American Bankruptcy Institute
Central States Bankruptcy Workshop

Limited Liability Company Debtor Cases

Mark A. Carter, Moderator
Hinshaw & Culbertson LLP | Chicago

Kimberly Ross Clayson
Taft Stettinius & Hollister, LLP | Southfield, Mich.

Hon. Peter W. Henderson
U.S. Bankruptcy Court (C.D. Ill.) | Peoria

Peter J. Keane
Pachulski Stang Ziehl & Jones | Wilmington, Del.

Sandra D. Mertens
Gensburg Calandriello & Kanter, P.C. | Chicago

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THE LIMITED LIABILITY COMPANY IN CHAPTER 11: KEY ISSUES

PANELISTS FOR TODAY'S PROGRAM

Mark A. Carter
Hinshaw & Culbertson LLP
Chicago

Kimberly Ross Clayson
Taft Stettinius & Hollister, LLP
Southfield, MI

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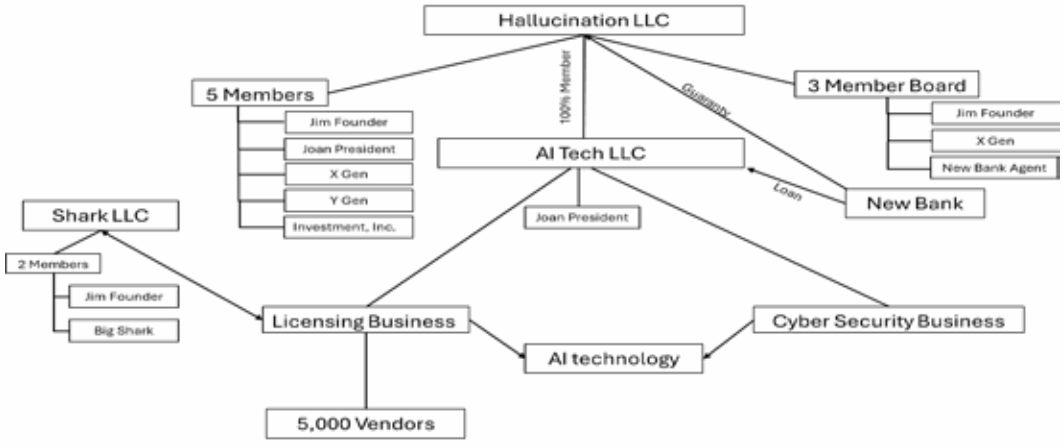
Gensburg Calandriello & Kanter, P.C.
Chicago

CASE STUDY: ENTITY STRUCTURE



CASE STUDY: AI TECH LLC – THE BACKGROUND

- AI Tech LLC is a premier, industry leading licensor of generative AI technology originally developed by Jim Founder.
- AI Tech's AI technology and the related licenses are worth $6.0 million – approximately 90% of the value of the company.
- AI Tech is 100% owned by Hallucination LLC, a manager-managed LLC formed under Delaware law.
- AI Tech has obtained a loan for $3.0 million from New Bank, secured by liens on all of AI Tech's assets and a guaranty from Hallucination.
- Given its successes and technological capabilities, AI Tech recently embarked on creating a cyber security business to further offset growing labor and other costs of operations.

CASE STUDY: AI TECH LLC – THE TRANSACTION

- Unfortunately, AI Tech's licensing successes weren't replicated in its cyber security business:
  - First 3 clients experienced massive data breaches due in large part to failures In processes created and installed by AI Tech.
  - AI Tech's exposure has not been determined yet, but liability is beyond dispute. Losses are expected in excess of $10 million.
- Jim Founder, seeing the writing on the wall, and having previously received interest in the purchase of the AI licensing business from Big Shark, another business partner, decides to "sell" the AI technology and the licensing business to "Shark LLC," a company owned by Jim Founder and Big Shark.
  - Purchase price is $3.0 million or half its value but enough to satisfy the New Bank debt.
  - At the time of closing, AI Tech's unsecured debt is $4.0 million, *excluding* the cyber claims.
- New Bank consented to the sale and loaned the necessary funds to Shark LLC to purchase the AI technology and licensing business at $3.0 million.
- The sale closed without the knowledge of the Board of Hallucination or its members, other than Jim Founder and Joan President, the President of AI Tech. Joan President executed all of the sale documents on behalf of AI Tech.

CASE STUDY: AI TECH LLC – THE REACTION

- Y Gen learned of the sale to Shark LLC when one of AI Tech's cyber clients complained about the sudden lack of access to the AI Technology.
- Y Gen knows that AI Tech cannot survive without the AI technology and the cashflow from the licensing business. Y Gen also helped solicit Investment, Inc. to invest in AI Tech and feels "concerned" about her representations made to investors.
- Upon reviewing the Hallucination LLC agreement, however, Y Gen discovered:
  - The affirmative vote of 100% of the members of Hallucination is required to authorize AI Tech's sale of its AI technology (its key asset) or merger but only the vote of 2/3rds of the Board members are necessary to authorize all other actions.
  - Fiduciary duties otherwise owed by members and managers are the subject of broad waivers and exculpations.
  - The standards for transactions with members and their companies are set very low and expressly permit transactions between AI Tech, Hallucination and third parties having common ownership and control.
- Y Gen threatens X Gen and New Bank Agent, but New Bank Agent declines to vote for the Chapter 11 filing by AI Tech. Without the knowledge of Jim Founder or support of New Bank Agent, the Hallucination Board (through X Gen) issues a resolution authorizing AI Tech to file Chapter 11. X Gen then "encourages" Joan President to cooperate and causes AI Tech to file a Chapter 11 case in the Delaware Bankruptcy Court.
- Jim Founder and Shark LLC are notified of the Chapter 11 filing by AI Tech and promptly file a Joint Motion to Dismiss the AI Tech Chapter 11 case.

CASE STUDY: AI TECH LLC – THE DISCUSSION: QUESTION #1

- Question #1: Should the Motion to Dismiss the AI Tech Chapter 11 Case filed by Jim Founder and Shark LLC be granted?

AI TECH LLC - AUTHORITY TO FILE CHAPTER 11

- <u>Authority To File:</u>

- Was the bankruptcy filing properly authorized?
  - Question of state law; usually look to LLC/operating agreement.
  - But: Federal law does not permit contracting away right to file bankruptcy.

- Federal bankruptcy law may pre-empt attempts to contract around bankruptcy relief as a matter of public policy.
  - No "golden share" for creditors. *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016).
  - But: ok for members with fiduciary duties to veto bankruptcy. *In re 301 W North Avenue*, 666 B.R. 583 (Bankr. N.D. Ill. 2025).

AI TECH LLC - AUTHORITY TO FILE CHAPTER 11

- <u>Ratification:</u>
- If the filing was not authorized, can it be ratified?
  - Again, question of state law. E.g., Delaware LLC Act §18-106(e).
  - Implied ratification prevents a movant who has benefited from bankruptcy from dismissing the case.
  - But see *In re Cinch Wireline Services, LLC*, 2025 WL 848199 (Bankr. W.D. Tex. Mar. 18, 2025) (holding ratification unavailable in Fifth Circuit).

AI TECH LLC - AUTHORITY TO FILE CHAPTER 11

- Outcome/Takeaways:
- Caselaw is based upon nuances of state statute and very fact specific. Delaware Law requirements and LLC agreement terms regarding authority would apply here.
- Assuming New Bank does not own a membership interest in Hallucination, New Bank Agent's right to vote will likely be considered unenforceable.
- Jim Founder did not vote, and his vote would still be necessary since the LLC agreement permitted board members to engage in transactions with AI Tech (permitted under Delaware law).
- Without the necessary two (2) votes, the dismissal motion would likely be granted per Delaware law unless X Gen (and Y Gen) can establish facts to support the ratification of the filing.

CASE STUDY: AI TECH LLC – THE DISCUSSION: QUESTION #2

- Question #2: If the Chapter 11 case is not dismissed, do any of the following have exposure for any of their pre-petition actions:
  - Jim Founder?
  - New Bank Agent?
  - Y Gen?
- Who has standing to enforce any such claims?

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **Member-managed vs. Manager-managed**
  - LLCs generally use two major structures: member-managed and manager-managed.
    1. Member-managed LLCs: default structure in most states, unless LLC documents say otherwise. All members actively participate in operations and decision-making of the business.
       - Characteristics: direct involvement, typically equal rights and voting power, routine decisions decided by majority vote, but major decisions often have higher threshold.
    2. Manager-managed LLCs: members delegate day-to-day operations and decision-making to one or more managers. Managers can be members or can be non-members hired for the role.
       - Characteristics: delegated authority to managers to bind the LLC (making contracts, hiring/firing employees, managing finances and operations), passive members, professional management, formal structure.

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **Member-managed vs. Manager-managed**

  - Scope of fiduciary duties of members or managers determined by state law.
    - *See, e.g., Bayou Steel BD, L.L.C. v. Black Diamond Cap., Mgmt. L.L.C (In re: Bayou Steel BD Holdings, L.L.C.)*, 651 B.R. 179, 184 (Bankr. D. Del. 2023).

  - Generally, only managers and managing members of an LLC will have fiduciary duties to the LLC and those that hold a controlling interest in the entity, but a person not named in the LLC agreement can be deemed a de facto manager and fiduciary of the LLC depending on the facts.
    - Must demonstrate that a defendant had access to the LLC's confidential information and engaged in acts on behalf of the LLC to establish the defendant's status as a de facto manager.
    - *See, e.g., In re Our Alchemy, LLC,* 2019 Bankr. LEXIS 2907 at *19 (finding de facto manager owing fiduciary duties to LLC when person had access to LLC's confidential information, planned business dealings on important issues, and assisted in updating the LLC's lenders).
    - *See also,* 805 ILCS 180/15-3(g)(3) (Illinois LLC Act) (member can become subject to fiduciary duties to the extent member "exercises some or all of the authority of a manager in the conduct of the company's business).

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **Fiduciary duty waivers**
  - Delaware LLC Act permits parties to an LLC agreement to waive fiduciary duties of members, managers, or other persons or to exculpate such members, managers, or persons. *See* 6 Del. C. §18-1101(c) (broad authority grant for expanding, restrict, or eliminating duties) and 18-1101(e) (authority for limiting or eliminating liability, i.e., exculpation).
  - Waivers enforceable in bankruptcy.
    - *See, e.g., In re Optim Energy, LLC ,* 2014 Bankr. LEXIS 2155, *18-20 (Bankr. D. Del. May 13, 2014); *In re Pack Liquidating, LLC*, 658 B.R. 305, 333-335 (Bankr. D. Del. 2023).
  - Waivers must be clear and unequivocal.
    - *See, e.g., Manti Holdings, LLC v. Carlyle Grp. Inc*., 2022 Del. Ch. LEXIS 36, *5-6 (Del. Ch. Feb. 14, 2022).
  - But implied covenant of good faith and fair dealing cannot be waived – always present.
    - *See, e.g., Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400, 418-19 (Del. 2013) (wonderful explanation of this doctrine).

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **Standing and derivative claims**
  - **Outside bankruptcy**: Creditors of a Delaware LLC lack standing to pursue derivative breach-of-fiduciary-duty claims, even if the LLC is insolvent or near insolvent.
    - *See, e.g., CML V, LLC v. Bax, 28 A.3d 1037* (Del. 2011) (DE LLC Act expressly limits standing for derivative actions to members or assignees of the applicable LLC).
  - **In bankruptcy**: Three prior DE Bankruptcy Court decisions applied the plain language of the DLLCA and followed the DE Supreme Court's holding in *Bax* to prevent creditors (or even trustees) from pursuing derivative claims on behalf of Delaware LLC debtors.
    - *See, e.g., In re Citadel Watford City Disposal Partners, L.P.*, 603 B.R. 897 (Bankr. D. Del. 2019) ; In re HH Liquidation, LLC, 590 B.R. 211 (Bankr. D. Del. 2018); *In re PennySaver USA Publishing, LLC*, 587 B.R. 445 (Bankr. D. Del. 2018).

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **Standing and derivative claims**
  - A new approach?
    - Recent decision from Delaware Bankruptcy Court changed the view about *Bax*.
    - *In re Pack Liquidating*, 658 B.R. 305 (Bankr. D. Del. 2024) (Bankruptcy Code creates a federal right for creditor derivative standing -- citing to Third Circuit precedent in *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003) – even though DE law does not allow creditors of debtor LLCs to sue LLC members and officers for breach of fiduciary duty).

AI TECH LLC - FIDUCIARY DUTIES OF MANAGERS & MEMBERS

- **<u>Outcome/Takeaways:</u>**
- Jim Founder's and New Bank Agent's actions may give rise to a breach; Y Gen's actions likely not sufficient.
- Fiduciary duty waivers are enforceable under Delaware law, so New Bank Agent and Jim Founder will have protection under the Hallucination duty waivers.
- Since the covenant of good faith can't be waived under Delaware law, both Jim Founder and New Bank Agent may have violated said obligation by ignoring the "100 % member consent" provision of the Hallucination LLC Agreement.
- Even if a claim can be made on the covenant of good faith, creditors lack standing to bring fiduciary duty claims under longstanding Delaware law.
- If the reasoning in *Pack Liquidating* is followed by the Court in the AI Tech case, however, the restrictions on standing to bring fiduciary duty claims could be ignored on preemption grounds, such that a creditors' committee could be granted derivative standing on claims against Jim Founder and New Bank Agent.

CASE STUDY: AI TECH LLC – THE DISCUSSION: QUESTION #3

- Question #3: Would the analysis and outcome(s) be different if AI Tech had filed a subchapter V case?

AI TECH LLC - SUBCHAPTER V

- Generally speaking, what is different in a subV case?
  - Eligibility requirements to consider under sec. 1182 in addition to authority to file pursuant to the operating agreement.
  - Are any of the other entities going to file bankruptcy? Debt limit calculation. Sec. 1182(1)(B)(i).
  - Is debtor or any of the affiliated entities publicly traded companies? Sec. 1182(1)(B)(ii) – (iii).
  - Still boils down to authority to file pursuant to the operating agreement.
- Any difference in outcomes had AI Tech been formed under Michigan law?
  - No specific statutory restrictions related to bankruptcy filings.
  - Still boils down to authority to file pursuant to the operating agreement.

AI TECH LLC- SUBCHAPTER V

- What is the role of a subchapter V Trustee?
  - Most significantly, facilitate consensual confirmation of a chapter 11 plan. Sec. 1183(b)(7).
  - On a motion and for cause, duties can expand – to anything from an investigatory role all the way to a trustee in possession. Sec. 1183(b)(2).
  - Subject to limits on the subchapter V Trustee's prosecutorial authority.
  - Only the Debtor can file a Chapter 11 plan.
- What risks could Jim Founder or New Bank Agent face with an active trustee?
  - Concerns *actually* rest with an active creditor who alleges pre- or post-petition mismanagement. Sec. 1183(b)(2).
  - An active subchapter V trustee is seeking consensus.
  - A subchapter V trustee may insist on a liquidation analysis that takes into account recovery of insider transactions to get creditor consent to a plan.

AI TECH LLC- SUBCHAPTER V

- **Example**: *In re Residents First, LLC*, Case No. 23-49817-mar, commenced in the U.S. Bankruptcy Court for the Eastern District of Michigan.
- Single-member LLC filed Chapter 11.
- During the Chapter 11 case, it was discovered that there were several intercompany transactions between the LLC Debtor and the sole member's other companies. Moreover, the LLC Debtor only held liabilities, and the debts incurred only benefited related companies and the related companies held all of the assets.
- The Subchapter V trustee's role was expanded by agreement to conduct a full investigation. The investigation revealed substantial insider transactions involving the LLC Debtor and benefiting the member's related companies.

AI TECH LLC - SUBCHAPTER V

- **Example**: *In re Residents First, LLC*, Case No. 23-49817-mar (continued)
- The LLC Debtor proposed a plan that offered di minimis return to the general unsecured creditors. The plan was to be funded by a support agreement with a related entity who would fund the plan repayments.
- In an effort to stymy the unsecured creditors and any powers the Subchapter V trustee might have had to pursue avoidance actions, the plan provided that if a party pursued those actions against related entities, the related entity could terminate the support agreement thereby resulting in no distribution to unsecured creditors.
- Objections were filed by the US Trustee, the Subchapter V trustee and the largest unsecured creditor.
- The LLC Debtor opted to mediate with the largest unsecured creditor (which prompted the bankruptcy case filing in the first place) and ultimately reached a substantial settlement which included voluntary dismissal of the LLC Debtor's bankruptcy case.

AI TECH LLC - SUBCHAPTER V

- **Outcome/Takeaways:**
- The Motion to Dismiss filed by Jim Founder and Shark LLC will be subject to the same analysis as applied in the Chapter 11 case.
- The control of Jim Founder and New Bank Agent over AI Tech may be impacted by an active subchapter V trustee:
  - liquidation analysis that takes into account recovery of insider transactions.
  - Disclosure of information which may be used by creditors in actions against Shark LLC and others.
- The circumstances may cause the expansion of the subchapter V trustee's authority by court order.

CASE STUDY: AI TECH LLC – THE DISCUSSION: QUESTION #4

- Question #4: Assuming AI Tech had filed a Chapter 11 case (instead of selling its AI technology) what tax implications should be considered with respect to a bankruptcy sale of the AI technology followed by confirmation of a Chapter 11 plan which released all cyber liability and supported a 10% distribution on unsecured claims?

AI TECH LLC - WHAT TAX ISSUES SHOULD THE LLC DEBTOR IN POSSESSION BE AWARE OF?

1. Tax Attributes

- Tax Classifications
  - Default: Partnership
  - Corporation (C)
    - S Election
  - Disregarded Entity
- Accounting Methods
  - Cash Basis
  - Accrual Basis
- Tax Year
  - Calendar Year
  - Fiscal Year
  - 52-53-Week Year
- Tax Returns
  - Who is responsible for filing?
  - What returns are required?
  - Unfiled returns & discharge

AI TECH LLC - WHAT TAX ISSUES SHOULD THE LLC DEBTOR IN POSSESSION BE AWARE OF?

2. Basis Concerns for LLCs & Members

Inside Basis

- Basis of assets within the LLC
  - Contribution value
  - Purchase price
  - Additional capital expenditures
  - Reduced by depreciation or amortization

Outside Basis

- Member's interest in the LLC
  - Contribution value (cash, property)
  - Share of profits & losses
  - Reduced by distributions

AI TECH LLC - WHAT TAX ISSUES SHOULD THE LLC DEBTOR IN POSSESSION BE AWARE OF?

3. "Phantom Income" to Members
   - Problem for LLCs taxed as a partnership or S corporation with "flow-through" taxation.
   - Can the LLC make member distributions to pay taxes?
     - Circuit split on whether transfer is for "reasonably equivalent value"
     - Fact-intensive analysis
   - Strategies:
     - Minimize net income pass-through
     - Pay wages to member-employees
     - Review Operating Agreement
     - Ask Court to approve tax distributions

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AI TECH LLC - WHAT TAX ISSUES SHOULD THE LLC DEBTOR IN POSSESSION BE AWARE OF?

Outcome/Takeaways:
Does AI Tech's sale of its AI technology generate any significant tax issues?

- AI Tech
- Hallucination
- Hallucination's Members
- Shark LLC & Members
- Potential Liability

Key Facts:
Sale price: $3.0 million
Loan balance: $3.0 million
Value at sale: $6.0 million
Basis: ??

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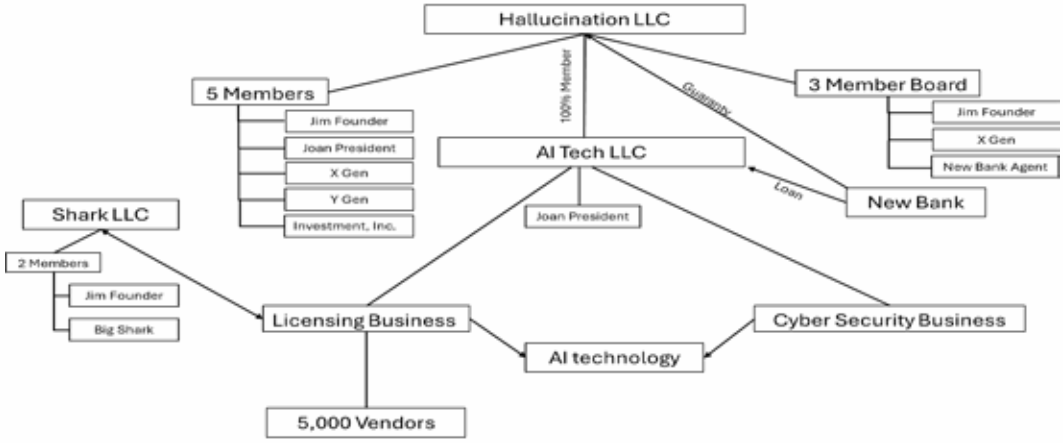
CASE STUDY: ENTITY STRUCTURE



CASE STUDY: AI TECH LLC – MATERIALS

- Refer to Supplemental Discussion Outline for additional analysis and citations to authority.

THANK YOU

Supplemental Outline

The Limited Liability Company in Chapter 11: Key Issues

I. DEVELOPMENTS ON AUTHORITY TO FILE CHAPTER 11 CASE

(A) LLC's Authority to File Chapter 11 Case.

(i) Bankruptcy courts look to state law in determining whether a Chapter 11 filing was properly authorized by an LLC debtor. The question initially turns upon whether the filer has complied with the law of the state of formation. The requirements for authorization of acts by LLCs are not the same under state LLC statutes and the caselaw interpreting them.

1. *In re 301 W North Avenue*, 666 B.R. 583 (Bankr. N.D. Ill. 2025).

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

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

(ii) Some state LLC statutes provide specific rules for ratification of actions by the LLC managers and members which may be relevant to whether a Debtor can survive a motion to dismiss an improperly authorized Chapter 11 filing. *See* 6 Del. C. §18-106(e).

(iii) In certain jurisdictions, the issue of whether a Chapter 11 case was properly authorized is jurisdictional. In other words, if the case was not properly authorized before filing, a bankruptcy court lacks jurisdiction to hear the case.

1. *Franchise Servs. of Am., Inc. v. United States Trustee (In re Franchise Servs. of Am., Inc.),* 891 F.3d 198 (5th Cir. 2018).

2. *In re Cinch Wireline Servs., LLC*, 2025 Bankr. LEXIS 665*, 2025 WL 848199 (Bankr. W.D. Tex. March 16, 2025).

(iv) Accordingly, decisions addressing whether a Chapter 11 case was properly authorized are very fact specific and the ability to identify and rely upon general rules from the caselaw is limited.

(B) Are subchapter V Cases Any Different?

(i) In general, subchapter V cases involve the same issues regarding authority to file bankruptcy.

1. I*n re Energy Drilling Servs., LLC*, No. 22-31772-jda, 2023 Bankr. LEXIS 3131, at *1 (Bankr. E.D. Mich. Jan. 13, 2023).

2. *In re Karben4 Brewing, LLC*, 661 B.R. 392, 396 (Bankr. W.D. Wis. 2024).

II. FIDUCIARY DUTIES OF MANAGERS AND MEMBERS

(A) Member-managed vs. Manager-managed.

(i) LLCs generally permit owners (called "members") to choose the management structure of the LLC and there are two major structures: member-managed and manager-managed.

(ii) Member-managed LLCs: default structure in most states, unless LLC formation documents say otherwise. All members actively participate in the day-to-day operations and decision-making of the business.

1. Characteristics: direct involvement by members, typically equal rights and voting power, most routine decisions decided by simple majority vote but major decisions often have higher threshold for approval, common for smaller businesses.

2. Pros: direct control over operations, less bureaucracy, cheaper (no external hiring needed).

3. Cons: possible conflict among members, time commitment, agency risk (since all members can bind the LLC, a single member may act outside the scope of the best interests of the LLC).

(iii) Manager-managed LLCs: members delegate day-to-day operations and decision-making to one or more managers. Managers can be members or can be non-members hired for the role.

1. Characteristics: delegated authority to managers to bind the LLC (making contracts, hiring/firing employees, managing finances and operations), passive members, professional management, formal structure (often preferred for larger LLCs).

2. Pros: efficient decision-making, can have specialized expertise in a particular line of business of the LLC, scalable, reduced agency risk.

3. Cons: less direct control for members, members may feel disconnected from business, cost of external manager, oversight still needed by members.

(iv) Bankruptcy courts will look to the state statutory law and related case law approaches to determine the scope of any fiduciary duties of members or managers.

1. *Anderson Dig., LLC v. ANConnect, LLC (In re Our Alchemy, LLC)*, 2019 Bankr. LEXIS 2907, *18 (Bankr. D. Del. Sept. 16, 2019).

2. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 662 (Del. Ch. 2012.

3. *In re 3P Hightstown, LLC*, 631 B.R. 205, 213 (Bankr. D.N.J. 2021).

4. *Bayou Steel BD, L.L.C. v. Black Diamond Cap., Mgmt. L.L.C (In re: Bayou Steel BD Holdings, L.L.C.)*, 651 B.R. 179, 184 (Bankr. D. Del. 2023).

(v) Delaware law looks closely to the language of the LLC agreement itself to give those words effect. But if the LLC agreement is silent as to the applicability of fiduciary duties, a court will apply the traditional "rules of law and equity, including the rules of law and equity relating to fiduciary duties." Absent modification by an LLC agreement, the fiduciary duties applicable to an LLC context are essentially identical to those applied in the corporate context.

(vi) Generally, only managers and officers of an LLC will have fiduciary duties to the LLC and those that hold a controlling interest in the entity but a person not named in the LLC agreement can be deemed a de facto managers and fiduciary of the LLC depending on a number of considerations:

1. *Anderson Dig., LLC v. ANConnect, LLC (In re Our Alchemy, LLC)*, 2019 Bankr. LEXIS 2907, *19 (Bankr. D. Del. Sept. 16, 2019).

(vii) Delaware courts consistently look "to who wields control in substance and have imposed the risk of fiduciary liability on the actual controllers." *Virtus Capital L.P. v. Eastman Chem. Co*., 2015 Del. Ch. LEXIS 34, 2015 WL 580553, at *17 (Del.Ch. Feb. 11, 2015). A third party exerts actual control over an entity through the existence of a relationship where the third party dominates the company's business affairs. *Kahn v. Lynch Comm. Sys., Inc*., 638 A.2d 1110, 1114-15 (Del. 1994)).

(B) Fiduciary duty waivers. The Delaware LLC Act permits parties to an LLC agreement to waive fiduciary duties of members, managers, or other persons or to exculpate such members, managers, or persons. *See* 6 Del. C. §18-1101(c) (broad authority grant for expanding, restrict, or eliminating duties) and 18-1101(e) (authority for limiting or eliminating liability, i.e., exculpation). Fiduciary duties can be limited or eliminated entirely, as long as the waiver is clear and unambiguous. However, the implied covenant of good faith and fair dealing can never be eliminated by contract---it's omnipresent.

(i) Waivers are enforced in bankruptcy:

1. *In re Pack Liquidating, LLC*, 658 B.R. 305, 333-335 (Bankr. D. Del. 2023) (LLC operating agreement waived fiduciary duties for managers but did not extend this waiver to officers. Bankruptcy court held that creditors could pursue derivative claims against officers for breach of fiduciary duties, even though the operating agreement waived such duties for managers. The court emphasized that the waiver did not extend to officers, allowing creditors to hold them accountable for actions detrimental to the estate).

2. *In re Optim Energy, LLC* , 2014 Bankr. LEXIS 2155, *18-20 (Bankr. D. Del. May 13, 2014) (finding that where a Delaware LLC operating agreement waived fiduciary duties for members and directors, claims for breaches of fiduciary duties and aiding and abetting breach of fiduciary duty claims must fail).

3. *Miller v. Black Diamond Cap. Mgmt., L.L.C. (In re Bayou Steel BD Holdings, L.L.C.)*, 642 B.R. 371, 401 (Bankr. D. Del. 2022) (dismissing chapter 7 trustee's claims against certain D&Os for breaches of fiduciary duties because while the Debtors' LLC agreements did not eliminate the D&O's fiduciary duties by section 18-1101(c) of the Act, they did provide exculpation from liability as authorized by section 18-1101(e), so the trustee's ability to seek monetary liability was eliminated by contract).

4. Note: In addition, when an exculpatory clause immunizes the managers of a LLC from breach of fiduciary duty claims, a controlling equity holder is likewise immunized. See Shandler v. DLJ Merch. Banking, Inc., 2010 Del. Ch. LEXIS 154, 2010 WL 2929654, at *16 (Del. Ch. July 26, 2010) (recognizing, in dismissing a claim for breach of the duty of care based upon the exculpatory clause that mentioned only directors, that "a controlling stockholder cannot be held liable for a breach of the duty of care when the directors are exculpated.").

(ii) Waivers must be clear:

1. *Manti Holdings, LLC v. Carlyle Grp. Inc*., 2022 Del. Ch. LEXIS 36, *5-6 (Del. Ch. Feb. 14, 2022) ("Under Delaware law, waiver is the intentional relinquishment of a known right. A waiver may be either express or implied, but either way, it must be unequivocal. The standards for proving waiver under Delaware law are quite exacting, and the facts relied upon to prove waiver must be unequivocal. A waiver of fiduciary duties, to the extent allowed by Delaware law, must be clear and unambiguous. And, as our courts have noted in connection with fiduciary duty waivers in the LLC context, because

drafters of the entity's documents must make their intent to eliminate fiduciary duties plain and unambiguous in order for such waivers to be effective, the interpretive scales tip in favor of preserving fiduciary duties.").

But watch out for the implied covenant of good faith and fair dealing. See 6 Del. C. § 18-1101(c) ("[T]he limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

2. *Bold St. Peters, L.P. v. Bold on Blvd. LLC*, 2024 Del. Ch. LEXIS 364, *18 (Del. Ch. Nov. 19, 2024) ("Of course, the implied covenant is omnipresent: one need not speak its name, even once, to make it appear. "This implied covenant 'inheres in every contract' and requires that contracting parties 'refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party from receiving the fruits of the contract.').

3. *Kelly v. Blum*, 2010 Del. Ch. LEXIS 31, 2010 WL 629850, at *13 (Del. Ch. Feb. 24, 2010) ("Under the LLC Act, the contracting parties to an LLC agreement may not waive the implied covenant of good faith and fair dealing.").

III. STANDING AND DERIVATIVE CLAIMS

(A) Outside of bankruptcy. Creditors of a Delaware LLC lack standing to pursue derivative breach-of-fiduciary-duty claims, even if the LLC is insolvent or near insolvent, bankruptcy courts have decided a number of Bax-related issues in cases involving Delaware LLCs.

(i) *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011) (the Delaware Supreme Court held (i) the DLLCA means what it says – namely that the DLLCA expressly limited standing for derivative actions to members or assignees of the applicable LLC, and (ii) notwithstanding the Court's decision in N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101-02 (Del. 2007) that creditors of an insolvent corporation have standing to pursue such derivative claims against the corporation's officers and directors, the Delaware legislature did not intend the holding in Gheewalla to apply in the context of an insolvent LLC to create standing for creditors to pursue such derivative claims).

(B) In bankruptcy. Bankruptcy courts have generally enforced Bax, until one recent decision has opened the door to a new approach. Three prior Delaware Bankruptcy Court decisions applied the plain language of the DLLCA and followed the Delaware Supreme Court's holding in Bax to prevent creditors (or even trustees) from pursuing derivative claims on behalf of Delaware LLC debtors.

(i) *In re Citadel Watford City Disposal Partners, L.P.*, 603 B.R. 897 (Bankr. D. Del. 2019) (post-confirmation trust was given authority to pursue all estate causes of action under a plan, court cited Bax as grounds for dismissing claims for breach of fiduciary duties).

(ii) *In re HH Liquidation, LLC,* 590 B.R. 211 (Bankr. D. Del. 2018) (creditors' committee sought breach of fiduciary duty claims against LLC managers, court held that DLLCA and Bax do not permit creditors to pursue such state law derivative actions).

(iii) *In re PennySaver USA Publishing, LLC*, 587 B.R. 445 (Bankr. D. Del. 2018) (court dismissed a Chapter 7 trustee's derivative claims for breaches of fiduciary duties allegedly owed to a Delaware LLC, citing to *Bax*).

(iv) **Recent decision from Delaware Bankruptcy Court changed the view about *Bax**: In re Pack Liquidating*, 658 B.R. 305 (Bankr. D. Del. 2024). Judge Goldblatt found that the Bankruptcy Code creates a federal right for creditor derivative standing -- citing to binding Third Circuit precedent in *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003) -- that exists even though Delaware law does not allow creditors of debtor LLCs to sue LLC members and officers for breach of fiduciary duty. Moreover, to the extent that federal right given by the Bankruptcy Code conflicts with state law, Judge Goldblatt also held that the federal Bankruptcy Code preempted Delaware state law. In so holding, Judge Goldblatt broke with the existing established line of Delaware bankruptcy cases that applied Delaware state law from Bax to deny such derivative standing to creditor representatives.

IV. SUBCHAPTER V – INVOLVEMENT OF A SUB V TRUSTEE

(A) Sub V debtor to consider/pursue insider claims and self-dealing – when it's a failing and when it's excusable.

(i) *Legacy Pools LLC*, No. 6:22-bk-03123-LVV, 2024 Bankr. LEXIS 2169, at *16-17 (Bankr. M.D. Fla. Sep. 13, 2024) – the court ordered that the Subchapter V case be converted to chapter 7 finding that "Debtor has likewise engaged in gross mismanagement of the estate by providing gratis services to family members, not pursuing claims against insiders and by misleading the UST about access to QuickBooks and requested financial records." The court determined that "[c]onversion also allows a chapter 7 trustee to gain immediate access to bank accounts and other assets that could dissipate upon dismissal."

(ii) *In re Edgewood Food Mart, Inc.*, 666 B.R. 418, 422 (Bankr. N.D. Ga. 2024) Lexis overview "Holding [1]-The evidence established that Debtor had general liability insurance of $1,000,000 and assault and battery insurance of $100,000; given the existence of a presumption in Debtor's principal's favor that he acted in good faith, Debtor did not act in bad faith by deciding not to pursue a claim for breach of fiduciary duty and instead negotiated the considerable concessions that allowed Debtor to repay a portion of its debts from its operating revenues; [2]-The Court concluded that, whether the Court applied a presumption that three years was sufficient absent unusual circumstances, or instead required Debtor to establish that a five-year plan was not required to treat the creditor fairly and equitably, the Plan met the fair and equitable requirement."

(iii) *In re Corinthian Communications, Inc.*, 642 B.R. 224, 225 (Bankr. S.D.N.Y. 2022) "The lack of any intercompany agreement between the debtor and its

affiliates raised a substantial issue whether the debtor had intercompany claims against the affiliates or vice versa, and the debtor's continued lack of disclosure to the trustee also constituted cause to expand the trustee's duties."

1. The court explicitly found cause to expand the Subchapter V trustee's duties under § 1183(b)(2), requiring the trustee to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor.

2. This expansion was prompted by a motion to remove the debtor as debtor in possession and was based on concerns about a lack of disclosure and transparency from the debtor's management.

(B) Subchapter V trustee's role as an investigator when there is member misconduct, conflicts of interest:

(i) *In re AJEM Hosp., LLC*, No. 20-80003, 2020 Bankr. LEXIS 3754, (Bankr. M.D.N.C. Mar. 23, 2020) The debtor consented to allow the Subchapter V trustee to conduct a narrow investigation of its financial affairs "specifically limited to investigating potential intercompany claims." Finding that "[t]he language of subparagraph (3) specifically allows the Court to limit the scope of an investigation 'to the extent that the court orders ...'" (citing 11 U.S.C. § 1106(a)(3); 8 COLLIER ON BANKRUPTCY ¶ 1183.03 (16th ed. 2020)).

(ii) *In re Duling Sons, Inc.*, 650 B.R. 578, 580-81 (Bankr. D.S.D. 2023) The Subchapter V trustee had conducted an investigation of the debtor pursuant to court order that led to a motion to remove the debtor in possession because the trustee's investigation concluded than an owner of the debtor who was the responsible person and held all of the corporate offices of the debtor, had engaged in self-dealing with the debtor such that the owner had an "incurable" conflict of interest with the debtor.

V. TAX CONSIDERATIONS[1]

(A) Flow-Through Taxation To Members.

(i) General Rule: Tax classification.

1. Pursuant to the definitions in 26 U.S.C. §7701 and the "check-the-box" regulations in Treasury Regulation §301.7701-1, et seq., a limited liability company with two or more members is, by default, taxed as a partnership. Partnerships are taxed pursuant to Internal

[1] Taxation of limited liability companies is complex, and depends on numerous factors such as the tax classification of the entity, business industry, owners, and assets. This handout is intended to provide general knowledge about select tax-related considerations for bankruptcy attorneys, and is not intended to be a thorough discussion of all tax laws or exceptions, nor apply tax laws to any particular facts. The author recommends all debtors and their bankruptcy counsel work closely with a qualified and knowledgeable tax professional who can advise about each particular situation.

Revenue Code Sections 701 through 771, which "passes through" income from the partnership to its individual partners, who report their share of the partnership's income on the owner's individual income tax return.

2. Similarly, a limited liability company with only one member is classified as a "disregarded entity" for tax purposes. A disregarded entity reports its income on the owner's individual income tax return, rather than filing a separate income tax return.

3. However, an LLC (having one or more members) may file Form 8832 Entity Classification Election to elect to be classified as a corporation for tax purposes. A C corporation is taxed under Internal Revenue Code Sections 301 through 391, which require the corporation to report all income and pay tax at the corporate level. Any dividends paid to shareholders or capital gain arising from the sale of corporate stock is reported on the owner's individual income tax return. This results in "double taxation" – the C corporation is taxed at the entity level, and any dividends paid to shareholders are taxed again at the individual level. Shareholders may not deduct losses of the corporation; rather, the C corporation reports and accumulates a corporate "net operating loss."

4. An LLC electing a corporation tax classification may then file Form 2553 Election by a Small Business Corporation to be taxed as an S corporation rather than a C corporation. Similar to a partnership, an S corporation "passes through" income from the S corporation to its individual shareholders, who report their share of the S corporation's income on the owner's individual income tax return.

(ii) Accounting Methods & Other Tax-Related Decisions.

1. Cash Basis Accounting. Most individuals and small businesses use the cash method of accounting, which reports income in the year *received* and expenses in the year *paid*. This means that paying expenses in advance may allow the taxpayer to deduct the expense in the year paid, even if the benefit will be received in the following year. An exception applies when the taxpayer's advance payment is for benefits that will be received more than 12 months after the payment is made (e.g., an insurance premium paid for 3 years of insurance). See 26 U.S.C. §§446-448.

2. Accrual Basis Accounting. Most corporations must and any eligible and electing businesses may use the accrual method of accounting, which reports income in the year it is *earned* and deducts expenses in the year *incurred*. This means that expenses paid in advance in a prior year may not be deductible in the year paid. Conversely, a

liability may be deductible before it is actually paid. For example, if a calendar-year business buys office supplies in December but pays the bill in January, it may be required to deduct the expense in the prior year because the bill was received in December and economic performance (i.e., receipt of the supplies) happened in December. See 26 U.S.C. §§446-448.

3. Calendar Year vs. Fiscal Year. Most taxpayers (including individuals) report their income, expenses, and taxes on a calendar year (i.e., January 1 through December 31st). However, most businesses can choose to report their income and expenses on a fiscal year (i.e., a year ending on the last day of a month other than December) or a 52-53-week tax year (i.e., a year that varies from 52 to 53 weeks but does not have to end on the last day of a month). The rules vary by entity type and tax classification, and may be able to be changed. See 26 U.S.C. §§441-444.

(iii) Member Basis and Value (26 U.S.C. §§ 701 – 755):

1. Capital Accounts. LLCs must keep capital accounts of their members. There are several methods of keeping capital accounts, including: (i) book value (see 26 U.S.C. §704(b); may use different timing of income, deductions, assets, and liabilities), (ii) tax value (reporting income and deductions in accordance with the Internal Revenue Code and Treasury Regulations), and (iii) Generally Accepted Accounting Principles (GAAP) (typically the same as book value). GAAP is not statutory, but it is a common set of accounting rules, requirements, and practices issued by the Financial Accounting Standard Board ("FASB") and the Governmental Accounting Standards Board ("GASB"). GAAP accounting is accepted by the Internal Revenue Service and Securities and Exchange Commission, and is often required for certain types of businesses including larger or public corporations. An example of the difference is when the business uses different depreciation schedules and rates for machinery, because accounting standards like GAAP promote a specific schedule, while the Internal Revenue Code allows for a shorter accelerated depreciation schedule. These differences affect the books and records as a whole, which in turn affect members' equity and capital accounts.

2. Contributions. When an LLC is taxed as a partnership, any contributions of money or property to an LLC is a non-taxable event. However, contributions of *services* to an LLC in exchange for a membership interest is usually taxable to the member, as compensation for services. However, if the interest granted in exchange for services is only a *profits* interest rather than a *capital*

interest, the contribution of services may be excluded from income. See Rev. Proc. 93-27 and 2001-43.

3. Outside Basis. When an LLC is taxed as a partnership, each member will receive an "outside basis" which is the member's interest in the partnership, which is based on the member's contributions and capital account, the member's share of profits and losses, the partner's share of liabilities which are treated as contributions, distributions of money or property, and other factors. A member's capital account may be the same or different than the member's outside basis, and the capital account may be negative (due to liabilities exceeding contributions and income), but the outside basis may never be negative. Outside basis is used to compute the member's pass-through tax attributes (e.g., deductions or losses), the gain or loss on the member's disposition of the membership interest, and the tax consequences of any cash or property distributions.

4. Inside Basis. When an LLC is taxed as a partnership, the partnership receives an "inside basis" in the assets contributed. Typically, upon contribution, the LLC will receive the same basis in the asset as the member had immediately before the contribution, and the member's outside basis will match the inside basis. If the LLC acquires the asset through purchase rather than contribution, the LLC's inside basis in the asset will typically be the purchase price. An LLC's inside basis in assets may be increased for additional capital expenditures (e.g., improvements to real property), and decreased through depreciation or amortization, among other reasons.

5. Distributions. When an LLC is taxed as a partnership, distributions of money or property to a member will reduce the member's capital account and outside basis in the membership interest. Distributions are generally made tax-free, so long as the member has sufficient outside basis in the LLC. Any distributions in excess of the member's capital account may be considered a capital gain to the member (losses may not be recognized in current distributions). The value of the distribution is usually based on the LLC's inside basis in the asset immediately before the distribution. However, when property (other than money) is distributed from the LLC to the member in liquidation of the partnership, the member will not recognize a loss on the liquidation of the member's membership interest, but instead will receive a basis in the property distributed based on the member's basis in the LLC. A member may recognize a loss if only money is distributed in liquidation which is less than the member's outside basis. Special rules apply for liquidations of inventory or unrealized receivables.

6. Disguised Distributions. In addition to distributions of cash or property from the LLC to a member, other disbursements from the LLC may be considered a distribution to the member, including: (i) the decrease in a partner's share of the liabilities in a partnership, (ii) payment of the member's personal obligations or liabilities, or (iii) assuming a member's personal debt. *See* 26 U.S.C. §752(b).

(iv) Key Issue: Cancellation of indebtedness income. (26 U.S.C. §108).

1. In general, whenever debt is cancelled or forgiven, the debtor must include the canceled amount in gross income for tax purposes. The lender is required to provide the debtor with Form 1099-C Cancellation of Debt, whenever the amount forgiven is $600 or more. Unless an exclusion applies, the amount of the forgiven debt must be reported on the debtor's income tax return.

2. Cancelled debt may be excluded from income when the cancellation takes place in a bankruptcy case under the Bankruptcy Code or when the taxpayer is insolvent. See Internal Revenue Code §108(a)(1) and Treasury Regulation §1.61-12 and §1.108-1 et seq. Typically when a debtor may exclude cancelled debt from income, the debtor must still reduce certain tax attributes, such as reducing net operating losses and certain credits, or reducing the basis of depreciable property. Treas. Reg. §1.108-7(a).

3. Special rules may apply in situations where the cancelled debt involves real property, farm property, or qualified real business property, where the debtor is a disregarded entity such as a single-member limited liability company, and in situations where the debt is forgiven by a person or entity related to the debtor. See Treasury Regulation §1.108-1 through 1.108-9.

(v) Key Issue: Phantom income.

1. When LLCs are taxed as pass-through partnerships or S corporations, the tax liabilities stemming from the business' income are the liabilities of the LLC's owners, not the LLC itself. Thus, an LLC debtor may have no income tax liability of its own, but rather the members may be required to treat their share of an LLC debtor's income as a personal tax liability. *See Pryor v. Tiffen (In re TC Liquidations LLC)*, 463 B.R. 257, 270 (Bankr.E.D.N.Y. 2011); *Official Comm. Of Unsecured Creditors of SGK Ventures, LLC v. NewKey Grp., LLC (In re SGK Ventures, LLC)*, 521 B.R. 842, 859 (Bankr.N.D.Ill. 2014).

2. When an LLC is the debtor in bankruptcy, income attributable to the LLC is paid to or reserved for creditors, rather than to LLC members

and owners. However, LLC members may still receive Schedule K-1s reporting the member's share of the LLC's income, even if the member did not receive the income directly. This is referred to as "phantom income" because the member is obligated to report and pay tax on the LLC income regardless of whether it was actually distributed to the member.

3. Courts are split on how to resolve this problem:

   (a) *In re SGK Ventures, LLC* found that making a distribution from the LLC to allow the members to pay taxes on phantom income was equivalent to a corporate dividend and could never be for reasonably equivalent value. 521 B.R. at 859 (citing to *In re TC Liquidations LLC*, 463 B.R. at 271). *See also Janssen v. Reschke*, 2020 WL 1166221, *5-6 (N.D.Ill. March 11, 2020), affirmed in 2020 WL 6044284, *12 (N.D.Ill. Oct. 13, 2020); *In re Portland Injury Institute LLC*, 2023 WL 2750397, *5 (Bankr.D.Ore. March 31, 2023).

   (b) *In re F-Squared Investment Management, LLC* disagreed, arguing that there was consideration because the members had consented to converting the C corporation to an LLC and the entity had then promised to make such mandatory tax distributions in the Operating Agreement. 633 B.R. 663, 672-73 (Bankr.D.DDel. 2021).

   (c) *In re Ballantyne Brands, LLC* also found the Estate, who bears the burden of proof to demonstrate the lack of reasonably equivalent value, "has not demonstrated that the tax distributions were anything other than reimbursement of the Defendants' aliquot share of the tax liabilities attributable to the Company's profits, a liability created under the Operating Agreement." 656 B.R. 117, 144 (Bankr.W.D.N.C. Oct. 2, 2023).

   (d) *In re Modell's Sporting Goods, Inc.*, on a motion to dismiss, strictly construed the holdings in *F-Squared*. There were no facts to suggest the debtor had previously converted from a C-Corp to an LLC or that the owners had relied on a promise that the LLC would make them whole for pass-through taxes. Also, there were no facts to suggest the dividends or distributions were tax reimbursement transfers at all; rather, "it is difficult to see how or why there would be any taxable income to pass through to shareholders" when the LLC debtor suffered continuing losses and was balance-sheet insolvent. 2023 WL 2961856, *35 (Bankr.D.N.J. April 14, 2023).

(e) *In re Horizon Group Management, LLC)* found that the LLC's payments to the IRS for the owner's tax liability was not an avoidable transfer because the IRS accepted the payments in "good faith." The LLC debtor was a disregarded entity. 617 B.R. 581, 593-95 (Bankr.N.D.Ill. 2020).

(f) Suggested strategies. Attorneys representing an LLC debtor or its members should work closely with the accountant and financial advisor to determine ways to reduce pass-through income, including through offsetting expenses and deductions, thus eliminating the net tax effect on an LLC's members. One such method is to pay wages to the members in their capacity as employees of the LLC, which will both reduce overall net income and provide some funds to the employee members to pay any corresponding pass-through taxes. If the Operating Agreement provides for tax reimbursement distributions to members, the members may make a claim against the estate for such contractual payments. Finally, the LLC debtor may seek to make tax reimbursement distributions through an approved plan if the Court approves.

(vi) Key Issue: Trust Fund Recovery Penalty ("TFRP").

1. "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall . . . be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over." 26 U.S.C. §6672(a).

2. Typical application: Trust fund portion of employment taxes (i.e., the amount withheld from employee paychecks). Also some excise taxes.

(a) Illinois imposes a similar personal liability for sales taxes collected by customers (or that should have been collected) but not paid over to the government. See 35 ILCS §735/3-7.

(b) When the LLC is the taxpayer, the IRS will look to a "responsible person" as an additional source of collection of the TFRP, who may be: a member or owner, a Manager, or any employee who is designated responsible to collect or pay the taxes to the IRS. Internal Revenue Manual §5.1.21.6.5. The IRS may assess TFRP against more than one person, but may only collect the taxes once from all sources aggregately.

(c) Factors include: (i) ownership, (ii) officer or job title and authority to make decisions, (iii) authority to sign checks (or make electronic payments), (iv) control over and responsibility for entity's finances, and specifically over payroll and/or payroll tax returns, (v) knowledge of the business' financial obligations, and authority to decide which obligations would be paid (over the IRS), and (vi) knowledge of unpaid taxes, and efforts to pay the taxes (over other obligations). In general, any person who has "significant control" over the company's finances can be considered a "responsible officer" and face personal liability for unpaid trust fund taxes.

(d) IRS Form 4180, Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes.

(e) *Brounstein v. U.S.*, 979 F.2d 952, 956 (3d Cir. 1992) (non-owner officers and higher-level employees may be required to quit rather than obey the orders of an owner to pay other creditors before current trust fund taxes).

(f) *Hochstein v. U.S.*, 900 F.2d 543 (2d Cir. 1990) (non-owner controller may be a responsible person for the TFRP because controller oversaw company's finances and was responsible to prepare payroll and file employment tax returns, had authority to sign checks, and knew about financial problems).

(g) *Gephardt v. U.S.*, 818 F.2d 469 (6th Cir. 1987) (non-owner general manager may be a responsible person for the TFRP because manager signed most of the checks to creditors and payroll checks to employees, directed bookkeeper about which bills to pay, knew about financial problems and missed tax payments, and directed payment of other liabilities over the IRS).

VI. TAX RETURN FILING (OR NON-FILING)

(A) General Rules:

(i) Limited liability companies taxed as a partnership are required to file Form 1065 income tax returns by March 15th of each year and provide Schedule K-1s to all members.

(ii) Limited liability companies taxed as a corporation are required to file Form 1120 or 1120S corporation income tax returns by April 15th of each year. S corporations are required to provide Schedule K-1s to all members.

(iii) Single-member limited liability companies must report all income on the member's Schedule C, Profit or Loss from Business, which is part of Form 1040 individual income tax return. Form 1040 is due by April 15th of each year.

(iv) Extensions may extend the deadlines to *file* an income tax return (if the extension is filed timely), but do not extend the deadline to *pay* the tax due. Taxes not paid by the deadline are subject to late payment penalties.

(v) During a bankruptcy case, taxpayers must continue to timely file all required returns, and should pay all current taxes as they come due. Failure to file returns and pay current taxes during a bankruptcy may result in a case being dismissed, converted to a liquidating bankruptcy (Chapter 7), or the Chapter 13 plan may not be confirmed.

(vi) Typically, the debtor-in-possession, or court-appointed trustee, is responsible for filing the entity's income tax return during the bankruptcy proceeding. The debtor-in-possession, rather than the limited liability company's principal, assumes the fiduciary responsibility to file the business tax returns.

(B) "Substitute for Returns" ("SFRs").

(i) Internal Revenue Code §6020(b); Internal Revenue Manual §5.18 – IRS has authority to prepare and file returns for taxpayers who failed to file but have a tax liability.

(ii) Bankruptcy Code Section 523(a) contains numerous exceptions to discharge, including (1)(B)(i) when a tax return "was not filed or given" and whenever the debtor has acted fraudulently or (1)(C) in a manner calculated to evade or defeat a tax. In a "hanging paragraph" after Section 523(a)(20), the statute defines the term "return" to mean:

> a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.
>
> In short, because an SFR return is prepared by the IRS pursuant to Internal Revenue Code Section 6020(a), any taxes assessed through an SFR are typically considered non-dischargeable. *See In re Mallo*, 774 F.3d 131 (10th Cir. 2014); *In re McGrew*, 559 B.R. 711 (Bankr.N.D.Iowa 2016); *Biggers v. Internal Revenue Service*, 775 B.R. 589 (M.D.Ten. 2016).

(iii) Qualified Business Income Deduction (26 U.S.C. §199A). Enacted through the Tax Cuts and Jobs Act of 2017 ("TCJA"), Section 199A allows individual owners of certain entities taxed as sole proprietorships, S corporations, or partnerships to deduct up to 20% of their qualified business income, plus up to 20% of real estate investment trust dividends and qualified publicly traded partnership income, for income tax purposes. The

deduction does not apply to C corporations. The purpose of the deduction is to reduce pass-through business income in a way that would mirror the TCJA's reductions in C corporation taxes. The deduction does not apply to investment income, capital gain from the sale of business assets, income from the distribution of inventory or unrealized receivables, wages and guaranteed payments, or foreign income. Like most of the TCJA, the Qualified Business Income Deduction is set to expire on December 31, 2025. On May 15, 2025, the "One Big Beautiful Bill" was presented to the House of Representatives (H.R. 1, 119th Congress), which proposes to extend and increase the Section 199A deduction for qualifying pass-through entities.

(iv) Net Investment Income Tax (26 U.S.C. §1411). Under Section 1411, an additional tax of 3.8% applies to certain net investment income of individuals, estates, and trusts, whose income exceeds certain thresholds (currently $200,000 for single taxpayers or $250,000 for married taxpayers). Members of an LLC may be subject to this tax if they receive reportable gains from the sale or disposition of their LLC membership interest and the income is considered "passive." Members must report the sales on Form 8948, Sales and Other Dispositions of Capital Assets, and may be required to file Form 8960, Net Investment Income Tax for Individuals, Estates, and Trusts.

(v) Losses on Small Business Stock (26 U.S.C. §1244). Under Section 1244, the owner of an entity classified as a corporation and considered a "small business" (i.e., aggregate money and property received by corporation in exchange for stock does not exceed $1 million on the date of the stock issuance) may receive special tax treatment in the event of a capital loss. Specifically, the individual or partnership owner's loss on the disposition of such stock will be characterized as an "ordinary loss" rather than a "capital loss," up to $50,000.

VII. WORKING WITH THE INTERNAL REVENUE SERVICE

(A) Authorizations & Forms.

(i) Form 2848 Power of Attorney – To appoint an attorney, CPA, or enrolled agent to represent a taxpayer.

(ii) Form 8821 Tax Information Authorization – Allows any other individual, corporation, firm, organization, and partners to inspect or receive confidential information

(iii) Form 4506 Request for Copy of Tax Return (within last 3 years)

(iv) Form 4506-T (and Form 4506-T-EZ) Request for Transcript of Tax Return (within last 3 to 10 years, information available varies)

(B) Audits.

(i) The automatic stay does not prohibit the IRS from determining the amount of tax that is owed, assessing a tax, making demands for tax returns, or issuing notices of a deficiency and demands for payment.

(ii) In general, to assess additional taxes, penalties and interest, the IRS has 3 years from the later of (i) the date the tax return was filed, or (ii) the due date of the return (including extensions). 26 U.S.C. §6501. This limitations period can be extended. For example, when a tax return contains a "substantial omission" of income (e.g., more than 25% of the gross income listed on the tax return), the statute of limitations for assessment is 6 years rather than 3. If the taxpayer filed a false return or did not file at all, there is no statute of limitations, and the IRS may assess additional taxes, penalties, and interest at any time.

(iii) For tax years beginning January 1, 2018, audits of LLCs taxed as partnerships were subject to the Bipartisan Budget Act of 2015 ("BBA"), replacing the longstanding Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). Under the BBA, a partnership is liable for any tax due as a result of adjustments to partnership-related items unless the partnership elects to "push out" those adjustments to partners under 26 U.S.C. §6226. Typically the adjustments to tax are made at the partnership level, and the partnership may request certain modifications. The partnership must designate a "Partnership Representative" who has sole authority to act on behalf of the partnership and bind all partners. Adjustments under the BBA are handled through an "administrative adjustment request" ("AAR") described in 26 U.S.C. §6227, rather than amending the partnership's income tax return and Schedule K-1s. Some partnerships may be eligible to make an election so that the BBA audit scheme will not apply; however, large partnerships (with 100 or more partners) and disregarded entities (such as single-member LLCs) are ineligible to elect out of the BBA.

VIII. ALTERNATIVES TO BANKRUPTCY FOR TAX LIABILITIES

(A) IRS and IDOR Installment Agreements (Internal Revenue Manual §5.14 & §5.15).

(i) Streamlined & Guaranteed Agreements – For certain types of tax liabilities of $50,000 or less; paid over 36 to 72 months.

(ii) "In Business" Express Agreements – For business tax liabilities of $25,000 or less; paid over 24 months.

(iii) Form 9465 Installment Agreement Request.

(iv) Form 433-D Installment Agreement.

(v) Form 433-F Collection Information Statement.

(B) Offers in Compromise (Internal Revenue Manual §5.8; Treasury Regulation §301.7122).

(i) Grounds: Doubt as to Collectability, Economic Hardship, and Public Policy of Equity.

(ii) Eligibility & Conditions:

1. Tax filing compliance (i.e., all prior returns have been filed), and *current* payment compliance (i.e., current federal tax deposits and payments have been made). Both must continue during the IRS's review process.

2. Future filing and tax payment compliance for five years *after* acceptance.

(iii) Payment options:

1. Lump Sum – Paid within 5 months of acceptance. Considers current equity in assets and 12 months of future net income.

2. Periodic Payment – Paid in equal installments of up to 24 months from date of submission. Considers current equity in assets and 24 months of future net income.

(iv) Form 656 Offer in Compromise.

(v) Form 433-A and 433-A (OIC) Collection Information Statement for Individuals and Self-Employed (including single-member LLCs).

(vi) Form 433-B and 433-B (OIC) Collection Information Statement for Businesses.

(C) Currently Not Collectible ("CNC") Status (Internal Revenue Manual §5.16).

(i) CNC status is a temporary or long-term suspension of IRS collection activity. The IRS balances the potential for collection against the costs and its ability to collect, and decides not to pursue collection. Taxpayers can be in CNC status until the IRS's statute of limitations for collection expires. Alternatively, the IRS may remove CNC status under various circumstances, such as the taxpayer filing a tax return reporting significant income.

(ii) LLC liquidating under Bankruptcy Chapter 7 or 11 – IRS account can be closed under a CNC analysis if it is a "no asset" case and/or no further proceeds will be received from the bankruptcy and anticipated collection from any abandoned or after-acquired property is insufficient to warrant further collection efforts.

(iii) LLC no longer operating – IRS account can be closed under a CNC analysis when the business is no longer operating and all assets have been dispersed.

(iv) Operating LLCs – IRS past-due account can be closed under a CNC analysis when the business can pay current taxes but cannot pay its back taxes, and enforcement cannot be taken because the business has no distrainable accounts receivable or other receipts or equity in assets. A financial analysis of the business will be required (Form 433-B and supporting documentation).

(v) Note that the IRS may seek to collect any trust fund recovery penalties from the members or principals of an LLC or entity.

(D) Penalty Abatement Requests (Internal Revenue Manual §20.1).

(i) Reasonable cause – Taxpayer exercised ordinary business care and prudence but nevertheless failed to comply with the tax law.

(ii) Ordinary business care and prudence – Taxpayer took a degree of care that a reasonably prudent person would exercise.

(iii) Examples: Death, serious illness, or unavoidable absence; fire, casualty, natural disaster; inability to obtain records.

(iv) Abatable penalties – Accuracy-related penalties (Treas. Reg. §1.6664-4); Delinquency penalties (Treas. Reg. §301.6651-1(c)); Information return penalties (Treas. Reg. §301.62674-1); Tax return preparer penalties (Treas. Reg. §1.6694-2(e)(1)-(6)); and Material advisor penalties (Treas. Reg. §301.6707-1(e)(3)).

(v) Estimated tax penalties are typically not abatable, but may be excepted under IRC §6654(e)(1)-(3) and/or IRM 20.1.3.

Additional Resources:

- IRS Publication 3402 Taxation of Limited Liability Companies
- IRS Publication 908 Bankruptcy Tax Guide
- Internal Revenue Manual (including sections 5.1 – 5.18, 20.1)

Faculty

Mark A. Carter is a partner with Hinshaw & Culbertson LLP in Chicago and assists clients with complex business transactions. His legal knowledge encompasses corporate formation and governance, finance and lending, acquisitions and dispositions, contract and commercial transactions, and business insolvency. Since the start of his legal career, Mr. Carter has worked with public and private companies, including start-ups and emerging brands, on a broad range of matters, including asset and business mergers and acquisitions (M&A), distressed M&A, capital-raising, debt transactions and restructurings. In the process, he has advised board members, managers and partners regarding their duties and obligations, and developed processes for addressing corporate governance matters. Mr. Carter also assists financial institutions and other lenders with middle-market loan documentation, secured transactions, workouts, distressed real estate and collateral dispositions. With more than 30 years of industry experience, including food and beverage, telecommunications, steel fabrication, health care, motor fuel and construction, he formulates and implements business-driven objectives and effective strategies for accomplishing transactions aligned with management's goals. Through his blended practice, Mr. Carter is frequently called upon to assist clients with tailoring their contracts for insolvency-preparedness, structuring and effectuating distressed acquisitions, and, where circumstances warrant, restructuring their operations and financial affairs. Before joining Hinshaw, he spent most of his career with a Chicago boutique insolvency and bankruptcy law firm. More recently, he practiced with a Chicago-based business law firm. Mr. Carter received his B.A. with high honors in 1985 from the University of Illinois at Urbana-Champaign and his J.D. in 1988 from the University of Illinois College of Law.

Kimberly R. Clayson is a partner in the Bankruptcy and Restructuring practice group at Taft Stettinius & Hollister, LLP in Southfield, Mich. She serves a diverse client portfolio in the areas of insolvency law, creditors' rights, business law and health law. Ms. Clayson has experience advising clients on creditor rights in bankruptcy matters and bankruptcy-related litigation. She also advises financially distressed companies and nonprofit organizations in bankruptcy restructuring, out-of-court wind-ups and dissolutions. Ms. Clayson is experienced in bankruptcy-related financial investigations. Her bankruptcy litigation experience includes litigating nondischargeability actions to fiduciary duty claims and other contested matters. She presently serves as a subchapter V trustee in the Eastern District of Michigan, and frequently writes and speaks on bankruptcy topics related to business bankruptcies, subchapter V and health care compliance law. Ms. Clayson received her B.A. in international relations from James Madison College at Michigan State University with an emphasis in economics, and her J.D. from the University of Detroit Mercy School of Law, where she earned the 2004 Book Award for excellence in her writing and research course.

Hon. Peter W. Henderson is a U.S. Bankruptcy Judge for the Central District of Illinois in Peoria, appointed on April 1, 2023. Before his appointment, he was an attorney with the Federal Public Defender's Office, where he represented indigent federal criminal defendants at the trial and appellate levels, and managed the Federal Defender's litigation of motions under the First Step Act, as well as post-conviction petitions under 28 U.S.C. § 2241 and 2255. He also taught a course in appellate advocacy as an adjunct professor at the University of Illinois College of Law. Judge Henderson has served as lead counsel in more than 100 felony cases in the Central District of Illinois and more than

300 appeals in the Seventh Circuit Court of Appeals. He received his A.B. in 2007 magna cum laude from Brown University and his J.D. in 2012 from the University of Illinois College of Law, where he was admitted to the Order of the Coif and was a Harno Scholar.

Peter J. Keane is an attorney with Pachulski Stang Ziehl & Jones in Wilmington, Del., where he represents clients in complex restructurings, financially distressed situations and liquidations, including debtors, trustees, creditors' committees, asset-purchasers, lenders, mass tort claimants, and other significant creditors and parties in interest. He is regularly involved in the largest and most complex bankruptcy cases all around the country. Mr. Keane has authored articles for the American Bankruptcy Institute, the American Bar Association, and the *Journal of Corporate Renewal* on a variety of bankruptcy topics, and also wrote book chapters on § 363 sales for several years for the *Norton Annual Survey of Bankruptcy Law*. He was named in the 2024 edition of *The Best Lawyers in America*, was selected as a Delaware Rising Star by Thomson Reuters' *Super Lawyers* in 2021 and 2022, was selected in 2019 by The M&A Advisor for its 10th Annual Emerging Leaders award, and was part of the 2017 National Conference of Bankruptcy Judges Next Generation Program. Mr. Keane received his B.A. from the University of Delaware and his J.D. *magna cum laude* from the University of New Hampshire Law School.

Sandra D. Mertens is a partner with Gensburg Calandriello & Kanter, P.C. in Chicago, where she practices in the areas of federal and state tax controversy and consulting, offshore account disclosures, estate-planning, probate, estate and trust administration, general business law and commercial litigation. She has negotiated many tax resolutions with the IRS and Illinois Department of Revenue, reducing her clients' overall tax liabilities and helping them lower their monthly payment. Since 2008, Ms. Mertens has served as a periodic contributor to *Debits and Credits*, a newsletter published by the Independent Accountants Association of Illinois. She also has been published in the *Illinois Bar Journal* (where she now also serves as on the editorial board), *CBA Record*, and her firm's blog, GCK on Law. Ms. Mertens is a member of the CBA's State and Local Tax Committee and a council member on the ISBA's Federal Taxation Committee, and she has lectured and prepared seminar materials for accountant and attorney education on a variety of topics, including offers in compromise, trust fund recovery penalties, IRS Voluntary Classification Settlement Program for workers, foreign reporting requirements, and the IRS's Offshore Voluntary Disclosure Program and compliance procedures. In addition, she assists large and small businesses with all stages of their business, from formation of an entity to contracts, employee issues and dissolution. Ms. Mertens is admitted to the Illinois State Bar Association, the U.S. District Court for the Northern District of Illinois, the U.S. Bankruptcy Court and the U.S. Tax Court, and she has been admitted *pro hac vice* in the U.S. District Court for the District of Columbia, New York State Court and others. She has received multiple awards, including most recently the Outstanding Faculty Award for 2023 from the National Business Institute for her presentations on various topics in the areas of tax, corporate, probate, and estate and trust administration. Ms. Mertens received her J.D. with honors from the Illinois Institute of Technology Chicago-Kent College of Law.