



S T O L L · K E E N O N · O G D E N

M E M O R A N D U M

TO: Rob Sitkoff, Justin Vigdor, Ann Conaway, Ellisa Habbart, Bob Keatinge,
Bill Clark and Tom Geu

FROM: Tom Rutledge

DATE: March 4, 2008

RE: Charging Order Provision to the Uniform Statutory Trust Act

I had hoped, before last weekend's meeting on the Uniform Statutory Trust Act, to be able to forward to Rob and everyone else a revised Section 504A. Sadly, that did not happen, and I was not able to e-mail out the revised language until Saturday morning, and as such there was obviously little time to vet same. Therefore, in the hopes of perhaps bringing this issue to a resolution before the next meeting, I thought it best to circulate a memo to all involved (as well as to Professor Tom Geu in that he/you has thought more about charging orders than he/you might care to admit).

So that everyone is on the same page, the charging order that will appear in the USTA is, as contrasted with the other unincorporated business organization acts, a strange animal. In the partnership/limited partnership/limited liability company, we have the notion of the "transferable interest," being the economic rights of an owner or of an owner's transferee. The "transferable interest" does not embody any right to participate in management. The charging order is a lien upon that transferable interest that secures collection of the judgment where the judgment debtor is a partner/member. A charging order, of itself, does not change the relationship between the partner/member or a transferee thereof; all it does is direct the divergence of distributions, as

made, from actual receipt by the judgment debtor to the judgment creditor. When the judgment is satisfied, the charging order is lifted, and from that point forward distributions are made directly to the partner/member or the transferee whose interest had previously been subject to the charging order. Of course, a foreclosure of the charging order would result in a permanent alteration of that relationship, but that is a distinct transaction from the awarding of the charging order.

The charging order that will appear in the USTA, as indicated above, is a rather strange animal. Under the USTA, the default rule is that a beneficial interest in the trust is freely transferable. USTA Draft For 2/29/08 Meeting, § 504(a). *See also* DELSTA § 3805(d). Assuming that default rule is not modified, a judgment creditor of a beneficial owner will be able to execute on the beneficial interest and, so to speak, step into the shoes of the beneficial owner and thereafter exercise all of the rights incident to that position. Note, however, that free transferability is the default rule. We have been considering the circumstance that the trust agreement may limit the transferability of the beneficial interest. Should those limitations become spendthrift in nature, we would inadvertently create a business organization from which the distributions could not be attached by creditors for satisfaction of a judgment. Certainly without meaning to do so, we would have created a powerful asset protection tool. This, however, is in no manner our intent. As such, we are putting a charging order provision into the USTA to be applicable only in those situations in which the trust agreement has rendered the beneficial interest nontransferable, even to the degree that it might otherwise be spendthrift.

To that end, I propose the following language (Rob, what is set forth below is somewhat revised even from that sent you last Saturday), and invite your comments thereon. Please note

particularly the statement made at footnote 5 with respect to foreclosure; I think we need a show of hands on which way to go on that point.

- (a) If a beneficial interest is not freely transferable by a beneficial owner such that the transferee has all rights of the transferor,¹ then a judgment creditor of a beneficial owner or a transferee thereof may satisfy a judgment against the judgment debtor only as provided in this section.²
- (b) A court of appropriate jurisdiction may issue a charging order, being a judgment lien against distributions when and as made by the statutory trust to the beneficial owner or transferee, in favor of the judgment creditor, for the unsatisfied portion of the judgment.³
- (c) A charging order issued under subsection (b) requires the statutory trust to pay over to the judgment creditor any distribution that would otherwise be paid to the beneficial owner until the unsatisfied amount of the judgment has been satisfied.
- (d) To effectuate the collection of distributions pursuant to a charging order in effect under subsection (b), the court may: (1) appoint a receiver of the distributions subject to the charging order, with the power to enforce the beneficial owner's right to a distribution, if any; and (2) make all other orders necessary to give effect to the charging order.^{4 5}
- (e) A statutory trust or beneficial owner that is not subject to the charging order may pay to the judgment creditor the full amount due under the judgment lien and thereby succeed to the rights of a judgment creditor, including the charging order.⁶

¹ The first clause of subsection (a) defines, functionally, what would in partnership or LLC law be the notion of the non-transferability of the right to participate in management.

² This second clause of subsection (a) repeats the exclusivity language of RUPA § 504(e), ULPA § 703(e) and RULLCA § 503(g). *See also* DEL. CODE ANN. § 15-504(d) (DelRUPA), § 17-703(d) (DelRULPA) and § 18-703(d) (DeLLCA).

³ Subsection (b) provides for the issuance of a "charging order" and then defines what that is.

⁴ This subsection (f) repeats the enforcement rights language of RUPA § 504(a), ULPA § 703(a) and RULLCA § 503(b). This language was deleted from DelRUPA, DelRULPA and DeLLCA in 2005.

⁵ It needs to be recognized that this draft does NOT include a provision by which the judgment creditor may foreclose upon the interest. *Contrast* RUPA § 504(b), ULPA § 703(b) and RULLCA § 503(c). Foreclosure language was deleted from DelRUPA, DelRULPA and DeLLCA in 2005.

⁶ This provision permits either the statutory trust or a beneficial owner therein to purchase the judgment against the judgment debtor, succeeding to the rights of the judgment creditor, which rights include the rights under

- (f) This [Act] does not deprive a beneficial owner or a transferee of the benefit of any exemption laws applicable to the beneficial interest.⁷

As highlighted in footnote 5 above, this charging order provision does not contain a foreclosure provision; with respect to that statement, please note that subsection (2) is not a foreclosure provision, but rather an opportunity for either another beneficial owner or for the business trust to acquire the judgment creditor's interest under the judgment. This provision does not, of itself, deprive the beneficial owner/transferee whose beneficial interest has been charged of their position as an owner/transferee. Where foreclosure is provided for in the context of a partnership/LLC, the purchaser at the foreclosure sale receives, vis-à-vis the partnership/LLC, only the rights of a transferee (or, to use Bill Callison's formulation, a bare-naked assignee). To the extent of the proceeds of the foreclosure sale, the judgment creditor's judgment lien is satisfied, the judgment lien is released, the purchaser has the rights of a transferee of that beneficial interest, and the judgment debtor's interest in the statutory trust is terminated. All in all, I am not sure that the typically applied foreclosure regimen is in any manner flawed. My rationale for not including such a provision in the statutory trust context is that it could perhaps (and Rob, I think this is a question for you) run afoul of the spendthrift-like provisions that we are trying to here address. That said, if we are going to include a foreclosure provision, I would insert the following as a new subsection (F) and thereafter provide:

- (F) A court of appropriate jurisdiction may order a foreclosure upon the beneficial interest subject to the charging order [at any time]⁸ [upon a showing

the charging order. This provision is consistent with RUPA § 504(c), ULPA § 703(c) and RULLCA § 503(e). Similar language was deleted from DelRUPA, DelRULPA and DelLLCA in 2005.

⁷ This subsection (f) repeats the exemption language of RUPA § 504(d), ULPA § 703(d) and RULLCA § 503(f). *See also* DEL. CODE ANN. § 15-504(c) (DelRUPA), § 17-703(c) (DelRULPA) and § 18-703(c) (DelLLCA).

⁸ ULPA § 703(b) uses the "at any time" formula.

that distributions from the statutory trust will not satisfy the judgment within a reasonable time].⁹ The purchaser of the beneficial interest at the foreclosure sale has only such rights as are afforded a permissible transferee under the governing instrument.

It is at that last sentence where we run into a significant circularity problem. We conceptualize the application of the charging order in a statutory trust context only where the rights of assignees are limited by the governing instrument. With this language, the purchaser at the foreclosure sale has only those limited rights, which in fact may be none at all. By allowing a foreclosure we may be setting up a situation in which the purchaser in fact is entitled to nothing. We can always defend such a scenario on the basis that some governing instruments will not be so restrictive and further that it is the purchaser's obligation to engage in due diligence with respect to the valuation of what it is they may be purchasing.

At your earliest convenience, please circulate to everyone your thoughts and suggestions so that we can quickly get at least this matter put to bed.

⁹ This test for determining whether a foreclosure is appropriate is based upon RULLCA § 503(c).