

How Does a LLC Member's Chapter 7 Bankruptcy Impact Management Rights?

The United States Bankruptcy Code provides that any interest that a debtor holds in property as of the date of the debtor's bankruptcy filing becomes property of the debtor's bankruptcy estate. 11 U.S.C. § 541(c)(1). In a chapter 7 bankruptcy case, a trustee will be appointed to, among other things, liquidate property of the debtor's bankruptcy estate for the ultimate payment of the debtor's creditors. 11 U.S.C. § 704(a)(1).

Where a chapter 7 debtor's assets include a limited liability company membership interest with management rights, the scope of the chapter 7 trustee's rights with respect to such membership interest is not always clear. While the chapter 7 trustee can clearly exercise the bankruptcy estate's rights to the economic benefits of the membership interest, in some instances, the chapter 7 trustee's rights may extend beyond mere economic rights to include the right to make management decisions that would ordinarily be made by the limited liability company member. For this reason, a third party dealing with a limited liability company with a member who may be the subject of a chapter 7 bankruptcy case should be cognizant of how a member's chapter 7 bankruptcy filing could impact that member's management powers.

Single Member Limited Liability Companies Are Especially Prone to the Exercise of Management Authority by a Chapter 7 Trustee

While results may vary based on differences in state law concerning limited liability companies, a significant number of bankruptcy courts have held that where the sole member of a single-member limited liability company files a chapter 7 bankruptcy petition, the chapter 7 trustee acquires not only the debtor's economic interest in the limited liability company, but also the debtor's rights to control and manage the limited liability company. *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003); *In re A-Z Elecs., LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006); *Monroe Capital, Inc. v. Frumusa (In re Frumusa)*, No. 09-21527, 2010 WL 1509291 (Bankr. W.D.N.Y. Apr. 14, 2010). *See also In re Modanlo*, 412 B.R. 715 (Bankr. D. Md. 2006) (chapter 11 trustee appointed for limited liability company's sole member had the right to exercise management and governance rights in the limited

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liability company).

Multimember Limited Liability Companies May Be Subject to the Exercise of Management Authority by a Chapter 7 Trustee, but Results Vary Widely

Bankruptcy courts have taken various approaches to determining what rights a chapter 7 trustee acquires when a member of a member-managed, multimember limited liability company files for bankruptcy protection. Whether or not the trustee acquires a debtor's management rights in a multimember limited liability company depends on a variety of factors, including the nature of the limited liability company's operating agreement and applicable state law.

Some courts have held that a debtor's economic and management rights in a multimember limited liability company become property of the bankruptcy estate by virtue of section 541 of the Bankruptcy Code. *See In re Daugherty Constr. Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995) (finding that debtor's entire membership interest in limited liability companies became property of the bankruptcy estate in his chapter 11 case); *Klingerman v. ExecuCorp, LLC (In re Klingerman)*, 388 B.R. 677, 679 (Bankr. E.D.N.C. 2008) (same). Section 541 provides that a debtor's interest in property becomes property of the estate even where an agreement or applicable non-bankruptcy law (such as state law concerning transferability of limited liability company interests) purports to restrict the transfer of the debtor's interests. 11 U.S.C. § 541(c)(1). Courts applying section 541 to a chapter 7 debtor's interest in a limited liability company would most likely find that the chapter 7 trustee acquires all rights of the debtor in the limited liability company (including management rights, if any), regardless of any restrictions contained in a limited liability company operating agreement itself or in state law governing transferability of limited liability company interests. *See LaHood v. Covey (In re LaHood)*, 437 B.R. 330, 336 (Bankr. C.D. Ill. 2010) (holding that a trustee steps into the debtor's shoes under section 541(a) of the Bankruptcy Code because section 541(c) trumps any of the operating agreement's or state law's contrary provisions; therefore, the trustee had the right to participate in winding up the limited liability company).

In the context of chapter 11 bankruptcy cases, some courts have enforced operating agreement provisions that restrict the transfer of limited liability company interests, thereby preventing parties other than the debtor-member from acquiring a debtor's management rights in a limited liability company. *See Broyhill v. Deluca (In re Deluca)*, 194 B.R. 65, 77-78 (Bankr. E.D. Va. 1996)



(superseded by statute); *Northrop Grumman Tech. Servs., Inc. v. Shaw Grp. Inc. (In re IT Grp.)*, 302 B.R. 483 (D. Del. 2003). The analysis concerning operating-agreement and state-law restrictions on the transfer of limited liability company interests would likely be applied similarly in a chapter 7 bankruptcy case. Whether an operating agreement containing restrictions on transfer will be upheld by a bankruptcy court when considering a transfer of management rights to a chapter 7 trustee largely depends on the specific language in the operating agreement itself, as well as applicable state law concerning whether or not other limited liability company members can be compelled to accept performance from a party other than the chapter 7 debtor.

Conclusion

Parties doing business with or negotiating with a limited liability company should take steps to determine whether any of its members are the subject of a chapter 7 bankruptcy proceeding. The limited liability company may be required to seek approval from the chapter 7 trustee before taking certain actions that previously would have been subject only to approval by the now bankrupt limited liability company member.

Please contact any attorney in Reinhart's Business Reorganization Practice Area if you have any questions concerning the impact of a limited liability company member's bankruptcy filing.

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