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Members Beware! LLC Members Will Be Insiders for Bankruptcy Preference Purposes

In September 2011, in *In re Longview Aluminum, LLC*, 10-2780 (7th Cir. 2011), the Seventh Circuit Court of Appeals held that members of an LLC are insiders for preferential transfer purposes under the Bankruptcy Code. This is the case even if the member holds only a minority membership interest and is not actually in control of the enterprise. Pursuant to this decision, in a subsequent bankruptcy of the LLC, distributions received by members within the one year before the bankruptcy filing, rather than within 90 days for noninsiders, may be subject to recovery by a bankruptcy trustee.

Under the Bankruptcy Code, a payment made within 90 days of the filing of the bankruptcy petition can be recovered as a preference if the payment was on account of an antecedent debt; made while the debtor was insolvent; and the payment allowed the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor's assets. However, with respect to "insiders" of the debtor, the preference period is extended to one year before the filing of the bankruptcy petition. The Bankruptcy Code defines an insider to include an officer or director of a corporation, or a person in control of the debtor. However, the Code does not define who constitutes an insider of an LLC.

In *Longview*, Dominic Forte was one of five members of a member-managed Delaware LLC, holding only 12% of the membership interests. From 2001 to 2002, Forte made repeated requests to Lynch, the 50% member, to inspect the books and records of the LLC. Lynch denied Forte's requests, and on July 10, 2002, Forte sued Lynch alleging that Lynch and Longview refused his requests to review records and refused to allow him to participate in management decisions relating to the LLC. Longview moved to intervene in the suit and on August 20, 2002, Lynch and the other three members of Longview adopted a resolution precluding Forte's access to the books and records during the pendency of the lawsuit. On November 7, 2002, the parties entered into a settlement agreement pursuant to which the LLC agreed to pay Forte $400,000 and his attorneys' fees. Forte was paid $200,000 upon the November 7 execution of the agreement, and $15,000 for attorneys' fees on January 16, 2003. Longview filed a Chapter 11 petition on March 4, 2003, four months after the initial $200,000 payment. The bankruptcy trustee sued Forte for recovery of both payments as avoidable preferences. Forte conceded that the $15,000 payment, which was made within 90 days of the

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bankruptcy filing, was a preference and returned it. However, Forte denied that the $200,000 payment made outside the 90 day period was avoidable as a preference because he was not an insider of Longview under the Bankruptcy Code.

Forte argued that the lower courts erred when they equated an LLC's member's status to that of a director of a business corporation. Forte maintained that a member's authority to manage an LLC can be substantially altered by the terms of the LLC agreement. In addition, in this case, Forte was frozen out of any management decisions, which was the subject of the lawsuit and resulted in the settlement agreement pursuant to which he was paid the $200,000. Clearly, Forte argued, he was not a person in control of the LLC, as the Bankruptcy Code requires of one to be an insider. Finally, he argued that the absence of a Bankruptcy Code definition of an insider of an LLC required that the court find a close relationship or the lack of arm's length dealings between the debtor LLC and the transferee member for the member to be deemed to be an insider.

In affirming the bankruptcy court and the district court, the Seventh Circuit held that a member of an LLC is an insider for preference purposes, even in the absence of a definition relating to LLCs in the Bankruptcy Code. The Seventh Circuit started its decision by stating that insider status is to be decided on a case-by-case basis based upon the totality of the circumstances. The court then went on to discuss prior court decisions in which a member of an LLC was found to be analogous to a director of a business corporation. The court also agreed with the District Court's conclusion that under Delaware law, a corporation that is managed by its directors is analogous to an LLC that is generally managed by its members. Forte argued that an LLC may be managed by a manager, and that in such cases, the members' authority could be vastly different than the authority of a corporate director. The court was not persuaded, observing that the default provision under the Delaware statute was that an LLC is to be member managed unless the operating agreement provides otherwise. In any event, said the court, Longview was not manager managed but was member-managed.

The Seventh Circuit continued saying that titles such as "director" or "officer" are not determinative in deciding whether a person is an insider. Rather, the court said, it is the legal rights that a typical director or officer or similarly situated person holds that is important. Forte argued that in his case, he was effectively prevented from exercising any management authority or control over the LLC. The court dismissed this argument, saying that the LLC resolution barring Forte's access to Longview's books and records was temporary in nature and that he

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remained a member of the LLC. Forte's membership status caused him to retain meaningful rights to control the entity, especially the right to vote. The court distinguished several cases cited by Forte wherein individuals had resigned insider positions but their resignation was not formalized at the time the alleged preference payment was made. The court found that these individuals were not "in control" of the debtor when they received payments, whereas Forte remained a member of Longview at the time he was paid. Finally, the court dispensed with Forte's argument that because LLCs were not specifically addressed in the Bankruptcy Code's definition of insider, the court must find that there was a close relationship or less than arm's length dealings with the debtor. While these are factors that courts should consider, said the Seventh Circuit, the comparison of members to corporate directors yields a better interpretation of the statute.

This case is troublesome for a number of reasons. First, as a holder of only 12% of the membership interests, Forte clearly was not in a position of control of Longview. However, in addition to his minority status, he was apparently wrongfully shut out of management and ultimately received a settlement payment because of it. Yet the court virtually ignored the fact that Forte was not a person in control and focused instead almost exclusively on his mere status as a member in the LLC. The court's formalistic equating of an LLC manager with a corporate director appears to be no more reasonable than equating a member holding a minority membership interest to a minority shareholder of a business corporation, who is clearly not an insider under the Bankruptcy Code. However, the court did not even discuss this point. Even more troubling is the court's holding that if one is a member of a member of a manager-managed LLC, he or she will nonetheless be deemed to be a per se insider for preference purposes. While one can understand the Bankruptcy Code's defining a corporate director to be an insider whether or not he or she is diligent in performing his or her duties, a member of a manager-managed LLC is in a totally different position. Because LLCs are ignored in the Bankruptcy Code definition of insider, other circuit courts of appeal may take a different position than the Seventh Circuit in Longview, with the issue being ultimately having to be decided by the United States Supreme Court.

This decision should prompt members of LLCs, particularly those LLCs in financial distress, to review their membership status. It seems clear that at least in the Seventh Circuit, even if the LLC is manager-managed and the member holds only a minority interest, the member will be deemed to be an insider, and distributions made to the member within one year before a bankruptcy filing will be subject to

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avoidance. This extends the preference period to one year for even those members who are not managing or in control of the LLC. Finally, although the Seventh Circuit in *Longview* appears to require that a person withdraw from the LLC in order to terminate his or her status as an insider, unlike a corporate director who may resign at any time, Wisconsin Statutes 183.0802(3) prevents a member who acquired his or her interest for no or nominal consideration or where the operating agreement restricts withdrawal, from withdrawing other than on the terms of the operating agreement, or if it is silent, until the dissolution and winding up of the LLC. In such circumstances, voluntary withdrawal becomes impossible and the non-managing minority member will be at risk for distributions made within the year-long preference period for an indefinite period of time.

If you have questions or concerns about members of LLCs as insiders for bankruptcy preference purposes, please contact Peter C. Blain at 414-298-8129 or your Reinhart attorney."

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