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**BUSINESS INTERESTS IN CONSUMER CASES:
PARTNERSHIP INTERESTS, LLC'S, INTELLECTUAL
PROPERTY AND OTHER "EXOTIC" INTERESTS**

**ISSUES CONCERNING PARTNERSHIP INTERESTS
AND LIMITED LIABILITY COMPANIES**

Mark S. Goldstein
Of counsel, Lowe, Stein, Hoffman, Allweiss & Hauver, L.L.P.
701 Poydras Street, Suite 3600
New Orleans, Louisiana 70139
(504) 581-2450

I. LIQUIDATION OF CHAPTER 7 DEBTOR'S MEMBERSHIP INTEREST IN A LIMITED LIABILITY COMPANY (LLC)

A. Executive Summary

1. If the Debtor has a **100% membership interest** in the LLC, the jurisprudence generally recognizes that the Chapter 7 Trustee can sell the assets of the LLC and use the proceeds to pay the bankruptcy estate's creditors. See, e.g.:

In re Albright, 291 B.R. 538 (Bankr. D. Colorado, 2003)

In re B&M Land and Livestock, LLC, 498 B.R. 262 (Bankr. D. Nevada, 2013)

2. If the Debtor has a membership interest in a **multi-member LLC**, the Chapter 7 Trustee can market the economic component of that membership interest (i.e. the right to receive distributions and pass-through of profits and/or losses during the ongoing operation of the LLC and upon its dissolution). However, the Trustee will have difficulty in exercising the Debtor's managerial or voting rights associated with the membership interest (although some jurisprudence suggests that trustees do obtain such rights), and the Trustee will face legal obstacles in forcing the liquidation of the LLC in order to get an immediate distribution of the full net asset value of the Debtor's membership interest for the benefit of the Debtor's bankruptcy estate. See, e.g.:

In re Ehmman, 319 B.R. 200 (Bankr. D. Arizona, 2005)

In re Warner, 480 B.R. 641 (Bankr. N.D. West Virginia, 2012)

B. Under Non-Bankruptcy Law, an LLC is Governed by the Law of the State in Which it is Organized, and by its Operating Agreement (if it Has One)

1. These **governing provisions** define the membership interest, including limitations on the transferability of the interest, the rights of a member's creditors to seize or collect from those interests, and the termination (or disassociation) of those interests. These provisions vary from state to state, and from operating agreement to operating agreement.
2. **Limits on transferability, creditors' rights to seize.** Generally,
 - (a) LLC membership interests can only be transferred with the consent

of the other members (unless the operating agreement provides otherwise);

- (b) a membership interest cannot be seized by the member's creditors (but the member's right to distributions can be obtained by the seizing creditor through a "**charging order**"); and
- (c) the **death, disability, and/or bankruptcy** of an individual member could cause the dissolution of the LLC unless the other members take specific action.

- 3. **Mandatory buy-back rights triggered by bankruptcy of member.** Some operating agreements provide for the company or the non-bankrupt members having the right to purchase the bankrupt member's interest pursuant to a formula-defined price, and/or over an extended period of time.
- 4. Because of the variation in the states' LLC laws, and the wide ranging possibilities of operating agreement provisions, each case has to be evaluated on its own in order to determine the nature of the membership interest under non-bankruptcy law, and most importantly, what the Chapter 7 Trustee can do with that interest pursuant to bankruptcy law and non-bankruptcy law, which may conflict.

C. **LLC Membership Interests as Property of the Estate: 11 U.S.C. § 541**

- 1. 11 U.S.C. § 541(c) provides as follows:

(c)(1) Except as provided in paragraph (2) of this sub-section, an interest of the debtor in property becomes property of the estate under sub-section (a)(1), (a)(2), or (a)(5) of this section 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 insolvency or financial condition of the debtor, on the commencement of a case under this title, or on 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. [emphasis added]

2. Courts have held that 11 U.S.C. § 541(c)(1) pre-empts provisions in state laws and operating agreements which provide for the automatic disassociation of a member upon that member's bankruptcy filing, or might be construed to restrict the transfer of the membership interest to the bankruptcy trustee (to the extent that a membership interest becomes property of the estate pursuant to 11 U.S.C. § 541(a)). See, e.g.:

In re Klingerman, 388 B.R. 677 (Bankr. E.D. N.C. 2008).

3. Trustees may also effectively cite § 541(c)(1) to block the LLC's or its non-bankrupt members' rights to purchase the Debtor's membership interest from the bankruptcy estate. See, e.g.:

In re Cutler, 165 B.R. 275 (Bankr. D. Ariz. 1994) (a partnership case, but the analysis should be equally applicable to LLCs).

4. § 541(c)(1) also has been used to prevent the otherwise mandatory dissolution and liquidation of the LLC because of a member's bankruptcy filing. See, e.g.:

Matter of Daugherty Construction, 188 B.R. 607, 611 (Bankr. D. Neb. 1995), but this was a Chapter 11 debtor-in-possession case, the debtor was able to assume the operating agreement as an executory contract, and both §§ 541(c)(1) and 365(e) were cited as authority that the dissolution of the LLC, otherwise authorized under Nebraska law, was not triggered.

D. Question: Are Provisions in State Law or an Operating Agreement Providing for the Disassociation of a Member Upon that Member's Bankruptcy Filing Pre-empted by § 541(c) (and § 365)?

Yes:

Matter of Daugherty Construction, 188 B.R. 607, 611 (Bankr. D. Neb. 1995) (a Chapter 11 D-I-P case).

In re Dixie Mgmt. & Inv. Ltd. Partners, 474 B.R. 698 (Bankr. W.D. Ark. 2011) (a Chapter 11 D-I-P case).

In re Garbinski, 465 B.R. 423 (Bankr. W.D. Pa. 2012).

No:

Northwest Wholesale, Inc. V. PAC Organic Fruit, LLC, 357 P.3d 650 (Wash. 2015) (federal bankruptcy law does not pre-empt state LLC law).

E. Consensus: The Economic Rights Accompanying LLC Membership Interests are Property of the Individual Member’s Bankruptcy Estate Pursuant to § 541(a)(1), and at a Minimum the Chapter 7 Trustee is Entitled to that Economic Component of (i.e., the Right to Distributions) Just Like a Seizing Creditor

F. Consensus: The LLC’s Assets are not Property of the Estate

See, e.g.:

In re Bolon, 538 B.R. 391 (Bankr. S.D. Ohio, 2015), recognizing that although the Chapter 7 Trustee could exercise both the economic and non-economic rights of the debtor’s 100% owned LLC, the LLC’s transfer of property was not avoidable by debtor’s trustee, since the transferred property was owned by the LLC, not the debtor.

G. It is Possible that the Chapter 7 Trustee Can Obtain the Non-Economic Components of the Membership Interests (i.e., the Debtor’s Rights to Manage and/or Vote and/or Otherwise Participate in the Affairs of the LLC).

There are cases suggesting the Chapter 7 Trustee can exercise the debtor’s non-economic rights, e.g.:

In re Warner, 480 B.R.. 641 (Bankr. N.D. West Virginia, 2012)

In re Hickory Ridge, LLC, 2010 WL 1727968 (Bankr. D.D. W. Va. April 27, 2010)

In re LaHood, 437 B.R. 330 (C.D. Ill. 2010) (where the debtor held a 50% membership interest, and providing that Chapter 7 trustee had right to participate in decisions regarding the wind-up of the LLC).

In re Garbinski, 465 B.R. 423 (Bankr. W.D. Pa. 2012). Here, the Bankruptcy Court held that § 541(c)(1) operated to override any provision in state law requiring treatment of the trustee as a “mere assignee” who does not enjoy any management rights, and that the Chapter 7 Trustee could exercise the debtor member’s rights to seek a state law liquidation of the company.

In re H&H Food Mart, LLC, 461 B.R. 904 (Bankr. N.D. Georgia 2011).

However, see:

Northwest Wholesale, Inc. V. PAC Organic Fruit, LLC, 357 F.3d 650 (Wash. 2015) (where the Supreme Court of Washington held that bankruptcy law did not preempt state law, and that the bankruptcy filing would restrict Trustee's interest to that of an assignee.)

H. Apparent Consensus: With Respect to Single Member LLCs, the Chapter 7 Trustee is a “Substituted Member” Can Exercise Both the Debtor’s Economic and Managerial Components of the Debtor’s Membership Interests. However, this Does Not Mean There is a Substantive Consolidation or a Total Disregard of the LLC Entity, and Presumably the Trustee Must Pay the LLC’s Creditors and Otherwise Perform the Appropriate Management Functions for the LLC Before Making a Distribution to the Bankruptcy Estate

See, e.g.:

In re Albright, 291 B.R. 538 (Bankr. D. Colorado, 2003);

In re A-Z Electronics, LLC, 350 B.R. 886 (Bankr. D. Idaho 2006)

In re B&M Land and Livestock , LLC, 498 B.R. 262 (Bankr. D. Nevada, 2013)

I. The Executory Contract Issues

Generally, courts will evaluate an operating agreement using the Countryman criteria, and unless the bankrupt member had active managerial obligations, or mandatory cash-call obligations, courts will likely conclude that the operating agreement is not an executory contract. If it does constitute an executory contract, in the Fifth Circuit it will likely not be assumable by the Chapter 7 Trustee unless all of the non-bankrupt members agree, because the LLC is a voluntary association. See 11 U.S.C. § 365(c) and see, e.g.:

In re O’Connor, 258 F.3d 392, 402 (5th Cir. 2001) (holding that the Trustee holding the debtor’s partnership interest cannot assume a partnership agreement without the other partners’ consent).

In re Ehmman, 319 B.R. 200 (Bankr. D. Arizona, 2005)

J. Fifth Circuit Law

There is no controlling Fifth Circuit caselaw dealing directly with a Chapter 7 Trustee's liquidation of an LLC membership interest. However, see In re O'Connor, 258 F.3d 392 (5th Cir. 2001), a case dealing with the treatment of a partnership interest that was part of a Chapter 11 bankruptcy estate, where (1) the Liquidating Trustee (a person other than the Debtor/partner) could not assume the partnership agreement which was an executory contract without the other partners' consent, and (2) the Fifth Circuit held that the partnership agreement was an executory contract which could not be assumed by the Liquidating Trustee, and (3) because the Liquidating Trustee failed to sue to recover the economic value of the Debtor's interest, the Debtor's entire interest in the partnership passed through to him and not the Liquidating Trustee. In re O'Connor, 258 F.3d at 403-405. While this case does not foreclose the possibility that the Fifth Circuit would permit a Chapter 7 Trustee to force a liquidation of an LLC's assets in order to potentially maximize the bankruptcy estate's recovery of the Debtor's economic interest, this case does indicate a respect for the non-debtor partners' (or members') rights.

K. Query: Can the Non-Debtor Members of an LLC Enforce a Dissolution Clause Triggered by the Event of a Member's Chapter 7 Bankruptcy Filing?

Keeping in mind that the Fifth Circuit would frown upon a Chapter 7 Trustee attempting to assume the Debtor's position in an operating agreement against the non-debtor members' wishes, the only thing stopping the non-debtor members from dissolving the LLC would be § 541(c)(1). The question then would become whether a dissolution provision constitutes a restriction of the Trustee's interest in the membership interest or is something "that effects or gives an option to effect a forfeiture, modification, or termination of the Debtor's interest in property." Whether or not the dissolution of the LLC would have that prohibited effect on the Debtor's interest may be a question of fact, considering that the liquidation of the LLC may actually enhance the value of the Debtor's interest, to the estate's benefit.

II. LIQUIDATION OF CHAPTER 7 DEBTOR'S PARTNERSHIP INTEREST

See, e.g.:

In re Cutler, 165 B.R. 275 (Bankr. D. Ariz. 1994), where the Bankruptcy Court upheld the Chapter 7 Trustee's right to the 1/4 interest in profits and surplus corresponding to the Debtor's 25% partnership interest in a company, free and clear of the partnership agreement's provision granting the other partners the option to purchase the Debtor's interest at book value, but also holding that the Trustee could not assume the Debtor-partner's management function, nor could the Trustee compel

the sale of the partnership assets themselves.

In re O'Connor, 258 F.3d 392, 402 (5th Cir. 2001), a case dealing with the treatment of a partnership interest that was part of a Chapter 11 bankruptcy estate, where (1) the Liquidating Trustee (a person other than the Debtor/partner) could not assume the partnership agreement which was an executory contract without the other partners' consent, and (2) the Fifth Circuit held that the partnership agreement was an executory contract which could not be assumed by the Liquidating Trustee, and (3) because the Liquidating Trustee failed to sue to recover the economic value of the Debtor's interest, the Debtor's entire interest in the partnership passed through to him and not the Liquidating Trustee. In re O'Connor, 258 F.3d at 403-405.

In re Garbinski, 465 B.R. 423 (Bankr. W.D. Pa. 2012).

III. ARTICLES

1. "Can an Estate Effectively Liquidate a Fractional Interest in an LLC?", American Bankruptcy Institute Journal, October, 2015, 34-OCT Am. Bankr. Inst. J. 32
2. "Transferability of a Member's Interests - - Bankruptcy of a Member of a Limited Liability Company, 9 La. Civ. L. Treatise, LLC & Partnership Bus. & Tax Plan § 1:45 (4th ed.)
3. § 3.99, Limited Liability Company Handbook, Mark a. Sargent and Walter D. Schwidetzky.
4. "CONSUMER TRACK: Square Pegs in Round Holes: How Partnership LLC Interests are Treated in Bankruptcy", 101515 ABI-CLE 5, American Bankruptcy Institute, October 15, 2015