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Current Status of LLC Bankruptcy Issues

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I. Applying Bankruptcy Law to LLCs.

A. Eligibility of an LLC to File a Bankruptcy Petition.

Title 11 of the United States Code (the “Bankruptcy Code”) permits “persons” to file bankruptcy petitions, and the statutory definition of “person” includes “individual, partnership, and corporation.” Bankruptcy Code § 101(41). Although an LLC is not a “partnership” in a state law sense, the Bankruptcy Code defines “corporation” to include:

- (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;
[or]

- (iv) unincorporated company or association;

Bankruptcy Code § 101(9)(A). For the purposes of determining an LLC’s eligibility to file a bankruptcy petition, an LLC should be able to fit within either of the subsections cited above. It might be possible to argue with the characterization of an LLC as a corporation because § 101(9)(B) specifically excludes limited partnerships from the definition of corporations, but this distinction is unlikely to matter in any event. The definition of “person” lists individuals, partnerships and corporations as entities “included” within the definition, but is not so exclusive as to prevent another type of entity not listed in the statute from also being characterized by a court as a “person.”

It is also worth observing that the classification of an LLC as a partnership or as a corporation for purposes of determining the applicability of the Bankruptcy Code should have little other effect on the disposition of a bankruptcy proceeding. Most of the provisions of the Bankruptcy Code that apply specifically to partnerships relate to issues, such as the liabilities of general partners, that are not likely to apply in an LLC context.

The distinction between a “partnership” and a “partnership association” that fits within the Bankruptcy Code definition of “corporation” arose in In re Rambo Imaging, L.L.P., 2008 Bankr. LEXIS 2311 (Bankr. W.D. Tex. July 15, 2008). In that case, the bankrupt entity was a Texas general partnership that had elected limited liability partnership status. Although the partnership agreement described numerous actions that could be taken only with the approval of two-thirds of

the holders of partnership units, and delegated other actions to the “Managing Partners,” the agreement did not specifically address the power to put the partnership into bankruptcy. The partnership was clearly a general partnership, but the court engaged in an analysis of the limited liability of the partners, and relied on a treatise reference in Collier’s, to conclude that an LLP should be treated as a “partnership association,” and therefore a “corporation” for Bankruptcy Code definitional purposes. On that basis, the court held that a dissident general partner did not have the power to commence an involuntary bankruptcy proceeding on behalf of the partnership.

The court in In re Midpoint Development, L.L.C., 313 B.R. 486 (Bankr. W.D. Okla. 2004) noted the omission of LLCs from the Bankruptcy Code, and analogized to corporations and partnerships. In that case, the court held that even a limited liability company in dissolution is entitled to make a bankruptcy filing, because a dissolved LLC is still in the process of winding up, and the winding up process may be conducted through bankruptcy. However, this case was ultimately reversed by the Tenth Circuit because the bankrupt LLC had not only dissolved, but had actually filed articles of dissolution that became effective prior to the bankruptcy filing. On the effective date of the articles of dissolution, the Oklahoma LLC ceased to exist, and so could not later file for bankruptcy. See In re Midpoint Development, L.L.C., 466 F.3d 1201 (10th Cir. 2006).

B. Authority to File a Bankruptcy Petition.

As a general proposition, state law determines who has the legal right to file a bankruptcy petition. See Price v. Gurney 324 U.S. 100 (1945). With respect to general partnerships, the federal bankruptcy rules once provided that a bankruptcy petition could be filed by any general partner, provided that all general partners consented, see former Fed. Bankr. R. § 1004(a), but that rule was deleted because it was inappropriate for the bankruptcy rules to attempt to define what is essentially a state law governance rule. In the corporate context, the power to file a petition will usually rest with a corporation’s board of directors, but in an LLC setting, the authority of managers is not as clear. State LLC statutes generally do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC’s governing documents. If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC’s managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

Most of the cases addressing the power to file a bankruptcy petition are divided into two categories: those that deal with the statutory power to initiate bankruptcy, and others that address whether a bankruptcy has been appropriately commenced given the terms of an LLC’s governing documents or other agreements.

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