

Overview of When the Charging Order Fails

The statutory limitations of the charging order were once thought to be insurmountable. However, there exist a few instances where a creditor of a limited partnership's or LLC's partner or member was able to gain ownership of their company interest, notwithstanding the statutory limitations of the charging order. Three cases are relevant to this topic. (Because the charging order statutes for LLCs are very similar or even identical to those of limited partnerships, this section applies equally to both types of entities.) The first two cases were decided in California district courts. In both these cases, the court decided to ignore the limitations of the charging order because, the court ruled, charging order protection was originally enacted as a means of protecting the non-debtor partners in the partnership and to insure that partnership business remains uninterrupted, not so that a debtor-partner can escape paying his debts. Because in both cases the partnership interest could be transferred to the creditor without causing an interruption in business, the courts on both occasions decided that charging order restrictions did not apply and the partnership interest was transferred to the creditor. Although the court in one case only allowed this transfer with the other partners' consent, in the other case the transfer was allowed without the consent of the other partners. Despite the fact that these cases technically should only hold weight in California, they set a precedent that may be imitated by other courts nationwide.

Another situation in which charging order protection may fail is found in a recent bankruptcy proceeding. In this proceeding, the court ruled that the debtor's LLC membership interest was forfeited to the bankruptcy estate, due to the fact that the LLC's operating agreement was deemed a non-executory contract. Under bankruptcy law, an executory contract would include an agreement wherein the company's partners have ongoing obligations towards the company, such as the requirement to act as advisors or to periodically contribute cash or other capital. Such an executory contract would be subject to a certain section of the bankruptcy code, which section would uphold the limitations of state or other applicable law (thus allowing the limitations of the charging order remedy to apply). The court makes it clear, however, that if a partnership or operating agreement is non-executory, the company interest would instead be subject to another section of the bankruptcy code, which section would override any other statutory limitations on the bankruptcy trustee's right to the debtor's assets.

In light of these cases, there is yet another situation wherein charging order protection may be circumvented. That is where all members of the company are debtors to the same creditor. In this situation, the underlying reasons for charging order protection would not apply to the situation at hand, and therefore a court could conceivably disregard charging order restrictions.

To summarize, the following factors may jeopardize the charging order component of an asset protection plan:

- An LLC's or limited partnership's operating/partnership agreement is non-executory (which is probably only important if the company's owner files or is forced into bankruptcy)
- The forfeiture of a debtor's membership interest to a creditor would not interrupt partnership business

- All members/partners of the LLC/limited partnership become a debtor of the same creditor

The solution is to ensure that the operating or partnership agreement is executory in nature. Such an executory agreement, if carefully drafted by a skilled professional, will also cause an interruption in ongoing member obligations towards the company to also cause an interruption in the company's business. This would allow the debtor-member to argue that such an interruption in business prohibits any court from transferring his company interest to a creditor.

There are many considerations that must be made when drafting such an agreement. Such considerations are without the scope of this website and are best left to a competent attorney or asset protection consultant. However we can broadly state that the following obligations will effectively reinforce charging order limitations:

- Ongoing obligations to contribute cash or other capital to the entity
- Ongoing obligations to contribute non-managerial services (such as advisement services)
- Ongoing obligations to manage the entity, if appropriate

Lastly, we must make sure that never, under any circumstance, could all members of the LLC personally become debtors of the same creditor. We accomplish this by one or more of the following:

- At least one of the LLC members is not exposed to liability. This is best accomplished by making one of the members a trust, LLC, or other entity that only engages in safe activities

At least one member is not an insider or affiliate of any other member under the U.F.T.A. Also, it is best for this member to live in a different state than the other members. This would make it highly unlikely that this member would ever be personally listed as a defendant on the same lawsuit as another member. With this in mind, make sure that the LLC or LP is not member-managed. Otherwise, a plaintiff suing the LLC or LP could name all of the members as co-defendants, claiming each was responsible for mismanagement of the LLC, which led to the tort offense.