC Collection Agency
500 S. Broadway
Los Angeles, CA 90007

Re: Your demand to pay $710.00
Sears Roebuck, Acct. No. ______________________

Gentlemen:

Under the federal Fair Debt Collection Practices Act, 15 U.S.C.A. §1692 c(c), I'm asking you to terminate your debt collection communications to me.

About two months ago, I was hospitalized for an emergency heart by-pass surgery. Since then I've been unable to return to work. Doctors expect that I should be sufficiently recovered to perform my job duties in another 45 days. My wife has found a part-time job in the meantime, but her earnings are not sufficient to make any payment on the above debt.

Please note that your collection letter indicated the amount of the debt as $710. My records show the amount to be no more than $605.

I would also like to point out that your employees have engaged in illegal collection practice by calling me at 6:30 in the morning on March 2, 1989, and then making repeated phone calls during the day. Such calls have caused a great deal of distress to me and my family.

When I'm able to go back to work, I hope to make small payments toward paying off the debt. In the meantime, I'll appreciate your understanding in the matter.

Very truly,

John Smith

cc: Sears Roebuck
1200 Alameda
Los Angeles, CA 90017

Better Business Bureau
450 Oak Street
Los Angeles, CA 90005

Strategy 2: Complaint to Consumer Protection Agencies

Another strategy to stop collection harassment is for the consumer to write letters to state and federal agencies charged with enforcing the laws against debt collection abuses.

Most government agencies as a practical matter do not take action against an isolated instance of debt collection abuse but, if there has been a documented history of complaints against a particular collection agency, your letter may just produce an inquiry from the enforcement agency. Also, a copy of your letter sent to the collection agency and creditor may result in voluntary cessation of further harassment.

The complaint letter should be addressed to the Federal Trade Commission, Bureau of Consumer Protection, Washington, D.C., 20580, for most non-banking transactions. Copies of the letter should be sent to the state attorney general's office, consumer protection division in the local district attorney's office and also to any other regulatory agencies connected. If the collector's abusive behavior appears routine (e.g., the deception or harassment appears in a form letter), this should be pointed out to the enforcement agency.

Sample Letter Complaining of Debt Collection Abuses to Federal Trade Commission

John Smith
123 Main Street
Los Angeles, CA 90015

March 10, 1989

Federal Trade Commission
Bureau of Consumer Protection
Division of Credit Practices
Washington, D.C. 20580

Gentlemen:

I am writing to complain of abusive debt collection practices by ABC Collection Agency, 500 S. Broadway, Los Angeles, CA 90007 and request that you investigate this matter.

1. The collection agency is demanding a payment of $710 for a debt that according to my records is no more than $605. Neither the collection agency nor the creditor has taken any steps to investigate this dispute.

2. The collection agency has contacted my parents and my neighbor regarding this particular debt. I believe such contacts are illegal.

3. An employee of the collection agency has called me at 6:30 in the morning and then has made repeated calls during the day. The person has used abusive, insulting, and derogatory language during these calls.

4. The collection agency has made repeated threats to take legal action against me unless I made a full payment against the said debt. However, to this date they have done nothing more than send dunning letters and make repeated phone calls, which goes to prove their threat of legal action was deceptive and illegal.

5. I've asked the collection agency to terminate all collection contacts with me. However, this request has gone unheeded.

Due to a medical emergency I've been unable to work at my job for the past two months. I'm doing my best to get back on my feet. In the meantime, I would appreciate any assistance from your agency in this matter.

Very truly yours,

John Smith

cc: Attorney General's Office
Bureau of Consumer Protection
Sacramento, CA 97345

ABC Collection Agency
500 S. Broadway
Los Angeles, CA 90007

Sears Roebuck
1200 Alameda
Los Angeles, CA 90017

Strategy 3: Complaint to the Collector about the Amount of Debt

If you dispute the amount of debt for any reason (erroneous billing, services not rendered, payments not applied) you should immediately write to the collection agency asking it to investigate. The federal Fair Debt Collection Practices Act requires debt collection agencies and lawyers (but generally not creditors) to stop collection efforts until they investigate the disputed debt, as long as the consumer's written request was received within 30 days of the first communication from the collector regarding the debt.

If the dispute involves a revolving charge account, a credit card account, or an electronic transfer of money, federal regulations specify that if a consumer, within 60 days of receiving an erroneous bill, sends a letter to the creditor disputing the billing, the creditor must re-examine the bill. In most such cases, collectors will generally stop their collection efforts and investigate the matter.

Strategy 4: Have a Lawyer Send a Letter Requesting the Collector to Stop Contacts

The Fair Debt Collection Practices Act requires collection agencies to stop contacting a consumer known to be represented by a lawyer, as long as the lawyer responds to the collection agency's inquiries within a reasonable time. Creditors, although not covered by the FDCPA, will, too, generally honor such requests from a debtor's lawyer.

In most cases, a letter from the consumer asking a collector to stop collection contacts would produce results. Many consumers experiencing temporary financial difficulties go to a lawyer with the intention of filing a bankruptcy when all they actually need is relief from a few abusive bill collectors collecting unsecured debts. A letter from a lawyer as shown below will produce immediate results, i.e., termination of collection contacts.

Sample Letter from a Lawyer Requesting Termination of Collection Contacts

Law Offices of
Smith, Jones, & Little
2001 Avenue of the Stars
Century City, CA 90055

March 25, 1989

ABC Collection Agency
500 South Broadway
Los Angeles, CA 90007

Re: John Smith
Sears Roebuck, Acct No. ________________
Demand to pay $710.00

Gentlemen:

This is to advise you that Mr. John Smith is represented by the law offices of Smith, Jones & Little. In the matter of the above-mentioned indebtedness you are advised to direct any future contacts regarding this or other accounts of my client to me. You're asked to cease all contacts with my client forthwith.

I've been advised by Mr. Smith that your employees have engaged in certain prohibited debt collection practices.

In particular, your agency has made contacts to my client at 6:30 in the morning and has made repeated phone calls during the day. Such practices have caused my client and his family severe emotional distress. Any continued harassment by your employees will aggravate that distress.

You should also be advised that my client disputes the amount of the debt as explained in his letter of March 10, 1989 to you. To this day, he has received no response from you.

My client is presently undergoing certain physical problems and has been laid off from work temporarily. He intends to pay the correct amount of the debt as soon as he is able to. In the meantime, I would appreciate your cooperation in this matter.

Very truly yours,

Bob Jones

cc: Federal Trade Commission
Bureau of Consumer Protection
Division of Credit Practices
Washington, D.C. 20580

Strategy 5: Propose a Workout Agreement with the Creditor

Many consumers, after being sufficiently harassed by a collection agency, will succumb to the pressure and agree to pay the debt, in installments.

You should approach this strategy only after doing a realistic evaluation of your future financial prospects that will take into account the urgency of other debts and the extent of legal recourse available to the creditor. You may discover that a creditor, even after taking a judgment against you, would be unable to satisfy it under your current financial circumstances. In other words, take a long and hard look at all your debts and then assign priority to them in terms of adverse impact on your cash flow.

As a rule, most creditors and collection agencies take the initial position that they must receive the entire outstanding balance in one payment. They'll urge the consumer to borrow from a finance company or relatives, or obtain a bill consolidation loan at much higher interest rates to pay off the debt. But, if the debt is not secured with a collateral and has a low interest rate or no interest (e.g., medical bills), it is to the consumer's advantage to stretch out the payments on this debt so that secured debts and debts with higher interest and late charges may be paid first. Through skillful negotiations a consumer can get a collector to agree to a realistic installment payment plan.

A note of caution: You should never fall in the trap of giving the collector a post-dated check as part of a workout arrangement. Writing a check without sufficient funds to cover it is a crime under certain circumstances. Many collectors demand post-dated checks, knowing that the consumer will not be able to make the check good when the time comes and they'll be able to use it as a leverage to extract cash payment from the consumer under the threat of criminal prosecution.

Legal Remedies against Abusive Debt Collectors 8

There are basically two areas of redress available to a consumer who has been subjected to abusive debt collection practices.

Statutory Relief

The consumer can seek relief under the Fair Debt Collection Practices Act or various state consumer protection statutes. The purpose of the FDCPA is to protect consumers from abusive debt collection practices and at the same time provide effective remedial measures.

A debt collector who violates the FDCPA while collecting a consumer debt is usually subject to suit by "any person" affected by the violations. As a remedy, the successful consumer may recover actual damages, statutory damages, attorney's fees, costs and perhaps punitive damages and injunctive relief.

Note, however, that the FDCPA provides a one-year statute of limitations for private actions. In other words, a consumer claiming to have been injured due to any FDCPA violations must bring an action within one year from the date on which such a violation occurs.

Tort Relief

The principal remedy against abusive debt collection practices is still an action in tort. There are distinct advantages and disadvantages to a tort approach to abusive debt collection conduct.

One major advantage of a tort claim is that it allows you to proceed against creditors and their agents who generally may not be subject to the Fair Debt Collection Practices or other state consumer protection statutes. These statutes are usually limited to debt collection agencies. Another major advantage of tort claims in many states is the availability of punitive or exemplary damages for various conduct which is malicious or reckless.

The major disadvantage of a tort claim is that many states impose a much higher standard of proof on the consumer claiming to have been injured by the outrageous conduct of the debt collector than is generally required under consumer protection statutes.

Action under Tort

Various tort theories may be available to a harassed debtor. These include:

- **Intentional infliction of emotional distress (or mental anguish)**
- **Invasion of right of privacy**
- **Intentional interference with employment relationships**
- **Defamation**
- **Malicious prosecution**
- **Abuse of process**

In this chapter, we'll briefly look at these legal remedies available to a consumer against abusive debt collectors.

Intentional Infliction of Emotional Distress

The theory of tort of intentional infliction of emotional distress was principally developed as protection against abusive debt collection practices. To be successful under this theory, the creditor's conduct must be:

- intentional, reckless, or negligent;
- outrageous or unreasonable;
- undertaken without a legal privilege; and
- the proximate cause of mental distress, severe mental distress or physical injury to the debtor.

In most jurisdictions a consumer has only to prove emotional distress even though there was no physical injury to recover damages. The legal proof required to show the degree of outrageousness and the severity of distress vary from court to court. The conduct must be "so outrageous in character, and so extreme in degree, as to go beyond all bounds of decency, and to be regarded as atrocious, and intolerable in a civilized community."

Generally, a collector is entitled to take any reasonable steps necessary to collect a debt. The collector can legally notify the debtor of the status of the debt, remind the debtor to pay and warn him of the legal consequences of default. A debt collector will also be within his rights to threaten the consumer with a poor credit rating if he did not pay the debt. Similarly, threats of wage assignment or garnishment are permissible too. Contacting the debtor's employer for employment verification is also accepted by courts.

To illustrate the tort of intentional infliction of emotional distress, we should look at some actual cases:

- In a case where a debt collector made a series of calls to a debtor, became abusive, warned the debtor to "stay out of Minnesota if you know what's good for you and your family," and attempted to collect interest not owed, there was sufficient evidence of extreme and outrageous conduct to justify jury award of $6,000, damages for emotional distress and damages of $3,900 for attorney's fees for defending the prior suit.

- In another case where threatening, harassing, and obscene statements by a debt collector caused the debtor heart attack and severe mental distress, an action in tort was sustained.

- In another case where a veterinarian had threatened to do away with little children's dog unless mother paid charges for treating the dog, such a threat could be found to be extreme, outrageous and intolerable in present day society.

- A lawsuit was sustained where a consumer alleged that a collector threatened him with loss of job and credit blacklisting, harassed him by phone at home and at work, placed phone calls (some long distance, collect) to the consumer's friends, relatives and employers, sent him late night telegrams and subjected him to a barrage of letters and insults.

- A buyer's allegation that a seller placed a threatening phone call at 11:00 p.m. concerning a disputed debt to the house of the buyer's neighbor, resulting in the buyer's being called to that house and humiliated before others and causing an extended illness was sufficient to sustain a cause of action for intentional infliction of emotional distress.

Invasion of Privacy

The right to privacy is recognized in some form in most jurisdictions. Again, it is not necessary to prove that physical harm was done to the consumer.

Courts generally recognize that creditors have a right to use reasonable means to collect their debts, but they also recognize that this right must be balanced against the consumer's right to privacy. In other words, the debt collector's conduct must be beyond "reasonable bounds" or be "highly offensive" before being held actionable.

Here are some actual cases involving invasion of privacy:

- A creditor who phoned a consumer's home 8 or 10 times a day for two weeks, phoned the consumer three times in 15 minutes at work (at school), called her employer and her landlord, and phoned at late hours, concerning a partially disputed debt, leading the consumer to suffer nervousness, anguish, humiliation, loss of sleep, loss of a roommate and fears for her employment was found guilty by invasion of privacy.

- In another case a female debt collector called the debtor's wife and sister-in-law and, without identifying herself except as "Doris," insinuated that she had an extramarital relationship with the debtor. A suit for invasion of privacy was justified in this instance.

- A plaintiff was awarded $2,700 for his impaired credit, mental anguish, humiliation and embarrassment caused when a store accidentally issued a credit card to the plaintiff's brother in the plaintiff's name, and then served plaintiff with suit at his job after being informed of the error.

- In this context, public disclosure of private facts even though true would invite a suit for invasion of privacy. For example, a 5 foot by 8 foot sign listing debtors in a store window would constitute invasion of privacy. In another instance, listing a plaintiff's name under a list headed "NO CHECKS" in plain view of customers at a retail store checkout counter would be sufficient to sustain an invasion of privacy lawsuit.

- A consumer who alleged that her creditor yelled at her in his store and also in front of neighbors about an unjustly inflated bill was awarded $4,000 damages for invasion of privacy, emotional distress and impaired health.

Intentional Interference with Employment Relationships

If a collector threatens to cause a loss of job or takes steps which puts the consumer's job in jeopardy, and as a result of the collector's actions the consumer loses his job, he would be able to pursue remedy under this theory of tort.

The following cases illustrate the tort of employment interference:

- A consumer who refused to settle a claim with an insurer who in turn threatened his current employer with cancellation of the entire insurance policy which resulted in loss of his employment, pursued an action in tort against the insurer. A court award of damages was upheld on appeal.

- An employee was fired two days after a creditor had threatened to cause the termination of the job if the employee did not immediately pay one delinquent installment. The creditor's conduct was actionable for actual damages to the fired employee.

- A plaintiff was awarded $7,600 after a creditor, who was on the board of the hospital where plaintiff worked, obtained a resolution from the board that the plaintiff be fired if a disputed debt of $325.35 was not paid.

Defamation

In debt collection cases, tort under defamation theory arises either from a letter to the consumer's employer or from publication of a list of debts allegedly due (a "deadbeat list"). Ordinarily, a credit report given to other creditors is privileged.

Malicious Prosecution and Abusive Process

Both of these torts apply to wrongful use of judicial processes. For example, a creditor who initiates a bad check prosecution solely to cause payment of a disputed debt may be liable for malicious prosecution.

- $25,000 in general damages and $5,000 in punitive damages were awarded in a malicious prosecution case where payee brought bad check charges against the plaintiff as a result of giving a NSF check for a pre-existing, disputed debt.

Fighting Back against Abusive Collection Practices

Here is how two consumers fought back against abusive debt collection practices.

A CitiBank Visa cardholder brought suit against Citicorp Credit Services, Inc., (CCSI) for its allegedly abusive debt collection practices. The cardholder sought damages under the Federal Fair Debt Collection Practices Act and brought a state law claim for intentional infliction of emotional distress. Although the court dismissed the cardholder's suit under the FDCPA, it allowed the cardholder's suit for intentional infliction of emotional distress to go forward.

First, a brief background.

In 1986, the cardholder fell behind in his Visa payments; the unpaid balance exceeded $5,000. CitiBank and CCSI made numerous attempts to collect the debt, both by mail and by phone. The cardholder wrote to CCSI, explaining that medical emergencies and related expenses prevented him from making the required payments, and informed CCSI that he would make partial payments. CCSI, however, continued to make harassing phone calls. The phone calls were made both to his home and to his office.

As a result, the cardholder brought suit against CCSI in federal court. At trial, the cardholder testified that CCSI would not listen to his explanation for the delinquency. He stated that CCSI's repeated phone calls caused both physical and emotional damages and that his wife had been "reduced to tears." CCSI and Citicorp argued that their behavior was within the bounds of the law and entirely proper.

The court, however, was sympathetic to the cardholder's claim for intentional infliction of emotional distress. The essential element of a claim for intentional infliction of emotional distress is that the defendant engage in conduct that is "so insulting as naturally to humiliate" the target of the conduct. In fact, the claim of intentional infliction of emotional distress was largely developed in response to abusive debt collection practices.

In this case, the cardholder alleged that CCSI's conduct was intended to distress him and his wife and that such distress was forseeable. Moreover, he argued that he and his wife suffered emotional and physical complaints due to CCSI's actions. The court found that his claims merited a hearing before a jury and allowed him to continue with his lawsuit. Should he prove his allegations, he would be entitled to damages (*Meads v. Citicorp Credit Services, Inc.*, Civ. Act. No. 287.182 (S.D. Ga. May 10, 1988).)

There is yet another potent weapon in the armour of a consumer. The Federal Racketeering Influence and Corrupt Organizations (RICO) Act is a broad statute prohibiting specific types of illegal conduct by an enterprise, including outrageous debt collection conduct.

In a suit against a debt collection agency, it was alleged that the collector violated RICO by seeking illegal "collection charges" of $20 or more from consumers on their dishonored checks and threatening arrest and criminal prosecution if the charge was not paid. These acts allegedly constituted extortion and mail fraud, crimes specifically within the scope of RICO prohibitions. The case was settled by a stipulated judgment against the collection agency and its owner, providing injunctive relief, termination of business and corporate dissolution of the agency, and treble damages to the plaintiffs. *(Downey v. The Goodwin Agency, Inc.*, 8 Clearing House Rev. 553 (Clearing House No. 13,878) (M.D. Ga. 1974) (consent judgment)).

RICO is a powerful weapon in the hands of an aggrieved judgment debtor. He can collect reasonable attorney's fees if he proves his case in the court. In addition, the law provides for treble damages which is a strong deterrent against abusive debt collection practices.

RICO can also be used when credit is extended or debt collected at interest rates greatly in excess of the maximum legal rate. RICO has been generally used in criminal prosecutions. But as the above case demonstrates, it can also be used effectively to counter abusive practices of debt collection agencies.

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Locating the Missing Debtor 9

Assuming the debt is a valid debt, locating the debtor is the first step in any collection effort. Let's face it, without the debtor you cannot get to the second base. All your efforts, whether judicial or extrajudicial, are of little value if you cannot find the debtor.

While statutes in every state gives the judgment creditor many tools and remedies in locating and seizing a debtor's assets, they do not offer him much help in finding the judgment debtor. In many states, the judgment creditor can subpoena relatives, business associates, employers and all those in contact with, or who have knowledge of, the judgment debtor and question them. However, in all probability, those served with the subpoena will try to evade the process, be untruthful and frustrate every effort of the judgment creditor to locate the debtor. From a practical standpoint, the judgment creditor will face general reluctance from court to hold the witnesses in contempt of court and punish them for not complying with court process.

Consequently, when it comes to locating the judgment debtor, a creditor is pretty much left on his own and he has to use his imagination and resourcefulness to achieve the desired result.

A Word of Caution

In trying to locate the missing debtor, you must keep in mind the provisions of the Fair Debt Collection Practices Act. The creditor can only obtain information from a third party concerning the location of the debtor and not reveal that a debt is due. The creditor should be careful not to divulge any information which may reflect on the debtor's character. By carefully following a few simple steps, you'll be able to steer clear of any claim by the debtor that you have breached his right to privacy or defamed his character.

Skip-Tracing

Not all debtors intentionally hide their whereabouts from their creditors. Failure to notify a creditor of the change in address may be inadvertent. The debtor who has left the area or moved to another address without informing the creditor, either intentionally or due to an oversight, is called a skip. The attempt to locate this debtor is known as "skip-tracing."

How can you tell if a debtor has become a skip?

This generally is not hard to figure out. The two most common indicators are that the phone lines are disconnected and the mail is being returned. A quick check with the phone company to see if there is a new phone number or with the post office to see if there is a forwarding address will confirm that the debtor has become a skip.

There are other obvious indicators that may confirm your suspicions. You may receive inquiries from other creditors and encounter evasiveness of friends and neighbors concerning the debtor's location. The debtor's checks may be returned due to non-sufficient funds; loss of employment or problems related to the debtor's personal life, such as separation or divorce will also tip you off that the debtor is about to or has become a skip.

Debtor's File

Before initiating the location effort, you as a creditor should first carefully review the documentation of the transaction that led to the creation of the debt. This may include the rental or loan application, references and the debtor's payment records. In all cases, the debtor's file should be the first step in your search for the missing debtor.

If you have maintained good documentation, the debtor's file would provide a wealth of information that will help you locate the debtor. The file would reveal the debtor's former addresses and employers' names and addresses. As the debtor makes payments during the course of the transaction, you should note the number and location of the bank account and any change of address information. This information is very valuable in locating the debtor who has defaulted.

The file also may reveal information regarding other credit transactions entered into by the debtor, such as auto loans, credit cards, student loans, etc. You can obtain additional information by contacting other creditors to determine whether they are having problems with their accounts. Creditors are generally very helpful in providing information concerning a debtor as they, too, might be facing a similar situation in the future.

Other creditors can provide or confirm names of employers, relatives, friends and other people that might be helpful in locating the debtor. They can advise whether their accounts are current and how much is being paid presently on those accounts. Other creditors can also furnish information concerning pending lawsuits against the debtor.

If the debtor's file reveals the names of any ex-spouses or in-laws, then the creditor must make a special effort to contact these references. These people sometimes provide more information concerning the debtor than a friend or close relative.

A check of public records including motor vehicle registrations, public utilities, schools, and real estate recordings might also reveal the debtor's new whereabouts.

Using Telephone to Locate the Debtor

The telephone is clearly the least expensive and least time-consuming tool you can use in locating the debtor. Contacting third parties through the telephone has the added advantage that the contact may appear more informal and the sources are likely to be more expansive regarding the debtor's location and his current activities.

If the debtor is no longer working or has changed jobs, ask to speak to the payroll department to determine where the last check was mailed or whether a forwarding address has been left. It is also permissible to ask the employer to have one of the debtor's close friends contact you at that person's convenience. Naturally, you should not reveal your business name or the purpose of the call, but a phone number and the name of a specific person to contact should be given.

You'll be surprised at the wealth of information that you can obtain from telephone books and by making telephone calls to the debtor himself, his friends, neighbors and relatives. Get hold of a reverse street address telephone book and contact some of the neighbors of the debtor. If the debtor lives in an apartment house, contact his neighbors in the apartment house by calling them directly.

Do not feel bashful or intrusive; ask neighbors anything you wish to know concerning the debtor. People in general like to talk and you're only trying to collect what's owed to you. If you know anything about the debtor's business, job, children, or hobbies, use this information to convey an impression that you are a close acquaintance of the debtor. This in turn will allow your contacts to expand on what they know about the debtor. You may find out where the debtor does his banking, what kind of a car he owns, where he parks his car, where he works, and other valuable information that will be sufficient not only to locate the debtor but also his hidden assets that may satisfy the debt.

Getting Information from Credit Bureaus

Many financial institutions, landlords and businesses subscribe to credit bureau services, and they're a valuable source of information. A credit bureau report will reveal the inquiries made by other creditors concerning the debtor. It will give you the debtor's social security number, date of birth, previous addresses, and a list of other creditors. It will also reveal any lawsuits or judgments in existence. Information on lawsuits, drunk driving or other convictions, divorce proceedings, evictions, etc. should be used to canvass public records for potential leads.

Using School Records to Locate the Debtor

If the debtor's file reveals that the debtor has children, then by contacting the neighborhood schools you can determine whether those children are still enrolled, or whether they have been transferred to another school. School enrollment records often provide valuable leads. If a child is enrolled in college or is at least 18 years of age, then it is within the bounds of skip-tracing techniques to ask that child the new address of the parent.

Using Mail to Locate the Debtor

If the efforts to locate the debtor through telephone contacts fail, then using the mail is often the next recourse.

One technique that professional collection agencies, skip-tracers and creditors frequently use to locate debtors involves using registered mail addressed to a fictitious name in care of the debtor, and marked "deliver to addressee only." Such a letter will be forwarded to the new address with the new address marked on the envelope. Of course, when it reaches the new address it will not be delivered because of the notation "deliver to addressee only." When the envelope is returned to the sender, it will have the forwarding address of the debtor.

Similarly, registered letters sent in care of debtor's name to unions and professional organizations of which the debtor is a member and marked "deliver to addressee only" will provide fruitful results.

Freedom of Information Act - How to Use It to Locate the Debtor

The Freedom of Information Act is a federal law passed in 1966 requiring various governmental agencies to make available to the public certain information. A creditor can use this law to locate the missing debtor.

For instance, a debtor has moved from his present address without notifying the creditor. If he has left a forwarding address with the post office, you can use the Act to learn his new address. Send a letter to the postmaster at his last known address along with $1in service fee as follows:

Dear Postmaster,

Pursuant to the Freedom of Information Act, please provide the forwarding address of the following person. Enclosed is $1 fee and a stamped return envelope for your convenience.

____

Name

____

Last address

____

____

Thank you,

Signed ______________________________

You'll promptly receive the new address if it was left with the postmaster.

Sometimes, you may have the address of the debtor which is nothing more than a post office box. In such a case, the Freedom of Information Act has been useful in obtaining the street address. Postal regulations require that a street address be given on the application for a post office box. This information is kept on file at the post office. Again, write a letter to the postmaster asking for the debtor's street address.

Using Legal Process to Locate the Debtor

If all else fails in locating the debtor, you may have to resort to the use of legal process. State statutes often give creditors the right to subpoena witnesses and custodians of records in order to locate a judgment debtor. This means of locating the debtor should be used only as a course of last resort, since it is the most expensive and time-consuming means.

Before resorting to the legal process, you should send a letter to the previous employer of debtor asking for relevant information about him.

Employer Name
Address
City, State, Zip

Re: Judgment creditor vs. Judgment debtor
Judgment amount: $__________
Case No. __________

Gentlemen:

The above-named judgment creditor has obtained a judgment against the named judgment debtor on the said date.

I would like to request any information in your possession that may aid in execution of judgment. Specifically, would you please furnish the following information on the above-named judgment debtor:

Date of employment: ______________________

Nature of duties: ______________________

If terminated, date of termination: ______________

Name and address of new employer: ______________________

____

References, if any: ______________________________

Your cooperation in this matter will be greatly appreciated and would obviate any need for further legal process necessitating your personal appearance in court.

A self-addressed envelope is enclosed for your reply. Thanking you in advance,

Very truly yours,

Signed ____________________

Essential Steps to Locating the Missing Debtor

1. Check the debtor's file for any clues. Loan or rental application, checks or other payment records, references, letters, etc.

2. Check the telephone information operator for the new telephone number and address.

3. Send $1 to the postmaster of the district or town where he previously lived and ask for any forwarding address that may have been left.

4. Call phone numbers found in the debtor's file that may unearth potential new leads.

5. Call the debtor's former employers or speak to his co-workers or friends and ask them to have the debtor contact you.

6. Speak to any references given on a credit or rental application, especially relatives, friends, ex-spouses or in-laws.

7. Contact the local credit bureau and obtain a credit report.

8. Contact the neighbors using the reverse street address telephone directory.

9. Obtain information from the motor vehicle bureau, veterans agencies, courthouse records, county recorder, or other public agencies.

10. Finally, check the neighborhood schools, churches or synagogues.

How to Protect Yourself as a Judgment Creditor

✓ Whenever possible, try to make husband and wife "jointly and sev-erally" liable on any debt. Obtain both signatures on any contract, note or lease agreement. It's obviously easier to collect a judgment against both husband and wife than against just one spouse.

✓ If a debtor's financial position and credit history appear weak, do not hesitate to demand a co-signer or guarantor of payment. Much to your surprise, parents, relatives, friends and even employers will often guarantee repayment of a debt.

✓ Maintain a complete and accurate file on the debtor. Loan or rental application, employment history, trade and banking references, personal references, marital history, credit report, delinquencies, judgments, bankruptcies and other legal proceedings, real or personal property recordings – all these provide a wealth of information in locating missing debtor and eventually in collecting the debt.

✓ During the course of a transaction, update your file periodically: debtor's new address, divorce or remarriage, bank location and debtor's account number, new job, etc. Keep in mind, a well-documented file means fewer collection problems.

✓ Once the debtor becomes delinquent, proceed promptly and firmly. If you've allowed the delinquency to reach an unmanageable level, the debtor will have little incentive to cure it. Also, the longer you wait in following up, the more difficult the collection of a judgment will be.

✓ If you procrastinate in your collection efforts, the debtor is likely to move to a new location without informing you; he may close his bank accounts or transfer funds to put them beyond your reach; he may transfer ownership of his home or vehicles to his parents or friends; or, he may get his friendly boss to reduce his salary to half of what it is.

✓ Where a debtor is liable to a creditor for two or more debts, the creditor generally has the right to direct to which debt a payment shall be applied. Use this to your advantage wherever possible. For instance, apply the payment to an older debt or to a debt that may be legally more difficult to prove and enforce, or one that's unsecured.

Judgment Debtor Interrogatories 10

Once a judgment has been obtained, a creditor can make any reasonable inquiry into the debtor's financial affairs. This inquiry can take the form of interrogatories propounded on the judgment debtor in aid of execution. Written interrogatories are often referred to as a poorman's discovery technique; they are cost effective and, as a preliminary step, are of immense help in discovering a defendant's assets and his ability to pay on the debt.

Generally, the debtor inquiry can be as broad as necessary to determine the true status of the defendant's financial condition. If the judgment debtor resists such inquiry, a motion can be filed for contempt or to impose sanctions. If the court finds that the defendant willfully failed to answer questions or evaded interrogatories propounded by the creditor, costs and fees may be awarded to the creditor.

On the following pages is a set of questions designed to elicit sufficient information to the judgment creditor about the defendant's financial condition.

Sample Interrogatories for Judgment Debtor

1. Give your name, including any nicknames or other names used.
2. Give your present residence address.
3. Give your residence telephone number.
4. Give your social security number.
5. Give your age and the date of your birth.
6. State where you were born.
7. State your marital status and, if married, state your spouse's full name, social security number, and date of birth.
8. State whether your spouse is presently employed, and if so, give your spouse's employer and state how long your spouse has been so employed.
9. State your spouse's present residence address.
10. Do you have any children? If so, state each child's full name, residence address, and date of birth.
11. List all the places where you have lived in the past year by stating the street address, any post office address, city, state, zip code, and for each place, give the dates during which you lived there.
12. Give your occupation.
13. Who is your employer?
14. What is the address where you work?
15. What is the telephone number where you work?
16. Do you work part-time anywhere?
17. Give the dates during which you have been employed by your present employer.

18. State all business ventures you have engaged in during the past year and for each give:

    (a) The name of the business.
    (b) Its address.
    (c) The beginning and ending dates of your association with said business.
    (d) Identify other persons associated with the business.
    (e) Describe the purpose of the business.
    (f) State whether you still own any interest in the business.

19. State all partnerships in which you have been engaged in during the past year and for each give:

    (a) The name of the partnership.
    (b) The partnership address.
    (c) Beginning and ending dates of the partnership business.
    (d) Identify the partners.
    (e) The purpose of the partnership business.
    (f) State whether you still own any interest in the partnership.

20. Give the amount of income you received from your trade or profession for the past year.

21. Give the amount of the income your spouse received for the previous year.

22. List income from other sources, including but not limited to investments, interest, dividends, pension funds, profit sharing plans, and trust funds by identifying each source and the amount of money received for the past year.

23. Give the date and place of filing of your last state income tax returns and federal income tax return.

24. List all accounts you have with any banks, credit unions, savings and loan associations, or other financial institutions you have maintained either in your name or together with any person for the past year, and for each account, state:

    (a) The name of the financial institution.
    (b) Its address.
    (c) The name on the account.
    (d) The account number.
    (e) The average balance in the account for the previous year.
    (f) The current balance of the account.

(g) Whether any IRA accounts exist.
(h) The location of the IRA account.
(i) The amount in the account.

25. Give all safe deposit boxes you have kept since one year prior to the entry of the judgment and give:

    (a) The bank or other institution where it is located.
    (b) The address of that institution.
    (c) The name or names on the box.
    (d) Describe in detail the contents of the box.

26. Identify each person who has possession or custody of any financial records reflecting your financial condition during the past year.

27. List anything you have in your possession which belongs to someone else.

28. Have you ever filed bankruptcy, and if so, state the date of filing, the name of the bankruptcy court, the location of the bankruptcy court, the nature of the proceedings, and the name of the attorney who represented you.

29. List all outstanding obligations, the name of the creditor, address of the creditor, amount due, and the amount of payments.

30. Have you ever been a defendant or a plaintiff in a lawsuit in the past five years? If so, for each action, state:

    (a) The name of the court.
    (b) The location of the court.
    (c) The case number.
    (d) The type of proceeding.
    (e) The result or outcome.
    (f) Identify the attorney who represented you.

31. List all of your properties that have been taken by a court order, attached, executed, or foreclosed since the entry of the judgment against you, and for each item of property, state:

    (a) Its description.
    (b) The name and location of the court that ordered seizure of the property.
    (c) The type of the case and case number.
    (d) The date the property was seized.

32. Have you paid off any accounts within the past year and if so, what was the collateral or security?

33. If you have co-signed with any person to repay a debt, list the following for each debt:

    (a) The identity of the person to whom the debt is owed.
    (b) The place the debt was incurred.
    (c) The nature of the debt.
    (d) The identity of the person with whom you co-signed.
    (e) The amount due.

34. List any loan you have made to any of your relatives since the entry of the judgment against you and for each such loan:

    (a) Identify the relative's name and address.
    (b) State the relative's relationship to you.
    (c) State the amount of the loan.
    (d) State when the relative received the proceeds of the loan.
    (e) State the amount repaid and the date of repayment, if repaid.
    (f) State the present balance.
    (g) State the consideration for any loan.

35. List any loans that you have received from any relatives in the past year and for each such loan, state:

    (a) The name and address of the relative.
    (b) The relative's relationship to you.
    (c) The amount of the loan.
    (d) The date you received the proceeds of the loan.
    (e) The amount you have repaid and the date of repayment, if repaid.
    (f) The present balance.
    (g) Whether any relative holds a perfected security interest in any of your property.

36. List all losses you have suffered from fire, theft, or gambling within the last year and for each such loss:

    (a) Describe the property.
    (b) State how it was lost.
    (c) Give the date of loss.
    (d) State the value of the property.

(e) State whether an insurance claim for the loss has been filed and if so, identify the insurance company.
(f) State whether an insurance claim has been paid and if so, identify the insurance company making the payment and the amount of the payment.
(g) Has the property been recovered.

37. List all of your real estate and personal property you have sold, traded, pawned or given away since the entry of the judgment against you and for each item of property, state:

(a) Description of the property
(b) The date of the transfer.
(c) The identity of the person whom it was transferred.
(d) The relationship to you of the person to whom it was transferred.
(e) The consideration you received in return for the property.

38. List any of your property that has been returned to or repossessed by a creditor or secured party during the past year and for each item of property, state:

(a) The name of the creditor or secured party.
(b) A description of the property.
(c) The value of the property.
(d) The date it was returned or repossessed.

39. List any other creditors, including wages, commissions, or funds that you may owe any employee or other person and for each such employee or other person, state:

(a) The name of the employee or other person.
(b) The amount due.
(c) When contracted.
(d) The nature of the work or reason for the debt.

40. Name any person or business that owes you money or is indebted to you in some manner.

41. Do you owe any federal, state or local taxes and if so, state:

(a) The identity of the government branch to which it is owed.
(b) The amount due.
(c) The type of tax.
(d) The place incurred.
(e) The place assessed.

42. Do you make any alimony or child support payments in connection with a divorce, dissolution of marriage, or separation agreement, and if so, state:

    (a) The name of the person to whom it is paid.
    (b) The amount of payment.
    (c) The name of the court.
    (d) The date of the decree.
    (e) The type and the case number.

43. List any inheritances that you have received within the past year and for each such instance, state:

    (a) The source of the inheritance.
    (b) The monetary amount received and description of any property and its value.
    (c) The date you received the proceeds.

44. If you owe any debts for which you have pledged any of your property as a guarantee for payment, list the following for each debt:

    (a) The name of the person or business to whom the debt is owed.
    (b) A full and complete description of the pledged property.
    (c) The value of the property.
    (d) The date the debt was incurred.
    (e) Identify the document you signed in pledging the property.
    (f) The amount due on the debt.
    (g) Where any lien is recorded or filed.

45. Have you made any written statements or completed any applications or financial affidavits concerning your financial situation within the past year? If so, state:

    (a) The name of the person or business receiving the statement, application, or financial affidavit.
    (b) The date made.

46. With respect to any parcel of real property which you may own or in which you may have an interest, including a leasehold interest, state:

    (a) Its address.
    (b) Its legal description.
    (c) The original purchase price.
    (d) The balance on each mortgage on the property.

(e) The identity of the mortgage holder.
(f) The date of each mortgage.
(g) The market value of the property.
(h) Identify the person in possession of the property.
(i) Identify any leases on the property.
(j) Book and page number and where recorded.

47. Identify any stocks, bonds, annuities, negotiable instruments and securities that you own either individually or with someone else, and if jointly owned, identify each other owner and state that owner's interest in the property.

48. List the jewelry, watches, rings, artworks, stamp collections, coin collections, artifacts and antiques that you own and the estimated value of each.

49. List all the household appliances that you own and for each item, state:

(a) The year, make, and model including the serial number.
(b) The value.
(c) Identify all co-owners.
(d) Whether any liens exist.

50. List all the household furniture that you own and for each item, state:

(a) A full and complete description.
(b) The value.
(c) Identify all co-owners.
(d) Whether any liens exist.

51. List any livestock that you may own and state for each:

(a) The description.
(b) The address where it is located.
(c) The market value.
(d) Identify all documents pertaining to its registration, certification, or lineage.
(e) Identify any joint owner.

52. List all the automobiles or other motor vehicles including mobile homes and trailers that you own or are presently buying and for each item, state:

(a) The year, make, model, identification number, and certificate of title number.
(b) Its location.

(c) Identify any co-owners.
(d) The market value.
(e) Whether any liens exist.

53. List any farming equipment that you own and for each item, state:

(a) The description, including the year, make, model, and identification number.
(b) The address of its location.
(c) Identify any co-owners.
(d) The market value.
(e) Whether any liens exist.

54. List all machinery, equipment, and tools of business or other tools that you own or have an interest in and for each, state:

(a) The description.
(b) The address of its location.
(c) The identity of all co-owners.
(d) The market value.
(e) Whether any liens exist.

55. List all office equipment, furnishings, and supplies which you own and for each item, state:

(a) The description.
(b) The address of its location.
(c) The identity of all co-owners.
(d) The market value.
(e) Whether any liens exist.

56. Do you own a personal computer or other computer hardware or software and if so, state:

(a) The description.
(b) The address of its location.
(c) The identity of all co-owners.
(d) The market value.
(e) Whether any liens exist.

57. List all other personal property owned by you not previously listed including but not limited to: ships, boats, motorcycles, airplanes, cameras, guns, campers, golf clubs, sporting equipment, stereo systems, video cassette recorders, and musical instruments and for each item, state:

(a) The description, including year, make, model, identification or serial number, certificate of title number.
(b) The address of its location.
(c) The value.
(d) The identity of any co-owners.
(e) Whether any liens exist.

58. Identify each patent, copyright or trademark in which you have an interest and state its value.

59. List any interest you have in property now being held by someone else, including but not limited to interest in land, money, stocks, bonds, bequests, or other personal property and for each item, state:

(a) The identity of the person holding the interest.
(b) The description of the property.
(c) The address of the location of the property.
(d) The nature of your interest in the property.
(e) The value of your interest in the property.

60. List any insurance policies you own and for each such policy, state:

(a) The identity of the insurance company.
(b) The cash value of the policy.
(c) The type of insurance.
(d) The face value.
(e) The item or person insured.
(f) The annual premium.

61. Do you have money in any pension or retirement fund where you now work or have worked previously and if so, state:

(a) The name and address of employer.
(b) The name of the fund.
(c) The amount due you.
(d) The terms and provisions upon which it will be paid to you or your beneficiaries.

62. Do you have any money or security now posted as a bond? If so, state:

(a) The amount of the bond.
(b) The reason for the bond.

63. Identify all books, papers, and deeds relating to your estate, business, trade or property which you have not previously disclosed in your answers to these interrogatories and for each identify the person who has possession of it, if not in your possession.

64. Are you the beneficiary of any trust? If so, state the circumstances of the trust.

65. Do you have deposits with any utility or telephone companies? If so, state:

    (a) The name and address of the entity.
    (b) Amount of deposit.
    (c) When such deposit is due to be returned to you.

Examination in Supplementary Proceedings

IN THE ______________________ COURT

COUNTY OF ________________________

STATE OF __________________________

CASE NO.__________________________

______________________________ vs. ______________________________

Plaintiff/Judgment Creditor *Defendant/Judgment Debtor*

Name __________________________ Spouse __________________________

SS# __________ Dr. Lic.__________ SS# __________ Dr. Lic.__________

Address ________________________ How long ______ Phone __________

No. of dependents and relationship ________________________________

Employed by ____________________ Occupation ___________ How long ____

Address ____

Salary $ __________ How paid _______________________ When __________

Employer of spouse ________________ Occupation ___________How long ____

Salary $ __________ How paid _______________________ When __________

Interest in any business ____

Other income ____

Own home__ Value $______ Mtgs. $_______ Equity $______ Date of homestead ____

Name of mortgagee ____________________ Payments $ ________ When ________

Rent _________ Amount $ _________ Per Month _______ Due _____________

Landlord's name and address ____

Interest in other real estate _____ Encumbered _______ Description _________________

Bank _________________________________ In whose name ______________________

Checking or savings ____________ Last bank account ____________ Closed _________

Safe deposit box _______ Wheré ____

Cash on person $ __________ Cash elsewhere _____________________________________

Stocks, bonds, securities ____

Life insurance ____________________ Amount $ ________ Yearly premium $________

Jewelry __________________________ Interest in estate _________________________

Auto or interest therein ____

Registered owner ____________________ Legal owner & address _________________

Value $_________ Payments $__________ per __________ Unpaid balance $ _________

Other vehicles ____

Ever filed for bankruptcy ______ When ________________ Where ________________

Property pledged or pawned____

Debts owed to debtor ____

Debts owed by debtor____

Names of parents __________________ Address __________________ Phone ________

Names of relatives or friends_______________ Address________________ Phone _____

Promise to pay ____

Remarks ____

____

Dated : ________________________ (Signed) ___________________________

Judgment Debtor

SECTION IV

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Using Exemption Laws to Protect Property 11

A judgment debtor has a very potent weapon in his arsenal against a creditor who's attempting to seize his assets to satisfy a debt: Exemption laws.

The federal government and all states, by constitutional or statutory provision, insulate certain property of the debtor from seizure by his creditor. The protected property is referred to as exempt property; if property is exempt and the debtor has taken all the necessary procedural steps to claim the exemption, creditors cannot attach the exempt property to the extent of the exemption without the consent of the debtor.

In effect, the debtor retains all rights of ownership of exempt property. He retains the right to possess, sell, encumber and use the property.

All exemption laws have three basic purposes:

- Protection of the debtor;
- Protection of the debtor's family;
- Protection of the society.

The amounts and types of exemptions provided under various statutes are far from uniform among the states. Nonetheless, many items of exempt property are common to most states.

Homestead Exemption

All but six jurisdictions provide a homestead exemption designed to safeguard the home for the debtor and his family. This exemption represents one of the most significant rights of debtors. First homestead exemption law was enacted in Texas in 1839 and now every state has enacted homestead protection statute, in one form or another.

Who and What Is Protected

The homestead exemption applies to real estate owned and occupied by the debtor. Generally, homestead exemption is available on single-family homes. However, in many states it is now extended to condominiums or apartments, and in some cases to mobile homes.

In most states, the debtor has to be the head of a family in order to claim homestead exemption, and the homestead must be used as the family's primary residence. Once a homestead has been established, the exemption is generally not lost if the debtor ceases temporarily to occupy his residence. In many states the homestead exemption survives death and possibly divorce. Some states now make the homestead available to single persons.

Amount of Protection

The value, size, and type of property that is eligible for homestead protection varies greatly from jurisdiction to jurisdiction. Most homestead statutes limit the exemption by size, value or both.

Texas, for instance, has perhaps the most liberal homestead statute in the nation. Texas has a homestead exemption of 200 acres in rural areas without regard to value, and of $10,000 in value at time of acquisition of urban property without regard to subsequent improvements. Under these liberal provisions, a $10,000 vacant lot bought in an urban area with improvements of $100,000 would be completely exempt. Similarly, a $100,000 house built on rural property would be completely exempt. In other states, the amount of the exemption is not related to the amount of acreage, but only to the dollar value.

Debts against Which the Homestead Is Protected

Exemption laws differ with respect to when a debtor must establish his homestead in relation to when the debt asserted against it arose. Most states extend homestead protection regardless of when the homestead was acquired or declared. In these jurisdictions the debtor generally may protect his exemption merely by asserting it after the sheriff levies on the land or before the property is sold. However, a number of states provide that the homestead is not exempt from debts incurred before it was acquired.

Claiming Homestead Exemption

The judgment debtor or claimant is often required to assert the right to the homestead exemption. In many states, the debtor must record a homestead declaration in the real estate records. However, some states now provide for an automatic homestead exemption upon occupancy by the homeowner as a principal residence.

The relationship between judgment lien law and the homestead exemption often creates perplexing issues. Most states provide that a judgment lien does not attach to homestead property. Thus, a purchaser of the homestead property takes it free of the judgment creditors' claims, even though the purchaser claims no homestead exemption in the purchased property. On the other hand, in some states the judgment lien usually does attach to the property, to the extent that the property exceeds the size or value of the allowed homestead exemption.

Life Insurance Exemption

The first life insurance exemption statute was enacted in 1840. Currently, every state grants significant exemptions for life insurance from collection by the owner's creditors. In many states, the exemption is extended against creditors of the beneficiary.

In addition to exemptions for individual life insurance policies, many states provide for exemption of term insurance as well as group life insurance.

Amount Protected

Many states place no limitation on the amount of life insurance which is exempt. Some jurisdictions limit the exemption by placing a dollar ceiling on the face amount of the policies held by the insured. In these states, if the face amount exceeds the ceiling, creditors of the insured can reach payable proceeds which exceed the limitation.

All of these statutes exempt insurance proceeds payable to a qualified beneficiary upon insured's death. In addition, the exemption usually extends to the cash surrender value of the policy. Many states exempt the proceeds which are paid upon the death of the insured from the reach of the beneficiary's creditors as well.

Exemption of life insurance proceeds is justified on the basis that it affords protection to dependents of the insured. However, many states grant the exemption even if persons other than dependents are beneficiaries.

Other Exemptions

Welfare Payments

Slightly more than half the states place the most significant type of public assistance, aid to families with dependent children, beyond the reach of creditors. Some states grant exemptions for other types of public assistance such as aid to the blind, the elderly and the disabled. The statutes not only prohibit a creditor from garnishing the state for payments to be made to the debtor but also exempt the assistance money after it has been paid to the debtor.

Retirement Income

The federal and state governments exempt funds paid through public retirement programs. In addition, many statutes protect the income from a variety of private retirement programs.

All social security payments are exempt from all types of legal process. By a variety of statutes, states exempt different forms of private retirement plans.

Alimony and Child Support

Although alimony and child support payments represent an important type of support income, these payments are seldom exempted from the claims of either the payor's or the payee's creditors.

Other Exempt Income

Most states exempt unemployment and workmen's compensation payments. Similarly, most states grant either a limited or complete exemption for disability and health insurance payments.

Appendix to Section IV: Income Exemptions of Each State

Both federal and state legislation exempt specified income of a judgment debtor from the reach of creditors by the use of garnishment or other judicial process.

Federal legislation provides a basic wage exemption pursuant to Title III of the Consumer Credit Protection Act (CCPA) and provides some specific exemptions principally related to federal payments and the Employee Retirement Income Security Act (ERISA). Under ERISA, pensions generally cannot be garnished.

Congress has legislated a major exception to these specific federal income exemptions. Pursuant to the Child Support Enforcement Act of 1975, the income exemptions are not applicable as to enforcement of alimony or child support decrees.

Under the federal wage exemption scheme established by CCPA, the maximum part of the aggregate disposable earnings of an individual for any work week that is subject to garnishment may not exceed the lesser of (1) 25% of his disposable earnings for that week or (2) the amount by which his disposable earnings for the week exceeds 30 times the federal minimum hourly wage.

CCPA does permit a greater garnishment to enforce court support orders. "Disposable" earnings are defined as that part of an individual's gross compensation for personal services that remains after deduction of amounts required by law to be withheld.

Although CCPA preempts state garnishment laws that permit greater garnishment than that provided by CCPA, more protective state exemption law still can apply instead of CCPA.

Under state exemption laws, creditors' access to the debtor's income may be further curtailed. Indeed, a few states, such as Florida and Texas, flatly prohibit garnishment of wages. The state wage exemption statutes affect various forms of income, including wages, pensions, and public assistance payments.

Specific income exemptions enacted by each state are enumerated below:

Arizona	50% of earnings for thirty days prior to levy for use of family.
Alabama	30% of weekly disposable income or amount by which disposable earnings per week are in excess of 50 times federal minimum hourly wage.
Alaska	Earnings of judgment debtor not to exceed $350 for head of family, $200 for single man for personal services rendered within 30 days preceding levy of execution where necessary to support debtor's family.
Arkansas	Wages for sixty days exempt provided statement is filed that wages are less than $200 if single, and $500 for a family. First $25 a week net wages exempt.
California	Greater than 50% or portion exempt by federal statute of the earnings of the defendant or judgment debtor received for his personal services rendered at any time within thirty days next preceding the levy of attachment or execution.
Colorado	Earnings 70%, 35% if single.
Connecticut	Greater amount 75% of disposable earnings per week up to greater of 65% or amount equal to 40 times federal minimum hourly wage.
Delaware	Earnings: 90% in New Castle County, 60% in Kent and Sussex, not exempt if self-employed. Liability for balance applies only to necessities of life.
District of Columbia	Greater of 75% of disposable earnings per week or amount of disposable earnings per week equal to 30 times federal minimum hourly wage. Withhold by garnishee-employer 90% of first $200 of gross wages, payable in a month in excess of $200 or under $500.
Florida	All earnings exempt except for alimony and support payments at discretion of court.
Georgia	Greater of 75% of disposable earnings per week or amount by which disposable earnings exceed 30 times the federal minimum hourly wage.

Hawaii	95% of first $100, 90% of next $100, and 80% of gross wages in excess of $200 per month or equivalent per week.
Idaho	Earnings 75% for his personal service rendered within thirty days preceding levy if necessary for use of family supported by his labor; provided that if garnishment be founded upon debt for necessaries, exemption shall not exceed 50% of wages or salary due at time of service of execution or attachment. In no case shall exemption exceed $100 at any one time.
Illinois	Earnings: 85% with minimum of $50 per week if single, or $65 if head of household, and maximum of $200 per week.
Indiana	75% of disposable earnings per week in excess of 30 times federal minimum hourly wage.
Iowa	75% of disposable earnings for week or amount by which disposable earnings exceed 30 times federal minimum hourly wage, whichever is greater. Maximum amount that can be garnished in any year is $250 for each creditor.
Kansas	75% of disposable earnings for week or amount by which disposable earnings exceed 30 times federal minimum hourly wage, whichever is greater. Exemption inapplicable to support orders.
Kentucky	Greater of 75% of disposable income per week or amount by which disposable earnings exceed 30 times federal minimum hourly wage. Exemption inapplicable to support orders.
Louisiana	75% of disposable earnings for any week, but not less than $70 on loans in excess of 10%. Lenders forbidden to use garnishment.
Maine	Greater of 75% of disposable earnings for week or amount by which disposable earnings exceed 10 times federal minimum hourly wage.

Maryland	Wages $150 exempt multiplied by the number of weeks in which said wages were earned or 75% of such wages, whichever is greater; except that in Caroline, Worcester, Kent and Queen Anne counties, exemption for any work week shall be greater of 75% of wages due or 30 times federal minimum wage.
Massachusetts	Wages for personal labor or services exempted from attachment to amount of $125 per week. Exemption of $75 of personal income which is not otherwise exempt by law.
Michigan	Householder with family, 60% exemption with following limitations: On first garnishment, maximum $50 per week for labor of one week. For more than one week's labor, maximum $90 and minimum $60. As to subsequent garnishments for one week's labor, maximum per week is $60 and minimum $24. For a period of more than 16 days, maximum is $60 and minimum $30. Employee, not householder with family, first garnishment 40% exemption with $50 maximum, $20 maximum and $10 minimum.
Minnesota	75% of net wages due at time of attachment, garnishment, or levy or 8 times the number of business days and paid holidays, not greater than 5 per week in the pay period, times the federal minimum hourly wage, whichever is greater. Where debtor has been on relief, exemption for a period of six months from date of return to private employment.
Mississippi	75% of wages or salaries of resident laborer or employee.
Missouri	Greater of (1) 75% of weekly earnings, (2) weekly amount equal to 30 times federal minimum hourly wage or (3) 90% of work week earnings.
Montana	All earnings for forty-five days preceding garnishment, limited to 50% exemption.
Nebraska	Greatest of 75% of disposable earnings or amount equal to 30 times federal minimum hourly wage or 85% of disposable earnings if wage earner is head of family.

Nevada	The greater of 75% of disposable earnings or the amount by which disposable earnings exceed 30 times the minimum federal hourly wage.
New Hampshire	Wages for labor performed after service of writ: wages for labor performed before service exempt unless action founded on debt on judgment issued by state court. In such cases wages equal to 50 times federal minimum hourly wage are exempt. Special exemption for small loan law debt.
New Jersey	Earnings 90% if debtor earns $7,500 a year or less. If more than $7,500, garnishee fixed by court.
New Mexico	Greater of 75% of debtor's disposable earnings or of excess of 40 times federal minimum hourly wage rate. Disposable earnings is that part of the debtor's salary remaining after deduction of amounts required to be withheld by law.
New York	Earnings 90%, unless less than $85 per week is earned. Balance is payable as installments.
North Carolina	Earnings sixty days preceding garnishee, if necessary for support of family.
North Dakota	Greater of 75% of debtor's disposable earnings or of excess of 40 times federal minimum hourly wage.
Ohio	Greater of 82 1/2% of the debtor's disposable income or 175 times federal minimum hourly wage. Statutory scheme preempted by Federal Consumer Protection Act.
Oklahoma	Earnings: 75% ninety days; 100% shown to be necessaries for support of family; single man, 75% of wages.
Oregon	Greater of 75% of disposable earnings for week or amounts by which disposable earnings exceed 30 times the federal minimum hourly wage.
Pennsylvania	100% of all wages. Does not apply to support orders of court.

Rhode Island	Earnings: $50 plus salary and wages of dependents; 100% for debtor on relief; and all earnings one year after off-relief.
South Dakota	100% of all earnings within sixty days, if necessary for support of family. However, 15% may be attached for judgment for food, fuel, or medicines.
Tennessee	Wages to 50%, minimum $20, maximum $50 per week; if single, 40%, $17.50 and $40 per week respectively; $2.50 per week addition for each dependent.
Texas	All wages for personal services.
Utah	Married man or head of family: one half of earnings for 30 days prior to levy if his earnings are necessary for family support. Minimum exemption of $50 per month on judgments arising from debts on consumer credit sales greater of 75% disposable earnings per week or 30 times federal minimum hourly wage.
Vermont	75% of disposable earnings for that week or excess of 30 times federal minimum hourly wage, whichever is greater.
Virginia	75% of disposable earnings for that week or excess of 30 times federal minimum hourly wage, whichever is greater. Exemption is inapplicable to court order for support.
Washington	The greater part of 40 times of the state hourly minimum wage or of 75% of disposable earnings of defendant is exempt from garnishment. Disposable earnings means that part of the earnings remaining after deductions of the amount required by law to be withheld.
West Virginia	$20 per week minimum of 80% of wages due or to become due within one year after issuance of execution.
Wisconsin	Greater of 75% of debtor's disposable earnings or excess of 30 times federal minimum hourly wage. Disposable earnings means that part of earnings after deduction of required by law to be withheld. Employees with depend-

ents: basic exemptions, $120 plus $20 per dependent for each 30-day period prior to service of process. Maximum exemption, 75% of income. Employees without dependents, basic exemption of 60% of income for each 30-day period prior to service of process. Minimum $75. Maximum $100.

Wyoming

Judgments on consumer credit sales, home or loan, greater of 75% of disposable earnings or excess over 30 times federal minimum hourly wage. Otherwise 50% of earnings for personal service 60 days before levy if necessary for use of resident family.

Appendix to Section IV: Exemptions under Section 522(d) of the Bankruptcy Code

(d) The following property may be exempted under sub-section (b) (1) of this section:

(1) The debtor's aggregate interest, not to exceed $7,500 in value, in real property or personal property that the debtor or a dependent of the debtor uses as a residence, in a cooperative that owns property that the debtor or a dependent of the debtor uses as a residence, or in a burial plot for the debtor or a dependent of the debtor.

(2) The debtor's interest, not to exceed $1,200 in value, in one motor vehicle.

(3) The debtor's interest, not to exceed $200 in value in any particular item, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments, that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.

(4) The debtor's aggregate interest, not to exceed $500 in value, in jewelry held primarily for the personal, family, or household use of the debtor or a dependent of the debtor.

(5) The debtor's aggregate interest, not to exceed in value $400 plus any unused amount of the exemption provided under paragraph (1) of this subsection, in any property.

(6) The debtor's aggregate interest, not to exceed $750 in value, in any implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor.

(7) Any unmatured life insurance contract owned by the debtor, other than a credit life insurance contract.

(8) The debtor's aggregate interest, not to exceed in value $4,000 less any amount of property of the estate transferred in the manner specified in section 542 (d) of this title, in any accrued dividend or interest under, or loan value of, any unmatured life insurance contract.

SECTION V

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Law of Fraudulent Transfers 12

Few areas of law are more elusive and less understood than the law of fraudulent transfers. For judgment debtors and creditors alike, fraudulent transfers is an area full of booby-traps. Without a proper understanding of the law both are very likely to run into a host of problems.

As a first step in any kind of financial planning undertaken to protect the assets from potential judgment creditors, it is necessary that you become thoroughly familiar with the applicable state laws on fraudulent conveyances and the Federal Bankruptcy Code. Ignorance of these laws may cause you to engage in transfer of assets which could be set aside as fraudulent to creditors.

Introduction

If a creditor is seeking collection of delinquent debts or enforcing a judgment, it is very likely that the debtor may be delinquent with other creditors too. The debtor may attempt to protect his assets from the reach of creditors by secreting them or by transferring them to third parties. Typically, such transfers are for less than fair consideration, and almost always with a "string" attached to allow the debtor to reclaim the property after the financial woes have disappeared.

If the debtor were legally capable of doing this, creditor's collection efforts would be thoroughly frustrated. However, beginning in the Sixteenth century with the Statute of Elizabeth, creditors have been able to set aside such transfers as "fraudulent conveyances".

In the United States, basically two types of fraudulent conveyance statutes have been adopted by the various states. One is the direct descendant of the Statute of Elizabeth; the other, adopted by about half the states, is the Uniform Fraudulent Conveyance Act.

The Uniform Act is essentially a restatement of the Statute of Elizabeth. It did not so much change the law of fraudulent conveyances as it clarified its principles, streamlined its procedures, and relieved lawyers and judges of the need to produce tortuous legal reasoning in order to justify many cases under the old Statute of Elizabeth.

History

The law of fraudulent conveyances is generally considered to have begun with the English Statute 13 Elizabeth, c.5(1570), which provided:

I. For the avoiding and abolishing of feigned, convenor and fraudulent feoffments, gifts, grants, alienations (and) conveyances...which...are devised and contrived of malice, fraud, covin, collusion or guile to the end purpose and intent, to delay, hinder or defraud creditors...

II. Be it therefore...enacted...that all and every...conveyance...to or for any intent or purpose before declared and expressed shall be...deemed and taken (only as against that person...whose actions...are, shall or might be in any wise disturbed, hindered, delayed, or defrauded) to be clearly and utterly void, frustrate and of none effect...

IV. Provided that this Act...shall not extend to any interest...conveyed...upon good consideration and bona fide law fully conveyed or assured to any person...not having at the time of such conveyance or assurance to them made, any manner of notice or knowledge of such covin, fraud or collusion...

The statute was read to mean that conveyances made with the intent to hinder, delay or fraud creditors are not actually void, but rather are voidable as to creditors who were hindered, delayed or defrauded, the conveyance remaining valid as between grantor and grantee. However, from an early point, the courts concluded that the creditor did not actually have the transfer voided, but rather could proceed directly in the transferred property.

Twyne's Case

The earliest notable case on fraudulent conveyances, and one whose implications live to this day was the very famous *Twyne's Case*, 3 Coke 80b, 76 Eng. Rep.809 (Star chamber 1601). Actually, *Twyne's Case* was a good study of basic human nature.

It recognized that debtors who subjectively intend to cheat their creditors objectively tend to act in certain ways. Thus, when these observable manifestations are found, they can serve as evidence of the debtor's subjective fraudulent intent. As other courts have put it, these objective, observable facts are badges, evidences, or marks of fraudulent intent.

In the *Twyne's Case* a debtor was obligated to two creditors and, upon suit by one of the creditors, secretly transferred to the other creditor substantially all of his property. The debtor retained possession of the property conveyed and continued to manage it as his own. When the suing creditor obtained judgment and sought to levy upon the property, he was prevented from doing so on the ground that the property belonged to the other creditor.

The court held that the debtor's conveyance was fraudulent, and in recognition of the difficulty creditors faced in proving actual fraudulent intent to hinder or delay creditors' collection efforts, developed so-called "badges of fraud" to assist creditors in carrying their weighty burden of proof. The badges of fraud simply refer to circumstances indicative of the intent to defraud.

Specifically, in *Twyne's Case,* the court held that the conveyance was secretly made, that it was made pending litigation, that the transfer was general, without exception of the debtor's apparel or any other necessaries of life, and that the debtor retained possession of the property conveyed and used it as his own.

Modern-Day Adaptation

The notion of "badges of fraud" emanating from the Statute of Elizabeth ultimately found its way into jurisdictions of the United States and remains intact in roughly one-half of the states today. The fraudulent conveyance statutes in the states are basically modernized versions of the Statute of Elizabeth, providing creditors with the ability to avoid transfers made by debtors with the intent to hinder, delay or defraud creditors' collection efforts. The courts have variously held that the presence of one or more "badges" constituted either evidence, prima facie evidence, or conclusive evidence of fraudulent intent.

Twyne's Case also raises the question of preferring one creditor over another and whether the transfer made to the preferred creditors should be avoided. As we saw in that case, the debtor was in fact obligated to the creditor to whom the property was conveyed, and the value of the debtor's conveyance did not exceed the debt.

Ordinarily, such a preferential payment is not a fraudulent conveyance. For avoiding such a payment in favor of another creditor would merely work as substitution of one creditor for another. But in *Twyne's Case*, the preference was secretly made, the debtor retained possession of the property, and there were facts from which the preferred creditor's knowledge of, if not deliberate acquiescence for participation in, the debtor's fraudulent scheme could be inferred. Under present law, such circumstances may render a preference voidable.

The notion of "badges of fraud," and the various presumptions of fraudulent intent emanating from it, created uncertainty and conflict in the American jurisdictions; facts which created "prima facie" presumptions of intent to defraud in one jurisdiction created conclusive presumptions or perhaps no presumptions at all in others. In order to inject more consistency and predictability into the law of fraudulent conveyances, the Uniform Fraudulent Conveyance Act was drafted in 1919, with the hope that the states would quickly enact it. Roughly half the states have adopted the Act, and the law of fraudulent conveyances in states which have not adopted the Act remains comparatively unsettled.

Fraudulent Conveyances - In General

Fraudulent conveyance law in general is designed to protect creditors from debtors who transfer their assets in a form detrimental to creditors' claims. A creditor pursuing a delinquent debt or claim would as a first step reduce the claim against the debtor to a judgment. While enforcing the judgment, he may discover that the debtor has at some prior time disposed of his assets in a manner which now hinders, delays, or precludes altogether, satisfaction of the creditor's judgment. In such a case, creditor would have to rely upon the remedies available under various fraudulent conveyance statutes.

If a judgment creditor can show that the transfer or coveyance made by the debtor is fraudulent, the creditor may attach or levy execution directly upon the property in the hands of the debtor's grantee, or the creditor may simply annul the debtor's conveyance, and then proceed against the debtor or the property as if the conveyance had never been made.

Fraudulent conveyance law also provides provisional remedies for creditors whose claim against the debtor is not yet reduced to judgment, or whose claim is not even mature, fixed or liquidated. Under fraudulent conveyance law such persons nevertheless qualify as "creditors." When such a creditor notices or discovers that the debtor is conveying or has conveyed property in a manner which will hinder the creditor or frustrate collection efforts once the claim is mature or reduced to a judgment, that creditor may seek provisional relief in the nature of an injunction or restraining order, receivership, attachment or any other remedy which the circumstances of the case may require.

Every conveyance made by a debtor with intent to hinder, delay, or defraud creditors is fraudulent, as is every conveyance for less than fair consideration by a debtor who intends to incur debts beyond the ability to pay as they mature. In all these circumstances, creditors are entitled to the relief of setting aside the conveyance or levying on the property as if the conveyance had never been made.

Fraudulent Intent Not Necessary

Of course, there will be situations where the forbidden fraudulent intent of the debtor is not present or apparent and may be impossible to prove. For example, a debtor may simply give property to a friend, relative, or person in need for purely benign or charitable purposes. The debtor may make a "gift" of property or conduct a "bargain sale" of possessions to either raise ready cash, or with the hope or understanding that the property may be repurchased at a later date. Then again, a debtor may sell or otherwise convey property for less than fair value while engaged in an undercapitalized business or transaction.

All of these transfers, to describe a few, may be fraudulent conveyances subject to attack by creditors without regard to the debtor's subjective intent or belief. In other words, a fraudulent conveyance need not necessarily involve actual intent to defraud creditors.

In the United States, basically two types of fraudulent conveyance statutes have been adopted by the various states; one is the direct descendant of the Statute of Elizabeth; the other, adopted by about half the states, is the Uniform Fraudulent Conveyance Act.

"Statute of Elizabeth" Jurisdictions

In those jurisdictions that have not adopted the Uniform Fraudulent Conveyance Act, modernized versions of Statute of Elizabeth are in force which prohibit in general language every conveyance made with intent to hinder, delay or defraud creditors. We've examined above the basic evolution of the law of fraudulent conveyances based on the Statute of Elizabeth.

The language of such statutes seems to suggest that a debtor's actual fraudulent intent must affirmatively be proved. The courts nonetheless have developed categories of constructive fraud by creating so-called "badges of fraud" to assist creditors in proving debtor's actual fraudulent intent.

The courts have in practice recognized that fraud may be established without actual intent to defraud. For example, a debtor who makes a transfer for less than fair value, and thereby becomes insolvent in the sense of having insufficient assets to pay his debts would be presumed to have an intent to defraud[1].

The majority of the courts hold that the creditor must prove that the debtor did not receive fair value for the transfer or that the debtor as a result of the transfer was unable to pay his debts.[2]

Whether the debtor has received fair value for the transfer would hinge on whether he had received near equivalent property or an amount equivalent to the antecedent debt.[3] In many states if the debtor retains possession and use of the transferred property or retains rights in the property, the transfer may be prima facie or conclusively fraudulent.

We'll look in greater detail what constitutes fair consideration or reasonably equivalent exchange later in this chapter.

Many states require proof of actual fraudulent intent, although the "badges of fraud" may sometimes be used to support an inference of intent to defraud. These badges might include transfers pending litigation,[4] transfers for grossly inadequate consideration,[5] and

transfers made outside the usual mode of business[6] or under unusually secretive circumstances.[7]

There is yet another situation that must be dealt with. What about the persons who become creditors of the debtor after the alleged fraudulent conveyance has occurred? It is possible that these creditors can also establish the requisite proof of intent to defraud if they can prove the transfer was made with the intent to defraud subsequent creditors.[8]

Of course, the creditor would face the much more difficult task of showing that the debtor anticipated or should have anticipated future obligations at the time of the conveyance.[9]

A third issue that must be considered under traditional fraudulent conveyance statutes is whether a good faith purchaser for value is protected as against the creditor of the transferor when the transferor made the conveyance with the intent to hinder, delay or defraud creditors. The law generally protects good faith purchasers for value who had no notice of the transferor's fraudulent intent. [10]

The purchaser is not made to investigate the transferor's business and motives, and the burden of establishing good faith is on the creditor.[11]

If the purchaser had actual knowledge or facts which would put a reasonable person sufficiently suspect and would lead him to the discovery of the fraud, then the transferee would not be considered to have entered into the transaction in good faith. The transferee who enters into the transaction in bad faith may not only lose the asset transferred but might also be liable for damages if, for example, the creditor can establish that a tort was committed as against the creditor by the transferee.[12]

Creditor's Recourse

What is the practical recourse for a creditor who faces a debtor who has made a fraudulent conveyance?

The creditor in such situations may simply ignore the transfer and go directly after the transferred asset in the hands of the transferee. In order to take this course of action the creditor must be certain that the transfer was a fraudulent conveyance. If his conclusion was incorrect he may face liability to the transferee. The more cautious route may be to have the transfer avoided and then levy upon the property. In that regard, the use of creditor's bill often serves as the procedural mechanism through which the conveyance is avoided.

Uniform Fraudulent Conveyance Act Jurisdictions

In the 1920's the commissioners on Uniform State Laws promulgated the Uniform Fraudulent Conveyance Act (UFCA). Approximately one-half of the jurisdictions have adopted the Uniform Fraudulent Conveyance Act.

The following jurisdictions have adopted the Uniform Fraudulent Conveyance Act: Arizona, California, Delaware, Idaho, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Tennessee, Utah, Virgin Islands, Washington, Wisconsin, and Wyoming. The most recent adoption occured in 1969. In the above states, this is the basic state statutory law on fraudulent transfers.

(Recently the commissioners on the Uniform State Laws took another look at fraudulent conveyances. In 1984 they drafted what is now called the Uniform Fraudulent Transfer Act (UFTA), which is intended to repeal and replace the UFCA. However, as of late 1985, only three states - Hawaii, North Dakota, and Oregon - have adopted the UFTA. Therefore, the discussion in this chapter will be limited to various provisions of UFCA only; however, it is worth noting that results under the UFTA and the UFCA most often will be the same.)

There are two principal sections of UFCA that enable creditors to avoid fraudulent conveyances, one section is based upon actual fraud, and the other is based upon "constructive fraud."

Actual Fraudulent Transfers

The first major category of fraudulent transfers is that in which it can be established that the debtor had the actual intent to hinder, delay, or defraud its creditors.

Section 7 of UFCA deals with actual or intentional fraud as follows:

Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law to hinder, delay or defraud either present or future creditors, is fraudulent as to both present and future creditors.

The language under this statute closely resembles the interpretation under the Statute of Elizabeth since both require a showing of actual intent.

Also note that both present and future creditors may avoid a conveyance as fraudulent under Section 7 of UFCA. Parties who become creditors after the transfer occurs need no t show that the debtors specifically intended to defraud subsequent creditors nor are they required to show an intent to defraud a particular subsequent creditor. In short, "a general actual intent to defraud existing creditors is sufficient to create rights in all subsequent creditors." A transfer intended to defraud present or future creditors is fraudulent as to both. [13]

Fraudulent Transfers in Real Life

An example of an actual fraudulent transfer would be when a debtor, with deliberate planning sells his property to someone and hides the proceeds from his creditors. He may, for example, put the proceeds in a secret Swiss bank account. The debtor's purpose is to keep it from his creditors, so that he can personally enjoy it later on. To add to the dilemma of creditors, such rather blatant and obvious fraudulent transfers are rarely seen in real life. More often, a debtor's attempts to defraud his creditors are typically far more subtle and sophisticated.

In most cases involving debtor's fraudulent conduct, direct evidence of fraudulent intent is often difficult, if not impossible, to produce. Modern science has not been able to come up with any technology to read a person's mind and tell us what he was thinking when he transferred away his property. Yet, it is necessary to prove that the debtor had the subjective evil intent to defeat, delay or defraud his creditors when he made the transfer. How can we do this?

For this, we fall back on the concept of badges of fraud that originated under the Statute of Elizabeth. Again, badges of fraud are really circumstantial evidence of fraud, the badges being those facts that commonly are associated with a fraudulent conveyance such as a general transfer of assets, intra-family transfers, transfers for less than fair consideration, and transfers with retention of use or possession.[14]

Phony Transfers

In a phony transfer a debtor formally transfers title to the transferee, but retains all economic and other benefits to the asset. In legal terms a phony transfer is labeled as a "transfer in trust" as described by Justice Brandeis, in the famous case of *Benedict v. Ratner,* 268 U.S.353 (925), which is in effect "a transfer with absolute dominion reserved"

In a phony transfer nothing changes in a realistic sense. Even though the debtor signs a title document that says title to his property has been transferred to somebody else, the facts thereafter show that the debtor continues to enjoy the use and benefit of the property just as if he were still its full owner. The law does not tolerate these phony transfers. If creditors or a trustee can show such a transfer in trust, then that is almost conclusive of the fact that a fraudulent transfer has taken place.

Other Badges of Fraud

Other badges of fraud are not conclusive in themselves, yet nonetheless point toward fraud. For example, where a debtor transfers title to an asset but retains possession of the asset without showing a legitimate commercial or business purpose for retaining possession, the debtor's action would be considered a badge of fraud.

A transfer of all or most of one's assets, leaving the transferor with little or nothing to his name also has been held to be a sign of fraudulent intent. Similarly, transfers during the pendency of a suit or intra-family transfers are also badges of fraud.

A transfer for unconscionably low consideration is also a sign of fraud. In fact, a transfer in which the transferee pays or purports to pay more for the asset than it is worth also has been listed as a mark, badge or evidence of fraud. Indeed, *Twyne's Case* even stated that language in the deed of transfer, stating that the transfer was legitimate, actually showed quite the opposite. As the court pointed out, there was no need for a really legitimate transaction to be so labeled. When one is trying to cheat his creditors however, then one is tempted to place into the document the self-serving statement that it is a legitimate transfer.

In assisting the creditor to prove actual intent, UFCA Section 4 (b) sets forth "factors" to be given consideration in the determination of actual intent. The factors are actually the type of facts that have been characterized as "badges of fraud" in the existing fraudulent conveyance law.

Section 4(b) of the UFCA lists the following factors:

"In determining actual intent under subsection (a)(1), consideration may be given, among other factors, to the fact that:

"(1) the relationship between the transferor and the transferee was close;

"(2) the transferor retained possession or dominion after the transfer;

"(3) the transfer was concealed;

"(4) prior to the transfer a creditor had sued, or was threatening to sue, the transferor;

"(5) the transfer was of substantially all the debtor's assets;

"(6) the debtor has absconded or has removed or changed the form of the assets remaining in his possession so as to make the assets less subject to creditor process;

"(7) the value of the consideration received by the debtor was not reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;

"(8) the debtor was insolvent or heavily indebted or reasonably should have expected to become so indebted;

"(9) the transfer occurred shortly before or after a substantial debt was incurred.

Proof of the existence of any one of the factors listed in this subsection does not in itself constitute prima facie proof that the debtor has made a fraudulent transfer or incurred a fraudulent obligation."

To recap, the litmus test of determining whether a transfer is fraudulent or not, is to ask yourself this question: How would someone act in an objective way if he were trying to cheat his creditors? If that is the way this particular transferor acted, then this, at least, is evidence, of a badge, or mark of his fraudulent intent.

Constructive Fraudulent Transfers

Proving actual fraudulent intent on the part of the transferor has never been easy. As we've seen above, it requires unearthing a number of so-called "badges of fraud." Thus, the law has always recognized a second major category of fraudulent transfers. These are transfers that are "deemed-in-law" to be fraudulent without regard to the actual intent of the transferor.

Section 4 of UFCA, which contains the principal constructive fraud provision, reads as follows:

Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent, if the conveyance is made or the obligation is incurred without a fair consideration.

The classic example of a presumed-in-law fraudulent transfer is: When an insolvent simply gives away his property to his children, thereby getting nothing in return.

The theory behind constructive fraud is that property owned by an insolvent, although formally titled in the insolvent debtor's name, in equity really belongs to his creditors. Thus, if the debtor transfers away that property without getting a reasonably equivalent commercial exchange in return, then this is so prejudicial to creditors who in equity own the property that the law will give these creditors a remedy. The law will permit the creditors to get their property back, even though they cannot prove that the transferor had any evil intent to cheat them, but he made the transfer. The result would remain the same even if it can be shown that the transferor had benign or charitable motives in transferring the property.

The UFCA lists three of the so-called "deemed-in-law" fraudulent transfers, also called "presumed-in-law" or "constructive fraudulent transfers". The common thread running through the three constructive fraudulent transfers is that it involves a transfer by someone who is insolvent or near-insolvent, without getting in return fair consideration.

Categories of Constructive Fraudulent Transfers

The three categories of constructive fraudulent transfers are:

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1. Transfer by an insolvent for less than fair consideration, or for less than a reasonably equivalent exchange;

2. Transfer for less than fair consideration by a business person without retaining sufficient capital to meet the likely future needs of that business; and

3. Transfer for less than fair consideration by anyone - business person or consumer - without retaining enough property to meet his likely future debts as they become due.

Most fraudulent transfer litigation by creditors or a trustee in bankruptcy involves one of these presumed-in-law or constructively fraudulent transfers. The trustee makes out his case simply by showing the objective fact that a transfer was made by an insolvent or near-insolvent without getting the required fair consideration, or reasonably equivalent exchange in return. It is not necessary to establish that the transferor had any evil intent.

Fair Consideration or Reasonably Equivalent Exchange

The law of constructive fraudulent transfers establishes the standard of fair consideration or reasonably equivalent exchange. However, a transferor need not receive the exact market value of the property to satisfy this standard. Rather, something less than fair market value typically has been allowed. And this is for a good reason.

First of all, the law takes into account the fact that we live in a free market society where people are looking for "good deals" through fair and hard bargaining. Such free market mechanism cannot be ignored nor should it be discouraged.

Secondly, determining fair market value of an asset is not an easy task; a complex set of factors go into interplay in arriving at a fair market value. Therefore, courts are reluctant to upset transfers that have been fairly negotiated between the parties, simply because it can be shown at a later date that the transferor did not receive, in someone's opinion, then-fair market value of the property.

The appropriate question is: How far below the fair market value is acceptable to keep us within the "fair consideration" or the "reasonably equivalent exchange" concept and thus protect the transfer from a creditor's attack as a constructive fraudulent transfer?

The *Durrett* Decision

To answer the above question, we must look to the now-famous Durrett decision. *Durrett vs. Washington Nat'l. Ins. Co.*, 621 F. 2d (5th Cir. 1980): The court in this decision determined that fair consideration would be received as long as the debtor received at least 70% or more of the fair market value of the property. If the debtor did not receive at least that figure, the court reasoned that fair consideration had not been received.

Under the actual facts of the *Durrett* case, the parties had stipulated that only about 58% of the fair market value of the property had been received. Thus, the courts said that the case had failed to meet the standard of fair consideration.

Durrett decision has given us some general guidelines as to what might constitute a fair consideration. However, there might be instances where the market value of the property is so well-known and so easily attainable that even a small deviation from the fair market value might be considered less than a reasonably equivalent exchange.

Consider, for example, publicly-listed stock or securities. This can be sold on the public exchanges at a known and given price any day of the week. Thus, if a debtor does not get something pretty close to the listed market price on the day of his sale, then it could be successfully argued that a reasonably equivalent exchange had not taken place.

At the other end of the spectrum, there might be assets that are hard to market, have limited appeal and may be subject to distress sale. In such cases, if a debtor obtained, say, 50% of the fair market value, the courts may well be justified in accepting that as fair consideration under the circumstances.

In short, what constitutes a fair consideration or a reasonably equivalent exchange depends upon the peculiar circumstances of the case. The *Durrett* 70% rule should be used as a good rule of thumb with variations on the up side as well as down side acceptable depending upon the actual circumstances of the case.

Good Faith Purchaser

In order to successfully attack a fraudulent conveyance a creditor or trustee in bankruptcy has to cross two hurdles. First, he must prove the debtor's fraudulent intent - either actual or constructive. But this is not enough. He must also as a second step prove that the transferee is a "bad guy". In other words, the transferee lacked good faith in obtaining the property.

Under Section 9 of Uniform Fraudulent Conveyance Act a transferee is completely protected if he acts in good faith and pays equivalent value. In other words, no matter how fraudulent was the transfer by the debtor, there is nothing a creditor or trustee can do about it, if the transferee who now holds the property is a "good guy."

Good Faith Transferee

Now, precisely who is this good faith transferee who is protected from fraudulent transfer attack? A transferee who qualifies as a bona fide purchaser can keep the property free of the trustee's or creditor's claim to it, even though the transferor fraudulently transferred it to him.

Under the Uniform Fraudulent Conveyance Act, the good faith purchaser must meet three requirements:

- He takes the property in good faith;

- He takes the property without knowledge of the fraud on creditors that the transferor actually or constructively is seeking to perpetrate; and

- He himself gives fair consideration - that is, a reasonably equivalent exchange for the property received.

These are three essential elements for a transferee to qualify as a bona fide purchaser. If he fails on any one of these three elements, then he is not protected under the Fraudulent Conveyance Act and he will lose the property to creditors or the trustee in bankruptcy. Thus, a transferee may pay full and fair market value for the property, but if it can be established that he did so in bad faith or with knowledge that the transfer had the effect of hindering and delaying the transferor's creditors, then the transferee will lose the property to the trustee or creditors.

Less Than Fair Consideration

What if a transferee satisfies two of the three elements set forth above?

Say, a transferee acts in good faith and he acts without knowledge of the fraud being perpetrated on the transferor's creditors. He does, however, bargain too hard and ends up paying less than fair consideration.

As we observed above in the *Durrett* case, the transferee apparently acted in good faith and without knowledge that his purchase of the debtor's asset might be a transfer that had the effect of defrauding the transferor's creditors. But he only paid 58% of the fair market value which was less than acceptable to the court under its standard of reasonably equivalent exchange or fair consideration.

In such a case the transferee must give up the property to the creditors or trustee; he however, retains, a lien on the property to reimburse him for the consideration that he actually paid. In other words, a transferee who bargains too hard loses the benefit of his bargain. The court considers that bargain too unfair to the creditors to be tolerated even within the context of a free market society.

In a situation like this the court will order the property sold. From the sale proceeds the transferee will be given the amount needed to reimburse him for what he did pay - the 58% that the *Durrett* purchaser paid. The balance of the sale proceeds from the property will then be turned over to the trustee or creditors.

Fraudulent Conveyances in Bankruptcy

The Bankruptcy Code, like non-bankruptcy law, invalidates fraudulent conveyances. In fact, the provisions of Bankruptcy Code are very much like the non-bankruptcy fraudulent conveyance statutes. While the language in Section 548 of the Bankruptcy Code and the UFCA is not identical, there are, in fact, only a couple of substantive differences between them.

Section 548 of the Bankruptcy Code is based on the Uniform Fraudulent Conveyances Act. Section 548(a)(1) corresponds to Section 7 of the UFCA; it empowers the trustee to invalidate transfers made with actual intent to hinder, delay or defraud creditors. Section 548(b) is similar to the partnership provisions of Section 8(a) of the UFCA. And Section 548(a)(2) resembles UFCA Section 4-7.

It provides for avoidance of transfers where the debtor received less than a "reasonably equivalent value," and:

(i) was insolvent or became insolvent as a result of the transaction; or

(ii) was engaged in business or was about to engage in a business transaction with unreasonably small capital; or

(iii) intended to incur or believed that he would incur debts beyond his ability to pay.

Statute of Limitations

The UFCA does not have its own statute of limitation. States generally have a 3- to 6-year limitations period for actions to invalidate fraudulent conveyances. Under Section 548 of the Bankruptcy Code, the bankruptcy trustee may only reach transfers made within one year of the filing of the bankruptcy petition. This is one of the major differences between the provisions of the UFCA and the Bankruptcy Code.

Thus, a trustee in bankruptcy can attack a fraudulent transfer, either under Section 548 of the Code or under the applicable state law. In almost all cases, however, the substantive

results will be the same under either statute, in spite of the fact that the language in the two statutes does not read exactly alike.

Illustration: Assume that Mr. Smith, on June 1, 1986, gives his daughter a new piano as an anniversary present. Mr. Smith is insolvent at the time of the gift. On July 19, 1987, more than a year later, Mr. Smith files a bankruptcy petition. Mr. Smith's bankruptcy trustee will not be able to recover the piano. Under Section 548, the transfer was a fraudulent conveyance (the transfer for less than "reasonably equivalent value" while insolvent) but it was made more than a year prior to the bankruptcy petition.

In reality, the trustee has greater powers. Section 548 is not the only provision in the Bankruptcy Code that invalidates fraudulent conveyances. The trustee may also use Section 548, 544(b) to invalidate fraudulent conveyances.

Under Section 544(b), the trustee can use applicable state laws to void any pre-bankruptcy transfer. Section 544(b) incorporates state fraudulent conveyance law into the Bankruptcy Code. In other words, if outside of bankruptcy the transfer would be governed by the Statute of Elizabeth fraudulent conveyance statute, then Section 544(b) corresponds with the Statute of Elizabeth; if the state statute is the UFCA, then Section 544(b) is the UFCA.

Additionally, the trustee would have the benefit of the state limitations period to set aside fraudulent conveyances. In the above example, although the trustee could not use the Bankruptcy Code Section 548 to set aside the fraudulent conveyance, he could nonetheless proceed under the state fraudulent conveyance statutes which would have longer limitations period.

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[1]In re *Kassuba*, 10 Bankr. 309 (Sd Fla. 1981); *Tri-Star Cabinet & Top Co., v. Heatherwood Homes, Inc.*, 41 Ill. App. 3d 11, 354 NE2d 4 (1976); *Nelson v. Hansen*, 278 Ore. 571, 565 P2d 727 (1977); *Whipp v. Grider*, 330 Ill. App. 131, 70 NE2d 262 (1947).

[2]In re *Russo*, 1 Bankr. 369 (EDNY 1979); *Kailbab Indus., Inc. v. Family Ready Homes, Inc.*, 80 Ill. App. 3d 782, 372 NE2d 139 (1978); *Chambers v. Citizens & S. Nat'l Bank*, 242 Ga. 498, 249 SE2d 214 (1978).

[3]*Continental Bank v. Marcus*, 242 Pa. Super. 371, 363 A2d 1318 (1976); *West Gate Bank of Lincoln v. Eberhardt*, 202 Neb. 762, 277 NW2d 104 (1979); In re *Checkmate Stereo & Elecs. Ltd.*, 9 Bankr. 585 (Bankr. EDNY 1981); *John Ownben Co. Inc. v. Comm'r*, 645 F2d 540 (6th Cir. 1981).

[4]In re *Reed's Estate*, 566 P2d 587 (Wyo. 1977).

[5] *Arnold v. Dirrim*, 398 NE2d 442 (Ind. App. 1979).

[6]*Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville*, 358 F. Supp. 317 (ED Mo. 1973).

[7]*Rees v. Craighead Inv. Co.*, 251 Ark. 336, 472 SW2d 92 (1971).

[8]Fla. Stat. Ann. § 726.07; Ill. Ann. Stat. ch. 59, § 4; Tex. Bus. & Com. Code § 24.02.

[9] *DeWest Realty Corp. v. Internal Revenue Service*, 418 F. Supp. 1274 (SDNY 1976); *Waukesha County Department of Social & Health Services v. Loper*, 53 Wis. 2d 713, 193 NW2d 679 (1974).

[10]*Wallin v. Scottsdale Plumbing Co., Inc.* 27 Ariz. App. 591, 557 P2d 190 (1976); *First S. Properties, Inc. v. Gregory*, 538 SW2d 454 (Tex. Civ. App. 1976).

[11] *Bank of Commerce v. Rosemary & Thyme Inc.*, 218 Va. 781, 239 SE2d 909 (1981).

[12]*Jahner v. Jacob*, 252 NW2d 1 (NE1977); *Alan Drey Co., Inc. v. Generation, Inc.*, 22 Ill. App. 3d 611, 317 NE2d 673 (1974).

[13]*Pettit v. North Am. Stock Exch.*, 217 F. Supp. 21 (DCNY 1963); *T.W.M. Homes Inc. v. Atherwood Realty & Inv. Co.*, 214 Cal. App. 2d 826, 29 Cal. Rptr. 887 (1963); *Yeiser v. Rogers*, 19 NJ 284, 116 A2d 3 (1955); *Masomi Sasaki v. Yana Kai*, 56 Cal. App. 2d 406, 133 P2d 18 (1943).

[14]*Arnold v. Dirrim*, 398 NE2d 442 (Ind. App. 1979); *U.S. v. Fernon*, 640 F2d 609 (11th Cir. 1981) For a summary of various badges of fraud under Section 7 of UFCA, see 5 Debtor-Creditor Law 22-57-22-58 (Matthew Bender 1982).

Specific Cases under Fraudulent Transfers 13

In the previous chapter we looked at several basic principles that characterize fraudulent transfers. In this chapter we will look at some actual cases decided by courts, and also look at some hypothetical examples of what may or may not be construed as fraudulent transfers.

Executory Promises of Support

This case involved an insolvent debtor who just prior to filing his bankruptcy transferred his house to his children in return for a promise from them to support him during his declining years. The court held that this was a presumed-in-law or constructive fraudulent transfer that could be set aside. *West Minister Savings Bank v. Saubler,* 39 A.2d 862 (Md. Ct.App.1944).

The court reasoned that an executory promise to furnish support does not constitute the fair consideration or reasonable equivalent exchange that the law demands. The consideration given for the transfer must be something that has recognized commercial value. What the court had in mind was something, such as money or salable property, that the creditors can use to make up for the original property that they lost by reason of the transfer. Note, however, that the law does not object to the satisfaction of a valid antecedent indebtedness owed by the transferor.

The court reasoned that if the creditors are going to lose property that in equity belonged to them and that, except for the transfer, they could have levied upon, then they ought to get in turn something that is equally useful to them. If the consideration received by the transferor is not of that kind, then the law declares that fair consideration was not received. In the instant case, of course, creditors cannot get their debts paid by a promise by children to furnish support to the parent.

The court then applied the remedy available in situations where less than fair consideration is furnished. The court ruled that the children transferees were protected to the extent that they already had actually furnished the support services prior to the filing of the suit to set aside the transfer. To that extent, the court ruled that they did qualify as bona fide good faith purchasers. The children were not, however, protected to the extent that their promise to furnish support, was executory and not yet performed.

The remedy in a case like this would be to order the sale of the property that was transferred and from the sale proceeds to reimburse the children for the sum already expended for the support of the insolvent parent and to turn over the balance of the sale proceeds to the creditors.

Other Executory Promises

The concept of executory promises as constituting the fair consideration or reasonable equivalent exchange as a necessary ingredient for a valid transfer has been rejected by courts on more than one occasion. In fact, Section 548(d) - (2)(a) of the Bankruptcy Code expressly codifies this principle by defining value as excluding "an unperformed promise to furnish support to the debtor or to a relative of the debtor."

Let's take a hypothetical case, where an insolvent debtor prior to his bankruptcy transfers his property to an attorney in return for a promise from that attorney to render future legal services. Of course, the Bankruptcy Code allows the creditors to examine the attorney fee arrangements and, to the extent that a fee arrangement is not reasonable, ask the court to modify it.

Suppose, however, that this arrangement was made more than one year before the bankruptcy and thus is outside the scope of Section 329 of the Code. Could the transfer of money to the attorney be attacked as a presumed-in-law fraudulent transfer? Did the insolvent debtor receive a reasonable equivalent exchange or fair consideration, when he received from the attorney only an executory promise to furnish personal legal services?

The truth of the matter is that the creditors derive no benefit from the transferee's executory promise to furnish legal services in the future. As we saw before, the children's promises to furnish support to their insolvent parent do not help creditors to pay their debts; an insolvent debtor's arrangement with an attorney to receive a promise of future legal services is equally of no value to the creditors. Thus, an executory promise of an attorney to render purely personal services to the transferor cannot qualify for fair consideration.

Inter-Corporate Transfers

Corporations, often owned by a single individual, are easy vehicles for fraudulent transfers for those so inclined. A typical scheme that may be fraudulent to the creditors may work like this:

Suppose a bank loans $100,000 to a parent corporation. In order to secure the loan, the bank takes back a security interest on the subsidiary corporation's assets. Unfortunately, the subsidiary corporation is heavily in debts and is forced into insolvency. The assets upon which the creditors can levy have been mortgaged away to the bank without the subsidiary corporation having received anything in return. All of the loan money went to the parent corporation, a separate legal entity.

Such a setup is clearly subject to fraudulent transfer attack. Although the bank gave fair consideration, the consideration all went to the parent corporation, which was not the actual debtor. The law requires fair consideration or reasonably equivalent exchange to be given to the debtor who actually transfers the property.

Here is the logic behind fair consideration theory. If an insolvent or a near-insolvent party gives away property that, in equity, belongs to the creditors, then this will be permitted only as long as the creditors get some reasonably equivalent property in return. In the above case, the parent corporation got the benefit of the money, upon which the creditors of the subsidiary corporation, a separate legal entity, cannot levy upon. Creditors or trustee in bankruptcy of the subsidiary corporation would have a prima facie case for setting aside the security interest as a presumed-in-law fraudulent transfer.

Leveraged Buyouts

In a typical leveraged buyout arrangement, management of the company obtains a loan secured by the assets of the corporation to pay off the existing shareholders. Taking a hypothetical case, assume a bank loans $100,000 to the sole shareholder of a corporation to allow him to buy the stock from the prior sole shareholder. The corporation in turn gives the mortgage on its assets to secure the loan to the new shareholder.

Such an arrangement is also a variation of a constructive fraudulent transfer. The corporation has transferred or mortgaged its assets but has received nothing in return, all of the loan money - or the consideration - went to the new sole shareholder. Thus, if the corporation is insolvent or made insolvent by reason of undertaking its stockholders' obligation, this is a prima facie case of a presumed-in-law fraudulent transfer.

Insolvency Test

In order to make a prima facie case for constructive fraudulent transfer, it is not necessary to show that the corporation was insolvent on its balance sheet. Under UFCA Section 5 it is only necessary to show that "the property remaining with the debtor after the mortgage is an unreasonably small capital" to meet the anticipated risks of that corporation. If, as a result of the mortgage, the corporation is left with insufficient capital to meet the future claims of trade creditors, then a prima facie case of presumed-in-law fraudulent transfer has been made out. See *United States v. Glen Eagles Inv. Co., Inc.*, 565F.Supp. 556 (M.D.P.A. 1983).

Appendix to Section V: Uniform Fraudulent Conveyance Act

Sec. 1. Definition of Terms. In this act "Assets" of a debtor means property not exempt from liability for his debts. To the extent that any property is liable for any debts of the debtor, such property shall be included in his assets.

"Conveyance" includes every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or incumbrance.

"Creditor" is a person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent.

"Debt" includes any legal liability, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent.

Sec. 2. Insolvency.

(1) A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured.

(2) In determining whether a partnership is insolvent there shall be added to the partnership property the present fair salable value of the separate assets of each general partner in excess of the amount probably sufficient to meet the claims of his separate creditors, and also the amount of any unpaid subscription to the partnership of each limited partner, provided the present fair salable value of the assets of such limited partner is probably sufficient to pay his debts, including such unpaid subscription.

Sec. 3. Fair Consideration. Fair consideration is given for property, or obligation,

(a) When in exchange for such property, or obligation, as a fair equivalent therefor, and in good faith, property is conveyed or an antecedent debt is satisfied, or

(b) When such property, or obligation is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained.

Sec. 4. Conveyances by Insolvent. Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.

Sec. 5. Conveyances by Persons in Business. Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.

Sec. 6. Conveyances by a Person about to Incur Debts. Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.

Sec. 7. Conveyance Made with Intent to Defraud. Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.

Sec. 8. Conveyance of Partnership Property. Every conveyance of partnership property and every partnership obligation incurred when the partnership is or will be thereby rendered insolvent, is fraudulent as to partnership creditors, if the conveyance is made or obligation is incurred.

(a) To a partner, whether with or without a promise by him to pay partnership debts, or

(b) To a person not a partner without fair consideration to the partnership as distinguished from consideration to the individual partners.

Sec. 9. Rights of Creditors Whose Claims Have Matured.

(1) Where a conveyance or obligation is fraudulent as to a creditor, such creditor, when his claim has matured, may, as against any person except a purchaser for fair consideration without knowledge of the fraud at the time of the purchase, or one who has derived title immediately from such a purchaser,

(a) Have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim, or

(b) Disregard the conveyance and attach or levy execution upon the property conveyed.

(2) A purchaser who without actual fraudulent intent has given less than a fair consideration for the conveyance or obligation, may retain the property or obligation as security for repayment.

Sec. 10. Rights of Creditors Whose Claims Have Not Matured. Where a conveyance made or obligation incurred is fraudulent as to a creditor whose claim has not matured he may proceed in a court of competent jurisdiction against any person against whom he could have proceeded had his claim matured, and the court may,

(a) Restrain the defendant from disposing of his property,

(b) Appoint a receiver to take charge of the property,

(c) Set aside the conveyance or annul the obligation, or

(d) Make any order which the circumstances of the case may require.

Sec. 11. Cases Not Provided for in Act. In any case not provided for in this Act the rules of law and equity including the law merchant, and in particular the rules relating to the law of principal and agent, and the effect of fraud, misrepresentation, duress or coercion, mistake, bankruptcy or other invalidating cause shall govern.

Sec. 12. Construction of Act. This Act shall be so interpreted and construed as to effectuate its general purpose to make uniform the law of those states which enact it.

Sec. 13. Name of Act. This Act may be cited as the Uniform Fraudulent Conveyance Act.

Sec. 14. Inconsistent Legislation Repealed. Section . . . . are hereby repealed, and all acts or parts of acts inconsistent with this Act are hereby repealed.

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The following material on corporations and their benefits and strategies to make your business judgment proof and reduce state taxes is reprinted with permission from the Corporation Manual published by Laughlin Associates, Inc.

What Is a Corporation?

In brevity, a corporation is a legal, artificial person: a person that is separate, distinct and apart from you. It is NOT you. You are NOT it. It is a distinct, different, and totally separate legal or artificial person.

Let's take a close look at what a corporation is. A corporation is a distinct, legal entity separate and apart from its members, stockholders, directors or officers. Although it is a separate entity, it can act only through its members, officers or agents and can have no knowledge or belief on any subject independent of the knowledge or belief of its people. A stockholder (owner or partial owner) is a holder of shares of stock in the corporation and is not in legal contemplation or danger. A stockholder is not the employer of those working for the corporation nor is he the owner of corporate property.

A corporation is an artificial person. Its rights, duties and liabilities do not differ from those of a natural person under similar conditions except, of course, where the exercise of duty would require the ability to comprehend or think. That's what the board of directors is for: they do the thinking. Proof that the directors thought on behalf of the corporation is evidenced by minutes or a resolution. For example, a corporation may become a debtor or trespasser. A corporation can buy, trade, sell and make loans; literally anything you as a person can do. Think it through. The possibilities become fascinating.

A corporation is a citizen of the state wherein it is created. (That is why you may want to incorporate in Nevada to take advantage of the best corporation and tax laws in the U.S.) A corporation does not cease to be a citizen of the state in which it is incorporated by engaging in business or acquiring property in another state.

Since corporations are solely creatures of statute, the powers of a corporation of another state are derived from the constitution and laws of the state in which it is incorporated.

A corporation is a legal person which has an existence separate and apart from the stockholders. As an artificial person, a corporation is considered to have its domicile or home in the state where it is incorporated and the place where it has its registered or statutory resident agent or home office in that state. When the corporation is actually in a different place, the site of its resident agent is sometimes said to be its "statutory domicile."

The existence of the corporation is not affected by the death or bankruptcy of a shareholder or by the transfer of its shares. It has a continuous existence. It is immortal as long as it complies with the annual requirements of the state in which it is incorporated.

It may be advantageous to use the corporate form of doing business to insulate the owner from the risks and liabilities of his businesses or to insulate a stable business from a risky business of the same owner.

Why You Should Incorporate: Limited Liability

There are a number of excellent reasons why you should be incorporated, plus many miscellaneous advantages and benefits. The foremost of them is, of course, the limited liability, protection of your personal assets from the creditors of the corporation.

When you create or form a corporation, you have created a legal entity, in effect a legal person. That entity is responsible for its own acts. You are NOT individually responsible (there are certain remote exceptions).

All you have to do is read the newspapers, listen to the radio, watch TV. It appears our nation is becoming more legalistic and our people more conversant with litigation. Everyone is either suing someone or being sued!

You read of malpractice suits, class action suits, discrimination suits, personal injury suits, antitrust suits, and on and on ad infinitum. You read of juries awarding fantastic amounts to plaintiffs.

IT CAN very easily and without warning HAPPEN TO YOU. One lawsuit can wipe you out and possibly destroy your life. You can prevent that risk. You can protect yourself. Be smart—INCORPORATE!

We suggest that you consider the wisdom of operating several corporations. Put separate activities in separate corporations with different names and then possibly set up a holding corporation that owns all the others.

Think about it! There are many variations and many strategies YOU may employ. Cut down and minimize the risk. Let the corporation take the risk; protect yourself. "An ounce of prevention is worth a pound of cure."

What Is a Holding or Parent Corporation?

The term "holding corporation" is reasonably self-explanatory. A holding corporation "holds" control of other corporations (subsidiaries).

"Control" as used in regard to a holding corporation usually means that the holding corporation owns at least 80% of the stock of the subsidiary corporation.

A holding corporation is often referred to as "the parent corporation." This is a somewhat self-explanatory term which pictures the holding corporation as the parent and, therefore, its subsidiary corporation or corporations as the holding corporation's children.

Do I Want a Holding Corporation?

There are good, valid and profitable reasons for utilizing a holding corporation. We will point out some of them. When these reasons exist or are in place, then, yes, you want a holding corporation.

However, when there are NO compelling reasons to utilize and operate a holding corporation, we recommend, as a general rule, a brother-sister relationship. Under the brother-sister relationship, the involved corporate entities are independent corporations, although under common control (the same control). In "tax terms" they are members of a controlled or affiliated group.

We believe it is usually more "comfortable" to have the corporations severed one from another, completely independent of each other, and therefore not having one or more owned by one another.

In either situation, most dealings between the corporations should be contractual in nature (reduced to writing in contract form). They should be natural transactions—not artificial. It usually only takes a little brain work to make them really happen. Each corporation involved should actually perform or deliver its duties or obligations under the contract. Each corporation should meticulously observe all corporate formalities.

What Is a Brother - Sister or Multiple Corporate Structure?

Often, instead of a holding company structure, a brother/sister or multiple corporate structure is preferable. The primary difference between a brother/sister structure and a holding company structure is that with a brother/sister structure or strategy, the stock of the corporations involved is owned by an individual stockholder or stockholders instead of being owned by a parent corporation. This brother/sister ownership is usually referred to as common control or common ownership. In tax talk they may be or become part of an affiliated or controlled group.

When all else is equal, we recommend the brother/sister structure as opposed to a holding corporation structure. We feel that it puts more distance between the involved corporations and better establishes the separateness and identities of the involved entities. Therefore, we refer to the structure as being more "comfortable." We feel that it may also assist in limiting liability to whichever entity might be attacked or at risk.

The little guy and/or privately held corporations can take advantage of and gain some great benefits from utilizing certain brother/sister corporate strategies that big brother, public corporations cannot because of their massive, public ownership. Although—make NO mistake about it, they would dearly love to. Yes—believe it or not—a sometimes advantage to the little guy that big brother cannot touch.

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How to Be Judgment Proof and, Incidentally, Legally and Simply Preclude or Terminate State Income Taxes... Among Other Things 15

Some say "you can't be judgment proof and/or legally eliminate state income taxes." They're wrong because where there's a will, there's a way, and, after all, "Nothing is impossible." You can learn how by reading this. It works and is simple and legitimate.

This strategy is so simple that it usually takes a while for the impact of it to really soak in. It is so simple that many times it sends our lawyer friends digging and researching for weeks, playing the devil's advocate, trying to shoot it full of holes or tear it down. That's okay with us . . . we think that's the way it should be. We are convinced this strategy will stand up under any legal scrutiny or research and will further stand up in any court in the land if it is done properly.

Why? ? ? Because the principle of this strategy has been around since one business started doing business with another. There is nothing more tried and true in America than that principle. There is simply no law against two companies doing good, red blooded American business with each other. That is essentially what we are advocating here. That is the strategy.

So—how do two companies do business together so you can operate judgment proof and/or state income tax free? ? ? ? ?

Well, a lawyer friend once told me that the best liability insurance anybody could have was to be completely poverty stricken and destitute. That way you can be a turnip (you can't get blood out of a turnip) and, therefore, be judgment proof. I also know that if you never make a profit in your home state, you owe no income tax to your state provided your state income tax is based on net earnings, or profit, or taxable income as most states are. (The exception is an income tax based on gross income.)

But hey, wait a minute! Being judgment proof and not paying any state income taxes just isn't any fun if you are completely poverty stricken and never make a profit. No one wants to live in the street just so they won't get sued or have to pay state income tax. Rest easy . . with this strategy you'll be judgment proof. You'll eliminate your state income tax, live well, and have financial security, legitimacy, ease, efficiency and peace of mind.

Step-By-Step Blueprint on How to Do Business "State Income Tax Free" and Be Judgment Proof

(1) Incorporate your home state business that you currently derive income from. Make it a Nevada corporation and qualify it to do business in your home state. If you choose to use a corporation formed in your home state, or are already incorporated in your home state, that will generally work, too. For purposes of this example, we are going to call your home state corporation, **"Red, Inc."** That's because your home state operation will have a lot of red ink. It will try and try and try to make a profit but if it ends up with red ink (losing money), then there are no state income taxes to pay, now are there? Of course not . . .

NOTE: Elect a calendar year ending 12/31 as the tax year for **"Red Inc."**

(2) Next, set up a Nevada company — and make that company a Nevada corporation. For purposes of this example we will call this corporation, **"Warbucks Nevada, Inc."** Base that Nevada corporation in Nevada. This won't cost a lot of money because you can establish an economical, viable, provable operating base by utilizing the "Staffed Contract Office Package Service" provided by Laughlin Associates, Inc. By utilizing the Staffed Contract Office Package Service your **"Warbucks Nevada, Inc."** can have a Nevada office complete with its own telephone system, contract employees, Carson City, Nevada business license, Nevada bank account, complete mail service, and an all important one line advertisement in the Nevada yellow pages (providing what lawyers call a "public holding out to do business"— essential). All of this can be done for a very low price.

With the Office Package, **"Warbucks Nevada, Inc."** has its corporate base in tax free Nevada. It will operate only in tax free Nevada. It is going to earn a lot of money in Nevada. Therefore, any profit that **"Warbucks Nevada, Inc."** makes will be state tax free. Wow! Now what?

NOTE: Elect a fiscal tax year ending 6-30 for **"Warbucks Nevada, Inc."**

(3) Now **"Red, Inc."** enters the picture. Operating in your home state, **"Red, Inc."** decides it would be a fine idea to buy some products and/or services from **"Warbucks**

Nevada, Inc." in Nevada. Remember that **"Red, Inc."** and**"Warbucks Nevada, Inc."** are separate corporations and are therefore separate persons. A corporation is an artificial person created by law. Corporations are separate from each other, and they are separate from you. Therefore, if **"Red, Inc."** writes a check to **"Warbucks Nevada, Inc."** money is spent by **"Red, Inc."** (your home state based person) and money is received by **"Warbucks Nevada, Inc."** (your Nevada based person). There is an expense in your home state to **"Red, Inc."**, and there is income in Nevada to **"Warbucks Nevada, Inc."** There was money earned in Nevada and an expense in your home state. If **"Red, Inc."** spends all its profit, it makes no money for your home state to tax...You even have an excellent judgment proofing tool...We'll explain how in a little bit.

This blue print puts the pieces in place to be judgment proof and to eliminate state income taxes. Now I'll explain in clear detail just how the blue print works...First, eliminating state income taxes...

Suppose that **"Red, Inc."** spends a lot of money with **"Warbucks Nevada, Inc."**, so much that when the end of its tax year rolls around, **"Red, Inc."** hasn't made any profit. That means **"Red, Inc."**, your home state company, according to its books and records, owes no state income taxes. The good news is that **"Warbucks Nevada, Inc."**, your Nevada company, has had a fantastic year and your profits are in tax free Nevada. Since you control both corporations, that is truly "The Happy Solution" for you.

Your home state income taxes have been eliminated and you're the proud owner of a Nevada corporation that is now making the profit and netting you up to 11.5% more profit for your labor. You $ave thousands or tens of thousands of dollars every year. Wow! You now have the great competitive edge.

It is said you don't have to be a lot smarter than the other guy—just a little edge will do. Think of what you can do with this kind of an advantage.

Oh yes . . .

Just what products and services can **"Warbucks Nevada, Inc."** sell to **"Red, Inc."** from Nevada while operating solely in the state of Nevada? First, we stress that the business conducted between the two entities should be legitimate, reasonable, and viable which is easily constructed. We are not suggesting this as a sham, and it would be subject to a calculated risk if done as a sham. We believe if it's worth doing, it's worth doing right. So, what are some products and services that **"Red, Inc."** buys from **"Warbucks Nevada, Inc."?**

Some ideas that can work, and are successfully used, are copyright material, research & development, and advertising. Turn on your creative juices — let your imagination serve

your planning. Remember, "what the mind of man can conceive and believe, it can achieve." Prepare whatever you wish the corporation to sell, and ship what is to be sold to your **"Warbucks Nevada, Inc."** Nevada office. **"Red, Inc."** buys these products or services from **"Warbucks Nevada, Inc."** You can be anywhere in the world and supply those services or products to and through your Nevada corporation.

What we suggest as the most solid and workable option is that **"Warbucks Nevada, Inc."** simply loan money to **"Red, Inc."** **"Red, Inc."** would simply be buying the use of money from **"Warbucks Nevada, Inc."** When you borrow money, you generally pay interest. **"Red, Inc."** is no exception to that rule . . . Here's how it works...

Put money into **"Warbucks Nevada, Inc."** in exchange for stock. Maybe you supply **"Warbucks Nevada, Inc."** with a product or service that can be resold. Don't get me wrong, money is the best thing to put into **"Warbucks Nevada, Inc."** but many have successfully implemented this strategy by putting products (inventory) and services to be resold into the corporation...For the moment we'll talk about money and touch on other considerations later.

"Warbucks Nevada, Inc." uses the money that has been invested in it to make money. It does this by loaning that money to **"Red, Inc."** and possibly others. The condition of that loan to **"Red, Inc."** is that the money owed is due and payable when **"Warbucks Nevada, Inc."** asks for it (calls the note). The note (the piece of paper that is evidence of the loan terms) in this case is a demand promissory note which means that it's due when **"Warbucks Nevada, Inc."** demands payment.

Also, as any good business does, **"Warbucks Nevada, Inc."**, which you own charges **"Red, Inc."**, your home state operation, interest on the money that it loans to **"Red, Inc."** I remind you that **"Warbucks Nevada, Inc."** is located in and operating from Nevada. Nevada has no usury laws, so **"Warbucks Nevada, Inc."** charges **"Red, Inc."** whatever interest rate **Warbucks** thinks is fair. In our example, we'll say the rate is 26%. The interest is due each month or year. The interest may even be compounded monthly. This will get **"Red, Inc."** even further in debt to **"Warbucks Nevada, Inc."** which can be very beneficial as you'll see later.

To summarize so far, **"Red, Inc."** borrows money from **"Warbucks Nevada, Inc."** at 26% interest per year with the principal balance due upon demand (when **"Warbucks Nevada, Inc."** calls the note). The money owed to **"Warbucks Nevada, Inc."** is evidenced by a demand promissory note signed and executed by **"Red, Inc."** (the debtor) at the Nevada offices of **"Warbucks Nevada, Inc."** This shows that they money is borrowed in Nevada and, if worded correctly, that the note is governed by the laws of Nevada. (Sample notes are contained in the book, Corporation Forms and Explanations Made Easy, published by Laughlin Associates, Inc.)

How much does **"Red, Inc."** borrow from **"Warbucks Nevada, Inc."**? Well, at 26% simple interest (used only for example because with no usury laws in Nevada, **Warbucks** could charge more), if **"Red, Inc."** borrowed $100,000, this would mean a business interest expense to **"Red, Inc."** in your home state of at least $26,000 in one year . . . or the interest could be compounded monthly and interest charges would be even more . .

Do you see what profitable things are happening here?????

Depending upon the amount of money borrowed and the interest rate that the two companies (which you own) agree upon, the interest expense to **"Red, Inc."** in your home state could be as high or as low as you decide...

If the expense to **"Red, Inc."** in your home state is equal to or greater than the profit that your home state operation (**"Red, Inc."**) would have made if it had not borrowed from **"Warbucks Nevada, Inc."**, then **"Red, Inc."** in your home state has made no profit.

The result is that if **"Red, Inc."** makes no profit, then there are no state income taxes due. On the other hand, **"Warbucks Nevada, Inc."** in Nevada has made a state tax free profit. You have just legally precluded or terminated state income taxes.

Oh, yes...How does all this work if you put products (and services) into **"Warbucks Nevada, Inc."** for re-sale? Well, instead of just loaning money to **"Red, Inc."**, **"Warbucks Nevada, Inc."** would sell these products and services to **"Red, Inc."** and invoice the purchase. The purchase price is whatever the two companies, both of which you own, agree upon.

Everything works the same from there. **"Warbucks Nevada, Inc."** sells the products and services to **"Red, Inc."** and takes back a promissory note due and payable when **"Warbucks Nevada, Inc."** calls it. Interest on that note is due monthly (maybe with interest compounded monthly) or yearly. That interest is still an expense to **"Red, Inc."**, and the result can be the same: No profit for **"Red, Inc."** in your home state. The principal amount of the note may also be deductible to **"Red, Inc."** Again, we suggest the simple loaning of money from **"Warbucks Nevada, Inc."** to **"Red, Inc."**, but many use products (inventory) and services successfully.

So there you have it as far as state income tax is concerned. Your home state operation (**"Red, Inc."**) makes no profit, therefore there are no state income taxes due... So what about being judgment proof?

O.K. let's be judgment proof, too...

The stage is already set. . . and all that really remains is a few simple steps to make your business operation judgment proof. Let's analyze **"Red, Inc."** and **"Warbucks Nevada, Inc."** for just a second so this will be totally clear. . .

"Red, Inc." is busily conducting your current business. It's buying, selling, making deals. It's the corporation in the high exposure position. If a business deal goes sour, if something goes wrong, it's **"Red, Inc."** that will be sued.

"Warbucks Nevada, Inc." is based in Nevada and it maintains a low profile. It's merely financing a few things here and there for profit. Its main client is **"Red, Inc."** which you own. It's a totally separate corporation. **"Warbucks Nevada, Inc."** chances of getting sued are one in a million.

The idea is to make **"Red, Inc."** judgment proof, to turn **"Red, Inc."** into a turnip that no one can bleed and at the same time make sure it has the money, equipment, fixtures, land, buildings, etc. to conduct your business.

"Red, Inc." can also be transformed into your "liability lightning rod." I'm sure you're familiar with the concept of a lightning rod. When lightning strikes one, it doesn't do harm to the valuable things the lightning may otherwise destroy. The same is true here . . . When **"Red, Inc."** gets sued, the suit will not harm the valuable things you are trying to protect. Here is how it works:

We've already established the fact that **"Red, Inc."** is heavily indebted to **"Warbucks Nevada, Inc."** and the heavier in debt that **"Red, Inc."** is to **"Warbucks Nevada, Inc."** the better.

"Red, Inc." borrows money from **"Warbucks Nevada, Inc."** every time it gets a chance. It probably even finances part of its interest payments due to **"Warbucks Nevada, Inc."** because it can't quite make them all in cash. Therefore, each month or year the debt keeps increasing. It would not be hard to establish a debt so large to **"Warbucks Nevada, Inc."** that it eclipses the value of all the assets of **"Red, Inc."**.

Let's say **"Red, Inc."** has assets totaling $250,000.00 that you want to protect. **"Red, Inc."** borrows and borrows from **"Warbucks Nevada, Inc."**, getting deeper and deeper in debt. Finally, it's at least $250,000.00 or more in debt. The debt figure is limited only by the principal amount **"Warbucks Nevada, Inc."** and **"Red, Inc."** agree upon and the corresponding interest rate. Of course, owning those corporations you may have something to say about what they agree upon.

Well, **"Warbucks Nevada, Inc."** is no dummy — after all, you own it. When **"Warbucks Nevada, Inc."** loans money to anybody, **"Warbucks Nevada, Inc."** is going to make sure they get paid or else. So **"Warbucks Nevada, Inc."** will want some collateral on the loan to **"Red, Inc."** **"Warbucks Nevada, Inc."** and **"Red, Inc."** enter into a "security agreement." This is a common, powerful tool that is used to secure certain assets as collateral on a loan. With this security agreement they agree that the assets, receivables, inventory,

everything belonging to **"Red, Inc."** is collateral for that loan. On any equity in real property **Red, Inc.** would issue a trust deed (mortgage) to **"Warbucks Nevada, Inc."** (Sample forms for such an agreement and trust deed may be found in Corporation Forms and Explanations Made Easy, published by Laughlin Associates, Inc.)

Then, as notice to the world that these assets are collateral for a debt owed to **"Warbucks Nevada, Inc."** in Nevada, **"Warbucks Nevada, Inc."** will record what is called a "UCC-1" financing statement with the Secretary of State's office in Nevada and with the Secretary of State's office and appropriate County Recorders in your home state. This UCC-1 form states that these assets are collateral for a note that is owed. It gives notice to the world that these assets are encumbered. It gives notice to the world that no one can touch these assets until the debt owed to **"Warbucks Nevada, Inc."** is paid.

Let me tell you something about UCC-1 filings and the security agreement that perfects a security interest in the assets of **"Red, Inc."** They come before everything else (except some tax claims). In other words, **"Warbucks Nevada, Inc."** is in a first position on all of the assets that **"Red, Inc."** owns and those assets can't be touched until **"Warbucks Nevada, Inc."** is paid.

In the case of a trust deed being used to secure equity in real property, that trust deed would be recorded in the county in which the property is located. This also has the effect of giving notice to the world that the property is encumbered by debt.

Now let's think about what happens if **"Red, Inc."** gets sued. The person suing you finds a dirty, mean and nasty attorney to sue **"Red, Inc."** One of the first things he asks the attorney is "what can we take this company for?" Of course, that is one of the big questions in the attorney's mind also, especially since many attorneys work on a percentage of what they can collect. That's how a lot of attorneys hope to get rich and that's how a lot of attorneys do actually get rich.

But in this case, that's when the lawyer and the person suing **"Red, Inc."** take a very cold shower. They do a search to see what **"Red, Inc."** is worth. That search includes looking for any real property the corporation owns along with any debt against it and any UCC-1 filings encumbering assets that **"Red, Inc."** may own. They find a big debt. . . they find that all of the assets of **"Red, Inc."** are encumbered. **"Red, Inc."** is worthless! It has nothing! My heavens, it's not even worth suing.

That's probably the end of the lawsuit against **"Red, Inc."** right there. On the other hand, let's say the person suing you just happened to pick a particularly sadistic lawyer. This person just wants to sue you anyway. So he files the lawsuit. He even gets a judgment. Now what happens?

Remember **"Warbucks Nevada, Inc."** is owed money by **"Red, Inc."** as evidenced by a promissory note due on demand. When **"Warbucks Nevada, Inc."** calls the note, **"Red, Inc."** has to pay. **"Warbucks Nevada, Inc."** decides it is time to get paid and calls the note. Oh heavens, **"Red, Inc."** can't pay such a large debt. **"Warbucks Nevada, Inc."** has no recourse except to execute on its security interest and/or trust deeds in the assets of **"Red, Inc."** In other words, **"Warbucks Nevada, Inc."** takes the assets of **"Red, Inc."** to satisfy the debt.

What happened? That's the same question the sadistic attorney who sued you is asking. He's got a judgment against **"Red, Inc."**, and **"Red, Inc."** has nothing to execute that judgment on. In fact, you could even call that attorney and tell him, "I'll just give you the whole corporation, come on down and get it." Because even though **"Warbucks Nevada, Inc."** has taken the assets of **"Red, Inc."** the debt that **"Red, Inc."** owed to **"Warbucks Nevada, Inc."** may have been so large that **"Red, Inc."** still owes money to **"Warbucks Nevada, Inc."** That being the case, the only thing a person suing the company would gain is a large debt owed to **"Warbucks Nevada, Inc."** that you own.

That's all there is to it. To summarize:

(1) **"Red, Inc."** owed **"Warbucks Nevada, Inc."** money.

(2) The money **"Red, Inc."** owes **"Warbucks Nevada, Inc."** is evidenced by a promissory note due when **"Warbucks Nevada, Inc."** says it's due.

(3) As security or collateral on that note **"Warbucks Nevada, Inc."** and **"Red, Inc."** have agreed that the assets of **"Red, Inc."** will be collateral and security for the note.

(4) As notice to the world and evidence of the fact that these assets are collateral on the loan, a UCC-1 filing is done in Nevada and in your home state, and a trust deed is executed on any real property and filed in the county in which the property is located (Sample trust deeds, and Nevada and California UCC-1 forms are available in Corporation Forms and Explanation Made Easy, published by Laughlin Associates, Inc.)

(5) **"Warbucks Nevada, Inc."** is in a first position on the assets of **"Red,Inc."** and no one suing **"Red, Inc."** can touch those assets until the debt to **"Warbucks Nevada, Inc."** (that you own) is paid.

(6) You are judgment proof, because even if there is a judgment against **"Red, Inc."**, there is nothing to take.

We believe this strategy is the best liability insurance you could find. Remember, a Nevada base for **"Warbucks Nevada, Inc."** is essential.

NOTE: It is imperative that to be truly judgment proof, whenever you do business, you do business as **"Red, Inc."** and not you. That means signing things as **"Red, Inc."** by: You, its President. You don't want anyone to have any cause of action against you personally.

What if "Red, Inc." needs institutional financing?

Is **"Red, Inc."** really broke? Well... yes and no. Perhaps it depends on how you want it. If **"Red, Inc."** desires bank financing or has similar needs, you can always prepare a consolidated financial statement for **"Red, Inc."** and **"Warbucks Nevada, Inc."** and present a very desirable position for **"Red, Inc."**

What is the real reason for doing This?

Never implement this strategy as a strategy to avoid taxes. Never state that as your primary purpose. The primary purpose is to open a company in Nevada and take advantage of Nevada's multiple pro-business benefits. The fact that you eliminated your home state taxes, and gained a great competitive advantage, super protection, and the best possible insurance is only an incidental happening or fringe benefit - it's only a happy result of the primary Nevada benefits . . . isn't it?

Is This Right? Of Course It Is...

Remember, what Federal Judge Learned Hand said in *Helvering v Gregory* 69 F(2d) 809 (2d Cir. 1934), "Any one may so arrange his affairs that his taxes shall be as low as possible: he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." This case was affirmed by the U.S. Supreme Court in *Gregory v Helvering,* 293 U.S. 454 (1935). The U.S. Supreme Court further agreed, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

What Do I Need to Do This????

Hopefully this special report has shown you how to do this but the best set of instructions in the world is useless without the tools to carry out the instructions.

Here are the tools you need:

(1) One Nevada corporation (**"Red, Inc."**) doing business in your home state.

(2) One Nevada corporation (**"Warbucks Nevada, Inc."**) based in and doing business in Nevada.

(3) Nevada officebase (to prove the corporation rents or has office space in Nevada.)

(4) People in the Nevada office to take care of business, answer the phone, greet and handle callers, customers, etc. (to prove that the corporation has operating base in Nevada).

(5) Telephone for the corporation in the Nevada office (proving operations are in Nevada with yellow page advertising showing the public this corporation does business there—what lawyers call a public holding out to do business.)

(6) A business license in the Nevada city where your corporate office is located.

(7) A bank account where its Nevada office base exists.

(8) Major service contracts, notes, exchanges of funds or any other major business transactions should be consummated, signed, notarized, and the money exchanged at your Nevada office or through the Nevada bank account.

The Estate Plan That Never Dies: "Long Term Corporate Planning Revisited"

Here is the "Long Term Corporate Planning" we suggest you consider. The sequence is important so follow it closely:

(1) Establish a corporation which when formed is what is called a "corporate shell." It has no assets, no liabilities, and its stock is worthless at this point.

(2) Cause the sale of its worthless (because it has no assets yet) stock from the corporation to your investors (heirs) at one cent ($.01) per share, divided by the prorated amounts you choose. Since the stock has been sold to them, it's not a gift. One object of all stock is to increase in value over a period of time. If the stock does increase in value, then nothing wrong, illegal, unethical, or strange has occurred.

(3) Form a limited partnership with you as general partner and your heirs as limited partners. The sole purpose of this limited partnership is to hold the stock of the corporation you just formed. In a limited partnership the general partner(s) manages the business and the limited partner(s) take no part in the running of it. Remember, the business of this limited partnership is to hold the stock of the new corporation. This means the general partner (you) will vote the stock at the annual stockholders meeting.

All of the stockholders (you and your investors/heirs) put their newly acquired stock into the limited partnership. In return you become a 1% general partner and a 1% limited partner. Your investors/heirs become 98% limited partners. You, the general partner, manage the business. You vote the stock.

This limited partnership will have a set life. It will be in existence for a certain number of years. That number depends on you. Make the term of years long enough so that when the limited partnership ends, you either won't be around or if you are, you won't want to control the corporation. For example, the limited partnership may have a life of 30 or 40 or 50 years. You make that decision.

The limited partnership can be drawn up so that it ends upon the death of any of the general partners. So when you die, the limited partnership terminates and the other partners (your heirs) take their 98% of the stock in the corporation and go home. Only your 2% of the stock will go through probate and hopefully your estate will be small enough, because of your wise prior planning, to eliminate any problems.

Your heirs have the stock and they own the company, but you, by virtue of your general partnership, have complete control of the corporation, its assets, its money, real estate—everything. You can sell these assets and pay yourself the money, or add to the assets, pay for any and all expenses, travel, medical, and so forth. You can do anything you want for as long as you live.

But, wait a minute, the corporation doesn't have any assets or money. So . . .

(4) Put your assets and money into the corporation. Some suggested possibilities as to how you may accomplish this are as follows:

Sell the assets to the corporation in exchange for a demand promissory note to mature in 50 years or whatever term you deem appropriate. Take money out of the corporation any time you wish and mark it "to apply on promissory note." Word the note so that in the event of your demise, any sums remaining payable to you by the corporation under the note are automatically forgiven. We suggest the demand promissory note bear interest, probably at 12% simple interest per annum, and that the corporation pay you the interest when it becomes due. This will satisfy the IRS. Where does the corporation get the money to pay this interest? From the money or assets you sold to the corporation. You are simply taking money out of one pocket and putting it in another.

It's true the interest received by you may be taxable, depending on your adjusted gross income . . . that is on your "taxable" income or, stated another way, on how good a manager you are.

Explore the possibility of putting your assets into the corporation as a "Capital Contribution." With a little thought, innovation, and ingenuity you will discover many other ways to transfer your assets into the corporation successfully. There, so much for getting the assets into the corporation.

When you put your assets into the corporation, the value of its stock increases, but there are no taxes until such time as dividends are paid by the corporation or the stock is sold. In both cases this is a matter over which you have complete control and for which you can adequately plan in advance to legally avoid taxes.

The bottom line is this: When you pass on the Happy Haven in the Sky, your heirs already own all you want them to have. If you've ever thought of striking back from The Grave, here's your chance — This is almost like being The Executor or Executrix of your own will. Since your heirs already own your estate when you pass on, there's no transfer, no probate, no big taxes — no problems. It's all done, "The Happy Solution."

Also consider the possibility of taking from the corporation a contract in exchange for your services rendered: A life-time contract and guarantee that the corporation will provide for you, including all of your medical bills, convalescent care, and such other expenses and items as you may wish. (Be careful of possible tax consequences here - consult your tax advisor.)

With this plan you know what is going to happen to your loved ones when you pass on. Everything you have worked for, acquired, and have is going to the ones you wish it to go to. There won't be a long drawn-out probate case in court. You can have peace of mind. You don't have to worry about little or nothing existing for your heirs after all the legal fees, expenses, inheritance taxes, and so forth are paid. What can take years of legal delay, astronomical expenses, waste and agony for the ones you love is accomplished by them at their stockholders meeting through the election of directors and officers (probably prearranged). The transition is smooth. Everything continues without interruption. You have the peace, joy, satisfaction, and confidence of knowing that your loved ones have exactly what you intend for them to have.

What we're saying is this: Corporations never die, they just get a new president. Take advantage of this corporate immortality. Put what you have into a corporation and the corporation will live long past you to successfully distribute your assets to the people you wish to have them. This will eliminate the normal pitfalls of estate planning, probate and taxes.

Even though you utilize "Long Term Corporate Planning," have a simple will to handle any loose ends that, for one reason or another, might not have gotten into the corporation. You could will everything to the corporation which would make distribution consistent with your "Long Term Capital Planning."

Multiple Corporations

I have an acquaintance who owns a limousine service business. He has found a solution to the liability problem in multiple corporations. He formed several corporations, each owning a limousine or two. He figures if one of his limousines was involved in an accident, in the worst-case scenario all he would lose would be the one corporation that owned the limousine, and the rest of his business would remain unaffected.

Apart from protection from liability, multiple corporations have many tax and business advantages. Since total income of the enterprise is divided among several corporations, each corporation enjoys the benefits of lower tax brackets. A corporation is required to pay out excess income as dividends and is generally penalized on accumulated earnings over $250,000. With multiple corporations you are multiplying this credit several times, thereby generating significant tax savings. Corporations may adopt the accounting method, taxable period, and make elections such as depreciation, inventory valuation, installment sale, investment tax credit, etc. to suit their special needs. With multiple corporations you can increase the benefits by changing timing or methods among them. If you are planning to sell your business, sometimes it is easier to sell it in parts. Multiple corporations will come handy in such a situation.

There are also some disadvantages. If you are running a business as a single entity, you have the advantage of matching cash requirements of one operation with the cash generated by other operations. With multiple corporations, each corporation stands on its own and you lose the flexibility in the use of funds in your business. Of course, you can get around this problem by causing one corporation to loan funds to another. This disadvantage extends to the tax front. In a single business, profits from one part of the business are offset by the losses from other parts of the business. In multiple corporations, some will be profitable, some others not, and the profits and losses will not automatically be netted one against the other.

If you do decide that multiple corporations arc for you, division of your business should be made along natural lines. Your objective is to own the property or business without incurring the liability arising from the hazards of operation. There can be a horizontal division of your business along different product lines or geographical regions, or you can have the functional division of the business, for example into sales and manufacturing operations.

Here are some examples of how certain businesses have used multiple corporations. A wholesale grocery business was divided into five corporations, one for each town in which it operated. The incorporation of 51 branches of a shoe chain into 21 corporations limited liability on leases. An owner of a chain of gas stations formed 24 separate corporations, one for each gas station. Multiple corporations are an ideal vehicle for limiting liability for real estate owners. You would need to work out tax angles to be sure.

Checklist – Business Legal Exposure and Liability

Most business owners tend to minimize or entirely overlook the need to protect themselves and their businesses from potential lawsuits and liability. The importance of such protection cannot be overemphasized. Years of hard work in building up a profitable business can be wiped out through a single lawsuit which could have been averted by proper planning.

The following checklist, by no means comprehensive, highlights those areas that pose the greatest danger to both businesses and individual owners and should be used to review the legal fitness of your business.

✓ **Accident, Liability and Property Damage.** Assess various risks, formulate and implement a plan to minimize them and review the insurance protection available.

✓ **Antitrust Violations.** Review corporate pricing policy, distribution, and licensing agreements. Define marketing policy, especially with reference to general sales and procurement procedures, guidelines for field representatives and contacts with competitors.

✓ **Inventions, Patents, Trademarks, and Trade Secrets.** Conduct a thorough analysis to ensure adequate protection.

✓ **Discrimination.** Guard against discrimination in employment hiring, promotion and firing. Watch out for age, sex, and race discrimination. Personnel policies should be periodically updated to reflect the latest changes in law and court decisions.

✓ **Libel and Slander.** Greatest potential for libel and slander lies in labor disputes, references for past employees, dealings with competitors, and customer collection activities.

✓ **Breach of Contract.** Areas to watch here are: employee hiring and firing and dealings with vendors and customers.

✓ **Product Liability.** Minimize exposure by taking the following steps:

(a) get products pretested by an independent laboratory;
(b) set up a quality control program;
(c) make sure instructions for proper use of the product are clear and prominently displayed on labels;
(d) make warranty definite - stating exactly what is being warranted and what is not; if the component parts or accessories are being warranted by others, see that these warranties are passed on;
(e) review product advertising and promotional literature to see that the claims are legitimate and reasonable;
(f) carry adequate product liability insurance; a policy with proper coverage can protect against claims, against defective or mislabeled products, products sold for improper use or under improper circumstances, negligence and breach of implied warranty.

Articles of Incorporation 16

The material in this chapter consists of forms of articles of incorporation, sometimes referred to as charters or certificates of incorporation, containing provisions concerning the name, purpose, place of business, names and addresses of directors and incorporators, and capitalization of the corporation.

Articles of incorporation may detail the operation of a business, but usually such details are spelled out in the corporation's bylaws.

Various state statutes prescribe the appropriate form and content of articles of incorporation. Generally, a standardized form of articles of incorporation is available in each state and you should use such a form and follow the required procedure for filing them with the appropriate state official.

Included in this chapter is a general form of articles of incorporation.

Checklist of Items to Be Considered in Drafting Articles of Incorporation

- Name of corporation.
- Purpose for which formed.
- Duration of corporate existence.
- Post office address of initial registered office and name of initial registered agent or place in which principal office for transacting business is located.
- Number of directors.
- Names and addresses of initial directors.
- Names and addresses of incorporators.
- Capital structure:
  - Class of stock to include both common and preferred.
  - Value of stock to be par or nonpar.
- Optional provisions.
- Signatures and acknowledgments.

Caution: Local statutes should, of course, be consulted to determine the applicability of a checkpoint in a particular jurisdiction.

Articles of Incorporation - General Form

State of ____________________________)
)
County of __________________________)

To: Secretary of State

____

____

Article I

Name of Corporation

The name of the corporation hereby incorporated is ____________________.

[Note: Usually one of the following must be included as part of the corporation's name: "Corporation," "Company," "Corp.," "Co.," or "Inc."]

Article II

Registered Office and Agent

The address of the ______________________ Corporation's initial registered office in the State of ______________________ is:

____.

The initial registered agent at that registered office is:

____.

Article III

Duration of Corporation

The duration of the corporation is: __________ [e.g., perpetual, term of years].

Article IV

Purposes of Corporation

The purpose for which the corporation is organized is:

____.

To do anything that may lawfully be done by a corporation organized under the ____________________ Business Corporation Act, as that act may be amended or supplemented from time to time.

Article V

Directors

The number of directors constituting the initial board of directors is __________, and the names and addresses of the persons who are to serve as directors until the first annual meeting of the shareholders or until their successors are elected and qualified are:

Name	Address
____________________	______________________________
____________________	______________________________
____________________	______________________________

Article VI

Incorporators

The names and addresses of the incorporators are:

Name	Address
____________________	______________________________
____________________	______________________________
____________________	______________________________

Article VII

Authorization of Shares

The aggregate number of shares that the corporation is authorized to issue is _______, divided into _________ classes. The designation of each class, the number of shares of each class, and the par value, if any, of the shares of each class or a statement that the shares of any class are without par value, are as follows:

Class	Series	Number of Shares	Par Value Per Share
_______________	_______________	_______________	$____________
_______________	_______________	_______________	$____________
_______________	_______________	_______________	$____________

The preferences, qualifications, limitations, restrictions, and the special or relative rights in respect of the shares of each class are: _________________.

Article VIII

Issuance of Shares

The class and number of shares that the corporation proposes to issue without further report to the Secretary of State and the consideration (expressed in dollars) to be received by the corporation are:

Class of Shares	Number of Shares	Total Consideration
_______________	_______________	$______________
_______________	_______________	$______________
_______________	_______________	$______________

Article IX

Commencement of Business

The corporation shall not commence business until it has received at least $__________ as consideration for the issuance of shares.

Article X

Indemnification of Officers and Directors

The corporation's board of directors is expressly authorized to indemnify its officers and directors to the full extent permitted by the laws of the State of ____________________. It is the corporation's policy to safeguard its officers and directors from liability for actions they take in good faith to further the interests of the corporation and its shareholders.

____

Signatures

[Acknowledgments]

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Limited Partnership 17

The main attraction of limited partnership, as its name implies, is limited liability for its partners. In general, limited partners are not personally liable for partnership debts and obligations beyond the amount of their contributions.

This is the single most important characteristic that distinguishes a limited partnership from a general partnership and a limited partner from a general partner. The general partner in a limited partnership is personally liable for all debts and obligations of the limited partnership without limitation.

Role of Limited Partnership in Protecting Your Assets

Although limited partners ordinarily are not personally liable for partnership debts and obligations, they may incur such liability in a suit by partnership creditors to the extent of their contribution or interest in the partnership. For example, if the partnership and general partners become insolvent, the judgment creditor can sue to enforce the unpaid balance of a limited partner's agreed contribution or to collect part or all of his contribution which was withdrawn or repaid after the creditor's claim existed.

In this chapter we'll examine the rights of a partner in the partnership and specific property of the partnership vis-a-vis other partners and creditors of the partnership and also of individual partners. By understanding these rights, you'll be in a better position to evaluate the role of limited partnership in protecting your assets.

We'll first discuss the right of a partner in a specific partnership property and its status against the claims of creditors of individual partner and then contrast it with the right of a partner in the partnership. One is beyond the reach of creditors while the other can be reached, but only with great difficulty.

Requisites for Limited Liability

In order for a limited partner to preserve his or her limited liability, certain conditions must be fulfilled:

---

1. The limited partnership must be formed with substantial compliance in good faith with statutory requirements.

2. The limited partner's surname must not be used in the name of the limited partnership.

3. If the partnership certificate contains a false statement, and the limited partner has the knowledge of falsity and the statement was relied upon by a third party to his detriment, the limited liability may no longer be available.

4. A limited partner must not take part in control of the business.

Forming a Limited Partnership: Legal Overview

A limited partnership is a purely statutory creation in which individuals, upon complying with the statutory requirements, can contribute specified sums to the capital of a partnership firm and then limit their liability to the amount of their capital contribution.

Limited Partnership Defined

The Uniform Limited Partnership Act defines a limited partnership (and the Revised Uniform Limited Partnership Act adds to this a domestic limited partnership) as a partnership formed by two or more persons under the laws of a state and having one or more general partners and one or more limited or special partners. Limited partners are not bound by the obligations of the partnership.

The Uniform Limited Partnership Act does not specifically exclude corporations from such a partnership. The Revised Uniform Limited Partnership Act defines person as a natural person, partnership, limited partnership (domestic or foreign), trust, estate, association or corporation.

Partnership Business

The Uniform Limited Partnership Act, adopted by the majority of jurisdictions, and the Revised Uniform Limited Partnership Act adopted by a few jurisdictions, provide that a limited partnership may carry on any business that a partnership without limited partners could carry on, except those designated in the Act.

Statutory Compliance

A limited partnership is formed if there has been substantial compliance in good faith with the requirements of the enabling statute and by the filing of a certificate of affirmation, in compliance with the enabling statute. The partnership operates under a firm name. While the Uniform Limited Partnership Act does not require a limited partnership to identify itself as such in its name, the Revised Uniform Limited Partnership Act does require such identification.

General Partner

A general partner is a person whose rights, powers, and obligations are similar to those of partners in an ordinary partnership, while a limited partner is one who contributes capital primarily as a financial investment, with liability generally limited to an amount equal to the investment. A limited partner is one who is not bound by the obligations of the partnership.

A general partner in a limited partnership has rights and powers and knowledge comparable to those possessed by the members in an ordinary general partnership, and may become individually liable for all the debts of the firm. The general partner is accountable to other partners as a fiduciary.

Limited Partner

The rights of a limited partner are generally confined to the rights to have full information and to receive a share of the income, and the same rights as a general partner in reference to the dissolution and winding up by decree of a court.

A limited partner is liable for any losses of the partnership to the extent of the partner's investment in the assets of the business; however, a limited partner is not liable as a general partner unless, in addition to the exercise of the limited partner's rights and powers as a limited partner, the partner also takes part in the control of the business.

Under the Revised Uniform Limited Partnership Act a limited partner who knowingly permits the use of his name in the name of the limited partnership, except where the name is also the name of a general partner or the corporate name of the corporate general partner, would be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner. Otherwise, a limited partner is not liable for the obligations of the partnership unless the limited partner is also a general partner or if the limited partner takes part in the control of the business.

Limited Partnership – At a Glance

Here are some of the characteristics of a limited partnership, including one that involves members of a family.

✓ Some partners can be general partners subject to the liabilities of the law as to general partners.

✓ Wife and/or children can be limited partners. Each limited partner can be entitled to a fixed percentage of the profits and losses from the operation of the business, or the liability of each limited partner can be expressed so as not to exceed the value of his capital contribution.

✓ Upon liquidation, the distributive shares of the partners can be in proportion to their partnership interest.

✓ General partners can be given complete management and control.

✓ Special or limited partners can be denied a voice in the management and operation of the business.

✓ General partners can be given limited authority to determine whether there is a need for additional working capital for enhancement of the business, or profits to be withheld for future expansion or development.

✓ With the death of a limited partner, his executor or personal representative may have all his rights just as if he had survived. Under these circumstances the partnership would continue to operate, but the continuation of the partnership after the death of a limited partner should be made contingent upon the consent of the general partners.

✓ The partnership agreement should provide either that the partnership terminates upon a general partner's death, bankruptcy, incompetency or transfer inter vivos of his general interest, or that the partnership may continue in such event only if all the partners agree to a continuation.

✓ The partnership would remain unaffected if a limited partner goes bankrupt or becomes incompetent.

✓ The agreement may set the duration of the partnership; at the end of the agreed term, there must be either dissolution or an agreement to continue.

✓ The partnership agreement may state the primary business activity of the partnership.

✓ In a limited partnership, the limited partner should not engage in the management of the business. If he does, he might be subject to liability as a general partner.

Partner's Right in Specific Partnership Property Is Not Assignable to Third Persons

There are several reasons why a partner cannot individually assign his rights in specific partnership property. Since the partnership relationship is a voluntary association one partner does not have the right to thrust a stranger upon the other partners without their consent. If a partner were permitted to assign his rights in specific partnership property, this would amount to imposing a new partner upon the rest of the partners.

The non-assignability of a partner's right in specific partnership property prevents interference by a third party with the conduct, management and disposition of partnership business and property. Even if there were no objections to an outsider taking part in the management of partnership affairs, it would often be a difficult, even an impossible, task to compute an individual partner's beneficial interest in a specific partnership asset.

The creditors of the partnership have the right to have all the firm assets applied to the payment of the partnership debts.

While a partner may not assign his interest in specific partnership property to a third person, the partner may nonetheless assign this right to other partners. It has been held that the Uniform Partnership Act does not prohibit a partner from assigning his interest in specific partnership property to his remaining partner or partners.

Partner Cannot Sell or Mortgage His Right in Specific Partnership Property

Since real ownership and legal title to partnership property is vested in the partnership, an individual partner cannot effectively sell or mortgage his right in specific partnership property. If a partner does attempt to sell or mortgage his interest in specific partnership property, title will not pass nor will a lien be created, and the vendee or mortgagee will take nothing thereunder except that partner's share of the profits and a share of the surplus after the settlement of the partnership business.

Tenancies in Partnership Are Not Subject to Partition

A limited partner cannot divide his interest in the partnership and transfer, sell, exchange, hypothecate or gift this divided interest to someone else.

Partner's Right in Specific Partnership Property Is Not Subject to Attachment, Execution or Garnishment

As mentioned above, one of the incidents of tenancy in partnership is that a partner's right in the property is not subject to attachment or execution by a judgment creditor, except on a claim against the partnership.

In one New York case, there was a dispute between the judgment creditor of one of the partners and the assignee for the benefit of the creditors of the partnership with regards to the ownership of certain property.

On October 27, 1950, the judgment creditor issued an execution to the sheriff and on the next day, October 28, the sheriff levied upon the property involved. Also, on the same date assignment of the property was made. Under New York law a judgment debtor's property becomes bound by the execution from the time of the delivery to the proper officer. Prior to actual levy under the execution, the title of the purchaser in good faith and without notice is protected, but an assignee for the benefit of creditors is not a bona fide purchaser. If the property belonged to the judgment debtor, the judgment creditor, by virtue of his execution, would have a superior title to that of the assignee. However, the property levied upon was a partnership property, and the partnership property is not available to satisfy a judgment against an individual partner. In other words, the assignee acquired title to the property by virtue of the assignment. The judgment creditor could not execute upon the partnership property.

Partnership funds cannot be garnished to satisfy the debts of an individual partner even where partners are husband and wife. *HILK vs. Bank of Washington,* 251 SW2d 963 (Mo App1952).

On Death of a Partner His Right in Specific Partnership Property Vests in Surviving Partner

As mentioned above, one of the incidents of tenancy in partnership is that upon the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, in which case his right in such property vests in his legal representative. Such surviving partner or partners or the legal representative of the last surviving partner has no right to possess a partnership property for any but a partnership purpose.

Partner's Interest in Partnership

Until now we have discussed partner's right in specific partnership property and, generally speaking, this right in specific partnership property cannot be levied upon by a judgment creditor.

In addition to a partner's right in specific partnership property, each partner has another type of property right - his interest in the partnership. Under the Uniform Partnership Act, a partner's interest in the partnership is defined as his share of the profits and surplus after the partnership debts are paid and after partnership accounts are settled and the rights of the partners' interest are adjusted. This interest under the Act is personal property regardless of the character of the partnership property.

Partner's Interest in Partnership Is Assignable

While a partner cannot assign his interest in specific partnership property he can make an assignment of his interest in the partnership. Such a conveyance to a partner or a third party does not of itself dissolve the partnership and free the partners from the terms and conditions of the partnership agreement.

Many assignments of a partnership interest are made merely as collateral security for a loan. The assigning party in such cases has no intention of terminating the partnership relationship.

In the absence of an agreement to the contrary during the continuance of the partnership, the assignee is not entitled to interfere in the management or administration of the partnership business or affairs, and is not entitled to any information or accounting of partnership transactions or to an inspection of the partnership books.

The assignee is merely entitled to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled. In the event of dissolution of the partnership the assignee is entitled to receive his assignor's interest and may require an account from the date of the last account agreed to by all the partners.

Partner's Interest in Partnership Vests in Executor

When a partner dies, his rights in specific partnership property, as mentioned above, vest in the surviving partner or partners. However, his interest in the partnership, which is considered personal property, vests in his executor.

The personal representative of the deceased partner has the duty to require that an accounting be made either by the surviving partner or by a receiver under court supervision. Where a complaint, alleging a cause of action for partnership accounting, was filed against the surviving partner by the beneficiaries under the will of the deceased partner, the court held it was subject to demurrer for defect of parties plaintiff in that deceased partner's personal representative was not a party plaintiff.

Rights of a Divorced Spouse

While we're on the subject of protecting a partner's interest in a partnership from the claims of a creditor, it's important to discuss the rights of a divorced a spouse of a partner.

The Uniform Partnership Act does not specifically address the issue of the rights of a divorced spouse of a partner. Can he or she assert a community property right in or obtain equitable distribution on account of the partner's property rights in the partnership? In at least one state, namely Texas, the divorced spouse is no more than the assignee of the partner's interest.

Specific Partnership Property

The divorced spouse is in a position analogous to the position of a partner's assignees, creditors and heirs. Thus, the divorced spouse has no interest in specific partnership property; it is not community property and is not subject to equitable distribution to a partner's divorced spouse.[1]

Interest in Partnership

Again by analogy to assignees, creditors, and heirs, the divorced spouse may have community property rights in or be entitled to equitable distribution on account of a partner's interest in the partnership.[2] So, although the divorced spouse cannot be awarded a specific partnership property, he or she would be entitled to share in the spouse's partnership interest.

In assessing the precise nature of the divorced spouse's interest, the courts have departed somewhat from the principles governing assignees and creditors. In the first place, it has been held that the spouse is entitled to share in the full value (including goodwill) of the

partnership interest, rather than merely to share in distributions to the spouse by the partnership. It has been held that this value may be based on the buyout right fixed in the partnership agreement.

Although a partner's spouse may be entitled to share in the full value of the partner's interest, that does not necessarily mean that the spouse becomes an assignee of the interest. Rather, the spouse may be given a money judgment based on the value of the interest,[3] and this judgment may be enforced by a charging order.[4]

Right to Participate in Management

Even a spouse who obtains an interest in the partnership in a divorce is not a partner and consequently has no right to participate in management.[5]

Creditor of an Individual Partner

All of the above discussion now brings us to the $64,000 question:

How does a judgment creditor satisfy the individual debt of a partner?

As we've noted above, the creditors of a partnership have the first call upon the jointly owned property of the partnership. Likewise, the personal creditor of an individual partner would look to the personal estate of the partner for the satisfaction of such individual obligations. As stated in *Virginia-Carolina Chemical Company vs. Walston,* 187 NC 817, 123 SE 196 (1924):

> "...Partnership creditors are entitled to have the partnership assets first applied to the payment of the debts of the partnership, and the separate and private creditors of the individual partners are entitled to have the separate and private estate of the partners with whom they have made individual contracts first applied to their debts."

This priority to attach the separate and private estate of the partner of the judgment debtor-partner is valid even in a case where the particular creditor happens also to be a partnership creditor.

Thus, when a bank, which was a creditor of the partnership had obtained a personal guarantee from an individual partner, this creditor could exhaust the individual member's assets to the exclusion of the other creditors of the partnership, and then share pro-rata with them in the assets of the insolvent firm. *Iowa: Simons vs. Simons,* 215 Iowa 654, 246 NW 597 (1933).

Partner's Interest According to the Uniform Partnership Act

In order to understand the extent of levy on a partner's interest in a partnership, it is important to understand precisely what that interest is. The Uniform Partnership Act provides a precise definition of a partner's interest in the partnership. The two relevant sections of this Act are reproduced below.

§25. Nature of a Partner's Right in Specific Partnership Property

"(1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.

"(2) The incidents of this tenancy are such that:

"(a) A partner, subject to the provisions of this Act and to any agreement between the partners, has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.

"(b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.

"(c) A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. When partnership property is attached for a partnership debt the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the homestead or exemption laws.

"(d) On the death of a partner his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

"(e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin."

§ 26. Nature of Partner's Interest in the Partnership

"A partner's interest in the partnership is his share of profits and surplus, and the same is personal property."

The immediate result of the above provisions of the Uniform Partnership Act is first, to prevent the direct execution, attachment or garnishment against a partner's right in specific partnership property and second, to limit the claim of the creditor to whatever is remaining of the partner's interest.

Defining Partner's Right in Partnership

In practical terms the hapless creditor pursuing a debtor whose last remaining asset consists of an undivided interest in a partnership has to look to his share of the partnership after the partnership has been dissolved, the business has been wound up, debts of the partnership have been satisfied and then share pro-rata in the debtor-partner's profits of the firm.

The creditor, in other words, cannot collect from the firm anything in excess of the member's net equity therein. *First Nat'l Bank v. Schuetz,* 103 Kan 288, 173 P 288 (1918).

The essence of the rule was perhaps best stated by the District Court in *Maryland Cas. Co. v. Glassell-Taylor Co., Louisiana:* 63 F Supp 718 (WD La 1945), where it was held:

> "The interest of the partner is residuary and can be made to respond to individual debts only after liquidation and satisfaction of partnership creditors."

Compare *Adler v. Nicholas,* 166 F2d 674 (10th Cir [Colo] 1948), where the court said in part:

> "A partner's interest in the partnership property is his share of the surplus after all partnership debts have been paid, and that surplus alone is liable for the separate debts of each partner. It, therefore, must follow that the partnership creditors' claims must first be satisfied out of the partnership assets before there was any distributable surplus to the partners to which the Government could look for the satisfaction of the individual tax liability of the partners, and even then it would be limited in its attempt to collect the income taxes due from each partner to his interest in the remaining net proceeds of the partnership."

See also the following from *Claude v. Claude,* 191 Ore 308, 228 P2d 776 (1951):

> "Our conclusions above with reference to the disposition of the personal property in the manner indicated are based primarily upon the well-known rule that partners do not, as individuals, own any specific part of the firm property. The interest of a partner in the firm assets is the share to which he is entitled after claims against the firm are satisfied and the equities and accounts, as between the partners, adjusted."

The judgment creditor has to wait not only till the process of dissolution is completed but he must also prove that winding up of the partnership affairs is completed.

Citizens' Nat'l Trust & Savings Bank v. McNeny, 10 Cal App2d 488, 52 P2d 492 (1935):

"The partnership was not terminated by its dissolution, but continued during the winding up of the partnership affairs."

The most obvious effect of the rules immediately said above is, of course, to bar attachment and execution, as well as garnishment, of specific property belonging to the partnership, and to severely limit the reach of the creditors to a debtor-partner's interest in the partnership.

The above discussion should not lead to an erroneous conclusion that the creditor of a partner is entirely without recourse in reaching the debtor's interest in the partnership.

In a number of jurisdictions, the undivided interest of the member in his firm has been held to be a property right which is subject to levy in the same manner as other property. In Gaynes v. Conn, it was held that the court properly assessed the respective interests of all parties in a piece of partnership realty in a proceeding in aid of execution.

And where this remedy is not available, the enactment of the Uniform Partnership Act in a majority of jurisdictions results in the assurance that in those states at least, the creditor can resort to the "charging order," for which provision is made in Section 28 of the Uniform Act.

In the following chapter, we'll examine the remedy of charging order provided by the Uniform Partnership Act that allows a creditor to reach a debtor-partner's interest in the partnership, and then we'll took at the practical implicantions of the rote played by the limited partnership in protecting an individual's assets against the claims of creditors. As it wilt become apparent, creditor of a limited partner is in a rather unenviable position, for he has to cross several hurdles before 6e can realize satisfaction of a debt held. In many cases, these hurdles may become insurmountable for many a creditor.

[1] *Riegler v. Riegler*, 243 Ark. 113, 419 S.W.2d 311 (1967) (chancellor erroneously awarded wife specific property owned by husband's medical partnership); *Warren v. Warren*, 12 Ark. App. 260, 675 S.W.2d 371 (1984) (divorce court should not have awarded partner's wife an undivided interest in partnership); *Dotson v. Grice*, 98 N.M. 207, 647 P.2d 409 (1982) (because spouse has no community interest in specific partnership property, need not join in conveyance); *McKnight v. McKnight*, 543 S.W.2d 863 (Tex. 1976). But *cf. Smoot v. Smoot*, 568 S.W.2d 177 (Tex. Civ. App. 1978) (whether spouse had community property right in partner's interest in partnership held to depend on source of particular property acquired by partnership).

[2] *Wilen v. Wilen*, 61 Md. App. 337, 486 A.2d 775 (1985); *Bannen v. Bannen*, 286 S.C. 4, 331 S.E.2d 379 (S.C. App. 1985); *McKnight v. McKnight*, 543 S.W.2d 863 (Tex. 1976).

[3] *Bannen v. Bannen*, 286 S.C. 4, 331 S.E.2d 379 (S.C. App. 1985) (spouse precluded by statute from having a legal or equitable interest in medical partnership).

[4] *Riegler v. Riegler*, 243 Ark. 113, 419 S.W.2d 311 (1967).

[5] *Block v. Lea*, 688 P.2d 724 (Haw. App. 1984) (wife had no right to accounting).

[6] *Arkansas: Terral v. Terral*, 212 Ark 221, 205 SW2d 198 (1947), 1 ALR2d 1092 (1948).

Georgia: All Florida Sand v. Lawler Constr. Co., 209 Ga 720, 75 SE2d 559 (1953).

New York: Rhoades v. Robles, 1 Misc2d 43, 145 NYS2d 286 (1955).

Ohio: Mine Safety Appliances Co. v. Best, 49 Ohio L Abs 552, 36 Ohio Ops 361, 76 NE 2d 108 (1947).

Pennsylvania: Luick v. Luick, 164 Pa Super 378, 64 A2d 860 (1949).

Texas: O'Connor v. Gable, 298 SW2d 209 (Tex Civ App 1957).

[7] 185 Kan 655, 347 P2d 458 (1959).

Charging Order: Creditor's Remedy to Reach Partner's Interest in Partnership 18

The Uniform Limited Partnership Act provides that a judgment creditor (or, in some jurisdictions, any creditor) of a limited partner may obtain a court order charging a limited partner's interest in the partnership with payment of any unsatisfied amount of a judgment debt. The statute further provides that such interest may be redeemed with the separate property of any general partner, but may not be redeemed with partnership property. It also expressly provides that the remedies conferred by the statute shall not be deemed exclusive of others which may exist and nothing in the act shall be held to deprive a limited partner of his statutory exemption.

Charging Order - Generally

Under the Uniform Partnership Act, the charging order has replaced the levy of execution as method by which a judgment creditor can reach the interest of an individual partner in the partnership. The judgment creditor does not acquire any greater rights than the debtor is entitled to for his own benefit.

The charging order remedy is intended to protect innocent partners of a partnership that have nothing to do with the claims of creditors of individual partners.

A judgment creditor of a partner may obtain a charging order by making due application to a competent court which then charges the interest of the debtor partner with payment of the unsatisfied amount of the judgment debt with interest thereon. The court may then or later appoint a receiver of the partner's share of the profits, and of any other money due or to fall due to him in respect of the partnership.

A receiver appointed on the application of a partner's judgment creditor and acting under a charging order is entitled to any relief necessary to conserve partnership assets for partnership purposes.

Rights of Creditors of Limited Partner

Section 22 of the Uniform Limited Partnership Act provides that:

"(1) On due application to a court of competent jurisdiction by any judgment creditor of a limited partner, the court may charge the interest of the indebted limited partner with payment of the unsatisfied amount of the judgment debt; and may appoint a receiver, and make all other orders, directions, and inquiries which the circumstances of the case may require.

(2) The interest may be redeemed with the separate property of any general partner, but may not be redeemed with partnership property.

(3) The remedies conferred by paragraph (1) shall not be deemed exclusive of others which may exist.

(4) Nothing in this act shall be held to deprive a limited partner of his statutory exemption."

Where the Uniform Limited Partnership Act has been adopted, the charging order is the exclusive remedy of the judgment creditor as respects the partner's interest in his firm. Where the judgment debtor fails to object to its entry, the co-partners, once they are found as a fact to be such, have no standing to oppose it.

Even under this statute, of course, the court may deny relief until settlement of the accounts of the partnership, thus establishing the entitlement of the judgment debtor, if any, to the assets of the firm.

Redeeming the Charged Interest

The Uniform Partnership Act provides two methods whereby the interest charged may be redeemed at any time before foreclosure or, in case of a sale being directed by the court, may be purchased without thereby causing a dissolution.

Any one or more of the partners may redeem or purchase the debtor partner's interest with their separate property. The alternative method is for any one or more of the partners, with the consent of all the partners, whose interests are not so charged or sold, to redeem or purchase the debtor partner's interest with partnership property.

Fraudulent Conveyance Voidable

If the transferee of partnership assets knew that a judgment creditor had obtained a charging order against a partner's interest in the partnership, if the transfer was without a fair consideration, and if the transferee knew that the transfer would diminish the value of the judgment creditor's lien, the judgment creditor will be entitled to recover from the transferee.

Here's a case in point.

Where the judgment creditors of the general partners of a limited partnership brought an action to set aside as fraudulent and void a conveyance by the limited partnership to a corporation shortly prior to the entry of judgments against the general partners, the court held that the record made out a prima facie case for a decree directing retransfer of title to the limited partnership. In its opinion, the court stated:

> "Although the property of a partnership is not subject to attachment or execution except on a claim against the partnership, a judgment creditor of any general or limited partner has a statutory right to obtain an order charging his debtor's interest in the partnership with payment of the unsatisfied amount of the judgment with interest thereon . . . By conveying the hotel property from the limited partnership to G.C.H. Incorporated, the judgment debtors hindered, delayed and interfered with plaintiffs' ability to obtain the charging orders to which they were and are entitled. Until and unless the record title is retransferred to the limited partnership, plaintiffs are in no position to reach, through charging orders, the interests of the judgment debtors in the partnership property. . .The statutory right to charging orders against the judgment debtors' interests in a partnership is not broad enough to permit the obtaining of charging orders against the equitable interests of the judgment debtors under a declaration of trust executed by stockholders of a grantee corporation. It is to be noted that the declaration of trust is limited, in its reference to creditors, to creditors of the partnership, and that it does not purport to be for the benefit also of creditors of individual members of the partnership."

Creditor's Recourse against a Partner's Interest: Practical Implications

Although partnership property is shielded from the attack of a partner's individual creditor, the creditor does have recourse against the partner's interest in the firm.

As a first measure, the creditor may bring extra-legal pressures to induce the partner to assign his interest to the creditor, either absolutely or as security. Failing this, the creditor may employ the charging order remedy as specified in the Uniform Partnership Act §28, a device derived from the English Partnership Act. Although the UPA nowhere says that a charging order is the exclusive process available to the partner's individual creditor, the courts have generally interpreted it to be as such.[1]

Under UPA §28 (1), "the charging order remedy is available to any judgment creditor of a partner." In other words, the charging order is not a prejudgment remedy. Further, the charging order remedy has been granted to claimants who are not strictly judgment creditors, such as spouses seeking alimony or child support.[2]

The remedy is available even if the partnership agreement prohibits or limits assignments of partnership interests.[3]

Charging Order: Lien on the Partner's Interest

As we've seen in the earlier discussions, the charging order is a judicial proceeding in which the charging creditor must show that the debtor has an interest in the charged firm. If the non-debtor partners deny that the charged partner has such an interest, the question may have to be adjudicated under local court rules in a separate action.[4]

The order leads to a sort of lien on the partner's interest in the firm, but does not confer priority on the charging creditor over a partnership creditor.

Appointment of a Receiver

Moreover, the charging order alone is of little comfort to the charging creditor even vis-a-vis other creditors of the individual partner. In *Princeton Bank & Trust Co. v. Berley,* [5], the court held that a levying creditor of an individual partner had priority over an earlier charging creditor of the partner who had not obtained an order of receivership or any other order directing the delivery of property.

As suggested by the *Princeton Bank* case, the charging creditor should obtain one of the judicial orders ancillary to the charging order itself that are contemplated by U.P.A.§28. First, the creditor may request the court to order, pursuant to the last clause of §28(1), that

payments, particularly distributions of earnings or withdrawals of capital,[6] that would otherwise go to the debtor partner should go to the creditor instead.[7]

The effect of such an order is quite similar to a garnishment and would, of course, depend on what the debtor partner was entitled to withdraw from the firm pursuant to the partnership agreement. U.P.A. §28(1) also authorizes the appointment of a receiver for the charged interest (as distinguished from the partnership or its property). The receiver is entitled to the judicial relief needed to conserve partnership property for payment to the creditors, but does not participate in management. The charging order and any ancillary orders should be made only upon giving full notice and opportunity to be heard to both debtor and non-debtor partners.[8]

After the charge and the entry of payment and other orders, the debtor continues to be a partner in all respects except distributions and withdrawals from the firm. Moreover, the charging creditor is not yet in the position even of an assignee of the interest.[9]

Foreclosure of Partner's Interest

This is apparent because U.P.A. §28 (2) refers to the further step of foreclosure on the debtor partner's partnership interest, which would be necessary only if the interest had not already been assigned to the creditor. By foreclosing, the creditor can obtain a sale of the interest at which the interest is purchased by the creditor or a third party.[10]

Despite the reference to foreclosure in §28(2), there is some authority against a right of foreclosure on a partnership interest.[11]

Foreclosure would seem at least to be within the broad judicial power under the last clause of §28(1).[12]

However, because the foreclosing creditor threatens the continuity of the firm, foreclosure should be decreed only as a last resort - that is, if the charged interest is not likely to pay off the debt within a reasonable time.[13]

Even after foreclosure and sale, the creditor may be far from collecting the debt. At the foreclosure sale, only the partner's interest, not specific assets of the partnership, is sold.[14]

It is unlikely that the interest will bring a high price from third parties, because of the limited role to which the purchaser is relegated. If the creditor is the purchaser, it will still be entitled only to receive the charged partner's cash flow. Moreover, until dissolution the creditor has no right to an accounting.[15]

The principal change in the creditor's current status as a result of the foreclosure and sale is that the creditor now owns the partner's entire financial interest in the partnership, including all amounts ultimately due the partner on dissolution after settlement of liabilities.[16]

Often the only way the creditor can effectively obtain anything on account of the debtor partner's interest will be to exercise the assignee's power to seek a judicial dissolution under U.P.A. §32(2). On dissolution, the creditor can finally obtain whatever share would have come to the debtor partner after payment of all partnership creditors and claims of co-partners.

The rules concerning judicial foreclosure of a partnership interest are probably also applicable to non-judicial foreclosure of a consensual lien on a partnership under the Uniform Commercial Code insofar as the rights of debtor, creditor, and purchaser are concerned.

Non-Debtor Partners' Recourse

The non-debtor partners have a number of options in dealing with the threat to the continuity of the partnership posed by a charged interest. They may forestall the threat of foreclosure by redeeming the charged interest before foreclosure with their own property or, if they all consent, with partnership property.

There is no express statutory procedure for determining the redemption price. It may be the amount of the creditor's claim, which would make redemption uneconomic if the claim were greater than the value of the partner's interest. The court probably has general authority under the last clause of U.P.A. §28 (1) to value the interest and permit redemption at the value.

If the partners redeem the interest for the amount of the debt, and this is less than the value fixed by the court, the court may treat this as a loan to the debtor partner or order that the redeeming partners hold the interest in trust for the debtor partner. If the court decrees foreclosure, the non-debtor partners may buy the interest at the foreclosure sale.

The non-debtor partners (either before or after foreclosure) can remove the uncertainty created by the creditor's presence by dissolving the firm and buying the assets on liquidation. Pursuant to U.P.A. §27(2), the partners must account on dissolution to the charging creditor for the debtor partner's interest.[17]

If the partners do purchase the interest, a strong argument can be made that, as on redemption for less than value, the interest should be held in trust for the debtor partner, because of the fiduciary relation among the partners.

Distribution of Assets

Section 23 of the Uniform Limited Partnership Act provides that:

"1. In settling accounts after dissolution the liabilities of the partnership shall be entitled to payment in the following order: