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Restructuring & Insolvency

Tax

Section 363 Sale Order Enjoining Successor Liability Claims Not Subject to Subsequent Attack by State Agencies

By Charles A. Dale III and David A. Mawhinney

A recent decision in the ongoing bankruptcy proceedings for Chrysler has reinforced the authority of a bankruptcy court to interpret its own sale orders, and where appropriate, to enforce such an order by preventing creditors from asserting successor liability and other claims against the purchaser. This decision sends a highly reassuring message to strategic and financial investors who are considering the acquisition of a financially troubled company through a bankruptcy sale process.

Background

On April 30, 2009, Chrysler LLC and several affiliates ("Old Chrysler") filed for relief under chapter 11 of the Bankruptcy Code[1] in the United States Bankruptcy Court for the Southern District of New York.[2] A month later, the bankruptcy court approved the sale of substantially all of Old Chrysler's assets to NewCarco LLC ("New Chrysler") free and clear of claims and interests.[3] Despite clear language in the bankruptcy court's sale order authorizing the sale of Chrysler's assets free and clear of all "interests," and further enjoining the pursuit of successor liability claims by Chrysler's creditors, the States of Illinois, Indiana, and Michigan assessed unemployment taxes against the New Chrysler using pre-bankruptcy unemployment experience ratings for Old Chrysler. In effect, these state agencies treated New Chrysler as a mere successor of Old Chrysler. As a result, New Chrysler was forced to pay an additional $50 million to state unemployment funds between 2009 and 2013.

Upon a motion by New Chrysler seeking relief from its unemployment tax burden, the bankruptcy court decided that the federal *Tax Injunction Act*[4] deprived it of jurisdiction to enforce the sale order against the States. On appeal, however, the United States District Court for the Southern District of New York ruled in New Chrysler's favor, holding that the States had fair notice of the automaker's bankruptcy proceedings in 2009 and that they could not now challenge the bankruptcy court's jurisdiction to enforce its own sale order. Although this decision remains subject to further appeal, it is highly significant for strategic and financial investors that may purchase a troubled company or its assets out of bankruptcy.

The Power of a "Free and Clear" Sale Order

Section 363(b) of the Bankruptcy Code allows a debtor to use, sell, or lease its property outside the ordinary course of business. With proper notice, Section 363(f) allows a debtor

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[1] 11 U.S.C. §§ 101 *et seq.*

[2] *See In re Old Carco LLC (f/k/a Chrysler LLC) et al.* ("*Old Carco I*"), 505 B.R. 151, 153 (Bankr. S.D.N.Y. 2014).

[3] *See id.*

[4] 28 U.S.C. § 1341.

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to sell its property "free and clear of any ***interest*** in such property" provided that certain conditions are met.[5] The Bankruptcy Code, however, does not define the term "interest." As a result, it has been left to the courts to decide what rights and obligations are expunged by a sale "free and clear" of "any interest." Historically, "interest" was understood to mean a property interest in the asset itself, such as a lien. As Section 363 sales became the preferred method of selling distressed businesses, the judicial interpretation of this term expanded. Several courts have ruled that Section 363(f) permits a sale free and clear of obligations connected to, or arising from, the use or operation of the property being sold.[6] This view has been accepted in several jurisdictions including the influential Second and Third Circuits. Accordingly, Section 363 sales have gained marketplace acceptance as a powerful tool that protects purchasers of distressed businesses from a wide variety of debts and obligations, including successor and product liability claims.[7] Indeed, sales under "Section 363" have become an increasingly popular vehicle for reorganizing a distressed business through a court approved auction. Debtors, creditors, and purchasers of distressed businesses tend to prefer Section 363 sales over chapter 11 plan transactions because of the speed, efficiency, and certainty they offer. Perhaps more importantly, purchasers are willing to pay market value for distressed assets because of the strength of a Section 363 sale order, deeming the acquired assets "free and clear" of any pre-existing interest in such property[8]—virtually perfect title.

Debtor Experience Rating and Successor Tax Liability

Employing an expansive notion of the "interests" that may be discharged in a Section 363 sale, bankruptcy courts have even ordered sales free and clear of criteria that governmental agencies use to assess a purchaser's post-sale tax liability, finding that such criteria are inexorably connected to the property sold.[9] In the context of unemployment insurance, for example, states commonly set an employer's unemployment tax rate to match the anticipated benefits to be paid in the coming year. States do this by looking at the employer's historical claims experience (commonly known as the "Experience Rating"). An employer's future unemployment tax obligation is, therefore, influenced by the unemployment insurance benefits historically paid to former employees during a statutory look-back period.

In 2012, the United States Bankruptcy Court for the District of Massachusetts enforced one of its prior Section 363 sale orders to prevent the Massachusetts Division of Unemployment Assistance ("DUA") from using the debtor's Experience Rating to calculate the purchaser's contribution rate to the state's unemployment contribution fund.[10] The bankruptcy court

[5] *See* 11 U.S.C. § 363(f). The conditions are (1) applicable non-bankruptcy law permits the sale of such property free and clear of such interest; (2) the holder of the interest consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) the holder of the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

[6] *See In re Chrysler, LLC*, 576 F.3d 108, 126 (2d Cir. 2009); *In re Trans World Airlines, Inc.*, ("*TWA*"), 322 F.3d 283, 289 (3rd Cir. 2003).

[7] *See United Mine Workers of America Benefit Plan v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 582 (4th Cir. 1996) (sale of coal mine free and clear of obligation to fund retiree benefit plans); *TWA*, 322 F.3d at 289-90 (sale of airline free and clear of employment-based litigation); *Chrysler*, 576 F.3d at 126 (sale of automobile business free and clear of product liability and asbestos-related claims).

[8] *See* 11 U.S.C. § 363(f).

[9] *See In re USA United Fleet Inc.*, 496 B.R. 79 (Bankr. E.D.N.Y. 2013).

[10] *See In re PBBPC, Inc.*, 467 B.R. 1, 10 (Bankr. D. Mass. 2012).

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concluded that the DUA's right to apply the debtor's Experience Rating to the purchaser was an "interest" in the purchased property within the meaning of Section 363(f), finding that the right arose "because, and only because, the buyer purchased assets of the bankruptcy estate."[11] The statute imputing the Experience Rating to the purchaser created a direct link between the contribution rate and the assets purchased.[12] The Bankruptcy Appellate Panel for the First Circuit affirmed the decision in *Mass. Dep't of Unemployment Assistance v. OPK Biotech, LLC (In re PBBPC, Inc.)*[13], concluding that "[s]ince the motivation and underlying rationale for the successor rate structure is to recover money from the purchaser of the Debtor's assets for the benefit of the state and other employers, it is an interest in the property sold."[14]

Section 363 Sale Order Not Subject to Collateral Attack

Section 363 sales, and the orders approving them, were a central feature of the reorganization of the American automobile industry in 2009, when both Old Chrysler and General Motors Corporation sold their assets to newly formed companies. Five years later, 2014 saw several significant challenges to the scope of both the Chrysler and General Motors' Section 363 sale orders.[15] In both cases, adequate notice has proved critical to whether an order issued under Section 363 shields the purchaser from liabilities of the debtor. In its recent decision in the Chrysler case, the United States District Court for the Southern District of New York fortified the strength of a Section 363 sale order where the challenging parties had adequate notice of the sale process.[16]

In the Chrysler case, the United States District Court for the Southern District of New York considered whether governmental agencies could challenge a Section 363 sale order enjoining the application of Old Chrysler's pre-bankruptcy Experience Rating to the purchaser when those agencies had notice of the sale. The sale order defined "claims and interests" to include "all claims or rights based on any successor or transferee liability."[17] In addition, the sale order enjoined the assertion of any claims against New Chrysler arising from, related to, or in any connection with the ownership, sale, or operation of Old Chrysler's assets, including "liabilities on account of any taxes arising, accruing or payable under, out of, in connection with, or in any way relating to the operation of the Purchased Assets prior to the Closing of the Sale Transaction."[18]

Following the sale, several state agencies established New Chrysler's unemployment insurance tax rate using Old Chrysler's Experience Rating.[19] As a result, between June

[11] *See id.* at 9.

[12] *See id.*

[13] 484 B.R. 860 (1st Cir. B.A.P. 2013).

[14] *See id.* at 870.

[15] In the spring of 2014, plaintiffs filed a series of class action lawsuits against the newly reorganized General Motors ("New GM") after it announced a series of product recalls for vehicles manufactured by old General Motors. Plaintiffs include those who suffered personal injury prior to the bankruptcy sale and those who suffered diminution in value, loss of use, lost wages, etc. as a result of the product defects. New GM has moved to enforce the bankruptcy sale order, pursuant to which it acquired the assets of Old GM free and clear of all non-assumed claims. The plaintiffs argue that the bankruptcy sale order does not relieve New GM of liability as to their claims because they did not receive adequate notice of the bankruptcy proceedings. *See generally*, *In re Motors Liquidation Company*, *et al.*, Case No. 09-50026 (Bankr. S.D.N.Y.).

[16] *See In re Old Carco LLC (f/k/a Chrysler LLC) ("Old Carco II")*, 2014 WL 6790781 (S.D.N.Y. Dec. 1, 2014).

[17] *See Old Carco I*, 505 B.R. at 153.

[18] *See id.* at 154.

[19] *See id.* at 155.

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2009 and June 2013, New Chrysler paid over $50 million in taxes more than it would have paid if it had been treated as a new employer rather than the successor to Old Chrysler.[20] On October 18, 2013, New Chrysler filed a motion asking the bankruptcy court to enforce the sale order against these state agencies and to relieve it from Old Chrysler's Experience Rating.[21] New Chrysler argued that the Experience Rating was an "interest" that was cut off by the "free and clear" provision in the sale order, and that the order enjoined the state unemployment agencies from treating it as the successor to Old Chrysler under state law.[22] The bankruptcy court denied the motion, finding that the *Tax Injunction Act*, which prohibits federal courts from enjoining the collection of taxes under state law, deprived it of jurisdiction to decide the motion.[23]

On appeal to the district court, New Chrysler argued that the bankruptcy court failed to account for the fact that each state agency in question had adequate notice of Chrysler's sale motion and declined to challenge the court's jurisdiction at that time.[24] The district court agreed, relying heavily on the Supreme Court's decision in *Travelers Indemnity Co. v. Bailey*[25] for the proposition that subject matter jurisdiction may not be collaterally attacked or questioned after the fact by a party that had adequate notice of the prior proceeding. The district court noted that the sale order was a final order, which precluded subsequent challenge to the bankruptcy court's jurisdiction over the matter.[26] Furthermore, the bankruptcy court expressly retained jurisdiction to clarify and enforce the terms of the sale order.[27] Invoking the *Tax Injunction Act* to prevent the bankruptcy court from enforcing its sale order was "plainly" an attack on the jurisdiction of the bankruptcy court to clarify its sale order and to enter that order in the first place.[28]

In this case, the state agencies involved were creditors in the bankruptcy proceeding and received actual notice of Chrysler's sale motion.[29] Accordingly, the district court held that having had a fair opportunity to challenge the bankruptcy court's jurisdiction, and having failed to do so, the state unemployment agencies were estopped from resisting enforcement of the sale order.[30] It is important to note that the district court's decision was limited to the question of bankruptcy court jurisdiction to decide whether New Chrysler acquired the business free and clear of Old Chrysler's Experience Rating. The dispute will now return to the bankruptcy court for resolution of this issue.

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[20] *See id.*

[21] *See id.* at 158.

[22] *See id.*

[23] *See Old Carco I*, 505 B.R. at 159. Moreover, the bankruptcy court held that the Act deprived it of subject matter jurisdiction to decide New Chrysler's motion. *See id.* at 162 ("If the States are procedurally barred from arguing their positions because they failed to raise their jurisdictional arguments at the time of the Sale Motion or object to the proposed order, Chrysler can raise this argument in the state administrative or judicial process to the extent Chrysler is not procedurally barred from doing so. But the merit of Chrysler's argument does not affect the Court's conclusion that it lacks Jurisdiction to entertain it.").

[24] *See Old Carco II*, 2014 WL 6790781, at *1 (S.D.N.Y. Dec. 1, 2014).

[25] 557 U.S. 137 (2009).

[26] *See Old Carco II,* 2014 WL 6790781, at *3.

[27] *See id.*

[28] *See id.*

[29] *See id.*

[30] *See id.* at *4.

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The district court's decision in *Old Carco* reinforces the power of the Section 363 sale process where proper notice is given—particularly to creditors and governmental units that have ongoing dealings with or oversight of the "reorganized" business.

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Legal Insight

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The Limited Liability Company and the Bankruptcy Code

By David A. Murdoch

This K&L Gates *Legal Insight* highlights certain potential bankruptcy and insolvency issues that clients and legal practitioners should take into account when forming a limited liability company ("LLC") under state law. These issues affect the drafting of key provisions in an LLC operating agreement to set forth management and ownership rights and remedies and to identify what the parties intend if insolvency arises or a bankruptcy is filed for the LLC or one or more of its members.[1]

Despite statutory certainty with respect to the formation and operation of LLCs in the fifty states and the District of Columbia and notwithstanding the contractual flexibility available and permitted in operating agreements that govern the membership interests of LLCs, the risks of insolvency, bankruptcy and dissolution of LLCs remain undefined in the United States Bankruptcy Code, 11 U.S.C. §§ 101 - 1532 (the "Bankruptcy Code"). Indeed, the Bankruptcy Code neither defines LLCs nor adequately addresses critical issues that affect the rights, liabilities and remedies of LLCs, their members, creditors or third parties-in-interest in critical Chapter 11 reorganization cases or Chapter 7 liquidations.

This lack of clarity in federal bankruptcy law increases business risks for owners, investors and managers of LLCs when business adversity threatens. The extent to which future ambiguities are not addressed in the operating agreement affects the ultimate resolution of matters relating to insolvency, bankruptcy and dissolution. It leaves far too much to expensive litigation, trials and judicial decision.

Owners and managers of LLCs should not rely solely on state law provisions that, in effect, dissolve the LLC in the event of a bankruptcy filing. Legal counsel can exercise contractual freedoms in operating agreements that are well crafted and otherwise enforceable under state laws governing LLCs.

Nevertheless, debtors and trustees in bankruptcy can reject operating agreements no matter how well drafted or intended. Balancing between certainty in state law and clearly drafted contracts, on the one hand, and legal ambiguity in federal law, on the other hand, is essential for good corporate management and ownership in the LLC context, especially if bankruptcy occurs.

[1] For convenience, this K&L Gates *Legal Insight* refers to the operating agreement (herein the "operating agreement") as the primary instrument that affects the formation of an LLC and the handling of potential insolvency issues, although there are other related documents that deal with the formation, registration and governance of an LLC.

The Limited Liability Company and the Bankruptcy Code

Key Issues

I. The Rights and Obligations of the Non-Bankrupt Member to Operate the LLC Following Bankruptcy of a Member

The paramount issue for a non-bankrupt member of an LLC following the bankruptcy of another member is whether the non-bankrupt member has the right or the obligation to operate or to wind up and dissolve the LLC.

The operating agreement for an LLC may provide that "any remaining member(s) shall have the right to continue the LLC upon the bankruptcy of a member or occurrence of any other event which terminates the continued membership of a member in the LLC." State law governing the LLC should be examined to see if it also has a provision that the LLC will be dissolved in certain events, including the bankruptcy of a member.[2] In certain circumstances, however, the Bankruptcy Code may invalidate these so-called *ipso facto* provisions in operating agreements that terminate the LLC upon occasion of bankruptcy. *See* Bankruptcy Code § 365(e)(1).[3]

Thus the operating agreement, state law governing the LLC, and the Bankruptcy Code's provisions dealing with the invalidity of *ipso facto* termination clauses in an agreement, determine whether a non-bankrupt party should proceed, with or without bankruptcy court approval, in the operation or dissolution of an LLC following the bankruptcy of another member.

II. Assignability of Interest in an LLC

An operating agreement normally provides for the financial and membership interests of the member of the LLC. The financial interests include the right to share in any income, gain, loss, or expense in accordance with the agreement's sharing provisions. By comparison, the membership interests include the power and right to appoint managers who make decisions of importance as defined in the operating agreement.

In bankruptcy, the financial interests of members are usually assignable, but the membership interests are not. Thus the bankrupt member or its trustee may assign the financial interest to a third party without the consent of the non-bankrupt member. But the same bankrupt member or its trustee would not be able to assign the membership interest, in most cases, without the consent of the non-bankrupt member. Both the governing instruments and state law governing the LLC should be examined to assure this result.[4]

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[2] *E.g.*, *compare* Delaware Limited Liability Company Act, Title 6, Chapter 18, § 18-304, "Events of Bankruptcy," and § 18-801, "Dissolution" (stating that absent an LLC agreement to the contrary, the bankruptcy or dissolution of any member does not cause the LLC to be dissolved or its affairs to be wound up, but the LLC shall be continued without dissolution), *with* Pennsylvania's Limited Liability Company Law of 1994, Title 15, Chapter 89, § 8971, "Dissolution," subsection (a)(4) (An LLC is dissolved and its affairs wound up upon the happening of certain named events, including bankruptcy of a member that terminates the continued membership of the member in the LLC, "….unless the business of the company is continued by the consent of all the remaining members given within 90 days following such event or under a right to do so stated in the operating agreement.").

[3] An "*ipso facto* provision" in a bankruptcy context refers to a term in an agreement that contemplates the termination or modification of the agreement, or of any right or obligation under the agreement, conditioned on (A) the insolvency or financial condition of the bankrupt party to the agreement; (B) the commencement of a bankruptcy or reorganization case under the Bankruptcy Code; or (C) the appointment or taking possession by a trustee in a case under the Bankruptcy Code or by a custodian before the commencement of such case. Bankruptcy Code § 365(e)(1)(A), (B) or (C).

[4] *See, e.g.,* Delaware Limited Liability Company Act, Title 6, Chapter 18, §§ 18-701-705, "Assignment of Limited Liability Company Interests," and Pennsylvania's Limited Liability Company Law of 1994, Title 15, Chapter 89, § 8924, "Limited Transferability of Membership Interest," and § 8948, "Dissociation of Member Limited" (An operating agreement may

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III. Executory Contracts and Ipso Facto Provisions

Bankruptcy Code § 365(b)(1) contemplates that a debtor in possession or a trustee may not assume an executory contract that is in default unless it or he, at the time of assumption, cures such default or provides adequate assurance of such prompt cure. Nevertheless, Bankruptcy Code § 365(b)(2) provides exceptions to this rule, including an exception that the debtor in possession or trustee need not cure the default if the breach refers to a provision in the executory contract relating to "…the insolvency or financial condition of the debtor at any time before the closing of the case;…" or "the commencement of a case under this title." 11 U.S.C. § 365(b)(2)(A) or (B).

Notwithstanding the foregoing, Bankruptcy Code §§ 365(e)(1) and 365(c)(1)(A) and (B) also need to be reviewed to ascertain whether an exception to the anti-*ipso facto* provision applies, e.g., where applicable non-bankruptcy law excuses a party from accepting performance on the contract from a party other than the debtor. An LLC operating agreement is "executory" where performance remains due or obligations are outstanding on the part of both parties to the contract. Such a contract may not be assignable as a matter of law, which, in turn, may establish an exception to the anti-*ipso facto* provision. Thus termination of executory contract rights would not violate the Bankruptcy Code provision that prohibits termination of the contract solely because of the bankruptcy of one of the parties.

IV. Authority for Bankruptcy Filing

Operating agreements sometimes attempt to restrict the filing of a bankruptcy either by the LLC itself or by one of its members. For example, a provision might state that a member or the LLC itself "…will not commence bankruptcy or insolvency proceedings; or consent to the commencement of bankruptcy or insolvency proceedings against the LLC or a member thereof; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy or insolvency." In this situation, an evaluation must be made whether such a provision would be deemed unenforceable and void as a matter of public policy. *Compare In re Huang,* 275 F.3d 1173 (9th Cir. 2002), *with In re DB Capital Holdings LLC,* 463 B.R. 142 (10th Cir. B.A.P. 2010).

The scrivener for an LLC operating agreement should attempt to assure that any such provision attempting to restrict or prohibit a bankruptcy is enforceable under non-bankruptcy law and as a matter of public policy. The scrivener should also determine if alternative provisions, such as restrictions on bankruptcy filing imposed on the LLC or its members, are enforceable or subject to risk of non-enforcement under certain circumstances. Both client and counsel need to discuss this analysis. Finally, such provisions may be binding on members but not controlling of unsecured creditors who commence an involuntary bankruptcy under Bankruptcy Code § 303. *See In re DB Capital Holdings LLC*, No. 10-cv-03031, 2011 WL 3236169 (D. Colo. July 28, 2011).

V. An LLC or LLC Member Bankruptcy Creates Property of the Estate

Although the Bankruptcy Code does not yet define an LLC, Bankruptcy Code § 541 broadly defines what constitutes property of a debtor to include "all legal or equitable interests of the debtor in property as of the…commencement of the case." This provision extends to all property "…wherever located and by whomever held…"

Bankruptcy Code § 541(c)(1) covers attempts to exclude property from the estate of a debtor. It provides that an "interest" of the debtor becomes property of the estate "…notwithstanding any

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restrict a member's right voluntarily to dissociate from the LLC or to assign his/her membership interest prior to the dissolution and winding up of the LLC.).

provision in an agreement, transfer instrument or applicable non-bankruptcy law…that is conditioned on the insolvency or financial condition of the debtor."

Thus language in the operating agreement or under applicable state law may be held unenforceable or invalid as "*ipso facto* clauses."[5] Accordingly, bankruptcy courts might hold that both the LLC member's financial rights and its voting and management rights become property of the estate within the jurisdiction of the bankruptcy court. *See, e.g., In re Dixie Management & Inv. Ltd. Partners,* 474 B.R. 698, 700-01 (Bankr. W.D. Ark. 2011).

This analysis, in turn, raises the question whether a bankruptcy trustee of the estate or the debtor in possession of the estate can realize liquidation value on the economic, voting or management rights of the LLC or its bankrupt LLC member by sale or transfer to a third party. Courts are reluctant to assign or sell voting and management rights of a bankrupt LLC membership because other non-bankrupt members may not wish to have a new member who has obtained such rights by purchase out of bankruptcy and without consent of the non-bankrupt member(s).

Although the Bankruptcy Code permits a debtor or trustee to assume and transfer or assign an executory contract, despite a clause prohibiting such transfers or assignments, the Code also limits such authority if "applicable law excuses a party, other than the debtor, to such contract…from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract…prohibits or restricts assignment of rights or delegation of duties." Bankruptcy Code § 365(c)(1)(A). Some bankruptcy courts have expanded the interpretation of this provision to include LLC operating agreements because their membership provisions are personal in nature and should not be transferred and assigned against the wishes or consent of the non-bankrupt member(s). Non-bankrupt members should be entitled to select those with whom they wish to do business and not have an "assignee" of a bankrupt member forced upon them.[6]

In light of this analysis, many scriveners of LLC operating agreements bifurcate assignment rights that might permit transfer of the economic or financial interests of the LLC member, but prohibit such assignments or transfers of voting and management rights without the consent of the non-bankrupt party or parties to the LLC. *See, e.g., In re IT Group Inc.,* 302 B.R. 483 (D. Del. 2003).

VI. Interpretation of Operating Agreements in LLC Bankruptcies: Selected Provisions

A. Insiders, Preferences and Other Voidable Transfers

The Bankruptcy Code does not define or provide express examples of which entities associated with an LLC are "insiders," but it does address these issues for corporations and partnerships. *See* Bankruptcy Code §§ 101(31)(B) and (C). The Bankruptcy Code's silence relating to LLCs increases litigation risk and heightens the possibilities of unnecessary inconsistencies in bankruptcy court decisions. This issue is important because a transfer to an "insider" typically extends the time of recovery, for example, of voidable preferences, from ninety days to one year. *See* Bankruptcy Code § 547. Relatives, directors, officers, persons in control of the debtor, general partners and other persons named in Bankruptcy Code § 101 know they may be, or be deemed to be, "insider" transferees of

[5] *See, e.g.,* UNIFORM LIMITED LIABILITY COMPANY ACT ("ULLCA") § 601 (attempting to dissociate a membership interest in the event of bankruptcy). As noted in footnote 3, *supra, ipso facto* clauses in an agreement are not effective because they are triggered by the insolvency or financial condition of the debtor at any time before the closing of a bankruptcy case or by the commencement of a bankruptcy filing itself.

[6] *See also* Bankruptcy Code §§ 365(e)(1) and 365(f)(1).

corporations or partnerships who can be required to disgorge property transferred by the debtor corporation or partnership to them for a significant period prior to the filing of the bankruptcy. This is usually one year for preferences and two to four years for fraudulent transfers.

In the case of LLCs, however, a member of a multi-member LLC cannot know whether it will be deemed to be an "insider," and would likely contest such designation, if it did not fall within the other definitions, particularly the requirement of being in control of a debtor. Without statutory guidance, courts have attempted to provide so-called non-statutory analyses of what constitutes an "insider" for purposes of an LLC or LLC member bankruptcy. These analyses have usually relied upon comparisons to the statutory provisions for corporations or partnerships and depend upon whether the relationships rise to the level of "control" or are "similar" or "close" in nature to the corporate and partnership relationships.

Thus the scrivener for the LLC operating agreement and his or her client should determine whether to define who in the LLC is "in control" or who is a member manager or a non-member manager with powers, authority and information like a director or officer in a corporation or a general partner in a partnership. Absent such definition, the ultimate decision will be left to the courts, whose decisions may be inconsistent. Paying attention to which jurisdiction is involved would also bear upon what the operating agreement might say in this regard if it is not intended to "override" state law such as the ULLCA. *Compare In re Longview Aluminum, LLC,* 657 F.3d 507, 509-10 (7th Cir. 2011) (applying a "similarity approach"), *with Butler v. David Shaw Inc.,* 72 F.3d 437, 443 (4th Cir. 1996) (applying a "control" approach), and *In re Winstar Commc'n Inc.,* 554 F.3d 382, 396-97 (3d Cir. 2009) (applying a "closeness" approach).

B. Rights of First Refusal

Operating agreements may provide rights of first refusal to non-selling members of the LLC when a member receives an offer for purchase of any or all of its interest in the LLC at a price and under terms and conditions acceptable to the member who wishes to sell. Under a right of first refusal, the non-selling member would have the right to purchase the selling member's interest on the same terms and conditions as are set forth in the third party's offer. An operating agreement could further provide that a non-selling member who does not elect to exercise this right may find that the third party has become a member of the LLC with all the rights and obligations of a member. Section 365(f)(1) of the Bankruptcy Code, however, permits assignment of a debtor's rights in any executory contract, notwithstanding a provision in the contract that prohibits, restricts or conditions such assignment.

Thus the question arises whether the bankrupt member will be able to sell its LLC interest to a third party or whether the non-bankrupt members will be able to exercise their rights of first refusal to obtain the bankrupt member's asset(s). A bankruptcy court could hold that a right of first refusal will be unenforceable if it may "hamper the Debtors' ability to assign the property or foreclose the estate from realizing the full value of the Debtors' interest in [t]he []LLC."[7] A bankruptcy court would also have to address whether the assignment included only financial and economic rights or whether it purported to transfer management and voting rights of the bankrupt member of the LLC.

C. Governing Law

An operating agreement ordinarily will have a governing law provision. The expected effect is that the operating agreement would incorporate applicable state law for LLCs that conform with the needs and

[7] *In re IT Group Inc.,* 302 B.R. 483, 488 (D. Del. 2003) (treating an LLC operating agreement as an executory contract for purposes of the Bankruptcy Code).

requirements of the parties. The parties would expect any omissions in the operating agreement to be governed by the provisions of state law. Any provision that differed from standard state law for LLCs would have to be examined for enforceability on the basis of the agreement of the parties "as permitted" by such state law. Thus selection of the state of formation of the LLC or of the law governing the parties requires careful analysis of differing provisions of the potentially applicable state laws.

VII. LLC Opinion Givers and Recipients

Third-party opinions may need to be rendered in connection with the transfer of an LLC or membership interest therein. Counsel required to give or to receive such a legal opinion should consult reports published by the TriBar Opinion Committee in 2006 and 2011.[8] These reports, however, do not cover bankruptcy issues discussed in this K&L Gates *Legal Insight*, so bankruptcy counsel should be consulted before rendering or receiving a third-party opinion in a transaction involving an LLC or its members, whether or not the transaction is related to, or contemplates, a bankruptcy.

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[8] TriBar Opinion Committee, *Third-Party Closing Opinions; Limited Liability Companies,* 61 BUS. LAW. 679 (2006), and *Supplemental TriBar LLC Opinion Report: Opinions on LLC Membership Interests*, 66 BUS. LAW. 1065 (2011).

Legal Insight

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First Circuit: Private Equity Sponsor Liable for Portfolio Company Pension Underfunding

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In a decision that could have significant implications for private equity investors, the United States Court of Appeals for the First Circuit has determined that a private equity fund may be liable under ERISA for an underfunded pension plan in which its bankrupt portfolio company had participated. Citing the active role played by the fund's general partner in the management of the portfolio company, the court found that the fund was not a mere investor, but rather was a "trade or business" that may be included within the portfolio company's control group for purposes of assessing withdrawal liability for the company's underfunded pension plan.

Acknowledging that a "fine line" exists between managing one's investments in a business and managing a business in which one invests, the First Circuit decided in *Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund* that a private equity fund was sufficiently involved in the affairs of a portfolio company to potentially incur liability for the company's unfunded pension obligations. However, the court directed that further proceedings be conducted to determine whether the private equity funds at issue were under common control with the portfolio company as is required to incur liability under ERISA. Given the significant potential exposure for private equity sponsors of companies with underfunded defined benefit pension plans, this case will be closely watched over the coming months.

Multiemployer Pension Plan Withdrawal Liability

The Employee Retirement Income Security Act of 1974 ("ERISA")[1] as amended by the Multiemployer Pension Plan Amendment Act of 1980 ("MPPAA"),[2] and for years before ERISA was adopted, the Taft Hartley Act, authorize the formation of a "multiemployer plan." Multiemployer plans are typically run by unions for the benefit of union members within a particular industry and bargained over with unrelated unionized employers within such industry. Multiemployer plans can become underfunded for a number of reasons, including investment experience and insufficient contributions from employers. ERISA defers recognizing employer liability for funding shortfalls in multiemployer pension plans until an employer ceases contributing to the plan, for example, by bargaining out of the plan, entering into an asset sale, or filing for bankruptcy. These events create a "withdrawal" and the withdrawing employer is assessed liability using one of the four ERISA-specified methods of determining the employer's proportionate share of the liability. In general, these methods create a fraction in which the amount of the withdrawing employer's contributions is the numerator and the aggregate of all contributing employers' contributions is the denominator. The fraction is multiplied by the amount of the pension plan's underfunding and the result is the withdrawing employer's liability.

ERISA imposes the pension liability, jointly and severally, on each trade and business that is under common control with the withdrawing employer. Thus, to impose withdrawal liability on an organization other than one directly obligated to the pension plan, two conditions must be satisfied:

[1] 29 U.S.C. §§ 1001-1461.

[2] 29 U.S.C. §§ 1381-1461.

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(i) the organization must be a "trade or business"; under (2) "common control" with the obligated entity.

The threshold issue in the *Sun Capital* case was whether the funds, individually or in the aggregate, were a "trade or business" for purposes of ERISA. ERISA does not define the phrase "trade or business". Instead, the statute defers to the Secretary of the Treasury's use of these terms in the regulations implementing the Internal Revenue Code.[3] Unfortunately, the Treasury regulations do not define "trade or business" either.

Private Equity Investor Exposure to Pension Withdrawal Liability

In 2006, several investment funds ("Sun Fund III" and "Sun Fund IV," and collectively, the "Sun Funds" or the "Funds") controlled by Sun Capital Advisors, Inc. ("Sun Capital") decided to invest in Scott Brass, Inc. ("SBI" or the "Company"), a Rhode Island based manufacturer of metal products including brass and copper coil. At the time, the Company participated in the New England Teamsters and Trucking Industry Pension Fund, a multiemployer pension plan (the "Pension Fund"). The Sun Funds invested in the Company indirectly through multiple holding companies. Mindful of the 80% test for the purpose of establishing "common control" under the ERISA/MPPAA, each Fund limited its investment in the Company; Sun Fund IV acquired 70%, and Sun Fund III acquired 30%.

Like many private equity funds, Sun Capital is not a passive investor. Rather, its business model involves purchasing struggling companies at discounted valuations, turning them around, and selling them for a profit in 2-5 years. The private placement memoranda Sun Capital circulated to its investors explained that the Sun Funds would be actively involved in the management and operation of the companies in which they invested. To this end, each Fund was owned by a limited partnership whose general partners were authorized to make decisions about hiring, terminating, and compensating agents and employees of the Sun Funds and their portfolio company investments. Each general partner formed a management company, which provided employees and consultants to the Company in exchange for consulting and management fees (paid by the Company through the holding company). In return for managing their investments, each Fund was obligated to pay the general partners a fee based on a percentage of the annual aggregate commitments to the Fund. Accordingly, Sun Capital was able to acquire the Company (through the Sun Funds) and control it (through affiliated management companies).

After acquiring SBI, the Sun Funds installed Sun Capital employees in two of the three director positions at the Company. In exchange for providing management services, the Company paid the general partner of Sun Fund IV $186,368.33, which offset the fees Sun Fund IV would otherwise be obligated to pay the general partner for managing the Funds' investment in the Company.

In 2008, as the price of copper declined, the Company began to experience severe financial difficulties. It withdrew from the Pension Fund in the fall of 2008, went out of business, and was forced into bankruptcy by its creditors. The Pension Fund assessed $4.5 million in withdrawal liability and suggested that both Sun Funds and the Company were jointly and severally liable for this amount as a single "employer." The Pension Fund argued that, under ERISA, the Sun Funds' "controlling interest" in the Company put all three under "common control." In 2010, the Sun Funds sued the Pension Fund in the United States District Court for the District of Massachusetts seeking a declaratory judgment that they were not liable for the Company's withdrawal liability.[4]

[3] 29 U.S.C. § 1301(b)(1).

[4] *See Sun Capital Partners III, LP, et al., v. New England Teamsters and Trucking Industry Pension Fund*, 2012 WL 5197117, at *1 (D. Mass. Oct. 18, 2012).

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The District Court Decision

The district court entered summary judgment for the Sun Funds finding that they were not "trades or businesses" and, therefore, not liable under ERISA/MPPAA for SBI's withdrawal liability.[5] In so holding, the court did not address the second requirement for withdrawal liability, that is whether the Funds were in "common control" with the Company.

Historically, the Supreme Court has not considered investing to be a trade or business.[6] In *Commissioner v. Groetzinger*, the Court established a two-prong test for when an activity constitutes a trade or business: (1) the primary purpose of the activity must be for income or profit; and (2) the activity must be performed with continuity and regularity.[7] The Pension Fund, however, urged the district court to follow a 2007 opinion by the PBGC Appeals Board ruling that a private equity fund, structured very much like the Sun Funds, qualified as a "trade or business" under *Groetzinger*. In its letter ruling, the PBGC developed an "investment plus" test for determining whether a private equity investor was a "trade or business." The PBGC concluded that private equity funds meet the "investment plus" criteria because they are typically involved in running the businesses they acquire.[8]

The district court declined to follow the PBGC opinion, finding it unpersuasive.[9] First, the district court noted that the Sun Funds had no employees or office space, nor did they make or sell any goods.[10] The district court analogized the Funds' stake in the Company to that of a shareholder, concluding that the size of their investments and their involvement in electing directors and officers did not make them actively involved in management of the business.[11] Since their tax returns indicated income from only capital gains and dividends, the district court found the Sun Funds' income to be purely investment-based. Furthermore, it refused to attribute the management fees of the general partners to the Funds, noting that income generated by an agent through an ancillary activity will not be imputed on the principal.[12]

Having concluded the Sun Funds were neither a trade nor a business, the district court nevertheless suggested liability may be found if the primary purpose of the decision to keep each Fund's stake in the Company under 80% was to "evade or avoid" withdrawal liability, in which case 29 U.S.C. § 1392(c) would require the court to disregard the transaction.[13] The Sun Funds conceded that one purpose of structuring their investment in SBI as a 70/30 split between them was to minimize the risk of withdrawal liability. The district court did not find, however, that this was the *principal* purpose because the Funds cited diversification of their investment portfolios and different life-cycles of the two Funds as additional purposes.[14] Moreover, the court noted that were it to ignore the Sun Funds' investment, the Funds would be entirely severed from the Company, making it logically impossible for liability to attach.

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[5] *See id.* at *10.

[6] *See Whipple v. Comm'r.*, 373 U.S. 193, 202 (1963) ("When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.").

[7] 480 U.S. 23, 35 (1987).

[8] *See Sun Capital*, 2012 WL 5197117, at *6-7.

[9] *Id.* at *8.

[10] *Id.* at *9.

[11] *Id.* at *9-10.

[12] *Id.* at *8, 10 ("The trade or business of an agent does not transfer to the principal.").

[13] *Id.* at *12.

[14] *Id.* at *16.

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The First Circuit Decision

On appeal, the First Circuit took a "very fact-specific approach" in concluding that at least one of the Funds—Sun Fund IV—was a "trade or business" for the purposes of analyzing withdrawal liability under ERISA/MPPAA.[15]

Although it agreed with the district court that the PBGC decision was not binding, the First Circuit nevertheless found persuasive and adopted the "investment plus" approach to decide whether a private equity fund is a "trade or business" under ERISA/MPPAA.[16] The First Circuit saw "no need to set forth general guidelines for what the 'plus' is," but concluded that Sun Fund IV was sufficiently involved in and derived economic benefits from the management of SBI to be more than a passive investor.[17] Not only did the Sun Funds place Sun Capital employees on the Company's board, they were able to "funnel management and consulting fees" to Sun Fund IV's general partner, which fees would offset what Sun Fund IV would otherwise owe its general partner in the form of investment fees. Accordingly, the First Circuit concluded that, unlike the taxpayers in the previous Supreme Court opinions, Sun Fund IV derived meaningful economic benefit from its control over the Company above and beyond the benefits ordinarily enjoyed by a passive investor.[18] The First Circuit could not decide whether Sun Fund III was a trade or business, however, because the record did not indicate whether it had received similar offsetting management fees.

The First Circuit rejected the argument that the Funds were not engaged in trade or business because affiliates of the Funds' general partners, and not the Funds themselves, performed management services for the Company. The First Circuit noted that the general partners were acting as agents of the Funds under the terms of the limited partnership agreement.[19] The general partner of Sun Fund IV performed management services on behalf of and for the benefit of the Sun Funds. Agency principles thus bound Sun Fund IV to the acts of its general partner, making the Fund actively involved in the management of the Company for the purposes of assessing withdrawal liability.

Finally, the First Circuit agreed with the district court that § 1392(c) could not serve as a basis to impose liability on the Sun Funds. Even if the decision to split ownership in the Company 70/30 - thereby coming under the 80% control-threshold - could be seen as an impermissible attempt to "evade or avoid" liability, the remedy called for by § 1392(c)—ignoring the transaction that created the 70/30 division—would sever the Sun Funds' relationship with the Company entirely.[20] By invoking § 1392(c), the Pension Fund was essentially asking the district court to rewrite the investment such that Sun Fund IV would have 100% control of the Company. The First Circuit noted that § 1392(c) does not authorize a court to create a "fictitious transaction" like this.[21]

Having decided that at least one of the Sun Funds operated as a "trade or business" with respect to its investment in SBI, the First Circuit directed the district court on remand to decide the status of Sun Fund III and, perhaps more importantly, determine whether the Funds were in "common control" with the Company such that they may be considered a single "employer" under the MPPAA.

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[15] *Sun Capital Partners III, LP et al. v. New England Teamsters & Trucking Induss. Pension Fund*, No. 12-2312, 2013 WL 3814984, at * 8 (1st Cir. July 24, 2013).

[16] *See id*. at *8.

[17] *See id*.

[18] *See id*. at * 13 ("The services paid for by [the Company] were the same services that the Sun Funds would otherwise have paid for themselves to implement and oversee an operating strategy at [the Company].").

[19] *See id*.

[20] *See id*. at *15.

[21] *See id*.

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Conclusion

In the wake of *Sun Capital*, courts in the First Circuit will apply the "investment plus" analysis to decide whether a private equity investor is a "trade or business" which may be liable under ERISA for a portfolio company's withdrawal liability. The First Circuit acknowledged the "fine lines" it was drawing and concluded:

> We recognize that Congress may wish to encourage investment in distressed companies by curtailing the risk to investors in such employers of acquiring ERISA withdrawal liability. If so, Congress has not been explicit, and it may prefer instead to rely on the usual pricing mechanism in the private market for assumption of risk.[22]

Many (if not most) multiemployer plans are presently underfunded due to a combination of investment performance, low discount rates used to calculate liabilities, and union bargaining tactics. In addition, with private-sector union membership declining, many multiemployer defined benefit pension plans have a smaller base of active workers from which to keep the plan funded. These pension liabilities continue as significant potential liabilities for entities that previously thought of themselves only as investors that limited their risk to the equity investment.

This case was decided specifically under the multiemployer rules of ERISA. However, the district court's determination of the "common control" question may well have ramifications for the exposure of private equity funds to liability for underfunded single employer pension plans, particularly following the bankruptcy of a portfolio company.

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[22] *See id*. at * 13.