LLC Operating Agreement Prohibiting Bankruptcy Filing is Enforceable

June 9, 2011 by Laurie Nelson

This might not be man bites dog news, but in the structured finance world, it ranks pretty close. A U.S. bankruptcy court has ruled that a borrower can agree not to file bankruptcy.

It all starts with the development of a high-end condo project in Aspen, Colorado called Dancing Bear Aspen.

In December 2010, the Tenth Circuit Bankruptcy Appellate Panel affirmed a Colorado bankruptcy court order granting a motion to dismiss a bankruptcy petition filed on behalf of DB Capital Holdings, LLC (the "Debtor") which developed Dancing Bear Aspen. The Court affirmed the lower court's finding that the Debtor's LLC Operating Agreement expressly barred the Debtor from filing for bankruptcy.

The Debtor's LLC Operating Agreement stated that the Debtor "to the extent permitted under applicable Law, will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy…."

One of the Debtor's two members filed the Chapter 11 petition and countered a motion to dismiss the filing by arguing that the Court should invalidate the LLC Operating Agreement provision barring such filing because it "was executed at the demand, and for the sole benefit of" the lender and, therefore, was unenforceable as a matter of public policy. In support of this position, numerous cases were cited, holding that contractual provisions prospectively prohibiting bankruptcy protection are unenforceable.

Until I read this case, I'd have put some money on that argument. But the Court rejected that argument, finding that the case law involved debtors' agreements with third parties to waive the benefits of bankruptcy and did not mean that members of an LLC could not agree among themselves to not file for bankruptcy. The Court also noted that there was no evidence that the LLC provision was coerced by a creditor.

The facts reveal, not shockingly, that this covenant was added at the request of the Debtor's mortgage lender. So how does this work again? Is the secret that the creditor needs to ask nicely? May I pretty please have a covenant against bankruptcy?

I spoke a bit about this case with one of Dechert's bankruptcy partners, Shmuel Vasser, who focuses on finance and structured transactions.

L. Nelson: What were your initial thoughts when this holding came to your attention?

S. Vasser: The Court's decision is arguably inconsistent with the generally accepted premise that agreements prohibiting future bankruptcy filings are unenforceable. The decision makes clear that LLC members can agree among themselves to restrict the company from filing bankruptcy. But the decision should not be viewed as granting carte blanche approval to pre-petition agreements waiving bankruptcy protection.

L. Nelson: For a lender to rely on such a restriction in an LLC operating agreement, the lender would need a way to limit the members' ability to amend the operating agreement, no?

S. Vasser: Correct, but the Court didn't address requiring lenders to consent to amendments to operating agreements. Nor did it address requiring independent directors to approve bankruptcy filings.

L. Nelson: What about the elephant in the room -- the coercion argument? The Court stated that it was not deciding, whether, under some set of facts, an LLC's operating agreement containing terms coerced by a lender would be enforceable. Why else would members include a restriction on bankruptcy unless a lender or some other third party requested it? What's coercion and what's not?

S. Vasser: Good question. There's nothing in the decision that provides any practical guidance as to what is impermissible coercion and what is not. The more interesting question is why such a distinction is relevant to begin with. If the internal corporate governance prohibition on bankruptcy filing is enforceable, it isn't clear why the existence of a third party who may or may not benefit from it alters this analysis. It should be obvious that the practical effect of a provision restricting a bankruptcy filing is typically for the benefit of a counterparty.

L. Nelson: I'm clearly not a litigator, so can you tell me if the DB Holdings holding carries less precedential weight because it is an *unpublished* opinion?

S. Vasser: Various courts have local rules dealing with the use of unpublished opinions. The local rules for this particular court provide that unpublished opinions may be cited for their persuasive value, but are not precedential.

L. Nelson: Thanks Shmuel. I can't imagine we'll stop worrying about borrower bankruptcy just because of this case. On the other hand, we certainly need to consider requiring this type of restriction in borrowers' org docs as part of our lender term sheets and commitments. But we

can save a bit of worry time for undue influence claims and lender liability arguments. My takeaway is that once inside the confines of a bankruptcy courtroom, unexpected things can happen (and probably will).