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The Curious Case of the LLC: Often Used, but Rarely Understood

Elizabeth A. Green, Moderator
BakerHostetler; Orlando, Fla.

Barbara G. Barton
Barton Brimm, PA; Murrells Inlet, S.C.

Hon. David M. Warren
U.S. Bankruptcy Court (E.D.N.C.); Raleigh

Brian K. Smithweck
Adams and Reese LLP; Mobile, Ala.

Rafael X. Zahralddin-Aravena
Elliott Greenleaf; Wilmington, Del.

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THE CURIOUS CASE OF THE LLC: OFTEN USED, BUT RARELY UNDERSTOOD

Presented by:

Hon. Stephani Humrickhouse
U.S. Bankruptcy Court, E.D. North Carolina

Barbara Barton, Esq.
Barton Brimm, P.A.
Murrells Inlet, South Carolina

Elizabeth Green, Esq.
Baker & Hostetler LLP
Orlando, Florida

Brian Smithweck, Esq.
Adams and Reese LLP
Mobile, Alabama

Rafael Zahralddin-Aravena, Esq.
Elliott Greenleaf
Wilmington, Delaware

Materials Prepared By (In Addition to Presenters):

Andrew Layden, Esq.
Baker & Hostetler LLP

Kate Harmon, Esq.
Elliott Greenleaf

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INTRODUCTION

If you could set your time machine for 1970 and go back to the practice of law on that date, use of terms such as "cell phones", "facebook" and "text messaging" would have no meaning. Similarly, the animal now known as an "LLC" would not be recognized.

The limited liability company ("LLC") is a creature born of statute, with its origins around 1977. Since that date, LLCs have become widely used and are familiar to most practitioners as an optional form of organizational entity on the list with corporations, partnerships and limited partnerships. Oddly, it has become such a popular choice that creation of LLCs in many states is far outstripping creation of any other type of legal entity.

Simply put, an LLC is a hybrid between a corporation and a partnership. It can provide its members with protection from liability but can also offer tax advantages similar to partnerships. Because it is a creature of statute, the provisions controlling LLCs may differ from state to state. Each state and the District of Columbia have LLC Acts, most of which are based upon the Uniform Limited Liability Company Act (ULLCA). However, the ULLCA has been revised several times and each state's version may incorporate pieces of each revision or even their own unique contributions. This article will attempt to deal with the law in its uniform state but practitioners are cautioned to search their own state for any variations.

I. LLC BASICS

A. CHOOSING THE BEST ORGANIZATIONAL VEHICLE.

In general, LLCs are less formal than C corporations and can allow ongoing operations and governance without board meetings, modification of fiduciary duties, avoidance of corporate level taxation, avoidance of double tax on liquidation, and other tax advantages. They are controlled by their Operating Agreement which can contain numerous provisions not available in corporate entities, such as special allocation of profits and losses. In some jurisdictions, an LLC is not required to have an operating agreement at all and in most jurisdictions, absence of an agreement or silence in an agreement will be remedied by reference to the LLC Act.

In partnerships, the partners have exposure to liability to the partner's creditors. Even in limited partnerships, participation in the partnership may result in exposure to limited partners. This is avoided in LLCs, where participation by members has no impact on the members' liability exposure and where this is no joint and several liability for partnership obligations.

B. OPERATIONS OF THE LLC.

As noted above, the LLC is governed by the terms of its Operating Agreement or, in the absence of an agreement, by the terms of the LLC Act. For day to day operations, the LLC can be managed by its members or by a separately designated manager, who is usually, but not always, a member.

C. SINGLE MEMBER VS. MULTI MEMBER.

As a result of an evolution in the tax laws attempting to address the evolution in LLC law, multi member LLCs are taxed as partnerships for federal income tax purposes, unless they elect to be treated differently (For example, multi member LLCs may elect to be taxed as a corporation.) Single member LLCs are a disregarded entity for tax purposes, which means that they are simply part of the single member's tax return.

In the event that an individual's primary goal is limitation of liability exposure, the choice of a single member LLC as a vehicle should be carefully considered. Generally speaking, the ability of a creditor or a bankruptcy trustee to pierce a single member LLC is far greater than a multi member LLC.

The comments to the ULLCA (2013) indicate that the Act is designed to protect the rights of the members of the LLC to pick their partners. In the event of a single member LLC, that protection is not a consideration.

In many states, creditors are capable of taking over a single member LLC through charging liens or foreclosures. In bankruptcy, a single member who files bankruptcy may subject his LLC to the complete management of the trustee.[1]

It should be noted that *ipso facto* clauses contained in many loan agreements, providing that the filing of a bankruptcy is an act of default, are normally void pursuant to 11 U.S.C. §541(c)(1) and are not enforceable as against the bankruptcy trustee. However, the void status of these property interests may only apply to property that becomes property of the estate pursuant to 11 U.S.C. §541(a)(1), (2) and (5). If the interest becomes property of the estate pursuant to 541(a)(3), then the *ipso facto* clause remains operative and the only interest that the estate can claim is that of a dissociated member. In other words, in the event that the membership interest was not property of the estate at the initiation of the case but is recovered by the trustee pursuant to §550, then the interest is that of a dissociated member and the *ipso facto* clause comes into play.[2]

D. DISTRIBUTIONS.

The terms of the Operating Agreement and the ongoing operations determine the availability of distributions to the members. However, many states limit distributions in order to protect creditors.

For example, Delaware law (Delaware LLC Act §18-607) prohibits distributions when the liabilities of the LLC exceed the fair value of the LLC's assets. Any member who receives such a distribution with knowledge that the liabilities exceed the value of the assets is personally liable for repayment to the LLC.

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[1] *In re: Mondalo*, 412 B.R. 715 (Bankr.D. Md 2006); *In re: Klingerman*, 388 B.R. 677 (Bankr.E.D.N.C. 2008); *In re: Hickory Ridge, LLC* , 2010 WL 1727968 (Bankr. N.D. W. Va. 2010).

[2] *See In re: Hanckel (Campbell v. Hanckel)*; Adv. Proceeding 12-80247-dd (Bankr.D.S.C. 2014) and *In re: Hanckel (Campbell v. Hanckel)*; Adv. Proceeding 14-80116-dd (Bankr.D.S.C. 2015).

In addition, the distributions from LLCs cannot be paid to a member if a charging lien is in place against that member or if a bankruptcy trustee is in control of the member's interest and/or the LLC.

II. AUTHORITY TO FILE

A. ELIGIBILITY.

LLCs are eligible to file for bankruptcy protection. Section 109(a) of the Bankruptcy Code permits a "person" to file a bankruptcy petition. The statute defines "person" to include individuals, partnerships and corporations.[3] The Bankruptcy Code defines "corporation" to include a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association" and an "unincorporated company or association." [4] It is generally recognized that, for purposes of eligibility to seek bankruptcy protection, a LLC is a corporation and is, consequently, eligible for relief under the Bankruptcy Code.[5]

B. STATUTORY AUTHORITY.

The United States Supreme Court held that "[t]he authority to file a bankruptcy petition must be found in the corporation's instruments and in applicable state law."[6]

Generally, state LLC statutes do not expressly state whether managers or members have the power to seek bankruptcy protection and generally leave it to the individual entity to determine the provisions by which it is to be governed. Because LLCs are generally creations of contract, determination of who has the authority to seek bankruptcy protection on behalf of an LLC necessarily turns on an analysis of the LLC's operating agreement or other governing documents.

C. EFFECT OF NON-BANKRUPTCY STATE LAW ON POWER TO FILE.

In re Lexington Hospitality Group, LLC, 577 B.R. 676 (Bankr. E.D. Ky. Sept. 15, 2017):

> The Court held that state law controls how a company may authorize filing bankruptcy but that federal law controls whether operating agreement provisions restricting authority to file bankruptcy are valid. Here, a lender required the operating agreement to be amended to include a provision requiring written votes from the lender and all LLC members before filing for bankruptcy could be authorized. The Court ruled that such a provision was not valid because, in restricting the ability to file bankruptcy, the intent was to take control of that decision away from the LLC and give such control to the lender with no other legitimate purpose. The Court then held that contracting away the right to file bankruptcy was not permissible under federal law.

[3] 11 U.S.C. § 101(41).

[4] 11 U.S.C. § 101(9)(A).

[5] 2 COLLIER ON BANKRUPTCY (16th Ed. Rev., 2009) ¶ 109.01[1][b], at 109-11 (*citing In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289 (Bankr. N.D. Ohio 2001) and *Gilliam v. Speier (In re KRSM Props.)*, 318 B.R. 712 (B.A.P. 9th Cir. 2004)).

[6] *Price v. Gurney*, 342 U.S. 100, 106 (1945):

The Court then looked to the remainder of the operating agreement to determine whether the LLC manager had the authority to file bankruptcy. The plain language of the operating agreement gave the manager the authority to manage the LLC's business affairs unless there was a restriction on same elsewhere in the operating agreement. Once the Court invalidated the provision requiring the lender's approval, there were no other restrictions on filing for bankruptcy. The Court also determined that Kentucky law, the state where the LLC was formed, gave managers the exclusive power to manage the business and affairs of an LLC unless the operating agreement restricted that authority and noted that Kentucky law does not require unanimous member consent to authorize bankruptcy filing.

In re Solomons One, LLC, 2013 LEXIS 4551 (Bankr. D. Md. Oct. 31, 2013):

The Debtor LLC filed for bankruptcy protection after authorization by 51 2/3% of its membership. The dissenting members sought the dismissal of the bankruptcy petition, arguing that, where the operating agreement is silent as to the requisite consent required to authorize a bankruptcy filing, Maryland law (the state where the LLC was formed) requires unanimous consent of the members.

The Court looked at the operating agreement as a whole and under "the law of objective contract interpretation," the court decided that "a reasonable person could only understand [the operating agreement] as requiring the consent of the majority of the member interests to authorize the filing of a bankruptcy petition." *Id.* at * 13-15. The Court specifically observed that, under the operating agreement, "both ordinary course and extraordinary transactions" could be accomplished by majority vote. *Id.* at *15. Only three actions required unanimous consent: the dissolution of the LLC, the acquisition of additional property and modification of the operating agreement. The Court then concluded that "the operating agreement [ ] sets forth a reasonable and sound governance agreement that dictates majority rule on all matters other than one which changes the nature of the Debtor, leads to its termination or changes the original agreement among the members as to how they would conduct the affairs of the Debtor." *Id.* at *17. The Court discounted the dissenting members' argument that Maryland law requires unanimous consent by noting that "although the Act requires unanimous consent of the members to authorize a bankruptcy filing, that provision is expressly qualified by 'unless otherwise agreed.'" *Id.* at *22.

D. BANKRUPTCY REMOTENESS.

In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016):

In this matter, a lender contested the authority of an LLC to file bankruptcy where the lender had insisted upon, and received, a "golden share" in the LLC as a condition of loaning funds to the LLC where the "golden share's" consent was required for the LLC to file bankruptcy. The Court held that such a provision was "tantamount to an absolute waiver" of the LLC's right to see bankruptcy protection and was therefore void as a matter of federal public policy. The Court stated that federal public policy protects LLC rights to petition for bankruptcy protection and that there is a plethora of caselaw that invalidates prepetition agreements that seeking abrogate such rights. The Court also noted that states cannot abrogate such rights through statutes governing LLCs or otherwise.

In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. April 5, 2016):

The Debtor LLC defaulted upon a loan agreement with the lender, which resulted in a forbearance agreement under which the lender required an amendment to the Debtor LLC's operating agreement making the lender a "special member" to the LLC with no ownership interest but with veto power over the filing of bankruptcy proceedings. The Debtor LLC again defaulted on the loan agreement, after which the lender instituted foreclosure proceedings against the Debtor LLC at which time the Debtor LLC filed for bankruptcy protection, staying the foreclosure proceedings. The Court stated "[f]or public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy." *Id.* at 12 *citing Klingman v. Levinson*, 831 F.2d 1292, 1296 (7th Cir. 1987). In addressing enforceable bankruptcy remote LLCs, the Court articulated that such structures must allow a blocking member or director to adhere to her or his "normal fiduciary duties, and therefore in some circumstances, vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor they were chosen by." *Id.* at 913.

In examining the special member provision in the context of Michigan law, the Court found that, as a member of a Michigan LLC, the special member was required to consider the Debtor LLC's interests. *Id.* at 913. The Court held that the blocking provision was void because it allowed the special member to consider only its interest which was a violation of Michigan law. *Id*. at 914.

DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC), 463 B.R. 142 (BAP 10th Cir. 2010):

The manager of the Debtor LLC initiated bankruptcy proceedings on behalf of the Debtor LLC. The LLC's operating agreement included a provision to expressly bar the LLC from filing for bankruptcy specifically stating "to the extent permitted under applicable law, [the LLC] will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy…" One of the LLC members objected to the bankruptcy filing based upon this provision.

The bankruptcy court granted the LLC's member's motion to dismiss the bankruptcy filing, which was affirmed by the 10th Circuit BAP. The Court rejected the manager's argument that the provision prohibiting bankruptcy filing was void as against federal public policy, distinguishing the facts of this matter from situations where non-member lenders insist on provisions prohibiting the LLC from filing for bankruptcy. The Court stated that "Debtor has not cited any cases standing for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy, nor has the court located any." *Id.* at *10.

In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007):

The Debtor LLC's operating agreement provided that the LLC's lender had a membership interest in the LLC and that any filing for bankruptcy protection by the LLC required consent of the lender. The LLC sought to file for bankruptcy protection but the lender-member would not consent. The LLC solicited the filing of an involuntary bankruptcy petition against it which the LLC did not contest. The lender sought a dismissal of the involuntary bankruptcy petition and the Court agreed, finding that this attempt to circumvent the lender's contractual rights as a member of the LLC was inappropriate; the Court dismissed the case stating: "The fact is that the petitioning creditors' participation in this case was solicited by the Debtor which was prohibited by the Operating Agreement from filing a voluntary case without [lender's] consent." *Id.* at 202.

In re Franchise Services of North America, 2018 WL 485959 (Bankr. S.D. Miss. Jan. 17, 2018):

A lender filed a motion to dismiss a chapter 11 proceeding filed by an LLC, arguing that it had been filed without the proper entity authority. A majority equity holder of the Debtor LLC joined in that motion. In denying the lender's motion to dismiss, the Court concluded that a blocking provision in favor of a creditor was contrary to public policy and invalid. As the majority equity owner had joined in the lender's motion to dismiss, the Court was required to look at the validity of the blocking provision from the majority equity holder's perspective. In so doing, the Court concluded that a blocking provision could be enforced by a majority equity holder and the Court therefore dismissed the bankruptcy proceeding. The Debtor has appealed and the Court has certified three questions for the Fifth Circuit Court of Appeals:

- Is a provision, typically called a blocking provision or a golden share, which gives a party (whether a creditor or equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?
- If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
- Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share?
- If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

The Fifth Circuit Court of Appeals issued an opinion on May 22, 2018 affirming the Bankruptcy Court's decision. *See Franchise Services of North America, Inc. v. U.S. Trustee (In re Franchise Services of North America, Inc.)*; C.A. No. 18-60093 (5th Cir. May 22, 2018) (Opinion): "Federal law does not prevent a bona fide shareholder from exercising its right to vote against a bankruptcy petition just because it is also an unsecured creditor. Under these circumstances, the issue of corporate authority to file a bankruptcy petition is left to state law. The debtor is a Delaware corporation governed by that state's General Corporation Law. Finding nothing there that would nullify the shareholder's right to vote against the bankruptcy petition, we affirm."

In re NNN 123 North Wacker, LLC, 510 B.R. 854, 859 (Bankr. N.D. Ill. 2014):

> The Court enforced an LLC operating agreement requiring approval of the independent manager and unanimous consent of members to file bankruptcy because entity formalities of the LLC were observed.

In re Orchard at Hansen Park, LLC, 347 B.R. 822, 826 (Bankr. N.D. Tex. 2006):

> The Court upheld an operating agreement provision that required unanimous consent and vote of an independent manager prior to filing a bankruptcy petition.

In re Green Power Kenansville, LLC, 2004 LEXIS 2541 (Bankr. E.D.N.C. Nov. 18, 2004):

> The Court upheld an operating agreement provision that gave authority to an independent manager for any bankruptcy filing.

In re Pasta Bar by Scotto II, LLC, 2015 LEXIS 3941 at *3 (Bankr. S.D.N.Y. Nov. 19, 2015):

> The Court upheld an operating agreement provision that required approval of a supermajority of the LLC members to approve a bankruptcy filing as enforceable and invalidating a bankruptcy filing based upon only 50 percent approval as unauthorized.

E. *IPSO FACTO* CLAUSES.

With regard to bankruptcy filings and LLCs, many LLC operating agreements contain boilerplate provisions that provide that the LLC is terminated upon insolvency or bankruptcy filing; these clauses are known as *ipso facto* clauses. If *ipso facto* clauses in an LLC's operating agreement or in a state statute applicable to a specific debtor LLC are counter to the goals of the Bankruptcy Code (i.e. (i) maximizing the debtor's assets, liquidating same, and distributing proceeds to the debtor's creditors; and (ii) providing the debtor with a fresh start), a bankruptcy court will likely hold such clauses unenforceable. Operating agreement provisions that are triggered solely because of a bankruptcy filing are likely to be determined to be *ipso facto* clauses and therefore held to be unenforceable. This is especially true when such provisions divest the debtor of its property rights.

Section 541(c)(1)(B) blocks the operation of *ipso facto* clauses, i.e. clauses that become operational upon the debtor's bankruptcy filing (whether the debtor is the LLC or a member of an LLC).

Meiburger v. Endeka Enters., LLC (In re Tsiaoushia), 383 B.R. 616 (Bankr. E.D. Va. 2007):

> The chapter 11 trustee sought a determination that two provisions of the operating agreement were valid and fully enforceable. Such provisions provided that the LLC would dissolve upon the filing of a bankruptcy petition by a member of the LLC and that members would liquidate the LLC's assets upon dissolution. The Court considered the LLC's arguments that the LLC operating agreement was an executory contract and, consequently, the provisions that provided for automatic dissolution upon a member filing for bankruptcy

protection was an *ipso facto* clause made unenforceable by section 365(e)(1) of the Bankruptcy Code.

The Court determined that the operating agreement was not an executory contract. The Bankruptcy trustee could then enforce the provisions of the operating agreement that required the LLC to be dissolved upon a member's filing for bankruptcy and the trustee was able to overcome objections that such clauses were impermissible *ipso facto* clauses.

In re Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006):

After determining that the operating agreement was not an executory contract (as discussed in further detail *infra*), the Court also looked at whether the provision of the operating agreement providing LLC members with the right of first refusal was an *ipso facto* clause under section 365(e) of the Bankruptcy Code or an impermissible restraint on assignment under section 365(f) of the Bankruptcy Code. Because the Court determined that the operating agreement was not an executory contract, the Court held that the clause providing right of first refusal to the other LLC members was not unenforceable under sections 363(e) or (f) of the Bankruptcy Code. Consequently, the Court concluded that the receiver took the debtor's property, including the 20% interest in the LLC, as it found it on the date of the petition and that the interest was subject to the right of first refusal, holding that the such right existed without regard to whether a member filed for bankruptcy protection and it was not triggered by the bankruptcy filing. *Id.* at 638.

In re Strata Title, LLC, 2013 LEXIS 1704 (Bankr. D. Az. 2013):

The Debtor LLC held a 45% interest in a second LLC, Santerra, the purpose of which was to acquire, own and operate an apartment complex. Santerra's operating agreement required the approval of a supermajority of the membership for actions such as borrowing funds or selling assets and provided that other members could buy out a member's interest if that member filed for bankruptcy protection.

Once the Debtor LLC filed for bankruptcy protection, Santerra's other members served notice of their intent to exercise the purchase option to which the Debtor LLC responded that such provision was not enforceable as it was an *ipso facto* clause.

After determining that the operating agreement was an executory contract (as discussed in further detail *infra*), the Court then determined that the purchase option was an unenforceable *ipso facto* clause because it was triggered solely by the bankruptcy filing of a member and once the membership interest became property of the estate under section 541(c) of the Bankruptcy Code, section 363(l) of the Bankruptcy Code invalidated any provision of the operating agreement that limits the debtor's continued use or sale of the property based upon filing for bankruptcy protection. *Id.* at *3.

III. EXECUTORY CONTRACTS

A. APPLICATION OF THE COUNTRYMAN DEFINITION.

Countryman's definition of an executory contract: "A contract under which the obligation of both the bankrupt and the other party to the contract as so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.[7]

Meiburger v. Endeka Enters., LLC (In re Tsiaoushia), 383 B.R. 616 (Bankr. E.D. Va. 2007):

> The Court applied the Countryman definition and looked at the operating agreement to determine whether the individual debtor had any unperformed duties arising under the operating agreement as a member of the LLC; the Court found that the member did not have any such duties. Consequently, the Court determined that section 365(e)(1) of the Bankruptcy Code was not applicable and the two provisions at issue were valid and enforceable. *Id.* at 620.

In re Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006):

> The Debtor held a 20% interest in an LLC. A bidding war occurred after the receiver received a number of offers to purchase the debtor's LLC interest from other LLC members. The receiver filed a sale motion under section 363(f) of the Bankruptcy Code in which the receiver sought approval from the bankruptcy court to sell the LLC interest free and clear. *Id.* at 633-634. The LLC lodged objections to the sale motion, alleging that the other LLC members had a right of first refusal and that the successful bidder could not change the terms of the LLC operating agreement by requiring the receiver to reject all executory contracts. *Id.* at 634.
>
> The Court first looked to the Countryman definition to determine whether the LLC operating agreement was an executory contract such that it could be assumed or rejected and, upon analysis of the Countryman definition, the Court determined that the LLC operating agreement was not an executory contract holding that future and remote contingencies do not make an operating agreement into an executory contract under section 365 of the Bankruptcy Code. *Id.* at 636. The Court then looked to whether the *ipso facto* clauses were enforceable, as set forth in further detail *supra*.

In re Strata Title, LLC, 2013 LEXIS 1704 (Bankr. D. Az. 2013):

> The Debtor LLC held a 45% interest in a second LLC, Santerra, the purpose of which was to acquire, own and operate an apartment complex. Santerra's operating agreement required the approval of a supermajority of the membership for actions such as borrowing funds or selling assets and provided that other members could buy out a member's interest if that member filed for bankruptcy protection.

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[7] Vern Countryman, Executory Contracts in Bankruptcy, Part I, 57 MINN. L. REV. 439, 460 (1973).

Once the Debtor LLC filed for bankruptcy protection, Santerra's other members served notice of their intent to exercise the purchase option to which the Debtor LLC responded that such provision was not enforceable as it was an *ipso facto* clause.

The Court first determined whether Santerra's operating agreement was an executory contract, finding that it was because it required certain actions by its members that the Court held required the Debtor LLC's active participation and were therefore not remote. The Court then looked to whether the *ipso facto* clauses were enforceable, as set forth in further detail *supra*.

Meiburger v. Endeka Enterprises, LLC (In re Tsiaoushis), 383 B.R. 616 (Bankr. E.D. Va. 2007):

The debtor/LLC member's non-managing interest in the LLC came into the bankruptcy estate by operation of section 541 of the Bankruptcy Code and was determined to not be an executory contract under section 365 of the Bankruptcy Code where the debtor/LLC member had no unperformed duties. The Court analyzed the operating agreement and determined that only "remote or speculative future duties" remained for the debtor/LLC member. The Court stated "[t]here is no *per se* rule. Each operating agreement is separately analyzed." The Bankruptcy trustee could then enforce the provisions of the operating agreement that required the LLC to be dissolved upon a member's filing for bankruptcy and the trustee was able to overcome objections that such clauses were impermissible *ipso facto* clauses.

In re Denman, 513 B.R. 720 (Bankr. W.D. Tenn. 2014):

The Court held, in an individual chapter 13 bankruptcy proceeding, that an LLC operating agreement is not a contract for purposes of section 365 of the Bankruptcy Code and was rather better characterized as an entity formation document. Consequently, the Court was not required to undertake a section 365 analysis and the debtor's interest in the LLC came into the bankruptcy estate. The Court also ruled that an LLC member/non-debtor's attempt to exercise his rights under the purchase provision of the operating agreement was impermissible as that provision was an unenforceable *ipso facto* clause. The Court refused to lift the automatic stay to allow the exercise of the purchase option.

B. WHAT DIFFERENCE DOES IT MAKE? THE IMPACT OF ASSUMPTION OR REJECTION.

Designation of an LLC operating agreement as an executory contract impacts the applicability of the automatic stay to the operating agreement. For example, if an LLC member is the debtor, other LLC members may seek to invoke an option to buy the bankrupt member's interest in the LLC upon the member's filing for bankruptcy protection. However, such an action would violate the automatic stay put in place by Section 362 of the Bankruptcy Code.

If the operating agreement is deemed an executory contract, then section 365 of the Bankruptcy Code applies and the trustee must either assume or reject it. Assumption of the operating agreement results in the bankruptcy estate obtaining all of the benefits of the debtor's interest in the LLC but the estate must also perform as required under the operating agreement (including responding to calls for capital out of the debtor's estate assets, etc.). Another benefit of assumption is that the trustee can exercise all management rights available to it under the operating agreement.

Movitz v. Fiesta Investments, LLC (In re Ehmann), 319 B.R. 200 (D. Ariz. 2005):

> The Court determined that the debtor/LLC member's non-managing interest in the LLC at issue did not require any additional significant action on the part of the debtor in order to avail him of distributions and, consequently, the operating agreement was non-executory so section 365 of the Bankruptcy Code would not apply. The Court considered future potential obligations, like responding to capital calls, and determined that such future potential obligations did not make the operating agreement an executory contract. The debtor's interest in the LLC therefore became part of the bankruptcy estate pursuant to section 541 of the Bankruptcy Code and provisions of the operating agreement that would have prohibited transfer of interest were unenforceable under Section 541(c)(1).

Caymus Ventures LLC v. Jundanian (In re Jundanian), 2012 LEXIS 1370 (Bankr. D. Md.Mar. 30, 2012):

> A non-debtor/LLC member brought a declaratory judgment action seeking a determination by the Court that the debtor lost his management rights in the LLC when the debtor reacquired his membership interest in the LLC through an auction held related to the debtor's plan of reorganization. The non-debtor LLC member asserted that the LLC's operating agreement prohibited the transfer of management rights.
>
> The Court ruled that the debtor's interest, including his voting and management rights, became property of the debtor's estate pursuant to section 541 of the Bankruptcy Code and that "Section 541(c)(1) overrides both the *ipso facto* provisions in the [Maryland] Act and the restriction on transfer provision in the Operating Agreement." The Court ruled that, because the debtor's interests were part of the bankruptcy estate by operation of section 541, those interests were able to be auctioned. However, the Court also ruled that the provisions of the operating agreement that prohibited transfer of management rights would be respected as they related to the debtor's re-acquisition of his interests through the auction.

IV. SALE OF A DEBTOR'S PARTIAL LLC MEMBERSHIP INTEREST

A. SINGLE MEMBER LLC

As noted above, a single member's LLC is far easier to reach in bankruptcy than multimember LLCs. In the event of a single member filing, the Chapter 7 trustee owns and controls the single member LLC. This has been held to include both the economic rights and the management rights.[8]

[8] *In re: Klingerman*, 388 BR 677 (Bankr.N.C.2008); *In re: Mondanlo*, 412, 412, BR 715(Bankr.D.Md.2006); *In re Hickory Ridge, LLC*, 2010 WL 1727968 (Bankr. N.D. W. Va., Apr. 27, 2010); *In re B & M Land & Livestock, LLC,* 498 B.R. 262, 267 (Bankr.D.Nev.2013)(holding that "where a debtor has a membership interest in a single-member LLC and files a petition for bankruptcy under Chapter 7, the Chapter 7 trustee's rights automatically include the right to manage that entity"); *Fursman v. Ulrich* (*In re First Protection, Inc.*), 440 B.R. 821, 830 (9th Cir. BAP 2010)(holding that "the [Chapter 7] trustee was not a mere assignee, but stepped into [the d]ebtors' shoes, succeeding

It should be noted that the Trustee's control of a single member LLC does not amount to a consolidation of the entity into the individual case. Instead, the LLC must still be treated as a separate entity, with separate creditors, unless and until substantive consolidation occurs. In other words, the LLC assets are not part of the Debtor's estate and are not protected by the automatic stay, simply because a Debtor owning a single member LLC files bankruptcy.[9]

B. MULTI MEMBER LLC

There are several ways that a Trustee might seek to assert the Debtor's membership rights in a multi member LLC to maximize its value. If the Trustee asserts the Debtor's membership rights pursuant to § 541, as "property of the estate" acquired by the Trustee, then the Trustee can assert the rights of a member, such as demand for access to the books and records, and may have the right to seek dissolution in certain circumstances.[10] The Trustee might also seek to assert the Debtor's membership rights pursuant to § 365, if the operating agreement is an executory contract, which might give rise to additional liquidation or dissolution rights. The Trustee might also be able to assert rights as a hypothetical judgment creditor pursuant to § 544(a).

It is essential to remember that results will vary in the extreme, depending upon the terms of the Operating Agreement, the state law regarding LLCs and, most importantly, state law as to property rights. Because state law controls the definition of property and the ability to reach different kinds of property, the application of property law in each state will have a significant impact on what interest can be sold.

For an interesting comparison, see *In re Garrison-Ashburn, LLC*, 253 BR 700 (Bankr. E.D.Va. 2000) and *In re: Campbell*, 475 BR 622 (Bankr.N.D.Ill 2012). The Virginia court in *Garrison* held that that the bankruptcy estate included both the economic and non-economic rights in the LLC, which included the member's management rights. The Illinois court in *Campbell*

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to all of their rights, including the right [as sole owners and members of Redux, a limited liability company,] to control Redux"); *In re A–Z Electronics, LLC,* 350 B.R. 886, 891 (Bankr.D.Idaho 2006)(holding that, where one of the joint Chapter 7 debtors owned 100% of the membership interests in a limited liability company, the Chapter 7 trustee "was the only one entitled to manage [such limited liability company] and decide, *inter alia,* whether the LLC would or would not file bankruptcy"); *In re Albright,* 291 B.R. 538, 541 (Bankr.D.Colo.2003)(explaining that "[b]ecause the Trustee became the sole member of Western Blue Sky LLC upon the [d]ebtor's bankruptcy filing, the Trustee now *411 controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets"); *In re Modanlo,* 412 B.R. 715, 731 (Bankr.D.Md.2006), *aff'd,* 266 Fed.Appx. 272 (4th Cir.2008)(holding that the appointed Chapter 11 trustee of a limited liability company's sole member "had the power to place [the limited liability company] into bankruptcy ... and, standing in the shoes of the [d]ebtor ... possess[ed] both the economic and governance rights to participate in the management of [the limited liability company] that the [d]ebtor himself enjoyed prior to his bankruptcy filing").

[9] *In re McCormick*, 381 B.R. 594 (Bankr.S.D.N.Y. 2008); *In re Knefel*, 2007 WL 2416535 (Bankr.E.D. Va. Aig. 17, 2007); *In re Gorcham*, 2009 Bankr. LEXIS 2995 (Bankr. D. Neb.Sept. 16, 2009); *In re Hopkins*, No. DG 10-13592, 2012 WL 423916, at *1 (Bankr. W.D. Mich. Feb. 2, 2012) (Debtor's interest in LLC is part of bankruptcy estate, but property held by the LLC is not); *In re Brittain*, 435 B.R. 318, 322 (Bankr. D.S.C. 2010) (Debtor's wholly-owned LLC is property of estate to extent of distributional interest, but property held by LLC is not property of estate unless Debtor can show he has equitable interest in such property); *In re Breece*, 487 B.R. 599 (B.A.P. 6th Cir. 2013) (Debtor could not claim homestead exemption in property owned by her single-member LLC).

[10] *See In re Ehmann*, 319 B.R. 200 (Bankr. D.Ariz. 2005); *In re Garbinski*, 465 B.R. 423 (Bankr. N.D. Pa. 2007); *In re Klingerman*, 388 B.R. 677 (Bankr. E.D.N.C. 2008).

determined that the Debtor's management rights in a manager-managed LLC did not transfer to the bankruptcy estate because they were not property rights. In the likely event that the LLC Operating Agreement provides that the filing of bankruptcy causes a member to lose management rights, then this is not an issue.

In most cases, the Trustee is generally limited to selling the economic interest only. Any buyer would become an "assignee" of the membership interest, and most state laws governing LLCs and most operating agreements restrict the rights of an assignee to a distributional interest only. In order to obtain voting rights and other rights of a full member, most operating agreements require the consent of the other members – something the Trustee is unlikely to get.

Sale of only the economic interest can still provide a valuable asset for the Trustee. The sale of the economic interest, however, might be subject to sale restrictions in the operating agreement. Many operating agreements, for example, give other members the right of first refusal and have stringent timing requirements for notice of intent to sell. Whether the Trustee is bound by these restrictions may depend on whether the operating agreement is an executory contract or not. If it is an executory contract, then courts have held that the Trustee can reject the executory contract, and thereby essentially reject the first refusal terms (remember the 60-day deadline for determination of assumption or rejection in a chapter 7 case.) If the court finds that the operating agreement is not an executory contract, then the Trustee has no ability to reject it and must abide by its terms. Note, however, that the Trustee still might have an argument that the restrictions constitute an unreasonable restraint on alienation.

C. SAMPLE CASES:

In *In re Knowles*, 2013WL152434 (Bankr. M.D. Fla., Jan, 15, 2013), the Chapter 7 Trustee sought to sell each Debtor's 1/6 interest in a family LLC. The operating agreement contained a right of first refusal to certain family members and to other members, in an order of priority, and required only that the family member with highest priority meet (not exceed) the price offered by the third party. The Trustee argued that the operating agreement was an executory contract, and he sought to reject it so that he would not be bound by the right of first refusal. In this way, the Trustee hoped to be able to garner higher bids in order to maximize the value of the interest. The Court found that the operating agreement was not executory under the facts of the case. As a result, the Trustee could not reject it, and was bound by its terms. Specifically, any sale by the Trustee was subject to the limits imposed by the right of first refusal.

A similar question was at issue in *In re Ichiban, Inc*., 2014 WL2937088 (Bankr. E.D. Va., June 30, 2014), with a different result under the facts. In that case, the operating agreement gave a right of first refusal to the company, and then to its members. The company objected to a sale by auction, because it argued that the right of first refusal gave it the right to elect to purchase the membership interest at the highest bid. The Court found that there were many continuing obligations of the members, and that the operating agreement was an executory contract. The Court then found that it was rejected when not assumed by the Trustee within 60 days. As a result, the right of first refusal was "not enforceable in this bankruptcy case as to the Debtor," and the Trustee was able to proceed with the sale process without meeting the first refusal requirements.

The operating agreement in *In re Talbut* also contained a right of first refusal to the members. 2015 WL5145598 (Bankr. N.D. Ohio, Aug. 28, 2015). The Debtor owned a 25%

interest, and he and the other members objected to the Trustee's motion to sell to a stalking horse bidder and motion to approve overbid and auction procedures. The proposed sale procedures did not include compliance with the right of first refusal requirements in the operating agreement. There was no discussion of whether the operating agreement was an executory contract, but the Court held that the operating agreement was enforceable, and it denied the Trustee's motion to sell because it did not comply with the operating agreement's requirements for the transfer of a member's interest (specifically, the right of first refusal requirements). The decision hinged on § 363(f)(1), and the fact that the Trustee was unable to meet the burden of showing that non-bankruptcy law permitted the sale. The Trustee was determined, and filed a second motion to sell. *In re Talbut*, 2016 WL937373 (Bankr. N.D. Ohio, March 10, 2016) ("*Talbut II*"). In *Talbut II*, the Trustee argued that Virginia statutory law permitted the sale without compliance with the first refusal requirements of the operating agreement. He argued that he had the rights under § 544(a)(1) as a judicial lien creditor, and as such, he would be entitled to obtain a lien on the membership interest and foreclose on it. The Court rejected that argument and held that Virginia law did not permit the foreclosure of a charging lien.

The Bankruptcy Court in *In re Minton* clarified what it means when an operating agreement, which is an executory contract, is rejected. 2017 WL354319 (Bankr. C.D. Ill., Jan. 24, 2017). In that case, the Debtor held a 20% interest in an LLC, and the LLC filed a declaratory judgment action against the Chapter 7 Trustee essentially arguing that the operating agreement had been rejected, and as a result, the bankruptcy estate no longer had an interest in the LLC. The Court quickly pointed out that this is an inaccurate interpretation of the law. This case contains a good discussion of LLCs, operating agreements, and the effect of rejection on an executory contract. The Court noted that rejection constitutes a breach of the contract, but it does not terminate the contract. Instead, it "frees the bankruptcy estate from any obligations under that contract." The Court ultimately found that the operating agreement at issue in this case was not an executory contract. The Court then addressed whether the Trustee was bound by the sale restrictions contained in the operating agreement. Because there was not a sale motion pending, the Court held that the issue was not ripe for determination. However, the Court noted that the Trustee would not necessarily be bound by sale restrictions that were "unreasonable restraints on alienation."

In *In re Safa*, Case No. 16-03150-dd (Bankr. D.S.C., Sept. 22, 2017), the Bankruptcy Court elected not to address the issue of whether the operating agreement was an executory contract, and instead approved the sale pursuant to § 363(f)(4) due to the presence of a bona fide dispute. The Trustee sought to sell the Debtor's 1/3 economic interest in an LLC. The other members objected, arguing that the operating agreement was an executory contract which was rejected, and that as a result, the Debtor's rights in the LLC could not be sold. The Court noted that whether an LLC operating agreement is an executory contract is a fact-intensive inquiry, and that its resolution was not necessary for approval of the sale. The Court allowed the sale of the economic interest "as is, where is", with no warranty, as proposed by the Trustee. The Court noted: "Property interests are best disposed of promptly with disputes over entitlement to the proceeds resolved at a later time."

V. LENDER EXPOSURE IN DEALING WITH LLCS

A. CONTRACT THEORIES.

At its most fundamental level, lender liability can arise from the contractual relationship between the borrower and the lender. For example, borrowers may assert claims for breach of contract based on a lender's (1) failure to lend after a loan commitment becomes legally binding, (2) failure to honor loan modification terms or forbear after promising to do so, (3) improper interpretation of loan documents, or (4) breaching the implied covenant of good faith and fair dealing.[11]

B. TORT THEORIES.

Borrowers may also assert claims arising under tort law. Common tort-based theories of lender liability include fraud, economic duress and tortious interference.[12] As with contract-based claims of lender liability, these claims are not unique to LLCs, and can arising from any borrower-lender relationship.

C. STATUTORY LIABILITY.

Additionally, a number of state and federal statutes can also can also form the basis for lender liability. For example, a lender with sufficient control over a borrower may be liable to the IRS for withholding taxes, and a lender deemed to be an "owner" or "operator" under CERCLA under certain circumstances can be liable for cleanup costs. [13]

D. INSTRUMENTALITY THEORY.

Generally, the debtor / lender relationship does not create a fiduciary duty or make the lender liable for the acts or omissions of the borrower.[14] However, a lender may expose itself to liability where it exercises excessive control over the borrower's day-to-day operations such that the lender assumes dominant and total control over the borrower's business affairs.[15]

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[11] *See e.g. Lender Liability: Taking Stock in an Uncertain Time*, Kim & Giang, *available at* https://www.sheppardmullin.com/media/article/713_Lender%20Liability%20Article%20-%20Eugene%20Kim.pdf at 2-4 (collecting cases addressing contract-based lender liability claims); *Lender Liability Considerations*, *available at* http://apps.americanbar.org/abastore/products/books/abstracts/5070531_SamCh.pdf. *See also* UCC § 1-304 (stating that "[e]very contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement.")

[12] *Id.* at 4-6 (outlining elements of each claim and identifying cases involving tort-based lender liability claims).

[13] *See e.g. Lender Liability: Taking Stock in Uncertain Times*, at 7; Taxes: 26 U.S.C.S. §§ 3402 & 3505, and 26 U.S.C.S. § 6672; Environmental Liability: 42 U.S.C.S. §§ 9607 & 9609.

[14] *Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp.*, 483 F.2d 1098, 1105 (5th Cir. 1973). The Eleventh Circuit has adopted as binding all Fifth Circuit decisions handed down on or before September 30, 1981. *See Bonner v. City of Prichard*, 661 F.2d 1206, 1207 (11th Cir. 1981). *See also e.g. In re Sallee*, 286 F.3d 878, 893 (6th Cir. 2002).

[15] *Lender Liability* at 6.

The Fifth Circuit (prior to the creation of the 11th Circuit) stated that "[i]f a lender becomes so involved…that it is in fact actively managing the debtor's affairs, then the quantum of control necessary to support liability under the 'instrumentality' theory may be achieved."[16] The Fifth Circuit formulated a two-part test for determining whether a "dominant" corporate should be held liable for the "subservient" corporation's obligations: "First, the domінent corporation must have controlled the subservient corporation, and second, the dominant corporation must have proximately caused plaintiff harm through misuse of this control."[17]

E. EQUITABLE SUBORDINATION & RECHARACTERIZATION.

A bankruptcy court has the power "under principles of equitable subordination [to] subordinate for purposes of distribution all or part of another allowed claim to all or part of another allowed claim."[18] Equitable subordination of a claim "moves the creditor down in the order of payment out of the assets in the bankruptcy estate, generally reducing (or eliminating) the amount the creditor can recover."[19] Equitable subordination is an extreme remedy that should be used sparingly, and "[c]laims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct."[20]

In the Eleventh Circuit, there is a three-part test: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.[21] Inequitable conduct for purposes of equitable subordination of a claim has been defined as generally falling into one of the following categories: (1) fraud, illegality, breach of fiduciary duties; (2) undercapitalization; or (3) claimant's use of the debtor as a mere instrumentality or alter ego.[22]

The burden of proof for an equitable subordination claim varies based on whether the creditor is an insider.[23] If the creditor is not an insider or fiduciary, the movant must establish that

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[16] *Krivo* at 1105.

[17] *Id* at 1103; *see also Wisthle Investment Group, LLC v. CR Hancock Bridge, LLC*, 2009 WL 651798, *3 (M.D. Fla. 2009).

[18] 11 U.S.C. § 510(c)(1).

[19] *In re Lifschultz Fast Freight*, 132 F.3d 339, 341 (7th Cir. 1997).

[20] *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 701 (5th Cir. 1977).

[21] *Id.* at 699-700.

[22] *See e.g. In re Eddy,* 572 B.R. 774, 781 (Bankr. M.D. Fla. 2017; *Lender Liability Considerations* at ft. nt. 76 (collecting cases). *See also In re Citrus Tower Blvd. Imaging Center, LLC*, 520 B.R. 892, 904 (Bankr. N.D. Ga. 2014) (finding that typically, whether the "inequitable conduct" prong is satisfied is a question of fact, unless the allegations of the complaint are insufficient on their fact to support an equitable subordination claim.)

[23] *In re Bavaria Yachts USA, LLLP*, 575 B.R. 540, 566 (Bankr. N.D. Ga. 2017). *See e.g. In re Chira*, 353 B.R. 693, 723, (Bankr. S.D. Fla. 2006). It is significant to note that 11 U.S.C. § 101(31) defines "insider" as "including" (but not limited to) to parties listed in the statute, and thus, lenders can be considered an "insider" of a debtor if justified under the circumstances.

the conduct was more egregious.[24] Significantly, the Bankruptcy Code's definition of "insider" is non-exclusive, and parties should consider whether the lender may be considered a non-statuary insider for purposes of an equitable subordination analysis.[25]

Lenders should also consider whether the related, but distinct, concept of recharacterization could apply to their alleged debt. In essence, a recharacterization analysis seeks to distinguish true debt from camouflaged equity.[26] Distinct from equitable subordination, recharacterization determinations turn on whether a debt actually exists, not on whether it should be equitable subordinated.[27] While a recharacterization analysis is based on a totality of the circumstances, as a practical matter, courts in the Eleventh Circuit generally consider the thirteen (13) factors established by the Fifth Circuit in the *Montclair* case, which include (1) the intent of the parties, (2) participation in management flowing from the transaction, (3) the identity of interest between the creditor and stockholder, and (4) the ability of the borrower to obtain loans from outside lending institutions.[28]

F. CHARGING ORDERS.

Lenders should consider the limited recourse available to a creditor against a debtor's membership interests in an LLC. Generally, a judgment-creditor of a member of an LLC is unable to directly attach the assets of the LLC or obtain management rights in an LLC.[29] Rather, a judgment-creditor is typically limited to obtaining a charging lien, by which the creditor may recover the distributions made to the judgment-debtor to satisfy the outstanding judgment.[30] The commentary to the Revised Uniform LLC Act clarifies that purpose and limitations of a charging order, stating that:

> While in effect, the [charging] order entitles the judgment creditor to whatever distributions would otherwise be due to the member or transferee whose interest is subject to the order. However, the judgment creditor has no say in the timing or amount of those distributions. The charging order does not entitle the judgment creditor to accelerate any distributions or

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[24] *Id.*

[25] *See e.g. In re Winstar Comm. Inc.,*554 F.3d 382, 395 (3d Cir. 2009) (stating that "[W]e agree…that actual control (or its close equivalent) is necessary for a person or entity to constitute an insider under §101(31)'s 'person in control' language. However, a finding of such control is not necessary for an entity to be a non-statutory insider…In light of these enumerated categories [in 101(31)], we hold that it is not necessary that a non-statutory insider have actual control; rather, the question is whether there is a close relationship between the debtor and creditor and …anything other than closeness to suggest that any transactions were not conducted at arm's length.")

[26] *In re First NLC Financial Services, LLC*, 396 B.R. 562, 567-68 (Bankr. S.D. Fla. 2008).

[27] *Id.* (collecting cases); *see also Montclair, Inc. v. Comm.,* 318 F.2d 38 (5th Cir. 1963).

[28] *Id.*

[29] *See e.g.* Fla. Stat. 605.0503 (providing that, with certain exceptions, a charging order is "the sole and exclusive remedy" by which a judgment creditor of a member may satisfy a judgment from the judgment debtor's interest in an LLC.); *see also McClandon v. Dakem & Associates, LLC*, 219 So.3d 269, 270 (Fla. 5th DCA 2017) (finding that trial court erred in appointing receiver to manage LLC because charging order was exclusive remedy.)

[30] *See e.g. Olmstead v. FTC*, 44 So.3d 76, 79 (Fla. 2010).

to otherwise interfere with the management and activities of the limited liability company."[31]

VI. STAY CONSIDERATIONS

A. THE AUTOMATIC STAY

The filing of a petition for bankruptcy immediately invokes the provisions of the automatic stay pursuant to 11 U.S.C. § 362(a). The automatic stay operates to protect the debtor and the debtor's property from creditors. The purpose of the automatic stay is to give the debtor time to reorganize or effect a liquidation. In addition, the automatic stay serves to prevent creditors from scrambling to seize the debtor's assets. The applicability of the automatic stay, including who is protected and what is protected, is primarily dependent on who the filing debtor is. When an LLC itself files a petition for bankruptcy, the applicability of the automatic stay to the LLC is fairly straightforward.[32] It is the potential extension of the automatic stay to a non-debtor member of an LLC in bankruptcy or a non-debtor LLC owned by a member in bankruptcy where things can get complicated.

B. THE DEBTOR LLC

As previously discussed, an LLC is a legal entity separate and apart from its members that possesses the ability to file a petition for bankruptcy. Like any other debtor, an LLC that files for bankruptcy is protected from creditor claims by the automatic stay. The automatic stay prohibits creditors of the LLC from seizing its assets or pursuing claims against it. In order to receive the benefit of the automatic stay, the LLC itself should file its own petition for bankruptcy; it cannot count on the extension of a debtor member's automatic stay for protection.[33] Similarly, the automatic stay typically will not extend to parent/subsidiary or brother/sister LLCs; each LLC that is need of protection should file its own separate petition for bankruptcy. Likewise, a non-debtor member of an LLC should not depend on the LLC's automatic stay for protection.

C. THE DEBTOR MEMBER

A question that frequently arises in regards to the automatic stay is the effect on the LLC when a member files for bankruptcy. In answering that question, it is necessary to distinguish between the debtor's membership interest in the LLC and the separate assets of the LLC. When a debtor files for bankruptcy, the debtor's membership interest(s) becomes part of the bankruptcy estate and is protected by the automatic stay. However the member does not have an interest in the LLC's property; the debtor's bankruptcy estate will only consist of the member's economic rights and management rights in the LLC interest. As noted above, the assets of the LLC are protected by the automatic stay when the LLC itself files for bankruptcy, but many debtors, particularly

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[31] RULLCA § 503 cmt.

[32] *But see In re McCabe*, 345 B.R. 1 (D. Mass. 2006) (holding that amending the terms of the LLC's LLC Agreement to reduce the debtor member's interest violated the automatic stay).

[33] Note that an LLC must seek bankruptcy protection under Chapter 7 or 11; it is not considered an individual for purposes of filing under Chapter 13.

debtors with single member LLCs, have argued that the automatic stay applicable to the debtor member of a member in bankruptcy should extend to the assets of the LLC as well.

D. EXTENDING THE AUTOMATIC STAY TO NON-DEBTORS.

Many debtors have taken the position that the automatic stay applies to wholly owned single member LLCs. For the most part courts reject this argument.[34] It stands to reason that if a debtor expects the LLC to be treated as a separate entity for purposes of liability protection outside of bankruptcy, then the LLC should be treated as a separate entity for purposes of the automatic stay. Further, as many courts have pointed out, there is nothing preventing an otherwise eligible LLC from filing a petition for bankruptcy under Chapter 7 or 11.

However, while courts are typically adverse to the argument, there are cases where debtors have been successful. In extending the automatic stay, the courts typically rely on 11 U.S.C. § 105(a), which provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

Using this statutory authority, courts have extended the automatic stay to non-debtor entities when warranted by "unusual circumstances" and/or where there would otherwise be an immediate adverse impact on the debtor.

The Fourth Circuit expounded upon the extension of the automatic stay to non-debtors, explaining that in order for such relief to be available, there must be "unusual circumstances" and "something more than the mere fact that one of the parties to the lawsuit has filed a Chapter 11 bankruptcy". According to the court, such an unusual situation would arise "when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor". For example, the Second Circuit Court of Appeals extended the automatic stay of an individual's chapter 11 filing to his wholly owned non-debtor corporation, holding that the adjudication of a claim against the corporation would have an immediate adverse impact on the debtor.[35] The issue in the case was the appeal by the debtor and his corporation of a judgment against them.

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[34] *See e.g. In re McCormick*, 381 B.R. 594 (Bankr. S.D.N.Y.) (stating that "the automatic stay created upon the filing of a bankruptcy petition is limited to debtors and does not encompass non-filing codefendants.").

[35] *Queenie, Ltd. v. Nygard*, 321 F.3d 283 (2d. Cir. 2003). The court provided several examples of immediate adverse economic consequences including: (1) a claim against a non-debtor for an obligation for which the debtor was a guarantor, (2) a claim against a debtor's insurer, and (3) actions where there is an identity between the debtor and third-party defendant that a judgment against the third-party defendant will in effect be a judgment or finding against the debtor.

However, as noted above, the extension of the automatic stay to a non-debtor single member LLC or to a non-debtor member is an extraordinary remedy that is only warranted in "unusual circumstances." Most courts are hostile to the idea of extending the automatic stay to a non-debtor. If it appears that automatic stay protection could be necessary for a debtor's wholly owned LLC, and the LLC is otherwise eligible, the best course of action is for the LLC to file its own separate petition for bankruptcy.