Entity Governance Issues in Bankruptcy

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I. INTRODUCTION

At a basic level, “entity governance” refers to an entity’s form (corporation, partnership, limited liability company, etc.), and the terms and conditions under which that form is operated (bylaws, operating agreement, partnership agreement, etc.), which are typically governed by the law of the entity’s state of formation. The commencement of a bankruptcy case can implicate a vast number of entity governance issues, and these issues will only increase over time as new and differing entity structures are developed. This makes it difficult, if not impossible, to identify every governance issue that may arise in a bankruptcy case. Rather than attempt to do so, this article highlights, and in some cases suggests potential solutions for, some of the most common governance issues that a bankruptcy practitioner may encounter in a Chapter 11 bankruptcy case.

II. IS BANKRUPTCY THE BEST OPTION?

Financially distressed entities often seek bankruptcy counsel because they are having trouble paying debts in the ordinary course of business, but the debtor’s management may not understand the various insolvency options available to them. In most situations, the debtor’s management and key employees have little or no experience in the insolvency realm, which often leads to a crisis-like atmosphere. The bankruptcy practitioner’s role is to process the information conveyed by the debtor and provide guidance on the potential options.1

As an initial matter, it is important for the bankruptcy practitioner to gain an objective understanding – from both a business and financial perspective - of how the debtor got into its current situation.2 For example, there may have been a single unexpected event that created

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1 See Preparing Corporate and Individual Clients for Bankruptcy, American Bankruptcy Institute 40th Annual Alexander L. Paskay Memorial Bankruptcy Seminar, April 1, 2016, pg. 3.

liability for the company, or the debtor may be facing long-term business issues. Aggressive activity by one or more creditors may have contributed to the debtor’s financial circumstances. Perhaps the debtor’s primary secured lender or a key group of creditors have lost faith in the debtor’s management team. The debtor’s insiders may have mismanaged the debtor, or worse, fraudulently transferred assets to themselves or related companies. Often, a combination of these factors creates the debtor’s financial hardship.

Ultimately, the debtor and its counsel need to decide whether the debtor will attempt to reorganize or liquidate – a decision that will drive many aspects of the case moving forward. In other words, is the debtor’s business – or specific portions of it – profitable and worth saving, or is an orderly liquidation a better alternative.

Broadly speaking, a reorganizing debtor has four major restructuring options to choose from: (1) out of court workout; (2) conventional Chapter 11 case; (3) pre-negotiated Chapter 11 case; and (4) pre-packaged Chapter 11 case.

3 A workout generally involves the debtor reaching an agreement with creditors to resolve their claims. Workouts often involve some combination of equity infusion, refinancing, forbearance, and restructuring of the debtor’s liabilities. Except where a Chapter 11 is necessary, out of court workouts are often preferable over Chapter 11 cases for multiple reasons, such as reduced cost to both the debtor and creditors, greater flexibility in crafting an effective solution, and less disruption to the debtor’s and creditors’ business models. Taken together, these advantages are significant, and can often result in the well-represented debtor negotiating better treatment with its creditors in a workout scenario than the debtor could realize in a Chapter 11 context. However, by its nature, a workout is consensual. Obtaining the consent of all key creditors may prove to be impossible, especially in situations where the debtor’s creditors are diverse and do not act together. In those situations, a Chapter 11 filing may be necessary because it provides a mechanism to bind dissenting creditors. See Morris Massel, The Pros and Cons of Prepackaged Bankruptcy, available at http://www.stblaw.com/docs/default-source/cold-fusion-existing-content/publications/pub1647.pdf?sfvrsn=2

4 A conventional Chapter 11 case generally involves the debtor filing the case prior to any agreement on the specifics of a sale or Chapter 11 plan. Id.

5 A pre-negotiated Chapter 11 case generally involves the debtor and key creditors negotiating the key terms of a sale or Chapter 11 plan prior to filing, and it may include execution of a plan support or “lock-up” agreement contractually binding the parties to certain material terms. For a discussion of lock-up agreements, see Josef S. Athanas and Caroline A. Reckler, Lock-Up Agreements – Valuable Tool or Violation of the Bankruptcy Code? Available at https://www.lw.com/upload/pubContent/_pdf/pub4557_1.pdf, Norton Journal of Bankruptcy Law & Practice, Vol. 15, #4, August 2006.
A liquidating debtor generally has five insolvency proceedings to choose from: (1) Corporate Chapter 11; (2) Corporate Chapter 7; (3) Assignment for the Benefit of Creditors; (4) State Court Receivership; and (5) Dissolution.

We will assume the debtor’s management has considered all available alternatives and decided to pursue a Chapter 11 bankruptcy.

III. PRE-FILING CONSIDERATIONS FOR THE DEBTOR’S MANAGEMENT

A bankruptcy practitioner may find it helpful to advise the debtor’s management regarding its fiduciary duties in connection with evaluating a potential bankruptcy filing. In some circumstances, the debtor’s management should have separate counsel. Because state laws regarding fiduciary duties vary by type of entity and applicable state law, as does the extent to which fiduciary duties may be modified by agreement, counsel should be cognizant of the

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6 A pre-packaged or “pre-pack” Chapter 11 generally involves the debtors and key creditors negotiating the terms of a Chapter 11 plan, finalizing the plan, and soliciting acceptances of the plan pre-filing. Once accepted, the debtor files the bankruptcy and almost immediately seeks to implement the accepted plan.

7 The debtor remains in control of its business, but operating and legal costs are relatively high. The debtor is benefitted by the automatic stay and Chapter 5 causes of action. Creditors are generally familiar with the bankruptcy process itself. See Preparing Corporate and Individual Clients for Bankruptcy, American Bankruptcy Institute 40th Annual Alexander L. Paskay Memorial Bankruptcy Seminar, April 1, 2016, pg. 4.

8 The debtor loses control of its business to an appointed Chapter 7 trustee. A Chapter 7 case may present a higher risk of claims against principals of the debtor. The debtor is benefitted by the automatic stay and Chapter 5 causes of action. Creditors are generally familiar with the bankruptcy process itself.

9 The debtor loses control of its business to its selected assignee. Possible benefits include: (i) limited court involvement, (ii) no U.S. Trustee oversight and expense, (iii) an accelerated process compared to Chapter 7 or 11 cases; and (iv) decreased cost compared to Chapter 7 or 11 cases. Possible disadvantages include: (i) creditors and the court are often unfamiliar with the process because it varies from state-to-state, which can create unnecessary confusion and conflict; (ii) no automatic stay, (iii) no Chapter 5 causes of action; and (iv) potentially increased risk of an involuntary bankruptcy petition. For a discussion of pros and cons of an Assignment for the Benefit of Creditors vs. a Chapter 7 liquidation, see Matthew S. Barr, Examining Assignments for the Benefit of Creditors, available at https://www.law360.com/articles/433794/examining-assignments-for-the-benefit-of-creditors.

10 The process varies from state-to-state. Advantages include its accelerated process compared to bankruptcy filings and relatively low costs. Disadvantages include that the debtor loses control of its business, there is no automatic stay, and no Chapter 5 causes of action.

11 The process varies from state-to-state but generally the debtor controls the dissolution. Advantages include relatively low cost. Disadvantages include: (i) unlike the other types of liquidation, there is no centralized insolvency proceeding; (ii) no automatic stay; (iii) no Chapter 5 avoidance powers; (iv) potentially increased risk of an involuntary bankruptcy petition; and (v) increased risk of inequitable distribution of the debtor’s remaining assets.
fiduciary duties governing the debtor’s management. For purposes of the below discussion, we have assumed the debtor is a Delaware corporation.\textsuperscript{12}

\textit{Standard of Conduct.} Ordinarily, a corporation’s board of directors has full control over the affairs of the corporation. The board’s power to act on the corporation’s behalf is governed by the directors’ fiduciary relationships with the corporation and its shareholders, which imparts on the directors duties of care and loyalty. The duty of care generally consists of an obligation to act on an informed basis. The duty of loyalty generally requires the board and its directors to maintain, in good faith, the corporation’s and its shareholders’ best interests over any other interests.

Directors’ actions in balancing these duties while conducting the corporation’s affairs are generally protected by the business judgment rule. The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. Significantly, the business judgment rule generally applies only in the context of a valid exercise of business judgment by \textit{disinterested} directors.\textsuperscript{13} Potential debtors should be especially vigilant in screening directors from transactions in which they are interested, especially considering the increased rights of creditors to challenge board decisions in the event of insolvency (discussed below).

\textsuperscript{12} The board’s fiduciary duties to the debtor depend on applicable law. Delaware law is discussed herein because it is well-established and relied upon by many other jurisdictions.

\textsuperscript{13} See, \textit{e.g.}, \textit{Carsanaro v. Bloodhound Technologies, Inc.}, 65 A.3d 618, 637 (Del. Ct. Chau. 2013) (discussing business judgment rule in context of shareholder action) [“To overcome the presumption of loyalty, a stockholder plaintiff must allege facts supporting a reasonable inference that there were not enough independent and disinterested individuals among [something is missing from this quote] the directors making the decision to comprise a board majority. Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply…exacting scrutiny to determine whether the transaction is entirely fair to the stockholders.”]
Effect of Insolvency on Fiduciary Duties. With respect to a solvent corporation, the residual economic stakeholders are the stockholders. Thus, the standard of conduct requires that directors seek prudently, loyally, and in good faith to manage the business of a corporation for the benefit of its shareholder owners.

When a corporation becomes hopelessly insolvent and there is little realistic likelihood that equity will receive anything, its creditors become the class economically impacted by change in the corporation’s value. While the stockholders technically remain residual claimants, they can benefit from increases in the corporation’s value only after the claims of the corporation’s creditors have been satisfied. A corporation’s insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value. Thus, creditors of a hopelessly insolvent firm may seek standing to assert that the directors breached their fiduciary duties by improperly harming the economic value of the firm, to the detriment of creditors who had legitimate claims on its assets. In short, the board of an insolvent entity has a fiduciary duty to the entity, which may be enforced by all constituencies including secured and unsecured creditors.

While earlier cases discussed the "zone of insolvency," current cases have retreated from the idea that there is a duty owed to creditors (and not the corporation and its shareholders) in the zone of insolvency. When a solvent company is under financial stress or there is widespread financial distress in an industry, the Delaware Supreme Court held that a director’s fiduciary duty to protect the interests of the corporation and shareholders does not change:

[T]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for

14 Solvency is generally determined on a balance-sheet basis: whether the sum of the entity’s debts is greater than all of the entity’s assets, at a fair valuation, or by whether the entity has sufficient capital to continue its operations.
Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.\textsuperscript{15}

Thus, directors of corporations in the “zone of insolvency” do not owe fiduciary duties directly to creditors but to the corporation itself. Creditors do not have standing to bring a direct claim against directors when a corporation is in the “zone of insolvency.”\textsuperscript{16}

IV. ADDRESSING PROBLEMS WITH THE DEBTOR’S EXISTING MANAGEMENT.

The debtor’s existing management typically has some level of responsibility for the debtor’s financial condition, and creditors often attack the debtor’s management for their actions or inactions leading to the debtor’s bankruptcy filing. Commonly, allegations against a failing business’s management run the gamut from relatively less serious claims such as neglect and poor decision making, to more serious claims such as fraud, dishonesty, and gross mismanagement.

Retaining the debtor’s pre-petition management during a bankruptcy case generally involves some level of risk, with the magnitude of that risk varying based on the circumstances. In circumstances where that risk is substantial, a prudent bankruptcy practitioner should consider whether changes in management – either before or at the outset of a bankruptcy case – are appropriate. Generally speaking, while existing management is typically more familiar with the debtor’s business and thus may be more efficient, existing management may also have engaged in questionable or improper pre-petition conduct and may bring other “baggage” into the case.

\textsuperscript{15} N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007); see also Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155 (Del. Ch. 2014) (reaffirms Gheewalla that creditors have no right to bring direct claims against directors; creditors do have standing to bring derivative suits on behalf of the corporation if the corporation is insolvent.)

\textsuperscript{16} See Gheewalla, 930 A.2d at 101.
Separately, and sometimes more importantly, existing management may have lost the trust of key creditor constituencies that will have significant involvement in the bankruptcy case.

In some cases, it may be unquestionably necessary to change the debtor’s management. For example, there may be credible allegations that the debtor’s existing management engaged in fraud or directed the debtor to systematically violate the law. Under those circumstances, attempting to maintain the debtor’s pre-petition management could immediately jeopardize a Chapter 11 case from the debtor-in-possession’s perspective by justifying the appointment (or litigation over the appointment) of a trustee or examiner.

Section 1104 of the Bankruptcy Code describes the circumstances under which the court may appoint a trustee or examiner. Generally speaking, a trustee replaces the debtor in possession, while an examiner investigates certain aspects of the case or of the debtor’s operations. While there is a strong presumption in a Chapter 11 case that the debtor should remain in possession, Section 1104(a)(1) provides that the court “shall order the appointment of a trustee” if a party in interest or the United States Trustee demonstrates “cause,” which includes: fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause…

In the Eleventh Circuit, a determination of whether cause exists to appoint a Chapter 11 trustee under Section 1104(a)(1) is a fact intensive inquiry, and often involves the consideration of the following factors:

(A) materiality of the misconduct;

(B) evenhandedness or lack of same in dealings with insiders or affiliated entities vis-à-vis other creditors or customers;

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17 See, e.g., 11 U.S.C. §§ 1104(a), (c).

18 11 U.S.C. § 1104(a)(1) (emphasis added). To be clear, a bankruptcy court may also appoint a Chapter 11 trustee pursuant to § 1104(a)(2), which involves a “broader” exercise of the court’s discretion and does not require a finding of fault. See, e.g., In re Sundale, Ltd., 400 B.R. 890, 901 (Bankr. S.D. Fla. 2009).
(C) the existence of pre-petition voidable preferences or fraudulent transfers;
(D) unwillingness or inability of management to pursue estate causes of action;
(E) conflicts of interest on the part of management interfering with its ability to fulfill fiduciary duties to the debtor; and
(F) self-dealings by management or waste or squandering of corporate assets.  

In contrast to the appointment of a Chapter 11 trustee, the appointment of an examiner under Section 1104(c) represents a “less drastic alternative” for providing independent input into a Chapter 11 case.  

An examiner does not generally replace the debtor in possession like a Chapter 11 trustee, but rather, is generally tasked with investigating the debtor’s business or “allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor…” While generally less intrusive than a Chapter 11 trustee, the appointment (or litigation over the appointment) of an examiner, and the costs and delays associated with that litigation, has the potential to derail a debtor’s reorganization efforts.

Even in situations where there are no grounds to justify appointment of a Chapter 11 trustee or examiner, the retention of independent professionals may be appropriate where key creditor or regulatory constituents have lost confidence in the debtor’s management team and their ability to guide the debtor through its financial crises. Restoring confidence in the debtor’s management team may make a consensual non-bankruptcy solution viable and reduce the risk of a Chapter 11 trustee or examiner if a bankruptcy is filed.

19 See, e.g., In re Sundale, Ltd., 400 B.R. 890, 900 (Bankr. S.D. Fla. 2009). Counsel should also consider whether retaining existing management could increase the risk of the debtor failing to satisfy its post-petition obligations, such as the requirement to file monthly operating reports, which could increase the risk of conversion or dismissal under Section 1112. See, e.g., In re Basil Street Partners, LLC, 477 B.R. 856 (Bankr. M.D. Fla. 2012) (generally discussing post-petition nature of inquiry under Section 1112).

20 7 Collier on Bankruptcy ¶ 1104(c) (16th ed.).

Where a pre-petition change in management is advisable, the appropriate actions vary widely based on the individual facts and circumstances of each case. Common examples of changes in management include the pre-petition retention of independent board members, a Chief Executive Officer, a Chief Restructuring Officer, or financial advisors. Debtor’s counsel should carefully craft the retained professionals’ role and authority within the debtor’s management structure to address the relevant concerns without unduly disrupting operations.

V. AUTHORITY TO FILE.

It is well established a non-individual debtor cannot file a valid bankruptcy petition without proper authority to do so, and that such authority is determined by reference to the entity’s governing documents and applicable state law. It is also well established that the absolute waiver of the right to file bankruptcy, or its functional equivalent, is void as a matter of public policy under federal law. Between those extremes, there has been significant litigation over the limits that can be placed on an entity’s rights to file for bankruptcy.

There are several corporate governance tools commonly used to limit or eliminate the entity’s ability to file bankruptcy. One is a so-called “blocking provision,” which is generally used “as a catch-all to refer to various contractual provisions through which a creditor reserves a right to prevent a debtor from filing for bankruptcy.” A typical “blocking provision” in a company’s governing document gives a creditor the right to appoint an independent member of the board of directors and requires unanimous board consent to authorize the filing of a bankruptcy petition. In that scenario, the independent director can prevent the entity from filing a bankruptcy petition by withholding his or her consent. Another is a so-called “golden share,”

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22 See, e.g., Price v. Gurney, 342 U.S. 100, 106 (1945); 2 Collier on Bankruptcy ¶ 301.04 (16th ed.)


24 In re Franchise Services of North America, Incorporated, 891 F.3d 198, 205 (5th Cir. 2018).
which in the bankruptcy context “generally refers to the issuance to a creditor of a trivial number of shares that gives the creditor the right to prevent a voluntary bankruptcy petition…” Similar to a blocking board member, a “golden share” structure generally exists where the entity’s governing documents require unanimous consent by equity holders to file bankruptcy. Limitations on an entity’s authority to file bankruptcy may be created at any point in the entity’s lifetime, including the original governance documents, in connection with obtaining a significant equity infusion or credit facility, or after a default.

As stated above, the enforceability of these structures continues to be extensively litigated, and the outcome many times turns on factors such as whether the party benefitting from the “blocking” mechanism (i) holds a meaningful equity position (rather than an equity stake primarily to control extraordinary actions like a bankruptcy filing) or (ii) was primarily acting as a creditor or investor with respect to the debtor, or whether the mechanism was put into place in connection with a loan or after a default. An appendix of the key case law on this issue in the Eleventh Circuit, along with leading cases outside of the Eleventh Circuit, is attached hereto as Exhibit A.

VI. BAD FAITH FILING

Assuming the debtor has proper authority to file, debtor’s counsel should consider and evaluate the risk of bad faith challenges to the filing of the petition. The Eleventh Circuit in Phoenix Piccadilly\(^26\) held that a debtor’s bad faith in filing its petition for relief constitutes cause for dismissal of the bankruptcy case under Section 1112(b). In making that determination, the court may consider “any factors which evidence an intent to abuse the judicial process and the purposes of the reorganization provision or, in particular, factors which evidence that the petition

\(^{25}\) Id.
\(^{26}\) In re Phoenix Piccadilly, Ltd., 849 F.2d 1393, 1394 (11th Cir. 1988).
was filed to delay or frustrate the legitimate efforts of secured creditors to enforce their rights.”27

The Eleventh Circuit identified seven (7) factors that evidence a bad faith filing:

1. the debtor has only one asset to which it does not hold legal title;

2. the debtor has few unsecured creditors whose claims are small in relation to the claims of the secured creditors;

3. the debtor has few employees;

4. the debtor’s financial problems involve essentially a dispute between the debtor and the secured creditors which can be resolved in pending proceedings;

5. the timing of the debtor’s filing evidences an intent to delay or frustrate the legitimate efforts of the debtor’s secured creditors to enforce their rights;

6. the lack of a realistic possibility of an effective reorganization; and

7. whether the debtor is seeking to use the bankruptcy provisions to create and organize a new business, not to reorganize or rehabilitate an existing enterprise, or to preserve going concern values of a viable or existing business.

It should be noted that Phoenix Piccadilly is a 1988 decision. There is a substantial and well-developed body of case law in the Eleventh Circuit interpreting and applying the “Phoenix Piccadilly” factors in many factual scenarios and identifying additional circumstances that evidence bad faith filings. Counsel should be aware of the potential applicability of this case law to the relevant facts and evaluate the likelihood and merits of an early motion to dismiss the case as a bad faith filing.

VII. CORPORATE GOVERNANCE DURING CHAPTER 11

Outside of bankruptcy, an entity’s management enjoys broad control over business decisions such as asset sales, financing, mergers and acquisitions, and the like, generally subject only to fiduciary duties under applicable state law. Creditors are generally protected by contractual remedies, such as initiating a lawsuit for damages. But once a bankruptcy case is filed, the automatic stay bars most collection efforts outside the bankruptcy court, giving the

27 Id. (internal citations omitted).
debtor a “breathing spell” to reorganize or liquidate – which arguably justifies creditors and other parties-in-interest having greater visibility and input into the debtor’s business decisions.28

The bankruptcy process allocates control over the debtor’s business differently than otherwise applicable state law in at least four general ways. First, the debtor becomes a debtor-in-possession, which is vested with the power of the trustee, effectively giving the debtor’s pre-bankruptcy management control over day-to-day operations of the business.29 As the trustee, the debtor is required to comply with a number of statutory duties, reporting requirements, and information requests.30 Because the debtor “assumes the responsibilities of a trustee” over the estate, it also assumes “the corresponding fiduciary obligations” to the bankruptcy estate, which broadly includes acting as a fiduciary for the estate, its creditors, and its equity owners.31

Second, a Chapter 11 bankruptcy may involve multiple statutory and “Ad Hoc” committees. Perhaps most significantly, the Bankruptcy Code contemplates the creation of an official committee of unsecured creditors, which provides unsecured creditors with an organized voice in the bankruptcy process and allows for some level of oversight and input into the debtor’s post-bankruptcy decision making.32 Under Section 1102(b)(3), the committee is required to provide access to information to non-committee members who hold similar claims and act as a conduit for comments from non-committee members.33 Additionally, Section 1103

28 1 Collier on Bankruptcy ¶ 15.04[2] (16th ed.).
32 1 Collier on Bankruptcy ¶ 15.04[2] (16th ed.).
33 Id.; 11 U.S.C. § 1102(b)(3)(A) and (B).
provides that a committee “may” take various other actions, including, among other things, consulting with the debtor regarding the administration of the case, “investigating the acts, conduct, assets, liability, and financial condition” of the debtor or “any other matter relevant to the case or formulation of a plan,” and “participat[ing] in the formulation of a plan.”34 Other than these broad parameters, the Bankruptcy Code does not require that an unsecured creditor’s committee take any particular action, and as a result, the unsecured creditor’s committee involvement in the case generally varies greatly based on the size, complexity, and economics of the Chapter 11 case.35 Regardless, the very existence of an unsecured creditors committee (and other official or ad hoc committees)36 is a notable departure from pre-bankruptcy corporate governance.

Third, the Bankruptcy Code limits a debtor’s authority to engage in transactions outside the “ordinary course of business” absent bankruptcy court approval. For example, the debtor is barred from obtaining unsecured credit or engaging in the use, sale, or lease of property “outside the ordinary course of business” absent bankruptcy court approval.37 One court summarizes the framework established by Section 363 as being “designed to allow a trustee (or debtor-in-possession) the flexibility to engage in ordinary transactions without unnecessary creditor and bankruptcy court oversight, while protecting creditors by giving them the opportunity to be heard when transactions are not ordinary.”38 This distinction can create issues over whether a debtor

34 11 U.S.C. § 1103(c).

35 1 Collier on Bankruptcy ¶ 15.04[2][B] (16th ed.).

36 The Bankruptcy Code expressly contemplates the creation of additional creditor committees or of a committee of equity security holders. See 11 U.S.C. § 1102(a)(1). Additionally, while not contemplated by the Bankruptcy Code, in larger cases it is common for various creditors or equity holders to create “Ad Hoc” committees to advance their joint interests.

37 See 11 U.S.C. §§ 363(c), 364.

38 In re Roth American, Inc., 975 F.2d 949, 952 (3d Cir. 1992).
has authority to enter into a certain transaction without court authority when conducting business post-petition, and represents a notable departure from the corporate decision-making process outside of bankruptcy.

Fourth, secured creditors hold an important, perhaps enhanced, role in corporate governance during a Chapter 11 bankruptcy, especially if they hold a perfected lien on the debtor’s cash on the petition date.\textsuperscript{39} Secured creditors have special protections under Section 362(d) to demand adequate protection or seek relief from the automatic stay, and, if the creditor holds a lien on cash collateral, the ability to demand adequate protection under Section 363(c)(2). Taken together, these rights often lead to the negotiation of a DIP financing agreement or agreed-upon cash collateral order that often gives secured creditors significant leverage over the course of a Chapter 11 case, which can substantially affect a debtor’s post-petition decision making.\textsuperscript{40}

The debtor’s management, especially where they are unfamiliar with the bankruptcy process, may view these bankruptcy-specific dynamics as unfairly or unduly encroaching on their decision-making and day-to-day control over their business. Previewing and preparing the debtor’s management for these issues is beneficial to ensuring a relatively smooth transition to operating in a Chapter 11 bankruptcy.

\textbf{VIII. SELECT LIMITED LIABILITY COMPANY ISSUES}

The limited liability company (“LLC”) is a creature born of statute, with its origins around 1977. Since that date, LLCs have become widely used and are familiar to most practitioners as an optional form of organizational entity on the list with corporations, partnerships and limited partnerships. It has become such a popular choice that creation of LLCs in many states is far outstripping creation of any other type of legal entity.

\textsuperscript{39} 1 Collier on Bankruptcy ¶ 15.04[2][E] (16\textsuperscript{th} ed.).

\textsuperscript{40} Id.
Simply put, an LLC is a hybrid between a corporation and a partnership. It can provide its members with protection from liability but can also offer tax advantages similar to partnerships. Because it is a creature of statute, the provisions controlling LLCs may differ from state to state. Each state and the District of Columbia have LLC Acts, most of which are based upon the Uniform Limited Liability Company Act (ULLCA). However, the ULLCA has been revised several times and each state’s version may incorporate pieces of each revision or even their own unique contributions.

A. IPSO FACTO CLAUSES.

With regard to LLCs filing bankruptcy, many LLC operating agreements contain boilerplate provisions that provide that the LLC is terminated upon insolvency or bankruptcy filing; these clauses are known as *ipso facto* clauses. These *ipso facto* clauses in an LLC’s operating agreement or in a state statute applicable to a specific debtor LLC are often counter to the goals of the Bankruptcy Code of (i) maximizing the debtor’s assets, liquidating same, and distributing proceeds to the debtor’s creditors, and (ii) providing the debtor with a fresh start. As a result, there has been significant litigation over the enforceability of these types of provisions.

Debtors typically argue that such provisions are improper *ipso facto* clauses that modify or terminate contractual or property rights held by the debtor and are therefore preempted by Section 541(c)(1)(B) of the Bankruptcy Code. As evidenced by the cases cited in Exhibit B, whether the debtor is successful in that argument may depend on how the court approaches the question – if the membership interest is treated as property of the estate, a provision or statute divesting the debtor of its rights in the LLC would generally be preempted by Section 541(c)(1), while if the membership interest is the product of an executory contract (i.e. the operating

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agreement), it becomes less clear that an *ipso facto* provision is preempted because Section 365(c)(1) prevents assumption or assignment of an executory contract where applicable law “excuses a party…from accepting performance from or rendering performance to an entity other than the debtor…” 42 A selection of cases addressing this issue is attached hereto as *Exhibit B*.

**B. IS AN LLC OPERATING AGREEMENT AN EXECUTORY CONTRACT, AND WHY DOES IT MATTER?**

If the operating agreement is deemed an executory contract, then Section 365 of the Bankruptcy Code applies and the trustee must either assume or reject it. Assumption of the operating agreement results in the bankruptcy estate obtaining all of the benefits of the debtor’s interest in the LLC, but the estate must also perform as required under the operating agreement (including responding to calls for capital out of the debtor’s estate assets, etc.). Another benefit of assumption is that the trustee can exercise all management rights available to it under the operating agreement.

As a result, there has been significant litigation over whether LLC operating agreements constitute executory contracts. An appendix of selected cases addressing this issue is attached hereto as *Exhibit C*.

**C. SALE OF A DEBTOR’S LLC MEMBERSHIP INTEREST.**

*Single Member LLC.* A single member LLC is far easier to reach in bankruptcy than multimember LLCs. In the event of a single member bankruptcy filing, the Chapter 7 trustee owns and controls the single member LLC. This has been held to include both the economic rights and the management rights. 43

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42 See, e.g., *Nine Years Later and We Are Still Peering Through the Muck: Are LLC Membership Agreements Property Interests or Executory Contracts?* Available at https://business-finance-restructuring.weil.com/executory-contracts/nine-years-later-and-we-are-still-peering-through-the-muck-are-llc-membership-agreements-property-interests-or-executory-contracts/

It should be noted that the Trustee’s control of a single member LLC does not amount to a consolidation of the entity into the individual case. Instead, the LLC must still be treated as a separate entity, with separate creditors, unless and until substantive consolidation occurs. In other words, the LLC assets are not part of the Debtor’s estate and are not protected by the automatic stay, simply because a Debtor owning a single member LLC files bankruptcy.44

Multi-Member LLC. There are several ways that a Trustee might seek to assert the Debtor’s membership rights in a multi member LLC to maximize its value. If the Trustee asserts the Debtor’s membership rights pursuant to § 541, as “property of the estate” acquired by the Trustee, then the Trustee can assert the rights of a member, such as demand for access to the books and records, and may have the right to seek dissolution in certain circumstances.45 The Trustee might also seek to assert the Debtor’s membership rights pursuant to § 365, if the operating agreement is an executory contract, which might give rise to additional liquidation or

498 B.R. 262, 267 (Bankr.D.Nev.2013)(holding that “where a debtor has a membership interest in a single-member LLC and files a petition for bankruptcy under Chapter 7, the Chapter 7 trustee's rights automatically include the right to manage that entity”); Fursman v. Ulrich (In re First Protection, Inc.), 440 B.R. 821, 830 (9th Cir. BAP 2010)(holding that “the [Chapter 7] trustee was not a mere assignee, but stepped into [the d]ebtors' shoes, succeeding to all of their rights, including the right [as sole owners and members of Redux, a limited liability company,] to control Redux”); In re A–Z Electronics, LLC, 350 B.R. 886, 891 (Bankr.D.Idaho 2006)(holding that, where one of the joint Chapter 7 debtors owned 100% of the membership interests in a limited liability company, the Chapter 7 trustee “was the only one entitled to manage [such limited liability company] and decide, inter alia, whether the LLC would or would not file bankruptcy”); In re Albright, 291 B.R. 538, 541 (Bankr.D.Colo.2003)(explaining that “[b]ecause the Trustee became the sole member of Western Blue Sky LLC upon the [d]ebtor's bankruptcy filing, the Trustee now *411 controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets”); In re Modanlo, 412 B.R. 715, 731 (Bankr.D.Md.2006), aff’d, 266 Fed.Appx. 272 (4th Cir.2008)(holding that the appointed Chapter 11 trustee of a limited liability company's sole member “had the power to place [the limited liability company] into bankruptcy ... and, standing in the shoes of the [d]ebtor ... possess[ed] both the economic and governance rights to participate in the management of [the limited liability company] that the [d]ebtor himself enjoyed prior to his bankruptcy filing”).

44 In re McCormick, 381 B.R. 594 (Bankr.S.D.N.Y. 2008); In re Knefel, 2007 WL 2416535 (Bankr.E.D. Va. Aig. 17, 2007); In re Gorcham, 2009 Bankr. LEXIS 2995 (Bankr. D. Neb. Sept. 16, 2009); In re Hopkins, No. DG 10-13592, 2012 WL 423916, at *1 (Bankr. W.D. Mich. Feb. 2, 2012) (Debtor’s interest in LLC is part of bankruptcy estate, but property held by the LLC is not); In re Britannia, 435 B.R. 318, 322 (Bankr. D.S.C. 2010) (Debtor’s wholly-owned LLC is property of estate to extent of distribution of interest, but property held by LLC is not property of estate unless Debtor can show he has equitable interest in such property); In re Breeze, 487 B.R. 599 (B.A.P. 6th Cir. 2013) (Debtor could not claim homestead exemption in property owned by her single-member LLC).

dissolution rights. The Trustee might also be able to assert rights as a hypothetical judgment creditor pursuant to § 544(a).

It is essential to remember that results will vary in the extreme, depending upon the terms of the Operating Agreement, the state law regarding LLCs and, most importantly, state law as to property rights. Because state law controls the definition of property and the ability to reach different kinds of property, the application of property law in each state will have a significant impact on what interest can be sold.

In most cases, the Trustee is generally limited to selling the economic interest only. Any buyer would become an “assignee” of the membership interest, and most state laws governing LLCs and most operating agreements restrict the rights of an assignee to a distributional interest only. In order to obtain voting rights and other rights of a full member, most operating agreements require the consent of the other members – something the Trustee is unlikely to get.

Sale of only the economic interest can still provide a valuable asset for the Trustee. The sale of the economic interest, however, might be subject to sale restrictions in the operating agreement. Many operating agreements, for example, give other members the right of first refusal and have stringent timing requirements for notice of intent to sell. Whether the Trustee is bound by these restrictions may depend on whether the operating agreement is an executory contract or not. If it is an executory contract, then courts have held that the Trustee can reject the executory contract, and thereby essentially reject the first refusal terms (remember the 60-day deadline for determination of assumption or rejection in a chapter 7 case.) If the court finds that the operating agreement is not an executory contract, then the Trustee has no ability to reject it and must abide by its terms. Note, however, that the Trustee still might have an argument that the restrictions constitute an unreasonable restraint on alienation. An appendix of sample cases addressing these issues is attached as Exhibit D.
EXHIBIT A

AUTHORITY TO FILE

1. KEY CASES IN THE ELEVENTH CIRCUIT


The Debtor LLC’s operating agreement provided that the LLC’s lender had a membership interest in the LLC and that any filing for bankruptcy protection by the LLC required consent of the lender. The LLC sought to file for bankruptcy protection but the lender-member would not consent. The LLC solicited the filing of an involuntary bankruptcy petition against it which the LLC did not contest. The lender sought a dismissal of the involuntary bankruptcy petition and the Court agreed, finding that this attempt to circumvent the lender’s contractual rights as a member of the LLC was inappropriate; the Court dismissed the case stating: “The fact is that the petitioning creditors’ participation in this case was solicited by the Debtor which was prohibited by the Operating Agreement from filing a voluntary case without [lender’s] consent.” Id. at 202.

In re H&W Food Mart, LLC, 461 B.R. 904 (Bankr. N.D. Ga. 2011)

The court enforced a provision of LLC operating agreement stating that a manager ceased to be manager if the manager filed an individual bankruptcy case, and dismissed a voluntary petition filed by an LLC that was executed by the former debtor manager given that the manager previously filed an individual bankruptcy case.


One of the corporation’s two directors filed a voluntary petition without the consent of the other director. The court held that “[t]here is no question that the authority to manage the affairs of the corporation does not include the right to file a petition for relief under any of the operating chapters of the Bankruptcy Code. The debtor’s business was ownership and operation of various RV parks, and “obviously [did] not include the business of the Debtor to file for relief under Chapter 11 of the Bankruptcy Code.”


Stating that “the Debtor cannot be precluded from exercising its right to file Bankruptcy and any contractual provision to the contrary is unenforceable as a matter of law…”

2. KEY CASES OUTSIDE THE ELEVENTH CIRCUIT

In re Franchise Services of North America, 891 F.3d 198 (5th Cir. 2018):
The Fifth Circuit held that federal law does not prevent a *bona fide* shareholder from exercising its voting rights in the entity’s corporate governance documents to prevent the entity’s filing of the bankruptcy case just because the shareholder is also an unsecured creditor. Significantly, the Fifth Circuit stated that “a different result might be warranted if a creditor with no stake in the company held the right [or if]…there were evidence that a creditor took an equity stake simply as a ruse to guarantee a debt…We leave those questions for another day.” *(Id. at 209).*


The Court held that state law controls how a company may authorize filing bankruptcy but that federal law controls whether operating agreement provisions restricting authority to file bankruptcy are valid. Here, a lender required the operating agreement to be amended to include a provision requiring written votes from the lender and all LLC members before filing for bankruptcy could be authorized. The Court ruled that such a provision was not valid because, in restricting the ability to file bankruptcy, the intent was to take control of that decision away from the LLC and give such control to the lender with no other legitimate purpose. The Court then held that contracting away the right to file bankruptcy was not permissible under federal law.

The Court then looked to the remainder of the operating agreement to determine whether the LLC manager had the authority to file bankruptcy. The plain language of the operating agreement gave the manager the authority to manage the LLC’s business affairs unless there was a restriction on same elsewhere in the operating agreement. Once the Court invalidated the provision requiring the lender’s approval, there were no other restrictions on filing for bankruptcy. The Court also determined that Kentucky law, the state where the LLC was formed, gave managers the exclusive power to manage the business and affairs of an LLC unless the operating agreement restricted that authority and noted that Kentucky law does not require unanimous member consent to authorize bankruptcy filing.


“It is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor’s decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy.”


In this matter, a lender contested the authority of an LLC to file bankruptcy where the lender had insisted upon, and received, a “golden share” in the LLC as a condition of loaning funds to the LLC, where the “golden share’s” consent was required for the LLC to file bankruptcy. The Court held that such a provision was “tantamount to an absolute waiver” of the LLC’s right to seek bankruptcy protection and was therefore void as a matter of federal public policy. The Court stated that federal public policy protects LLC rights to petition for bankruptcy
protection and that there is a plethora of caselaw that invalidates prepetition agreements seeking to abrogate such rights. The Court also noted that states cannot abrogate such rights through statutes governing LLCs or otherwise.

*In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. April 5, 2016):

The Debtor LLC defaulted upon a loan agreement with the lender, which resulted in a forbearance agreement under which the lender required an amendment to the Debtor LLC’s operating agreement making the lender a “special member” to the LLC with no ownership interest but with veto power over the filing of bankruptcy proceedings. The Debtor LLC again defaulted on the loan agreement, after which the lender instituted foreclosure proceedings against the Debtor LLC at which time the Debtor LLC filed for bankruptcy protection, staying the foreclosure proceedings. The Court stated “[f]or public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy.” *Id.* at 12 citing *Klingman v. Levinson*, 831 F.2d 1292, 1296 (7th Cir. 1987). In addressing enforceable bankruptcy remote LLCs, the Court articulated that such structures must allow a blocking member or director to adhere to her or his “normal fiduciary duties, and therefore in some circumstances, vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor they were chosen by.” *Id.* at 913.

In examining the special member provision in the context of Michigan law, the Court found that, as a member of a Michigan LLC, the special member was required to consider the Debtor LLC’s interests. *Id.* at 913. The Court held that the blocking provision was void because it allowed the special member to consider only its interest which was a violation of Michigan law. *Id.* at 914.


The Debtor LLC filed for bankruptcy protection after authorization by 51 2/3% of its membership. The dissenting members sought the dismissal of the bankruptcy petition, arguing that, where the operating agreement is silent as to the requisite consent required to authorize a bankruptcy filing, Maryland law (the state where the LLC was formed) requires unanimous consent of the members.

The Court looked at the operating agreement as a whole and under “the law of objective contract interpretation,” the court decided that “a reasonable person could only understand [the operating agreement] as requiring the consent of the majority of the member interests to authorize the filing of a bankruptcy petition.” *Id.* at * 13-15. The Court specifically observed that, under the operating agreement, “both ordinary course and extraordinary transactions” could be accomplished by majority vote. *Id.* at *15. Only three actions required unanimous consent: the dissolution of the LLC, the acquisition of additional property, and the modification of the operating agreement. The Court then concluded that “the operating agreement [ ] sets forth a reasonable and sound governance agreement that dictates majority rule on all matters other than one which changes the nature of the Debtor, leads to its termination or changes the
original agreement among the members as to how they would conduct the affairs of the Debtor.” *Id.* at *17. The Court discounted the dissenting members’ argument that Maryland law requires unanimous consent by noting that “although the Act requires unanimous consent of the members to authorize a bankruptcy filing, that provision is expressly qualified by ‘unless otherwise agreed.’” *Id.* at *22.

*DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 463 B.R. 142 (BAP 10th Cir. 2010):

The manager of the Debtor LLC initiated bankruptcy proceedings on behalf of the Debtor LLC. The LLC’s operating agreement included a provision to expressly bar the LLC from filing for bankruptcy specifically stating “to the extent permitted under applicable law, [the LLC] will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy…” One of the LLC members objected to the bankruptcy filing based upon this provision.

The bankruptcy court granted the LLC’s member’s motion to dismiss the bankruptcy filing, which was affirmed by the 10th Circuit BAP. The Court rejected the manager’s argument that the provision prohibiting bankruptcy filing was void as against federal public policy, distinguishing the facts of this matter from situations where non-member lenders insist on provisions prohibiting the LLC from filing for bankruptcy. The Court stated that “Debtor has not cited any cases standing for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy, nor has the court located any.” *Id.* at *10.

*In re Bay Club Partners-472, LLC*, 2014 WL 1796688, at *3-6 (Bankr. D. Or. May 6, 2014)

Denying motion to dismiss where lender requested provision in operating agreement prohibiting filing voluntary petition before all debts were paid in full.


The Court enforced an LLC operating agreement requiring approval of the independent manager and unanimous consent of members to file bankruptcy because entity formalities of the LLC were observed.

*In re Orchard at Hansen Park, LLC*, 347 B.R. 822, 826 (Bankr. N.D. Tex. 2006):

The Court upheld an operating agreement provision that required unanimous consent and vote of an independent manager prior to filing a bankruptcy petition.
In re Green Power Kenansville, LLC, 2004 LEXIS 2541 (Bankr. E.D.N.C. Nov. 18, 2004):

The Court upheld an operating agreement provision that gave authority to an independent manager for any bankruptcy filing.

In re Pasta Bar by Scotto II, LLC, 2015 LEXIS 3941 at *3 (Bankr. S.D.N.Y. Nov. 19, 2015):

The Court upheld an operating agreement provision that required approval of a supermajority of the LLC members to approve a bankruptcy filing as enforceable and invalidating a bankruptcy filing based upon only 50 percent approval as unauthorized.
EXHIBIT B

**IPSO FACTO CLAUSES IN LLC OPERATING AGREEMENT**


The chapter 11 trustee sought a determination that two provisions of the operating agreement were valid and fully enforceable. Such provisions provided that the LLC would dissolve upon the filing of a bankruptcy petition by a member of the LLC and that members would liquidate the LLC’s assets upon dissolution. The Court considered the LLC’s arguments that the LLC operating agreement was an executory contract and, consequently, the provisions that provided for automatic dissolution upon a member filing for bankruptcy protection was an *ipso facto* clause made unenforceable by section 365(e)(1) of the Bankruptcy Code.

The Court determined that the operating agreement was not an executory contract. The Bankruptcy trustee could then enforce the provisions of the operating agreement that required the LLC to be dissolved upon a member’s filing for bankruptcy and the trustee was able to overcome objections that such clauses were impermissible *ipso facto* clauses.


After determining that the operating agreement was not an executory contract (as discussed in further detail *infra*), the Court also looked at whether the provision of the operating agreement providing LLC members with the right of first refusal was an *ipso facto* clause under section 365(e) of the Bankruptcy Code or an impermissible restraint on assignment under section 365(f) of the Bankruptcy Code. Because the Court determined that the operating agreement was not an executory contract, the Court held that the clause providing a right of first refusal to the other LLC members was not unenforceable under sections 365(e) or (f) of the Bankruptcy Code. Consequently, the Court concluded that the receiver took the debtor’s property, including the 20% interest in the LLC, as it found it on the date of the petition and that the interest was subject to the right of first refusal, holding that the such right existed without regard to whether a member filed for bankruptcy protection and it was not triggered by the bankruptcy filing. *Id.* at 638.

*In re Strata Title, LLC*, 2013 LEXIS 1704 (Bankr. D. Az. 2013):

The Debtor LLC held a 45% interest in a second LLC, Santerra, the purpose of which was to acquire, own and operate an apartment complex. Santerra’s operating agreement required the approval of a supermajority of the membership for actions such as borrowing funds or selling assets and provided that other members could buy out a member’s interest if that member filed for bankruptcy protection.
Once the Debtor LLC filed for bankruptcy protection, Santerra’s other members served notice of their intent to exercise the purchase option to which the Debtor LLC responded that such provision was not enforceable as it was an *ipso facto* clause.

After determining that the operating agreement was an executory contract (as discussed in further detail *infra*), the Court then determined that the purchase option was an unenforceable *ipso facto* clause because it was triggered solely by the bankruptcy filing of a member and once the membership interest became property of the estate under section 541(c) of the Bankruptcy Code, section 363(l) of the Bankruptcy Code invalidated any provision of the operating agreement that limits the debtor’s continued use or sale of the property based upon filing for bankruptcy protection. *Id.* at *3.*
EXHIBIT C
OPERATING AGREEMENTS AS EXECUTOR Y CONTRACTS


The Court applied the Countryman definition and looked at the operating agreement to determine whether the individual debtor had any unperformed duties arising under the operating agreement as a member of the LLC; the Court found that the member did not have any such duties. Consequently, the Court determined that section 365(e)(1) of the Bankruptcy Code was not applicable and the two provisions at issue were valid and enforceable. Id. at 620.


The Debtor held a 20% interest in an LLC. A bidding war occurred after the receiver received a number of offers to purchase the debtor’s LLC interest from other LLC members. The receiver filed a sale motion under section 363(f) of the Bankruptcy Code in which the receiver sought approval from the bankruptcy court to sell the LLC interest free and clear. Id. at 633-634. The LLC lodged objections to the sale motion, alleging that the other LLC members had a right of first refusal and that the successful bidder could not change the terms of the LLC operating agreement by requiring the receiver to reject all executory contracts. Id. at 634.

The Court first looked to the Countryman definition to determine whether the LLC operating agreement was an executory contract such that it could be assumed or rejected and, upon analysis of the Countryman definition, the Court determined that the LLC operating agreement was not an executory contract, holding that future and remote contingencies do not make an operating agreement into an executory contract under section 365 of the Bankruptcy Code. Id. at 636. The Court then looked to whether the ipso facto clauses were enforceable, as set forth in further detail supra.

In re Strata Title, LLC, 2013 LEXIS 1704 (Bankr. D. Az. 2013):

The Debtor LLC held a 45% interest in a second LLC, Santerra, the purpose of which was to acquire, own and operate an apartment complex. Santerra’s operating agreement required the approval of a supermajority of the membership for actions such as borrowing funds or selling assets and provided that other members could buy out a member’s interest if that member filed for bankruptcy protection.

Once the Debtor LLC filed for bankruptcy protection, Santerra’s other members served notice of their intent to exercise the purchase option to which the Debtor LLC responded that such provision was not enforceable as it was an ipso facto clause.

The Court first determined whether Santerra’s operating agreement was an executory contract, finding that it was because it required certain actions by its members that the Court held required the Debtor LLC’s active participation and were therefore not remote. The Court then looked to whether the ipso facto clauses were enforceable, as set forth in further detail supra.

The debtor/LLC member’s non-managing interest in the LLC came into the bankruptcy estate by operation of section 541 of the Bankruptcy Code and was determined to not be an executory contract under section 365 of the Bankruptcy Code where the debtor/LLC member had no unperformed duties. The Court analyzed the operating agreement and determined that only “remote or speculative future duties” remained for the debtor/LLC member. The Court stated “[t]here is no per se rule. Each operating agreement is separately analyzed.” The Bankruptcy trustee could then enforce the provisions of the operating agreement that required the LLC to be dissolved upon a member’s filing for bankruptcy and the trustee was able to overcome objections that such clauses were impermissible ipso facto clauses.

In re Denman, 513 B.R. 720 (Bankr. W.D. Tenn. 2014):

The Court held, in an individual chapter 13 bankruptcy proceeding, that an LLC operating agreement is not a contract for purposes of section 365 of the Bankruptcy Code and was rather better characterized as an entity formation document. Consequently, the Court was not required to undertake a section 365 analysis and the debtor’s interest in the LLC came into the bankruptcy estate. The Court also ruled that an LLC member/non-debtor’s attempt to exercise his rights under the purchase provision of the operating agreement was impermissible as that provision was an unenforceable ipso facto clause. The Court refused to lift the automatic stay to allow the exercise of the purchase option.


The Court determined that the debtor/LLC member’s non-managing interest in the LLC at issue did not require any additional significant action on the part of the debtor in order to avail him of distributions and, consequently, the operating agreement was non-executory so section 365 of the Bankruptcy Code would not apply. The Court considered future potential obligations, like responding to capital calls, and determined that such future potential obligations did not make the operating agreement an executory contract. The debtor’s interest in the LLC therefore became part of the bankruptcy estate pursuant to section 541 of the Bankruptcy Code and provisions of the operating agreement that would have prohibited transfer of interest were unenforceable under Section 541(c)(1).


A non-debtor/LLC member brought a declaratory judgment action seeking a determination by the Court that the debtor lost his management rights in the LLC when the debtor reacquired his membership interest in the LLC through an auction held related to the debtor’s plan of reorganization. The non-debtor LLC member asserted that the LLC’s operating agreement prohibited the transfer of management rights.
The Court ruled that the debtor’s interest, including his voting and management rights, became property of the debtor’s estate pursuant to section 541 of the Bankruptcy Code and that “Section 541(c)(1) overrides both the ipso facto provisions in the [Maryland] Act and the restriction on transfer provision in the Operating Agreement.” The Court ruled that, because the debtor’s interests were part of the bankruptcy estate by operation of section 541, those interests were able to be auctioned. However, the Court also ruled that the provisions of the operating agreement that prohibited transfer of management rights would be respected as they related to the debtor’s re-acquisition of his interests through the auction.
EXHIBIT D
TRUSTEE’S RIGHTS UNDER OPERATING AGREEMENT

In In re Knowles, 2013WL152434 (Bankr. M.D. Fla., Jan, 15, 2013), the Chapter 7 Trustee sought to sell each Debtor’s 1/6 interest in a family LLC. The operating agreement contained a right of first refusal to certain family members and to other members, in an order of priority, and required only that the family member with highest priority meet (not exceed) the price offered by the third party. The Trustee argued that the operating agreement was an executory contract, and he sought to reject it so that he would not be bound by the right of first refusal. In this way, the Trustee hoped to be able to garner higher bids in order to maximize the value of the interest. The Court found that the operating agreement was not executory under the facts of the case. As a result, the Trustee could not reject it, and was bound by its terms. Specifically, any sale by the Trustee was subject to the limits imposed by the right of first refusal.

A similar question was at issue in In re Ichiban, Inc., 2014 WL2937088 (Bankr. E.D. Va., June 30, 2014), with a different result under the facts. In that case, the operating agreement gave a right of first refusal to the company, and then to its members. The company objected to a sale by auction, because it argued that the right of first refusal gave it the right to elect to purchase the membership interest at the highest bid. The Court found that there were many continuing obligations of the members, and that the operating agreement was an executory contract. The Court then found that it was rejected when not assumed by the Trustee within 60 days. As a result, the right of first refusal was “not enforceable in this bankruptcy case as to the Debtor,” and the Trustee was able to proceed with the sale process without meeting the first refusal requirements.

The operating agreement in In re Talbut also contained a right of first refusal to the members. 2015 WL5145598 (Bankr. N.D. Ohio, Aug. 28, 2015). The Debtor owned a 25% interest, and he and the other members objected to the Trustee’s motion to sell to a stalking horse bidder and motion to approve overbid and auction procedures. The proposed sale procedures did not include compliance with the right of first refusal requirements in the operating agreement. There was no discussion of whether the operating agreement was an executory contract, but the Court held that the operating agreement was enforceable, and it denied the Trustee’s motion to sell because it did not comply with the operating agreement’s requirements for the transfer of a member’s interest (specifically, the right of first refusal requirements). The decision hinged on § 363(f)(1), and the fact that the Trustee was unable to meet the burden of showing that non-bankruptcy law permitted the sale. The Trustee was determined, and filed a second motion to sell. In re Talbut, 2016 WL937373 (Bankr. N.D. Ohio, March 10, 2016) (“Talbut II”). In Talbut II, the Trustee argued that Virginia statutory law permitted the sale without compliance with the first refusal requirements of the operating agreement. He argued that he had the rights under § 544(a)(1) as a judicial lien creditor, and as such, he would be entitled to obtain a lien on the membership interest and foreclose on it. The Court rejected that argument and held that Virginia law did not permit the foreclosure of a charging lien.

The Bankruptcy Court in In re Minton clarified what it means when an operating agreement, which is an executory contract, is rejected. 2017 WL354319 (Bankr. C.D. Ill., Jan. 24, 2017). In that case, the Debtor held a 20% interest in an LLC, and the LLC filed a
declaratory judgment action against the Chapter 7 Trustee essentially arguing that the operating agreement had been rejected, and as a result, the bankruptcy estate no longer had an interest in the LLC. The Court quickly pointed out that this is an inaccurate interpretation of the law. This case contains a good discussion of LLCs, operating agreements, and the effect of rejection on an executory contract. The Court noted that rejection constitutes a breach of the contract, but it does not terminate the contract. Instead, it “frees the bankruptcy estate from any obligations under that contract.” The Court ultimately found that the operating agreement at issue in this case was not an executory contract. The Court then addressed whether the Trustee was bound by the sale restrictions contained in the operating agreement. Because there was not a sale motion pending, the Court held that the issue was not ripe for determination. However, the Court noted that the Trustee would not necessarily be bound by sale restrictions that were “unreasonable restraints on alienation.”

In In re Safa, Case No. 16-03150-dd (Bankr. D.S.C., Sept. 22, 2017), the Bankruptcy Court elected not to address the issue of whether the operating agreement was an executory contract, and instead approved the sale pursuant to § 363(f)(4) due to the presence of a bona fide dispute. The Trustee sought to sell the Debtor’s 1/3 economic interest in an LLC. The other members objected, arguing that the operating agreement was an executory contract, which was rejected, and that as a result, the Debtor’s rights in the LLC could not be sold. The Court noted that whether an LLC operating agreement is an executory contract is a fact-intensive inquiry, and that its resolution was not necessary for approval of the sale. The Court allowed the sale of the economic interest “as is, where is”, with no warranty, as proposed by the Trustee. The Court noted: “Property interests are best disposed of promptly with disputes over entitlement to the proceeds resolved at a later time.”