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LIMITED LIABILITY COMPANIES AND THE CURRENT STATUS OF BANKRUPTCY ISSUES

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I. Background and Characteristics of LLCs

A. What are they and how are they different from corporations and partnerships?

A Limited Liability Company ("LLC") is a hybrid entity created by statute that is a cross between a corporation and a partnership. LLCs are generally intended to provide limited liability to its equity holders (like a corporation) and, at the same time, offer the advantages of one level of tax (like a partnership) without the restrictions placed on S corporations. LLC's came to be largely because businesses were looking for a tax efficient vehicle, without the formal governance requirements of a corporation, like mandatory board meetings, but with the limited liability afforded to the equity owners of corporations. LLCs may just have one member or multiple members. Some jurisdictions permit "Series LLCs" to be formed within the LLC itself to allow LLCs to insulate liabilities and obligations *vis a vis* each series.

1. Formation. LLCs are generally formed once one or more persons agree to form an LLC and file a certificate of formation (Delaware) or Articles of Organization (California). This document is generally only one page and generally may be signed and filed by an "authorized person" who does **not** need to be one of the Members (see for example, 6. Del. C. §18-201; Cal. Corp. Code §17702.01). In California, the Secretary of State has prescribed the form on which the Articles are to be prepared (Sec. of State Form LLC-1). The California Articles of Organization look similar to the Certificates of Limited Partnership filed in California to form limited partnerships.

2. Operation. The internal affairs of the LLC are governed by an operating agreement. In some jurisdictions, such as Delaware, the operating agreement is referred to as a limited liability company agreement. Generally, members will prefer to memorialize their governance rights, obligations and economic arrangement in a written operating agreement, though in most jurisdictions some or all of the terms of an operating agreement may be oral. To the extent members do not address all of the internal affairs of an LLC, a state LLC act will fill in the gaps. Because LLC acts can fill in the gaps and prescribe the entire rights and obligations of members when no operating agreement is in place, LLC acts are known as "default" statutes. The operating agreement often looks much like a limited partnership agreement except that Partners are referred to as "members" and in lieu of general partners, the LLC has "managers." Unlike the general partner of a limited partnership, the manager need not own an interest in the LLC. An LLC can be either "member-managed," where all of the members are involved in management decisions (much like a general partnership), or "manager-managed," where management responsibilities are delegated to fewer than all of the members. Members who wish to form LLCs with centralized management like a corporation will often create manager-managed operating agreements where the managers may be referred to as directors.

3. Advantages and Disadvantages as compared to corporations and partnerships.

a. LLCs v. Corporations. The advantages of LLCs over "C" corporations include: (i) permission of simple governance structures without formal board meetings; (ii) in many jurisdictions, the right to modify or even eliminate fiduciary duties where such duties may not be modified or eliminated in the corporate context; (iii) no corporate-level tax; (iv) ability to specially allocate profits and losses; (v) no double-tax on liquidation; (vi) property with "debt in excess of basis" may be contributed to an LLC and can be structured to avoid gain recognition (See IRC §§ 731 and 752) – which is not the case with corporations (IRC § 357(c); (vii) a person contributing appreciated assets to an LLC in exchange for membership interests is not required to recognize gain on the exchange (IRC § 721) - whereas a person who contributes appreciated property to a corporation in exchange for stock and who, together with other persons contributing property, does not own at least 80% of the capital stock of the corporation, must recognize gain on the exchange; (viii) stock for services is always taxable under §83 - receipt of an interest in an LLC for a profits interest is generally not taxable under Rev. Proc. 93-27, 1993-2 C.B. 343. As for advantages of LLCs over "S" Corporations, while S corporations enjoy limited liability and flow-through tax treatment (i.e., one level of tax), S corporations are subject to a number of burdensome restrictions. Further, the pass-through tax treatment of S corporations is neither as flexible nor as advantageous as the pass-through tax treatment of partnerships. For example, the distribution of appreciated property from a partnership to a partner is generally not subject to income tax, whereas the appreciation on property distributed from an S corporation to its shareholders with respect to S corporation stock will generally be subject to tax. The disadvantages of LLCs as compared to corporations include (x) the Partnership tax rules of Subchapter K are far more complex than the tax rules for S and C corporations; (y) corporate "reorganizations" within the meaning of §368(a) do not include partnerships or LLCs - only corporations may be reorganized tax-free under § 368; and (z) the tax benefits of "Qualified Small Business Stock" does not apply to LLC interests.

b. LLCs v. Partnerships. Although limited partners of a limited partnership have limited liability and pass-through tax advantages, under most limited partnership acts, limited partners may jeopardize their limited liability by participating in the control of the business of the partnership. Members of an LLC, on the other hand, are permitted to be active in the LLC's business while retaining limited liability. Unlike limited partners, general partners of a limited partnership are subject to unlimited liability. Under the LLC statutes, no member is required to have the general liability of a general partner. Although corporate entities may be used as a general partner to insulate the shareholders of a corporate general partner from liability, this structure is cumbersome and expensive (one more entity with a tax return and a minimum franchise tax). Members of an LLC are not automatically classified as limited partners under the passive loss rules and they are not necessarily treated as holders of securities for purposes of Federal Securities Laws. Unlike general partnerships, members of an LLC are not jointly and severally or unlimitedly liable for partnership liabilities. However, members of professional LLCs would remain liable for their own negligence and may, depending upon the state's laws governing the profession, be liable for the negligence of fellow members.

B. Basic Characteristics of LLC Statutes

1. Formation – Certificate of Formation or Articles of Organization. LLCs are formed by filing a Certificate of Formation or Articles of Organization with the Secretary of State. The Articles generally must state (a) name (which must include "limited liability company" or an abbreviation thereof); (b) purpose; (c) address of registered agent; and (d) the managers, if any. The California Revised Uniform Limited Liability Company Act (the "California LLC Act") requires the LLC to state if it is one manager-managed, manager-managed, or member-managed.

2. Operations -- Operating Agreements. The operating agreement, like a partnership agreement, sets forth the business relationship among the members and their rights and obligations. Most members who form LLCs will enter into an operating agreement to describe how the LLC will be managed and how the profits and losses will be shared and when distributed. It may be written or oral, although some states require it in writing and some states require certain provisions to be in writing (see, for example, Cal. Corp. Code §17704.04 requiring to be in writing a right to receive a distribution on dissociation and §17704.10(e) requiring any modification of fiduciary duties to be in writing). Most current statutes permit the operating agreement to override many of the statutory provisions.

a. In some states, the operating agreement may provide for the election of officers.

b. The California LLC Act permits oral operating agreements, but requires certain "default" provisions to be modified in writing only. (see, for example, Cal. Corp. Code § 17701.10(e) that permits the modification of fiduciary duties only in a written operating agreement with informed consent of the members.) Many LLC acts provide that certain fundamental rights of members, such as rights to information about the LLC, voting rights on a merger or dissolution of the LLC, dissenters' rights, etc., cannot be eliminated or varied, except to the extent expressly provided in the statute and only in the articles of organization or a written operating agreement. Not all states provide for "appraisal rights" or "dissenters' rights" in a merger.

3. Management. LLCs are operated either by the owner members (like a partnership) or managers, elected by the members, who themselves may be members. Many LLC

statutes cover the election, removal and resignation of managers; duties of managers and members (when acting as a manager); authority to appoint officers; indemnification of managers, members, etc.; voting by managers; and agency power of members (i.e., apparent authority).

a. Some LLC statutes address the fiduciary duty of members to the others while some states do not. Fiduciary duties fall into two general categories: (1) duty of loyalty and (2) duty of care.

b. Under California's LLC Act, managers owe the LLC and its members the fiduciary duties of loyalty and care. Members owe the same fiduciary duties in a member-managed LLC, but a member who is not a manager of a manager managed LLC does not have any fiduciary duty merely by being a member of the LLC. Cal. Corp. Code §17704.09.

4. <u>Finance, Distributions and Withdrawals</u>. All states permit the members to create their own financial terms. Withdrawals are often limited subject to creditors' rights.

5. <u>Assignment of Interests</u>. While the economic rights of LLC interests are generally freely transferable by statute, most operating agreements restrict the free transferability of such interests. Further, most state statutes, while permitting the right to transfer the economic rights of LLC interests, do not bestow on the assignee other rights and powers of a member, like voting rights, access to books and records or the right to require managers to act in a fiduciary manner. Some jurisdictions restrict judgment creditors' rights to foreclose on a membership interest.[1] Some states, like California, will permit the foreclosure and sale of an LLC interest after a showing that distributions under a charging order would not pay the judgment debt within a reasonable time (Cal. Corp. Code §17705.03(b)). Such foreclosure, however, does not generally substitute the assignee as a member other than the right to receive distributions. The member rights are retained by the original member.

6. <u>Dissolution</u>. An LLC normally dissolves at the expiration of a term, an event of dissolution specified in an operating agreement, or a majority vote (or greater percentage set forth in the operating agreement) of the members. Certificates of dissolution generally must be filed.

7. <u>Miscellaneous</u>.

a. Some states, **unlike** California with some exceptions, provide for professional LLCs.

b. Foreign LLCs are generally permitted (i.e., an LLC formed in Delaware may operate to do business in South Carolina). However, not all states permit non-U.S. LLCs to be governed by state LLC legislation. Most state statutes provide that the law of the state of the LLC's formation governs its internal affairs and the authority of its members and managers and the liability of a member as member and a manager as manager for the debts, obligations or other liabilities of the LLC. This is important because the law of the states vary as to what, if any,

[1] See for example Section 18-703(d) of the Delaware LLC Act provides: "The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest and attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member."

fiduciary duties are owed or can be modified or eliminated and when members can be liable for the debts of creditors.

c. "Series LLC" is the term used to describe a form of entity with internal funds, portfolios, cells, or divisions, each of which may have separate members, managers, assets and liabilities, and business purpose or investment objectives. The principal distinguishing characteristic is the internal liability shield for each series of the Series LLC.

C. Tax Classification of Limited Liability Companies

Generally, Limited Liability Companies are taxed as partnerships for federal income tax purposes when there are two or more members and as a "disregarded entity" (i.e., ignored for tax purposes) when there is just one member. Alternatively, Limited Liability Companies may file IRS Form 8832 and "check-the-box" to be treated as an association, taxable as a corporation for federal income tax purposes. The taxation of LLCs was not always that straight-forward.

1. Background. Until January 1, 1997, the federal income tax treatment of an unincorporated organization rested on whether the organization contained a certain number of corporate characteristics. Treasury Regulation § 301.7701-2 (prior to January 1, 1997) provided that if an unincorporated organization has "associates" and an objective to carry on business and divide the gains, the organization must lack at least two of the following four corporate characteristics to be classified as a Partnership for federal income tax purposes: (i) continuity of life; (ii) centralized management; (iii) limited liability; and (iv) free transferability of interests. In numerous Revenue rulings and private letter rulings over the past many years, the Service has applied the entity classification criteria of Treasury Regulation § 301.7701-2 and classified Limited Partnerships organized under various state statutes as partnerships for federal income tax purposes depending, in some cases, on how they were organized. To reduce the Service's burden issuing Revenue Rulings for every state on the classification of partnerships every time a state modified its limited partnership act, the Service promulgated Rev. Proc. 89-12, 1989-1 CB, 798 (which was later supplemented by Rev. Proc. 92-33) setting forth the rules for rulings on the classification of limited partnerships.

2. Limited Liability Companies. In 1988, the Service issued Rev. Rule 88-76 holding that an LLC formed under the laws of the state of Wyoming lacked the corporate characteristics of free transferability of interests and continuity of life and, accordingly, would be taxed as a partnership. This ruling opened the floodgate to other states revising their laws to permit the formation and operation of LLCs. By the middle of 1996, every state and the District of Columbia had enacted LLC enabling statutes. California's LLC statute became effective September 30, 1994.

3. Rev. Proc. 95-10. In late 1994, the Service released Rev. Proc. 95-10, setting forth rules for rulings on the classification of limited liability companies. The Revenue procedure was based in large part on the principles of Rev. Proc. 89-12 and relaxed the classification rules for LLCs. The Service's guidance with respect to classification relied on member/manager distinctions and created a new concept known as "member-managers". Generally, if member-managers had a large enough interest in the LLC, the LLC would lack the corporate characteristics of centralized management.

4. Check-The-Box Regulations. On December 18, 1996, the Treasury released Final Regulations which, effective as of January 1, 1997, replaced the then existing regulations for classifying certain business organizations (the "Old Regs") with an elective regime TD 8697, December 18, 1996. Under the Old Regs, the tax classification of an unincorporated entity was formalistic and was based on the historical differences under local law between partnerships and corporations. The check-the-box regulations are much simpler and adopt an elective approach. Under the check-the-box regulations, certain unincorporated organizations, referred to in the regulations as "eligible entities", which include domestic limited partnerships and LLCs, will automatically be treated as partnerships for federal income tax purposes unless an affirmative election is made to the contrary. Treas. Reg. § 301.7701-3. The regulations permit eligible entities to elect to be classified other than as a partnership or change their classification by filing IRS form 8832.

a. Check the Box for Eligible entities — Regulation § 301.7701-3.

(1) Generally. Any business entity that is not required to be treated as a corporation for federal tax purposes (referred to as an "eligible entity") may choose its classification under the Regulations. Generally, an eligible entity, such as a domestic LLC or LP, with at least two members can be classified as either a partnership or an association taxable as a corporation, and an eligible entity with a single member can be classified as an association or can be disregarded as an entity separate from its owner (e.g. sole proprietorship if the member is an individual, or a division if the member is a corporation).

(2) Default Classification. Unless the entity elects otherwise, a domestic eligible entity such as a limited partnership or LLC formed in the United States or District of Columbia, is classified as a partnership if it has two or more members or disregarded as an entity if it has a single owner. A foreign eligible entity, unless it elects otherwise, is treated as a partnership if it has two or more members and at least one member does not have limited liability, or disregarded if it has a single owner that does not have limited liability (as defined in the Regulation).

(3) Elections. An eligible entity may elect to be classified other than as provided under the default classification provisions, or change its classification, by filing IRS Form 8832, Entity Classification Election, with the Service Center designated on the Form.

D. Manager Managed v. Member Managed – Fiduciary Duties and Authority.

LLCs can be governed in many different ways. For example, it can be much like a general partnership where two individuals manage the enterprise together and make all decisions on behalf of the LLC (member-managed). It can be much like a limited partnership where, for example, a member provides the needed capital to an organization and takes on a passive role, where another member manages the day to day affairs of the LLC and makes all decisions (manager-managed). An LLC can be much like a corporation with centralized management where the members delegate the policy decisions to a board of managers (manager-managed). The distinction between manager managed and member managed LLCs is important as it often determines who owes fiduciary duties to the other and who has the authority (apparent or otherwise) to bind the LLC.

1. Member-Managed. Generally, a member-managed LLC provides for the members to manage the LLC's day-to-day affairs. Generally every member is an agent of the LLC for the purpose of its business and in many states will have the apparent authority to bind the LLC (see, for example, Cal. Corp. Code §17703.01(a)). Some states, like Delaware, do not recognize apparent authority and the operating agreement governs the binding effect of a member's action. Further, because Members have "agency" authority, most jurisdictions by statute or by common law will provide that the member has a fiduciary duty to the other members and the LLC. For example, under the California LLC Act, §17704.09 provides in pertinent part that a member owes fiduciary duties to the other members and the LLC and defines them as the duty of loyalty and the duty of care.

a. The California statute then provides that duty of loyalty "***is limited*** to the following:

(1) To account to a limited liability company and hold as trustee for it any property, profit, or benefit derived by the member in the conduct and winding up of the activities of a limited liability company or derived from a use by the member of a limited liability company property, including the appropriation of a limited liability company opportunity.

(2) To refrain from dealing with a limited liability company in the conduct or winding up of the activities of a limited liability company as or on behalf of a party having an interest adverse to a limited liability company.

(3) To refrain from competing with a limited liability company in the conduct or winding up of the activities of the limited liability company."

b. A member's duty of care is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct or a knowing violation of law.

c. The California LLC Act also provides that the member will discharge its duties and exercise its rights "consistent with the obligation of good faith and fair dealing."

d. While Cal. Corp. Code §17701.10 precludes an operating agreement from eliminating the "duty of loyalty, the duty of care, or any other fiduciary duty," an operating agreement may identify specific types of activities that do not violate the duty of loyalty as long as not "manifestly unreasonable." The duty of care may not be unreasonably reduced and the contractual obligation of good faith and fair dealing may not be eliminated but may prescribe standards by which performance is measured so long as not manifestly unreasonable.

2. Manager-Managed. Generally, a manager-managed LLC provides for the managers (who need not be members, but who often are) to manage the LLC's day-to-day affairs. In this case, the managers, and not the members, are agents of the LLC for the purpose of its business and will have the authority to bind the LLC. Managers of manager-managed LLCs will owe fiduciary duties to the members of the LLC. Under California LLC law, the managers' duties to the members are the same as the duties of a member of a member-managed LLC to its members described above. Members who are not managers will generally not owe fiduciary duties to the other members merely by reason of being a member of the LLC. That doesn't mean that a member

of a manager-managed LLC will never owe a fiduciary duty. As stated in the commentary to the Uniform Limited Liability Company Act (2006), as amended in 2013, whether a member has a fiduciary duty or not is not exclusively based on status and provides the following example to illustrate the point:

"EXAMPLE: Although a limited liability company is manager-managed, one member who is not a manager owns a controlling interest and effectively, albeit indirectly, controls the company's activities. A member owning a minority interest brings an action for dissolution under Section 701(a)(4)(C)(ii) (oppression by "the managers or those members in control of the company"). This paragraph does not prevent the court from construing the claim as alleging a breach of fiduciary duty by the controlling member."

3. Default Fiduciary Duties Under the Delaware LLC Act. Prior to 2012, most Delaware practitioners believed that "default" fiduciary duties of loyalty and care existed for Delaware LLCs (though the statute was silent), and a number of cases from the Delaware Court of Chancery assumed the existence of such default fiduciary duties.

a. Section 18-1101(c) of the LLC Act provides that to the extent at law or equity a member or manager has fiduciary duties, they may be expanded, restricted or eliminated in an LLC agreement.

b. In Gatz Properties, LLC v. Auriga Capital Corp., 59 A.3d 1206 (Del. 2012), the Delaware Supreme Court invited the Delaware legislature to address the issue of default fiduciary duties for LLCs. The legislature's response was an amendment to Section 18-1104 of the LLC Act to add the following: "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern." This amendment confirmed that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, under the equitable principals of agency law, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties.

E. Limitations on Distributions from an LLC.

As noted above, withdrawals or distributions are often limited to protect creditors' rights.

1. Limitations on Distributions under the Delaware LLC Act. § 18-607 Limitations on distribution:

> "(a) A limited liability company shall not make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their limited liability company interests and liabilities for which the recourse of creditors is limited to specified property of the limited liability company, exceed the fair value of the assets of the limited liability company, except that the fair value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the

assets of the limited liability company only to the extent that the fair value of that property exceeds that liability. For purposes of this subsection (a), the term "distribution" shall not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.

(b) A member who receives a distribution in violation of subsection (a) of this section, and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to a limited liability company for the amount of the distribution. A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution. Subject to subsection (c) of this section, this subsection shall not affect any obligation or liability of a member under an agreement or other applicable law for the amount of a distribution.

(c) Unless otherwise agreed, a member who receives a distribution from a limited liability company shall have no liability under this chapter or other applicable law for the amount of the distribution after the expiration of 3 years from the date of the distribution unless an action to recover the distribution from such member is commenced prior to the expiration of the said 3-year period and an adjudication of liability against such member is made in the said action."

2. Limitation on Distributions under the California LLC Act.

§17704.05:

"(a) A limited liability company shall not make a distribution if after the distribution either of the following applies:

(1) The limited liability company would not be able to pay its debts as they become due in the ordinary course of the limited liability company's activities.

(2) The limited liability company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the limited liability company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those of persons receiving the distribution.

(b) A limited liability company may base a determination that a distribution is not prohibited under subdivision (a) on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable under the circumstances.

(c) Except as otherwise provided in subdivision (f), the effect of a distribution under subdivision (a) is measured as follows:

(1) In the case of a distribution by purchase, redemption, or other acquisition of a transferable interest in the limited liability company, as of the date money or other property is transferred or debt incurred by the limited liability company.=

(2) In all other cases, as of the date the distribution is authorized, if the payment occurs within 120 days after that date, or the payment is made, if the payment occurs more than 120 days after the distribution is authorized.

(d) A limited liability company's indebtedness to a member incurred by reason of a distribution made in accordance with this section is at parity with the limited liability company's indebtedness to its general, unsecured creditors.

(e) A limited liability company's indebtedness, including indebtedness issued in connection with or as part of a distribution, is not a liability for purposes of subdivision (a) if the terms of the indebtedness provide that payment of principal and interest are made only to the extent that a distribution could be made to members under this section.

(f) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness is treated as a distribution, the effect of which is measured on the date the payment is made.

(g) In subdivision (f) of Section 17701.02, "distribution" does not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business under a bona fide retirement plan or other benefits program.

§17704.06:

"(a) Except as otherwise provided in subdivision (b), if a member of a member-managed limited liability company or manager of a manager-managed limited liability company consents to a distribution made in violation of Section 17704.05, the member or manager is personally liable to the limited liability company for the amount of the distribution that exceeds the amount that could have been distributed without the violation of Section 17704.05.

(b) To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of the authority and responsibility to consent to distributions and imposes that authority and responsibility on one or more other members, the liability stated in subdivision (a) applies to the other members and not the member that the operating agreement relieves of authority and responsibility.

(c) A person that receives a distribution knowing that the distribution to that person was made in violation of Section 17704.05 is personally liable to the limited liability company but only to the extent that the distribution received by the person exceeded the amount that could have been properly paid under Section 17704.05.

(d) A person against which an action is commenced because the person is liable under subdivision (a) may do all of the following:

(1) Implead any other person that is subject to liability under subdivision (a) and seek to compel contribution from the person.

(2) Implead any person that received a distribution in violation of subdivision (c) and seek to compel contribution from the person in the amount the person received in violation of subdivision (c).

(e) An action under this section is barred if not commenced within four years after the distribution."

II. Applying Bankruptcy Law to LLCs.[2]

A. Eligibility of an LLC to File a Bankruptcy Petition.

Title 11 of the United States Code (the "Bankruptcy Code") permits "persons" to file bankruptcy petitions, and the statutory definition of "person" includes "individual, partnership, and corporation." Bankruptcy Code § 101(41). Although an LLC is not a "partnership" in a state law sense, the Bankruptcy Code defines "corporation" to include:

> (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; [or]

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> (iv) unincorporated company or association;

Bankruptcy Code § 101(9)(A). For the purposes of determining an LLC's eligibility to file a bankruptcy petition, an LLC should be able to fit within either of the subsections cited above. It might be possible to argue with the characterization of an LLC as a corporation because § 101(9)(B) specifically excludes limited partnerships from the definition of corporations, but this distinction is unlikely to matter in any event. The definition of "person" lists individuals, partnerships and corporations as entities "included" within the definition, but is not so exclusive as to prevent another type of entity not listed in the statute from also being characterized by a court as a "person."

It is also worth observing that the classification of an LLC as a partnership or as a corporation for purposes of determining the applicability of the Bankruptcy Code should have little other effect on the disposition of a bankruptcy proceeding. Most of the provisions of the Bankruptcy Code that apply specifically to partnerships relate to issues, such as the liabilities of general partners, that are not likely to apply in an LLC context.

[2] A substantial portion of the remainder of this outline appeared previously in James J. Wheaton, *Current Status of Bankruptcy Issues*, American Law Institute Video Webcast, Limited Liability Entities 2016 Update, February 16, 2016.

The distinction between a "partnership" and a "partnership association" that fits within the Bankruptcy Code definition of "corporation" arose in In re Rambo Imaging, L.L.P., 2008 Bankr. LEXIS 2311 (Bankr. W.D. Tex. July 15, 2008). In that case, the bankrupt entity was a Texas general partnership that had elected limited liability partnership status. Although the partnership agreement described numerous actions that could be taken only with the approval of two-thirds of the holders of partnership units, and delegated other actions to the "Managing Partners," the agreement did not specifically address the power to put the partnership into bankruptcy. The partnership was clearly a general partnership, but the court engaged in an analysis of the limited liability of the partners, and relied on a treatise reference in Collier's, to conclude that an LLP should be treated as a "partnership association," and therefore a "corporation" for Bankruptcy Code definitional purposes. On that basis, the court held that a dissident general partner did not have the power to commence an involuntary bankruptcy proceeding on behalf of the partnership.

The court in In re Midpoint Development, L.L.C, 313 B.R. 486 (Bankr. W.D. Okla. 2004) noted the omission of LLCs from the Bankruptcy Code, and analogized to corporations and partnerships. In that case, the court held that even a limited liability company in dissolution is entitled to make a bankruptcy filing, because a dissolved LLC is still in the process of winding up, and the winding up process may be conducted through bankruptcy. However, this case was ultimately reversed by the Tenth Circuit because the bankrupt LLC had not only dissolved, but had actually filed articles of dissolution that became effective prior to the bankruptcy filing. On the effective date of the articles of dissolution, the Oklahoma LLC ceased to exist, and so could not later file for bankruptcy. See In re Midpoint Development, L.L.C., 466 F.3d 1201 (10^{th} Cir. 2006).

B. Authority to File a Bankruptcy Petition.

As a general proposition, state law determines who has the legal right to file a bankruptcy petition. With respect to general partnerships, the federal bankruptcy rules provide that a bankruptcy petition may be filed by any general partner, provided that all general partners consent, see Fed. Bankr. R. § 1004(a), but in corporate and other contexts, the power to file a petition will depend on the actual authority of those wishing to do so. The decision will usually rest with a corporation's board of directors, but in an LLC setting, the authority of managers is not as clear. State LLC statutes generally do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC's governing documents. If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC's managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

Most of the cases addressing the power to file a bankruptcy petition are divided into two categories: those that deal with the statutory power to initiate bankruptcy, and others that address whether a bankruptcy has been appropriately commenced given the terms of an LLC's governing documents or other agreements.

1. Statutory Power to File.

In In re A-Z Electronics LLC, 350 B.R. 886 (Bankr. D. Idaho 2006), a bankruptcy proceeding on behalf of an LLC had been commenced by the LLC's sole member, but the member was himself a debtor in a Chapter 7 bankruptcy case. On that basis, the court concluded that the member's bankruptcy trustee had the statutory status of the member, and therefore was the only person entitled to commence the bankruptcy case on behalf of the LLC. In In re Delta Starr Broadcasting, L.L.C., 2006 WL 285974 (E.D. La. Feb. 3, 2006), the court analyzed the Louisiana LLC statute and concluded that a bankruptcy petition should be likened to other major actions requiring majority approval of an LLC's members under that statute. Although the LLC had not undertaken formal procedures (including resolutions or a meeting) before initiating the LLC's bankruptcy, the court concluded that a majority of the members had unambiguously approved the filing, and that Louisiana law did not require "corporate" formalities in order for an LLC to take valid member action.

Two 2010 cases address the status of persons as members authorized to participate in the bankruptcy filing decision. In In re Wyatt & McAlister, PLLC, 2010 WL 1709920 (Bankr. S.D. Miss. Apr. 23, 2010), a member resigned as an employee of a professional limited liability company but preserved her ownership interest in the LLC. The court held that because she had not resigned and therefore remained a member, she was entitled to vote on whether to put the LLC into bankruptcy, and because she was a 50% member, the other member did not have authority to file the bankruptcy petition without her approval. In In re Lake County Grapevine Nursery Operations, 441 B.R. 653 (Bankr. N.D. Cal. 2010), a member that had pledged his entire membership interest and was in default on the underlying loan was found to have authority as a member because the pledge did not have the effect of acting to defease the member of his status as such without further action to confer membership status on the creditor.

A 2013 Virginia case applied the *ipso facto* provision of § 365 of the Bankruptcy Code to declare ineffective the Virginia LLC Act's bankruptcy dissociation provision and give effect to a filing, but this case dealt with the status of a member at the time of the filing, rather than the member's statutory power. In this case, the debtor's personal bankruptcy case had been dismissed, and the question was whether the LLC of which he was a member had a properly authorized bankruptcy petition, given that he may have ceased to be a member when his petition was filed. The court concluded that the debtor's approval of the LLC filing was valid because the debtor's non-economic interest in the LLC was the property of the estate because the *ipso facto* clause invalidated the effect of the operating agreement and the Virginia LLC act. However, having said that the *ipso facto* clause rendered those provisions invalid, as if the rights were never divested, the court then spoke of the rights as "revesting" in the debtor. See In re Virginia Broadband, LLC, 498 B.R. 90 (Bankr. W.D. Va. 2013). Contrast this case with in In re B&M Land and Livestock, LLC, 498 B.R. 262 (Bankr. D. Nev. 2013) (Chapter 7 debtor as the sole member of an LLC did not have power to file a Chapter 11 petition for the LLC).

2. Contractual Power to File.

The value of a contractual provision limiting the authority of managers or members to file a bankruptcy petition was made clear in In re Avalon Hotel Partners, LLC, 302 B.R. 377 (Bankr. D. Or. 2003). In this case, the operating agreement required 75% member approval for certain "Major Decisions." Although bankruptcy was not specifically listed as an event triggering the "Major Decision" clause, the court reached the conclusion that a bankruptcy filing was analogous to a conversion into another type of entity, and imposed the 75% requirement. However, it is preferable to anticipate bankruptcy more explicitly.

Courts have generally enforced explicit contractual provisions governing the right to file a bankruptcy case, including provisions that have been drafted to protect creditors. In In re Orchard at Hansen Park, LLC, 347 B.R. 822 (Bankr. N.D. Tex. 2006), the operating agreement required unanimous member consent for the filing of a voluntary bankruptcy case, and the court allowed a creditor to intervene and contest the authority of one of the members to file the petition. The court concluded that a creditor had standing to make that challenge, reviewed an operating agreement provision that required unanimous member vote, and concluded that without evidence of that vote, the filing member was without authority to file the bankruptcy petition on behalf of the LLC. Compare In re Telluride Income Growth Limited Partnership, 311 B.R. 585 (Bankr. D. Colo. 2004) (dissolved LLC serving as general partner of limited partnership was not eligible to initiate bankruptcy on behalf of limited partnership because limited partnership agreement provided for the termination of the LLC's status as general partner upon dissolution).

A Virginia bankruptcy case reached a similar result. In In Re Loudoun Heights, LLC, 2014 Bankr. LEXIS 2085 (Bankr. E.D. Va. June 26, 2014), the bankrupt LLC had two members, including another LLC with a 93% membership interest. However, prior to the bankruptcy filing, that LLC had been administratively terminated for failure to file its annual report and pay its annual fee, and therefore was deemed under the Virginia LLC Act to have dissociated as a member of the bankrupt LLC. The bankruptcy filing was authorized by the sole remaining member, and even though the other member LLC had been reinstated subsequent to the bankruptcy filing, the court refused to give that reinstatement effect for the purposes of determining whether the bankruptcy filing had been properly authorized at the time of the filing several months before.

Two cases also emphasize the importance of providing more explicitly for the possibility of an LLC's bankruptcy. In both cases, had the operating agreements been more explicit, the court's analysis would have been unnecessary. See In re 210 West Liberty Holdings, LLC, 2009 WL 1522047 (Bankr. N.D.W. Va May 29, 2009) (provision that "all decisions" be made by majority vote is sufficient to allow bankruptcy filing over member objection because the objecting member's approval was not necessary to constitute majority); In re Ice Oasis, LLC, 2008 WL 5753355 (Bankr. N.D. Cal. Nov. 7, 2008) (in two member LLC with 50/50 ownership, both members were required to approve the bankruptcy filing because the operating agreement provided for "all decisions" to be approved by a majority, and bankruptcy is not an ordinary course decision that may be approved by the managing member).

In two other cases, courts have enforced provisions that give lenders an explicit voice in the filing of a bankruptcy petition. In In re Global Ship Systems, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007), the operating agreement established the creditor as a "Class B shareholder," and the filing of a voluntary bankruptcy by the LLC required the consent of the Class B shareholder. This case actually involved the ruse of the LLC soliciting the filing of an involuntary case that it then failed to contest, but the court concluded that that end-run around the creditor's contractual rights as a member was inappropriate, and granted the creditor relief from the stay because the bankruptcy had been filed without its consent. In In re Green Power Kenansville, LLC, 2004 WL 5413067 (Bankr. E.D.N.C. Nov. 18, 2004), an LLC's sole member had assigned its interest in the LLC to a third party, which then commenced a bankruptcy petition on behalf of the LLC. The assignment violated a loan agreement, the voting of the interest by the assignee was contrary to a pledge agreement provision that allowed the creditor to vote all of the original member's interests upon a loan default, and the assertion of authority by the assignee apparently attempted to override an independent manager provision that effectively required lender consent to a bankruptcy filing by the LLC. The court enforced the independent manager provision, despite the fact that the assignee may not have had knowledge of the provision, on the basis that the assignee member was governed by the written operating agreement irrespective of knowledge. Because the assignee lacked power to file the petition, the court dismissed the bankruptcy case.

In In re Quad-C Funding LLC, 498 B.R. 135 (S.D.N.Y. 2013), a dissident LLC member challenged the filing of a Chapter 11 petition for the LLC on the basis that the requisite supermajority vote of members had not approved the filing. The other members of the LLC had circumvented the dissident member's effective veto right by raising additional capital and issuing additional LLC units that eliminated the dissident member's ability to block the filing. The dissident member asked the court to consider the validity of the issuance of the additional units (based on the lack of accredited investor status of the new investors), but the court concluded that in bankruptcy, it was not obligated to investigate the non-bankruptcy legal status of the voting rights of each LLC member.

3. Effect of Non-Bankruptcy Law.

State receivership law and other state remedies can also affect the way in which LLC laws interact with bankruptcy.

The court in In re Orchard Village Investments, LLC, 405 B.R. 341 (D. Ore. 2009) was required to consider whether non-bankruptcy state receivership law could be used to prevent the filing of a bankruptcy petition. Following the creation of the state receivership, the receiver was granted broad authority that arguably divested the members of the authority to file a bankruptcy petition. The LLC's operating agreement specifically denied the LLC's manager the authority to file a bankruptcy petition, and reserved that power to the members by majority consent. In this case, the disputed bankruptcy petition was filed by the manager, and ratified post-petition by the members. The court held the post-ratification approval sufficient under the operating agreement, and held that the state receivership proceeding could not trump the ability to file the federal bankruptcy petition.

4. Using Bankruptcy-Remote Techniques.

The effectiveness of creditor efforts to utilize bankruptcy-remote single purpose entities (SPEs) and contractual restrictions on bankruptcy filings to limit the ability of an LLC to file for bankruptcy requires careful drafting, and these techniques may not always be honored by courts confronted with them.

The creditors involved in In re Crossover Financial I, LLC, 477 B.R. 196 (Bankr. D. Colo. 2012) had extracted an agreement by the debtor LLC and its sole member pledging the member's interest and providing the creditors with voting rights by proxy in the event of default. However, the court concluded that the creditors exercising these rights simply became assignees or transferees under the Colorado LLC statute, and did not have the right to participate in management or otherwise to divest the sole member of his status as a member. For that reason, the sole member's adoption of a unanimous consent directing the filing of the LLC's bankruptcy petition was within the member's legal power.

Another case emphasizes the importance to creditors of carefully drafting provisions intended to cover bankruptcy filings. In In re General Growth Properties, Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009), several hundred SPEs had been established with "independent managers" who had the power to consent or withhold consent to a bankruptcy filing by each SPE. Before the bankruptcy petitions were filed against the ultimate parent and the numerous subsidiaries, the independent managers were discharged and replaced, in a manner that apparently complied with the provisions of the SPEs' operating agreements. Because the new independent managers arguably had more expertise than the prior independent managers, the court concluded that this maneuver could not be deemed to be in bad faith, and refused to dismiss the bankruptcy petitions on that basis.

The practical effect of a unanimity requirement was at issue in a dispute over the bankruptcy of a regional sports network, In re Houston Regional Sports Network, L.P., 2014 WL 554824 (Bankr. S.D. Tex. Feb. 12, 2014). In that case, the bankrupt limited partnership had an LLC general partner, and the general partner was controlled by four "directors". The directors represented differing interests and owners of the LLC, and certain decisions, including bankruptcy reorganization, required director unanimity. One of the directors argued that the bankruptcy petition should be dismissed because its unwillingness to reorganize the partnership rendered the proceeding fatal, but the court concluded that despite disclaimers of fiduciary duties in the limited partnership agreement, and the fact that the directors were one step removed as directors of a general partner, the directors all owed fiduciary duties to the limited partnership bankruptcy estate. Accordingly, the court refused to dismiss the proceeding because of its expectation that all the directors would take future actions consistent with their fiduciary duties to the debtor.

Two different bankruptcy courts rendered decisions in 2016 that had the effect of overriding operating agreement provisions that empowered a creditor or a nominee of a creditor to utilize a bankruptcy approval requirement to block a bankruptcy filing by a debtor LLC. In In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. D. Ill. 2016), the operating agreement had been amended, following a loan default by the Michigan LLC, to permit the lender to designate a "special member" of the LLC. The special member's consent was required in order to take certain actions, including the filing of a bankruptcy petition, and the amendment also purported to absolve the special member from considering any interests other than those of the creditor. In a somewhat convoluted decision, the court determined that the waiver of fiduciary duties was not valid under Michigan law, but nevertheless held that the purported elimination of fiduciary duties was fatal to the creditor's contractual approval right. On public policy grounds, the court upheld the validity of the bankruptcy filing. In re Intervention Energy Holdings, LLC, 2016 WL 3185576 (Bankr. D. Del. 2016), the court conducted a more extensive analysis of the public policy disfavoring waivers of the right to file bankruptcy, and treated as invalid an operating agreement provision that required unanimous member consent, where the Delaware LLC's lender had been admitted to the LLC and issued a single ownership unit. Without discussing whether the operating agreement at issue actually contained a waiver of fiduciary duties, the court focused on the absence of fiduciary duties as the basis for finding, again on public policy grounds, that the bankruptcy filing was valid. Interestingly, in both cases, the LLCs and their non-creditor members had failed even to consult the creditor members regarding the bankruptcy filings, so that the creditor members were not even given the opportunity to demonstrate that their participation in the bankruptcy filing decision was conducted in accordance with the kinds of fiduciary duties that would typically be expected to apply.

C. Venue.

In re Blixseth, 484 B.R. 360 (Bankr. App. 9th Cir. 2012), involved an involuntary bankruptcy petition filed by a state department of revenue. The debtor resided in the state of Washington, and owned interests in a Nevada LLC and a Nevada LLLP. The assets of these entities were in turn located outside Nevada. The question arose whether Nevada was the state in which the debtor's principal assets were located. The lower court concluded that the intangible entity interests should be deemed located in the debtor's state of residence (Washington), but the appeals court reversed that decision, concluding that having elected the benefit of Nevada's laws in establishing the entities, the interests in which constituted the principal bankruptcy assets, venue was proper in the state of formation of those entities. A dissent in the case asserted that the case was wrongly decided because it ignored the effect of Article 9 in specifying the situs of intangible property rights.

D. Effects of an LLC Bankruptcy Filing.

1. LLC Bankruptcy Filing as a Dissolution Event.

The LLC statutes do not define a bankruptcy filing by an LLC as an event of dissolution or dissociation, and so it is unnecessary to determine whether the winding-up process will be triggered by such a bankruptcy as a matter of state law.

2. Composition of the Bankruptcy Estate.

The "estate" of a bankrupt LLC will include "all legal or equitable interests" of the LLC as of the time of filing. Bankruptcy Code § 541(a). In addition to the LLC's property, these interests will include all rights of the LLC under an operating agreement to additional member contributions or required member loans.

In re KRSM Properties, LLC, 318 B.R. 712 (Bankr. App. 9th Cir. 2004), the court was confronted with a claim by the member-owners of a bankrupt LLC that they were entitled to challenge a creditor's attempt to recover tax payments made by the LLC on behalf of the individual owners. The members took the position that they were synonymous with the LLC, that their tax obligations were those of the LLC, and that the prior tax payments were properly made. The court correctly concluded that the status of the LLC as a pass-through entity did not vitiate the separateness of the LLC from its members, and concluded that the LLC's bankruptcy estate could attempt to claw back the prior tax payments.

In re Ealy, 307 B.R. 653 (Bankr. E.D. Ark. 2004), the court observed the general rule that the assets of an LLC are not equitably owned by its members, so that the bankruptcy estate of a member does not include the LLC's assets. However, in that case, the court found other equitable circumstances for treating the individual member as having an equitable interest in real estate nominally owned by the LLC.

3. Preferences.

Under Bankruptcy Code § 547(b)(4), the "insiders" of a debtor are subject to a one year preference period. Managers of an LLC are likely to be considered insiders of the LLC, and members in a member-managed LLC will probably have the same status. It is possible that investor members of an LLC that do not otherwise participate in the LLC's business might fall outside the "insider" preference period.

Although Section 101(31) of the Bankruptcy Code does not explicitly define managers and others in positions of management responsibility of an LLC as "insiders," the court in In re CEP Holdings, LLC, 2006 WL 3422665 (Bankr. N.D. Ohio Nov. 28, 2006) concluded that the statutory definition of officers of a corporation as corporate insiders should be "transferred" to determine insider status for an LLC. The court concluded that the title bestowed upon a potential insider would not be determinative, but that the appropriate test was the actual position and responsibility of the insider. Because managers and members with significant responsibilities may have the kind of relationship with an bankrupt LLC that would make their dealings with the LLC subject to scrutiny because of the possibility of non-arms-length transactions, it is likely that such persons will be presumed to have insider status for the purposes of evaluating potential preferences.

In In re Carr & Porter, LLC, 416 B.R. 239 (Bankr. E.D. Va. 2009), an attorney who owned the debtor law practice organized as an LLC sold his interest back to the Company. The debtor agreed to pay Porter $1 million in multiple payments over several years and accordingly made regular installment payments to Porter until the debtor LLC filed for bankruptcy. Trustee claimed that these payments were transfers to an insider in violation of Section 547(b) of the Bankruptcy Code and that Porter was required to turn over assets he received from the debtor. The court held that as a former member, Porter was not an insider within the meaning of Section 547(b) and granted summary judgment in his favor. Even though after the sale of his interest, Porter remained an important attorney with the debtor, was responsible for the debtor's most significant client and helped obtain a loan for the debtor, Porter relinquished all of his executive authority and no longer functioned in a managerial capacity. Therefore, payments made to Porter were not transfers to an insider and did not have to be turned over to the trustee. Interestingly, the trustee failed to pursue what should have been a more viable claim – that the debt was incurred and/or the payments made by the LLC "in respect of" an LLC interest at a time when such distributions were wrongful under Virginia's LLC statute.

4. Member or Creditor?

The court in In re Cybersight, LLC, 2004 WL 2713098 (D. Del. Nov. 17, 2004) addressed the status of a former member's claim to payment in respect of a membership interest. The former member had arbitrated the amount of his claim for the former interest, and reduced the arbitration award to judgment. The court concluded that notwithstanding the fact that the award related back to a prior equity interest in the LLC, the interest was properly viewed as a debt obligation of the debtor LLC, so that the former member was entitled to be treated as a general unsecured creditor.

A different result was reached by the court in In re Tristar Esperanza Properties, LLC, 488 B.R. 394 (Bankr. App. 9th Cir. 2013). In that case, the court concluded that the former member's arbitration award in respect of the former member's interest was required to be treated for bankruptcy purposes as a claim for damages arising from the purchase or sale of a security of the debtor or an affiliate of the debtor. Thus, the former member's claim was required to be subordinated to those of other creditors. This result was applied even though the former member had withdrawn three years prior to bankruptcy.

5. Applicability of Stay to Members.

In contrast to the partnership context, where a stay that extends to the property of individual partners may be appropriate in order to protect creditor access to the assets of the partners, it would not be appropriate for a stay to be made applicable to the members of an LLC. As a general proposition, the members and managers of an LLC are not liable, by reason of their status as such, for the obligations of the entity.

Courts have generally recognized the distinction between an LLC's assets and the assets of members, and have held that when one or the other files bankruptcy, the bankruptcy stay does not include the assets of the other. In In re Calhoun, 312 B.R. 380 (Bankr. N.D. Iowa 2004), the court noted that in a case involving an individual member bankruptcy, LLCs in which the debtor had an interest would not be subject to or protected by the provisions of the automatic stay. Similarly, in In re Resource Energy Technologies, LLC, 419 B.R. 746 (Bankr. W. D. Ky. 2010), the court concluded that discovery orders against the member of a bankrupt LLC did not violate the stay because the stay did not extend to the members, even though the orders obligated the members to obtain information from the LLC.

By contrast, in In re Saxby's Coffee Worldwide, LLC, 440 B.R. 369 (Bankr. E.D. Pa. 2009), the court issued an injunction to bar actions against the owners of the debtor LLC. At the time of its bankruptcy filing, seven lawsuits were pending against the debtor's members and entities owned by the debtor's members. The members filed a motion for preliminary injunction under Section 105 of the Bankruptcy Code to stop the defendants from prosecuting these actions. Although an automatic stay generally may not be invoked to protect non-debtors, Section 105 provides that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). Accordingly, the court held that in this case an injunction was warranted to stop actions against members of the LLC because their time, energy and commitment were necessary for the formulation of a reorganization plan, which would be jeopardized if the debtor's members had to defend themselves from pending lawsuits. However, the court refused to issue an injunction with respect to actions against entities owned by the debtor's members because these entities did not play a significant role in the operation of the debtor. See also In re Gander Partners LLC, 432 B.R. 721 (Bankr. N.D. Ill. 2010) (issuance of stay involving state law proceeding against guarantor in interest of the bankruptcy estate).

6. Agreement to Issue LLC Interest as an Executory Contract.

In In re Sandman Associates, L.L.C., 251 B.R. 473 (W.D. Va. 2000), a prospective member of an LLC entered into a letter agreement with the LLC to make a capital contribution in exchange for an interest. The letter contemplated that the new member would sign the operating agreement, but even though the contribution was made, the operating agreement was never signed. After the parties engaged in series of disputes, the LLC filed for bankruptcy in an effort to shed itself of the dissident contributor. The court concluded that the failure to sign the operating agreement was a technical matter that did not alter the fact that the performance obligations of the contributor under the letter agreement (i.e. the making of the contribution) had been satisfied. Because the performance had already occurred and the letter agreement did not contemplate any unperformed future acts, the letter was not an executory contract capable of being rejected by the bankrupt LLC.

7. Substantive Consolidation.

Two courts addressed the equitable doctrine of substantive consolidation in 2005. Substantive consolidation is often sought by bankrupt debtors that wish to include the assets of legally separate but related entities in the bankruptcy estate, or by creditors wishing to gain access to the assets of non-bankrupt but affiliated entities.

In In Re Brentwood Golf Club, LLC, 329 B.R. 802 (Bankr. E.D. Mich. 2005), the LLC operator of a golf course was the bankrupt, and its lender sought to be able to reach the assets of a separate LLC that operated the restaurant at the golf course. The court found that the bank could reach the assets of the restaurant LLC on both a piercing the corporate veil basis and under the doctrine of substantive consolidation. The court considered evidence that ownership of the restaurant assets had never been transferred from the golf course LLC to the restaurant LLC, that the two LLCs did not maintain separate bank accounts until after the bankruptcy petition was filed, that the lease to the restaurant LLC was at a substantially below-market rate (less than approximately fifty cents per square foot), that the restaurant LLC had failed to make rent payments or other payments required under the lease, that the financial records of the entities were "inextricably" intertwined, and that the reality of operations of the golf course made the restaurant and the course interdependent. The court found that the two entities met the requirements of Michigan's common law alter ego test. Although it was unnecessary to its decision, the court then proceeded to evaluate the substantive consolidation issue, and separately went through the substantive consolidation analysis under the second circuit's Augie/Restivo and the D.C. Circuit's Auto-Train tests. The court noted that substantive consolidation did not necessarily require it to find facts as plain as those that enabled it to apply the state law alter ego test, and concluded that substantive consolidation was appropriate under both standards.

In Re Owens Corning, 419 F.3d 195 (3d Cir. 2005) involved an attempt by bankrupt Owens Corning to force the substantive consolidation of its non-bankruptcy subsidiaries. One of the principal lenders had extended financing that was based on separate guaranties received from, among others, certain of Owens Corning's non-consolidated subsidiaries. The Third Circuit reversed the district court's holding that the entities should be substantively consolidated. The non-consolidated subsidiaries (both LLCs and corporations) had been maintained separately before the filing of the bankruptcy petition, and the evidence of commingling and lack of separateness was minimal. The court concluded that consolidation would be appropriate only if separateness of the entities had been disregarded prior to the filing of the bankruptcy petition, such that Owens

Corning's creditors knew the separation of the entities had broken down, or if the assets of the entities were so commingled that separating them after the filing of the petition would be prohibitive. The Third Circuit found that neither factor was present and also seemed troubled by the fact that substantive consolidation was being used "offensively" by the debtor in order to prefer certain creditors over others.

III. Bankruptcy of a Member.

A. Nature of a Bankrupt Member's Bankruptcy Estate.

As observed above, the bankruptcy estate of a debtor includes all of the debtor's legal or equitable interests as of the filing of the bankruptcy petition. In the many cases that have addressed the bankruptcy of a partnership's general partner, it has been observed that the partner's interest in the partnership consists of the partner's economic rights, the partner's management rights, and the partner's rights as a co-owner of partnership property. In re Cardinal Industries, Inc., 116 B.R. 964, 970-71 (Bankr. S.D. Ohio 1990). The concept of co-ownership of partnership property flows from sections 24 and 25 of the original Uniform Partnership Act, which specify that a partner holds partnership property as a tenant in partnership with the other partners.

Because the members of an LLC do not have any interest in an LLC's property, a member's bankruptcy estate will consist of the member's economic rights in the LLC (referred to in some statutes as the member's "distributional interest"), and the member's management rights in the LLC. See In re Garrison-Ashburn, L.C., 253 B.R. 700, 707-708 (E.D. Va. 2000) (bankruptcy estate includes both economic and non-economic rights in the LLC). A more extensive discussion of the distinction between economic and non-economic rights, and the extent to which they are affected by provisions of state law and operating agreements, is contained in subsections C and D below.

A different result was reached in In re Campbell, 475 B.R. 622 (Bankr. N.D. Ill. 2012), where the court found that although the rights of members of a member-managed LLC became part of the bankruptcy estate based on Illinois state law defining property rights, the status of one of the bankrupt members as the manager (as opposed to member-manager) of a manager-managed LLC was not a property right, so that the management rights could not be exercised by the trustee unless and until the trustee removed and replaced the manager in accordance with the operating agreement.

A unique situation was presented by In re Lee, 2015 WL 4724944 (S.D. Ind. Aug. 10, 2015), where the bankrupt[3] member had no economic interest in the LLC, but had majority voting rights. The court concluded that the voting rights constituted property of the estate, because the effect of that result would be to protect other economic benefits available to the debtor, including his continued status as the employed manager of the LLC, and his ability to award himself (by virtue of his majority vote) incentive and bonus payments.

B. Scope of Estate.

[3] The authors note that bankruptcy law specialists may prefer to use the word "debtor member" rather than "bankrupt member" to describe a member who has filed a bankruptcy petition. This outline was prepared by and originally for non-bankruptcy law specialists and the author's believe non-specialists might better understand a debtor member to be a bankrupt member when the term "bankrupt" member is used.

The contents of a bankrupt member's bankruptcy estate are also affected by pre-bankruptcy agreements and by the distinction between a member's rights in the member's membership interest from a possible interest in the underlying assets of the LLC.

1. Pre-Bankruptcy Restrictive Contracts.

In In re Weiss, 376 B.R. 867 (N.D. Ill. 2007), the debtor member was subject to operating agreements that prohibited a pledge or assignment of the member's interests without the consent of the LLCs' managers. Notwithstanding this restriction, the debtor pledged his interests in the LLCs to his creditors, and the creditors sought relief from the bankruptcy stay in the member's case on the basis that they were secured creditors. The court concluded that the interests were not subject to the security interests because the member had no legal right to make the pledges, and concluded that the security interests in the LLC interests were therefore unperfected because they could not attach to collateral that the debtor had no right to transfer.

2. Debtor's Interest in the LLC.

The separateness of an individual debtor from a related LLC, even where an LLC is a single-member LLC, was emphasized by the court in In re McCormick, 381 B.R. 594 (Bankr. S.D.N.Y. 2008). In that case, the debtor filed for individual relief under Chapter 13 of the Bankruptcy Code, and attempted to draw the single-member LLC of which he was the sole member into his individual bankruptcy case. The court concluded that the automatic stay that applied to the individual debtor would not apply to the LLC, and concluded that because an entity was not an eligible debtor under Chapter 13, the LLC could not be a co- or joint debtor with the bankrupt member under Chapter 13. A similar result occurred in In re Knefel, 2007 WL 2416535 (Bankr. E.D. Va. Aug. 17, 2007), in which the court concluded that a single-member LLC owned by the member debtor was not subject to the automatic stay that applied to the individual debtor.

Several other cases yielded similar results. In In re Aldape Telford Glazier, Inc., 410 B.R. 60 (Bankr. D. Ida. Jul. 23, 2009), a bankrupt corporation was the sole member of the non-bankrupt LLC and listed the assets of the LLC as its own assets in the corporation's bankruptcy petition schedules. The court held that the winding up of the LLC had not been completed (which would have involved the payment of the LLC's creditors and evidence of actual distribution to the member). The assets of the LLC could not be deemed to be the assets of the debtor because they had not been distributed to the debtor. Similarly, in In re Harder, 413 B.R. 827 (Bankr. D. Ore. 2009), the debtor requested that the court issue an injunction barring the creditors of numerous LLCs, in which the debtor was a member, from pursuing lawsuits against the LLCs. The debtor argued that an injunction was warranted under Section 105 of the Bankruptcy Code because without it, any plan of reorganization would be jeopardized. The court declined to order the injunction. First, the court emphasized that the real estate holdings of the LLCs were property of LLCs that were not in bankruptcy. They were not the debtor's property and the court needed to evaluate any prejudice to the debtor's reorganization, not to the LLCs' reorganization. Additionally, even though the debtor's rights in the LLCs would generally be a part of his estate and would be affected by any lawsuits against the LLCs, this was not such a case because the debtor had assigned his ownership interests in the LLC to a workout expert. Finally, issuing an injunction would unnecessarily prejudice the LLCs' creditors and would result in a greater harm to them than to the debtor. Substantially the same result was reached in In re Campbell, 475 B.R. 622 (Bankr. N.D. Ill. 2012), where the primary assets of an LLC owned by two bankrupt members were interests in other LLCs and a limited partnership. In this case, the court concluded that the interests of those entities were owned by the LLC, and not by the members, and therefore were not property of the bankruptcy estate.

Many cases involving an attempt to ignore the separateness of an LLC by drawing a non-bankrupt LLC's assets into a bankrupt member's LLC estate constitute efforts by the bankrupt to enlarge the bankruptcy estate, but In re Goreham, 2009 Bankr. LEXIS 2995 (Bankr. D. Neb. Sept. 16, 2009) involved a case in which a member successfully transferred assets away from his non-bankrupt LLC, to the detriment of creditors. The debtor was the sole member of an LLC that owned a piece of real estate. Within ninety days before the bankruptcy filing, the debtor caused the LLC to transfer the real estate to a corporation owned by the debtor's son. The court refused to set aside this transfer, holding that although the debtor's interest in the LLC was his personal property and thus property of his bankruptcy estate, the LLC's underlying property was not. The transfer made by the LLC could not be avoided as a preferential transfer under Section 547(b) because it was not attributable to the debtor.

3. Winding Up an LLC In Which a Bankrupt Member Owns an Interest.

As discussed below, there are a number of decisions surrounding the extent to which a bankrupt member can continue to participate in the management activities of an LLC. However, once an LLC is dissolved and is in the process of winding up, the outcome may be different. In In re LaHood, 2009 WL 803558 (Bankr. C.D. Ill. Mar. 19, 2009), aff'd in part, 437 B.R. 330 (C.D. Ill. 2010), the court concluded that a non-bankrupt member of a dissolved LLC continued to have the right to participate in the winding up process. Michael and Richard Lahood each owned 50% membership interest in an LLC. Michael filed for bankruptcy, and Richard (also a creditor of Michael's) declared the LLC dissolved pursuant to a provision of the operating agreement that provided for member bankruptcy as a dissolution event. Without seeking relief from stay, Richard then caused the LLC to wind up by conveying the LLC's real property to himself and Michael in equal shares. The court held that the distribution of the real estate was invalid because it violated the LLC statutory provision that prescribes that creditors of the LLC should be paid first when winding up the LLC's affairs.

The trustee also asserted that Michael had the right to participate in the LLC's winding up of its affairs under Illinois law because Michael's dissociation was not wrongful. The court agreed and found that Michael's dissociation was not in breach of any provision of the LLC's operating agreement.

A second case emphasizes the power of even a bankrupt member to manage the winding up process. In In re Greeson, 2009 Bankr. LEXIS 1732 (Bankr. D. Kan. Jun. 2, 2009), the court allowed the distribution of the bankrupt LLC's assets to the member, even though the bankrupt member had sold and distributed the assets of the LLCs to the bankruptcy estate without satisfying the statutory requirement that creditors be paid first. The debtors dissolved the LLC before bankruptcy. They then filed for bankruptcy and took the position that upon the dissolution of the LLC, the LLC's assets became their property and part of their bankruptcy estate. To strengthen their position, the debtors effectuated formal transfers, pursuant to which the LLC conveyed its equipment and accounts receivables to the debtors. Creditors objected to the debtors' position because under Kansas statutory scheme of distribution priorities when winding up an LLC, an LLC's property must first be used to satisfy creditors' claims. The court declined to apply the "trust fund doctrine" and found that even though the debtors violated the Kansas LLC act, the creditors could vindicate their rights against the assets in the bankruptcy process. But see In re Williams, 455 B.R. 485 (Bankr. E.D. Va. 2011), where the court confronted the issue of how to wind up and liquidate an LLC when both of the LLC's members had filed individual bankruptcy petitions. The court concluded that under the Virginia LLC statute, both members had dissociated as members upon their bankruptcy, and therefore had only the rights of assignees. Because there were no remaining members, the court concluded that it had the authority to appoint a liquidating trustee.

C. Provisions of State Law and Operating Agreements that Apply in Bankruptcy.

Most LLC acts provide, as a default rule, that unless otherwise agreed by an LLC's members, the bankruptcy of a member will be an event of dissociation. Most operating agreements will address the extent to which a bankruptcy filing by a member will trigger dissociation or dissolution, but this contractual language will often be co-extensive with the statutory default rules.

To the extent that the remaining members of an LLC elect to continue the business of an LLC following an event of dissociation or dissolution, both statutory law and operating agreements will generally provide that the bankrupt member loses status as a member and thereby ceases to have any management rights in the LLC. At that point, the member's rights in the LLC will typically be limited to economic or "distributional" rights. The bankrupt member will have the status of a transferee or assignee of an LLC interest, and cannot again take on the status of a member unless admitted to membership by the requisite vote of the remaining members. The effect of these general statutory and contractual rules in the bankruptcy context is addressed in subsection D below. Some more general issues are also addressed by the following cases:

1. Forfeiture of an Interest May Be Treated as a Preference in Favor of Non-Debtor Members.

In In re Lull, 2008 WL 3895561 (Bankr. D. Hawaii Aug. 22, 2008), the bankrupt member had been removed from his status as a member of the LLC. There was a dispute as to whether the removal (which the court denoted as a "transfer") took place before or after the filing of the petition, but in any event, the court analyzed the automatic dissociation of the bankrupt member under the Hawaii LLC statute, and concluded that whether the forfeiture took place under the terms of that statute or the operating agreement, the consequent benefit to the other members might be treated as a preference. The court concluded that the non-bankrupt member was a statutory insider (and therefore subject to the one-year preference), found that the non-bankrupt member received more because of the bankrupt member's removal/forfeiture than he would have as an unsecured creditor, and reserved for later judgment a determination of the actual amount of the preference. This kind of preference analysis, if applied more widely by the courts, could have a significant impact on the ability of LLCs and non-bankrupt members to effectively enforce contractual and statutory restrictions that might otherwise be enforceable, because a court could potentially treat every forfeiture or reduction of a bankrupt member's economic interest as a preference directly recoverable from the LLC's other members (even where the non-bankrupt members may not have liquidity in the LLC sufficient to pay the amount of the preference into the bankruptcy estate).

2. Exercise of Rights as Member or Manager.

Without substantive discussion of the question, a North Carolina bankruptcy court held that a bankrupt member had standing to seek judicial dissolution of a non-bankrupt LLC notwithstanding the fact that the North Carolina LLC Act and the operating agreement caused the bankrupt member to cease to be a member upon the filing of his bankruptcy petition. Under the dissolution provisions of the North Carolina statute, absence of status as a member should have defeated the bankrupt member's subsequent attempt to pursue judicial dissolution, but the court treated the prohibition as an invalid *ipso facto* clause (see the further discussion below), and without further analysis, proceeded to analyze the requested dissolution on its substantive merits in later proceedings. See In re Klingerman, 388 B.R. 677 (Bankr. E.D.N.C. 2008). The continuing rights of a bankrupt member (or that bankrupt member's personal representative) to exercise management rights can also arise in a context where the bankrupt member may object to the assertion of management rights, because those rights will be exercised by the debtor's bankruptcy trustee. In In re Modanlo, 412 B.R. 715 (Bankr. D. Md. 2006), the bankrupt member objected to actions proposed to be taken by his bankruptcy trustee. The trustee had designated himself as the manager of a single-member LLC controlled by the bankrupt, and the court analyzed Delaware law and concluded that the personal representative had the statutory power to continue a single-member LLC following a dissolution caused by the bankruptcy of its sole member. Having continued the LLC in its status as personal representative of the sole member, the trustee therefore had the power to designate itself as the manager.

By contrast, in In re Hickory Ridge, LLC, 2010 WL 1727968 (Bankr. N.D.W. Va. Apr. 27, 2010), the court simultaneously gave effect to state law provisions regarding the dissociation of a member upon bankruptcy but then held that the bankruptcy trustee succeeded to the dissociated member's management rights, and therefore had the right to control the LLC's actions in its own bankruptcy.

D. Enforceability of Statutory and Operating Agreement Provisions in the Bankruptcy Context.

1. Operating Agreement as an Executory Contract.

It is generally established that partnership agreements, to the extent they delineate material unperformed obligations of the partners, are executory contracts within the meaning of the Bankruptcy Code. Almost all of the cases that have thus far addressed bankruptcy issues in the LLC context have likewise held that operating agreements are executory contracts. See In re Daugherty Construction, Inc., 118 B.R. 607 (Bankr. D. Neb. 1995), ("Daugherty"); In re DeLuca, 194 B.R. 65 (Bankr. E. D. Va. 1996) ("DeLuca I"); In re DeLuca, 194 B.R. 79 (Bankr. E. D. Va. 1996) ("DeLuca II"). Operating agreements will contain numerous provisions relating to ongoing agreements and covenants of the parties, and for this reason, it is often appropriate that they also be classified as executory contracts for purposes of the Bankruptcy Code. For example, in Allentown Ambassadors, Inc., 361 B.R. 422 (Bankr. E.D. Pa. 2007), the court concluded that an operating agreement relating to the operation of an independent professional baseball league was an executory contract because the members had continuing duties, including duties to manage the LLC (*i.e.*, the baseball league), and the duty to make additional cash contributions as needed for the operation of the LLC.

An operating agreement was found to be an executory contract in In re DeVries, 2014 WL 4294540 (Bankr. N.D. Tex. Sept. 27, 2014). The operating agreement related to the operation of a business that operated a dairy farm, and among the obligations of the members were the obligations to make additional capital contributions and to provide loan guarantees. The court concluded that those obligations were executory, because the debtor member's obligations to contribute capital and to execute guarantees were not hypothetical, given both the volatile nature of the dairy industry and the fact that loan guarantees had been required in the past. The court went further to find that a separate cross-purchase agreement to which the members were parties was not severable from the operating agreement, and that the two would need to be treated as a single indivisible agreement. Having found that the operating agreement was an executory contract, the court found that by failing to assume either of the agreements, the trustee was deemed to have rejected them under § 365. Under § 365(g), the rejection of an executory contract constitutes a breach, and the operating agreement provided that a breaching member would have the status of a mere assignee. Accordingly, the court held that the trustee had no ability to exercise the non-economic rights available under the operating agreement, because those were reserved for "active" members of the LLC. The court concluded that it did not need to address the effect of the *ipso facto* clause prohibition because of the deemed rejection of the agreement.

Notwithstanding the trend of cases holding that partnership agreements and operating agreements are executory contracts, several courts have determined that operating agreements did not contain sufficient unperformed obligations to be treated as executory contracts. The court in In re Garrison-Ashburn, L.C., 253 B.R. 700 (E.D. Va. 2000) found that the operating agreement did not contemplate future performance by the members, but merely served to establish the framework under which the LLC would be managed. Because the court concluded that the operating agreement was not an executory contract, the court gave effect to the current Virginia LLC act provision that makes the bankruptcy of a member an event of dissociation, and concluded that the prohibitions on *ipso facto* clauses that apply to executory contracts did not apply to this LLC. The court's reasoning appeared to be affected both by a Virginia statutory change since the date of the cases cited above, which changed the bankruptcy of a member from an event causing the dissolution of the LLC itself to one that causes the dissociation of the member, and by the fact that the LLC's operating agreement did not include the kinds of provisions that would have created the possibility of future performance obligations (such as provisions related to future capital contributions or loans, requiring active participation in management or imposing negative restrictions on the ability of members to compete or otherwise take actions contrary to the interests of the LLC).

Another court held that because an operating agreement did not contain any current obligations or continuing management role for an LLC's member, the operating agreement was not an executory contract capable of being assumed, assigned or rejected. See In re Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006). In that case, the court permitted the non-bankrupt members to utilize a right of first refusal found in the operating agreement. A court's analysis of operating agreement obligations (or the lack thereof) yielded the same result in In re Warner, 480 B.R. 641 (Bankr. N.D.W. Va. 2012). However, by contrast, the court in In re Strata Title, LLC, 2013 WL 1773619 (Bankr. D. Ariz. Apr. 25, 2013), held both that an operating agreement that contained a purchase option was an executory contract, and that the exercise of that option, which was triggered by the bankrupt member's filing, was an invalid *ipso facto* clause. The Strata Title court did not engage in an extensive analysis of § 365. The executory contract determination was based in large part on the fact that the LLC owned property that was being actively marketed, and that the participation of the members (including the debtor) was necessary to address a variety of issues, including approval of a sale.

In In re Tsiaoushis, 2007 WL 2156132 (E.D. Va. July 19, 2007), both the district court and the bankruptcy court in a previous decision found that the operating agreement was not an executory contract because there were no material, continuing obligations of the members. The bankrupt debtor had no managerial duties in a manager capacity, and had no unperformed duties as a member. Because the agreement imposed no additional duties or responsibilities, the court found that the agreement was not an executory contract, that it was therefore not subject to the Bankruptcy Code Section 365 analysis discussed further below, and that the trustee would be entitled to enforce the provisions of the operating agreement requiring the dissolution and winding up of the LLC as a result of the debtor member's bankruptcy filing.

A similar result was reached in In re Ehmann, 319 B.R. 200 (Bankr. D. Ariz. 2005). In Ehmann, the LLC had been formed by an individual debtor's parents, apparently for estate planning purposes. Ehmann's bankruptcy trustee pursued various claims against the LLC, asserting that it had the right to make those claims because it was stepping into the shoes of Ehmann as a member. In its defense, the LLC attempted to rely on some of the bankruptcy provisions discussed in the following sections of this outline, and claimed that the trustee did not have the power to assume the debtor member's rights under the operating agreement, which it alleged to be an executory contract. The court concluded, however, that the operating agreement of the LLC contained no unperformed obligations of the type that would cause it to be deemed an executory contract, and that in fact, the debtor member had no "obligations" to be performed that would trigger the bankruptcy law provisions sought to be applied by the LLC. Those substantive bankruptcy law issues were not reached because the court concluded that no executory contract was involved.

A second decision was issued in Ehmann in late 2005. 334 B.R. 437 (Bankr. D. Ariz. 2005). In this decision, a bankruptcy court permitted the bankruptcy trustee to exercise a member's rights to seek remedies for breaches of the operating agreement by the non-bankrupt manager, who was apparently authorizing loans and other insider transactions in a manner that was contrary to the operating agreement. The transactions appeared to be designed to avoid distributing to the bankrupt Ehmann his share of the proceeds of a prior transaction which resulted in significant cash being available to the LLC. The court concluded that an injunctive remedy would not be effective against this misbehavior, and ordered the appointment of a receiver. Note, however, that this opinion was withdrawn by the bankruptcy court in late January 2006.

In re Wilson, 2014 WL 3700634 (Bankr. N. D. Tex. July 24, 2014) similarly found an operating agreement not to be an executory contract. The court, citing Ehmann, noted that neither the bankruptcy trustee nor any member of the LLC considered the agreement an executory contract (the argument was being advanced by a creditor), and found that the absence of obligations to make additional capital contributions as well as the fact that the management powers of the members were rights but not obligations meant that the rights under the operating agreement were not executory duties of the type found in an executory contract.

The analysis utilized by a number of courts that have found LLC operating agreements to be executory contracts was directly rejected in In re Denman, 513 B.R. 720 (W.D. Tenn. 2014). In that case, the debtor was a 70% owner of an LLC, and the operating agreement provided that any other member would have the option to purchase another member's interest upon a "triggering event" that included member bankruptcy. When the debtor member filed for bankruptcy, another member sought to enforce that provision. The court discussed the Countryman standard and several cases concluding that LLC operating agreements are not per se executory contracts, and conducted a relatively extensive analysis of the Tennessee LLC act on the way to determining that operating agreements under the Tennessee statute are distinct from typical executory contracts. The court noted that obligations under a Tennessee LLC operating agreement are not bilateral because a member's failure to perform does not excuse performance of the other members, because Tennessee LLC operating agreements may be entered into in connection with single member LLCs, when there is no mutual assent or consideration, because operating agreements may be amended without the approval of all members, and because operating agreements can bind new members without their explicit assent. The court then considered the operating agreement at issue, and finding that the membership interests were analogous to corporate securities and that the agreement did not contain any material member obligations, concluded that the agreement was not an executory contract. The court went further to determine that the purchase right was an invalid *ipso facto* clause because it created a right that was triggered only upon the bankruptcy.

A 2015 bankruptcy case involving a general partnership distinguished the Denman result. In Sullivan v. Mathew, 2015 WL 1509794 (N.D. Ill. Mar. 30, 2015), the court was confronted with a situation in which the exercise of certain rights under the partnership agreement depended upon the bankruptcy trustee's having properly assumed a partnership agreement that the court determined to be an executory contract. The trustee had not assumed the partnership agreement within 60 days after the order for relief, which under the Bankruptcy Code causes a deemed rejection. See §365(d)(1). The court considered the Countryman definition of executory contracts, and determined that there were sufficient additional duties under the partnership agreement that were "significant, ongoing obligations." The court found that the failure to perform those obligations would be a material breach, and concluded that an executory contract existed, and that the agreement had been deemed rejected because it had not been timely assumed. The court indicated its belief that "the Denman decision is tethered to the particular qualities of Tennessee LLC agreements," that the Denman reasoning was not applicable to partnerships, and that the Denman result was therefore unpersuasive.

A 2009 case addressed, in relatively summary fashion, the executory contract status of an operating agreement provision designating a member as "Vice President" of an LLC. The court concluded that an operating agreement provision that terminated the member's status as an officer upon the filing of his personal bankruptcy petition was not an invalid *"ipso facto"* clause because the member's service as an officer should be thought of as a personal service contract, not an assignable executory contract. See JD Factors, LLC, v. Freightco, LLC, 2009 WL 3401965 (N.D. Ind. Oct. 16, 2009).

2. Applicable Bankruptcy Law Provisions.

Section 365(a) of the Bankruptcy Code provides that the bankruptcy trustee, subject to court approval, may assume or reject any of the debtor's executory contracts. Section 365(f) further provides that except as provided in § 365(c), the trustee may assign an executory contract notwithstanding any contrary provision in any contract or under applicable law.[4]

The general rule is that the trustee or debtor in possession is permitted to assume an executory contract even if nonbankruptcy law or the contract itself would forbid such an assumption. Section 541(c) of the Bankruptcy Code overrides any restriction on the transferability of an asset in the bankruptcy estate that may be imposed by an agreement or nonbankruptcy law, and Section 365(e)(1) permits the avoidance of so-called *"ipso facto"* clauses that would otherwise provide for the termination or modification of a contract or contract right that might be triggered by the debtor's commencement of the bankruptcy case or insolvency or financial condition prior to the termination of the bankruptcy case. Two other sections of the Bankruptcy Code, however, hold out the possibility that it might still be possible to enforce statutory and agreement provisions that are triggered by a partner's or member's bankruptcy.

Section 365(c) of the Bankruptcy Code provides that the trustee or debtor in possession may not assume or assign an executory contract if:

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment;

Bankruptcy Code § 365(c). This section is consistent with similar language in § 365(e)(2), which exempts the same categories of executory contracts from the provisions cited above that would otherwise override *ipso facto* clauses.

> Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

Based on a strict construction of the statutory language, therefore, it would seem that a trustee (including the debtor in possession) will not be permitted to assume an operating agreement if it can be determined that the agreement is of a type as to which state law excuses a nonbankrupt member from accepting performance from or rendering performance to any party other than the debtor or the debtor in possession.

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[4] General practitioners should note that for purposes of Chapter 11 of the Bankruptcy Code, references to the "trustee" should be considered to refer also to a debtor in possession. Bankruptcy Code § 1107.

A 2015 case decided by the Supreme Court of Washington addressed the interplay between these Bankruptcy Code provisions and state law. In Northwest Wholesale, Inc. v. PAC Organic Fruit, LLC, 357 P.3d 650 (Wash. 2015), the court was tasked with determining whether a former member could assert a derivative claim on behalf of the company. The case turned on the state law and bankruptcy law effect of language in the Washington LLC statute that treated the debtor-member as dissociated as a member of the LLC at the time of the bankruptcy filing, so that the interest succeeded to would be deemed the interest of an assignee, rather than the interest of a member (only members have standing to bring in derivative suit). The court concluded, relying on Garrison-Ashburn, that the bankruptcy estate received the interest as defined by state law. The court went further and determined that it was unnecessary to decide whether §365(e)(1) would invalidate that clause because §365 applies to executory contracts, and even if the operating agreement at issue was an executory contract, §365(e)(2) would excuse performance because the remaining member would not be required to accept performance from a former member or his or her successor in bankruptcy.

3. The Right Of A Debtor Member To Assume An Operating Agreement.

Two courts have addressed in detail whether a debtor in possession or trustee may assume an operating agreement, notwithstanding state law provisions that would provide for bankruptcy as a disassociation or dissolution event. In the absence of bankruptcy law provisions that override state law, the bankruptcy of a member would, at least in member-managed LLCs, trigger an opportunity for the remaining members to vote whether to continue the LLC. In any event, the bankruptcy would cause the bankrupt member's status as a member to cease.

a. Daugherty.

In Daugherty, which was decided in October 1995, the bankruptcy court concluded that the provisions of the Nebraska Limited Liability Company Act were overridden by the Bankruptcy Code, and that the bankruptcy of a member did not trigger a dissolution of the LLC. The court held that even under an operating agreement, Section 365(c)(1) does not permit a party to avoid accepting from or rendering performance to a debtor in possession. 188 B.R. at 614. This analysis is consistent with the majority rule in partnership cases, and the leading case in partnership area is In re Cardinal Industries, Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990). The Daugherty court specifically rejected a separate line of cases which have held that a partnership dissolves, and a partner's status as such ceases, upon a partner's bankruptcy filing.

b. The DeLuca Cases.

Both of the DeLuca cases arose from the bankruptcy filings of a husband and wife who are involved in numerous entities, including several LLCs. In DeLuca I, the principal question was whether the remaining members of the LLC could remove the DeLucas as managers of the LLC and insert a new manager, when the underlying operating agreement required unanimous member consent for the appointment of a new manager. The court concluded that the pre-petition removal of the DeLucas as managers was valid because the operating agreement was silent on removal but state law permitted removal upon a majority vote of the members. The court also found that a new manager could be appointed by the remaining members after the bankruptcy petition because the bankruptcy petition of the DeLucas had the effect of terminating the DeLucas' status as members.

In DeLuca II, the DeLucas were members of an LLC that was itself one of two members of a second LLC. The other member of the second LLC sought the court's determination that the DeLucas' bankruptcy caused a dissolution of the first LLC (because there were no non-bankrupt members of that LLC who could vote to continue), and that the dissolution of the first LLC therefore triggered the dissolution of the second LLC. Again, the court gave effect to state law provisions and agreed that the second LLC had dissolved as a result of the DeLucas' Chapter 11 filing. However, without reaching the question whether the DeLucas had unlawfully dissolved the second LLC, the court concluded that it would not disturb the prior appointment of a bankruptcy trustee in favor of allowing the remaining member of the second LLC to wind up the LLC's business. The applicable Virginia statute would have permitted all members (presumably including the first LLC) that had not "wrongfully dissolved" the LLC to participate in the winding up.

In both of the DeLuca cases, the court relied primarily on Breeden v. Catron, 158 B.R. 624 (Bankr. E. D. Va. 1992), aff'd, 158 B.R. 629 (E. D. Va. 1993), aff'd, 25 F.3d 1038 (4th Cir. 1994), a general partnership case in which the lower courts and the Fourth Circuit concluded that the language of Section 365(c) should be read literally to prevent the debtor in possession's assumption of a partnership agreement because applicable state law would not require the remaining partners to perform their obligations under the partnership agreement or to accept the performance of the bankrupt partner's obligations from any party other than the bankrupt partner. In such circumstances, the Catron court concluded, neither the trustee nor the debtor in possession could assume the contract. In the DeLuca cases, the court likened the partnership agreement at issue in Catron to the operating agreements involved in the DeLuca cases, and concluded that the state law provisions governing dissolution and the status of a bankrupt member should be given effect notwithstanding the Bankruptcy Code's general preference toward permitting the assumption of executory contracts.

As noted elsewhere in this outline, a more recent case from the bankruptcy court in the Western District of Virginia reached a different result than the DeLuca cases. That court held that the noneconomic management rights in the LLC were property of the bankrupt member, and without mentioning or even analyzing the DeLuca cases, held that the statutory provision that would otherwise have deemed the bankrupt member a mere assignee was an invalid *ipso facto* provision under Bankruptcy Code §541(c)(1)(B).

For a complete discussion of the DeLuca cases and the underlying legal issues, see Wheaton, "Dumping Deadbeats: Enforcing Limited Liability Company Agreements in Bankruptcy," Journal of Limited Liability Companies, Fall 1996, at 60.

4. Enforcement of Membership Interest Purchase Options in Bankruptcy.

Several cases have addressed situations in which non-bankrupt members have attempted to claim the benefit of purchase options that would allow the redemption or acquisition of a bankrupt member's interest. For example, in In re Capital Acquisitions & Management Corp., 341 B.R. 632 (Bankr. N.D. Ill. 2006), the court found that an operating agreement was not an executory contract, and on that basis, that the provisions of § 365 were not applicable to render a right of first refusal to purchase an LLC interest an invalid *ipso facto* provision. However, the court also noted that even if the operating agreement were an executory contract, the right of first refusal would still not apply. The right was not actually triggered by the bankruptcy filing itself, or the appointment of a trustee or receiver, but by the election to sell the bankrupt member's interest. This seems to be a bit of hair-splitting, but the court concluded that because the provision at issue was not itself triggered by the bankruptcy filing, but by a subsequent action during the bankruptcy proceeding, the sale provision did not constitute an invalid *ipso facto* clause. Other cases involving rights of first refusal and purchase options discussed elsewhere in this outline include In re Denman, 513 B.R. 720 (W.D. Tenn. 2014) and In re Strata Title, LLC 2013 WL 1773619 (Bankr. D. Ariz. Apr. 25, 2013).

5. Other Cases Addressing Assumption and *Ipso Facto* Issues.

Several other cases have addressed the relationship of the bankruptcy law provisions to single-member LLCs. In In re Desmond, 316 B.R. 593 (Bankr. D.N.H. 2004), an individual debtor sought to prevent a creditor of a wholly-owned LLC from taking action against the LLC by asserting that obligations entered into by the LLC were invalid because the authorization of the obligations by the debtor in his manager capacity was invalid because the management rights were an asset of his individual bankruptcy estate. The court found that because the LLC was not in bankruptcy, nothing about the debtor's individual bankruptcy deprived him of the right to take action on behalf of the LLC. The court distinguished In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003). In Albright, the court concluded that it could disregard statutory provisions requiring approval for the admission of an assignee as a member because the LLC at issue was a single-member LLC, and there were no other members whose approval was required before the chapter 7 trustee could be substituted as a member for the bankrupt debtor-member. In In re Pickel, 487 B.R. 289 (Bankr. D.N.M. 2013), the court followed the logic of the Albright case in concluding that § 541(c)(1) trumped a provision of the Virgin Islands LLC statute that caused a bankrupt member to be dissociated. The LLC was a single-member LLC, and the court noted that giving effect to the LLC provision would leave the company without a member or manager.

Two Delaware cases have also addressed the *ipso facto* clause issue and the status of and distinction between economic and management rights in an LLC. In Milford Power Company, LLC v. PDC Milford Power, LLC, 866 A. 2d 738 (Del. Ch. 2004), the court analyzed the appropriate bankruptcy law sections and concluded that bankruptcy law preempted any provisions of the LLC operating agreement that would deprive a debtor of making its economic rights available to assignee, but would allow the enforcement of the agreement to the extent it restricted the assignment of the debtor's management rights. A similar result was reached by another Delaware court in In Re IT Group, Inc., 302 B.R. 483 (D. Del. 2003). See also In re Soderstrom, 484 B.R. 874 (M.D. Fla. 2013), where the court held that a non-bankrupt member of an LLC could object to a trustee's proposed sale of the bankrupt debtor's interest in the LLC because that sale purported to include the bankrupt member's management rights. The court briefly analyzed the interplay of § 365 with an operating agreement that constituted an executory contract, and upheld a bankruptcy court determination that § 365 should be applied to prevent the estate's ability to assume the debtor's management interest in the LLC.

The court in the Allentown case also conducted an extensive analysis of the Section 365 and *ipso facto* clause issues. Having concluded that the operating agreement relating to the operation of a professional baseball league constituted an executory contract, the court concluded that the debtor member's interest in the LLC was not terminated as a result of the member's bankruptcy. The court synthesized the partnership and LLC cases addressing the tension between the various Section 365 subsections, and concluded that the North Carolina statutory provisions that restrict assignments of membership interests are sufficiently ambiguous that they do not constitute applicable non-bankruptcy law prohibiting assignment. The court also concluded on the facts that the operation of the LLC did not demonstrate that a member's duties were the kinds of non-delegable duties that should render the membership interest non-assignable.

In the JD Factors case noted above, the court also concluded that under § 365(c)(1), an Indiana law provision to the effect that a person cannot become a member without the consent of all the other members would be likely to be given effect.

E. LLC as Insider of Member Debtor.

In In re Barman, 237 B.R. 342 (Bankr. E.D. Mich. 1999), the court held that for the purposes of defining the "insiders" of an individual Chapter 7 debtor, an LLC is sufficiently close to a corporation to apply the bankruptcy principles that apply to corporations. Under the Bankruptcy Code, a corporation of which the debtor is a director, officer or control person, or an affiliate or insider of an affiliate, constitutes an insider. A corporation is an affiliate if the debtor controls 20% or more of its "voting securities." In this case, which involved a South Carolina LLC, the court found that the LLC was an insider of the member debtor because the debtor was one of three of the LLC's members and owned or controlled one-third of the voting rights in the LLCs.

IV. Series LLCs

A. Definition. "Series LLC is the term used to describe a form of entity with internal funds, portfolios, cells, or divisions, each of which may have separate members, managers, assets and liabilities, and business purpose or investment objectives. The principal distinguishing characteristic is the internal liability shield for each series of the Series LLC."[5]

The first Series LLC legislation was enacted in Delaware in 1996. 6 Del. Code § 18-215. In addition to Delaware, the following jurisdictions have adopted Series LLC legislation: Alabama; District of Columbia; Illinois; Indiana; Iowa; Kansas; Missouri; Montana; Nevada; Oklahoma; Puerto Rico; Tennessee; Texas; and Utah.

Although California does not authorize the creation of Series LLCs, the California Franchise Tax Board takes the position that each Series must file its own California FTB Form 568, Limited Liability Company Return of Income, and pay its own separate LLC annual tax and fee if it is registered or doing business in California. See California 2015 Limited Liability Company Tax Booklet, Section F, p. 8; FTB 3556 LLC MEO pp. 4-5 (Rev. 2015). Arguably, if each Series LLC doing business in California pays the LLC annual tax and fee, the limited liability of each Series should be respected, though it is not clear. California Bill SB 323, introduced in 2011, to adopt the Revised Uniform Limited Liability Company Act, included provisions for the creation of a Series LLC (Article 12), but those provisions were dropped from the Bill that was eventually approved.

5. Donn, Ely, Frost, Keatinge, Schippel, *Series LLCs*, LLCs, Partnerships, and unincorporated Entities Committee of the Business Law Section of the American Bar Association, September 16, 2016.

Without using the term "Series," some other states permit classes or groups of one or more members having certain expressed relative rights, powers and duties, including voting rights, but without providing for the internal liability shield. E.g., Cal. Corp. Code § 17712.01.

B. May a separate Series that is insolvent file a bankruptcy petition separate and apart from the LLC?

A petition may be filed by any "person." 11 U.S.C. § 109 (a).

"Person" includes an individual, partnership, or corporation. 11 U.S.C. § 101(41), but does not include an estate or trust (other than a business trust). 11 U.S.C. § 101(15).

In addition to those enumerated as eligible, "other similar entities are as well."

"Entity" includes person, estate, trust, governmental unit, and United States trustee. Is a Series an "Entity"? Though this is a federal bankruptcy law question, reference to state LLC Acts may help in the analysis. At least one state's LLC Act that establishes Series defines the Series LLC as a legal person. See 6 Del. C. § 18-101(12). Illinois, Texas and Alabama do not. See also Section 102(7) of the draft of the Limited Liability Company Protected Series Act, National Conference of Commissioners on Uniform State Laws, Annual Meeting July 8 – 14, 2016.

It is unclear whether a Series that is not defined as an "entity" may be a "person" under the Bankruptcy Code. According to one commentary, "...it would appear that an individual Delaware series is not a 'person' for purposes of federal bankruptcy law and, therefore, cannot file a petition in bankruptcy without statutory authority." Conaway and Tsoflias, The Delaware Series LLC: Sophisticated and Flexible Business Planning, 2 Mich. J. of Private Equity & Venture Capital Law 97, 124 (2012). For an argument that an individual series should be a "person" under bankruptcy law, see Wagner and Peters, Bankrupts and the Series LLC, 102 Ill. Bar J. 236 (2014).

C. Substantive Consolidation.

If the LLC files a petition in bankruptcy will an approach of "substantive deconsolidation" apply to limit the claims of creditors with respect to one series to the assets of that series?

Assuming the series can file, how will the principles of "substantive consolidation" be applied?

Who would give a "substantive non-consolidation" opinion with respect to a separate series?