AMERICAN BANKRUPTCY INSTITUTE

2018 Central States Bankruptcy Workshop

Business Track

Small- and Closely Held-Business Issues

CONCURRENT SESSION

David K. Welch
Burke, Warren, MacKay & Serritella, P.C.; Chicago

Deborah J. Caruso
Rubin & Levin, P.C.; Indianapolis

Robert C. Folland
Barnes & Thornburg LLP; Columbus, Ohio

Hon. Marci B. McIvor
U.S. Bankruptcy Court (E.D. Mich.); Detroit

2018

Administering LLC Interests in Bankruptcy

By: Deborah J. Caruso and Elizabeth N. Hahn[1]
Rubin & Levin, P.C.

Indianapolis Bar Association
2018 Advanced Consumer Bankruptcy Roundtable
April 26, 2018

I. INTRODUCTION: LLC BASICS AND LLCS IN INDIANA

A limited liability company ("LLC") is a statutorily-created business entity that is governed in Indiana by the Indiana Business Flexibility Act[2] (the "IBFA") and in other states by similar statutes. The IBFA provides that an LLC is formed pursuant to Ind. Code § 23-18 by the filing of articles of organization with the Secretary of State.[3] The LLC is governed by the LLC's operating agreement and the laws of the state in which the LLC was formed. An LLC can be managed by a managing member, or by the members acting together.

A debtor's membership interest in an LLC can potentially be an important asset in any bankruptcy case.

In most states, including Indiana, the interest of a member in an LLC is personal property[4] that is assignable, in whole or in part, unless the operating agreement provides otherwise. An assignment typically entitles the assignee to distributions made pursuant to the operating agreement, but does not authorize the assignee to participate in the management of the LLC, unless the operating agreement provides otherwise.[5] In essence, the assignee becomes an

[1] Original article by Deborah J. Caruso, Meredith R. Theisen, and Erick P. Knoblock; Indianapolis Bar Association 2015 Advanced Consumer Bankruptcy Roundtable, April 30, 2015 (with James T. Young contributing research and articles on the topic).
[2] I.C. § 23-18-1 *et seq*.
[3] I.C. §§ 23-18-2-4, 23-18-2-6.
[4] I.C. § 23-18-6-2.
[5] Paul J. Galanti, 17 Indiana Practice Series, Business Organizations, §7A.8 (internal footnotes omitted).

unapproved member of the LLC and cannot exercise management rights until approved by the other members.[6] Based on this reading of the IBFA and the Bankruptcy Code, it would appear that a bankruptcy trustee takes a debtor's interest in an LLC as an assignee. An assignee is not treated as a full member, but as a member pending approval by the other members subject to the terms of the operating agreement. At the very minimum, this entitles the assignee to distributions from the LLC assuming that the operating agreement calls for regular distributions to the members. The Indiana Court of Appeals stated as much in the case of *Branch v. Kirlich*,[7] in which the Court noted that a judgment creditor was similar to an assignee and would only be entitled to the economic rights of the LLC membership and not management rights.[8] The *Branch* case involved an LLC with more than one or two members.

It would seem that the trustee's rights and the extent of those rights are clearly defined and limited by the Indiana Code and similar statutes in other states. However, not all LLC's are multi-member entities and some LLC's have only one member. A bankruptcy trustee may have substantially more power and options when administering a single asset LLC.

II. SINGLE-MEMBER LLCS

A. Trustee's Ability to Assume Control Over the Single-Member LLC

As stated above, it would appear that only the debtor's economic interests (*i.e.* rights to payments distributions) in the LLC are assets of the bankruptcy estate. The trustee, as an assignee, may not have authority to manage or control the LLC. The trustee may only have the right to a charging order with respect to the LLC, but some courts have given the trustee greater

[6] *Id*.
[7] 835 N.E.2d 582 (Ind. App. 2005).
[8] *Id*. at 592.

rights when the debtor is the only interest holder in a single-member LLC, which is managed by one managing member.

For example, in the case of *In re Modanlo*,[9] the bankruptcy court applied Delaware state law to conclude that the bankruptcy trustee could assume control of the single-member LLC in question.[10] The court noted that normally a trustee would only be entitled to a debtor's economic interest in an LLC, however, because the debtor in this situation was the sole member of the LLC, the trustee was authorized by Delaware law to consent to the continuation of the LLC as the debtor's personal representative.[11] This allowed the trustee to become the managing member of the LLC and to administer the LLC as an asset of the bankruptcy estate.

Similarly, in the case of *In re Albright*,[12] a Colorado bankruptcy court reached a similar conclusion but for somewhat different reasons. The Court concluded that because the trustee had been assigned the debtor's membership interest in the LLC, the trustee could control the governance of the LLC consistent with Colorado's Limited Liability Act.[13] The court rejected the argument that the trustee was only entitled to a charging order and instead noted that because the LLC was a single-member entity, and there were no other members with interests in the LLC that required protection, the trustee could assume control of the LLC.[14]

A similar result was reached in *In re A-Z Electronics, LLC*,[15] in which the United States Trustee moved to convert or dismiss the Chapter 11 case based on the unauthorized filing of the petition because the managing and sole member of the LLC was himself in the process of a

[9] 412 B.R. 715 (Bankr. D. Md. 2006
[10] *Id*. at 731.
[11] *Id*.
[12] 291 B.R. 538 (Bankr. D. Colo. 2003).
[13] *Id*. at 540.
[14] *Id*. at 541.
[15] 350 B.R. 886 (Bankr. D. Id. 2006).

Chapter 7 bankruptcy.[16] The court held that under Idaho law, when the LLC's sole member filed bankruptcy, his interest in the LLC became personal property of the Chapter 7 bankruptcy estate.[17] Thus, the LLC's sole member had no authority to file the Chapter 11 bankruptcy for the LLC because at that point, the LLC was subject to the sole and exclusive authority of the LLC's sole member's trustee and that the sole member's trustee was the only one entitled to manage the LLC and decide whether the LLC would or would not file bankruptcy.[18]

Additionally, in the case of *Fursman v. Ulrich, (In re First Protection, Inc.),*[19] the Ninth Circuit stated:

> We conclude that all of the Debtors' contractual rights and interest in [the LLC] became property of the estate under § 541(a)(1) by operation of law when they filed their petition. Section 541(c)(1)(A) overrides both contract and state law restrictions on the transfers or assignment of Debtor's interest in [the LLC] in order to sweep all their interests into their estate . . . As a result, the Trustee was not a mere assignee, but stepped into Debtors' shoes, succeeding to all of their rights, including the right to control [the LLC].[20]

In narrowing the above line of cases, a New Hampshire bankruptcy court in the case of *Desmond v. U.S. Asset Funding, LP (In re Desmond),*[21] reached a different conclusion regarding the treatment of single-member LLCs. In this case, a debtor filed a Chapter 11 petition and listed among his assets his 100% control of an LLC. Shortly thereafter, the LLC entered into a contract with a creditor, which the LLC subsequently breached. The creditor sought to sell the collateral that secured the contract and the debtor and the trustee sued to enjoin the creditor's sale. The debtor cited *Albright* for the proposition that the debtor's 100% membership rights in the LLC included the right of control and management of the LLC, and thus the automatic stay

[16] *Id.* at 888.
[17] *Id.* at 890.
[18] *Id.* at 891.
[19] 440 B.R. 821 (9th Cir. B.A.P. 2010).
[20] *Id.* at 830.
[21] 316 B.R. 593 (Bankr. D.N.H. 2004).

should protect the LLC and its assets.[22] The court concluded that the LLC was not a debtor in any bankruptcy case and that the agreement made between the LLC and the creditor were the actions of two non-debtors, thus allowing the creditor to pursue its full range of remedies against the LLC.[23]

The majority position seems to be that when an LLC is controlled and 100% owned by a single member who is a debtor, the trustee can step into the debtor's shoes and take complete control of the entity. However, as evidenced in the preceding cases above, exactly how the LLC is to be treated is somewhat dependent on the state law authorizing and governing LLCs as entities.

B. Assets of Single-Member LLCs: Debtor's Exemptions and the Automatic Stay

In bankruptcy, the assets of the debtor are typically protected by the automatic stay when the bankruptcy case is filed. For cases involving LLCs, the automatic stay would protect a debtor's membership interest in the LLC, such that no creditor could obtain a charging order in satisfaction of the debtor's debts once the bankruptcy case is filed. However, the LLC's assets are subject to a completely different analysis. The majority position is that the LLC's assets are not protected by the automatic stay even when the LLC is owned and controlled by a single member debtor.

In addition to the *Desmond* case described above, other courts have adhered to the traditional principle that the LLC's assets are separate from the debtor's assets. Bankruptcy courts in Iowa, Massachusetts, and Idaho all agreed that the automatic stay does not protect the

[22] *Id*. at 595-96
[23] *Id*. at 596.

assets of an LLC.[24] The Massachusetts bankruptcy court in the case of *In re Furlong*,[25] noted that "unless a corporation is itself a bankruptcy debtor, the automatic stay afforded to an individual debtor under section 362(a) does not extend to the assets of a corporation in which the Debtor has an interest, even if the interest is 100% of the corporate stock."[26] Similarly, in the case of *In re Penn*,[27] a Georgia bankruptcy court held that "once the sole owner of an LLC files a bankruptcy petition, the membership interests themselves become property of the owner's estate, but it does not compel the conclusion that the actual assets of the LLC are property of the owner's estate. Accordingly, the Debtor's argument that the automatic stay applied to protect [the LLC], a nondebtor, from the [creditor's] foreclosure must be rejected."[28] Thus, it would seem that in order for an LLC to receive the protection of the automatic stay, the LLC would be required to file its own bankruptcy petition.

In contrast, however, some courts have allowed the automatic stay to apply to LLC assets in limited cases. For example, in the case of *In re Ealy*,[29] the debtors owned and operated a child care center. The debtors purchased the property for the child care center using an LLC specifically created for that purpose. The bankruptcy court found that the debtors held equitable title to the real estate holding that the debtors never intended that the LLC would have sole title to the real estate. Therefore, the automatic stay extended to the real estate. Similarly, in *In re Schwab*,[30] the bankruptcy court determined that certain LLC assets were property of the debtor for purposes of applying the exemption statute where there was evidence that the debtor had

[24] *In re* Calhoun, 312 B.R. 380 (Bankr. N.D. Iowa 2009), *In re* Furlong, 437 B.R. 712 (Bankr. D. Mass. 2010), *In re* Aldape Telford Glazier, Inc., 410 B.R. 60 (Bankr. D. Idaho 2009).
[25] 437 B.R. 712 (Bankr. D. Mass. 2010).
[26] *Id.* at 721 (citing *In re* Calhoun, 312 B.R. 380 (Bankr. N.D. Iowa 2009)).
[27] Case No. 09-14624-WHD, 2010 WL 9445533 (Bankr. N.D. Ga. April 2, 2010).
[28] *Id*. at *4.
[29] 307 B.R. 653 (Bankr. E.D. Ark. 2004)
[30] 378 B.R. 854 (Bankr. D. Minn. 2007)

purchased the assets using their own personal line of credit and had not intended the assets to be property of the LLC. Both of these cases are based on equitable principles of ownership intent and their holdings are limited. The court in *Ealy* stressed that the lack of debtor intent was one of the most important factors in its decision and that appeared to be the case in *Schwab* as well.

C. Fraudulent Transfers and Preferences in Single Member LLCs

Membership in an LLC is personal property of the debtor, and thus transfers of the membership interest would be subject to normal preference and fraudulent transfer analyses. However, the majority rule is that LLC assets are not property of the bankruptcy estate or the debtor, and therefore would not be subject to the same analyses. For example, in *Nossaman-Petitt v. Adams Enters, Inc. (In re Adams),*[31] the debtors purchased property and transferred it to an LLC owned exclusively by one of the debtors. Shortly before their bankruptcy filing, the LLC transferred the property to another LLC owned by the debtors' son. The court concluded that because the property had been owned by the debtor's LLC at the time of the transfer, it was not property of the debtor and was not subject to the avoidance provisions of the Bankruptcy Code.[32] The trustee could not avoid the transfer and could not recover the property for the bankruptcy estate.[33] This outcome presents the clever debtor with an easy way to avoid the trustee's powers to recover assets for the bankruptcy estate. It remains to be seen if other courts will adopt the analysis employed by the court in *Adams*.

D. Single-Member LLC Operating Agreements not Executory Contracts

[31] Case No. 09-4002-TLS, 2009 WL 3681850 (Bankr. D. Neb. Sept. 25, 2009).
[32] *Id*. at *2.
[33] *Id*.

The court in *First Protection*,[34] as previously discussed above, further noted that section 365 of the Bankruptcy Code relating to executory contracts was not applicable to that case because "there is no reason to prohibit a Trustee in bankruptcy from assuming all of the rights and obligations of a Debtor who is the only member of a single member LLC. In that case, there are no non-Debtor members whose interests could be harmed by the operation of the LLC by a Trustee or a Debtor in possession."[35] As discussed further below, the approach that courts will take on this issue in the context of multi-member LLCs is less clear.

III. MULTI-MEMBER LLCS

A. The Trustee's Ability to Sell and/or Control the Debtor's Membership Interest

Unlike a single-member LLC, bankruptcy courts in the past have held that the trustee may only be entitled to the economic benefits of the debtor's membership rights in a multi-member LLC. However, this position is eroding with several fairly recent court opinions. In *In re B& M Land and Livestock LLC,*[36] a Nevada bankruptcy court held that section 541 of the Bankruptcy Code, provides that all of the debtor's interest in a LLC is property of the estate, and trumps any conflicting analysis or rules in state law relating to the control of LLCs or partnerships. As a result, a bankruptcy trustee has more rights and remedies than a state court judgment creditor who is only entitled to a charging order.[37]

Because a trustee has more rights and remedies than a state judgment creditor, a trustee typically has the authority to liquidate the debtor's economic interests. Courts in Massachusetts and Louisiana have held that the trustee can sell the debtor's member interest similar to any other

[34] *Fursman v. Ulrich* (*In re* First Protection, Inc.), 440 B.R. 821 (9th Cir. B.A.P. 2010).
[35] *Id.* at 832 (citing *Modanlo*, 412 B.R. at 727).
[36] *In re B&M Land and Livestock LLC,* 498 B.R. 262 (Bankr. D. Nev. 2013).
[37] *See also In* re Blixseth, 484 B.R. 360, 369 (B.A.P. 9th Cir. 2012).

type of personal property and the trustee can sell the member interest to other members of the LLC.[38] In these cases, the courts have noted that they will closely scrutinize any sales to other members of the LLC to ensure that the transactions are being conducted at arm's length and that the other LLC members are not unfairly benefiting at the expense of the debtor's creditors.

In addition to selling the LLC interest, a trustee may force the dissolution of a multi-member LLC in order to obtain value for the estate. For example, in *In re Garbrinski*,[39] the bankruptcy court held that the trustee was entitled to force the dissolution of a multi-member LLC that was only partly owned by the debtor.[40] In this case the debtor owned a 49.5% interest in one LLC and a 50% interests in two other LLCs. The court held that section 541(c) of the Bankruptcy Code permitted the trustee to "exercise rights as a partner/member seeking to obtain judicial dissolution and winding up of the entities by invoking state law remedies involving dissolution or liquidation of [the] LLC or limited partnership entities."[41] Accordingly, section 541 of the Bankruptcy Code may authorize the trustee to participate in the affairs of a debtor's LLC, which may include commencing dissolution actions and removing existing members from management.

B. Non-Bankrupt Members' Rights Following Another Member's Bankruptcy Filing

Other members of an LLC must be careful regarding actions they take post-petition that effect a debtor's interest in the LLC. For example, in *In re Lee,*[42] Judge Graham held that other

[38] *In re Harding*, Case. No. 06-01324-WCH, 2009 WL 161862 (Bankr. D. Mass. Jan. 22, 2009), *In re Rosbottom*, Case No. 09-11674, 2010 WL 3294315 (Bankr. W.D. La. Aug. 19, 2010) (concluding that decision to sell estate's minority interest was within sound business judgment of trustee, on basis of operating agreement restrictions on transferability of membership interests and provisions dealing with mandatory buy/sell rights, mechanics of achieving compelled sale price, right of first refusal and mechanics for obtaining a valuation of interest proposed to be sold, in light of possible cost of marketing estate's interest while dealing with issue of extent to which restrictions on transfer were enforceable against debtor or estate).
[39] 465 B.R. 423 (Bankr. W.D. Pa. 2012).
[40] *Id.* at 427.
[41] *Id*.
[42] 524 B.R. 798 (Bankr. S.D. Ind. 2014).

members of an LLC violated the automatic stay by adopting a resolution to remove the debtor as a member of the LLC and to terminate his voting rights postpetition.[43] Judge Graham found that the other members' exercised control over property of the estate*, i.e.,* the debtor's voting rights, regardless of whether members had authority to take such action in the debtor's absence.[44]

Other courts have reached similar conclusions. For example, in *In re McCabe*,[45] a Massachusetts bankruptcy court found that the postpetition conduct of the debtor's former business partner in unilaterally amending the terms of the LLC operating agreement to reallocate the membership interests violated the automatic stay. The Court held that, although the business partner asserted that this reallocation of the parties' interests merely formalized a preexisting status of his and the debtor's relative capital contributions to the LLC and was in the nature of a ministerial act, the LLC's operating agreement required that any amendment be duly executed by both members.[46]

Similarly, in *Matter of Daugherty Const., Inc*.[47] a Nebraska bankruptcy court concluded that the post-petition actions of the LLC's other members to remove the debtor as manager were actions that amounted to "exercise of control over property of the estate and in violation of the automatic stay provisions" under section 362(a)(3) of the Bankruptcy Code.[48]

C. Exemptions for LLC Interests

In the case of *In re Mays*,[49] Judge Coachys addressed the issue of exempting an LLC interest. In the *Mays* case, the debtor attempted to exempt 100% of the LLC interest pursuant to

[43] *Id.* at 804.
[44] *Id.*
[45] 345 B.R. 1 (Bankr. D. Mass. 2006).
[46] *Id.* at 7.
[47] 188 B.R. 607 (Bankr. D. Neb. 1995).
[48] *Id.* at 615.
[49] *In re Jeffrey v. Mays and Edith R. Mays, U.S. Bankruptcy Court for S.D. of Indiana, Case No. 10-11132-JKC-7A, Order dated December 3, 2010.*

I.C. § 23-18-1-1. The debtors had argued that any transferable interest they had was limited to "economic interests," and because the revenues from the LLC were zero, the entire interest was exempt. Judge Coachys rejected the debtors' position, and held that the debtors were limited to the $350 in available exemptions for intangible assets provided under Indiana law[50] (rather than the 100% exemption sought by the Debtors). It is interesting to note that in a footnote Judge Coachys questioned the Trustee's concession that he was limited to the rights of an assignee/judgment creditor and that the trustee is entitled to only the member's "economic interests" in the LLC. Judge Coachys questioned why the trustee should be treated as an "assignee" given the expansive wording in section 541(a) of the Bankruptcy Code. As discussed above, many courts would agree that the trustee has much greater rights than an assignee and may have management rights in a single-member LLC and at least the right to sell a debtor's LLC interest.

D. Operating Agreements as Executory Contracts and the Section 365 Limitations

An operating agreement for an LLC will define the various rights and obligations of the members, including restrictions against transfer of the membership units. The operating agreement may also contain a provision that provides for dissolution of the LLC in the event of a member bankruptcy. Courts have grappled with whether the LLC operating agreements are executory contracts and whether the trustee is bound by the terms of the executory contract. The Bankruptcy Code does not define the term "executory contract," however the Seventh Circuit generally applies the "Countryman" definition—"a contract is executory if 'the obligation of both the bankruptcy and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the

[50] I.C. § 34-55-10-2(c).

other.'"[51] The determination of whether an LLC operating agreement is an executory contract is made on a case-by-case basis to "determine if the operating agreement contains sufficient unperformed obligations to require treatment as an executory contract."[52]

> Operating agreements often contain standard provisions potentially requiring members to take some future, contingent act, such as indemnifying the LLC for tax liabilities, making future capital contributions to the LLC, or voting on substantial transactions involving the LLC. Such hypothetical, remote, or speculative obligations are generally insufficient to require treating an operating agreement as an executory contract. Rather, a debtor must have substantial, current, unperformed obligations if an operating agreement is to be treated as an executory contract. For example, an operating agreement is executory as to a debtor where the debtor is obligated to provide services as a general contractor for an ongoing real estate development project conducted through the LLC. An operating agreement can also be executory if the debtor has an important role in the management of the LLC.[53]

If the operating agreement is an executory contract, it is subject to the limitations of sections 365(c) and (e) of the Bankruptcy Code. Section 365(e)(1) and (2) of the Bankruptcy Code provides that a contractual provision requiring the termination of the agreement based upon a debtor's bankruptcy filing (a so-called *ipso facto* clause) will *not* be given effect *unless* (a) applicable law excuses the counterparty to the contract from accepting performance from the trustee, and (b) the counterparty to the contract objects to the trustee's efforts to assume or assign the contract. Similarly, section 365(c) provides that, although a trustee may generally assume and assign an executory contract, a trustee may not assume a contract if (a) applicable law would excuse the counterparty to the contract from accepting performance from a person other than the debtor, and (b) the counterparty objects to the trustee's effort to assume or assign the contract.

[51] *BMA Ventures, LLC v. Prillaman (In re Minton)*, 2017 Bankr. LEXIS 199, *10-11 (Bankr. C.D. Ill. Jan. 23, 2017). (quoting *Mitchell v. Streets (In re Streets & Beard Farm Partnership)*, 882 F.2d 233, 235 (7th Cir. 1989)).
[52] *Id*. at *11
[53] *Id*. at *11-12.

Some courts have held that an operating agreement is not an executory contract. For example, in the case of *Movitz v. Fiesta Investments LLC (In re Ehmann),*[54] an Arizona bankruptcy court concluded, "that because the operating agreement of a [LLC] imposes no obligations on its members, it is not an executory contract.[55] Accordingly, the trustee acquires all of the debtor's rights and interests pursuant to sections 541(a) and (c)(1) of the Bankruptcy Code, and the sections 365(c) and (e) limitations do not apply.[56] In this case, the Court determined that the LLC's operating agreement was not an executory contract because the debtor's interest was effectively passive (*i.e.* there was nothing for the debtor to do to continue to receive distributions).[57] Because the LLC's operating agreement was not executory, the trustee's rights were controlled by section 541 of the Bankruptcy Code and all the restrictions on the transfer of the debtor's interest under Arizona law and the LLC's operating agreement were inapplicable pursuant to section 541(c) of the Bankruptcy Code.[58] Accordingly, the trustee could sell the LLC interest free of any transfer restrictions. The Court did, however, indicate that if the debtor's interest was active (*i.e.* the debtor had to affirmatively undertake some acts to gain entitlement to distributions, thus making the operating agreement an executory contract) the trustee would be restricted by Arizona law and the terms of the operating agreement.[59]

By contrast, in *In re Minton*, after determining that the LLC operating agreement was not executory, the Court had to determine whether the trustee was bound by the provisions of the

[54] 319 B.R. 200 (Bankr. D. Ariz. 2005).
[55] *Id.* at 201.
[56] *Id*.
[57] *Id.* at 205-06.
[58] *Id.* at 206. *See* 11 U.S.C. § 541(c)(1) (an interest of the debtor in property becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law that restricts or conditions transfer of such interest by the debtor, or that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case, or on the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before commencement of a bankruptcy case, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property).
[59] *Id.* at 205-06.

operating agreement, specifically those related to the sale or disposition of the member's interest in the LLC.[60] The LLC argued that the trustee takes the membership interest in the LLC subject to the same restrictions that existed at the commencement of the case.[61] The trustee, on the other hand, argued that the sale provisions in the LLC operating agreement are void as impermissible *ipso facto* clauses under section 541(c)(1).[62] The Court pointed out that under section 541(c)(1), the debtor's interest in the LLC became property of the estate regardless of a provision in the operating agreement (or nonbankruptcy law), that would otherwise prevent the transfer.[63] However, according to the Court, section 541(c)(1) does no more than that—

> Pursuant to §541, a Chapter 7 trustee steps into the debtor's shoes as an LLC member and succeeds to all rights and obligations under an LLC operating agreement. Section 541(c)(1) does not operate to define the bundle of rights that go with property. Nor does it expand a trustee's rights beyond those held by the debtor. Section 541(c)(1) therefore does not provide authority for the Trustee to sell the estate's interest in [the LLC] free of the constraints of the Operating Agreement.[64]

Although the trustee does have some potential remedies in order to avoid some sale restrictions set forth in an operating agreement (*e.g*. under section 363(f) of the Bankruptcy Code and the unenforceability of "unreasonable restraints on alienation" under state law), in general, sale restrictions found in an LLC operating agreements are enforceable in bankruptcy "where they do not significantly impair a trustee's ability to obtain the fair market value of the estate's interest in the LLC."[65]

[60] 2017 Bankr. LEXIS 199 at *17.
[61] *Id*.
[62] *Id*.
[63] *Id*. at *18.
[64] *Id*. at *19. (internal citations omitted).
[65] *Id*. at *19-20.

There are several courts that have held that operating agreements are executory contracts because such agreements contain material, mutual, unperformed obligations that would qualify it as an executory contract.[66] In these cases, courts have held that if the operating agreement is assumed by the trustee, it remains subject to the limitations of section 365 of the Bankruptcy Code, which potentially could limit the trustee's ability to sell the debtor's membership interest.[67]

However, some jurisdictions have held that an operating agreement is never an executory contract, even if the debtor's interest is considered active *(e.g.* material, mutual unperformed obligations). For example, in the case of *In re Denman*,[68] a Tennessee bankruptcy court held that an operating agreement for a LLC in which a Chapter 13 debtor held a membership interest was a business formation and governance instrument that simply defined the membership interests and rights and duties that attached thereto, and was not a contract between the debtor and the other members of the LLC.[69] Accordingly, the fact that the members of the LLC had material unperformed obligations under the operating agreement did not make the operating agreement a per se executory contract.[70] The Court reached this conclusion because, according to relevant Tennessee law, one member's failure to perform under an LLC operating agreement does not excuse the other members' performance thereunder and because an operating agreement has many features that are at odds with a normal contract.[71] Accordingly, the limitations of sections 365(c) and (e) of the Bankruptcy Code did not apply in this case and the trustee assumed the

[66] *See In re* Allentown Ambassadors, 361 B.R. 422 (Bankr. E.D. Pa. 2007) (holding that an operating agreement is an executory contract because material, unperformed obligations remain on both sides); *Matter of* Daugherty Construction, Inc., 188 B.R. 607 (Bankr. D. Neb. 1995) (same); *In re* Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006) (same); *In re* Knowles, 2013 WL 152434 (Bankr. M.D. Fla. 2013) (same).
[67] *Id*.
[68] 513 B.R. 720 (Bankr. W.D. Tenn. 2014).
[69] *Id.* at 723
[70] *Id*.
[71] *Id*. at 722-26.

debtor's membership interest free of any restrictions under Tennessee law or the LLC operating agreement.[72] However, *Denman* is an unusual case in which the decision by the court was based on the unique qualities of Tennessee law regarding operating agreements.[73]

Other courts, although applying a different analysis, have agreed with the *Denman* Court's conclusion that the Trustee assumes the debtor's membership interests without any restriction. In *In re Dixie Management & Inv. Ltd. Partners*,[74] an Arkansas bankruptcy court held that the *ipso facto* clause in the LLC's operating agreement, providing that it would be an event of disassociation for any member to petition for bankruptcy relief, did not prevent the debtor's 62% membership interest in the LLC from being included as property of the estate.[75] In this case, the Arkansas state statute providing that a party ceases to be a member of a LLC when the party "[f]iles a voluntary petition in bankruptcy" was preempted by section 541(c)(1) of the Bankruptcy Code, and did not prevent the debtor's membership interest from being included as property of the estate.[76]

If the trustee rejects the operating agreement, the trustee's rejection is deemed a breach of the operating agreement, not a termination or rescission of a contract.[77] The rejection, therefore, does not extinguish the operating agreement or the other member's rights attached thereto—whatever rights the parties possess post-rejection are governed by the operating agreement and "ordinary principles of state law."[78] Therefore, the rejection of an operating agreement does not "invalidate the provisions in that agreement that allocate each member's share of the interests in

[72] *Id*. at 725.
[73] *Id*.
[74] *Duncan v. Dixie Mgmt. & Inv., Ltd. Partners* (*In re* Dixie Management & Inv. Ltd. Partners), 474 B.R. 698 (Bankr. W.D. Ark. 2011).
[75] *Id.* at 701.
[76] *Id*.
[77] *In re Minton*, 2017 Bankr. LEXIS 199 at *8.
[78] *Id.* at *9.

the LLC."[79] As a result, the trustee's rejection of the operating agreement would not change the fact that the bankruptcy estate owns a property interest in the LLC.[80] The trustee is thus able to sell this interest, but the rejection frees the bankruptcy estate of the monetary burdens and obligations under the operating agreement. Accordingly, when a trustee sells a debtor's interest in an LLC and rejects the operating agreement, the new owner of the debtor's LLC interest takes it subject to the equitable remedies of the other members in light of the trustee's breach.

E. Buy-Sell Agreements as Executory Contracts and Section 365(a)

Similar to LLC operating agreements, Courts have also had to address whether buy-sell agreements are executory contracts. The Court in *Roomstore*[81] had to determine whether the parties' buy-sell agreement was an executory contract that could be rejected by the debtor pursuant to Section 365(a) of the Bankruptcy Code. Acknowledging that although the issue presented in *Roomstore* was "fairly limited and straightforward," the Court still had to face the daunting task of applying "abstract legal principles" to unique facts.[82] At issue, was a certain provision in the buy-sell agreement that gave an LLC the right to purchase the chapter 11 debtor's (Roomstore, Inc.) interest in the LLC upon the debtor's bankruptcy filing.[83] The buy-sell agreement provided for a method for determining the purchase price upon exercise of that option, but the purchase price determined by the agreement was not necessarily the market value of the debtor's interest.[84] Therefore the debtor sought to reject the buy-sell agreement.

---

[79] *Id.* (citing *In re Strata Title, LLC*, 2013 Bankr. LEXIS 2315, *3(Bankr. D. Ariz. June 6, 2013)).
[80] *Id*.
[81] *In re Roomstore, Inc*., 473 B.R. 107 (Bankr. E.D. Va. 2012)
[82] *Roomstore*, 473 B.R. at 110.
[83] *Id*. The provision at issue provided that "[i]f a Member. . . files a voluntary petition under any bankruptcy or insolvency law. . . then the Company [LLC] shall have the option for a period of 180 days after the date of the Insolvency Event to purchase the Membership Interest for Fair Market Value . . . ." "Fair Market Value" was also defined in the buy-sell agreement.
[84] *Id*.

The Court further looked at a split in two circuits in the application of the Countryman definition to a "paid-for but unexercised option."[85] The Ninth Circuit held that a purchase option not exercised prior to the bankruptcy is not an executory contract.[86] The basis for the Ninth Circuit decision in *Robert L. Helms Construction and Development Co.* was to use the following approach—"to ask whether the option requires further performance from each party at the time the petition is filed. Typically, the answer is no, and the option is therefore not executory. The optionee need not exercise the option-if he does nothing, the option lapses without breach. The contingency which triggers potential obligations- exercising the option- is completely within the optionee's control…"[87]

The Court ultimately agreed with the debtor (and the 4th Circuit line of cases), "that a contingent obligation, even though not yet triggered on a debtor's petition date, is nevertheless executory until expiration of the contingency because '[u]ntil the time has expired during which an event triggering a contingent duty may occur, the contingent obligation represents a continuing duty to stand ready to perform if the contingency occurs.'"[88] The Court also discussed *In re Simon Transportation Services* and it's "functional approach" utilized in determining whether a contract is executory "by looking 'to the benefits to be gained by the debtor's estate…'"[89] In *Roomstore*, the buy-sell agreement contained more than a simple purchase option or right of first refusal—it was a complex contract with multiple continuing conditions. The buy-sell agreement contained provisions that prohibited members of the LLC

[85] *Id*. at 112.
[86] *Id.* (citing *Unsecured Creditors' Committee v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co.)*, 139 F.3d 702 (9th Cir. 1998)).
[87] *Id*. (quoting *Robert L. Helms Constr. and Dev. Co*., 139 F.3d at 705-706).
[88] *Id.* at 112-13. (quoting *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.),* 756 F.2d 1043, 1045 (4th Cir. 1985)).
[89] *Id.* (quoting *In re Simon Transportation Services*, 292 B.R. 207, 218 (Bankr. D. Utah 2003)).

from encumbering their interests in the LLC, or transferring their membership interests except as permitted in the agreement, thus rendering the agreement executory.[90] Further, if the debtor could not reject the buy-sell agreement, a valuable asset may be removed from the estate—the debtor's rejection of the agreement will give it an opportunity to expose the asset to the market, and maximize its value for the benefit of the bankruptcy estate.[91]

IV. CONCLUSION

The administration of an individual debtor's interest in an LLC in a bankruptcy case today can be fairly complicated depending on the type of LLC, the assets under the control of the LLC, the terms of the operating agreement, and the provisions of state law that control the LLC. It is clear, however, that a debtor's interest in a LLC is part of the bankruptcy estate and the automatic stay does apply to the interest, but it is less clear exactly what the trustee can do with the interest in a multi-member LLC. Courts generally seem to be interested in protecting other members of an LLC who could potentially be injured by the trustee taking control of a member's interest; however, those concerns seem to disappear if the debtor owns an interest in a single-member LLC. With increased utilization of LLCs, no doubt trustees will administer more LLC interests and we can expect more court opinions defining the trustee's rights and authority in administering the LLC interest.

[90] *Id*. at 114.
[91] *Id.* at 115-16.

CONSIDERATIONS TO PONDER BEFORE FILING A FEDERAL BANKRUPTCY OR STATE RECEIVERSHIP CASE

I. Introduction

Business bankruptcy law is designed to rehabilitate struggling businesses. State receiverships are an alternative to bankruptcy and a receiver is appointed to maximize the returns from the sale of assets either as a going concern sale or liquidation.[i] Before you file for bankruptcy protection, there are a number of things to consider. This article briefly discusses some options you may consider before seeking protection under the Bankruptcy Code or receivership statute. Among other things, when deciding whether to file a federal bankruptcy or state receivership case you should contemplate the following five considerations: 1) special protections afforded by the Bankruptcy Code regarding executory contracts; 2) automatic stay; 3) judicial experience; 4) discharge; and 5) selling assets free and clear of liens.

II. Special Protections afforded by the Bankruptcy Code regarding Executory Contracts

First, most businesses are parties to contracts. When a corporate entity desires to reshuffle its business operations, Section 365 of the Bankruptcy Code gives it ammunition to prosper in the future.[ii] The provisions afforded in the Bankruptcy Code allow a debtor to assume, assign, and reject executory contracts.[iii] Primarily an economic decision, a business can assume the profitable contracts and reject the unprofitable contracts.

If the bankruptcy estate rejects a contract, then the estate becomes liable for damages from the breach. Under Section 502(g), a breach is treated as if it occurred before filing the bankruptcy petition.[iv] As a result the creditor would have a money damages claim against the

bankruptcy estate.[v] In return, the contract counterparty would receive a pro rata distribution for money damages.

By contrast, some receivership statutes are silent about the rights of a receiver to assume or reject executory contracts.[vi] At a minimum, the receiver's order should clearly provide that receivers may reject a contract or lease that burdens the receivership estate and that the counterparty may file a claim for damages incurred as a result of the breach.[vii]

III. Automatic Stay

Second, as a matter of policy it is important that the distressed business is not dismembered by its creditors and similarly situated creditors receive equal distribution. At the commencement of a debtor filing a bankruptcy petition, a new estate is created and the automatic stay is put in place that stays all actions against any property or interest.[viii] The filing of a bankruptcy case offers the immediate protection of an automatic stay, which gives the debtor the breathing room of collection of debts and litigation.

Unlike the Bankruptcy Code, not all states have receivership statutes that prohibit creditors and parties from suing the receivership entities or seeking to collect its assets.[ix] In some states the duration of the automatic stay is limited to 60 to 90 days.[x] As a practice point, a receivership order should include a provision that ceases all collection efforts from creditors and stays all litigation to give the debtor breathing room.

IV. Judicial Experience

Third, U.S. Bankruptcy Courts handle bankruptcy cases and have significant expertise to handle reorganizations and liquidations of financially distressed companies. In many instances, "a bankruptcy is preferable for business reorganizations or to liquidate a large complex business with assets in different states."[xi] Pursuant to Section 541(a) of the Bankruptcy Code, a

bankruptcy court has nationwide jurisdiction over all property of the bankruptcy estate.[xii] In a receivership, a judge may not have the same level of expertise given that the vast majority of a judge's state court docket is devoted to criminal matters.

Nevertheless, because bankruptcy judges are bound by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, there is little flexibility as to how the case will proceed. As a consequence, parties to a bankruptcy case have a level of predictability in the outcome of decisions. In contrast, because receivership statues are not as developed, a state court judge has more latitude in designing remedies and procedures to fit the particular needs of the parties and the case.[xiii] On the downside, receivership statutes are generalized and do not have stringent provisions and do not bring clarity to the receivership process. As a result, receivership case law is scarce and does not provide the substance.

V. Discharge

Fourth, an attorney may consider whether to pursue a chapter 11 bankruptcy or a receivership given the need to relieve the debtor of its obligations. A corporation or partnership in a chapter 7 case cannot discharge its debts.[xiv] The debts of a debtor in a chapter 7 case are not discharged. However, the Bankruptcy Code maintains that in a Chapter 11 case a discharge is applicable. For example, under Section 1141(d)(1) of the Bankruptcy Code, a business that successfully confirms a plan of reorganization in chapter 11 may receive a discharge of all debts that arose before the confirmation.[xv] By contrast, the discharge is inapplicable when a debtor confirms a chapter 11 plan that liquidates the business.[xvi] Claims are discharged whether the creditor filed a proof of claim, or voted on the plan.[xvii]

By contrast a state court cannot allow a business to discharge its debts unless creditors consent. The U. S. Supreme Court held in *International Shoe v. Pinkus*, 278 U.S. 261, 49 S.Ct. 108, 73 L.Ed. 318 (1929) stated the following:

> "A state is without power to make or enforce any law governing bankruptcy that impairs the obligation of contracts or extends to persons or property outside its jurisdiction or conflicts with the national bankruptcy law.… The power of Congress to establish uniform laws on the subject of bankruptcies throughout the United States is unrestricted and paramount. Constitution, art. 1, s 8, cl. 4. The purpose to exclude state action for the discharge of insolvent debtors may be manifested without specific declaration to that end; that which is clearly implied is of equal force as that which is expressed."

Because a receivership estate cannot discharge its debts, it "means the debts will either be paid in full or new arrangements are reached with enough creditors that the company can succeed."[xviii]

VI. Selling Assets Free and Clear of Liens

Lastly, a distressed business may seek to liquidate its business or sell as a going concern. To reshape a debtor's ongoing business, it may decide to sell its overpriced and non-productive assets. Chapter 11 of the Code gives debtors the ability to offer a buyer a clean title, free and clear of all liens.[xix] Historically, "Chapter 2735 of the Ohio Revised Code did not have provisions that authorized the sale of assets by a receiver free and clear of liens."[xx]

Today more states are modernizing their receivership statutes to mirror the process under Section 363 of the Code.[xxi]

> "On January 30, 2013, House Bill No. 9 ("H.B. No. 9") was introduced to the 130th General Assembly. H.B. No. 9 contained a number of modifications and clarifications to Ohio's receivership laws and rewrote Chapter 2735 of the Ohio Revised Code and provided express language that a receiver had the authority to sell property free and clear of liens. After a yearlong discussion and review by the Legislature, HB No. 9 was passed in December, 2014 and the Governor duly signed the bill into law."[xxii]

For example, Section 2735.04(D)(1-10) of the Ohio Revised Code provides that a receiver, "subject to court approval and the requirements set out in this section, may sell property free and clear of liens by private sale, by private auction, by public auction, or by any other method that the court determines is fair to the parties with an interest in the property."[xxiii]

VII. Conclusion

There are numerous factors to consider prior to seeking protection under the Bankruptcy Code or a receivership statute. This article suggests the above-stated considerations before deciding to utilize chapter 11 or a state receivership statute. Depending on the circumstances and the nature of the business, it may be a more effective way to accomplish the same goals by pursuing a state receivership.

---

[i] http://c.ymcdn.com/sites/www.olta.org/resource/resmgr/pdf/06-nitschke.pdf
[ii] 11 U.S.C. § 365(a).
[iii] 11 U.S.C. §§ 365(a), 541(c).
[iv] 11 U.S.C. § 502(g).
[v] 11 U.S.C. §§ 365(g), 502(g).
[vi] https://www.thompsoncoburn.com/insights/blogs/credit-report/post/2013-09-17/receivership-reforms-part-three-creditors-rights-and-priority-of-claims
[vii] *Id*.
[viii] 11 U.S.C. § 362.
[ix] https://www.thompsoncoburn.com/insights/blogs/credit-report/post/2013-09-17/receivership-reforms-part-three-creditors-rights-and-priority-of-claims
[x] *Id*.
[xi] *Id*.
[xii] *See* 11 U.S.C. § 541(a) ("a bankruptcy case creates an estate of property wherever located and by whomever held").
[xiii] Strategic Alternatives For and Against Distressed Businesses, *Significant Pro and Cons of Receivership from Various* Perspectives, Jonathan P. Friedland
[xiv] 11 U.S.C. § 727(a)(1).
[xv] 11 U.S.C. § 1141(d)(1).
[xvi] 11 U.S.C. § 1141(d)(3)
[xvii] 11 U.S.C. § 1141(d)(1)(A).
[xviii] *Id*.
[xix] 11 U.S.C. § 363(f).
[xx] *Id*.
[xxi] https://graydon.law/ohios-new-receivership-law/
[xxii] *Id*.
[xxiii] See ORC Chapter 2735.04(D)(1-10).

"Small Business Debtor" v. Small Business: Round Pegs in Square Holes

American Bankruptcy Institute
25th Annual Central States Bankruptcy Workshop
Lake Geneva, Wisconsin

June 8, 2018

David K. Welch, Esq.
Burke, Warren, MacKay & Serritella, P.C.
330 N. Wabash Ave., Suite 2100
Chicago, Illinois 60611

"Small Business Debtor" v. Small Business: Round Pegs in Square Holes[1]

David K. Welch
BURKE, WARREN, MACKAY & SERRITELLA, P.C.
American Bankruptcy Institute
25th Annual Central States Bankruptcy Workshop
Lake Geneva, Wisconsin
June 8, 2018

INTRODUCTION

This outline proceeds in four parts. The first part provides an overview of the types of business debtors that seek to reorganize or liquidate under chapter 11. The second part identifies shortcomings in the current chapter 11 restructuring process for small business debtors. The third part notes attempts to reform the system to better accommodate small business debtors. The final part sets forth considerations counsel should keep in mind when representing small businesses in chapter 11 cases.

I. OVERVIEW

A. The Small Business Debtor vs. The Small Business

1. The "small business debtor" is typically nothing more than a corporate chapter 13 debtor. 11 U.S.C. § 101(51)(C) and (D).

2. The overwhelming number of small businesses are much more than corporate chapter 13 debtors.

3. The focus should be on providing statutory relief to small businesses not just "small business debtors" in "small business cases."

B. Chapter 11 Commercial Filings

1. 2017 & 2016—A total of 11,191 commercial chapter 11 filings

   a. 2016: 5,447 filings
   b. 2017: 5,744 filings

---

[1] Many thanks are extended to my dedicated associates, Brian P. Welch and R. Jacob Jumbeck, for their enormous support and assistance in preparing these materials.

2. What types of companies are filing chapter 11 cases?[2]

   a. Companies with assets over $100,000,000?

      i. 7 companies—i.e., 1.1%

   b. Companies with assets between $10,000,001–$100,000,000?

      i. 48 companies—i.e., 7.5%

   c. Companies with assets between $0–$10,000,000?

      i. 584 companies—i.e., 91.4%.
      ii. *See also* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J.L. & ECON. 381, 386–87 (2007) (finding that in a sample size of debtors from the Northern District of Illinois, 75 percent of debtors had debt under $2 million and 77 percent had fewer than 20 employees).

C. Who Are the 91.4%?

- *Small- to Medium-Sized Businesses*

   a. These businesses tend to share at least three (3) common characteristics:

      i. Closely held;
      ii. Simple capital structure; and
      iii. Fewer than 500 employees

   b. According to the United States Small Business Administration, employers with less than 500 employees represent 99.7% of all United States businesses. *See* U.S. SMALL BUS. ADMIN. OFFICE OF ADVOCACY, *Frequently Asked Questions* (June 2016) ("SBA-FAQ" 2), http://www.sba.gov/advo/stats.

II. ISSUES WITH THE CURRENT CHAPTER 11 PROCESS FOR SMALL, CLOSELY HELD BUSINESSES

"Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply

[2] This data comes from the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 report, which consisted of a sample size of 690 debtors taken from 2007. *See* COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 277.

liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender."

– COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 277 (quoting *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013)).

A. Bankruptcy can be *EXPENSIVE*

1. Professional fees as an example

   a. the mean chapter 11 case lasts for 437 days. *See* Stephen J. Lubben, *Corporate Reorganization & Professional Fees*, 82 AM. BANKR. L.J. 77, 95 (2008).

   b. studies have indicated that debtors' lead counsel alone can bill an average of 1,725.5 hours per case. *Id.* at 98.

   c. in these cases, the mean hourly rate charged the debtor's counsel was $290.54. *Id.*

   d. the average chapter 11 lead counsel alone billed their client $501,326.77 per case, at an average cost of roughly $1,147.20 per day. *Id.*

2. Other large costs associated with additional administrative expenses, motion practice, creditors' committees, and conversion. *See, e.g.*, NAT'L BANKR. CONFERENCE, *A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize*, NORTON BANKR. L. ADVISER (Thomson Reuters, Saint Paul, Minn.), Feb. 2010, Westlaw, 2010 No. 2 Norton Bankr. L. Adviser 1 (noting that in a study that analyzed filings between 1995 and 2001 in the Southern District of New York and the District of Arizona, creditors holding non-priority unsecured claims recovered nothing from firms with assets (at filing) under $200,000 and around 3% of their claims from firms with assets under $2 million); Stephen J. Lubben, *What We "Know" About Chapter 11 Cost Is Wrong*, 17 FORDHAM J. CORP. & FIN. L. 141 (2012) (reviewing literature and presenting empirical data to contradict common perceptions of bankruptcy costs); *Oral Testimony of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 36 (Apr. 19, 2013) (ASM Transcript) (describing how the DIP budget for professionals' fees has ballooned and noting that such costs keep small businesses out of chapter 11).

B. Reporting Requirements

1. SEC-style disclosure requirements in normal cases.

2. Can strain a small, closely held debtor that often do not keep records that contain the type of detail required in chapter 11 proceedings.

3. Additional reporting requirements typically required when using cash collateral or borrowing from a secured lender can overwhelm the debtor both financially and administratively.

C. Financing and Cash Flow

1. Small businesses have limited access to capital

   a. Most banks are unwilling to make loans to small businesses in any amount. Most lenders target borrowers with borrowing needs of $10m or more, while most small businesses need only a fraction of this amount. Simply put, the traditional loan market does not exist for a small business.

   b. Furthermore, small business debtors have little bargaining power in negotiating terms for postpetition financing.

      - Small business debtors often agree to terms that substantially favor the lender as a condition to the lender's consent to a new loan. These terms include:

        i. Waivers of claims and defenses
        ii. Releases,
        iii. Binding acknowledgments,
        iv. Liens on unencumbered assets
        v. Excessive fees; higher interest rates;
        vi. Expansive default triggers that are tied to performance in the chapter 11 case and the implementation of a chapter 11 exit strategy;
        vii. Extensive collateral and financial reporting often due on a daily and/or weekly basis.

2. Use of Cash Collateral or better referred to as "Banking Yourself"

   - Basic Premise: collect the cash, control the cash, control the case. While nothing in the Bankruptcy Code requires a lender to lend, Section 363 of the Bankruptcy Code authorizes a debtor's use of cash collateral by consent of the lender and/or further order of court.

a. "Cash collateral" is defined as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest.

b. Use the income a business generates during bankruptcy to finance a case while at the same time adequately protecting any secured interest in the cash collateral.

c. Allows the debtor to have more leverage and flexibility in the proceedings as well as avoid the pitfalls of a borrowing order.

d. Increased likelihood of recoveries by unsecured creditors when using cash collateral.

D. Business Owner and Employee Issues

1. Roles the business owners play

a. In a small business, officers and directors tend to be the major stakeholders in the company. Moreover, the same business owners tend to wear many hats—owner, operator, secured creditor, unsecured creditor, landlord, etc.

b. Often becomes a question of lines being blurred between the roles these individuals play and in what capacity.

2. Personal Obligations of the Small Business Owner.

a. Lenders often require small business owners to personally guaranty the debt and/or pledge additional collateral.

b. Tax issues as well – be careful of potential tax consequences of various transactions.

c. Never borrow from the IRS or the Union as this can be the most expensive cash that may have non-dischargeability aspects.

E. The "Small Business" Election Hindering Rather Than Helping

1. Background

a. Prior Amendments to the Bankruptcy Code: 1994 & 2005

i. The Bankruptcy Reform Act of 1994 created a new type of bankruptcy reorganization, within the existing Chapter 11 of

the Bankruptcy Code, for "small business" debtors. *See* Bankruptcy Reform Act of 1994, H.R. 5116, 103d Cong. § 217(a), 108 Stat. 4106, 4127 (1994).

ii. Congress refined these reforms in the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which added additional small business protections. *See* Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 AM. BANKR. L.J. 645, 667 (2005) (providing an intricate analysis of the small business reforms in BAPCPA).

b. Included in BAPCPA was a definition of "small business debtor."

i. These are debtors with, among other characteristics, debts (secured and unsecured) totaling no more than $2,566,050 and with a primary activity other than real estate ownership or operation. *See* 11 U.S.C. § 101(51D) (2018).

c. Goal of the Reforms

i. Improving the plan confirmation and performance rates of these cases.

ii. Specific and shortened deadlines for plan proposal and confirmation.

iii. Lessen the costs of a small business reorganization.

2.Specific Amendments

a. Increased Trustee Duties

i. Conducting an initial debtor interview before the first § 341 meeting, 28 U.S.C. § 586(a)(7)(A);

ii. Visiting the appropriate business premises and viewing the state of the books and records under certain circumstances, *id.*; and

iii. Reviewing and monitoring the debtor's activities to identify whether a plan will be forthcoming, *id.*

b. Increased Debtor Duties

i. Filing financial information with the petition that other Chapter 11 businesses are not required to file—e.g., The small business debtor must file a recent balance sheet, statement of operations, cash-flow statement, and federal income tax return or a statement that such documents do not exist, either with the petition or within seven days of the filing of the petition, see 11 U.S.C. § 1116(1);

ii. Being eligible only for a 30-day extension of time to file schedules and a statement of affairs,

iii. Making senior management available for meetings scheduled by the court or the U.S. Trustee, and

iv. Allowing the U.S. Trustee to inspect the debtor's business premises and books and records on reasonable notice

c. Shortened Deadlines

i. The exclusive period to file a plan for small business debtors has been shortened to 180 days, and a plan must be filed within 300 days of the filing of the petition. *See* 11 U.S.C. § 1121(e).

ii. Plans may now serve as disclosure statements, and the plans themselves may be on forms approved by the court or adopted nationally pursuant to federal rulemaking authority. *See* 28 U.S.C. § 2075; 11 U.S.C. § 1125(f).

iii. Even the court has been directed to keep the small business debtor on a fast track by requiring that a confirmable plan for a small business debtor be confirmed within 45 days of its filing. *See* 11 U.S.C. § 1129(e).

3. Are these changes effective?

a. Consensus: **NO—ESPECIALLY SHORTENING DEADLNES IS NOT THE SOLUTION**

- Shortened deadlines, for example, squeezes the debtors and courts often require strict compliance.

b. There needs to be other options. The shortening of deadlines does not necessarily equate to a savings.

III. ATTEMPTS AT REFORM

A. Numerous authors and organizations have attempted to reform the ways in which small businesses are treated in bankruptcy, varying from

1. small amendments to the Code's definitions, *see, e.g.*, Anne Lawton, *An Argument for Simplifying the Code's "Small Business Debtor" Definition*, 21 AM. BANKR. INST. L. REV. 55, 55 (2013),

2. adding wholesale new chapters to the Code, *see, e.g.*, Robert J. Keach, *Committee on the Judiciary Subcommittee on Oversight, Agency Action, Federal Rights and Federal Courts, United States Senate, "Small Business Bankruptcy: Assessing the System"* (Mar. 7, 2018) (proposing to add Chapter 10 to the Code specifically for small and medium sized entities),[3] and

3. Everything in between, *see, e.g.*, NAT'L BANKR. CONFERENCE, *A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize*, NORTON BANKR. L. ADVISER (Thomson Reuters, Saint Paul, Minn.), Feb. 2010, Westlaw, 2010 No. 2 Norton Bankr. L. Adviser 1.

IV. CONSIDERATIONS WHEN REPRESENTING SMALL BUSINESSES

A. Fees; Fee Management

B. Cash Collateral Usage vs. Borrowing

1. Prepare short-term and long-term cash flow projections including key assumptions

2. Organize adequate protection argument

3. Offer additional collateral

4. Use the benefits of *Timbers*,[4] *Addison Properties*,[5] and other such cases in developing cash collateral budgets, theories and arguments.

C. Develop Strategy to Protect Guarantors

1. Have guarantors hire counsel immediately.

---

[3] As of the preparation of these materials, this proposed legislation was still pending.

[4] *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988).

[5] *In re Addison Props. Ltd. P'ship*, 185 B.R. 766 (Bankr. N.D. Ill. 1995).

2. *Caesars*[6] injunction?

D. Analyze and Understand Claims

1. Find your friendly creditors and your support

2. Tackle objections early

E. Formulate Exit Strategy Options at Inception of Case

1. Recognize reorganization strengths and weaknesses

2. New value issues

3. Timing considerations for implementation of exit strategy

4. Cooperation of professionals for term pay-out of allowed administrative claims as of confirmation.

CONCLUSION

Small businesses comprise the vast majority of the chapter 11 cases that are being filed. Yet, the requirements of a reorganization case do not recognize the needs and limitations of a small business. Serious revisions to the small business case statutes should be enacted to make relief for the small business debtors more affordable and more effective.

[6] *Caesars Entm't Operating Co., Inc. v. BOKF, N.A.* (*In re Caesars Entm't Operating Co., Inc.*), 808 F.3d 1186 (7th Cir. 2015) (holding that when a movant seeks a third-party injunction against lawsuits attending a bankruptcy proceeding, the movant only needs to establish two things: (1) a likelihood of success on the merits—i.e., that staying the third-party action will enhance the prospects of a *successful* reorganization; and (2) that granting the injunction serves the public interest—i.e., the interest in successful reorganizations). On remand in the bankruptcy court, Judge Goldgar applied the standard the Seventh Circuit Court of Appeals articulated and granted the debtor's motion for a third-party injunction. *See Caesars Entm't Operating Co., Inc. v. BOKF, N.A.* (*In re Caesars Entm't Operating Co., Inc.*), 561 B.R. 441, 449–57 (Bankr. N.D. Ill. 2016).