PICK YOUR PARTNER VERSUS THE UNITED STATES BANKRUPTCY CODE

By Herrick K. Lidstone, Jr.[*]
and
Allen Sparkman[**]

Unincorporated Entities and the Pick Your Partner Principle

Partnership law from the beginning contained provisions implementing what has come to be known as the "pick your partner" principle, reflecting the early development of the partnership law provision that admission of a partner to a partnership requires unanimous consent of the partners.[1] As limited partnership and limited liability company statutes developed, the pick your partner principle was embodied in those statutes.[2] The Colorado, Delaware, and Texas limited liability company statutes provide that the interest a member has in a limited liability company is personal property and, subject to agreement, may be assigned.[3] These same provisions, however, also state that, absent agreement otherwise, the assignee only receives the assignor's rights to profits and losses and distributions and does not receive any rights to participate in management.[4]

- Colorado and Delaware provide that a member ceases to be a member upon the assignment of all of the member's membership interest,[5] whether or not the assignee becomes a member.[6]

- By contrast, Texas law provides that the "assignor continues to be a member and is entitled to exercise any unassigned rights or powers of a member of the

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[*] Mr. Lidstone is a shareholder and managing director of Burns Figa & Will, P.C., in Greenwood Village, Colorado, and an adjunct professor at the University of Denver Sturm College of Law, Denver, Colorado.

[**] Mr. Sparkman is a founding partner of Sparkman + Foote LLP, which has offices in Denver and Houston. Mr. Sparkman is resident in the firm's Houston office.

[1] Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 Suffolk U. L. Rev. 587, 589–90 (2009). The authors express their appreciation to Professor Kleinberger (William Mitchell College of Law) for his thoughtful review of this article.

[2] Professor Kleinberger (*op. cit.* n. 1) notes that the inclusion of the pick your partner principle in limited liability company statutes enables an entity that in some circumstances looks very corporate to impose restrictions on transfers and assignees that go well beyond what would be permitted under corporate law. *Id*. at 597.

[3] COLO. REV. STAT. § 7-80-702(1) (2015); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1) (2014); TEX. BUS. ORGS. CODE § 101.108. (2015).

[4] COLO. REV. STAT. § 7-80-702(1); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1); TEX. BUS. ORGS. CODE § 101.108.

[5] "Membership interest" ("Limited liability company interest" in Delaware) is defined as the member's economic rights and does not include governance rights. COLO. REV. STAT. § 7-80-102(10); DEL. CODE ANN. tit. 6, § 18-101(8). The Texas Business Organizations Code defines membership interest with respect to a limited liability company as including "a member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management." TEX. BUS. ORGS. CODE § 1.002(54).

[6] COLO. REV. STAT. § 7-80-702(1), (2); DEL. CODE ANN. tit. 6, § 18-702(b)(3). Texas defines membership interest with respect to a limited liability company as including "a member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management." TEX. BUS. ORGS. CODE § 1.002(54).

company until the assignee becomes a member."[7]

The Texas provision may be viewed as an extreme consequence of the pick your partner doctrine and, in most cases, should be addressed in the LLC's operating agreement, or the company may find itself with a large part of the voting power of its interests being exercisable by persons who no longer have an economic stake in the company.

Similar provisions are found in the Colorado,[8] Delaware,[9] and Texas[10] partnership and limited partnership statutes and are expanded in many, if not most, LLC operating agreements and partnership agreements. The authors believe that the policy behind these statutory "pick your partner" provisions is sound since,[11] in creating or restructuring a business as a closely

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[7] TEX. BUS. ORGS. CODE § 101.111(a).

[8] *See* COLO. REV. STAT. § 7-64-502 (partner's transferable interest is personal property; § 7-64-503 (partner's transferable interest is assignable but does not entitle the assignee to participate in management or conduct of the partnership's business or access to the partnership's books and records); §§ 7-62-701, -702, -704 (limited partnership statute provisions same as partnership statute). Article 64 of the Colorado Revised Statutes is Colorado's enactment of the Revised Uniform Partnership Act and is applicable to partnerships formed on or after January 1, 1998. *See* COLO. REV. STAT § 7-64-107 (2015). Article 60 of the Colorado Revised Statutes is Colorado's enactment of the Uniform Partnership Act (1914). *See* COLO. REV. STAT § 7-60-101. There are still many existing partnerships that were formed under Article 60. § 7-60-118(1)(g) provides that "[n]o person can become a member of a partnership without the consent of all the partners." *Id.* Section 7-60-127(1) provides that "[a] conveyance by a partner of the partner's interest in the partnership . . . merely entitles the assignee to receive in accordance with the assignee's contract the profits to which the assigning partner would otherwise be entitled." *Id.* Section 7-60-129 defines "dissolution of a partnership" to be "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on . . . of the business." *Id.* Finally, § 7-60-131(1)(e) provides that "[d]issolution is caused . . . (e) By the bankruptcy of any partner or the partnership." *Id.*

[9] *See* DEL. CODE ANN. tit. 6, § 15-502 ("A partnership interest is personal property. Only a partner's economic interest may be transferred."); § 15-503(a)(2), (3) (no right to participate in management or to inspect books and records); § 15-503(b)(3) (transferee may seek "a judicial determination that it is equitable to wind up the partnership business or affairs"); § 17-701 ("A partnership interest is personal property"); § 17-702(a)(2) (transferee has no rights as partner); § 17-702(a)(4) (partner ceases to be a partner upon assignment of all of the partner's partnership interest).

[10] *See* TEX. BUS. ORGS. CODE § 1.002(68) ("'Partnership interest' . . . includes the partner's share of profits and losses or similar items and the right to receive distributions. The term does not include a partner's right to participate in management."); § 152.401 (partnership interest is transferable); § 152.402(3) (transferee has no right to participate in the management or conduct of the partnership's business); § 152.403 ("The transferor continues to have the rights and duties of a partner other than the interest transferred."); § 152.404(d) ("For a proper purpose the transferee may require reasonable information or an account of a partnership transaction and make reasonable inspection of the partnership books. In a winding up of partnership business, a transferee may require an accounting only from the date of the latest account agreed to by all of the partners."); § 153.251(a) (partnership interest is assignable); § 153.251(b)(2) (assignee not entitled to become a partner or to exercise the rights or powers of a partner); § 153.252(a) (assignor continues to be a partner in the limited partnership "until the assignee becomes a partner" and assignor "may exercise any rights or powers of a partner, except to the extent those rights or powers are assigned"); § 153.252(b) ("[O]n the assignment by a general partner of all of the general partner's rights as a general partner, the general partner's status as a general partner may be terminated by the affirmative vote of a majority-in-interest of the limited partners.").

[11] Indeed, a comment to Section 502 of the Revised Uniform Limited Liability Company Act states that "one of the most fundamental characteristics of LLC law is its fidelity to the 'pick your partner' principle." REV. UNIF. LTD. LIAB. CO. ACT § 502 cmt. (2006). However, as is true in many cases of a generally sound policy, the rationale breaks down at the margin. In the case of a single-member LLC, there appears to be no reason to apply the pick your partner principle since the single member has no "partner." Likewise, the justification for the pick your partner principle is unclear, at best, in the case of widely-traded limited partnerships or LLCs where transferability may be expected.

held LLC or partnership entity, the owners often wish to restrict themselves and each other from transferring a membership interest in an LLC or a partnership interest without the consent of the other owners. State laws generally allow the owners of a business to pick their partners and maintain the partnership relationships. As discussed below, however, the impact of the U.S. Bankruptcy Code, when an owner (member or partner) files bankruptcy, may dramatically impact "pick your partner" and suggests careful drafting of the operative agreements.

What Are Membership Interests or Partnership Interests?

Ownership interests[12] in an LLC or a partnership are actually a collection of rights, which must be understood in the context of the entity statutes and the governing agreement. Unincorporated entity advisors will generally agree that a member's interest in a limited liability company or a partner's interest in a partnership is comprised of the following:

- An interest in the income, loss, gain, credits, distributions, tax allocations, and other financial attributes of the LLC or partnership ("Economic Rights");

- Certain ownership rights available only to persons who have been admitted as members of the LLC or partners of the partnership, including the right to inspect records, bring derivative actions, to notice of meetings of the owners and to vote on matters presented to the owners ("Owner's Rights"); and

- Certain rights to actually manage or operate the business that may be attributable to the manager of a manager-managed LLC, the managing member of a member-managed LLC, the general partner of a limited partnership, or the managing partner of a general partnership ("Management Rights").

These rights are defined by the limited liability company's operating agreement or the partnership agreement and other governing documents.[13] Many partnership agreements and operating agreements have provisions that restrict transfers of an interest in the entity unless the agreement's requirements are followed.[14] These requirements may include a right of first

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[12] Ownership interests in an LLC or partnership can be referred to by the governing statutes in a number of ways. Delaware refers to the ownership interest in an LLC as a "limited liability company interest," whereas Colorado and Texas both refer to it as a "membership interest." DEL. CODE ANN. tit. 6, § 18-101(8); COLO. REV. STAT. § 7-80-102(10); TEX. BUS. ORGS. CODE § 1.002(54). This article will use the reasonably common terms "membership interest" for an ownership interest in an LLC and "partnership interest" for an ownership interest in a partnership, consistent with Colorado, Delaware, and Texas law. Governing documents for an LLC or a partnership should be drafted using terms that are consistent with the applicable governing statute.

[13] It is important to note that where the operating agreement, partnership agreement, or other governing documents are incomplete, the default rules of the applicable statute will fill in any gaps. It is likely that the default rules will seldom be satisfactory as a matter of business judgment.

[14] The following is a simple provision prohibiting transfer except to existing members of an LLC: "Should any Member or Assignee attempt to sell, transfer, assign, or in any way alienate all or any portion of his Economic Interest by charging order against the Member or Assignee, or otherwise ('Transferred Interest') to a Person not then a Member, whether now owned or hereafter acquired, without the prior written consent of the Managers (whether such transfer is voluntary or involuntary, by operation of law, by court order, by charging order, or otherwise), such attempted sale, transfer, assignment, or other form of alienation shall be deemed to be void *ab initio*, and this shall be considered to be a 'Terminating Event' unless it is accomplished in accordance with the procedures outlined in this

refusal in the other owners or the entity itself and a repurchase right for transfers that violate the agreement's restrictions. These protect the remaining owners from voluntary or even involuntary transfers by an owner, such as in a divorce proceeding where the court orders one-half of the interest be transferred to a spouse,[15] or in a charging order proceeding where the creditor of the member or partner seeks foreclosure of the charging order. Divorce statutes and charging order statutes are products of state law and would be subject to the procedure for foreclosure against a personal property interest.[16]

The state law "pick your partner" rules, as implemented and expanded in many operating agreements and partnership agreements, are intended to prohibit or penalize a member or partner who conveys the member's or partner's interest, whether the conveyance is voluntary or involuntary. In most cases, at best the assignee would be treated as holding Economic Rights without the Owner's Rights or Management Rights of a member or partner.

Arguably, a transfer of the Economic Rights alone does not upset the "pick your partner" principle. Were a member or partner to transfer the Owner's Rights or Management Rights to a stranger, however, the remaining owners would be saddled with a new partner holding the Owner's Rights and Management Rights, and the stranger may not have short- or long-term views that are compatible with those of the remaining owners. Where, as in Texas, an owner can transfer the Economic Rights while retaining the Owner's Rights and Management Rights, ownership becomes divorced from decision-making—again placing the remaining owners in an unexpected situation.

The Uniform Commercial Code Is Not Supportive of "Pick Your Partner"

In state law, Article 9 of the Uniform Commercial Code has provisions that may be inconsistent with the "pick your partner" principles of the partnership and limited liability company acts. Section 9-408(a) as enacted in many states, including Colorado, provides in part,

> Except as otherwise provided in subsection (b), a term in . . . an agreement between an account debtor and a debtor which relates to a . . . general intangible,[17] including

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Article IX," which usually involve a right of first refusal, manager (or member) approval, and treatment of the assignee as merely an economic interest holder unless admitted to the LLC as a member. *See* HERRICK K. LIDSTONE, JR. & ALLEN SPARKMAN, LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO §§ 3.1.8–.9 (CLE in Colorado, Inc., 2015).

[15] Note that in Texas a membership interest or partnership interest may be community property. TEX. BUS. ORGS. CODE § 101.106(a-1) (A membership interest may be community property under applicable law). However, "a member's right to participate in the management and conduct of the business of the limited liability company is not community property." § 101.106(a-2); § 154.001(b) ("A partner's partnership interest may be community property under applicable law.").

[16] In September 2014, the South Carolina Supreme Court ruled that a foreclosure sale was valid and trumped the operating agreement's repurchase right, and that the repurchase right could not be enforced. Levy v. Carolinian, LLC, 763 S.E.2d 594, 597–98 (S.C. 2014). See discussion in Doug Batey, *South Carolina Supreme Court Invalidates LLC Operating Agreement's Repurchase Right After Charging Order Foreclosure*, LLC Law Monitor (Sept. 15, 2014), http://www.llclawmonitor.com /2014/09/articles/charging-orders/south-carolina-supreme-court-nvalidates-llc-operating-agreements-repurchase-right-after-charging-order-foreclosure/.

[17] The term "general intangible" is defined in section 9-102(a)(42) to mean: "any personal property" with

> a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the person obligated on the . . . account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the . . . general intangible, is ineffective to the extent that the term:
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> (1) would impair the creation, attachment, or perfection of a security interest; or
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> (2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the . . . general intangible.[18]

Sections 4-9-406, 4-9-408 and 4-9-409 of the Uniform Commercial Code (as enacted in Colorado) have similar provisions relating to promissory notes, health care receivables, chattel paper, payment intangibles, accounts, letters of credit, and other general intangibles, both in the assignability of the ownership and the creation of a security interest in the ownership interest.[19] Colorado has preserved the primacy of the "pick your partner" principle for limited liability companies, partnerships, and other entities by providing the following exemption from the Uniform Commercial Code: "Sections 4-9-406 and 4-9-408, C.R.S. shall not apply to an owner's interest."[20] Delaware and Texas have enacted similar provisions exempting partnership and limited liability company interests from the application of sections 4-9-406 and 4-9-408 of the Uniform Commercial Code.[21] Attorneys drafting an LLC or partnership agreement should be cognizant of the potential impact on these and similar statutory exemptions of a choice of law provision in the agreement.

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exceptions not applicable here. U.C.C. § 9-102(a)(42) (AM. LAW INST. & UNIF. LAW COMM'N 2010). As discussed earlier, *see* discussion *supra* notes 3, 8–10 and accompanying text, state limited liability company and partnership statutes define a member or partner's interest as "personal property." *E.g.*, COLO. REV. STAT. § 7-80-702(1); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1); TEX. BUS. ORGS. CODE § 101.108.

[18] U.C.C. § 9-408(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

[19] COLO. REV. STAT. §§ 4-9-406, -408, -409 (2015).

[20] COLO. REV. STAT. § 7-90-104. The term "owner's interest" is broadly defined in section 7-90-102(44) to include "shares of stock in a corporation, a membership in a nonprofit corporation, a membership interest in a limited liability company, the interest of a member in a cooperative or in a limited cooperative association, a partnership interest in a limited partnership, a partnership interest in a partnership, and the interest of a member in a limited partnership association." *Id.*

[21] DEL. CODE ANN. tit. 6, §§ 15-104(c) (partnerships), 17-1101(g) (limited partnerships), 18-1101(g) (limited liability companies); TEX. BUS. ORGS. CODE §§ 101.106(c) (limited liability companies), 154.001(d) (partnerships and limited partnerships).

Unincorporated Entities and Bankruptcy[22]

If a member or partner files for bankruptcy, the "pick your partner" principle may be applied in uncertain ways and may, in fact, be ignored. Bankruptcy is a matter of federal law[23] and may override state law and any "pick your partner" provisions found in the operating agreement or the partnership agreement.

Property of The Estate

Consider a member of a multi-member limited liability company who files for bankruptcy protection either in liquidation (under Chapter 7) or for a reorganization (under Chapter 11 or, for a consumer debtor, Chapter 13). Section 541(a)(1) provides,

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: (1) Except as provided in subsections (b) and (c)(2) of this section [541], all legal or equitable interests of the debtor in property as of the commencement of the case.[24]

By operation of law, therefore, the filing of the bankruptcy petition creates an estate, which includes the owner's interest in an LLC or partnership.[25] The bankruptcy estate may be managed by a third-party trustee (under Chapter 7) or the debtor in possession (under Chapters 11 and 13).[26] This is a transfer which arguably should be subject to the "pick your partner" limitations except for the pre-eminency of bankruptcy law.[27]

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[22] The authors express their gratitude for the review of the bankruptcy discussion in this article by Kyung S. Lee, a partner in the Houston office of Diamond McCarthy LLP and Deanna L. Westfall, a partner in the Denver office of Weinstein & Riley, P.S.

[23] 11 U.S.C § 101 (2012).

[24] 11 U.S.C. § 541(a)(1).

[25] 11 U.S.C. § 541(a) (2012). Section 541(a) has five additional clauses that are equally expansive, intending to capture anything the debtor owns at the filing date or has a right to acquire as of the filing date. § 541(a)(1)–(5).

[26] *See* 11 U.S.C. § 542(a) (2012). Section 1107 of the Bankruptcy Code places the debtor in possession in the position of a fiduciary, with the rights and powers of a chapter 11 trustee. 11 U.S.C. § 1107(a) (2012). When used herein, the term "trustee" includes the debtor in possession.

[27] The Delaware limited liability company act provides that a member ceases to be a member upon filing a bankruptcy petition. DEL. CODE ANN. tit. 6, § 18-304(1)b (2015). Similarly, a partner of a Delaware or Texas general partnership ceases to be a partner if the partner becomes a debtor in bankruptcy. DEL. CODE ANN. tit. 6, § 15-601(6) (2015); TEX. BUS. ORGS. CODE § 152.501.501(b)(6)(A) (2015). These Delaware and Texas provisions will likely be disregarded under Section 541(c)(1)(B) of the Bankruptcy Code. *See In re* Garbinski, 465 B.R. 423, 426–27 (Bankr. W.D. Pa. 2012) (Citing *In re* First Protection, Inc., 440 B.R. 821, 830 (B.A.P. 9th Cir. 2010); *In re* Prebul, 2011 Bankr. LEXIS 2795, 2011 WL 2947405 (Bankr. E.D. Tenn. 2011); *In re* Dixie Management & Inv. Ltd. Partners, 2011 Bankr. LEXIS 1686, 2011 WL 1753971 (Bankr. W.D. Ark. 2011); *In re* Daugherty Construction, Inc., 188 B.R. 607 (Bankr. D. Neb. 1995) ("The cases are pretty clear that Section 541(c)(1) acts to override any provision of state law that would otherwise limit or restrict a trustee with respect to a debtor's limited liability or limited partnership interests. In other words, any attempt to invoke state law to treat a trustee as a mere 'assignee,' who does not enjoy any management rights in the LLC or partnership entities, fails as a result of Section 541(c)(1).").

Section 541(c)(1) of the Bankruptcy Code[28] provides that property of the debtor becomes property of the debtor's bankruptcy estate notwithstanding any transferability restrictions[29] or any provision "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."[30]

Section 541(c)(1) refers to any interest of the debtor in property—it does not limit the interest to the debtor's "Economic Rights" or "rights to a distribution." Even where a partnership or a limited liability company has attempted to separate the Economic Rights from Owner's Rights as contemplated in the respective "pick your partner" statutes or agreement provisions, § 541(c)(1) says "no."[31] Consequently, the trustee of the bankruptcy estate moves directly into the shoes of the debtor and retains the Owner's Rights[32] of the debtor in the LLC or partnership in addition to Economic Rights notwithstanding any transferability restriction or other agreement or law to the contrary.[33]

Any effort to dissociate the trustee (or the debtor) from the limited liability company or partnership would likely be found to violate the automatic stay that is imposed under 11 U.S.C. § 362.[34] Section 362(a)(3) prohibits "any act to obtain possession of property of the estate or of

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[28] Section 541(c)(1) provides as follows:

> 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 non-bankruptcy law -- (A) that restricts or conditions transfer of such interest by the debtor; or (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property. 11 U.S.C.S. § 541(c)(1) (2014).

[29] 11 U.S.C. § 541(c)(1)(A).

[30] 11 U.S.C. § 541(c)(1)(B).

[31] *See* § 541(c)(1)(A); Ebert v. DeVries Family Farm, LLC (*In re* DeVries), No. 11–43165–DML–7, 2014 WL 4294540, at *13 & n.93 (Bankr. N.D. Tex., Aug. 27, 2014) (quoting Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law."); Rine & Rine Auctioneers, Inc. v. Douglas Cty. Bank & Trust Co. (*In re* Rine & Rine Auctioneers, Inc.), 74 F.3d 854, 857 (8th Cir. 1996) (citing N.S. Garrot & Sons v. Union Planters Nat'l Bank of Memphis, (*In re* N.S. Garrott & Sons), 772 F.2d 462, 466 (8th Cir. 1985)) ("Once that state law determination is made, however, we must still look to federal bankruptcy law to resolve" the extent to which that interest is property of the estate)). This was also the conclusion reached by a Tennessee bankruptcy court in *In re* Denman, 513 B.R. 720, 727 (Bankr. W.D. Tenn. 2014).

[31] It is important to note that this does not necessarily apply to Management Rights. As discussed below, under § 365(e)(2) and § 541(c)(1)(B) of the Bankruptcy Code, the other members of the LLC will not be required to accept the trustee of the debtor's estate stepping into any management role of the debtor.

[33] *See* Klingerman v. ExecuCorp LLC (*In re* Klingerman), 388 B.R. 677, 679 (Bankr. E.D. N.C. 2008) (holding that debtor's "rights and interest in the LLC, economic and noneconomic, became property of the estate upon the filing of his petition"); *In re* Ellis, No. 10–16998–AJM–7A, 2011 WL 5147551, at *3 (Bankr. S.D. Ind. Oct. 27, 2011) (finding that the debtor retained both his economic and non-economic interest in the LLC when he filed his chapter 7 petition).

[34] *See* McCabe v. George Panagiotou & Gedco, LLC (*In re* McCabe), 345 B.R. 1, 7 (D. Mass. 2006) (holding that a non-debtor member amending a LLC agreement post-petition to reallocate the debtor's membership interest violates the automatic stay); *In re* Daugherty Const., Inc., 188 B.R. 607, 615 (Bankr. D. Neb. 1995) (concluding that LLC members voting post-petition to remove the debtor as manager and approving a new manager are actions that

property from the estate or to exercise control over property of the estate."[35] This issue arose in *Walro v. The Lee Group Holding Company, LLC*,[36] where the bankruptcy debtor was manager holding Management Rights and controlling member (with a 51% ownership and vote, Economic Rights and Owner's Rights) of an LLC (the Lee Group) at the time he filed bankruptcy. On the filing, the other members applied language of the operating agreement to treat the debtor as a non-voting assignee and acted to appoint a new manager. The chapter 7 trustee filed a complaint and a motion for summary judgment seeking reinstatement of the debtor's rights as a voting member (Owner's Rights) and sought the invalidation of the post-petition actions taken by the other members. After analyzing the operating agreement and Indiana law, the bankruptcy court granted the motion for summary judgment concluding that "Debtor was a member of the Lee Group as of the Petition Date and that Debtor's voting rights were conferred as an incident of that membership."[37] The court concluded that the debtor's voting rights were property of the estate under § 541(a) and that the action by the other members to remove those voting rights violated the automatic stay under § 363(a)(3).[38] The opinion in *Walro* does not discuss Section 365(e)(2) of the Bankruptcy Code[39] but states:

> By his Complaint, the Trustee did not seek to step into Debtor's shoes as manager, nor did he ask that the Court compel Debtor to remain as manager. In fact, the trustee has repeatedly and explicitly emphasized that he does not seek that type of relief. For that reason, the Court need not determine—at least in the context of this proceeding—whether the Code or relevant non-bankruptcy law supports either type of action.[40]

The Operating or Partnership Agreement and* Ipso Facto *Clauses.

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amount to "exercise of control over property of the estate and in violation of the automatic stay provisions" under 11 U.S.C. § 362((a)(3). The opinion does not discuss Section 365(e)(2) of the Bankruptcy Code, discussed *infra*, note 68 and accompanying text) . *But see In re* Garrison–Ashburn, 253 B.R. 700, 708–09 (Bankr. E.D. Va. 2000) (holding that an operating agreement is not an executory contract, and thus, because the Virginia LLC Act provided that a member became dissociated upon filing bankruptcy and thereafter had only the rights of an assignee, but dissociation of the member did not cause dissolution of the limited liability company, the bankruptcy estate had only the rights of an assignee despite Section 541(c)(1)). *Cf.* Nw. Wholesale, Inc. v. Pac Organic Fruit, LLC, 334 P.3d 63 (Wash. Ct. App. 2014) (Harold and Shirley Ostenson became 49% members of LLC in 1998, and the Ostensons filed for bankruptcy under Chapter 11 in 2007. Thereafter, the Ostensons brought a derivative action on behalf of the LLC. The court held that the Ostensons did not have standing to bring the derivative action because the Washington LLC statute provided that a member became dissociated with only the rights of an assignee upon filing a voluntary bankruptcy. The Ostensons relied on *In the Matter of Daugherty Const., Inc*. to support their contention that they retained membership and management rights in the LLC. The Washington court did not find *In the Matter of Daugherty Const., Inc.* persuasive because of the differences between the Washington and Nebraska LLC statutes. Because Washington law provides that a member's dissociation does not dissolve the LLC, and the dissociated member retains the member's economic rights, the court found the Washington statute to be similar to the Virginia LLC statute and adopted the reasoning of *In re Garrison-Ashburn*. *Id.* at 74-77.).

[35] 11 U.S.C. § 362(a)(3) (2012); *see also In re* Stinson, 221 B.R. 726, 730–31 (Bankr. E.D. Mich. 1998) (discussing that section 362(a)(3) is designed to prevent dismemberment of the bankruptcy estate and ensure the trustee has an opportunity to determine the rights and interest of the debtor in property).

[36] (*In re* Lee), 524 B.R. 798 (Bankr. S.D. Ind. 2014).

[37] *Id.* at 802.

[38] *Id.* at 804, ¶ 20.

[39] *See infra* note 68 and accompanying text.

[40] *In re* Lee, 524 B.R. at 805, ¶ 24.

Even though the bankruptcy estate takes the membership interest or partnership interest (and all Economic Rights and Owner's Rights) as property of the estate, the interest remains subject to governing law and the governing agreements. LLCs and partnerships are governed by the applicable statutes as well as by the governance contracts (usually referred to as "operating agreements"[41] and "partnership agreements"), which impose obligations on, and give certain rights to, members, partners, and assignees.

These contracts may include *ipso facto* provisions—provisions that are triggered by a person's financial condition or a bankruptcy filing. An *ipso facto* provision may be a provision that a member's bankruptcy filing constitutes the member's withdrawal from the LLC. A bankruptcy filing may trigger a buy-sell obligation. For example, the Delaware limited liability company act provides that a member ceases to be a member upon filing a voluntary bankruptcy petition.[42] A partner of a Delaware or Texas general partnership ceases to be a partner if the partner becomes a debtor in bankruptcy.[43] While these may be the case under the state statute and the governing agreements, these would be *ipso facto* clauses discussed below and likely unenforceable in bankruptcy where the trustee would step into the shoes of the debtor.

Section 365(e)(1) of the Bankruptcy Code provides that any provision in an executory contract, unexpired lease, or in applicable law (such as the Delaware and Texas statutes referenced above) that takes effect upon the appointment of a trustee, the commencement of a bankruptcy case, or "the insolvency or financial condition of the debtor at any time before the

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[41] In Texas, either a "company agreement" or "LLC agreement."

[42] DEL. CODE ANN. tit. 6, § 18-304(1)b (2014).

[43] DEL. CODE ANN. tit. 6, § 15-601(6) (2014); TEX. BUS. ORGS. CODE § 152.501(b)(6)(A) (2015). Interestingly, this issue did not exist under the Colorado Uniform Partnership Law, which is derived from § 29 of the Uniform Partnership Act (1914). As in the Uniform Partnership Act (1914), COLO. REV. STAT. § 7-60-131(1)(e) provides that dissolution of a partnership is caused "[b]y the bankruptcy of any partner or the partnership." COLO. REV. STAT. § 7-60-131(1)(e) (2006). Upon dissolution, the partner's bankruptcy trustee has the ability to extract the bankrupt partner's value from the partnership before allowing the remaining partners to re-commence the entity as a new partnership. *Id.*

The bankruptcy trustee cannot avail itself of the dissolution remedy under the more modern statutes. In the more modern partnership statutes, "bankruptcy" results in dissociation or withdrawal of the partner, not the dissolution of the partnership. *See* COLO. REV. STAT. § 7-64-601(1)(f)(I) (2006); DEL. CODE ANN. tit. 6, § 15-601(6)(b) (2005); TEX. BUS. ORGS. CODE § 152.501(b)(6)(A) (2012).

The LLC statutes also do not provide that bankruptcy of a member results in the dissolution of the LLC either specifically (as in DEL. CODE ANN. tit. 6, § 18-801(b) (2005), which specifically states that the filing of a bankruptcy by a member does not result in the dissolution of the LLC) or by not addressing the question at all (as in Colorado and Texas). Delaware law does provide that a member filing bankruptcy results in that person ceasing to be a member of an LLC formed under Delaware law. *See* § 18-304(1)(b).

Colorado does not address this question. Since the creation of the bankruptcy estate does not constitute an "assignment" or "transfer," the transferability provisions are not applicable, and consequently the provisions of COLO. REV. STAT. § 7-80-702(2) (2006) are inapplicable. That subsection states that "[a] member ceases to be a member upon assignment or transfer of all the member's membership interest." *Id.*

Texas also does not address the bankruptcy of a member of an LLC, although it states that "an assignor of a membership interest in a [LLC] continues to be a member of the company and is entitled to exercise any unassigned rights or powers of a member of the company [such as Owner's Rights and Management Rights to the extent not transferable] until the assignee becomes a member of the company." TEX. BUS. ORGS. CODE § 101.111(a) (2012). Thus the bankrupt member who may no longer have any Economic Rights will retain Owner's Rights.

closing of the [bankruptcy] case" is unenforceable.[44]

Section 541(c)(1)(B) goes beyond § 365 in that it applies to all of the property of the debtor, not just executory contracts which are the subject of § 365. This section provides that any interest of the debtor in property "becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . that is conditioned on the insolvency or financial condition of the debtor . . . or taking possession by a trustee in a case under this title or a custodian before such commencement . . . ."[45]

Thus, provisions in state law or in operating agreements, partnership agreement, or other contracts that are conditioned on a person's bankruptcy or insolvency are not enforceable when that person files bankruptcy. As a result, LLC members and partners in a partnership who have carefully chosen their business partners may find themselves in business with a trustee that has different, and likely more short-term, goals than their former (now bankrupt) business partner.

Operating Agreements and Partnership Agreements As Executory Contracts.

Even though an LLC membership interest or partnership interest may be property of the bankruptcy estate, and *ipso facto* clauses are disregarded for that purpose, the examination of the operating agreement or partnership agreement does not end, and the court must look to other sections of the Bankruptcy Code to determine how such property must be treated.[46] Where a contract (operating agreement, partnership agreement, or other agreement) is an "executory contract," "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[47] In order to accept the benefits of an executory contract, the trustee must also be prepared to perform its obligations under the executory contract.[48]

The Bankruptcy Code defines when the trustee must accept an executory contract, and any executory contract not accepted within the mandated time period is deemed rejected. Section 365(d) provides that:

> (1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60–day period, fixes, then such contract or lease is deemed rejected.
>
> (2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified

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[44] 11 U.S.C. § 365(e)(1) (2012).

[45] *Id.* § 541(c)(1)(b) (2012).

[46] Bonneville Power Admin. v. Mirant Corp. (*In re* Mirant Corp.), 440 F.3d 238, 252 (5th Cir. 2006).

[47] 11 U.S.C. § 365(a) (2012).

[48] *See id.* § 365(b) (2012).

period of time whether to assume or reject such contract or lease.[49]

Section 365(g) provides that the rejection of an executory contract by the trustee constitutes a breach of the contract. By so stating, § 365(g) establishes "that in bankruptcy, as outside of it, the other party's rights remain in place" even after rejection.[50] "[R]ejection does not embody the contract-vaporizing properties so commonly ascribed to it. . . . Rejection merely frees the estate from being obligated to perform any future obligations"[51] under it, but the agreement has not disappeared. The operating agreement or partnership agreement (as applicable) still governs the bankruptcy estate's rights in the entity. Therefore, if the operating agreement or partnership agreement is an executory contract and if the trustee rejects that agreement, the court must look to the agreement itself to determine the effect of the rejection.

The Bankruptcy Code, however, does not define the term "executory contract."[52] Therefore, courts look to the "facts and circumstances of each case to determine the status of a particular operating agreement"[53] or partnership agreement. "Whether a contract is "executory" within the meaning of the Bankruptcy Code is a question of federal law."[54] The United States Supreme Court has stated that the legislative history of Section 365(a) indicates that Congress intended that an executory contract be defined as a contract "on which performance is due to some extent on both sides."[55] Many courts use the definition first proffered by Professor Vern Countryman in 1973:[56] "[A] contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the

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[49] *Id.* § 365(d) (2012).

[50] Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir.2012). *See also In re* Hughes, 166 B.R. 103, 105 (Bankr. S.D. Ohio 1994) ("Consistent with the bankruptcy law's general deference to state-law rights in or to specific property, rejection of a contract does not terminate such rights that arise from rejected contracts. Rejection is not itself an avoiding power.").

[51] Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. Fla. 2007) (quoting Cohen v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992)).

[52] *Bildisco*, 465 U.S. at 522 n. 6 (quoting H.R. Rep. No. 95-595, p. 347 (1977).

[53] Meiburger v. Endeka Enters., L.L.C. (*In re* Tsiaoushis), 383 B.R. 616, 618 (Bankr. E.D. Va. 2007).

[54] Griffel v. Murphy (In re *Wegner*), 839 F.2d 533, 536 (9th Cir. 1988).

[55] *Bildisco*, 465 U.S. at 522 n.6 (quoting H.R. Rep. No. 95-595, p. 347 (1977)) (citing S. Rep. 95-989, p. 58 (1977)), superseded by statute, 11 U.S.C. § 1113 (2012); *see also* Griffel v. Murphy (*In re* Wegner), 839 F.2d at 536.

[56] Unsecured Creditors' Comm. of Robert L. Helms Const. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Const. & Dev. Co., Inc.), 139 F.3d 702, 705 (9th Cir. 1998) (quoting *Bildisco*, 465 U.S. at 522–23 (internal quotations omitted)). *See also,* Lewis Bros. Bakeries Inc. & Chicago Baking Co. v. Interstate Brands Corp. (*In re* Interstate Bakeries Corp.), 751 F.3d 955, 962 (9th Cir. 2014) ("This circuit has adopted Professor Countryman's definition of an executory contract for purposes of the Bankruptcy Code."); *See, e.g., In re* Exide Techs., 607 F.3d 957, 962 (3d Cir. 2010) ("With congressional intent in mind, this Court has adopted the [Countryman] definition."); Olah v. Baird (*In re* Baird), 567 F.3d 1207, 1211 (10th Cir. 2009) ("We therefore take this occasion to formally adopt the Countryman definition. . . ."); Lawson v. Lawson (*In re* Lawson), 14 F.3d 595 (4th Cir. 1993) ("The bankruptcy code does not define an executory contract, but the Fourth Circuit has adopted the generally accepted test for executoriness articulated by Professor Vern Countryman."); *In re* Crippin, 877 F.2d 594, 596 (7th Cir. 1989) (describing the Countryman test as "[a] common definition, which this court has cited with approval"); Nw. Airlines, Inc. v. Klinger (*In re* Knutson), 563 F.2d 916, 917 (8th Cir. 1977) (adopting the Countryman definition of an executory contract).

other.'"[57] Commentators have noted that:

> Although the Countryman definition has been widely adopted by the courts, it has not been universally adopted. Some courts have adopted the "functional approach," an approach that works backwards from an examination of the purposes to be accomplished by rejection and, if the purpose has already been accomplished, determines that the contract cannot be executory.[58]

The Fifth Circuit explained the functional approach as follows: "Section 365 derives from Sec. 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's lease or executory contracts or to "reject" them if they were economically burdensome to the estate."[59]

The true nature of an executory contract is that it contains future performance obligations at least of the debtor.[60] These may include future obligations to guarantee debts, make capital contributions, perform services, or other future performance obligations. Unfortunately, as will become clear in the following examples, courts are not always clear in their analysis of operating agreements and partnership agreements when determining whether they are executory contracts and subject to § 365, or are not executory contracts and therefore property of the estate under § 541 and not subject to the § 365 assumption or rejection requirement.

For example, the Sixth Circuit Court of Appeals held that an executory contract as contemplated under § 365 must have "material obligations left to be performed by both parties to [a] contract."[61] *In re Ehmann* held that "a contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'"[62]

Courts have held that a contract is not executory if the only performance required by one side is the payment of money.[63] A contract that only imposes remote or hypothetical duties is

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[57] Vern Countryman, *Executory Contracts in Bankruptcy Part I*, 57 Minn. L. Rev. 439, 458–62 (1973) *quoted in In re* Ehmann, 319 B.R. 200, 203 (Bankr. D. Ariz. 2005).

[58] David M. Founier & John Henry Schanne, The Executory Contract Ride Through: A Doctrine from the Past Provides an Option for the Present, NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 179, 183 (2009) , http://www.pepperlaw.com/resource/1237/27H1, (citing *In re* Magness, 972 F.2d 689, 694 (6th Cir. 1992). *See* Rieser v. Dayton Country Club Co. (*In re* Magness), 972 F.2d 689, 694 (6th Cir. 1992) (holding that the Countryman test "was found by this court to be helpful but not controlling in the resolution of what is an executory contract.") (citing Chattanooga Memorial Park v. Still (*In re* Jolly), 574 F.2d 349 (6th Cir. 1978)); Sipes v. Atl. Gulf Cmtys. Corp. (*In re* Gen. Dev. Corp.), 84 F.3d 1364, 1375 (11th Cir. 1996) ("While it does not appear that the Eleventh Circuit has adopted the "functional approach" over the "Countryman approach", the Eleventh Circuit ... appears more inclined to embrace the "functional approach.") (internal citations omitted).

[59] *In re* Austin Development Company, 19 F.3d 1077, 1081 (5th Cir. 1994).

[60] *See* cases cited *infra*, note 112.

[61] *In re* Terrell, 892 F.2d 469, 472 (6th Cir. 1989).

[62] *In re* Ehmann, 319 B.R. 200, 203-04 (Bankr. D. Ariz. 2005). *See also*, Phx. Exploration, Inc. v. Yaquinto (*In re* Murexco Petroleum, Inc.), 15 F.3d 60, 62-63 (5th Cir. 1994).

[63] Ocean Marine Servs. P'ship No. 1 v. Digicon, Inc. (*In re* Digicon, Inc.), 71 F. App'x 442, at *6 (5th Cir. 2003) (citing *In re* Placid Oil Co., 72 B.R. 135, 138 (Bankr. N.D. Tex. 1987)).

not an executory contract. [64] However, the "[c]ontingency of an obligation does not prevent its being executory under section 365."[65] "Factors relevant in evaluating an LLC operating agreement include whether the operating agreement imposes remote or hypothetical duties, requires ongoing capital contributions, and the level of managerial responsibility imposed on the debtor."[66]

Where the operating agreement, partnership agreement, or other contract is executory and is accepted by the trustee, the trustee must cure any defaults under the executory contract (other than defaults related to an *ipso facto* clause).[67] Upon assumption, the trustee must be prepared to perform future obligations. On the other hand, as set forth in § 365(g), rejection of an executory contract constitutes a breach of such contract or lease.

Is The Operating Agreement or Partnership Agreement an Executory Contract?

Where a contract that becomes property of the estate is not an executory contract, the trustee retains the bankrupt member's or partner's "Owner's Rights and Economic Rights." This is where a divorce from the interests of the other business owners may occur. In most cases, the trustee's goals are short-term—for the benefit of the general unsecured creditors of the bankruptcy estate. The trustee's interests are not necessarily long-term; whereas the interests of the other members or partners in a successful business are usually of a longer term. The trustee may try to use the leverage of the operating agreement or partnership agreement to force a favorable (to the bankruptcy estate) financial settlement from the company or the other owners.

Where the operating agreement, partnership agreement, or other contract is an executory contract, the other members or partners are better protected. To accept the contract, the trustee must be willing to perform all of the executory obligations of the bankrupt debtor. If the trustee rejects the contract, the contract becomes in default and the bankruptcy estate becomes subject to damages and potentially other penalties described in the operating agreement or the partnership agreement that apply on default of an owner.

As discussed below, many cases show that trustees prefer to avoid operating agreements and partnership agreements being categorized as being executory; the remaining business partners would prefer that the agreements be classified as executory.

Personal Services Agreements Cannot Be Assumed.

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[64] *In re* Capital Acquisitions & Management Corp., 341 B.R. 632, 636 (Bankr. N.D. Ill. 2006). Meiburger v. Endeka Enters. LLC (*In re* Tsiaoushis), 383 B.R. 616, 618 (Bankr. E.D. Va. 2007).

[65] Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046 (4th Cir. 1985).

[66] Warner v. Warner, 480 B.R. 641, 651 (Bankr. N.D. W. Va. 2012) *aff'd sub nom* Sheehan v. Warner, 585 F. App'x 130 (4th Cir. 2014) (holding that "[t]here is a lack of consensus among the courts regarding the executory nature of operating agreements of limited liability companies because there are no *per se* rules regarding the classification of limited liability operating agreements.") (quoting Bensusan v. Prebul (*In re* Prebul), Case No. 09-14010, 2011 Bankr. LEXIS 2795, at *23, 2011 WL 2947045, at *7 (Bankr. E.D. Tenn. July 19, 2011)) (citations omitted) (internal quotation marks omitted)).

[67] 11 U.S.C. § 365(b)(1)(A) (2004).

As discussed above, § 365(e)(1) invalidates provisions that prevent the bankruptcy estate from receiving the benefit of an executory contract. But this provision is not always applicable. Importantly in the case of a bankruptcy filed by a member or partner with Management Rights, § 365(e)(2) provides that § 365(e)(1) does not apply if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance or rendering performance to the trustee or to an assignee of such contract . . . "[68]

Where Management Rights are concerned, § 365(c)(1) of the Bankruptcy Code provides that the trustee may not assume or assign an executory contract if:

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the trustee, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.

For example, where the bankrupt debtor is a manager or service provider to the limited liability company or partnership pursuant to the operating or partnership agreement and is not permitted to delegate his or her performance, the trustee should not be permitted to assume the managerial role if the other owners object.[69] The contract should be considered to be executory under § 365(e)(2) since there remain unperformed obligations that likely should be considered to be material. The limited liability company or partnership does not have to accept the trustee's performance of those obligations and, therefore, the trustee cannot accept the agreement without the consent of the other members or partners.[70]

Where the trustee does not seek to assume the debtor's role as manager but rather seeks to leave the debtor in that role, as in *Walro v. The Lee Group Holding Company, LLC*,[71] the operating agreement should not (for that reason) be an executory contract. In *Walro*, the bankruptcy court did not perform an analysis whether the operating agreement was an executory contract under § 365, noting that:

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[68] Section 365(e)(2)(A) provides:

> Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

[69] Of course, if the terms of the agreement provide that the manager or service provider can delegate performance without breach of the underlying agreements, then the trustee should be able to step into the Management Rights as well.

[70] *See Warner*, 480 B.R. at 650, (the court noted that "[a]n overlap, arguably a conflict, exists between §§ 365 and 541(c)(1). *See In re* Garbinski, 465 B.R. 423, 426 (Bankr. W.D. Pa. 2012) ("Section 365 is thus in apparent conflict, or at least in tension, with 11 U.S.C. sec. 541(c)(1) . . . . "). Section 541(c)(1) voids *ipso facto* provisions while § 365(e)(2) would permit the non-debtor entity to enforce an *ipso facto* clause within the contract."). The court in Warner decided to leave this issue for another day as it had determined that the Operating Agreement in that case was not an executory contract.

[71] 524 B.R. 798, 803-04 (Bankr. S.D. Ind. 2014).

> The Trustee did not seek to step into Debtor's shoes as manager, nor did he ask that the Court compel Debtor to remain as manager. . . . For that reason, the Court need not determine—at least in the context of this proceeding—whether the Code or relevant non-bankruptcy law supports either type of action.[72]

Continuing Duties Are Sufficient to Cause the Operating Agreement to be an Executory Contract.

In *Ebert v. DeVries Family Farm, LLC* (*In re DeVries*),[73] the court reviewed an operating agreement that included three continuing obligations to determine whether they constituted sufficient unperformed obligations to turn the operating agreement into an executory contract:

1. The operating agreement provided that the debtor was obligated to contribute such time to the LLC as necessary for its operations. The court recognized that "whether a debtor is required to participate in any management obligations is a factor that courts consider in determining whether an agreement is an executory contract."[74] However, under the terms of the operating agreement at issue, management was to be solely overseen by the manager who exercised control over 100 percent of the Company and at no point did the Debtor in that case contribute any meaningful amount of time to the Company's business affairs. More importantly, Debtor's failure to participate in management duties did not constitute a "material breach" under the Operating Agreement, did not lead to his dissociation from the Company, nor have any real effect on his membership rights. The court concluded that the debtor's obligation to contribute time to the management of the Company was not an executory obligation.

2. The operating agreement required the members, including the bankrupt debtor, to contribute capital "as may be determined by a majority vote of the Members,"[75] and failure to make the required capital contribution would be cause for termination of membership. The trustee argued that the likelihood of the debtor being required to contribute capital was too remote to be considered an executory obligation. However, the court noted that even though the debtor "has not yet been called on to contribute additional capital to the Company [it] does not relieve Debtor of this obligation."[76] The court went on to note that "given the highly volatile nature of the dairy industry, Debtor's obligation to contribute capital to the Company is neither remote nor hypothetical."[77] Consequently, this obligation to contribute was found to be an executory obligation.

3. The court also found that the obligation set forth in the operating agreement for each member to guarantee loans to the Company if the guarantee was required

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[72] *Id.* at 805.

[73] 2014 WL 4294540 (Bankr. N.D. Tex. Sept. 27, 2014).

[74] *Id.* at *9.

[75] *Id*.

[76] *Id.* at *10.

[77] *Id*.

> by the bank was also an executory obligation and neither remote nor hypothetical.[78] The members had in the past guaranteed such obligations, and the continuing obligation to do so was executory.

The court also discussed the obligations in the cross purchase agreement among the members—an agreement separate from the operating agreement but entered into by the members at the same time.[79] The court found that "it is clear that the parties entered into the Operating Agreement and Cross Purchase Agreement with the intent to create global procedures for the Company" and the two agreements were a "package deal." The court noted that the agreements should therefore be construed as one,[80] and the trustee, by failing to timely assume the Cross Purchase Agreement had therefore also rejected the operating agreement "by operation of law under section 365(d) of the Code."[81]

The *In re DeVries* court then went on to explain what rejection of the executory contracts meant in this context:

By rejecting the Operating Agreement, the Trustee is relieved from performing any future obligations under it,[82] but it has not disappeared. The Operating Agreement still governs the Trustee's rights under it. Therefore, the court must look to the Operating Agreement to determine the effect of its breach.

In this case, the operating agreement said that a member "shall attain the status of a mere assignee if the member breaches the operating agreement" and as a result would no longer be entitled to participate in management (Owner's Rights in this context).[83] The debtor retained the Economic Rights, however.[84]

In another case, Strata Title, LLC filed for bankruptcy protection.[85] Strata was a 45% owner of Santerra Apartments, LLC.[86] Strata's single member, John Lupypciw, is the manager but not a member of Santerra.[87] Santerra's operating agreement required a super-majority (60% vote) by the members to perform certain actions, which the court determined were "not

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[78] *Id.* at *11.

[79] The defendants argued that even if the court found the operating agreement itself not to be an executory contract, the Cross Purchase Agreement and the Operating Agreement should be construed together, and the Trustee's failure to timely assume the Cross Purchase Agreement resulted in a rejection of both the Cross Purchase Agreement and the Operating Agreement. The Cross Purchase Agreement governed, among other things, the transfer of membership units in the event of a member's death or withdrawal, and outlined certain restrictions on alienation of the membership units.

[80] *Citing In re* Mirant Corp., 303 B.R. 319, 322 n.7 (Bankr. N.D. Tex. 2003), *citing with approval* Kopel v. Campanile (*In re* Kopel), 232 B.R. 57, 65 (Bankr. E.D. N.Y. 1999).

[81] *In re DeVries*, 2014 WL 4294540 at ¶ 40.

[82] *Citing* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012) (Easterbrook, J.), *cert. denied*, 133 S. Ct. 790 (2012) ("After rejecting a contract, a debtor is not subject to an order of specific performance.") (citing *Bildisco*, 465 U.S. at 531).

[83] *In re DeVries*, 2014 WL 4294540 at ¶ 49.

[84] *Id.* at ¶ 48 n.102.

[85] *In re* Strata Title, LLC, 2013 WL 1773619, *1 (Bankr. D. Ariz. Apr. 25, 2013).

[86] *Id.* at *2 n.11

[87] *Id.* at *1.

remote and are material":

1) Sale of the Property;
2) Refinancing of the Property; and
3) Removal of the manager.[88]

The court found that Santerra (and Mr. Lupypicw) were actively marketing Santerra's property and was facing an upcoming refinancing deadline. The other members of Santerra had made a threat to remove Mr. Lupypciw as manager. Because of the super-majority provisions, the court found that these issues required resolution through the Debtor's active participation and, therefore, the operating agreement in this case was an executory contract. Similarly, in *Milford Power*, the Delaware Chancery Court held that while federal bankruptcy law pre-empted state law, §§ 365(e)(2) and 365(c)(1) created "a strong argument that these sections preclude a Bankruptcy Trustee from assuming at least those aspects of the contract granting the debtor managerial rights even if the Trustee is the debtor in possession."[89] In contrast, however, the Bankruptcy Court in *In re Alameda Investments, LLC*[90] distinguished *In re Strata Title* and stated that the mere fact that members had the right to vote on various matters would not, by itself, make an operating agreement executory.

In *In re Garrison-Ashburn, LC.*[91] the court found that where the bankrupt debtor had no management role or other continuing obligation, the operating agreement was not an executory contract. Nevertheless, the *Garrison-Ashburn* court enforced provisions of the Virginia Limited Liability Company Act which provided a member would be dissociated upon the filing of a bankruptcy petition and retain only Economic Rights as an "assignee." A commentator[92] notes that "Garrison-Ashburn, however, departed from the majority of courts holding that in the case of non-executory agreements, under §541(c)(1), the full bundle of rights associated with an LLC interest (including management rights) would be retained by a debtor after the commencement of a bankruptcy case." This aspect of the decision has been criticized by other courts on the grounds that a statute that relegates a member's interest to those of an assignee is itself "applicable non-bankruptcy law" and an *ipso facto* clause that in effect terminates the debtor's membership interest under § 541(c)(1)(B).[93]

Another case finding that the operating agreement in question was not an executory contract is *In re Ehmann*.[94] There the Bankruptcy Court said:

> While Fiesta undoubtedly owes many obligations to its members pursuant to the Operating Agreement, for the contract to be executory there would also have to be

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88 *Id*. at *2.

89 Milford Power Company, LLC v. PDC Milford Power, LLC, 866 A.2d 738, 752 (Del. Ch. 2004).

90 2013 WL 32116129 (Bankr. C.D. Cal. 2013), *aff'd* 2014 WL 868605 (B.A.P. 9th Cir. 2014).

91 In re Garrison-Ashburn, LC, 253 B.R. 700 (Bankr. E.D. Va. 2000).

92 Lawrence A. Goldman, *The Crossroads of LLCs and Bankruptcy—A Treacherous Intersection* (Bus. Law Section of the Am. Bar Assoc., S. F., Cal.), Apr. 16, 2015.

93 In this regard, *see In re* Kling*er*man, 388 B.R. 677, 679 (Bankr. E.D. N.C. 2008); *In re* La*H*ood, 437 B.R. 330, 336 (Bankr. C.D. Ill. 2010); and *In re* Ellis, 2011 Bankr. LEXIS 4169, *7-8 (Bankr. S.D. Ind. 2011).

94 2005 WL 78921 (Bankr. D. Ariz. Jan. 13, 2005).

> some material obligation owing to the company by the member. Moreover, such member's obligation must be so material that if the member did not perform it, Fiesta would owe no further obligations to that member.[95]

The court went on to discuss its conclusions following "a close reading of the Operating Agreement itself":

> It imposes many obligations on the managers, but as noted above the manager is the Debtor's father, not the Debtor. Article V is entitled "Rights and Obligations of Members," but in fact it identifies only rights and no obligations. . . . In short, the Article of the Operating Agreement that is partially titled "Obligations of Members" reveals that members have no obligations to the Company.[96]

In re Ehmann is, therefore, consistent with other cases where courts have found operating agreements not to be executory contracts where the operating agreement does not require that the bankruptcy debtor perform future services for the limited liability company or partnership entity or perform other material future obligations. In *In re Warner*, the court said:

> In this case, the Operating Agreement reveals that there are no material unperformed and continuing obligations owed by the Debtor: the Debtor is not a manager of McCoy Farm; he has never contributed capital to the LLC; he has no obligation to provide any personal expertise or service to the company; and he may withdraw at any time so long as notice is given.[97]

Where an operating agreement or partnership is not an executory contract, it does not have to be accepted by the trustee. It continues in effect with no change and the trustee steps into the same position as the now-bankrupt debtor occupied. However, by being party to the operating agreement, the trustee only has the same rights and is subject to the same limitations as the debtor originally had, including any limitations on future transferability.

Possible Death-Knell for Pick Your Partner in Bankruptcy?

Unfortunately, however, not all cases are well-argued or well-reasoned or fit within a simple analysis. Judges are generally not business law specialists and do not always give careful analysis to business law principles when deciding cases before them. An example of this is *In re Denman*.[98] In *Denman*, the court also reviewed the operating agreement and determined that an operating agreement was not an executory contract. The court failed to conduct the careful analysis that the *DeVries* court conducted, but rather analyzed the issue as follows:

> The court has extensively reviewed the Operating Agreement of this case and now

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[95] *In re Ehmann*, 319 B.R. at 204.

[96] *Id.*

[97] Sheehan v. Warner (*In re* Warner), 480 B.R. 641, 651 (Bankr. N.D. W. Va. 2012).

[98] *In re* Denman, 513 B.R. 720 (Bankr. W.D. Tenn. 2014). *See* Jay Adkisson, *Denman Creates Confusion for Bankrupt Debtor's Interest in LLC*, FORBES (Dec. 19, 2014), http://onforb.es/1AnT7et.

> finds that it is not an executory contract as contemplated and governed by sec. 365 of the Bankruptcy Code. As the title of the Operating Agreement indicates, this agreement is meant to operate Opus, a separate legal entity from its members. The Operating Agreement establishes rights and duties attached to the Membership Interests. The members were required to make an "Initial Contribution" under Section 6.1 of the Operating Agreement to capitalize Opus. No other material member obligations appear to exist under this Operating Agreement.[99]

Had the court stopped its discussion here, the issue would have been clear – no continuing material obligations in the operating agreement means that the operating agreement would not be treated as an executory contract under 11 U.S.C. § 365. Unfortunately, the court went on to confuse the issue significantly, stating:

> The Operating Agreement here is a Tennessee LLC operating agreement subject to the Tennessee LLC Act. The Operating Agreement is a legal instrument that defines the membership interests and rights that each member holds in Opus. These membership interests are personal property of the individual members analogous to shares of corporate securities. Mr. Denman's Membership Interest became property of the sec. 541(a) estate upon the filing of his Chapter 13 petition. 11 U.S.C. sec. 541(a). In conclusion, the LLC operating agreement here is not an executory contract and is more appropriately classified as a business formation and governance instrument; therefore, the Opus Operating Agreement here is not an executory contract under sec. 365, however, Mr. Denman's Membership Interest is sec. 541 property of the estate.[100]

Few experienced business lawyers would consider LLC membership interests to be "analogous to corporate securities." First of all, the term "securities" is an extremely broad term that invokes consideration of federal and state securities laws as well as, perhaps, article 8 of the Uniform Commercial Code. Even if read to mean "shares of corporate stock," there are significant differences between corporate stock and interests in limited liability companies and partnerships, and the separation between Economic Rights, Owner's Rights, and Management Rights is only one of those differences.

Perhaps the more surprising (and inaccurate) statement is the court's effort to distinguish "a business formation and governance instrument" from the entire world of contracts. If not a contract, what can it be?

Professor Carter Bishop has expressed the fear that *Denman*, if followed in the future, would mean that a bankruptcy trustee could obtain all of a debtor's LLC interest and deal with it notwithstanding any contractual restrictions.[101] The authors believe that *Denman* should be considered an outlier and, at worst, limited to an interpretation of the Tennessee LLC Act

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[99] *Id.* at 726.

[100] *Id.* (The court also said that "in essence, the LLC obligations are unilateral obligations to the LLC and not bilateral obligations among members." (*Id.* at 724)).

[101] Email from Professor Carter G. Bishop, Professor of Law, (Suffolk University, to lnet-llc@yahoogroups.com (Nov. 21, 2014, 07:03 MDT) (on file with author).

which is significantly different than other state LLC Acts.

- Unlike many LLC Acts, the Tennessee LLC Act does not contain a provision stating that "it is the intent of this article to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[102]

- The Tennessee LLC Act defines "LLC Documents" as either, or both, the LLC's articles and, "*if the LLC has an operating agreement*, whether written or oral, its operating agreement."[103]

- Unlike other LLC Acts, the Tennessee LLC Act contemplates that all provisions that would normally be included in an operating agreement may be set forth in the LLC's articles.[104] Although this would be possible under other LLC Acts, it is not customary practice.[105]

- The Tennessee LLC Act also contains a very corporate-like provision relating to the classification of interests, providing, inter alia, that "the LLC documents may denominate membership interests or financial rights as units, shares, percentages, participations, distribution interests, ownership or economic interests, with or without voting rights, and with or without fixed or variable rights to participate in distributions, assets and properties, allocations of profits and losses and fixed or variable obligations to the LLC or any combination thereof."[106]

The court in *Denman* showed its lack of understanding of LLCs in general and of Tennessee LLCs in particular. The court discussed single-member LLCs even though the LLC at issue in Denman was not a single-member LLC. The court noted that Tennessee law provides that a new members are deemed to have agreed to the operating agreement[107] and stated:

> This makes sense if the LLC operating agreement is considered a governance instrument merely defining the membership interests. However, under contract law, parties cannot be deemed to be parties to a contract without their consent. Similarly, parties to contracts must mutually assent to amendments to existing contracts; whereas, LLC agreements may be amended without all members approving. TENN. CODE ANN. §48-206-102(b). Such LLC provisions undermine the privity of contract and demonstrate that LLC operating agreements are unique instruments apart from

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[102] *E.g.*, COLO. REV. STAT. § 7-80-108(4) (2004) (LLCs); *see also* DEL. Code Ann., tit. 6, § 15-103(d) (2009) (partnership agreements) and § 18-1101(b) (2013) (LLCs). The authors submit that there is no authority or policy reason that such a statutory statement should be applicable to establish that an LLC is essentially a creature of contract.

[103] TENN. CODE ANN. § 48-249-102(16) (2014) (emphasis added).

[104] *Id*. at § 48-249-202(b)(1).

[105] *See, e.g.*, COLO. REV. STAT. § 7-80-204(1)(f) (2004); *see generally*, Herrick K. Lidstone, Jr. and Allen Sparkman, LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO § 3.1.6 (CLE in Colorado, Inc. 2015).

[106] TENN. CODE ANN. § 48-249-303(a) (2014).

[107] *Id*. at §48-206-102(a).

executory contracts.

The court ignored the fact that members must agree to become members and that agreement constitutes their assent to the operating agreement and to its amendment provisions. The court also failed to note that Tennessee law provides that members of an LLC may enter into an operating agreement not just "to regulate the affairs of the LLC and the conduct of its business" but also "to govern relations between or among the members."[108] Something that governs relations between or among the members sounds like a contract.

Despite the *Denman* court's apparent misunderstanding of LLCs, the court raises what may be a more important issue. Discussing both the Countryman and Sixth Circuit definitions of executory contracts,[109] the court noted that a member's breach of an operating agreement did not excuse performance by the other members or the by LLC—meaning that the other members of the LLC have to perform for the benefit of the LLC (and the bankrupt member's estate) notwithstanding the estate's default under the terms of the operating agreement. This was clearly a bankruptcy favorable, owner-entity unfavorable opinion which hopefully will have limited future effect. However, *Denman*, as well as *In re Ehmann*,[110] appear to be consistent with the view expressed by the United States Supreme Court that the legislative history of Section 365(a) indicates that Congress intended that an executory contract be defined as a contract "on which performance is due to some extent on both sides."[111] To the extent that the view expressed in *Denman* and *In re Ehmann* is widely adopted in the future, the "pick your partner" likely becomes meaningless in the bankruptcy context.

Arguments exist to counter the *Denman* and *In re Ehmann* view. Some courts have held that "even though there may be material obligations outstanding on the part of only one of the parties to the contract, a contract may nevertheless be deemed executory under the functional approach if its assumption or rejection will ultimately benefit the estate and its creditors."[112] Assume the following situation:

> Closely Held LLC, a Texas limited liability company, is managed by Bob Debtor, who is one of four equal members of Closely Held LLC. Because he is a member, Bob Debtor receives no compensation from Closely Held LLC for serving as its manager.
>
> Bob Debtor has also licensed certain intellectual property to Closely Held LLC. Under the license agreement, Closely Held LLC pays royalties to Bob Debtor. Bob Debtor's only ongoing obligations under the license agreement are to license any future developments that Bob Debtor may develop in the intellectual property and to cooperate with Closely Held LLC in any action to defend the rights of Closely Held LLC in the intellectual property. Bob Debtor has no obligation to work on future

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108 *Id*. at § 48-249-203(a).

109 *See* Countryman, *supra*, note 57; Founier & Schanne, *supra* note 58 and accompanying text.

110 *See supra*, note 62 and accompanying text.

111 *See supra*, note 55 and accompanying text.

112 *In re* Cardinal Industries, Inc., 146 B.R. 720, 729 (Bankr. S.D. Ohio 1992); *accord*, *In re* Arrow, Inc., 60 B.R. 117, 122 (Bankr. S.D. Fla. 1986).

developments of the intellectual property.

Bob Debtor files for bankruptcy because of debts incurred in an unrelated business.

At least under the functional approach, Bob Debtor's position as manager of Closely Held LLC should be considered an executory contract. If so, Closely Held LLC should not be required to accept further service from Bob Debtor as manager pursuant to Section 365(e)(2) of the Bankruptcy Code unless the trustee assumes the operating agreement as an executory contract. If the trustee assumes the executory contract, Bob Debtor can continue to provide services to the LLC since the restrictions of § 365(c)(1) and § 365(e)(1) would not be applicable.[113] If the contract is determined not to be executory, Bob Debtor can continue to provide services as manager without question. On the other hand, the license would not appear to be an executory contract unless the facts demonstrate that the likelihood of valuable future developments to the intellectual property is such that Bob Debtor's knowledge is vital to those possible developments. In that case, Closely Held LLC should be able to prevent assignment of Bob Debtor's rights under the license.[114]

Note that if neither Bob Debtor's position as manager nor the license agreement is considered an executory contract, Closely Held LLC would be forced to accept an individual as manager who at best will be distracted by his bankruptcy and could lose the benefit of possible future developments in the intellectual property that Bob Debtor might achieve. This would be untenable from a policy standpoint.[115]

CONCLUSION

When attorneys make appropriate arguments and courts carefully consider the law, elements of "pick your partner" should survive even through a bankruptcy of a member or partner. While it is true that Economic Rights and Owner's Rights will become included in the bankruptcy estate under § 541(a), where the operating agreement or partnership agreement is an executory contract the trustee may be required to make a decision whether to accept (and

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[113] Where Bob Debtor was the manager before the bankruptcy and following the filing of the petition, Closely Held LLC will be accepting services only from him. In §§ 365(c)(1) and (e)(1), the Bankruptcy Code prohibits persons other than the person already performing the services (that is an assignee) from acquiring the Management Rights without the other parties' consent.

[114] Intellectual property rights are subject to the following rules:

An exclusive copyright license provides the licensee with a property right that is freely transferrable. A non-exclusive copyright license cannot, as a matter of law, be assigned without the owner's consent. *In re* Sunterra Corp., 361 F. 3rd 257, 260 (4th Cir. 2004); *In re* Golden Brooks Fam. Ent., Inc.,. 269 B.R. 300, 309 (Bankr. D. Del. 2001).

Both exclusive and non-exclusive patent licenses are personal and non-delelegable. *In re* Catapult Ent., Inc. 165 F. 3d 747 (9th Cir. 1999); *In re* Aerobox Structures, LLC, 373 B.R. 135, 141 (Bankr. D. N.M. 2007).

Trademark licenses are not assignable absent a clause expressly authorizing assignment. *In re* XMH Corp., 647 F.3d 690 (7th Cir. 2001).

For a collection of cases on the executory contract status of intellectual property and technology licenses, *see* Michelle Morgan Harner, Carl E. Black, & Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 Am. Bankr. Inst. L. Rev. 187, 192 n.24 (2005).

[115] *See In re* First Protection, Inc., 440 B.R. 821 (B.A.P. 9th Cir. 2010) (The purpose of Section 365(c)(1) is "to protect non-debtor third parties whose rights may be prejudiced by having a contract performed by an entity other than the one with which they originally contracted.").

therefore perform future obligations) or reject (and therefore be in default under the contract).

When a member or partner files a petition in bankruptcy, relationships and goals change. The trustee's obligation is to act for the benefit of unsecured creditors of the bankruptcy estate in general – and whether to keep the business operating is a subset of the much larger goal. Where the bankrupt member or partner has a controlling vote, that vote will likely go to the trustee who may use the vote to replace a manager or to dissolve the entity. In that case, the trustee will likely argue to prevent the operating agreement or partnership agreement from being treated as an executory contract – the trustee would prefer simply to step into the bankrupt member's or partner's Economic Rights and Owner's Rights with no action to accept or reject an agreement being required.

Unfortunately, the courts are not always clear in their determination as to what constitutes an executory contract or the legal elements considered in determining whether an agreement is in fact an executory contract. A commentator[116] has summarized this well when he stated "the state of the law concerning the enforceability of [*ipso facto*] clauses, or provisions of State limited liability company acts purporting to cause a change of the nature of an interest in a limited liability company upon the holder's bankruptcy, continues to evolve and can best be described as murky." The same can be said about bankruptcy court interpretation of most aspects of the relationship between the bankrupt member or partner and the entity (LLC or partnership). The commentator went on to summarize "the current state of the law" as follows:

1. A debtor will retain economic rights in an LLC regardless of language in an LLC agreement or a statutory default rule that purports to cause a termination or automatic transfer of such rights upon the filing of a bankruptcy case.

2. A debtor's retention of non-economic rights attendant to an LLC interest (i.e., continued participation in management, right to vote, right to financial information) will depend on whether the LLC agreement at issue is executory. If the agreement is not executory, the trustee should retain such rights. If the contract is assumed, whether the trustee has the right to assign the contract may depend on restrictive provisions of the contract unrelated to the event of the debtor's bankruptcy.

3. If the LLC agreement is executory, whether a trustee or an assignee of a debtor or bankruptcy trustee, retains non-economic rights will depend on the particular facts and circumstances at issue and whether the court applies a hypothetical or actual test of assignability. In particular, the language of the LLC statute or agreement, or the terms of other applicable non bankruptcy law will have to be analyzed to determine whether the assignment of certain contract rights is forbidden. Finally, if assignability is forbidden, upholding an *ipso facto* clause may depend on whether the identity of a party is material to the contract.

There are many factors that are involved in the determination whether contracts such as operating agreements and partnership agreements are executory, the damages when executory

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[116] Lawrence A. Goldman, *The Crossroads of LLCs and Bankruptcy—A Treacherous Intersection*, (Bus. Law Section of the Am. Bar Assoc., S. F., Cal.), Apr. 16, 2015.

contracts are rejected, and the respective rights of the parties to the contract following acceptance or rejection; as a result, each case requires a fact-intensive inquiry that must address the particular circumstances of the issues being presented and the agreement under consideration.

The courts have told us (and will likely continue to tell us) what the battleground issues are and it will be up to the litigators presenting the cases to the courts to make their arguments. The authors hope that the litigators' arguments will be made with the assistance of attorneys who understand limited liability company and partnership law.