



Limited Liability Companies and the Bankruptcy Code

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This Note highlights potential bankruptcy and insolvency issues that parties and their counsel 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 including management and ownership rights and remedies, as well as what the parties should do if an insolvency arises or a bankruptcy proceeding is initiated against the LLC or one or more of its members.

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Parties frequently choose limited liability companies (LLCs) to form new businesses. LLC growth has been explosive. In Delaware alone, 327,443 LLCs represented about 70% of the new businesses formed in calendar years 2008 through 2011. Parties forming LLCs should consider the impact of the Bankruptcy Code. This Note includes a discussion of:

- The right of the non-bankrupt member or members to operate or terminate the LLC following another member's bankruptcy.
- The assignability and sale of LLC interests in bankruptcy.
- Restrictions on the filing of a bankruptcy either by the LLC itself or by one or more of its members.
- The creation of property of the estate in LLC or LLC member bankruptcies.
- The interpretation of operating agreements in LLC bankruptcies, including matters affecting insiders, preferences and rights of first refusal (ROFR).
- LLC opinion givers and recipients.

TREATMENT OF LLCs IN BANKRUPTCY

Despite statutory certainty governing the formation and operation of LLCs and the contractual flexibility permitted in operating agreements governing the LLC and its membership interests, the risks of insolvency, bankruptcy and dissolution of LLCs remain undefined in the Bankruptcy Code. The Bankruptcy Code does not:

- Define LLCs.
- Adequately address critical issues that affect the rights, liabilities and remedies of LLCs and their:
 - members;

- creditors; or
- third parties-in-interest in critical Chapter 11 reorganization cases or Chapter 7 liquidations.

This lack of clarity increases business risks for owners, investors and managers of LLCs during threats of business adversity. The extent of unaddressed ambiguities in the operating agreement affects the ultimate resolution of matters relating to insolvency, bankruptcy and dissolution. This uncertainty, if left unaddressed, is too often resolved through expensive litigation, trials and judicial decision.

Owners and managers of LLCs should not rely solely on state law provisions that dissolve the LLC in the event of a member's bankruptcy filing. Even in those jurisdictions, the parties can contract for remedies in operating agreements that maintain the LLC in the event of a member bankruptcy (see *Operating the LLC after a Member's Bankruptcy*).

However, 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.

OPERATING THE LLC AFTER A MEMBER'S BANKRUPTCY

The key 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.

Under some state statutes, including those of Delaware and New York, an LLC is not automatically dissolved as a result of the bankruptcy of a member, unless the operating agreement so states (see *Del. LLC Act § 18-801(b)* and *N.Y. LLC Law § 701(b)*). However, some state statutes provide that the LLC is automatically dissolved in the event of the bankruptcy of a member unless the operating agreement provides otherwise (see *Pa. LLC Act of 1994 § 8971(a)(4)*). Therefore, members of LLCs formed in these states can provide in the operating agreement 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.”

Without language of this type, where state law provides for automatic dissolution, or if the operating agreement explicitly provides that the LLC dissolves on the bankruptcy of a member, the Bankruptcy Code may invalidate these *ipso facto* provisions that end the LLC on a member's bankruptcy (§ 365(e)(1), *Bankruptcy Code* and see *Termination of an LLC by a Non-bankrupt Member*). *Ipso facto* provisions, which are generally unenforceable in bankruptcy, permit an agreement to end automatically because of a party's bankruptcy, insolvency or financial condition (see *Standard Clause, Ipso Facto Clause* (<http://us.practicallaw.com/1-381-3321>)).

Therefore, the operating agreement, in addition to state law governing the LLC and the Bankruptcy Code's provisions invalidating *ipso facto* termination clauses, impacts whether a non-bankrupt party should proceed, with or without bankruptcy court approval, in the operation or dissolution of an LLC after another member's bankruptcy.

TERMINATION OF AN LLC BY A NON-BANKRUPT MEMBER

An operating agreement is executory when performance remains due or obligations are outstanding on the part of both parties to the contract (see *Practice Note, Executory Contracts and Leases: Overview: What is an Executory Contract?* (<http://us.practicallaw.com/8-381-2672>)). Section 365(b)(1) of the Bankruptcy Code states that a debtor-in-possession or a trustee may not assume an executory contract that is in default unless when making the assumption, it either cures all defaults or provides adequate assurance that all defaults will be promptly cured (§ 365(b)(1), *Bankruptcy Code*). However, the debtor or trustee need not cure the default if the breach refers to an *ipso facto* 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” (§ 365(b)(2)(A), (B), *Bankruptcy Code* and see *Practice Note, Executory Contracts and Leases: Overview: Assumption* (<http://us.practicallaw.com/8-381-2672>)). Therefore, if the breach is a bankruptcy event, neither the debtor nor the trustee has an obligation to cure this breach.

However, a debtor cannot assume or assign a contract where non-bankruptcy statutory or common law excuses the non-debtor party from accepting performance from, or delivering performance

to, an entity other than the debtor without the non-debtor's consent (such as personal service contracts, federal government contracts, and franchise, dealer and distributorship agreements) (§ 365(c)(1), *Bankruptcy Code* and see *Practice Note, Executory Contracts and Leases: Overview: Contracts Not Assignable Under Nonbankruptcy Law* (<http://us.practicallaw.com/8-381-2672>)). Therefore, an operating agreement may not be assumable or assignable as a matter of law because certain of its membership provisions are personal in nature (see *Assignability of a Bankrupt Member's Interest in an LLC*).

An exception to the general unenforceability of *ipso facto* clauses allows the non-debtor party to exercise these provisions to end unassignable contracts (§ 365(e)(2)(A), *Bankruptcy Code*). Therefore, if the operating agreement is unassignable, then non-bankrupt members may terminate it without violating the Bankruptcy Code provision that prohibits termination of the contract solely because of the bankruptcy of one of the parties.

ASSIGNABILITY OF A BANKRUPT MEMBER'S INTEREST IN AN LLC

Operating agreements normally describe the financial and governance rights associated with the membership interests in the LLC. The financial interest includes the right to share in any income, gain, loss or expense in accordance with the agreement's allocation and distribution provisions. By comparison, the membership interest's governance rights can include voting power and the power to appoint managers who make the decisions described in the operating agreement.

Under state LLC law, the financial interests of members are usually assignable in and out of bankruptcy, but the governance rights are not, unless otherwise provided in the operating agreement (see *Del. LLC Act §§ 18-702* and *Pa. LLC Act of 1994 § 8924*). Therefore, the bankrupt member or its trustee may assign the financial interest to a third party without the consent of the non-bankrupt members, assuming it complies with the transfer provisions in the operating agreement. Both the governing instruments and state law governing the LLC should be examined to assure this result (see *PLC Corporate & Securities, Standard Document, LLC Agreement: Multi-member, Manager-managed: Article X* (<http://us.practicallaw.com/3-500-9206>)). For example, under the Pennsylvania Limited Liability Company Act of 1994, an operating agreement may restrict a member's right to dissociate voluntarily from the LLC or to assign its membership interest before the dissolution and winding up of the LLC (see *Pa. LLC Act of 1994 § 8948*).

The Bankruptcy Code does not ordinarily undo the transfer provisions of the operating agreement, except where the debtor LLC or LLC member has the ability to reject the operating agreement as an executory contract (§ 365(g), *Bankruptcy Code* and see *Practice Note, Executory Contracts and Leases: Overview: Rejection* (<http://us.practicallaw.com/8-381-2672>)).

SALE OF LLC INTERESTS IN BANKRUPTCY

A bankruptcy trustee or a debtor-in-possession may sell property of the debtor's estate pursuant to section 363 of the Bankruptcy Code or pursuant to a plan of reorganization (§ 363, *Bankruptcy Code* and see *Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview* (<http://us.practicallaw.com/1-385-0115>)). Whether a bankruptcy trustee or the debtor can realize liquidation value on the economic, voting or management rights of the membership interest of the bankrupt LLC member by sale or transfer to a third party is an issue for the courts. Courts are unlikely to assign or sell voting and management rights of the bankrupt LLC member's interest because other non-bankrupt members may not wish to have a new member who has obtained those rights by purchase out of bankruptcy and without consent of the non-bankrupt members (see *Horizons A Far, LLC v. Webber (In re Soderstrom)*, 484 B.R. 874, 880 (M.D. Fla. 2013)). However, a court may do so where the bankrupt LLC member has no obligations to the LLC. In that case, the operating agreement may not be executory, thereby allowing the trustee to assume all the rights and powers held by the debtor without the limitations imposed by section 365 of the Bankruptcy Code, as such rights and powers are property of the bankruptcy estate (see *Movitz v. Fiesta Inv., LLC (In re Ehmann)*, 319 B.R. 200, 203-06 (Bankr. D. Ariz. 2005); see also § 541, *Bankruptcy Code* and *An LLC or LLC Member Bankruptcy Creates Property of the Estate*).

Although the Bankruptcy Code permits a debtor or trustee to assume and transfer or assign an executory contract, despite a clause prohibiting these transfers or assignments, it also limits this authority where non-bankruptcy statutory or common law excuses the non-debtor party from accepting performance from, or delivering performance to, an entity other than the debtor without the non-debtor's consent (§ 365(c)(1), *Bankruptcy Code* and see *Assignability of a Bankrupt Member's Interest in an LLC*). Some bankruptcy courts have expanded their interpretations of this provision to include LLC operating agreements because certain of their membership provisions are personal in nature and should not be transferred and assigned against the wishes or without the consent of the non-bankrupt members. 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 on them (§ 365(f)(1), *Bankruptcy Code*).

For these reasons, many LLC operating agreements divide assignment rights to:

- Permit transfer of the economic or financial interests of the LLC member.
- Prohibit assignments or transfers of voting and management rights without the consent of the non-bankrupt party or parties to the LLC.

(See *Northrop Grumann Technical Servs., Inc. v. Shaw Group Inc. (In re IT Group, Inc., Co.)*, 302 B.R. 483 (D. Del. 2003); *In re Weilnau*, No. 11-30467, 2012 WL 893264, at *3 (Bankr. N.D. Ohio Mar. 14, 2012) (holding that the following provisions were valid under Ohio law: "provisions of the LLC's Operating Agreement that impose restrictions relating to the sale or

assignment of membership units to third parties. The Operating Agreement restricts sales to the sale of the economic interest in the units only and, absent approval by the other LLC's members, does not permit the buyer the rights and privileges of membership in the LLC, which includes the right to participate in the management of the affairs of the LLC.")).

AUTHORITY FOR BANKRUPTCY FILING

Operating agreements sometimes attempt to restrict or prohibit the filing of a bankruptcy either by the LLC itself or by one of its members. For example, the parties might include a provision in the operating agreement stating that a member or the LLC:

"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."

The parties must evaluate whether this type of provision would be deemed unenforceable under applicable non-bankruptcy law or void as a matter of public policy of the state (compare *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173 (9th Cir. 2002) (holding this type of provision against public policy), with *In re DB Capital Holdings LLC*, 463 B.R. 142 (10th Cir. B.A.P. 2010) (holding this type of provision not against public policy).

These provisions may be binding on members but not on unsecured creditors who may commence an involuntary bankruptcy under section 303 of the Bankruptcy Code (see *Aspen HH Ventures, LLC v. G.D.B.S at Snowmass, Inc. (In re DB Capital Holdings LLC)*, No. 10-cv-03031, 2011 WL 3236169 (D. Colo. July 28, 2011) and *Practice Note, The Involuntary Bankruptcy Process* (<http://us.practicallaw.com/0-522-5462>)).

Courts tend to interpret strictly these type of restrictive provisions. For example, one court recently held that the LLC's managing member did not lack the authority to file a bankruptcy case because while the operating agreement did not give it explicit authority to do so, it was only prohibited from taking "any action to dissolve, wind-up or liquidate the [Debtor]" without the members' unanimous consent (see *In re East End Dev., LLC*, No. 812-76181, 2013 WL 1820182, at *4-6 (Bankr. E.D.N.Y. Apr. 30, 2013)).

AN LLC OR LLC MEMBER BANKRUPTCY CREATES PROPERTY OF THE ESTATE

Although the Bankruptcy Code does not define an LLC, it broadly defines property of the estate 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" (§ 541, *Bankruptcy Code*).

Section 541(c) of the Bankruptcy Code 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 provision in an agreement, transfer instrument, or applicable non-bankruptcy law . . . that is conditioned on the insolvency or financial condition of the debtor” (§ 541(c)(1)(B), *Bankruptcy Code*).

Therefore, language in the operating agreement or under applicable state law that forfeits, modifies or ends the debtor’s interest in the LLC on bankruptcy (such as section 602(7)(a) of the *Revised Uniform Limited Liability Company Act* (RULLCA), under which a member of a member-managed LLC is dissociated in the event of the member’s bankruptcy) may be held unenforceable or invalid as an *ipso facto* clause.

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 *In re Dixie Mgmt. & Inv. Ltd. Partners*, 474 B.R. 698, 700-01 (Bankr. W.D. Ark. 2011) (holding that Arkansas’s dissociation statute conflicted with section 541 of the Bankruptcy Code)).

INTERPRETATION OF OPERATING AGREEMENTS IN LLC BANKRUPTCIES

Insiders and Preferences

The Bankruptcy Code does not define or provide examples of which entities associated with LLCs are insiders, but it does address these issues for corporations and partnerships (§ 101(31)(B), (C), *Bankruptcy Code*). The Bankruptcy Code’s silence about LLCs increases litigation risk and the possibility of unnecessary inconsistencies in bankruptcy court decisions. This is important because a transfer to an insider typically extends the time of recovery of voidable preferences from 90 days to one year (§ 547, *Bankruptcy Code*). Relatives, directors, officers, persons in control of the debtor, general partners and other persons defined as insiders by the Bankruptcy Code can expect to be deemed insider transferees of corporations or partnerships who can be required to disgorge property transferred by the debtor corporation or partnership to them up to one year before the bankruptcy filing (§ 101(31), *Bankruptcy Code* and see *Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors: Insiders* (<http://us.practicallaw.com/6-381-6416>)).

For LLCs, however, a member of a multi-member LLC cannot know whether it will be deemed to be an insider, and might contest this designation if it does not qualify for another definition of “insider,” such as being in control of the debtor. Without statutory guidance, courts have attempted to provide non-statutory analyses of what an insider is for an LLC or LLC member’s bankruptcy. These analyses:

- Usually rely on comparisons to the statutory provisions for corporations or partnerships.
- Depend on whether the relationships rise to the level of “control” or are “similar” in nature to the corporate and

partnership relationships.

Parties to the LLC operating agreement must, therefore, determine whether to define who 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.

In most commercial contexts, the powers of the members and managers are explicit in the operating agreement. But without a clear definition, the ultimate decision will be left to the courts, whose decisions may be inconsistent. The jurisdiction involved may also bear on the drafting of a control definition if the parties do not intend to override state law such as the RULLCA (compare *In re Longview Aluminum, LLC*, 657 F.3d 507, 509-10 (7th Cir. 2011) and *Legal Update, Longview Aluminum: 7th Circuit Adopts Similarity Test to Treat LLC Member as Insider in Preference Action* (<http://us.practicallaw.com/8-508-1110>) (applying a similarity approach), with *Butler v. David Shaw, Inc.*, 72 F.3d 437, 443 (4th Cir. 1996) (applying a control approach), and *Schubert v. Lucent Techs. Inc. (In re Winstar Commc’ns Inc.)*, 554 F.3d 382, 396-97 (3d Cir. 2009) and *Legal Update, Third Circuit Affirms Delaware Bankruptcy Court Ruling on Vendor as Non-Statutory Insider in Preference Action* (<http://us.practicallaw.com/9-384-8581>) (applying a closeness approach)).

Rights of First Refusal

Operating agreements may provide ROFRs to non-selling members of the LLC when a member receives an offer for purchase of any or all of its interests in the LLC at a price and under terms and conditions acceptable to the member who wishes to sell. With an ROFR, the non-selling member has the right to purchase the selling member’s interest on the same terms and conditions as those set out in the third party’s offer. If the non-selling member does not exercise this right, the third-party offeror, once it completes the purchase of the selling member’s interest, becomes a member of the LLC with all the rights and obligations of a member.

The Bankruptcy Code permits assignment of a debtor’s rights in any executory contract, despite any provision in the contract that prohibits, restricts or conditions this assignment (§ 365(f), *Bankruptcy Code*). The question, therefore, arises whether the bankrupt member should be able to sell freely its LLC interest to a third party, despite the ROFR provision, or whether the non-bankrupt members should be able to exercise their ROFR to obtain the bankrupt member’s assets. A bankruptcy court could hold that an ROFR is 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 [the] . . . LLC” (*In re IT Group, Inc., Co.*, 302 B.R. at 488). 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.

For a standard ROFR clause, see *PLC Corporate & Securities*,

Standard Clauses, LLC Agreement: Right of First Refusal (<http://us.practicallaw.com/2-383-9900>).

LLC OPINION GIVERS AND RECIPIENTS

Parties may need third-party opinions for the transfer of an LLC or membership interest. Counsel required to give or receive this type of legal opinion should consult reports published by the TriBar Opinion Committee in 2006 and 2011 (see *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)). These reports, however, do not cover bankruptcy issues discussed in this Note. 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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- Fraudulent Conveyances in Bankruptcy: Overview
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- Preferential Transfers: Overview and Strategies for Lenders and Other Creditors
(<http://us.practicallaw.com/6-381-6416>)

Practice Notes

- Dissolving a Delaware LLC
(<http://us.practicallaw.com/6-522-2446>)
- LLC Agreement Commentary
(<http://us.practicallaw.com/1-381-0515>)

Standard Documents

- LLC Agreement (Multi-member, Manager-managed)
(<http://us.practicallaw.com/3-500-9206>)
- LLC Agreement (Single Member)
(<http://us.practicallaw.com/2-381-2420>)

Standard Clause

- Ipso Facto Clause
(<http://us.practicallaw.com/1-381-3321>)

Checklists

- Forming an LLC Checklist
(<http://us.practicallaw.com/2-381-1369>)
- LLC Agreement Checklist
(<http://us.practicallaw.com/0-381-1370>)

For the links to the documents referenced in this note, please visit our online version at <http://us.practicallaw.com/8-525-6082>

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