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Limited Liability Company Interests as Property of a Debtor's Estate—Executory Agreements and the Conundrum of Section 365

By Joshua R. Elias and Lawrence A. Goldman

"Limited Liability Company Interests as Property of a Debtor's Estate—Is the Operating Agreement Executory?" sets a scenario in which Debtor Inc. (Debtor) commences a case under chapter 11 of the U.S. Bankruptcy Code (the Code), and among Debtor's assets is a membership interest in ABA, LLC (Company). The operating agreement of Company identifies various events as causing a "dissociation" of a member. One event is the commencement of a bankruptcy proceeding involving a member. Another event, in the case of Debtor, is Joe Smith ceasing to have day-to-day control over the business affairs of Debtor. The companion article addresses §541 of the Code, which applies when Debtor's membership interest is reflected by a limited liability company (LLC) agreement that is non-executory, and surveys cases analyzing whether an LLC agreement is executory or non-executory.

Under §541(c)(1), if the LLC agreement is *not* executory, both economic and non-economic rights attendant to the LLC interest will be property of Debtor's estate, notwithstanding dissociation provisions by agreement or statute to the contrary.

For the purposes of this article, let's assume that the LLC agreement *is* executory, because the obligations of both Debtor and the other members of Company's operating agreement are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other. If Debtor reorganizes with Joe Smith at the helm, does Debtor retain its full bundle of rights with respect to the LLC interest? What if a trustee is appointed to manage Debtor's estate, and the trustee seeks to assign the LLC interest to a third party as part of a sale of Debtor's assets?

In the case of an executory contract being held by a debtor's estate, we move from the clarity §541 provides with respect to rights under a non-executory contract, and enter the murkiness of §365—a statutory section seemingly fraught with contradiction and internal inconsistency. Indeed, the only clarity under §365 is that the question of whether the debtor in possession or a trustee can assume an executory contract and exercise the noneconomic rights of the debtor in an executory contract is heavily dependent on non-bankruptcy, state law. In contrast to §541, where it is a foregone conclusion that the trustee (or debtor) can enforce the terms of a non-executory contract and invalidate ipso facto clauses affecting "an interest of the debtor in property . . ." due to the financial condition of the debtor, the commencement of a bankruptcy case, or the appointment or taking possession by a trustee, §365 may limit the trustee's (or debtor's) right of assumption or assignment of an executory contract.

Section 365 of the Bankruptcy Code

In furtherance of the ultimate goal of chapter 11 of the Code to rehabilitate the debtor, subject to certain exceptions discussed herein, §365 allows a trustee to assume or reject an executory contract. Executory contracts, depending on the obligations that remain unperformed, can be benefits or burdens. As a result, the Code authorizes a debtor in possession or trustee to reject an executory contract where burdensome obligations can impede a successful reorganization. On the other hand, assumption of the executory contract may assist a debtor in avoiding liquidation or provide a trustee with a valuable asset for the benefit of creditors.

To realize the maximum value inherent in an executory contract, the trustee (or the debtor) must be able to retain the bundle of

rights under the contract in reorganization or assign the contract's bundle of rights to a third party. However, some LLC statutes purport to cause forfeiture of the rights of an LLC member in the case of the member's bankruptcy. For example, a default provision of the Delaware Limited Liability Company Act is that a member ceases to be a member upon the filing of a voluntary petition in bankruptcy. Del. Code Ann. tit. 6, § 18-304. In addition, LLC operating agreements, like this article's hypothetical agreement, frequently purport to dissociate a member in the case of a member's insolvency.

Section 365(e)(1) seemingly invalidates statutory or contractual ipso facto clauses that attempt to terminate or modify an executory contract on account of the financial condition of the debtor, the commencement of a bankruptcy case, or the appointment or taking possession by a trustee. Section 365(e)(1) provides:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on
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> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
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> (B) the commencement of a case under this title; or
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> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Section 365(e)(2), however, overrides §365(e)(1) if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties[.]" This language is very similar—but not identical—to language in §365(c), which speaks to excusing performance from, or rendering performance to, "an entity other than the debtor or the debtor in possession."

Section 365(c)(1) provides:

> (c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—
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> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and
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> (B) such party does not consent to such assumption or assignment . . .

Also not to be overlooked is §365(f), which provides as follows:

> (f)(1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.
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> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if–
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> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
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> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.
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> (3) Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

One court has observed that §365(e)(2) and §365(c)(1), taken together, are an expression of Congress's recognition that certain types of contracts—for example, personal service contracts—should not be assumable by a bankruptcy trustee in circumstances when state law would not require the non-debtor parties to the contract to accept performance from a substitute party. Thus, §18-304 of the Delaware Limited Liability Company Act should be regarded as an expression of Delaware public policy that, absent a contractual provision to the contrary, members of a Delaware limited liability company should not be forced to have as comembers a bankruptcy trustee or an assignee. *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. 2004),

> . . . §18-304 expressly recognizes the unique relationships that exist among members of LLCs and protects solvent members from being forced into relationships they did not choose that result from the bankruptcy of one of their chosen co-investors. Likewise, other provisions of the LLC Act that provide that assignees of membership interests be denied any right to participate as a member in the governance of the entity, absent a provision in an LLC agreement to the contrary also constitute applicable law that excuses a solvent member from accepting substitute performance as a member from a Bankruptcy Trustee or an assignee of a Bankruptcy Trustee.

In *In re IT Group* 302 B.R. 483 (D. Del. 2003), the issues before the court were whether a debtor could transfer membership rights without the consent of the other mem-

bers and the enforceability against the debtor of a right of first refusal. "Applicable law" was the Delaware Limited Liability Company Act and the court held that under §18-702(b)(2) of the Delaware Act members are permitted to assign bare economic interests to another party. Because "applicable law" did not excuse the members from rendering economic performance to an assignee, §365(e)(2)(A) was held not applicable and the default provision—no transfer without consent—was held to be an unenforceable ipso facto clause. However, the court held that the right of first refusal was not an ipso facto clause because it was triggered by a transfer and not by a member filing for bankruptcy. The court also held that the right of first refusal was not an unenforceable restraint on assignment in violation of §365(f).

In re *Allentown Ambassadors*, 361 B.R. 422 (Bankr. E.D. Pa. 2007), is another case illustrating judicial struggles to reconcile the various subsections of §365 in the context of a limited liability company statute and operating agreement. The issue in the case was whether a provision of a baseball league's operating agreement that purported to terminate a debtor's status as a member of the league—organized as an LLC—upon debtor's bankruptcy filing was enforceable under §365(e). The court observed that the LLC act in question (the North Carolina LLC Act) permitted a member to assign its membership interest, unless prohibited in an operating agreement, but, except as otherwise provided in an operating agreement, an assignee could become a member with the full bundle of economic and noneconomic rights only upon the consent of all other members. The applicable operating agreement provided that an assignee would only have economic rights and would only be admitted as a member if certain conditions were met, one of which was consent of a majority in interest of the disinterested members.

The debtor contended that it remained a member of the LLC following the filing of its bankruptcy case and that the ipso facto provision of the operating agreement purporting to terminate its membership interest was not enforceable under §365(e). Since the court determined that the operating agreement was an executory contract it embarked on an effort to harmonize the various subsections of §365:

> Section 365(e)(1) prohibits termination or modification of an executory contract after the commencement of a bankruptcy case due to a contractual provision conditioned on the commencement of a bankruptcy case. However, § 365(e)(2) overrides subsection (e)(1) if applicable law excuses a party from accepting performance from the trustee or an assignee and the party does not consent to assumption or assignment of the executory contract. Language similar to §365(e)(2) is found in § 365(c), which governs assumption and assignment of executory contracts. Section 365(c) states that executory contracts are neither assumable nor assignable if applicable law excuses a party from accepting performance from an entity other than the debtor or debtor-in-possession (DIP).
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> The court then turned to §365(f):
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> Construction of §365(c) is complicated further by its uncertain relationship to §365(f). Section 365(f) provides that an executory contract is assignable notwithstanding a contractual provision or "applicable law," prohibiting assignment. However, it is expressly subject to §365(c), which states that "applicable law" excusing a party from accepting performance from an entity other than the debtor renders an executory contract non-assignable (and non-assumable). So, an executory contract is assignable notwithstanding "applicable law" prohibiting assignment, but subject to "applicable law" prohibiting assignment!

The *Allentown Ambassadors* court looked to *Matter of West Electronics, Inc.,* 852 F.2d 79 (*3*d Cir. 1988), for construction of §365(c). In *West Electronics*, the Third Circuit held that a debtor in possession, which had a prepetition supply contract with the United States, could not assume the government contract because "applicable law" (a government contracts statute, 41 U.S.C. §15) required government consent to the assignment of the contract:

> West Electronics is prominent as the first appellate case establishing "the hypothetical test" for assumability of an executory contract under §365(c). Under the "hypothetical test" for the assumability of an executory contract, regardless whether a debtor-in-possession actually intends to assign an executory contract, the court must analyze whether "applicable law" would require the non-debtor party to consent if, "hypothetically," the DIP attempted to assign the contract. "In other words, if a contract could not be assigned under applicable nonbankruptcy law, it may not be assumed or assigned by the trustee [or the DIP]." *Cinicola v. Scharffenberger*, 248 F.3d at 121. Significantly, for purposes of the instant case, if a contract cannot be assumed under the §365(c) "hypothetical test" employed in this Circuit, a contractual provision modifying or terminating the debtor's rights under the contract will be enforceable due to the close relationship between §365(c)(1) and §365(e)(2). If §365(c)(1) is applicable, so is §365(e)(2). Once §365(e)(2) is applicable, it overrides §365(e)(1).
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> *Allentown Ambassadors*, 361 B.R. at 447–448.

Continuing with its analysis of the *West Electronics* decision, the court stressed that the Third Circuit construed the applicable statute as treating government contracts as per se personal service contracts that traditionally may not be assigned without consent, and therefore held that §365(c)(1) prevented assignment, and under the hypothetical test, assumption of the contract by the debtor in possession.

The court determined that a three-part process was necessary for application of

§365(e) and analyzing the ipso facto provision of the operating agreement in question that purported to terminate the debtor's noneconomic rights in the LLC upon the bankruptcy filing: (i) the specific nature of the contractual property rights at issue; (ii) whether applicable law expresses a clear policy that the identity of the contracting party is crucial to the contract; and (iii) whether the identity of a hypothetical assignee would be material to a non-debtor party to the contract, taking into account the enterprise in which the debtor and non-debtor are engaged.

Ultimately, the *Allentown Ambassadors* court reasoned that applicable law, the North Carolina LLC Act, contained a qualified power of assignment and unlike the statute in *West Electronics* did not unequivocally express statutory non-assignability of management rights. As such, the North Carolina LLC Act did not constitute applicable law that excuses a party, other than the debtor from accepting performance or rendering performance to an entity other than the debtor or the debtor in possession within the meaning of §365(c)(1)(A). In so concluding, the court cited another bankruptcy court decision, In re *ANC Rental Corp.,* 277 B.R. 226 (Bankr. D. Del. 2002*),* in which the court approved a debtor's assumption of executory contracts permitting the operation of car rental concessions at several airports. In *ANC Rental*, the court stated that for §365(c) to apply, "the applicable law must specifically state the contracting party is excused from accepting performance from a third party under circumstances where it is clear from the statute that the identity of the contracting party is crucial to the contract or public safety is at issue." 277 B.R.

In sum, *Allentown Ambassadors* is an example of judicial application of the "hypothetical test" to the determination of a bankruptcy trustee's (or debtor's) LLC membership rights under an executory operating agreement. The hypothetical test is followed in the Third, Fourth, Ninth and Eleventh Circuits. In contrast, however, the First and Fifth Circuits have adopted the "actual test," which will disallow assumption of an executory operating agreement only where a reorganization results in the non-debtor parties actually having to accept performance from a third party. See, for example*, Institut Pasteur v. Cambridge Biotech Corp.,* 104 F.3d 489 (1st Cir. 1997), *cert. denied,* 521 U.S. 1120, 138 L. Ed. 2d 1014, 117 S. Ct. 2511 (1997).

A court's application of either the hypothetical test or the actual test is also a factor in construing the meaning of the word "trustee" in §365(c). Courts applying the hypothetical test treat "trustee" synonymously with "debtor-in-possession" relying upon §1107(a) of the Bankruptcy Code, which provides that "a debtor-in-possession shall have all the rights . . . and powers, and shall perform all the functions and duties, . . . of a trustee serving in a case . . ." In contrast, courts applying the actual test do not treat "trustee" and "debtor-in-possession" as synonymous because mere assumption by the debtor without actual assignment means that the non-debtor party is not being compelled to accept performance from a party other than the debtor.

So, back to our hypothetical operating agreement, which purports to dissociate Debtor because it commenced a bankruptcy proceeding. If Debtor is able to reorganize and continue to perform under the executory operating agreement, is the Debtor nonetheless precluded from assuming the operating agreement? Arguably, Debtor should not be precluded, particularly if Joe Smith is going to remain at the helm of Debtor with responsibility for Debtor's day-to-day affairs. In this case, the non-debtor counterparty is getting what it bargained for. But if we're dealing with the Delaware Limited Liability Company Act or other statute with language comparable to that found in §18-304 of such act, under the court's analysis in *Milford Power* this result is not free from doubt.

Change the facts, however, to the business of Debtor being sold as part of a plan of reorganization and Joe Smith will not be at the helm of the business. Does this change the result? Under the actual test, assignment of the full bundle of rights under the executory operating agreement should not stand up to a challenge by the non-debtor counterparty because such party is being forced to deal with a party other than the debtor. But, under the hypothetical test, absent a clear expression of contractual intent in the operating agreement to the effect that Joe Smith's continued control over Debtor was critical to the non-debtor's bargain under the operating agreement, then arguably the purchaser of Debtor's business should be able to step into Debtor's shoes under the operating agreement, provided that the purchaser is able to perform.

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ADDITIONAL RESOURCES

For other materials related to this topic, please refer to the following.

Business Law Section Program Library

The Crossroads of LLCs and Bankruptcy—A Treacherous Interaction (PDF) (Audio)

Presented by: LLCs, Partnerships and Unincorporated Entities, Business Bankruptcy, Middle Market and Small Business

Location: 2015 Spring Meeting

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The LLC & Partnership Reporter

Operating Agreements, Executory Contracts and Denman

By Jay Adkisson

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