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The Limited Liability Company and the Bankruptcy Code

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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.

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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

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

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.)

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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).

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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).

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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).