AMERICAN BANKRUPTCY INSTITUTE

2019 Central States Bankruptcy Workshop

Business Track

Contracting Around the Bankruptcy Code and Communicating with Your Corporate Partner

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CONCURRENT SESSION

2019

Bankruptcy Proofing LLC Management Rights

Hypotheticals

What advice should you give your clients in the following situations and what language should you include in the Operating Agreement to make it more likely that their goals are met and interests protected?

A. Your client wants you to draft an Operating Agreement for an LLC she plans to organize with two colleagues. Each of the three members are authorized to vote on critical issues and one member will have authority to manage all other aspects of the company. Among other things, your client wants the Operating Agreement to prevent voting and management rights from transferring to a trustee in the event a member files a bankruptcy petition.

B. Your client plans to purchase a membership interest in an LLC, and will act as the LLC's managing member. You are asked to make sure that your client will retain its management rights if it subsequently files a Chapter 11 bankruptcy petition.

Ispo Facto Clauses

Many Operating Agreements and state limited liability statutes include *ipso facto* provisions that purport to terminate a member's right to participate in the management of the company upon a bankruptcy filing.

TYPICAL *IPSO FACTO* PROVISION

A member is deemed to have suffered an Event of Withdrawal upon the happening of any of the following events with respect to such Member: (1) the Member (A) makes an assignment for the benefit of creditors; (B) files a voluntary petition in bankruptcy; (C) is adjudicated a bankrupt or insolvent; (D) files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation…

ARE THESE *IPSO FACTO* PROVISIONS ENFORCEABLE

Ispo facto clauses such as these, whether contractual or statutory, are not generally enforceable under 11 U.S.C. §541(c)(1) which provides that *all "interests of the debtor in property becomes property of the estate… notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law - a. that restricts or conditions transfer of such interest by the debtor; or b. that is conditioned…on the commencement of a case under this title, or the appointment of or taking possession by a trustee in 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."*

Clearly a debtor's economic interest in an LLC will become property of the estate under §541(c)(1), but the Bankruptcy Code leaves open the possibility that the management rights will not.

Is an Operating Agreement an Executory Contract

Notwithstanding 11 U.S.C. §541(c)(1), it is possible to prevent a member's management rights from passing to a trustee under 11 U.S.C. §365(c)(1)(A) if the Operating Agreement qualifies as an executory contract.

Countryman Test

Failure of either party to complete performance would constitute a material breach excusing performance of the other.

Functional Approach

Debtor's assumption or rejection of the contract will benefit the estate.

The *In re Denman* court held that, by their very nature, Operating Agreements are virtually never executory contracts because:

- one member's breach does not excuse performance by other members;
- unlike a true contract, the Operating Agreement can be modified by fewer than all members;
- It is possible to have a single member LLC, but you cannot have a contract without two parties.

In re Denman, 513 B.R. 720 (Bankr. WD. Tenn. 2014).

Is *In re Denman* missing a critical piece of the analysis? Does a member have an obligation to the LLC itself and vice versa? Can a member's breach excuse performance by the LLC, such as the payment of distributions?

There is case law to support the idea that the LLC itself is a party to the Operating Agreement where (i) the applicable state limited liability statute provides that the LLC is a party, or (ii) the Operating Agreement itself includes the LLC as a party to the Operating Agreement. *Xereas v. Heiss*, 933 F. Supp. 2d 1 (D.D.C. 2013); *Elf Atochem North America v. Jaffari*, 727 A2d 286, 293 (Del. 1999); *Trover v. 419 OCR, Inc.*, 921 N.E. 2d 1249 (Ill App. Ct. 2010).

CAN WE DRAFT AN OPERATING AGREEMENT MORE LIKE A PARTNERSHIP AGREEMENT?

More often than not, courts have found that Partnerships Agreements are executory contracts. What are the distinguishing characteristics that make Partnership Agreements executory and can we incorporate them into an Operating Agreement?

- Partners can sue one another directly for breaches of the agreement. *Sullivan v. Mathew*, 2015 U.S. Dist. LEXIS 40033, at *24-25 (N.D. Ill. 2015). Meanwhile, members in an LLC can generally only sue one another by bringing a derivate action.
- Partners have an obligation to contribute capital and a failure to do so is a default. *Calvin v. Siegal(In re Siegal)*, 190 B.R. 639, 643 (Bankr. D. Ariz. 1996); *In re Sunset Developers*, 69 B.R. 710, 712 (Bankr. D. Idaho 1987).
- Partners owe continuing fiduciary obligations of good faith and fair dealing to one another. *Calvin v. Siegal* 190 B.R. at 643.
- Partnerships generally require continuing, mutual obligations from the partners. *Sullivan v. Mathew*, 2015 U.S. Dist. LEXIS 40033, at *15.

DRAFTING TIPS

To protect transfer of a member's interest to a Chapter 7 trustee, consider including the following provisions in your client's Operating Agreements:

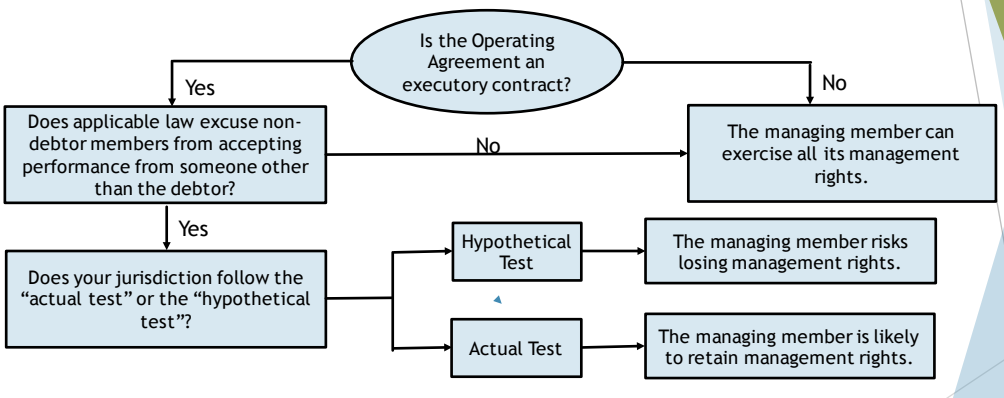
- Include ongoing obligations for members to contribute capital to the LLC. The member's obligation to contribute additional capital must be more than a remote or hypothetical possibility.
- Require members to continue to participate in the management of the company, or to provide other support to the LLC and its operations.
- Make the LLC a party to the Operating Agreement.
- Provide that the members owe each other and/or the LLC a continuing fiduciary duty.
- Provide that the LLC or other members are excused from performing a particular obligation if a member breaches an obligation under the Operating Agreement. For instance, you may provide that the LLC has no obligation to make distributions to a member so long as the member is in default by failing to make required capital contributions. This is particularly important in jurisdictions that rely solely on the Countryman test.
- To the extent an Operating Agreement can be amended by fewer than all members, make sure that any amendment that will affect the rights of a member requires the consent of the affected member.
- Include language supporting a finding of a personal service contract.

Example of a "personal service" clause

The Members agree and acknowledge that this Agreement is a non-assignable personal service contract and each Member entered into this Agreement in reliance on the specific identity of each other Member and the appointed Manager(s). This Agreement shall be performed by, and only by, the Members and Managers identified herein, or additional Members recognized under Article 3. The Members have entered into this Agreement because of, and in reliance on, the personal associations, special skills and knowledge attributable to the other Member(s) and appointed Manager(s), and the personal trust that exists between the Members and appointed Managers. No Member shall be required to accept performance under this Agreement from any Member or Manager who is not recognized pursuant to the terms of this Agreement.

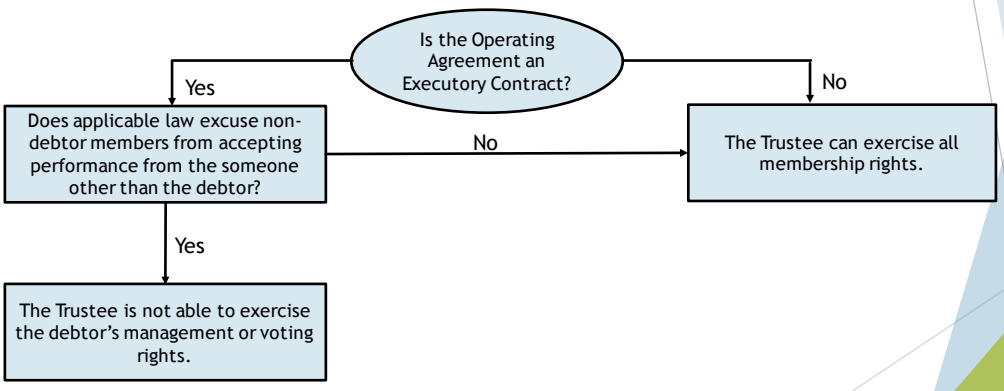
Managing Member as Chapter 11 Debtor Seeking to Retain Management Rights

Can the debtor/member continue to manage the non-debtor LLC over the objection of other members?



Chapter 7 Debtor Seeking to Prevent Transfer of Management Rights to Chapter 7 Trustee

Can the Chapter 7 Trustee step into debtor's shoes and exercise management or voting rights in the non-debtor LLC over the objection of the other members?



COMMERCIAL LEASES IN BANKRUPTCY

Drafting a Commercial Lease that is Resistant to Assumption and Assignment in Bankruptcy, and other Landlord Protections

TERMINATION CLAUSES

The best protection against assumption of a commercial lease is prepetition termination. Leases that have been terminated pre-petition are not subject to assumption under 11 U.S.C. §365. As a result, it might be advisable to draft a lease so that the landlord has the option to terminate upon default with minimal notice (the effectiveness of such clause will be subject to state law).

- This type of clause favors the landlord's ability to terminate a lease before a tenant files bankruptcy, thereby preventing the lease from being caught up in the Chapter 11 process or from being assumed and assigned by the debtor.
- Keep in mind that terminating only a tenant's right to possession is often not sufficient to prevent an assumption and assignment in bankruptcy.
- The downside of lease termination is the inability to collect future rents or to make a claim against the estate.

SAMPLE LEASE TERMINATION PROVISION:

Upon the occurrence of an event of default, Landlord shall have the right to terminate the Lease upon written notice to Tenant and shall thereafter be entitled to possession of the Premises. Termination of the Lease is effective immediately upon delivery of such written notice to the Tenant, and Landlord shall be entitled to immediately commence an action in summary proceedings to recover possession of the premises. Tenant waives all notice in connection with such termination, including by way of illustration but not limitation notice of intent to terminate, demand for possession or payment, and notice of re-entry. No receipt of money by the Landlord from the Tenant after the termination of this Lease shall reinstate, continue or extend the term, nor affect or waive any notice given by the Landlord to the Tenant prior to such receipt of money.

USE RESTRICTIONS AND "TENANT MIX" REQUIREMENTS IN SHOPPING CENTERS

Include language prohibiting a tenant's assignment to an assignee whose use would conflict with or violation an exclusive-use or prohibited-use clause between the landlord and *another tenant*. *In re Toys "R" Us, Inc.*, 587 B.R. 304 (Bankr. E.D. Va. 2018).

Conversely, specify that landlord's involuntary violation of an exclusive-use or prohibited-use clause is not a default.

PREDETERMINED ADEQUATE PROTECTION

There does not appear to be any case law deciding whether a lease provisions that defines "adequate assurance of future performance" is enforceable in bankruptcy. However, if such adequate assurance terms are reasonable, they are likely to be persuasive to a judge in the event of an adequate protection dispute.

PROTECTIONS AGAINST LEASE REJECTION AND DEBTOR DEFAULT

- Security Deposit – Landlord is a secured creditor up to the amount allowed under 11 U.S.C. §502(b)(6).
    - Warning - security deposits are often applied to reduce the amount recoverable by a landlord under §502(b)(6). *In re Atl. Container Corp.*, 133 B.R. 980 (Bankr. N.D. Ill. 1991).
- Letter of Credit & Personal Guarantees are exercisable by landlord without lifting the automatic stay. However, some cases have ruled that a landlord's recovery under a letter of credit may be applied to reduce a landlord's maximum claim amount under §502(b)(6). *Solow v. PPI Enters. (U.S.)*, 314 F.3rd 197 (3rd Cir. 2003).

OTHER BANKRUPTCY ISSUES

Is it possible to draft a commercial lease that favors the "proration method" of determining debtor's obligation to pay stub rent?

Are lease profit-sharing provisions enforceable? Probably not.
Antone Corp. v. Haggen Holdings, LLC, 2017 WL 3730527 (D. Del. Aug. 30, 2017);
Great Atl. & Pac. Tea Co., Inc., 2016 WL 6084012 (S.D.N.Y. Oct. 17, 2016);
In re Jamesway Corp., 201 B.R. 73, 78 (Bankr. S.D.N.Y 1996).

Hypothetical

A. Your client wants you to draft the Operating Agreement for a limited liability company she intends to organize with three of her business colleagues. Each of the four members will have the ability to vote on certain matters and two of the members will be responsible for the day to day operations of the company. Among other things, your client wants to make sure that – in the event one of the members files a bankruptcy petition – that member's management rights will not be exercisable by the Chapter 7 Trustee. What should you advise your client and how should you draft the Operating Agreement so that it is more likely that a Chapter 7 Trustee will be barred from participating in the Management of the LLC?

B. Your client is an LLC that owns membership interests in various entities. Your client wants to amend the various operating agreements to make sure it will not lose its management rights if it files a bankruptcy.

Ispo Facto Clauses

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TYPICAL *IPSO FACTO* PROVISION

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ARE THESE *IPSO FACTO* PROVISIONS ENFORCEABLE

Ispo facto clauses such as these, whether contractual or statutory, are not generally enforceable under 11 U.S.C. §541(c)(1).

> *Section 541(a) provides that an estate is comprised of "all legal or equitable interest of the debtor as of the commencement of the case". Furthermore, section 541(c)(1) provides that all "interests 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 commencement of a case under this title, or the appointment of or taking possession by a trustee in 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."*

Clearly a debtor's economic interest in an LLC will become property of the estate under §541(c)(1).

Is an Operating Agreement an Executory Contract

Is there a way to prevent the management rights from passing to the Trustee under 11 U.S.C. §365? The answer depends on whether it is possible for an Operating Agreement to qualify as an executory contract?

A. Countryman Test

"failure of either to complete performance would constitute a material breach excusing performance of the other."

Difficulties under Countryman test:

- **one member's breach does not excuse performance by other members;**
- **unlike a true contract, the Operating Agreement can be modified by fewer than all members;**
- **is a single member LLC a contract with one person.**

***In re Denman*, 513 B.R. 720, (Bankr. WD. Tenn. 2014)**

Are these court's missing a critical piece of the analysis? Does a member have an obligation to the LLC itself? Can a member's breach excuse performance by the LLC, such as the payment of distributions?

B. Functional Approach Test

What is the purpose of rejecting the contract, and has that purpose already been accomplished?

- **How does this approach apply when the issues is assumption instead of rejection?**

C. General Considerations

- **Do the members have ongoing membership duties.**
- **Are member dues to contribute future capital more than remote or hypothetical.**
- **Is the LLC a party to the Operating Agreement.**
- **Do the members owe each other a fiduciary duty.**