Administering LLC Interests in Bankruptcy

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American College of Bankruptcy
Seventh Circuit Education Committee Seminar
September 24, 2021

I. Introduction

A limited liability company ("LLC") is a statutorily-created business entity that is governed in Indiana by the Indiana Business Flexibility Act[2] (the "IBFA") and in other states by similar statutes. The IBFA provides that an LLC is formed pursuant to Ind. Code § 23-18 by the filing of articles of organization with the Secretary of State.[3] The LLC is governed by the LLC's operating agreement and the laws of the state in which the LLC was formed. An LLC can be managed by a managing member, or by the members acting together.

In most states, including Indiana, the interest of a member in an LLC is personal property[4] that is assignable, in whole or in part, unless the operating agreement provides otherwise.[5] The rights of members in an LLC include economic rights and governance rights—economic rights generally include the right to a distribution of an LLC, or share of the LLC's assets upon dissolution, whereas governance rights include the "default right to manage the company and the right to vote upon decisions of the company."[6] In Indiana, and in many other

[1] Original article by Deborah J. Caruso, Meredith R. Theisen, and Erick P. Knoblock; Indianapolis Bar Association 2015 Advanced Consumer Bankruptcy Roundtable, April 30, 2015 (with James T. Young contributing research and articles on the topic).
[2] I.C. § 23-18-1 *et seq*.
[3] I.C. §§ 23-18-2-4, 23-18-2-6.
[4] I.C. § 23-18-6-2.
[5] I.C. § 23-18-6-3.1(b)(1).
[6] Radwan, "Members Only: Can a Trustee Govern an LLC When Its Member Files for Bankruptcy?" 53 Loy. L.A. L. Rev, 1, 10 (2019).

states, there are provisions which only allow an assignee to receive only distributions to which the assignor would be entitled, but it does not authorize the assignor to participate in the management in the LLC.[7] As a result, a charging order is essentially the "only remedy against a member's interest in an LLC."[8]

II. Property of the Estate under the Bankruptcy Code

A bankruptcy estate is created upon the filing of a bankruptcy petition and is comprised of property as set forth in section 541 of the Bankruptcy Code, including "all legal or equitable interests of the debtor in property as of the commencement of the case."[9] Section 541(c)(1) provides—

> Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—
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> (A) that restricts or conditions transfer of such interest by the debtor; or
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> (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

The determination of property rights in the assets of the debtor's bankruptcy estate has been left to state law unless a federal interest requires a different result.[10] Therefore, "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

[7] I.C. § 23-18-6-3.1(b)(3).
[8] *Brant v. Krilich*, 835 N.E.2d 582, 592 (Ind. App. 2005).
[9] 11 U.S.C. §541(a)(1).
[10] *U.S. v. Butner*, 440 US 48 (1979).

the debtor files for bankruptcy protection."[11] It is clear that a member's economic interest in an LLC becomes property of the bankruptcy estate—where courts disagree is whether a member's governance interests become property of the estate and "whether they can be passed to the bankruptcy trustee because many state statutes dissociate members upon a bankruptcy filing."[12]

III. Single-Member LLCs

A. Trustee's Ability to Assume Control Over the Single-Member LLC

Many bankruptcy courts have concluded that the trustee "controls all the rights associated with [a single-member] LLC previously owned by the debtor, including rights to control and make decisions on the LLC's behalf."[13]

The Colorado bankruptcy court held in *In re Albright*,[14] that pursuant to the Colorado limited liability statute, the debtor's membership interest in her single-member LLC constituted the personal property of the debtor.[15] According to the court, under Colorado state law, because the debtor was the sole member of the LLC, it was not necessary to obtain the unanimous consent from other members in order to allow a transferee to participate in the management of the LLC—there were no other members. Therefore, the chapter 7 Trustee obtained all of the debtor's rights in the LLC upon the filing of her bankruptcy petition pursuant to section 541(a) of the Bankruptcy Code.[16] The court rejected the debtor's argument that the trustee was only entitled to a charging order under Colorado state law, observing that the purpose of a charging order was to protect other members of an LLC from "having involuntarily to share governance responsibilities with someone they did not choose, or from having to accept a creditor of another

[11] 53 Loy. L.A. L. Rev, 1, 16.
[12] *Id*. at 17.
[13] *In re B&M Land & Livestock, LLC*, 498 B.R. 262, 267 (Bankr. D. Nev. 2013).
[14] 291 B.R. 538 (Bankr. D. Colo. 2003).
[15] *Id*. at 540.
[16] *Id*.

member as a co-manager," and that a charging order limitation served no purpose in a single-member LLC.[17]

A similar result was reached in *In re A-Z Electronics, LLC*,[18] in which the United States Trustee moved to convert or dismiss the Chapter 11 case based on the unauthorized filing of the petition because the managing and sole member of the LLC was himself in the process of a Chapter 7 bankruptcy.[19] The court held that under Idaho law, when the LLC's sole member filed bankruptcy, his interest in the LLC became personal property of the Chapter 7 bankruptcy estate.[20] Thus, the LLC's sole member had no authority to file the Chapter 11 bankruptcy for the LLC because at that point, the LLC was subject to the sole and exclusive authority of the LLC's sole member's trustee and that the sole member's trustee was the only one entitled to manage the LLC and decide whether the LLC would or would not file bankruptcy.[21]

In the case of *In re Modanlo*,[22] the bankruptcy court applied Delaware state law in reaching its conclusion that the bankruptcy trustee could assume control, of the single-member LLC of which the debtor was the sole member.[23] The issue in *Modanlo*, was twofold—first, the bankruptcy court had to address whether the chapter 11 trustee was able to revive the LLC after it was dissolved pursuant to Delaware state law upon the debtor's bankruptcy filing; and second whether the chapter 11 Trustee had the managerial rights to place the LLC into bankruptcy upon the trustee's appointment. The court first determined that the chapter 11 Trustee was the personal/legal representative of the debtor and had complied with the Delaware state law in

[17] *Id*. at 541.
[18] 350 B.R. 886 (Bankr. D. Id. 2006).
[19] *Id.* at 888.
[20] *Id.* at 890.
[21] *Id.* at 891.
[22] 412 B.R. 715 (Bankr. D. Md. 2006).
[23] *Id*. at 731.

reviving the LLC. Next, the court addressed the line of decisions[24] that have concluded that governance rights are generally not assignable, noting the important distinction between these cases (multi-member LLCs) and the LLC in question, which was a single-member LLC.[25] Relying upon the Colorado bankruptcy court's decision in *Albright*, the court in *Modanlo* held that the chapter 11 trustee possessed both the economic and governance rights that the debtor enjoyed prior to his bankruptcy filing.[26] The court further found "that the decisional law interpreting LLC acts that divest bankruptcy trustees of a LLC member's management rights are founded on notions that (remaining) members (like partners in a partnership) should not be forced to accept substituted performance by a member's trustee" was applicable only in the context of a multi-member LLC, not in a single-member LLC.[27]

In *Fursman v. Ulrich, (In re First Protection, Inc.),*[28] the debtors were the sole owners of the LLC who attempted to transfer their management rights to a relative after bankruptcy filing. The Ninth Circuit rejected the argument that the debtors' non-economic rights, or management rights to the LLC, did not become property of their bankruptcy estate.[29] The court agreed with the outcome in *Albright*, but reached its conclusion under section 541(c)(1)(A) of the Bankruptcy Code—

> We conclude that all of the Debtors' contractual rights and interest in [the LLC] became property of the estate under § 541(a)(1) by operation of law when they filed their petition. Section 541(c)(1)(A) overrides both contract and state law restrictions on the transfers or assignment of Debtor's interest in [the LLC] in order to sweep all their interests into their estate . . . As a result, the Trustee was not a mere assignee, but stepped into Debtors' shoes, succeeding to all of their rights, including the right to control [the LLC].[30]

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[24] See *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. 2004).
[25] *Id*. at 725.
[26] *Id*.
[27] *Id*. at 731.
[28] 440 B.R. 821 (9th Cir. B.A.P. 2010).
[29] *Id*. at 829.
[30] *Id.* at 830.

The bankruptcy court in a recent case, *In re Thomas,*[31] relied upon section 541(c)(1)(B) of the Bankruptcy Code in concluding that a Tennessee state law appeared "to limit a trustee in bankruptcy to the exercise of only those governance rights needed to wind up the affairs of the limited liability company reserved to a member whose membership interest is terminated."[32] The Tennessee statute provided that an LLC membership interest terminated upon the filing of a bankruptcy petition by the member, and upon termination—

> [T]he member loses all governance rights except the right to wind up the affairs of the limited liability company in the event that the business of the limited liability is discontinued. If the existence and business of the company are continued, however, "the member whose membership interest has terminated loses all governance rights and will be considered merely a holder of the financial rights owned before the termination of the membership interest, other than any financial rights transferred by the member in connection with the termination of the membership interest."[33]

The Tennessee provision defines "membership interest" "to include both financial rights and governance rights and further specifies that the **membership interest**, **not merely the financial rights**, of a member are **personal property**."[34] As a result, a debtor's membership interest, not only financial rights, became property of the bankruptcy estate under section 541(a)(1). The court held that the Tennessee provision's "attempt to separate a member's financial rights from his or her governance rights upon the filing of a bankruptcy petition does appear to run afoul of section 541(c)(1)(B) because it is a provision in non-bankruptcy law that is conditioned upon the commencement of a case under title 11 that effects a modification or forfeiture of the debtor's rights."[35] As an aside, the court noted that although not an issue before the court, its conclusion does not depend on whether the debtor is a single-member or multi-member LLC.[36]

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[31] 2020 Bank. LEXIS 1364 (Bankr. W.D. Tenn. May 7, 2020).
[32] *Id.* at *8.
[33] *Id*. at *7 (quoting Tenn. Code Ann. § 48-249-505(a)(1)).
[34] *Id*. at *10.
[35] *Id*. at *11.
[36] *Id*. at *11, n. 3.

B. Assets of Single-Member LLCs: Debtor's Exemptions and the Automatic Stay

In bankruptcy, the assets of the debtor are typically protected by the automatic stay when the bankruptcy case is filed. For cases involving LLCs, the automatic stay would protect a debtor's membership interest in the LLC, such that no creditor could obtain a charging order in satisfaction of the debtor's debts once the bankruptcy case is filed. However, the LLC's assets are subject to a completely different analysis. The majority position is that the LLC's assets are not protected by the automatic stay even when the LLC is owned and controlled by a single-member debtor.

In *Desmond v. U.S. Asset Funding, LP* (*In re Desmond)*[37] the debtor filed a chapter 11 bankruptcy petition which listed among his assets 100% control of an LLC. When a creditor of the LLC sought to sell its collateral owned by the LLC, the debtor and the trustee sought to enjoin the sale, and argued that because the debtor's sole membership rights in the LLC included the right of control and management of the LLC, the automatic stay should protect the LLC and its assets.[38] The court concluded that the LLC was not a debtor in any bankruptcy case and that the agreement made between the LLC and the creditor were the actions of two non-debtors, thus allowing the creditor to pursue its full range of remedies against the LLC.

Most other courts have adhered to the traditional principle that the LLC's assets are separate from the debtor's assets.[39] There have been a few courts that have allowed the

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[37] 316 B.R. 593 (Bankr. D. N.H. 2004).
[38] *Id*. at 595.
[39] See, *In re Furlong,* 437 B.R. 712, 721 (Bankr. D. Mass. 2010) (holding "unless a corporation is itself a bankruptcy debtor, the automatic stay afforded to an individual debtor under section 362(a) does not extend to the assets of a corporation in which the Debtor has an interest, even if the interest is 100% of the corporate stock"); *In re Calhoun*, 312 B.R. 380 (Bankr. N.D. Iowa 2009); *In re Aldape Telford Glazier, Inc*., 410 B.R. 60 (Bankr. D. Idaho 2009); *In re Penn*, 2010 Bankr. LEXIS 1546, *4 (Bankr. N.D. Ga. April 2, 2010)(holding "once the sole owner of an LLC files a bankruptcy petition, the membership interests themselves become property of the owner's estate, but it does not compel the conclusion that the actual assets of the LLC are property of the owner's estate. Accordingly, the Debtor's argument that the automatic stay applied to protect [the LLC], a nondebtor, from the [creditor's] foreclosure must be rejected."); *In re Jones*, 628 B.R. 819 (Bankr. D.S.C. May 24, 2021).

automatic stay to apply to LLC assets in limited cases. In *In re Ealy*,[40] the debtors owned and operated a child care center and purchased property in the name of an LLC a week prior to the formation of the LLC.[41] The bankruptcy court held that the debtors held equitable title to the property, not the LLC—their equitable title "to the [p]roperty flows not from their ownership interest in the LLC that owns the [p]roperty, but from the facts and circumstances leading up to the LLC's acquisition of the [p]roperty."[42] The debtors had not intended the LLC would have sole title to the real estate, and had only created the LLC because she thought it was required in order to close on the property.[43] Therefore, the automatic stay extended to the real estate. Similarly, in *In re Schwab*,[44] the bankruptcy court determined that certain LLC assets were property of the debtor for purposes of applying the exemption statute where there was evidence that the debtor had purchased the assets using their own personal line of credit and had not intended the assets to be property of the LLC.

C. Fraudulent Transfers and Preferences in Single Member LLCs

Membership in an LLC is personal property of the debtor, and thus transfers of the membership interest would be subject to normal preference and fraudulent transfer analysis. However, the majority rule is that LLC assets are not property of the bankruptcy estate or the debtor, and therefore would not be subject to the same analysis. For example, in *In re Adams,*[45] the debtors purchased property and transferred it to an LLC owned exclusively by one of the debtors. Shortly before their bankruptcy filing, the LLC transferred the property to another LLC owned by the debtors' son. The court concluded that because the property had been owned by

[40] 307 B.R. 653 (Bankr. E.D. Ark. 2004)
[41] *Id*. at 655.
[42] *Id*. at 657-58.
[43] *Id*. at 658.
[44] 378 B.R. 854 (Bankr. D. Minn. 2007)
[45] *Nossaman-Petitt v. Adams Enters, Inc. (In re Adams)*, 2009 Bankr. LEXIS 3164 (Bankr. D. Neb. Sept. 25, 2009).

the debtor's LLC at the time of the transfer, it was not property of the debtor and was not subject to the avoidance provisions of the Bankruptcy Code.[46] The trustee could not avoid the transfer and could not recover the property for the bankruptcy estate.[47] This outcome presents the clever debtor with an easy way to avoid the trustee's powers to recover assets for the bankruptcy estate. It remains to be seen if other courts will adopt the analysis employed by the court in *Adams*.

D. Single-Member LLC Operating Agreements not Executory Contracts

The court in *In re First Protection, Inc,* discussed *supra*, noted that section 365 of the Bankruptcy Code relating to executory contracts was not applicable to that case because "there is no reason to prohibit a Trustee in bankruptcy from assuming all of the rights and obligations of a Debtor who is the only member of a single member LLC. In that case, there were no non-debtor members whose interests could be harmed by the operation of the LLC by a Trustee or a debtor in possession."[48] As discussed *infra*, the approach that courts will utilize in the context of multi-member LLCs is less clear.

IV. MULTI-MEMBER LLCS

A. The Trustee's Ability to Sell and/or Control the Debtor's Membership Interest

Many courts have held that even in the case of multi-member LLCs, section 541(c)(1) of the Bankruptcy Code invalidates any state law or operating agreement provision that would terminate membership interests or prohibit sale or transfer of interests upon a member's bankruptcy filing. Most of these courts do not first consider whether the operating agreement is an executory contract under Section 365 of the Bankruptcy Code. Courts have disagreed about

[46] *Id*. at *2.
[47] *Id*.
[48] 440 B.R. at 832 (citing *Modanlo*, 412 B.R. at 727).

whether section 541(c)(1) of the Bankruptcy Code permits a Trustee to succeed to all "governance" rights held by the debtor, including voting rights, the right to act as manager, or the ability to dissolve the entity. Such differences are important for Trustees to consider, if only because the value of a membership interest without voting and management rights may be less than the value with such rights.

Many courts hold, following the approach taken in *Fursman,* that section 541(c)(1) invalidates *any* restriction of the Trustee's ability to assume or sell all of the rights held by the debtor, including governance rights.[49] However, many other courts have interpreted section 541(c)(1) more narrowly. For example, in in *In re Garrison-Ashburn, L.C.*,[50] the bankruptcy court held that § 541(c)(1) invalidated an *ipso facto* provision terminating the debtor's membership upon bankruptcy filing, but did *not* invalidate a provision in the operating agreement prohibiting assignment of management rights without the permission of other members. The court reasoned that § 541(c)(1) merely allows the interest to come into the estate or to be transferred, *subject to* the same restrictions that would apply outside of bankruptcy.

As stated by an Illinois bankruptcy court in *BMA Ventures, LLC v. Prillaman* (*In re Minton*):

> By its plain terms, §541(c) governs what interests 'become[] property of the estate.' Congress enacted §541(c) to eliminate barriers to the transfer of property into the estate, and not to void restrictions on the transfer of property from the trustee to third parties. Simply stated, nothing in the language of §541(c)(1) addresses, much less authorizes, the transfer by the trustee of assets that are subject to prohibitions or restrictions on transfer. [51]

[49] See *Cardiello v. United States,* 465 B.R. 423 (Bankr. W.D. Pa. 2012); *Sherron Associates Loan Fund XXI LLC v. Thomas,* 503 B.R. 820 (Bankr. W.D. Wash. 2013).
[50] 253 B.R. 700 (Bankr. E.D. Va. 2000).
[51] 2017 Bankr. LEXIS 199, at *18-19 (Bankr. C.D. Ill. Jan. 23, 2017). See also *Grochocinski v. Campbell*, 475 B.R. 622 (Bankr. N.D. Ill. 2012).

Notwithstanding these disagreements about whether a Trustee may exercise *all* of a debtor's rights to actively "manage" an LLC, most courts have concluded that a Trustee may exercise *voting* rights associated with the debtor's membership interest. An example is the Indiana bankruptcy court's decision in *Walro v. Lee Group Holding Co., LLC (In re Lee),*[52] which determined that the debtor's majority (51%) voting rights in an LLC were property of the estate – a result which could potentially give the Trustee considerable control over management of the entity.

The facts in *Lee* were somewhat unusual, though perhaps not uncommon in situations where it is alleged that a limited liability company was formed as part of a fraudulent transfer scheme. The debtor, Lester Lee, was alleged to have made a number of fraudulent transfers before filing his petition, including transfers to a newly-formed LLC known as the Lee Group Holding Co. Under the operating agreement, Lee had no right to receive profits, but was given majority voting rights. The other membership interests were held by his wife and children, who were entitled to receive all of the profits. When Lee filed a Chapter 7 petition, the other members voted to remove Lee as manager and to terminate his voting rights. In a decision affirmed by the district court, the bankruptcy court agreed with the Trustee's argument he was entitled to exercise the voting rights, and that the other members had violated the bankruptcy stay. Other courts have reached similar conclusions.[53]

[52] 524 B.R. 798 (Bankr. S.D. Ind. 2014), *aff'd* 2014 Bankr. LEXIS 5069 (S.D. Ind. December 18, 2014).
[53] See, *In re McCabe*, 345 B.R. 1 (Bankr. D. Mass. 2006) (members' unilateral amendment of operating agreement violated automatic stay); *Matter of Daugherty Const., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995). (members' unilateral removal of debtor as manager was violation of automatic stay.)

B. Exemptions for LLC Interests

In the case of *In re Mays*,[54] Judge Coachys addressed the issue of exempting an LLC interest. In the *Mays* case, the debtor attempted to exempt 100% of the LLC interest pursuant to Indiana Code section 23-18-1-1. The debtors had argued that any transferable interest they had was limited to "economic interests," and because the revenues from the LLC were zero, the entire interest was exempt. Judge Coachys rejected the debtors' position, and held that the debtors were limited to the $350 in available exemptions for intangible assets provided under Indiana law[55] (rather than the 100% exemption sought by the Debtors). It is interesting to note that in a footnote Judge Coachys questioned the Trustee's concession that he was limited to the rights of an assignee/judgment creditor and that the trustee is entitled to only the member's "economic interests" in the LLC. Judge Coachys questioned why the trustee should be treated as an "assignee" given the expansive wording in section 541(a) of the Bankruptcy Code. As discussed above, many courts would agree that the trustee has much greater rights than an assignee and may have management rights in a single-member LLC and at least the right to sell a debtor's LLC interest.

C. Operating Agreements as Executory Contracts and the Section 365 Limitations

An operating agreement for an LLC will define the various rights and obligations of the members, including restrictions against transfer of the membership units. The operating agreement may also contain a provision that provides for dissolution of the LLC in the event of a member bankruptcy. Courts have grappled with whether the LLC operating agreements are

[54] *In re Jeffrey v. Mays and Edith R. Mays, U.S. Bankruptcy Court for S.D. of Indiana, Case No. 10-11132-JKC-7A, Order dated December 3, 2010.*
[55] I.C. § 34-55-10-2(c).

executory contracts and whether the trustee is bound by the terms of the executory contract. The Bankruptcy Code does not define the term "executory contract," however the Seventh Circuit generally applies the "Countryman" definition—"a contract is executory if 'the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'"[56] The determination of whether an LLC operating agreement is an executory contract is made on a case-by-case basis to "determine if the operating agreement contains sufficient unperformed obligations to require treatment as an executory contract."[57]

> Operating agreements often contain standard provisions potentially requiring members to take some future, contingent act, such as indemnifying the LLC for tax liabilities, making future capital contributions to the LLC, or voting on substantial transactions involving the LLC. Such hypothetical, remote, or speculative obligations are generally insufficient to require treating an operating agreement as an executory contract. Rather, a debtor must have substantial, current, unperformed obligations if an operating agreement is to be treated as an executory contract. For example, an operating agreement is executory as to a debtor where the debtor is obligated to provide services as a general contractor for an ongoing real estate development project conducted through the LLC. An operating agreement can also be executory if the debtor has an important role in the management of the LLC.[58]

If the operating agreement is an executory contract, it is subject to the limitations of sections 365(c) and (e) of the Bankruptcy Code. Section 365(e)(1) and (2) of the Bankruptcy Code provide that a contractual provision requiring the termination of the agreement based upon a debtor's bankruptcy filing (a so-called *ipso facto* clause) will *not* be given effect *unless* (a) applicable law excuses the counterparty to the contract from accepting performance from the trustee, and (b) the counterparty to the contract objects to the trustee's efforts to assume or assign the contract. Similarly, section 365(c) provides that, although a trustee may generally assume

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[56] *BMA Ventures, LLC v. Prillaman (In re Minton)*, 2017 Bankr. LEXIS 199, *10-11 (Bankr. C.D. Ill. Jan. 23, 2017). (quoting *Mitchell v. Streets (In re Streets & Beard Farm Partnership)*, 882 F.2d 233, 235 (7th Cir. 1989)).
[57] *Id*. at *11
[58] *Id*. at *11-12.

and assign an executory contract, a trustee may not assume a contract if (a) applicable law would excuse the counterparty to the contract from accepting performance from a person other than the debtor, and (b) the counterparty objects to the trustee's effort to assume or assign the contract.

Some courts have held that an operating agreement is not an executory contract. For example, in the case of *Movitz v. Fiesta Investments LLC (In re Ehmann),*[59] an Arizona bankruptcy court concluded, "that because the operating agreement of a [LLC] imposes no obligations on its members, it is not an executory contract.[60] Accordingly, the trustee acquires all of the debtor's rights and interests pursuant to sections 541(a) and (c)(1) of the Bankruptcy Code, and the 365(c) and (e) limitations do not apply.[61] In the *Movitz* case, the Court determined that the LLC's operating agreement was not an executory contract because the debtor's interest was effectively passive (*i.e.* there was nothing for the debtor to do to continue to receive distributions).[62] Because the LLC's operating agreement was not executory, the trustee's rights were controlled by section 541 of the Bankruptcy Code and all the restrictions on the transfer of the debtor's interest under Arizona law and the LLC's operating agreement were inapplicable pursuant to section 541(c) of the Bankruptcy Code.[63] Accordingly, the trustee could sell the LLC interest free of any transfer restrictions. The Court did, however, indicate that if the debtor's interest was active (*i.e.* the debtor had to affirmatively undertake some acts to gain

[59] 319 B.R. 200 (Bankr. D. Ariz. 2005).
[60] *Id.* at 201.
[61] *Id*.
[62] *Id.* at 205-06.
[63] *Id.* at 206. *See* 11 U.S.C. § 541(c)(1) (an 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, or that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case, or on the appointment of or taking possession by a trustee in a bankruptcy case or a custodian before commencement of a bankruptcy case, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property).

entitlement to distributions, thus making the operating agreement an executory contract) the trustee would be restricted by Arizona law and the terms of the operating agreement.[64]

By contrast, in *In re Minton*, after determining that the LLC operating agreement was not executory, the Court had to determine whether the trustee was bound by the provisions of the operating agreement, specifically those related to the sale or disposition of the member's interest in the LLC.[65] The LLC argued that the trustee takes the membership interest in the LLC subject to the same restrictions that existed at the commencement of the case.[66] The trustee, on the other hand, argued that the sale provisions in the LLC operating agreement are void as impermissible *ipso facto* clauses under section 541(c)(1).[67] The Court pointed out that under section 541(c)(1), the debtor's interest in the LLC became property of the estate regardless of a provision in the operating agreement (or non-bankruptcy law), that would otherwise prevent the transfer.[68] However, according to the Court, section 541(c)(1) does no more than that—

> Pursuant to §541, a Chapter 7 trustee steps into the debtor's shoes as an LLC member and succeeds to all rights and obligations under an LLC operating agreement. Section 541(c)(1) does not operate to define the bundle of rights that go with property. Nor does it expand a trustee's rights beyond those held by the debtor. Section 541(c)(1) therefore does not provide authority for the Trustee to sell the estate's interest in [the LLC] free of the constraints of the Operating Agreement.[69]

Although the trustee does have some potential remedies in order to avoid some sale restrictions set forth in an operating agreement (*e.g*. under section 363(f) of the Bankruptcy Code and the unenforceability of "unreasonable restraints on alienation" under state law), in general, sale restrictions found in an LLC operating agreements are enforceable in bankruptcy "where they do

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[64] *Id.* at 205-06.
[65] 2017 Bankr. LEXIS 199 at *17.
[66] *Id*.
[67] *Id*.
[68] *Id*. at *18.
[69] *Id*. at *19. (internal citations omitted).

not significantly impair a trustee's ability to obtain the fair market value of the estate's interest in the LLC."[70]

There are several courts that have held that operating agreements are executory contracts because such agreements contain material, mutual, unperformed obligations that would qualify it as an executory contract.[71] In these cases, courts have held that if the operating agreement is assumed by the trustee, it remains subject to the limitations of section 365 of the Bankruptcy Code, which potentially could limit the trustee's ability to sell the debtor's membership interest.[72]

However, some jurisdictions have held that an operating agreement is never an executory contract, even if the debtor's interest is considered active *(e.g.* material, mutual unperformed obligations). For example, in the case of *In re Denman*,[73] a Tennessee bankruptcy court held that an operating agreement for an LLC in which a Chapter 13 debtor held a membership interest was a business formation and governance instrument that simply defined the membership interests, rights and duties that attached thereto, and was not a contract between the debtor and the other members of the LLC.[74] Accordingly, the fact that the members of the LLC had material unperformed obligations under the operating agreement did not make the operating agreement a per se executory contract.[75] The Court reached this conclusion because, according to relevant Tennessee law, one member's failure to perform under an LLC operating agreement

[70] *Id*. at *19-20.
[71] *See In re Allentown Ambassadors*, 361 B.R. 422 (Bankr. E.D. Pa. 2007) (holding that an operating agreement is an executory contract because material, unperformed obligations remain on both sides); *In re Daugherty Construction, Inc*., 188 B.R. 607 (Bankr. D. Neb. 1995) (same); *In re Capital Acquisitions & Management Corp.*, 341 B.R. 632 (Bankr. N.D. Ill. 2006) (same); *In re Knowles*, 2013 WL 152434 (Bankr. M.D. Fla. 2013) (same); *In re Pearce v. Woodfield (In re Woodfield)*, 602 B.R. 747 (Bankr. D. Or. 2019) (same).
[72] *Id*.
[73] 513 B.R. 720 (Bankr. W.D. Tenn. 2014).
[74] *Id.* at 723
[75] *Id*.

does not excuse the other members' performance thereunder and because an operating agreement has many features that are at odds with a normal contract.[76] Accordingly, the limitations of sections 365(c) and (e) of the Bankruptcy Code did not apply in this case and the trustee assumed the debtor's membership interest free of any restrictions under Tennessee law or the LLC operating agreement.[77] However, *Denman* is an unusual case in which the decision by the court was based on the unique qualities of Tennessee law regarding operating agreements.[78]

Other courts, although applying a different analysis, have agreed with the *Denman* Court's conclusion that the Trustee assumes the debtor's membership interests without any restriction. In *In re Dixie Management & Inv. Ltd. Partners*,[79] an Arkansas bankruptcy court held that the *ipso facto* clause in the LLC's operating agreement, providing that it would be an event of disassociation for any member to petition for bankruptcy relief, did not prevent the debtor's 62% membership interest in the LLC from being included as property of the estate.[80] In this case, the Arkansas state statute providing that a party ceases to be a member of a LLC when the party "[f]iles a voluntary petition in bankruptcy" was preempted by section 541(c)(1) of the Bankruptcy Code, and did not prevent the debtor's membership interest from being included as property of the estate.[81]

If the trustee rejects the operating agreement, the trustee's rejection is deemed a breach of the operating agreement, not a termination or rescission of a contract.[82] The rejection, therefore, does not extinguish the operating agreement or the other member's rights attached thereto—

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[76] *Id*. at 722-26.
[77] *Id*. at 725.
[78] *Id*.
[79] *Duncan v. Dixie Mgmt. & Inv., Ltd. Partners* (*In re* Dixie Management & Inv. Ltd. Partners), 474 B.R. 698 (Bankr. W.D. Ark. 2011).
[80] *Id.* at 701.
[81] *Id*.
[82] *In re Minton*, 2017 Bankr. LEXIS 199 at *8.

whatever rights the parties possess post-rejection are governed by the operating agreement and "ordinary principles of state law."[83] Therefore, the rejection of an operating agreement does not "invalidate the provisions in that agreement that allocate each member's share of the interests in the LLC."[84] As a result, the trustee's rejection of the operating agreement would not change the fact that the bankruptcy estate owns a property interest in the LLC.[85] The trustee is thus able to sell this interest, but the rejection frees the bankruptcy estate of the monetary burdens and obligations under the operating agreement. Accordingly, when a trustee sells a debtor's interest in an LLC and rejects the operating agreement, the new owner of the debtor's LLC interest takes it subject to the equitable remedies of the other members in light of the trustee's breach.

D. Buy-Sell Agreements as Executory Contracts and Section 365(a)

Similar to LLC operating agreements, courts have also had to address whether buy-sell agreements are executory contracts. The court in *In re Roomstore, Inc* [86] had to determine whether the parties' buy-sell agreement was an executory contract that could be rejected by the debtor pursuant to section 365(a) of the Bankruptcy Code. Acknowledging that although the issue presented in *Roomstore* was "fairly limited and straightforward," the Court still had to face the daunting task of applying "abstract legal principles" to unique facts.[87] At issue, was a certain provision in the buy-sell agreement that gave an LLC the right to purchase the chapter 11 debtor's (Roomstore, Inc.) interest in the LLC upon the debtor's bankruptcy filing.[88] The buy-

[83] *Id.* at *9.
[84] *Id.* (citing *In re Strata Title, LLC*, 2013 Bankr. LEXIS 2315, *3(Bankr. D. Ariz. June 6, 2013)).
[85] *Id*.
[86] 473 B.R. 107 (Bankr. E.D. Va. 2012)
[87] *Roomstore*, 473 B.R. at 110.
[88] *Id*. The provision at issue provided that "[i]f a Member. . . files a voluntary petition under any bankruptcy or insolvency law. . . then the Company [LLC] shall have the option for a period of 180 days after the date of the Insolvency Event to purchase the Membership Interest for Fair Market Value . . . ." "Fair Market Value" was also defined in the buy-sell agreement.

sell agreement provided for a method for determining the purchase price upon exercise of that option, but the purchase price determined by the agreement was not necessarily the market value of the debtor's interest.[89] Therefore the debtor sought to reject the buy-sell agreement.

The court further looked at a split in two circuits in the application of the Countryman definition to a "paid-for but unexercised option."[90] The Ninth Circuit had held that a purchase option not exercised prior to the bankruptcy is not an executory contract.[91] The basis for the Ninth Circuit decision in *Robert L. Helms Construction and Development Co.* was to use the following approach—"to ask whether the option requires further performance from each party at the time the petition is filed. Typically, the answer is no, and the option is therefore not executory. The optionee need not exercise the option-if he does nothing, the options lapses without breach. The contingency which triggers potential obligations- exercising the option- is completely within the optionee's control…"[92]

The court ultimately agreed with the debtor (and the 4th Circuit line of cases), "that a contingent obligation, even though not yet triggered on a debtor's petition date, is nevertheless executory until expiration of the contingency because '[u]ntil the time has expired during which an event triggering a contingent duty may occur, the contingent obligation represents a continuing duty to stand ready to perform if the contingency occurs.'"[93] The court also discussed *In re Simon Transportation Services* and it's "functional approach" utilized in determining whether a contract is executory "by looking 'to the benefits to be gained by the

[89] *Id*.
[90] *Id*. at 112.
[91] *Id.* (citing *Unsecured Creditors' Committee v. Southmark Corp. (In re Robert L. Helms Constr. and Dev. Co.)*, 139 F.3d 702 (9th Cir. 1998)).
[92] *Id*. (quoting *Robert L. Helms Constr. and Dev. Co*., 139 F.3d at 705-706).
[93] *Id.* at 112-13. (quoting *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.),* 756 F.2d 1043, 1045 (4th Cir. 1985)). *See also In re Avianca Holdings Sociedad Anónima*, 618 B.R. 684, 700-01 (Bankr. S.D.N.Y. 2020).

debtor's estate…'" [94] In *Roomstore*, the buy-sell agreement contained more than a simple purchase option or right of first refusal—it was a complex contract with multiple continuing conditions. The buy-sell agreement contained provisions that prohibited members of the LLC from encumbering their interests in the LLC, or transferring their membership interests except as permitted in the agreement, thus rendering the agreement executory.[95] Further, if the debtor could not reject the buy-sell agreement, a valuable asset may be removed from the estate—the debtor's rejection of the agreement will give it an opportunity to expose the asset to the market, and maximize its value for the benefit of the bankruptcy estate.[96]

V. CONCLUSION

The administration of an individual debtor's interest in an LLC in a bankruptcy case today can be fairly complicated depending on the type of LLC, the assets under the control of the LLC, the terms of the operating agreement, and the provisions of state law that control the LLC. It is clear, however, that a debtor's interest in a LLC is part of the bankruptcy estate and the automatic stay does apply to the interest, but it is less clear exactly what the trustee can do with the interest in a multi-member LLC. Courts generally seem to be interested in protecting other members of an LLC who could potentially be injured by the trustee taking control of a member's interest; however, those concerns seem to disappear if the debtor owns an interest in a single-member LLC. With increased utilization of LLCs, no doubt trustees will administer more LLC interests and we can expect more court opinions defining the trustee's rights and authority in administering the LLC interest.

[94] *Id.* (quoting *In re Simon Transportation Services*, 292 B.R. 207, 218 (Bankr. D. Utah 2003)).
[95] *Id*. at 114.
[96] *Id.* at 115-16.