LLC Operating Agreements in Bankruptcy: Are They Executory?

Mark B. Conlan and Lawrence A. Goldman

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Imagine your client is considering a strategic bankruptcy filing in order to restructure indebtedness, and one of the debtor's key assets is its membership interest in a limited liability company (LLC) entitling the debtor to designate management. The LLC operating agreement identifies various events as causing a member's "dissociation," including the commencement of a bankruptcy case involving a member.

Your concern is what happens to the debtor's rights with respect to the LLC interest? Can the debtor's LLC membership interest, including the value enhancing control rights, be assigned to a third party in an asset sale?

The extent to which the debtor, bankruptcy trustee or assignee succeeds to the debtor's pre-bankruptcy LLC rights will depend on several factors: (i) whether the operating agreement is executory; (ii) if the operating agreement is executory, the nature of the relationship of the debtor to the other LLC members; and (iii) the statutory and/or contractual language purporting to govern the consequences of an LLC member's bankruptcy. This article focuses on the first prong—whether the operating agreement is an executory contract.

An interest in an LLC is personal property, the nature of which depends on the operating agreement or, if the agreement does not address a specific issue, the statutory default rules. An LLC interest may be divided into two parts: (i) the economic interests—the right to share in profits and losses and receive distributions; and (ii) the non-economic rights, including the right to vote, participate in management, and receive information about the enterprise. Generally, dissociation results in the retention of economic rights but the loss of management rights.

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

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A typical contractual ipso facto clause would provide for a member's automatic withdrawal from an LLC upon: (i) the member becoming a debtor in an insolvency case; (ii) the member seeking, consenting to or failing to contest the appointment of a receiver, custodian or trustee for itself; or, as applicable, (iii) the member ceasing to: (a) own a majority of the outstanding voting equity interests in the LLC, or (b) otherwise have responsibility for the oversight of the day-to-day affairs of the LLC.

Under Bankruptcy Code §541(a), a debtor's estate includes "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 LLC interests. Code §541(c)(1) provides, 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 non-bankruptcy law—(A) that restricts or conditions transfer of such interest by the debtor; or (B) that is conditioned … on the commencement of a case … the appointment of … a trustee …, and that effects … a forfeiture, modification, or termination of the debtor's interest in property.

Courts have consistently held 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, it would seem that, pursuant to §541(c)(1), the entire bundle of rights associated with an LLC interest—economic and non-economic—should be part of the bankruptcy estate.

But life and the Code are not that simple. If the LLC agreement is executory, Code §365 will trump §541 as to the non-economic elements of the LLC interest, and statutory and contract law restrictions on the estate's rights and powers may be enforced. Whether the debtor, a trustee or assignee may retain non-economic interests is a function of a complex analysis arising from the application of various provisions of §365. *See* 11 U.S.C. §§365(c), 365(e) and 365(f). They contain confounding language that is, in part, consistent with, and, in part, seemingly in conflict with, §541(c)(1), while also being, in part, seemingly internally inconsistent. In short, if the operating agreement is executory, ipso facto provisions like dissociation clauses will be enforced as to non-economic rights if "applicable law" excuses a party to an LLC agreement, other than the debtor, from accepting performance from or rendering performance to a party other than the debtor, and such third party does not consent. Thus, estate value derived from control rights over the LLC asset may be lost.

What Makes an Operating Agreement Executory?

Commonly understood, an executory contract is one where performance remains due by all of the parties. However, in bankruptcy, executory contracts are more narrowly construed. The most frequently cited definition of an "executory contract" is from Professor Countryman: "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." Countryman, Vern, "Executory Contracts in Bankruptcy: Part I," 57 Minn. L. Rev. 439 (1973).

There is no blanket rule applicable to LLC operating agreements. LLC agreements are analyzed on a case-by-case basis to determine if they contain sufficient unperformed material obligations to require treatment as executory contracts. *BMA Ventures v. Prillaman*, 2017 WL 354319 (Bankr. C.D. Ill. Jan. 24, 2017). Operating agreements often include provisions requiring members to take some future, contingent act, such as indemnifying the LLC for tax liabilities, making future capital contributions, or voting on substantial LLC transactions. *In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632, 636 (Bankr. N.D. Ill. 2006). However, hypothetical, remote or speculative obligations are generally insufficient to make an operating agreement an executory contract. *In re Tsiaoushis*, 383 B.R. 616, 619 (E.D. Va. 2007). A debtor must have substantial, current, unperformed obligations if an operating agreement is to be treated as an executory contract. *Id.* Whether an operating agreement is an executory contract will depend on the materiality of non-performance of remaining obligations. This will require an analysis of the operating agreement as a whole, the applicable LLC act, and other applicable state law. *Id.* at 620.

Operating agreements were determined to be executory contracts in *Matter of Daugherty Construction*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995), where the debtor had obligations to contribute additional capital in the event of fiscal loss and to provide general contractor services, and in *In re Allentown Ambassadors*, 361 B.R. 422 (Bankr. E.D. Pa. 2007), where all members had continuing management duties for an independent professional baseball league and were required to make additional capital contributions.

Other examples where courts found operating agreements to be executory include: *In re DeVries*, 2014 WL 4294540 (Bankr. N.D. Tex. 2014) (operating agreement executory where the debtor was obligated to make additional capital contributions and provide loan guarantees in

highly volatile dairy industry); *In re McSwain*, 2011 Bankr. LEXIS 3921 (Bankr. W.D. Wa. 2011) (operating agreement executory because of "multiple, mutual obligations" of the parties, including the debtor's ongoing management duties and obligations to vote on major decisions and make additional capital contributions, and where the debtor was barred from competing against the company or disclosing confidential information). In *In re Strata Title,* 2013 WL 1773619 (Bankr. D. Ariz. 2013), the court found the operating agreement was executory in a member-managed LLC because certain material actions required approval by a super-majority of the members, including removal of the manager and sale of company property.

In contrast, operating agreements have been held to be non-executory contracts where the debtor-member does not have ongoing obligations that are so material that the other members would be excused from further performance if the debtor-member fails to perform. *See*, *In re Garrison-Ashburn*, 253 B.R. 700 (E.D. Va. 2000) (no executory contract and §365 inapplicable to an operating agreement that imposes no duties or responsibilities on its members, but merely provides for the structure of the management of the entity); *In re Alameda Investments*, 2013 WL 3216129 (Bankr. C.D. Cal. June 25, 2013), *aff'd* 2014 WL 868605 (9th Cir. B.A.P. Mar. 05, 2014) (operating agreement not executory based on voting rights alone where the debtor-member had no performance obligations, no management role, and no duty to provide personal services under the operating agreement); *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005) (operating agreement not executory because it imposed no duties on its members; therefore, a trustee acquired all of the member's economic and non-economic rights and interests); *In re Denman*, 513 B.R. 720, 726 (Bankr. W.D. Tenn. 2014) (court conclusion that the LLC agreement was not an executory contract and was more appropriately classified as "a business formation and governance instrument" where the members had no other material obligations other than an initial capital contribution).

Query whether member voting rights on future events (i.e., a sale of the company's business) as compared to decision-making vested in a single member would be determinative, absent any other material ongoing obligations.

Conclusion

The dilemma posited at the opening of this article may be mitigated by planning at the inception of the venture. If your client is the control party, it may be advisable to include provisions in an LLC agreement ensuring that the client retains control if it becomes a debtor in bankruptcy. In

other words, avoid ipso facto clauses. Conversely, if your client is an investor and is counting on the financial strength or special expertise of a co-venturer—the benefit of picking a partner—you should state such points and draft the agreement so that there are material ongoing obligations of the members to the others and to the company.•