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## Bankruptcy Issues Affecting Joint Ventures

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Joint ventures (JVs), formed by two or more JV members or partners who agree to work together on a project, face unique issues in the bankruptcy context. The JV may be formed to complete a single program or project (and is dissolved thereafter), or it may be formed as an ongoing enterprise to compete for and perform on numerous programs or projects. It is likely that at some point during its lifecycle, the JV will be affected by bankruptcy-related issues. Two typical scenarios include: (1) the JV itself files for bankruptcy or (2) one or more of the JV members files for bankruptcy.

### The JV Goes Into Bankruptcy



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Although JVs have been formed to purchase assets from a bankrupt debtor, there do not appear to be many recent JV bankruptcy filings nationwide. This may be because a bankruptcy filing by the JV often requires the consent of all members. To keep it from failing, a JV member may infuse cash and resources. If failure is inevitable, the JV members might fund the orderly liquidation and winddown of the JV outside of bankruptcy. When the JV makes a strategic decision to file for bankruptcy, a threshold issue is whether a joint venture even exists. In a JV, the parties to the JV agree to form a separate legal entity so that the JV business is conducted separately from the contributing parties' core business

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purposes. Normally, the parties to the JV set forth their agreement in writing, and the rights and responsibilities of each party to the JV are established in the operative documents forming the joint venture, such as an operating agreement. Absent a written JV agreement, the courts have identified certain factors that establish the formation of a JV including: (1) the existence of a specific agreement

place of business or property in the U.S.<sup>2</sup> Section 101(41) defines "person" to include an "individual, partnership or corporation."<sup>3</sup> While the Code does not identify "limited liability company"

or "joint venture" in the definition of "person," both limited liability companies (LLCs) and JVs are generally considered to be included in the statutory definition of "person" and thus eligible to file for bankruptcy.

The authority for filing a JV debtor needs to be carefully analyzed. The JV agreement or JV operating documents may specifically identify the entity or member with authority to file bankruptcy on the JV's behalf. Absent

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between two or more persons to carry on an enterprise for-profit; (2) evidence in the agreement of the parties' intent to be JVs; (3) a contribution of property, financing, skill, knowledge or effort by each party; (4) some degree of joint control over the venture by each party; and (5) the existence of a provision for the sharing of both profits and losses.<sup>1</sup> The party asserting the JV bears the burden of proof in establishing the JV's existence.

Although there are no provisions in the Bankruptcy Code that specifically address JVs, JVs are eligible to file for bankruptcy. Section 109(a), which determines debtor eligibility, only requires that a person have a domicile,

specific provisions in the JV documents, state law generally controls. Where the JV was formed as a partnership, Bankruptcy Rule 1004 governs. Rule 1004(a) specifies that while all general partners must consent to the filing of a voluntary petition, the petition may be executed and filed on behalf of the partnership by fewer than all the general partners. Where the JV was formed as a LLC, proper authorization for the filing of a bankruptcy petition will depend on whether the LLC is managed by its members or a manager. If the LLC is member-managed and treated as a partnership under the Code, Rule 1004 controls. Otherwise, if the LLC is managed by one or more designated managers, the designated manager

<sup>1</sup> See *Brown v. Cara*, 420 F.3d 148, 159-60 (2d Cir. 2005); *Treuhald Capital Group LLC v. Cohen et al. (In re Cohen)*, Adv. Pro. No.: 08-8058-478, (Bankr. E.D.N.Y. July 20, 2010); *Dimas LLC v. Investment Grade Loans, et al. (In re Dimas LLC)*, Adversary No. 02-5453, (Bankr. N.D. Cal. July 23, 2007).

<sup>2</sup> 11 U.S.C. § 109(a).

<sup>3</sup> 11 U.S.C. § 101(41).

generally has the authority to file a bankruptcy petition.<sup>4</sup>

In cases where one JV partner files a bankruptcy petition with the consent of fewer than all the partners, the bankruptcy is deemed an involuntary filing pursuant to § 303(b)(3) of the Code, and Rule 1004 requires that: (1) the petitioning partners or other petitioners to promptly send to or serve on each general partner who is not a petitioner a copy of the petition, and (2) the clerk shall promptly issue a summons for service on each general partner who is not a petitioner.<sup>5</sup> Similar to other involuntary filings, the bankruptcy court must determine whether the alleged debtor should remain in bankruptcy.

### Single-Asset Issues

JVs are often formed to own or develop one certain parcel of real property, and the filing may be deemed a single-asset real estate case (SARE). In SARE cases, special Code provisions limit the length of the case and make it more difficult to reorganize. The Code defines SARE,<sup>6</sup> and the definition no longer includes a cap (as it did before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)), so even highly valuable pieces of real estate are subject to the SARE restrictions.

The SARE definition includes three basic elements: (1) the debtor's property constitutes a single property or project; (2) the debtor's property generates substantially all the debtor's revenue; and (3) the debtor has no business other than the operation of the real property and incidental activities. First, the courts have interpreted the phrase "single property or project" broadly to include multiple properties, so long as such properties have a common plan involving their use.<sup>7</sup> The court's broad interpretation of this language means that more real estate projects could be subject

to the SARE provisions. Second, debtors whose business activities do not generate revenue separate and apart from the sale or lease of the underlying real estate are generally considered SARE debtors.<sup>8</sup> Third, the purchase and development of land, home construction and home marketing and sales are all activities deemed by the courts to be "incidental" to the operation of real estate.<sup>9</sup>

*JVs face unique issues in the bankruptcy context, both when the JV itself files for bankruptcy and when one or more of the JV members file for bankruptcy.*

If deemed a SARE, the debtor is subject to § 362(d)(3) of the Code, which conditions the automatic stay. Under § 362(d)(3), the automatic stay terminates 90 days after the bankruptcy filing unless the debtor either files a confirmable plan of reorganization or commences monthly interest payments to its secured lenders. Generally, under § 1121(b) of the Code, a debtor has 120 days from the petition date to file a plan of reorganization and may seek extensions of up to 18 months upon a showing of cause. However, for a SARE debtor, § 362(d)(3) effectively compresses the time period to a minimum of 90 days if the debtor has not commenced monthly payments equal to the nondefault rate of interest on the secured claim of the creditor seeking relief. To avoid making interest payments, a SARE debtor could file a plan of reorganization within the 90-day timeframe but not confirm the plan until much later in the case. However, § 362(d)(3)(A) requires that any such plan have a "reasonable possibility of being confirmed within a reasonable period of time." A debtor may not present a "junk" plan to avoid the payment of interest. The plan must be confirmable.

### What to Do When a JV Member Files for Bankruptcy

A number of complicated issues arise when one of the JV members files for bankruptcy. The filing will

have a profound negative impact on the JV, so the members should include provisions and set out procedures in the JV agreement that the JV will follow in a bankruptcy. The JV members should develop a protocol for separately identifying JV property so that such property is not deemed "property of the estate" when one of the JV members files for bankruptcy. Section 541 of the Code defines "property of the estate" broadly, including "all legal or equitable interests of the debtor in property as of the commencement of the case." If the debtor is a member to a JV agreement, the debtor's interest in the JV is an asset of the bankruptcy estate and must be included. The debtor's interest in the JV's property, including bank accounts or equipment, could be deemed property of the estate if careful records and separate accounts are not maintained. All property of the JV should be titled in the JV's name, and bank accounts should be maintained in the name of and under the control of the JV, and not in the name of the individual JV members. Co-mingled property will automatically be deemed property of the estate, and it may be difficult or impossible to disentangle these JV assets.

Similar issues can arise in connection with cash collateral. Section 363(a) of the Code defines "cash collateral" broadly, and § 363(c) prohibits a debtor from using cash collateral without the consent of its secured lender or a court order authorizing the use of cash collateral. Use of cash collateral may be conditioned upon providing the secured lender with adequate protection for such use. The practical effect of § 363 is that if the secured lender has a perfected revolving security interest in inventory and accounts receivable, the debtor, upon filing for chapter 11, cannot use any cash generated by the sale of inventory or the collection of accounts receivable without consent or approval from the bankruptcy court. In most cases, this can freeze the debtor's operations. If strict separation between the debtor's core business and the JV is not maintained, this could also significantly impede the operations of the JV.

By keeping JV assets separated from the member assets, should one or more of the JV members file for bankruptcy, the JV will have the ability to access the resources necessary to continue day-to-day operations. If the JV account is held in the name of the

<sup>4</sup> See generally *In re Channel 64 Joint Venture*, 61 B.R. 255, 257 (Bankr. S.D. Ohio 1986).

<sup>5</sup> See Fed R. Bankr. P. 1004; *In re Roxy Roller Rink Joint Venture*, 67 B.R. 474, 477 (Bankr. S.D.N.Y. 1985).

<sup>6</sup> See 11 U.S.C. § 101(51B).

<sup>7</sup> See *In re The McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996); see also *In re Philmont Dev. Co.*, 181 B.R. 220, 224 (Bankr. E.D. Pa. 1995) (interpreting term "single project" as broad enough to encompass string of semi-detached houses).

<sup>8</sup> Compare *Kara Homes Inc. v. Nat'l City Bank (In re Kara Homes Inc.)*, 363 B.R. 399, 406 (Bankr. D. N.J. 2007) (holding that debtors that were in business of acquiring land, constructing and selling homes were SARE debtors), with *In re Club Golf Partners LP*, No. 07-40096, 2007 WL 1176010, at \*5 (E.D. Tex. Feb. 15, 2007) (holding that debtor, which generated substantial income from activities not related to real estate such as renting golf carts and selling merchandise, was not SARE debtor); *Centofante v. CBJ Dev. Inc. (In re CBJ Dev. Inc.)*, 202 B.R. 467, 474 (9th Cir. B.A.P. 1996) (holding that hotel is not SARE because it generates revenues from activities other than operation of property itself); *In re K'kenko*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (holding that marina is not SARE because it also generates revenues from storing, repairing and winterizing boats).

<sup>9</sup> Compare *Kara Homes*, 363 B.R. at 406 (reasoning that debtor could not expect to generate revenue from its activities but for eventual sale of real estate), with *Ad Hoc Group of Timber Noteholders v. Pac. Lumber Co. (In re Scotia Pac. Co.)*, 508 F.3d 214 (5th Cir. 2007) (holding that debtor in business of harvesting and selling timber is not SARE because production of timber requires sophisticated operations beyond underlying real estate).

bankrupt JV member, that bank account will not be available to pay employee wages, taxes or other crucial business expenses until the bankruptcy court enters an order authorizing the use of cash collateral. U.S. Trustee guidelines require that, absent court authority to the contrary, a debtor must close its prepetition bank accounts and open new debtor in possession bank accounts once the bankruptcy petition is filed. If the JV account is titled in the name of the bankrupt JV member, the JV account may have to be shut down and reopened as a new account, with “debtor in possession” in the title. It is crucial that the JV and its assets be identified and maintained as legally separate and distinct from the JV members.<sup>10</sup>

Finally, the treatment of the JV agreement in the bankruptcy can raise complex issues. Section 365(a) of the Code allows a debtor, subject to court approval, to assume or reject any executory contract or unexpired lease of nonresidential real property. Unless the JV was already winding down, the JV agreement is generally an executory contract that may be assumed by the debtor,<sup>11</sup> and assumption of an executory contract requires court approval. Most courts will apply the business-judgment test to determine whether assumption or rejection is appropriate. To comply, a debtor must show that its decision to assume or reject will be beneficial to the estate and is an exercise of sound business judgment.<sup>12</sup> The business-judgment standard requires that the court approve the debtor’s business decision unless that judgment is the product of bad faith, whim or caprice.<sup>13</sup> The entire contract must be assumed or rejected, absent consent of the counterparty. Moreover, under § 365(b), the contract may not be assumed unless the debtor first cures most defaults or provides “adequate assurance” that any defaults will be cured.<sup>14</sup>

Generally, provisions in a contract that prohibit, restrict or condition assignment, such as buyout rights, rights of first refusal, or allow the nondebtor party to declare default or to terminate the contract on the grounds of insolvency, financial condition or bankruptcy, are deemed impermissible *ipso facto* clauses under § 365(f) of the Code. In *Northrop Grumman Tech. Serv. Inc. v. The Shaw Group Co. (In re The IT Group Inc.)*,<sup>15</sup> the district court considered whether a buyout right and right of first refusal contained in the operating agreement of a JV were impermissible *ipso facto* clauses and restraints on assignment. In that case, the debtor and two other entities formed a joint venture.<sup>16</sup> Thereafter, the debtor filed for chapter 11.<sup>17</sup>

The JV agreement provided that a bankruptcy filing by or against any member was an event of default and gave the nondefaulting members the right to buy out the defaulting member’s economic interest at a price specified in the agreement.<sup>18</sup> It also gave each member a right of first refusal in the event that any other member wanted to transfer its rights to a nonaffiliated third party.<sup>19</sup> After filing for bankruptcy, the debtor sought court authority to assign its rights under the agreement to a nonaffiliated third party. The two nondebtor JV members objected, claiming, among other things, that their buyout rights were triggered by the debtor’s default and that they should be allowed to exercise their right of first refusal.<sup>20</sup> The non-affiliated third party countered that the right of first refusal in the JV agreement was invalid under § 365(f) because the provision impermissibly restricted or conditioned assignment, even though it did not prohibit assignment outright.<sup>21</sup> On appeal, the district court affirmed the bankruptcy court ruling that the buyout provision was an unenforceable *ipso facto* clause and held that the assignment of the JV agreement to the nonaffiliated third party was subject to the other members’ right of first refusal under applicable Delaware law.<sup>22</sup> Because there is always a possibility that a bankruptcy court may not enforce a particular contract provision, it is advisable to have experienced bankruptcy counsel

review the JV organizational documents at the formation stage to ensure that the nondebtor contract party’s rights are adequately protected.

## Conclusion

JVs face unique issues in the bankruptcy context, both when the JV itself files for bankruptcy and when one or more of the JV members file for bankruptcy. Careful planning on the part of the JV members—and a well-drafted JV agreement—can help avoid some of the more difficult issues and ease the uncertainties that will undoubtedly arise upon a bankruptcy filing. ■

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<sup>10</sup> If assets are co-mingled, the nondebtor JV member bears the burden of establishing what assets are not property of the estate. See *Haley, Chisolm & Morris Inc. v. Parrish*, 127 B.R. 366, 372 (Bankr. W.D. Va. 1991) (nondebtor JV member failed to present clear and convincing evidence that co-mingled property did not belong to debtor). Even if the debtor JV member consents to the designation of certain property as non-debtor property, it is likely that creditors and other parties in interest will object, because such parties have a vested interest in increasing the number of potential assets which could be used to fund distributions to creditors. See generally *Haskins v. U.S. (In re Lister)*, 846 F. 2d 55, 57 (10th Cir. 1988) (“Generally, creditors are presumed to act primarily in their own interest.”); *In re Jensen-Farley Pictures Inc.*, 47 B.R. 557, 571 (Bankr. D. Utah 1985).

<sup>11</sup> See *Post v. Sigel & Co., Ltd. (In re Sigel & Co., Ltd.)*, 923 F.2d 142, 143 (9th Cir. 1991).

<sup>12</sup> See, e.g., *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984) (stating that traditional standard applied by courts to authorize rejection of executory contract is that of “business judgment”).

<sup>13</sup> *Lubrizol Enters. v. Richmond Metal Finishers Inc. (In re Richmond Metal Finishers Inc.)*, 756 F.2d 1043, 1047 (4th Cir. 1985).

<sup>14</sup> See *Sigel & Co.*, 923 F.2d at 144 (debtor must cure default under JV agreement by paying unpaid *pro rata* share of mortgage).

<sup>15</sup> *Northrop Grumman Tech. Serv. Inc. v. The Shaw Group Co. (In re The IT Group Inc.)*, 302 B.R. 483 (D. Del. 2003).

<sup>16</sup> *Id.* at 485.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* at 485-86.

<sup>19</sup> *Id.* at 485.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 488.