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EFFECTS OF BANKRUPTCY FILING BY MEMBERS AND SHAREHOLDERS AND EXECUTORY CONTRACTS

by

Nancy Schmidt Roush
Lathrop & Gage, LLP
2345 Grand Boulevard, Suite 2200
Kansas City, Missouri 64108
Tel. 816 460-5820; email nroush@lathropgage.com

Thomas O. Wells
Thomas O. Wells, P.A.
540 Biltmore Way
Coral Gables, Florida 33134
Tel. 305 444-0016; email tom@twellslaw.com

C. Richard Rayburn, Jr.
Shelley K. Abel
Rayburn Cooper & Durham, P.A.
227 West Trade Street, Suite 1200
Charlotte, North Carolina 28202
Tel. 704 334-0891; email rrayburn@rcdlaw.net or sabel@rcdlaw.net

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I. Scope of Outline

A. The Case Study: An individual (the "bankrupt debtor") owning stock in a corporation or membership interest in a limited liability company files (either voluntarily or involuntarily) for bankruptcy. The unsecured creditors of the bankrupt debtor are seeking to collect upon debts owed by the bankrupt debtor not related to the corporation or limited liability company. These creditors are generally referred to as outside creditors because their claims do not relate to (and are "outside" of) the corporation or limited liability company.

B. Goals: The goals of the planner related to attacks by outside creditors are as follows:

1. Bankrupt Debtor Shareholder and Corporation: The bankrupt debtor and the other shareholders of a corporation want to limit the effects of the bankruptcy to the terms of:

   a. the shareholders agreement;

   b. terms of Articles of Incorporation if transfer restrictions are incorporated into the Articles of Incorporation; and/or

   c. state law in a state such as Nevada (NRS 78.746) that provides that the exclusive remedy of a judgment creditor of the bankrupt debtor is a charging order if:

      (i) the corporation (a) has fewer than 100 shareholders of record at any time, (b) is not a publicly traded corporation or a subsidiary of a publicly traded corporation and (c) is not a professional corporation;

      (ii) does not apply to any liability of the bankrupt debtor that existed as the result of an action filed before July 1, 2007; and

      (iii) does not supersede any written agreement between such bankrupt debtor and a creditor if the written agreement does not conflict with the Articles of Incorporation, Bylaws or any shareholders agreement to which such bankrupt debtor is a party.

2. Bankrupt Debtor Member and LLC: The bankrupt debtor and the other members of a limited liability company want to limit the effects of the bankruptcy to the terms of:

   a. the operating agreement;

   b. terms of Articles of Organization if transfer restrictions are incorporated into the Articles of Organization; and/or

   c. state law:

(i) in a state such as Florida (Section 608.433) that provides that the exclusive remedy of a judgment creditor of the bankrupt debtor is a charging order if the limited liability company has multiple members;1 and

(ii) provided the bankruptcy filing of the bankrupt debtor does not trigger a dissociation and liquidation (monetization event) of the bankrupt debtor.

C. Areas to be Reviewed: In effectuating such goal, we will review the effect of the bankruptcy filing on:

1. The bankrupt debtor's ownership of stock or membership interest;

2. The corporation or limited liability company owned by the bankrupt debtor;

3. The rights of the bankrupt estate to the stock or membership interest of the bankrupt debtor; and

4. The rights of the other shareholders or members of the corporation or limited liability company.

II. Bankruptcy Terms

A. General Property of the Bankrupt Estate: Title 11 of the United States Code (the "Bankruptcy Code") sets forth the federal bankruptcy laws. Chapter 5 of Title 11 sets forth general rules applicable to creditors, the bankrupt debtor and the "bankruptcy estate." Section 541[2] defines the property of the bankrupt estate. Section 541(a) provides that "the commencement of a case under Section 301 (voluntary bankruptcy filing), Section 302 (joint bankruptcy filing), or Section 303 (involuntary bankruptcy filing) of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held

> (1) Except as provided in Section 541(b) (e.g., funds held in a Section 529 plan or a qualified retirement plan) and Section 541(c)(2) (a spendthrift trust that has transfer restrictions enforceable under nonbankruptcy laws), all legal or equitable interests of the debtor in property as of the commencement of the case."

Section 541(c)(1) provides that except as provided in Section 541(c)(2) (the provision relating to a spendthrift trust that has transfer restrictions), an interest of the debtor in property becomes property of the estate under Section 541(a)(1) **notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law (i.e., state law)**

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[1] *But see Olmstead v. FTC,* 44 So. 3d 76 (Fla. 2010)) which was statutorily incorporated into law by revisions to Section 608.433, Florida Statute..

[2] The use of "Section ___" throughout refers to the Bankruptcy Code, 11 U.S.C. § ___.

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

Section 541(c)(1) allows the bankruptcy court and estate to disregard the terms that restrict transferability and assignment set forth in a shareholders agreement or operating agreement. Section 541(c)(1) also allows the bankruptcy court and estate to disregard state law that may restrict the assignment of a member's interest to a third party absent the consent of the other members or restrict a creditor's remedy to a charging order. *See In re Capital Acquisitions & Management Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006); *Meiburger v. Endeka Enterprises, L.L.C.* (*In re Tsiaoushis*), 383 B.R. 616 (Bankr. E.D. Va. 2007); *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708-09 (Bankr. E.D. Va. 2000) (an operating agreement that was not an executory contract did not impose any restrictions on the bankrupt estate and the bankruptcy court could disregard Virginia LLC act provisions); and *Samson v. Prokoph (In re Smith)*, 185 B.R. 285, 291-95 (Bankr. S.D. Ill. 1995) (Chapter 7 trustee steps into shoes of debtor limited partner and may exercise the right to dissolve the partnership where the limited partnership agreement was not an executory contract).

There is a separate set of specific rules applicable to executory contracts under Section 365. Section 541 addresses all non-executory contract restrictions in bankruptcy.

Planning Note: In order to avoid allowing the bankruptcy estate or bankruptcy court to disregard the transfer restriction terms of the operating agreement or shareholders agreement or the limitations to the rights of a creditor under state law with respect to a member's interest in a multi-member LLC, asset protection planners want to structure the client's stock or membership interest to avoid the application of Section 541(c)(1).

B. Executory Contract: In bankruptcy, a contract is controlled by Section 541(c)(1) if it is not an executory contract and Section 365 if it is an executory contract. As referenced previously, a bankruptcy court and estate can disregard the terms of the agreement and nonbankruptcy law under Section 541(c)(1). However, a different set of rules apply if the contract is an executory contract.

1. Definition of Executory Contract: The definitions used in bankruptcy are set forth in Section 101. There is no statutory definition of an "executory contract." The legislative history states that though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides. See H.R. Rep. No. 95-595 at 347 (1977); and *accord NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6 (1984). Most courts have adopted Professor Countryman's definition of an executory contract as:

> A contract under which the obligation of both the bankrupt debtor and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 Minn. L. Rev. 439, 460 (1973).

"Executoriness" is ordinarily determined as of the bankruptcy petition date. *Accord Enterprise Energy Corp. v. United States* (*In re Columbia Gas Sys, Inc.*), 50 F. 3d 233, 240 (3d Cir. 1995). The court in *In re Tsiaoushis*, 383 B.R. at 620, explained the analysis as follows:

> The analysis used to determine whether a particular limited liability company operating agreement is an executory contract under Bankruptcy Code § 365(e)(1) is clear. There is no per se rule. Each operating agreement is separately analyzed. The courts, utilizing the Countryman definition, examine the operating agreement to determine whether there are unperformed obligations on the part of the parties. If not, the operating agreement is not an executory contract. Garrison-Auburn; Capital Acquisitions; Fiesta. If there are unperformed obligations of both the debtor and the other party or parties, the court must determine whether, if not performed, non-performance would constitute a material breach excusing the other party from further performance. If so, the operating agreement is an executory contract. Daugherty; DeLuca. The reported cases go no further. None, after determining that an operating agreement is an executory contract, evaluates the applicability of § 365(e)(2) which exempts certain executory contracts from the application of the ipso facto prohibition. That would be the final step in the analysis.

The purpose of Section 365 and the ability of the bankrupt estate to either assume or reject an executory contract is to permit the bankrupt debtor to escape onerous and burdensome contracts in which obligations of the debtor far exceed any possible benefit to the estate. *In re Riodizio, Inc.*, 204 B.R. 417, 422 (Bankr. S.D.N.Y. 1997) (citing *In re Leibinger-Roberts, Inc.*, 105 B.R. 208, 211 (Bankr. E.D.N.Y. 1989). *See also Sipes v. Atlantic Gulf Communities Corp.* (*In re General Dev. Corp.*), 84 F.3d 1364, 1375 (11th Cir. 1996) (affirming on the proper analysis of whether assumption or rejection of a contract will produce a benefit to the bankrupt estate).

2. Decision with respect to an Executory Contract: The bankruptcy trustee will typically assume the executory contract if the trustee determines that such assumption will result in a net economic benefit to the bankrupt estate. An example of a trustee assuming an executory contract is one in which a shareholders agreement which is an executory contract provides that the

corporation or other shareholders must repurchase the stock of the bankrupt debtor for a price which the trustee determines is greater than what the trustee could otherwise obtain.

The bankruptcy trustee will typically reject the executory contract if the trustee determines that such rejection will result in a net economic benefit to the bankrupt estate. An example of a trustee rejecting an executory contract is one in which an operating agreement which is an executory contract provides that the debtor member (and accordingly, the bankruptcy estate) must contribute substantial capital to the LLC without having any way to force a distribution from or liquidation of the LLC.

3. An Executory Contract in Default prior to Bankruptcy Filing: Section 365(b) provides that if an executory contract is in default by the debtor prior to the bankruptcy filing (e.g., the bankrupt debtor fails to make a capital call prior to bankruptcy filing), then bankruptcy trustee may not assume the contract unless, at the time of assumption,

   a. the trustee cures or provides adequate assurance that the trustee will promptly cure such default;

   b. the trustee compensates or provides adequate assurance that the trustee will compensate a party other than the debtor to such contract for any actual pecuniary loss to such party resulting from such default; and

   c. the trustee provides adequate assurance of future performance under the contract.

   The cure requirement of Section 365(b) does not apply to a default that is a breach of a provision relating to the insolvency or financial condition of the bankrupt debtor at any time before the closing of the bankruptcy, the commencement of the bankruptcy or the appointment of or taking possession by a bankruptcy trustee. *See* Section 365(b)(2).

   Planning Note: The LLC or corporation should consider imposing an obligation (e.g., a capital call) prior to the bankruptcy filing upon the bankrupt debtor which if breached by the bankrupt debtor would require the bankruptcy trustee to satisfy such breach prior to an assumption of an executory contract.

4. Non-Executory Contract: If a contract is non-executory, then it is neither assumable nor rejectable by the bankruptcy trustee. *See In re Chateaugay Corp.*, 102 B.R. 335, 345 (Bankr. S.D.N.Y. 1989). But remember that Section 541(c)(1) allows the trustee to disregard certain contractual provisions and nonbankruptcy laws.

C. Executory Contract Assumed: Pursuant to Section 365(a), a bankruptcy trustee may assume any executory contract that is not a personal service contract that may not be

assumed under Section 365(c)(1) (with limited exceptions not relevant here). Pursuant to Section 365(f)(1), the trustee may assume an executory contract even if the contract prohibits, restricts or conditions the assignment of such contract (but see discussion in paragraph E below on circuit split). In a Chapter 7 case, the trustee must assume such executory contract within 60 days of the commencement of the bankruptcy case or the contract is deemed rejected but this period can be, and routinely is, extended. *See* Section 365(d)(1). In a Chapter 11 or 13, the trustee may assume or reject an executory contract at any time before the confirmation of the plan, provided a non-debtor counterparty may seek an earlier determination. *See* Section 365(d)(2). Upon assumption of the contract, the bankruptcy trustee must abide by all of the terms of the executory contract applicable to the bankrupt debtor. If the bankruptcy trustee assumes the executory contract, it may assign its rights in the executory contract provided adequate assurance is provided with respect to future performance of all obligations applicable to the bankrupt debtor with respect to the executory contract. *See* Section 365(f)(2). The assignment of a timely assumed executory contract relieves the bankrupt estate and trustee from any liability for any breach occurring after such assignment. *See* Section 365(k). As set forth in *In re General Dev. Corp.*, the trustee will assume a contract if it produces a benefit to the bankrupt estate (e.g., includes a redemption obligation that allows the bankrupt estate to monetize the equity interest).

D. Executory Contract Rejected: The bankruptcy trustee may also reject an executory contract pursuant to Section 365(a) in order to avoid a detriment to the bankrupt estate. In a Chapter 7, if the executory contract is not timely assumed, it is deemed rejected. *See* Section 365(d)(1). The rejection of an executory contract constitutes a breach of such contract by the bankrupt debtor under Section 365(g)(1) as of the date immediately preceding the date of the bankruptcy petition. The purpose of the timing of Section 365(g)(1) is to treat such claim for breach applicable to a rejected contract as a prepetition non-priority claim which can be discharged pursuant to Section 727, 1141, or 1328.

It is important to note that rejecting an executory contract governing an equity interest does not cancel, repudiate or terminate the state law ownership or Bankruptcy Code rights with respect to such equity interest. *In re Bergt*, 241 B.R. 17, 21-22 (Bankr. D. Ala. 1999). If a bankruptcy trustee rejected an operating agreement with respect to a Florida LLC, the bankrupt estate would still have a charging order remedy under Section 608.433, Florida Statutes (*see* paragraph L, "Strong Arm Power").

E. Executory Contract that cannot be Assumed: Section 365(c)(1) provides that the bankruptcy trustee cannot assume or assign any executory contract if applicable law excuses the other party (other than the bankrupt debtor) from accepting performance from or rendering performance to an entity other than the bankrupt debtor and such other party does not consent to such assumption or assignment. *See JD Factors, LLC v Freightco, LLC*, 2009 WL 3401965, 2009 U.S. Dist. LEXIS 96705 (N.D. Ind. Oct. 16, 2009) (a member designated as a vice president of an Indiana LLC pursuant to an operating agreement was a non-assignable executory contract due to the personal service contract provisions and Indiana law requiring the consent of all other members for a third party to become a member of the LLC); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr.

E.D. Va. 1996) (the pre-petition removal of the bankrupt debtor manager who was also a member where the operating agreement required unanimous member consent was allowed because state law permitted removal of a manager with majority member consent; Section 365(e)(2) applied where the debtor manager had ongoing duties and responsibilities to the LLC and whose personal identity and participation was material to the development project); *JTB Enter. v. D & B Venture, L.C. (In re DeLuca)*, 194 B.R. 79, 91 (Bankr. E.D. Va. 1996) (due to the operating agreement and the fact that extensive development of the underlying project remained to be completed, the "identity of the manager is material to very existence of the enterprise"); *Breeden v. Catron*, 158 B.R. 624, 626 (Bankr. E.D. Va. 1992), aff'd, 158 B.R. 629 (E.D. Va. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994) (a bankrupt debtor general partner cannot assume a partnership agreement that is an executory contract because applicable state law does not require the remaining partners to perform their obligations under the partnership agreement or to accept the performance of the bankrupt debtor partner's obligations from any party other than the bankrupt debtor); and *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821-22 (Bankr. D. Colo. 1981) (a limited partnership dissolved under state law on the day of the general partner's bankruptcy filing because under Section 365(c) and the executory limited partnership agreement cannot be assumed by a debtor in possession without the consent of all of the limited partners).

Circuits are split regarding whether this restriction on assumability should also be applied to a debtor-in-possession who seeks to assume and perform himself the otherwise non-assumable contract. The majority approach interprets Section 365(c)(1) as prohibiting assumption of an executory contract only where a debtor in possession actually intended to assign a contract that was non-assignable under applicable law. This "actual" test allows a debtor to assume a non-assignable contract as long as the debtor does not seek to assign it. *See, e.g.*, *Institut Pasteur v. Camridge Biotech Corp.*, 104 F.3d 489, 491 (1st Cir. 1997); *In re Footstar, Inc.*, 323 B.R. 566, 570 (Bankr. S.D.N.Y. 2005) (distinguishing between "trustee" and "debtor-in-possession" and arguing that, while a trustee may not be able to assume a non-assignable contract, nothing prevents a debtor-in-possession from doing so and collecting cases).

Other circuits have interpreted § 365(c)(1) in favor of a "hypothetical" or "literal" test, under which a contract cannot be assumed if the debtor could not hypothetically assign it under applicable law, even though the debtor had no actual intent to make any such assignment. *See, e.g.*, *RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.)*, 361 F.3d 257, 265-70 (4th Cir. 2004); *Perlman v. Catapult Entertainment (In re Catapult Entertainment Inc.)*, 165 F.3d 747, 749-50 (9th Cir. 1999); *In re James Cable Partners*, 27 F.3d 534, 537 (11th Cir. 1994); *In re West Elecs., Inc.*, 852 F.2d 79, 83 (3d Cir. 1988).

Planning note: If you want the bankruptcy trustee to not assume a shareholders agreement or operating agreement because it may allow for monetization of the equity interest funded by the corporation or LLC, consider incorporating personal service obligations in the shareholders agreement or operating agreement such as an obligation to serve as a director, manager or officer of the entity or an obligation to provide specific personal services to the entity that are linked directly to the bankrupt debtor's specialized expertise and training. Also provide that the other shareholders and members are

uniquely relying upon the bankrupt debtor to provide such services to the entity and to the extent that the bankrupt debtor fails to perform such services, then the obligations owed by the nonbankrupt shareholders and members to the bankrupt debtor are excused and terminated.

Note that some bankruptcy courts have determined that duties to be performed by a bankrupt debtor are not the kinds of non-delegable duties that should render the membership interest as being non-assignable. *See Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re Allentown Ambassadors, Inc.)*, 361 B.R. 422 (Bankr. E.D. Pa. 2007) (held that an operating agreement for a North Carolina LLC that operated an independent professional baseball league was an executory contract because members had continuing duties to manage the LLC and to make additional cash contributions as needed to operate the LLC but held that the North Carolina statutory provisions that restrict assignment of membership interest are sufficiently ambiguous so as not to constitute non-bankruptcy law prohibiting assignment of the membership interest and the management duties are not non-delegable).

F. Abandonment of Property: Section 554 allows the bankruptcy trustee to abandon any property of the bankrupt estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate. In addition, any property listed on the bankruptcy schedule of property under Section 521(1) that is not otherwise administered at the time of the termination of the bankruptcy proceedings is deemed to be abandoned pursuant to Section 554(c).

G. Ipso Facto Clause:

1. Definition of Ipso Facto Clause: Section 365(e)(1) provides that an executory contract, or any right or obligation thereunder, may not be terminated or modified at any time after the commencement of the bankruptcy solely because of a provision in the contract that is conditioned on:

a. the insolvency or financial condition of the bankrupt debtor at any time before the filing of bankruptcy;

b. the commencement of the bankruptcy; or

c. the appointment of a bankruptcy trustee.

This is known as the "ipso facto" clause allowing the bankruptcy trustee to disregard provisions that trigger an action upon the bankruptcy filing of the bankrupt debtor. *See Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995) (Section 365(e)(1) exempts ipso facto provisions included in partnership agreements). Bankruptcy courts have expanded the application of ipso facto clauses to disregard state law provisions tied to the bankruptcy filing of the bankrupt debtor. *See Weaver v. Nizny*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (upon filing of partner's Chapter 11 petition in reorganization, Section 365(e)(1) prevents the ipso facto dissolution of the partnership under state law).

2. Ipso Facto Clause Exception not Applicable: Section 365(e)(2) provides that the ability of the bankruptcy trustee to disregard ipso facto provisions under Section 365(e)(1) does not apply when the contract is a personal service contract similar to the provisions of Section 365(c)(1). *Breeden v. Catron,* 158 B.R. at 629, is an example of Section 365(e)(2) in which the trustee was not allowed to use the ipso facto clause provision under Section 365(e)(1) to disregard the dissolution of the partnership under Virginia's partnership law upon the bankruptcy filing of the general partner. Other Section 365(e)(2) cases include *Phillips v. First City, Texas-Tyler, N.A. (In the Matter of Phillips),* 966 F.2d 926, 935 (5th Cir. 1992) and *In re Sunset Developers*, 69 B.R. 710, 713 (Bankr. D. Idaho 1987). However, some bankruptcy courts have come to an opposite conclusion based on similar facts that a bankruptcy trustee can disregard a state law dissolution provision triggered by the bankruptcy filing of a partnership or partner. *See Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d at 614; *Cardinal Indus., Inc. v. Buckeye Fed. Sav. & Loan Ass'n (In re Cardinal Indus., Inc.),* 105 B.R. 834, 849 (Bankr. S.D. Ohio 1989); and *In re Corky Foods Corp.*, 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988).

H. Preferences:

1. Definition of Preference Payment, Preference Period and Insiders: A preference payment made to third parties within 90 days of the commencement of the bankruptcy under Section 547(b) is subject to avoidance by the bankruptcy trustee. A preference payment is a transfer by the bankrupt debtor for or on the account of an antecedent debt owed by the debtor prior to such transfer while the debtor was insolvent. Under Section 547(f), the debtor is presumed to be insolvent during the 90 day period prior to the bankruptcy filing. The trustee may avoid such preference payment (and cause the transferee to pay funds to the bankrupt estate equal to such preference payment) if it enables the transferee creditor of the bankrupt debtor to receive more than such creditor would have received in a Chapter 7 liquidation bankruptcy case. The preference period is one year for transfers made to insiders. *See* Section 547(b)(4)(B). Insiders include the corporation or LLC owned by the bankrupt debtor that is an officer, director or manager or a shareholder or member who owns 20% or more of the equity of such entity. *See* Section 101(31). Insiders also include any other person who is an officer, director or manager of such corporation or LLC or owns or has the right to vote 20% or more of the equity of such entity that has an insider relationship with the bankrupt debtor. *See* Section 101(2) as to definition of "affiliate."

2. Importance of Understanding Preference Payments: The one year insider preference is important because any LLC or non-debtor member that receives a payment from the bankrupt debtor within one year of the bankruptcy filing could be forced to return such payment to the bankrupt estate absent the application of an exception under Section 547(c). The other important point of a preference payment is that if the bankrupt debtor is forced to dispose of his equity interest prior to the bankruptcy pursuant to a forfeiture provision, then the consequent

benefit to the non-debtor members could be construed as a preference payment made to an insider if the non-debtor members receive more from the forfeiture/removal of the bankrupt debtor than they would have as unsecured creditors of the bankrupt estate. *See Kotoshirodo v. Dorland and Assocs., Inc. (In re Lull)*, 2008 WL 3895561, 2008 Bankr. LEXIS 4543 (Bankr. D. Haw. Aug, 22, 2008). One of the exceptions to a preference under Section 547(c)(1) is a transfer between the bankrupt debtor and the other members made in a contemporaneous exchange for new value given to the bankrupt debtor. Another exception to a preference under Section 547(c)(2) is a transfer made in the ordinary course of business or financial affairs of the bankrupt debtor and transferee and made according to ordinary business terms.

Planning Note: Based on the *In re Lull* holding, non-debtor shareholders and members effectuating a forfeiture transfer from the bankrupt debtor or shareholder within one year prior to the commencement of the bankruptcy should be very cautious and understand that they may have to pay cash to the bankrupt estate equal to the preference payment that a bankruptcy court imputes to such member or shareholder. You can include such forfeiture provisions in your shareholder or operating agreement but you should confirm how the applicable bankruptcy court for the bankrupt debtor would treat such transfer prior to effectuating such provision.

I. Fraudulent Transfers: In addition to state statutes on fraudulent transfers, Section 548 of the Bankruptcy Code provides a trustee the power to avoid a fraudulent transfer made within two years prior to the petition date. *See* Section 548. Actions must be brought within 2 years of the petition date or within 1 year of the appointment of a trustee, whichever is later. *See* Section 546(a). Fraudulent transfer laws protect creditors by voiding transfers that are made with an intent to hinder, delay, or defraud creditors. Intent to defraud is typically established by review of the various "badges of fraud." These badges of fraud focus on the debtor's conduct and circumstances at or near the time of a transfer, including whether the transfer was made shortly before or after a debt was incurred, whether the transfer was to an "insider," and whether the transferor received reasonably equivalent value for the assets transferred. Amendments to operating agreements should be made for purposes other than hinder, delay, or defraud creditors. Discharge in bankruptcy may be denied if the bankruptcy trustee or a creditor can demonstrate that the debtor's pre-bankruptcy planning was done with an intent to hinder, delay, or defraud creditors.

J. Management Rights: A bankrupt debtor member's bankruptcy estate owning a membership interest consists of economic rights in the LLC (referred to in some states as distributional interest) and non-economic management rights. *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 707-08 (Bankr. E.D. Va. 2000). Under state law, management rights of managers and managing members may be delegated (i.e., assigned) unless otherwise provided by the Articles of Organization or operating agreement (e.g., Section 608.4236, Florida Statutes). However, an assignee of a membership interest does not have any right to exercise any rights or powers of the assigning member (e.g., Section 608.432(2)(a) and (c), Florida Statutes). Although a Board of Directors can create one or more committees,

the rights of a director of a corporation are personal to the individual elected to serve as a director and cannot be assigned without a new election of the shareholders. (e.g., Sections 607.0802(1) and 607.0803(3), Florida Statutes). In bankruptcy, such management rights are generally not assignable. *See JD Factors, LLC v Freightco, LLC*; *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65; *Breeden v. Catron*; and *Skeen v. Harms*. However, there are some exceptions to this general rule in which the bankruptcy court decided that such management rights could be assumed by the bankruptcy trustee – particularly involving single member LLCs. *See Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re Allentown Ambassadors, Inc.)*, 361 B.R. 422 (Bankr. E.D. Pa. 2007); *In re Modanlo*, 412 B.R. 715 (Bankr. D. Md., 2006) (a bankruptcy trustee of a debtor that owned a single-member LLC could exercise management rights); and *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho, 2006) (a bankruptcy trustee of a debtor that owned a single-member LLC could exercise sole and exclusive management rights).

K. Economic Interest: An economic interest is the right to receive distributions from the corporation or shareholder. Distributions are defined as the direct or indirect transfer of money or other property or the incurrence of indebtedness by a LLC to or for the benefit of its members in respect of their economic interests.

L. Strong Arm Power: In addition to all of the rights of the bankrupt debtor in property and the expansive reach of Section 541(a) to include other property, the trustee has the right and power of a hypothetical judgment lien creditor and a bona fide purchaser of real property under Section 544. This provision provides the trustee with the right to a charging order on an LLC interest under the laws of most states, the right to foreclose upon and sell stock, and the right in some states to foreclose upon and sell an LLC interest. See Bishop, Carter G., Fifty State Series: LLC Charging Order Statutes (January 23, 2012). Suffolk University Law School Research Paper No. 10-03. Available at SSRN: http://ssrn.com/abstract=1542244 or http://dx.doi.org/10.2139/ssrn.1542244.

M. Trustee / Debtor in Possession: In most Chapter 11 bankruptcy reorganization cases no trustee is appointed as opposed to Chapter 7 liquidation cases where there is always a trustee. In Chapter 11 cases the Bankruptcy Code creates a legal fiction known as the debtor-in-possession but vests the debtor with the powers of a trustee. In this outline the "trustee" terminology is used in order to avoid the confusion inherent in the "debtor" versus "debtor-in-possession" terminology.

N. Discharge / Revesting of Property: The goal of a Chapter 11 case is to obtain a confirmation order for a plan which discharges all of the debts that existed prior to filing and revests the property of the estate in the prepetition debtor free and clear of all liens and encumbrances upon confirmation of the bankruptcy plan pursuant to Section 1141(b) and (c). *See also* Section 1327(b) and (c) for Chapter 13 cases.

III. Member in Bankruptcy

A. Operating Agreement as an Executory Contract under Section 365(a)

1. Examples of Operating Agreement as Executory Contract: A majority of courts have determined that a limited partnership agreement is an executory contract. Samson v. Prokoph (In re Smith), 185 B.R. 285, 292-93 (Bankr. S.D. Ill. 1995).

2. Methods of Making Operating Agreement an Executory Contract:

   a. obligation to make a capital call: *See In re Sunset Developers*, 69 B.R. 710, 712 (Bankr. D. Idaho 1987); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995); and *Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re* Allentown Ambassadors, Inc.), 361 B.R. 422 (Bankr. E.D. Pa. 2007).

   b. duties and obligations owed to other members and partners: See Summit *Invest. and Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996); *In re Daugherty Constr., Inc.*, 188 B.R. at 612; and *Allentown Ambassadors, Inc.*, 361 B.R. 422.

B. Operating Agreement as a Non-Assumable Executory Contract under Section 365(c)(1)

1. Examples of Operating Agreement as Personal Service Contract: A bankruptcy court held that an operating agreement that designated a member as a Vice President could not be assumed and the provision that the member's status terminated upon the filing of personal bankruptcy was not an invalid "ipso facto" clause because member's service as an officer is a personal service contract. *JD Factors, LLC v. Freightco, LLC*, 2009 WL 3401965, 2009 U.S. Dist. LEXIS 96705 (N.D. Ind. Oct. 16, 2009); *Broyhill v. DeLuca* (*In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996); *JTB* Enter. *v. D & B Venture, L.C. (In re DeLuca)*, 194 B.R. 79 (Bankr. E.D. Va. 1996); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995); *Breeden v. Catron*, 158 B.R. 624 (Bankr. E.D. Va. 1992), aff'd, 158 B.R. 629 (E.D. Va. 1993, aff'd, 25 F.3d 1038 (4th Cir. 1994); *In re Cardinal Industries, Inc.*, 116 B.R. 964, 979 (S.D. Ohio 1990); and *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821-22 (Bankr. D. Colo. 1981). In *Green v. Bellerive Condos. Ltd. P'ship,* 763 A.2d 252 (Md. App. 2000), *cert. denied*, 768 A.2d 55 (Md. 2001), *cert. denied*, 534 U.S. 824 (2001), court ruled that a charging order creditor does not step into the debtor limited partner's shoes with respect to management rights and information rights and that the creditor could not participate in decisions concerning partnership opportunities. However, in *Meyer v. Christie*, 2011 U.S. Dist. LEXIS 76657 (D. Kan. July 15, 2011), a charging order can be issued to allow creditor to participate in management of single member LLC under Kansas Revised LLC Act when the bankrupt debtor is the sole member.

2. Methods of Making a Personal Service Contract:

a. Designate member as manager or managing member;

b. Designate member as an officer; and

c. Include provision that services to be rendered by bankrupt debtor to LLC are critical to the continued investment by the other members and operation and viability of the LLC and to the extent that the bankrupt debtor fails to perform such services, then the obligations owed by the nonbankrupt members to the bankrupt debtor are excused and terminated.

C. Operating Agreement as a Non-Executory Contract

1. Examples of Operating Agreement as a Non-Executory Contract:

a. *In re Capital Acquisitions & Management Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006) (the operating agreement did not contain current obligations or continuing management role for the bankrupt debtor member);

b. Meiburger v. Endeka Enterprises, L.L.C. (In re Tsiaoushis), 383 B.R. 616 (Bankr. E.D. Va. 2007) (the operating agreement did not have any material, continuing obligations for the bankrupt debtor member, including no managerial duties or unperformed duties);

c. Movitz v. Fiesta Investments, LLC (In re Ehmann), 319 B.R. 200, 204-05 (Bankr. D. Ariz. 2005) (the bankrupt debtor was not a manager and did not have any obligations imposed pursuant to the operating agreement and the court determined that the duty to refrain from voluntarily withdrawing was not sufficient to create an executory contract);

d. In re Garrison-Ashburn, L.C., 253 B.R. 700, 708-09 (Bankr. E.D. Va. 2000) (an operating agreement that was not an executory contract did not impose any restrictions on the bankrupt estate and the bankruptcy court could disregard Virginia LLC act provisions); and

e. Sampson v. Prokoph (In re Smith), 185 B.R. 285, 291-95 (Bankr. S.D. Ill. 1995) (Chapter 7 trustee steps into shoes of debtor limited partner and may exercise the right to dissolve the partnership where the limited partnership agreement was not an executory contract).

2. Effects of being a Non-Executory Contract: The bankruptcy court in *In re Ehmann* appointed a receiver for a multi-member LLC to operate and dissolve the LLC and held that the bankrupt debtor's interest in the LLC was not subject to any contractual limitations in the operating agreement that limited the bankruptcy trustee to only the status of an assignee.

D. Single Member LLC Cases

1. *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003): Chapter 7 trustee controls debtor's membership interest in a Colorado single-member LLC and can cause the LLC to sell its assets and distribute the proceeds; only applies to a single-member LLC.

2. In re Modanlo, 412 B.R. 715 (Bankr. D. Md. 2006): a bankruptcy trustee of a debtor that owned a single-member LLC could exercise management rights and designate itself as manager of the LLC.

3. In re A-Z Electronics, LLC, 350 B.R. 886 (Bankr. D. Idaho 2006): a bankruptcy trustee of a debtor that owned a single-member LLC could exercise sole and exclusive management rights.

E. Effect of Filing Bankruptcy to a Prepetition Charging Order Granted More than 90 days before Bankruptcy Filing:

1. *In re Keeler*, 257 B.R. 422 (Bankr. D. Md. 2001) (charging order granted on December 20, 1989 against a bankrupt debtor partner indirectly owning a 45% limited partnership interest in a Maryland limited partnership with commencement of bankruptcy on December 20, 1999 treated as a perfected, secured lien that cannot be avoided by any order issued in the bankruptcy case and "rides through" bankruptcy that can be acted upon after the termination of automatic stay and discharge of the bankruptcy).

2. Neubauer v. Mercantile Safe Deposit & Trust Co., 1993 U.S. Dist. LEXIS 2832 (D. Md. 1993) (a charging order that is issued and valid prior to the 90th day preceding the bankruptcy filing is not a preferential transfer and continues through the bankruptcy proceeding)

F. General Planning:

1. Include provisions in operating agreement to be an executory contract under Section 365(a);

2. Take an action to cause a default in the executory contract which needs to be remedied by the bankruptcy trustee prior to assumption under Section 365(b); do not trigger default caused by the insolvency or financial condition of the bankrupt debtor as such default will not be recognized pursuant to Section 365(b)(2);

3. Include personal service provisions to be performed by bankrupt debtor in the operating agreement so that it cannot be assumed under Section 365(c)(1);

4. Review whether to exercise a forfeiture provisions which could result in a voidable preference transfer or a fraudulent conveyance; and

5. Goal is for the membership interest to be deemed "valueless" and either abandoned under Section 554 or have it revest in the bankrupt debtor free and clear of all liens and encumbrances upon confirmation of the bankruptcy plan pursuant to Section 1141(b) and (c) or Section 1327(b) and (c).

G. Operating Agreement:

1. Have provision addressing the business purpose of LLC so that bankruptcy court will not disregard rights of nondebtor members;

2. Consider including capital call provision that can be imposed solely on the bankrupt debtor;

3. Include capital call provision that can be imposed on all members;

4. Impose managerial duties on bankrupt debtor and obligation to attend managerial meetings;

5. List fiduciary duties imposed on bankrupt member such as a duty to provide the LLC with information obtained in the course of the member's business or affairs that may prove beneficial to the LLC;

6. Consider providing that bankruptcy of bankrupt debtor does not cause a dissociation of member or a membership termination triggering a monetization of member's interest;

7. Eliminate bankrupt debtor's right to withdrawal or dissociate from LLC;

8. Tie redemption or cross-purchase provision to a percentage (e.g., 85%) of the fair market value of the bankrupt debtor's interest in the LLC based upon a valuation determined by an appraiser selected by the nondebtor members that reduces the value for lack of marketability discount, minority interest discount and personal goodwill of members if there is no noncompete – avoid aggressing forfeiture provision;

9. Eliminate voting rights of bankrupt debtor member upon involuntary assignment without the consent of the other nondebtor members such as follows:

    9.1 General. No Member shall sell, transfer, pledge or otherwise encumber or dispose of any Interest in the Company or any interest therein, or voluntarily allow such Interest to be subject, directly or indirectly, to transfer by operation of law or agreement (collectively, a "Transfer"), without the prior written consent of all of the other Members.

    9.2 Redemption of Member's Interest in the Company. If any Member (a "Defaulting Member") transfers all or any part of his Interest in the Company in violation of Section 9.1 hereof, then one or more of the other Members (collectively, the "Non-Defaulting Members") may (but shall

not be required to) purchase, and the Defaulting Member shall sell, all of the Defaulting Member's Interest in the Company to the Non-Defaulting Members who have elected in writing to exercise such right within sixty (60) days of the date of the notice from the Company to the Non-Defaulting Members of such invalid transfer (the "Notice Date"). The Non-Defaulting Member(s) who have made such election to purchase shall purchase the Defaulting Member's Interest in the Company by depositing with the Company within ten (10) days after the expiration of the foregoing 60-day period a certified or cashier's check in the amount of 85% of the fair market value of the Defaulting Member's Interest in the Company as determined by an appraiser (the "Appraiser") selected by those Non-Defaulting Members who own a majority of the interest in the Company owned by all Non-Defaulting Members (the "Purchase Price"), as determined at the close of business on the Notice Date. If no Non-Defaulting Member elects to purchase the Defaulting Member's Interest in the Company, then the Company may (but shall not be required to) purchase, and the Defaulting Member shall sell, all of the Defaulting Member's Interest in the Company to the Company if the Company tenders a certified or cashier's check in the amount of the Purchase Price within 30 days of the expiration of the foregoing 60-day period. If two or more Non-Defaulting Members elect to purchase the Defaulting Member's Interest in the Company, then such Non-Defaulting Members shall pay a portion of the Purchase Price and shall purchase a portion of the Defaulting Member's Interest in the Company based upon the number of Units then owned by each such Non-Defaulting Member at the close of business on the Notice Date. The Defaulting Member's right to distribution of Net Cash and allocations of profits and losses from the Company and any other right attributable to the Defaulting Member as a partner in the Company shall be suspended immediately upon an invalid transfer and shall be distributed and reallocated to the Non-Defaulting Members until the Defaulting Member's Interest in the Company is transferred either to the Non-Defaulting Member(s) or the Company, as the case may be. In determining the Purchase Price, the Appraiser shall take into account, in its sole and absolute discretion, a discount for lack of marketability, a discount for minority interest and a discount for lack of any noncompete covenant with members and managers of the Company causing the Company to have no or little corporate goodwill.

9.3 Involuntary Assignment by Member. In the event a Member's Interest is taken or encumbered by levy, foreclosure, charging order, execution, or other similar involuntary proceeding (a "taking") and the Non-Defaulting Member(s) and the Company do not elect to purchase the Interest of the Member as provided in Section 9.2 hereof, then the statutory or other involuntary assignee of a Member's Interest shall only have the right to an allocation of profits and losses attributable to that Member's Interest in the Company pursuant to Section __ hereof and shall

receive only the distributions of the Net Cash Flow of the Company attributable to that Member's Interest properly disbursed pursuant to Section ___ hereof. The statutory or involuntary assignee of the Member's Interest shall not, under any circumstances, have the right to interfere in the management or in the administration of the Company's business, assets, or affairs, to require any information or account of Company transactions, to inspect the Company's books and records during the continuance of the Company or to act in any manner as a Member. Upon the issuance of a court order or other enforceable directive effecting a taking, an Interest of the Member which has been taken under, or which is subject to any of the circumstances described above, shall be deemed to have been exchanged with the Company for an Interest as a Member, entitled to the same distributions and percentage of the Company's capital, profits, and losses as were attributable to such Interest that has been exchanged (other than any salary, fee or other payment made in recognition of, or as compensation for, such Member's management responsibilities and services, which will no longer be rendered by such person or entity as a Member) but shall no longer have any right to vote and/or manage the Company. The Company shall not dissolve in the event of the dissolution or bankruptcy of a Member, whether by voluntary or involuntary action. In such event, effective upon the dissolution or commencement of the bankruptcy proceeding, the affected Member's Interest shall be deemed to have been exchanged with the Company for an interest as a Member entitled to the same distributions and percentage of Company capital, profits, and losses as such person was entitled as a Member (other than any salary, fee or other payment made in recognition of, or as compensation for, such Member's management responsibilities and services, which will no longer be rendered by such person or entity as a Member) but shall no longer have any right to vote and/or manage the Company. In the event any exchange described herein would result in the Company not having a Member whose interests have not been liened or charged as aforesaid, such exchange shall be delayed for a period not to exceed ten (10) days during which period the Non-Defaulting Members may elect, by a vote of those Non-Defaulting Members with a majority of the issued and outstanding Units of the Company then owned by the Non-Defaulting Members, a new Member, or to dissolve the Company. A Member shall give notice to all Non-Defaulting Members of any deemed exchange in accordance with this Section 9.3.

10. Add an executory contract provision such as follows:

Executory Agreement in Bankruptcy. The parties agree that this Agreement constitutes an executory contract with respect to all Membership Interest issued by the Company and shall be governed by 11 U.S.C. § 365 in connection with the bankruptcy of the Company or of any Member because, among other provisions and obligations, this Agreement imposes on each Member the following affirmative duties (each of which

constitutes a material unperformed, future obligation): (a) the duty and obligation to contribute additional capital to the Company in accordance with Section ____ hereof; (b) the duty and obligation not to withdraw or disassociate as set forth in Section ___hereof; (c) the duty and obligation of good faith and fair dealing in accordance with Section ___ hereof; (d) the duty and obligation not to transfer his or its Membership Interest in the Company except in accordance with Article __; and (e) the duty and obligation not to bring any action for dissolution or appraisal rights as set forth in Section ___ hereof. Accordingly, any trustee in bankruptcy with rights in and to any of the Membership Interest issued by the Company shall be required to comply with the terms of this Agreement and Florida law governing this Agreement, including without limitation, the restrictions of the rights of a creditor of a Member or transferee pursuant to Section ______ of the Act.

IV. Shareholder in Bankruptcy

A. Corporations Differ from LLCs

1. No charging order or assignee concept is provided by state law (except in Nevada).

2. Like an LLC, the best option will be "executory contract – rejected" but only as long as this results in the inability to assign the stock. It will be harder to argue that the rights and obligations of the shareholders agreement (a private contract between the parties) are so tied to the asset (stock), that a rejection of the shareholders agreement results in the inability to assign the stock, however.

3. The second best option is "executory contract – affirmed" as the third party to whom the stock is assigned will then be subject to the buy-sell provisions and can be bought out.

4. The second worse option is "executory contract – rejected" if you cannot convince the court that the stock has to be rejected along with the shareholders agreement. In this case you have lost the ability to enforce the buy-sell provisions against the third party, but the other shareholders still have some basis to make a claim for their rights.

5. The worst option is "not an executory contract," as this means the court can disregard the terms of the shareholders agreement.

B. Shareholder Agreement as an Executory Contract under Section 365(a)

1. The holding of a majority of courts that buy-sell agreements are executory would apply to shareholder agreements also.

2. Methods to make the shareholders agreement executory are similar as for operating agreements.

a. Capital Contributions – Unusual and creates certain corporate issues for "non-assessible" stock.

C. Shareholder Agreements – Set up for Rejection?

1. If you set the agreement up for rejection, such as having personal services, and lose on the "stock and agreement tied together" argument, you will have to be prepared to have the personal services requirement waived to move you into the "affirmed" category, and also may have to offer monetization by purchasing the interest.

2. Set up for rejection by requiring personal services.

D. Planning

1. Avoid a corporation altogether. If you have an existing entity taxed as a corporation, and there is too big a tax cost to change to an LLC (or other drawbacks), consider these ways to get state law transfer restrictions like an LLC:

a. Convert to a Nevada corporation where there are charging order restrictions to the rights of a judgment creditor under Section 78.746 of Nevada's Private Corporations Statute. Presumably those rights are applicable in the bankruptcy of a debtor shareholder like for an LLC.

b. Convert to an LLC under state law and make the election to be taxed as an S or C corporation.

2. Avoid a single owner corporation. In a single owner LLC, if the Trustee becomes the sole owner it can consent to a transfer or can liquidate. A single owner corporation would seem to have the same issues. One court stated that attempts to have "peppercorn" (sham, token) members to avoid this would not work. Thus, entities with multiple owners (and with no owner in control) are stronger protection.

3. Draft to make the shareholders agreement executory.

a. Although generally bankruptcy courts have found buy-sell agreements to be executory, a mere option to buy on certain triggers may not be enough. A mandatory obligation to purchase on an owner's death may help.

b. Include affirmative obligations, such as an obligation to contribute capital (but based on vote of multiple owners with some cap). If the obligation is too remote, hypothetical, or token, it likely will not help.

c. Give the owners an obligation to comply with a fiduciary duty to the other owners. (But can a creditor use this against you by preventing the other owners to act against the interests of the creditor as assignee?)

d. State that the parties intend the agreement to be executory under the bankruptcy code.

4. Draft to include personal services (assuming you want to set up for rejection). NOTE – this may or may not work depending on the identity of the shareholders.

   a. Require all shareholders to serve as directors and attend meetings.

   b. Require all shareholders to be officers or other committee role?

   c. State that services provided by each shareholder are critical and unique and failure to perform will excuse the obligation of other shareholders to perform?

   d. State that family members have some experience or expertise that makes them uniquely suited to being the managers (but this may not actually apply to all family members).

   e. Require multi-generation to participate in management to transfer knowledge between family members.

   f. Include a provision that automatically terminates an owner's voting and managerial rights upon the bankruptcy of that owner, which should be binding since based on personal trust, etc.

   g. It is important that this be for the existing owners and any permitted transferees (like descendants or future employees) and not just any owner.

   h. It will likely be hard to make actions as a shareholder a "personal service" as it is a state law right and not dependent on the terms of the operating agreement as is the case for an LLC. Consider giving proxies or setting up voting trusts to vote the stock, or issue non-voting stock, but someone has to have the right to vote and so can you "guess" who will be the debtor ahead of time, or put this in place at the last minute?

5. Avoid one owner having a majority so that the Trustee or third party to whom the asset is assigned will not have a majority vote. Avoid having a husband and wife together have a majority if they are both liable on the same debt, such as bank guarantees, and include a super-majority voting requirement.

6. If the shareholder agreement includes a mandatory purchase or a put, particularly for cash, this may be helpful to the Trustee because it makes it easier to monetize the investment. This is a reason to avoid a mandatory purchase except on circumstances such as death.

7. Is there a drag-along right, which in the hands of a Trustee would let the Trustee sell the entire company? Consider eliminating this and rely on sale of assets.

8. Do not include any *ipso facto* clauses.

   a. Draft the triggers, purchase price and terms the same regardless of the cause of the transfer.

   b. Include legitimate reasons why you need buy-sell provisions (other than creditor protection) such as keeping ownership in the family or with employees.

   c. Draft the provisions for the price and terms of a purchase fairly or based on an objective rationale (such as a longer period to pay if the trigger due to unexpected circumstances and thus company cannot "plan ahead" for the repurchase obligation).

   d. Avoid any language that implies filing a bankruptcy (which in effect is a transfer of the interest to the Trustee) is a "transfer" that triggers the buy-sell?

   e. Consider: Price to be determined by a third party appraiser selected by the company, and based on the interest being purchased after taking into account all applicable discounts, paid over 9 years bearing interest at the AFR with no security. If this applies to all shareholders on any transfer (other than a permitted one) does this work?

9. If the owner is an irrevocable trust, many of these issues are avoided. (Subject to the transfer in fraud of creditors risk from the grantor's creditors on funding.)

144R18

In re GREGORY LEO EHMANN, Debtor. LOUIS A. MOVITZ, Trustee, Plaintiff, v. FIESTA INVESTMENTS, LLC, Defendant.

Chapter 7, CASE NO. 2-00-05708-RJH, ADVERSARY NO. 04-00956

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF ARIZONA

319 B.R. 200; 2005 Bankr. LEXIS 80

January 13, 2005, Decided

SUBSEQUENT HISTORY: Partial summary judgment granted by *Movitz v. Fiesta Invs., LLC (In re Ehmann), 2005 Bankr. LEXIS 2382 (Bankr. D. Ariz., Dec. 7, 2005)*

DISPOSITION: Fiesta's motion to dismiss denied.

CASE SUMMARY:

PROCEDURAL POSTURE: Defendant, an Arizona limited liability company, filed a motion to dismiss an adversary action filed by plaintiff, a Chapter 7 bankruptcy trustee, seeking a declaration that the trustee had the status of a member in the company, a determination that the assets of the company were being wasted, misapplied or diverted for improper purposes, and an order for dissolution and liquidation of the company or the appointment of a receiver for the company.

OVERVIEW: The limited liability company was formed by the debtor's parents to remove assets from the parents' estates for estate tax purposes and to accumulate investments for the benefit of their children after the parents' deaths. The debtor was a member of the company when his bankruptcy case was filed. The company argued that the trustee had no rights with respect to the company other than the right to receive a distribution that might be made to the debtor if and when the company decided to make such a distribution. The court, however, concluded that the trustee's rights were not controlled by the law of executory contracts and *11 U.S.C.S. § 365* because there were no obligations imposed on the members of the company that bore on the rights that the trustee sought to assert. Consequently, the court found that the trustee's rights were controlled by the more general provision under *11 U.S.C.S. § 541(c)(1)*, which rendered the limitations in the Operating Agreement and the provisions of *Ariz. Rev. Stat. §§ 29-732(A), 29-655(C)* inapplicable to the trustee's rights and powers with respect to the company.

OUTCOME: The court denied the company's motion to dismiss.

CORE TERMS: executory contract, executory, partnership, assignee, manager, partnership agreement, partner, contract rights, withdraw, contract law, bankruptcy case, appointment of a receiver, receiver, acquires, entitle, liquidation, accumulate, heir, obligations imposed, property right, judgment creditor, material breach, adversary proceeding, nonexecutory, enforceable, unperformed, liquidated, membership, dissolve, assigned

LexisNexis(R) Headnotes

Business & Corporate Law > Limited Liability Companies > Management Duties & Liabilities
Business & Corporate Law > Limited Liability Companies > Members & Other Constituents
Contracts Law > Types of Contracts > Executory Contracts

[HN1] Where the operating agreement of a limited liability company imposes no obligations on its members, it is not an executory contract. Consequently when a member who is not the manager files a Chapter 7 case, his trustee acquires all of the member's rights and interests pursuant to *11 U.S.C.S. § 541(a)* and *(c)(1)*, and the limitations of *11 U.S.C.S. § 365(c)* and *(e)* do not apply.

Contracts Law > Breach > Material Breach
Contracts Law > Performance > General Overview
Contracts Law > Types of Contracts > Executory Contracts
[HN2] Although the Bankruptcy Code contains no definition of an executory contract, the United States Court of Appeals for the Ninth Circuit has adopted the "Countryman Test": A contract is executory if the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.

Bankruptcy Law > Case Administration > Administrative Powers > Executory Contracts & Unexpired Leases > General Overview
Contracts Law > Types of Contracts > Executory Contracts
[HN3] An unexercised option is not an executory contract.

Business & Corporate Law > Limited Liability Companies > Members & Other Constituents
Business & Corporate Law > Limited Partnerships > Management Duties & Liabilities
Contracts Law > Types of Contracts > Executory Contracts
[HN4] It is facile to assume that all partnership agreements are executory contracts. Closer analysis reveals that if there are no material obligations that must be performed by the members of a limited liability company or the limited partners in a limited partnership, then the contract is not executory and is not governed by *11 U.S.C.S. § 365*.

Bankruptcy Law > Estate Property > Content
Contracts Law > Debtor & Creditor Relations
[HN5] *11 U.S.C.S. § 541(c)(1)* expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor.

COUNSEL: [**1] For GREGORY LEO EHMANN aka GREG EHMANN, Debtor: JOHN J. HEBERT, HEBERT SCHENK P.C., PHOENIX, AZ.

For LOUIS A. MOVITZ, Trustee: TERRY A. DAKE, TERRY A. DAKE, LTD., PHOENIX, AZ.

For GREGORY LEO EHMANN, Debtor: MARK W. ROTH, HEBERT SCHENK, P.C., PHOENIX, AZ.

For LOUIS A. MOVITZ, Plaintiff: TERRY A. DAKE, TERRY A. DAKE, LTD., PHOENIX, AZ.

For FIESTA INVESTMENTS, LLC, Defendant: MARK W. ROTH, HEBERT SCHENK, P.C., PHOENIX, AZ.

JUDGES: Randolph J. Haines, U.S. Bankruptcy Judge.

OPINION BY: Randolph J. Haines

OPINION

[*201] OPINION DENYING DEFENDANT'S MOTION TO DISMISS COUNT I

The Court here concludes that [HN1] because the operating agreement of a limited liability company imposes no obligations on its members, it is not an executory contract. Consequently when a member who is not the manager files a Chapter 7 case, his trustee acquires all of the member's rights and interests pursuant to *Bankruptcy Code* [1] §§ 541(a) and *(c)(1)*, and the limitations of *§§ 365(c)* and *(e)* do not apply.

1 Unless otherwise indicated, all chapter, section, and rule references are to the Bankruptcy Code, *11 U.S.C. §§ 101-1330*, and to the *Federal Rules of Bankruptcy Procedure, Rules 1001-9036*.

[**2] **Procedural Background**

Plaintiff Louis A. Movitz ("Trustee") is the Chapter 7 Trustee for the estate of Debtor Gregory L. Ehmann ("Debtor"). The Trustee has sued Defendant Fiesta Investments, LLC ("Defendant" or "Fiesta"), an Arizona limited liability company of which the Debtor was a member when his bankruptcy case was filed. The Trustee's suit seeks a declaration that the Trustee has the status of a member in Fiesta, a determination that the assets of Fiesta are being wasted, misapplied or diverted for improper purposes, and an order for dissolution and liquidation of Fiesta or the appointment of a receiver for Fiesta.

[*202] Fiesta has moved to dismiss the complaint. The Court understood Fiesta's motion as directed to Count II of the complaint to be based solely on an argument that the Court lacks subject matter jurisdiction, which this Court has already denied. The motion to dismiss Count I rests more on substantive law, arguing essentially that the Trustee has no rights with respect to Fiesta other than the right to receive a distribution that might have been made to the Debtor if and when Fiesta decides to make such a distribution. Such a motion to dismiss should be granted [**3] only if the Court con-

cludes that the Trustee could prove no set of facts that would entitle him to any remedy other than simply waiting to see if Fiesta should ever decide to make a distribution.

Background Facts

The Trustee's complaint identifies Fiesta as an Arizona limited liability company that was formed in approximately 1998 by the Debtor's parents, Anthony and Alice Ehmann. At the time it was formed, it had two assets, a 17% interest in City Leasing Co. Ltd. and 25% interest in Desert Farms LLC. Shortly after this bankruptcy case was filed, however, City Leasing was liquidated and as a result of that liquidation Fiesta received cash distributions in the amount of approximately $ 837,000 in the summer of 2000. Fiesta is still receiving regular quarterly distributions of cash from its other asset, Desert Farms.

The Trustee's complaint stems from the fact that although no formal distributions have been declared or paid to members, and certainly not to the Debtor, substantial amounts of cash have flowed out of Fiesta to or for the benefit of other members, including $ 374,500 in loans to members or to corporations owned or controlled by members, a $ 42,500 payment to one [**4] member, and $ 124,000 paid to another member to redeem his interest. In response to the Trustee's demand for information and distributions, the managing member of Fiesta, the Debtor's father, responded that he had created "Fiesta a few years ago to remove assets from our estate for estate tax purposes, and to accumulate investments for the benefit of our children after our deaths. . . . We see no reason to accede to the wishes of any member or assignee of any member which runs contrary to our original goals." Yet the outflow of over half a million dollars does not seem to be consistent with the original goal "to accumulate investments for the benefit of our children after our deaths."

The Parties' Arguments

While the parties disagree on several relevant legal principles, a dispute that is absolutely central to the motion to dismiss is whether the Trustee's rights are governed by *Bankruptcy Code § 541(c)(1)* or by *§ 365(e)(2)*. In a very general sense, the latter provision, if applicable, permits the enforcement of state and contract law restrictions on the Trustee's rights and powers, whereas the former provision, if applicable, would render such restrictions and conditions [**5] unenforceable as against the Trustee. Because *§ 541* applies generally to all property and rights that the Trustee acquires, whereas *§ 365* applies more specifically to executory contract rights, the answer to this question hinges on whether the Trustee is asserting a property right or an executory contract right.

The Trustee's complaint does not expressly seek to exercise any rights under an executory contract, nor does it identify the Fiesta Operating Agreement as being an executory contract, but merely attaches it as an exhibit. Indeed, as Fiesta notes, the deadline for the Trustee to have assumed or rejected an executory contract [*203] has long since passed. [2] In its motion to dismiss, Fiesta relies heavily on various provisions of the Fiesta Operating Agreement which provide that in the event a trustee acquires a member's interests, such action shall not dissolve the company or entitle "any such assignee to participate in the management of the business and affairs of the company or to exercise the right of a Member unless such assignee is admitted as a Member. . . ." Operating Agreement P 7.2. "Such an assignee that has not become a Member is only entitled to receive to the extent [**6] assigned the share of distributions . . . to which such Member would otherwise be entitled with respect to the assigned interest." *Id.* Fiesta further notes that such limitations on the rights of assignees of members' interests in LLCs are specifically authorized by state law, *Arizona Revised Statutes ("A.R.S.") § 29-732(A)*. Fiesta also argues that the Trustee is akin to a judgment creditor, and that *A.R.S. § 29-655(C)* provides that a charging order is the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the member's interest in an LLC. Nowhere in its motion to dismiss, however, does Fiesta argue that the Operating Agreement creates an executory contract between Members and the LLC, that *§ 365(e)(2)* renders such provisions on which Fiesta relies enforceable against the Trustee, or that *§ 541(c)(1)* is for some other reason inapplicable.

2 The bankruptcy case was filed as a voluntary Chapter 7 on May 26, 2000. *Bankruptcy Code § 365(d)(1)* provides that in a Chapter 7 case, an executory contract is deemed rejected unless assumed or rejected by the Trustee within 60 days after the filing of the case.

[**7] In response, the Trustee argues that he is not a mere assignee of the Debtor's membership interest, but rather acquired all of the Debtor's right, title and interest pursuant to *§ 541(a)*. He argues, further, that the Trustee took the Debtor's rights free of certain conditions and restrictions that would otherwise devalue the asset in the hands of any other assignee, pursuant to *§ 541(c)(1)*.

In reply, Fiesta relies on *§ 365(e)* to maintain that the state and contract law restrictions are enforceable against the Trustee notwithstanding *§ 541(c)(1)*. Nowhere, however, does Fiesta ever establish, much less even attempt to demonstrate, that the Trustee's complaint seeks to enforce rights under an executory contract. To the contrary, Fiesta simply assumes or flatly asserts that the Trustee's rights hinge entirely on an executory con-

tract: "In the case at bar, there is no dispute that if the Operating Agreement is considered as a partnership agreement it is an executory contract." Fiesta Reply at 6. And yet the very case that Fiesta cites after making that assertion itself concluded that a partnership relationship may include both an executory contract and a nonexecutory property interest [**8] in the profits and surplus. *Cutler v. Cutler (In re Cutler), 165 B.R. 275, 280 (Bankr. D. Ariz. 1994)*(Case, B.J.).

If a partnership relation entails both executory contract rights and nonexecutory property rights, then it would seem to necessitate a threshold determination of which kind of rights are at issue for the particular kind of relief a Trustee seeks with respect to a partnership or LLC. Before reaching that issue, however, it may be fruitful first to examine whether the Fiesta Operating Agreement even includes any executory contract rights.

Legal Analysis

[HN2] Although the Bankruptcy Code contains no definition of an executory contract, the Ninth Circuit has adopted the "Countryman Test": "[A] contract is executory [*204] if the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'" [3]

> 3 *Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co., Inc.), 139 F.3d 702, 705 (9th Cir. 1998)*, quoting *Griffel v. Murphy (In re Wegner), 839 F.2d 533, 536 (9th Cir. 1988)*, and citing Vern Countryman, *Executory Contracts in Bankruptcy*: Part I, 57 MINN. L. REV. 439, 460 (1973).

[**9] While Fiesta undoubtedly owes many obligations to its members pursuant to the Operating Agreement, for the contract to be executory there would also have to be some material obligation owing to the company by the member. Moreover, such member's obligation must be so material that if the member did not perform it, Fiesta would owe no further obligations to that member.

As noted above, in its briefing on the motion to dismiss Fiesta has not attempted to demonstrate that the Operating Agreement is in fact an executory contract, much less to demonstrate exactly what material obligation is owed to the company by its members. Moreover, the founding member's statement of the purposes for which the company was formed suggests that it is very likely there are no such obligations. The purpose was twofold: to remove assets from the parents' estates for estate tax purposes, and to accumulate investments for the benefit of their children after their deaths. One would certainly not expect the children-members to have any obligations with respect to satisfaction of that first goal, which was a unilateral act by the parents, and it is highly unlikely the children-members undertook any obligations [**10] with respect to the second goal, any more than would an ordinary prospective heir.

This suspicion is borne out by a close reading of the Operating Agreement itself. It imposes many obligations on the managers, but as noted above the manager is the Debtor's father, not the Debtor. Article V is entitled "Rights and Obligations of Members," but in fact it identifies only rights and no obligations. It (1) limits members' liability for company debts, (2) grants members the right to obtain a list of other members, grants members the right to approve by majority vote the sale, exchange or other disposition of all or substantially all of the company's assets, (4) grants the members rights to inspect and copy any documents, (5) grants members the same priority as to return of capital contributions or to profits and losses, and (6) grants the permissible transferee of a member's interests the right to require the company to adjust the basis of the company's property and the capital account of the affected member. In short, the Article of the Operating Agreement that is partially titled "Obligations of Members" reveals that members have no obligations to the company.

In the entire Agreement, [**11] the only provision where members, who are not managers, agree to do anything is Article 7.4, which provides in part that "Each member agrees not to voluntarily withdraw from the company as a member. . . ." It is now questionable in the Ninth Circuit whether such an agreement merely to refrain from acting is sufficient, standing alone, to create an executory contract. [4] But we need not go that far to resolve this issue, because [*205] the sentence in which each member agrees not to voluntarily withdraw goes on to say: "And each Member further agrees that if he attempts to withdraw from the Company in violation of the provisions of this paragraph, he shall receive One Dollar ($ 1.00) in payment of his interest in the Company and the remaining portion of such Member's interest shall be retained by the Company as liquidated damages." This reveals that what at first may have appeared as a mandatory obligation is in fact merely an option, which gives each member the option of withdrawing if he is willing to accept $ 1.00 for his interest. But under *Helms*, such [HN3] an unexercised option is not an executory contract. [5]

> 4 In the case where the Ninth Circuit first expressly adopted the Countryman test, it held that such an agreement to refrain from acting may be sufficient to make a contract executory: "Because of the exclusive nature of the license which Fenix

received, Select-A-Seat was under a continuing obligation not to sell its software packages to other parties. Violation of this obligation would be a material breach of the licensing agreement." *Fenix Cattle Co. v. Silver (In re Select-A-Seat Corp.), 625 F.2d 290, 292 (9th Cir. 1980)*(decided under the prior Bankruptcy Act). That decision was legislatively repealed in 1984 by the adoption of *§ 365(n)*. More recently, the *en banc* decision in *Helms, supra note 3*, reformulated the test in a way that focuses only on affirmative performance: "The question thus becomes: At the time of filing, does each party have something it must do to avoid materially breaching the contract?" *139 F.3d at 706*. And the Andrews/Westbrook analysis, as thoroughly explained in *In re Bergt, 241 B.R. 17, 21-36 (Bankr. D. Alaska 1999)*, demonstrates that it makes no sense to determine the "executoriness" of a contract if its assumption would impose no administrative liability on the estate, because the avoidance of such administrative liability when it exceeds the contractual benefits is the sole reason for executory contract law.

[**12]

5 *Helms, supra note 3, 139 F.3d at 705.*

As demonstrated by the excellent analysis in *Smith,* [6] [HN4] it is facile to assume that all partnership agreements are executory contracts. Closer analysis reveals that if there are no material obligations that must be performed by the members of a limited liability company or the limited partners in a limited partnership, then the contract is not executory and is not governed by Code *§ 365*. [7] This case is therefore unlike others that have expressly found "an obligation to contribute capital" and other "continuing fiduciary obligations among the partners that make this [Partnership] Agreement an executory contract." [8]

6 *Samson v. Prokopf (In re Smith), 185 B.R. 285, 292-93 (Bankr. S.D. Ill. 1995)* (a majority of courts that have found limited partnership agreements to be executory contracts "have either accepted the executory contract characterization summarily or have dealt with limited partnership agreements under which the limited partner has continuing financial obligations to the partnership.").

[**13]

7 *See, e.g., In re Garrison-Ashburn, L.C., 253 B.R. 700, 708-09 (Bankr. E.D. Va. 2000)*(there is no executory contract and *§ 365* does not apply to an operating agreement that imposes no duties or responsibilities on its members, but merely provides for the structure of the management of the entity); *Smith, supra note 6, 185 B.R. at 291-95* (limited partnership agreement was not executory as to a limited partner/debtor who had no material obligations to perform; the Chapter 7 trustee steps into the shoes of the debtor and may exercise debtor's right to dissolve the partnership).

8 *Calvin v. Siegal (In re Siegal), 190 B.R. 639, 643 (Bankr. D. Ariz. 1996)*(Case, J.), citing *In re Sunset Developers, 69 B.R. 710, 712 (Bankr. D. Idaho 1987). See also Summit Invest, and Dev. Corp. v. Leroux, 69 F.3d 608 (1st Cir. 1995)(§ 365* applies to general partner debtors who have duties and obligations to limited partnership); *Broyhill v. DeLuca (In re DeLuca), 194 B.R. 65 (Bankr. E.D. Va. 1996)* (*§ 365* applies to debtors who were managers of limited liability companywith ongoing duties and responsibilities; because debtors' personal identity and participation were material to the development project, the *§ 365(e)(2)* exception to assumption applies); *In re Daugherty Constr., Inc., 188 B.R. 607, 612 (Bankr. D. Neb. 1995)*(operating agreements are executory contracts because there are material unperformed and continuing obligations among the members, including participation in management and contributions of capital).

[**14] In the absence of any obligation on the part of the member, it is difficult to see [*206] where an executory contract lies. This is consistent with the whole purpose of Fiesta. It was created simply as a way to reduce the estate tax liabilities that might otherwise have been incurred upon the death of the parents and the distribution of their estate to their heirs. Indeed, as *King Lear* suggests, the irrevocable transfer of the parents' assets to Fiesta and the irrevocable gift of membership interests in Fiesta to their children probably creates even less obligations on the children than the ordinary filial obligations morally felt by most expectant heirs.

Moreover, not only do there not appear to be *any* obligations imposed upon members by the Fiesta Operating Agreement, but there are certainly none with respect to either receipt of a distribution or proper management of the company by its managers. Members do not have to do anything to be entitled to proper management of the company by the managers. The Trustee's complaint does not involve the Debtor's lone arguable obligation not to voluntarily withdraw.

Because there are no obligations imposed on members that bear on the rights [**15] the Trustee seeks to assert here, the Trustee's rights are not controlled by the law of executory contracts and *Bankruptcy Code § 365*. Consequently the Trustee's rights are controlled by the more general provision governing property of the estate, which is *Bankruptcy Code § 541*.

[HN5] Code *§ 541(c)(1)* expressly provides that an interest of the debtor becomes property of the estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. All of the limitations in the Operating Agreement, and all of the provisions of Arizona law on which Fiesta relies, constitute conditions and restrictions upon the member's transfer of his interest. Code *§ 541(c)(1)* renders those restrictions inapplicable. This necessarily implies the Trustee has all of the rights and powers with respect to Fiesta that the Debtor held as of the commencement of the case.

It therefore appears that the Trustee may be able to prove a set of facts that would entitle the Trustee to some remedy. The appropriate remedy might include a declaration of the Trustee's rights, redemption of the Debtor's interest, [9] appointment of a receiver to operate the [**16] partnership in accordance with its purposes and the members' rights, [10] or dissolution, wind up and liquidation. Consequently [*207] Fiesta's motion to dismiss must be denied.

9 As noted above, Fiesta has already redeemed one member's interest for $ 124,000. That suggests that it has the power to do so, that redemption of a member's interest is not contrary to Fiesta's interests or purposes, and that $ 124,000 might be an appropriate value for the Debtor's interest. Because the schedules filed in this case reflect priority and unsecured debts of less than $ 70,000, such a remedy might entirely satisfy the Trustee while simultaneously avoiding any disruption of the partnership or any conflict with the purposes for which it was created.

10 Although *§ 105(b)* provides that "a court may not appoint a receiver in a case under this title," the precise language of that provision and case law make clear that it applies only to the administrative bankruptcy "case," not to an adversary proceeding. A "case" is what is commenced by the filing of a petition, *e.g.*, *§ 301*, whereas a "proceeding" is commenced by a summons and complaint, *Bankruptcy Rules 7001 & 7004*. The provision was added simply because the Code "has ample provision for the appointment of a trustee when needed." S. Rep. No. 989, 95th Cong. 2d Sess. 29 (1978). Consequently *§ 105(b)* "does not prohibit the appointment of a receiver in a related adversary proceeding if otherwise authorized and appropriate." 2 LAWRENCE P. KING, *COLLIER ON BANKRUPTCY P 105.06*, at 105-84.7 (15th Ed. 2004). *Accord, Craig v. McCarty Ranch Trust (In re Cassidy Land and Cattle Co.), 836 F.2d 1130, 1133 (8th Cir. 1988)*; *In re Memorial Estates, Inc., 797 F.2d 516, 520 (7th Cir. 1986)*("The power cut off by *section 105(b) of the Bankruptcy Code* is the power to appoint a receiver for the bankrupt estate, that is, a receiver in lieu of a trustee.").

[**17] Dated this 13th day of January, 2005.

Randolph J. Haines

U.S. Bankruptcy Judge

THE CROSSROAD OF ALTERNATIVE ENTITIES AND BANKRUPTCY – A TREACHEROUS INTERSECTION

CURRENT STATUS OF BANKRUPTCY ISSUES

August 2010

James J. Wheaton
Liberty Tax Service
1716 Corporate Landing Parkway
Virginia Beach, VA 23454
(757) 301-8144
jim.wheaton@libtax.com*

*** Contact information updated as of May 2012**

CURRENT STATUS OF BANKRUPTCY ISSUES

James J. Wheaton
Troutman Sanders LLP
222 Central Park Avenue
Virginia Beach, Virginia 23462

I. Applying Bankruptcy Law to LLCs.

A. Eligibility of an LLC to File a Bankruptcy Petition.

Title 11 of the United States Code (the "Bankruptcy Code") permits "persons" to file bankruptcy petitions, and the statutory definition of "person" includes "individual, partnership, and corporation." Bankruptcy Code § 101(41). Although an LLC is not a "partnership" in a state law sense, the Bankruptcy Code defines "corporation" to include:

> (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; [or]
>
> ***
>
> (iv) unincorporated company or association;

Bankruptcy Code § 101(9)(A). For the purposes of determining an LLC's eligibility to file a bankruptcy petition, an LLC should be able to fit within either of the subsections cited above. It might be possible to argue with the characterization of an LLC as a corporation because § 101(9)(B) specifically excludes limited partnerships from the definition of corporations, but this distinction is unlikely to matter in any event. The definition of "person" lists individuals, partnerships and corporations as entities "included" within the definition, but is not so exclusive as to prevent another type of entity not listed in the statute from also being characterized by a court as a "person."

It is also worth observing that the classification of an LLC as a partnership or as a corporation for purposes of determining the applicability of the Bankruptcy Code should have little other effect on the disposition of a bankruptcy proceeding. Most of the provisions of the Bankruptcy Code that apply specifically to partnerships relate to issues, such as the liabilities of general partners, that are not likely to apply in an LLC context.

The distinction between a "partnership" and a "partnership association" that fits within the Bankruptcy Code definition of "corporation" arose in In re Rambo Imaging, L.L.P., 2008 Bankr. LEXIS 2311 (Bankr. W.D. Tex. July 15, 2008). In that case, the bankrupt entity was a Texas general partnership that had elected limited liability partnership status. Although the partnership agreement described numerous actions that could be taken only with the approval of two-thirds of the holders of partnership units, and delegated other actions to the "Managing Partners," the agreement did not specifically address the power to put the partnership into bankruptcy. The partnership was clearly a general partnership, but the court engaged in an analysis of the limited liability of the partners, and relied on a treatise reference in Collier's, to

conclude that an LLP should be treated as a "partnership association," and therefore a "corporation" for Bankruptcy Code definitional purposes. On that basis, the court held that a dissident general partner did not have the power to commence an involuntary bankruptcy proceeding on behalf of the partnership.

The court in In re Midpoint Development, L.L.C., 313 B.R. 486 (Bankr. W.D. Okla. 2004) noted the omission of LLCs from the Bankruptcy Code, and analogized to corporations and partnerships. In that case, the court held that even a limited liability company in dissolution is entitled to make a bankruptcy filing, because a dissolved LLC is still in the process of winding up, and the winding up process may be conducted through bankruptcy. However, this case was ultimately reversed by the Tenth Circuit because the bankrupt LLC had not only dissolved, but had actually filed articles of dissolution that became effective prior to the bankruptcy filing. On the effective date of the articles of dissolution, the Oklahoma LLC ceased to exist, and so could not later file for bankruptcy. See In re Midpoint Development, L.L.C., 466 F.3d 1201 (10th Cir. 2006).

B. Authority to File a Bankruptcy Petition.

As a general proposition, state law determines who has the legal right to file a bankruptcy petition. With respect to general partnerships, the federal bankruptcy rules provide that a bankruptcy petition may be filed by any general partner, provided that all general partners consent, see Fed. Bankr. R. § 1004(a), but in corporate and other contexts, the power to file a petition will depend on the actual authority of those wishing to do so. The decision will usually rest with a corporation's board of directors, but in an LLC setting, the authority of managers is not as clear. State LLC statutes generally do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC's governing documents. If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC's managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an LLC operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

Most of the cases addressing the power to file a bankruptcy petition are divided into two categories: those that deal with the statutory power to initiate bankruptcy, and others that address whether a bankruptcy has been appropriately commenced given the terms of an LLC's governing documents or other agreements.

1. Statutory Power to File.

In In re A-Z Electronics LLC, 350 B.R. 886 (Bankr. D. Idaho 2006), a bankruptcy proceeding on behalf of an LLC had been commenced by the LLC's sole member, but the member was himself the subject of a Chapter 7 bankruptcy proceeding. On that basis, the court concluded that the member's bankruptcy trustee had the statutory status of the member, and therefore was the only person entitled to commence the bankruptcy proceeding on behalf of the LLC. In In re Delta Starr Broadcasting, L.L.C., 2006 WL 285974 (E.D. La. Feb. 6, 2006), the court analyzed the Louisiana LLC statute and concluded that a bankruptcy petition should be likened to other major actions requiring majority approval of an LLC's members under that statute. Although the LLC had not undertaken formal procedures (including resolutions or a meeting) before initiating the LLC's bankruptcy, the court concluded that a majority of the members had unambiguously approved the filing, and that Louisiana law did not require "corporate" formalities in order for an LLC to take valid member action.

2. Contractual Power to File.

The value of a contractual provision limiting the authority of managers or member to file made bankruptcy petition was a clear in In re Avalon Hotel Partners, LLC, 302 B.R. 377 (Bankr. D. Or. 2003). In this case, the operating agreement required 75% member approval for certain "Major Decisions." Although bankruptcy was not specifically listed as an event triggering the "Major Decision" clause, the court reached the conclusion that a bankruptcy filing was analogous to a conversion into another type of entity, and imposed the 75% requirement. However, it is preferable to anticipate bankruptcy more explicitly.

Courts have generally enforced explicit contractual provisions governing the right to file a bankruptcy proceeding, including provisions that have been drafted to protect creditors. In In re Orchard at Hansen Park, LLC, 347 B.R. 822 (Bankr. N.D. Tex. 2006), the operating agreement required unanimous member consent for the filing of a voluntary bankruptcy proceeding, and the court allowed a creditor to intervene and contest the authority of one of the members to file the petition. The court concluded that a creditor had standing to make that challenge, reviewed an operating agreement provision that required unanimous member vote, and concluded that without evidence of that vote, the filing member was without authority to file the bankruptcy petition on behalf of the LLC. Compare In re Telluride Income Growth Limited Partnership, 311 B.R. 585 (Bankr. D. Colo. 2004) (dissolved LLC serving as general partner of limited partnership not eligible to initiate bankruptcy on behalf of limited partnership because limited partnership agreement provided for the termination of the LLC's status as general partner upon dissolution).

Two recent cases also emphasize the importance of providing more explicitly for the possibility of an LLC's bankruptcy. In both cases, had the operating agreements been more explicit, the court's analysis would have been unnecessary. See In re 210 West Liberty Holdings, LLC, 2009 WL 1522047 (Bankr. N.D.W. Va May 29, 2009) (provision that "all decisions" be made by majority vote is sufficient to allow bankruptcy filing over member objection because objecting member's approval not necessary to constitute majority); In re Ice Oasis, LLC, 2008 WL 5753355 (Bankr. N.D. Cal. Nov. 7, 2008) (in two member LLC with 50/50 ownership, both members required to approve bankruptcy filing because operating

agreement provided for "all decisions" to be approved by a majority, and bankruptcy is not an ordinary course decision that may be approved by the managing member).

In two other cases, courts have enforced provisions that give lenders an explicit voice in the filing of a bankruptcy petition. In In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007), the operating agreement established the creditor as a "Class B shareholder," and the filing of a voluntary bankruptcy by the LLC required the consent of the Class B shareholder. This case actually involved the ruse of the LLC soliciting the filing of an involuntary case that it then failed to contest, but the court concluded that that end-run around the creditor's contractual rights as a member was inappropriate, and granted the creditor relief from the stay because the bankruptcy had been filed without its consent. In In re Green Power Kenansville, LLC, 2004 WL 5413067 (Bankr. E.D.N.C. Nov. 18, 2004), an LLC's sole member had assigned its interest in the LLC to a third party, which then commenced a bankruptcy petition on behalf of the LLC. The assignment violated a loan agreement, the voting of the interest by the assignee was contrary to a pledge agreement provision that allowed the creditor to vote all of the original member's interests upon a loan default, and the assertion of authority by the assignee apparently attempted to override an independent manager provision that effectively required lender consent to a bankruptcy filing by the LLC. The court enforced the independent manager provision, despite the fact that the assignee may not have had knowledge of the provision, on the basis that the assignee member was governed by the written operating agreement irrespective of knowledge. Because the assignee lacked power to file the petition, the court dismissed the bankruptcy proceeding.

3. Effect of Non-Bankruptcy Law.

The court in In re Orchard Village Investments, LLC, 405 B.R. 341 (D. Ore. 2009) was required to consider whether non-bankruptcy state receivership law could be used to prevent the filing of a bankruptcy petition. Following the creation of the state receivership, the receiver was granted broad authority that arguably divested the members of the authority to file a bankruptcy petition. The LLC's operating agreement specifically denied the LLC's manager the authority to file a bankruptcy petition, and reserved that power to the members by majority consent. In this case, the disputed bankruptcy petition was filed by the manager, and ratified post-petition by the members. The court held the post-ratification approval sufficient under the operating agreement, and held that the state receivership proceeding could not trump the ability to file the federal bankruptcy petition.

C. Effects of an LLC Bankruptcy Filing.

1. LLC Bankruptcy Filing as a Dissolution Event.

The LLC statutes do not define a bankruptcy filing by an LLC as an event of dissolution or dissociation, and so it is unnecessary to determine whether the winding-up process will be triggered by such a bankruptcy.

2. Composition of the Bankruptcy Estate.

The "estate" of a bankrupt LLC will include "all legal or equitable interests" of the LLC as of the time of filing. Bankruptcy Code § 541(a). In addition to the LLC's property,

these interests will include all rights of the LLC under an operating agreement to additional member contributions or required member loans.

In In re KRSM Properties, LLC, 318 B.R. 712 (Bankr. App. 9th Cir. 2004), the court was confronted by a claim by the member-owners of a bankrupt LLC that they were entitled to challenge a creditor's attempt to recover tax payments made by the LLC on behalf of the individual owners. The members took the position that they were synonymous with the LLC, that their tax obligations were those of the LLC, and that the prior tax payments were properly made. The court correctly concluded that the status of the LLC as a pass-through entity did not vitiate the separateness of the LLC from its members, and concluded that the LLC's bankruptcy estate could attempt to claw back the prior tax payments.

In In re Ealy, 307 B.R. 653 (Bankr. E.D. Ark. 2004), the court observed the general rule that the assets of an LLC are not equitably owned by its members, so that the bankruptcy estate of a member does not include the LLC's assets. However, in that case, the court found other equitable circumstances for treating the individual member as having an equitable interest in real estate nominally owned by the LLC.

3. Preferences.

Under Bankruptcy Code § 547(b)(4), the "insiders" of a debtor are subject to a one year preference period. Managers of an LLC are likely to be considered insiders of the LLC, and members in a member-managed LLC will probably have the same status. It is possible that investor members of an LLC that do not otherwise participate in the LLC's business might fall outside the "insider" preference period.

Although Section 101(31) of the Bankruptcy Code does not explicitly define managers and others in positions of management responsibility of an LLC as "insiders," the court in In re CEP Holdings, LLC, 2006 WL 3422665 (Bankr. N.D. Ohio Nov. 28, 2006) concluded that the statutory definition of officers of a corporation as corporate insiders should be "transferred" to determine insider status for an LLC. The court concluded that the title bestowed upon a potential insider would not be determinative, but that the appropriate test was the actual position and responsibility of the insider. Because managers and members with significant responsibilities may have the kind of relationship with an bankrupt LLC that would make their dealings with the LLC subject to scrutiny because of the possibility of non-arms-length transactions, it is likely that such persons will be presumed to have insider status for the purposes of evaluating potential preferences.

In In re Carr & Porter, LLC, 416 B.R. 239 (Bankr. E.D. Va. 2009), an attorney who owned the debtor law practice organized as an LLC sold his interest back to the Company. The debtor agreed to pay Porter $1 million in multiple payments over several years and accordingly made regular installment payments to Porter until the debtor LLC filed for bankruptcy. Trustee claimed that these payments were transfers to an insider in violation of Section 547(b) of the Bankruptcy Code and that Porter was required to turn over assets he received from the debtor. The court held that as a former member, Porter was not an insider within the meaning of Section 547(b) and granted summary judgment in his favor. Even though after the sale of his interest, Porter remained an important attorney with the debtor, was

responsible for the debtor's most significant client and helped obtain a loan for the debtor, Porter relinquished all of his executive authority and no longer functioned in a managerial capacity. Therefore, payments made to Porter were not transfers to an insider and did not have to be turned over to the trustee. Interestingly, the trustee failed to pursue what should have been a more viable claim – that the debt was incurred and/or the payments made by the LLC "in respect of" an LLC interest at a time when such distributions were wrongful under Virginia's LLC statute.

4. Member or Creditor?

The court in In re Cybersight, LLC, 2004 WL 2713098 (D. Del. Nov. 17, 2004) addressed the status of a former member's claim to payment in respect of a membership interest. The former member had arbitrated the amount of his claim for the former interest, and reduced the arbitration award to judgment. The court concluded that notwithstanding the fact that the award related back to a prior equity interest in the LLC, the interest was properly viewed as a debt obligation of the debtor LLC, so that the former member was entitled to be treated as a general unsecured creditor.

5. Applicability of Stay to Members.

In contrast to the partnership context, where a stay that extends to the property of individual partners may be appropriate in order to protect creditor access to the assets of the partners, it would not be appropriate for a stay to be made applicable to the members of an LLC. As a general proposition, the members and managers of an LLC are not liable, by reason of their status as such, for the obligations of the entity.

Courts have generally recognized the distinction between an LLC's assets and the assets of members, and have held that when one or the other files bankruptcy, the bankruptcy stay does not include the assets of the other. In In re Calhoun, 312 B.R. 380 (Bankr. N.D. Iowa 2004), the court noted that in a case involving an individual member bankruptcy, LLCs in which the debtor had an interest would not be subject to or protected by the provisions of the automatic stay.

By contrast, in In re Saxby's Coffee Worldwide, LLC, 2009 Bankr. LEXIS 3848 (Bankr. E.D. Pa. Dec. 4, 2009), the court issued an injunction to bar actions against the owners of the debtor LLC. At the time of its bankruptcy filing, seven lawsuits were pending against the debtor's members and entities owned by the debtor's members. The members filed a motion for preliminary injunction under Section 105 of the Bankruptcy Code to stop the defendants from prosecuting these actions. Although an automatic stay generally may not be invoked to protect non-debtors, Section 105 provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Accordingly, the court held that in this case an injunction was warranted to stop actions against members of the LLC because their time, energy and commitment were necessary for the formulation of a reorganization plan, which would be jeopardized if the debtor's members had to defend themselves from pending lawsuits. However, the court refused to issue an injunction with respect to actions against entities owned by the debtor's members because these entities did not play a significant role in the operation of the debtor.

6. Agreement to Issue LLC Interest as an Executory Contract.

In In re Sandman Associates, L.L.C., 251 B.R. 473 (W.D. Va. 2000), a prospective member of an LLC entered into a letter agreement with the LLC to make a capital contribution in exchange for an interest. The letter contemplated that the new member would sign the operating agreement, but even though the contribution was made, the operating agreement was never signed. After the parties engaged in series of disputes, the LLC filed for bankruptcy in an effort to shed itself of the dissident contributor. The court concluded that the failure to sign the operating agreement was a technical matter that did not alter the fact that the performance obligations of the contributor under the letter agreement (i.e. the making of the contribution) had been satisfied. Because the performance had already occurred and the letter agreement did not contemplate any unperformed future acts, the letter was not an executory contract capable of being rejected by the bankrupt LLC.

7. Substantive Consolidation.

Two courts addressed the equitable doctrine of substantive consolidation in 2005. Substantive consolidation is often sought by bankrupt debtors that wish to include the assets of legally separate but related entities in the bankruptcy estate, or by creditors wishing to gain access to the assets of non-bankrupt but affiliated entities.

In In Re Brentwood Golf Club, LLC, 329 B.R. 802 (Bankr. E.D. Mich. 2005), the LLC operator of a golf course was the bankrupt, and its lender sought to be able to reach the assets of a separate LLC that operated the restaurant at the golf course. The court found that the bank could reach the assets of the restaurant LLC on both a piercing the corporate veil basis and under the doctrine of substantive consolidation. The court considered evidence that ownership of the restaurant assets had never been transferred from the golf course LLC to the restaurant LLC, that the two LLCs did not maintain separate bank accounts until after the bankruptcy petition was filed, that the lease to the restaurant LLC was at a substantially below-market rate (less than approximately fifty cents per square foot), that the restaurant LLC had failed to make rent payments or other payments required under the lease, that the financial records of the entities were "inextricably" intertwined, and that the reality of operations of the golf course made the restaurant and the course interdependent. The court found that the two entities met the requirements of Michigan's common law alter ego test. Although it was unnecessary to its decision, the court then proceeded to evaluate the substantive consolidation issue, and separately went through the substantive consolidation analysis under the second circuit's Augie/Restivo and the D.C. Circuit's Auto-Train tests. The court noted that substantive consolidation did not necessarily require it to find facts as plain as those that enabled it to apply the state law alter ego test, and concluded that substantive consolidation was appropriate under both standards.

In Re Owens Corning, 419 F.3d 195 (3d Cir. 2005) involved an attempt by bankrupt Owens Corning to force the substantive consolidation of its non-bankruptcy subsidiaries. One of the principal lenders had extended financing that was based on separate guaranties received from, among others, certain of Owens Corning's non-consolidated subsidiaries. The Third Circuit reversed the district court's holding that the entities should be substantively consolidated. The non-consolidated subsidiaries (both LLCs and corporations) had been maintained separately before the filing of the bankruptcy petition, and the evidence of

commingling and lack of separateness was minimal. The court concluded that consolidation would be appropriate only if separateness of the entities had been disregarded prior to the filing of the bankruptcy petition, such that Owens Corning's creditors knew the separation of the entities had broken down, or if the assets of the entities were so commingled that separating them after the filing of the petition would be prohibitive. The Third Circuit found that neither factor was present and also seemed troubled by the fact that substantive consolidation was being used "offensively" by the debtor in order to prefer certain creditors over others.

A recent case emphasizes the importance to creditors of carefully drafting provisions intended to cover bankruptcy filings by single purpose entities (SPEs). In In re General Growth Properties, Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009), several hundred SPEs had been established with "independent managers" who had the power to consent or withhold consent to a bankruptcy filing by each SPE. Before the bankruptcy petitions were filed against the ultimate parent and the numerous subsidiaries, the independent managers were discharged and replaced, in a manner that apparently complied with the provisions of the SPEs' operating agreements. Because the new independent managers arguably had more expertise than the prior independent managers, the court concluded that this maneuver could not be deemed to be in bad faith, and refused to dismiss the bankruptcy petitions on that basis.

II. Bankruptcy of a Member.

A. Nature of a Bankrupt Member's Bankruptcy Estate.

As observed above, the bankruptcy estate of a debtor includes all of the debtor's legal or equitable interests as of the filing of the bankruptcy petition. In the many cases that have addressed the bankruptcy of a partnership's general partner, it has been observed that the partner's interest in the partnership consists of the partner's economic rights, the partner's management rights, and the partner's rights as a co-owner of partnership property. In re Cardinal Industries, Inc., 116 B.R. 964, 970-71 (Bankr. S.D. Ohio 1990). The concept of co-ownership of partnership property flows from sections 24 and 25 of the original Uniform Partnership Act, which specify that a partner holds partnership property as a tenant in partnership with the other partners.

Because the members of an LLC do not have any interest in an LLC's property, a member's bankruptcy estate will consist of the member's economic rights in the LLC (referred to in some statutes as the member's "distributional interest"), and the member's management rights in the LLC. See In re Garrison-Ashburn, L.C., 253 B.R. 700, 707-708 (E.D. Va. 2000) (bankruptcy estate includes both economic and non-economic rights in the LLC). A more extensive discussion of the distinction between economic and non-economic rights, and the extent to which they are affected by provisions of state law and operating agreements, is contained in subsections C and D below.

B. Scope of Estate.

The contents of a bankrupt member's bankruptcy estate are also affected by pre-bankruptcy agreements and by the distinction between a member's rights in the member's membership interest from a possible interest in the underlying assets of the LLC.

1. Pre-Bankruptcy Restrictive Contracts.

In In re Weiss, 376 B.R. 867 (N.D. Ill. 2007), the debtor member was subject to operating agreements that prohibited a pledge or assignment of the member's interests without the consent of the LLCs' managers. Notwithstanding this restriction, the debtor pledged his interests in the LLCs to his creditors, and the creditors sought relief from the bankruptcy stay in the member's case on the basis that they were secured creditors. The court concluded that the interests were not subject to the security interests because the member had no legal right to make the pledges, and concluded that the security interests in the LLC interests were therefore unperfected because they could not attach to collateral that the debtor had no right to transfer.

2. Debtor's Interest in the LLC.

The separateness of an individual debtor from a related LLC, even where an LLC is a single-member LLC, was emphasized by the court in In re McCormick, 381 B.R. 594 (Bankr. S.D.N.Y. 2008). In that case, the debtor filed for individual relief under Chapter 13 of the Bankruptcy Code, and attempted to draw the single-member LLC of which he was the sole member into his individual bankruptcy proceeding. The court concluded that the automatic stay that applied to the individual debtor would not apply to the LLC, and concluded that because an entity was not an eligible debtor under Chapter 13, the LLC could not be a co- or joint debtor with the bankrupt member under Chapter 13. A similar result occurred in In re Knefel, 2007 WL 2416535 (Bankr. E.D. Va. Aug. 17, 2007), in which the court concluded that a single-member LLC owned by the member debtor was not subject to the automatic stay that applied to the individual debtor.

Two other recent cases yielded similar results. In In re Aldape Telford Glazier, Inc., 410 B.R. 60 (Bankr. D. Ida. Jul. 23, 2009), a bankrupt corporation was the sole member of the non-bankrupt LLC and listed the assets of the LLC as its own assets in the corporation's bankruptcy petition. The court held that the winding up of the LLC had not been completed (which would have involved the payment of the LLC's creditors and evidence of actual distribution to the member). The assets of the LLC could not be deemed to be the assets of the debtor because they had not been distributed to the debtor. Similarly, in In re Harder, 413 B.R. 827 (Bankr. D. Ore. 2009), the debtor requested that the court issued an injunction barring the creditors of numerous LLCs, in which the debtor was a member, from pursuing lawsuits against the LLCs. The debtor argued that an injunction was warranted under Section 105 of the Bankruptcy Code because without it, any plan of reorganization would be jeopardized. The court declined to order the injunction. First, the court emphasized that the real estate holdings of the LLCs were property of LLCs that were not in bankruptcy. They were not the debtor's property and the court needed to evaluate any prejudice to the debtor's reorganization, not to the LLCs' reorganization. Additionally, even though the debtor's rights in the LLCs would generally be a part of his estate and would be affected by any lawsuits against the LLCs, this was not such a case because the debtor had assigned his ownership interests in the LLC to a workout expert. Finally, issuing an injunction would unnecessarily prejudice the LLCs' creditors and would result in a greater harm to them than to the debtor.

Although many cases involving an attempt to ignore the separateness of an LLC by drawing a non-bankrupt LLC's assets into a bankrupt member's LLC estate constitute efforts

by the bankrupt to enlarge the bankruptcy estate, In re Goreham, 2009 Bankr. LEXIS 2995 (Bankr. D. Neb. Sept. 16, 2009) involved a case in which a member successfully transferred assets away from his non-bankrupt LLC, to the detriment of creditors. The debtor was the sole member of an LLC that owned a piece of real estate. Within ninety days before the bankruptcy filing, the debtor caused the LLC to transfer the real estate to a corporation owned by the debtor's son. The court refused to set aside this transfer, holding that although the debtor's interest in the LLC was his personal property and thus property of his bankruptcy estate, the LLC's underlying property was not. The transfer made by the LLC could not be avoided as a preferential transfer under Section 547(b) because it was not attributable to the debtor.

3. Winding Up an LLC In Which a Bankrupting Member Owns an Interest.

As discussed below, there are a number of decisions surrounding the extent to which a bankrupt member can continue to participate in the managment activities of an LLC. However, once an LLC is dissolved and is in the process of winding up, the outcome may be different. In In re LaHood, 2009 WL 803558 (Bankr. C.D. Ill. Mar. 19, 2009), the court concluded that a non-bankrupt member of a dissolved LLC continued to have the right to participate in the winding up process. Michael and Richard Lahood each owned 50% membership interest in an LLC. Michael filed for bankruptcy, and Richard (also a creditor of Michael's) declared the LLC dissolved pursuant to a provision of the operating agreement that provided for member bankruptcy as a dissolution event. Without seeking relief from stay, Richard then caused the LLC to wind up by conveying the LLC's real property to himself and Michael in equal shares. The court held that the distribution of the real estate was invalid because it violated the LLC statutory provision that prescribes that creditors of the LLC should be paid first when winding up the LLC's affairs.

The trustee also asserted that Michael had the right to participate in the LLC's winding up of its affairs under Illinois law because Michael's dissociation was not wrongful. The court agreed and found that Michael's dissociation was not in breach of any provision of the LLC's operating agreement.

A second case emphasizes the power of even a bankrupt member to manage the winding up process. In In re Greeson, 2009 Bankr. LEXIS 1732 (Bankr. D. Kan. Jun. 2, 2009), the court allowed the distribution of the bankrupt LLC's assets to the member, even though the bankrupt member had sold and distributed the assets of the LLCs to the bankruptcy estate without satisfying the statutory requirement that creditors be paid first. The debtors dissolved the LLC before bankruptcy. They then filed for bankruptcy and took the position that upon the dissolution of the LLC, the LLC's assets became their property and part of their bankruptcy estate. To strengthen their position, the debtors effectuated formal transfers, pursuant to which the LLC conveyed its equipment and accounts receivables to the debtors. Creditors objected to the debtors' position because under Kansas statutory scheme of distribution priorities when winding up an LLC, an LLC's property must first be used to satisfy creditors' claims. The court declined to apply the "trust fund doctrine" and found that even though the debtors violated the Kansas LLC act, the creditors could vindicate their rights against the assets in the bankruptcy process.

C. Provisions of State Law and Operating Agreements that Apply in Bankruptcy.

Most LLC acts provide, as a default rule, that unless otherwise agreed by an LLC's members, the bankruptcy of a member will be an event of dissociation. Most operating agreements will address the extent to which a bankruptcy filing by a member will trigger dissociation or dissolution, but this contractual language will often be co-extensive with the statutory default rules.

To the extent that the remaining members of an LLC elect to continue the business of an LLC following an event of dissociation or dissolution, both statutory law and operating agreements will generally provide that the bankrupt member loses status as a member and thereby ceases to have any management rights in the LLC. At that point, the member's rights in the LLC will typically be limited to economic or "distributional" rights. The bankrupt member will have the status of a transferee or assignee of an LLC interest, and cannot again take on the status of a member unless admitted to membership by the requisite vote of the remaining members. The effect of these general statutory and contractual rules in the bankruptcy context is addressed in subsection D below. Some more general issues are also addressed by the following cases:

1. Forfeiture of an Interest May Be Treated as a Preference in Favor of Non-Debtor Members.

In In re Lull, 2008 WL 3895561 (Bankr. D. Hawaii Aug. 22, 2008), the bankrupt member had been removed from his status as a member of the LLC. There was a dispute as to whether the removal (which the court denoted as a "transfer") took place before or after the filing of the petition, but in any event, the court analyzed the automatic dissociation of the bankrupt member under the Hawaii LLC statute, and concluded that whether the forfeiture took place under the terms of that statute or the operating agreement, the consequent benefit to the other members might be treated as a preference. The court concluded that the non-bankrupt member was a statutory insider (and therefore subject to the one-year preference), found that the non-bankrupt member received more because of the bankrupt member's removal/forfeiture than he would have as an unsecured creditor, and reserved for later judgment a determination of the actual amount of the preference. This kind of preference analysis, if applied more widely by the courts, could have a significant impact on the ability of LLCs and non-bankrupt members to effectively enforce contractual and statutory restrictions that might otherwise be enforceable, because a court could potentially treat every forfeiture or reduction of a bankrupt member's economic interest as a preference directly recoverable from the LLC's other members (even where the non-bankrupt members may not have liquidity in the LLC sufficient to pay the preferenced amount into the bankruptcy estate).

2. Exercise of Rights as Member or Manager.

In one recent case, without substantive discussion of the issue, a North Carolina bankruptcy court held that a bankrupt member had standing to seek judicial dissolution of a non-bankrupt LLC notwithstanding the fact that the North Carolina LLC Act and the operating agreement caused the bankrupt member to cease to be a member upon the filing of his bankruptcy petition. Under the dissolution provisions of the North Carolina statute, absence of

status as a member should have defeated the bankrupt member's subsequent attempt to pursue judicial dissolution, but the court treated the prohibition as an invalid *ipso facto* clause (see the further discussion below), and without further analysis, proceeded to analyze the requested dissolution on its substantive merits in later proceedings. See In re Klingerman, 388 B.R. 677 (Bankr. E.D.N.C. 2008). The continuing rights of a bankrupt member (or that bankrupt member's personal representative) to exercise management rights can also arise in a context where the bankrupt member may object to the assertion of management rights, because those rights will be exercised by the debtor's bankruptcy trustee. In In re Modanlo, 2007 WL 2609470 (Bankr. D. Md. May 19, 2006), the bankrupt member objected to actions proposed to be taken by his bankruptcy trustee. The trustee had designated himself as the manager of a single-member LLC controlled by the bankrupt, and the court analyzed Delaware law and concluded that the personal representative had the statutory power to continue a single-member LLC following a dissolution caused by the bankruptcy of its sole member. Having continued the LLC in its status as personal representative of the sole member, the trustee therefore had the power to designate itself as the manager.

D. Enforceability of Statutory and Operating Agreement Provisions in the Bankruptcy Context.

1. Operating Agreement as an Executory Contract.

It is generally established that partnership agreements, to the extent they delineate material unperformed obligations of the partners, are executory contracts within the meaning of the Bankruptcy Code. Almost all of the cases that have thus far addressed bankruptcy issues in the LLC context have likewise held that operating agreements are executory contracts. See In re Daugherty Construction, Inc., 118 B.R. 607 (Bankr. D. Neb. 1995), ("Daugherty"); In re DeLuca, 194 B.R. 65 (Bankr. E. D. Va. 1996) ("DeLuca I"); In re DeLuca, 194 B.R. 79 (Bankr. E. D. Va. 1996) ("DeLuca II"). Operating agreements will contain numerous provisions relating to ongoing agreements and covenants of the parties, and for this reason, it is often appropriate that they also be classified as executory contracts for purposes of the Bankruptcy Code. For example, in Allentown Ambassadors, Inc., 361 B.R. 422 (Bankr. E.D. Pa. 2007), the court concluded that an operating agreement relating to the operation of an independent professional baseball league was an executory contract because the members had continuing duties, including duties to manage the LLC (i.e., the baseball league), and the duty to make additional cash contributions as needed for the operation of the LLC.

Notwithstanding the trend of cases holding that partnership agreements and operating agreements are executory contracts, several courts have determined that operating agreements did not contain sufficient unperformed obligations to be treated as executory contracts. The court in In re Garrison-Ashburn, L.C., 253 B.R. 700 (E.D. Va. 2000) found that the operating agreement did not contemplate future performance by the members, but merely served to establish the framework under which the LLC would be managed. Because the court concluded that the operating agreement was not an executory contract, the court gave effect to the current Virginia LLC act provision that makes the bankruptcy of a member an event of dissociation, and concluded that the prohibitions on *ipso facto* clauses that apply to executory contracts did not apply to this LLC. The court's reasoning appeared to be affected both by a Virginia statutory change since the date of the cases cited above, which changed the bankruptcy

of a member from an event causing the dissolution of the LLC itself to one that causes the dissociation of the member, and by the fact that the LLC's operating agreement did not include the kinds of provisions that would have created the possibility of future performance obligations (such as provisions related to future capital contributions or loans, requiring active participation in management or imposing negative restrictions on the ability of members to compete or otherwise take actions contrary to the interests of the LLC).

Another court held that because an operating agreement did not contain any current obligations or continuing management role for an LLC's member, the operating agreement was not an executory contract capable of being assumed, assigned or rejected. See In re Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006). Likewise, in In re Tsiaoushis, 2007 WL 2156132 (E.D. Va. July 19, 2007), both the district court and the bankruptcy court in a previous decision found that the operating agreement was not an executory contract because there were no material, continuing obligations of the members. The bankrupt debtor had no managerial duties in a manager capacity, and had no unperformed duties as a member. Because the agreement imposed no additional duties or responsibilities, the court found that the agreement was not an executory contract, that it was therefore not subject to the Bankruptcy Code Section 365 analysis discussed further below, and that the trustee would be entitled to enforce the provisions of the operating agreement requiring the dissolution and winding up of the LLC as a result of the debtor member's bankruptcy filing.

A similar result was reached in In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005). In Ehmann, the LLC had been formed by an individual debtor's parents, apparently for estate planning purposes. Ehmann's bankruptcy trustee pursued various claims against the LLC, asserting that it had the right to make those claims because it was stepping into the shoes of Ehmann as a member. In its defense, the LLC attempted to rely on some of the bankruptcy provisions discussed in the following sections of this outline, and claimed that the trustee did not have the power to assume the debtor member's rights under the operating agreement, which it alleged to be an executory contract. The court concluded, however, that the operating agreement of the LLC contained no unperformed obligations of the type that would cause it to be deemed an executory contract, and that in fact, the debtor member had no "obligations" to be performed that would trigger the bankruptcy law provisions sought to be applied by the LLC. Those substantive bankruptcy law issues were not reached because the court concluded that no executory contract was involved.

A second decision was issued in Ehmann in late 2005. 334 B.R. 437 (Bankr. D. Ariz. 2005). In this decision, a bankruptcy court permitted the bankruptcy trustee to exercise a member's rights to seek remedies for breaches of the operating agreement by the non-bankrupt manager, who was apparently authorizing loans and other insider transactions in a manner that was contrary to the operating agreement. The transactions appeared to be designed to avoid distributing to the bankrupt Ehmann his share of the proceeds of a prior transaction which resulted in significant cash being available to the LLC. The court concluded that an injunctive remedy would not be effective against this misbehavior, and ordered the appointment of a receiver. Note, however, that this opinion was withdrawn by the bankruptcy court in late January 2006.

A recent case addressed, in relatively summary fashion, the executory contract status of an operating agreement provision designating a member as "Vice President" of an LLC. The court concluded that an operating agreement provision that terminated the member's status as an officer upon the filing of his personal bankruptcy petition was not an invalid "*ipso facto*" clause because the member's service as an officer should be thought of as a personal service contract, not an assignable executory contract. See JD Factors, LLC, v. Freightco, LLC, 2009 WL 3401965 (N.D. Ind. Oct. 16, 2009).

2. Applicable Bankruptcy Law Provisions.

Section 365(a) of the Bankruptcy Code provides that the bankruptcy trustee, subject to court approval, may assume or reject any of the debtor's executory contracts. Section 365(f) further provides that except as provided in Section 365(c), the trustee may assign an executory contract notwithstanding any contrary provision in any contract or under applicable law. Note that for the purposes of Chapter 11 of the Bankruptcy Code, references to the "trustee" should be considered to refer also to a debtor in possession. Bankruptcy Code § 1107.

The general rule is that the trustee or debtor in possession is permitted to assume an executory contract even if nonbankruptcy law or the contract itself would forbid such an assumption. Section 541(c) of the Bankruptcy Code overrides any restriction on the transferability of an asset in the bankruptcy estate that may be imposed by an agreement or nonbankruptcy law, and Section 365(e)(1) permits the avoidance of so-called "*ipso facto*" clauses that would otherwise provide for the termination or modification of a contract or contract right that might be triggered by the debtor's commencement of the bankruptcy case or insolvency or financial condition prior to the termination of the bankruptcy case. Two other sections of the Bankruptcy Code, however, hold out the possibility that it might still be possible to enforce statutory and agreement provisions that are triggered by a partner's or member's bankruptcy.

Section 365(c) of the Bankruptcy Code provides that the trustee or debtor in possession may not assume or assign an executory contract if:

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment;

Bankruptcy Code § 365(c). This section is consistent with similar language in § 365(e)(2), which exempts the same categories of executory contracts from the provisions cited above that would otherwise override *ipso facto* clauses.

> Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or

> delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

Based on a strict construction of the statutory language, therefore, it would seem that a trustee (including even the debtor in possession) will not be permitted to assume an operating agreement if it can be determined that the agreement is of a type as to which state law excuses a nonbankrupt member from accepting performance from or rendering performance to any party other than the debtor or the debtor in possession.

3. The Right Of A Debtor Member To Assume An Operating Agreement.

Two courts have addressed in detail whether a debtor in possession or trustee may assume an operating agreement, notwithstanding state law provisions that would provide for bankruptcy as a disassociation or dissolution event. In the absence of bankruptcy law provisions that override state law, the bankruptcy of a member would, at least in member-managed LLCs, trigger an opportunity for the remaining members to vote whether to continue the LLC. In any event, the bankruptcy would cause the bankrupt member's status as a member to cease.

a. Daugherty.

In Daugherty, which was decided in October 1995, the bankruptcy court concluded that the provisions of the Nebraska Limited Liability Company Act were overridden by the Bankruptcy Code, and that the bankruptcy of a member did not trigger a dissolution of the LLC. The court held that even under an operating agreement, Section 365(c)(1) does not permit a party to avoid accepting from or rendering performance to a debtor in possession. 188 B.R. at 614. This analysis is consistent with the majority rule in partnership cases, and the leading case in partnership area is In re Cardinal Industries, Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990). The Daugherty court specifically rejected a separate line of cases which have held that a partnership dissolves, and a partner's status as such ceases, upon a partner's bankruptcy filing.

b. The DeLuca Cases.

Both of the DeLuca cases arose from the bankruptcy filings of a husband and wife who are involved in numerous entities, including several LLCs. In DeLuca I, the principal question was whether the remaining members of the LLC could remove the DeLucas as managers of the LLC and insert a new manager, when the underlying operating agreement required unanimous member consent for the appointment of a new manager. The court concluded that the pre-petition removal of the DeLucas as managers was valid because the operating agreement was silent on removal but state law permitted removal upon a majority vote of the members. The court also found that a new manager could be appointed by the remaining members after the bankruptcy petition because the bankruptcy petition of the DeLucas had the effect of terminating the DeLucas' status as members.

In DeLuca II, the DeLucas were members of an LLC that was itself one of two members of a second LLC. The other member of the second LLC sought the court's determination that the DeLucas' bankruptcy caused a dissolution of the first LLC (because there were no non-bankrupt members of that LLC who could vote to continue), and that the dissolution of the first LLC therefore triggered the dissolution of the second LLC. Again, the court gave effect to state law provisions and agreed that the second LLC had dissolved as a result of the DeLucas' Chapter 11 filing. However, without reaching the question whether the DeLucas had unlawfully dissolved the second LLC, the court concluded that it would not disturb the prior appointment of a bankruptcy trustee in favor of allowing the remaining member of the second LLC to wind up the LLC's business. The applicable Virginia statute would have permitted all members (presumably including the first LLC) that had not "wrongfully dissolved" the LLC to participate in the winding up.

In both of the DeLuca cases, the court relied primarily on Breeden v. Catron, 158 B.R. 624 (Bankr. E. D. Va. 1992), aff'd, 158 B.R. 629 (E. D. Va. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994), a general partnership case in which the lower courts and in the Fourth Circuit concluded that the language of Section 365(c) should be read literally to prevent the debtor in possession's assumption of a partnership agreement because applicable state law would not require the remaining partners to perform their obligations under the partnership agreement or to accept the performance of the bankrupt partner's obligations from any party other than the bankrupt partner. In such circumstances, the Catron court concluded, neither the trustee nor the debtor in possession could assume the contract. In the DeLuca cases, the court likened the partnership agreement at issue in Catron to the operating agreements involved in the DeLuca cases, and concluded that the state law provisions governing dissolution and the status of a bankrupt member should be given effect notwithstanding the Bankruptcy Code's general preference toward permitting the assumption of executory contracts.

For a complete discussion of the DeLuca cases and the underlying legal issues, see Wheaton, "Dumping Deadbeats: Enforcing Limited Liability Company Agreements in Bankruptcy," Journal of Limited Liability Companies, Fall 1996, at 60.

4. Other Cases Addressing Assumption and Ipso Facto Issues.

Several other cases have addressed the relationship of the bankruptcy law provisions to single-member LLCs. In In re Desmond, 316 B.R. 593 (Bankr. D.N.H. 2004), an individual debtor sought to prevent a creditor of a wholly-owned LLC from taking action against the LLC by asserting that obligations entered into by the LLC were invalid because the authorization of the obligations by the debtor in his manager capacity was invalid because the management rights were an asset of his individual bankruptcy estate. The court found that because the LLC was not in bankruptcy, nothing about the debtor's individual bankruptcy deprived him of the right to take action on behalf of the LLC. The court distinguished In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003). In Albright, the court concluded that it could disregard statutory provisions requiring approval for the admission of an assignee as a member because the LLC at issue was a single-member LLC, and there were no other members whose approval was required before the chapter 7 trustee could be substituted as a member for the bankrupt debtor-member.

Two Delaware cases have also addressed the *ipso facto* clause issue and the status of and distinction between economic and management rights in an LLC. In Milford Power Company, LLC v. PDC Milford Power, LLC, 866 A. 2d 738 (Del. Ch. 2004), the court analyzed the appropriate bankruptcy law sections and concluded that bankruptcy law preempted any provisions of the LLC operating agreement that would deprive a debtor of making its economic rights available to assignee, but would allow the enforcement of the agreement to the extent it restricted the assignment of the debtor's management rights. A similar result was reached by another Delaware court in In Re IT Group, Inc., 302 B.R. 483 (D. Del. 2003).

The court in the Allentown case also conducted an extensive analysis of the Section 365 and *ipso facto* clause issues. Having concluded that the operating agreement relating to the operation of a professional baseball league constituted an executory contract, the court concluded that the debtor member's interest in the LLC was not terminated as a result of the member's bankruptcy. The court synthesized the partnership and LLC cases addressing the tension between the various Section 365 subsections, and concluded that the North Carolina statutory provisions that restrict assignments of membership interests are sufficiently ambiguous that they do not constitute applicable non-bankruptcy law prohibiting assignment. The court also concluded on the facts that the operation of the LLC did not demonstrate that a member's duties were the kinds of non-delegable duties that should render the membership interest non-assignable.

In the JD Factors case noted above, the court also concluded that under § 365(c)(1), an Indiana law provision to the effect that a person cannot become a member without the consent of all the other members would be likely to be given effect.

E. LLC as Insider of Member Debtor.

In In re Barman, 237 B.R. 342 (Bankr. E.D. Mich. 1999), the court held that for the purposes of defining the "insiders" of an individual Chapter 7 debtor, an LLC is sufficiently close to a corporation to apply the bankruptcy principles that apply to corporations. Under the Bankruptcy Code, a corporation of which the debtor is a director, officer or control person, or an affiliate or insider of an affiliate, constitutes an insider. A corporation is an affiliate if the debtor controls 20% or more of its "voting securities." In this case, which involved a South Carolina LLC, the court found that the LLC was an insider of the member debtor because the debtor was one of three of the LLC's members and owned or controlled one-third of the voting rights in the LLCs.

BUSINESS LAW

by Thomas O. Wells and Jordi Guso

Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member

Doctors, entrepreneurs, and officers and directors of public companies with exposure to potential, future claims of creditors sometimes create family limited partnerships and family limited liability companies (collectively referred to as FLPs) for estate planning and wealth preservation purposes in order to minimize their exposure to claims of potential future creditors. Through a combination of Florida laws and contractual provisions, creditors' rights are limited against assets of an FLP, including rights to foreclose upon or monetize a debtor partner's interest in an FLP. In bankruptcy, however, those laws and contractual provisions may not be recognized or enforced if the partnership or operating agreement of the FLP is found *not* to be an "executory contract."

This article provides lawyers with an outline of asset protection benefits provided by an FLP, analyzes how a bankruptcy proceeding by a partner in the FLP affects these protections, and suggests language to address the issues raised in *In re Ehmann (Movitz v. Fiesta Investments, LLC)*, 310 B.R. 200 (Bank. D. Ariz. 2005).

Florida Law FLP Creditor Protections

An FLP has two types of creditors — inside creditors and outside creditors. Inside creditor claims arise from alleged actions or omissions of the FLP. Inside creditors may levy against the assets of an FLP, but generally cannot levy against the individual assets of limited partners or members of the FLP. Outside creditor claims arise from alleged actions or omissions by a debtor partner of the FLP. This article's focus is on the rights of outside creditors to the debtor partner's interest in the FLP.

Florida law generally restricts the rights of an outside creditor to a charging order imposed upon the debtor partner's FLP interest.[1] In contrast, in a general partnership, the debtor partner's interest may be judicially foreclosed if a debtor partner's interest is subject to a charging order. Therefore, practitioners often use limited partnerships or limited liability companies — and not general partnerships — to protect and maintain the integrity of the assets of the FLP. Another reason to use a limited partnership or a limited liability company for an FLP is that the parties may contractually restrict the transferability of a debtor partner's interest in the FLP.[2] Further, an assignee of the FLP interest is not allowed to become a new or substituted partner, review the books and records of the FLP, nor vote as a partner in the FLP.[3]

Bankruptcy Law Effects on an FLP

If a debtor partner files bankruptcy, both the FLP and the other partners of the FLP can be effected. Sections 541 (property of the estate) and 365 (executory contracts and unexpired leases) of the Bankruptcy Code are critical to the analysis. Both of these sections expressly restrict or override state law and contractual terms. For example, §541(c)(1) states:

> [A]n interest of the debtor in property becomes property of the estate...notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —
> (A) that restricts or conditions transfer of such interest by the debtor; or
> (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title...and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.[4]

Similarly, §365(e)(1) provides in pertinent part:

> Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . of the debtor may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on —
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title; or
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

On the authority of §365(e)(1) that ipso facto clauses are unenforceable in bankruptcy, some bankruptcy courts have essentially "red-penned" contractual terms in an underlying partnership or operating agreement or state law provisions to prevent the automatic withdrawal of a debtor partner in an FLP or termination of the debtor partner's interest in the FLP upon the bankruptcy filing of the debtor partner.[5] Other bankruptcy courts have interpreted §365 differently and allowed the state law and contractual provisions to take effect,[6] including by looking to subsection (c) of §365, which states:

The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.

Additionally, a few bankruptcy courts have found that a partnership agreement is an executory contract,[7] while other courts have concluded that a partnership agreement is not an executory contract.[8]

On top of this analysis, bankruptcy courts also consider the effect of §541. A recent case that brings the analysis under both §§541 and 365 to the forefront is *Ehmann*. In *Ehmann*, the court analyzed the duties owed by a bankrupt member to the LLC to determine whether the operating agreement was an executory contract. The court concluded that such duties must be so material that if the member did not perform such duties, the LLC would owe no further obligations to that member.[9]

For example, the purpose in creating the LLC in *Ehmann* was to remove assets from the parents' estates for estate tax purposes and to accumulate investments for the benefit of their children after the death of the parents. The bankrupt member was not a manager. The "Rights and Obligations of Members" in the operating agreement did not impose any obligations upon the bankrupt member.[10] The only provision in the operating agreement imposing an obligation on the nonmanaging bankrupt member was the agreement by such member not to voluntarily withdraw from the LLC as a member. The *Ehmann* court determined that an agreement to refrain from acting is not sufficient to create an executory contract.[11] The *Ehmann* court found that the operating agreement's duty not to withdraw did not create an executory contract because such duty was tantamount to an option by a member to withdraw and receive $1 in payment for his membership interest with the remaining portion of such membership interest being retained by the LLC as liquidated damages.

If the FLP's partnership or operating agreement *is not* an executory contract, the bankrupt trustee's rights to the interest in the FLP are governed by the general provisions of 11 U.S.C. §541(c).[12] Section 541(c)(1) provides that an interest of the debtor becomes property of the bankruptcy estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. All limitations in the FLP's partnership or operating agreement and all provisions of Florida law that restrict or condition the transfer of a debtor partner's interest in the FLP are inapplicable pursuant to §541(c)(1). Accordingly, the bankruptcy trustee has all of the rights and powers with respect to the FLP that the debtor partner held as of the filing of bankruptcy and is not limited solely to a charging order or prohibited to review the books and records of the FLP or vote as a partner or member of the FLP. The key asset protection features of an FLP are sterilized if the partnership or operating agreement of the FLP is not an executory contract.

If the FLP's partnership or operating agreement *is* an executory contract, the bankruptcy trustee's rights to the interest in the FLP are governed by the general provisions of 11 U.S.C. §§365(c) and (e).[13] Although there is some judicial ambiguity, §§365(c)(1) and 365(e)(2) allow for the enforcement of state and contract law restrictions upon a bankruptcy trustee's rights to a bankrupt partner's interest in the FLP.[14] In other words, practitioners want the FLP partnership or operating agreement to constitute an executory contract so that their asset protection terms will likely be respected in the bankruptcy of one of its partners.

"Ehmannizing" the Partnership Agreement

The *Ehmann* court focused on the

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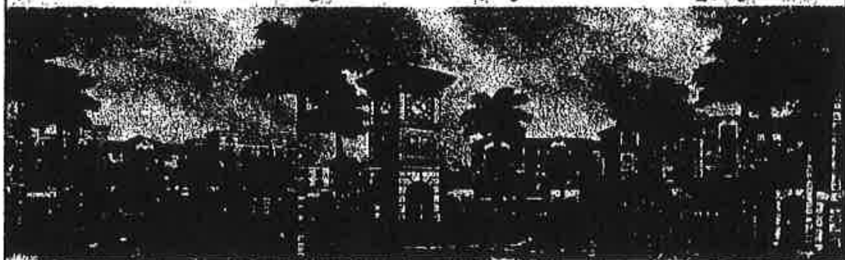

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following duties by nonmanaging members and provisions of the FLP partnership or operating agreement to cause it not to be an executory contract: a) the purpose of the FLP; b) the requirement of members to make future capital contributions; c) the requirement for members to be involved in the management of the FLP; and d) the imposition of fiduciary duties upon the members. In order to "Ehmannize" the FLP partnership or operating agreement, the authors suggest that operating and partnership agreements include the following provisions:

- A provision setting forth the business purpose of the partnership so that the bankruptcy court will not frustrate such purpose and adversely affect the rights of the nonbankrupt partners or members by disregarding the partnership or operating agreement and state partnership or limited liability company laws.
- A statement that the parties desire and agree that the partnership agreement constitute an executory contract under 11 U.S.C. §365 with a summary of each duty imposed upon a partner to create the executory contract.
- A duty to make future capital contributions by each partner to the partnership.
- An obligation for each partner to comply with certain fiduciary duties owed to the other partners and the partnership.
- An obligation that each partner be involved in the management of the partnership and attend regular partnership meetings.

Summary

Cases such as *In re Ehmann* and *Sampson v. Prokopf (In re Smith)*, 185 B.R. 285, 292-293 (Bankr. S.D. Ill. 1995), hold that if the partnership or operating agreement is not an executory contract under federal bankruptcy law, then the asset protection features generally applicable to a bankrupt partner or member's interest in the FLP under state and contract law will not apply to the bankrupt partner or member's bankruptcy trustee. In order to ensure that the FLP partnership or operating agreement is an executory contract and that such asset protection features continue to apply in a bankrupt partner or member's bankruptcy, certain obligations need to be imposed upon such bankrupt partner or member and incorporated into the FLP partnership or operating agreement. These obligations include the duty to make future capital calls and to be involved in the future management of the FLP. ☐

[1] *See* Fla. Stat. §§608.433(4) (limited liability company), 620.1703 (limited partnership), and 620.8504 (general partnership). *See also Asset Protection in the Partnership Context: What's All the Hoopla?*, 68 Fla. B.J. 43 (Feb. 1994), for a summary of judicial and statutory case law addressing asset protection provided by an FLP.

[2] *See* Fla. Stat. §§620.1702(6) (limited partnership) and 608.432 (limited liability company).

[3] *See* Fla. Stat. §§608.433(1) and 608.432(2)(a) (limited liability company), 620.1702(1)(c) (limited partnership), and

As vice president of Trugman Valuation Associates, Linda heads up the firm's estate and gift tax practice. She is also an expert in the area of family limited partnerships. Estate attorneys and CPAs regularly call on Linda for a range of experience and expertise not easily found among independent business valuation professionals. In fact, the leading appraisal, business valuation and CPA organizations across the country frequently request Linda as an instructor and lecturer. Linda is on the Board of Examiners of two of the leading appraisal organizations and she serves the profession on numerous levels. Dedicated to leadership and outstanding service in business valuation, Linda brings the full commitment, resources and expertise of Trugman Valuation Associates to every assignment.

Linda B. Trugman
CPA*/ABV, MCBA, ASA, MBA

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Read the extensive list of Linda's credentials at www.trugmanvaluation.com, or e-mail her at linda@trugmanvaluation.com for more information.

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620.8503(1)(c) (general partnership).

[4] 11 U.S.C. §541(c).

[5] *See Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995) (§365(e)(1) exempts the ipso facto provision included in the partnership agreement); and *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (upon filing of a partner's Ch. 11 petition in reorganization, §365(e)(1) prevents the ipso facto dissolution of the partnership under state law). *See also* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) (recommendations of the National Bankruptcy Commission).

[6] Certain courts have held that the ipso facto provision is not applicable to a partnership agreement that is an executory contract pursuant to 11 U.S.C. §365(e)(1) and the bankruptcy trustee cannot disregard dissolution provisions tied to the bankruptcy filing of a partner. *See In re Sunset Developers*, 69 B.R. 710, 712-713 (Bankr. D. Idaho 1987) (§365(c) prevented §365(e) from applying to a partnership agreement); *Finkelstein v. Security Properties, Inc.*, 888 P.2d 161 (Wash. App. 1995) (§365(e)(2) clarifies Congress' intention to prevent only private contracts from counteracting the Bankruptcy Code, not to prevent state law, such as partnership law, from determining the status of a partnership); and *In re Helms*, 10 B.R. 817, 821-822 (Bankr. D. Colo. 1981) (holding that limited partnership dissolved on the day of the general partner's bankruptcy filing because under §365(c), executory limitdd partnership agreements cannot be assumed by a debtor-in-possession without the consent of all of the limited partners).

[7] *Sampson v. Prokopf (In re Smith)*, 185 B.R. 285, 292-293 (Bankr. S.D. Ill. 1995) (stating that a majority of courts that have found limited partnership agreements to be executory contracts "have either accepted the executory contract characterization summarily or have dealt with limited partnership agreements under which the limited partner has continuing financial obligations to the partnership); *Calvin v. Siegel (In re Siegel)*, 190 B.R. 639, 643 (Bankr. D. Ariz. 1996); and *In re Sunset Developers*, 69 B.R. at 712 (in which an obligation to contribute capital to the partnership by the debtor partner creates an executory contract); *Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d at 614 (executory contracts apply to general partner debtors who have duties and obligations to the limited partnership); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996) (executory contracts apply to debtors who were managers of a limited liability company with ongoing duties and responsibilities. Because debtors' personal identity and participation were material to the development project, 11 U.S.C. §365(e)(2) exception applies); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995) (operating agreements are executory contracts because there are material unperformed and continuing obligations among the members, including participation in management and contribution of capital).

Certain obligations need to be imposed upon such bankrupt partner or member and incorporated into the FLP partnership or operating agreement.

[8] *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Smith*, 185 B.R. at 291-295 (limited partnership agreement was not an executory contract as to a limited partner/debtor who had no material obligations to perform; the Ch. 7 trustee steps into the shoes of the debtor and may exercise debtor's right to dissolve the partnership); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708-709 (Bankr. E.D.Va. 2000) (there is no executory contract and 11 U.S.C. §365 does not apply to an operating agreement that imposes no duties or responsibilities on its members, but merely provides for the structure of the management of the entity).

[9] *In re Ehmann*, 310 B.R. at 204.

[10] The "Rights and Obligations of Members" in the operating agreement: 1) limited a member's liability for the LLC's debts; 2) granted the member the right to obtain a list of the other members; 3) granted the member the right to approve, by majority vote, the sale, exchange, or other disposition of all or substantially all of the assets on the LLC; 4) granted the member rights to inspect and copy LLC documents; 5) granted the member the same priority as to return of capital contributions or profits and losses; and 6) granted the permissible transferee of a member's interest the right to require the LLC to adjust the basis of the LLC's property and the capital account of the affected member.

[11] *See In re Helms*, 10 B.R. at 706, which reformulated the executory contract test following the 1984 legislative changes to 11 U.S.C. §365(n) to provide that the test focuses only on affirmative performance or obligations.

[12] *In re Ehmann*, 310 B.R. at 206.

[13] 11 U.S.C. §365(e)(2) is as follows: "Paragraph (1) of this subsection [which provides that ipso facto provisions are not enforceable] does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment; or (B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor."

[14] The judicial ambiguity is whether §365(e)(1) (providing that ipso facto provisions are unenforceable) or §§365(c)(1) and 356(e)(2) controls the rights of the bankrupt partner's interest in a partnership agreement that is an executory contract. For contrasting holdings, compare *In re Corky Foods Corp.*, 85 B.R. 903 (Bankr. S.D. Fla. 1998) (Florida partnership law dissolving a limited partnership upon the bankruptcy filing of a general partner is disregarded under §365(e)(1)); *Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d at 614; *In re Siegel*, 190 B.R. at 646; and *In re Ninzy*, 175 B.R. at 939; and *In re Cardinal Indus., Inc.*, 116 B.R. 964, 981-82 (Bankr. S.D. Ohio 1990); with *In re Sunset Developers*, 69 B.R. at 713 (§365(e) does not apply to partnership agreement and the debtor-in-possession is not entitled to assign or assume the partnership contract); *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981) (the trustee cannot assume the position of general partner of a limited partnership since he or she is not the person with whom the limited partners contracted. Thus, the partnership dissolved when the trustee was appointed); and *In re Morgan Sangamon Partnership*, 269 B.R. 652, 654 (Bankr. N.D. Ill. 2001) (reasoning that the Uniform Partnership Act general partner cannot be compelled, without consent, to accept a new partner and, therefore, ipso facto clause in the partnership agreement is enforceable).

***Thomas O. Wells** is a shareholder in the wealth preservation and tax planning group with the Miami office of Berger Singerman, P.A. Mr. Wells is board certified by The Florida Bar in tax law. He obtained his J.D. from the University of South Carolina School of Law and his LL.M. in taxation from the graduate tax program at the University of Florida College of Law.*

***Jordi Guso** is a shareholder in the business reorganization team with the Miami office of Berger Singerman, P.A. He obtained his J.D. from the University of Miami School of Law.*

This column is submitted on behalf of the Business Law Section, Diane Noller Wells, chair, and Samuel A. Lewis, editor.