CHARGING ORDERS AND THE NEW UNIFORM LIMITED PARTNERSHIP ACT

DISPELLING RUMORS OF DISASTER

By Daniel S. Kleinberger, Carter G. Bishop, and Thomas Earl Geu

Last year, an article published in this magazine focused on the charging order as "the Exclusive Remedy Against a Partnership Interest" and announced the "[s]hocking [r]evelation" that ULPA (2001)—the new Uniform Limited Partnership Act—undermines the "exclusive remedy" limitation on charging orders. The authors asserted categorically that, "from an asset protection perspective, the 2001 Act is considerably less protective of a partner's partnership interest than the 1976 Act." Elizabeth M. Schurig & Amy P. Jetel, *A Charging Order Is the Exclusive Remedy Against a Partnership Interest: Fact or Fiction?*, Prob. & Prop. 57, 58 (Nov./Dec. 2003).

As this article will show, the rumors of disaster are unfounded, and ULPA (2001)'s provisions on charging orders are nothing to be feared. To support this calming assertion, this article will explain: (1) the history and purpose of the charging order remedy, (2) the consequences of charging order foreclosure (including the possibility of redemption), and, most importantly from a practical perspective, (3) the current state of the law governing charging orders, foreclosure, and limited partnerships. Like the November/December article, this article leaves aside the separate issues that arise when secured creditors exercise rights and remedies under UCC Article 9.

Origins of the Charging Order

The charging order is a judgment creditor's remedy, available by court order when the judgment debtor owns an interest in a general or limited partnership. The order is directed to the partnership, for the benefit of the creditor, and, while in effect, entitles the judgment creditor to whatever distributions would otherwise be due to the debtor partner whose interest is subject to the order. Charging order provisions can also be found in every LLC statute except Nebraska's.

The charging order has been a fundamental part of U.S. partnership law since the early twentieth century, when the first uniform general and limited partnership acts each included a charging order provision. Uniform Partnership Act (UPA) § 28 (1914); Uniform Limited Partnership Act § 22 (1916). The remedy originated, however, two decades earlier, in Section 23 of English Partnership Act of 1890.

The 1890 Act was the first statute to codify English partnership law, and Section 23 was intended to protect the *partnership* business from disruption at the hands of the creditors of an *individual partner.* The protection was necessary because of the then prevailing "aggregate" view of a partnership and the resulting confusion over the rights of partners (and their separate creditors) in partnership property.

Under the aggregate view, the firm was not a juridical person, had no legal status separate from its individual members, and could not own property in its own right. Firm assets were therefore seen as owned by the partners collectively. This construct made life complicated enough when a creditor of the *partnership* sought to levy on the *partnership* assets. When a creditor of a *partner* took action against *partnership* assets, the result was often chaos:

> 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 [writ of execution], and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and caused 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 execution debtor. A more clumsy method of proceeding could hardly have grown up.

Brown, Janson & Co. v. A. Hutchinson & Co., 1895 Q.B. 737 (Eng. C.A.) (Lindley, J.).

The same chaos existed under U.S. law at the time, and the drafters of the 1914 and 1916 U.S. acts copied the English innovation. The charging order was designed to prevent a judgment creditor of an individual partner from obtaining access to the underlying partnership assets that gave value to an individual partner's interest in the firm. The charging order became the judgment creditor's "exclusive" (and, emphatically, indirect) access to those assets. That is, a judgment creditor of a partner had no rights whatsoever in the assets of the firm but was exclusively remitted to collecting whatever income stream those assets might produce for the judgment debtor.

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Thus, the charging order was created as a tool for "entity asset protection" not "partner asset protection," and that is still the rule. As a California court has explained, charging orders "are not intended to protect a debtor partner against claims of his judgment creditors where no legitimate interest of the partnership, or of the remaining or former partners is to be served." *Taylor v. S & M Lamp Co.*, 12 Cal. Rptr. 323, 328 (Cal. Ct. App. 1961). Or, in the words of a Maryland court: "While limited partnerships were not created to assist creditors, but to enable persons to invest their money without being liable for partnership debts for more than their contribution, . . . neither were they intended to protect a partner's interest in the partnership against legitimate personal creditors." *Bank of Bethesda v. Koch*, 408 A.2d 767, 770 (Md. Ct. Spec. App. 1979).

Limits of Charging Order Intrusion

A charging order does redirect some of a partnership's distribution stream but, in doing so, intrudes only marginally into the affairs of the enterprise and its other owners. The various uniform partnership acts differ somewhat in how they state this point, but since 1976 all versions of ULPA have followed the same paradigm. Under Section 703 of the Revised Uniform Limited Partnership Act (RULPA) (1976), "the judgment creditor [with a charging order] has only the rights of an assignee of the partnership interest," is not actually an assignee, and owns no part of the charged interest. Even an actual assignee is entitled "to receive, to the extent assigned, *only* the distribution to which the assignor would be entitled," and even an actual "assignment of a partnership interest does not . . . entitle the assignee to become or to exercise any rights of a partner." Id. § 702 (emphasis added). A fortiori, the holder of a charging order has no right to meddle in the conduct of the partnership's activities. Moreover, the granting of a charging order has no effect whatsoever on the management rights of the debtor partner whose economic rights are subjected to the charging order.

The situation is the same under ULPA (2001), albeit expressed somewhat differently. Following the lead of the Revised Uniform Partnership Act (RUPA), Section 703 of the new Act substitutes "transferee" for "assignee" and relies on a more modern formulation of the very limited rights of a partner's transferee. Also, the new Act follows RUPA's terminology for characterizing the rights pertaining to a charging order.

Under all uniform partnership acts (and the English Partnership Act of 1890 as well), a court that issues a charging order has the power to issue additional, ancillary orders to give effect to the charging order. These ancillary orders can include appointing a receiver to collect the proceeds of the charging order, but in any event should be limited to giving effect to the charging order. A Comment to ULPA (2001) provides two useful, contrasting examples:

> A judgment creditor with a charging order believes that the limited partnership should invest less of its surplus in operations, leaving more funds for distributions. The creditor moves the court for an order directing the general partners to restrict re-investment. [The Act's charging order provision] does not authorize the court to grant the motion.

A judgment creditor with a judgment for $10,000 against a partner obtains a charging order against the partner's transferable interest. The limited partnership is duly served with the order. However, the limited partnership subsequently fails to comply with the order and makes a $3000 distribution to the partner. The court has the power to order the limited partnership to turn over $3000 to the judgment creditor to "give effect to the charging order."

ULPA § 703 cmt.

It is, of course, possible for a trial judge to misunderstand the distinction between partnership property and partner property and issue an ancillary order that overreaches. In the reported cases (and unreported cases available through Westlaw and Lexis), however, it is rare for ancillary orders to interfere with partnership management. Moreover, the interference occurs only when fraud or comparable misconduct is involved.

For example, in *Deutsch v. Wolff*, 7 S.W.3d 460 (Mo. Ct. App. 1999), the limited partnership had only one general and one limited partner, the general partner had been found liable for defrauding the limited partner, and the limited partner had obtained the charging order to collect on the fraud judgment. The court held that "vesting the receiver with management power" was appropriate because "when managers of a partnership have willfully engaged in a series of illegal activities resulting in a breach of their fiduciary obligations to the limited partners causing dissipation of partnership resources, a court may remove the general partner and appoint a receiver to assume control of partnership affairs." Id. at 464. Another case holds: "While [a receiver acting under a charging order] is not entitled to share in the management of the firm as a partner, the receiver would be of little use if he could not protect 'profits and surplus' by preventing such unauthorized and illegal dissipations of firm assets as the complaint alleges in this case." *Windom Nat'l Bank v. Klein*, 254 N.W. 602, 605 (Minn. 1934).

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Charging Order Foreclosure

The charging order paradigm does contemplate foreclosure, and the November/December article asserted that ULPA (2001) goes further than prior law in authorizing that remedy. Understanding why that assertion is wrong requires, first, understanding the circumstances and consequences of charging order foreclosure and, second, appreciating the current state of the law concerning the foreclosure of limited partnership charging orders.

Suppose that a charging order brings the judgment creditor nothing—whether through disingenuousness of the partners or simply the nature of the firm and its assets. Must the judgment creditor wait forever, repeatedly renewing the order and, if necessary, the underlying judgment itself? At least since 1914, the answer under U.S. partnership law has been no; the judgment creditor may seek foreclosure of the charging order. See UPA § 28(2) (1914) (permitting redemption "at any time before foreclosure").

Foreclosure involves the court-ordered sale of the charged interest, and the purchaser at the sale—whether the beneficiary of the charging order, the partnership itself, another partner, or some unrelated person—becomes at most an assignee of the judgment debtor's right to receive distributions (or, in modern parlance, has merely the rights of a transferee to those distributions). The lot of a "naked assignee" is not a happy one: not a partner, not protected by partner-to-partner fiduciary duty, not entitled to participate in partnership affairs in any way, and with virtually no rights to obtain partnership-related information.

Moreover, the naked assignee faces adverse tax consequences. The purchaser of a foreclosed partnership interest is considered a partner for federal tax purposes (even though not a partner under state partnership law), Rev. Rul. 77–137, 1977–1 C.B. 178, which means that the purchaser is subject to tax on its share of the partnership's income regardless of whether the partnership actually distributes any of that income.

The tax situation is different for a mere holder of a charging order. Because that person does not own the underlying interest, the person should not be considered a partner for tax purposes. There is no specific IRS authority on this point. But the point follows from core concepts of partnership tax law and means that—so long as the charging order is not foreclosed and the interest sold—the debtor partner remains taxable on its share of partnership income even though that share is distributed directly to the judgment creditor.

Thus, the typical judgment creditor does not salivate at the prospects of foreclosure, and a foreclosure sale will typically draw no crowd. The foreclosure and sale may cause the dissociation of the partner whose interest is charged, if the relevant partnership statute or the partnership agreement so provide. But if the other partners wish to avoid that result, they certainly can do so by agreement.

The Possibility and Consequences of Redemption

The partners can also avoid even the limited intrusion that comes from having a judgment creditor (or some other stranger) enforcing a charging order or purchasing at a foreclosure sale. Partnership statutes provide for the redemption of a charged interest at any time before foreclosure. The partner whose interest is charged may redeem, as may the partnership and some or all of the other partners (using nonpartnership property). Redemption involves merely paying the amount of the unsatisfied judgment. If the debtor partner redeems, the charging order will, of course, be removed. If the partnership or other partners redeem, they should be viewed as succeeding to the judgment creditor's rights under the charging order. Although the statutory language on redemption is unclear and there is little authority on point, the redeeming partnership or partner owns only the right to be repaid the redemption price from the debtor partner's future distributions and not the actual interest.

Charging Order Foreclosure and the Law of Limited Partnerships

The November/December article suggested that many practitioners believe that a judgment creditor's "exclusive remedy" under RULPA may be limited to a charging order and a court may lack the power to order foreclosure. This belief is wrong for several reasons. First, RULPA contains no exclusive remedy language. Second, although RULPA itself does not provide for foreclosure, each state's version of RULPA is "linked" to a general partnership statute. See RULPA § 1105 (1976) ("In any case not provided for in this [Act] the provisions of the Uniform Partnership Act govern."). Both the UPA and RUPA expressly contemplate foreclosure, UPA § 28(2) (1914); RUPA § 504(b) (1997), and, almost without exception, courts have held that a limited partnership charging order may therefore be foreclosed.

For example, *Madison Hills Ltd. Partnership II v. Madison Hills, Inc.*, 644 A.2d 363, 368 (Conn. App. Ct. 1994), analyzed the linkage question in detail and held categorically that "the remedy provisions of the UPA are available to judgment creditors under the ULPA." *Crocker Nat'l Bank v. Perroton*, 255 Cal. Rptr. 794, 798 (Cal. Ct. App. 1989), involved a charging order obtained under a provision of the California *limited* partnership act but quoted the *general* partnership act's foreclosure/sale provision and stated: "Cases requiring creditors to obtain charging orders also indicate that sale of the partnership interest is permissible where the creditor has first obtained a charging order and has demonstrated that monies collected under the charging order are insufficient to satisfy the judgment."

The weight of case law on this point is heavy, and the list of additional authority is long. See, e.g., *Baybank v. Catamount Constr., Inc.*, 693 A.2d 1163, 1165–66 (N.H. 1997); *Tupper v. Kroc*, 494 P.2d 1275 (Nev. 1972). Florida is the one notable exception. *Givens v. Nat'l Loan Investors, L.P.*, 724 So. 2d 610, 611 (Fla. Dist. Ct. App. 1998).

In approximately a half dozen states, the limited partnership statute does refer to the charging order as the "exclusive remedy," but some of those statutes also expressly contemplate foreclosure. See, e.g., Del. Code Ann. tit. 6, § 17–703; Tex. Rev. Civ. Stat. art. 6132a-1, § 7.03. (The special and strange case of Alaska is discussed below.)

Moreover, courts interpreting the "exclusive remedy" language understand that (1) the exclusivity is vis-à-vis the judgment creditor's access to *partnership* property; (2) the remedy limitation pertains to how a judgment creditor may "attach" a partner's economic rights; and (3) the language does not preclude a court from making further remedial orders. As explained by one leading case (which upheld foreclosure of a limited partnership charging order):

> Because the partner's rights in specific property of the partnership cannot be attached or made subject to execution; . . . and the partner's management rights cannot be assigned to or conferred on anyone other than a partner; . . . the charging order is the sole remedy available to a judgment creditor of a partner.

Madison Hills, 644 A.2d at 367 (statutory citations omitted).

The partners can also avoid even the limited intrusion that comes from having a judgment creditor enforcing a charging order or purchasing at a foreclosure sale.

Chrysler Credit Corp. v. Peterson further illustrates how an "exclusive remedy" can permit and sometimes may even require additional remedies. After reciting that "[t]he charge order is the exclusive remedy for a judgment creditor of a limited partner[,]" the case holds that "the [statutory] charge order provisions must be read in conjunction with the provisions of . . . the Uniform Fraudulent Conveyances Act" and that "when a judgment creditor alleges a fraudulent conveyance of a debtor's limited partnership interest, the creditor may obtain a charge order that attaches to whatever limited partnership interest he is later determined to have . . . in a plenary action to set aside the conveyance as fraudulent." 342 N.W.2d 170, 172–73 (Minn. Ct. App. 1984).

Some courts are considerably more casual about the exclusive remedy concept. For example, as noted above, the Texas limited partnership act contains exclusive remedy language, but in *World Fuel Servs. Corp. v. Moorehead*, 229 F. Supp. 2d 584, 598 (N.D. Tex. 2002), the federal district court took no account of that language: "Since the Court has decided to appoint a receiver to collect, sell, and liquidate all of defendant's non-exempt assets in satisfaction of the judgment—including his interest in any limited partnerships and limited liability companies—a charging order is not necessary."

In sum, in the overwhelming majority of jurisdictions, a charging order on a limited partnership interest may be foreclosed by order of the

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court, and neither that foreclosure nor the resulting judicial sale will interfere with the legitimate interests of the partnership and the other partners.

The Strange Case of Alaska and the Lesson to Be Learned

There is thus nothing to be feared from the charging order and foreclosure provisions of ULPA (2001). Even so, a state that enacts ULPA (2001) could engraft a nonuniform provision to expressly preclude foreclosure. As the November/December article notes, Alaska has done that with its version of RULPA. As enacted in 2000, Alaska Stat. § 32.11.340(b) provides:

> This section [on charging orders] provides the exclusive remedy that a judgment creditor of a general or limited partner or of the general or limited partner's assignee may use to satisfy a judgment out of the judgment debtor's interest in the partnership. Other remedies, including foreclosure on the general or limited partner's partnership interest and a court order for directions, accounts, and inquiries that the debtor general or limited partner might have made, are not available to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's interest in the limited partnership and may not be ordered by a court.

The legislative history of this provision is instructive. According to the minutes of the Alaska House legislative action, a legislative staff attorney reported that "a Connecticut court ruled that a judgment creditor of a limited liability partnership interest could strictly foreclose on the partnership interest and *become an actual partner.*" *Hearing on H.B. 222 Before the House Judiciary Standing Comm.*, 2000 Leg., 21st Sess. (Alaska Jan. 19, 2000) (statement of Committee Aide for House Judiciary Standing Committee) (emphasis added). Diligent research through both Westlaw and Lexis has found no account of any such case in Connecticut or elsewhere. Furthermore, even if such a case does exist, it would be contrary to the overwhelming weight of authority and the Alaska reaction would be scofflaw-friendly overkill. There is no need to prohibit all foreclosures and all other orders—just those that ignore the origins and purpose of the charging order and purport to give a *partner's* judgment creditor a direct interest in the *partnership's* assets or a right to be involved in managing those assets.

But even that prohibition would be unnecessary, because it already inheres in the nature of a charging order. Moreover and worse, the actual Alaska prohibition may preclude application of fraudulent transfer statutes. If so, a judgment debtor, in connivance with friendly fellow partners, could easily stonewall the legitimate claims of a judgment creditor. For example, the debtor's distribution rights could somehow "morph" into a payment right enjoyed by a person affiliated with the debtor. The Alaska approach is hardly a model for other states.

Conclusion

Charging orders and foreclosure have been part of the law of limited partnerships for almost a century, and properly so. The new Act—ULPA (2001)—merely modernizes the law's language a bit, and the official comment to Section 703 militates against excessive use of ancillary orders. A "charging order does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership." A foreclosure transfers the judgment debtor's economic rights but "does not . . . create any rights to participate in the management and conduct of the limited partnership's activities." There is nothing "shocking" or even novel about the new Act's approach to charging orders, and the charging order issue is no reason to fear adoption of the new Act. ■