

Twenty-Second Annual BBA Spring Break Weekend
May 4-5, 2018

Issues Arising in Cases Filed by LLCs or Their Members

Moderator

Honorable Michelle M. Harner
United States Bankruptcy Judge
District of Maryland

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LLCs in Bankruptcy

Twenty-Second Annual BBA Spring Break Weekend

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I. Bankruptcy Alternatives

A. Workouts

- Extension of Maturity Date
- Forgiveness/Forbearance of Debt Service for a Period of Time
- Revision/Waiver of Restrictive Loan Covenants and Representations
- Extensions of Credit

B. Loan Sale/Friendly Foreclosure

- Does the market justify sale at par?
- Default Interest/Late Fees collectible?
- Cooperation Agreements likely

C. Assignment for the Benefit of Creditors

- Potential for relatively quick distribution to creditors
- Potential for reduced costs compared to bankruptcy cases
- Borrower has ability to select specific professional as assignee
- Md. Code, Comm. Law Section 15-101, *et seq.*

D. Receivership

- Lender has ability to select receiver

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- Receiver preserves, manages and/or liquidates property with limited liability risk, and no risk of lender as mortgagee in possession.
- Takes complete control of asset

II. Insider Issues.

A. Select Consequences of Being an “Insider”

i. One-Year Preference Period. Insiders are subject to a one-year look back period for recovery of preferential transfers. 11 U.S.C. § 547(b)(4)(B); *see also In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011); *see Shubert v. Lucent Technologies, Inc. (In re Winstar Communications, Inc.)*, 554 F.3d 382 (3d Cir. 2009).

ii. Potential for Greater Fraudulent Transfer Exposure. Insiders with employment contracts may be exposed to fraudulent transfer liability. 11 U.S.C. § 548(a)(1)(B)(ii)(IV); *see In the Matter of TransTexas Gas Corp.*, 597 F.3d 298 (5th Cir. 2010); *In re TSIC Inc.*, 428 B.R. 103 (Bankr. D. Del. 2010).

iii. Increased Risk of Equitable Subordination. Claims of insiders are subject to a relaxed standard for equitable subordination. *See In re QuVIS, Inc.*, 504 Fed. Appx. 747, 748, 2102 U.S. App. LEXIS 24930 (10th Cir. Dec. 5, 2012).

iv. Limited Plan Voting Rights. Votes of insiders accepting Chapter 11 plans are disregarded for the purpose of determining whether at least one impaired class has accepted the plan. *See* 11 U.S.C. 1129(a)(10); *see also In re The Village at Lakeridge, LLC*, 2013 Bankr. LEXIS 2329 (9th Cir. BAP April 5, 2013).

v. In Pari Delicto Defense Has Limited Applicability. The *in pari delicto* defense generally is held to be inapplicable to claims against insiders. *See, e.g., Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130, 133 (2d Cir. 1993).

B. The Statutory Definition Of “Insider”

The Bankruptcy Code defines “insider” as follows:

- (31) The term “insider” includes –
- (A) if the debtor is an individual –
 - (i) relative of the debtor or of a general partner of the debtor;
 - (ii) partnership in which the debtor is a general partner;
 - (iii) general partner of the debtor; or
 - (iv) corporation of which the debtor is a director, officer, or person in control;
 - (B) if the debtor is a corporation –

- (i) director of the debtor;
 - (ii) officer of the debtor;
 - (iii) person in control of the debtor;
 - (iv) partnership in which the debtor is a general partner;
 - (v) general partner of the debtor; or
 - (vi) relative of a general partner, director, officer, or person in control of the debtor;
- (C) if the debtor is a partnership –
- (i) general partner in the debtor;
 - (ii) relative of a general partner in, general partner of, or person in control of the debtor;
 - (iii) partnership in which the debtor is a general partner;
 - (iv) general partner of the debtor; or
 - (v) person in control of the debtor;
- (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
- (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
- (F) managing agent of the debtor.

11 U.S.C. § 101(31).

The Bankruptcy Code defines “affiliate” as follows:

- (2) The term “affiliate” means –
- (A) entity that directly or indirectly owns, controls, or holds with the power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities
- (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
 - (ii) solely to secure a debt, if such entity has not in fact exercise such power to vote;
- (B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds the power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities –
- (i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
 - (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

11 U.S.C. § 101(2).

C. Insider Status – No Strict Code-Based Definition Resulting in “Non-Statutory” Insiders.

i. Non-Exhaustive List. The list of statutory insiders is not exhaustive. *See In re Krehl*, 86 F.3d 737, 741 (7th Cir. 1996); *see also* 11 U.S.C. § 102(3) (“‘includes’ and ‘including’ are not limiting”); G. David Dean and Amanda Bassen, *Absence of Reference to LLCs in the Code: An “Insider Problem”*, 31-7 ABI JOURNAL (August 2012). Courts have described the analysis for determining whether a person is a non-statutory insider in different ways:

The insider analysis is a case-by-case decision based on the totality of the circumstances, and bankruptcy courts have used a variety of factors in their determinations. One approach focuses on the similarity of the alleged insider’s position to the enumerated statutory categories, while another approach focuses on the alleged insider’s control of the debtor. If the alleged insider holds a position substantially similar to the position specified in the definition, a court will often find that individual to be an insider. But, based on the legislative history of the statute, our case law has also held that the term insider can also encompass anyone with a “sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm’s length with the debtor.”

In re Longview Aluminum, L.L.C., 657 F.3d at 509 (quoting *In re Krehl*, 86 F.3d at 741-42). *Accord, Hill v. Oria (In re Juliet Homes, LP)*, 2011 Bankr. LEXIS 5116 (Bankr. S.D. Tex. December 28, 2011).

[T]his category includes those individuals or entities whose business or professional relationship with the debtor “compels the conclusion that the individual or entity has a relationship with the debtor, close enough to gain an advantage attributable simply to affinity rather than to the course of business dealings between the parties.

In re The Village at Lakeridge, LLC, 2013 Bankr. LEXIS at 14 (quoting *In re Friedman v. Sheila Plotsky Brokers, Inc. (In re Friedman)*, 126 B.R. 63, 70 (9th Cir. BAP 1991)); *accord Shults & Tamm v. Ruley*, 2013 U.S. Dist. LEXIS 76760 (D. Haw. May 31, 2013).

Bankruptcy courts have accordingly “focused on the closeness between the transferee and the debtor, the degree of control or influence the transferee exerts over the debtor, and whether the transactions were conducted at arms length.” *Capmark Fin Group, Inc. v. Goldman Sachs Credit Partners L.P.*, 49 B.R. 335, 351 (S.D.N.Y. 2013) (quoting *In re Oakwood Homes Corp.*, 340 B.R. 510, 523-24 (Bankr. D. Del. 2006)); accord *Miami Police Relief & Pension Fund v. Tabas (In re The Fla. Fund of Coral Gables Ltd.)*, 144 Fed. Appx. 72, 75 (11th Cir. 2005).

ii. Control Not Required. Courts have rejected the argument that a person must control the debtor to be found to be a non-statutory insider:

A finding of actual control by the bankruptcy court would make Creditor a statutory insider and would avoid the question of whether it was a non-statutory insider altogether. Obviously, then, a bankruptcy court does not have to find actual control of the debtor by the creditor.

Anstine v. Carl Zeiss Meditec AG (In re U.S. Med., Inc.), 531 F.3d 1272, 1275 (10th Cir. 2008); accord, *Shubert v. Lucent Technologies Inc. (In re Winstar Communications, Inc.)*, 554 F.3d 382, 395 (3d Cir. 2009).

iii. LLC Members May Be Viewed as Directors for When Determining Insider Status. The leading case for this proposition is *In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011). Several other cases have reached the same conclusion. See *In re Pearson*, No. 1:10-bk-00946MDF, 2010 Bankr. LEXIS 3553, 2010 WL 3956762, at *3 (Bankr. M.D. Pa. 2010) (“In Pennsylvania, members of limited liability companies are individuals with an ownership interest in the LLC and a right to participate in the management of the business. . . . Since [the LLC member] is a member of the LLC, [the LLC] is an ‘insider’ of [the LLC member].”); *In re Die Fliedermaus LLC*, 323 B.R. 101, 111 (Bankr. S.D.N.Y. 2005) (“the [New York Limited Liability Company Law] presumptively puts members in control of the LLC, and as such they are in a position to exert influence over the LLC. This sufficiently places them within the parameters of the Bankruptcy Code’s definition of insider”); *In re Barman*, 237 B.R. 342, 348-49 (Bankr. E.D. Mich. 1999) (“[The LLC] is also within the statutory definition of an ‘insider’ of [the LLC member] because [the LLC member] is one of its three members, and thus holds a position that is analogous to that of a ‘director, officer or person in control’ of [the LLC]”).

In *Longview Aluminum*, one member of a five member LLC, holding 12% of the membership interests, was at odds with the other members. He was barred by the other members from access to books and records. He sued, and the parties entered into a settlement under which he was to be paid \$400,000 to give up his rights as a member of the board of the LLC. He was paid \$200,000, and the LLC went into bankruptcy more than 90 days, but less than one year, after the payment. The payment was avoided as a preference.

The Seventh Circuit affirmed, reasoning that the defendant's 12% interest gave him the right under Delaware law (which governed) and the operating agreement to vote on management of the LLC. The Court noted that Delaware law provides that unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members." 657 F.3d at 510 (citing 8 Del. Code § 141(a)). The Seventh Circuit reasoned that the attributes of management of a LLC were analogous to the management rights of a corporation's board of directors. Although the exact rationale is a bit unclear, it appears that the Seventh Circuit concluded that the 12% member was a statutory insider without regard to whether he had any control over the debtor.

The treatment of members of a LLC (and to the extent applicable, partners in a LLP) is a marked difference from treatment of shareholders in a corporation. Typically, shareholders in a corporation are not treated as insiders unless they control the debtor, *see, e.g., In re N & D Properties, Inc.*, 799 F.2d 726, 729 (11th Cir. 1986), or own, directly or indirectly, more than 20% of the voting securities in the debtor, and are therefore considered an affiliate.

The number of partners or members, and the fact that no single partner or member could exercise control, does not appear to prevent a finding that partners or members are insiders. In *Longview Aluminum*, the defendant held only 12% of the membership interests and lacked the ability to control the company. The number of potential insiders, by itself, may not preclude a finding that they are insiders. *See, e.g., Office of the U.S. Trustee v. Fieldstone Mortg. Co.*, 2008 U.S. Dist. LEXIS 91479 (D. Md. Nov. 5, 2008) (denying approval of Key Employee Retention Plan because vice presidents of debtor were considered officers and therefore insiders, even though the debtor had more than sixty vice-presidents).

MEMBERS ONLY?

Trustee Powers and Forfeited LLCs.

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I. Bankruptcy Trustees v. Single Member LLCs (When Member Files Bankruptcy)

A. The Traditional Rule - Property of the estate encompasses solely a debtor’s economic interest and not the authority to manage or control the LLC. This rule typically exists among multi-member LLCs.

1. Traditional Rule inapplicable to Single Member LLCs

In re Modanlo, 412 B.R. 715, 731 (Bankr. D. Md. 2006). Applying Delaware law, the Court held that LLC statutes that divested bankruptcy trustees of a member's management rights were founded on notions that (remaining) members (like partners in a partnership) should not be forced to accept substituted performance by a member's trustee. The court found this concern to be applicable only in the context of multi-member LLCs, not single member LLCs. Accordingly, the Court ruled that the bankruptcy trustee had the power upon his appointment to place a debtor’s single member LLC into bankruptcy and, standing in the shoes of the debtor and complying with the mandates of the Delaware LLC Act, possesses both the economic and governance rights to participate in the management of the single member LLC that the debtor himself enjoyed prior to his bankruptcy filing.

B. Maryland LLC Act. v. Delaware LLC Act

The similarities between the Maryland and DE LLC statutes provide the same basis for Maryland bankruptcy trustees to assume control of single member LLCs upon the bankruptcy filing of the sole member. Stepping into the shoes of the debtor upon the filing of the bankruptcy, the trustee can dispose of the assets of the LLC if the LLC was member managed.

MD Corp & Assn Code § 4A	DE Com & Trade Code Title 6
§ 4A-603 (2016) Assignment of interest. (a) In general. -- Unless otherwise agreed: (1) Only an economic interest in a limited liability company may be assigned; and (2) An economic interest is wholly or partly assignable. (b) Effect. -- An assignment of an economic interest in a limited liability company does not: (1) Dissolve the limited liability company; or	§ 18-702 Assignment of limited liability company interest. (a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee 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 a limited liability company

<p>(2) Entitle the assignee to:</p> <p>(i) Become a member; or</p> <p>(ii) Exercise any rights of a member, including the noneconomic interest of the assignor.</p>	<p>agreement or, unless otherwise provided in the limited liability company agreement, upon the vote or consent of all of the members of the limited liability company</p>
<p>§ 4A-606 (2016) Cessation of Membership</p> <p>Unless otherwise agreed, a person ceases to be a member of a limited liability company upon the occurrence of any of the following events:</p> <p>(1) The person withdraws from the limited liability company as authorized by § 4A-605 of this subtitle;</p> <p>(2) The person is removed as a member in accordance with the operating agreement;</p> <p>(3) The person:</p> <p>(i) Makes an assignment for the benefit of creditors;</p> <p>(ii) Institutes a voluntary proceeding with respect to the person under the federal bankruptcy code;</p> <p>(iii) Is adjudged bankrupt or insolvent or has entered against the person an order for relief in any bankruptcy or insolvency proceeding;</p> <p>(iv) Files a petition or answer seeking for that person any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation;</p> <p>(v) Seeks, consents to, or acquiesces in the appointment of a trustee for, receiver for, or liquidation of the</p>	<p>§ 18-304 Events of bankruptcy.</p> <p>A person ceases to be a member of a limited liability company upon the happening of any of the following events:</p> <p>(1) Unless otherwise provided in a limited liability company agreement, or with the consent of all members, a member:</p> <p>a. Makes an assignment for the benefit of creditors;</p> <p>b. Files a voluntary petition in bankruptcy;</p> <p>c. Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding;</p> <p>d. Files a petition or answer seeking for the member any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation;</p> <p>e. Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the member in any proceeding of this nature;</p> <p>f. Seeks, consents to or acquiesces in the appointment of a trustee, receiver or liquidator of the member or of all or any substantial part of the member's properties; or</p>

<p>member or of all or any substantial part of the person's properties; or</p> <p>(vi) Files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against the person in any proceeding described in this item;</p> <p>(4) The continuation of any proceeding against the person seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law, or regulation, for 120 days after the commencement thereof, or the appointment of a trustee, receiver, or liquidator for the members or all or any substantial part of the person's properties without the person's agreement or acquiescence, which appointment is not vacated or stayed for 120 days or, if the appointment is stayed, for 120 days after the expiration of the stay during which period the appointment is not vacated;</p> <p>(5) In the case of a member who is an individual, the individual's:</p> <p>(i) Death; or</p> <p>(ii) Adjudication by a court of competent jurisdiction as incompetent to manage the individual's person or property;</p> <p>(6) In the case of a member who is acting as a member by virtue of being a trustee of a trust, the termination of the trust;</p> <p>(7) In the case of a member that is a partnership or another limited liability company, the dissolution and</p>	<p>(2) Unless otherwise provided in a limited liability company agreement, or with the consent of all members, 120 days after the commencement of any proceeding against the member seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation, if the proceeding has not been dismissed, or if within 90 days after the appointment without the member's consent or acquiescence of a trustee, receiver or liquidator of the member or of all or any substantial part of the member's properties, the appointment is not vacated or stayed, or within 90 days after the expiration of any such stay, the appointment is not vacated.</p>
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<p>commencement of winding up of the partnership or limited liability company;</p> <p>(8) In the case of a member that is a corporation, the dissolution of the corporation or the revocation of its charter;</p> <p>(9) In the case of a member that is an estate, the distribution by the fiduciary of the estate's entire economic interest in the limited liability company; or</p> <p>(10) On assignment of all of a person's economic interest in the limited liability company as provided in § 4A-603(d) of this subtitle.</p>	
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C. Constraints on Powers of the Trustee

1. Maryland LLC Statutes

MD Corp & Assn Code § 4A-603 Assignment of Interest

- (a) In general. -- Unless otherwise agreed:
 - (1) Only an economic interest in a limited liability company may be assigned; and
 - (2) An economic interest is wholly or partly assignable.
- (b) Effect. -- An assignment of an economic interest in a limited liability company does not:
 - (1) Dissolve the limited liability company; or
 - (2) Entitle the assignee to:
 - (i) Become a member; or
 - (ii) Exercise any rights of a member, including the noneconomic interest of the assignor.

- (c) Release of assignor's liability. -- If an assignee of an economic interest in a limited liability company becomes a member of the limited liability company, the assignor is not released from the assignor's liability under § 4A-502 of this title to the limited liability company.
- (d) Assignment of entire member's economic interest. -- On assignment of all of a member's economic interest in a limited liability company, the member ceases to be a member of the limited liability company and forfeits the member's noneconomic interest in the limited liability company.
- (e) Pledge or grant of a security interest, lien, or encumbrance. -- The pledge or grant of a security interest, lien, or other encumbrance in or against all or a part of the economic interest of a member does not cause the member to cease to be a member or affect the member's noneconomic interest in the limited liability company.

MD Corp & Assn Code § 4A-604 Rights of Assignee to Become Member

- (a) In general. -- An assignee of an economic interest in a limited liability company may become a member of the limited liability company under any of the following circumstances:
 - (1) In accordance with the terms of the operating agreement providing for the admission of a member;
 - (2) By the unanimous consent of the members; or
 - (3) If there are no remaining members of the limited liability company at the time the assignee obtains the economic interest, on terms that the assignee may determine in accordance with § 4A-902(b)(1) of this title.
- (b) Rights and obligations of assignee. -- An assignee who becomes a member:
 - (1) Has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under the operating agreement and this title; and

- (2) Is liable for any obligations of his assignor to make capital contributions.

MD Corp & Assn Code § 4A-607 Rights of Creditor

(a) Definitions.

- (1) In this section the following words have the meanings indicated.
- (2) "Creditor" means a person for whom a court may issue an attachment under Title 3, Subtitle 3 of the Courts Article.
- (3) "Debtor" means a person whose property or credits are subject to attachment under Title 3, Subtitle 3 of the Courts Article.

(b) Charge against debtor; receiver. --

- (1) On application by a creditor of a debtor holding an economic interest in a limited liability company, a court having jurisdiction may charge the economic interest of the debtor in the limited liability company for the unsatisfied amount of the debt.
- (2) The court may appoint a receiver for the distributions due or to become due to the debtor with respect to the limited liability company and make all other orders, directions, accounts, and inquiries that the debtor would have been entitled to make or that the circumstances of the case may require.

(c) Lien; foreclosure.

- (1) A charging order constitutes a lien on the economic interest of the debtor in the limited liability company and requires the limited liability company to pay over to the creditor only any distributions that would otherwise be payable to the debtor whose economic interest is charged.
- (2) Subject to paragraph (3) of this subsection, the noneconomic interest of a debtor whose economic interest is subject to a charging order is unaffected and is retained by the debtor.

- (3) (i) Unless otherwise agreed, on a showing that the distributions under a charging order will not pay the amount owed to the creditor within a reasonable time, the court may order foreclosure of the economic interest subject to the charging order and order the sale of the economic interest of the debtor.
 - (ii) The purchaser of the economic interest of the debtor at the foreclosure sale is an assignee as provided in §§ 4A-603 and 4A-604 of this subtitle.
 - (d) Redemption. -- Before a foreclosure under this section, an economic interest charged may be redeemed with property:
 - (1) Other than property of the limited liability company, by the debtor;
 - (2) Other than property of the limited liability company, by one or more of the members other than the debtor; or
 - (3) Of the limited liability company, with the consent of the members as provided in the operating agreement or, if the operating agreement does not so provide, with the consent of all of the members whose economic interests are not so charged.
 - (e) Right of debtor under exemption laws not affected. -- This title does not deprive a debtor of a right under exemption laws with respect to the economic interest of the debtor in the limited liability company.
 - (f) Exclusive remedy. -- This section provides the exclusive remedy by which a creditor of a member may attach the membership interest of the member or otherwise satisfy the outstanding debt of the member out of the membership interest of the member

MD Corp & Assn Code § 4A-606.1 Interest of Member after Cessation

- (a) Liquidation of interest. -- Unless otherwise agreed, if a person ceases to be a member of a limited liability company under § 4A-606 of this subtitle, and the limited liability company is not dissolved as a result, then, within a reasonable time after the person ceased to be a member, the limited liability company may elect to pay the person or the person's successor in interest, in complete

liquidation of the person's membership interest, the fair value of the person's economic interest in the limited liability company as of the date the person ceased to be a member, based upon the person's right to share in distributions from the limited liability company.

- (b) Assignment of interest. -- If a person ceases to be a member of a limited liability company under § 4A-606 of this subtitle and the limited liability company elects not to completely liquidate the person's membership interest under subsection (a) of this section, that person will be deemed to be an assignee of the unredeemed economic interest under §§ 4A-603 and 4A-604 of this subtitle.

2. **Maryland Fraudulent Conveyance Laws:**

Md. Code Ann. Comm. Law § 15-205 Every conveyance made without fair consideration when the person who makes it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and other persons who become creditors during the continuance of the business or transaction without regard to his actual intent.

Md. Code Ann. Comm. Law § 15-207 Every conveyance made and every obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud present or future creditors, is fraudulent as to both present and future creditors.

Berger v. Hi-Gear Tire & Auto Supply, Inc., 257 Md. 470, 475, 263 A.2d 507, 510 (1970). Even if the grantor has a fraudulent intent, this will not vitiate or impair a conveyance unless the grantee participates in the fraudulent intent. *Long v. Dixon*, 201 Md. 321, 323, 93 A.2d 758 (1953); *Kennard v. Elkton Banking and Trust Co.*, 176 Md. 499, 503, 6 A.2d 258 (1939); *McCauley v. Shockey*, 105 Md. 641, 645, 66 A. 625 (1907).

Md. Code Ann. Comm. Law § 15-208 (prohibits the sale of limited liability company property without fair consideration)

- (b) Limited liability company property. -- Every conveyance of limited liability company property and every limited liability company obligation incurred when the limited liability company is or will be rendered insolvent by it, is fraudulent as to creditors of the limited liability company, if the conveyance is made or the obligation is incurred to:

- (1) A member, whether with or without a promise by him to pay the limited liability company's debts, unless the conveyance or obligation represents fair and reasonable compensation for services provided or to be provided by the member to the limited liability company and the services are provided or will be provided within 120 days before or after the date the conveyance is made or the obligation is incurred; or
- (2) A person not a member, without fair consideration to the limited liability company as distinguished from consideration to the individual members.

3. Bankruptcy Code Fraudulent Conveyance Statutes

11 U.S.C. § 548 (enables a bankruptcy trustee to avoid pre-bankruptcy fraudulent transfers)

- (1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
 - (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
 - (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
 - (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
 - (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for

which any property remaining with the debtor was an unreasonably small capital;

(III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or

(IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business. (Emphasis added).

4. The LLC Operating Agreement

Pursuant to 11 U.S.C. § 541, a chapter 7 bankruptcy trustee steps into a debtor's shoes as a member of a limited liability company and succeeds to all rights and obligations under a limited liability company operating agreement.

Bankruptcy Code § 541(c)(1) does not define the bundle of rights that go with property. Nor does it expand a trustee's rights beyond those held by the debtor. *Matter of Sanders*, 969 F.2d 591, 593 (7th Cir. 1992).

Sullivan v. Paul (In re Paul), 355 B.R. 64, 67 (Bankr. N.D. Ill. 2001). Bankruptcy Code § 541 does not allow the trustee to sell the bankruptcy estate's interest in ICG free of the constraints of ICG's Operating Agreement. The Trustee's rights and powers are limited to those held by the Debtor as of commencement of his bankruptcy case. See *In re Ehman*, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005).

Matter of Sanders, 969 F.2d 591, 593 (7th Cir. 1992). The trustee was subject to express terms of ICC's Operating Agreement. Filing a bankruptcy petition does not expand or change a debtor's interest in an asset; it merely changes the party who holds that interest... Further, a trustee takes the property subject to the same restrictions that existed at the commencement of the case... To the extent an interest is limited in the hands of a debtor, it is equally limited as property of the estate... (internal citations omitted).

Sheehan v. Warner (In re Warner), 480 B.R. 641, 656 (Bankr. N.D.W.Va. 2012). [E]levating trustees to "super member" status alters the fundamental makeup of a LLC member relationship. A trustee may have incentives that

are incongruent with the non-debtor members; for instance, a trustee may want to liquidate the LLC property to pay creditors even in the face of a viable, profitable LLC. The relationship of a trustee to non-debtor members may be tenuous given that they are forced to deal with an individual with whom they did not choose to be associated. See *Breeden v. Catron (In re Catron)*, 158 B.R. 624, 627 (Bankr.E.D.Va.1992) (observing that “fundamentally a partnership is based upon the personal trust and confidence of the partners”). Indeed, supplanting a debtor already grinds against the notion of *delectus personae*. Black's Law Dictionary 459 (8th ed. 2004) (defining *delectus personae* as the “rule that when personal relations are important, a person cannot be compelled to associate with another person”).

II. Forfeited LLCs

A. Applicable Maryland Law

Md. Code Corps. & Assoc. § 4A-920. No bar to valid acts or defense of suit

The forfeiture of the right to do business in Maryland and the right to the use of the name of the limited liability company under this title does not impair the validity of a contract or act of the limited liability company entered into or done either before or after the forfeiture, or prevent the limited liability company from defending any action, suit, or proceeding in a court of this State.

Md. Code Corps. & Assoc. §4A-908(2)(b)

Notwithstanding the filing of articles of cancellation, the limited liability company continues to exist for the purpose of paying, satisfying, and discharging any existing debts or obligations, collecting and distributing its assets, and doing all other acts required to liquidate and wind up its business and affairs.

Md. Code Corps. & Assoc. § 4A-915 Articles of reinstatement -- Filing

The authority to do business in Maryland of any limited liability company that is forfeited for nonpayment of taxes, unemployment insurance contributions, or reimbursement payments or failure to file an annual report may be reinstated by filing articles of reinstatement with the Department.

Md. Code Corps. & Assoc. § 3-515. Powers of directors on forfeiture

- (a) Directors become trustees. -- When the charter of a Maryland corporation has been forfeited, until a court appoints a receiver, the directors of the corporation become the trustees of its assets for purposes of liquidation.

- (b) General powers. -- The director-trustees are vested in their capacity as trustees with full title to all the assets of the corporation. They shall:
 - (1) Collect and distribute the assets, applying them to the payment, satisfaction, and discharge of existing debts and obligations of the corporation, including necessary expenses of liquidation; and
 - (2) Distribute the remaining assets among the stockholders.
- (c) Specific powers. -- The director-trustees may:
 - (1) Carry out the contracts of the corporation;
 - (2) Sell all or any part of the assets of the corporation at public or private sale;
 - (3) Sue or be sued in their own names as trustees or in the name of the corporation; and
 - (4) Do all other acts consistent with law and the charter of the corporation necessary or proper to liquidate the corporation and wind up its affairs.
- (d) Majority governs. -- The director-trustees govern by majority vote.

B. Forfeited LLC v. Forfeited Corporation

1. Unlike a corporation, a limited liability company does *not* cease to exist when its charter is forfeited for failing to file personal property tax returns. A limited liability company only forfeits its rights to do business. Md. Code Corps. & Assoc. § 4A, which has a savings clause clarified by the Court of Special Appeals of Maryland in *Price v. Upper Chesapeake Health Ventures, et al.*, 995 A.2d 1054, 192 Md. App. 695 (2010).

However, upon close review of the text of the LLC statute and its legislative history, ***we find that tax-failure forfeiture by an LLC, while resulting in the loss of important rights, does not make the LLC a legal non-entity.***
2. In 1992, the General Assembly enacted the Limited Liability Company Act, C & A §§ 4A-101, et seq. See 1992 Md. Laws, Chapter 536. In 1995, the Legislature passed H.B. 871, a departmental bill proposed by the State Department of Assessments and Taxation, which added certain provisions to the Act to become effective on January 1, 1996, including C & A § 4A-911(d). The purpose of this bill was to "require that limited

liability companies, limited liability partnerships and limited partnerships forfeit their right to do business in Maryland and the right to the use of their names if they have not paid specified taxes or filed an annual report with the state." Maryland General Assembly, Department of Fiscal Services, Fiscal Note for H.B. 871 (1995). Although C & A § 3-503(d) provides, in the case of a corporation, that 'the charters of . . . corporations that failed to file an annual tax report are repealed, annulled, and forfeited, and the powers conferred by law on the corporations are inoperative, null, and void,' C & A § 4A-911(d) states only that an LLC that fails to file a tax report *forfeits 'the right to do business in Maryland and the right to the use of its name.'* The statute does not say that LLC articles of organization, like corporate charters, are forfeited for failure to file tax reports or pay taxes. C & A § 4A-920 also indicates that the LLC does not become non-existent after it forfeits those rights, providing:

The forfeiture of the right to do business in Maryland and the right to the use of the name of the limited liability company under this title does not impair the validity of a contract or act of the limited liability company entered into or done either before or after the forfeiture, or prevent the limited liability company from defending any action, suit, or proceedings in a court of this State.

Price, 995 A.2d at 1060 (Emphasis added) (citing Md. Corps. & Assoc. § 9A-1016, 10-218, and 12-810, providing identical non-impairment provisions for limited liability partnerships, limited partnerships, and business trusts, respectively).

3. Like section Md. Code Corps. & Assoc. § 3-516, Md. Code Corps. & Assoc. §4A-908(2)(b) provides that even after cancellation, a Maryland limited liability company may continue "...collecting and distributing its assets, and doing all other acts required to liquidate and wind up its business and affairs." Moreover, unlike corporations whose acts are null and void during the time the corporation's charter is revoked, under Md. Code Corps. & Assoc. § 4A-920, limited liability companies' actions during this time are valid.
4. Unlike a corporation, presently a forfeited LLC cannot sue even if the suit is part of the winding down of its affairs.
5. *Mintec Corp. v. Miton*, 392 B.R. 180 (D. Md. 2008), which held that a corporation whose charter had been forfeited was nevertheless "authorized in the name of its director-trustees *or in its own name* to engage in—legitimate winding up activities. This principle is the basis of several bankruptcy court decisions that draw a distinction between the capacity to sue, the ability of a defunct corporation to file a chapter 7 petition,

and the capacity to wind up the affairs of a corporation. “From all these cases, the Court synthesizes the following rule of law: An involuntary or a voluntary chapter 7 petition may be filed against or *by a dissolved corporation while the dissolved corporation is still in existence under state law.*” *In re Liberal Mack Sales, Inc.* 24 B.R. 707, 710 (Bankr. Kan. 1982) (Emphasis added).

6. In reaching this conclusion, the United States Bankruptcy Court for the District of Kansas relied upon, the Honorable Judge Paul Mannes’ opinion in *In Re Hearn Corp.*, 18 B.R. 557, 560 (Bankr. D. Md.1982). “The single question presented by this case is whether, under Maryland law, a corporation that has forfeited its charter retains the corporate identity and power necessary to file a voluntary petition under Chapter 7.” *Hearn*, 18 B.R. at 559. Judge Mannes emphasized the distinction between an entity’s corporate existence versus its capacity to sue, which both corporations and limited liability companies lose upon their failure to pay personal property taxes. State law determines the questions of when a corporation exists and what the terms of its existence are. *Chicago Title and Trust Co. v. 4136 Wilcox Bldg. Corp.*, 302 U.S. 120, 125-26, 58 S.Ct. 125, 127, 82 L.Ed. 147 (1937); *Horn Silver Mining Co. v. New York*, 143 U.S. 305, 312, 12 S.Ct. 403, 404, 36 L.Ed. 164 (1892). Section 3-516 of the Corporations and Associations Article of the Maryland Code indicates that directors of a defunct corporation become trustees of the assets of the corporation. The trusteeship extends to all assets that pass to the directors during liquidation. Section 3-516 allows the directors to take necessary and proper acts to effect liquidation because the aim of Chapter 7 is an orderly liquidation of an estate.

C. Capacity to Sue

1. Standing vs. Capacity to Sue

In *JGR Associates, LLC v. Brown (In re Brown)*, 442 B.R. 585, 598 (Bankr. E.D. Mich. 2011), the court distinguished “three separate potentially relevant concepts: (1) capacity to sue, (2) Article III standing (constitutional standing), and (3) real part in interest (prudential standing).” The court stated that “prudential principles are limits on standing, they do not themselves create jurisdiction; they exist only to remove jurisdiction where Article III standing requirements are otherwise satisfied.” *Brown*, 442 B.R. at 598.

The court noted that subject matter jurisdiction can never be forfeited or waived, but “In contrast, ‘[o]bjections to standing based upon prudential considerations are waived if not timely raised.’” *Brown*, 442 B.R. at 598 (citing *Lee v. Deloitte & Touche LLP*, 428 F.Supp.2d 825, 831 (N.D. Ill. 2006)). The court noted that “because the substance of Brown’s objection is

that the Plaintiffs are not the real parties in interest, the ‘question is resolved in this case by federal law’” which “generally arise in conjunction with Rule 17(a), incorporated by Fed. R. Bankr. P. 7017, which permits substitution of the real party in interest once an objection has been made.” *Brown*, 442 B.R. at 599.

2. **Raising Capacity to Sue.** A party’s capacity to sue is determined by federal rather than state law. Specifically, Fed. R. Bankr. P. 7017 allows a federal court to substitute the proper party to an action.

(a) REAL PARTY IN INTEREST.

- (1) *Designation in General.* An action must be prosecuted in the name of the real party in interest. The following may sue in their own names without joining the person for whose benefit the action is brought:

- (A) an executor;
- (B) an administrator;
- (C) a guardian;
- (D) a bailee;
- (E) a trustee of an express trust;
- (F) a party with whom or in whose name a contract has been made for another's benefit; and
- (G) a party authorized by statute.

- (2) *Action in the Name of the United States for Another's Use or Benefit.* When a federal statute so provides, an action for another's use or benefit must be brought in the name of the United States.

- (3) ***Joinder of the Real Party in Interest.*** The court may not dismiss an action for failure to prosecute in the name of the real party in interest until, after an objection, a reasonable time has been allowed for the real party in interest to ratify, join, or be substituted into the action. After ratification, joinder, or substitution, the action proceeds as if

it had been originally commenced by the real party in interest.

(b) CAPACITY TO SUE OR BE SUED. Capacity to sue or be sued is determined as follows:

(1) for an individual who is not acting in a representative capacity, by the law of the individual's domicile;

(2) for a corporation, by the law under which it was organized; and

(3) **for all other parties, by the law of the state where the court is located, except that:**

(A) **a partnership or other unincorporated association with no such capacity under that state's law may sue or be sued in its common name to enforce a substantive right existing under the United States Constitution or laws; and**

(B) 28 U.S.C. §§754 and 959(a) govern the capacity of a receiver appointed by a United States court to sue or be sued in a United States court.

3. **Fed. Fed. R. Bankr. P. 7009** made applicable by Fed. R. Bankr. P. 1018, a party's capacity to sue or be sued *must be raised by a specific denial* and with supporting facts within the party's knowledge.

In General: Except when required to show that the court has subject matter jurisdiction, a pleading need not allege:

(A) *A party's capacity to sue or be sued;*

(B) A party's authority to sue or be sued in a representative capacity; or

(C) The legal existence of an organized association of persons that is not made a party.

(1) *Raising Those Issues: To raise any of those issues, a party must do so by a specific denial, which must state any supporting facts that are peculiarly within the party's knowledge.*

4. **Waiver of Defense of Lack of Capacity.** In *Dollar Savings Stores, Inc. v. Brown (In re: Fantastik, Inc.)*, 49 B.R. 510 (Bankr. D. Nev. 1985), the court held that even an otherwise valid defense of a plaintiff's lack of capacity to *sue is waived if not timely raised by specific negative averment in a motion or answer* and that Fed. R. Civ. P. 17 was applicable and that it "would be patently inequitable to deny a creditor access to the bankruptcy court to adjudicate a claim simply because that creditor could not bring that action in the courts of the state where the bankruptcy court sits." *Accord, Estate of Eckel v. Narcisco (In re Narcisco)*, 146 B.R. 792, 793 (Bankr. E.D. Ark. 1992) (Defendants' failure to raise in their answer the issue of plaintiff's lack of capacity to sue constitutes a waiver of that defense); *F.D.I.C. v. Calhoun*, 34 F.3d 1291, 1299 (5th Cir. 1994) ("Capacity to sue is a defense, and the federal rules require not only that the defendant raise the issue of capacity, but he must do so by 'specific negative averment.' Fed. R. Civ. P. 9(a)... Defenses objecting to lack of capacity that are not raised are waived"); *see also Tudor Oaks Limited Partnership v. Cochrane (In re Cochrane)*, 273 B.R. 272, 276-277 (Bankr. M.D. Fla. 2001) (corporate plaintiff's inability to sue in state court did not preclude the plaintiff from filing an adversary proceeding in the bankruptcy court); *In re Flex Financial Holding Company*, 518 B.R. 891, 897-898 (Bankr. D. Kan. 2014) (lack of capacity to sue under state law did not preclude a plaintiff from prosecuting its claim in bankruptcy court).

5. **Substitution of Parties - Md. Rule 2-241**

- (a) Substitution. *The proper person may be substituted for a party who*
- (1) dies, if the action survives,
 - (2) becomes incompetent,
 - (3) transfers an interest in the action, whether voluntarily or involuntarily,
 - (4) ***if a corporation, dissolves, forfeits its charter, merges, or consolidates,***
 - (5) if a public officer, ceases to hold office, or
 - (6) if a guardian, personal representative, receiver, or trustee, resigns, is removed, or dies.

- (b) Procedure. Any party to the action, any other person affected by the action, the successors or representatives of the party, or the court may file a notice in the action substituting the proper person as a party. The notice shall set forth the reasons for the substitution and, in the case of death, the decedent's representatives, domicile, and date and place of death if known. The notice shall be served on all parties in accordance with Rule 1-321 and on the substituted party in the manner provided by Rule 2-121, unless the substituted party has previously submitted to the jurisdiction of the court.
- (c) Objection. Within 15 days after the service of the notice of substitution, a motion to strike the substitution may be filed.
- (d) Failure to substitute. If substitution is not made as provided in this Rule, the court may dismiss the action, continue the trial or hearing, or take such other action as justice may require.

D. Petitioning Creditors in Involuntary Bankruptcies

1. Applicable Rules

- a. **Fed. R. Bankr. P. 1018** provides, among other things, that Fed. R. Bankr. P. 7008 and 7009 apply to all proceedings contesting an involuntary petition.

Unless the court otherwise directs and except as otherwise prescribed in Part I of these rules, *the following rules in Part VII apply to all proceedings contesting an involuntary petition ...* Rules 7005, **7008-7010**, 7015, 7016, 7024-7026, 7028-7037, 7052, 7054, 7056 and 7062. The court may direct that other rules in Part VII shall also apply. For the purposes of this rule a reference in the Part VII rules to adversary proceedings shall be read as a reference to proceedings contesting an involuntary petition.

- b. **Fed. R. Bankr. P. 7009** made applicable by Fed. R. Bankr. P. 1018, a party's capacity to sue or be sued must be raised by a specific denial and with supporting facts within the party's knowledge.
- c. **Fed R. Bankr. P. 1011** permits an alleged debtor or its representative to contest and involuntary petition and requires defenses and objections to the involuntary petition to be raised in accordance with Fed. R. Civ. P. 12.

- (a) Defenses and Objections: When Presented. Defenses and Objections to the petition shall be presented in the manner prescribed by *Rule 12 F.R. Civ. P. and shall be filed and served within 21 days after service of the summons*, except that if service is made by publication on a party or partner not residing or found within the state in which the court sits, the court shall prescribe the time for filing and serve the response.

2. Case Law

In re Vento Development Corp., 560 F.2d 2 (1st Cir. 1977), the alleged debtor appealed the entry of an order for relief on the basis that the involuntary petition had been filed: (1) by fewer than three creditors; and (2) in bad faith. In particular, the alleged debtor challenged the capacity of CMI, an unincorporated association, to be a petitioning creditor. The First Circuit rejected the alleged debtor's contention and denied the appeal, ruling "Should there be any doubt that capacity to sue is equivalent to capacity to petition as a creditor, we note that bankruptcy, an equitable proceeding, is more liberal than garden variety lawsuits with respect to parties. The bankruptcy court must protect the debtor as well as numerous creditors." *Vento*, 560 F.2d at 4.

Estate of Eckel v. Narcisco (In re Narcisco), 146 B.R. 792, 793 (Bankr. E.D. Ark. 1992) (Defendants' failure to raise in their answer the issue of plaintiff's lack of capacity to sue constitutes a waiver of that defense); *F.D.I.C. v. Calhoun*, 34 F.3d 1291, 1299 (5th Cir. 1994) ("Capacity to sue is a defense, and the federal rules require not only that the defendant raise the issue of capacity, but he must do so by 'specific negative averment.' FED. R. Civ. P. 9(a)... Defenses objecting to lack of capacity that are not raised are waived").

In Tudor Oaks Limited Partnership v. Cochrane (In re Cochrane), 273 B.R. 272, 276-277 (Bankr. M.D. Fla. 2001), the court held that a corporate plaintiff's inability to sue in state court did not preclude the plaintiff from filing an adversary proceeding in the bankruptcy court.

While it is without dispute that F.R.B.P. 7017(b), as adopted by F.R.Civ.P. 17(b) provides that the capacity of a corporation to sue or to be sued shall be determined by the law under which it was organized. An important exception to this Rule is: that *a partnership or other unincorporated association, which has no such capacity by the law of such state, may sue or be sued in its common name for the purpose of enforcing for or against it a substantive right*

existing under the Constitution of the United States or law of the United States.

The suit pending before this Court is an enforcement of a right granted by Congress to a creditor to obtain a determination of the dischargeability of a particular debt.

The jurisdiction to make such a determination is exclusively within the competence of the Bankruptcy Court where the case filed by the Debtor is pending.

For these reasons it is quite evident that while Tudor Oaks Limited Partnership may not have the capacity to pursue a legal action in courts of this State, it certainly has an absolute right to do so in the Federal Bankruptcy Court. Cochrane, 273 B.R. at 276-277.

Emphasis added.

Under **Md. Code Ann. Corp. & Assn. §4A-101(k)**, a limited liability company is defined as “a permitted form of unincorporated business organization which is organized and existing under this title.” In *In re Flex Financial Holding Company*, 518 B.R. 891, 897-898 (Bankr. D. Kan. 2014), the court held that a lack of capacity to sue under state law did not preclude a plaintiff from prosecuting its claim in bankruptcy court.

But for parties whose capacity is determined by Civil Rule 17(b)(3), including limited liability companies, there are two exceptions to the application of the law of the state where the federal court is located. The first applies in this case. It provides that an entity to which Civil Rule 17(b)(3) applies and which has no capacity under the law of the state where the court is located may nevertheless sue or be sued in its common name to enforce a substantive right under the laws of the United States. As discussed above, this provision has been held applicable to a dischargeability proceeding filed by a foreign limited partnership.²⁸ It also “has enabled a partnership or other unincorporated association to sue and be sued in a federal court under the Fair Labor Standards Act, National Labor Relations Act, Labor Management Relations Act, the antitrust laws, patent laws, Emergency Price Control Act, War Labor Disputes Act, Capehart Act, Securities Exchange Act, Railway Labor Act, Federal Arbitration Act, as well as other federal statutes.”²⁹ The Bankruptcy Code is a part of the laws of the United States. It gives a holder of a claim against a debtor the substantive right to file a proof of claim and gives the debtor the right to object to the claim. A

claim holder has no ability to choose the court in which the claim will be asserted—it must be filed in the court in which the debtor's bankruptcy case is pending. Allowing a limited liability company claim holder that is not authorized to do business under the law of the state where that bankruptcy court is located to assert its claim there promotes the jurisdiction of the bankruptcy court to adjudicate all claims against the debtor's bankruptcy estate.

3. Forfeited LLC's can be petitioning creditors in involuntary bankruptcy petitions under Federal Rule 17, *Yan v. Zhang*, Case Nos. 17-00742-PWG and 17-00870-PWG (D. Md. 2018 Grimm J.)

Judge Grimm held that a state court judgment is not impaired by the subsequent forfeiture of the LLC that had obtained the judgment and that the filing of an involuntary petition in a federal bankruptcy court by the forfeited LLC is not the initiation of a lawsuit that would otherwise be barred in Maryland state court. Accordingly, the holding in *Price v. Upper Chesapeake Health Ventures, Inc.*, 995 A.2d 1054, 1061-62 (Md. Ct. Spec. App. 2010) did not bar the filing of the involuntary petition. The court relied on *Willow Grove Citizens Association v. County Council of Prince George's County*, in which the Court of Special Appeals held that the forfeiture of an LLC does "not impair the validity" of an application filed with a county agency, because an application is not a lawsuit, and an agency is not a Maryland court. 175 A.3d 852, 855, 857 (Md. Ct. Spec. App. 2017). The Court of Special Appeals concluded that, because the forfeited LLC "did not file its application in a Maryland court, the implicit prohibition against bringing lawsuits in § 4A-920 is irrelevant." *Id.* (emphasis added).

The court further held that Fed. Bankr. 7017 should apply- "bankruptcy, an equitable proceeding, is more liberal than garden variety lawsuits with respect to parties" in determining "capacity to sue" and "capacity to petition as a creditor." *In re Vento Dev. Corp.*, 560 F.2d 2, 4 (1st Cir. 1977). The petitioning creditor was trying to collect on a judgment from a debtor whose failure to pay caused the creditor not to pay its taxes and forfeit its rights under Corps. & Ass'ns § 4-911(a), yet the creditor acted to undo the forfeiture while the bankruptcy proceeding was pending and while it still was a party to the proceeding. If applied, Federal Rule 17 would permit the creditor to file suit in federal court, despite its lack of capacity to sue in state court. *See* Fed. R. Civ. P. 17(c)(3). The rules in bankruptcy court should not be stricter. *See In re Vento Dev. Corp.*, 560 F.2d at 4.

BBA Spring Break 2018

Issues Arising in Cases Filed by LLCs or their Members

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I. Eligibility of an LLC to File a Bankruptcy Petition

Title 11 of the United States Code (the “Bankruptcy Code”) establishes which entities are eligible to be a debtor in a bankruptcy case:

A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter **by an entity** that may be a debtor under such chapter.

11 U.S.C. § 301(a) (emphasis added). The term “entity” includes “person, estate, trust, governmental unit, and the U.S. Trustee.” 11 U.S.C. § 105(15). The term “person” includes “individual, partnership, and corporation” but does not expressly reference an LLC. Bankruptcy courts recognize that an LLC is a “person” and an eligible entity for bankruptcy. *See In re Solomons One, LLC*, No. 13-24475-TJC, 2013 WL 5934656 (Bankr. D. Md. Oct. 31, 2013).

II. Authority to File a Bankruptcy Petition

The larger issue that arises is whether the LLC has the authority to file a bankruptcy petition. Such determination depends on the laws of the state in which the LLC is organized and the provisions of the LLC’s operating agreement. *See generally Price v. Gurney*, 324 U.S. 100, 106 (1945) (the law of the entity’s state of organization determines whether a voluntary petition is filed with the proper authority).

A. Statutory Power to File

The statutory authority of managers or members to file a bankruptcy petition on behalf of the LLC is based on state law. *In re A-Z Electronics, LLC*, 350 B.R. 886, 889 (Bankr. D. Idaho 2006) (“State law, not bankruptcy law, is used to determine whether the party signing the entity petition had the authority to do so.”). Maryland law expressly provides that, unless otherwise agreed in the operating agreement, unanimous consent of the members is required to file a voluntary petition. MD. CODE, CORPS. & ASS’NS § 4a-403(d)(2)(i).

In contrast, many states, including the District of Columbia, Virginia and Delaware, do not specifically address the ability of an LLC to file a voluntary bankruptcy petition. In those states, where there is no direct statutory authority, some courts have found indirect statutory authority. In *In re Delta Starr Broad., L.L.C.*, No. CIV.A. 05-2783, 2006 WL 285974 (E.D. La. Feb. 6, 2006), the court analyzed the Louisiana LLC statute that required a majority vote for certain extraordinary decisions. Although the statute did not expressly mention bankruptcy, the court concluded that a bankruptcy petition was akin to other major actions requiring majority approval of an LLC’s members. *See also A-Z Electronics*, 350 B.R. at 890-91 (interpreting Idaho statute that places management and decisional authority in hands of members to include the filing of a bankruptcy petition).

A similar analysis could be applied under the District of Columbia law that requires the consent of all members to “undertake any other act outside the ordinary course of the company’s activities and affairs . . .,” D.C. CODE ANN., § 29-804.07, or under Virginia and Delaware law that require that any action required or permitted to be taken by the members of the LLC be taken upon a majority vote. VA. CODE ANN. § 13.1-1022; DEL. CODE ANN., title 6, § 18-402.

B. Contractual Power to File

State law permits owner members to enter into an operating agreement to determine, as a management issue, who has authority to file a petition for relief on behalf of an LLC and who must consent to such filing. Although the language may vary significantly, courts will generally uphold procedures set forth in the operating agreement. *See In re NNN 123 N. Wacker, LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014) (enforcing operating agreement that required unanimous consent of LLC members to file a voluntary petition or otherwise initiate proceedings to have the company adjudicated bankrupt or insolvent); *In re FKF Madison Park Grp. Owner, LLC*, No. 10-11867 KG, 2011 WL 350306, at *3 (Bankr. D. Del. Jan. 31, 2011) (“Determining authority [to file a bankruptcy petition] is a question of state law, and in the case of a limited liability company is governed by the operating agreement, which defines the rights of members.”). Therefore, the language chosen in an operating agreement should be thoughtfully chosen.

In situations where the operating agreement may be silent on what authority is required to file bankruptcy, courts have inferred the necessary authority based on a review of the operating agreement as a whole.

In *In re Solomons One, LLC*, No. 13-24475-TJC, 2013 WL 5934656 (Bankr. D. Md. Oct. 31, 2013), the Bankruptcy Court for the District of Maryland interpreted the debtor’s operating agreement to resolve a dispute as to whether a majority vote or unanimous consent was required to authorize the bankruptcy filing. Members representing 51 2/3% of the membership interests voted in favor of filing the bankruptcy, but the operating agreement was silent as to the requisite approval. *Id.* at *1.

Although Maryland’s LLC statute requires unanimous consent of the members to file a bankruptcy, the Court noted that such provision is qualified by “unless otherwise agreed.” *Id.* at *7. Thus, instead of requiring unanimous consent, the Court inferred a majority vote requirement from an analysis of the operating agreement itself. Under the principle of objective contract interpretation “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 *5. The Court reviewed every section of the operating agreement and noted which corporate actions required a majority vote and which required unanimous consent.

Under the operating agreement, “both ordinary course and extraordinary transactions” can be accomplished by a majority vote. *Id.* at *5-*6. The only actions requiring unanimous consent were dissolution of the LLC, acquisition of additional property and modification of the agreement itself. *Id.* These corporate actions were specifically carved out of the majority rule norm and the Court found this to be significant. Invoking the maxim *expressio unius est exclusio alterius* (“the express mention of one thing implies the exclusion of the other”), the Court found that the enumeration of these corporate actions implied the exclusion of other, non-enumerated corporate actions from application of a heightened voting standard. *Id.* at *6.

Similarly, in *In re East End Dev., LLC*, 491 B.R. 633, 638-39 (Bankr. E.D.N.Y. 2013), the operating agreement was silent on what authority was required to file a bankruptcy

petition. Based on a review of the operating agreement and applicable law, the court concluded that the managing member had full authority to file the petition. The operating agreement conferred broad powers upon the managing member to act on behalf of the debtor and the examples set forth in the operating agreement were merely illustrative. In contrast, the actions for which the managing member must obtain the consent of the other fifty-percent member were narrow and specific. *Id.* at 639-40.

C. Contractual Provisions Prohibiting Bankruptcy Filing

One issue that is in flux is whether an operating agreement can prohibit the filing of a bankruptcy petition. This type of provision commonly occurs in bankruptcy remote special purposes entities (SPEs). Contractual and express advance waivers of the right of an individual to file a voluntary petition are generally unenforceable as they violate the strong public policy that the bankruptcy system remains available to all individuals. However, the Bankruptcy Appellate Panel of the Tenth Circuit upheld an operating agreement between LLC members that prohibited the LLC from filing for bankruptcy. *In re DB Capital Holdings, LLC*, 463 B.R. 142, 2010 WL 4925811 (10th Cir. BAP (Colo.) 2010).

In *DB Capital Holdings*, the operating agreement stated that: “The Company. . . to the extent permitted under applicable Law, 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. . . .” *Id.* at *2. The manager who filed the bankruptcy petition argued that this provision was invalid because it was executed at the demand and for the sole benefit of the debtor’s main secured creditor. For that reason, the manager claimed that the provision was unenforceable as a matter of public policy. *Id.* at *3.

The panel disagreed noting that the “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.*; accord *In re Squire Court Partners Ltd. P’ship*, 574 B.R. 701 (E.D. Ark. 2017) (discussing how in partnership context, “[i]t is one thing for the court to overrule a creditor that seeks to block a debtor from filing for bankruptcy; it is quite another for the courts to overrule the owners of an entity.”). In addition, the debtor failed to present any evidence that the language in the operating agreement was coerced by a creditor. The court declined, however, to opine whether, under the right set of facts, an LLC’s operating agreement containing terms coerced by a creditor would be unenforceable. *DB Capital Holdings* at *3.

D. Creditor Input in the LLC’s Ability to File

In certain limited circumstances, creditors may have some control over whether the LLC is permitted to file for bankruptcy protection. In *In re Global Ship Systems, LLC*, 391 B.R. 193, 199 (Bankr. S.D. Ga. 2007), the LLC’s operating agreement established the secured creditor as a “Class B shareholder” and required the consent of the Class B shareholder for the LLC to file a voluntary petition for bankruptcy. To circumvent this provision, the debtor solicited the filing of an involuntary case that it then failed to contest. *Id.* The court concluded that the end-run around the creditor’s contractual rights as a member of the LLC was inappropriate, and granted the creditor’s motion to dismiss and motion for relief from the stay because the bankruptcy had been filed without the creditor’s consent. *Id.* at 202-04. Because the creditor held both an equity and debt interest in the debtor, the creditor had the right to prevent, by withholding consent, a voluntary bankruptcy case.

In *In re Green Power Kenansville, LLC*, No. 04-08384-8-JRL, 2004 WL 5413067 (Bankr. E.D.N.C. Nov. 18, 2004), an LLC’s sole member assigned its interest in the LLC to a third party, which then commenced a bankruptcy case. The assignment (i) violated the

loan agreement, (ii) the voting of the interest by the assignee was contrary to a pledge agreement provision that allowed the creditor to vote all the original member's interests upon a loan default, and (iii) the assertion of authority by the assignee apparently attempted to override an independent manager provision that effectively required lender consent to a bankruptcy filing by the LLC. *Id.* at *2. The court enforced the independent manager provision, even though the assignee may not have had knowledge of the provision on the basis that the assignee member was governed by the written operating agreement irrespective of knowledge. *Id.* at *4. Because the assignee lacked power to file the petition under the LLC's operating agreement, the court dismissed the bankruptcy proceeding.

In both cases cited above, the creditor's power to control the LLC's ability to file a bankruptcy petition appears to have been negotiated at the inception of the relationship, as opposed to when the debtor was in a default. Because such negotiations occurred as a result of the LLC's business judgment when the parties were presumably acting in good faith, the courts were inclined to uphold these arm's length negotiations. Therefore, the LLC's decision to prohibit a bankruptcy filing was upheld.

E. Blocking Provisions or Golden Shares

Courts have rejected creditor blocking provisions or "golden share" provisions if improper intentions are behind the inclusion of such provisions in an LLC's operating agreement, as foreshadowed by the court in *DB Capital Holdings*. The issue of the validity of a blocking provision given to an equity holder of the debtor has been certified to the Fifth Circuit Court of Appeals in *In re Franchise Serv. of N.A., Inc.*, No. 1702316EE, 2018 WL 485959 (Bankr. S.D. Miss. Jan. 17, 2018).

In *In re Bay Club Partners-472, LLC*, No. BR 14-30394-RLD11, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014), the LLC's operating agreement prohibited it from filing a bankruptcy petition, but the company filed a petition for relief anyway. The lender sought to have the case dismissed citing the prohibition against filing for bankruptcy contained in the debtor's operating agreement. The court held that the general rule in the "Ninth Circuit has been very clear that a debtor's prepetition waiver of the right to file a bankruptcy case is unenforceable because it is a violation of public policy." *Id.* at *4-5. The court went on to hold that, although the loan documents did not contain a bankruptcy waiver, the evidence of the case established something "more cleverly insidious" in that the lender required the bankruptcy waiver to be included in the debtor's operating agreement and that the restrictive covenant would only be effective until the loan was paid. *Id.* at *5. The court held that insertion of the waiver language in the operating agreement was no less against public policy than including of such provision in a loan document and suggested that the lender had improper intentions. *Id.* Accordingly, the bankruptcy waiver was unenforceable and thus the Chapter 11 filing was properly authorized.

Likewise, in *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899, 903-04 (Bankr. N.D. Ill. 2016), the debtor defaulted on its debt to a creditor and agreed to give the creditor "special member" status if the creditor promised not to pursue remedies of default. The debtor amended its operating agreement to make the creditor a member of the debtor with the right to approve or disapprove any "Material Action"—defined to include institution of bankruptcy proceedings—by the debtor. *Id.* at 904. As a special member, the creditor had no interest in the profits or losses of the debtor, had no right to distributions, had no tax consequences, and was not required to make capital contributions to the debtor. *Id.* Instead, the creditor "was kept separate and apart from the Debtor in all ways but for its authority to block the Debtor from petitioning for bankruptcy relief" and was under no obligation to consider any interest or desires other than its own. *Id.* The court disagreed with the creditor and held that members of an LLC have a duty to consider the interests of the entity and not only their own interests. Therefore, the blocking provision given to the creditor in the amended operating

agreement was unenforceable as a matter of Michigan corporate governance and bankruptcy law. *Id.* at 914.

In *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 261 (Bankr. D. Del. 2016), the debtor defaulted on its debt and agreed to make the creditor a common member if the creditor agreed to waive all defaults. The debtor amended its operating agreement to require unanimous consent from its members to file for bankruptcy. *Id.* The debtor issued 22,000,001 “Common Units” to interest holders and one Common Unit to the creditor. *Id.* at 260. In rejecting the “golden share” given to the creditor, the court held that:

A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.

Id. at 265.

In September 2017, the court in *In re Lexington Hospitality Group, LLC*, 577 B.R. 676, 683 (Bankr. E.D. Ky. 2017) adopted a similar ruling that certain bankruptcy restrictions in an LLC's operating agreement that gave the lender a veto power over the LLC's ability to seek bankruptcy relief were void as against federal public policy. The debtor was formed to own and operate a hotel. As part of its financing of the purchase of the hotel, the lender required that the operating agreement be amended to admit an entity wholly owned by the lender as a member of the LLC with a thirty percent membership interest. *Id.* at 679-80. The membership interest was later amended to fifty percent. The amended operating agreement included several provisions that limited the debtor's ability to file for bankruptcy and required a seventy-five percent vote of the members. *Id.* When the LLC filed for bankruptcy, the lender filed a motion to dismiss arguing that the debtor did not have the corporate authority to file the bankruptcy petition.

The court held that the prepetition granting of an absolute block to a creditor violated federal public policy and was void. *Id.* at 683-84. The court further noted that while the amended operating agreement required that an independent manager consent to the filing of a bankruptcy, in reality, “the Independent Manager is not actually independent from the creditor who negotiated for her participation in a bankruptcy decision.” *Id.* at 685. The lender had complete control to block the LLC's bankruptcy filing. Further, “unlike a member or manager, [the lender] has no restrictions and no fiduciary duties to [the LLC] that might limit self-interested decisions that ignore the best interest of the Company.” *Id.* at 686. Consequently, the court denied the motion to dismiss the case.

While each case involves a different contractual provision, in all of the cases, the provision amounted to a debtor agreeing to limit its right to seek bankruptcy relief as a condition of supplying credit. Under these circumstances, the courts found that these blocking provisions violated federal public policy. However, the validity of a blocking position or golden share given to an equity holder of a debtor was recently upheld in *In re Franchise Serv. of N.A., Inc.*, No. 1702316EE, 2018 WL 485959 (Bankr. S.D. Miss. Jan. 17, 2018), which has been certified on direct appeal to the Fifth Circuit Court of Appeals.

In *In re Franchise Serv.*, the articles of incorporation of the debtor prohibited the corporation from seeking bankruptcy relief without the consent of the minority shareholder. *Id.* at *10-11. The case arose from a multi-step merger and acquisition transaction resulting in the

debtor's acquisition of a car rental company. A wholly owned subsidiary of the investment bank invested \$15 million in the debtor. In exchange, the subsidiary received 49.76 percent interest in the debtor in the form of preferred stock, becoming the largest single shareholder. The investment bank was owed an advisory fee of \$500,000 and an arrangement fee of \$2.5 million from the debtor. *Id.* at *9-10. When the debtor filed bankruptcy, the investment banking company filed a motion to dismiss, arguing that the debtor filed the petition without proper corporate authority for its failure to obtain the subsidiary's consent as required by the articles of incorporation. The subsidiary filed a joinder to the motion to dismiss. The debtor argued that the golden share or blocking provision was void as a matter of public policy. *Id.* at 10-11.

The court found that the investment company was a creditor on account of the unpaid advisory and arrangement fees. Therefore, to the extent that the investment company claimed to hold a golden share or blocking provision, the court held that it was void as a matter of public policy and denied its motion to dismiss. *Id.* at *17.

In contrast, no evidence was presented to show that the subsidiary was a creditor. In fact, the only evidence introduced demonstrated that the subsidiary invested \$15 million in the debtor and owned 49.76 percent interest. Because the subsidiary was an equity holder, the court held that the rights given to it under the articles of incorporation requiring its consent to file the petition were valid, enforceable and not contrary to public policy under federal law. *Id.*

Given the lack of controlling authority on the issue and the relative novelty and recent frequency of the use of blocking provisions, the court certified three questions for direct appeal to the Fifth Circuit Court of Appeals:

1. Is a provision, typically called a blocking provision or a golden share, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?
2. If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
3. Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

Id. at *5. The answers to these questions and pending appeal is important. The subject matter is controversial and it demonstrates the tension between federal bankruptcy law and state corporate law.

III. Property of the Estate of a Bankrupt LLC

The "estate" of a bankrupt LLC includes "all legal or equitable interests" of the LLC as of the time of the LLC's bankruptcy filing. 11 U.S.C. § 541. These interests include all rights of the LLC under its operating agreement.

In *In re KRSM Properties, LLC*, 318 B.R. 712, 715 (B.A.P. 9th Cir. 2004), the court was confronted with the issue of whether estimated tax payments made by a single-member

LLC on account of personal tax liability of its owners were property of the LLC estate subject to turnover. The court held that when the LLC sold the real estate owned in its name, the proceeds from the sale remained property of the LLC's estate. *Id.* at 719. The estate was required to use the proceeds to pay the LLC's creditors first and then, if any proceeds remained, the remaining proceeds would be returned to the owners. The court reasoned that the status of the LLC as a pass-through entity did not impair the separateness of the LLC from its members, and concluded that the LLC's bankruptcy estate could attempt to claw back the prior tax payments. *Id.* 719-20.

IV. Bankruptcy of a Member

Typically, the filing of a personal bankruptcy by a member of a multi-member LLC will have limited effect on the LLC's ability to seek bankruptcy. However, the personal bankruptcy of single-member LLC's only member removes the member's statutory authority to file a bankruptcy petition on behalf of the LLC. *In re B & M Land and Livestock, LLC*, 498 B.R. 262, 267 (Bankr. D. Nev. 2013) (“[W]here 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.”); *In re A-Z Electronics, LLC*, 350 B.R. 886, 889 (Bankr. D. Idaho 2006) (U.S. Trustee successfully moved to convert or dismiss LLC's Chapter 11 petition for “cause” because the LLC's single member lacked authority to file petition).

[See C. Hamilton-Eisler discussion herein for a more detailed discussion on issues unique to single member LLC's.]

A. Assets of the LLC are Not Property of the Debtor/Member's Estate

When a member of an LLC files for bankruptcy, all the debtor/member's legal or equitable interests on the petition date become part of the debtor's bankruptcy estate. 11 U.S.C. § 541. Although the assets of the LLC are not property of the bankruptcy estate, the member's LLC membership interest becomes property of the estate and is subject to the control of the trustee. See *In re B & M Land and Livestock*, 498 B.R. at 267. LLC membership interests are intangible personal property. Even if the LLC interest has no obvious value, the trustee may have an opportunity to sell or otherwise use the LLC interest.

In *In re Ealy*, 307 B.R. 653, 657-58 (Bankr. E.D. Ark. 2004), the court observed the general rule that assets of an LLC are not property of its members. Thus, the bankruptcy estate of a member does not include the LLC's assets. In this case, the court found other equitable circumstances for treating the individual member as having an equitable interest in real estate nominally owned by the LLC. Such interest did not flow from the individual member's interest in the LLC. *Id.*

The debtor/member's schedules must properly reflect the membership interest in the LLC on Schedule B under “stock and interests in incorporated and unincorporated businesses, including an interest in an LLC, partnership and joint venture.” The debtor/member should place a value on the membership interest in the LLC, even if it is nominal. The debtor/member should not include the assets of the LLC in his or her schedules or include debt secured by the assets of the LLC on Schedule D. If the debtor/member personally guaranteed the secured debts of the LLC, then the debtor/member should include those LLC creditors on Schedule F – “Creditors Holding Unsecured Nonpriority Claims.”

B. Debtor/Member's Economic Interest and Non-Economic Interest in the LLC—An Analysis of Section 541 and *Ipsa Facto* Clauses

Whether a particular interest held by the debtor/member is “property of the estate” under Section 541 of the Bankruptcy Code is a question of federal bankruptcy law, but the nature

and extent of that interest is defined by state law. *Butner v. U.S.*, 440 U.S. 48 (1979). Generally, the debtor/member's bankruptcy estate will consist of the member's economic interest in the LLC (also referred to as the member's "distributional interest") and the member's non-economic/management rights in the LLC. See *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 707-08 (E.D. Va. 2000); *In re Virginia Broadband, LLC*, 498 B.R. 90 (Bankr. W.D. Va. 2013); *In re Jundanian*, No. 10-21513-TJC, 2012 WL 1098544 (Bankr. D. Md. March 30, 2012).

Under most state limited liability laws, a debtor/member's bankruptcy filing causes the member to be disassociated from the LLC. Generally, the consequences of dissociation are the retention of economic rights but the loss of all governance rights. Contract or statutory provisions purporting to cause dissociation of a member from an LLC as a consequence of the commencement of a bankruptcy case are referred to as "*ipso facto*" clauses. Provisions in an operating agreement that seek to deprive a member/debtor of both economic and non-economic rights in the LLC upon the member/debtor's bankruptcy filing will not likely be upheld because such clauses are pre-empted by federal bankruptcy law. *In re Virginia Broadband, LLC*, 498 B.R. 90 (Bankr. W.D. Va. 2013); *In re Jundanian*, No. 10-21513-TJC, 2012 WL 1098544 (Bankr. D. Md. March 30, 2012).

Courts have struggled with the application of these concepts. In *In re Garrison-Ashburn*, 253 B.R. at 704-706, the court held that the LLC member's bankruptcy estate included both the debtor/member's economic and non-economic management rights in the LLC. In applying Virginia law, the court stated that the filing of a bankruptcy by a member of an LLC constitutes an event of dissociation under Va. Code Ann. § 13.1-1040.1(6)(a). Dissociation of a member does not dissolve the LLC. The LLC continues to exist. The effect of a dissociated member is to divest the member of all rights as a member to participate in the management or operation of the company, similar to an assignment of interest under Va. Code Ann. § 13.1-1039. The only rights remaining are the dissociated member's economic rights as defined in Va. Code Ann. § 13.1-1002. The dissociated member is expelled from the company, but does not forfeit the value of his economic ownership interest. Accordingly, when the member filed his voluntary petition, he ceased to be a member and had no further voice or vote in the management of the LLC, leaving the sole remaining member with the unilateral power to approve the sale at issue in the case.

The court in *Garrison-Ashburn* went on to consider whether the Virginia statute § 13.1-1040.1(6)(a) that resulted in dissociation of a member upon a bankruptcy filing was effective in light of Sections 365(c), 365(e) and 541(c) of the Bankruptcy Code. The Court first considered what becomes property of the estate of the member under Section 541(c). The Court held that Section 541 was intentionally drafted broadly. Therefore, Section 541(a) encompasses all the member's interest in the LLC, whatever that interest may be, whether economic or non-economic. The estate received the entire interest of the member in the LLC including its burdens and restrictions under Virginia law. However, the court inexplicably determined that the debtor's bankruptcy estate did not include the debtor's management rights—a determination inconsistent with Section 541(c)(1)(B).¹

In re Klingerman, 388 B.R. 677, 679 (Bankr. E.D.N.C. 2008), the court agreed with *Garrison-Ashburn* in that Section 541(a) encompasses all the debtor/member's interest in the LLC whatever that interest may be, whether economic or non-economic. The court disagreed with the *Garrison-Ashburn* court's conclusion that the debtor/member's bankruptcy estate included only the rights of an assignee. "Section 541(c) provides that *all* of the debtor's interest passes to the estate *notwithstanding* applicable nonbankruptcy law that effects a modification or

¹ The second question considered by the court concerned the impact of Sections 365(c) and (e). Both provisions prevent the enforcement of certain bankruptcy *ipso facto* provisions in executory contracts and unexpired leases. Because the court determined that the operating agreement at issue was not an executory contract, it held that these provisions were not applicable to its determination. *Id.* at 708-09.

termination of the debtor’s interest upon the commencement of a bankruptcy case.” *Id.* The court held that converting a debtor’s membership interest to that of an assignee by operation of statute constitutes a modification or termination of the interest that is rendered ineffective by Section 541(c).

In *In re Virginia Broadband*, 498 B.R. at 96-97, the Bankruptcy Court for the District of Virginia once again was faced with the *ipso facto* provision contained in Va. Code Ann. § 13.1-1040.1(6). The provision converts the debtor/member to an assignee and strips the debtor/member of his non-economic rights in the LLC merely because the debtor/member filed a personal bankruptcy. To clarify (and perhaps correct) its previous decision, the court held that the debtor/member held certain economic and non-economic interests in the LLC as a member of the LLC prior to the commencement of the member’s bankruptcy case. *Id.* at 96. Upon filing for bankruptcy, those interests became property of the estate under Section 541(c)(1). When the debtor/member’s case was dismissed, pursuant to Section 349(b)(3), the property of the debtor/member’s bankruptcy estate, including all interest in property (economic and non-economic), reverted in the member. *Id.* at 97. Because the member’s interest was restored to the same interest he held prior to the commencement of the case, the member had the requisite authority to vote in favor of certain LLC consents, including the authority for the LLC to file its own bankruptcy. *Id.*

Similarly, in *Jundanian*, the Bankruptcy Court for the District of Maryland analyzed whether Section 541(c)(1) of the Bankruptcy Code overrides the *ipso facto* clause contained in the LLC’s operating agreement and in the Maryland Limited Liability Act, Corp. & Assn’s, § 4A-606, WHICH provides that a person ceases to be a member of the LLC when he or she files a voluntary petition for bankruptcy. 2012 WL 1098544 at *4-5. The court noted that “the legislative history of § 541 provides that subsection (c) invalidates restrictions on the transfer of property of the debtor, in order that all of the interests of the debtor in property will become property of the estate.” *Id.* at *5 (quoting House Report No. 95-595, 95th Cong., 1st Sess. 368 (1977)). Similar to the holding in *Garrison-Ashburn*, the bankruptcy estate succeeded to all the member/debtor’s rights, both economic and non-economic in an LLC—including the member’s voting and managements rights. *Id.* at *6. However, even if the estate succeeded to the voting and management rights, the operating agreement restricted any transfer in that “the transferee shall have no voting rights and no right to serve as a Manager.” *Id.* Under these circumstances, the Court concluded that neither Section 541(c)(1) nor Section 365 could override the restriction on transfer provisions. The Court discussed how Congress enacted Section 541(c) to eliminate barriers to the transfer of property *into* the estate, but not to void restrictions on the transfer of property from the trustee to third parties. *Id.*

The Court did not need to resolve whether the operating agreement was an executory contract because Section 365 did not apply to the sale of the interest in the LLC. To the extent, the operating agreement was an executory contract within the meaning of Section 365, it was rejected pursuant to the member’s confirmed plan. *Id.* at *7. Therefore, the Court concluded that the debtor, who reacquired his membership interest through an auction held pursuant to his confirmed plan, only retained the right to receive distributions on account of his membership interest but that such sale did not transfer any voting or management rights.

C. Debtor/Member’s Non-Economic Interest in the LLC—An Analysis of Section 365 and the Operating Agreement as an Executory Contract

If the operating agreement giving rise to the LLC interest is executory, Section 365 will trump Section 541 as to non-economic elements of the LLC interest. Whether the debtor/trustee retains such non-economic interests becomes a function of a complex analysis under Section 365.

In *In re Warner*, 480 B.R. 641 (N.D. W.Va. 2012), the Chapter 7 trustee argued that the LLC had been dissolved as a result of the debtor/member's bankruptcy filing and that the Chapter 7 trustee could proceed to liquidate the company. The court's initial inquiry was into whether the operating agreement was an executory contract under Section 365. *Id.* at 648. If the operating agreement is executory then Section 365(c)(1) allows non-debtor parties to prevent the trustee from assuming or assigning the rights of the debtor if the contract is an agreement where substitute performance is not permitted. In addition, Section 365(e)(1) invalidates *ipso facto* provisions that prevent the bankruptcy estate from receiving the benefit of an executory contract. *Id.* at 649.

Although Section 365 does not define the term "executory contract," the Fourth Circuit Court of Appeals has defined a contract as executory if the "obligations of both the bankrupt and the other party are so far underperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." *Id.* at 650-51 (quoting *Gloria Mfg. Corp. v. Int'l Ladies' Garment Workers' Union*, 734 F.2d 1020, 1022 (4th Cir. 1984) (internal quotes omitted)). Because there are no *per se* rules regarding the classification of LLC operating agreements, the court requires that each operating agreement be analyzed on an individual basis and its decision will depend on the materiality of non-performance of remaining obligations. *Id.*; see also *In re Tsiaoushis*, 383 B.R. 616, 620 (E.D. Va. 2007); *In re Garrison-Ashburn*, 253 B.R. 700 (E.D. Va. 2000) (finding that operating agreements were not executory). Factors relevant in evaluating an LLC operating agreement include whether the operating agreement imposes remote or hypothetical duties, requires ongoing capital contributions, and requires a level of managerial responsibility imposed on the debtor.

In the *Warner* case, the court found that the operating agreement was not executory because there were no material, underperformed and continuing obligations owed by the debtor, the debtor was not a manager of the LLC, the debtor never contributed capital to the LLC, the debtor had no obligation to provide personal expertise or service to the company, and the debtor could withdraw at any time so long as notice was given. *Id.* at 651-52. Even though the operating agreement contained a "buy back" provision, the court held that this provision did not create a performance obligation, but rather only constrained how members could sell their interest. *Id.*

The court next considered the extent of the trustee's interest in the LLC under Section 541. Pursuant to the operating agreement, when the debtor/member filed for bankruptcy, it resulted in a dissolution of the LLC, rather than dissociation of the member. *Id.* at 654. Because the operating agreement required dissolution, the court examined whether the dissolution of the LLC acts to modify, terminate or forfeit the debtor's economic or non-economic interest in the LLC in violation of Section 541(c)(1). The court held that such trigger violated Section 541(c)(1) and thus was invalid and unenforceable. *Id.* at 655. The trustee steps into the debtor's shoes and succeeds to all his rights under the operating agreement existing as of the commencement of the case. Although this placed the trustee in a tenuous position with the remaining members of the LLC, the court found that the trustee had other avenues available for realizing value for the debtor's estate. *Id.* at 657-58.

In sum, if the LLC membership desires to ensure that a co-member's bankruptcy will cause a forfeiture of non-economic rights of the member, and cut off the possibility of having to do business with an unknown bankruptcy trustee, the operating agreement needs to be drafted in a way to provide for material ongoing obligations of the parties to the LLC and one another. If the operating agreement is deemed to be executory, in order to retain the non-economic rights, the debtor/member will be compelled to assume the agreement. For a variety of reasons, the debtor may not be able to do so. Even if the debtor assumes the agreement, the member may still have to navigate Sections 365(c)(1), (e) and (f), which analysis is beyond the scope of these materials.