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## **LLC Member Bankruptcy**

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**I. Overall Summary**

- A. **What is included in the debtor's bankruptcy estate? [PART II]**
  - i. Both the economic and management rights become property of the debtor's estate and nothing may preclude this result
  - ii. For example, an option to purchase triggered by bankruptcy is an unenforceable *ipso facto* provision
- B. **Can a Chapter 7 trustee exercise any of the debtor's management rights? [PARTS III-V]**
  - i. Whether the trustee may exercise the debtor's management rights depends upon whether the operating agreement is an executory contract.
  - ii. If not executory, the trustee may exercise the debtor's management rights
  - iii. If executory, the state LLC law transfer restrictions preclude the trustee from exercising management rights
  - iv. The prevailing view is that a debtor in possession (DIP) can always exercise the management rights b/c identical person.
- C. **What can the trustee sell to a third party? [PART VII]**
  - i. The executory issue controls what the trustee may do with the management rights during the estate but has nothing to do with the trustee's sale of the interest. In such a sale, the trustee is bound by the same rules as the debtor
  - ii. The trustee may not sell the interest free and clear of state LLC transfer laws or contract options. Indeed, if any sale triggers the option, it would be triggered by a trustee sale.
  - iii. The "free and clear" sale rules neither creates nor destroys property characteristics but merely apply to strip liens and other interests of non-debtor parties in the property. So, the trustee may not sell the economic rights free and clear of their characteristics (to only economics and not management).
- D. **Are the rules different for a SMLLC? [PART VI]**
  - i. Yes. By definition, no executory contract therefore trustee exercise all the debtor's management rights (unless professional services but may still liquidate the LLC).

## II. Property of the Debtor's Estate [BRC §§ 541(a)(1) & 541(c)]

- A. **QUESTION:** Are the debtor's management rights included in the bankruptcy estate? Yes, but if the OA is executory, various "savings provisions" override the trustee's right to exercise any debtor's management rights.
- B. All "legal or equitable interests of the debtor in property"
  - i. Transferable interest (economic rights)
    - a. Call or purchase options in favor of LLC or other members remain but are subject to automatic stay
  - ii. All remaining rights pertaining to the debtor's LLC interest (management rights)
- C. Disappearing Management Rights Preserved [BRC § 541(c)]
  - i. State LLC law & OA "other member consent" transfer restrictions [BRC § 541(c)(1)(A)]
  - ii. *Ipso facto* dissociation management forfeiture provisions [BRC § 541(c)(1)(B)]
    - a. Call or purchase options in favor of LLC or other members triggered by bankruptcy do not preclude LLC membership interest becoming part of estate
- D. Consequences
  - i. While state LLC and OA transfer restrictions along with *ipso facto* forfeiture provisions do not prevent a member's economic or management rights from becoming property of the estate, the trustee may not ignore the transfer restrictions in violation of the conditions
  - ii. The importance of **BRC § 541(c)** is to create an opportunity of a trustee to exercise the debtor's management rights without the consent of other LLC members.
    - a. **Example.** The trustee may not sell the debtor's management rights "free and clear" of the transfer restrictions without the consent of the other members [BRC § 363(f)(2)] because state LLC law continues to restrict transfer [BRC § 363(f)(1)].
    - b. **Option Example.** However, the trustee might be able to sell the economic interest free and clear of a purchase option if the other members or the LLC could be compelled to accept a monetary satisfaction of such interest (plausible since management rights do not travel with the interest on the sale).
- E. Case Example
  - i. **In re Cardinal Industries, Inc., 116 B.R. 964 (Bankr. S. D. Ohio 1990).** Even the general partner's exclusive right to manage a limited partnership is included in the general

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