THE CHARGING ORDER AND ESTATE PLANNING: AN OVERVIEW OF CHARGING ORDER PROTECTED ENTITIES AND THEIR POTENTIAL ROLE IN WEALTH PRESERVATION

I. Introduction

A certain legal maxim declares “A right is only as great as its remedy.” In other words, a right is only meaningful to the extent there is adequate recourse or compensation to restore or repair the given right in the event of its breach or deprivation. Indeed, where a remedy is severely limited and practically inadequate, the underlying right to which that remedy attaches is either lacking in value or subordinate to a greater right. It follows then, that a party seeking to restore a right lacking in remedial recourse will not dedicate much time or resources to the endeavor because the ultimate recompense, if any at all, is not likely to justify the cost of securing it.

Enter the charging order: The remedial instrument meant to bestow upon creditors the right to collect on a partner’s or a Limited Liability Company (“LLC”) member’s unpaid personal debts by way of that debtor-partner or member’s interest in his respective entity. Traditionally, a decent amount of mystery and uncertainty has surrounded the charging order because of the lack of statutory guidance relating to its scope and application. Generally, the charging order grants a creditor rights in a debtor-partner or LLC member’s interest in his respective entity. However, those rights are limited to the debtor-partner or member’s right to receive distributions from the respective entity. In other words, these “transferee rights” do not grant creditors any control or ability to participate in the management of the company. As such, creditors have no say as to when, and in what amount, distributions can be made. Thus, a creditor with a charging order is often left with limited options for recovering a partner’s or
member’s unpaid debts in the event a partnership or LLC decides not to distribute to its partners or members.

Because creditors can be viewed as helpless under the scenario described above, the charging order is often considered an ineffective remedy. However, sound policy reasons and the history of the charging order support the need for this unique remedy in spite of its alleged shortcomings. Consider the right of a creditor to collect on the unpaid debts of a debtor-partner or LLC member. Most, if not all, see this as a valid right and worthy of enforcement. On the other hand, the ability of a given entity’s non-debtor partners or members to be able to continue their collective business with the partners of their choosing (and without the fear of being held hostage by the personal debts of another partner/member and his creditors) is at least equally important in terms of legal rights and protections. Thus, a legal quandary is created as partners, LLC members, creditors and debtors are all left wondering whose rights are supreme.

As a result, the charging order’s ineffectiveness as an equitable remedy lessens the value of the right it is meant to restore (debt repayment). Certainly, the right to collect on the debts of a debtor-partner or LLC member’s interest in his or her entity will never be considered a “great” right so long as the charging order remains an impotent remedy. Rather, charging order protected entities, such as some partnerships and LLCs, will continue to be seen as legitimate wealth preservation vehicles for one’s business or investment assets.

II. Charging Order Protection

In today’s ever-increasingly litigious society many people are seeking to protect the assets and wealth they have spent the better part of their lives accumulating. For many investors and businesses, the entity of choice has become the LLC because of its commonly touted strengths of flow-through taxation and limited liability. However, in addition to these appealing
attributes, the less mentioned characteristic of “charging order protection” also makes the LLC an ideal entity for certain business and investment ventures as well as estate planning. The purpose of this article is to give a general overview of why the charging order came into being and how it is currently applied in various jurisdictions. This article will also touch on the perceived weaknesses of the charging order and suggest planning opportunities for avoiding potential issues when dealing with a debtor-member’s creditor. Lastly, this article proposes that business people and investors should take advantage of the statutory protections afforded to entities considered to have charging order protection as a measure of wealth preservation from their partners or co-members who may have creditor issues.

A General Overview and History

A charging order is a remedy a creditor of an LLC debtor-member uses whenever the creditor wants to satisfy the debtor member’s unpaid personal debts, a.k.a. “outside liabilities”, with his interest in the LLC. Charging orders are not a form of judicial recourse for debts incurred by the LLC itself, a.k.a. “inside liabilities”. LLCs provide charging order protection because, generally, the charging order only allows the creditor to act as an assignee of the LLC debtor member’s interest in the LLC. Charging orders do not allow a creditor to invade the LLC assets or obtain managerial or voting rights in the entity to satisfy outside liabilities incurred by one of its members. Rather, charging orders typically compel creditors to helplessly wait as assignees until the LLC makes distributions to its members, at which point the creditors are able to intercept the distribution intended for the debtor member and apply it to the outside liability he incurred. Thus, because creditors have no say or control over the timing and amount of distributions from an LLC, creditors cannot force an LLC to make distributions or to involuntarily dissolve for the purposes of satisfying outside liabilities.
Charging orders became the preferred judicial remedy for partnership entities in 1914 when the Conference Commissioners on Uniform State Laws (the “Commissioners”) approved the Uniform Partnership Act ("UPA"). UPA was largely the result of the undesirable process in which a creditor would obtain a judgment against a debtor-partner and then attempt to satisfy the judgment with the partner’s interest in partnership assets. This process was problematic because the creditor could satisfy the judgment by having the sheriff seize the partnership assets, sell the debtor-partner’s interest in those assets, and thereby indirectly cause the “compulsory dissolution and winding up” of the partnership.

Such a result seemed hardly an equitable one for the “innocent” partners who had managed to keep their personal financial affairs from interfering with their partnership activities. Furthermore, the ability of a creditor to step into the shoes of a debtor-partner and cause the dissolution of the partnership essentially granted any such creditor unintended managerial rights and control over the partnership entity. In theory, a creditor could refrain from dissolving and winding-up the partnership and, instead, compel the remaining partners to participate in an involuntary ongoing partnership with him. The resulting entity would be a forced partnership, the very notion of which is at odds with the principle of *delectus personae*. *Delectus personae* is the idea that partnerships, as well as LLCs, “are at their core… relationships of trust between partners” and that “when personal relationships are important, a person cannot be compelled to associate with another person.”

To prevent creditors from compelling the dissolution of a partnership, UPA limited creditors’ remedies to the charging order. UPA specifically states that “partnership property is not subject to attachment or execution”. UPA further states that upon application to a competent court, the court “may charge the interest of the debtor partner with payment of the
unsatisfied amount of such judgment debt with the interest thereon”. The court can then “appoint a receiver” for the partner-debtor’s share of the profits “and any other money due” to the partner so that the debtor-partner’s share of any distributions of such profits or money would go towards satisfying the partner’s unpaid debt. Thus, UPA eliminated the possibility that a creditor could cause the involuntary dissolution of a partnership by limiting the remedies available to that of the debtor’s interest in the partnership’s distribution of profits rather than allowing the creditor to usurp the debtor’s position as a partner.

Since UPA’s inception, several other uniform Acts relating to flow-through entities have come into being (most notably the Uniform Limited Partnership Act (“ULPA”) and the Uniform Limited Liability Company Act (“ULLCA”)). Each of these Acts has been revised or amended at least once. While a cursory comparison of the newer revised versions of the Acts to the older ones may not disclose meaningful differences in their treatment of charging orders, a more careful review of these Acts reveals an apparent attempt by the Commissioners to provide more explicit and substantive guidance on the charging order’s scope and application. A very brief and high-level analysis of these changes, and the comments that accompany them, is helpful in understanding the charging order’s scope and application.

UPA and the ULPA originally granted creditors the right to “charge” the interest of the debtor partner, while the revised versions of UPA and ULPA (“RUPA” and “RULPA”) refer to the interest charged as a “transferable interest” of the judgment debtor instead of the debtor’s “partnership interest”. RUPA defines a “transferable interest” as the “partner's share of the profits and losses of the partnership and the partner's right to receive distributions” and maintains that the “interest is personal property”. UPA and ULPA contained similar definitions for the term “partnership interest”; however, it is important to note that the definitions section of
RUPA defines “partnership interest” as an interest that includes a partner’s “transferable interest”. By clarifying that a “transferrable interest” is part of a “partnership interest”, it becomes clear that a “partnership interest” and a “transferrable interest” are not the same. Moreover, because a “transferrable interest” is part of a “partnership interest”, the language indicates that the former is something less than the latter.18

Earlier versions of UPA did not make clear this subtle, yet meaningful, distinction.19 The distinction is meaningful because it clarifies that the creditor has a lesser interest in partnership assets and operations than an actual partner and, as such, does not have the authority to “steer” the other partners in an undesired direction against their will. The RULPA further clarifies that a “transferable interest” is the interest a creditor can charge and not the “partnership interest”. RULPA defines a “transferrable interest” as a “partner’s rights to receive distributions” and the only interest in the partnership a partner can transfer.20 In addition to more clearly defining the charged interest as the transferable interest, RUPA and RULPA provide that charging orders are liens on this interest.21 Because charging orders can serve as a lien on the debtor’s transferrable interest in the partnership, a creditor with a charging order can foreclose on and sell the transferrable interest, but the creditor cannot foreclose on the assets of the partnership. In turn, any party who purchases the interest upon foreclosure obtains nothing more than a transferrable interest in the partnership, or the partner’s right to distributions.22 This clarification is helpful because it reinforces the idea that a creditor only has rights in the debtor’s transferrable interest, or distributions, and not the assets of the partnership.

The creditor can also essentially use judicial foreclosure as a negotiating tool to force an untimely distribution from a partnership, or similar entity, and a forfeiture of the debtor’s share of the earnings. By making judicial foreclosure an option, creditors can indirectly force the
remaining non-debtor partners or members to purchase that interest at the foreclosure sale. Judicial foreclosure seems to discredit the notion that a charging order does not grant creditors control in a flow-through entity. If a creditor can force an entity to make a distribution, it has, for all intents and purposes, exercised a measure of control over that entity. Some jurisdictions apparently view judicial foreclosure as overly aggressive and, as a result, specifically provide the charging order as the exclusive remedy under state law.\(^{23}\) However, other jurisdictions allow judicial foreclosure of a transferable interest and in these jurisdictions the charging order protection flow-through entities offer is less than that of the jurisdictions where it is not allowed.

Another aspect of RUPA that seems inconsistent with the idea of granting a creditor rights in a partner’s interest to collect on unpaid debts without allowing the creditor the ability to cause the involuntary dissolution of the partnership is found in the comments to Section 504. In section 504, the Commissioners explain that a transferable interest allows a creditor possessing this interest to “seek judicial liquidation of the partnership.”\(^{24}\) Similarly, ULLCA’s creditors’ rights section, partially defines “distributional interest” as the right to “seek judicial liquidation of the company.”\(^{25}\) However, the Revised Uniform Limited Liability Company Act (“RULLCA”) removed this language from its text\(^{26}\) perhaps because the very notion of granting a creditor the ability to liquidate a partnership or LLC seems to invalidate the purpose of restricting creditor remedies against such entities to charging order in the first place.

Like the RULLCA, the RULPA does not include language that would grant a creditor the right to seek judicial liquidation via a charging order.\(^{27}\) Moreover, the comments to RULPA’s creditors’ rights urge creditors to collect debtor partners’ outside liabilities without “interference in the management and activities of the limited partnership.”\(^{28}\) On a side note, the Commissioners have drafted for approval Limited Liability Partnership Act Amendments
(“LLPAA”) for the UPA which also excludes the option of judicial liquidations.\textsuperscript{29} These proposed amendments treat charging orders similar to RULLCA and RULPA in that they do not afford creditors of limited liability partners the right to seek judicial liquidation of the partnership in an effort to satisfy a partner debtor’s outside liability.\textsuperscript{30} The remaining language in the LLPAA is substantially the same as in the other Acts as there are no major deviations from the core principles.\textsuperscript{31} Thus, while the RULLCA, RULPA, and LLPAA seem to treat the charging order in a manner consistent with with \textit{delectus personae}, the RUPA has not made similar revisions, which suggests that general partnerships may not have the same degree of charging order protection as LLCs, LPs, and LLPs in jurisdictions that have adopted the model Acts.\textsuperscript{32}

The revisions and amendments made to the model Acts since their inception help define the application and the scope of the charging order. The model Acts make clearer the following concepts: (1) a transferable interest is only a right to receive distributions from the partnership or LLC and is something less than a partnership interest, which is consistent with the idea that partners or LLC members should not be forced to dissolve their entities because of a debtor-partner’s or member’s unpaid personal debts or do business with creditors of a debtor-partner or member (except under the UPA where a transferable interest grants a right to seek judicial liquidation of the partnership); (2) the charging order is meant to be a lien on a partner’s or member’s transferable interest in the entity that can be foreclosed on and sold; and (3) charging orders are the exclusive remedy available by which creditors may pursue partner or membership interests, although judicial liquidation could be considered a separate remedy.

While it is helpful to review the model Acts to better understand the charging order and its application to partnerships and LLCs, it is important to remember the Acts have not been adopted in their entirety, or even partially, in every state.\textsuperscript{33} Thus, while the Commissioners have
attempted to create uniform law regarding charging orders, each state’s laws differ with respect
to the scope and application of the charging order. Nonetheless, because the charging order
emerged from the UPA and has since made its way through the refining fire of the other model
Acts and their revisions, looking to these sources and their development of the charging order
may prove useful in understanding its application in a given jurisdiction.

III. Procedural Aspects of Charging Orders

   Obtaining and Applying a Charging Order

   Generally, to obtain a charging order, a creditor must first receive a judgment against
the debtor to proceed as a judgment creditor. A judgment creditor then submits an application to
a court of competent jurisdiction for a charging order against the judgment debtor’s interest in
the LLC to satisfy the unpaid debt. Once issued, the charging order remains in place until the
debt is fully paid. As noted above, the ULLCA provides that a charging order “constitutes a lien
on the judgment debtor’s transferable interest”\(^3\) meaning that, as a lien, the court can order
foreclosure on the transferable interest. In jurisdictions adopting the ULLCA or allowing
foreclosure on the transferable interest, LLC members may be forced to purchase the interest at a
judicial sale. However, in jurisdictions that limit a creditor’s remedies to a charging order, and
thus, exclude the possibility of foreclosure, the creditor is not able to force the LLC to make
distributions or cause the involuntary dissolution of the entity.

   Charging Orders as the Exclusive Remedy

   How a charging order is obtained and applied depends on whether the jurisdiction in
which the charging order is sought treats the charging order as the exclusive remedy for creditors
seeking to recover unpaid debts through an LLC member’s interest in the entity. The ULLCA
makes the charging order and judicial foreclosure of the charging order the exclusive remedies

for persons seeking to enforce a judgment against a member or partner. Some states do not follow the ULLCA and provide the charging order alone as the exclusive remedy for creditors of LLC members. However, other states, both implicitly and explicitly, do not limit a judgment creditor’s remedy against LLC members to charging orders.

Nevada is a jurisdiction that recently amended its LLC statute to clarify that a charging order is the exclusive remedy for creditors seeking recourse against a member’s interest in an LLC. The legislative history for the amendment indicates that the legislature specifically intended to preclude creditors from being able to foreclose on an LLC’s assets. Georgia, on the other hand, does not limit the remedies available to creditors of LLC members by stating that the charging orders “shall not be deemed exclusive.” In jurisdictions similar to Nevada, where charging orders are the exclusive remedy for creditors of LLC members, the laws are more favorable to those seeking to form an entity that offers charging order protection because, among other reasons, the LLC members are not faced with the issue of purchasing an interest in their entity at a foreclosure sale.

V. Aspects of Charging Order Protection

Withhold Distributions

Typically, in jurisdictions where charging orders are the exclusive remedy, a creditor is only entitled to the debtor’s distributional interest in his LLC membership interest. In other words, the creditor can essentially use the charging order as a garnishment on distributions from the LLC to the judgment debtor, but cannot participate in managerial decisions. Due to a judgment creditor’s inability to participate in management, creditors are unable to force the other LLC members to make distributions for the purpose of satisfying the judgment debtor’s outstanding debt. Furthermore, the LLC is not obligated to make distributions and, thus, can
retain its earnings for reinvestment. Accordingly, so long as the LLC allows accumulation of earnings, its members can decide to withhold distributions from the debtor member and possibly leave the judgment creditor helplessly waiting for an indefinite period of time.

Unfortunately, withholding distributions from a judgment creditor acting as an assignee of the judgment debtor’s distributional interest usually means the other LLC members do not receive their share of the LLC profits. Until the debtor-member is willing to satisfy the original debt or otherwise negotiate and pay a settlement amount, the charging order can potentially remain in place forever, meaning neither the LLC members, nor the creditor, receive anything from the LLC. However, as discussed in more detail below, planning opportunities exist that help to prevent the “freezing” of the assets held in the LLC without sacrificing the charging order protection the LLC offers. Still, the ability to keep LLC assets from falling into the hands of creditors by withholding the debtor’s distributions is a strategy that weakens the value of a charging order and provides the debtor significant leverage in negotiating a discounted settlement amount of the unsatisfied debt.

K.O.’d by the K1

In addition to their ability to withhold distributions, another way LLC members derive protection from a charging order is through a theory known as the “K.O.’d by the K-1” theory. The “K.O.’d by the K-1” theory posits that whenever a judgment creditor obtains a charging order against an LLC member, the creditor, as an assignee, can be taxed on the debtor’s distributional share of the income generated by the LLC even if the LLC does not distribute the income. Accordingly, the phantom tax the creditor incurs provides LLC members with increased charging order protection as it is unlikely that a creditor would want to bear the tax burden of a debtor’s undistributed income.
However, commentators, academics, and practitioners alike disagree on whether the concept of “K.O.’d by the K-1” legitimately applies to charging orders in the context of an LLC and its members. Those who subscribe to the “K.O.’d by the K-1” theory generally rely on Rev. Rul. 77-137 and Evans v. Commissioner to support their position. Rev. Rul. 77-137 dealt with a limited partner assigning his interest in a limited partnership (“LP”) to a separate person not already a partner in the LP. The partnership agreement provided that a partner could “assign irrevocably to another the right to share in the profits and losses of the partnership and to receive all distributions … to which the partner would have been entitled.” The court held that, as a result of the assignment, the assignee had acquired “substantially all of the dominion and control” over the partnership interest. As such, the assignee was treated as a substituted partner for income tax purposes and required to report the distributive share of partnership items of income, gain, loss, deduction, and credit attributable to the assignor partner’s interest in the LP on his individual K-1.

In Evans, a partner assigned his interest in a partnership to a corporation in which he was the sole stockholder. The assignment of the partnership interest entitled the corporation to receive one-half of the partnership’s profits and losses. The tax court below held that the assignment effectively transferred an obligation to pay tax on the partnership income from the assignor partner’s distributive interest in the partnership. On appeal, the Seventh Circuit affirmed the tax court’s ruling stating that the transfer of the partnership interest ended the partnership between the appellant and his former partner for tax purposes, but created a new partnership between the corporation and the former partner. As such, the court held that the corporation was a partner for federal tax purposes and any income from the partnership was attributable to the corporation. Thus, proponents of the “K.O.’d by the K-1” theory argue that,
similar to Rev. Rul. 77-137 and *Evans*, an assignment or transfer of an LLC member’s distributional interest will result in an assignee having to recognize income from the LLC for tax purposes due to his deemed right to the income. 57

Those who do not agree with the “K.O.’d by the K-1” theory argue that the theory is limited in its scope and should not be paraded about as having universal application. 58 For instance, opponents argue that the plain language of Rev. Rul. 77-137 distinguishes itself from charging orders in the context of LLCs as it specifically states that the assignee had acquired substantial “dominion and control” over the limited partnership interest. 59 Charging orders, however, only grant judgment creditors an economic interest in the LLC member’s distributional interest which is certainly something less than “dominion and control of the interest.” 60 As such, it is arguable that Rev. Rul. 77-137 does not apply to a judgment creditor possessing a charging order for an LLC member’s distributional interest due to the creditor’s lack of acquiring a controlling interest in the LLC.

Similarly, in *Evans* the court determined the petitioner had made a transfer of his “entire partnership interest” in both income and capital. 61 As such, the petitioner was not liable for taxes on the partnership interest because he did not transfer “less than [his] entire interest.” 62 The court established that an assignment of income only, and not equity, is something less than an assignor’s interest and, as a result, is not taxable to the assignee. 63 Likewise, a charging order also only grants an interest in the member’s distributional share of income and not an equitable interest. Accordingly, the judgment creditor’s interest is less than an entire interest in the LLC and, thus, is not taxable to him as the assignee. Moreover, others have argued that holding creditors liable for undistributed profits creates complicated issues of possibly requiring debtor’s
to recognize income from “forgiven” debt and whether a return of capital should even be taxed in
the first place. 64

Clearly, the merits of the “K.O.’d by the K-1” theory and its relation to charging orders
against LLC members are debatable. Because courts have not specifically addressed the theory
as it would apply to LLCs, its specific application to an LLC remains unsettled. The fact that the
court has not established a bright-line standard in this area only strengthens an LLC’s degree of
charging order protection due to the possibility that it may indeed be a valid legal theory. Thus,
so long as it is questionable as to whether the “K.O.’d by the K-1” theory applies to charging
orders against LLCs, the possibility that a creditor may be held liable for a debtor’s undistributed
earnings coupled with the possibility of litigation, provide the innocent LLC members with an
increased degree of wealth preservation and bargaining control.

IV. Planning Opportunities for Charging Order Protected Entities

Based on an LLC’s ability to shield its assets from its members’ creditors, significant
opportunity exists for wealth preservation planning. When planning for an LLC holding
valuable assets, the use of multiple LLCs can provide additional protection for those assets by
serving as additional layers of wealth preservation. The use of multiple LLCs also increases the
LLC members’ ability to control distributions to themselves. To achieve increased protection
and control, each LLC members must create an individual subsidiary LLC to serve as a member
of the operating LLC. Each individual with a vested interest in the operating LLC would be the
sole member of his or her respective subsidiary LLC.

Under this structure, the operating LLC is able to make distributions intended for the
individuals to each subsidiary LLC without interference from creditors bearing charging orders.
The creditors would not be able to interfere with the distributions because they can only use
charging orders against a debtor’s interest in the LLC and the entities receiving the distributions, the subsidiary LLCs, are not debtors. Upon receiving distributions from the operating LLC, the individual members of the subsidiary LLCs can then decide whether or not the LLCs will distribute the earnings further. Structuring the LLCs in this manner prevents the “locking-up” of the operating LLC’s earnings that would otherwise occur if the operating LLC opted to withhold distributions to prevent creditor interception. Moreover, this type of planning grants each member a degree of autonomy in making individual distributions. Thus, by enabling the LLCs to act independently, LLC members can not only better protect their assets, but enjoy them as well.65

Diagram 1

To illustrate, suppose Clients A, B, and C form Operational LLC in Nevada. A, B, and C would then each form single-member subsidiary LLCs (LLC Sub 1, LLC Sub 2, and LLC Sub 3) to operate as members of Operational LLC. At this point, whenever Operational LLC has earning or other assets to distribute, it would distribute these earnings or assets to LLC Sub 1, LLC Sub 2, and LLC Sub 3 in accordance with its Operating Agreement. A, B, and C can then decide independent of each other whether or not to further distribute the earnings or assets via LLC Sub 1, LLC Sub 2, and LLC Sub 3.

To further illustrate, suppose A, B, and C place assets in Operational LLC for business or investment purposes and that Creditor seeks to recover unpaid debts from A through his LLC interest. Creditor may obtain a judgment in his favor against A; however, Creditor can only charge A’s interest in LLC Sub1. Thus, B and C do not have to have delay their distributions from LLC Main in an effort to protect A’s distribitional interest. Consequently, Creditor is
placed in the disadvantageous position of having to wait for an attachable distribution or negotiate a discounted settlement amount.

In summary, distributions from Operational LLC intended for Client A, Client B, and Client C are not subject to interception by creditors with charging orders whenever the distributions are made to the subsidiary LLCs instead of the individual-debtors. Thus, because Operational LLC makes the initial distributions to the Subsidiary LLCs rather than the individuals themselves, the creditor’s statutory right as an assignee to receive LLC distributions to the debtor is avoided because the creditor cannot charge an LLC’s distributional interest in another LLC for the debt of an individual-debtor.

V. Single Member LLCs

One possible weakness in the LLC’s charging order protection characteristic is the single-member LLC. In many jurisdictions it is not entirely clear whether the same charging order protections afforded to a multi-member LLC are available to a single member LLC. The reasoning is that the intent of limiting charging order remedies against LLCs to collection on a member’s distributional interest is to prevent the practical inefficiencies of non-debtor LLC members having to work with unfamiliar creditors in carrying on a business. Additionally, as mentioned above, charging orders were instituted to protect partners from the unrelated debts of other partners. As such, charging order protection purportedly exists for the benefit of the non-debtor members of an LLC and not the debtor-member. With single member LLCs, this issue does not exist as there are no other members to protect. Thus, it is possible that single member LLC exposure to charging orders extends beyond the debtor’s distributional interest.

Some jurisdictions do not draw a distinction between single and multi-member LLCs. For example, Nevada’s limited liability company statute does not differentiate between multi-
member LLCs and single member LLCs when addressing charging orders. In Nevada, and similar jurisdictions, it could likely be argued that creditors are relegated to the “rights of an assignee of the … member’s interest” regardless of whether the entity is a multi-member or single member LLC. This assertion is supported by the idea that once a person transfers assets into an LLC or the LLC generates income, these assets and earnings become the property of the LLC and not the member. As a result, the property held by an LLC may not be subject to the claims of the individual member’s creditors even if the LLC is a single member entity since the charging order is only a claim against the individual and the individual no longer had a property interest in the LLC assets. Thus, in the case of any statute similar to Nevada’s, it appears that single member LLCs may be afforded the same protection against charging orders as are multi-member LLCs. However, because this area of law is not well-defined, it may be prudent to have additional LLC members.

VI. Conclusion

In jurisdictions that provide charging orders as the exclusive remedy for creditor’s seeking recovery against a debtor’s interest in an LLC, LLC members are shielded from involuntary dissolution and having to work with a creditor-partner not of their choosing. Furthermore, when Parent and Subsidiary LLCs are used in conjunction with an Operational or Investment LLC, the non-debtor LLC members have even more protections and flexibility in circumventing the negative effects to them of the charging order. As such, the LLC offers significant wealth preservation capabilities in jurisdictions where the charging order is the exclusive remedy by empowering its members with the ability to protect their assets from the unrelated debts of fellow members and their creditors. Accordingly, businesses and investors
interested in maximizing their ability to secure the protection of their assets should consider forming LLCs in jurisdictions having favorable charging order protection laws.

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1. J. Gordon Gose, *The Charging Order Under the Uniform Partnership Act*, 28 Wash. L. Rev. & St. B.J. 1, 5 (1953) (stating in reference to the Uniform Partnership Act that “… the charging order statute is couched in most general terms” which is “[i]n contrast to statutes pertaining to more conventional enforcement proceedings such as executions, attachments, and garnishments” and that this may contribute to its ambiguity.
2. *See infra* Part II.
The remainder of this article will discuss the charging order in the context of an LLC except when addressing the origins and evolution of the charging order. Because of the similarities between LLCs and LLPs, much of what applies to the LLC in terms of the charging order also applies to the LLP.

Gose, supra note 1, at 3.

Id. at 1-3.


BLACK’S LAW DICTIONARY 459 (8th ed. 2004) (stating that *delectus personae* is “[b]ased on the principle, [that] a partner has the right to accept or reject a candidate proposed as a new partner.”). However, in *In re Ehmann*, the court held that state law and an LLC operating agreement did not prevent a bankruptcy trustee from exercising all of the powers and rights of the debtor member regardless of the other members’ interests in the entity whenever the debtor member’s interest is non-executory. The court implied that a passive interest in an LLC can be considered non-executory. In *Ehman*, because the debtor member’s interest was non-executory, the court allowed the bankruptcy trustee to disregard any state laws or provisions within the operating agreement that would prevent the transfer of the debtor’s rights. This would presumably include rights to dissolve and liquidate the partnership.

To prevent an LLC membership interest from being considered non-executory, incorporate the following: (1) the LLC should have a clearly stated purpose; (2) the members should have clear fiduciary duties to one another and to the LLC explicitly included in the operating agreement; (3) the members should have some involvement in the LLC and (4) the operating agreement should include mandatory capital call provisions. See Christopher M. Riser, *Wealth preservation Planning with Family Limited Partnerships and LLCs*, ALI-ABA Video Law Review, June 26, 2007 (citing *In re Ehmann* (Movitz v. Fiesta Investments, LLC), 310 B.R. 200 (Bank. D. Ariz. 2005)).

UNIF. P’SHIP ACT § 28 (1914). This initial version of the Act did not expressly make charging orders the exclusive remedies available to creditors. See id.

Id. at § 25.

Id. at § 28.

Id.

UNIF. P’SHIP ACT § 28 (1914); UNIF. LTD. P’SHIP ACT § 22 (1916).

Id.


See UNIF. P’SHIP ACT § 28 (1914) (stating that “[a] partner’s interest in the partnership is his share of the profits and surplus, and the same is personal property”).

Id. at § 101(9).

See UNIF. P’SHIP ACT § 28 (1914).

UNIF. LTD. P’SHIP ACT §§ 703(a) & 102(22) (2001) (stating in the comment to § 701 that it is only an economic right, thus inferring that there is no equitable right included and in the comment to § 703 that the “creditor has no say in the timing or amount of those distributions” and that the order “does not entitle the creditor to accelerate any distributions or to otherwise interfere with the management and activities of the limited partnership.”); UNIF. LTD. P’SHIP ACT § 22 (1916).

UNIF. P’SHIP ACT § 504(b) (1997); UNIF. LTD. P’SHIP ACT § 703(b) (2001).

UNIF. P’SHIP ACT § 504(b) (1997); UNIF. LTD. P’SHIP ACT § 703(b) (2001) (stating in the comment to this section that the “[f]oreclosure of a charging order effects a permanent transfer of the charged transferable interest to the purchaser [but]… does not … create any right to participate in the management and conduct of the limited partnership’s activities … [a]s [t]he purchaser obtains nothing more than the status of a transferee”.

Nevada is an example of a state that has amended its LLC and partnership statutes to exclude the possibility of foreclosure. See Nev. Rev. Stat. 86.401(2)(a). See Notes from Assembly Committee on Judiciary for Leg., 72nd Sess. (Nev. May 2003); Notes from Assembly Committee on Judiciary for Leg., 72nd Sess. (Nev. April 2003).

UNIF. P’SHIP ACT comment to § 504 (1997).

UNIF. LTD. LIAB. CO. ACT comment to § 504 (1996). The 1996 version of the ULLCA used the term distributional interest rather than transferable interest. The two terms had essentially the same meaning. See id at § 101 including comments.


This paper asserts that the intent of the charging order is to allow creditors a form of recourse when seeking to recover unpaid debts through certain flow-through or disregarded entity partner or membership interests without causing the involuntarily dissolution of those entities or the forced partnership or association of the non-debtor partners and members with the debtor-member's creditors.

See Table 1.


REVISED UNIF. P'SHIP ACT § 504 (1997); UNIF. LTD. LIAB. CO. ACT § 504 (1996).

See Table 1 for each jurisdiction’s statute that addresses charging orders and whether the charging order is the exclusive remedy of that jurisdiction.

Nev. Rev. Stat. 86.401(2)(a): [This section] provides the exclusive remedy by which a judgment creditor of a member or an assignee of a member may satisfy a judgment out of the member's interest of the judgment debtor. See S.B. 2, 2003 Leg., 20th Spec. Sess. (Nev. 2003).


See Ga. Code Ann. 14-11-504(a) and (b). Emphasis added.

See, e.g., Nev. Rev. Stat. 86.401(1); (2).

Id. at 86.351(1).

See infra. Part IV.

In bankruptcy cases, “[f]ederal law determines the extent to which a partnership interest becomes a part of the bankruptcy estate.” In other words, depending on state law and the partnership agreement, a bankruptcy trustee may take more than a distributional interest or right as an assignee in an LLP even in jurisdictions where charging orders are the exclusive remedy based on recent case law. As such, bankruptcy trustees would become owner of the debtor-partner’s equitable partnership interest which would allow ownership and management rights and the possibility of dissolution. Steve Leimberg’s Wealth preservation Planning Newsletter #89 (August 8, 2006) at http://www.leimbergservices.com (citing In re Baldwin, 2006 WL 2034217 (10th Cir. BAP, Okla., July 11, 2006); Movitz v. Fiesta Invs. (In re Ehman), 319 B.R. 200, 204 (Bankr.D.Ariz.2005), orders and opinions available at http://www.assetprotectionbook.com/AZ_Ehmann_2005.htm). Courts would likely handle cases dealing with an LLC member’s bankruptcy in a similar manner.


See Christopher M. Riser, Tax Consequences of Charging Orders: Is the K.O. by K-1 K.O.’d by the Code?, Wealth preservation J. (Winter 1999) (arguing that it is illogical to tax a judgment creditor on a judgment debtor’s share of partnership income because the authoritative rulings commonly cited to support such an assertion should be understood to be limited to their narrow facts); F. Owen Evans III and William J. Hyland, Jr., The LLC Envelope, 77 Fla. Bar J. 50 (2003) (arguing that because an assignee of partnership interest is treated as a partner for federal income tax purposes, the same logic should apply to a judgment creditor “utilizing a charging order to obtain the rights as an assignee of a member of an LLC” (citing as examples for “K.O. the K-1”: Peter Spero, Wealth preservation: Legal Planning Strategies and Forms P9.02 (Warren, Gorham, and Lament 2001); John R. Jones, Family Limited Partnerships Achieve Tax and Nontax Goals, 23 Tax’n for Law 196, 200 (1994-95); and as an example against “K.O. by the K-1”: Susan Kalintan, Assignment of an Interest in a Limited Liability Company and the Assignment of Income, 64 U. Cin. L. Rev. 443, 522-29 (1996))).

Rev. Rul. 77-137.

Evans v. Comm’r, 447 F.2d 547 (7th Cir. 1971).

Rev. Rul. 77-137.

Id.

Id.

Id.

Evans, 447 F.2d at 548.

Id.

Id. at 549.

Id. at 549-50.

Id. at 550 (citing I.R.C. §704(e)(1) and Poggetto v. United States 306 F.2d 76 (9th Cir. 1962)).

58 See Riser, *supra* note 43.


60 *Id.* (arguing that retain substantial rights in a partnership interest does not constitute the requisite dominion and control from Rev. Rul. 77-137)).

61 Evans, 447 F.2d at 549-50.

62 *Id.* at 550.

63 See *Riser, supra* note 43.


65 See *Diagram 1.*

66 See Adkisson, *supra* note 8 (citing *In re Albright*, No. 01-11367 (Colo. Bkrpt. April 4, 2003)).

67 *In re Albright*, No. 01-11367 (Colo. Bkrpt. April 4, 2003) (stating that the charging order exists “to protect other members of an LLC from having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager” and that the charging order exists to protect “the autonomy of the original members, and their ability to manage their own enterprise”).

68 See *id.*


70 *Id.*


72 *Id.* This treatise cites IRS Chief Council Advisory 199930013 which held that the “IRS may not levy on the assets of a single member LLC in order to satisfy the individual tax liability of the sole member-owner.” *Id.* The treatise adds that “[s]ince state law provided that the assets sought to be levied upon were the property of the LLC and not the individual member, the individual taxpayer member did not have a property interest in those assets that the IRS could levy upon.” *Id.* However, the IRS did not that other collection options were available. *Id.*


95 Nigri v. Lotz, 453 S.E 2d 780 (Ga. Ct. App. 1995) (noting that the prohibition in Georgia’s version of the UPA against the sale of a charged interest is inconsistent with the charging remedy promissory notes held by the limited partnership).
In re Priestley, 93 B.R. 253 (D.N.M. 1998) (memorandum opinion) (finding that a bankruptcy trustee has the authority under federal bankruptcy law to sell debtor’s interest as a general partner in profits and surplus of the limited partnership).

167 S.D. Codified Laws § 48-7-703 (Michie 2002).
168 S.D. Codified Laws § 47-34A-504 (Michie 2002).
173 Equitable Trust v. Roland, 644 S.W.2d 46 (Tex. Ct. App. 1982) (although the court did not directly rule on a judgment creditor’s ability to foreclose on a partnership interest, the court noted in a summary of facts: “The court entered a charging order … appointed a receiver of [the debtor’s] share of the profits of or any other money due [to the debtor] in respect to … partnership interests … [and] entered an order foreclosing the interest ….”).
188 Wis. Stat. §179.63 (2002-03).