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Partnership and Limited Liability Company Agreements: Managing the Bankruptcy Risk

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A. A General Overview of the Treatment of Executory Contracts and Unexpired Leases Under Section 365(a) of the Bankruptcy Code – Assumption and Rejection

The authority of a bankruptcy trustee to assume or reject "executory contracts and unexpired leases" is set forth in Section 365(a) of the Bankruptcy Code. Typically, in a Chapter 11 case, a debtor-in-possession (the "DIP") is vested with the power of a Trustee in this regard.[2] The concept of rejection has its roots in the principle that a debtor or trustee should be able to abandon burdensome property.[3] If a DIP (or Trustee), in the exercise of its business judgment, decides to keep a contract, it may do so by curing defaults, notwithstanding a contrary provision in the affected agreement providing for termination due to bankruptcy, insolvency or the like.

Additionally, the Trustee or the DIP may assume and assign its interest in an agreement pursuant to Section 365 of the Bankruptcy Code, notwithstanding a contractual anti-assignment provision.[4] There are exceptions to these general rules regarding pre-bankruptcy contracts and leases. Many of these exceptions are housed in Section 365(c) of the Bankruptcy Code, which provides that the Trustee or the DIP may not assume or assign an executory contract or unexpired lease if "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."[5] Numerous other exceptions are contained in the so called "safe harbor" provisions of the Bankruptcy Code that govern treatment of the derivatives and other similar specialized financial instruments upon a bankruptcy filing.

The Bankruptcy Code neither defines nor attempts to define "executory contract" and "unexpired lease." However, the House Report on Section 365 of the Bankruptcy Code indicates that the term "generally includes contracts on which performance remains due to some extent on both sides."[6] The Supreme Court, citing the legislative history, has characterized an executory contract as one "on which performance is due to some extent on both sides."[7]

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[2] *See* 11 U.S.C. § 1107(a); 11 U.S.C. § 1107(a) ("a debtor in possession . . . shall perform all the functions and duties . . . of a trustee serving in a case under this chapter").

[3] *United States v. Dewey Freight Systems*, 31 F.3d 620, 621 (8th Cir. 1994) ("damage caused by rejection is a prepetition claim, so that it will not burden the reorganizing enterprise").

[4] 11 U.S.C. §§ 365(a)(6) and (f); 11 U.S.C. §§ 365(a)(6) and (f). *See also In re U.L. Radio Corp.*, 19 B.R. 537, 543 (Bankr. S.D.N.Y. 1982) (Section 365(f) gives the power to the courts to render unenforceable any provision in an agreement that has the sole effect of restricting assignment).

[5] *See* 11 U.S.C. § 365(c)(l)(A) (2000).

[6] *Id. See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 6303-04.

[7] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 522 n.6, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984).

The Countryman definition is the most widely cited definition of "executory contract" employed by courts when called upon to decide the legal status of a pre-bankruptcy agreement for the purpose of the application of Section 365.[8] Under the Countrymen definitions an executory contract is:

> a contract under which the obligation of both the bankrupt and 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.[9]

A number of courts have eschewed the Countryman definition as being too rigid and have followed a more result-oriented approach.[10] Courts taking this approach focus on whether an estate will benefit from a proposed assumption or rejection.[11] Under the "functional" approach, courts consider the purpose behind permitting the DIP or the Trustee to assume or reject a contract, rather than focusing on the dictionary definition of "executory contract." These courts follow an analytical approach focusing on the question of whether the proposed assumption or rejection will benefit the bankruptcy estate.[12] In addition to criticizing the rigidity of the Countryman definition, several courts have criticized its failure to further the goals of the Bankruptcy Code to maximize the value of the estate assets.[13]

Employing a benefit/burden analysis in many cases will most often result in the same outcome as applying the Countryman definition. For example, rejecting an employment agreement to avoid the estate's obligation to make large severance payments, meets the standard for being "executory" regardless of whether the Countryman definition or the benefit/burden analysis is applied.[14] However, under the benefit/burden approach, a contract may be executory even if one party has fully performed. Thus, when a buyer fully performed his obligations under a land sale contract, the court still found the contract capable of rejection when the contract called for a $300,000 parcel of realty to be sold for $251,750.[15] Similarly, a contract probably would not be executory using a benefit/burden analysis when parties to a land sale contract have significant obligations that would render the contract executory, since the estate would benefit from having the claim of the non-debtor treated as a lien against the estate rather than forcing the debtor to assume or reject the agreement.[16]

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[8] *See*, *e.g.*, Countryman, "Executory Contracts In Bankruptcy: Part I," 57 Minn. L. Rev. 439, 460 (1973); "Executory Contracts In Bankruptcy: Part II," 58 Minn. L. Rev. 479 (1974); In re Knutson, 563 F.2d 916 (8th Cir. 1977) (adopts Countryman definition).

[9] *Id*.

[10] *In re Norquist*, 43 B.R. 224 (Bankr. E.D. Wash. 1984) (the remaining material obligation on the part of the non-debtor served no useful purpose, and, although the contract could be executory, it need not be held to be, if its rejection would not further the objectives of the Code).

[11] *Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

[12] See: *Sixth Circuit: In re Monument Record Corp.*, 61 B.R. 866 (Bankr. M.D. Tenn. 1986); *Eleventh Circuit: In re Government Security Corp.*, 101 B.R. 343 (Bankr. S.D. Fla. 1989), *aff'd*, 111 B.R. 1007 (S.D. Fla. 1990).

[13] *See Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

[14] *Id.* This contract in almost certainly would be viewed as executory if the Countryman definition were to be applied.

[15] *In re W&L Associates, Inc.*, 71 B.R. 962 (Bankr. E.D. Pa. 1987).

[16] *In re Booth*, 19 B.R. 53 (Bankr. D. Utah 1982).

The Second Circuit, by way of example, has never expressly adopted the Countryman definition as a test; rather, the court refers instead to the legislative history for the proper definition of "executory contract:"[17]

> A test less exclusive than Countryman's that takes into account the mutual performance requirement embodied in the legislative history should be substituted. Under this test, a contract is executory if each side must render performance, on account of an existing legal duty or to fulfill a condition, to obtain the benefit of the other party's performance. Weighing the relative benefits and burdens to the debtor is the essence of the decision to assume or reject; if each party must still give something to get something, the contract is executory, and the debtor must demonstrate whether assumption or rejection confers a net benefit on the estate. If the debtor has done everything it needs to do to obtain the benefit of its bargain, assumption serves no purpose, and the debtor may simply sue to enforce its rights. Similarly, if the other party has done everything necessary to require the debtor to perform, the debtor's performance adds nothing to the estate, the debtor will not assume the contract, and the other party can file a prepetition claim."[18]

The Fourth and Sixth Circuits, by way of a further example, have held that an executory contract is one that requires performance on both sides.[19]

B. A General Overview of Section 365(c)(1) of the Bankruptcy Code – An Exception to the General Rule

Section 365(c)(l) of the Bankruptcy Code contains an exception to assumption and assignment that is often referred to as the "personal service" exception. This is because most of the earliest decisions construing Section 365(c)(1) limited its application to agreements qualifying as personal service contracts under applicable non-bankruptcy law. The more recent trend by courts is the adoption of a substantially less restrictive approach to Section 365(c)(1), excepting "personal contracts and contracts of public importance" from assignment.[20] This approach is generally more favorable to non-debtor parties. Under this approach, personal service contracts, partnership agreements, government contracts, franchise agreements, limited liability company agreements, and IP agreements have all been found to fall within the exclusionary language of Section 365(c)(1) of the Bankruptcy Code.

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[17] *In re Ionosphere Clubs, Inc.*, 85 F.3d 992 (2d Cir. 1996).

[18] *Id.* 85 F.3d at 998-99, quoting In re Riodizio, Inc., 204 B.R. 417, 424 (Bankr. S.D.N.Y. 1997).

[19] *Fourth Circuit: RCI Tech. Corp. v. Sunterra Corp.*, 361 F.3d 257, 264 (4th Cir. 2004) (citing *In re Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985)). *Sixth Circuit: Sloan v. Hicks*, 761 F.2d 319 (6th Cir. 1985); *see also* In re Preston, 53 B.R. 589 (Bankr. M.D. Tenn. 1985).

[20] *In re Headquarters Dodge Inc.*, No. 92-1030, 1992 U.S. Dist. LEXIS 18640, at *15 (D.N.J. Nov. 25, 1992) (noting that some courts have applied section 365(c) to personal contracts and contracts of public importance), *rev'd sub nom.*, 13 F.3d 674 (3d Cir. 1993).

The courts are split on the issue of whether Section 365(c)(1) prevents the Trustee or the DIP from assuming a contract for the benefit of the estate, if the contract is a Section 365(c)(1) contract that cannot be assigned. Courts have employed two different approaches with respect to this issue.

- **Actual Test**: Under this approach, Section 365(c)(1) of the Bankruptcy Code applies only if the Trustee or the DIP actually seeks to assign an executory contract that may not be assigned under applicable non-bankruptcy law.

- **Hypothetical Test**: Under the approach, Section 365(c)(1) of the Bankruptcy Code prohibits the assumption and performance of an executory contract by the Trustee or the DIP when applicable law prohibits the assignment of the contract in question. Consequently, if a contract falls within the exception, a bankruptcy filing may end an entities' rights under such contract. This harsh result may be avoided if the Trustee or the DIP obtains the non-debtor contract party's consent to the assumption (and assignment).

C. Issues Concerning Partnership and LLC Agreements Under Section 365(c)(1) of the Bankruptcy Code

As noted above, courts have found partnership agreements and limited liability agreements to be executory contracts. This has important implications for debtors that are members of partnerships because the ability of partners to assign their partnership interests is often restricted by state law. Counterparties to these agreements view section 365(c)(1) as one of the few protections provided to them under the Bankruptcy Code.

In applying Section 365(c)(l) of the Bankruptcy Code, courts have given effect to the restrictions imposed by state partnership law, including restrictions on the proposed transfer or assignment of a partnership interest. The factors that courts have considered when upholding such restrictions include whether the identity of the contracting party is material to the agreement, and whether the identity of the other partners in the absence of agreement, entitle the assignee, during the continuance of the partnership, to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books.

It is likely that a contract counterparty will seek to enforce, under Section 365(e)(2) of the Bankruptcy Code,[21] a clause that provides for the termination of the contractual relationship upon

[21] Section 365(e) of the Bankruptcy Code states:

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease 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—
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> (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.

a bankruptcy filing – *i.e.*, a so-called *ipso facto* clause. The language of Section 365(e)(2) of the Bankruptcy Code closely tracks the language of Section 365(c)(1). Thus, as a practical matter, to determine whether an *ipso facto* clause is enforceable under Section 365(e)(2), a party must first determine whether the contract or lease falls within Section 365(c)(1). As discussed above, this determination largely will depend upon the type of contract or lease and whether the particular court applies the hypothetical or actual test. Indeed, the same split of authority regarding the hypothetical and actual tests that exists in the context of section 365(c)(1) of the Bankruptcy Code also exists in the context of Section 365(e)(2) of the Bankruptcy Code.

The extent that a court will enforce an *ipso facto* clause under Section 365(e)(2) of the Bankruptcy Code largely depends upon whether the court would permit the Trustee or the DIP to assume the agreement notwithstanding the existence of applicable non-bankruptcy law restricting the assignment of the agreement. If a non-debtor is confident that binding precedent requires the application of the hypothetical test under Section 365(c)(1) of the Bankruptcy Code, then the non-debtor should also be fairly confident that an *ipso facto* clause in the relevant agreement will be given effect under Section 365(e)(2) of the Bankruptcy Code. This conclusion, however, does not relieve the non-debtor of its obligation to seek relief from the automatic stay, because even the enforcement of a valid *ipso facto* clause generally requires such relief.

For example, if a bankruptcy court were to determine that the state partnership or LLC statute applicable to the agreement in question does not require the non-debtor party to accept performance from the Trustee or the DIP (as distinguished from the pre-petition, non-debtor entity) and if the non-debtor party does not consent to an assumption by the Trustee or the DIP of an operating agreement, then the Trustee or the DIP cannot assume such operating agreement. Such would be the case under applicable Delaware law.[22]

> (2) 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; 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.

[22] *See* DEL. CODE ANN. tit. 6, § 18-702. Section 18-702 of the Delaware Act, for example, could provide a basis for such a determination. The relevant portion of that section states:

> The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement [and] upon the [approval] of all of the members of the limited liability company [other than the member assigning the limited liability company interest and unless] otherwise provided in a limited liability company agreement: (1) [a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member, [and] (2) [a]n assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

To further illustrate this point, if Section 365(e)(2) of the Bankruptcy Code applies because the bankruptcy filing occurs in Delaware, the *ipso facto* exception will not invalidate the provision of an operating agreement that provides for liquidation of an LLC upon a member's bankruptcy filing, and such LLC may be dissolved pursuant to the terms of the operating agreement.[23] Conversely, if Section 365(e)(2) of the Bankruptcy Code does not apply, the *ipso facto* exception will invalidate the liquidation provision of such operating agreement upon a member's bankruptcy filing, and the LLC may not be dissolved pursuant to such provision.

D. Managing Counterparty Bankruptcy Risk – Structuring the Transaction and Drafting Considerations

- Form a new entity to serve as the venture vehicle to "ring fence" the new entity, whether the entity is a partnership or LLC to: (a) avoid consolidation with an affiliate of the new entity that may file for bankruptcy relief; and (b) separate the assets of the new entity from all other entities, to among other things, limit liability in any number of ways;

- The formation documents should provide that each owner of an interest in the newly formed vehicle should hold its interest in such vehicle through a newly formed holding company that has no operations and is prohibited from having operations, assets, or liabilities other than ownership of its interests in the newly created vehicle (a so-called special purpose entity);

- The formation documents should set forth (in the recitals or covenants) the relationship of the parties and the reasons they are forming a joint venture, whether that joint venture will be a partnership or an LLC contract, it should describe the subjective factors considered by the parties in entering into the agreement (e.g., the unique qualifications of the potential partner or member, the counterparty's reliance on the potential debtor's qualifications, the counterparty's need for a specialized

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Under § 18-702, the assignment of a membership interest results only in the transfer of the economic interest associated with such membership interest (unless the operating agreement states otherwise) and not the transfer of any underlying rights associated with the membership. *See id.* In the instant case, the Operating Agreement expressly requires that all Joint Venture members must approve any transfer of a membership interest. Because a court could construe postpetition debtor in possession Flounder as the transferee or assignee that is an entity distinct from the prepetition Flounder, a court could conclude that Delaware law permits Prosper to refuse to accept the performance of postpetition Flounder's managerial duties under the Operating Agreement. *See In re IT Grp.*, 302 B.R. 483, 487 (D. Del. 2003) (concluding that the debtor-members were barred from transferring their full membership interests in a limited liability company because Delaware law excused the nondebtors from accepting substitute performance from the debtor-members' assignees); *In re Catron*, 158 B.R. at 638–39 (noting that the debtor in possession partner is a separate entity from the prepetition partner, and as a partnership agreement is in nature a personal services contract, the nondebtor partners are excused from accepting substitute performance thereunder); *In re W. Elec., Inc.*, 852 F.2d at 82–83 (applying the hypothetical test and also stating that the use of the words "debtor or debtor in possession" in § 365(c)(1)(A) reflected Congress' "judgment that in the context of the assumption and assignment of executory contracts, a solvent [pre- petition debtor] and an insolvent debtor in possession going through bankruptcy are materially distinct entities," and the insolvent debtor in possession "could not force the [contract's counterparty] to accept the 'personal attention and services' of a third party").

[23] *See* 11 U.S.C. § 365(e)(2).

service or product and the potential debtor's unique ability to provide such service or product;

- The formation documents should expressly provide (in the recitals or covenants) that the potential debtor may not substitute the services or product of a third party and, of course, may not assign or delegate its obligations under the contract to a third party;

- The formation documents should provide for the issuance of a single share of preferred stock (sometimes referred to as a "golden share") and provide in the organizational documents that vehicle being formed cannot file for bankruptcy relief without the consent of the holder of the golden share;[24]

- Any operating or partnership agreement should include specific provisions concerning a change of control of a member or partner in the vehicle being created;

- The governing agreement should provide the non-operating members or partners with periodic financial reports or notice of any material adverse change, to allow such parties to monitor a potential debtor's financial condition and take immediate action when necessary or appropriate;

- The governing agreements should include an expansive *ipso facto* bankruptcy and insolvency default providing the non-debtor party with the specific right to terminate upon the filing of a voluntary or involuntary bankruptcy case or similar proceeding;

- All agreements should contain provisions to govern any amendments to ensure that protective provisions cannot be amended to the detriment of any non-filing parties, in the event a bankruptcy case is filed by any of the parties to the governing agreement(s);

- The governing partnership agreement or operating agreement should include provisions barring a partner or member from pledging its interests in the newly formed vehicle as collateral;

- The partnership or operating agreement should include provisions requiring the consent of all members (or a super-majority) for a grant of authority to file for bankruptcy relief and provide for the liquidation of the entity upon the insolvency of, or filing for bankruptcy by, any member or partner of or in the vehicle, its direct or indirect equity holders, etc.;

[24] Note, not all courts, however, enforce a bankruptcy authorization provision in an LLC's operating agreement or other organizational documents if such contractual provision is found to be inconsistent with applicable state law or inconsistent with principles applicable under the Bankruptcy Code such as principles based in public policy. *Intervention Energy Holdings, LLC*, Case No. 16-11247 (KJC) (Bankr. D. Del. June 3, 2016)

- If the vehicle is an LLC, provide for the loss of a member's managerial rights (if manager-managed, as opposed to member-managed), upon the insolvency or filing for bankruptcy relief of such manager; and

- Provide for the distribution of certain key assets of the vehicle (e.g., intellectual property rights) in a specified manner, in the event of a liquidation or bankruptcy filing by any of the members, partners, etc.

E. Steps to Take Once a Bankruptcy Case is Filed

- A non-debtor party that has decided to terminate the relevant agreement because of the bankruptcy filing should file a motion for relief from the automatic stay to exercise its rights under Section 365(e)(2) of the Bankruptcy Code, if it has such rights, as soon as it receives notice of the bankruptcy filing; and

- If a non-debtor party elects not to terminate immediately upon a bankruptcy filing, it should monitor the case to ensure that the debtor does not assume or assume and assign, as absent timely objection by the non-debtor party under Section 365(c)(l) of the Bankruptcy Code or otherwise, the bankruptcy court may enter an order authorizing the relief sought by the debtor entity.

F. Conclusion

A non-filing counterparty may seek to enforce the limitations provided in § 365(c) and (e) of the Bankruptcy Code for any number of reasons, including;

- Avoiding involvement with an entity that is subject to financial turmoil and uncertainty;

- Performance and going concern worries;

- Reputational risk;

- An opportunity to renegotiate; and

- Avoiding being forced to partner with possible successor to a debtor entity.

Accordingly, it is important for insolvency specialists and transactional attorneys to be familiar with the operation of Bankruptcy Code § 365(c) and (e), and how these Bankruptcy Code provisions are applied by different courts.

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Exculpation of Fiduciary Duties for Managers of Limited Liability Companies and the Impact of *In re Simplexity, LLC*

A. Delaware LLC Agreements and the Delaware Limited Liability Company Act

1. The scope of fiduciary duties varies from state to state, but Delaware is the most common jurisdiction of incorporation/formation, and one that many other states generally mirror in their own corporate law.[1] Delaware limited liability companies, in particular, are an increasingly popular corporate form, due in part to their exceptional flexibility in permitting contractual tailoring of the fiduciary duties of managers.

2. The Delaware Limited Liability Company Act (the "Act") provides that, absent any modifications pursuant to the Act, managers of a limited liability company owe fiduciary duties to the company and its members comparable to the duties owed by directors to a corporation and its shareholders,[2] subject to some important differences that are the focus of this presentation. Del. Code Ann. tit. 6, § 18-1104.

3. The Act allows a limited liability company to shield managers from liability for contractual and fiduciary breaches, as well as eliminate most fiduciary duties in the first place.

   a) Section 1101(e) of the Act allows companies to limit the liability of members, managers or other persons for breaches of contractual and fiduciary duties. It provides that:

      "A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or

[1] In Delaware, fiduciary duties consist of two components: the duty of care and the duty of loyalty. The duty of care requires that the actions and conduct of directors and officers be informed and considered and that decisions must be made with "requisite care." The duty of loyalty requires that a director or officer must act in good faith and in a manner he or she reasonably believes to be in the best interests of the corporation. The duty of "good faith" is generally seen as a subset of the duty of loyalty in Delaware. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. Sup. Ct. 2006).

[2] If the corporation is insolvent, the creditors of the corporation take the place of the shareholders as the residual interest holders and may assert derivative actions on behalf of the corporation for breach of fiduciary duties. *See North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is solvent, [fiduciary] duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.").

omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."

Del. Code Ann. tit. 6, § 18-1101(e).

b) Section 1101(c) of the Act allows companies to eliminate or reduce the actual fiduciary duties themselves. It provides that:

"To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."

Del. Code Ann. tit. 6, § 18-1101(c).

c) Provisions in a limited liability agreement limiting liability pursuant to Section 1101(c) of the Act and those waiving the underlying duties pursuant to Section 1101(e) of the Act are both commonly referred to as "exculpation", but they can have very different implications, including with regard to "aiding and abetting" liability, as discussed below.

d) The implied covenant of good faith and fair dealing, and any liability for breach of such covenant, cannot be limited or eliminated. *See* Del. Code Ann. tit. 6, § 18-1101(c) ("the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

4. The Act's flexibility for permitting waivers of fiduciary duties and limitations of liabilities for managers is considerably broader than what is permitted for directors of corporations in Delaware.[3]

a) Delaware General Corporation Law would permit corporations to limit director liability for breaches of fiduciary duties, but corporations cannot do so for knowing violations of law, and cannot limit liability for breaches of the duty of loyalty. *See* Del. Code Ann. tit. 8, § 102(b)(7). Moreover, for corporations -- unlike for Delaware LLCs -- only director liability, and not the underlying duty itself, may be limited, which leaves stakeholders with certain equitable remedies and the ability to state claims for aiding and abetting fiduciary breaches against parties not covered by the exculpation. *See RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 862-63, 873-75 (Del. 2015).

[3] The Delaware Limited Partnership Act offers similar flexibility as the Act with respect to limited partnerships. *See* Del. Code Ann. tit. 6, § 17-1101(e) and (f)).

b) Notably, Delaware law goes farther than most other jurisdictions in allowing contractual modification of fiduciary duties in limited liability company agreements. For example, New York law permits a limitation of liability for managers, but the carve-outs to that limitation are more broad than the implied covenant of good faith and fair dealing, and there is no provision for the elimination of the duties themselves, just resulting liability. *See* NY Limit Liab Co § 417 (McKinney) (providing that a N.Y. limited liability agreement cannot eliminate any liability resulting from bad faith, intentional misconduct or personal financial profit).

5. In order to be effective, exculpation clauses must be in the limited liability company agreement and be "plain and unambiguous." *Bay Center Apartments Owner, LLC v. Emery Bay PKI*, LLC, 2009 WL 1124451 (Del. Ch. April 20. 2009) ("[T]he interpretive scales also tip in favor of preserving fiduciary duties under the rule that the drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous.").[4]

   a) If drafted to take advantage of Section 1101(c) of the Act, exculpation clauses can broadly remove all duties except good faith and fair dealing, or they can be more surgical and establish a carefully negotiated liability regime, such as requiring procedures for insider transactions and providing a safe harbor for transactions approved within those procedures. Limited liability company agreements also may *increase* the scope of duties owed by managers over the default fiduciary duties under Delaware law. They can also reduce, modify, or increase the duties owed pursuant to Section 1101(c) of the Act while modifying or eliminating the liability for some or all managers for any breach of such duties pursuant to Section 1101(e) of the Act.

      (1) One common example of an "increased" duty would be procedural requirements for self-interested transactions (e.g., referral to particular committee or a minority member vote) that would not necessarily be required by default duties of loyalty and care imposed by state law.

6. Despite their significant protection to directors and officers,[5] exculpation clauses are an imperfect shield.

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[4] For corporations, any liability limitation must be in the certificate of incorporation, making it a matter of public record. *See* Del. Code Ann. tit. 8, § 102(b)(7).

[5] Absent exculpation, decisions by the board of a corporation or members of a limited liability company are reviewed under one of three standards, depending on the risk of potential conflicts of interest or self-dealing. *See In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 43–45 (Del. Ch. 2013). The default standard for directors and officers is the deferential "business judgment rule." The business judgment rule creates a presumption that the directors and officers acted on an informed basis, in good faith and with the honest belief that the action was in the best interests of the company and its shareholders. Directors and officers must fulfill their duties of care and loyalty to receive the protection of this presumption. "Enhanced scrutiny" is an intermediate standard applied in certain recurring situations where "the realities of the decision making context can subtly undermine the decisions of even independent and disinterested directors." *Id.* at 43. The classic example is resistance by an incumbent

a) Exculpation clauses cannot prevent lawsuits from being filed and may require costly litigation before being enforced.

b) There is a split among the courts in Delaware as to whether a defendant may have a complaint dismissed solely by virtue of relying upon the existence of an exculpation clause in a LLC agreement.

(1) *Compare In re USDigital,* 443 B.R. 22, 44 (Bankr. D. Del. 2011); *In re Midway Games, Inc*., 428 B.R. 303 (Bankr. D. Del. 2010), *In re BHC Communications, Inc. Shareholders Litig*., 789 A.2d 1, 8-9 (Del. Ch. 2001); and *Malpiede v. Townson*, 780 A.2d 1075, 1079 (Del. Ch. 2001) (each case holding that an exculpation clause could form the basis to dismiss a complaint) with *Burtch v. Opus L.L.C. (In re Opus East L.L.C.),* 480 B.R. 561, 572 (Bank. D. Del. 2012); *Mervyn's LLC v. Lubert–Adler Group IV, LLC (In re Mervyn's Holdings, LLC),* 426 B.R. 488, 502 (Bankr. D. Del. 2010); *Miller v McCown DeLeeuw & Co., Inc. (In re The Brown Schools),* 368 B.R. 394, 401 (Bankr. D. Del. 2007) (all denying motions to dismiss based on exculpation clauses).

c) Therefore, as discussed below, clever pleadings (e.g., allegations of bad faith or breach of other duties that are not able to be contracted away pursuant to the Act, or which happen not to be covered by a given exculpation clause) may result in a plaintiff being able to pursue its complaint past a motion to dismiss, thereby leading to discovery, and potentially time-consuming and costly litigation for the defendants.

d) Moreover, a waiver of fiduciary duties only eliminates the duties otherwise imposed on managers or directors by state corporate law; such a waiver does not necessarily reach duties imposed in other contexts. For example, the court in *In re Houston Regional Sports Network, L.P.* 505 B.R. 468 (Bankr. S.D. Tex. 2014) stated that the fiduciary duties owed by the individuals managing the affairs of a bankruptcy estate, which arise as a matter of bankruptcy law, are not abrogated by a blanket fiduciary duty waiver in the applicable governing documents. *Id*. at 482.

B. The *Simplexity* Decision

1. The decision of the Bankruptcy Court for the District of Delaware in *In re Simplexity, LLC*, 2017 WL 65069 (Bankr. D. Del. Jan. 5, 2017) is the latest decision holding that an

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board of directors to a hostile takeover. This standard largely shifts the burden of persuasion to the defendant decision makers to demonstrate that the decision in question was reasonable and for the benefit of the corporation. The more stringent "entire fairness" standard applies when a board operates under an actual conflict of interest. This standard requires the board to establish that the challenged transaction was *objectively* fair, not just fair in the board's reasonable judgment at the time. To satisfy this standard, a defendant must establish that the transaction was the product of fair dealing and fair price. *Id*. at 44.

exculpation claim is an affirmative defense and, therefore, cannot serve as the basis for a motion to dismiss.

2. Simplexity, LLC ("Simplexity"), Simplexity Services, LLC ("Services") and Adeptio INPC Holdings, LLC ("Holdings") (collectively, the "Debtors") were at one time the largest on-line sellers of mobile phones and other wireless products. Services is a single-member Delaware limited liability company owned and managed by Simplexity. Simplexity is a single-member Delaware limited liability company owned and managed by Holdings. Holdings is a two member Delaware limited liability company managed by Versa Capital Management, LLC.

3. The Debtors began to incur operating losses when they shifted from on-line activation to in-store activation. In 2013, the Debtors negotiated multiple forbearance agreements with their lender, First Third Bank (the "Bank"), who provided the Debtors with a $15 million revolving credit facility and a $30 million term loan. In March 2014, the Bank terminated its forbearance agreement and notified the Debtors that it intended to sweep all cash receipts from the Debtors' bank accounts. On March 10, 2014, the Bank swept all funds in the Debtors' bank accounts, totaling approximately $1.2 million, and indicated that it would continue to sweep all receivables deposited to the Debtors' accounts to reduce the amounts owed to the Bank.

4. On March 26, 2014, the Debtors filed for chapter 11 protection and commenced an auction process to sell their assets pursuant to section 363 of the Bankruptcy Code. After the closing of the sale, the Debtors' bankruptcy cases were converted to cases under chapter 7 of the Bankruptcy Code and a chapter 7 trustee was appointed.

5. On March 16, 2016, the chapter 7 trustee filed a complaint against, among others, certain of the Debtors' officers and Versa Capital Management, LLC, alleging that the defendants failed to adequately respond to the Bank's actions and thereby did not preserve the value of the Debtors as a going concern. In addition, the trustee alleged that the defendants overlooked or ignored the dire situation and failed to file for bankruptcy protection sooner, before the Bank was able to sweep all of the Debtors' available cash.

6. The defendants filed motions to dismiss relying, in part, on the exculpation provisions contained in the Debtors' limited liability company agreements, each of which provided that under Delaware law there will be no liability for the defendants' breach of their fiduciary duties. However, the Debtors' limited liability company agreements each contained different exculpation provisions as set forth on Annex A, which weakened the defendants' argument and will be discussed in more detail below in Section C.4. Despite the different exculpation clauses in the agreements, the defendants argued that the broadest exculpation clause for the subsidiary entity should control for all of the affiliated entities, and therefore, the complaint should be dismissed. The trustee argued that an exculpation clause is an affirmative defense that cannot form the basis of a motion to dismiss, and in any event, one entity's exculpation clause cannot shield an affiliated entity or its members.

7. The bankruptcy court denied the motions to dismiss, finding that an exculpation clause is an affirmative defense and cannot form the basis for a motion to dismiss. The bankruptcy court specifically noted that the complaint alleged violations of gross negligence and disloyalty, which distinguished the case from the cases relied upon by the defendants where exculpation clauses did form the basis for a motion to dismiss.

8. After the bankruptcy court denied the defendants' motions to dismiss, the defendants filed rule 12(c) motions for judgment on the pleadings—a similar motion to a motion to dismiss, but one which allows the court to consider certain affirmative defenses. These motions, which rely upon the same exculpation clauses, have now been fully briefed and are awaiting a decision from the court.

C. Takeaways and Lessons

1. Delaware law provides limited liability companies with powerful tools to protect their managers and officers by eliminating liability for breaches of certain fiduciary duties and limiting the underlying duties themselves.

2. However, as demonstrated by the *Simplexity* decision, exculpation clauses are *not* a silver bullet for avoiding litigation entirely. While an exculpation clause may ultimately be an effective defense to allegations of improper conduct, the value of such a defense is lessened if it is unavailable at the motion-to-dismiss stage of litigation and instead is only available after an expensive, distracting and intrusive discovery and litigation process.

3. If a lawsuit survives the motion-to-dismiss phase, the decision-making process of the board of directors may be exposed to discovery. Managers should ensure that there is a sound record demonstrating the process and rationale behind their decisions, and should take care to protect attorney-client privilege where appropriate.

4. Drafting matters! The defendants in *Simplexity* were made more vulnerable by the fact that the applicable limited liability company agreements all worded their respective exculpation clauses in different ways (and were reduced to arguing that the most expansive agreement should control for all of the entities). Moreover, the agreements did not obviously sort out amongst themselves which one would control in the event of a conflict. If all of the exculpation clauses were consistent, it is possible that the trustee would not have pursued litigation against defendants with a clearer affirmative defense based on maximally protective contracts up and down the chain of entities.

    a) Check the entire chain of limited liability agreements, not just the agreement for the entity where the managers sit. Make sure the agreements are all consistent.

    b) Do not rely on form language; some limited liability agreements have language pre-dating the 2004 amendments to the Act (which broadened the extent to which duties can be waived) or that is adapted from other jurisdictions or prior bespoke deals, and may not offer maximum protection for the managers.

c) Pay special attention to how the duty of loyalty is treated in the documents (as such duty commonly cannot be waived in other jurisdictions or is retained to be modified in subsequent deal-specific provisions and procedures that are no longer relevant).

Annex A – Exculpation Provisions

II. Simplexity Services, LLC ("**Services**")	**III. Section 8.01 Exculpation**. IV. (a) No Fiduciary Duties. To the fullest extent permitted by law: V. (i) notwithstanding any duty otherwise existing at law or in equity, and notwithstanding any other provision of this agreement, no Indemnified Party shall owe any duty (including fiduciary duties) to the Company, the Member or any other person that is a party to or is otherwise bound by this Agreement, in connection with any act or failure to act, whether hereunder, thereunder or otherwise; provided, however, that this clause (i) shall not eliminate the implied contractual covenant of good faith and fair dealing, and VI. (ii) No Indemnified Party shall have any personal liability to the Company, the Member, or any other Person that is a party to or is otherwise bound by this Agreement for monetary damages in connection with any act or failure to act, or breach, whether under this Agreement, the Act or otherwise provided, however, that this clause (ii) shall not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing. VII. (b) No Personal Liability. If any provision of Section 8.01(a)(i) or (a)(ii) is held to be invalid, illegal or unenforceable, the duties and personal liability of any Indemnified Party to the Company, of the Member or any other Person that is a party to or is otherwise bound by this Agreement shall be eliminated to the greatest extent permitted under the Act. A. **Section 10.02 Conflict of Interest**. To the maximum extent permitted by applicable law, the Company and the Member hereby waive any claim or cause of action against any Versa Person for any breach of any fiduciary duty to the Company or the Member or any of the Company's Affiliates by any such Versa Person,

	including, without limitation, as may result from a conflict of interest between the Company or the Member or any of the Company's Affiliates and such Versa Person. The Member acknowledges and agrees that in the event of any such conflict of interest, each such Versa Person may, in the absence of bad faith, act in the best interests of such Versa Person, including, without limitation its Affiliates, employees, agents and representatives. No Versa Person shall be obligated to recommend or take any action in its capacity as an officer or a Member of the Company that prefers the interests of the Company or the Member or any of the Company's Affiliates over the interests of such Versa Person, and each of the Company and the Member hereby waives the fiduciary duty, if any, of such Versa Person to the Company and/or the Member, including, without limitation, in the event of any such conflict of interest or otherwise. No Versa Person shall be liable for monetary damages for losses sustained, liabilities incurred, or benefits not derived by the Member in connection with such decisions.
Adeptio INPC Holdings, LLC ("**Holdings**")	**Section 9.01 Exculpation**. No Indemnified Party shall be liable, responsible or accountable in damages or otherwise to the Company or the Members for any act or omission of the Indemnified Party on behalf of the Company, provided that the act or omission is not determined by a court to be due to such Indemnified Party's willful misconduct or recklessness. **Section 9.03 Limitation of Duties: Conflict of Interest**. To the maximum extent permitted by applicable law, the Company and each Member hereby waives any claim or cause of action against the Manager and each Versa Controlled Party and their respective Affiliates, employees, agents and representatives, . . . provided that, with respect to actions or omissions by the Manager, such waiver shall not apply to the extent the act or omission was attributable to the Manager's gross negligence or knowing violation of law . . . provided that, with respect to actions or omissions by

	the Manager, such waiver shall not apply to extent the act or omission was attributable to the Manager's gross negligence or knowing violation of law . . . provided that, with respect to actions or omissions by the Manager, such waiver shall not apply to the extent the act or omission was attributable to the Manager's gross negligence or knowing violation of law as determined by a final judgment, order or decree of a court of competent jurisdiction . . .
Simplexity, LLC ("**Simplexity**")	**Section 8.1 Limitation on Liability**. No current or former Manager of the Company shall be personally liable to the Company or the Member for monetary damages for breach of fiduciary duty as Manager of the Company notwithstanding any provision of law imposing such liability; provided, however, that this provision shall not eliminate liability of a Manager (i) for any breach of the Manager's duty of loyalty to the Company and the Member, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or (iii) for any transaction from which the Manager derived an improper personal benefit. No amendment or repeal of this paragraph shall adversely affect any of the rights or protections afforded to a Manager of the Company for or with respect to any acts or omissions of such Manager occurring prior to such amendment or repeal. **Section 8.2 Limitation of Duties; Conflict of Interest**. To the maximum extent permitted by applicable law, the Company and each Member, Manager, officer and employee of the Company hereby waives any claim or cause of action against any [Versa] Person for any breach of any fiduciary duty to the Company or its Member or any of the Company's Affiliates by any such Versa Person, including, without limitation, as may result from a conflict of interest between the Company r its Members or any of the Company's Affiliates and such Versa Person or otherwise. Each Member acknowledges and agrees that in the event of any such conflict of interest, each such Versa Person may, in the absence of bad faith, act in the best interests of such Versa Person, including without limitation its Affiliates, employees, agents and representatives. No Versa Person

	shall be obligated to recommend or take any action that prefers the interests of the Company or any of the Company's Affiliates over the interests of such Versa Person, including its Affiliates, employees, agents or representatives, and each of the Company and each Member, Manager, officer and employee of the Company and/or its Affiliates, including, without limitation, in the event of any such conflict of interest or otherwise; provided that, with respect to actions or omissions by any Manager or officer of the Company who may be a Versa Person, such waiver shall not apply to the extent the act or omission was attributable to the Manager's gross negligence or knowing violation of law as determined by a final judgment, order or decree of a court of competent jurisdiction) which is not appealable or with respect to which the time for appeal therefrom has expired and no appeal has been perfected).

American Bankruptcy Institute
2017 New York City Conference
Panel on LLC Bankruptcies

Recent Unauthorized Filing Cases

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I. Blocking Power – Forbearance Agreement Amendments to Organizational Documents Requiring the Consent of the Lender to File for Bankruptcy

A. *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016) (Carey, J).

After the debtor filed a voluntary chapter 11 petition, its senior secured lender moved to dismiss the petition as an unauthorized filing. The debtor is a Delaware limited liability company, engaged in oil and gas exploration, almost entirely in North Dakota. In connection with a pre-bankruptcy forbearance agreement, the lender had been given one common unit, representing a membership interest in the debtor, and the debtor's LLC agreement was amended to require the unanimous consent of all members for a bankruptcy filing. The chapter 11 filing was made without the lender's consent. The lender sought dismissal on the ground that its consent was required under the amended LLC agreement.

The bankruptcy court denied the motion to dismiss. Rejecting the parties' invitation to decide the issue as a matter of Delaware state law regarding agreements that abrogate fiduciary duties, the court decided that a contractual provision that waived or restricted a debtor's right to file for bankruptcy was unenforceable as a matter of federal law. For this proposition the court relied principally on two lines of cases. The first holds that an individual debtor's pre-bankruptcy waiver of the right to obtain a discharge of a debt in bankruptcy is enforceable. *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987); *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647, 651-54 (9th Cir. B.A.P. 1998); *In re Weitzen*, 3 F. Supp. 698 (S.D.N.Y. 1933) (quoted in its entirety). The second holds that even for corporation, pre-petition agreement that interfere with a debtor's rights under the Bankruptcy Code are unenforceable. *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1025-26 (9th Cir. 2012); (§ 524(g) asbestos plan channeling injunction); *MBNA Am. Bank v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)*, 275 B.R. 712, 723 (Bankr. D. Del. 2002) (§ 363 sale).

The decision recognized that other courts have upheld provisions in LLC agreements requiring unanimous consent or supermajority approval to file for bankruptcy. *In re Orchard at Hansen Park, LLC*, 347 B.R. 822, 827 (Bankr. N.D. Tex. 2006) (unanimous consent, dismissal granted); *In re Avalon Hotel Partners, LLC*, 302 B.R. 377, 381 (Bankr. D. Or. 2003) (75% approval, dismissal denied, based on subsequent ratification of filing).

Significantly, however, in *Intervention Energy*, the LLC agreement was amended pursuant to a forbearance agreement with a creditor. Therefore, the court viewed the restriction on filing for bankruptcy as based in a contract with a creditor, rather than as part of the original charter.

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

After the debtor filed a voluntary chapter 11 petition, its senior secured lender moved to dismiss the petition as both a bad faith and unauthorized filing. The debtor is a Michigan limited liability company that runs a vacation resort. In connection with a pre-bankruptcy forbearance agreement, the debtor's LLC operating agreement was amended to make the lender a special member of the LLC with no interest in profits or losses, no right to distributions or tax consequences, no obligation to make capital contributions, but the right to approve or disapprove any material action, including a bankruptcy filing. The chapter 11 filing was made following the debtor's default to the lender, and the commencement of a mortgage foreclosure action, but without the lender's consent. The lender sought dismissal on the grounds of the filing was in bad faith and unauthorized. As to the latter ground, the lender alleged that its consent was required under the amended LLC operating agreement. In opposition to the dismissal motion, the debtor produced broker price options that showed the debtor had equity in its property.

The bankruptcy court denied the motion to dismiss on both grounds. In rejecting the lender's bad faith filing argument, the court considered the 14 factors set forth in *In re Tekena USA, LLC*, 419 B.R. 341, 346-47 (Bankr. N.D. Ill. 2009) (using factors from *In re Grieshop*. 63 B.R. 657, 663 (N.D. Ind. 1986)) , and found that the debtor had more than one creditor, had not previously filed for bankruptcy (prior defaults to the lender did not count for this purpose), and although had no assets other the lender's collateral and was not currently operating, had equity in its property and the possibility of confirming a plan over the lender's objection.

In considering the unauthorized filing ground for dismissal, the court began by observing that, in general, absolute prohibitions against filing for bankruptcy are void against public policy, citing *Klingman v. Levinson*, 831 F.2d at 1296; *In re Shady Grove Tech Ctr. Ltd. P'ship*, 216 B.R. 386, 390 (Bankr. D. Md. 1998), *as supplemented*, 227 B.R. 422 (Bankr. D. Md. 1998); but restrictions in corporate control documents may be treated differently from those in contracts, citing *Klingman v. Levinson*, 831 F.2d at 1296; *In re 203 N. LaSalle St. Ltd. P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000). Nevertheless, the court held that a "blocking director" (or "blocking member" of an LLC) cannot exercise managerial voting power to prevent a bankruptcy filing in derogation of fiduciary duties, relying on *In re Gen. Growth Props.*, 409 B.R. 43, 64 (Bankr. S.D.N.Y. 2009); *In re Kingston Square Assocs.*, 214 B.R. 713, 736 (Bankr. S.D.N.Y. 1997) (refusing to dismiss an involuntary chapter 11 petition engineered by management to circumvent an independent director's blocking power); *In re Spanish Cay Co., Ltd.*, 715, 723 (Bankr.

S.D. Fla. 1993) (permitting insiders to be involuntary petitioning creditors for similar reasons).

The court quoted the provision of the amended LLC operating agreement that relieved the special member from considering any "interests or factors affecting the Company or the Members," and contrasted it with the provision of the Michigan Limited Liability Act, Mich. Comp. Laws Ann. § 450.4404 (1), requiring a "manager" to discharge managerial duties "in good faith . . . and in a manner the manager reasonably believes to be in the best interest of the limited liability company." The court then found the amendment to the LLC operating agreement that contained the blocking power void as a matter of both Michigan corporate governance law and federal bankruptcy law.

II. Unanimous Consent Requirement in Organizational Documents – Implied and Apparent Authority to Act for LLC

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

The two debtors have ownership interests in an office building in Chicago. The building is owned by 33 single purpose LLCs as tenants in common. The debtors, both Delaware LLCs, are one of these tenants in common (referred to as "TIC-0") and another entity (referred to as "TIC-Member") with a disputed ownership interest in TIC-0. Troy Thomas, an individual claiming to be the owner of TIC-0 moved to dismiss the voluntary petitions of TIC-0 and TIC-Member as unauthorized filings. The TIC-0 LLC operating agreement required the unanimous consent of its members to file for bankruptcy for so long as a particular loan was outstanding. Such loan was outstanding at the time of the bankruptcy filing. Thomas had not consented to such filing, nor had been asked to consent.

The disputed ownership of TIC-0 stems from the following facts: In 2005, TIC-0 solicited investors through a private placement memorandum ("PPM") in which subscriptions were offered for investments of $25,000. The PPM stated that it was subject to revision. TIC-Member was initially issued a certificate showing 100% ownership of TIC-0. TIC-Member then entered into a mezzanine loan in which it pledged its ownership interest in TIC-0 as collateral to its lender. Shortly thereafter, Thomas and his wife signed a subscription agreement for TIC-0 and sent it a payment of $25,000 to the designated escrow agent. Less than a month later, the Thomases were issued a certificate showing their membership in TIC-0. This certificate was not signed by TIC-Member, the sole existing member of TIC-0 with authority under the TIC-0 operating agreement to admit new members, but was instead signed by Triple Net Properties, LLC ("Triple Net"), which was identified in the PPM as the manager of TIC-0. The certificate, however, did not state that Triple Net had signed it in any representative capacity. Triple Net was also identified as the manager of TIC-Member in the TIC-Member LLC operating agreement. In 2006, the mezzanine loan owed by TIC-Member was paid by a wire transfer from a TIC-0 bank account.

The bankruptcy cases were filed seven years later in 2013. Fifteen months after the filings, Thomas moved to dismiss both cases as unauthorized filings. Thomas argued, based on his certificate, that he was a member of TIC-0 whose consent to the filing was required but not obtained. The debtors argued that Thomas's certificate was invalid, having been signed by Triple Net without identifying any representative capacity, and that he had instead been given a membership interest in TIC-Member.

The bankruptcy court dismissed the TIC-0 case, but denied dismissal of the TIC-Member case. Neither the parties nor the court took issue with the enforceability of the requirement for unanimous consent of the members of TIC-0 to authorize the filing. The court cited *In re DB Capital Holdings, LLC*, 463 B.R. 142 (table), 2010 WL 4925811, at *3 (10th Cir. B.A.P. Dec. 6, 2010) (opinion), for the proposition that an agreement among the LLC members to limit their ability to file for bankruptcy is presumptively valid. The issue was whether the Thomases were or were not members of TIC-0. That issue turned on the validity of Triple Net's signature on the certificate.

Thomas argued that because Triple Net was the manager of TIC-Member, it had the authority to act on behalf of TIC-Member and sign the certificate. The debtors argued that Triple Net did not state that it was acting in a representative capacity, and therefore, the court should apply Delaware case law that a member's signature does not bind an LLC unless the member signs is such capacity or "if there is evidence of an intent to act in that capacity." *Credit Suisse Secs. (USA), LLC v. W. Coast Opportunity Fund, LLC*, C.A. No. 4380-VCN, 2009 WL 2356881, at *3 (Del Ch. July 30, 2009). The court applied the holding in *Ray v. Harris*, C.A. No. 06-07-005 RBY, 2008 WL 2410208, at * (Del. Super. Feb. 26, 2008), in which the signature on a contract of an individual without any notation of corporate capacity was sufficient to bind the corporation when the subject matter of the contract was construction on real property owned by the corporation of which the individual was the principal. The bankruptcy court reasoned that because the certificate was signed by an entity purporting to act with requisite authority, and as the manager of TIC-Member, such entity did in fact have the requisite authority to act, there was sufficient evidence of intent of the entity to act in a representative capacity. Moreover, because the subscription price had been paid, and the certificate was delivered, there was apparent authority for the issuance of the certificate. Consequently, Thomas was a member of TIC-0 who did not consent to the filing, and the filing was unauthorized.

The court rejected a laches defense by the debtor, observing 11 U.S.C. § 1112(b) imposes no deadline to seek dismissal, and the debtor had not demonstrated any prejudice resulting from the 15-month delay in moving to dismiss. The court therefore dismissed the TIC-0 case. The TIC-Member case was not dismissed, because Thomas argued for membership in TIC-Member only as an alternative if he was not found to be a member of TIC-0. No other issue about the authority to file the TIC-Member case had been raised.

III. Supermajority Approval Requirement – Attempt to Invalidate Bankruptcy Authorization Resolution by Arguing that Membership Interests of Supporters of the Bankruptcy Filing Were Improperly Issued

In re Quad-C Funding, LLC, 496 B.R. 135 (Bankr. S.D.N.Y. 2013) (Gropper, J.)

The debtor was an asset-based lender and Delaware LLC, formed by the combination of two entities, Crossroads ABL, LLC ("Crossroads") formed by a company with expertise in loan origination; the other, Saranac ABL, LLC ("Saranac"), formed by a company with access to capital and expertise in loan management. Initially, the membership interests were allocated 40% to Crossroads and 60% to Saranac, which was also the manager of the LLC. The organization documents provided that the consent of a supermajority, 62.5%, of the common unit members required to approve certain actions of the LLC, including both the raising capital by the sale of common or preferred membership units and the filing for bankruptcy relief. Nevertheless, there was an exception that permitted Saranac, the manager, to raise additional capital without such required consent for up to $200,000 through the sale of common units and $5,000,000 for the sale of preferred units through a private placement memorandum ("PPM"). The new members had to be "accredited investors" under SEC Rule 501, which required them to meet certain minimum financial standard of net worth or income. Saranac did, in fact, raise new capital through the PPM to accredited investors who had personal or business relationships with the individual beneficial owners of Saranac, and new common and preferred units were issued. These new units had the effect of diluting the percentage ownership of Crossroads below the ability to block major decisions.

The relationship between Crossroads and Saranac soured, and led to state court litigation for the dissolution of the debtor. Such litigation included both an unsuccessful preliminary attempt by Crossroads to invalidate the new units, and a successful attempt to compel the payment of Crossroad's legal fees by the debtor under an indemnity provision of the origination documents. The partial judgment for legal fees, which appealed and bonded, and continuing requests for reimbursement of additional fees, which was draining the debtor's cash, led Saranac to call a meeting of the members to authorize a chapter 11 filing. The members, including the ones holding the new units, voted to authorize the chapter 11 filing. Shortly thereafter, Crossroads moved to dismiss the filing as unauthorized, arguing that the new units that had enabled the satisfaction of the supermajority requirement were themselves unauthorized.

The bankruptcy court denied the motion to dismiss. After recognizing that the authority of an LLC to file is determined by state law, citing, *Price v. Gurney*, 324 U.S. 100, 106 (1945), the court held that burden and type of proof in determining a motion to dismiss a bankruptcy case was a matter of federal law, citing to *In re W.R. Grace & Co.*, 475 B.R. 34, 156 (D. Del. 2012); *In re Lady Madonna Indus., Inc.*, 76 B.R. 281, 287 (S.D.N.Y. 1987). Observing a split in authority among bankruptcy courts on which party has the burden of proof on a motion to dismiss for lack of authority to file, the Judge Gropper approved the rule followed by case such as *In re ComScape Telecomms., Inc.*, 423 B.R.

816, 830 (Bankr. S.D. Ohio 2009); *In re S&S Liquor Mart, Inc.*, 52 B.R. 226, 228 (Bankr. D. R.I. 1985); and reasoned that placing the burden on the debtor allows opposing parties "to force the debtor to expend its diminished resources litigating over whether it could seek to rehabilitate or liquidate itself in an orderly fashion." The court therefore placed the burden on the moving party.

In the case before the court, Crossroads did not meet that burden. The state court had already, if preliminarily, rejected the challenge to Saranac's authority to issue new units based on the PPM. The bankruptcy court then rejected the new challenge that these unit holders were not "accredited investors," by observing that the debtor's management had gone through the customary steps of verifying the investor's status, and that allowing an investigation into this collateral issue would be wrong as a matter of federal policy. It would permit parties "to obstruct a bankruptcy filing, damage creditor interests, [and] possibly doom a chance at rehabilitation." In light of the allegation that Crossroads may have received an insider preference in the state court litigation, the bankruptcy court further opined that the dismissal of a bankruptcy case "for non-compliance with corporate bylaws or state law upon the motion of a stockholder who holds what otherwise might be a preferential transfer, would be unjustified in both law and equity," quoting *In re Am. Globus Corp.*, 195 B.R. 263, 265 (Bankr. S.D.N.Y. 1996).

IV. Implied Authority of Managing Member – Interpretation of LLC Operating Agreement

In re East End Dev., LLC, 491 B.R. 633 (Bankr. E.D.N.Y. 2013) (Grossman, J.)

The debtor, a New York LLC engaged in the business of owning and developing real property in Sag Harbor, New York, had two members, each with a 50% interest, 21 West Water Street Holdings, Inc. ("21 West") and MM Sag Harbor LLC ("MM Sag Harbor"), which was designated the managing member in the LLC operating agreement. Following the commencement of mortgage foreclosure proceedings on the debtor's real property and failed settlement negotiations with the mortgagee, MM Sag Harbor, as managing member, authorized the debtor's chapter 11 filing without 21 West's consent. Four months after the filing, and after the debtor had obtained DIP financing from the mortgagee, proposed a plan and obtained approval of its disclosure statement, 21 West moved to dismiss the petition as both an unauthorized and bad faith filing.

The question for the bankruptcy court was whether the LLC operating agreement, which did not expressly address the issue, conferred the requisite authority on the managing member to file the debtor's chapter 11 petition without the other member's consent. The operating agreement contained provisions that authorized the managing member to make all decisions, except as other expressly provided, but permitted the managing member to submit any matter to a vote of all members. It also specified that the managing member had the following powers: to cause the debtor to acquire, own, operate, manage, develop and maintain assets; to sell condominium units and other assets; and to prosecute, defend or settle litigation, or to adjust claims or demands of or against the debtor. Notably, the

operating agreement listed four matters that required the consent of a majority of the membership interests: (1) agreements between the debtor and the managing member or an affiliate of the managing member; (2) actions to dissolve, wind-up or liquidate the debtor (except when such actions are required by the agreement); (3) mergers with, consolidations with, acquisitions of substantially all the assets of, another entity; and (4) admissions of new members (except when no dilution of interests occurs). The agreement further provided that persons dealing with the managing member are entitled to rely on the managing member's authority to act, and the managing member's execution of a document is conclusive as to such authority.

The bankruptcy court began its analysis by referring to the Supreme Court's placement of the authority to file a bankruptcy petition on behalf of corporation with the entity having "the power of management." *Price v. Gurney*, 324 U.S. at 104. Such power is determined under state law, citing. *In re Avalon Hotel Partners, LLC*, 302 B.R. 377, 380 (Bankr. D. Or. 2003); *Am. Globus Corp.*, 195 B.R. at 265. Under governing New York law, the operating agreement determines the authority to file for bankruptcy, and if the agreement is silent, the default provisions of the New York Limited Liability Company Act apply, citing *Overhoff v. Scarp, Inc.*, 12 Misc.3d 350, 359, 812 N.Y.S.2d 809 (N.Y. Sup. Ct. 2005). Neither the debtor's operating agreement nor the New York statute contained a specific provision governing the authority to file a bankruptcy petition.

21 West sought dismissal, arguing that filing a bankruptcy petition is akin to a liquidation or a winding-up, which the operating agreement required the consent of a majority of the members to undertake. The bankruptcy court rejected this argument, observing that the agreement was not a bare-bones document, and that it conferred broad powers upon the managing member, subject to a few specific limitations. The specified powers of the managing member were illustrative rather than exhaustive. The court distinguished the debtor's agreement from the one that led to the dismissal of the case in *Avalon Hotel Partners*, 302 B.R. at 380. The agreement in *Avalon Hotel Partners* required the consent of more than 75% of the members for a non-exclusive list of "major decisions," which was held to encompass filing for bankruptcy, since that decision was outside the ordinary course of business even for an entity in dissolution. Judge Grossman further relied on the definition of "bankruptcy" in section 102(d) of the New York Limited Liability Law, which referred to the Bankruptcy Code or an applicable state insolvency statute, and held that "bankruptcy" was not synonymous with "liquidation." Rather, bankruptcy more closely resembled the adjustment of claims and demands against the debtor, which the debtor's operating agreement expressly empowered the managing member to do.

The bankruptcy court also rejected 21 West's contention that the petition had been filed in bad faith. Relying on *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304, 1310 (2d Cir. 1997); *Gen. Growth Props.*, 409 B.R. at 56; the court held that a bad faith dismissal of a chapter 11 petition in the Second Circuit required both objective futility and subjective bad faith, the court found both elements lacking. The debtor had already proposed a plan, which called for an auction sale of the real property preserving the mortgagee's ability to credit bid, and its objective in filing was to preserve the value of its assets after negotiations had failed. That the two 50%

members of the debtor disagreed over how best to deal with the mortgagee was not indicative of bad faith by the managing member. The liquidating plan proposed by the debtor was a permissible use of chapter 11, and the possibility that the mortgagee may be the successful bidder for the property or that the members of MM Sag Harbor would be released from liability under their personal guarantees did not support a finding that the petition was filed in bad faith.