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Trust Planning for Your Children

Paul Chmielewski, Esq., LL.M.

Many clients create trusts at their death for the benefit of their children. A common goal when creating these trusts is that the trust assets be free from the claims of their beneficiaries' creditors as well as free from claims of a child's spouse in the event of a divorce. A properly structured discretionary trust is often used to shield trust assets from claims by a child's creditors. It is also commonly thought that a lifetime discretionary trust is not subject to marital claims in the event of a child's divorce.



Under Colorado law, separate property is not subject to marital claims in divorce proceedings. Separate property generally includes property acquired before marriage, property acquired by inheritance and property identified as separate property in a marital agreement between the parties. Nevertheless, appreciation in separate property during marriage is considered marital property. With respect to discretionary trusts, Colorado courts have gone a step further and declared that most discretionary trusts will be considered a contingent gift rather than property. This might make you think that discretionary trusts have heightened protection in the event of divorce. Although logical, this belief is mistaken.

The same courts that have decided that discretionary trusts are not property have gone on to consider the income from or assets in these trusts when making distributions of property among divorcing spouses. The courts have relied on a Colorado statute that says that "economic circumstances" can be considered when making property distributions in divorce proceedings. Given this language, the courts have said that even though discretionary trusts are not property, they are an economic circumstance to be considered in making property distributions.

As a result, it is likely that even a well-drafted discretionary trust for the benefit of your child will be considered an "economic circumstance" that the court will consider when making a property distribution in divorce proceedings. Nevertheless, discretionary trusts are still valuable planning tools. First, they can help avoid rapid depletion of trust assets due to excessive spending by trust beneficiaries. Discretionary trusts are also a very effective method of shielding trust assets from third party creditor claims. Finally, if proper generation skipping transfer tax allocations are made, discretionary trusts can be used to pass assets down for several generations without the imposition of any gift, estate or generation-skipping transfer tax on the trust assets.

Obviously, the use of discretionary trusts is complicated and gives rise to various considerations. Please contact our office or another competent legal advisor if you want to learn more about the advantages and disadvantages of using these trusts.



Asset Protection and Business Ownership

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Personal liability arising from business activities is often referred to as “upward liability.” The term “upward liability” refers to damages arising from business operations that subject a business owner to personal liability. The creation of a limited liability entity, such as a corporation, limited liability company (“LLC”), or limited liability limited partnership (“LLLP”) protects business owners from personal liability in the event that a lawsuit is initiated due to business activities. In these situations, a business owner’s risk is limited to the assets owned by his or her business entity. As a result, business owners often feel safe if they create a business entity to conduct their business affairs.

Unfortunately, many business owners never consider the impact that their personal actions can have on their business operations and/or assets. If a business owner is sued due to actions arising from his or her personal activities, the business owner’s creditors may be entitled to attach the assets of the business and/or the owner’s interest in the business to satisfy their judgment. This type of liability is often referred to as “downward liability.” For example, if the business owner has a party at their house and someone is injured, the injured party may be able to attach the assets of the business and/or the business owner’s ownership in the business entity unless the business and/or its assets are properly structured.

Both S-corporations and C-corporations provide “upward liability” protection to business owners. However, these entities do not provide “downward liability” protection. In Colorado, the same is true of single member limited liability companies (“SMLLC”). As a result, a business owner that utilizes these entities to conduct business operations can lose his or her business assets to creditors for liability arising from personal actions.

Fortunately, there is an alternative. In Colorado, either a multi-member limited liability company (“MMLLC”) or a limited liability limited partnership (“LLLP” also often referred to as a “Family Limited Partnership”) can be used to provide a shield from both “upward liability” and “downward liability.” Although the “downward liability” protection afforded by these entities is significant, the protection is not absolute.

When a MMLLC or a LLLP is involved, creditors receive a “charging order” to satisfy their personal claims against the business owners. A charging order does not allow creditors to obtain an ownership interest in a business entity or its assets. Instead, a charging order merely enables a judgment creditor to receive distributions, if any, made from these entities to the individual owner who is liable to creditors. A charging order cannot be used to force distributions to be made from a MMLLC or LLLP. As a result, creditors of the owners of MMLLCs and LLLPs are not able to obtain control of the entity’s business operations or assets. This is in direct contrast to creditors of S-corporations, C-corporations and SMLLCs who can attach corporate stock, membership interests and possibly entity assets to satisfy a judgment against the entity’s owner.

Although “downward liability” protection is not available to owners of SMLLCs in Colorado, SMLLCs are often used in conjunction with MMLLCs or LLLPs to achieve “downward liability” protection for business owners. This is accomplished by creating a MMLLC or LLLP, which in turn is the sole owner of one or more SMLLCs. Often, several underlying SMLLCs are created to segregate liability among specific industry

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Enforceability of Indemnification Provisions of Construction Contracts in Colorado

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On April 11, 2007, Governor Ritter signed into law Senate Bill 87 which made certain indemnity provisions in construction agreements void as against public policy and unenforceable. The legislature's intent in enacting Senate Bill 87 was to prevent a party to a construction contract from transferring responsibility for its own negligence to another party, such as its contractors and subcontractors. With certain exceptions, Senate Bill 87 eliminated all "broad form" indemnity provisions from construction agreements entered into on or after July 1, 2007. In a broad form indemnity, Party A, the indemnitor, agrees to be liable for all damages incurred by Party B, the indemnitee, even if the damages were caused solely by Party B's own negligence. Senate Bill 87 also voided any provision in a construction agreement that requires a party to purchase additional insurance coverage for damages not arising out of its own negligence or fault. To prevent parties from evading Senate Bill 87 through contractual choice of law provisions specifying the application of another state's law, the statute mandates that Colorado law apply "to every construction agreement affecting improvements to real property within the state of Colorado."

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"Construction agreement" means a contract, subcontract, or agreement for materials or labor for the construction, alteration, renovation, repair, maintenance, design, planning, supervision, inspection, testing, or observation of any building, building site, structure, highway, street, roadway bridge, viaduct, water or sewer system, gas or other distribution system, or other work dealing with construction, or for any moving, demolition, or excavation connected with such construction.

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groups. For example, a person may create separate SMLLCs to own each separate piece of rental real estate they own. This segregates the liability of each SMLLC to the single piece of real estate owned by that SMLLC. Creditors of one SMLLC will not be able to obtain control of the assets of any of the other SMLLCs. At the same time, the overlying MMLLC or LLLP provides downward liability protection for the business assets owned by the SMLLCs. Please note that downward liability protection is not available unless the SMLLCs are owned by a MMLLC or LLLP.

The reason SMLLCs are often used in conjunction with MMLLCs or LLLPs is because, for tax purposes, SMLLCs do not have to file their own tax return. Instead, all income from SMLLCs is reported on the tax returns of the overlying MMLLC or LLLP. As a result, only one single tax return is required to be filed regardless of the number of SMLLCs owned by the overlying MMLLC or LLLP.

In contrast, each separate MMLLC and/or LLLP is required to file its own tax return. Creating a separate MMLLC or LLLP for each property would require a separate tax return for each entity created. When properly structured, the use of SMLLCs in conjunction with MMLLCs and LLLPs provides both "upward liability" and "downward liability" protection and decreases tax preparation costs. ■

"...for tax purposes, single member limited liability companies do not have to file their own tax return."

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Enforceability of Indemnification Provisions in Colorado Construction Contracts, Cont.

There are some important nuances to Senate Bill 87. First, Senate Bill 87 allows contractual provisions that require the negligent party to indemnify other parties not only for the negligent party's own fault, but also the fault of its agents, representatives, subcontractors, or suppliers. For example, Senate Bill 87 permits a contractor to indemnify an owner when the contractor is not at fault, but the contractor's agents, representatives, subcontractors, or suppliers are at fault. Accordingly, the scope of a party's own negligence for which it can be held responsible under Senate Bill 87 is broader than its individual conduct. Second, Senate Bill 87 does not apply to: (1) property owned or operated by a railroad; (2) various water, sanitation, and sewer districts; and (3) lease or rental agreements between a landlord and a tenant. Third, Senate Bill 87 does not apply to builder's risk insurance. Thus, Senate Bill 87 has significantly impacted construction contracts by making most "broad form" indemnity provisions void and unenforceable for construction agreements entered into on or after July 1, 2007. ■



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