

# Limited Liability Companies: Bankruptcy Issues

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## I. Introduction

Because limited liability companies (“LLCs”) are still relatively new state-law creations, the treatment of these entities in bankruptcy is uncertain, i.e., will they be treated as partnerships or corporations for bankruptcy purposes? *See In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289, 292 (Bankr. N.D. Ohio 2001) (“an LLC is neither a corporation or a partnership, as those terms are commonly understood. Instead, an LLC is a hybrid”). This uncertainty is especially troublesome with respect to single-member LLCs. This is because if an LLC is treated as a partnership, it could dissolve upon the bankruptcy of its sole member and its assets distributed to creditors and the bankrupt member. If, on the other hand, the LLC were treated as a corporation, it would not dissolve upon the bankruptcy of the last remaining member, although the member’s ownership interest could be transferred. Some commentators believe that, at least under the DLLC Act, an LLC should be treated as a corporation because the LLC operating agreement is similar to a certificate of incorporation and a member’s interest is analogous to a share of stock in a corporation. *See* Larry E. Ribstein and Robert R. Keatings, *Limited Liability Companies*, § 14.04, at 14-18 (2000) (“[F]rom a policy standpoint, LLCs probably should be considered corporations for bankruptcy purposes because the special bankruptcy provisions that apply to partnerships primarily relate to the general partner’s duty to contribute to payment of the firm’s debts”); Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies Tax and Business Law*, ¶1.04 (2)(a) (1999).

## II. Treatment of LLCs Under Bankruptcy Code

Bankruptcy courts generally look to state law to determine whether dissolution occurs upon the bankruptcy of the sole member. Under the DLLC Act, for example, an LLC whose member is in bankruptcy would be treated as if it were a corporation with a bankrupt shareholder and the bankruptcy would not cause a dissolution. If a Delaware LLC agreement is properly drafted, under Delaware law even the bankruptcy of the last remaining member will not, by itself, cause the dissolution of the LLC. Furthermore, under the DLLC Act, it is permissible to admit “springing members,” i.e., a person may be admitted as a member (including as the sole member) without acquiring an interest in the LLC or being required to make a capital contribution. *See* Del. Code Ann. tit. 6, §§ 18-801(a)(4) and (b); James G. Leyden Jr., *A Key State’s Approach to LLCs: Delaware Can Be Different*, 9-MAY Bus. L. Today 51, 63 (2000).

There are no specific provisions in the Bankruptcy Code (“Code”) or Bankruptcy Rules that deal with LLCs, and the application of bankruptcy law and specific Code provisions is uncertain. The Code does not include an LLC within the definition of a

debtor that is eligible for relief. However, it is likely that a bankruptcy court would conclude that an LLC would qualify as a debtor under the Code. *See In re ICLNDS Notes Acquisition, LLC, supra*, 259 B.R. at 292 (“There is no specific reference in the Code to a limited liability company. Under the rules of construction applicable to the Code, however, the use of the term “includes” is not limiting . . . . In other words, individuals, corporations and partnerships are clearly eligible for relief, but other similar entities are as well”); Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Limited Liability Companies in Bankruptcy*, in *The Best Entity for Doing the Deal*, at 747, 763-64 (PLI Corp. Law and Practice Course Handbook Series No. 747 (1996)). Case law is just beginning to develop in this area. Does an LLC qualify as a “corporation” (which includes an “association having a power or privilege that a private corporation, but not an individual or a partnership, possesses” and a “partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association”) as defined in sec. 101(9) of the Code, or does it qualify as a “person” (which includes an “individual, partnership and corporation”) as defined in sec. 101(41) of the Code? As noted above, the Code currently does not recognize an LLC as a distinct or separately defined entity. However, a court may find that an LLC has significant similarities to both partnership and corporate entities to qualify as a “person” entitled to protection under the Code. *See In re ICLNDS Notes Acquisition, LLC, supra*, 259 B.R. at 293 (“[a]s corporations and partnerships are eligible to be debtors, and because an LLC draws its character from both of those forms of doing business, an LLC is similar enough to those entities that it also comes within the definition of “person” and is eligible for protection under the Code”); *In re Midpoint Development LLC*, 313 B.R. 486, 488-89 (Bankr. W.D. Okla 2004) (holding that LLCs are sufficiently analogous to corporations and partnerships to be debtors under the Code, and stating that under Oklahoma LLC Act, “a dissolved limited liability company qualifies as a debtor in order to wind up its affairs”).

Where and whether an LLC files a bankruptcy petition can be different depending on whether corporate or partnership characteristics are deemed to apply. Proper authorization for the filing of a voluntary bankruptcy petition will depend on whether the LLC is treated as a partnership or a corporation, and such determination may be different depending on whether the LLC is member-managed or manager-managed. If the LLC is member-managed and is treated as a partnership under the Code, all of the members would be required to consent to a bankruptcy filing. If the LLC is managed by one or more designated managers, it is unclear (absent specific provisions in the LLC’s operating agreement) whether the manager(s) alone may determine whether to file a bankruptcy proceeding, or whether the filing of a bankruptcy petition is such an extraordinary event that all members would be required to consent. An LLC’s operating agreement should expressly address who is authorized to file a bankruptcy petition on behalf of the LLC. *See In re Avalon Hotel Partners, LLC, supra*, 302 B.R. at 381 (ruling that the filing of bankruptcy petition by LLC’s manager without member approval was not authorized under either State law or operating agreement, but consent resolution was effective to ratify petition and render bankruptcy filing properly authorized where operating agreement provided for amendment of operating agreement by written consent of 75% of members); Federal Rule of Bankruptcy Procedure 1004 (which requires the

consent of all partners to the filing of a voluntary petition on behalf of a partnership and requires service of an involuntary petition on all non-petitioning general partners); Federal Rule of Bankruptcy Procedure 1004 (which requires the consent of all partners to the filing of a voluntary petition on behalf of a partnership and requires service of an involuntary petition on all non-petitioning general partners); Thomas F. Blakemore, *Limited Liability Companies and the Bankruptcy Code*, 13 Am. Bankr. Inst. J. 12 (June 1994).

It is also unclear whether an LLC could contest the filing of an involuntary Chapter 7 or Chapter 11 bankruptcy petition against it on the basis that it is not a “person” under sec. 101(41) of the Code, or whether an LLC could convert a Chapter 11 proceeding to a Chapter 7 proceeding. Section 303(a) of the Code states that an involuntary bankruptcy proceeding may be filed only against “a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced.” Under sec. 303(d) of the Code, a general partner in a partnership debtor that did not join in the filing of an involuntary bankruptcy petition may challenge the petition and seek to have it denied. This provision would apply to an LLC only if it is treated the same as a partnership in bankruptcy. If an LLC is treated as a corporation in bankruptcy, only creditors would be permitted to file an involuntary petition against the LLC, and individual members could not file an involuntary proceeding against the LLC. (The operating agreement could even expressly prohibit such a filing).

### **III. Effect of Bankruptcy Filing by LLC Member**

Under most state LLC statutes, if a member files a bankruptcy case the LLC automatically dissolves (unless otherwise specified in the operating agreement). Is this provision of a state LLC statute overridden by the Code because it constitutes an *ipso facto* clause (i.e., a clause that modifies or eliminates a party’s contractual rights solely because of a bankruptcy filing) which is unenforceable under sections 541(c)(1), 363(l) and 365(e) of the Code? The answer may depend on whether the articles of organization and operating agreement are regarded as executory contracts (i.e., contracts on which performance remains due to some extent on both sides). The question then becomes whether these documents are “organic” governing documents (as opposed to executory contracts) and whether a bankruptcy court, even if it held the documents to be executory, would enforce the documents with the sole exception of the bankruptcy-remote provisions if the agreements were rejected, or permit such rejection to cause a dissolution of the LLC without providing at least a “winding down” period.

If the LLC cannot be dissolved because of the bankruptcy, will this have an adverse impact on characterization of the entity for tax purposes because it will then have continuity of life? Will such a determination depend on whether a member of an LLC files a Chapter 7 proceeding or a Chapter 11 proceeding? Can the bankrupt member assign some or all of his, her or its LLC interest, despite statutory or contractual provisions that prevent such a transfer? If the bankrupt member is also a manager, is the

distraction of the bankruptcy and the lack of an on-going financial interest in the entity likely to affect his or her actions on behalf of the LLC? Under recently enacted amendments to the Illinois LLC act, a member who becomes a debtor in bankruptcy, executes an assignment for the benefit of creditors, etc., becomes a “dissociating member” and such a member’s right to participate in the management of the LLC thereupon terminates. *See* James M. Jorissen, *Member Bankruptcy Under the New Minnesota Limited Liability Company Act: An Executory Contract Analysis*, 77 Minn. L. Rev. 953 (1993).

#### A. Case Law

In *In Re Daugherty Construction, Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995), the court held that the LLC articles of organization and operating agreements of the two LLCs of which the debtor was a member were executory contracts that the debtor could assume or reject. The court also found that the state LLC statute providing for dissolution of an LLC upon a bankruptcy filing by a member violates the Code, and therefore was not enforceable against the debtor-member upon commencement of the debtor-member’s bankruptcy case. The court further held that the actions of the other members of the two LLCs upon commencement of the debtor-member’s Chapter 11 bankruptcy petition, including holding meetings in the debtor’s absence, voting to continue the LLCs’ construction business, and actually continuing and controlling the LLCs’ business under new membership, violated the automatic stay provisions of sec. 362(a) of the Code and would be set aside to the extent that they impaired, modified, or terminated the member-debtor’s interest in the limited liability companies. However, because this was a case of first impression and the court determined that the acts of the other members appeared to be good faith attempts to protect their interests in the LLCs under the operating agreement and the state LLC statute, the court concluded that sanctions against the other members were not appropriate. *See also In the Matter of GP Express Airlines, Inc.*, 200 B.R. 222, 232 (Bankr. D. Neb. 1996) (the court, citing *In re Daugherty*, stated that “the Bankruptcy Code will not enforce provisions in private agreements or under nonbankruptcy law which terminate a debtor’s interest in property or an executory contract merely because of a bankruptcy filing”); *In re Sandman Associates, L.L.C.*, 251 B.R. 473, 482-43 (W.D.Va. 2000) (holding that where debtor LLC filed Chapter 11 bankruptcy petition solely for purpose of rejecting alleged executory contract to admit new member, new member’s failure to execute LLC operating agreement as provided in the contract was not material breach that would create executory contract that debtor could reject); Anthony Michael Sabino, *Litigating the Limited Liability Company, Part II: A Tale of Two Bankruptcy Courts*, 69-APR N.Y. St. B.J. 22 (1997); *Limited Liability Companies and Bankruptcy*, Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, 937 PLI/Corp. 747, 800-05 (1996).

However, in *Broyhill v. DeLuca (In Re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996), the court held that an operating agreement is an executory contract, but that because the object of the agreement (the development of a real estate project) had been started but not yet completed and the parties had on-going duties and responsibilities with respect to the

successful conclusion of the project, the nature of those duties and responsibilities constituted a contract for personal services under applicable state law because the identity of the managers was material to the existence of the LLC. The court noted that such a contract for personal services cannot be forced on an unwilling party and is not subject to the Code prohibition on the enforceability of *ipso facto* clauses. The court further noted that “for the purpose of analyzing the effect of a member’s bankruptcy upon the continued exercise of membership rights, it seems most appropriate to treat the relationship among members of a limited liability company as analogous to that of that [sic] among the partners of a partnership.” *Id.* at 74. The court also stated that an LLC “is a form of legal entity that has attributes of both a corporation and a partnership but is not formally characterized as either one. Generally, an LLC offers all of its members, including any member-manager, limited liability as if they were shareholders of a corporation but treats the entity and its members as a partnership for tax purposes.” *Id.* at 71. (The court in *In re ICLNDS Notes Acquisition, LLC, supra*, cited this passage from *DeLuca* in support of its holding that an LLC was eligible to file a bankruptcy petition).

In a companion case, *JTB Enterprises, L.C. v. D & B Venture, L.C. (In Re DeLuca)*, 194 B.R. 79 (Bankr. E.D. Va. 1996), the court concluded that because the LLC operating agreement provided that each of the members had an equal vote, the holder of a 50 per cent membership interest could not cast “a majority vote of the members,” as required by the operating agreement, to remove the managing member notwithstanding that the holder of the 50 per cent interest may have had the larger capital account, and the court held that the decision of the member holding such 50% interest to file a Chapter 11 petition on behalf of the LLC was a “major decision” under the operating agreement that required the vote of all the members. The court noted that it was aware that its holdings in the two related *DeLuca* decisions were contrary to the ruling of the court in *In Re Daugherty, supra*, but that it believed its holdings were consistent with the controlling authority in the district.

In *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D.Va. 2000), the court held that both before and after the enactment of amendments to the applicable LLC statute providing for the continued existence of an LLC, the bankruptcy of a member effected an assignment of that member’s interest, whereby the disassociated member would retain his or her right to share in the LLC profits, losses and distributions but would forfeit any right to participate in management of the LLC. The court also ruled that the operating agreement was not an executory contract because it “merely provides the structure for the management of the company” and “imposes no additional duties or responsibilities on the parties” and the economic interest of the bankrupt member was not impaired nor did it affect the ability of the LLC to continue in business. *Id.* at 708. The court distinguished *In re DeLuca, supra*, by finding that, as opposed to *DeLuca*, “[t]his case does not concern an entity whose organic documents or enabling statute dissolves the entity on the filing of a member’s petition in bankruptcy.” *Id.* See also *Dye v. Sandman Associates (In re Sandman Associates, L.L.C.)*, 251 B.R. 473, 482-83 (W.D. Va. 2000) (holding that, as a matter of law, an LLC’s letter agreement that it would grant a membership interest to a new member in exchange for a capital contribution was not an executory contract that could be rejected by the LLC, even where the new member had not actually executed the

LLC operating agreement); *Solomon v. Barman (In re Barman)* 237 B.R. 342, 348-49 (Bankr. E.D. Mich. 1999) (ruling that an LLC is sufficiently analogous to a corporation for purposes of determining whether one of three members of an LLC was an “insider” under the Code; the court found an insider relationship because member owned or controlled one-third of the voting rights in the LLC and his relationship with the LLC was analogous to that of a corporate director, officer, or person in control; the court stated that his relationship to the other members “could not be said to be at arms length and would require close scrutiny”).

#### **IV. Lender Concerns in Structuring LLC Borrowing Entities**

As a result of their negative experiences in recent years involving bankruptcy filings by and against borrowers, real estate lenders have learned that if a borrowing entity with very few creditors is created, such as a bankruptcy-remote LLC, it will be much more difficult for the borrower to file, or have filed against it, a bankruptcy proceeding or avoid early dismissal. *See, e.g., Barakat v. Life Ins. Co. of Virginia*, 99 F. 3d 1520, 1526 (9<sup>th</sup> Cir. 1996) (holding that where the only bona fide, impaired claim in the bankruptcy case was the claim of the mortgage lender, the debtor “should [not] be able to cramdown a plan that disadvantages the largest creditor”); John C. Murray, *The Lender’s Guide to Single-Asset Real Estate Bankruptcies*, 31 Real Prop. Prob. & Tr. J. 393, 461-471 (Fall 1996); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Finance Topics, American College of Real Estate Lawyers, Midyear Meeting, Scottsdale, Arizona, April 4-5, 1997, Tab 24, at 3; Varallo and Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 Bus. Law. 239 (1992).

A desirable alternative for a lender seeking to protect its interests without opening itself up to unwanted liability may be to require the LLC to appoint an “independent director,” i.e., a reputable individual or entity with no prior or current affiliation or relationship with either the lender or the LLC, as an additional member of the LLC. However, the inclusion of such a “bankruptcy remote provision” in an LLC operating agreement, especially one that requires approval of certain entity actions by an independent director who is in actuality under the influence of a major secured lender, may later be determined by a bankruptcy court to run afoul of the Code’s prohibition of provisions preventing an entity from commencing a bankruptcy reorganization. Also, several courts have held that as an entity approaches insolvency, i.e., becomes unable to pay its debts as they become due in the ordinary course of business, the directors owe a fiduciary duty to all the creditors of the company. In *In re Kingston Square Associates*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997), the debtor was unable to obtain its board of directors’ permission to file a voluntary bankruptcy proceeding because of the refusal of the “independent director” to authorize such a filing. The debtor then orchestrated an involuntary filing by certain unsecured creditors (with the help of the debtor’s limited partners). The bankruptcy court found that such actions were not taken in bad faith and that the debtor reasonably believed that the best course of action for the entity was to file bankruptcy. The court further held that such actions were necessary because the “independent director” had abdicated his fiduciary duty to the debtors, creditors and limited partners in favor of the interests of the mortgage lender. The court therefore refused to grant the secured creditor’s motion to dismiss the involuntary filing. The court

also appointed a Chapter 11 trustee, and held that the debtor's board of directors had violated their fiduciary duties owed to the debtor, its limited partners and its unsecured creditors and interest holders, in favor of the interests of the mortgage lender. The court declined, however, to specifically nullify the debtor corporation's bylaw provision containing the bankruptcy-proof provisions as against public policy. In *In re Avalon Hotel Ptnrs, LLC*, *supra*, the Oregon bankruptcy court held that the equitable doctrine of "judicial estoppel" (which precludes a party from taking inconsistent positions in different courts) did not apply to a promise made by the LLC to a state court and its manager not to file a Chapter 11 bankruptcy petition. The court stated that, "[a]s a matter of public policy, it is not appropriate to enforce judicial estoppel where the impact would fall not just on the alleged offending parties [the LLC and its manager], but also on parties to which a chapter 11 debtor in possession owes fiduciary duties, including minority member who are not parties to the State Court litigation . . . and creditors in this case". *Id.* at 383. The court also ruled that the LCC's filing of a Chapter 11 bankruptcy petition was done in good faith, because it involved more than a simple two-party dispute and was necessary to maximize the value of the LLC's assets for all the LLC's creditors

*See also In re Cumberland Farms, Inc.*, 249 B.R. 341, 349-51 (Bankr. D. Mass. 2000) (finding clear breach of duty where director caused cash flow from property to be used to repay loans from "his" company to detriment of debtor's finances generally, and noting that directors must act "with absolute fidelity and must place their duties to the corporation above every other financial or business obligation . . . They cannot be permitted to serve two masters whose interests are antagonistic"); *Geyer v. Ingersoll Pub. Co.*, 621 A.2d 784, 787-89 (1992); *Credit Lyonnais Bank, Nederland, N.V. v. Pathe Comm. Corp.*, No. 12150, 1991 WL 277613 (Del. Ch., Dec 30, 1991); *In re Andreuccetti*, 975 F.2d 413, 421 (7<sup>th</sup> Cir. 1992); *Clarkson Co., Ltd. v. Shaheen*, 660 F.2d 506, 512 (2<sup>nd</sup> Cir. 1981); *Tampa Waterworks Co. v. Wood*, 121 So. 789 (Fla. 1929); *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981); *In re Schulz*, 208 B.R. 723, 729 (M.D. Fla. 1997); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 n.2. (Del. Ch. 1997); *In re Brian Jacks*, 243 B.R. 385, 390 (Bankr. C.D. Cal. 1999); *Credit Agricole Indosuez v. Rossiyskiy Kredit Bank*, 708 N.Y.S.2d 25, 31 (N.Y. 2000) (stating that New York "trust fund" doctrine provides that once company is insolvent, officers and directors stand in position of trustees, holding corporate assets in trust for creditors' benefit); *Pereira v. Cogan*, 2002 U.S. Dist. LEXIS 8513 (S.D. N.Y., May 10, 2002) at \*14-15 (holding that action for breach of fiduciary duty by corporate directors is equitable in nature and such a claim is insufficient to entitle defendants to jury trial); *In re Schipper*, 933 F.2d 513, 515 (7<sup>th</sup> Cir. 1991) (holding that debtor's fiduciary duty to creditors is analogous to duties of corporate fiduciary). *But see Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc)*, 225 B.R. 646, 655 (N.D. Ill. 1998), *remanded by Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 2000 W.L. 28266 (N.D. Ill. Jan. 11, 2000) (ruling that directors' fiduciary obligation, when corporation is near insolvency, requires only that they "exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth-creating capacity"); *Fir Tree Partners, L.P. v. MCG Communications, Inc.*, No. 114674 (Sup. Ct. of N.Y., County of N.Y., Nov. 7, 2001) (dismissing complaint alleging corporation's board of directors owed fiduciary duty to creditors where financial statements strongly suggested impending insolvency, based on

technical holding that broad “no action” clause in indenture prevented public debt holders from taking action with respect to indenture or underlying notes); *LaSalle Nat’l Bank v. Perelman*, 82 F.Supp.2d 279, 291-92 (D. Del. 2000) (ruling that although, under Delaware law, debtor in Chapter 11 bankruptcy has fiduciary duty to act in best interest of estate as a whole, including its creditors, equity interest holders and other parties in interest, officers and directors generally do not owe fiduciary duty to creditors of corporation unless corporation is insolvent). *See generally* Steven L. Schwarcz, *Rethinking a Corporation’s Obligations to Creditors*, 17 CARDOZO L. REV. 647, 671 (1996) (“It is not the corporation’s closeness to insolvency that is relevant, but rather whether, under the circumstances, a corporation’s contemplated action would cause insolvency, meaning that insolvency is one of the reasonably expected outcomes”); Andrew D. Shaffer, *Corporate Fiduciary-Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479, 517 (2000); Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 THE AM. BANKR. L. J. 103, 107 (1998) (“the general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances . . . , e.g., insolvency . . . . When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors”); Glenn E. Siegel, Stephen J. Gordon, and Eric Steven O’Malley, *What Duty is Owed in Vicinity of Bankruptcy?*, 227 N.Y. L.J. 1 (Feb. 19, 2002); Michael D. Fielding, *Preventing Voluntary And Involuntary Bankruptcy Petitions by Limited Liability Companies*, 18 Bank. Dev. J. 51, 58 (2001) (warning that *Kingston Square Associates, supra*, “raises a warning flag, not only to anyone considering the use of a bankruptcy-remote vehicle in an LLC, but also to those employing any bankruptcy-hindrance mechanism that implicates fiduciary duties”); Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *New Developments in Structural Finance: Report by the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York*, 56 Bus. Law. 95, 162-66 (2000) (discussing fiduciary duties of directors and impact of *Kingston Square Associates, supra*); Gregory Varallo and Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992); James R. Stillman, *Real Estate Mezzanine Financing in Bankruptcy*, Tab 24 at 3 (April 4-5, 1997) (transcript available from the American College of Real Estate Lawyers Midyear Meeting on Finance Topics).

## V. Authority to File Bankruptcy on Behalf of LLC

.Because LLCs are neither partnerships nor corporations – though they have characteristics of both – can a member or manager file a bankruptcy petition on behalf of the LLC without engaging in the unauthorized practice of law? This question was recently addressed and answered in *ICLNDS Notes Acquisition, LLC, supra*. In this case the court held that the debtor, ICLNDS Notes Acquisition (“ICLNDS”), an Ohio LLC, was not eligible under the Code to file a *pro se* Chapter 7 bankruptcy petition, and that ICLNDS’s manager engaged in the unauthorized practice of law by filing the petition. (It is not certain from the court’s decision whether the manager was a member of the LLC,

or an independent manager. Under Ohio law, an LLC may be managed by a manager who is not a member. Ohio Rev. Code Ann. § 1705.25).

ICLNDS's voluntary bankruptcy petition (with attached schedules) was signed by David Bruno both as "Manager" of ICLNDS and as the non-attorney petition preparer under § 110 of the Code. (Section 110 regulates the activities of non-lawyers who prepare bankruptcy petitions for compensation, and permits a lay person to assist another person with ministerial acts such as typing a petition). ICLNDS did not file an application to employ an attorney in connection with the filing. The United States trustee brought an action to dismiss ICLNDS's bankruptcy petition, arguing that an LLC could not appear in court *pro se*, and that Mr. Bruno had engaged in the unauthorized practice of law by filing the petition. ICLNDS and Mr. Bruno neither responded to the trustee's motion nor appeared at the hearing on the motion.

The court agreed with the trustee's arguments, and granted the trustee's motion to dismiss the case. The court first addressed the issue of whether an LLC constituted an entity eligible to file a bankruptcy petition under the Code. The court noted that, under §§ 109(a) and 101(13) of the Code, the debtor must be a person or a municipality, and that § 101(41) of the Code defines "person" as including individuals, corporations, and partnerships. The court then stated that although there is no specific reference in the Code to LLCs, "[u]nder the rules of construction applicable to the Code . . . the use of the term 'includes' is not limiting (citation omitted). In other words, individuals, corporations and partnerships are clearly eligible for relief, but other similar entities are as well"). *Id.* at 292.

The court determined that under Ohio law (as in other states), an LLC is neither a partnership nor a corporation, but a "hybrid" that has features of both a corporation and a partnership. Therefore, the court held, "[a]s corporations and partnerships are eligible to be debtors, and because an LLC draws its character from both of those forms of doing business, an LLC is similar enough to those entities that it also comes within the definition of 'person' and is eligible for protection under the Code". *Id.* at 293.

The court then turned to the issue -- which appeared to the court to be one of first impression -- of whether ICLNDS could make a *pro se* appearance in court through its manager (who was not an attorney), or could only be represented by counsel. The court stated that although, under 28 U.S.C. § 1654, individuals have the right to represent themselves without a lawyer in federal proceedings, "[t]hat right does not extend to permit them to represent other people or entities because by doing so they would be engaging in the unauthorized practice of law. The general rule is that corporations, which are artificial entities, may only appear in court through an attorney." *Id.* The court noted that the Ohio Supreme Court had adopted a similar rule. The court also noted that this same general rule, supported by the vast majority of case law, applied to partnerships as well, i.e., partnerships must be represented by counsel in legal proceedings. Accordingly, the court ruled that whether an LLC is viewed as a corporation, a partnership, or a hybrid, it could only appear in court through an attorney. The court further noted that had ICLNDS so requested, it ordinarily would have been granted an additional period of time

to obtain legal counsel. However, the court granted the trustee's motion to dismiss the case because ICLNDS, despite being on notice, did not respond to the motion to dismiss or file an application to employ counsel.

Finally the court cited, as an additional reason to dismiss the case, the fact that Mr. Bruno's actions in preparing and filing the bankruptcy petition and schedules constituted the unauthorized practice of law. The court stated that under Ohio law, the practice of law "includes commencing an action or proceeding in which the person is not a party (citation omitted)." *Id.* at 294. Therefore, the court held, an individual who prepares and signs a bankruptcy petition (which commences the case) other than in the individual's own name, is commencing the case for another and has engaged in the unauthorized practice of law. (The court also noted that the unauthorized practice of law would include counseling another individual or entity on financial matters in connection with bankruptcy). The court ruled that the fact that Mr. Bruno signed the petition as a non-lawyer bankruptcy petition preparer did not protect him because § 110 of the Code "does not authorize a non-lawyer to give substantive advice and counsel about the bankruptcy process or otherwise to engage in the practice of law (citations omitted)." *Id.* at 295. The court noted that while Bankruptcy Rule 9010 authorizes a debtor's agent, attorney in fact, or proxy to appear in court and act in the debtor's behalf, this Rule expressly states that such representative may only "perform any act not constituting the unauthorized practice of law." *Id.* at n.2 and n.3.

The court's ruling in *ICLNDS Notes Acquisition* that an LLC can only appear in court through an attorney, and that a non-lawyer who prepares and files a bankruptcy petition on behalf of an LLC is engaged in the unauthorized practice of law (whether an LLC is regarded as a corporation, partnership, or hybrid entity), brings some much-needed guidance to what had heretofore been an unanswered question. The court's analysis of this issue is sound and well reasoned, and should encourage LLCs to retain and consult counsel before making the decision to file a bankruptcy petition. State court decisions have also held that an LLC may not file a *pro se* appearance and must be represented by counsel. *See Poore v. Hollow Enterprises*, C.A. No. 93A-09-005 (Del. Super. Ct. Mar. 29, 1994) (holding that, based on the contractual nature of an LLC and its limited liability, an LLC is prohibited from representing itself in a Delaware court and must be represented by Delaware legal counsel); *Strother v. Harte*, 2001 WL 428251 (April 25, 2001 (same)); *Paton v. Old Mill Builders, LLC*, 2000 WL 1912695 (Comm. Super. Dec. 14, 2000) (same); *Valentine L.L.C. v. Flexible Business Solutions, L.L.C.*, 27 Comm.L.Rptr. 378, 2000 W.L. 960901 (Conn. Super. June 22, 2000) (same); *Banco Popular North American v. Austin Bagel Co., L.L.C.*, 2000 WL 669644 (S.D.N.Y. May 23, 2000) (same); *International Ass'n of Sheet Metal Workers Local 16 v. A.J. Mechanical*, D.Or. June 16, 1999) (same); *Valiant Ins. Co. v. Nurse Network, LLC*, 1998 WL 712359 (Conn. Super. Ct., Sept 25, 1998) (same); Elizabeth S. Miller, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing with Registered Limited Liability Partnerships and Limited Liability Companies*, Partnerships and LLCs – Important Case Law Developments 2001, American Bar Association Annual Meeting, Chicago, Illinois, August 7, 2001, p 193 *et seq*; Elizabeth S. Miller, *The Emerging LLC and LLP Case Law: A Survey of Cases Dealing With Registered Limited Liability*

*Partnerships and Limited Liability Companies*, American Bar Association 2003 Annual Meeting, San Francisco, California, August 12, 2003.

The basic jurisdictional defect in *ICLNDS Notes Acquisition* was astutely raised by the trustee and prevented ICLNDS, as an LLC, from filing a *pro se* bankruptcy petition or being represented by its non-attorney manager, thereby resulting in dismissal of the case. It is puzzling why ICLNDS did not elect to cure this defect simply by hiring counsel and re-filing the petition. It is interesting to speculate as to what the result would have been if the trustee had not asserted this defect, i.e., could (or would) the court have raised and decided this issue *sua sponte*? Could or would the issue have been raised via an appeal? What if the jurisdictional issue had not been raised during the bankruptcy court proceedings, and there was a court-approved conveyance of the real property owned by ICLNDS? Would title insurance protect the grantee if it were later determined that the bankruptcy court did not in fact have subject matter jurisdiction?

It is hard to conceive of a conveyance out of bankruptcy that would not be defensible from a title standpoint, as long as the property had been conveyed in accordance with (and by the parties authorized by) the LLC's operating agreement. The grantee should be entitled to the status of a bona fide purchaser even if the LLC's bankruptcy petition had not been properly filed (which would not involve a title defect). If the members of the LLC had not all agreed to file the petition in the manner done by ICLNDS, and the dissent had been brought to the attention of the title insurer, it would need to make an informed underwriting decision before agreeing to issue the title policy. If such dissent was unknown to and had not been disclosed to the title insurer, the newly insured purchaser (or lender) might be subject to defenses raised by the title insurer for matters "created, suffered assumed or agreed to" by the insured, or known to the insured and not disclosed to the title insurer. However, if the jurisdictional issue had not been raised by anyone before the conveyance out of bankruptcy and no specific exception had been taken by the title insurer in the title policy issued to the new purchaser or lender, then any subsequently asserted jurisdictional defects would appear to be covered under the policy's insuring provisions against loss from "any defect, lien, or encumbrance on the title" and "unmarketability." A title insurer would probably not wish to create a blanket exception for the "effect of the bankruptcy" of the LLC, because the conveyance would arise out of the bankruptcy proceeding and the coverage provided would be "illusory."

Mortgage lenders should be especially careful, when lending to an LLC, to make certain that the LLC owns the property and that the individual signing on behalf of the LLC is in fact authorized to sign the mortgage and note, in order to prevent subsequent avoidance of the mortgage lien by a trustee in bankruptcy. *See, e.g., Alpine Bank v. Moreno (In re Moreno)*, 293 B.R. 777, 785-87 (Bankr. D. Colo. 2003) (deed of trust executed by LLC instead of actual individual owner of property, even though executed by individual owner in her capacity as manager of the LLC, which owned adjacent property, provided no actual or constructive notice to bankruptcy trustee in subsequent combined Chapter 7 bankruptcy proceedings of individual owner and LLC, and enabled trustee to avoid deed of trust under section 544(a) of the Code; no equitable grounds existed for

validating defective deed of trust because bank lender's own negligence caused it to be defective).

## VI. LLCs as Asset-Protection Vehicles

The efficacy of a single-member limited liability company ("LLC") as an asset-protection vehicle has been thrown into doubt as the result of recent cases. In *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003), the debtor, who filed a Chapter 13 bankruptcy petition that was later converted to a Chapter 7 liquidation, was the sole member and manager of a Colorado LLC at the time of the filing. The LLC was not a debtor in bankruptcy. The Chapter 7 trustee contended that because the debtor was the sole member and manager at the time the debtor filed bankruptcy, the trustee now controlled the LLC and could therefore sell the real property owned by the LLC and distribute the net sales proceeds to the bankruptcy estate. The debtor argued that the trustee acted only for the debtor's creditors and at most was entitled to a statutory charging order (against distributions made on account of the debtor's LLC membership interest) and could not assume management of the LLC or sell its property. The court referred to the Colorado LLC statute, under which the debtor's membership interest constituted the personal property of the member. According to the court, "[b]ecause there are no other members in the LLC, the entire membership interest passed to the bankruptcy estate, and the trustee became a 'substituted member.'" *Id.* at 540. The court also stated that, "upon the Debtor's bankruptcy filing, the Trustee now controls, directly or indirectly, all governance of that entity, including decisions regarding liquidation of the entity's assets." *Id.* at 541. The court reasoned that because there were no other members in the LLC, no written unanimous approval of the transfer was necessary, as would be the case under Colorado law if there were other members - no matter how small such other membership interests may be.

Colorado's LLC statute, similar to those in other states, provides that if the unanimous consent of all members in a multi-member LLC is not obtained, the bankruptcy estate is only entitled to receive the bankrupt member's share of the profits or other compensation that the bankrupt member was otherwise entitled to, and would not be entitled to any role in the voting or governance of the LLC. However, in a footnote the court stated that this statutory limitation "does not create an asset shelter for clever debtors. To the extent a debtor intends to hinder, delay or defraud creditors through a multi-member LLC with 'peppercorn' co-members, bankruptcy avoidance provisions and fraudulent transfer law would provide creditors or a bankruptcy trustee with recourse." *Id.* at n.9. The court rejected the debtor's assertion that the trustee should be entitled only to a charging order, finding that a charging order existed only to protect other members of an LLC, and in a single-member LLC there were no non-debtor members to protect. The court ruled that the trustee, as the sole member of the LLC, therefore controlled the LLC and could cause the LLC to sell its property and distribute the net proceeds to the bankruptcy estate, or alternatively the trustee could elect to distribute the LLC's property to the bankruptcy estate and then liquidate the property himself. However, the court did permit the debtor to make a claim for her post-petition mortgage payments to preserve the real property of the LLC, which was now an asset of the bankruptcy estate. Although the

bankruptcy court's decision in *In re Albright* stands for the proposition that single-member LLCs may not provide "charging order" protection, it does not mean that these types of structures are worthless as asset-protection devices. Single-member LLCs still are valid and useful business-planning vehicles and provide significant protection for their members with respect to the "internal liabilities" of the LLC entity itself

*See also Associates Commer. Corp. v. Rodio (In re Rodio)*, 257 B.R. 699, 701 (Bankr. D. Conn. 2001) (property belonging to limited liability company itself is not part of bankruptcy estate of bankrupt member); *In re Calhoun*, 312 B.R. 380, 383-84 (Bankr. N.D. Iowa 2004) (stating that, while an LLC is a "person" eligible to file bankruptcy, "[n]o provision in the Code permits an individual and a business to file jointly" and that "when an LLC and one of its members both seek to file a bankruptcy petition, they must do so separately"; and holding that because filing of Chapter 7 bankruptcy petition by individual debtor has no effect on property or debts of LLCs, sec. 362(a) automatic stay does not prohibit actions against separate LLC entities associated with individual debtor); 805 ILCS 180/30-1(a) (2002) ("A member is not a co-owner of, and has no transferable interest in, property of a limited liability company"). *Cf. In re Ealy*, 307 B.R. 653, 657-58 (Bankr. E.D. Ark. 2004) (ruling that bankruptcy automatic stay applied to foreclosure action against property operated by individual debtors as day care center, even though prior to debtors' bankruptcy purchase money lender had deeded property to LLC, of which debtors were sole members, and title to property was solely in name of LLC at time of conveyance and loan; court held that debtors were "equitable owners" of property because testimony revealed that creation of LLC was result of "oversight" and misunderstanding by debtors, who had signed purchase contract as individuals and did not operate the property as an LLC at that time; court stated that "there was no intention to create a separate legal entity for the future," and distinguished *In re Rodio, supra*, by stating that, in that case, the "court did not find sufficient equitable interest"); *Movitz v. Fiesta Investments, LLC (In re Ehmman)*, 319 B.R. 200, 205-06 (Bankr. D. Ariz. 2005) (holding that LLC operating agreement was nonexecutory contract where no material obligations were imposed on members, raising possibility that bankruptcy trustee could force liquidation of member's interest notwithstanding limitations in operating agreement).

## VII. Lender-Member Issues

Some lenders may *require* the borrower to form an LLC in connection with a loan workout (or at the inception of the loan where required by rating agencies in connection with securitized financing transactions), in order to create a "bankruptcy remote entity" by having the lender become a member (with a limited managerial right to vote) for the sole purpose of blocking any future attempt by the LLC to voluntarily file for bankruptcy. *See Exton Plaza Associates v. Commonwealth of Pennsylvania, supra*, 763 A. 2d at 522 (refinancing lender required general partnership borrower to convert to single-purpose bankruptcy-remote entity as condition to obtaining loan). The operating agreement would require unanimous consent by all members for a bankruptcy filing. Theoretically, the lender should be able to exercise its right to vote to block a bankruptcy filing because

an LLC shields all members from personal liability, regardless of participation in management.

When an existing entity with significant debt seeks a workout with its creditors, it may voluntarily, or at the specific request of creditors, be reorganized as or converted to an LLC with some or even all of its creditors as owning members. This may be also be perceived as a significant business advantage to creditors who seek management input in return for partial debt forgiveness or deferral. This is so because an LLC permits participation by members in management in a manner different than their participation in earnings and, to the extent that existing debt remains after the restructure or else is deferred through, e.g., a loan modification, an LLC's non-taxability at the entity level may lessen the likelihood that the entity debt will be reclassified as equity. *See* Richard M. Graf, *Use of LLCs as Bankruptcy-Proof Entities Widens*, *The National Law Journal*, April 10, 1995.

But becoming a member of a borrowing LLC may be contrary to the lender's current institutional lending policies and may also expose the lender to unwanted lender liability, equitable subordination, bankruptcy, conflict-of-interest and fiduciary risks associated with possessing or exercising significant management and control rights in the borrower. The lender also risks having a bankruptcy court find that it is an "insider" of the borrower, which would extend (under § 547 (b)(4) of the Code) the bankruptcy preference period applicable to payments made by the borrower to the lender from 90 days to one year, and would also expose the lender to a possible claim by other creditors of the LLC that the lender-member's lien should be equitably subordinated, or even avoided, under sections 101(31)(c), 547(b)(4) and (5); and 510(c) of the Code. Furthermore, as a matter of general equity and/or public policy, a bankruptcy court may prohibit the use of a structure that effectively prohibits or severely inhibits the filing of a bankruptcy petition by an LLC. *See* Frederick Z. Lodge, Robert E. Michael, and Christopher S. Dewees, *Bankruptcy Remote Structures in Mortgage Loans*, *Probate & Property*, American Bar Association (May/June 1996), p. 49; Melanie Rovner Cohen and Christopher Combest, *Bankruptcy and Limited Liability Entities*, "Peas Porridge, Hot" – LLCs, Ps, LPs and Creditors, *American Bar Association Section of Real Property, Probate and Trust Law*, August 6, 1995, Sec. B, p. 23; Charles W. Murdock, *Limited Liability Companies in the Decade of the 90s: Legislative and Case Law Developments and Their Implications for the Future*, 56 *Bus. Law.* 499 (2001).

Title insurers may not be willing, in connection with a loan policy issued to a lender-member, to insure or defend against any claims arising out of allegations by the LLC or any of its other members that, as a result of a foreclosure action by the lender-member, the lender-member should be estopped to foreclose based on, among other things, breach of contract, breach of fiduciary duty, breach of the duty of good faith and fair dealing owed by one member to another, fraud, joint liability of the lender-member as a "joint venturer," or causation of (or contribution to the causation of) the alleged default.

In *Lawyers Title Ins. Corp. v. JDC (Am.)*, 52 F. 3d 1575 (11<sup>th</sup> Cir. 1995), the borrower and its lender formed a joint venture, which then borrowed \$38 million from the lender. The lender subsequently filed a foreclosure action against the joint venture and the Florida land trust that held legal title to the property on behalf of the joint

venture. The borrower raised the affirmative defenses of breach of fiduciary duty, breach of the duty of good faith and loyalty among partners, joint liability of the lender as a joint venture partner, and estoppel. The lender and the borrower eventually settled the action, and the lender then sought indemnification from the title insurer for the costs of settlement as well as the attorneys' fees incurred in the foreclosure action. The court held that the title insurer was not liable to the lender for these costs and had no duty to defend the lender because of the exclusion in the mortgagee's policy of title insurance for matters "created, suffered, assumed or agreed to " by the insured, which exclusion applied to the claims of the lender because the claims involved actions of the insured (the lender) in entering into various relationships with the borrower. The court further held that the provision of the title insurance policy providing coverage against the "invalidity and unenforceability of the insured mortgage" did not apply in this case, because "the provision insures against defects in the mortgage itself, but not against problems arising from or related to the underlying debt." *Id.* at 1583. Obviously, the same legal principles could apply in connection with an LLC in which the lender has taken an ownership interest.

Title insurers may also not be willing to insure the priority of a mortgage made to an LLC of which the lender is a member because of the risk (similar to the risk that exists in connection with mortgage loans to general or limited partnerships in which the lender acquires a partnership interest) that other non-member creditors of the LLC, including subordinate lienholders, may argue that they have been unfairly prejudiced because of the special privileges the lender-member has obtained and seek to subordinate the priority of, or even eliminate, the member-lender's mortgage lien either inside or outside of bankruptcy. Such other creditors could also argue that the stubborn refusal of a lender-member to agree to a bankruptcy filing that would be in the best interests of all creditors (as opposed to the interests of the lender-member) should not be countenanced by bankruptcy courts.

If it is determined that an LLC should be treated as a corporation under the Code, the lender-member could likely prevent an involuntary bankruptcy filing against the LLC by a member-manager by voting against it; however, if it is determined that the LLC should be treated as a partnership (i.e., a "person") under the Code, a bankruptcy court might permit an involuntary filing against the LLC by a member-manager, similar to such a filing by a general partner of a general or limited partnership.

A lender-member could conceivably lose the benefit of the third-party lender-protection provisions of the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), Pub. L. No. 96-510, 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C.A. secs. 9601-9675 (West 1995) and other federal and state environmental statutes with respect to real property owned or operated by the LLC if, as a result of its ownership interest in the LLC, it is deemed to be a direct "owner or operator" and therefore a "responsible person" under sec. 107(a) of CERCLA instead of merely a holder a security interest that would otherwise in most cases be protected from liability under secs. 101 (2) (a) and 107 (b) of CERCLA (and similar provisions in state statutes that are based on the CERCLA legislation).

### VIII. A Legislative Solution?

With respect to bankruptcy issues affecting LLCs (which are of great concern to title insurers), it is uncertain whether, in the absence of clear-cut case law, the Code will eventually be amended to specifically define and deal with LLCs. At a 1997 meeting of the National Bankruptcy Review Commission, which considered proposed amendments to the Code, the Small Business, Partnership and Single Asset Real Estate Working Group submitted a Memorandum suggesting that the Code be amended to provide for similar treatment of partners and LLC members under the Code, the exclusion of partnership and LLC agreements from the executory contract provisions of Section 365, and the unenforceability of *ipso facto* clauses. The Memorandum did not suggest altering the overall treatment of debtor LLCs in bankruptcy, but only provided for specific treatment of the LLC relationship for LLC member or LLC manager debtors. The Memorandum stated that LLC members are similar to general partners in member-managed LLCs and similar to limited partners or shareholders in manager-managed LLCs. See Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 Am. Bankr. L.J. 271, 311 (1997). No further action has been taken on this proposal and a legislative solution does not appear imminent, as the revisions to the Code effected by the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, P.L. 109-8 (with an effective date, with certain exceptions, of October 17, 2005, the date that is 180 days after the bill was signed into law on April 20, 2005), did not include any provisions addressing LLC issues.