AMERICAN BANKRUPTCY INSTITUTE

# 2018 Rocky Mountain Bankruptcy Conference

CONCURRENT SESSION

# Rounding Up the Unusual Suspects: Bankruptcy for Nontraditional Debtor Entities


**Eric E. Johnson, Moderator**
*Sherman & Howard, LLC; Denver*

**Mona L. Burton**
*Holland & Hart LLP; Salt Lake City*

**Jeffrey M. Reisner**
*Irell & Manella LLP; Newport Beach, Calif.*

**Mark A. Shaiken**
*Stinson Leonard Street LLP; Denver*


2018

Mona Burton
Holland & Hart LLP
222 S. Main St., Suite 2200
Salt Lake City, UT 84101
Telephone: (801) 799-5822
Email: mburton@hollandhart.com

II. Is the Alternative Entity Authorized to File Bankruptcy?

A. Jurisdiction to Determine Who Has Authority to Cause an Entity to File Bankruptcy

*In re D.B. Capital Holdings, LLC*, 463 B.R. 142 (10th Cir. BAP 2010). Whether a specific person has authority to cause a debtor to file a bankruptcy petition is determined by state law, and the bankruptcy court makes the determination on authority by looking to state law.

*In re Pasta Bar by Scotto II, LLC*, 2015 WL 7307246 (Bankr. S.D. N.Y. 2015). The Bankruptcy Code does not establish express rules relating to authority to file, and bankruptcy courts look to state law governing the entity.

B. Agreements Requiring Unanimity of Owners for a Bankruptcy Filing

*In re D.B. Capital Holdings, LLC*, 463 B.R. 142 (10th Cir. BAP 2010). Operating Agreement prohibited the company from filing bankruptcy. BAP upheld dismissal based on lack of authority. The court distinguished cases where the restriction on filing resulted from a contractual agreement with a lender.

*In re Squire Court Partners Limited Partnership*, 2017 WL 2901334, slip opinion (E.D. Ark. 2017). An amended partnership agreement required the unanimous vote of the partners for the partnership to file bankruptcy. General partner cause the partnership to file bankruptcy without the limited partners' consent. Motion to dismiss for lack of authority granted. The court distinguished *In re Lake Michigan Beach Pottawattamie Resort, LLC* and *In re Intervention Holdings, LLC* on grounds that an agreement between the entity and a creditor limiting a bankruptcy filing violates public policy, whereas an agreement among the owners of the entity restricting bankruptcy filing does not. The *Squire Court Partners* decision is currently on appeal before the Eight Circuit Court of Appeals, with the proceedings in abeyance pending settlement discussions.

C. Agreements Granting a Lender a Blocking Right to Prevent a Bankruptcy Filing

*In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (N.D. Ill. 2016). As part of a forbearance agreement between borrower and lender, borrower amended its Operating Agreement to add lender as a "Special Member" with the right to approve or disapprove "Material Actions" including a bankruptcy filing by borrower. As a Special Member, lander had no interest in profits or losses, no right to distributions and no obligation to make capital contributions. In exercising its right to approve or disapprove a bankruptcy filing, lender was not obligated to consider any interests or desires other than its own. This "blocking director" provision was held to violate Michigan Business Corporate Act, which requires managers to discharge their duties in good faith and in the best interests of the company. This provision was also held to violate public policy: "For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy."

*In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (2016). Forbearance agreement between debtor and lender required admission of the lender as a member and for any bankruptcy filing to require the unanimous approval of all members. Held: this provision is unenforceable as against federal public policy.

*In re Lexington Hospitality Group, LLC*, 2017 WL 4118117 (Bankr. E.D. Ky. 2017). Held: contractual provisions in operating agreements that essentially prohibit a company's ability to file bankruptcy without a creditor's consent are void.

*In re Ute Mesa Lot 2, LLC*, 17-16194 (Bankr. D. Co. 2017). In a currently pending action, creditor has filed motion to dismiss for lack of authority based on an amended operating agreement created contemporaneously with a forbearance agreement which admitted creditor as a member and requires unanimous approval of the members for a bankruptcy filing. Debtor contends this provision is void. Pending before Judge Romero.

D. Independent Managers/Directors

*In re Lexington Hospitality Group, LLC*, 2017 WL 4118117 (Bankr. E.D. Ky. 2017). A requirement for an independent manager, in and of itself, does not offend public policy, so long as they are truly independent. An independent manager who is to make decisions solely based on the benefit of the secured lender violates public policy.

*In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (N.D. Ill. 2016). A "blocking director" must always adhere to his or her general fiduciary duties to the debtor in fulfilling this role. This means that, at least theoretically, there will be situations where the director will vote in favor of a bankruptcy filing against the desire of the secured lender.

*In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D. N.Y. 2009). "If the Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they are mistaken."

E. Appointment of a State Court Receiver and its Effect on Who Has Authority to Cause an Entity to File Bankruptcy

*In re Corporate and Leisure Event Productions, Inc.*, 351 B.R. 724 (Bankr. D. Az. 2006). State court order appointed receiver and enjoined entity's directors from causing the company to file bankruptcy. Directors caused the company to file bankruptcy anyway. Held: receivers' motion to dismiss to dismiss for lack of authority denied: "The pendency of a receivership does not ordinarily prevent the filing of a voluntary petition."

*In re Sino Clean Energy, Inc.*, 565 B.R. 677 (D. Nev. 2017). State court receiver removed pre-receivership directors and appointed a new board. The prior board caused the company to file bankruptcy. Held: receiver's motion to dismiss for lack of authority granted. Distinguishes *Corporate and Leisure* on grounds that court order there prohibited the company's directors from filing bankruptcy altogether, while state court order in *Sino* did not. *Sino Clean Energy* decision is currently on appeal to the Ninth Circuit Court of Appeals.

Mona Burton
Holland & Hart LLP
222 S. Main St., Suite 2200
Salt Lake City, UT 84101
Telephone: (801) 799-5822
Email: mburton@hollandhart.com

VII. Pledging Equity Interests in Alternative Entities.

A. How are the Interests Classified, in Terms of Serving as Collateral?

1. Classification as Securities or General Intangibles

UCC 8-103(a). A share or similar equity interest issued by a corporation, business trust, joint stock company or similar entity is a security.

UCC 8-103(c). An interest in a partnership or a limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this article, or it is an investment company security. However, an interest in a partnership or limited liability company is a financial asset if it is held in a securities account. Interests in LLCs are generally considered to be general intangibles for purposes of Article 9. *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007).

UCC 9-310. A security interest in general intangibles may be perfected only by filing a UCC-1 financing statement.

UCC 9-310. A security interest in a security may be perfected by filing a UCC-1 financing statement or by taking possession of the security with an effective indorsement of the security in blank or to the secured party.

UCC 8-303. A purchaser of a security who gives value, takes without notice of any adverse claim, and obtains control of the security, attains "protected purchaser" status, and acquires the security free of any adverse claim. The term "purchaser" includes a secured party. UCC 1-201(b)(29) and (30); UCC 9-331(a).

UCC 9-331. Article 9 does not limit the rights of a protected purchaser of a security, and a protected purchaser of a security takes priority over an earlier security interest to the extent provided in Article 8.

2. Rights of Holders of LLC Interests

*In re Delta Petroleum Corporation*, Case No. 11-14006 (Bankr. Del. 2012). A debtor's property rights in bankruptcy are coextensive with its property rights and interests before bankruptcy, as defined by applicable non-bankruptcy law. Held: a debtor may not assume and assign a LLC operating agreement governed by Colorado law in violation of transfer restrictions in the operating agreement.

Delaware Code 18-701. A member's interest in an LLC is personal property. A member has no interest in specific LLC property.

Delaware Code 18-702. A LLC interest is assignable, and the assignee is entitled to share in profits and losses and to receive distributions, but the assignee has no right to participate in management or to any other rights and powers of the assignor.

Colorado Code 7-80-702. A member's interest in an LLC is personal property and may be assigned, but absent admission as a member, the assignee is entitled only to receive the assignor's share of profits and has no right to participate in management of the business.

Utah Code 48-3a-502. A transferrable LLC interest does not entitle the transferee to participate in management of the LLC but does entitle the transferee to receive distributions to which the transferor would be entitled.

B. Restrictions on Transfer of Securities and LLC Interests

UCC 8-204. A restriction on the transfer of a security imposed by the issuer is ineffective against a person without knowledge of the restriction unless the restriction is noted conspicuously on the security certificate, or the security is uncertificated and the registered owner has been notified of the restriction.

UCC 9-408. This section renders unenforceable certain restrictions on the transfer of an LLC interest. However, a careful practitioner needs to compare UCC 9-408 with applicable state LLC statutes to see if the LLC statute affects the ability of a LLC to restrict its members' ability to pledge LLC interests as collateral.

(1) Delaware

Delaware LLC Act § 18-1101(g). Section 9-408 of the UCC does not apply to any interest in an LLC, and this provision prevails over §9-408.

Delaware UCC § 9-408(e). This section does not apply to LLC interests.

(2) Colorado

*Condo v. Conners*, 266 P.3d 1110 (Colo. 2011). Held: An express anti-assignment clause in an operating agreement providing that transfers made without the consent of all members of the LLC are void is enforceable, and an assignment by a member of his interest in the LLC to his ex-wife pursuant to a divorce decree was void because it was made without the consent of the other LLC members.

Is the result different or the same in the context of a secured transaction?

Colorado LLC Act § 7-80-702. An interest in an LLC is personal property and may be assigned or transferred.

Colorado LLC Act § 7-80-108. The LLC operating agreement governs the rights and relations among the members, and the provisions of the LLC operating agreement prevail over inconsistent provisions in the Act.

Colorado UCC 4-9-408. The provision that transfer restrictions are ineffective for purposes of a security agreement appears to apply only to agreements between an account debtor and a debtor. This provision lacks the specificity of the Delaware statute with regard to 9-408 not applying to LLC interests.

(3) Utah

Utah LLC Act § 48-3a-501. A transferable interest is personal property.

Utah LLC Act § 48-3a-502. Transfer of a member interest in an LLC in violation of transfer restrictions contained in the operating agreement is ineffective if the transferee has knowledge or notice of the restriction at the time of the transfer.

Utah UCC § 70A-9a-408. The provision that transfer restrictions are ineffective for purposes of a security agreement appears to apply only to agreements between an account debtor and a debtor. This provision lacks the specificity of the Delaware statute with regard to 9-408 not applying to LLC interests.

C. Lender's Enforcement of its Security Interest

UCC Foreclosure Rights

UCC 9-610. After default, secured creditor may dispose of collateral. Every aspect of the disposition must be commercially reasonable. A secured party may purchase the collateral (1) at a public disposition or (2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

UCC 9-620. Secured party may accept collateral in full or partial satisfaction of the obligation. If in partial satisfaction, the debtor must agree to the terms of the acceptance in a record authenticated after default. If in full satisfaction, the debtor must agree to the terms of the acceptance in a record authenticated after default, or the secured party after default sends the debtor a proposal that is unconditional or subject only to a condition that collateral not in the secured party's possession be preserved, the proposal proposes to accept the collateral in full satisfaction and the secured party does not receive notification of an objection to the proposal.

Rights Provided by State Corporation/LLC Statutes

Delaware Code 18-703. On application by a judgment creditor of a member, a court may charge the LLC interest to satisfy the judgment. To the extent charged, the judgment creditor has only the right to receive distributions to which the judgment debtor would otherwise have been entitled. A charging order constitutes a judgment lien on the debtor's LLC interest. A charging order is the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the debtor's LLC interest, and other legal and equitable remedies are not available.

Colorado Code 7-80-703. On application by a judgment creditor of a member, a court may charge the LLC interest to pay the judgment. The court may appoint a receiver of the member's share of the profits, and may make all other orders as the circumstances of the case may require. The judgment creditor has only the rights of an assignee of the LLC interest.

Utah Code 48-3a-503. On application by a judgment creditor of a member, a court may enter a charging order against the LLC interest to satisfy the judgment. A charging order constitutes a lien on the debtor's LLC interest. The court may appoint a receiver of the distributions subject to the charging order and all other orders necessary to give effect to the charging order. This section provides the exclusive remedy by which a judgment creditor may enforce a judgment against a member's LLC interest.

D. Automatic Stay/§ 105 Injunction Issues.

1. *3-362 Collier on Bankruptcy P 362.03*. The automatic stay of § 362 is broad and, aside from the exceptions contained in § 362(b), applies to almost any type of formal or informal action against the debtor or property of the estate. However, the automatic stay does not stay actions against non-debtors or actions against non-estate property.

2. *2-105 Collier on Bankruptcy P105.04*. In circumstances where the action is not stayed by § 362, a bankruptcy court may issue an injunction under § 105(a) staying actions against non-debtors and against non-estate property.

3. *11 U.S.C. § 105(a)* provides that "The court may issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."

4. *In re Eagle-Picher Industries, Inc.*, 963 F.2d 855 (6th Cir. 1992): When issuing an injunction under § 105(a), a bankruptcy court must consider the traditional factors governing preliminary injunctions issued pursuant to Fed. R. Civ. Proc. 65: (a) the likelihood of success on the merits, (b) whether the debtor will suffer irreparable injury without the injunction, (c) the harm to others which will occur if the injunction is granted, and (d) whether the injunction would serve the public interest. *In re Excel Innovations, Inc.*, 502 F.3d 1086 (9th Cir. 2007): The majority of circuits have held that injunctive relief under § 105(a) must meet the usual preliminary injunction standard.

# Alternative Entities in Bankruptcy: Executory Status of the Organizational Agreement and Fiduciary Duties

Summary: This portion of the panel presentation discusses the treatment of organizational agreements during bankruptcy and how this impacts the management of alternative corporate entities. It then provides a brief overview of Delaware LLC fiduciary duty law generally and fiduciary duty issues that can arise in the context of bankruptcy.

## I. Is the Organizational Agreement Executory? Capable of Assumption/Assignment?

A. From the manager/partner perspective

1. The non-debtor manager/partner of an alternative entity should be concerned with what happens to rights held by other managers/partners should any of them file for bankruptcy. While many operating agreements include standard *ipso facto* clauses that purport to terminate or modify a holder's interest upon some set of specified events, such as filing for bankruptcy, courts have generally held that such clauses are preempted by § 541(c) or § 365(e) of the Bankruptcy Code, unless an exception applies. Oftentimes alternative entities are formed between people and/or entities who value each others' particular skills and personalities, which is why they decided to form a business venture together in the first place. In this context, the bankruptcy of one member/partner can cause especially great disturbances in management of the entity.

2. The bankruptcy of another manager/partner may lead to a number of negative consequences for the other non-debtor managers/partners. The biggest concerns of the non-debtor managers/partners in this event include:

   a. A trustee or debtor in possession acting as the entity's manager (especially if the other members could not remove the trustee during the case under § 362);

   b. A trustee or debtor in possession holding veto power over substantial transactions; and

   c. Third parties becoming assignees or even members over the other members' objections.[1]

3. These various consequences may result despite *ipso facto* clauses in operating agreements. How this plays out in the LLC context is instructive, and the key is whether or not an operating agreement is classified as an "executory contract."

---

[1] David L. Bury, Jr. and Thomas T. McClendon, *Planning for the Unexpected: Drafting Operating Agreements to Protect LLC Members from Another Member's Bankruptcy*, 72 BUS. LAW. 981, 989 (Fall, 2017) ("Bury Article").

B. Bankruptcy scenarios implicating operating agreement issues:

1. Entity itself is in bankruptcy;[2]

2. A manager of the entity is in bankruptcy; or

3. A partner or member of the entity is in bankruptcy

a. The remainder of this presentation will focus on the intersection of operating agreements and bankruptcy from the perspective of a debtor partner or member seeking to retain operating agreement rights.

C. Why it matters if an LLC operating agreement is deemed an executory contract (from the perspective of the debtor partner or member)

1. First, it is important to touch on the dual nature of the rights bound up in an LLC interest. LLC interests consist of both economic and non-economic rights. Economic interests include distribution rights and rights to share in the profits and losses of the LLC. Economic interests held by a debtor pass to the debtor's estate. Non-economic interests include voting and management rights.[3] Whether or not non-economic rights pass to the estate is a key concern for non-debtor managers: if non-economic rights pass to the bankruptcy estate, non-debtor managers may find themselves in the position of having to share management or decision-making authority with a trustee or other assignee with a new agenda or difficult internal approval processes.

2. There are two ways in which LLC interests held by a debtor may enter the debtor's bankruptcy estate: by operation of § 541 or § 365.[4] Under § 541, a bankruptcy filing creates a bankruptcy estate that includes all of the debtor's legal and equitable interests in "property," unless an interest is specifically excluded. § 365 deals with executory contracts and provides some exceptions to transfers of property to the estate that would otherwise enter by operation of § 541.[5] Some courts have held that § 365, which deals with executory contracts, may override § 541 to exclude LLC memberships interests from the bankruptcy estate as the more specific provision.[6]

3. Under either § 541 or § 365, the economic rights of an LLC interest held by a debtor will enter the debtor's estate. However, courts

[2] Entities that may file for bankruptcy include partnerships. § 109(a) of the Bankruptcy Code states that "only a person [with certain ties to the United States] may be a debtor under this title" and § 100(41) defines "person" as including a "partnership."
[3] Bury Article at 992.
[4] *See id.*
[5] *See id.*
[6] *See id.* at 986.

disagree about whether the non-economic rights held by a debtor may enter the debtor's estate.[7] This disagreement stems from a difference in legal reasoning as to whether non-economic rights enter the debtor's estate under § 541 as a property right, or under § 365 as an executory contract right. If a court "determines that the operating agreement is executory, it typically finds that § 365(e)'s exceptions permit termination or modification of the debtor's non-economic rights."[8]

4. Both § 541 and § 365 contain provisions that invalidate *ipso facto* provisions in operating agreements or provided for by state law. However, only § 365 has an exception.

5. § 541(c) provides in relevant part:
". . . an interest of the debtor in property becomes property of the estate under . . . this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—
. . .
(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

6. By comparison, § 365(e)(1) provides a similar *ipso facto* invalidation provision, but § 365(e)(2) adds an exception to invalidation where:
"(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"

7. Only executory contracts qualify for the exception to *ipso facto* invalidation contained in § 365(e)(2), and only if applicable law excuses a party other than the debtor from accepting performance from or rendering performance to a trustee or assignee. So, under § 541 an *ipso facto* provision is invalidated in its entirety and the operating agreement comes into the bankruptcy estate as property. Under § 365, the operating agreement may be assumed or rejected by the trustee or debtor in possession, and the non-economic rights bound up in the LLC interest may be terminated or modified in cases where applicable law excuses the nondebtor from accepting or rendering performance to a trustee or other assignee.

---

[7] *See id.* at 992.
[8] *Id.*

8. Thus, whether or not an operating agreement is deemed to be an executory contract is very important for whether or not a debtor's management rights, etc. will enter the debtor's estate.

D. Operating agreement as executory contract

1. § 365 provides special treatment for ongoing or "executory" contracts. This is because executory contracts are thought of in bankruptcy "as a combination of assets and liabilities to the bankruptcy estate: the performance the non bankrupt owes the debtor constitutes an asset, and the performance the debtor owes the non bankrupt is a liability."[9] Due to this dual nature of asset and liability, § 365 allows trustees to conduct a benefits analysis and decide whether to assume or reject an executory contract.[10]

2. "Executory contract" is not defined in the Bankruptcy Code.[11] To determine whether or not an operating agreement is executory, courts (other than those in the 11th Circuit) use the definition coined by Professor Vern Countryman.[12] Countryman defines an executory contract as a contract that "generally includes contracts on which performance remains due to some extent on both sides" and the "obligation of both the [debtor] and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[13] Most courts then conduct a fact-based review of the operating agreement to determine whether it meets the Countryman definition of an executory contract.[14]

3. Under the Countryman definition of executory contract, the existence of unperformed obligations is important to qualify an operating agreement as an executory contract. Courts have found the following characteristics to warrant classification of operating agreements as executory contracts:

   a. "obligation to make cash contribution or respond to capital calls (without veto right by member)
   b. obligation to provide personal services
   c. restriction from engaging in unauthorized transfer of membership interest
   d. non-compete and/or non-disclosure obligations

---

9 *In re Safety-Kleen Corp.*, 410 B.R. 164, 168 (Bankr. D. Del. 2009) (internal quotations omitted).
10 *See* 11 U.S.C. § 100; Bury Article at 988.
11 *Id.*
12 *Id.*
13 Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439 (1973).
14 Bury Article at 988–99.

10400392.2 01

e. affirmative restriction from voluntarily withdrawing as a member

f. guarantee of LLC's debt"[15]

4. Courts conduct a factual analysis of the operating agreement and case history to determine whether material unperformed obligations such as those just listed are present.[16] If they are, then the operating agreement is an executory contract and its treatment in bankruptcy is governed by § 365.

5. If the court finds no material unperformed obligations, then the operating agreement is not executory and both the economic and non-economic rights of the debtor party enter the debtor's estate by operation of § 541 simply as property.[17] This outcome also may occur if the parties do not raise the issue of executory status.[18] Another situation where an operating agreement would not be executory is where the only obligation of the debtor upon entering an operating agreement was for capital contribution, and the debtor made the contribution prior to filing bankruptcy. In such a case, the debtor has already performed all of its obligations under the operating agreement prior to filing for bankruptcy, and so the operating agreement is not executory because it lacks unperformed obligations.[19]

E. Who gets to assume an operating agreement as an executory contract

1. The general rule of § 365 is the trustee may assume an executory contract of the debtor. However, § 365(c)(1) "limits this power by prohibiting the trustee from assuming or assigning a contract if applicable law excuses a party to the contract, other than the debtor, from accepting performance from anyone other than the debtor."[20]

2. If applicable law excuses the managers or partners from accepting performance under the operating agreement by anyone other than the debtor, the trustee is not able to assume the contract[21] and only the debtor's economic rights enter the debtor's estate.[22]

---

[15] Bury Article at 1003–04 (internal citations omitted) (internal formatting altered).
[16] *See, e.g., In re Daugherty Construction, Inc.*, 188 B.R. 607 (Bkrtcy. D. Neb. 1995).
[17] *See* Bury Article at 992.
[18] *See, e.g., In re Tsiaoushis*, 383 B.R. 616, 619 (Bankr. E.D. Va. 2007).
[19] *See, e.g., In re Sandman Associates, L.L.C.*, 251 B.R. 473 (W.D. Va. 2000).
[20] *In re Morgan Sangamon Partnership*, 269 B.R. 652, 654 (Bkr. N.D. Ill. 2001).
[21] *See. e.g., id.* (finding that Illinois partnership law provides that "no person can become a member without the consent of all the partners" and so the operating agreement's *ipso facto* clause is enforceable to block the trustee from assuming the debtor's management rights in a partnership).
[22] *See In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 704 ("the dissociated member is expelled from the company, but does not forfeit the value of his ownership interest.").

3. In determining whether or not applicable law provides for this type of excuse of accepting or rendering performance, courts use either a "hypothetical" or an "actual" test.[23] In applying either test, courts must balance the competing policy aims of § 365(e)'s invalidation of *ipso facto* provisions, and § 365(e)(2)'s limitations on such invalidation as well as § 365(c)(1)'s limitations on a trustee's powers of assumption and assignment. On the one hand, courts must aim to maximize the value of the debtor's estate in bankruptcy, but on the other courts must protect the management rights of non-debtors under operating agreements who have a valid interest in their bargained for rights to admit to management only those parties they approve. As mentioned above, the debtor's economic rights always enter the debtor's estate as a property right, and so these tests relate only to the debtor's non-economic rights.

   a. Hypothetical Test

      (1) "The majority of circuits that have decided this issue adopted the "hypothetical test," which looks to whether under applicable law, there is any entity other than the debtor in possession from whom the non-moving party could reject performance. If there is such a hypothetical entity, then assumption of the agreement is prohibited, notwithstanding a debtor's actual intention not to make an assignment. This approach prohibits assumption even where the debtor does not intend to assign the contract."[24]

   b. Actual Test

      (1) Under the "actual test," "the court must determine on a case by case basis, whether the nondebtor party's contract 'will actually be assigned or that the nondebtor party will in fact be asked to accept performance from or render performance to a party—including the trustee—other than the party with whom it originally contracted.' Under the actual test, assumption is prohibited only where the debtor expresses an actual intent to assign the contract to a party to whom the nondebtor could refuse performance."[25]

      (2) A trustee or debtor in possession would more easily be able to assume a contract under the actual test, because the nondebtor party must "make an individualized

[23] *In re Edison Mission Energy*, Bankr. N.D. Ill., No. 12-49219, Dkt. no. 1017 (2013).
[24] *Id.* (internal citations omitted).
[25] *Id.* (internal citations omitted).

showing that it would not receive the 'full benefit of its bargain' were an entity to be substituted for the debtor from whom performance is due."[26]

4. Debtor in Possession

    a. § 1107(a) provides that "a debtor in possession shall have all the rights [other than compensation . . .] of a trustee serving in a case under this chapter." Thus, the debtor in possession in a chapter 11 case also has the right to assume or reject an executory contract such as an operating agreement.

5. Finally, it should also be noted that pursuant to § 365(b)(1)(A), the trustee or debtor in possession must cure any monetary default under an executory contract, or provide assurance that prompt cure is forthcoming, before assuming the contract.

F. Assignment of an operating agreement as an executory contract

1. If a court "rules that the exceptions allowing application of *ipso facto* provisions in § 365(c)(1) and (e)(2) do not apply or are moot," then § 365(f) applies[27] and a trustee or debtor in possession would be allowed to assign.[28]

G. Rejection of operating agreements

1. If an operating agreement is deemed to be an executory contract, then § 365 allows the trustee to assume or reject it depending on his or her assessment of what most benefits the estate.[29]

2. Rejection of "an executory contract does not terminate or rescind the contract. Rather, rejection frees the bankruptcy estate from any obligations under that contract and entitles the party to due performance from the debtor to file a proof of claim for damages."[30]

3. Also, rejection leaves the obligations between non-debtor parties in place.[31]

H. Key takeaways

1. In drafting operating agreements, consider how bankruptcy will affect management rights of members or partners.

---

[26] *Summit Inv. and Development Corp. v. Leroux*, 69 F.3d 608, 613 (1995).
[27] Bury Article at 1006.
[28] § 365(f) allows a trustee to assign executory contracts nothwithstanding a provision in the contract that "prohibits, restricts, or conditions the assignment of such contract."
[29] *See id.* at 988.
[30] *See id.* at 989.
[31] *See In re Minton*, No. 14-91293, 2017 WL 354319 (Bankr. C.D. Ill. Jan. 24, 2017).

2. If a client wants to protect against the eventuality of a trustee, debtor in possession, or other assignee taking on management rights and participating in the management of the entity, include provisions that ensure the operating agreement requires continuing obligations of and performance by the members or partners.

3. As a nondebtor member or partner who wants to prevent a trustee, debtor in possession, or other assignee from gaining management rights through the bankruptcy estate, raise the issue of the executory status of the operating agreement so that the § 365(e) exception to *ipso facto* provision invalidation may apply.

4. As a trustee or debtor in possession, contesting the status of an operating agreement as an executory contract may be the most efficient way to ensure that the entire LLC interest—both economic and non-economic rights—enter the bankruptcy estate as § 541 "property." Otherwise, courts often assume that an operating agreement is executory.[32]

## II. Fiduciary Duties (emphasis on DE law)

A. The issue: conflicts of interest

1. *Summit Inv. and Development Corp. v. Leroux* ("*Leroux*") provides a good segue from the discussion of operating agreements as executory contracts into a discussion of fiduciary duties in alternative entities in bankruptcy. In *Leroux*, non-debtor parties argued that a debtor in possession should never be allowed to assume an operating agreement as an executory contract because the debtor in possession has an inherent conflict of fiduciary duties: it owes a duty both to its co-partners and to its chapter 11 creditors.[33] The *Leroux* Court rejected this argument by reasoning (in part) that courts must "undertake a fact-'sensitive' inquiry to determine whether or not, in the circumstances of the particular case, nondebtor parties like [the plaintiff] can nonetheless obtain the 'full benefit' of their bargain." *Id.* at 614. While ultimately rejecting the nondebtor's argument, the *Leroux* Court did suggest that if a nondebtor party could show that it would not gain the benefit of its bargain due to a debtor in possession's conflicting fiduciary duties, the debtor in possession may not be allowed to assume the contract pursuant to § 365(c).

B. Who owes fiduciary duties

---

[32] *See, e.g., In re O'Connor*, 258 F.3d 392, 400 (5th Cir. 2001).
[33] *Summit Inv. and Development Corp. v. Leroux*, 69 F.3d 608, 613 (1995).

10400392.2 01

1. Prior to bankruptcy, directors and officers of an entity owe fiduciary duties to the entity and the entity's shareholders.[34]

2. Controlling shareholders also have some fiduciary duties, including the duty of loyalty[35] and the duty to disclose material facts to minority shareholders when buying shares from these minority holders.[36]

3. During bankruptcy, the trustee or debtor in possession owes fiduciary duties to the bankruptcy estate and to creditors.[37] As mentioned in *Leroux*, a debtor in possession also owes fiduciary duties to its co-partners.

C. Who can enforce fiduciary duties and who has standing to sue

1. Standing to pursue derivative claims is limited to holders of membership interests in the LLC or their assignees under § 18-1002 of Delaware's LLC Act. This would include the trustee, the debtor in possession, the entity (through its managers or court appointed trustee), or a litigation trust created pursuant to a plan for reorganization.[38]

2. In 2010, the Delaware Court of Chancery made clear that creditors of a Delaware LLC (whether solvent or insolvent) lack standing to sue for breach of fiduciary duty, even for derivative claims.[39]

D. Waiver of fiduciary duties

1. Delaware LLC law permits the elimination of fiduciary duties, except for the implied covenant of good faith and fair dealing.[40]

2. Delaware LLC law also permits the elimination of liability for breach of fiduciary duties (again, except for the implied covenant of good faith and fair dealing).[41]

---

[34] *See* Adrian Nasr, *Special-Purpose entity Lending Structures: What Developments Have Been Made Since the Landmark Bankruptcy Case* In re General Growth Properties, Inc.*?*, 25 ABI L. REV. 177, 184 (2017) ("Nasr Article").

[35] *See, e.g., Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) ("a parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings"). .

[36] *See, e.g., In re Wayport, Inc. Litigation*, 76 A.3d 296, 319 (Del. Ch. 2013).

[37] Nasr Article at 184.

[38] *See* Russell C. Silberglied, *Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment*, 10 J. BUS. & TECH. L., 181, 205 (2015).

[39] *See CML V, LLC v. Bax*, 28 A.3d 1037, 1046 (Del. 2011). In *North American Catholic Education Programming Foundation, Inc. v. Gheewalla* ("*Gheewalla*"), the Delaware Supreme Court held that creditors of insolvent corporations can assert derivative claims for breach of fiduciary duty. However, as *Gheewalla* dealt with a corporation, it did not address the issue of creditors' rights in the event of insolvency by a LLC. *CML V, LLC v. Bax* refused to extend derivative standing to creditors of LLCs.

[40] *See* Del. Code Ann. tit. 6, § 18-1101(c) (2016).

[41] *See* Del. Code Ann. tit. 6, § 18-1101(e) (2016).

3. To effectively waive fiduciary duties pursuant to § 18-1101(c), operating agreements should include "plain and unambiguous" eliminations of fiduciary duties.[42] Drafters should also consider "adding language relating to complete elimination of fiduciary duties, adding further language limiting the information and other considerations for independent managers, and adding language contemplating section 18-1101(e)."[43]

E. Contracting out and delegation of fiduciary duties

1. "Unless the operating agreement provides otherwise, members and managers may delegate their respective rights and powers to 'manage and control the business and affairs' of the LLC Act § 18-407. That delegation may be directed to agents, officers and employees of a member or manager or the LLC, and may be embodied in management or other agreements."[44]

F. Types of provisions that bankruptcy courts invalidate as improper limitations or waivers of fiduciary duties:

1. Waivers of the duty of good faith and fair dealing

a. As mentioned before, the duty of good faith and fair dealing cannot be waived under Delaware law. Provisions that attempt to effect a waiver of these duties will be invalidated as improper limitations or waivers of fiduciary duties.

2. Waivers of the right to file for bankruptcy

a. Additionally, bankruptcy courts will invalidate a provision that is found to violate federal bankruptcy policy by amounting to an "advance agreement to waive the benefits conferred by the bankruptcy laws."[45] An important example of such a provision is where a special member or independent manager has a blocking positions that could prevent a debtor from filing for bankruptcy without any consideration of the debtor's interests because of a fiduciary duty waiver.

b. In June 2016, a Delaware bankruptcy court considered a provision giving a special member a blocking position without any duty to anyone but itself in *In re Intervention Energy Holdings, LLC* ("*Intervention*") and invalidated it as an improper waiver of the right to seek federal bankruptcy

---

[42] *See Feeley v. NHAOCG, LLC*, 62 A.3d 649, 664 (Del. Ch. 2012).
[43] *See* Nasr Article at 184.
[44] Fredric J. Bendremer, *Those Delaware LLCs – another look*, 10 BUS. L. TODAY 5 (2001).
[45] *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 263 (Bankr. D. Del. 2016).

relief.[46] In *Intervention*, a debtor executed a forbearance agreement that admitted one of its creditors (or the creditor's affiliate) as a member with one common unit and required the approval of each holder of common units prior to the filing of a voluntary bankruptcy filing.[47] The creditor argued that this provision gave it, as a holder of a common unit, the authority to block the debtor's bankruptcy filing without any consideration of the debtor's interests because Delaware LLC law permits a broad and extensive waiver of fiduciary responsibility, including a contractual waiver of the right to file bankruptcy at will. The *Intervention* Court disagreed and held that "even if arguably permitted by state law, [the provision] is void as contrary to federal public policy."[48]

c. Thus, recent caselaw suggests that Delaware bankruptcy courts will not honor fiduciary duty waivers that are so sweeping that if enforced would prevent a debtor from filing for bankruptcy. One way to protect against this outcome is to draft a provision giving a creditor the power to appoint a third party to serve in a management capacity or exercise decision-making authority, rather than giving this power and authority directly to the creditor. This strategy helps to avoid the fiduciary duty problem raised by the agreement at issue in *Intervention*.

---

[46] *Id.* at 261, 265.
[47] *See id.* at 261.
[48] *Id.* at 265.

**ALTERNATE ENTITY PANEL MATERIALS**
(by Mark Shaiken, Stinson Leonard Street LLP)

# I. ELIGIBILITY OF A BUSINESS TRUST

A. Statutory Predicate

1. Subject to certain limitations in 11 U.S.C. § 109(b), only a "person" may be a debtor under chapter 7 or 11. § 109(a).

2. A "person" includes a "corporation" (§ 101(41)) and a "corporation" includes a "business trust." (§ 101(9)(A)(v)).

3. The term "business trust" did not appear in the Bankruptcy Act of 1898.

4. Rather, it first appeared in the Report of the Commission on the Bankruptcy Laws of the United States which stated that the term: "eliminates the requirement of the present Act that beneficial interest or ownership "be evidenced by certificate or other written instrument." The Commission stated that the certificate requirement gave undue significance to an evidentiary formality. H.R. Doc. No. 93-137, 93d Cong., 1st Sess. Part II at 27 (1973); *see In re Medallion Realty Trust*, 103 B.R. 8, 10 (Bankr. D. Mass. 1989).

B. Does "Eligibility" implicate the Bankruptcy Court's subject matter jurisdiction?

1. § 109 "eligibility" to be a bankruptcy debtor is not typically viewed as a subject matter jurisdiction issue. The analysis of whether a petitioner's eligibility for protection under Title 11 implicates subject matter jurisdiction must begin and largely end with the United States Supreme Court's 2006 decision in *Arbaugh v. Y&H Corp.*, 546 U.S. 500 (2006). In *Arbaugh*, at issue was whether 42 U.S.C. § 2000-2(a)(1)'s definition of an "employer" as one who has fifteen or more employees was a subject matter jurisdiction predicate in a Title VII discrimination case. In an 8-0 decision, the Court rejected the argument that Title VII's "number of employees" element was a subject matter jurisdiction predicate, and held: "If the Legislature clearly states that a threshold limitation on a statute's scope shall count as jurisdictional, then courts and litigants will be duly instructed and will not be left to wrestle with the issue. . . . But when Congress does not rank a statutory limitation on coverage as jurisdictional, courts should treat the restriction as nonjurisdictional in character. Applying that readily administrable bright line to this case, we hold that the threshold number of employees for application of Title VII is an element of a plaintiff's claim for relief, not a jurisdictional issue." *Arbaugh*, 546 U.S. at 515-16.

2. Thus, because a bankruptcy *subject matter jurisdiction* statute is present in Title 28, in section 1334, then Bankruptcy Code *substantive law* statutes, such as § 109, are non-jurisdictional under *Arbaugh's* bright line rule.

3. As a result, numerous circuit and bankruptcy courts have relied on *Arbaugh* and held that § 109's eligibility requirements are non-jurisdictional. *See In re Soames Lane Trust*, No. CC–16–1042–FDKu, 2016 WL 4198426 (B.A.P. 9th Cir. Aug. 8, 2016), at issue was whether a land trust was a "person" eligible to be a chapter 11 debtor under § 109. The Ninth Circuit BAP rejected the argument that the bankruptcy court lacked subject matter jurisdiction over the trust because it was arguably ineligible for Title 11 relief under § 109 citing *Arbaugh*, applying the *Arbaugh* principle to the "person" requirement of § 109(a) and (d). *Id.* at *4-6 (citations omitted; emphasis in original removed). *Accord In re Hamilton Creek Metro. Dist.*, 143 F. 3d 1381, 1385, n.2 (10th Cir. 1998). *See, also Finlay v. Zarnel (In re Zarnel)*, 619 F.3d 156, 164, 169 (2d Cir. 2010) (§ 109(h) credit counseling; citing *Arbaugh*); *In re Montgomery*, 37 F.3d 413, 425, n.5 (8th Cir. 1994) (§ 109(g) subsequent filing); *Rudd v. Laughlin (In re Rudd)*, 866 F.2d 1040, 1041-42 (8th Cir. 1989) ("Nor do we believe that 11 U.S.C. § 109 is meant to restrict the [28 U.S.C. § 1334] jurisdiction . . . ."); *In re Phillips*, 844 F.2d 230, 235, n.2 (5th Cir. 1988) (§ 109(g) subsequent filing); *In re Wenberg*, 94 B.R. 631, 636-37 (B.A.P. 9th Cir. 1988), *aff'd*, 902 F.2d 768 (9th Cir. 1990) (§ 109(e) extent of debts); *In re Baruch*, 564 B.R. 424, 429 (Bankr. M. D. Fla. 2016) (§ 109(h) credit counseling, citing *Arbaugh*); *In re Gen. Lending Corp.*, 505 B.R. 63, 69-70 (S.D. Fla. 2014) (§ 109(e) extent of debts); *In re Osborne*, 490 B.R. 75, 80 (Bankr. S.D.N.Y. 2013) (§ 109(h) credit counseling); *In re Fiorillo*, 455 B.R. 297, 305 (D. Mass. 2011)(§ 109(h), citing *Arbaugh*); *In re Wise*, 415 B.R. 579, 582-3 (Bankr. N.D. Ala. 2009)(§ 109(h), citing *Arbaugh*); *In re Manalad*, 360 B.R. 288, 294-95 (Bankr. C.D. Cal. 2007) (§ 109(h), citing *Arbaugh*); *In re Auto. Prof'l, Inc.*, 370 B.R. 161 (Bankr. N.D. Ill. 2007) (§ 109(b) domestic insurance company) *In re Ross*, 338 B.R. 134, 140-41 (Bankr. N.D. Ga. 2006) (§ 109(h) credit counseling); *In re Flores*, 291 B.R. 44, 52-3 (Bankr. S.D.N.Y. 2003) (§ 109(g) 180 subsequent filing); *In re Jarvis,* 78 B.R. 288, 289 (Bankr. D. Ore. 1987); *In re Republic Trust & Sav. Co.,* 59 B.R. 606, 609 n.1 (Bankr. N.D. Okla. 1986) (post confirmation challenge to eligibility waived because eligibility is non-jurisdictional); *In re Patton,* 49 B.R. 587, 588–89 (Bankr. M.D. Ga.1985) (§ 109(f) subsequent filing); *In re Tatsis*, 72 B.R. 908, 911 (Bankr. W.D. N.C. 1987) (§ 109(e) extent of debt); *In re Johnson,* 13 B.R. 342, 346 (Bankr. D. Minn.1981) (§ 109(b) farmer); *see also* 2 COLLIER ON BANKRUPTCY ¶ 109.01 at 109-8 (16th ed. 2016); *see also In re Wiencko*, 99 F. Appx. 466, 468-69 (4th Cir. 2004) (automatic stay applies even where debtor ineligible under § 109(e) because of extent of debts).

C. If a challenge is raised to a Trust's eligibility, what transpires in the bankruptcy case while the bankruptcy court determines eligibility?

1. In *In re Zarnel*, 619 F.3d 156 (2d Cir. 2010), a debtor failed to obtain credit counseling before filing her chapter 7 case in violation of § 109(h). Holding, as most cases do, that § 109(h) is not jurisdictional, the circuit court went on to address whether an ineligible "debtor" nevertheless has the benefit of the automatic stay under § 362 while its case is on file. In ruling that the automatic stay, available only to a "debtor," comes into effect even when an ineligible debtor commences a bankruptcy case, the circuit stated: "Having determined that a case is commenced, we turn to the question whether the automatic stay takes effect when a petition is filed by a debtor ineligible under § 109(h). We conclude that it does. Section 362, which outlines the basic commencement, effect, and termination of the automatic stay, provides significant indications to that effect. Section 362(b) lists circumstances under which the filing of a petition does not operate as a stay, but the debtor's ineligibility is not among them. Moreover, none of the mechanisms outlined in the remainder of the statute for confirming the existence of a stay or for granting relief from one address anything related to the ineligibility of a debtor." *Id.* at 170-71. *Accord Wiencko v. Ehrlich (In re Ehrlich)*, 99 Fed. Appx. 466, 468-69 (4th Cir. 2004) (automatic stay arises upon commencement of bankruptcy case even by a debtor ineligible under § 109 of the Bankruptcy Code); *In re Ross*, 338 B.R. 134, 139-40 (Bankr. N.D. Ga. 2006) (same); *In re Flores*, 291 B.R. 44, 52-53 (Bankr. S.D.N.Y. 2003); *In re Brown*, 342 B.R. 248, 255-56 (Bankr. D. Md. 2006) (same).

2. A bankruptcy filing, even by an ineligible debtor, does not render the bankruptcy case void *ab initio*. *Flores*, 291 B.R. at 52-53. Rather, "The better rule appears to this Court to be to recognize that a petition filed with the bankruptcy court is a petition, and the case thereby commenced is a case, unless and until the bankruptcy court determines that the debtor did not have the right to be a debtor, in which case the court can dismiss the case and fashion such other relief as may be necessary to protect the rights of secured or other creditors. *Ross*, 338 B.R. at 141; *accord In re Tomco*, 339 B.R. 145, 159-60 (Bankr. W.D. Pa. 2006).

3. *See also* § 349, providing the orders that are vacated upon dismissal of a bankruptcy case, and by negative implication, the orders that are not.

D. What is a Business Trust?

1. There is no bankruptcy code definition of the phrase "business trust." The meaning of the term is thus left to decisional law. *In re General Growth Props., Inc.*, 409 B.R. 43, 70 (Bankr. S.D.N.Y. 2009). Because the question is one of *procedure* – whether a trust has standing to file a petition – rather than *substantive rights*, the determination of whether a

petitioning trust is a "business trust" is generally held to be a question of federal law. *Brady-Morris v. Shilling (In re Kenneth Allen Knight Trust)*, 303 F.3d 671, 679 (6th Cir. 2002) ("*Knight Trust*"); *In re Rubin Family Irrevocable Stock Trust*, 2013 WL 6155606 at *7 (Bankr. E.D.N.Y. Nov. 21, 2013); *In re Jin Suk Kim Trust*, 464 B.R. 697, 702 (Bankr. D. Md. 2011); *In re Arehart*, 52 B.R. 308, 310-11 (Bankr. M.D. Fla. 1985); 2 COLLIER ON BANKRUPTCY ¶ 109.02[1][a] n. 12 (16th ed. 2017).

2. Federal courts have struggled to find uniform criteria to determine trust eligibility – instead, they "are, if not hopelessly divided, at least certainly divergent." *Knight Trust*, 303 F.3d at 679, *quoting In re Village Green Realty Trust*, 113 B.R. 105, 113 (Bankr. D. Mass. 1990); *see Jin Suk Kim Trust*, 464 B.R. at 702. The cases do generally agree, though, that there is no *definitive* list of relevant characteristics and that each decision is based on a very fact-specific analysis of the trust at issue. *Knight Trust*, 303 F.3d at 680; *Shawmut Bank Conn., Nat'l Ass'n LNC Invs., Inc. v. First Fidelity Bank (In re Secured Equip. Trust of Eastern Airlines, Inc.)*, 38 F.3d 86, 90-91 (2d Cir. 1994) ("*Secured Equip*"); *Jin Suk Kim Trust*, 464 B.R. at 703 & 704; *General Growth*, 409 B.R. at 70. There is, therefore, no bright line test dictating an interpretation to the Court.

3. History of the Transferable Certificate requirement

   (a) In *Morrissey v. Comm'r of Internal Revenue*, 296 U.S. 344 (1935), the Supreme Court set out a test to determine when trusts may be treated as corporations under the Internal Revenue Code—a test requiring, *inter alia*, "transferable certificates of ownership." The *Morrissey* test can be read to be the 1935 indicia of what is a corporation, to include transferable paper certificates of ownership. *Morrissey* was a test under the tax code, and the Supreme Court's decision did not purport to address any issues under the Bankruptcy Act. *Morrissey* addressed the work "trust" and did not address the phrase "business trust" a phrase which itself did not exist under the Bankruptcy Act.

   (b) Since 1935 when the Supreme Court penned *Morrissey*, two lines of cases have developed. In reliance on *Morrissey*, some courts require transferable certificates of ownership, while the other line of cases reject the *Morrissey*.

E. Illustrative decisions rejecting *Morrissey* and transferability as a requirement of a business trust

1. Overview

   (a) The Sixth Circuit joined other courts in concluding that Congress intended to dispense with the transferable certificate requirement when it made this statutory change. *Knight Trust*, 303 F.3d at 679-80; *In re Lancaster Family Trust*, 2010 WL 1463007 at *2-3 (Bankr. N.D. Miss. Apr. 12, 2010); *Rubin Family Irrevocable Stock Trust*, 2013 WL 6155606 at *8; *Tru Block Concrete*, 27 B.R. at 488. None of those decisions state the beneficial interests were transferable, yet each finds the trust to be eligible for bankruptcy relief.

(b) Of note, in *Shawmut Bank Conn., Nat'l Ass'n LNC Invs., Inc. v. First Fidelity Bank (In re Secured Equip. Trust of Eastern Airlines, Inc.),* 38 F.3d 86, , 87-88, 90-91 (2d Cir. 1994), the second circuit deemed the transferable interest issue so irrelevant that it rejected business trust classification for a trust which had issued certificates but did not engage in business activity.

(c) Similarly, other courts denied eligibility to trusts which issued transferable certificates to a variety of holders because they were not created with the purpose of transacting business. *See e.g., In re Gurney's Inn Corp. Liquidating Trust*, 215 B.R. 659, 664 & 668 (Bankr. E.D.N.Y. 1997); *In re Treasure Island Land Trust*, 2 B.R. 332, 334-35 (Bankr. M.D. Fla. 1980). If transferable interests ruled the question, the appellate court would not have denied eligibility.

2. Sixth Circuit *Knight Trust* Decision

(a) The Sixth Circuit set forth a "primary purpose of the trust" test as follows: "first, trusts created with the primary purpose of transacting business or carrying on commercial activity for the benefit of investors qualify as business trusts, while trusts designed merely to preserve the trust *res* for beneficiaries generally are not business trusts; and second, the determination is fact-specific, and it is imperative that bankruptcy courts make thorough and specific findings of fact to support their conclusions - findings, that is, regarding what was the intention of the parties, and how the trust operated." 303 F. 3d at 680.

(b) The Sixth Circuit rejected the following as dispositive:

(i) whether the trust includes beneficiaries who include the grantor or the grantor's family. *Knight Trust*, 303 F.3d at 674-75, 680.

(ii) whether the trust issues written certificates of ownership that are transferable.

3. Jin Suk Trust Decision

(a) A generation-skipping trust was held to be an eligible business trust where it was established by a grantor for her daughter - who was named the lifetime income beneficiary and was engaged in the business held by the trust. *Jin Suk Trust*, 464 B.R. at 704-05. The trust also named the lifetime income beneficiary as trustee and provided that the trust corpus passed to the income beneficiary's heirs named in her will. The purpose of the trust was not stated or known. The trust document gave unfettered discretion to the trustee to invest assets without fiduciary restrictions and allowed her to take assets for her support. *Id.*at 699-700. The court found that this discretion to invest the assets without regard to diversification rules and insulation of the trustee from liability showed the trust was not primarily concerned with preservation of corpus but was instead primarily a vehicle to continue investment activities with trust assets. *Id.* at 703. While the trust had no board of directors, officers, or certificates of ownership, *Id*. at 701, the court focused instead on the purpose and operation of the trust, noting that the trust had twelve employees and maintained contracts directly with service providers and tenants at its mall property. *Id*. at 704.

4. Rubin Family Irrevocable Stock Trust Decision

(a) A family trust that engaged in substantial economic activity meant to realize a profit for beneficiaries was a "business trust." *In re Rubin Family Irrevocable Stock Trust*, 2013 WL 6155606 at *9. The decision noted that, where a trust engages in significant *risk-taking* with its assets, "it would defy reason to conclude that the primary purpose" is to protect and preserve them. *Id. See also In re Metro Palms Trust I*, 153 B.R. 922, 923 (Bankr. M.D. Fla. 1993) (trust which sole business activity was supervision of management of single, leased office building with no employees was eligible debtor).

5. *Arehart* Decision

(a) In another case, a trust was found to be an eligible debtor even though it never maintained a place of business, never had any employees, never filed tax returns, never held an occupational license, did not have any income from any source, and never conducted business in any conventional sense. It did, however, initiate development plans with respect to its properties by contacting engineers, had property appraised, and investigated financing options, including equity financing and advertising the development. *Arehart*, 52 B.R. at 309; *see also In re Gonic Realty Trust*, 50 B.R. 710, 713 (Bankr. D.N.H. 1985) (trust created for benefit of trustee and his wife that owned and leased a mill held to be eligible debtor). The court focused on the expansive management control granted to the trustee and that language in the trust was written with development activity as its purpose. *Arehart*, 52 B.R. at 310.

6. General Growth Decision

(a) In finding a trust eligible, the court observed that "Lancaster Trust has no board, officers or stockholders, but these are characteristics of some closely-held business entities. ING argues that the Trust has an outside termination date and that the interest of Lancaster Trust's sole beneficiary is "non-transferable," but restrictions on the transfer of shares, particularly in the case of close corporations, are also common." 403 B.R. at 71 (citations omitted).

F. Illustrative Decisions where transferability of certificates is required for a trust to be bankruptcy eligible

1. Other cases have held that if the trust lacks transferable certificates, it cannot be an eligible debtor as a matter of law. Virtually of these cases, however, involve trust that have little or no business activities and / or the duties of the trust is to preserve the corpus of the trust and not engage in the risk-taking associated with a business activity.

(a) *See In re Gaetano Trust,* 2016 WL 4150257 at *1-2 (Bankr. D. Haw. Aug. 3, 2016) (case filed by non-attorney with history of abusive filings for trust which was not doing business); *In re Mortgage Banking Trust*, 2008 WL 3126186 at *24-25 (Bankr. D. Md. July 23, 2008) (trust required to distribute estate on grantor's death); *In re Hughes Living Trust*, 305 B.R. 59, 60-61 (Bankr. W.D. Okla. 2004); *In re Gurney's Inn Corp. Liquidating Trust*, 215 B.R. 659, 667-68 (Bankr. E.D. N.Y. 1997) (trust indisputably created for estate planning later used for business); *In re Sung Soo Rim Irrevocable Intervivos Trust*, 177 B.R. 673, 678 (Bankr. C.D. Cal. 1995); *In re Westgate Village Realty Trust*, 156 B.R. 363, 365 (Bankr. D N.H. 1993); *In re Woodsville Realty Trust*, 120 B.R. 2, 5 (Bankr. D. N.H. 1990) (nominee trust terminable at will of beneficiaries passively held real estate under trustees with no power over assets); *In re L&V Realty Trust*, 61 B.R. 423, 424 (Bankr. D. Mass. 1986) (trust held one, rented parcel, with no books or checking account and filed no tax returns); *In re Mosby*, 46 B.R. 175, 177 (Bankr. E.D. Mo.), *aff'd*, 61 B.R. 636 (E.D. Mo. 1985), *aff'd*, 791 F.2d 628 (8th Cir. 1986); *In re Armstead & Margaret Wayson Trust*, 29 B.R. 58 (Bankr. D. Md. 1982) (decision does not set out facts raised in a motion that persuaded court); *In re Citizens Bank & Trust Co.*, 8 B.R. 812, 814 (Bankr. N.D. Ill. 1981) (sole function of land trust was to hold legal title to one parcel); *In re Old Second Nat'l Bank*, 7 B.R. 37, 38 (Bankr. N.D. Ill. 1980) (land trust that did no business but merely held title); *In re Treasure Island Land Trust*, 2 B.R. 332, 334-35 (Bankr. M.D. Fla. 1980) (not actively engaged in business under trust document directing protection and preservation of property).

G. *In re John Q. Hammons Fall 2006 LLC*, 573 B.R. 881 (Bankr. D. Kan. Sept. 13, 2017), on appeal to the 10th Cir. BAP.

1. The Hammons chapter 11 cases, filed in the District of Kansas, are 75 operating companies – LLCs and corporations – that own thirty two Marriott and Hilton hotel properties throughout the United States, and by the Revocable Trust of John Q. Hammons dated December 28, 1989, as Amended and Restated, that owns directly or indirectly the 75 operating companies, three hotels, as well as numerous additional assets. All assets held by the Hammons Trust were operated for profit, but issued no certificates of ownership and therefore the Trust has no transferable certificates.

2. The court applied the primary purpose test, rejected the transferable certificates test and found the primary purpose of the trust was to take risk and conduct business, not to preserve the trust assets. It cited the following *facto*rs:

3. "The Hammons Trust itself had seven employees on its petition date, but its combined entities employ thousands of people. Since its inception, it has been operated for profit, and has generated a profit in most, if not all, years of its existence. The Hammons Trust itself owns multiple properties (three hotels, a storage facility, parking lots and garages, unimproved land, a baseball stadium, and a building that houses a sports hall of fame), and then also owns all of the equity issued by subsidiary entities owning hotels, casinos, office buildings, trade centers, a federal courthouse, etc. . . The Hammons Trust could borrow money, enter into contracts, purchase property, sell property, invest, etc., and it, in fact, did do all of those things. The trust document even guarded the trustee and successor trustees against any personal liability for risks taken by these business decisions. In addition, the Hammons Trust, since its inception, has had a central cash management system for the business it owns directly and through all its subsidiaries, and it has issued guarantees of those subsidiaries' debts." 573 B.R. at 894-95.

II. HODGE PODGE OF ISSUES ONCE A CASE IS FILED (non-trust cases)

A. Effect of "control" provisions in an operating agreement

1. Filing plan by special committee: *In re Indianapolis Downs, LLC*, 486 B.R. 286, 302 (Bankr. D. Del. 2013).

    (a) Sale plan was submitted by the debtor through a "Special Committee" that was formed pursuant to an amended operating agreement executed post-petition. Senior management and equity holders objected. The operating agreement gave the Special Committee the exclusive power and authority to take such actions for the debtor as the Special Committee deemed necessary in matters where a member of the debtor was likely to make a proposal regarding the bankruptcy case. The court agreed that since the equity members were expected to participate in the bidding process for the sale of the debtor, the Special Committee had authority to conduct the sale process as it saw fit.

2. Arbitration of governance dispute without lifting the stay: *In re Am. Media Distr., LLC*, 216 B.R. 486, 489 (Bankr. E.D .N.Y. 1998).

    (a) A minority member of a bankrupt debtor forced its fellow minority member into arbitration over a governance dispute without seeking relief from the automatic stay. The court found no violation of the stay because the debtor was not a party to the operating agreement - the agreement simply controlled the relationship between the members – therefore the court did not have the power to limit its enforceability. The court reasoned that the rights of the debtor's member "to participate in the governance of the business in which they hold equity interests are neither enjoined automatically nor abrogated upon the filing of a bankruptcy petition." *Id*. Thus, while the issues of governance between the minority members of the debtor would directly impact the course of the bankruptcy case, the operating agreement remained in full force and the bankruptcy court would not, or possible could not, create a barrier to its enforcement.

3. Receiver as debtor-in-possession.

    (a) In *Adams v. Marwil (In re Bayou Group, LLC)*, 363 B.R. 674, 687 (S.D. N.Y. 2007), the court held that while the receiver's powers as a receiver ended upon the commencement of the Chapter 11 case, the court order appointing the receiver also granted equitable relief to the creditors that replaced the business's management with the receiver as exclusive managing member, creating an additional 'hat' that did not cause the receiver's corporate management power to cease at the moment the business filed for bankruptcy. Thus, while the receiver continued to operate as the managing member of the entities and therefore the debtor-in-possession and was not required to turnover any property to the trustee. While the court acknowledged that this holding created a loophole in the bankruptcy court that allowed creditors to choose, pre-bankruptcy, to appoint their chosen "trustee," the loophole relies on an enforceable order that not only appoints a receiver, but also grants the entity acting as the receiver the authority to exclusively manage the pre-bankruptcy debtor.

(b) *In re Roxwell Performance Drilling, LLC*, 2013 WL 6799118, at *4 (Bankr. N.D. Tex. Dec. 20, 2013), the bankruptcy court distinguished *Bayou Group* and found the state-court-appointed receiver had no authority to manage or control the debtor in bankruptcy. The court distinguished *Bayou Group* by noting that the receiver in that case was appointed by a federal court that explicitly appointed the receiver with management powers. "To the extent that the *In re Bayou* opinions can be construed to mean that a receiver of a debtor in bankruptcy preserves the debtor as debtor in possession, the Court respectfully disagrees with such construction." *Id.* Instead, because the state court order appointing the receiver did not give the receiver wide-ranging managerial powers, the receiver was required, under § 543, to turn over all estate property to the trustee, who the court then appointed on request by the United States Trustee.

B. Impact of *Ipso facto* clauses

1. <u>Buyback</u>: *In re IT Group, Inc.*, 302 B.R. 483, 487 (D. Del. 2003): automatic buyback of interest of bankruptcy debtor unenforceable *ipso facto* clause; *accord In re Talbut*, 2015 WL 5145598, at *3 (Bankr. N.D. Ohio Aug. 28, 2015); *Breeden v. Catron* (*In re Catron*), 158 B.R. 624, 629 (E.D. Va. 1992) (debtor's partner interest in a general partnership was a non-assumable personal services contract and therefore *ipso facto* clause was enforceable).

2. <u>Forfeiture</u>: *Strata Title, LLC v. Pure Country Tower, LLC (In re Strata Title, LLC)*, 2014 WL 661174, at *4 (B.A.P. 9th Cir. 2014): The bankruptcy court enforced, and the BAP affirmed, an *ipso facto* forfeiture provision in the operating agreement of a non-debtor LLC that transferred the debtor's interest in the LLC to the other member automatically on a certain date. The court reasoned that the transfer, which was contingent on the failure of the non-debtor LLC to repay the non-debtor member's initial investment by February 23, 2013, required no action by either of the members and therefore did not violate the automatic stay. The bankruptcy court found that "the simple passage of time changed the nature of the property the Debtor once owned." *Id.* at *4.

3. <u>Option to Purchase</u>: *In re Denman*, 513 B.R. 720, 727 (Bankr. W.D. Tenn. 2014): provision in LLC operating agreement that gives members

automatic option to buy the interest of a member that commences a bankruptcy case unenforceable *ipso facto* clause; *see also In re Eustler*, 2017 WL 1157114 (Bankr. E.D. Wash. Mar. 24, 2017) (same as to shares in corporation); *In re Grablowsky*, 180 B.R. 134, 137 (E.D. Va. 1995) (non-debtor partners right to purchase partnership interest of debtor unenforceable *ipso facto* provision).

4. <u>Transfer of LLC interest to Chapter 11 plan liquidating trust</u>: Permitted notwithstanding prohibition in operating agreement because of alignment of interests between debtor and liquidating trust. *In re Alameda Investments, LLC*, 2013 WL 3216129, at *6 (Bankr. C.D. Cal. June 25, 2013).

5. <u>Automatic Dissolution of non-debtor LLC</u>: *In re Warner*, 480 B.R. 641, 656 (Bankr. N.D. W. Va. 2012) (automatic dissolution provision in LLC agreement upon bankruptcy of a member unenforceable *ipso facto* clause; *Prebul v. Bensusan*, 2012 WL 5997927, at *11 (E.D. Tenn. Nov. 30, 2012); *In re Daugherty Constr., Inc.* 188 B.R. 607, 611-12 (Bankr. D. Neb. 1995); *but see JTB Enters., LC v. D& B Venture, LC (In re DeLuca)*, 194 B.R. 79, 91-92 (Bankr. E.D. Va. 1996) (non-debtor LLC dissolved upon bankruptcy of member).

6. <u>LLC interest disassociation provision</u>: *In re Dixie Mgmt & Inv. Ltd. Partners,* 474 B.R. 698, 700-01 (Bankr. W.D. Ark. 2011) – provision unenforceable. *See also In re Garrison-Ashburn, L.C.,* 253 B.R. 700, 709 (Bankr. E.D. Va. 2000) (state law disassociated non-manager's interest upon his bankruptcy filing but his economic interests become property of the estate under § 541(c)(1)).

7. <u>Right of First Refusal</u>: *In re IT Group, Inc., Co.*, 302 B.R. 483, 487 (D. Del. 2003): A members rights of first refusal not triggered by the bankruptcy of a selling member is enforceable and is not an *ipso facto* clause and therefore, in the selling member's bankruptcy case, the other members must be given the opportunity to buy the interest; *accord In re Talbut*, 2015 WL 5145598, at *5 (Bankr. N.D. Ohio Aug. 28, 2015).

8. <u>treatment of interests in partnerships is divergent</u>.

   (a) <u>no dissolution or termination of interests</u>: *see In re Cardinal Industries, Inc.*, 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990) (provision of limited partnership agreement removing general partner that commenced bankruptcy case unenforceable *ipso facto* clause); *see also Summit Inv. & Devel. Corp v. LeRoux*, 1995 WL 447800, at *11 (D. Mass. 1994) (no removal of general partner from partnership); *In re Clinton Court,* 160 B.R. 57, 60 (Bankr. E.D. Pa. 1993) (debtor partnership not dissolved by prior chapter 11 filing of general partner); *In re Corky Foods Corp.,* 85 B.R.

903, 904 (Bankr. S.D. Fla. 1988) (motion to require debtor partner to abandon interest in partnership because of dissolution denied; state statute providing for dissolution held to be invalid ipso facto clause); *In re BC & K Cattle Co.,* 84 B.R. 69, 71 (Bankr. N.D. Tex. 1988) (general partner's chapter 11 filing did not deprive him of authority to file involuntary petition against partnership); *In re Rittenhouse Carpet, Inc.,* 56 B.R. 131, 133 (Bankr. E.D. Pa. 1985) ("removal of a debtor general partner of a limited partnership may not be predicated merely on the filing of a petition in bankruptcy, notwithstanding provisions of state law to the contrary"); *Quarles House Apts. v. Plunkett (In re Plunkett),* 23 B.R. 392, 394 (Bankr. E.D. Wis. 1982) (debtor general partner's right to manage nondebtor partnership's business and to receive management fee under partnership agreement is property of the estate); *Summit Investment and Development Corp. v. LeRoux,* 69 F.3d 608, 614 (1st Cir. 1995) (ipso facto termination clause in limited partnership agreement and limited partnership statute unenforceable against debtor general partner); *Calvin v. Siegal (In re Siegal)*, 190 B.R. 639, 646 (Bankr. D. Ariz. 1996) (bankruptcy of partner did not trigger dissolution of partnership because *ipso facto clause* was unenforceable); *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (Partnership did not dissolve automatically upon the filing of debtor's petition).

(b) dissolution or termination of interest: *In re Doddy,* 164 B.R. 276 (Bankr. S.D. Ohio 1994) (nondebtor partnership dissolved on chapter 13 filing by debtor general partner); *In re Tip O Texas RV Village,* 87 B.R. 195 (Bankr. M.D. Fla.1988) (debtor general partner had no right to manage four limited partnerships against whom involuntary petition had been filed); *In re Sunset Developers,* 69 B.R. 710 (Bankr. D. Idaho 1987) (debtor general partner had no authority to file involuntary petition against partnership; as debtor in possession, the general partner was a new entity and entitled only to contract profit to which an assignee is entitled, without management or voting rights); *Turner v. Lee (In re Minton Group),* 27 B.R. 385 (Bankr. S.D. N.Y. 1983), *aff'd,* 46 B.R. 222 (S.D. N.Y.1985) (chapter 11 filing by general partner dissolved limited partnership and deprived debtor general partner of management authority); *Normandin v. Normandin (In re Normandin),* 106 B.R. 14 (Bankr. D. Mass. 1989) (debtor general partner may not sell partnership assets; provision of state law denying debtor partner the right to control the winding up process not in conflict with Bankruptcy Code); *In re Morgan Sangamon P'ship*, 269 B.R. 652, (Bankr. N.D. Ill. 2001) (partnership agreement was not executory and chapter 7 bankruptcy of partner extinguished all but debtor-partner's economic rights).

(c) Trustee does not have power to sell assets of partnership: *Cutler v. Cutler (In re Cutler),* 165 B.R. 275, 281 (Bankr. D. Ariz. 1994) (Trustee could not assume debtor-partner's management function under partnership agreement, and could not compel sale of partnership assets themselves); *Connolly v. Nuthatch Hill Assocs. (In re Manning)*, 831 F.2d 205, 207 (10th Cir. 1987) (Partnership property is not property of the debtor-partner's estate and therefore § 363 does not authorize its sale).

(d) Plan could not transfer managerial control of limited partnership to Committee. *In re Manor Place Dev. Assocs., LP*, 144 B.R. 679, 684 (D. N.J. 1992); *but see in re D.F. Antonelli, Jr.*, 148 B.R. 443, 449-50 (D. Md. 1992) (assignment of managerial control of partnership to creditors committee permitted in chapter 11 plan).

9. *See also* § 541(c)(1)B) which provides that a debtor's interest "in property becomes property of the estate...notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law...that is conditioned on...the commencement of a case under this title...and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."

C. Trustee of a trust issues

1. The trust *res* is not property of the estate by virtue of the trustee filing a bankruptcy petition. *In re Signal Hill-Liberia Ave. Ltd. P'ship*, 189 B.R. 648, 651 (Bankr. E.D. Va. 1995).

2. Property of the estate is not just the interest in the property but also the debtor's power as trustee of a revocable trust over the property as long as that power is not exercised for a party other than the debtor under § 541(b)(1). *In re Reuter*, 499 B.R. 655, 671 (Bankr. W.D. Mo. 2013).

3. *Mann v. Kreiss (In re Kreiss)*, 72 B.R. 933, 939 (Bankr. E.D. N.Y. 1987): The debtor was the trustee for the beneficiaries, and was the remainderman, in his father's testamentary trust. The power to be exercised as trustee was not property of the estate under § 541(b)(1) because the power the debtor exercised over the trust *res* was solely for the benefit of the trust beneficiaries. The remainderman interest, however was property of the estate.