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By Thomas E. Rutledge

Nevada's Corporate Charging Order: Less There Than Meets the Eye

Traditionally, the law of unincorporated business organizations[1] has been premised upon the particular relationships between the members. For that reason, while the economic rights in the venture, as a default rule, have been by an individual participant freely transferable,[2] transference of the right to participate in management, which rights include those to vote or consent on various matters, the right to inspect records and as well the obligation to both be circumscribed by and as well as enjoy the benefit of fiduciary duties, have not been transferable absent the consent of the co-venturers.[3] Conversely, it has been the law of corporations that a share of stock is freely transferable personal property and that, absent an agreement to the contrary binding upon the transferor, a transferee of that share succeeds to all rights encompassed therein, including those that are purely economic such as the right to receive interim and liquidating dividends/distributions and as well the right to participate in management via, for example, voting with respect to the election of directors, voting on organic transactions such as merger and voluntary liquidation and record inspection.

In the context of unincorporated business organizations, there has been utilized the "charging order" as a mechanism for addressing the rights of the judgment creditor of an individual owner.[4] Assuming a judgment against an individual owner, the judgment creditor is not permitted to seize the owner's interest in the partnership/LLC. Rather, the creditor is granted a judgment lien against any distributions that may be made to that owner. As those payments are diverted to the judgment creditor, to that extent, the judgment is satisfied. Under particular laws, it is possible to

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foreclose upon a charging order; such serves only to sell the prospective economic rights in the venture, and does not convey to the purchaser management rights in the venture.[5] In this manner, the right of the partners/members to determine who will be the partners/members is preserved. Conversely, in a corporation, assuming a judgment against a shareholder, the law has traditionally allowed the judgment creditor to seize the corporate stock (just as the judgment creditor may seize other assets of the judgment debtor) in full or partial satisfaction of the judgment. Upon that event, the judgment creditor becomes a shareholder in the venture, vested with all rights thereof, and the judgment debtor ceases to be a shareholder.[6]

In recent years, proponents of "asset protection" have heavily promoted the partnership and the LLC as means for structuring assets, arguing in each instance that the limitation of a judgment creditor's rights to those set forth in the statutory charging order provisions is beneficial. While individual particulars within the analysis of certain promoters of "asset protection" have been criticized,[7] assuming the objective is to minimize the immediate value of the assets that are available to a judgment creditor, ownership of a business venture in unincorporated form is advantageous as contrasted with that in incorporated form.

At least until now; in 2007, Nevada, unique among the states in having done so, has included within its business corporation act charging order provisions. The effect of these provisions is, purportedly, to bring the closely held Nevada business corporation into parity with unincorporated business organizations.

Adopted as section 43.5 of SB 242,[8] there was added to the Nevada Business Corporation Act section 78.746, which provides as follows:

1. On application to a court of competent jurisdiction by a judgment creditor of a stockholder, the court may charge the stockholder's stock with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the stockholder's stock.
2. This section:
   - (a) Applies only to a corporation that:
     - (1) Has more than 1 but fewer than 75 stockholders of record at any time.
     - (2) Is not a subsidiary of a publicly traded corporation, either in whole or in part.
     - (3) Is not a professional corporation as defined in NRS 89.020.
   - (b) Does not apply to any liability of a stockholder that exists as the result of an action filed before July 1, 2007.
   - (c) Provides the exclusive remedy by which a judgment creditor of a stockholder or an assignee of a stockholder may satisfy a judgment out of the stockholder's stock of the corporation.
   - (d) Does not deprive any stockholder of the benefit of any exemption applicable to the stockholder's stock.
   - (e) Does not supersede any private agreement between a stockholder and a creditor.[9]

One aspect of this new section that is curious is that the holder of the charging order is limited to the "rights of an assignee," even as "assignee" is not a defined term, and neither are the "rights of an assignee." The language utilized fails on at least two points; it does not track that utilized in Nevada's unincorporated business organization laws, and second, it fails to recognize that, while those unincorporated laws already address, for purposes other than the charging order, the rights of an assignee, that differentiation does not exist in the corporate law.

Looking first to the language employed in the unincorporated business organization acts, the Nevada LLC Act speaks not of an assignee, but of a transferee, specifically providing that the rights of a transferee do not include those "to participate in the management of the business and affairs of the company or to become a member unless a majority in interest of the other members approves the transfer."[10] The Nevada Uniform Limited Partnership Act (2001) defines both "transferable interest" and "transferee,"[11] both of which terms are referenced in the charging order provision under that Act,[12] and likewise provides that a transferee of a transferable interest has no rights to participate in management.[13] It is worth noting that, under the Nevada Uniform Limited Partnership Act (2001), it is possible for the judgment creditor to request and receive an order of a foreclosure sale.[14] Consequently, in that this new provision of the Nevada business corporation act does not define what are the "rights of an assignee" of corporate stock, reference may be made to Nevada's unincorporated business organization acts, some of which may provide a rather confusing result to that inquiry.

What is missing from, and would be otherwise critical to the effectiveness of, the Nevada BCA charging order provision is an appreciation that, in the unincorporated realm, the charging order provision does

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not exist in a vacuum. The Nevada corporate charging order provision, as drafted, assumes that "charging order" has some sort of substantive meaning. The sin is that of thinking that the label is the thing labeled. The error was compounded in saying that the holder of the charging order "has the rights of an assignee" and there stopping, not appreciating that the "rights of an assignee" need to be then defined as they are not outside the context of the statute ascertainable. In each of the unincorporated entity acts, there is provided by statutory definition the "rights of an assignee/transferee." For example, under RUPA, while the economic rights in a partnership are freely transferable, that being the "transferable interest," the management/information rights are not similarly transferable. Consequently, it is known what are the "rights of an assignee/transferee" of a partnership interest.[15] Similar descriptions exist in limited partnership and LLC law.[16] The charging order, as set forth in unincorporated entity law, builds upon those provisions, addressing what is in effect a temporary (absent foreclosure) involuntary assignee, one who must first be a judgment creditor. As already noted, corporate law does not have a concept of a "assignee of only the economic rights" in the corporation; a transfer of stock has, historically, always involved the complete transfer of both the economic and the management/information rights. In that corporate law lacks these concepts, in assessing the charging order provision in the Nevada BCA, it seems most appropriate to focus not on what may have been the intended consequence of the statutory revision, but rather the effect of the language actually employed. To that end, it may be most appropriate to look first at what are the rights of an "assignee." As to that point, an "assignee" is "one to whom property rights or powers are transferred by another."[17] In a similar vein of looking at definitions, we see that "assign" includes "to transfer rights or property," and that with respect to the adjective "assignable," it includes "transferable from one person to another, *so that the transferee has the same rights as the transferor had.*"[18] Consequently, while the Nevada legislature, in seeking to add to its BCA the equivalent of the charging order as such exists in the unincorporated realm, namely a mechanism for granting a lien only upon the economic aspects of the ownership rights, they have in fact accomplished nothing of the sort, and rather may have created a unique "charging order" that affords the judgment creditor all of the rights in the corporate stock held by the judgment debtor.

Assuming a judgment against an individual owner, the judgment creditor is not permitted to seize the owner's interest in the partnership/LLC.

The requirement that the corporate charging order protections would apply only when the corporation has more than one shareholder[19] is intended to avoid the application of the charging order provision in the context of a single shareholder corporation, thereby preserving the rule set forth in *In re Albright*.[20]

A press release issued by the Nevada Resident Agent Association dated July 24, 2007 promoted this development in the law of corporations and equated the ability of a judgment creditor to seize the stock of the judgment debtor to a "reverse piercing" of the corporate veil, and that as well protected stockholders in small businesses "where stockholders are likely to have partnership-type relationships." With respect to the latter point, while it may be true that charging order protections could move the relationship of the shareholders to be more akin to that among partners/members, it does not necessarily follow that such is a positive development in the law. On an individual basis, the shareholders of a corporation may enter into a share restriction agreement that, in effect, will lessen, if not preclude, the ability of a judgment creditor to involve themselves in the activities of the venture. Further, this blurring of the lines between corporations and unincorporated business entities eliminates a feature useful in distinguishing them from one another and in so doing diminishes the viability of a broad menu of distinct forms of business that each have their own place in the choice of entity calculus. As to the argument that the charging order precludes "reverse piercing," that term is traditionally understood to involve a situation in which the assets of a corporation owned either in whole or in part by a shareholder will be applied to the satisfaction of the shareholder's individual debts. Even where a judgment creditor is able to seize the judgment debtor's stock in a business corporation, while such does allow that judgment creditor to exercise all rights of a shareholder (*e.g.*, the election of directors and the inspection of corporate records), such does not

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enable that judgment creditor/shareholder to access corporate assets to satisfy the judgment. Rather, the value of the shares, reflecting a pro rata value of the corporation's assets (appropriately discounted) has already, to that extent, satisfied the judgment.

The last subsection provides that the general default rule of the charging order as the exclusive remedy will not control over a private agreement between an individual shareholder and a creditor. One rationale for such a provision is to insure that a voluntary creditor of the corporation may take effective pledges of the corporate stock from all of the shareholders in order to secure corporate indebtedness. In the LLC/partnership realm, such could be equivalent to a prior agreement that, upon an involuntary transfer of an interest pursuant to a pledge agreement, the successor to that interest upon foreclosure would be admitted as a member/partner. That said, this provision is not in any manner limited to an agreement of all of the shareholders, but allows unilateral action by any individual shareholder. To that extent, this provision is inconsistent with that under unincorporated entity law, pursuant to which the owners get to determine who will be the co-owners, and, absent agreement to the contrary, an individual owner does not have the capacity to cause a third-party to the relationship to come into a right to participate in management.[21] In allowing unilateral action by an individual shareholder vis-à-vis its creditor, however, this charging order provision significantly departs from the rationale that has existed in unincorporated business organizations, namely limiting the exercise of management rights to those who have been approved by the owners of the venture other than the person proposing to make the transfer, a restriction that exists for the benefit of the business organization and the other owners. Here in the Nevada Business Corporation Act, we see a charging order provision that is for the benefit not of the other owners and the venture as a whole, but rather for the benefit of the individual shareholder who may on a case-by-case basis choose to favor (or not) some of its individual creditors.

Another curious element of this statue is its limitation to corporations having seventy-five or fewer shareholders, which limitation is explained in that above-referenced press release as being based upon the definition of a "small business" in the Internal Revenue Code as a corporation with fewer than seventy-five shareholders. This is rather confusing as the Code Sec. 1361 definition of a "small business," since 2004, has been one hundred shareholders, with rather liberal rules as to the counting of same.[22]

Does the addition of "charging order" provisions to the Nevada Business Corporation Act add substantially to the benefits of incorporating there as contrasted with any of the other states? Likely not. The claimed benefits of a charging order may, on a case-by-case basis, be achieved in business corporations by means of an appropriately drafted stock restriction agreement,[23] one that takes account of particular distinctions between different ventures, protections which may be enhanced by share transfer limitations contained in the articles of incorporation. Further, the ambiguities in the statutory language will no doubt, the first time the statute is sought to be applied, give rise to what may be substantial litigation over the open questions and what are exactly the "rights of an assignee of corporate stock."

Where, for a particular venture, charging order provisions are desired as a mechanism for protecting the private relationship between participants in a particular venture, why would that venture not initially choose to organize as a partnership, limited partnership or LLC? Each of these forms of business organization provides not only the benefits of the charging order, but as well other statutory limitations upon voluntary and involuntary transfers and in a more seamless manner addresses the rights (or not) of those who may become, at some level, participants in the venture?[24]

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ENDNOTES

1 For purposes of this discussion, the partnership, the limited partnership and, of more recent vintage, the limited liability company. This analysis does not include the business trust.

2 The Uniform Partnership Act (1914) ("UPA") §27; The Revised Uniform Partnership Act (1997) ("RUPA") §503; The Revised Uniform Limited Partnership Act (1985) ("RULPA") §702; The Uniform Limited Partnership Act (2001) ("ULPA") §702; The Uniform Limited Liability Company Act (1996) ("ULLCA") §502; The Revised Uniform Limited Liability Company Act (2006) ("RULLCA") §502; Prototype LLC Act (1992) §704.

3 UPA §27(1) (the assignee of a partner's interest in the partnership is not entitled "to interfere in the management or administration of the partnership business or affairs or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled."), §18(g) ("no person may become a member of a partnership without the consent of all the partners."); RUPA §503(a), §401(i); RULPA §702, §401 (general partner admission), §401(a)(ii) (limited partner admission); ULPA §702(a)(3), §401(4) (general partner admission), §301(3) (limited partner admission); ULLCA §502, §503(a); RULLCA §502(a)(3),

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ENDNOTES

§401(d)(3); Prototype LLC Act (1992) §704(a)(2), §704(a)(3), §706(a).

[4] UPA §28; RUPA §504; RULPA §703; ULPA §703; ULLCA §504; RULLCA §503; Prototype LLC Act (1992) §705.

[5] Thomas E. Rutledge, Carter G. Bishop and Thomas Earl Geu, *Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm*, 21 PROPERTY & PROBATE 35 (May/June, 2007).

[6] Of course, to the extent that the judgment debtor is subject to a binding share restriction agreement, the judgment creditor may find the ability to seize and exercise the rights incident to the shares to be limited. *See, e.g.*, HOWARD M. ZARITSKY, STRUCTURING BUY-SELL AGREEMENTS ¶ 7.05[1][a] (2nd Ed. 2000 and 2007 supp.) ("The courts have also held, however, that a buy-sell agreement that does not preclude encumbrances may still prevent a creditor from obtaining the interest by foreclosure or judicial sale."); ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS ¶ 7.23 (2006) ("To safeguard the power of participants in a closed corporation to choose their future associates, participants will want to restrict the right of shareholders to pledge their shares, or at least the sales of the stock by the pledgee. If the initial pledge is permitted, the participants may want to restrict voting power, inspection rights or other shareholder rights by the pledgee.") (citation omitted); 12 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §5454 (share transfer restrictions "typically serve as an important device to ensure that current shareholders can control the ownership and management of the corporation and prevent outsiders from 'invading the business.'") (2004 Rev'd Volume) (citation omitted).

[7] *See, e.g.*, Thomas E. Rutledge, State Law & State Taxation Corner, *Charging Orders: Some of What You Ought to Know (Part II)*, J. PASSTHROUGH ENTITIES, Jul.-Aug. 2006, at 25-26 (criticizing the typically promoted discussion of the tax treatment of payments under the charging order).

[8] Introduced to the Nevada Senate on March 8, 2007 and amended in the House by Amendment No. 959.

[9] The title of this section is "Action Against Stockholder By Judgment Creditor; Limitations." This provision was effective July 1, 2007. Subsection 1, save for LCC to corporate nomenclature, is identical to §86.401(1) of the Nevada LLC Act. Subsection 2(b) is identical to §86.401(2)(a) of that same Act, while Subsection (2)(d) is identical to §86.401(b).

[10] NRS §86.351(1).

[11] NRS §87A.135; §87A.140.

[12] NRS §87A.48.

[13] NRS §87A.475(1)(c).

[14] NRS §87A.480(2).

[15] *See, e.g.*, RUPA §503(A)(3); NRS §87.4341(1)(c).

[16] *See, e.g.*, RULLCA §502(a)(3); Prototype LLC Act §704(a)(3); NRS §86.351(1); ULPA §702(a)(3); NRS §87A.475(1)(c). The recently approved Uniform Limited Cooperative Act (available at NCCUSL.org) defines the "financial rights" (§102(11)) and "governance rights" (§102(13)) in a cooperative, provides that a member's interest in the cooperative includes both governance rights and financial rights (§601), provides that the rights of a member other than the financial interests are not transferable while the financial rights are transferable (§§603(b), (c)) and permits a charging order against the financial rights. §605.

[17] BLACKS LAW DICTIONARY (8 Ed. 2004).

[18] BLACKS LAW DICTIONARY (8 Ed. 2004) (*emphasis* added). In a similar vein, "An 'assignment' is a transfer of property or some other right from one person (an 'assignor') to another (the 'assignee'), which confers a complete and present right in the subject matter to the assignee." 6 AM.JUR.2d. A*ssignments* §1 (citations omitted).

[19] NRS §78.746(2)(a)(1).

[20] *In re Albright*, DC Colo., 291 B.R. 538 (2003). This intention is recited in Derek G. Rowley, *Charging Order Protection for Nevada Corporations: A White Paper by the Nevada Resident Agent Association* (February 2005). With respect to the *Albright* case, *see, e.g.*, Thomas Earl Geu and Thomas E. Rutledge, *The* Albright *Decision—Why a SMLLC is Not an Appropriate Asset Protection Vehicle*, 5 BUSINESS ENTITIES 16 (Sept./Oct., 2003).

[21] UPA §18(g); RUPA §401(i); RULPA §401 (general partners), §704(a)(ii) (limited partners); ULPA §401(4) (general partners), §301(3) (limited partners); ULLCA §503(a); RULLCA §401(d)(3); Prototype LLC Act (1992) §706.

[22] The Small Business Job Protection Act of 1996 set the shareholder limit at seventy-five. P.L. 104-188, §1301, 110 Stat. 1777 (1996). The limit was raised to one hundred and the method of counting the number of shareholders was liberalized by the American Jobs Creation Act of 2004 (P.L. 108-357, §§231-232, 119 Stat. 1433 (2004)). *See also* Code Sec. 1361(b)(1)(A).

[23] *See supra* note 6.

[24] My thanks to Professor Thomas E. Geu for his comments on an earlier draft of this piece, and to Allison Donovan (Stoll Keenon Ogden PLLC, Lexington, Kentucky) for her research assistance, it being understood, as always, that all errors and omissions herein are mine alone.

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