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Special Issues Involving LLCs

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SPECIAL ISSUES INVOLVING LLCs

Limited liability companies continue to present questions for bankruptcy practitioners and the bench stemming from the flexibility of such structures under applicable state law and the continuing efforts by both borrowers and lenders to improve bankruptcy remote structures.

A. Authority to File

Corporate entities may commence a voluntary bankruptcy case only with valid corporate authorization as determined by applicable state law. *See, e.g., Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255, 1258 (8th Cir. 1994) (citing *Price v. Gurney*, 324 U.S. 100, 106 (1945)). This principle underpins many standard features of bankruptcy remote structures such as the use of independent directors or managers. In light of the substantial flexibility provided by state LLC statutes in arranging or constraining the operations of LLCs and the duties of its members, parties are continuing to test this principle in efforts to further constrain a borrower's authority to voluntarily commence a bankruptcy case.

Two recent cases, *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) and *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), have addressed such attempts and have garnered significant attention. Both cases dealt with LLC borrowers, organized under Michigan and Delaware law respectively, that had defaulted on their loans and, in exchange for forbearance from their senior secured lenders, had amended their operating agreements to give their lenders a *de minimis* membership interest and to require unanimous member consent to authorize a voluntary bankruptcy case. In both situations, the amended operating agreements attempted to eliminate any state law duties of the lenders in their capacities as LLC members to other members or to the corporate entity. *Cf. In re*

Gen. Growth Props., Inc., 409 B.R. 43, 65 (Bankr. S.D.N.Y. 2009) (relying on language in the LLC operating agreement that imposed fiduciary duties on the independent managers "similar to that of a director of a [Delaware] business corporation" to hold that those managers properly considered the interests of the LLC shareholders and that their authorization for the LLC to voluntarily commence bankruptcy was not objective bad faith). After the borrowers continued to underperform and commenced voluntary bankruptcy cases without lender consent, both cases denied motions to dismiss by the lenders but on different grounds.

The *Lake Michigan* decision held that the operating agreement amendment at issue was unenforceable "both as a matter of Michigan corporate governance and bankruptcy law." 547 B.R. at 914. The Michigan law holding was based on the apparent conflict between the non-waivable duty under state law for managers to act in good faith in the best interests of the LLC and the explicit disclaimer of such duties for the lender/member under the operating agreement. *Id.* at 913-14; *cf.* Mich. Comp. Laws Ann. § 450.4401 (providing that LLC members are considered to be managers only if management is vested in the members). In addition, the court reasoned that a blocking director or manager structure may be valid as a matter of bankruptcy law only if such director or manager remains subject to "normal [] fiduciary duties" enabling such person to vote in favor of a bankruptcy even if contrary to the interests of the lender. *Id.* at 913.

In contrast, the *Intervention Energy* court denied the dismissal motion solely on federal grounds. 553 B.R. at 265-66. Starting from the proposition that debtors may not contract away bankruptcy rights, the court concluded that the amendment to the LLC operating agreement, by giving the ability to block a bankruptcy filing to an entity that was primarily in a creditor relationship with the debtor and that had no duties to anyone else was "tantamount to an absolute waiver of [the] right" to seek federal bankruptcy relief and void as contrary to federal public policy even if permitted under state law. *Id.* at 265.

To date, there have been few other decisions on point and a consensus approach to such provisions has not yet developed, as indicated by *Lake Michigan*, *Intervention Energy* and the following cases:

- *In re Global Ship Sys., LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007), considered whether an LLC debtor had engaged in bad faith by soliciting creditors to file an involuntary petition when the LLC operating agreement prohibited filing a voluntary petition without the consent of the Class B equity member. The Class B equity, comprising 20% of the LLC equity, had been acquired by the LLC's secured creditor in the initial extension of the loan (along with 18% annual interest plus fees) three years previously. *Id.* at 197. Although the LLC was seeking to forestall a foreclosure by the lender that would yield no recoveries to the LLC equity, the court characterized the lender as wearing "two hats in this case" and affirmed its right as a Class B member to withhold its consent to a bankruptcy filing. *Id.* at 203.

- *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, No. 10-046, 2010 WL 4925811 (10th Cir. BAP Dec. 6, 2010), affirmed the bankruptcy court's dismissal of a voluntary chapter 11 petition filed by the LLC manager without the unanimous consent of the LLC members as required by the amended LLC operating agreement. Although the manager alleged this operating agreement amendment to have been executed at the demand and for the sole benefit of the secured creditor (five months after the formation of the LLC and more than two and a half years before the LLC became insolvent), the court rejected the manager's public policy argument due to the lack of supporting authority for that argument, reasoning that cases "involv[ing] a debtor's agreement with third parties to waive the benefits of bankruptcy" do not "stand[] for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy" or that "such agreement [would be] void as against public policy"). *Id.* at *3.

- *In re Bay Club Partners–472, LLC*, No. 14–30394 (RLD), 2014 WL 1796688, at *4–5 (Bankr. D.Or. May 6, 2014), addressed motions to dismiss filed by the secured creditor and by an LLC member after the LLC voluntarily filed for bankruptcy nine years after being formed with an operating agreement that included an absolute bar against filing for bankruptcy for so long as it had any secured indebtedness outstanding. With testimony that the provision had been included at the request of the secured creditor, the court applied Ninth Circuit caselaw on prepetition contractual waivers of specific bankruptcy protections to conclude that the LLC operating agreement provision was unenforceable as a matter of public policy. *Id.* at *4-5.

- *Squire Court Partners Ltd. P'ship v. Centerline Credit Enhanced Partners LP Series J (In re Squire Court Partners Ltd. P'ship)*, Case No. 16-00935 (JLH), 2017 WL 2901334, at *3-4 (E.D. Ark. July 7, 2017), affirmed the bankruptcy court in dismissing a voluntary petition filed by the general partner of a limited partnership without the consent of the limited partners as required by the partnership agreement. The court distinguished the *Lake Michigan* conclusion that blocking structures required fiduciary duties to be valid and held that nonfiduciary owners may have a controlling role in the bankruptcy decision-making process, attributing such authority for corporate directors to delegation rather than the existence of fiduciary duties.

The relative dearth of such decisions to date may suggest that such LLC operating agreement provisions have so far been largely effective in keeping such cases out of the bankruptcy courts (perhaps in conjunction with other lender tools discussed below). An alternative explanation may be that such LLC operating agreement provisions are more likely to be found in situations where the secured lender is plainly undersecured and the economics do not otherwise incentivize the debtor to fight – indeed, the *Lake Michigan* bankruptcy case was dismissed for cause less than 2 months after that decision, and the *Intervention Energy* bankruptcy cases were dismissed for cause less than 7 months after that decision. Regardless, a consensus approach to such provisions has not yet developed among the courts and the *Lake Michigan* and *Intervention Energy* decisions may encourage further litigation on such issues.

Future decisions may be called upon to further explore the intersection of federal bankruptcy policies with corporate authority issues under state law. *See, e.g., Price v. Gurney*, 324 U.S. 100 (1945) (holding that a Chapter X petition filed by a shareholder was without authority and requiring dismissal despite allegations of substantial conflicts due to more than 50% of the corporation's equity being held in a voting trust controlled by bondholders, noting the availability of state law remedies for such conflicts); *Chicago Title & Trust Co. v. Forty-One Thirty-Six Wilcox Bldg. Corp.*, 302 U.S. 120 (1937) (holding that a corporation in dissolution proceedings and lacking authority under state law to initiate legal proceedings was not able to file a voluntary petition).

In addition, future decisions may further develop the relationship, if any, between the bankruptcy policies at issue with waivers of bankruptcy rights by contract with third parties or with preventing the ability of natural persons to voluntarily commence a bankruptcy case, and the bankruptcy policies at issue with limiting corporate authority to voluntarily commence a bankruptcy case and with lender disincentives for corporate decisionmakers to voluntarily commence a bankruptcy case. *See, e.g., F.D.I.C. v. Prince George Corp.*, 58 F.3d 1041, 1046 (4th Cir. 1995) (holding that a springing guaranty upon bankruptcy is not unenforceable as against public policy, "the [guaranty] did not prohibit [the guarantor] from resorting to bankruptcy" but merely provided for certain consequences upon certain actions being taken) (quoting *Twin City Pipe Line Co. v. Harding Glass Co.*, 283 U.S. 353, 356-57 (1931) ("The principle that contracts in contravention of public policy are not enforceable should be applied with caution and only in cases plainly within the reasons on which that doctrine rests. It is only because of the dominant public interest that one who . . . has had the benefit of performance by the other party will be permitted to avoid his own promise."); *Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255, 1258 (8th Cir. 1994) (where the borrower had pledged a controlling equity stake to its lender to secure a loan, along with a voting proxy for such shares and a power of attorney to the lender to record the transfer of such shares upon a default, holding that the lender had prevented the borrower from validly filing for bankruptcy after exercising on the pledged shares, recording such transfers, and displacing the corporate officer attempting to voluntarily commence bankruptcy); *United States v. Royal Business Funds Corp.*, 724 F.2d 12, 15-16 (2d Cir. 1983) (where the borrower attempted to file bankruptcy after having defaulted on its SBA loans and then agreeing to substantial additional financing from the SBA with appointment of the SBA as receiver to administer the borrower's assets, reasoning that the borrower's consent to the SBA restructuring "cannot be brushed aside" and that "no public or private interest is served by allowing [the borrower] to repudiate the arrangements it made with the SBA" and rejecting an "absolute right to file a bankruptcy petition" under the circumstances).

Both borrowers and lenders will continue to have incentives at loan origination to pursue bankruptcy remote structures as a credit enhancement to manage risks and lower borrowing costs. In certain situations, both borrowers and lenders will also continue to have incentives to implement bankruptcy remote structures to induce additional extensions of credit or forbearance as an alternative to bankruptcy or the exercise of lender remedies. Accordingly, courts may eventually be required to engage in an increasingly complex balancing of competing policies when considering such arrangements. At the margins, courts may be called upon to determine whether under any circumstances a fiduciary may bargain away full or partial consent rights over a voluntary filing to a creditor, whether under any circumstances a creditor may acquire the otherwise-valid rights of a non-fiduciary to consent to a voluntary filing, and whether under any circumstances applicable state law may condition corporate authority to voluntarily commence bankruptcy on creditor consent.

B. <u>Operating Issues</u>

The flexibility of LLC structures may present additional issues even after a valid commencement of a bankruptcy case.

1. Fiduciary Duties

It is well-established that a debtor in possession has fiduciary duties to the estate under federal common law. *See, e.g., Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) ("if a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession."); *In re Southmark Corp.*, 163 F.3d 925, 931 (5th Cir. 1999) ("A *sine qua non* in restructuring the debtor-creditor relationship is the court's ability to police the fiduciaries, whether trustees or debtors-in-possession ..., who are responsible for managing the debtor's estate in the best interest of creditors."); *see also, e.g., LaSalle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279 (D. Del. 2000) (analyzing claims of prepetition fiduciary breaches under Delaware law and of postpetition fiduciary breaches under federal common law).

However, many states provide LLCs with the ability to limit or eliminate fiduciary duties or liability for breaches thereof for LLC managers or members, and may provide similarly for LPs. *See, e.g.,* 6 Del. Code. § 18-1101(c), (e) (LLCs); 6 Del. Code. § 17-1101(d), (f) (LPs). Although few cases have squarely addressed this issue, the proposition that such state law limitations on prepetition fiduciary duties do not limit postpetition fiduciary duties under federal law does not appear to be controversial. *See, e.g., In re Hampton Hotel Investors, L.P.*, 270 B.R. 346, 361 (Bankr. S.D.N.Y. 2001) (finding that even if certain provisions in the partnership agreement alleged to permit self-dealing by the general partner applied to the conduct at issue, such provisions "could not trump the duties of a debtor in possession, which . . . takes on duties of a trustee under law.") (citing 11 U.S.C. § 1107).

In re Houston Regional Sports Network, L.P., 505 B.R. 468 (Bankr. S.D. Tex. 2014), addressed a situation where the limited partnership debtor was managed by a general partner, which was itself owned by the three limited partners and managed by directors appointed by the limited partners independently. After an involuntary petition orchestrated by two of the limited partners, the third limited partner moved to dismiss the case for bad faith and futility, based on its determination to exercise its rights under the partnership agreement to veto any proposed reorganization through its appointed director of the general partner. *Id.* at 479. The court rejected the futility argument on the grounds that "the fiduciary duties to a bankruptcy estate may not be absolved by any state law concepts to the contrary." *Id.* at 481.

Although *Houston Regional* did not examine whether liability limitations valid under state law would apply to postpetition breaches of fiduciary duties by the debtor in possession, its reasoning may apply to prevent such limitations from being effective. However, other protections may be available for persons in control of the debtor in possession for alleged postpetition breaches of duties. *See generally In re Strata Title, LLC*, Case No. 14-00319 (DPC), 2014 WL 6685470, at *2 (Bankr. D. Ariz. Nov. 25, 2014) (extending the immunities available to chapter 7 trustees and their attorneys to the debtor in possession's attorney because of the similarity in duties) (citing 11 U.S.C. §§ 1106(a), 1107(a)); *Richardson v. Monaco (In re Summit Metals, Inc.)*, 477 B.R. 484, 501 (Bankr. D. Del. 2012) (where the complaint was "composed almost entirely of claims stemming from official, Court-approved or Court-ordered actions, the factual allegations in the [c]omplaint do not support a right to relief against the [d]efendants."); *Davis v. Yageo*, 481 F.3d 661, 678-79 (9th Cir. 2007) (holding that abuse of process or malicious prosecution claims brought post-bankruptcy under state law by a creditor against directors and the majority shareholder were preempted by federal bankruptcy law).

2. Derivative Claims

State LLC statutes may also limit the ability of creditors to assert derivative claims, even if otherwise available under state law. *Compare, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (allowing creditors of corporations to assert derivative claims for breaches of fiduciary duties after insolvency), *with CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010) (holding that the "plain language" of the Delaware LLC statute limited standing to assert derivative claims to members or assignees of LLC interests and did not extend to creditors, and noting substantially identical language under the Delaware LP statute), *aff'd*, 28 A.3d 1037 (Del. 2011). Notably, in affirming the *Bax* decision, the Delaware Supreme Court specifically noted the availability of other remedies for creditors "for example, negotiating automatic assignment of membership interests upon insolvency clauses into the credit agreement and requiring the members and governing board to amend the LLC agreement accordingly." *Id.* at 1042 fn. 20.

In *Trusa v. Nepo*, No. 12071-VCMR, 2017 WL 1379594 (Del. Ch. Apr. 13, 2017), the court addressed, *inter alia*, derivative breach of fiduciary duty claims brought by a secured lender pursuant to the power of attorney granted by the LLC borrower to the lender in the security agreement "to take any action and to execute any instrument which the [l]ender may deem reasonably necessary or advisable in pursuing its remedies set forth herein." *Id.* at *6. The court declined to read this clause broadly enough to allow the lender to pursue derivative breach of fiduciary duty claims, and in light of the plain language declined to reach the debtor's arguments that such an provision would be impermissible under Delaware law and policy. *Id.* at *6, fn. 48.

C. <u>Limits of Federal Preemption</u>

State law tort claims against directors for breaching their fiduciary duties against self-dealing by determining to file bankruptcy, were not preempted because: they (a) were based on prepetition conduct, (b) did "not require the adjudication of rights and duties of creditors and debtors under the Bankruptcy Code," (c) did not require a determination that the bankruptcy was filed in bad faith, but rather "alleged that the directors and majority shareholder engaged in self-dealing to the detriment of the corporation through their decision to pursue bankruptcy and sought damages for breach of fiduciary duty under California state law," and (d) the bankruptcy court assigned to plaintiffs all prepetition claims. *Davis v. Yageo*, 481 F.3d 661, 679-80 (9th Cir. 2007).

Beware federal preemption being confused with lack of subject matter jurisdiction. Plaintiff (Choy) sued Shamrock's insurer, Redland, for refusing a settlement offer in bad faith and causing Shamrock to commence a bankruptcy case. Choy's action against Redland in state court was held to be preempted because "both of the claims asserted by Choy in his complaint depended upon a determination that Shamrock's bankruptcy petition had been filed in bad faith and such a determination was within the exclusive jurisdiction of the federal bankruptcy court." *Choy v. Redland Ins. Co*., 103 Cal. App. 4th 789, 795 (Cal. Ct. App. 2002).

Three of Astor's twelve instances of tortious interference or breach of fiduciary duties required "a finding that Thorpe filed for bankruptcy or filed certain papers in the bankruptcy proceedings in bad faith or for an improper purpose, as measured by the standards of New York tort law…" *Astor Holdings, Inc. v. Roski*, 325 F. Supp. 2d 251, 263 (S.D.N.Y. 2003). *Astor* held those 3 claims were therefore "barred." *Id*.

Conversely, *Astor* denied Roski's motion to dismiss two of Astor's claims involving conduct before and during Thorpe's bankruptcy case. Those claims were: "1. Astor's claims of tortious interference with the Venture Agreement based on Thorpe's failure to negotiate in good faith towards an operating agreement after July 1998 and on Thorpe's and Roski's alleged negotiation relating to the 'entity-in-formation'; and 2. Astor's claim of tortious interference with the bankruptcy settlement based on Thorpe's failure to otherwise promote Robot Wars and his broadcasting of the March 13, 1999, e-mail." *Astor* at 270.

D. Potential Workarounds

As borrowers and lenders continue their efforts to develop improved bankruptcy remote structures, multiple options remain available after *Lake Michigan* and *Intervention Energy*.

- *Manager Authority*. The LLC operating agreement should authorize the manager to act in the ordinary course only, with actions outside the ordinary course (specifically identifying bankruptcy as an example) to require the consent of independent directors and/or unanimous member consents.

- *Fiduciary Duties*. The LLC operating agreement should be structured to validly eliminate fiduciary duties for the blocking director or manager. When making decisions, such persons should be required to consider only the interests of corporate entity itself (and its unaffiliated creditors) and not permitted to consider the interests of other members, its parent entity, affiliates, or guarantors. The operating agreement should also constrain the circumstances for removal of such persons, with associated requirements for lender notification and consent.

- *Structural Modifications*. In addition to or in lieu of a blocking director structure, the LLC may be structured with multiple classes of shares or interests, with the consent of each class being required to voluntarily commence a case, and with one class being held by independent third parties without other managerial responsibilities.

- *Automatic Assignments*. The pledge and automatic transfer to the lender of key LLC interests or voting rights upon default, with associated power of attorney or automatic effectiveness, may constrain the LLC's ability to validly commence a voluntary case.

- *Member Incentives*. Bad boy / springing guarantees or standby letters of credit continue to be approved by courts and disincentivize LLC members/managers/parents from supporting a voluntary case. Such guarantees or LCs could also be structured to be effective upon a court order holding other lender protections (such as the blocking director structure) to be void.

- *Declaratory Relief*. The lender could seek declaratory judgment in state/federal court, in advance of bankruptcy filing, as to lack of corporate authority to file except under certain conditions, or affirming the validity of such provisions under applicable law. Obtaining a confession of judgment to hold pending the occurrence of a default may facilitate such relief.