SUPPLEMENTAL NORTH CAROLINA COMMENT (2017)

1. Paragraph 6 of Official Comment 8 to section 4(a)(1) of the Uniform Voidable Transactions Act ("UVTA") (N.C. Gen. Stat. § 39-23.4(a)(1) of the North Carolina Uniform Voidable Transactions Act ("NCUVTA")) provides contrasting examples of the results that would occur in the formation of a business entity, such as a limited liability company (LLC), which has a creditor thwarting feature providing only for charging orders against equity interests.

The first example states that in an "ordinary situation" in which none of the owners of the entity has any particular reason to anticipate personal liability or financial distress, the owners' transfers of assets to capitalize the LLC is not voidable under section 4(a)(1) of the UVTA (N.C. Gen. Stat. § 39-23.4(a)(1)).

In contrast, the second example states that if the owners of an existing business were to reorganize the business as an LLC when the "clouds of personal liability or financial distress have gathered over some of them," the transfer effecting the reorganization should be voidable under section 4(a)(1) of the UVTA (N.C. Gen. Stat. § 39-23.4(a)(1)).

Commentators have criticized Paragraph 6 of Official Comment 8 on the grounds that there is no guidance as to what the particular choice of words used in these examples indicate, such as what is meant by an "ordinary situation," what is meant by "financially distressed," and how broadly should that term be analyzed. *See* GEORGE D. KARIBJANIAN, GERALD "J.J." WEHLE, JR., ROBERT L. LANCASTER & MICHAEL A. SNEERINGER, AM. BAR ASS'N SECTION OF REAL PROP. & ESTATE LAW, THE NEW UNIFORM VOIDABLE TRANSACTIONS ACT: GOOD FOR THE CREDITOR'S BAR, BUT BAD FOR THE ESTATE PLANNING BAR? (April 21, 2016) at http://www.americanbar.org/content/dam/aba/administrative/real_property_trust_estate/committee/rp579000/uvta_white_paper_aba_2014_04_21.authcheckdam.pdf. [hereinafter cited as "Karibjanian, Wehle, Lancaster and Sneeringer."]

Moreover, the second example suggests that the "clouds of personal liability or financial distress" that have gathered over some of the owners is sufficient in itself to void the transfer effecting the reorganization. If so, the drafters of the NCUVTA do not think that this conclusion accurately reflects North Carolina law for the following reasons.

First, business entities, including LLCs, are typically formed for bona fide and legitimate business, estate planning, and tax purposes. North Carolina case law supports the validity of business entities that are formed for legitimate business purposes—e.g., "for the purpose of developing real estate"—even when a default judgment is outstanding against one of the owners. *See*, *e.g*. Herring v. Keasler, 150 N.C. App. 598 (2002).

Second, under N.C. Gen. Stat. § 39-23.4(a), a creditor must prove that a debtor's organization and capitalization of a business entity was made with intent to hinder, delay or defraud by a preponderance of the evidence. In determining a debtor's intent under N.C. Gen. Stat. § 39-23.4(a)(1), courts may consider the factors listed in N.C. Gen. Stat. § 39-23.4(b), including subsection (b)(13) whether "(t)he debtor transferred the assets in the course of legitimate estate or tax planning." The conclusion, supported by the second example in Paragraph 6 of Official Comment 8, that the organization and capitalization of a business entity

should be voidable *per se* would disregard consideration of these factors even when, under the facts and circumstances, they may lead to the determination that the debtor did not have the requisite intent to hinder, delay or defraud under N.C. Gen. Stat. § 39-23.4(a)(1).

Finally, commentators have noted that the second example appears to state "that if *any* member involved in the LLC, regardless of ownership interest, has the intent to avoid creditors, then the *entire* transaction—formation or conversion—is voidable." *See* Karibjanian, Wehle, Lancaster and Sneeringer. The drafters of the NCUVTA agree with the commentators that this conclusion is questionable, and they find no support for it in North Carolina law.

In summary, the drafters think that the organization and capitalization of a business entity should be examined in light of all the facts and circumstances when determining whether or not the transaction is voidable under N.C. Gen. Stat. § 39-23.4(a)(1), including such facts as whether the entity was formed in the course of legitimate estate or tax planning for bona fide and legitimate business purposes.

2. Paragraph 7 of Official Comment 8 to section 4(a)(1) of the UVTA (N.C. Gen. Stat. § 39-23.4(a)(1) of the NCUVTA) gives an example of the result that would occur if an individual debtor's principal residence is in a jurisdiction, such as North Carolina, which has no legislation providing creditor protection for a self-settled trust ("SST"), and the debtor establishes and transfers assets to an SST under the laws of a jurisdiction which does provide such protection.

The Official Comment states that under section 10 of the UVTA (N.C. Gen. Stat. § 39-23.9A(a)(1)) the voidable transfer law in the jurisdiction in which the debtor resides, *i.e.*, North Carolina in the example, would apply to the transfer. If that jurisdiction [North Carolina] follows the historical interpretation referred to in Comment 2 to section 4(a)(1), the transfer would be voidable under section 4(a)(1) of the UVTA in force in that jurisdiction [North Carolina]. Comment 2 states that the courts have held that a debtor's establishment of an SST is voidable "without regard to whether the transaction is directed at an existing or identified creditor…"

Commentators have concluded that Paragraph 7 of Official Comment 8, in light of the "historical interpretation" referred to in Comment 2, takes the position that under section 4(a)(1) the transfer of assets to the SST would be voidable *per se*. *See, e.g.* Karibjanian, Wehle, Lancaster and Sneeringer; and George D. Karibjanian, Richard W. Nenno & Daniel S. Rubin, *The Uniform Voidable Transactions Act: Why Transfers to Self-Settled Spendthrift Trusts by Settlors in Non-APT States Are Not Voidable Transfers Per Se*, 42 EST., GIFTS & TR. J. 04, 173 (July 13, 2017) [hereinafter cited as "Karibjanian, Nenno and Rubin."]. This interpretation of section 4(a)(1) would prevent, for example, a North Carolina resident from effectively establishing an SST under the laws of another State, such as Delaware, which provides creditor protection for assets in an SST.

The drafters of the NCUVTA think that if this is the intended result of the example in Paragraph 7 of Official Comment 8, in light of the "historical interpretation" referred to in Comment 2, it does not accurately reflect North Carolina law for two reasons.

First, the drafters agree with commentators that this result fails to recognize that creditor protection for transfers to an SST has historically been determined, not by fraudulent or voidable transfer laws, but by the traditional "self-settled trust doctrine" providing that creditors can reach the interest of a settlor in an SST without regard to fraudulent intent. The traditional self-settled trust doctrine is distinct from fraudulent or voidable transfer laws and does not invalidate a transfer to an SST as a whole. The transfer is valid, but the traditional self-settled trust doctrine merely provides a mechanism for creditors to reach the assets held in such a trust, if such doctrine is applicable under the governing law of the trust. On the other hand, fraudulent or voidable transfer laws address a broader range of transactions and require the invalidation of the transfer as a whole. *See* Karibjanian, Nenno and Rubin.

Conflating the UVTA with the self-settled trust doctrine disregards established conflict of law rules applicable to trusts, which have long been used in determining whether creditors can reach assets in an SST established in a State providing creditor protection. *See* Karibjanian, Wehle, Lancaster and Sneeringer. Recent cases affirm this distinction between the self-settled trust doctrine and the laws governing fraudulent or voidable transfers. *See* Karibjanian, Nenno and Rubin (citing Rush University Medical Center v. Sessions, 980 N.E. 2d 45 (Ill. 2012); Waldron v. Huber (In re Huber), 493 B.R. 798 (Bankr. W.D. Wash. 2013); and Battley v. Mortensen (In re Mortensen, 2011 BL 180087 (Bankr. D. Alaska July 8, 2011)).

North Carolina codified this traditional "self-settled trust doctrine" referred to by commentators in N.C. Gen. Stat § 36C-5-505(a)(2), which provides that a creditor may reach the maximum amount that can be distributed to or for the benefit of the settlor of an SST so long as such trust is governed by North Carolina law. This trust doctrine is subject to the rules for determining the governing law as to the meaning and effect of the terms of a trust outlined in N.C. Gen. Stat. § 36C-1-107(a)(1).

Under N.C. Gen. Stat. § 36C-1-107(a)(1), the governing law of a trust, including an SST, is "(t)he law of the jurisdiction designated in the terms [of the trust] unless the designation is contrary to the strong public policy of the jurisdiction having the most significant relationship to the matter at issue." Determining the jurisdiction having the most significant relationship to the matter at issue and determining whether the designation of a different governing law is contrary to public policy of that jurisdiction depends on a number of factors listed in the Official Comment to N.C. Gen Stat. § 36C-1-107, only one of which is the residence of the settlor.

Under this conflict of laws rule, a North Carolina resident may designate in the terms of the SST that the law of a jurisdiction that provides creditor protection for an SST, such as Delaware, governs the meaning and effect of the SST as to creditors' rights. The designation would be effective so long as it was not contrary to the public policy of the State having the most significant relationship with respect to creditors' rights as determined by the factors referenced above.

Second, the drafters of the NCUVTA acknowledge that, under N.C. Gen. Stat. § 39-23.9A(a)(1), North Carolina law would apply to a claim for relief under N.C. Gen. Stat. § 39-23.4(a)(1) that the transfer of assets to the SST was voidable even if the law of another State designated by a North Carolina resident in the terms of the SST governed as to creditor protection afforded by the SST. However, the drafters do not find any support in North Carolina

law for the statement in Comment 2 that section 4(a)(1) of the UVTA historically has been interpreted to render the transfer voidable *per se*. This result assumes that the requirement of that section that the transfer be made "with intent to hinder, delay or defraud" creditors has been met solely by means of the transfer. The only legal precedent cited for that conclusion are three Pennsylvania cases from the 1800s. Commentators note that these cases are unpersuasive as precedent because the Pennsylvania legislature did not confirm that transfers to SSTs are voidable *per se* when enacting its version of the Uniform Fraudulent Transfer Act or when codifying the traditional self-settled trust doctrine in its version of Section 505(a)(2) of the Uniform Trust Code. *See* Karibjanian, Nenno and Rubin. The drafters of the NCUVTA have found no North Carolina decision holding that transfers to an SST are voidable *per se* under the NCUVTA or its predecessor (the N.C. Uniform Fraudulent Transfer Act).

On the contrary, as noted above, under N.C. Gen. Stat. § 39-23.4(a), a creditor must prove that a debtor's transfer to an SST was made with intent to hinder, delay or defraud by a preponderance of the evidence. *See* Norman Owen Trucking Inc. v. Morkoski, 131 N.C. App. 168 (1998); Mascaro v. Mountaineer Land Group, LLC, 2006 NCBC 18 (N.C. Super. Ct. 2006); and Poulos v. Poulos, 2016 NCBC 71 (N.C. Super. Ct. 2016). In determining a debtor's intent under N.C. Gen. Stat. § 39-23.4(a)(1), courts may consider the factors listed in N.C. Gen. Stat. § 39-23.4(b), including subsection (b)(13) whether "(t)he debtor transferred the assets in the course of legitimate estate or tax planning." A conclusion that a transfer to an SST was voidable *per se* would disregard consideration of these factors which otherwise, under the facts and circumstances, may lead to the determination that the debtor did not have the requisite intent to hinder, delay or defraud under N.C. Gen. Stat. § 39-23.4(a)(1).

In summary, the drafters think that if the result of Paragraph 7 of Official Comment 8 of section 4(a)(1), in light of the "historical interpretation" of section 4(a)(1) referred to in Comment 2, is that transfers to an SST are voidable *per se* under that section, then, for the reasons discussed above, this is not the law in North Carolina.