# Square Pegs in Round Holes: How Partnership and LLC Interests Are Treated in Bankruptcy

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# INTRODUCTION

It is amazingly easy to found and register a new limited liability company. Visit a website such as Legal Zoom or Standard Legal, to name just two, and for less than $500, and in less than 30 minutes, anyone can have founding documents ready to sign and file.

Forming a partnership is even easier. A simple, general partnership can even be created by an oral contract. But often those that form these entities fail to consider what happens if one or more of those founders or investors file bankruptcy. Moreover, the results of such a filing are often uncertain, because the Bankruptcy Code has very few provisions dealing specifically with partnerships and LLC's. The result is that bankruptcy cases can provide a steady stream of unexpected results and difficult legal issues for the practitioner.

The purpose of this presentation is to help the practitioner spot and assist in resolving those issues. Whether you represent a creditor, debtor or the company itself, we think you may benefit from it.

## I. NATURE OF PARTNERSHIPS AND LLC'S

### A. A Very Short History.

The history of business entities primarily concerns the search for the perfect investment vehicle. Very broadly speaking, entrepreneurs and their investors seek four things:

1. Maximum liability protection for investors;
2. Favorable tax treatment;
3. Simple, flexible ownership and management; and
4. A relatively low level of governmental oversight and regulation.

However, prior to the advent of limited liability companies, none of the available entities were able to provide investors with all of these things at a level that satisfied them.

General partnerships, one of the oldest forms of business entities, provide pass-through taxation, but do not provide liability protection. A general partner is liable for virtually all debts of the partnership. Limited partnerships offer an improvement as to liability for limited partners but the general partner remain subject to liability. In addition, various state laws have restricted the flexibility of limited partnerships. Business trusts—at one time in wide spread use-- were able to provide some of the desired attributes, in varying degrees, but few states enacted statutes that gave business trusts the certainty that investors wanted. See, generally, 1 *Ribstein and Keatinge on Limited Liability Companies*,§1:2 (2015) Corporations provide shelter from liability for investors, but tax considerations and somewhat strict rules of governance and state regulation made them unpopular for some businesses.

In the 1990's, limited liability companies began to gain widespread acceptance as business entities. A decision by the Internal Revenue Service in 1988 to tax them as partnerships was a key event promoting their use. Rev. Rul. 88-76. Thereafter, many states adopted limited liability company statutes. State statutes authorizing LLC's vary significantly, but many of the essential characteristics are the same. The result is that LLC's have become the modern entity of choice.

B. Understanding Basic Similarities and Differences

The below chart provides a simple analysis of some key attributes of partnerships, corporations and LLC's.

| | Partnership | Limited Partnership | Corporation | LLC |
|---|---|---|---|---|
| **Separate Taxable Entity from Owner** | No | No | Yes | Depends, but can be |
| **Management** | May be divided among partners | General Partner only—limiteds may not manage | Board of Directors | Flexible, per articles of organization |
| **Owner Liability** | Unlimited | Unlimited as to general; limited to investment as to limited partner | Limited to investment | Limited to investment |
| **Units of Ownership** | Partnership interest | Partnership or Limited Partnership interests | Stock | Membership units or percentages |
| **Transferability of ownership** | Can sell partnership interest | Can sell partnership interest (subject to agreed limitations) | Can sell stock (subject to agreed limitations) | Can sell membership interest, (subject to agreed limitations) |

As you can see, the LLC column reflects significant flexibility as well as protection against liability for investors.

C. What does a partner in a partnership or a member of an LLC own?

An equity ownership in a limited liability company consists of two separate and distinct rights: (i) economic rights, or transferable rights, and (ii) governance, or management, rights. Members of an LLC do not have any interest in the LLC's property. See *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 707-708 (E. D. Va. 2000) The economic rights of members of an LLC are generally limited to the right to receive distributions from the LLC in accordance with its organizational documents. Governance rights consist of the rights of the members of the LLC to manage the business entity. The sale or assignment of an interest in an LLC does not necessarily entitle the transferee to be a member of the LLC. The LLC's governance documents frequently set forth restrictions on admission of new members.

A partner's interest in a partnership is considered personal property that may be sold or assigned to other persons. It has been observed that a partner's interest in the partnership consists of the partner's economic rights, the partners management rights, and the partners' rights as co-owner of partnership property. *In re Cardinal Industries, Inc.* 116 B.R. 964, 970-71 ( Bankr. S. D. Ohio 1990).

If assigned, however, the person receiving the assigned interest does not become a partner unless the other partners agree. The assignee of a partnership interest only receives the economic rights of the partner, such as the right to receive partnership profits. In addition, an assignment of the partner's interest does not give the assignee any right to participate in the management of the partnership. Such a right is a separate interest and remains with the partner unless and until the other partners agree to add a new partner.

D. Series LLC's

A number of states (including Iowa, Kansas and Missouri) have enacted statutes that authorize LLCs to be organized with "series" of members, managers, membership interests, or assets. See Iowa Code Ann. § 490A.305; Kan. Stat. Ann. § 17-76-143; and Mo. Rev. Stat. § 47.186. These series LLC's can be compared to (but are not exactly like) subsidiaries of a corporation. Generally speaking, those statutes provide that each series may be established with separate ownership, separate assets, and separate liabilities from those of each other series and from the ownership and property of the LLC of which it is a series. 2 *Ribstein and Keatinge on Ltd. Liab. Cos*. § 17:23 (2015) If so organized, the assets of each series are insulated from the liabilities of the other series and the assets of a series are not required to be applied to satisfy the obligations of another series. Series may have separate owners. Series and protected cells raise questions of state law and tax law. From a state law perspective, it is unclear whether the

segregation of the assets of series will be respected. Id. A further explanation of series LLC's is beyond the scope of this paper, but see 2 *Ribstein and Keatinge on Ltd. Liab. Cos*., § 4:17 (2015); and Powell, "Secured Lending to Series of LLC's: Beware What You Do Not (And Cannot) Know", 46 *Uniform Commercial Code Law Journal #2* (Jan. 2015).

## II. EFFECT ON ENTITY WHEN MEMBER OR PARTNER FILES BANKRUPTCY

### A. Dissolution Generally

Dissolution is defined as "the termination of a corporation's legal existence by expiration of its charter, by legislative act, by bankruptcy, or by other means; the event immediately preceding the liquidation or winding-up process." DISSOLUTION, Black's Law Dictionary (10th ed. 2014). Most states provide that the filing for bankruptcy of any partner or member causes dissolution of the partnership or LLC unless there is a contrary agreement by the members within the operating agreement. Steven A. Waters & Eric Terry, Bankruptcy and Insolvency Issues for Partnerships, LLC's, and Their Owners - The Good, the Bad, and the Ugly, *Tex. J. Bus. L*., Spring 2003, at 51, 83. A member filing for bankruptcy causes a dissolution, and a dissolution then causes the LLC to cease to exist. *In re Hart*, 530 B.R. 293, 302 (Bankr.E.D.Pa. 2015).

However, an LLC's operating agreement allowing a LLC to continue after a member files for bankruptcy via a vote by the remaining members is not dispositive on whether or not dissolution occurs. "It has been suggested that such an arrangement may not be recognized as a dissolution by a bankruptcy court and that, therefore, it is risky to draft an LLC's constituent documents to establish the bankruptcy of a member as the only event of dissolution. The thought is that this could result in the LLCs' having the corporate characteristic of continuity of life." *Id*. at 83. Courts have found some provisions enforceable while finding others unenforceable.

B. Examples of Enforceable Continuation Provisions

In *In re DeLuca* (applying Virginia law), members of an LLC sought a declaration that Chapter 11 debtors, managers of the LLC, had been properly removed as managers and that another member had been properly elected successor manager without the debtors' votes. 194 B.R. 65, 68 (Bankr.E.D.Va. 1996). The court found that the operating agreement provision allowing for dissolution of the LLC upon a member's bankruptcy filing, with the remaining members having the right to elect to continue business and elect a new manager, was not an invalid ipso facto provision for purposes of the Bankruptcy Code, 11 U.S.C.A. §365(e)(1), (2), and thus, the members had the right to elect a new manager upon the original managers' filing of the Chapter 11 petition. *Id.* at 77.

In *Milford Power Co., LLC v. PDC Milford Power, LLC*, the court determined that an ipso facto clause in the LLC agreement that was allowed under Delaware statute and allowed a minority interest member to have their interest divested did not conflict with the Bankruptcy Act, at least to the extent it divested minority members of their interest. 866 A.2d 738, 749 (Del. Ch. 2004).

In *Provident Energy Associates of Montana v. Bullington*, the court held that under Montana law, former Mont. Code Ann. §35-8-802(d)(iii), and the terms of the LLC's operating agreement, a corporation that was a member of the LLC had ceased to be a member of the LLC when it was adjudicated as bankrupt. 77 Fed. Appx. 427, 428 (9th Cir. 2003).

C. Unenforceable Continuation Provisions

However, the court in *Milford Power Co., LLC. v. PDC Milford Power, LLC.*, found that the minority member was not divested of the economic rights available to an assignee of an LLC membership. 866 A.2d 738, 749 (Del. Ch. 2004). Though the minority member's bankruptcy petition was dismissed under the Bankruptcy Code provision neutralizing an ipso facto clause

(11 U.S.C.A. §365(e)(1)), the minority member could not be subjected to any greater consequences than if the clause had been addressed in the context of a bankruptcy plan, clarified the court. *Id.* at 760.

In *In re IT Group, Inc., Co.*, debtors attempted to transfer their rights in an LLC and other LLC members challenged the attempted transfer. 302 B.R. 483, 485 (D. Del. 2003). The court decided that "the default provision contained in the LLC's operating agreement was an ipso facto clause that was unenforceable under the provision of the Bankruptcy Code, 11 U.S.C.A. §365(e)(1), barring termination or modification of an executory contract or unexpired lease, or rights or obligations thereunder, due to a debtor's commencement of a bankruptcy case, such that one of the remaining members of the LLC was precluded from exercising its buy-out rights under the agreement based on the debtors' petition filing." *Id.* at 487.

In *Matter of Daugherty Const., Inc.*, an LLC had a provision within the operating agreement that held that dissolution occurred when a member filed bankruptcy, but the remaining non-debtor LLC members could vote to continue business. 188 B.R. 607, 609 (Bankr.D.Neb. 1995). It went on to state that should they vote to continue, the bankrupt former member could not participate in the continuing enterprise. *Id.* The Court held that this provision and corresponding Nebraska statute were in conflict with provisions of the Bankruptcy Code, 11 U.S.C.A. §§363(1), 365(e), 541(c)(1). *Id.* at 614.

In *Horning v. Horning Const., LLC*, the court found that the shareholder of one-third interest, and founder of a limited liability company (LLC) that bore his name, could not involuntarily dissolve the LLC, where an operating agreement had not been executed to give the founder fair exit rights, and evidence otherwise did not demonstrate that it was not reasonably practicable to carry on business. 12 Misc. 3d 402, 407 (Sup 2006).

D. Executory Contracts Generally

The Bankruptcy Code does not actually define ”executory” or “executory contract.” The Countryman definition is the most widely accepted definition - “[An executory contract is a] contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” *See* Michelle Morgan Harner, Carl E. Black, Eric R. Goodman, Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy, 13 *Am. Bankr. Inst. L. Rev*. 187, 190 (2005). “Bankruptcy courts treat partnership agreements as executory contracts which, if unperformed by either party, would constitute a material breach of the partnership agreement.” 37 *A.L.R. Fed.2d* 129. Like a partnership agreement, an LLC operating agreement may or may not be considered an executory contract, subject to assumption or rejection.

Generally speaking, “the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.” 11 U.S.C.A. §365(a). However, in recent years, one of the limited exceptions that kept personal contracts from being assignable has been extended to “partnership agreements…and limited liability company agreements.” Harner, *supra* at 188. This exception, found in §365(c)(1) of the Bankruptcy Code, provides that a trustee or debtor in possession may not assume or assign an executory contract or unexpired lease if “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 such party does not consent.” 11 U.S.C.A. §365(c)(1).

Section 365(f) states that: “Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in

applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection." 11 U.S.C.A. § 365(f)(1). In contrast to the language of § 365(f)(1), the plain language of § 365(c)(1) appears to prohibit a debtor from assuming or assigning an executory contract or unexpired lease if "applicable law" excuses the non-debtor party from accepting performance from a new obligor. Harner, *supra* at 197. Read broadly, §365(c)(1) renders §365(f)(1) superfluous in certain factual contexts. *Id.* The assignment of an executory contract or unexpired lease necessarily involves the substitution of a new obligor and, thus, performance under the contract or lease by a party other than the debtor or debtor in possession. *Id.* Accordingly, §§365(f) and 365(c)(1) are brought into conflict when a debtor seeks to assume and assign an executory contract or unexpired lease and "applicable law" excuses a non-debtor party from accepting performance from a new obligor. *Id.* at 198.

Because assumption is a prerequisite to assignment, this conflict informs the interpretation of §365(c)(1) when a debtor seeks only to assume an executory contract or unexpired lease under §365(a). *Id.* Reconciling §§365(c)(1) and 365(f), courts have adopted various approaches. At least one court has found that §§365(c)(1) and 365(f) simply cannot be reconciled and decided to ignore the phrase "applicable law" in §365(f). *See Breeden v. Catron (In re Catron)*, 158 B.R. 629, 637 (E.D. Va. 1993) ("[W]hile §365(c) explicitly directs the court to consider whether 'applicable law' prohibits assignment, the language 'notwithstanding a provision ... in applicable law, that prohibits ... assignment' of §365(f) just as explicitly directs the court to ignore applicable law. The two clauses at the beginning of §365(f) simply cannot be reconciled."). Most courts, however, have resolved the apparent conflict between §§365(c)(1) and 365(f) by ascribing a different meaning to the phrase "applicable law" appearing in each

section. Harner, *supra* at 198-99. For example, the United States Court of Appeals for the First Circuit has interpreted the phrase "applicable law" in §365(f) as applying only to state laws that enforce contract provisions that prohibit, restrict or condition assignment, and the phrase "applicable law" in §365(c)(1) as applying to state laws that, on their own terms, prohibit, restrict or condition assignment of a particular type of contract. *Id.* at 199.

E. Assumption

Whether an executory contract can be assumed rests largely on whether or not the jurisdiction in question applies the "hypothetical" or "actual" test when construing §365(c)(1). Courts that have adopted the "actual" test interpret this provision as applying only when the debtor actually seeks to assign an executory contract or unexpired lease that cannot be assigned under applicable non-bankruptcy law under §365(c)(1). *Id.* at 235. Courts that have adopted the "hypothetical" test interpret this provision as prohibiting the assumption of any executory contract or unexpired lease if applicable law prohibits the assignment of the particular contract or lease – regardless of whether the debtor actually seeks to assign the contract or lease. *Id.* at 235.

The Third Circuit was the first to apply the hypothetical test in *Matter of W. Electronics Inc.*, 852 F.2d 79 (3d Cir. 1988). The court justified its decision on two grounds. "First, it found that the 'literal meaning of the words chosen by Congress' requires the application of a hypothetical test (*i.e.*, a plain language argument). Section 365(c)(1) does not say that a debtor 'may not assume *and* assign' an executory contract if applicable non-bankruptcy law excuses the non-debtor party from accepting performance from an entity other than the debtor in possession. *Id.* at 83. Rather, it says that a debtor 'may not assume *or* assign' an executory contract if applicable non-bankruptcy law excuses the non-debtor party from accepting performance from an entity other than the debtor in possession. 11 U.S.C.A. §365. Second, the Third Circuit found that 'a solvent contractor and an insolvent debtor in possession are materially distinct entities'

(*i.e.*, a separate entity argument). *In re W. Elecs. Inc.*, 852 F.2d at 83. Accordingly, the assumption of the contract by the debtor in possession constituted a constructive assignment from the pre-petition company to the post-petition company." Harner, *supra* at 237. The Fourth Circuit also picked up much of the court's reasoning and applied it to several Fourth Circuit cases. *Id.*

Other courts argue the actual test presents a better interpretation of the Bankruptcy Code than the hypothetical test. First, courts have found that the actual test is compatible with the literal language of §365(c)(1). Harner, *supra* at 238. Section 365(c)(1) gives effect to applicable non-bankruptcy law that restricts or conditions assignment outside of bankruptcy. *Id.* The assumption of an executory contract or unexpired lease does not affect an assignment, as so defined outside of bankruptcy, because the debtor in possession is not a new or separate entity. *Id.* Thus, if non-bankruptcy law is not applicable because no assignment is actually contemplated, then it arguably makes little sense to give effect to such anti-assignment law in bankruptcy when a debtor does not seek to assign a contract. *Id.* at 239. Under this interpretation, the term "applicable law" in §365(c)(1) refers only to law that actually applies to the actions that the debtor wishes to take. *Id.* Second, courts have found that the actual test is more consistent with the legislative history of §365(c)(1). *Id.*at 239. The legislative history indicates that "[s]ubsection (c) ... only applies in the situation in which applicable law excuses the other party from performance independent of any restrictive language in the contract or lease itself." S. Rep. No. 95-598, at 59 (1978), reprinted in 1978 U.S.C.C.A.N. 4717, 5845. Third, courts have found that the actual test is more compatible with the goal of maximizing the value of the bankruptcy estate. Harner, *supra* at 242.

> "If the ultimate goal of bankruptcy is the rehabilitation of a debtor's business, it makes little sense to prevent a debtor from assuming a potentially valuable asset. Given the nature and number of contracts that courts have found to fall within the scope of §365(c)(1), a court's decision to adopt either the actual or hypothetical test undoubtedly impacts the ability of a debtor to reorganize effectively. Courts that (1) do not consider the nature of the contract or whether the identity of the original contracting party is material and (2) apply the hypothetical test are likely to apply §365(c)(1) to prevent assumption whenever the contract in question is executory and there is some state or federal law that restricts assignment outside of bankruptcy, often to a debtor's estate's detriment." *Id.*

F. Rejection

There is judicial disagreement over what rejection truly entails. Some posit that rejection really just means that the trustee is choosing to not assume the executory contract. Michael T. Andrew, Executory Contracts in Bankruptcy: Understanding "Rejection, 59 *U. Colo. L. Rev*. 845, 849 (1988). Essentially, if the trustee decides that assuming the contract is not in the best interest of the estate, the trustee has the ability to reject (not assume) further responsibility. This would then constitute a breach and would enable the non-debtor party whose contract has been rejected to be a creditor like all others. *Id* at 863 ("…a trustee or debtor in possession does not 'reject' the liability reflected in a contract, but rather rejects—i.e., declines to accept—the transfer of title to the asset.").

"Section 365(g) provides that rejection of an executory contract or unexpired lease 'constitutes a breach of such contract or lease' ordinarily deemed to have occurred 'immediately before the date of the filing of the petition,' and the non-debtor's claim is allowable as if it had then arisen." *Id*. at 877. These provisions have resulted in three distinct interpretations. First,

executory contracts are excluded unless assumed. Second, a trustee can choose to assume (most) executory contracts. Lastly, if the trustee does not assume (rejects), then that constitutes a presumptive breach. *Id.* 881-882. There are three general types of cases dealing with rejection, and each treat rejection differently. The first consists of cases discussing whether particular contracts are "executory" as a preliminary issue before determining whether rejection is permitted. The second consists of cases holding that, when a contract is "executory" and rejected, the contract is somehow destroyed or otherwise altered. The third category, an aggravated derivative of the second, is comprised of cases holding that rejection of a contract somehow destroys a right in or to property created by the contract, even if that right is otherwise good as against all competing claimants and as against the estate itself. *Id.* at 884.

The first type is exemplified by *In re KMMCO, Inc.*, where a former, deceased president of the debtor had an employment contract with the debtor that provided for death benefit payments to his wife. 40 Bankr. 976, 976-77 (E.D. Mich. 1984). The agreement provided that the benefits would be payable until the earlier of ten years after the president's death or such time as the wife died, remarried or cohabited with another man. *Id.* The bankruptcy court approved rejection, and on appeal the district court identified the determinative issue as being whether the agreement was "executory" or "executed . . . as far as Mrs. Bajer's obligations are concerned." "If the contract was executory, it could be rejected with permission of the bankruptcy court, and KMMCO's obligations under the contract would be discharged. On the other hand, if it was already executed, rejection would not be permitted." *Id.* at 977.

The second type is exemplified by *In re TransAmerican Natural Gas Corp.*, 79 Bankr. 663 (Bankr.S.D.Tex. 1987). It illustrates the same confusion about rejection but to much more significant effect. There, the Chapter 11 debtor in possession, the operator of an oil refinery,

earlier had rejected a contract to purchase electric service from a power company for a specified period at specified rates. *Id.* at 664-65. The contract included a liquidated damages provision in favor of the power company. *Id.* at 665. The issue was not whether rejection was permissible, but rather its effect on the power company's claim. *Id.* The debtor argued that "when the contract was rejected, the liquidated damages clause was rejected as well, on the principle that an executory contract may be assumed only in whole and not in part, and that that principle is applied to rejection. *Id.* at 667. Agreeing with that argument, the court concluded that the court was not bound by the liquidated damages clause because by rejecting the contract, the debtor also rejected its obligation. *Id.* The court believed the contrary argument was circular. The court held the liquidated damages clause unenforceable in determining the claim not because the clause itself was objectionable, but because it was contained in a "rejected" "executory" contract. *Id.* at 668. The clear implication was that the clause would have been enforced if the contract had not been 'executory.' *Id.* In that conception, then, the happenstance of "executoriness" becomes the key to rewriting the contract, a result directly at odds with the logic, history and purpose of rejection doctrine.

This third type is exemplified by the Fourth Circuit's decision in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), cert. denied, 475 U.S. 1057 (1986). There the debtor had licensed certain technology to Lubrizol non-exclusively, and sought in its Chapter 11 case to reject the license and terminate Lubrizol's rights to the technology. *Id.* at 1045. The key issue, thought the court, was the hunt for mutual "executoriness." *Id.* Addressing first the debtor-licensor's side of the agreement, the court found executory aspects in the "continuing duties of notifying Lubrizol of further licensing of the process and of reducing Lubrizol's royalty rate to meet any more favorable rates granted to subsequent licensees." *Id.* In

addition, the debtor had the "additional contingent duties of notifying Lubrizol of suits, defending suits and indemnifying it for certain losses." *Id.* The 'executoriness' of Lubrizol's side of the arrangement was more difficult, because the court thought the mutual performance test required remaining duties other than merely the payment of money. But the necessary 'executory' obligations were found, as the court explained in this remarkable passage:

> [I]f Lubrizol had owed [the debtor] nothing more than a duty to make fixed payments or cancel specified indebtedness under the agreement, the agreement would not be executory as to Lubrizol. However, the promise to account for and pay royalties *required that Lubrizol deliver written quarterly sales reports and keep books of account subject to inspection by an independent Certified Public Accountant*. This promise goes beyond a mere debt, or promise to pay money, and was at the critical time executory.

*Id.* at 1046. The court went on to approve rejection of the license and termination of the licensee's interest, relying in part on the absence of any special protection for licensees in §365. *Id.* at 1048. The court did not pause to ask why the happenstance of "executoriness" should control an issue so important as the licensee's continued ability to use the technology. *Id.* Its only real attempt at an explanation of the result was to observe that the 'clear' purpose of §365(g), the rejection-as-breach rule, "is to provide only a damages remedy for the non-bankrupt party." *Lubrizol,* 756 F.2d at 1048. Other courts similarly have applied avoiding-power rejection in this context, although uneasiness with the result again has suggested to some the need for 'balancing' or 'good faith' tests. Andrew, *supra* at 918.

The most logical view of rejection is that that rejection is simply a failure to assume. Therefore, rejection of an executory contract simply puts the non-debtor in the same positon as other creditors and gives those creditors an avenue to recover what they lost in the contract. It makes no logical sense why a contract being executory would excuse the trustee from liability caused by the contract.

## III. SALE OF A PARTNERSHIP INTEREST OR LLC INTEREST BY A DEBTOR OR TRUSTEE

### A. Property under Section 541

The commencement of a case under the Bankruptcy Code creates an estate consisting of all of the property identified in §541(a). Harner, *supra* at 243. Section 541(a) defines "property of the estate" broadly as including "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C.A. §541(a)(1). A debtor's interest in an unassumed executory contract or unexpired lease generally is considered property of the debtor's estate under §541(a). Harner, *supra* at 244. Accordingly, although not adopted by all courts, an argument exists that a debtor in bankruptcy retains its rights under an executory contract or unexpired lease even if the contract or lease cannot be assumed by the debtor or trustee." *Id.*

In *Valley Media*, 279 B.R. 105 (Bankr.D.Del. 2002) the debtor, a supplier of entertainment software, filed a motion to sell its inventory at an auction and numerous vendors responded by asserting that their distribution agreements with Valley Media contained non-exclusive licenses that could not be assumed or assigned pursuant to §365(c)(1) and controlling Third Circuit precedent. *Id.* at 113-120. Since the non-exclusive licenses could not be assumed, the vendors reasoned that the contracts terminated upon the commencement of the debtor's case and the auction would constitute a first sale in violation of federal copyright law. *Id.* at 135. The bankruptcy court disagreed and found that the debtor's rights under the distribution agreements did not terminate upon but vested in the debtor and could be exercised by the debtor during the pendency of the bankruptcy. *Id.* The bankruptcy court first acknowledged that "[a] non-exclusive license of rights by a copyright owner to another party is not assignable by that party without the permission of the copyright holder under federal common law since the license represents only a personal and not a property interest in the copyright." *Id.* at 135. The distribution agreements

contained such non-exclusive licenses in that they gave the debtor the right to sell the software without becoming an infringer. *Id.* at 139. Accordingly, under the Third Circuit's decision in *West Electronics* and §365(c)(1), the debtor could not assume the distribution agreements. *Id.* at 137 ("The debtor and the debtor in possession are indeed considered to be different entities. *In re W. Electronics, Inc.*, 852 F.2d at 83 ...."). The debtor, however, was "not seeking to either assume the licenses for the benefit of the post-bankruptcy reorganized company or to assume and assign (*i.e.*, sell) the licenses for the benefit of the estate." *Id.* at 139. The debtor merely was seeking to exercise the rights it held under the distribution agreements to sell the goods as of the petition date. Thus, the debtor was permitted to exercise rights under the distribution agreements during the bankruptcy even though it could not assume the distribution agreements under *West Electronics*. Harner, *supra* at 244-45. Taking this reasoning to its logical conclusion, if the debtor is viewed as retaining its rights under an executory contract or unexpired lease during the bankruptcy even if such rights cannot be assumed, then the non-debtor party must first obtain relief from the automatic stay before it attempts to extinguish the debtor's contractual rights. Harner, *supra* at 245.

Contrary to the holding in *Valley Media*, however, some courts have found that the filing of a bankruptcy petition automatically divests a debtor of its rights under an executory contract if that contract would be subject to §365(c)(1). *Id.* at 246. Although most courts view a debtor's legal and equitable rights under an executory contract or unexpired lease as of the commencement of the case as constituting property of the estate under §541(a)(1), some courts have stated that such rights do not become part of the estate until the debtor assumes the contract or lease. *Id.* This characterization of a debtor's rights under an executory contract prior to assumption has been widely criticized. *Id.* Nevertheless, under the reasoning of these courts, and

given the interaction between §§541(a)(1) and 362(a), it is possible in some jurisdictions that the non-debtor party would not need to seek relief from the automatic stay before ceasing performance under a non-assumable contract. Because more recent and arguably well-reasoned authority has rejected this position, a non-debtor party should proceed cautiously and may be ill advised to proceed as if the bankruptcy filing automatically divested the debtor of its rights under a non-assumable contract. *Id.* at 246-47.

B. Enforcement of Sale Restrictions

According to §363(l), "when the restriction on transfer is based upon the debtor's insolvency or bankruptcy filing, the trustee is not bound to honor the restrictions and may sell the interest to the highest bidder." 11 U.S.C.A. §363(l). In *Cutler v. Cutler*, the partnership agreement provided three different buy-out prices depending upon the cause. 165 B.R. 275, 276 (Bankr.D.Ariz.1994). Upon the partner's bankruptcy, the price was equivalent to the partner's capital and income accounts; upon death, book value adjusted to fair market value; upon withdrawal, 87.5% of the death price. *Id.* The court held that the discriminatory price upon bankruptcy violated §363(l) of the Bankruptcy Code, since it was "conditioned" upon a bankruptcy filing and effected a "modification" of the debtor's interest. *Id.* at 279-80. In *In re Grablowsky*, the court held that the trustee in bankruptcy was not bound to a buy-sell agreement providing that upon occurrence of events causing dissolution as set forth in state statute (which included bankruptcy of a partner), the remaining partners had the right to purchase the partner's interest at fair market value. 180 B.R. 134, 136 (Bankr.E.D.Va. 1995). As a result, the trustee had the right to sell to the highest bidder. *Id.* at 138.

C. Ipso Facto Clauses

Ipso facto clauses are "provisions providing for the termination of the contract or lease in the event of the insolvency or weakening financial condition of one of the parties." Harner, *supra*

at 247. Section 365(e)(1) also makes ipso facto clauses unenforceable in bankruptcy. *Id.* at 248. "Section 365(e)(1) provides that, 'at any time after the commencement of the case,' a debtor's rights under an executory contract or unexpired lease 'may not be terminated or modified' by a provision in such contract or lease or in 'applicable law' that is conditioned on '(A) the insolvency or financial condition of the debtor ... (B) the commencement of a case ... or (C) the appointment of ... a trustee ... before such commencement.' Thus, section 365(e)(1) facially pre-empts contractual and statutory ipso facto provisions." *Id.* However, §365(e)(2) permits the enforcement of *ipso facto* clauses with respect to contracts or leases that, under §365(c)(1), are not subject to assumption or assignment. *Id.* at 249. In order to determine whether an ipso facto clause is enforceable under §365(e)(2), a party must first determine whether the contract or lease falls within §365(c)(1). *Id.* In turn, figuring out if §365(c)(1) applies largely depends on whether the court applies the actual or hypothetical test. *Id.*

Effectively, courts that apply the hypothetical test also find that ipso facto clauses are valid. *In re Catron*, 158 B.R. 629 (E.D. Va. 1993) aff'd, 25 F.3d 1038 (4th Cir. 1994). "The bankruptcy court first concluded that the partnership agreement was 'essentially a personal services contract' that could not be assumed under §365(c)(1) of the Bankruptcy Code because '[f]undamentally a partnership is based upon the personal trust and confidence of the partners.' For the same reasons, the bankruptcy court also concluded that the buyout option that was triggered by the debtor's bankruptcy was not invalidated by section 365(e)(1) of the Bankruptcy Code, but rather was validated by section 365(e)(2). Accordingly, the bankruptcy court granted the non-debtor parties' motion for relief from the automatic stay, and the debtor appealed." Harner, *supra* at 250-51. The district court affirmed, and concluded that "sections 365(c)(1) and

365(f) of the Bankruptcy Code simply cannot be reconciled, the district court adopted the hypothetical test…" *Id.* at 251.

In contrast, courts that have determined that §365(c)(1) of the Bankruptcy Code creates an actual test have invalidated ipso facto clauses in partnership agreements under §365(e)(1). *Id.* In *Summit Investment*, two general partners in the Belle Isle Limited Partnership, a limited partnership formed pursuant to Massachusetts law, filed cases under Chapter 11 of the Bankruptcy Code. 69 F.3d at 609. After the debtors filed their bankruptcy cases and before the debtors sought to assume their partnership interests, the non-debtor partners sought injunctive and declaratory relief to remove the debtors as general partners pursuant to a provision in the partnership agreement. *Id.* Under the partnership agreement, a general partner ceased to be a general partner if it filed a voluntary petition for bankruptcy. *Id.* The bankruptcy court, however, found the provision unenforceable under §365(e)(1). *Id.*at 614.

The district court and the First Circuit both affirmed the bankruptcy court's decision. *Id.* The First Circuit rejected the hypothetical test and adopted the actual test, whereby assumption is not precluded by section 365(c)(1) of the Bankruptcy Code when the identity of the contracting party remains unchanged. *Id.* at 613 ("[S]ection 365(c)[1] presents no bar to [the] assumption of the Agreement.").

D. Interest being sold

Under the Uniform Partnership Acts (UPA) of both 1997 and 1994, the "a partner's only transferable interest in the partnership is the partner's share of the partnership's profits and losses and the partner's right to receive distributions." Harner, *supra* at 207. "A transferee of a partner's transferable interest has the right to receive distributions of the partnership's profits; however, a transferee does not become a partner by virtue of the assignment or sale of the partner's

transferable interest and has no right to participate in the management of the partnership." *Id.* In this respect, UPA restrict the assignment of a partner's full or entire partnership interest. *Id.*

Invoking §365(c)(1), most circuits have given effect to the restrictions imposed by the Uniform Partnership Acts, as codified in full or in part in various states, on the attempted transfer or assignment of a partnership interest in bankruptcy. *Id.* at 208. For example, a court that decided (or was required) to follow the First Circuit's reasoning in *Pioneer Ford Sales* most likely would enforce such restrictions because the Uniform Partnership Acts restrict the assignment of partnership interests irrespective of any language contained in the partnership agreement. *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F.3d 608, 612 (1st Cir. 1995) (rejecting "hypothetical test" but finding Massachusetts limited partnership statute "applicable non-bankruptcy law" under §365(e)(2)(A) of the Bankruptcy Code). Courts that consider whether the identity of the contracting party is material to the agreement have enforced such restrictions because the identity of the partner generally is considered material to the underlying partnership agreement. Harner, *supra* at 209.

The court in *In re Klingerman*, held that a clause in the operating agreement for an LLC, indicating that a member of the LLC would cease to be a member upon his or her filing of a voluntary bankruptcy petition, did not serve to prevent the founding member of the LLC who subsequently filed for Chapter 11 relief from commencing a proceeding to compel the LLC's dissolution. 388 B.R. 677, 678 (Bankr. E.D. N.C. 2008). This was based on the theory that, having ceased to be member with the filing of his Chapter 11 petition, he no longer had standing to seek the LLC's dissolution, as the debtor's right to petition for dissolution was a non-economic interest in the LLC, which members of the LLC, by inserting the clause in the operating

agreement, could not prevent from being included in "property of the estate" under 11 U.S.C.A. §541(c)(1). *Id.*

E. Strong Arm Statutes

A bankruptcy strong arm statute is an avoidance power that allows a trustee to step into some of your creditors' shoes to undo a transaction so that all of your creditors can benefit. "The bankruptcy system is based on, among other things, the principle of equality of distribution so that creditors of the same class receive generally equivalent treatment." Robert Nelson, *The Not-So-Secret Crucible of Bankruptcy*, Utah B.J., January/February 2010, at 35. The Bankruptcy Code includes a number of provisions specifically aimed at avoiding and recapturing pre-bankruptcy transfers that in effect favor one creditor over the general creditor body. *Id.*

Section 544 gives a bankruptcy trustee (or debtor-in-possession) the status of a hypothetical lien creditor. 11 U.S.C.A. §544. This permits a trustee to avoid liens and other interests that have not been properly perfected before a bankruptcy filing. Id. Another provision, §547, is directed at preferential transfers. 11 U.S.C.A. §547. That section permits a trustee to recover debt payments made during the ninety days before bankruptcy (one year in the case of transfers to insiders). *Id.* It applies even if (a) the payments were on valid obligations of the debtor and (b) the creditor receiving the payment continued to have a claim even after the preference. *Id.* Section 548 permits avoidance of fraudulent transfers. 11 U.S.C.A. §548. Generally, it mirrors state fraudulent transfer laws that are also applicable in bankruptcy under the "strong arm" section. Under §548, a trustee may challenge transfers intended to hinder, delay, or defraud creditors. 11 U.S.C.A. §548(a)(1)(A). That language has been interpreted to include payments made in connection with Ponzi schemes. Nelson, *supra* at 36. The section also covers transfers made by an insolvent debtor for less than reasonably equivalent value. 11

U.S.C.A. §548(a)(1)(B). In that regard, §548 has been used to challenge pre-bankruptcy asset sales deemed to have been for an inadequate price." Nelson, *supra* at 36.

Courts have made numerous rulings on when strong arm statutes apply in specific factual contexts:

> -A bankruptcy trustee is precluded from asserting his "strong arm" powers as a hypothetical lien creditor to avoid a mortgage if the mortgage was properly recorded. 11 U.S.C.A. § 544(a)(2). In re Prescott, 402 B.R. 494 (Bankr.D.N.H. 2009). 3A Bankr. Service L.Ed. §31:129.
>
> -Chapter 11 debtor-in-possession, by virtue of strong-arm statute, was not on notice of mortgage lender's unperfected lien, as result of its 22-month delay in recording its mortgage, and was not barred, on waiver or estoppel theory, from seeking to avoid mortgage as preference. 11 U.S.C.A. §§ 544, 547(b). In re Schatz, 402 B.R. 482 (Bankr. D. N.H. 2009). 3A Bankr. Service L. Ed. § 31:129.
>
> -Regardless of validity of assignments by which mortgage was transferred between lenders, or of whether mortgage assignee was also in possession of mortgage note, mortgage, being properly recorded in accordance with Massachusetts law, was not subject to avoidance by trustee of debtor-mortgagors' Chapter 7 estate in exercise of strong-arm powers as judicial lien creditor, judgment creditor, or bona fide purchaser; recording of mortgage placed all of these entities on constructive notice of mortgage lien. 11 U.S.C.A. §544. *In re Marron*, 499 B.R. 1 (D. Mass. 2013). 3A Bankr. Service L. Ed. §31:129.
>
> -A state law fraudulent transfer claim that the debtor was authorized to pursue, pursuant to the strong-arm statute (§544(b)(1)), in its capacity as Chapter 11 debtor in possession, was not an asset that belonged to the debtor, but to the debtor's creditors; accordingly, the cause of action was not sold to a third party as part of a court-approved sale of the debtor's assets. Official Creditors' Comm. (*In re Cybergenics Corp.*), 226 F.3d 237 (3d Cir. 2000). *Recent Developments in Business Bankruptcy -- 2001*, 26 Cal. Bankr. J. 132, 162 (2002).

Three recent decisions by federal appellate courts, however, impede bankruptcy avoidance powers, allowing the shareholders to siphon cash away from an entity on the verge of collapse. Irina V. Fox, *Settlement Payment Exception to Avoidance Powers in Bankruptcy: An Unsettling Method of Avoiding Recovery from Shareholders of Failed Closely Held Company LBOs*, 84 Am. Bankr. L.J. 571, 572 (2010). Broadly interpreting the literal language of

Bankruptcy Code §§546(e) and 741(8), these decisions shield from avoidance powers payments made to shareholders in connection with leveraged buyouts ("LBOs"). *Id.* In holding that §§546(e) and 741(8) immunize shareholders' LBO payments from fraudulent transfer claims, these courts disregard the fact that the LBO left the company insolvent or with inadequate capital to pay its debts. *Id.* Many failed LBOs are the result of irresponsible lending and borrowing without well-developed business and financial strategies, which contributed, in part, to the current financial turmoil. *Id.* Stripping the bankruptcy trustee or debtor of avoidance powers for payments to shareholders in connection with an LBO potentially encourages poorly planned LBOs and may facilitate funneling cash away from failing companies to the detriment of the creditors. *Id.* Shielding all LBOs from avoidance would encourage reckless lending and borrowing practices. *Id.* at 574. Knowing that the transaction will not be unwound in bankruptcy creates a perverse incentive not to evaluate the long-term strategy for the bought-out company. *Id.* Indisputably, LBOs are a valuable vehicle for the economy because investment in healthy growth is crucial to the recovery of the global economy. *Id.* Nonetheless, not all LBO transactions should be encouraged. *Id.* Allowing the trustee to use her avoidance powers would serve as a deterrent for poorly planned LBOs and promote more accountability in lending and borrowing. *Id.*

## IV. RIGHTS OF CREDITORS TO LLC MEMBERSHIP INTERESTS

### A. Rights of Judgment Creditors

#### 1. What Interests of a Member of an LLC May Be Reached by a Judgment Creditor?

Unlike corporate stock, an equity ownership in a limited liability company by statute consists of two separate and distinct rights: (i) economic rights, or transferable rights, and (ii) governance, or management, rights. The economic rights of members of an LLC are generally

limited to the right to receive distributions from the LLC in accordance with its organizational documents. Governance rights consist of the rights of the members of the LLC to manage the business entity.

Generally, it is only the economic interest of a member that may be reached by creditors—not the rights to participate in management of the LLC. The creditor will not receive membership rights such as voting absent the agreement of the other members of the LLC or as otherwise provided in the operating agreement of the LLC.

2. Charging Orders.

a. Definition

(i) A charging order is a judicial lien or charge on the judgment debtor's transferable interest or financial rights in a partnership or LLC. "A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that otherwise be paid to the judgment debtor." Minn. Stat. § 322C.0503, subd.

(ii) Charging orders have been characterized as a "peculiar mechanism" of American law not originally a part of English common law. See, e.g., *91st Street Joint Venture v. Goldstein,* 691 A. 2d 272 (Md. 1997). However, by 1890, the charging order came into being as a part of the English Partnership Act of 1890. This statute served as the model for Section 28 of the Uniform Partnership Act. See, *City of Arkansas City v. Anderson,* 752 P.2d 673 (Kan. 1988).

(iii) Charging orders are now expressly addressed in Section 503 of the Revised Uniform Limited Liability Company Act. However, several states have scrambled to create nonuniform versions in order to protect their domestic business entities. The result is a sometimes confusing, inconsistent patchwork of statutory provisions. The Appendix to these materials contains a summary of the statutory provisions of several Midwestern states relating to the scope and procedures applicable to charging orders for LLCs.

(iv) Charging orders may be seen most accurately, not as a remedy for judgment creditors, but as a limitation on creditors' remedies. Unlike a judgment debtor's interest in a corporation, which may be seized and sold on the courthouse steps by the sheriff, the interest of a partner or a member of an LLC may not generally be sold by a judgment creditor. In the case of corporate stock, the sheriff may sell such stock to a third party or the judgment creditor may "credit bid" to acquire the shares.

(a) The charging order is generally the "exclusive remedy" by which a judgment creditor may enforce a judgment against a partner/member against the judgment debtor's interest in the business entity. *See, e.g,* Minn. Stat. § 322C.0503, subd. 7.

(b) The charging order is seen as an essential part of the "pick your partner" mentality that is fundamental to unincorporated businesses. The limitations on the rights of a judgment creditor to reach the interest of a partner or LLC member supports the pick your partner mentality because other LLC members are merely ordered by such

orders to make a monetary distribution from the LLC to someone other than their original partner, but the LLC members are not ordered or forced to work with the judgment creditor or a purchaser of the interest from a judgment creditor. It is not seen as a means to protect the debtor's interest in the business, but rather as a means to protect the non-debtor members from being forced into an involuntary partnership with somebody's creditor.

(c) In the view of at least one court, charging orders "are purely statutory tools that judgment creditors use to reach partnership interests of indebted partners….[W]e have characterized a charging order against a limited partnership interest as 'nothing more than a legislative means of providing a creditor some means of getting at a debtor's ill-defined interest in a statutory bastard, surnamed 'partnership,' but corporately protecting participants by limiting their liability as are corporate shareholders.'" *Green v. Bellerive Condominiums, LP,* 763 A.2d 252 (Md. 2000) quoting *Bank of Bethesda v. Koch*, 44 Md. App. 350, 354 (1979).

b. Effect of Charging Order

(i) The issuance of a charging order has the effect of creating a lien in favor of the judgment creditor by requiring the partnership/LLC to make all future "distributions" which would otherwise be made to the judgment debtor to the judgment creditor. However, a charging order does not force the LLC to make a distribution—it only directs to whom such distributions must be made. *See e.g.,*

Minn. Stat. § 322C.0503. A "distribution" is any transfer of money or other property "on account of" a member's transferable interest. Minn. Stat. § 322C.0102, subd. 7.

(ii) Since a charging order results in the creation of a lien on the judgment debtor's rights to distributions, it may be necessary to employ other creditors' remedies (e.g., a garnishment proceeding) in order to receive wages or salary payable to the judgment debtor by the entity.

(iii) A charging order does not entitle the judgment creditor to participate in the management of the LLC, including, presumably, the right to vote on making distributions. See, e.g., *Green v. Bellerive Condominiums LP,* 763 A.2d 252 (Md. 2000).

(iv) A judgment creditor may not be entitled to demand information about the LLC's operations or financial affairs. See, e.g., *Lumbermans Mutual Cas. Co. v. Luciano Enterprises, LLC,* 2005 WL 2340709 (D. Alaska, 2005); *Deutsch v. Wolff*, 7 S.W. 3d 460 (Mo. App. 1999). See also, Minn. Stat. § 322C.0502, subd. 3 (transferee of economic interest entitled to accounting only from the date of dissolution of LLC).

(v) Charging orders are afforded priority based upon the time of service upon the partnership/LLC. See, e.g., *City of Arkansas City v. Anderson,* 752 P.2d 673 (Kan. 1988); *Union Colony Bank v. United Bank of Greeley*, 832 P.2d 1112 (Colo. 1992). Presumably, a charging order would be subordinate to a prior perfected security interest in the judgment debtor's interest in the LLC under UCC 9-317(a)(2).

(vi) A judgment creditor with a charging order cannot force a sale of the debtor's entire interest in the entity. Rather, most statutes provide the creditor may, upon court *authorization*, foreclose the lien and sell the "transferable interest" of the judgment debtor. The purchaser at any such foreclosure sale will obtain only the debtor's rights to distributions and does not become a member of the LLC. See, e.g., Minn. Stat. § 322C.0503, subd. 3.

c. Procedures

(i) Unlike most remedies available to judgment creditors which do not require involvement of the court, a charging order is available only by court order. Most of the statutes do not provide a defense to the issuance of a charging order for a judgment debtor. Most statutes do not require any showing by the judgment creditor as to the necessity for such an order. See, e.g., Minn. Stat. § 322C.0503, subd. 1. As a result, the requirement for a court order seems like a needless exercise.

(ii) Because the form of charging order is dependent upon somewhat arcane provisions of state law for which there are few, if any, reported cases, it may be possible to convince a court to include additional provisions to the charging order. For example, in the appropriate case, the judgment creditor may seek to enjoin the LLC from making loans to the member, restrain the member from transferring her interest in the LLC, or otherwise further encumbering the membership interest.

(iii) If the court issues the charging order, the judgment creditor should serve the order on the debtor, all other members/partners and the

partnership/LLC. From the date of the receipt of the notice, the LLC will be potentially liable to the creditor for ignoring the order. See, *Joshlin Bros. Irrigation v. Sunbelt Rental, Inc.,* 2014 WL 248104d (Ark. App. 2014).

d. Debtor Exemptions.

(i) A judgment debtor is entitled to assert any state law exemptions that might exist. See, e.g., Minn. Stat. § 322C.0503, subd. 6. For example, in *Zavodnik v. Leven,* 773 A.2d 1170 (N.J. 2001), the New Jersey Supreme Court held that distributions from a professional partnership were "earnings" within the scope of that state's exemption for wages. Thus, a creative attorney for the judgment debtor may be able to defeat a creditor's application for a charging order by contending the right to distributions is exempt under state law.

e. Redemption.

(i) At any time before foreclosure, the judgment debtor whose interest in an LLC is subject to a charging order may "extinguish" the order by satisfying the judgment. See Minn. Stat. § 322C.0503, subd. 4. Thus, prior to foreclosure, the judgment creditor is effectively granted a lien on the debtor's rights to distributions until the judgment is satisfied.

In addition, the LLC or any member not subject to the charging order may pay the judgment creditor the full amount due under the judgment and succeed to the rights of the judgment creditor, including the charging order. See, Minn. Stat. § 322C.0503, subd. 5.

f. Foreclosure.

(i) Most states permit the judgment creditor to foreclose on the transferable interest of the judgment debtor. However, as with the case of obtaining a charging order in the first instance, the right to foreclose is generally subject to court authorization. See, Minn. Stat. § 322C.0503, subd. 3. In order to obtain authorization to foreclose upon the membership interest, the judgment creditor must demonstrate that distributions under the charging order will "not pay the judgment within a reasonable time." This determination is left to the discretion of the court. *Nigri v. Lotz,* 453 S.E.2d 780 (Ga. App. 1995).

Some courts may take the possible disruption of the LLC and its effect on the non-debtor members into consideration in making this determination. *See, Herring v. Keasler*, 563 SE2d 614 (NC App. 2002); *Bobak Sausage Co. v. Bobak Orland Park, Inc.*, 2008 WL 4814693 (ND Ill. 2008); *Hellman v. Anderson*, 233 Cal. App. 3d 840 (Cal. 1991). But see, *DiSalvo Properties, LLC, v. Bluff View Commercial, LLC*, No. ED101977, 2015 WL 3759402 (Mo. Ct. App. June 16, 2015). (If granted a charging order on the debtor's distributional LLC interests, then the judgment creditor will not be granted a court-ordered foreclosure and sale of the charged membership interests.)

(ii) If the interest is sold at a foreclosure auction, the purchaser acquires only the right to distributions. However, that right becomes a permanent right so as to be entitled to distributions even after the judgment is satisfied. But the purchaser does not acquire any additional rights such as management rights.

(iii) Nothing prohibits the non-debtor members from bidding on the interest of the judgment debtor. See, *Deutsch v. Wolff*, 7 S.W. 3d 460 (Mo. App. 1999).

(iv) In most cases, the judgment creditor will gain little by foreclosing on the membership interest. If the LLC makes regular distributions, the judgment creditor will receive them as a result of the charging order. If it does not, an auction of the membership interest will not likely draw multiple bidders. If the creditor merely wants to cut off the debtor from distributions, the charging order will suffice. Finally, if the creditor acquires the LLC interest, it may be liable for the member's distributive share of the taxes attributable to the LLC. See, Rev. Rul. 77-137 and IRS General Counsel Memorandum 36960 (1977).

g. Choice of Law.

Most courts have concluded intangible personal property is located wherever the debtor is located. See, e.g., *Waite v. Waite*, 492 P.2d 13 (Cal. 1972).

The courts called upon to address the "location" of an LLC interest have consistently held likewise. See, *Rockstone Capital, LLC v. Marketing Horizons, Ltd.,* 2013 WL 4046597 (Conn. Super. 2013); *American Institutional Partners, LLC v. Fairstar Resources, Ltd.,* 2011 WL 1230074 (D. Del. 2011); *Hotel 71 Mezz Lender LLC v. Falor*, 926 NE2d 1202 (NY 2010); *New Times Media, LLC v. Bay Guardian Co., Inc.*, 2010 WL 2573957 (D. Del. 2010); *American Institutional Partners, LLC v. Fairstar Res. Ltd.*, 2011 WL 1230074 (D. Del. 2011). Thus, judgment creditors may be able to exercise remedies against a

judgment debtor's interest in a foreign LLC in the court in which it obtained the judgment, rather than being forced to pursue remedies in the state of organization.

h. Single Member LLCs.

Since charging orders are designed to protect the interests of non-debtor members, several courts have held that where there are no non-debtor members to protect, a bankruptcy trustee was permitted to exercise management control and sell the assets of the LLC for the benefit of *creditors* of the debtor-member. *In re Albright,* 291 B.R. 538 (D. Colo. 2003); *In re Modanlo*, 412 B.R. 715 (D. Md. 2006). Outside of bankruptcy, the Florida Supreme Court answered a certified question from the 11th Circuit Court of Appeals that a charging order was not the exclusive remedy against a single member LLC under the Florida LLC statute. *Olmstead v. FTC*, 40 So. 3d 76 (Fla. 2010).

To avoid *Albright* issues, members of single-member LLCs may take extraordinary steps to protect their interests in the LLCs. Among the options: adding a second member with a minimal economic or management interest in the LLC; adding a corporate member owned by the principal member of the LLC; holding membership interests as community property; or adding a late-arriving member.

B. Alternative Remedies

Creditors who are frustrated with the charging order scheme may be encouraged to advance an attack on the exclusivity of charging orders as a remedy for a judgment creditor. They have met with mixed results to date.

1. Foreign LLCs.

A potential argument for the judgment creditor is raised if the LLC is a foreign LLC. In most states, the charging order limitation applicable to domestic LLCs does not apply to foreign LLCs. See *Times Media, LLC v. Bay Guardian Co., Inc.*, 2010 WL 2573957 (D. Del. 2010) (argument advanced by creditor but not addressed by court).

2. Reverse Veil Piercing.

Judgment creditors have attempted to reverse pierce the limited liability veil of the LLC in several cases, generally without much success. See, e.g., *In re Blatstein*, 192 F.3f 88 (3d Cir. 1999); *Commissioner of EPA v. State Five Industrial Park*, 37 A.3d 724 (Conn. 2012); *Postal Instant Press, Inc. v. Kasawa Corp.*, 162 Cal. App. 4th 1510 (Cal. App. 2008).

3. Receiver.

Many of the LLC statutes expressly permit the appointment of a receiver to "effectuate the collection of distributions" pursuant to a charging order. See, e.g., Minn. Stat. § 322C.0503, subd. 2(1). The scope of the authority of such a receiver is not clear. While the receiver may not generally be able to assert management rights, in some instances courts have granted receivers expanded powers in order to protect the assets of the judgment debtor from dissipation. See, e.g., *Deutsch v. Wolff*, 7 SW2d 460 (Mo. Ct. App. 1999); *Windom National Bank v. Klein*, 254 NW 602 (Minn. 1934).

C. Security Interests in LLC Membership Interests

Creation, perfection and enforcement of security interests in unincorporated business entities are governed by Article 9, and in some cases, Article 8, of the Uniform Commercial Code. There are several provisions of Article 9 that may be applicable in analyzing the issues raised for secured lenders, debtors and non-debtor members of such organizations. In addition, it

is critical that a secured lender (and its counsel) carefully review the organizational documents of the LLC and the applicable organic statute under which the LLC is formed.

Lenders and their counsel should also bear in mind the contractual freedom available to members of an LLC in order to achieve the results intended. States' LLC statutes typically defer to the operating agreement of the LLC by providing default rules. Thus, care should be taken in drafting the operating agreement and security agreement in order to accomplish the lender's objectives.

1. Attachment.

a. Description of Collateral.

It is important for a lender to bear in mind the two types of interests held by a member of an LLC when drafting its security agreement and financing statement. A security agreement which merely describes the debtor's interests in an LLC as a "membership interest" or "limited liability company interest" may find that it has obtained a security interest only in the economic interest of the member in the LLC. See, e.g., § 347.010(12) R.S. Mo. The Delaware LLC statute has a similar provision. 6 Del. C. § 18-101(8).

As a result, if a lender intends to encumber all of the debtor's rights in the LLC, both economic rights and management rights must be adequately described in both the pledge or security agreement and financing statement. Failure to do so could result in the secured lender obtaining a security interest in only the debtor's economic rights in the LLC. Such a result can be most unfortunate for a lender which succeeds

only to the economic rights of its debtor following default while the debtor remains firmly in control of management rights and thus able to decide when (if ever) to make distributions, sell assets, wind up the company, etc. In such a case, the foreclosing lender is "relegated to hopeful impotence." See, e.g., *B.A.S.S. Group, LLC v. Coastal Supply Co. Inc.,* 2009 WL 1743730 (Del. Ch. 2009).

b. Limitations on Transfers of Membership Interests.

Most states' organic statutes contain limitations on the creation of security interests in the owners' equity interests in unincorporated business entities. The Appendix contains summaries of several Midwestern states which set forth these limitations. Most, like Minnesota, provide a secured party may obtain a security interest in the economic interest of the member in the LLC, but not the non-economic interest, including governance rights, without compliance with the LLC's operating agreement. *See* Minn. Stat. §§ 322C.0502, 322C.0602 – 322C.0603).

c. Article 9 and Membership Transfer Limitations.

Article 9 of the UCC contains several provisions which facilitate the assignability of transactions to which Article 9 applies. UCC §§ 9-406 and 9-408 provide an override to specific restrictions on transfers of rights in certain types of personal property. These sections contain provisions that can override both restrictions imposed by law (including statutory restrictions) and transfer restrictions imposed by agreement. However, some state legislatures have enacted statutory provisions that make those

two provisions of Article 9 inapplicable to transfer restrictions that relate to partnerships and LLCs organized under the laws of those states. See, e.g., Del Code Ann. Tit.6 Sec. 18-1101(g); Va. Code Ann. Sec. 13.1-1001.1B; Section 101.106(c) Texas Business Organizations Code (providing that UCC 9-406 and 9-408 "do not apply to any interest in a limited liability company").

These statutory transfer restrictions and statutory validation of contractual transfer restrictions reflect the pick your partner principle applicable to unincorporated business entities. Such provisions are included in the Uniform Partnership Act (Section 27); the Uniform Limited Partnership Act (Sections 19 and 25); the Revised Uniform Limited Partnership Act (Sections 702 and 704); the Uniform Limited Liability Company Act (Sections 502 and 504); the Revised Uniform Partnership Act (Section 503); the Uniform Limited Partnership Act (Section 702); and the Revised Uniform Limited Liability Company Act (Section 502). These statutes generally provide that while an owner of an interest in an entity may freely transfer the owner's economic rights to a non-owner absent agreement to the contrary among the owners, the owner may not freely transfer owner's governance rights to a non-owner. For a transfer that includes governance rights to be effective, the other owners must consent. Many organizational and operating agreements for unincorporated business entities also contain contractual transfer restrictions.

d. Choice of Law.

Given the inconsistent provisions of the organizational statutes, a threshold issue for lenders may be to determine what law applies to the creation of a security interests in a debtor's LLC interests. Under the Minnesota statute, a "limited liability company" is defined to mean "an entity formed under this chapter." Minn. Stat. § 322C.0102, subd. 12. "Transferable interest" means the right of a member of a "limited liability company" to receive distributions from the LLC. Minn. Stat. § 322C.0102, subd. 28. Thus, it would appear that, at least in one state, the organic statutes will only apply to entities formed under that statute. They would not presumably apply to the creation of a security interest in a Minnesota debtor's interest in an Ohio LLC.

The choice of law provisions of Article 9 do not address what law applies to restrictions on assignment contained in LLC organizational documents. See, UCC § 9-401, comment 3. However, that comment also suggests that the state of the entity's formation is likely to govern the enforceability of a restriction on an assignment of an interest in such entity and not the law chosen by the parties to govern the terms of the loan documents or security agreement.

e. General Intangible v. Security.

The economic rights of a member of an entity will normally constitute a payment intangible under Article 9. The owner's complete ownership interest will generally be a general intangible that is not a

payment intangible, as are an owner's governance rights. Article 9 will thus apply to a transaction in which an owner's complete ownership interest, governance rights, or economic rights serve as collateral for an obligation as well as to the sale of only the economic rights. Article 9 does not apply to the sale of a complete ownership interest or of only the governance rights.

If the ownership interest of a member is not a "general intangible" under Article 9, Sections 9-406 and 9-408 will not apply. If the ownership interest qualifies as "investment property" under Article 8, they will not be applicable. Under Section 8-103(c), a partnership interest or limited liability company interest is not a security unless (i) the interest is traded on securities exchanges or in a security market; (ii) the interest is in an investment company security; or (iii) the terms of the interest expressly provide that it is a security governed by Article 8. As a result, the parties to a partnership or LLC agreement can exclude the membership interests from Article 9 by including in the terms governing the ownership interests and Article 8 opt in provision. Whether an entity issues certificates is not determinative as to the classification of the members' interests in the entity.

Section 9-406(d) provides that a term in an agreement between an account debtor (i.e., the entity) and a debtor (i.e., the debtor-member) that restricts the assignment, transfer or creation of security interest in a payment intangible (i.e., the economic rights of the debtor) or that

provides such a transaction may result in a default under the payment intangible, it is ineffective.

It is important to note this section is applicable only to the creation of a security interest in the member's economic rights since it is limited to payment intangibles. It has no application to transfer restrictions on an owner's governance rights or complete ownership interest. In addition, since the entity is not likely a party to the partnership agreement or operating agreement for the entity, it does not apply to transfer restrictions among the members of the entity (e.g., a contractual right of first refusal).

Section 9-408, rather than Section 9-406, applies to a transfer restriction to the extent the transfer is either a sale of the owner's economic rights or the grant of a security interest in the ownership interest or governance rights. That section provides that a term in an agreement between an account debtor (i.e., the entity) and a debtor (i.e., owner) which relates to a general intangible (i.e., ownership interest or governance rights). As with Section 9-406, the entity must be obligated under the agreement. The section will not limit rights among the members. Moreover, unlike Section 9-406, Section 9-408 does not extend to enforcement of a security interest in the general intangible. As a result, that section does not permit a foreclosing secured party to become a member of the entity following the debtor-member's default if the organizational documents contain restrictions on the admission of new members.

2. Perfection.

Because the partnership or LLC has the ability to determine whether its equity interests will be general intangibles or investment property under the UCC, it is critical for secured lenders to be aware the Article 9 requirements for perfecting security interests in each type of collateral.

Whether the ownership interest in an unincorporated entity is certificated is not relevant in determining the manner of perfection. The threshold issue is not whether the interests are certificated, but rather whether the interests are a security under the UCC. Only when the membership interests are securities will the question of whether they are represented by a certificate become relevant.

a. General Intangible.

If the membership interest to be pledged is either a payment intangible (i.e., the economic rights of the debtor) or a general intangible (i.e. the entire ownership interest or governance rights), the only method to perfect the security interest granted by the debtor is to file a financing statement in the appropriate filing office. UCC § 9-310(a). See, *In re Dreiling*, 2007 WL 172364 (Bky. W.D. Mo. 2007). Taking possession or control of a certificate has no legal consequence.

b. Security.

If the membership interests are investment property, there are three methods to perfect: filing, possession or control. UCC §§ 9-310(a);9-310(b); 9-312(b); and 9-314(a). Even if the membership interests constituting securities are not certificated, the lender can perfect by

possession by either becoming the registered owner of the security or through a control agreement. UCC § 9-314(c).

If the membership interests are certificated securities, the secured party can perfect by filing, taking possession of the certificate or obtaining control. Control in the case of a certificated security means obtaining possession of the certificate together with the power to effect a disposition of the collateral without any further action by the debtor. This is typically accomplished through the delivery of a stock power or assignment separate from certificate, executed in blank.

If an LLC interest is a security, having the security certificated can provide benefits to the lender that are not available if the interest is a general intangible. If the lender obtains control or possession of a certificated security, no other party can obtain control of that security. As a result, there can be no buyer of the security that is a protected purchaser who would take free of the lender's security interest and no competing lender can obtain priority by taking control or possession of the certificate.

c. Maintaining Perfection.

Regardless of whether the collateral is a general intangible or security, the lender should take steps to keep and maintain the status of its collateral during the term of its loan. The lender should require the organizational documents or its loan documents to restrict the ability of the LLC to either opt in to Article 8 or to prohibit the LLC from terminating its decision to opt in without the consent of the lender. Any

change in legal status could impair the perfection of the lender's security interest.

3. Enforcement.

The UCC provides several alternative remedies to secured parties upon the occurrence of an event of default upon a secured obligation secured by a security interest in a debtor's interest in an unincorporated business entity. See UCC § 9-601(a). All aspects of a disposition of collateral, including the method, manner, time, place and other terms must be commercially reasonable. UCC § 9-610(c).

a. Public Sale.

A public sale of collateral under Article 9 contemplates a public auction of the collateral at which the public is provided a meaningful opportunity to bid. Notice must be provided by the secured party to all debtors, all secondary obligors, any other party 10 days before the debtor consented to the acceptance held a security interest perfected by filing; any person from which the secured party has received notice of a claim of an interest in the collateral. UCC 9-610(b). In addition, the secured party should ensure the sale of the collateral is advertised appropriately. UCC § 9-610(b).

While Article 9 does not define "public disposition," the comment to UCC § 9-610 would indicate that the public have access to the sale and a meaningful opportunity for competitive bidding be provided.

While the intersection between securities laws and the UCC are beyond the scope of these materials, secured parties must be mindful that

the sale of membership interests may involve the sale of "securities." See comment, UCC § 9-610.

The secured party should also consider any contractual limitations or restrictions on transfer of membership interests in a borrower or its parent entities. Such restrictions may not only be found in the organic documents of the debtor, but may also be included in the change in control provisions of a mortgage of the underlying real property or in intercreditor agreements.

UCC § 9-612(b) permits a 10-day "safe harbor" for public dispositions of collateral. However, this may be too short, as a practical matter, in many cases.

b. Private Sale.

A private disposition of collateral is authorized by UCC § 9-610(b). Notice to the same parties required for a public disposition is required.

There are two principal differences in the two methods of disposition, however. First, a secured party may not purchase collateral at a private sale unless the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations. UCC § 9-610(c)(2). Neither of these exceptions will be applicable to a disposition of membership interests in an LLC or partnership interests. Second, the scope of notice differs in that UCC § 9-613(1)(e) mandates the notice contain notification of the "time and place

of a public disposition" whereas a private sale simply requires notification of the "time after which" a private disposition is intended to be made.

A private disposition is likely to be significantly cheaper than a public disposition. Where contractual restrictions on the scope of potential purchasers are a factor, a private sale may be the perfect vehicle to facilitate a transfer to a qualified transferee. If the secured party intends to acquire the collateral, a private disposition will not accomplish this goal. Thus, a private sale is likely to be of limited utility unless there is significant value in the collateral.

c. Strict Foreclosure.

Unlike former Article 9, which only permitted strict foreclosure with respect to tangible personal property in the possession of the secure party, Article 9 now permits "acceptance in satisfaction" with respect to any type of collateral. See UCC § 9-620. Strict foreclosure may be very useful in the enforcement of security interests in membership interests and may well be the remedy of choice for mezzanine loans secured by such collateral on a nonrecourse basis.

Article 9 now also permits partial strict foreclosures as well. The only difference between a partial strict foreclosure and a partial satisfaction is that the debtor must affirmatively consent to the proposed acceptance of collateral when only a portion of the obligations are to be satisfied by the secured party's acceptance of collateral in partial satisfaction. UCC § 9-620(c)(1).

UCC § 9-621 sets forth the parties to whom a proposal to accept collateral in satisfaction must be sent. It includes all debtors, all secondary obligors, any other party 10 days before the debtor consented to the acceptance held a security interest perfected by filing; and any person from which the secured party has received notice of a claim of an interest in the collateral. A proposal made by a secured party is binding. UCC § 9-620, Comment.

In order for a partial strict foreclosure proposal to be effective, the debtor must agree in a record authenticated after default and the secured party must not receive an objection from any of the noticed parties or the holder of a subordinate secured party. UCC § 9-620(a). A proposal for full satisfaction is effective if the secured party does not receive an objection from the noticed parties or a subordinate secured party. UCC § 9-620(a)(2).

Article 9 attempts to protect a secured party from claims that its passive retention of collateral constitutes an implied retention of collateral in satisfaction. UCC § 9-620(b).

Acceptance of collateral discharges the obligation to the extent consented to by the debtor transfers all of the debtor's rights in the collateral to the secured party; discharges the security interest that is the subject of the proposal and any subordinate security interest or lien; and terminates any other subordinated interest. UCC § 9-622(a).

Strict foreclosure may be the preferred remedy for proceeding against closely held nonrecourse mezzanine collateral. The creditor can save significant costs. It is a relatively quick remedy. In cases where the secured creditor is the only likely purchaser, either because of the economics or transfer restrictions, strict foreclosure provides a means for the secured party to acquire the collateral without the requirements of a public sale.

d. Collection Rights Under UCC 9-607.

Article 9 provides the secured party with multiple remedies upon the debtor's default. It also permits the exercise of various rights which may have been agreed upon by the parties prior to default. UCC § 9-607(a). Among the remedies available to a secured party with a security interest in payment intangibles are "notification" of account debtors or other persons obligated on collateral to pay to the secure party (§9-607(A)(1); collection of proceeds under § 9-315 (9-607(a)(2)); and exercising the rights of the debtor in respect of an underlying obligation owed by the account debtor (§ 9-607(a)(3)). An account debtor only includes a person obligated on an account, chattel paper or general intangible. UCC § 9-102(a)(3). Thus, it would not include a person obligated to the debtor pursuant to a promissory note. As noted above, it would include the entity in which the debtor has pledge her economic interest to the secured party.

D. Charging Orders and Limitations on Assignment of LLLC Membership Interests

| State | Charging Orders | Limitations on Security Interests | Comments |
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| Arkansas | "On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's limited liability company interest with payment of the unsatisfied amount of judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's limited liability company interest. This chapter does not deprive any member of the benefit of any exemption laws applicable to his or her limited liability company interest."<br><br>Ark. Code Ann. § 4-32-705 (West, Westlaw through 2015 Reg. Sess.). | "(a) Unless otherwise provided in writing in an operating agreement:<br>(1) A limited liability company interest is assignable in whole or in part;<br>(2) An assignment entitles the assignee to receive, to the extent assigned, only the distributions to which the assignor would be entitled;<br>(3) An assignment of a limited liability company interest does not dissolve the limited liability company or entitle the assignee to participate in the management and affairs of the limited liability company or to become or exercise any rights of a member"<br><br>Ark. Code Ann. § 4-32-704 (West, Westlaw through 2015 Reg. Sess.). | *AmerisourceBergen Drug Corp. v. Meier*, No. 5:06-MC-00053-JLH, 2007 WL 1560012 (W.D. Ark. May 29, 2007) (judgment creditor entitled to a charging order to the trust, of which the trust is the only member and owner of an LLC, pursuant to Ark. Code. Ann. § 4-32-705).<br><br>*Ault v. Brady*, 37 F. App'x 222 (8th Cir. 2002) (though not a bankruptcy case, the court supports the statute holding that when LLC interest is transferred, the transferee only receives the economic interest). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| Iowa | "1. On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor."<br><br>Iowa Code Ann. § 489.503 (West, Westlaw through 2015 Reg. Sess.). | "1. For a transfer, in whole or in part, all of the following applies to a transferable interest:<br><br>a. It is permissible.<br>b. It does not by itself cause a member's dissociation or a dissolution and winding up of the limited liability company's activities.<br>c. Subject to section 489.504, it does not entitle the transferee to do any of the following:<br><br>(1) Participate in the management or conduct of the company's activities.<br>(2) Except as otherwise provided in subsection 3, have access to records or other information concerning the company's activities.<br>2. A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled."<br><br>Iowa Code Ann. § 489.502 (West, Westlaw through 2015 Reg. Sess.). | *Wells Fargo Bank, Nat. Ass'n v. Continuous Control Solutions, Inc.*, 821 N.W.2d 777 (Iowa Ct. App. 2012) (Iowa court granting a charging order to judgment creditors against debtors for the economic interest in the LLC).<br><br>*Wells Fargo Bank, Nat. Ass'n v.* Continuous *Control Solutions, Inc.*, 821 N.W.2d 777 (Iowa Ct. App. 2012) (same case) (judgment debtors could not be ordered to give cash flow statements of LLC to judgment creditor because the right to view an LLC's records, etc. does not transfer with the economic interest). |
| **State** | **Charging Orders** | **Limitations on Security Interests** | **Comments** |
| Kansas | "(a) On application by a judgment creditor of a member or of a member's assignee, a court having jurisdiction may charge the limited | "(a) A limited liability company interest is assignable in whole or in part except as provided in an operating agreement. The assignee | *Meyer v. Christie*, No. 07-2230-CM, 2011 WL 4857905 (D. Kan. Oct. 13, 2011) (though the court determined that entering a charging order was not appropriate in this case because |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | liability company interest of the judgment debtor to satisfy the judgment. To the extent so charged, the judgment creditor has only the right to receive any distribution or distributions to which the judgment debtor would otherwise have been entitled in respect of such limited liability company interest.<br>(b) A charging order constitutes a lien on the judgment debtor's limited liability company interest.<br>(c) This act does not deprive a member or member's assignee of a right under exemption laws with respect to the judgment debtor's limited liability company interest.<br>(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of a member's assignee may satisfy a judgment out of the judgment debtor's limited liability company interest.<br>(e) No creditor of a member or of a member's assignee shall have any right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.<br>(f) The district court shall have jurisdiction to | of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company, except as provided in an operating agreement or, unless otherwise provided in the operating agreement, upon the affirmative vote or written consent of all of the members of the limited liability company. Notwithstanding anything to the contrary under applicable law, an operating agreement may provide that a limited liability company interest may not be assigned prior to the dissolution and winding up of the limited liability company.<br><br>(b) Unless otherwise provided in an operating agreement:<br>(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member;<br>(2) an assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the | the LLC interests were subsequently-acquired, this case analyzes: what is a charging order; what is the authority for a charging order; and when is it appropriate to order a charging order against judgment debtor?).<br><br>*In re Hayhook Cattle Co., LLC*, No. 10-41257, 2010 WL 5289004 (Bankr. D. Kan. Dec. 20, 2010) (Pursuant to **K.S.A. 17–76,112**(b)(3), when company (LLC member) became insolvent, movants (directors of company) no longer had managerial rights of LLC and could not prevent sole LLC member from filing bankruptcy). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | hear and determine any matter relating to any such charging order."<br><br>Kan. Stat. Ann. § 17-76, 113 (West, Westlaw through 2014 Reg. and Special Sess.). | assignor was entitled, to the extent assigned; and (3) a member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member's limited liability company interest. Unless otherwise provided in an operating agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member."<br><br>Kan. Stat. Ann. § 17-76, 112 (West, Westlaw through 2014 Reg. and Special Sess.). | |
| **State** | **Charging Orders** | **Limitations on Security Interests** | **Comments** |
| Minnesota | **"Charging order against transferable interest.** On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and | No restrictions on the ability to assign LLC interest, except that the assignee receives economic interest (distributions) and does not receive the right to "participate in the management or conduct of the company's activities"<br><br>Minn. Stat. § 322C.0502, subd. 1(3)(i). | Minnesota Statutes sections 322C are effective August 1, 2015; thus, there is only case law associated with 322B.<br><br>Minn. Stat. § 322B.32 (§ 322C.0503 effective on Aug. 1, 2015):<br><br>*Fed. Nat. Mortgage Ass'n v. Grossman*, No. CIV. 12-2953 SRN/JJG, 2014 WL 4055371 (D. Minn. Aug. 15, 2014) (Defendants wanted the court to limit Plaintiff's recovery of |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor."<br><br>Minn. Stat. § 322C.0503, subd. 1. | | damages to a charging order (as it is considered the sole remedy for interests of an LLC)—the court will leave this option open as well as others if the Plaintiff proves Defendants committed fraud).<br><br>Minn. Stat. § 322B.31 (§ 322C.0502 effective Aug. 1, 2015)<br><br>*Fed. Nat. Mortgage Ass'n v. Grossman*, No. CIV. 12-2953 SRN/JJG, 2014 WL 4055371 (D. Minn. Aug. 15, 2014) (same case) (discussing in footnotes that the LLC interest Plaintiff desires is only economic). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| Missouri | "On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the member's interest in the limited liability company with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the member's interest. Sections 347.010 to 347.187 do not deprive any member of the benefit of any exemption laws applicable to his interest in the limited liability company."<br><br>Mo. Ann. Stat. § 347.119 (West, Westlaw | "1. The interest of a member in a limited liability company is personal property and, except as provided in the operating agreement, may be assigned in whole or in part. An assignment of an interest does not entitle the assignee to participate in the management of the business and affairs of the limited liability company or to become or to exercise the rights of a member, except as provided in section 347.113. An assignee that has not become a member shall only be entitled to receive, to the extent assigned, the share of distributions and profits, including distributions representing the return of contributions, to which the assignor would otherwise | *Disalvo Properties, LLC v. Bluff View Commercial, LLC*, No. ED 101977, 2015 WL 3759402 (Mo. Ct. App. June 16, 2015) (over three years after court concluded judgment debtor owed judgment creditor over 1 million dollars, court entered a charging order against judgment debtor's membership interest in two LLCs, but a court cannot order a foreclosure and sale of the LLC interest). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | through 2015 Reg. Sess.). | be entitled with respect to the assigned interest. Unless otherwise provided in the operating agreement, a member shall not cease to be a member as a result of the pledge, encumbrancing or the granting of a security interest in the interest of such member in the limited liability company."<br><br>Mo. Ann. Stat. § 347.115 (West, Westlaw through 2015 Reg. Sess.). | |
| **State** | **Charging Orders** | **Limitations on Security Interests** | **Comments** |
| Nebraska | "(a) On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on a judgment debtor's transferable interest and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor."<br><br>Neb. Rev. Stat. Ann. § 21-142 (West, Westlaw through 2015 Reg. Sess.). | "(a) A transfer, in whole or in part, of a transferable interest:<br>(1) is permissible;<br>(2) does not by itself cause a member's dissociation or a dissolution and winding up of the limited liability company's activities; and<br>(3) subject to section 21-143, does not entitle the transferee to:<br><br>(A) participate in the management or conduct of the company's activities; or<br>(B) except as otherwise provided in subsection (c) of this section, have access to records or other information concerning the company's activities.<br>(b) A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor | Neb. Rev. Stat. Ann. § 21-142 (no available case references at this time; *but see* Neb. Rev. Stat. § 21-2654 repealed in 2013).<br><br>Neb. Rev. Stat. Ann. § 21-141 (no available case citations at this time; *but see* Neb. Rev. Stat. § 21-2621). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | | would otherwise be entitled."<br><br>Neb. Rev. Stat. Ann. § 21-141 (West, Westlaw through 2015 Reg. Sess.). | |
| **State** | **Charging Orders** | **Limitations on Security Interests** | **Comments** |
| North Dakota | "1. On application by a judgment creditor of a member or transferee, a court may enter a charging order against the transferable interest of the judgment debtor for the unsatisfied amount of the judgment. A charging order constitutes a lien on the transferable interest of a judgment debtor and requires the limited liability company to pay over to the person to which the charging order was issued any distribution that would otherwise be paid to the judgment debtor."<br><br>ND LEGIS H.B. 1136 (2015), 2015 North Dakota Laws H.B. 1136 (West's No. 348) (previously N.D. Cent. Code Ann. § 10-32.1-45). | "1. A transfer, in whole or in part, of a transferable interest:<br>a. Is permissible;<br>b. Does not by itself cause the dissociation of a member or a dissolution and winding up of the activities of the limited liability company; and<br>c. Subject to section 10–32.1–46, does not entitle the transferee to:<br><br>(1) Participate in the management or conduct of the activities of the company; or<br>(2) Except as otherwise provided in subsection 3, have access to records or other information concerning the activities of the company.<br><br>2. A transferee has the right to receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled."<br><br>ND LEGIS H.B. 1136 (2015), 2015 North Dakota Laws H.B. 1136 (West's No. 348) | Charging Order Statute (no case references as of this time).<br><br>Transferable Interest Statute (no case references as of this time). |

| State | Charging Orders | Limitations on Security Interests | Comments |
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| | | (previously N.D. Cent. Code. Ann. § 10-32.1-44). | |

| State | Charging Orders | Limitations on Security Interests | Comments |
|---|---|---|---|
| South Dakota | "(a) On application by a judgment creditor of a member of a limited liability company or of a member's transferee, and following notice to the limited liability company of such application, a court having jurisdiction may charge the distributional interest of the judgment debtor to satisfy the judgment.<br>(b) A charging order constitutes a lien on the judgment debtor's distributional interest."<br><br>S.D. Codified Laws § 47-34A-504 (West, Westlaw through 2015 Reg. Sess.). | "A transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled."<br><br>S.D. Codified Laws § 47-34A-502 (West, Westlaw through 2015 Reg. Sess.).<br><br>"(e) A transferee who does not become a member is entitled to:<br>(1) Receive, in accordance with the transfer, distributions to which the transferor would otherwise be entitled;<br>(2) Receive, upon dissolution and winding up of the limited liability company's business:<br><br>(i) In accordance with the transfer, the net amount otherwise distributable to the transferor;<br>(ii) A statement of account only from the date of the latest statement of account agreed to by all the members."<br>S.D. Codified Laws § 47-34A-503 (West, Westlaw through 2015 Reg. Sess.). | S.D. Codified Laws § 47-34A-504 is cited in *Koh v. Inno-Pacific Holdings, Ltd.*, 54 P.3d 1270, 1272 (Wash. Ct. App. 2002) as a statute of which Washington's Limited Liability Act was modeled.<br><br>S.D. Codified Laws §§ 47-34A-502, 503 (no case citations available at this time). |

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