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## Members Only: Can a Trustee Govern an LLC When Its Member Files for Bankruptcy?

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# MEMBERS ONLY: CAN A TRUSTEE GOVERN AN LLC WHEN ITS MEMBER FILES FOR BANKRUPTCY?

*Theresa J. Pulley Radwan\**

*Limited-liability entities allow owners to limit their personal risk similar to shareholders of a corporation while enjoying the ability to operate the business more in the manner traditionally used for a partnership. These attributes have made these business forms increasingly popular business over the past few decades because they offer the best of partnership world—control and pass-through taxation—while also offering the best of corporate world—limited liability to all of its owners. But if financial problems arise for these businesses and their owners, bankruptcy may be the final option to remedy financial difficulties. The current bankruptcy code, adopted at the same time that LLCs first came into existence, has faced various issues involving these new business entities. This Article considers the ability of a bankruptcy trustee to govern an LLC when one of the members of the LLC files for bankruptcy protection.*

*When a member of an LLC files a bankruptcy case, the member's interests in the LLC transfer to the estate. These interests include the right for the member to be paid by the LLC, known as economic interests, as well as governance interests. Governance interests include the right to manage the business and non-management interests such as the right to vote or seek dissolution of the entity. The transfer of economic interests into the estate provides no risk to the non-debtor members of the LLC, and the bankruptcy code and state laws together make the debtor's economic interest in the LLC available to pay creditors. But the transfer of governance rights to the trustee violates state law and threatens the fundamental "pick your partner" principle that governs LLCs. This Article concludes that bankruptcy cases allowing the trustee to take over a member's governance rights, particularly in the context of a multi-member LLC, ignore fundamental principles of state business law and violate one of the essential aspects of the LLC—the ability for its members to choose their own managers.*

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“For as long as America has existed, the primary authority over the creation of business organizations has resided with the individual states.”<sup>1</sup> Over the past few decades, states developed new forms of businesses—particularly embracing limited-liability entities that allow owners to limit their personal risk similar to shareholders of a corporation, while enjoying the ability to operate the business more in the manner traditionally used for a partnership.<sup>2</sup> The current favorite of these business forms, the Limited Liability Company (LLC), began in Wyoming in 1977 and expanded nationwide following Delaware’s adoption of the business form in 1992.<sup>3</sup> The LLC offers the best of the partnership world—control and pass-through taxation—while also offering the best of the corporate world—limited liability to *all* of its owners.<sup>4</sup> LLCs also offer a great deal of flexibility for the owners, even allowing the elimination of some or all fiduciary duties for management.<sup>5</sup> Inevitably, financial problems arise for some of these businesses and for their owners, and bankruptcy becomes the final option to remedy financial difficulties. But bankruptcy involves layering federal law onto the state-created business entity. The current bankruptcy code, adopted at the same time that LLCs first came into existence, has faced various issues involving these new business entities. This Article considers the ability of a bankruptcy trustee to manage an LLC when one of the member-managers files for bankruptcy protection. In considering that issue, this Article also considers related issues of what rights constitute property of the estate and whether an LLC’s Operating Agreement constitutes an executory contract. This Article concludes that bankruptcy cases allowing the trustee to take over a member’s management rights, particularly in the context of a multi-member LLC, ignore fundamental principles of state business law and violate one of the essential aspects of the LLC—the ability for its members to choose their own managers.

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1. Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1484 (1998).

2. Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 AM. BANKR. L.J. 271, 281 (1997).

3. REVISED UNIF. LTD. LIAB. CO. ACT, Prefatory Note (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (noting that every state has an LLC statute, and “in many states new LLC filings approach or even outnumber new corporate filings on an annual basis”).

4. Neely, *supra* note 2, at 281 (“LLCs are hybrids—seeking to combine the best aspects of the corporation with the best aspects of the partnership.”).

5. *Id.* at 283.

A. HISTORY OF THE LIMITED LIABILITY ENTITY<sup>6</sup>

Wyoming adopted the first limited liability company statute in 1977;<sup>7</sup> Florida followed suit a few years later.<sup>8</sup> Delaware—often seen as a leader of the business world<sup>9</sup>—did not adopt a limited-liability company statute until 1992.<sup>10</sup> LLCs flourished after that time, partly because of Delaware’s adoption of LLCs and partly due to changes in

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6. While this Article focuses on the impact of a bankruptcy filing on Limited Liability Companies, many of the same principles will apply to a bankruptcy filing’s impact on a Limited Liability Partnership. Parallels to limited liability partnerships will be included within the footnotes throughout the Article.

7. WYO. STAT. ANN. § 17-15-101 (repealed 2010); Neely, *supra* note 2, at 281. The LLC statute resulted from the efforts of attorneys on behalf of Hamilton Brothers Oil Company to create a limited-liability, tax-favored entity similar to one existing in Panama. The creators first sought enactment in Alaska, but after defeat in the Alaska legislature, turned to Wyoming for enactment. Hamill, *supra* note 1, at 1463–65. Alaska and Wyoming were chosen because their smaller population made passing legislation quicker and more likely to succeed. *Id.* at 1466. Passage of the statute did not guarantee success, and it took another decade for the IRS to agree that the LLC would be taxed as a partnership. *Id.* at 1467, 1469.

8. Florida Limited Liability Company Act of 1982, ch. 82–177, House Bill No. 43, 1982 Fla. Laws 580.

9. Steven J. Cleveland, *Process Innovation in the Production of Corporate Law*, 41 U.C. DAVIS L. REV. 1829, 1832 (2008) (“Delaware is a leading producer and innovator of corporate law.”); *see also Facts and Myths*, DEL. CORP. LAW, <https://corplaw.delaware.gov/facts-and-myths/> (last visited Sept. 29, 2019) (noting that Delaware has the most publicly-traded companies and is one of the five states nationwide with the largest number of corporations overall; the other states include Florida, California, New York, and Texas). The history of corporate law and the judicial system in Delaware are often-cited reasons for Delaware’s ability to keep up with larger states in corporate filings:

Many businesses choose to incorporate in Delaware because Delaware provides a well-developed body of corporate law (applied in an efficient manner by expert judges) that makes Delaware corporations more effective creators of value. Delaware does this by permitting managers and directors to make good-faith business decisions—including taking business risks in the corporation’s best interests—as well as by policing and punishing disloyal conduct and conflicts of interest . . . . Precisely because its law is balanced and flexible, and protects investors legitimate interests, Delaware is the U.S. domicile favored both by most investors in and most managers of American public companies.

*Id.* (citations omitted). Delaware’s reputation has suffered some in recent years. In 2017, the Institute for Legal Reform dropped Delaware from its long-standing number one ranking on fairness of its litigation system to number eleven. INST. FOR LEGAL REFORM, 2017 LAWSUIT CLIMATE SURVEY RANKING THE STATES A SURVEY OF THE FAIRNESS AND REASONABLENESS OF STATE LIABILITY SYSTEMS 29–30 (2017), <https://www.instituteforlegalreform.com/uploads/pdfs/Harris-2017-Executive-Summary-FINAL.pdf>. While the survey considers various aspects of litigation, the ranking largely considers business litigation in its Delaware figures due to the prevalence of business litigation in that state.

10. While Delaware has its own statutes governing LLCs and LLPs, this Article focuses on the UNIF. LTD. LIAB. CO. ACT (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2013). Delaware has similar, but not identical, provisions for these types of business entities. DEL. CODE ANN. tit. 6, ch. 15 (2013); DEL. CODE ANN. tit. 6, § 18-703(d) (2013).

the tax treatment of these new businesses.<sup>11</sup> Some states initially required that an LLC have more than one member, but today states generally permit single-member LLCs.<sup>12</sup>

For many, LLCs provide a perfect business organization in which owners can shield themselves from personal liability for business debts while enjoying pass-through taxation<sup>13</sup> and flexibility in the standards governing the business.<sup>14</sup> When limited-liability entities first became popular, the Internal Revenue Service (IRS) focused on four business identities in determining whether to allow the entity pass-through taxation: continuity of existence, management structure,

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11. Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, 1 n.1 (1997) (citing Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 428 n.227 (1995)) (noting that from 1992 through 1996, the country went from having five states with LLC statutes to fifty states and the District of Columbia). LLCs have become the most filed form of new business in Delaware. From 2013–2015, for example, roughly three times as many LLCs were filed in Delaware when compared to new corporations filed in Delaware. JEFFREY W. BULLOCK, DEL. SEC’Y OF STATE, DELAWARE DIVISION OF CORPORATIONS 2015 ANNUAL REPORT 2 (2015), [https://corpfiles.delaware.gov/Corporations\\_2015%20Annual%20Report.pdf](https://corpfiles.delaware.gov/Corporations_2015%20Annual%20Report.pdf) (108,967 corporations filed versus 358,803 LLCs).

12. Herrick K. Lidstone, Jr., *Single-Member LLCs and Asset Protection*, COLO. LAW., Mar. 2012, at 39, 39 (noting risk that assets of an LLC may be foreclosed upon to satisfy a judgment against the sole member of a single-member LLC, referring to the practice as “reverse piercing”). At the time that LLCs developed, Limited Liability Partnerships (LLPs) also gained popularity. Texas adopted the first LLP statute in 1991. M. Shaun McGaughey, *Limited Liability Partnerships: Need Only Professionals Apply?*, 30 CREIGHTON L. REV. 105, 106 n.6 (1996). The Texas statute allowed partnerships that would otherwise be general partnerships to become limited liability entities upon registration as such. N. Scott Murphy, Note, *It’s Nothing Personal: The Public Costs of Limited Liability Law Partnerships*, 71 IND. L.J. 201, 205 (1995). Though limited partnerships already existed, they required at least one general partner with personal liability for partnership obligations and did not allow limited partners to help manage the business. *Id.* at 210. LLPs, on the other hand, allowed limited liability for all owners, while allowing the owners to participate in management of the partnership. *Id.* As LLP statutes spread across the country, professional organizations became a significant user of this business form. *Id.* at 208. LLCs and LLPs share many attributes, but single-member LLPs are generally not permitted. *See* UNIF. P’SHIP ACT § 801(6) (NATL. CONF. OF COMM’RS ON UNIF. STATE LAWS 2013) (requiring dissolution of a partnership after ninety days when there are fewer than two partners). The vast majority of states adopted the UPA in some form. *Enactment Map, 1997 Partnership Act*, UNIF. LAW COMM’N, <https://www.uniformlaws.org/committees/community-home?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44> (last visited Sept. 29, 2019).

13. Corporations face a “two-tier” taxation system in which both the business and owners face tax liability on the distributions made by the business. Hamill, *supra* note 1, at 1460–61. However, partnership-like “flow-through” taxation does not always yield the optimum result, particularly in the event of low corporate tax rates and higher individual tax rates. *See* Hamill, *supra* note 1, at 1509–12 (discussing mid-twentieth century tax structure and how some businesses benefitted by being treated as corporations for tax purposes).

14. Thompson, *supra* note 11, at 3.

transferability of ownership, and limited liability.<sup>15</sup> While the LLC enjoyed corporate-like management structure (in some cases) and limited liability, it mirrored a partnership in its lack of continuity<sup>16</sup> and lack of transferability (as well as in some of its management structure).<sup>17</sup> That led to uncertainty as to whether to treat the entities as a corporation (with double taxation) or as a partnership (with pass-through taxation).<sup>18</sup> Today, the IRS operates under “check-the-box” rules that allow free selection of the partnership or corporate taxation structure for many types of business entities, including LLCs.<sup>19</sup>

The National Conference of Commissioners on Uniform State Laws adopted its first Limited Liability Company Act in 1996 and

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15. Treas. Regs. No. 33, art. 57, 62 (1921). Originally, limited liability was the only consideration that mattered to the IRS. Hamill, *supra* note 1, at 1504 (citing Treas. Regs. No. 33, art. 86 (1914)); *see* Treas. Regs. No. 45, art. 1505 (1921) (together providing that businesses in which *all* owners enjoyed limited liability would be taxed as corporations). That eventually shifted, such that continued existence and free transferability of ownership became more relevant factors. Hamill, *supra* note 1, at 1505 (citing Treas. Regs. 103, art. 19.3797-5 (1940)).

16. This lack of continuity comes from a presumption that the LLP or LLC will cease to exist upon the happening of specified events, or that a member or partner will cease to be part of the business entity upon certain events. A member or partner is presumed to be involuntarily dissociated from the LLC if, *inter alia*, the Operating Agreement provides for dissociation upon the occurrence of certain events, the LLC can no longer lawfully engage in business with that member/partner in place, the member/partner transfers all of its interest in the LLC, the member/partner dies, or the member/partner files for bankruptcy. REVISED UNIF. LTD. LIAB. CO. ACT § 602 (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006); UNIF. P'SHIP ACT § 601 (NATL. CONF. OF COMM'RS ON UNIF. STATE LAWS 2013). The LLC or LLP itself can be dissolved if, *inter alia*, the Operating or Partnership Agreement provide that a particular event will cause dissolution, or upon the vote of the requisite percentage of LLC members. REVISED UNIF. LTD. LIAB. CO. ACT § 701 (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006); UNIF. P'SHIP ACT § 801 (NATL. CONF. OF COMM'RS ON UNIF. STATE LAWS 2013).

17. Hamill, *supra* note 1, at 1473 (citing Rev. Rul. 88-76, 1988-2 C.B. 360).

18. *Id.* at 1467–69 (noting “conflicting views . . . among IRS officials”).

19. Corporations may not elect partnership taxation. Treas. Reg. § 301.7701-3(a)–(b) (2018); Treas. Reg. § 301.7701-2(b) (2018).

implemented significant changes in 2006<sup>20</sup> and 2011.<sup>21</sup> It has been adopted by nineteen states.<sup>22</sup> The 2011 (and 2013) amendments arose as part of the Harmonization of Business Entities Project and were designed to ensure coherence among the various statutes regarding unincorporated business entities.<sup>23</sup> The Uniform Limited Liability Company Act repeatedly recognizes its connection to the Uniform Partnership Act, and the need for consistency to the extent that the two

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20. The Uniform Law Commission identified the following as the primary changes from the Uniform Limited Liability Company Act of 1996 to the 2006 Act:

1. Election of status as member-managed or manager-managed occurs via the Operating Agreement rather than the certificate of organization.
2. LLCs may be used by non-profit entities.
3. Additional default rules dictating the relationship between the various members and managers are included.
4. The LLC has more flexibility in determining its own management structure.
5. Traditional fiduciary duties of corporations are included, but the Act allows modification or elimination of some of the duties if not unreasonable.
6. An LLC may be formed without a member, making it available for future use.
7. Agency concepts control whether the actions of members or managers bind the LLC.
8. The remedy allowing creditors a “charging order” against the LLC to satisfy a member’s debts is expounded upon; in particular, it “makes it absolutely clear that a purchaser of a foreclosed interest only obtains financial rights and does not become a member of the LLC by virtue of the foreclosure.”
9. Distributions to members are clarified and remedies added for inappropriate distributions.
10. A company may be dissolved in the event of oppression by managers or controlling members of the LLC.
11. Allowance of direct and derivative actions, as well as the possibility of a special litigation committee to consider the appropriateness of derivative claims.
12. Guidance for mergers and conversions into LLCs or from an LLC into another business form.

*Why Your State Should Adopt the Uniform Limited Liability Company Act (ULLCA) (2006) (Last Amended 2013)*, UNIF. LAW COMM’N,

<https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=83400262-b688-9311-9766-a07431bfec26&forceDialog=0> (last visited Sept. 29, 2019).

21. REVISED UNIF. LTD. LIAB. CO. ACT, Prefatory Note (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006); *Uniform Limited Liability Company Act (2011)*, UNIF. LAW COMM’N, <https://www.uniformlaws.org/committees/community-home?CommunityKey=bbea059c-6853-4f45-b69b-7ca2e49cf740> (last visited Sept. 29, 2019). The National Conference of Commissioners adopted the first Uniform Partnership Act including provisions regarding Limited Liability Partnerships in 1997, with significant changes in 2011. UNIF. P’SHIP ACT (NATL. CONF. OF COMM’RS ON UNIF. STATE LAWS 2013).

22. *Uniform Limited Liability Company Act (2011)*, *supra* note 21 (noting adoption in Washington, California, Idaho, Utah, Arizona, Wyoming, North Dakota, South Dakota, Nebraska, Minnesota, Iowa, Illinois, Alabama, Florida, Pennsylvania, New Jersey, Connecticut, Vermont, and Washington D.C., with introduction in South Carolina).

23. UNIF. LTD. LIAB. CO. ACT (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2013). The end product of this harmonization product became the UNIF. BUS. ORGS. Code (NATL. CONF. OF COMM’RS ON UNIF. STATE LAWS 2015).



entities mirror each other.<sup>24</sup> Bankruptcy courts have considered the issue of how to handle both partnership interests in an LLP and membership interests in an LLC. Given the similarity of the two business forms, it makes sense that the courts struggle with the intersection of state law with the bankruptcy code for both types of business entity. While this Article focuses on members of LLCs filing for bankruptcy protection, the same issues can also arise in the context of partners of an LLP filing a bankruptcy case.<sup>25</sup>

## B. CREATION AND ORGANIZATION OF AN LLC

### 1. Formation

Limited Liability Companies generally take one of two forms—the members (owners) of the LLC manage them,<sup>26</sup> or the members select managers<sup>27</sup> (who may also be members) to run the business.<sup>28</sup> By default, the members manage an LLC,<sup>29</sup> and each member can bind

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24. See, e.g., UNIF. LTD. LIAB. CO. ACT, Prefatory Note (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006); *infra*, text accompanying note 53.

25. See Neely, *supra* note 2, at 271–324 (1997).

26. The most current revisions to the Uniform Act refer to these as “member-managed” LLCs. REVISED UNIF. LTD. LIAB. CO. ACT § 102(12) (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006).

27. See *id.* § 407(c). The 2006 Act departs significantly from prior versions and many state laws in allowing a company to designate itself as manager-managed in the Operating Agreement rather than in a publicly filed document. *Id.* § 102 cmt. ¶ 10.

28. *Id.* § 407(a). The 2006 Act provides for a variety of ways to indicate management by managers: “manager-managed,” “managed by manager,” “management . . . ‘vested in managers,’” or the like. *Id.*

29. *Id.* § 102(12).

the LLC.<sup>30</sup> An LLC is formed by filing a Certificate of Organization<sup>31</sup> with the appropriate entity—typically the Office of the Secretary of State.<sup>32</sup> The filing provides the requisite notice to the world that the owners of the entity enjoy limited liability for the debts of the business organization.<sup>33</sup>

Members join a newly formed LLC in the manner explained in the Operating Agreement or with the consent of all remaining members.<sup>34</sup> Members of a member-managed LLC owe various fiduciary duties to the company, including the duty of loyalty—which prohibits self-dealing or benefitting at the expense of the LLC.<sup>35</sup> These fiduciary duties apply to the managers in a manager-managed LLC.<sup>36</sup>

The Operating Agreement of an LLC operates as a contract,<sup>37</sup> allowing the members of the LLC tremendous flexibility to set up the LLC in a manner that best meets their collective and individual needs. The Operating Agreement “governs: (1) relations among the members as members and between the members and the limited liability company; (2) the rights and duties . . . of a . . . manager; [and] (3) the

30. This qualifies as apparent authority because third parties would reasonably assume such authority based upon the statute and the relationship between the member and the LLC. *Id.* § 301 cmt. (noting that the 2006 Act codifies traditional agency concepts); RESTATEMENT (THIRD) OF AGENCY § 2.03, cmt. c (AM. LAW INST. 2006) (defining apparent authority to exist when a “third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal’s manifestations,” including by placing an individual in a position that suggests authority). An individual member’s authority may be limited, and notice of that limitation may be provided to third parties by either creating an LLC not managed by the members or by filing a limitation of authority with the office that accepts the filing of the Articles of Organization. REVISED UNIF. LTD. LIAB. CO. ACT § 302(a)(3) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006). However, § 301 eliminated statutory apparent authority. *Id.* § 301(a). The change demonstrates the increasing use of managers in LLCs, which would eliminate the need for every member to hold binding authority. *Id.* § 301 cmt. (quoting Daniel S. Kleinberger, *Progress Report on the Revised Uniform Limited Liability Company Act (“ULLCA”) and the Issue of “Corpufuscation”*, 12 A.B.A. SEC. BUS. L. PUBOGRAM 2 (2006)). A member also engaged in management of the LLC can bind the LLC based on common-law agency principles. *Id.* § 301 (citing RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. b (AM. LAW INST. 2006)).

31. REVISED UNIF. LTD. LIAB. CO. ACT § 201 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006). Prior to the newest amendments to the LLC Act, Articles of Organization was used more commonly than certificates of organization. *Id.* § 102 cmt.

32. *Id.* § 201(a).

33. *Id.* § 108(a) (requiring name that provides indication of limited liability).

34. *Id.* § 401.

35. *Id.* § 409(b).

36. *Schroeder v. Pinterest Inc.*, 17 N.Y.S.3d 678, 687 (N.Y. App. Div. 2015).

37. REVISED UNIF. LTD. LIAB. CO. ACT. § 110 cmt. (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (“A limited liability company is as much a creature of contract as of statute . . .”).

activities of the company.”<sup>38</sup> The Uniform Limited Liability Company Act provides several immutable provisions that cannot be modified for any LLC,<sup>39</sup> but otherwise the Act serves as a default set of rules governing LLCs.<sup>40</sup>

## 2. *Rights of Members*

The rights of members in an LLC include *economic* rights—the right to distributions made by the company or to a share of the company’s assets upon dissolution—and *governance* rights—the default right to manage the company and the right to vote upon decisions of the company.<sup>41</sup> Operating agreements frequently limit the governance rights of a member, particularly the right to help manage the company. One of the more notable changes in the 2006 Uniform Limited Liability Company Act (still in existence in later versions of the Act) allows members with voting and/or management interests in the company but *without* a right to the economic distributions from the company.<sup>42</sup> Prior to the 2006 change, the Uniform Limited Liability Company Act presumed that any member would have an economic, or “distributional” right.<sup>43</sup> Nevertheless, members usually hold economic rights and at least some governance rights in the company.

### a. How the Uniform Acts Distinguish Economic and Governance Interests

Each version of the Uniform Limited Liability Company Act distinguishes between the economic rights of a member and the governance rights of the member, and within the governance rights, the Act further distinguishes between general governance rights, such

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38. *Id.* § 110(a).

39. *Id.* § 110(c); REVISED UNIF. LTD. LIAB. CO. ACT § 105(c) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2013). Examples of un-waivable provisions include the law governing the LLC, the ability to sue and be sued, rules regarding records, modification of fiduciary duties (though they may be defined or modified in some aspects, depending on whether the state uses the 2006 or 2013 version), or modification of the bases for dissolution or winding up of the company.

40. REVISED UNIF. LTD. LIAB. CO. ACT § 110(b) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2013).

41. *Id.* § 502 cmt. (“A member’s rights in a limited liability company are bifurcated into economic rights (the transferable interest) and governance rights (including management rights, consent rights, rights to information, rights to seek judicial intervention).”).

42. *Id.* §§ 102(21), 401(e) (indicating that member does not need a transferable interest, defined as a right to economic distribution).

43. UNIF. LTD LIAB. CO. ACT, Art. V (NATL. CONF. OF COMM’RS ON UNIF. STATE LAWS 1996).

as voting and *management* rights. The 1996 Act began by defining a “distributional interest” of a member as “all of a member’s interest in distributions by the limited liability company”<sup>44</sup> and noting that a member’s *distributional* interest qualifies as personal property of the member that may be transferred.<sup>45</sup> The transferee of the interest obtained the right to distributions, but not the rights to manage the LLC, receive information, or access the records of the company.<sup>46</sup> If a member transferred *all* of his, her, or its distributional interest, or if the member filed for bankruptcy protection, the member would be dissociated from the LLC.<sup>47</sup>

The Act separately dealt with creditors seeking to collect from the member’s interest in the LLC, which, unlike a voluntary transfer of the distributional interest, would generally involve an involuntary taking of the member’s interest.<sup>48</sup> But essentially the same result ensued—the judgment creditor could take only the distribution interest (known now as economic rights) of the debtor via a charging order.<sup>49</sup> This limitation on transfer of governance interests arises from the “fundamental characteristic[] of LLC law”—the ability to select your business associates and, more importantly, those who run that business.<sup>50</sup>

The 2006 revisions to the Uniform Limited Liability Company Act largely maintained the concepts regarding transferability of a creditor’s attachment to a member’s interest, limiting that transfer or attachment to the member’s economic interest.<sup>51</sup> It expanded the definition of a transfer to include a “transfer by operation of law,”<sup>52</sup> including a reference to bankruptcy-related transfers in the comment.<sup>53</sup> The prefatory language to the Act restated the importance of limiting the transfer (voluntary or involuntary) of governance

44. UNIF. LTD LIAB. CO. ACT § 101(6) (NATL. CONF. OF COMM’RS ON UNIF. STATE LAWS 1996); *id.* at § 501, cmt. (“A distributional interest . . . is defined . . . as a member’s interest in distributions only and does not include the member’s broader rights to participate in management under section 404 and to inspect company records under section 408.”).

45. *Id.* § 501(b).

46. *Id.* §§ 502, 503.

47. *Id.* §§ 502 cmt., 601.

48. *Id.* § 504 cmt.

49. *Id.* § 504.

50. REVISED UNIF. LTD. LIAB. CO. ACT. § 502 cmt. (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

51. *Id.* § 102(21).

52. *Id.* § 102(20).

53. *Id.* § 102 cmt.

interests, noting that “[t]he charging order mechanism . . . is an essential part of the ‘pick your partner’ approach that is fundamental to the law of unincorporated businesses” and was included as early as 1914 in the Uniform Partnership Act.<sup>54</sup>

#### b. The Unusual Case of Single-Member LLCs

If a creditor seeks to collect from a member of an LLC by taking the member’s rights in the LLC, it generally does so through a charging order.<sup>55</sup> For a multi-member LLC, the charging order allows the creditor only the member’s economic rights.<sup>56</sup> The 2006 Uniform Limited Liability Company Act (the “2006 Act”) provides that “a *charging order constitutes a lien on a judgment debtor’s transferable interest*” which “provides the *exclusive remedy* by which a person seeking to enforce a judgment against a member or transferee may, in the capacity of judgment creditor, satisfy the judgment out of the judgment debtor’s transferable interest.”<sup>57</sup>

The most recent revisions to the Uniform Limited Liability Company Act (the “2011 Act”)<sup>58</sup> made several changes to the Act. One of the most significant modifications provides that a charging order against a single-member LLC may transfer the *entire*

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54. UNIF. LTD. LIAB. CO. ACT, Prefatory Note (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

55. 2 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 10.2, Westlaw (updated June 2019); *see* REVISED UNIF. LTD. LIAB. CO. ACT § 503 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (limiting cause of action to charging order for LLCs). Different states enacted different rules regarding whether charging orders serve as the *only* means to collect against a debtor’s interest in an LLC, particularly when the LLC is a single-member LLC. *See also* Robert R. Keatinge, Single Member LLCs: Now You See It, Now You Don’t – Regarding Disregarded Entities III(A)(2) (Feb. 17, 2015) (unpublished American Law Institute continuing legal education lecture materials), [https://utcle.org/conferences/PA14/get-asset-file/asset\\_id/33131](https://utcle.org/conferences/PA14/get-asset-file/asset_id/33131) (noting that Florida statutes do not make charging order sole remedy for single-member LLCs, but Delaware, Nevada, and Wyoming make it the sole remedy regardless of the number of members in the LLC).

56. But even in a multi-member LLC, the creditor may be able to sell the member’s LLC interest to collect on the debt. *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 503(c) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (“Upon a showing that distributions under a charging order will not pay the judgment debt within a reasonable time, the court may foreclose the lien and order the sale of the transferable interest.”).

57. *Id.* § 503 (emphasis added).

58. The Uniform Law Commission drafted the Revised Uniform Limited Liability Company Act of 2006 and amended it in 2011 and 2013. REVISED UNIF. LTD. LIAB. CO. ACT § 503 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006); REVISED UNIF. LTD. LIAB. CO. ACT § 503 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2011); REVISED UNIF. LTD. LIAB. CO. ACT § 503 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2013).

membership interest of the debtor—including governance interests.<sup>59</sup> The most recent version of the 2011 Act modified the section regarding charging orders to include the following language:

- (f) If a court orders foreclosure of a charging order lien against the sole member of a limited liability company:
- (1) the court shall confirm the sale;
  - (2) the purchaser at the sale obtains the member’s entire interest, not only the member’s transferable interest;
  - (3) the purchaser thereby becomes a member; and
  - (4) the person whose interest was subject to the foreclosed charging order is dissociated as a member.<sup>60</sup>

While no similar provision exists providing that, in a single-member LLC, a *voluntary* transfer of an interest includes the non-economic interests of the member,<sup>61</sup> because the non-economic interests can be transferred by consent of the entire membership,<sup>62</sup> and the single-member LLC includes just one member, that member can voluntarily transfer both an economic and non-economic interest. Thus, under the most recent revisions of the Uniform Act, in a single-member LLC, either the voluntary transfer of the member’s interest or the involuntary transfer of the interest via a charging order results in a transfer of both the economic and governance rights in the LLC.

The need to limit the ability to transfer governance interests in a multi-member LLC does not exist in a single-member LLC. As the drafters noted, the charging order remedy exists only to protect the *other* members of an LLC:

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59. REVISED UNIF. LTD. LIAB. CO. ACT § 503(f) cmt. (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (charging order “inapposite when a limited liability company has only one member. The exclusivity of the charging order remedy was never intended to protect a judgment debtor, but rather only to protect the interests of the judgment debtor’s co-owners.”).

60. REVISED UNIF. LTD. LIAB. CO. ACT § 503 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2011).

61.

[A] transfer, in whole or in part, of a transferable interest . . . does not entitle the transferee to: (A) participate in the management or conduct of the company’s activities and affairs; or (B) except as otherwise provided in subsection (c), have access to records or other information concerning the company’s activities and affairs.

REVISED UNIF. LTD. LIAB. CO. ACT. § 502 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

62. *Id.* § 102 cmt. (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006) (“Absent a contrary provision in the Operating Agreement or the consent of the members, a ‘transferable interest’ is the only interest in an LLC which can be transferred to a non-member.”).

The charging order remedy—and, more particularly, the exclusiveness of the remedy—protects the “pick your partner” principle.<sup>63</sup> That principle is inapposite when a limited liability company has only one member. The exclusivity of the charging order remedy was never intended to protect a judgment debtor, but rather only to protect the interests of the judgment debtor’s co-owners.

Put another way, the charging order remedy was never intended as an “asset protection” device for judgment debtors. . . . Accordingly, when a charging order against an LLC’s sole member is foreclosed, the member’s entire ownership interest is sold and the buyer replaces the judgment debtor as the LLC’s sole member.<sup>64</sup>

Like the 2006 and 2011 versions of the Uniform Limited Liability Company Act, the states differ in their approaches to transfer of or collection upon non-economic interests of the member of a single-member LLC. Most states simply provide that a charging order constitutes the exclusive remedy for a creditor to collect a member’s interest against an LLC and that a charging order provides only the member’s economic interest.<sup>65</sup> A handful of states expressly provide

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63. *Id.* § 503 cmt. f. Though this provision focuses on the charging order remedy for creditors, the comments regarding nontransferability of the member’s non-economic interest stress the same principal. *Id.* § 502 cmt. (“One of the most fundamental characteristics of LLC law is its fidelity to the ‘pick your partner’ principle . . . . This section is the core of the act’s provisions reflecting and protecting that principle.”).

64. *Id.* § 503 cmt. f.

65. CAL. CORP. CODE § 17705.03(f) (2014); 805 ILL. COMP. STAT. 180/30-20(e) (1993); IOWA CODE § 489.503(7) (2008); MINN. STAT. § 322C.0503(7) (2018); NEB. REV. STAT. § 21-142(g) (2010); N.J. STAT. ANN. § 42:2C-43 (West 2014) (including a specific note that the statute will not “be construed to affect in any way the rights of a judgment creditor of a member under federal bankruptcy or reorganization laws”); OHIO REV. CODE ANN. § 1705.19(b) (West 2012); TEX. BUS. ORGS. CODE ANN. § 101.112(d) (West 2009); see 2 RIBSTEIN & KEATINGE, *supra* note 55, at § 19.4 (noting split among states regarding availability of remedies other than charging order); see also Carter G. Bishop, *Fifty State Series: LLC Charging Order Statute Table* (Jan. 31, 2019) (Legal Studies Research Paper Series, Research Paper, No. 10-03), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1542244](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1542244) (indicating that more than half of states do not distinguish between single- and multi-member LLCs in charging order statutes, and listing eleven states that do not provide charging order as exclusive remedy for creditor collecting judgment of member against LLC) [hereinafter Bishop, *Fifty State Series: LLC Charging Order Statute Table*]. Though the statutes do not specifically provide a rule for single-member LLCs, at least one court has held that the failure to distinguish means that the state clearly intends that the charging order be the only remedy for single-member LLCs:

The Debtor cites two states (Florida and Utah) where the legislature has changed the LLC statute to expressly except single-member LLCs from the coverage of a charging-order statute’s limitation of remedies. And the Debtor cites three other states (Delaware,

that the charging order remedy constitutes the only remedy available, even for single-member LLCs,<sup>66</sup> while some state statutes provide that a charging order allows the creditor both the economic and governance rights of the member in a single-member LLC.<sup>67</sup>

### c. Policy for Limiting Transfer of Non-Economic Interests

The limitation on transferability of a member’s governance interests—either voluntarily or through a charging order—makes sense in light of the nature of businesses in which owners select each other and affirmatively choose to engage in business with each other. Unlike a corporation, in which shareholders do not manage the business and cannot bind the business,<sup>68</sup> LLC members can both manage and bind the business. Even in manager-managed LLCs, the managers are frequently also members, and the often relatively small number of members (compared to a large corporation) gives each member more say in the selection of management. As a result, the identity of the other managing members matters to every member; every member who can manage or bind the business creates risk to the

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Nevada, and Wyoming) where the legislatures amended their LLC laws to explicitly state that single-member LLCs share the same limitation of remedies as all other LLCs.

But none of this shows that Michigan’s statute is ambiguous—it is not.

*In re Dzierzawski*, 528 B.R. 397, 412 (Bankr. E.D. Mich. 2015); *see also* Carter G. Bishop, *Desiderata: The Single Member Limited Liability Company Olmstead Charging Order Statutory Lacuna*, STAN. J.L. BUS. & FIN. 222, 231–37 (2011) (discussing history of charging order in partnerships and limited liability companies) [hereinafter Bishop, *Desiderata*].

66. CONN. GEN. STAT. § 34-259b(e) (2017); DEL. CODE ANN. tit. 6, § 18-703(d) (2013); N.D. CENT. CODE § 10-32.1-45(6–7) (2017); S.D. CODIFIED LAWS § 47-34A-504(g) (2019); WYO. STAT. ANN. § 17-29-503(g) (2019); *see also* Bishop, *Fifty State Series: LLC Charging Order Statute Table*, *supra* note 65 (providing statutes for Alaska, Connecticut, Delaware, Nevada, South Carolina, South Dakota, and Wyoming). These statutes have been described as “pure asset protection” designed to shield the assets put into the LLC from the sole member’s personal debts. Lidstone, *supra* note 12.

67. D.C. CODE § 29-805.03(f) (2013); FLA. STAT. § 605.0503(5) (2019); IDAHO CODE § 30-25-503(f) (2015); N.H. REV. STAT. ANN. § 304-C:126(VI)(a) (2018); 15 PA. CONS. STAT. § 8853(f) (2017); UTAH CODE ANN. § 48-3a-503(6) (LexisNexis 2014); VT. STAT. ANN. tit. 11, § 4074(g) (2017); *see also* Olmstead v. F.T.C., 44 So.3d 76 (Fla. 2010) (allowing conveyance of governance interests to creditor for single-member LLC); Bishop, *Fifty State Series: LLC Charging Order Statute Table*, *supra* note 65 (providing statutory citations for LLC charging orders in all states).

68. MODEL BUS. CORP. ACT § 8.01(b) (AM. BAR ASS’N, 2017) (vesting power to manage corporate affairs to board of directors); 19 C.J.S. *Corporations* §§ 673–75 (2019) (discussing ability of officers, directors, and employees of company to bind company through traditional agency principles).



economic interest of other members. But with a single-member LLC, no other member who warrants such protection exists.<sup>69</sup>

### C. BANKRUPTCY AND THE ROLE OF THE TRUSTEE

In most bankruptcy cases, the court appoints a trustee to manage the bankruptcy estate.<sup>70</sup> The exception occurs in chapter 11 cases, in which a “debtor in possession” typically manages the estate.<sup>71</sup> The trustee serves as a representative of the bankruptcy estate.<sup>72</sup> The duties of the trustee differ by chapter, but generally involve collecting, managing, and disbursing property of the estate.<sup>73</sup> The trustee may also run the debtor’s business unless the court orders otherwise.<sup>74</sup>

#### 1. *Property of the Estate in Bankruptcy*

The bankruptcy code provides that any “legal or equitable” interests of the debtor “as of the commencement of the case” become property of the estate.<sup>75</sup> Property of the estate has always been defined and interpreted broadly.<sup>76</sup> The bankruptcy code does not indicate the property in which the debtor holds such rights; rather, that determination comes generally from state law.<sup>77</sup> Thus, a debtor’s membership interest in an LLC becomes property of that debtor’s bankruptcy estate—potentially including the ability of the trustee to manage that property—to the extent that *state* law provides that the debtor holds a legal or equitable interest in that membership interest at the moment that the debtor files for bankruptcy protection. Further, the bankruptcy code invalidates most provisions (whether by law or

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69. The lack of need for protection of other members does not mean that others would be unaffected. For example, consider a scenario where one single-member LLC is, in turn, a member in another multi-member LLC. In that case, replacing the member of the single-member LLC with a creditor of the single member means that the creditor would essentially become a member (not in name, but through the single-member LLC that it now controls) of the multi-member LLC.

70. 11 U.S.C. §§ 701, 1302 (2012).

71. The debtor becomes the debtor in possession, *id.* § 1101(1), but takes on most of the rights and duties of a bankruptcy trustee, *id.* § 1107(a). A trustee can be appointed for cause or in the best interest of the creditors. *Id.* § 1104(a). Appointment of a trustee eliminates the role of the debtor in possession. *Id.* § 1101(1).

72. *Id.* § 323(a).

73. *Id.* §§ 707, 1106, 1202, 1302.

74. *Id.* §§ 721, 1108, 1203, 1304.

75. *Id.* § 541(a)(1) (emphasis added).

76. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204–05 (1983) (noting that legislative history indicated intent for broad definition).

77. *Milford Power Co. v. PDC Milford Power, LLC*, 866 A.2d 738, 756 (Del. Super. Ct. 2004) (citing *Butner v. United States*, 440 U.S. 48, 54 (1979)).

contract) that limit the debtor’s ability to transfer its legal or equitable interest as a result of a bankruptcy filing.<sup>78</sup>

Clearly, a member’s economic interest in an LLC qualifies as property of the estate.<sup>79</sup> In fact, the Revised Uniform Limited Liability Company Act (the “LLC Act”) expressly provides that “[a] transferable interest is private property.”<sup>80</sup> A transferrable interest includes the member’s economic interest.<sup>81</sup> The member holds a legal interest in his or her economic interest, and that interest remains unchanged unless the member transfers it to another person or a court issues a charging order against it. The challenge comes in determining whether a member’s *governance* interests in an LLC qualify as property of the estate. On the one hand, the member enjoys the ability to exercise governance just before the bankruptcy filing, suggesting some type of non-economic right that can then be considered a property interest. In fact, that ability to govern the LLC relates so closely to that member that it generally *cannot* be transferred—voluntarily or through a charging order.<sup>82</sup> But that very inability to transfer the interest leads to disagreement regarding whether these governance interests continue to be property belonging to the debtor at the moment of the bankruptcy filing and whether those governance rights can be passed to the bankruptcy trustee because the statutes dissociate members upon a bankruptcy filing. “These statutes in essence function as state law ipso facto provisions; the policy behind them is that LLC members should not be required to include in their company a trustee or an assignee of the debtor’s interest against their will.”<sup>83</sup>

The member’s governance rights in an LLC terminate at the moment of a bankruptcy filing. The LLC Act provides that “[a] person is dissociated as a member when . . . in a member-managed limited

78. 11 U.S.C. § 541(c)(1) (“[A]n interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . that restricts or conditions transfer of such interest by the debtor . . .”).

79. See *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708 (Bankr. E.D. Va. 2000) (“There is no question that the economic rights, that is the membership interest, becomes property of the estate.”).

80. REVISED UNIF. LTD. LIAB. CO. ACT § 501 (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

81. *Id.* § 102(21).

82. See discussion, *supra* Section B(2).

83. Jay Lawrence Westbrook & Kelsi Stayart White, *The Demystification of Contracts in Bankruptcy*, 91 AM. BANKR. L.J. 481, 522 (2017).

liability company, the person (A) becomes a debtor in bankruptcy.”<sup>84</sup> Dissociation ends the member’s “right to participate *as a member* in the management and conduct” of the business.<sup>85</sup> While the LLC Act only expressly provides that a member holds a right to its transferrable (e.g., economic) interest,<sup>86</sup> this dissociation provision suggests the existence of a state-law right to the governance of an LLC—a right then taken away upon dissociation.

In order for the governance rights of a member of an LLC to be property of the estate, one of two scenarios must occur. Either the debtor must hold the right at commencement of the case, or the provision taking that right away from the debtor at commencement of the case must be invalidated. Given that state law removes any right to non-economic interests of the debtor<sup>87</sup> at the moment of commencement, it is not clear that the debtor enjoys such a right at commencement, even if the debtor clearly *had* such a right milliseconds earlier. Courts seem to presume that the debtor would not enjoy a right at commencement of the case under state law and instead tend to focus on the validity of states’ attempts to remove that right as a result of a bankruptcy filing. The bankruptcy code, 11 U.S.C. § 541(c)(1), provides that:

an interest of the debtor in property becomes property of the estate under subsection (a)(1)<sup>88</sup> . . . of this section

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84. REVISED UNIF. LTD. LIAB. CO. ACT § 602(8)(A) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

85. *Id.* § 603(a)(1) (emphasis added).

86. *Id.* § 501.

87. *Id.* § 603(a)(1).

88. 11 U.S.C. § 541(c) (2012). The invalidation provisions of § 541(c) only apply to interests brought into the estate under certain subsections of § 541(a). That distinction leads to inconsistent results regarding state law LLC provisions. *Waldron v. Huber (In re Huber)*, No. 11-41013, 2013 WL 6184972, (Bankr. W.D. Wash. Nov. 25, 2013), involved two Alaskan LLCs owned by a majority-member LLC and a minority-member family trust. The majority-member LLC (DGH, LLC) was owned by a different self-settled family trust created by the bankruptcy debtor. *Id.* at \*1. The issue involved the propriety of pre-petition transfers made by the debtor into the self-settled trust, and whether those transfers could be undone as fraudulent transfers in order to return the funds to the debtor’s bankruptcy estate. *Id.* If the assets of the trust fell within the bankruptcy estate, the trustee would arguably be the managing member of DGH, LLC, with a corresponding majority interest in the two Alaskan LLCs. *Id.* The court did, indeed, find that the pre-petition transfers qualified as fraudulent transfer, such that the trustee took an interest in DGH, LLC as property of the estate. *Id.* The minority members of the Alaskan LLCs then argued that the Operating Agreements for those LLCs terminated the management and voting rights of the majority member upon a bankruptcy filing because the transfer of DGH, LLC from the debtor to the bankruptcy estate equated to a change of ownership that under the Operating Agreement terminated voting and management rights. *Id.* at \*4. The trustee responded that § 541(c)(1)(A) invalidates those terms. *Id.*

notwithstanding any provision in an agreement . . . 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 . . . .<sup>89</sup>

This provision brings property into the estate that appears not to be part of the estate because the debtor lacks any interest in the property at the moment of filing. To the extent that state law or a contractual provision eliminates the debtor’s property interest solely as a result of the debtor’s bankruptcy filing, this section invalidates the state law or contractual provision, thus allowing the property to become part of the estate.

#### a. Multi-Member LLCs

Several courts hold that § 541(c)(1) means that a member’s governance interests qualify as property of the estate because the bankruptcy code disregards provisions in state law or in Operating Agreements invalidating those interests.<sup>90</sup> For example, *Cardiello v. United States (In re Garbinski)*<sup>91</sup> involved three LLC membership

at \*1. The court disagreed because § 541(c)’s restriction on bankruptcy ipso facto clauses only applies when the property comes into the estate under § 541(a)(1), (2), or (5). *Id.* at \*2. In this case, the property joined the estate through § 548’s fraudulent transfer provisions and § 541(a)(3) and (4), which bring recovered property into the estate. *Id.* at \*2–3. As a result, had the debtor *not* engaged in a fraudulent transfer and the property entered the estate simply by being property of the debtor at the time of filing, the ipso facto provision could have been invalidated. But because the debtor transferred it out of the estate and the trustee recovered it for the estate, the ipso facto provision remained intact! Even so, while the court allowed the ipso facto provision to remain intact, the court held that the transfer of the debtor’s interest to the bankruptcy estate did not meet the definition of a qualifying transfer in the Operating Agreements and, thus, did not cancel the voting and management rights of the debtor in the Alaskan LLCs. *Id.* at \*4.

89. 11 U.S.C. § 541(c)(1).

90. See *In re Baldwin*, 463 B.R. 142 (B.A.P. 10th Cir. 2006); *In re LaHood*, 437 B.R. 330 (C.D. Ill. 2010); *Duncan v. Dixie Mgmt. & Inv., Ltd. Partners (In re Dixie Mgmt. & Inv., Ltd. Partners)*, 474 B.R. 698 (Bankr. W.D. Ark. 2011); *In re Daugherty Constr., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995); *Caymus Ventures, LLC v. Jundanian (In re Jundanian)*, No. 10-21513-TJC, 2012 WL 1098544 (Bankr. D. Md. Mar. 30, 2012); *In re Ellis*, No. 10-16998-AJM-7A, 2011 WL 5147551 (Bankr. S.D. Ind. Oct. 27, 2011). One case provided a particularly interesting result. *In re H & W Food Mart, LLC*, involved a bankruptcy filing by a member of the LLC before the LLC itself filed for bankruptcy. 461 B.R. 904, 908–09 (Bankr. N.D. Ga. 2011). The member who filed for bankruptcy was one of the LLC members who voted to authorize the LLC’s filing; the trustee argued that the law dissociated the member and, thus, the debtor could not vote on the LLC’s bankruptcy filing. *Id.* The court upheld the provision of Georgia law dissociating the member from the LLC upon his bankruptcy filing, but then held that the member’s governance rights became part of the bankruptcy estate. *Id.* Thus, the member held an interest and the right still transferred into the estate, making the estate the proper party to vote on the LLC’s bankruptcy filing. *Id.*

91. 465 B.R. 423 (Bankr. W.D. Pa. 2012).

interests owned by one of the joint debtors.<sup>92</sup> The bankruptcy trustee sought to sell the debtor's interest in each of the LLCs to the other primary owner of the companies, who had been running the companies for over a year.<sup>93</sup> The court focused on § 541(c)(1)'s invalidation of state law, holding that the trustee could assume *all* rights of the debtor, including the governance rights and sell the debtor's interest, or even dissolve the LLC.<sup>94</sup> *Sherron Associates Loan Fund XXI (Lacey) L.L.C. v. Thomas (In re Parks)*<sup>95</sup> involved a multi-member LLC that filed for chapter 11 bankruptcy protection; its members also filed for bankruptcy protection individually after the LLC's creditors sued the members under a guaranty of the LLC's debts.<sup>96</sup> The creditors included the debtor's sister, who reached a settlement with the LLC.<sup>97</sup> Another creditor argued that the settlement constituted a preferential transfer to an insider recoverable by the estate.<sup>98</sup> In construing Washington law regarding insiders, the court needed to determine whether the debtors continued to hold any interests in the LLC upon their bankruptcy filings, which required a determination of whether to dissociate a member upon a bankruptcy filing.<sup>99</sup> The court, focusing on § 541(c)(1), held that the trustee takes all of the debtor's rights—including governance rights.<sup>100</sup> Because the debtor was not dissociated from the LLC by the bankruptcy filing, his sister qualified as an insider of the LLC.<sup>101</sup> The Ninth Circuit Bankruptcy Appellate Panel considered how to treat an LLC in bankruptcy in *Fursman v. Ulrich (In re First Protection, Inc.)*,<sup>102</sup> a case frequently cited by other courts.<sup>103</sup> The Fursmans transferred a 50 percent interest in Redux Development, LLC to Ms. Fursman's mother post-petition.<sup>104</sup> When

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92. *Id.* at 424.

93. *Id.*

94. *Id.* at 426–27.

95. 503 B.R. 820 (Bankr. W.D. Wash. 2013).

96. *Id.* at 823–24.

97. *Id.* at 823.

98. *Id.* at 825.

99. *Id.* at 831–32.

100. *Id.* at 832.

101. *Id.* at 833–34.

102. 440 B.R. 821 (B.A.P. 9th Cir. 2010).

103. *See, e.g., In re B & M Land & Livestock, LLC*, 498 B.R. 262, 266–68 (Bankr. D. Nev. 2013); *In re Pickel*, 487 B.R. 289, 292 (Bankr. D.N.M. 2013); *In re Parks*, 503 B.R. 820, 832 (Bankr. W.D. Wash. 2013); *Cardiello v. United States (In re Garbinski)*, 465 B.R. 423, 427 (Bankr. W.D. Pa. 2012); *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 648–50 (Bankr. N.D.W. Va. 2012); *Nw. Wholesale, Inc. v. Pac Organic Fruit LLC.*, 357 P.3d 650, 657–59 (Wash. 2015).

104. *In re First Prot., Inc.*, 440 B.R. at 824.

their bankruptcy case converted into chapter 7, the trustee sought to recover the transfer for the benefit of the Fursmans' creditors, which required a determination of what interests passed to the estate upon the bankruptcy filing.<sup>105</sup> In considering what becomes property of the estate pursuant to § 541, whether governance rights qualified as property rights that the trustee could take became the primary issue.<sup>106</sup> The court determined that all rights of the debtor transferred to the trustee because the code prevailed over any state law provisions limiting the transfer of those rights.<sup>107</sup> Each of these cases mirrors the result in partnership cases, where the governance rights of partners transfer to the estate despite state law professing otherwise.<sup>108</sup> But in each of these cases, the governance rights sought to be transferred did *not* clearly include an attempt by the trustee to actually run the LLC. Instead, the determination focused on the ability of the trustee to engage in other governance functions, such as selling the debtor's interest in the company, or recovering money for the estate's benefit.

These cases fail to recognize that state law might not deem *all* governance rights to be part of the member's property interest in the LLC. For example, Virginia's statute provides that a membership interest includes "a member's share of the profits and the losses of the limited liability company and the right to receive distributions of the limited liability company's assets."<sup>109</sup> Using that statute, the *In re Garrison-Ashburn, L.C.*<sup>110</sup> court held that generally rights of the debtor indeed transferred into the bankruptcy estate, and that dissociation provisions in state law that took those rights away from the debtor upon a bankruptcy filing could not be enforced.<sup>111</sup> However, though the debtor remained a member, thanks to the invalidation of the ipso facto provision, state law providing that any *management* rights that debtor held in the LLC would not be assignable without the permission of other members still governed

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105. *Id.* at 828.

106. *Id.* at 829.

107. *Id.* at 830.

108. *See, e.g., In re Johnson*, 565 B.R. 835, 841 (Bankr. S.D. Ohio 2017) (holding that governance rights of partners transfer to the estate even though state law provides otherwise).

109. *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 704 (Bankr. E.D. Va. 2000) (quoting VA. CODE ANN. § 13.1-1002 (2001)).

110. 253 B.R. 700, 704 (Bankr. E.D. Va. 2000).

111. *In re Garrison-Ashburn*, 253 B.R. at 707–08.

those rights.<sup>112</sup> Thus, the *Garrison-Ashburn* court distinguished between governance rights that could be transferred under state law (such as a right to vote as a member) and governance rights that could not be transferred under state law (management of the company). Other courts similarly limit the transfer of a debtor-member's management rights. *Grochocinski v. Campbell (In re Campbell)*<sup>113</sup> held that a provision in Illinois law, mandating that managers be selected by members, meant that the right to manage the LLC could not be a transferable property interest under state law and, thus, did not qualify as property of the estate under § 541(a).<sup>114</sup> The Supreme Court of Washington went one step further and limited the transfer of all governance rights when it considered its LLC member-dissociation law.<sup>115</sup> *Northwest Wholesale Inc. v. Pacific Organic Fruit LLC* involved a multi-member LLC in which the debtors held a non-management membership interest.<sup>116</sup> In deciding that § 541(c)(1) did not invalidate Washington law, the court referred to prior cases, noting that “*Garrison-Ashburn* reconciled the application of both state law and the federal bankruptcy code by recognizing and applying the rule that state law defines the debtor’s interest, including dissociation, then § 541 brings that interest into the debtor’s bankruptcy estate *burdened by whatever state law requires.*”<sup>117</sup> Put differently, the bankruptcy code provisions bringing property into the estate is necessarily limited by the state law determination of that property interest. To the extent that other cases decided differently, the court disagreed with them, critiquing an “expansive use of § 541(a) to *define* a debtor’s interest,”<sup>118</sup> and distinguishing them as cases involving single-member LLCs, in which no other members remained to be protected by the state statute,<sup>119</sup> or as cases in which the statute required

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112. *Id.* at 708. At least one court since *Garrison* rejected this result as allowing state law to modify the governance rights of a member due to a bankruptcy filing. *In re Ellis*, No. 10-16998-AJM-7A, 2011 WL 5147551, at \*3 (Bankr. S.D. Ind. Oct. 27, 2011).

113. 475 B.R. 622 (Bankr. N.D. Ill. 2012).

114. *Id.* at 631.

115. WASH. REV. CODE § 25.15.130(1)(d) (2014) (repealed 2015); *Nw. Wholesale, Inc. v. Pac Organic Fruit LLC.*, 357 P.3d 650, 658 (Wash. 2015).

116. *Nw. Wholesale*, 357 P.3d at 653.

117. *Id.* at 657 (emphasis added).

118. *Id.* at 658 (alteration in original).

119. *Id.* at 657 (citing *Fursman v. Ulrich (In re First Prot., Inc.)*, 440 B.R. 821 (B.A.P. 9th Cir. 2010)). Nonetheless, the court did not find that—even in a single-member LLC—§ 541(c) negates state law. *Id.* at 658 (stating “the court’s application of § 541(a) is troubling. The court

dissolution of the LLC which would prevent any interest from going to the bankruptcy estate.<sup>120</sup> Interestingly, this case came from the state courts rather than federal bankruptcy courts; presumably, a state court defers to state law more readily than does a federal court. Similarly, in *Caymus Ventures, LLC v. Jundanian (In re Jundanian)*,<sup>121</sup> the court upheld a provision in an Operating Agreement restricting the transfer of management rights in the LLC.<sup>122</sup> The trustee acceded to the other governance rights because § 541(c)(1) invalidated state law dissociating the member upon a bankruptcy filing.<sup>123</sup> But the trustee could not manage the LLC and could not sell the governance rights on the estate's behalf because provisions prohibiting the transfer remained valid despite § 541(c)(1), which only dealt with whether property becomes part of the estate, not with what happens to property once in the estate.<sup>124</sup>

In determining whether governance rights become property of the estate, courts focus more on the enforceability of state-law (and contractual) provisions that remove rights from a debtor who files for bankruptcy protection than on whether the debtor holds any rights at the commencement of the case. To the extent that the state-law provisions are invalidated, rights transfer to the estate. To the extent that the state-law provisions stand, rights do not transfer to the estate. While all courts agree that the distributional rights of a member transfer to the estate, and most even agree that the governance rights of a member transfer to the estate, neither conclusion answers whether a member's *management* rights can transfer to the estate. Once property becomes part of the estate, however, restrictions under contract or law regarding the use of that property generally remain valid.<sup>125</sup>

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acknowledged the *Butner* rule—that a debtor's interest is determined by state law—but failed to apply that rule.”).

120. *In re Daugherty Constr., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995); *Nw. Wholesale*, 357 P.3d at 658 (citing *Sheehan v. Warner (In re Warner)*, 480 B.R. 641 (Bankr. N.D.W. Va. 2012)).

121. No. 10-21513-TJC, 2012 WL 1098544 (Bankr. D. Md. Mar. 30, 2012)

122. *Id.* at \*5–6.

123. *Id.*

124. *Id.* at \*6.

125. *See* Bishop, *Desiderata*, *supra* note 65 (“Although the trustee may sell the LLC membership interest, the purchaser acquires only the limited economic rights of a transferee defined under state law and cannot exercise the management rights of an LLC member.”).



### b. Single-Member LLCs

Though courts disagree as to the ability to transfer a management interest to the trustee when a member-manager files for bankruptcy protection, that disagreement largely disappears when the member-manager is the sole member of the LLC. *In re B&M Land & Livestock, LLC*<sup>126</sup> involved a single-member LLC and the issue of whether a chapter 7 trustee could manage that LLC when its member-manager filed bankruptcy jointly with her husband. In particular, the debtor argued that she maintained her authority to manage the LLC, including opting to put the LLC into a chapter 11 bankruptcy case.<sup>127</sup> The court held that the trustee accedes to *all* of the debtor's interest in the LLC as property of the estate, including the management rights, the other governance rights, and the economic rights.<sup>128</sup> Other courts hold in a similar way regarding single-member LLCs.<sup>129</sup>

The transfer of governance rights, and particularly management rights, in a single-member LLC does not offend state-law policies regarding LLCs, as explained by the court in *In re Albright*.<sup>130</sup> *Albright* involved a bankruptcy filed by an attorney who was the sole owner of an LLC.<sup>131</sup> The court deemed the trustee a "substituted member" of the LLC under Colorado law.<sup>132</sup> While ordinarily the member's assignable interest does not include governance rights, the law provided that "[a] substituted member is a person admitted to all the rights of a member who has . . . assigned [his] interest . . . with the approval of all the members of the limited liability company . . . [and] has all the rights and powers . . . of [his] assignor."<sup>133</sup> Because no other members existed, and the statute exists to protect *other* members of the LLC, the entire membership interest, including all governance functions, passed to the trustee.<sup>134</sup> The court reached the same result

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126. 498 B.R. 262 (Bankr. D. Nev. 2013).

127. *Id.* at 264–65.

128. *Id.* at 266. The court did recognize that state law might limit the ability for the trustee to run some businesses, noting that "[t]his principle may be limited where the LLC is run by or deals with matters such as professional practices or personal services. For instance, a trustee likely may not manage a law firm, medical practice, or accounting firm that is organized as an LLC." *Id.* at 267.

129. *See, e.g., In re Modanlo*, 412 B.R. 715, 731 (Bankr. D. Md. 2006).

130. 291 B.R. 538, 539–40 (Bankr. D. Colo. 2003).

131. *Id.* at 539.

132. *Id.* at 540.

133. COLO. REV. STAT. § 7-80-702 (2006).

134. *In re Albright*, 291 B.R. at 540.

in *In re Dzierzawski*,<sup>135</sup> which involved a fraudulent transfer of an LLC interest and its return to the bankruptcy estate.<sup>136</sup> Because the debtor was the sole member, the trustee could “step into the Debtor’s shoes,” manage and/or liquidate the LLC, and distribute the assets to the creditors without prejudicing the rights of any other members.<sup>137</sup> The parties discussed Michigan law limiting a creditor’s rights against an LLC to merely a charging order against distributions to be made to the member.<sup>138</sup> But the court noted that “[t]he charging order exists to protect the *other members* of the LLC from having to involuntarily share governance responsibilities with someone they did not choose, or from having to accept a creditor of another member as a co-manager.”<sup>139</sup>

While not a single-member LLC, the two members of the LLC at issue in *Schwartz v. Cleveland (In re Cleveland)*<sup>140</sup> filed jointly as husband and wife.<sup>141</sup> The court noted that courts routinely hold that the trustee takes all rights, including management rights, in a single-member LLC when the member files for bankruptcy protection.<sup>142</sup> The debtors argued that the trustee should not be able to manage their LLC because management of an LLC constitutes a personal service, and one that requires special licensing<sup>143</sup> not held by the trustee.<sup>144</sup> The court treated the LLC as a single-member LLC in which *all* rights of the debtor transfer to the trustee.<sup>145</sup>

135. 528 B.R. 397 (Bankr. E.D. Mich. 2015).

136. *Id.* at 408.

137. *Id.* at 410.

138. *Id.* at 409. Though dismissal would allow Vulpina, the debtor’s largest creditor, to bring an action against the assets under state law, Michigan law provided:

[A] judgment creditor of a member of an LLC is limited to obtaining a charging order and lien against the membership interest of the judgment debtor. The judgment creditor cannot foreclose on that lien, and the only thing the charging order gives the creditor is the right to receive any distributions that the member is entitled to or becomes entitled to in the future.

*Id.* (citing MICH. COMP. LAWS § 450.4507 (2010)).

139. *Id.* at 412.

140. 519 B.R. 304 (Bankr. D. Nev. 2014).

141. *Id.* at 305.

142. *Id.* at 306.

143. As to the special licensing requirement, the court rejected the debtors’ argument because even if the trustee lacked the legal requirements to manage this LLC, the trustee could still sell the assets of the LLC (or dissolve it, or take any number of actions short of actually running the LLC). *Id.* at 307.

144. *Id.*

145. *Id.*

The result in a single-member LLC makes sense because state LLC law allows the management rights to be held by any party if all of the members so agree; with a single-member LLC (or a joint filing by the only two members of the LLC), the members have unanimously agreed to file for bankruptcy protection, and such an agreement can be deemed an agreement to substitute the trustee as the manager for the LLC.

The cases leave a clear statement that a member's economic interests in an LLC constitute property of the bankruptcy estate, and those interests pass to the trustee. In the single-member LLC realm, the governance rights of the member, including the right to manage the LLC, should also transfer to the trustee because no other member exists to protect the LLC. The difficulty comes in determining how to handle the governance rights, and particularly the management rights, of one member of a multi-member LLC because the bankruptcy code policy of bringing all assets into the estate with the goal of maximizing recovery for creditors conflicts with state law policy of protecting the right of LLC members to choose their colleagues.<sup>146</sup> Some cases provide that state and contractual provisions prohibiting transfer of the governance interests are unenforceable, and thus, all interests transfer to the estate.<sup>147</sup> Other courts hold that governance interests either do not transfer at all, or transfer subject to state law and contractual restrictions on the right of the trustee to exercise those governance rights.<sup>148</sup> From a policy perspective, the limitation on transfer of governance rights serves an important protective purpose for the remaining members—preventing the remaining members from accepting management of the LLC by someone that the members did not choose to manage the business, and preventing the trustee from exercising voting rights in a way that might harm the interests of the LLC.

## 2. *Executory Contracts*

Even if the member's governance interests qualify as property of the estate, executory contract provisions may provide a different result due to protections available to non-debtor members of the LLC because the property becomes part of the estate subject to legal

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146. Bishop, *Desiderata*, *supra* note 65, at 244.

147. *See, e.g., In re Daugherty Constr., Inc.*, 188 B.R. 607, 611 (Bankr. D. Neb. 1995).

148. *See, e.g., Olmstead v. F.T.C.*, 44 So.3d 76, 79 (Fla. 2010).

restrictions on the use of that property. As with § 541(c)(1), however, § 365 generally prohibits ipso facto provisions in contracts or law—provisions that restrict the rights of the debtor based on a bankruptcy filing.<sup>149</sup> However, § 365 gives back some power to the non-debtor parties by providing that an executory contract cannot be assumed or assigned by the trustee when “applicable law excuses a party, other than the debtor, . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession,” unless the other party consents to the assumption and assignment.<sup>150</sup> Thus, to the extent that a limited liability company’s Operating Agreement constitutes an executory contract between the members of the company, any legal provisions that prevent assignment of the management duties under the contract to a party other than the debtor would continue to apply in bankruptcy if applicable law would prevent other members from accepting that assignment.<sup>151</sup>

A critical distinction exists between § 541(c)(1)’s provisions—which would not permit state law to prevent the passage of governance rights into the estate—and § 365(c)(1)’s provisions—which would enable state law to prevent the transfer of governance rights to the trustee. The courts disagree most on the issue of whether an LLC Operating Agreement even qualifies as an executory contract. If an Operating Agreement qualifies as executory, provisions in state law or

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149. 11 U.S.C. § 365(e)(1)(2012) (“Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified . . . solely because of a provision in such contract . . . that is conditioned on . . . the commencement of a case under this title . . .”). As a technical matter, it is not clear that the ipso facto clause would be invoked in this situation anyway because the clause prohibits modification *after commencement* of the bankruptcy case, while the state law provision takes effect *upon commencement* of the bankruptcy case. 11 U.S.C. § 365(e)(1); REVISED UNIF. LTD. LIAB. CO. ACT §§ 602(8)(a), 603(a)(1) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006).

150. 11 U.S.C. § 365(c)(1)(a).

151. Debate exists regarding the extent to which a trustee may *assume* an executory contract in light of a non-assignment provision because § 365(c) ostensibly prohibits either assumption or assignment of the contract in light of the non-assignment provision. Some courts, applying the hypothetical approach, hold that a trustee cannot assume the contract if a hypothetical assignment would be prohibited. *See, e.g., In re W. Elecs. Inc.*, 852 F.2d 79, 83 (3d Cir. 1988). Other courts, applying the actual approach, hold that a trustee can assume the contract unless the trustee actually intends to assign it. *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489, 493 (1st Cir. 1997), *abrogated on other grounds by Hardemon v. City of Boston*, 144 F.3d 24 (1st Cir. 1998); *see also* Theresa J. Pulley Radwan, *Limitations on Assumption and Assignment of Executory Contracts by “Applicable Law”*, 31 N.M. L. REV. 299, 306 (2001) (discussing the limitations on assumptions and assignments in the context of executory contracts).

in the agreement itself that limit a member to transferring only the *economic* rights in the LLC could be used to prevent the transfer of governance rights to the trustee. If the Operating Agreement is not executory, those provisions become invalid unless the courts follow the *Garrison-Ashburn*<sup>152</sup> line of cases in allowing interests to pass into the estate subject to state-law transfer restrictions.<sup>153</sup>

The bankruptcy code does not define an executory contract. The most used definition of an executory contract, known as the Countryman definition, defines an executory contract as one under which both parties to the contract owe mutual obligations at the time of the bankruptcy filing which, if unperformed, would constitute a material breach<sup>154</sup> of the contract.<sup>155</sup>

#### a. Non-Management Obligations as Executory Contract

*Ebert v. DeVries Family Farm, LLC (In re DeVries)*<sup>156</sup> involved a multi-member LLC. The debtor created the DeVries Family Farm, LLC with his father and brothers.<sup>157</sup> The Operating Agreement provided that one of the brothers would serve as the managing member and that the remaining members would be obligated to make capital contributions as agreed upon by the members.<sup>158</sup> It also provided that the LLC could purchase the interest of any insolvent member, which would be triggered by (among other things) a member's bankruptcy filing.<sup>159</sup> When the debtor filed for bankruptcy protection, the bankruptcy court considered whether the filing dissociated the debtor from the LLC; whether the Operating Agreement qualified as executory and, if so, whether the trustee timely assumed it; and what became property of the estate.<sup>160</sup> The court noted that whether an

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152. See discussion, *supra* Section C(1)(a).

153. See, e.g., *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005) (finding § 541(c)(1) to control case because no executory contract existed and, thus, allowing transfer of governing interest to trustee).

154. State law determines whether a breach qualifies as material. Bishop, *Desiderata*, *supra* note 65, at 249 (noting several factors to be considered, including loss to and ability to compensate non-breaching party, ability to "cure," and whether breaching party acted in good faith).

155. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

156. *Ebert v. DeVries Family Farm, LLC (In re DeVries)*, No. 11-43165-DML-7, 2014 WL 4294540 (Bankr. N.D. Tex. Aug. 27, 2014).

157. *Id.* at \*1.

158. *Id.* at \*2.

159. *Id.* at \*2-3.

160. *Id.* at \*4.

Operating Agreement qualifies as executory depends on the terms of that specific Operating Agreement and required consideration of the ongoing duties of the members.<sup>161</sup> The debtor’s obligations to the company included requirements “to contribute as much time as necessary” and to contribute capital as agreed upon by the members.<sup>162</sup> While the court did not find that the time requirement constituted an ongoing material obligation, the court did find a continuing material obligation in the requirement to contribute capital and guarantee the LLC’s debts.<sup>163</sup> As such, the contract qualified as an executory contract.<sup>164</sup> The court then turned to the issue of what constitutes property of the estate when a member files for bankruptcy protection. It noted that under state law, a member’s interest includes the debtor’s governance rights, which would transfer to the estate under § 541.<sup>165</sup> However, the ability for these to become part of the estate when the Operating Agreement qualifies as executory falls under § 365 rather than § 541.<sup>166</sup> As a result, the remaining parties’ rights to prevent transfer of the governance rights remained intact.<sup>167</sup> Those rights included the right to deem the debtor a “mere assignee” upon his breach of the Operating Agreement, which prohibited him from engaging in any governance over the LLC—essentially limiting the trustee to taking only the debtor’s economic rights.<sup>168</sup> Further, the court refused to use the ipso facto clauses of §§ 541(c)(1) and 365(e)

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161. *Id.* at \*9.

162. *Id.*

163. *Id.* at \*9–10. Continuing obligations by the debtor, such as management duties or payment of capital contributions, are more likely to lead to a determination that the Operating Agreement qualifies as executory. *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 651 (Bankr. N.D.W. Va. 2012).

164. *In re DeVries*, 2014 WL 4294540, at \*11. This result can protect the other members of the LLC, even though the decision to assume or reject lies with the trustee (or debtor-in-possession) because, once rejected, it allows the other members to continue on with the business without the trustee as a member. For that reason, some attorneys recommend structuring any Operating Agreement to ensure that it is executory. *See, e.g., Domenick R. Lioce, Chinks in the Armor: Current Trends in Limited Liability Company Structure After Olmstead*, FLA. B.J., Jan. 2011, at 36, 38 (“[T]ax planners recommend 1) drafting the LLC Operating Agreement . . . as an ‘executory contract’ for bankruptcy law purposes and provid[ing] entity owners’ ongoing obligations; 2) [including] mandatory capital calls; 3) [designating] service obligations; 4) [including] noncompetition obligations; and 5) [creating] partnership or membership interests with owners of a trust or tenants by the entirety.”).

165. *In re DeVries*, 2014 WL 4294540, at \*12–13.

166. *Id.* at \*13.

167. *Id.* at \*13–14.

168. *Id.* at \*14.

to prohibit the contractual provision because the trustee did not assume the agreement.<sup>169</sup>

While the ongoing requirement to commit capital to the LLC created an executory contract in the *DeVries* case, not all courts agree. In fact, many—if not most—courts hold that LLC agreements do not inherently fall within executory contracts.<sup>170</sup> By contrast, partnership agreements are often held to be executory in nature because of the ongoing obligations of both general and limited partners to the partnership.<sup>171</sup> *In re Prebul*<sup>172</sup> involved the bankruptcy filing of a debtor who was also a non-managing member of an LLC.<sup>173</sup> The debtor claimed that the remaining members of the LLC “oppressed” him in violation of fiduciary duties owed between members of an LLC.<sup>174</sup> The other members argued that because the bankruptcy trustee failed to assume the Operating Agreement as an executory contract, it no longer applied with regard to the debtor, and thus, the debtor could not claim a breach of fiduciary duties.<sup>175</sup> In considering whether the Operating Agreement constituted an executory contract, the court declined to adopt any hard-and-fast rules regarding either the test to use in measuring whether a contract qualifies as executory or whether Operating Agreements as a rule qualify as executory contracts.<sup>176</sup> It concluded that the debtor’s only remaining obligation

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169. *Id.*

170. *In re Denman*, 513 B.R. 720, 725 (Bankr. W.D. Tenn. 2014) (citing *In re Ehmann*, 319 B.R. 200, 200 (Bankr. D. Ariz. 2005)) (“[T]he overwhelming majority of cases have determined LLC agreements are not executory contracts upon examination . . . .”); *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 641 (Bankr. N.D.W. Va. 2012); *Endeka Enters., LLC v. Meiburger (In re Tsiaoushis)*, 383 B.R. 616 (Bankr. E.D. Va. 2007); *In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 700 (Bankr. E.D. Va. 2000); *In re Alameda Invs., LLC*, No. 6:09-BK-10348-PC, 2013 WL 3216129 (Bankr. C.D. Cal. June 25, 2013); *In re Prebul*, No. 08-14010, 2011 WL 2947045 (Bankr. E.D. Tenn. July 19, 2011).

171. Thomas F. Blakemore, *Limited Liability Companies and the Bankruptcy Code: A Technical Review*, 13 AM. BANKR. INST. J., June 1994, at \*12; see *In re Nizny*, 175 B.R. 934, 936 (Bankr. S.D. Ohio 1994) (citing *In re Corky Foods Corp.*, 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988)) (“Initially, the court notes that the courts are in agreement that partnership agreements are executory contracts.”); *In re Sunset Developers*, 69 B.R. 710, 712 (Bankr. D. Idaho 1987); *In re Harms*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981); see also *Cutler v. Cutler (In re Cutler)*, 165 B.R. 275, 279–80 (Bankr. D. Ariz. 1994) (“The courts have generally assumed that partnership agreements are, at least in part, executory contracts.”).

172. No. 08-14010, 2011 WL 2947045 (Bankr. E.D. Tenn. July 19, 2011).

173. *Id.* at \*1.

174. *Id.*

175. *Id.* at \*7.

176. *Id.*

to the LLC was contribution of capital if the managing member required such a contribution, and that such an obligation did not render the contract executory.<sup>177</sup> As a result, the trustee took all of the debtor's rights in the LLC despite New York law that dissolved the LLC upon the debtor's bankruptcy filing.<sup>178</sup>

Each of these cases involved the ongoing obligations of a non-managing member of the LLC. While courts disagree on what makes an LLC Operating Agreement executory, a *manager* of a company will clearly have ongoing obligations to the company, and the members in a member-managed company will have the same ongoing obligations.<sup>179</sup> For a member with little or no management role, the remaining governance functions of voting or capital contributions may not suffice to make the contract executory.<sup>180</sup>

#### b. Management Obligations as an Executory Contract

The issue of whether a debtor's rights pass into the bankruptcy estate—and more specifically to a trustee in bankruptcy—generally implicates the *governance* rights of the debtor, not the economic rights of the debtor. Those governance rights include non-management rights, such as voting, and management rights to run the business. These governance rights can profoundly affect the other members of the LLC, particularly when the debtor-member of the LLC also manages the LLC. However, when the debtor also manages the LLC, executory contract provisions should prevail over § 541's property of

177. *Id.* at \*8.

178. *Id.* at \*10.

179. Bishop, *Desiderata*, *supra* note 65, at 250 (“The LLC operating agreement of a member-managed LLC is far more likely to be considered an executory contract than would the operating agreement of a manager-managed LLC . . .”).

180. *See, e.g.*, *Endeka Enters., LLC v. Meiburger (In re Tsiachoushis)*, No. 1:07-CV-436, 2007 WL 2156162, at \*1, \*4 (E.D. Va. July 19, 2007). In *Tsiachoushis*, the company's Operating Agreement provided that bankruptcy would lead to dissolution of the LLC, and the trustee sought such a dissolution when the debtor filed for bankruptcy. *Id.* at \*1. The issue did not involve the ability to assign the contract, and thus § 365(c)(1) was not at issue. Rather, the court needed to determine whether the Operating Agreement constituted an executory contract to decide whether § 365(e)(1) would invalidate the dissolution provision as an “ipso facto” clause. *Id.* at \*2. Because a member with merely economic interests in the company lacked ongoing material obligations to the LLC or its remaining members, the debtor could not be in breach of any obligations and, thus, under the Countryman standard, the Operating Agreement did not qualify as executory. *Id.* at \*4; *see also* *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 651–52 (Bankr. N.D.W. Va. 2012) (holding that debtor lacked management or contribution obligations, and his only remaining obligation to offer his shares to the company before selling it to anyone else did not constitute an “obligation,” but rather a restraint on the debtor's actions and, thus, did not constitute a duty sufficient to create an executory contract).



the estate provisions, allowing the economic rights to pass to the trustee but preventing the trustee from actually managing the LLC.

Applying the mutual-obligation executory contract definition to an Operating Agreement (or whatever contract creates the management duties) with a managing-member who filed for bankruptcy protection, the manager's obligations under the contract to manage the company in accordance with the manager's fiduciary duties clearly constitute an ongoing obligation. But for an agreement to be executory, the agreement must specify that the manager is owed something that, if not provided, would constitute a material breach of the agreement. Managers will typically receive something in exchange for the time and energy spent in management—whether it be a salary, regular distributions from the company, or additional ownership interest in the company. Failure to compensate the manager as agreed upon would then constitute the requisite mutual obligation to create an executory contract. As a result, the contract would be executory as to the managing member and fall within § 365.

Once in § 365, the management function would constitute a non-transferable obligation. Section 365(c) provides that an executory contract may not be assigned if “applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession,” absent consent of the non-debtor party.<sup>181</sup> Because most, if not all, states limit the ability of the manager of an LLC to transfer those management rights,<sup>182</sup> § 365(c)(1) effectively prevents those management rights from being assumed and assigned by the trustee.

The situation changes in the context of most chapter 11 cases, however. When a debtor files for chapter 11 bankruptcy, a trustee is generally not appointed. Rather, the debtor remains “in possession” and serves most functions of the trustee. Section 365(c)'s limitation specifically mentions performance by the debtor *or the debtor in possession*.<sup>183</sup> Given that the debtor in possession shares legal identity with the debtor for purposes of performance of an executory contract, and that § 365(c)(1) specifically retains the option of performance by

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181. 11 U.S.C. § 365(c)(1)(A) (2012).

182. REVISED UNIF. LTD. LIAB. CO. ACT § 102(21) (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006) (defining transferrable interest to include economic rights).

183. 11 U.S.C. § 365(c)(1)(A).

the debtor in possession, a manager who also acts as a debtor in possession in a chapter 11 case would still be able to manage the LLC while in the bankruptcy case. Thus, § 365(c) would allow the debtor-in-possession to assume the Operating Agreement and continue to serve in a management function. One of the first published opinions regarding LLCs when a member files for bankruptcy protection demonstrated this ability for the debtor-in-possession to assume the Operating Agreement and continue to manage the LLC.<sup>184</sup> The debtor in *In re Daugherty Construction, Inc.*<sup>185</sup> was a construction company that was a member-manager of several LLCs.<sup>186</sup> Under Nebraska law, the bankruptcy of a member of an LLC terminated the LLC unless the remaining members agreed to continue the business.<sup>187</sup> The non-debtor members of the LLCs voted to continue the LLCs without the debtor after its bankruptcy filing and voted to remove the debtor's president as the manager of the LLCs.<sup>188</sup> The *Daugherty* court noted the reasons why the law terminates an LLC upon bankruptcy of a member.<sup>189</sup> Most notably, an LLC acts like a partnership in that "members . . . have voluntarily associated in a business enterprise and the relationship among members may be personal in character."<sup>190</sup> Despite these compelling interests of non-members, the court held that state law cannot trump the bankruptcy code's clear provisions:

First, the debtor's interest in the LLCs constitutes property of the bankruptcy estate and state law purporting to terminate that interest is unenforceable under section 541(c). Second, under section 363, the debtor has the right to use, sell, or lease all property of the estate, including its membership interest in the LLC, notwithstanding state law to the contrary purporting to terminate the debtor's interest. Third, the LLC Articles of Organization and the Operating Agreement among the LLC members . . . constitute . . . executory contract which the debtor may attempt to assume under section 365 . . . .<sup>191</sup>

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184. *In re Daugherty Constr., Inc.*, 188 B.R. 607, 608–09 (Bankr. D. Neb. 1995).

185. 188 B.R. 607 (Bankr. D. Neb. 1995).

186. *Id.* at 609.

187. *Id.*

188. *Id.*

189. *Id.* at 611.

190. *Id.*

191. *Id.*

Sections 363, 365, and 541 each include provisions invalidating state law or contractual provisions that modify or terminate a contract in the event of a bankruptcy filing.<sup>192</sup> Thus, the Nebraska provision terminating the LLC upon the debtor's bankruptcy filing could not take effect.<sup>193</sup> And § 365(c) only applies when the contract would be assumed or assigned by the trustee, but the debtor, as debtor-in-possession, would assume the Operating Agreement.<sup>194</sup>

### 3. Policy for Preventing Trustee from Assuming Governance Interests in LLC

The bankruptcy code and cases provide some clear guidance when considering the ability to transfer the interests of a debtor to a trustee in a bankruptcy case. First, the economic interest of the debtor clearly qualifies as property of the estate, and state law or contract provisions that would terminate the debtor's economic interest in the LLC cannot be enforced. On the opposite end of the spectrum,<sup>195</sup> a managing member's rights and obligations to manage the company likely cannot be assigned to a third party by the trustee or debtor-in-possession because those obligations create an executory contract that cannot be assigned under state law; they likely may be assumed, however, by a debtor-in-possession. Further, in a single-member LLC the one and only member essentially consents to the transfer by filing

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192. *Id.* at 612–13; 11 U.S.C. §§ 363(l), 365(e), 541(c) (2012).

193. *In re Daugherty Constr.*, 188 B.R. at 612 (“Under section 363(l), the debtor has the right to continue as a member of the LLC, notwithstanding the termination clauses found in state law and in the LLC Articles and Agreements.”); *id.* at 613 (“[S]ection 541(c)(1) and section 363(l) . . . expressly invalidate provisions of ‘applicable law’ or ‘applicable non-bankruptcy law.’”).

194. *Id.* at 613–14. The *Daugherty* court went on to discuss the law of partnership agreements in bankruptcy. Though a split exists as to whether partnership agreements can be assumed, those cases that did not allow the assumption did so under the theory that it is really an assignment to a new entity—the debtor-in-possession. *Id.* at 614.

195. At least one court, citing to a popular treatise, held that § 541 can apply to the economic rights of a partner in a limited liability partnership, while § 365 applies to the management rights:

The court agrees with the analysis in a leading treatise, which suggests that the partnership relationship be viewed as an amalgam:

- (1) [A] property interest in the profits and surplus of the partnership, with the property interest surviving any termination of the agreement upon the partner's bankruptcy; and
- (2) [A]n executory contract with respect to the governance of the partnership property.

Cutler v. Cutler (*In re Cutler*), 165 B.R. 275, 280 (Bankr. D. Ariz. 1994) (citing 1 LAURENCE D. CHERKIS, COLLIER REAL ESTATE TRANSACTIONS AND THE BANKRUPTCY CODE ¶ 4.07[1], LEXIS (updated 2018)). The same principles can apply to an LLC.

bankruptcy, allowing assumption and assignment under the express language of § 365(c)(1)(B).<sup>196</sup>

As for the ability for a trustee to assume rather than to assign to another party management rights, the code and cases provide less clarity, but policy considerations of state law that focus heavily on the “pick your partner” principles should weigh heavily against allowing a trustee to assume management obligations and forcing non-debtor parties to accept a trustee that they did not select to manage the LLC. Sections 541 and 365 justify this result. Under § 541, the state law is not entirely clear that a management interest falls within personal property.<sup>197</sup> A *member’s* right to manage in a member-managed LLC arguably also constitutes a property right, based upon the LLC Act’s indication that dissociation ends the member’s “*right to participate as a member* in the management and conduct” of the business.<sup>198</sup> But the right to manage in a manager-managed LLC is not clearly a property interest.<sup>199</sup> And even to the extent that the right to manage falls within a property interest that transfers into the estate, courts should follow the *Garrison-Ashburn* precedent in subjecting management rights to state-law restrictions on the transfer of those rights to other parties.

This leaves one additional significant category to consider: the non-economic and non-management ownership interests of a member in a multi-member LLC, such as the right to vote, the right to access the records of the company, and the right to seek dissolution of the LLC. It seems that all of these “governance” rights constitute property of the estate; they are rights held by the members of the company pursuant to their membership interests. Whether these rights (without a management interest) cause an LLC Operating Agreement to be an executory contract is less clear and will likely be determined on a case-by-case basis. To the extent that the Operating Agreement is executory, whether the trustee should be able to assume these rights would likely require a determination of whether state law prohibits

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196. 11 U.S.C. § 365(c)(1)(B) (2012). Section 365(c)(1)(B) allows assumption and assignment if the other parties to the contract consent.

197. REVISED UNIF. LTD. LIAB. CO. ACT § 102(21) (NAT’L CONF. OF COMM’RS ON UNIF. STATE LAWS 2006). Of course, economic interests are transferrable interests that expressly qualify as personal property under the uniform law.

198. *Id.* § 603(a)(1) (emphasis added).

199. *Grochocinski v. Campbell (In re Campbell)*, 475 B.R. 622, 631 (Bankr. N.D. Ill. 2012).

assignment of these rights (as it almost certainly does<sup>200</sup>) absent approval of the other members of the LLC, and policy determination as to the potential harm caused to the non-debtor LLC members. But if a court deems the Operating Agreement not to be executory—finding essentially that the members lack any ongoing obligations to the LLC or that the LLC lacks ongoing obligations to the member—only § 541 matters, and it will certainly invalidate any restrictions on bringing the governance rights into the bankruptcy estate. A broad interpretation of executory contracts that treats the member's management rights as executory, and thus gives credence to restrictions on the transfer of those rights to third parties, best protects the non-debtor members of an LLC and preserves state law property considerations. For example, in *Milford Power Co. v. PDC Milford Power, LLC*,<sup>201</sup> the Operating Agreement provided that a member who filed for bankruptcy protection withdrew from the LLC.<sup>202</sup> The court considered the Operating Agreement to be executory because both parties conceded on that issue<sup>203</sup> and then applied § 365's provision—upholding Delaware law excusing non-debtors from accepting performance from another party—in determining that even voting and other non-governance rights could not transfer to the trustee.<sup>204</sup>

Several cases highlight the possible actions that a trustee might be able to take if given the debtor's non-management governance role within an LLC—even in a single-member LLC situation. For example, the trustee in *In re Modanlo*<sup>205</sup> successfully sought to resurrect the debtor's single-member LLC (which had been dissolved upon the debtor's bankruptcy filing pursuant to Delaware law) to call a meeting of shareholders of a corporation in which the LLC served as controlling shareholder so he could remove the debtor from the corporation's board of directors and ultimately file the LLC into bankruptcy.<sup>206</sup> *Sheehan v. Warner (In re Warner)*<sup>207</sup> involved a farm owned by the debtor and various family members as an LLC.<sup>208</sup> After

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200. REVISED UNIF. LTD. LIAB. CO. ACT § 102(21) (NAT'L CONF. OF COMM'RS ON UNIF. STATE LAWS 2006).

201. 866 A.2d 738 (Del. Super. Ct. 2004).

202. *Id.* at 742.

203. *Id.* at 750.

204. *Id.* at 760.

205. 412 B.R. 715 (Bankr. D. Md. 2006).

206. *Id.* at 716–19.

207. 480 B.R. 641 (Bankr. N.D.W. Va. 2012).

208. *Id.* at 644.

the debtor filed for bankruptcy protection, the trustee argued that the transfer of the membership interests to a creditor (who also happened to be a brother) violated the Operating Agreement, and thus, the debtor's interest fell within property of the estate.<sup>209</sup> The court agreed<sup>210</sup> and noted that property of the estate includes not only the monetary rights of the debtor but also governance rights.<sup>211</sup> The court then turned to whether the trustee could liquidate the debtor's interest in the farm.<sup>212</sup> Though the trustee argued that he took all of the debtor's rights in the farm, including the right to seek judicial dissolution of the farm, the court disagreed.<sup>213</sup> The trustee merely took those rights that the debtor held in the farm "as of commencement of the case."<sup>214</sup> The debtor lacked the ability to sell his interest in the farm without offering it first to the other members, and thus, the trustee lacked the ability to take the same actions.<sup>215</sup> He could, however, seek judicial dissolution of the LLC in order to recover the debtor's value in the LLC if the requirements for judicial dissolution under state law applied.<sup>216</sup> These cases show that even short of management rights, a trustee acceding to governance rights might be able to use the powers of voting and dissolution to significantly impact other non-debtor members of the LLC. A strict reading of §§ 365 and 541 to strike down state-law limitations on the ability to transfer these rights to a trustee fails to meet the goals of state law to protect non-debtor members from having their interests undermined by members that they did not approve of added to the LLC.

#### D. CONCLUSION

When a member of an LLC files a bankruptcy case, the member's interests in the LLC transfer to the estate. These interests include economic interests and governance interests. Governance interests further divide into management and non-management interests. The transfer of economic interests into the estate, and use of those economic interests to pay creditors, does no harm to the non-debtor

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209. *Id.* at 644–45.

210. *Id.* at 647.

211. *Id.* at 653, 655.

212. *Id.* at 656.

213. *Id.*

214. *Id.*

215. *Id.*

216. *Id.* at 657.

members of the LLC because transfer of merely the economic interests does not interfere with the non-debtor members' governance rights. But the transfer of governance rights to the trustee violates state law and threatens the fundamental "pick your partner" principle that governs LLCs. The bankruptcy code's ipso facto provisions in §§ 365 and 541 nullify state law provisions which would prevent the debtor's property rights from transferring into the estate, except that § 365 upholds state law prohibitions to the extent that the Operating Agreement falls under the provisions for executory contracts and the debtor's obligations qualify as non-transferrable personal services. Because of the ambiguity of the language of § 365 regarding whether the trustee can assume these personal service obligations, the courts should interpret the trustee's ability to assume these services in light of the mutual goals of maximizing recovery and protecting non-debtor members of the LLC. For management of the LLC, that balance should always tip against allowing the trustee to assume management obligations because they are not truly property interests, and assumption of those obligations defies state-law protections afforded to non-debtor members. For non-management governance rights, the courts should utilize executory contract principles when possible to preserve the rights of non-debtor members of the LLC and to ensure that state-law principles regarding property rights remain inviolate to the extent possible.