State Law & State Taxation Corner

By Thomas E. Rutledge[*]

Charging Orders: Some of What You Ought to Know (Part I)

The charging order, granted the creditor of the member of an LLC or of a partner, serves to assure the creditor of receipt of the distributions made by the LLC/partnership, while preserving the rule of unincorporated business organizational law that the right to participate in management is restricted to those admitted as members/partners, as well as the rule that the assets of a business organization are not the assets of the owners. As a compromise mechanism, the charging order is not entirely satisfactory to anyone involved. Still, it is a fixture of partnership/LLC law that needs to be understood.

Here, in Part I, I will review the history of the charging order, the language employed in various acts, the rights of the holder of a charging order *vis-à-vis* the partnership and the foreclosure of the charging order. Part II, to appear in the July-August issue of the JOURNAL, will address redemption of the charging order, the tax treatment of payments under a charging order, the *Albright* and *Ehmann* decisions, limits on payments made pursuant to the charging order and other topics.

The Economic/Management Rights Distinction in Unincorporated Business Organization Law

The charging order exists to balance two valid and competing interests: (1) those of the judgment creditor to collect on the judgment and (2) the interest of the partnership[1] to operate with minimal interference from a partner's creditor. In corporate law, no distinction is drawn between the rights to dividends/liquidating distributions and the rights to either vote for directors or vote on extraordinary transactions; the transfer of a share conveys both to the transferee. In unincorpo-

Thomas E. Rutledge is a Member in the law firm of Stoll Keenon Ogden PLLC in Louisville, Kentucky.

rated law, the interests of an owner are divided into (1) a "transferable interest," encompassing the economic rights of ownership and (2) management rights, which are not subject to unilateral transfer.[2] Rather, those management rights may be conveyed only upon the approval of some threshold, typically all, of the otherwise incumbent partners in the organization. It follows, therefore, that as a partner is limited to a voluntary transfer of only his or her financial interest in the partnership, it is to only that financial interest that a creditor of a partner may look. While the holder of the charging order has a lien on the distributions, as made, to the judgment debtor/partner, he or she has no right to participate in management and does not become a partner. At the same time, the partner/judgment debtor remains a partner, and his or her management rights are not diminished.[3] The charging order does not result in a transfer of the partner's transferable interest to the judgment creditor.[4] Upon foreclosure of the charging order, however, which transfers the transferable interests to the purchaser, the partner may be expelled from the partnership.[5]

The Need for an Answer[6]

The seminal article on charging orders was published in 1953 in the Washington Law Review & State Bar Journal. It introduced the topic by stating: "One of the most artificial and confusing procedures of the common law was the method by which the creditor of a partner enforced his claim against the interest of his debtor in the partnership."[7] The article quotes a description of the execution of judgments against partners in partnerships by Lord Justice Lindley of the English Court of Appeals, in an 1895 opinion:

> When a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a fi. fa., and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and cause the execution creditor to bring an action in Chancery in order to get an injunction to take an account and pay over that which was due by the executor debtor a more clumsy method of proceeding could hardly have grown up.[8]

The article suggests that there were two reasons for this unhappy resolution. *First*, lawyers and courts had "difficulty … in understanding the nature of a partner's interest in a partnership."[9] *Second*, "[t]he common law had no procedure for the seizure of the partner's intangible interest in the business."[10] The first reason still exists. The second reason suggests part of the solution to the charging order *problem* is careful consideration and statutory vetting of the nature of the abstract rights of a member in his or her partnership interest. This leads us to the statutory charging order provisions.

The Charging Order Formula

The charging order statutory formulae differ between the various states and between various unincorporated acts. Within a state, distinctions between the statutory language are generally (I would say absolutely, but to every categorical statement [except this one] there are exceptions) unprincipled and should be an invitation for review and reconciliation. That said, the language of the statute is crucial and dictates the effect of the order and the rights afforded the judgment creditor.

The Uniform Partnership Act (1997)[11] and the Uniform Limited Partnership Act (2001)[12] use the same formula for the charging order, initially providing:

> (a) On application by a judgment creditor of a partner or of a partner's transferee, a court having jurisdiction may charge the transferable interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor in respect of the partnership and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances of the case may require.[13]

A transferable interest is, in each act, a functionally defined term.[14] All the holder of a charging order has is the right to receive what the debtor/partner would have received in the way of distributions. With that exception, the holder of a charging order is a stranger to the partnership. The holder of a charging order has no interest in the partnership's property.[15] The holder of a charging order does not have rights to information from the partnership.[16] The holder of a charging order is not owed fiduciary duties or the obligation of good faith and fair dealing owed among the partners and the partnership.[17] The holder of a charging order may

not move for judicial dissolution or seek an accounting.[18] All the holder may do is insist upon receipt of what would otherwise have been distributed to the judgment debtor.[19] All in all, a narrow right.

"All Other Orders"– Does That Mean What It Says?

The statutory formulae authorize the court issuing the charging order to issue "all other orders, directives, accounts and inquiries." It starts to appear that the court has the capacity to order the partnership to make distributions or otherwise interfere in the intense operation of the partnership. Fortunately, that is the wrong reading. The court's authority to so act is qualified by "the judgment debtor might have made." As the judgment creditor has no right to participate in management, the court has no such authority. The court's authority is restricted to orders that assure the judgment creditor the receipt of the distributions[20] that would be made to the debtor.

The (Need for a) Judgment Creditor & Exclusivity

The modern charging order provisions provide that they are "the exclusive remedy by which a judgment creditor may satisfy a judgment" out of a partner's transferable interest.[21] While this statement may be of comfort to some as far as it goes, it is important to appreciate that it goes only so far. First, the exclusivity is limited to those who are judgment creditors; the provisions may have no effect where the action is not a monetary claim.[22] Prejudgment, other remedies may be available to protect the rights of the potential creditor. Furthermore, courts seem willing, and some states have expressly provided, that child support obligations may be satisfied by means of a charging order.[23]

Foreclosure of a Charging Order

Charging order provisions typically provide that holder may request, and the court may order, a foreclosure sale of the partner's transferable interest.[24] In so doing, the judgment creditor accelerates the receipt of value from the debtor's property. Consider a partnership that generates few, if any, distributions; the charging order will not cause the judgment creditor to be paid within a reasonable time. However, the assets of the partnership are such that the transferable interest has significant current value. The judgment creditor may move for foreclosure in order to generate the sale that will in part or whole satisfy the judgment.[25] Upon the foreclosure sale (and assuming the charging order was not redeemed [*i.e.*, satisfied] prior to foreclosure),[26] the purchaser receives the debtor partner's transferable interest in the partnership,[27] affording the purchaser the rights of a transferee.[28]

There are at least three consequences of the completed foreclosure sale. First, the debtor partner no longer has an economic interest in the partnership and may be expelled by a vote of all of the partners, or such lower threshold as is defined in the partnership agreement.[29] Second, the purchaser has the rights of a transferee, including the right to periodic and liquidating distributions as made and the right to apply for judicial dissolution of the partnership and in any dissolution, receive an accounting.[30] Third, the transferee becomes, for tax purposes, a "partner."[31] Still, the transferee is not owed fiduciary obligations or obligations of good faith and fair dealing by the partners[32] and has no voice in the management of the partnership.[33]

Does a Charging Order "Freeze the Deal"?

A not uncommon question is whether a charging order "freezes the deal," precluding the partners from amending the partnership agreement or altering their course of conduct. Consider ABC partnership, made up of A, B and C. May A and C, after the issuance of the charging order in favor of B's judgment creditor ("Creditor"), decide to cease making *pro rata* distributions to all of the partners, rather paying themselves "salaries" for operating the partnership? A trio of respected commentators have asserted that a "partnership cannot simply cease normal distributions in order to help the debtor partner hide assets from the creditor who received the charging order," but cite no authority in support of this proposition.[34] Nothing in RUPA or ULPA forbids them from doing so. In altering the deal, no fiduciary obligation or obligations of good faith and fair dealing owed to Creditor are violated,they were never owed to Creditor.[35] Creditor is not a party to the partnership agreement; by what right may he or she object to its amendment? There does not appear to be a reported decision precluding such conduct, and there is authority with respect to transferees indicating that modification of the deal is not forbidden.[36]

This is entirely a different question from whether it is a good idea. Assume that periodic distributions have been made pursuant to a provision in the partnership agreement or by separate unanimous agreement of the partners, thereafter constituting part of the partnership agreement.[37] Does B want to consent to the amendment of the partnership agreement that permits A and C to remove all of the net income as "salary"? B is left with no proceeds of his or her capital investment in ABC and continues to have Creditor pursuing him or her for satisfaction of the judgment. If B votes "yes" to amend the partnership agreement with a wink and a grin (and maybe even without winks and grins), the salary transfers might fall under the Uniform Fraudulent Transfer Act.[38] If the two nondebtor partners shared the wink and grin, all of them might be defrauding the creditor under tort law (fraud or conversion). Further, this action may make the court more likely to order a foreclosure sale of B's partnership interest. Is this not perhaps as expensive means by which B seeks to spite Creditor? Assume Creditor's judgment, by some means, is satisfied, and the charging order is lifted; how is B going to be sure his or her distributions begin again? A and C each feel that 50 percent of the distributions is better than 33.3 percent of the distributions, and acting in self-interest in refusing to again amend the partnership agreement is permitted.[39]

All of which is some of what you should know about charging orders. The July-August issue of the JOURNAL will continue this review and explore related tax and bankruptcy law issues.

ENDNOTES

* The author would like to thank Professor Thomas E. Geu for his thoughts and comments on this column.

1 For the balance of this article, issues will be discussed in the context of the partnership, as contrasted with a limited liability company or limited partnership, except where distinctions need to be made between these forms of unincorporated business organizations.

2 Collectively, a partner's "interest in the partnership," or "partnership interest." RUPA §101(9). *See also* ULPA §701, cmt.

3 *See* HILLMAN, VESTAL & WEIDNER, THE REVISED UNIFORM PARTNERSHIP ACT (West 2005 ed.), Authors' Comment 8 to RUPA §503; J. WILLIAM CALLISON AND MAUREEN SULLIVAN, PARTNERSHIP LAW AND PRACTICE (West) §7.20 at 7-39.

4 RUPA §504; ULPA §703.

5 RUPA §601(4)(ii); ULPA §601(b)(4)(B).

6 This discussion is drawn from Thomas Earl Geu, *Charging Orders*, presented at *Unincorporated Business Organizations at the Courthouse Door: The Corporate Rules Do Not Apply*, Committee on Partnerships & Unincorporated Business Organizations and Committee on Business and Corporate Litigation, Section of Business Law, American Bar Association (August 9, 2004).

7 J. Gordon Gose, *The Charging Order Under the Uniform Partnership Act*, 28 WASH. L. REV. 1 (1953) (hereinafter "Gose, Charging Orders and the UPA").

8 Gose, Charging Orders and the UPA, at 1, quoting *Brown, Janson & Co. v. Hutchinson & Co.*, 1 Q.B. 737 (1895).

9 *Id.* at 2.

10 *Id.*

11 Hereinafter, "RUPA."

12 Hereinafter, "ULPA." The forthcoming Revised Uniform Limited Liability Company Act utilizes a similar, but not identical, formula that is intended to indicate further than do RUPA and ULPA that courts should not interfere in internal affairs for the benefit of the judgment creditor with a charging order. As its language has not received approval by NCCUSL, it is not herein reviewed. Every LLC act, except that of Nebraska, has a charging order provision.

13 *See* RUPA §504(a); s*ee also* ULPA §703(a).

14 RUPA §502; ULPA §701.

15 RUPA §203. ULPA does not contain a provision equivalent to RUPA §203.

16 *See* RUPA §§403(b), (c); ULPA §§304, 407. *See also Green v. Bellerive Condo. Ltd. Partnership*, Md. AppCt, 135 MdApp 563, 763 A2d 252 (2000).

17 RUPA §404; ULPA §408.

18 RUPA §408; ULPA §§801, 802.

19 *See* ULPA §703, cmt.

20 *See* ULPA §703, cmt.

21 RUPA §504(e); ULPA §703(e). Although UPA §28 did not contain exclusivity language, it was often so interpreted. *See* Official Comment 5 to RUPA §504(c).

22 *See, e.g., Delta Development and Investment Co. v. Yeh*, Wash. CtApp, No. 47192-9-I, 2002 Wash. App. LEXIS 3008 (constructive trust available as a remedy for a creditor of a member where there was no monetary judgment).

23 *See* RUPA §504, cmt 5.

24 RUPA §504(b); ULPA §703(b).

25 *See, e.g., FDIC v. Birchwood Builders, Inc.*, SuperCt N.J., 240 NJSuper 260, 573 A2d 182, 186.

26 RUPA §504(c); ULPA §703(c).

27 *Id. See also* RUPA §502; ULPA §703(b).

28 RUPA §504(C); ULPA §703(c). *See also* RUPA §503; ULPA §702.

29 RUPA §601(4)(ii); ULPA §601(b)(4)(B).

30 RUPA §§503(b), (c); ULPA §§702(b)(1), 702(b)(2), 702(c).

31 Tax issues dealing with the charging order will be reviewed in Part II of this article.

32 *See* RUPA §404(a), (d); ULPA §408.

33 RUPA §503(a)(3); ULPA §702(a)(3).

34 HILLMAN, VESTAL & WEIDNER, *supra* note 3, Authors' Comment 9 to RUPA §504.

35 *See supra* note 17 and accompanying text.

36 *See, e.g., Bauer v. Blomfield Company/Holden Joint Venture*, Alaska SCt, 849 P2d 1365 (1993). *See also* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITIES COMPANIES—TAX AND BUSINESS LAW (2005) ¶ 8.06[2][3].

37 *See* RUPA §401(j); *see also* HILLMAN VESTAL & WEIDNER, *supra* note 3, Authors' Comment 8.b(i) to RUPA §401.

38 *See* RUPA §104(a); ULPA §107(a).

39 *See* RUPA §404(e); ULPA §408(e).