



*91st Annual National Conference of Bankruptcy Judges*

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**What is a Limited Liability Company &  
Why Does it Matter in Bankruptcy?**

**Presenters**

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## *Critical LLC Cases*

1. **In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016)**
  - Extends corporate blocking director consent analysis to LLC
  - Prebankruptcy, LLC agreed to Lender request to add a special **noneconomic** member to make the LLC “bankruptcy remote” in exchange for a loan default waiver
  - Operating Agreement required unanimity for bankruptcy filings and provided the special member did not have a fiduciary duty to exercise its consent in favor of the LLC or other members



## *Critical LLC Cases*

- **In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016) – CONTINUED**
- LLC filed for bankruptcy without special member consent and Lender filed motion to dismiss arguing that the LLC was not an authorized debtor
- Lender's motion to dismiss denied because the special member consent provision was unenforceable as a matter of state LLC law and federal bankruptcy policy
  - Absolute prohibition to file is void, contractual waiver is void, but entity blocking consent is not automatically void if the exercise is subject to a fiduciary duty
  - Michigan law does not permit the elimination of a member's fiduciary duties and if it did the provision would violate federal bankruptcy policy



## *Critical LLC Cases*

2. **In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016)**
  - Extends *Lake Michigan* to Delaware where fiduciary duties may be eliminated
  - Prebankruptcy, LLC agreed to Lender request to be added as a special **economic** member in exchange for a \$1 contribution and a secured line of credit
  - Operating Agreement required unanimity for bankruptcy filings



## *Critical LLC Cases*

- **In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016) - CONTINUED**
- LLC filed for bankruptcy without special member consent and Lender filed motion to dismiss arguing that the LLC was not an authorized debtor
- Lender's motion to dismiss denied because the special member consent was unenforceable as a matter of federal bankruptcy policy
  - Delaware LLC law expressly permits the elimination of fiduciary duties and grants the maximum effect to freedom of contract
  - The fact that Delaware law sanctions the blocking consent provision does not save the blocking consent provision under federal bankruptcy policy safeguarding the right of a person, including a business entity, to file bankruptcy



## *Critical LP Case*

- 3. In re Squire Partners Limited Partnership, 2017 WL 2901334 (E.D. Ark. 2017), appeal filed to 8<sup>th</sup> Circuit 8/4/17.**
  - Distinguished *Lake Michigan* and *Intervention Energy* as neither required the consent of a bona fide owner, like a limited partner
  - Prebankruptcy, the partnership agreed to amend the Partnership Agreement to require the unanimous consent of all partners for bankruptcy filings
  - The GP was liable for the partnership debt as was a GP affiliate which had guaranteed the debt. On default the GP filed on behalf of the partnership without consent of either LP



## *Critical LP Case*

- **In re Squire Partners Limited Partnership, 2017 WL 2901334 (E.D. Ark. 2017), appeal filed to 8<sup>th</sup> Circuit 8/4/17 - CONTINUED**
- The LPs' motion to dismiss was granted because the GP lacked authority to file without the LPs consent and the district court affirmed
  - The LPs are owners of the partnership with no fiduciary duties, not creditors, so the fiduciary analysis of in *Lake Michigan* and *Intervention Energy* is not controlling
  - The authority to file is jurisdictional and not a Section 1112(b) motion to dismiss that assumes jurisdiction



## *Analysis*

- **The existence or elimination of fiduciary duties may be an inappropriate proxy for analyzing the federal bankruptcy policy of a consent to block a bankruptcy filing**
- The fiduciary duty of a partner of a partnership or a member of an LLC depends upon the management structure of the partnership or LLC
  - In a general partnership, all partners have status fiduciary duties, but in a limited partnership, limited partners do not have fiduciary duties
  - In a member-managed LLC, all members (economic and noneconomic) have status fiduciary duties, but in a manager-managed LLC, members do not have status fiduciary duties



## *Analysis, continued*

- It is unnecessary to contractually eliminate fiduciary duties of of limited partners or members of a manager-managed LLC because they do not exist
- Surely entity selection should not affect federal bankruptcy policy
- *Squire Partners* raises this question by distinguishing between a creditor retaining the power to block bankruptcy (albeit through a weak proxy exploiting governance structure) and the retention of the power to block a filing by a legitimate equity owner of the entity



## *Analysis, continued*

- Neither *Lake Michigan* nor *Intervention Energy* factually determined whether the LLC was member-managed or managed-managed
- Both cases were presumably member-managed where at least members have a fiduciary duty or the analysis of duty elimination was irrelevant
- Improbability, LLC in Problem 1 is formed as a member-managed LLC
  - Should the problem be analyzed differently if it had been formed as a manager-managed LLC?



## *Analysis, continued*

- Chip Lion in Problem 1 was not required to make any financial contribution in exchange for his noneconomic membership interest
  - Should Mr. Lion be treated more like an owner under *Squire Partners* or more like a creditor proxy in *Lake Michigan* and *Intervention Energy*?
  - If the latter, how much must a creditor proxy “contribute” to validate blocking consent?
- What is the legal significance of a .01% limited partner in *Squire Partners* and a \$1 economic LLC member in *Intervention Energy*?



*Problem No. 2*

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**The Importance of Determining if  
An LLC Operating Agreement is an  
Executory Contract**



## ***LLC BASIC CHARACTERISTICS***

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- They are NOT corporations, partnerships or limited partnerships
- Formation – Certificate of Formation Filing
- Governance
  - LLC Statutes are “Default Statutes”
  - Operating Agreements – sets forth business relationship among members and their rights and obligations
  - Internal Affairs Doctrine - state of formation governs internal affairs of members and liability of members
- Management
  - Manager – Managed v. Member – Managed



# ***LLC BASIC CHARACTERISTICS***

## **■ Interests in LLCs**

- Membership Interest includes:
  - Economic rights – i.e., rights to distributions
  - Information rights
  - Management rights
- Assignment of Interests
  - Economic interests may be transferred unless the operating agreement precludes assignment
  - Management Rights may not be transferred without member consent

## **■ Fiduciary Duties**

- What are they? Duty of loyalty and duty of care
- Who owes them? Manager v. member managed
- Can they be modified or eliminated? Check state of formation

## **■ Tax Classification – Partnership tax default unless “check-the-box”**



## *Problem #2 – What is in the Bankruptcy Estate of the Debtor Member and is the Operating Agreement an Executory Contract?*

### ■ Hypothetical

- Bob, Carter, David and Evan form Regret LLC to acquire and operate a 4-unit apartment complex in California
- Member-Managed
- Carter contributes \$1.2 million for 55% membership interest
- Bob, David and Evan each contribute \$300k for 15% membership interest each
- Bob, the only California resident, is delegated day to day management
- Regret LLC Agreement:
  - Precludes assignment of management rights without consent of members
  - A member ceases to be a member upon becoming a debtor in bankruptcy
  - Majority of Membership Interests necessary to dissolve the LLC (but sale by LLC of all assets requires unanimous consent of members)
  - The LLC Agreement is silent as to Member's fiduciary duties
- Carter files for Chapter 7 bankruptcy. Trudy Tee is appointed as trustee
- Ms. Tee files a motion to assume the Agreement as an executory contract under Section 365. She intends to vote to dissolve Regret and sell the underlying complex



## ***Problem #2 – What is in the Bankruptcy Estate of the Debtor Member and is the Operating Agreement an Executory Contract?***

- Issue No. 1 - Does the bankruptcy estate of a debtor who is a member of an LLC include the debtor's management rights in the LLC even though state law purports to eliminate those rights when the debtor files a petition in bankruptcy?
  - Bankruptcy Code Section 541(c) preemption?
- Issue No. 2 - Assuming the debtor's estate includes all management rights existing prior to filing a petition, do the executory contract provisions of 11 USC § 365 preclude the trustee from exercising those management rights?
  - Is the LLC Agreement an executory contract?
  - If so, does Section 365(c) negate the trustee's power to assume the operating agreement?



## ***Problem #2 – What is in the Bankruptcy Estate of the Debtor Member and is the Operating Agreement an Executory Contract?***

- Issue No. 3 - If the operating agreement is not an executory contract, does Section 541(c) preempt state law restrictions on the Trustee's power to exercise the debtor's management rights?
- Issue No. 4 - If the bankruptcy court determines Ms. Tee controls the management rights of the LLC interest (either under 11 USC § 365 or 11 USC § 541), can Ms. Tee unilaterally dissolve Regret LLC and sell the interests for the benefit of the Chapter 7 creditors without considering the interests of the other member?
  - Does the bankruptcy trustee owe fiduciary duties to the other members?
  - Is the dissolution a breach of fiduciary duties?