BIG money

Charging Orders

A Powerful Judgment Enforcement Procedure

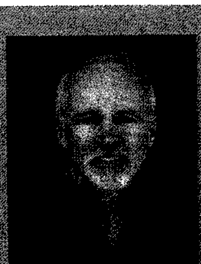
By Timothy A. Lambirth and Jennifer C. Price

So you've won your case and the court has granted you a judgment. Congratulations, but now what? The debtor is not going to just mail you a check.

Quite often, the judgment debtor has insufficient funds or assets to cover the judgment. How do you collect? First, perfect your judgment with liens. You can create a lien on real estate by recording abstracts of judgment in those counties where you know or suspect the debtor owns property. Next, record a form called a JL-1 with the secretary of state, which creates a judgment lien on the debtor's non-household personal property in the state.

Most attorneys are familiar with the usual methods of levy such as, wage garnishments and bank levies. There are other enforcement methods available if you can not find any viable bank accounts or the debtor is not an employee, but has interests in one or more partnerships.

In that situation, there exists a method of levy for enforcement of the judgment against a debtor's interest in a partnership. That procedure is initiated by obtaining a charging order against the debtor's interest in the partnership. This tool is effective against a judgment debtor's partnership interests, and similar holdings in similar entities.



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I. INTRODUCTION TO THE CHARGING ORDER

Historically, a writ of execution was levied directly against the partnership's assets, which were then seized by the sheriff. The charging order was later developed to protect the non-debtor partner or non-debtor member's assets within an entity and keep the creditor out of the business' affairs.

Statutory authority for the charging order is found at California Code of Civil Procedure § 708.310. It states that if a money judgment is rendered against a partner or member, but not against the partnership or limited liability company, the judgment debtor's interest in the partnership or limited liability company may be applied toward the satisfaction of the judgment by an order charging the judgment debtor's interest pursuant to Sections 15907.3, 16504, or 17705.03 of the California Corporations Code.

Noting that the charging order serves to protect the non-debtor partner or member, assets in a partnership (general or limited) or limited liability company (LLC) are *not* liable for a money judgment rendered against a partner or member *personally*. In order to reach those interests, a judgment creditor must first obtain a court order charging those interests with the amount of the judgment. To go after the assets of the partnership or LLC, the judgment creditor must obtain a court order *charging* those interests with the amount of the judgment.[1]

II. ADVANTAGES AND DISADVANTAGES OF A CHARGING ORDER

An advantage of using this procedure is that a charging order enables a party to place a lien on the judgment debtor's transferable or assignable interest in the partnership or LLC.[2] The lien is created by service of a notice of motion for a Charging Order on the judgment debtor and either:

(1) All the partners or the entire partnership, or
(2) All members of the LLC.[3]

The lien is effective during the period of enforceability of the judgment. The judgment becomes unenforceable upon when the court either refuses to issue the charging order or if the enforcement of the judgment is stayed.[4]

A drawback of employing this enforcement procedure is that the judgment creditor steps into the role of an assignee or transferee. Consequently, the creditor is *not able to make any managerial decisions or engage in voting* on issues related to the business. The judgment debtor is *only* entitled to receive the distributions to which the limited partner would ordinarily be entitled.[5] Accordingly, the judgment debtor or the controlling partners or managers may choose to distribute minimal funds or no funds at all. If they choose not to distribute funds, the creditor could then attempt to collect the judgment by foreclosing on the entity.

III. FORECLOSURE ACTIONS AND CHARGING ORDERS

A charged interest in either an LLC or partnership may be redeemed before foreclosure and sale by the judgment debtor in two different ways. One option is to redeem the interest with property other than the partnership or LLC property, by one or more of the other partners or members. Alternatively, the judgment debtor may redeem the charged interest with property of the partnership or LLC, if consent is obtained by the partners or members whose interests were not charged.[10]

Only at the point of foreclosure does the creditor become the owner of the charged interest. The court may order foreclosure on the limited partnership interest or debtor's LLC interest at any time.[11] In determining whether or not to foreclose, the court will consider whether foreclosure and sale will unduly interfere with the business of the partnership or LLC and whether all partners or members other than the judgment debtor have consented to the sale of the judgment debtor's interest.

A purchaser at a court-ordered foreclosure sale receives limited rights. The purchaser is entitled to the same rights as an assignee or transferee. Therefore, the purchaser will not be able to participate in operation or management of the partnership or LLC.

Under California Corporations Code §§ 15522(4), 15673, 15907.03(d), 16504(d), and 17302(d), a judgment debtor may claim any exemptions applicable to the partnership or LLC interest. No set procedure is laid forth in the Code for claiming exemptions. The only exemption that is apparent concerns where the debtor is in bankruptcy.

IV. SCOPE AND APPLICABILITY OF CHARGING ORDERS

Typically, charging orders may only be applied to a partnerships or a LLC. However, California Code of Civil Procedure § 187 "affords trial courts 'all the means necessary to carry [their jurisdiction] into effect,' and courts may adopt 'any suitable process or mode of proceeding . . . which may appear most conformable to the spirit of this Code' if the course of proceeding is not specifically pointed out."[12]

PROCEDURAL GUIDELINES HOW TO OBTAIN A CHARGING ORDER

A. Court Selection

A charging order may be filed in any competent court, but you should probably start with the court from which you obtained your judgment. The only limitation is that Federal Fair Debt Collection Practices Act venue restrictions prohibit a debt collector from bringing any legal action on a debt against a consumer outside the judicial district, except in three cases. A debt collector may only bring a legal action outside the judicial district on a debt against a consumer in the following venues:

(1) Within the judicial district where the consumer resides,
(2) Where the debtor possesses real property, or
(3) Where the debtor signed the contract sued upon.

If a creditor initiates a legal action outside these parameters, he may be subjected to liability, along with his attorney.

Judgment creditors must file a notice of motion and declaration in support of the motion.[6] A lien on a judgment debtor's interest in a partnership or limited liability company is created upon service of a notice of motion for a charging order on the judgment debtor and on either all partners of the partnership or all members of the LLC.

The partnership or LLC should be personally served and a Proof of Service filed with the court. The application for a charging order may be combined with a motion for the appointment of a receiver. Generally, an appointment of a receiver is only applicable to general partnerships due to the fact that limited partners and LLC members are treated as passive investors. The assumption is that limited partners do not have control over decision-making within the entity and therefore there is no need to appoint a receiver.

Once the application is filed against a judgment debtor partner, the court may issue an order charging the partner's interest in a limited partnership with the unsatisfied amount of the judgment.[7] In the same manner, the court may issue an order charging the partner's transferee's interest in a general or limited partnership or the member's assignee interest in the LLC.[8] The lien created continues under the terms of the order. If issuance of the charging order is denied, the lien is extinguished.

B. Notice and Timing

The partnership or LLC does not need to give effect to the charging order until they have received notice of the order. At that point in time, the partnership or LLC must pay out distributions (if any) to the judgment creditor instead of the judgment debtor. Notice is deemed effective where the notification is delivered at the partnership's or LLC's place of business. Taking that into consideration, a prudent lawyer should immediately personally serve a certified copy of the charging order after the court has issued it.

Additionally, counsel must be proactive in pursuit of the judgment debtor. In many cases, where the judgment debtor is elusive and is shielding assets within different entities, there will most likely be several creditors seeking to collect against those assets. In the event that there are competing liens, priority is given to the first creditor that obtains a lien, whether by charging order or another lien.[9]

EXCLUSIVITY OF REMEDY

The Corporations Code provides the *exclusive remedy* for a judgment creditor of a partner or a partner's transferee to satisfy a judgment from the judgment debtor's transferable interest in a California limited or general partnership. This similarly applies to the judgment debtor's membership interest in an LLC. The exclusivity language of the remedy pertains to the limited right of the judgment creditor to receive distributions and not to participate in partnership affairs.

However, attorneys must remember that an important exception to this rule exists. Where a conveyance is fraudulent, the judgment creditor's remedy is no longer limited to a charging order. Rather, the allegation of a fraudulent conveyance is a legal action completely separate from the charging order procedure. Under a fraud theory, the creditor is then able to pursue the partnership or LLC directly. This sets up a simultaneous two-pronged attack against the evasive creditor.

Although § 187 relates to procedural matters, it also "may relate to situations in which the rights and powers for the parties have been established by substantive law or court order but workable means by which those rights may be enforced or powers implemented have not been granted by statute."[13]

In *Phillips, Spallas & Angstadt, LLP v. Fotouhi*, the court applied a charging order against a corporation. The appellate court held that the trial court properly relied on § 187 and provided a practical manner for the judgment debtor to collect against a former partner.

In this case, Fatouhi entered into a partnership with Phillips, Spallas & Fotouhi, LLP. Four years later, Fatouhi left the partnership to start another law firm. Foutouhi's former partners sued him for violation of the partnership agreement. In arbitration the former partners were awarded liquidated damages of $2.4 million. Thereafter, Foutouhi filed a petition for Chapter 7 bankruptcy. The bankruptcy court found that he was "motivated by his expressed intention to deprive his former partners of any recovery on their massive judgment . . . and to mislead all parties as to the value of his interest in [the Partnership] as well as other assets." After bankruptcy, Foutouhi formed a corporation organized as a professional corporation that continued to operate the prior partnership as a law practice.

The court in granting the charging order reasoned that in this situation, the corporate form was not disregarded. It found that the superior court did not disregard the corporate form to satisfy claims against a shareholder but in fact held it liable for the obligations of the previous partnership. The order was limited in that it only reached Foutouhi's share in the profits and surplus of the partnership and not the shares of his partners in the corporation. The Court further explained that it was holding the corporation liable for the obligations of its previous partnership rather than Fotouhi's individual liabilities.

THE BIG MONEY LESSON

A Charging Order can be an effective tool, available to you to enforce your judgment if the judgment debtor is a partner in a partnership or a member of an LLC. While protection is offered to the non-debtor partners or members, the judgment creditor effectively places a lien on the judgment debtor's interest. At that point, the judgment could be satisfied over time, through distributions of profits of the partnership or LLC.

If these distributions are not sufficient to cover the judgment, a court, in its discretion, may foreclose upon the interest. While some uncertainty exists as to whether the judgment will be paid off under this enforcement procedure, the Charging Order at the very least will promote settlement between the parties.

Attorneys that are cognizant of this tool and who employ it in conjunction with other more traditional enforcement methods can be successful in collecting Big Money for their clients.

QUESTIONS FOR MCLE EXAM

20 True/ False:

1. A wage garnishment is the only effective enforcement procedure to go after a judgment-debtor. False

A. There are several other special judgment enforcement procedures. Two others include levies and charging orders.

2. A charging order allows a judgment creditor to go after the judgment debtor personally. False

A. The charging order is limited to only reach the judgment-debtor's interests in the partnership or LLC. It does not allow the creditor to go after the judgment-debtor personally.

3. The charging order protects non-debtor members or partners assets within an entity. True.

A. The charging order protects the assets of the non-debtor partners or non-debtor members. Most importantly, the charging order protects the entity and keeps the creditor out of the business' affairs.

4. A judgment creditor with a charging order is able to make operational decisions within the entity. False.

A. A drawback for judgment-creditors is that they are limited. They are only able to receive distributions to which the judgment-creditor partner or member would ordinarily be entitled to. The judgment-creditor lacks any authority to determine when or whether or not distributions will be paid.

5. The judgment creditor is only allowed to receive distributions to which the judgment debtor would ordinarily be entitled. True.

A. Judgment creditors are only able to receive distributions to which the judgment-debtor partner or member would ordinarily be entitled to.

6. A judgment debtor or controlling partner or manager must distribute funds upon receipt of the notice of the charging order. False.
A. The entity does not have to give effect to the charging order until they receive notice of the order. Therefore, a prudent attorney must obtain the order and serve the notice as soon as possible to avoid losing out on any distribution of profits.

7. A charging order can only be filed in the court where the judgment creditor obtained the judgment. False.
A. It can be filed in any competent court. However, as a practical pointer the judgment creditor should probably start with the court where it obtained the judgment. It is also important to bear in mind that the Federal Fair Debt Collection Practices Act places certain restrictions on where a debt collector may institute an action. Basically, a debt collector may only institute legal action where the debtor resides, where he possesses real property, or where the contract being sued upon was entered into.

8. A lien is created upon the service of notice of motion for a charging order on the judgment debtor and either all partners of the partnership or members of the LLC. True.
A. The advantage of using a charging order is that a lien is effectively placed on the transferable interest of the judgment-debtor in the partnership or the LLC.

9. The application for a charging order may be combined with a motion for the appointment of a receiver. True.
A. However, the appointment of a receiver is not necessary where limited partners are concerned. In theory, limited partners do not have control distributions and are treated as passive investors.

10. The lien extinguishes if the court denies the charging order. True.
A. The lien continues until either the charging order is denied by the court or where the judgment is no longer enforceable.

11. A charged interest may be redeemed before foreclosure and sale by the judgment debtor. True.
A. The court has the authority to foreclose at any time. The court will take into consideration whether or not the foreclosure and sale will unduly interfere with the business and whether all partners or members other than the judgment debtor have consented to the sale of the judgment debtors' interest.

12. The creditor is the owner of the charged interest after foreclosure has occurred. True.
A. Even after foreclosure has taken place the judgment creditor still has limited rights in that it can not participate in any management decisions.

13. A purchaser at a court ordered foreclosure sale is entitled to participate in management of the entity. False.
A. No. The purchaser is still limited to the rights of an assignee or transferee.

14. A charging order may be levied against an entity that has previously filed for bankruptcy. False.
A. This is the only exemption that a judgment-debtor may set forth where a charging order is issued.

15. A charging order is generally limited to LLCs and partnerships. True.
A. Note that the court has broad authority and discretion in granting charging orders. Case precedent exists where the Court has levied a charging order of a corporation.

16. A charging order may be used in conjunction with other special judgment enforcement procedures. True.
A. There are several special judgment enforcement procedures that may be used to effectively collect against an evasive judgment debtor.

17. Where there is a fraudulent conveyance the creditor may go after the assets of the LLC or partnership directly. True.
A. Where there is fraudulent conveyance a creditor is able to pursue the partnership or LLC directly under a separate cause of action.

18. The lien under the charging order is effective where enforcement of the judgment is stayed. False.
A. At that point the lien is extinguished.

19. The court may foreclose on the judgment debtor's interest at any time. True.
A. It is also important to note that a judgment-debtor may redeem the interest with property other than that of the partnership or LLC at any time prior to foreclosure.

20. A charging order can be an effective judgment enforcement procedure to collect against evasive debtors. True.

ENDNOTES

1. Cal. Code of Civ. Pro. § 699.720(a)(2)

2. *Phillips, Spallas & Angstadt, LLP v. Fotouhi*, 197 Cal. App. 4th 1132, 1139 (Ct. App. 2011) (quoting *Taylor v. S&M Lamp Co.*, 190 Cal. App. 2d 700, 711 (1961)).

3. Cal. Code of Civ. Pro. § 708.320(a).

4. Cal. Code Civ. Pro §§ 697.030, 697.040, 708.320(b).

5. Cal. Corp. Code §§ 15672(a), 15907.02(a)(2),(3),(b).

6. Cal. Code Civ. Pro. § 708.320.

7. Cal. Corp. Code §§ 15522, 15673. For California limited partnerships formed before July 1, 1984, the application may be made before judgment is entered against the partner.

8. Cal. Corp. Code §§ 15907.03(a), 16504(a), 17302(a).

9. Cal. Code of Civ. Pro § 697.020.

10. Cal. Corp. Code § 15907.03(c), 16504(c), 17302(c).

11. Cal Corp. Code §§ 15907.03(b), 16504(b), 17302(b), 17302(b).

12. *Phillips, Spallas & Angstadt, LLP v. Fotouhi*, 197 Cal. App.4th 1132, 1142 (Ct.App. 2011).

13. *Id.*