The Post-Judgment Debtor Examination: Details, Details, Details (Plus Secret Liens)

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It may not be easy to find all of the right rules, but when you do, they will help lead you to the assets.

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THE GENERAL PRACTICE lawyer faces daunting procedural challenges in cases involving creditor's rights. Indeed, the procedural ins and outs of enforcing judgments give new meaning to the word arcane, and the lawyer who fails to stay on the lookout for the hidden traps in these procedures runs many a risk—to the client's pocketbook, of course, but also to that of the lawyer who fails to follow the rules.

Take, for example, the "secret lien" hidden on the back side of an ORAP—the order for appearance of judgment debtor for examination issued to a debtor, to his or her family members and business associates, and to others possessing the debtor's assets. Every good creditor's rights lawyer knows how to use secret liens to defeat the shield of bankruptcy surrounding the unwary debtor. But it is the rare generalist who, handling the occasional creditor's rights case, even knows that secret liens exist, much less that they can prove a crucial tool in enforcing judgments on behalf of a creditor client.

It should go without saying that, down the road, the last thing the generalist wants is to take a call from the same client asking why the lawyer did not make use of secret liens during a debtor examination.

But of secret liens, more anon. The point here is that rules and procedures aplenty adorn the debtor examination, and the lawyer who does not learn and follow them to the letter can cause a client to lose a chance to collect and even trigger a liability claim.

THE BALANCE OF RIGHTS • The rules and procedures do not exist out of context. Instead, they reflect a principle of equity that informs the laws governing creditor's rights at both the state and federal levels, and once the lawyer grasps this principle, it becomes easier to move a creditor's rights matter toward settlement discussions—usually the creditor's best chance to collect.

The principle is easy: Equity demands that the law strike a balance between the right of the creditor to collect and the right of the debtor to due process. The difficulty comes in applying the principle in the real world, where it gives rise to a thicket of rules and procedures often specific to the court overseeing the matter.

Not surprisingly, since the statutes governing post-judgment examinations differ from state to state, some are more specific than others as to what creditors may or may not do in pressing their claims, and some say nothing at all on key points of procedure. As a result, it is often the individual judge who decides which rules to impose on such proceedings in his or her courtroom, and what the lawyer must do to follow them. (This discussion assumes that the proceeding takes place in state court. Federal judges presiding over creditor's rights proceedings generally follow state procedural law, but they too have wide leeway in shaping how matters will proceed in their own courtrooms.) What unites all judges in all jurisdictions, however, is that they tend to be punctilious. They want the lawyer to follow specific, detailed procedures in conducting the post-judgment examination, and many find in any deviation from the rules an excuse to delay matters until the lawyer gets it right.

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Get It Right The First Time

Since this can give the debtor time to hide or dispose of an asset that might satisfy the claim, the better idea is for the lawyer to get it right in the first place and, equally important, not waste time, having erred, trying to persuade an impatient judge to pay attention to substance, not form.

How? Judges do not post their rules on the door, much less publish them in, say, a handy booklet for lawyers handling their first debtor examination. Thus the lawyer must go to the one person who knows how the judge wants things done—the clerk—and then follow the rules in every proceeding and in every detail.

THE PROCEDURE • The complexities of debtor examinations begin with the application for the ORAP, which must be properly completed if the lawyer is to make effective use of the secret lien. To the innocent eye, the obverse of the ORAP is merely where the lawyer catalogues the assets believed to be in the possession of the individual to be examined. But the law governing creditor's rights operates such that, if the examination establishes that the examinee controls an asset that may satisfy the debt, the examinee may be ordered to turn it over to the creditor or to the sheriff. Or, if the examinee has transferred the property after receiving the ORAP, the ORAP acts as a pre-existing, unrecorded—hence "secret"—lien giving the creditor a security interest in and against the asset.

ORAP Magic

There is more here than meets the eye, however. The secret lien gets its power from the fact that

its effective date is the date of service of the order to appear, not the date of the actual levy. Lawyers who specialize in creditor's rights litigation understand that this can constitute an end run around the "preference window" of bankruptcy law, under which a creditor must return any payment or security for an antecedent debt received from a debtor who files for bankruptcy within 90 days. How? Assume that an ORAP is served on March 1, that the creditor levies against an asset on March 15, and that the debtor files for bankruptcy on June 15 expecting to void the levy of March 15. But the effective date of the lien is not March 15 but March 1, the date of service, so the lien falls outside the preference window and the creditor keeps the security interest it creates.

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Service

In most cases, ORAPs may not be served on the debtor's counsel. They must be served personally on the individual to be examined, along with a subpoena duces tecum listing the documents to be produced by the examinee and specifying grounds for the examination. What is more, a mere ORAP will not suffice. Neither will a mere subpoena. The lawyer must prepare both an ORAP and a subpoena, check and double check each for content, for errors in language and even spelling, then get the judge overseeing the matter to sign both, and finally order them served personally on the individuals to be examined.

Examination

The lawyer who gets this far in navigating the procedural minefield faces even more hazards in actually conducting a debtor examination. Most judges, for example, require that the examination take place in a courthouse with a court reporter present, and most require that the lawyer copy all documents produced during the examination via an on-the-go copy service. Most also limit the questions that may be asked of the debtor during the examination; indeed, in most jurisdictions, the lawyer does not have the right to pursue any line of questioning "reasonably calculated to lead to the discovery of admissible evidence," as in other litigation. This makes the debtor examination a game of cat and mouse, the object being to learn what interests the debtor has that might satisfy the debt, including business interests generating income streams that the creditor might intercept.

The lawyer must take special care when an examinee balks at answering a question. The lawyer may ask the court to intervene, but judges handle such requests in differing ways. Many hear requests for intervention only at specific times of the day, for example, and turn away the lawyer who shows up five minutes late. Some want a reporter present, and some want to see details of the matter in writing—who the examinee is, what questions he or she refuses to answer, why they are important to the creditor's case, and so on—before deciding any request.

Turnover Orders

Similarly, judges handle turnover orders in differing ways. Properly prepared, a turnover order can require the immediate surrender to the creditor, or to the court, of an asset under the control of an examinee, including both personal and business assets. But the lawyer must seek a turnover order from the judge before concluding the examination and dismissing the debtor or risk giving the debtor an opportunity to dispose of the asset. This can prove a deadly mistake with assets such as cash, jewelry, coin or stamp collections, even automobiles—all of them mobile (if not liquid) assets, and easily disposed of. It is possible, of course, to pursue

a claim against any third party receiving such an asset, but this can eat up so much time and money as to make the pursuit pointless. And in any case, if the disposal of the asset is a bona fide exchange for value, it can become impossible to recover it.

Charging Orders

In the event that the examination reveals any interests in general or limited partnerships, including limited liability partnerships and possibly limited liability companies operating as partnerships, the lawyer must prepare and obtain a charging order to deliver the debtor's economic interests to the creditor. Properly drawn and served on the partnership, a charging order—so called because it charges the creditor's interest against that of the debtor—gives the creditor the right to receive distributions until the obligation is satisfied. The creditor's ability to collect on a charging order, of course, varies inversely with the debtor's control over the partnership. If there are many partners and the debtor has little control, the creditor stands a good chance of receiving distributions. Conversely, the creditor has a lesser chance to collect to the degree that the debtor holds power to make or withhold distributions at will.

Out-Of-State Assets

The procedure for seizing out-of-state assets discovered during the examination—for example, rents, royalties, accounts receivable, commissions, consulting or finder's fees, and the like—is more difficult unless the assets are held by an entity that has offices in the forum state. In that case, the lawyer must obtain an assignment order by preparing a motion specifying what the target asset is and who possesses it, and seeking its assignment to the creditor. Since the court has jurisdiction only within its own state, it cannot levy out of state, but it can order that payments from out-of-state sources go directly to the creditor by way of an assignment. Short of a formal effort to domesticate the judgment and pursue assets in other states, the only alternative is to ask the judge to direct the debtor to assign the asset, preferably by issuing an ex parte order so as to avoid giving the debtor further leeway to divert the asset before receiving the assignment order. As an alternative, the lawyer may ask the judge to issue an ex parte temporary protective order prohibiting transfer or encumbrance of the asset pending a hearing on the noticed motion.

Settlements

A judgment creditor's ORAP, and/or the levies that follow, often result in settlement overtures by the debtor. The lawyer must take special care in taking any offer to discount the debt in exchange for rapid payment. Secret liens aside, the preference window of bankruptcy law works against creditors by voiding payments and security agreements received from a debtor who files for bankruptcy within 90 days of any such settlement. But the preference window does not operate to void any agreement to accept a discounted payment—say, 50 cents per dollar owed—or any agreement to release the debtor from further liability. Indeed, such agreements may lock the creditor into the discount or the release, despite the fact that the creditor must give back to the bankruptcy estate the monetary consideration received within the preference window.

This is not to say, however, that the lawyer ought never to negotiate security or discount agreements, much less liability releases, to enforce the judgment. To avoid the pitfalls, the lawyer should "draft around" the preference period, taking care to protect the creditor in a bankruptcy while avoiding language that the agreement is a nullity if the debtor files for bankruptcy. (Such agreements are invalid because making the agreement void upon a bankruptcy filing violates public policy.) Instead—and this is a subtle point—the agreement might specify that the debtor must make payment now but that the critical creditor covenants in the agreement (for example, any discount or release) will not become

effective until the passage of 91 days without a bankruptcy filing by the debtor or related entities.

Continuances

Very often, a judgment creditor's ORAP results in a request for continuance. The lawyer should resist requests for continuances, of course, since delays favor the debtor seeking to hide assets, and a looming examination tends to inspire settlement discussions. But when a continuance becomes necessary, the lawyer must determine beforehand what procedures the court requires and, as in all other matters, follow the rules meticulously.

Above all the lawyer should not assume that the rules for obtaining the court's approval of a continuance are the same as those governing continuances in other matters. For example, because the law in California and elsewhere provides that only judges may continue post-judgment examinations (in some states the law is silent on this matter) many judges refuse to allow the parties to agree to a continuance by written stipulation, without appearing in open court. Instead, the parties must appear and agree to the continuance, usually with a court reporter present.

Should a judge permit a continuance by stipulation, the lawyer must take care in wording the stipulation and order. The language should specify that the debtor waives the requirement that any order of continuance be made by the judge in the debtor's presence, and that the debtor understands that, without further notice, he or she must appear for examination on the continued date as though the judge had ordered the change in open court. The debtor must sign the stipulation personally, not through counsel, and as a matter of prudence, the lawyer should insist that the signature be notarized.

The lawyer who agrees to any continuance that is questionably enforceable should appear in court on the original date and ask for a bench warrant to be issued and held for the arrest of the examinee, should he or she fail to appear for examination at the continued date. The knowledge that the judge has signed a bench warrant can prove a sobering moment and give the examinee a powerful incentive to take the matter seriously and either appear at the next examination date or settle the matter. So may the mere fact of the examination itself, especially if it threatens to air out any dirty laundry. This gives the lawyer the potential to bring matters to such a head, in part because of the natural reluctance of a debtor to part with money and in part because of the procedural hazards of the post-judgment enforcement landscape. Lawyers may argue the merits of these punctilios, but dare not overlook them if they want to obtain quality results for their clients.

CONCLUSION • Yes, the procedural challenges of creditor's rights cases can be daunting, and no, it isn't always easy to find the rules to guide you. But a fundamental concept guides things: There has to be a balance between the rights of the creditor and those of the debtor. Understood in this context, procedures, as much as they might vary, make sense.

RECAP FOR

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- Two of the most important things in creditor's rights are the ORAP and the secret lien:

__ The ORAP is the order for appearance of judgment debtor for examination issued to a debtor, to his or her family members and business associates, and to others possessing the debtor's assets. If the examination establishes that the examinee controls an asset that may satisfy the debt, the examinee may be ordered to turn it over to the creditor or to the sheriff;

__ If the examinee has already transferred the property after receiving the ORAP, the ORAP acts as a pre-existing, unrecorded—hence "secret"—lien giving the creditor a security interest in and against the asset. The effective date is the date of service of the order to appear, not the date of the actual levy, so this can constitute an end run around the "preference window" of bankruptcy law.

- In most cases, ORAPs may not be served on the debtor's counsel, but must be served personally on the individual to be examined, along with a subpoena duces tecum listing the documents to be produced and specifying grounds for the examination.
- Rules for examining witnesses vary. These can include:

__ Requirements that the examination take place in a courthouse with a court reporter present; and

__ Requirements that the lawyer copy all documents produced during the examination via an on-the-go copy service;

__ Limits on the questions that may be asked of the debtor during the examination;

__ Differing levels of judicial intervention when examinees balk at questions.

- Turnover orders can require the immediate surrender to the creditor, or to the court, of an asset under the control of an examinee, but the lawyer must seek a turnover order from the judge before concluding the examination and dismissing the debtor or risk giving the debtor an opportunity to dispose of the asset.
- If the examinee has any interests in general or limited partnerships (including limited liability partnerships and possibly limited liability companies operating as partnerships), the lawyer must prepare and obtain a charging order, which will give the creditor the right to receive distributions until the obligation is satisfied.
- A judgment creditor's ORAP, and the levies that follow, often result in settlement overtures by the debtor. To avoid pitfalls, the lawyer should "draft around" the bankruptcy preference period, taking care to protect the creditor in a bankruptcy while avoiding language that the agreement is a nullity if the debtor files for bankruptcy.