BUSINESS LAW TODAY

Limited Liability Company Interests as Property of a Debtor's Estate—Is the Operating Agreement Executory?

By Lawrence A. Goldman

This article, and "Limited Liability Company Interests as Property of a Debtor's Estate—Executory Agreements and the Conundrum of Section 365" together, address the implications of a bankruptcy on a member's rights under LLC agreements.

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Debtor, Inc. (Debtor) commences a case under chapter 11 of the U.S. Bankruptcy Code (the Code), and among Debtor assets is a membership interest in ABA, LLC (Company). The operating agreement of Company identifies various events that would cause 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. Debtor continues to operate as a debtor in possession, and Smith continues to run the day-to-day affairs of Debtor.

What happens to Debtor's rights with respect to its interest in Company? Does the answer change if a trustee is appointed to take charge of Debtor's estate? Can the membership interest be assigned to a third party in the case of a purchase of the assets comprising Debtor's estate?

Ultimately, the extent to which a debtor in possession, a bankruptcy trustee, or—in the case of any assignment of the debtor's interest—a third party succeeds to the debtor's limited liability company (LLC) rights pre-bankruptcy will depend on several factors: (1) whether the operating agreement is executory, (2) the applicable statutory and/or contractual language purporting to govern the consequences of an LLC member's bankruptcy, and (3) if the operating agreement is executory, the nature of the relationship of the debtor to the other members of the limited liability company. This article will focus on the first prong of the inquiry—whether the agreement giving rise to the LLC interest is an executory contract.

An interest in an LLC is personal property, but the nature of the property interest is a function of the contract among the members of the LLC, and, if the contract does not address a specific issue, the applicable statutory default rules. In simple terms, an LLC interest may be divided into two parts: (1) the economic interests—the right to share in profits and losses of the enterprise and the right to receive distributions; and (2) the noneconomic rights, such as the right to vote, participate in management, and receive information regarding the affairs of the enterprise. Generally, the consequences of dissociation are the retention of economic rights but the loss of all governance rights attendant to the limited liability company interest.

Contract or statutory provisions purporting to cause a dissociation of a member from an LLC as a consequence of the commencement of a bankruptcy case are referred to as "ipso facto" clauses. The concept of member dissociation derives from a traditional principle of the partnership relationship—the right to pick one's partner and not be compelled to do business with another party involuntarily.

The following is a typical form of contractual ipso facto clause reflecting the scenario set forth above:

> *Automatic Withdrawal of Member.* A Member shall be deemed to have withdrawn from the Company and shall be treated as a Withdrawn Member under

this Agreement automatically upon the occurrence of any of the following events:

(a) Immediately if any Member shall (i) voluntarily file with a Bankruptcy Court a petition seeking an order for relief under the Federal bankruptcy laws, (ii) seek, consent to, or fail to contest the appointment of a receiver, custodian, or trustee for itself or for all or any significant part of its property . . .

(b) If Joe Smith ceases to (i) own a majority of the outstanding shares of common stock of Debtor, Inc. entitled to vote for the election of directors or (ii) hold the office of President and Chief Executive Officer of Debtor, Inc. or otherwise have responsibility for the oversight of the day-to-day affairs of Debtor, Inc.

§18-304 of the Delaware Limited Liability Company Act is a statutory ipso facto provision:

A person ceases to be a member of a limited liability company upon the happening of any of the following events:

(1) Unless otherwise provided in a limited liability company agreement, or with the written consent of all members, a member:

a. Makes an assignment for the benefit of creditors;

b. Files a voluntary petition in bankruptcy;

c. Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding.

Section 541 of the Bankruptcy Code

Under §541(a) of the Code, the commencement of a bankruptcy case creates an estate comprising "all legal or equitable interests of the debtor as of the commencement of the case." These property interests include contract rights of the debtor, including limited liability company interests. §541(c)(1) of the Code, states in pertinent part, that:

. . . an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—

a. that restricts or conditions transfer of such interest by the debtor; or

b. that is conditioned . . . on the commencement of a case under this title, or the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

The foregoing language is clear, and case law is consistent in holding that a debtor's economic interests in an LLC become property of the bankruptcy estate notwithstanding ipso facto provisions in operating agreements or LLC statutes to the contrary. Indeed, on first blush, it would seem that, based on the language of §541(c)(1), the entire bundle of rights associated with an LLC interest—economic and noneconomic—should be part of the bankruptcy estate.

But life and the Code are not that simple. If the agreement giving rise to the LLC interest is executory, §365 of the Code will trump §541 as to the noneconomic elements of the LLC interest, and whether the debtor, a bankruptcy trustee, or a third party assignee may retain such noneconomic interests becomes a function of a complex analysis arising from the application of various provisions of §365. If not already familiar with §§365(c), 365(e), and 365(f), the curious reader may want to take a peek at such subsections. They contain confounding language which is, in part, consistent with §541(c)(1), in part seemingly in conflict with §541(c)(1), and, in part, seemingly internally inconsistent. In short, ipso facto provisions such as dissociation clauses will be enforced as to noneconomic rights if "applicable law" excuses a party, other than the debtor, to an LLC agreement from accepting performance from or rendering performance to a party other than the debtor, and such third party does not consent.

The conundrum of §365 is addressed in a companion article in this newsletter, "Limited Liability Company Interests as Property of a Debtor's Estate—Executory Contracts and the Conundrum of Section 365." Suffice it to say, however, if Joe Smith ceasing to maintain control over Debtor is stated as a dissociation event for Debtor's interest in Company, the operating agreement should identify why Joe Smith's continuing affiliations with Debtor and with Company are material to the business objective of Company.

What Makes an Operating Agreement Executory?

So, is an LLC agreement an executory contract? Commonly understood, an executory contract is one where performance remains due by all of the parties. Arguably, that would capture most contracts. For bankruptcy purposes, however, the term is not construed in its broadest sense. The most frequently cited definition of an executory contract is that of Professor Vern Countryman in a 1973 law review article: "A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."

There is no blanket rule applicable to LLC operating agreements. Whether an LLC operating agreement is an executory contract will depend on the materiality of nonperformance of remaining obligations. This will require an analysis of the operating agreement as a whole, the applicable limited liability company act, and other applicable state law. *In re Tsiaoushis*, 383 B.R.616, 620 (E.D. Va. 2007).

Decisions addressing whether particular operating agreements are executory contracts illustrate the case-by-case sensitivity of the analysis.

The facts in *In re Daugherty Construction*, 188 B.R. 607 (Bankr. D. Neb. 1995), made the determination easy. The court found the applicable LLC agreements to be executory contracts because there were material unperformed and continuing obli-

gations of the members of the companies to participate in management, to contribute capital in the event of fiscal loss, and to provide general contractor and developer services.

In contrast, in *In re Garrison-Ashburn*, 253 B.R. 700 (E.D. Va. 2000), the court concluded that the operating agreement in question was not executory because it merely provided the structure for the management of the company and there was no obligation to provide additional capital, no obligation to participate in management, and no obligation to provide any personal expertise or service to the company.

In *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005), the issue was whether a chapter 7 trustee could exercise the rights of a member of an LLC and seek remedial action for alleged mismanagement of the company. The court explained that, if the operating agreement was an executory agreement, §365(e)(2), if applicable, would permit the enforcement of statutory and contract restrictions on a trustee's powers, but that if the contract was not an executory contract, §541(c)(1) would render such restrictions unenforceable against the trustee. Concluding that the applicable operating agreement was not executory, by distinguishing other cases in which courts found obligations to contribute capital and continuing fiduciary duties among partners in a partnership key factors in making operating agreements or partnership agreements executory contracts, the court stated that the chapter 7 trustee had all rights and powers with respect to the LLC that the debtor held as of the commencement of the case.

In *In re Allentown Ambassadors*, 361 B.R. 422 (Bankr. E.D. Pa. 2007), the court determined that an operating agreement pertaining to an independent professional baseball league was an executory contract because the members had continuing duties, including duties to manage the LLC (the baseball league) and the duty to make additional cash contributions as needed for operations.

The court found the operating agreement in question to be executory in *In re McSwain*, 2011 Bankr. LEXIS 3921 (Bankr. W.D. Wash. 2011), citing "multiple, mutual obligations" of the parties and the debtor's ongoing management obligations, his obligation to vote on major decisions and other specified issues, his obligation to vote on and contribute mandatory additional capital contributions, and his being subject to various restrictions on authorized transfers of the member interest, competition against the company, and disclosure of confidential information.

The operating agreement at issue in *In re Strata Title, LLC*, 2013 WL 1773619 (Bankr. D. Ariz. 2013), provided for a manager-managed LLC. The court concluded that the agreement was executory because certain actions, including removal of the manager and sale of property owned by the company, required approval by a super majority of the members, that these actions were material, and that the possibility of a vote on one or more of the issues was not remote, thereby requiring the participation of the members.

The Bankruptcy Court in *In re Alameda Investments, LLC*, 2012 Bankr. LEXIS 2564, 2013 WL 32116129 (Bankr. C.D. Cal. 2013), subsequently affirmed by the Ninth Circuit Bankruptcy Appellate Panel, distinguished *In re Strata Title*, and stated that the mere fact that members had the right to vote on various matters would not, by itself, make an operating agreement executory. The court stated that the debtor had no outstanding performance due under the operating agreement on the date of bankruptcy, had no role in the management of the company, and had no obligation to provide any personal expertise or service to the company. Moreover, the court stated that, even if circumstances triggering the limited voting rights arose, the failure of a member to vote would not constitute a material breach of the operating agreement excusing other parties thereto from performance.

In *In re Denman*, 513 B.R. 720 (Bankr. W.D. Tenn. 2014), the court determined that operating agreements under the Tennessee Limited Liability Company Act are not per se executory contracts because of "unique elements and features under state law that are inconsistent with contract law." With respect to the operating agreement in question, the court observed that, other than the requirement of an initial capital contribution, the members appeared to have no other material obligations. "In conclusion, the LLC operating agreement here is not an executory contract and is more appropriately classified as a business formation and governance instrument . . ." 513 B.R. at 726. The court held that the debtor's interest in the LLC was property of the estate under §541(c)(1); that, because the operating agreement was not executory, §365 was not applicable; and that the other member of the LLC could not enforce an ipso facto clause providing for a right to purchase another member's interest upon triggering events, including a member's bankruptcy.

The court found the operating agreement to be executory in *In re DeVries*, 2014 WL 4294540 (Bankr. N.D. Tex. 2014), where it related to the operation of a dairy farm business. In particular, the court concluded that obligations to contribute additional capital and provide loan guarantees were not remote, given the highly volatile nature of the dairy industry. Noteworthy, however, the court determined that, even though the operating agreement required members to contribute as much time as necessary to help run the company, this was not an executory obligation because management of the company was overseen by a manager.

While *Sullivan v. Mathew*, 2015 U.S. Dist. LEXIS 40033 (N.D. Ill. 2015), involved an interest in a general partnership as opposed to a limited liability company, the court surveyed the case law on the executory nature of LLC operating agreements. The court noted various ongoing obligations that could be triggered from time to time, including contributions of capital, if required; consent as to decisions outside day-to-day affairs overseen by managing partners; fiduciary duties among partners owed by statute; and responsibilities arising in connection with the dissolution of the venture. However, the court stated that a failure to perform some of these duties individually might not result in a material breach of the agreement and that, under applicable state law (Illinois) a material breach would be one that served to defeat the bargained-for objective of the parties in forming the partnership.

Practical Considerations

If a client entering a venture conducted as a limited liability company desires to ensure that a comember's bankruptcy will cause a forfeiture of noneconomic incidents of an LLC interest, and thereby cut off the possibility of having to do business with an unknown bankruptcy trustee or third party assignee—in other words, the benefit of "picking a partner"—the first step is to craft the contractual relationship to provide for material ongoing obligations of the parties to the LLC and to one another. If the operating agreement is deemed to be executory, in order to retain noneconomic 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 client may still have to navigate through the troubled waters of §365(c)(1) §365(e) and §365(f), described in the companion article, referred to above, in order to realize fully a business divorce from a bankrupt comember, but at least the first hurdle will have been overcome.

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ADDITIONAL RESOURCES

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

Business Law Section Program Library

What Is an Operating Agreement and Why Do We Care? (PDF) (Audio)
Presented by: LLCs, Partnerships and Unincorporated Entities
Location: 2015 Committee Meeting

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*
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Vol. 31, No. 2 April 2015