JUDICIAL DISSOLUTION OF LLCs AND THE BANKRUPTCY CODE

Thomas E. Plank*

INTRODUCTION

The potential dissolution of a limited liability company (a “LLC”), including a judicial dissolution discussed by Professor Moll,¹ will concern lenders who extend credit to LLCs. Lenders prefer that their borrowers repay the debt as it comes due and that the lenders not rely on their creditor remedies to be paid in full. Dissolution would cause the acceleration of the maturity date of the debt.² Acceleration could cause the lender loss if it is holding debt that has value greater than the principal amount.³

*Joel A. Katz Distinguished Professor of Law, University of Tennessee College of Law. A.B. 1968, Princeton University; J.D. 1974, University of Maryland. I have benefitted both professionally and financially serving as issuer’s counsel, bankruptcy counsel, and UCC counsel for sales and securitization of mortgage loans and other consumer and business receivables, first as a partner with Kutak Rock LLP from 1987 to 1994, and then as a part time consultant for law firms. The views expressed in this article are my personal views informed by my practice experience as well as my research and analysis of the issues and are not the views of any law firm for which I serve or have served as a consultant.


2 See DEL. CODE ANN. tit. 6, § 18-804(a)(1) (providing that upon the winding up of the LLC as a result of dissolution, the assets of the LLC shall be distributed to creditors of the LLC in satisfaction of the liabilities of the LLC); UNIF. LTD. LIAB. CO. ACT § 707(a) (2006) (amended 2013) (substantially same effect).

3 If a Lender holds a note or bond paying interest at a rate higher than the current rate of interest, and if the borrower cannot prepay the note or bond, then the note or bond will be worth more than the face amount of the debt. For example, a note for the payment of $1,000 in two years bearing interest at the rate of 8% payable annually would be worth approximately $1,000 if current market rates were only 6% per annum. The present value calculated using the formula \( PV = FV \times (1 + \frac{i}{n})^n \) where \( FV \) is the future value ($1,000 in this example), \( i \) is the interest rate and \( n \) is the number of periods over which interest is accrued. The present value of this $1,000 is $1,164.40 ($1,000 * 1.08 * 1.08 = $1,164.40). The lender could sell this note for close to the future value, that is,
Further, dissolution could cause a lender to recover less than the amount of the debt due. In the case of an unsecured lender that is relying on the LLC’s operations to provide the revenues to repay the debt, upon dissolution the LLC may have insufficient liquid assets to repay the accelerated debt. Even if a lender has a security interest in property owned by the LLC, a foreclosure sale of the collateral securing the debt may produce insufficient proceeds to repay the debt in full. To address this concern, many credit agreements specifically prohibit LLCs from dissolving without the lender’s consent, and creditors may also insist that LLC agreements contain restrictions on dissolution.

If an LLC or a member of an LLC becomes a debtor under the United States Bankruptcy Code, the LLC or a member that is a debtor in bankruptcy may use certain provisions of the Bankruptcy Code to affect the state law rights of the LLC and its members. For example, the LLC or the member that is a debtor in bankruptcy may be able to prevent or delay a dissolution under applicable state law. On the other hand, the LLC or the member may be able to pursue judicial dissolution. The purpose of this Article is to describe and analyze how members of an LLC can use these provisions to effect or thwart a judicial dissolution that otherwise would be available under applicable state law. Part I below provides a short summary of those provisions of the Bankruptcy Code that may be relevant to the ability of a member to assist or thwart a judicial dissolution. Parts II through IV describe how these provisions may affect judicial dissolutions.

I. RELEVANT BANKRUPTCY CODE PROVISIONS

When one thinks of “bankruptcy” one normally thinks of “insolvency.” Indeed, the early English definition of “bankruptcy” was “insolvency” in the sense of the inability to pay debts as they come due.  

for $1,164.40. However, if the debt is accelerated without any prepayment or make whole premium, the creditor would only receive $1,000.


5 See 1 SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE (London 1755) (unpaginated) (defining “bankrupt” as an adjective as “[i]n debt beyond the power of payment” and defining “insolvent” and “insolvency” respectively as “[u]nable to pay debts contracted” and “[u]nability to pay debts.”); WILLIAM PERRY, THE ROYAL
However, a person eligible to file for bankruptcy,\footnote{11 U.S.C. § 109 (2012) (providing that only a “person” that meets certain criteria may be a debtor in bankruptcy. A “person” includes a “corporation, partnership or individual.” Id. § 101(41). The term “corporation” is broad. See id. § 101(9):}

\begin{itemize}
    \item The term “corporation” (A) includes--(i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses; (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association; (iii) joint-stock company; (iv) unincorporated company or association; or (v) business trust; but (B) does not include limited partnership.
\end{itemize}


\footnote{11 U.S.C. § 301 (2012):}

\begin{itemize}
    \item [(a)] A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter.
    \item [(b)] The commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter.
\end{itemize}
a debtor in bankruptcy in an involuntary case upon the petition of creditors only if the debtor is generally not paying the debtor’s debts as they become due.\textsuperscript{8} Accordingly, a member in an LLC or an LLC itself can easily become a debtor in a voluntary bankruptcy case even if it is not insolvent and may also become a debtor in an involuntary case if it is insolvent in a cash flow sense, that is, it is not paying its current debts.

Upon the commencement of a bankruptcy case, a trustee is appointed. In a Chapter 7 case, in which the debtor’s assets are liquidated to repay the creditors, the trustee will be independent of the debtor.\textsuperscript{9} However, in a Chapter 11 case, which allows the debtor to stay in business and to seek to reorganize the debtor’s business and affairs, the debtor becomes the “debtor in possession,” the debtor in possession has substantially all of the rights and powers of a bankruptcy trustee, and typically the debtor as debtor in possession as trustee may continue to operate the debtor’s business.\textsuperscript{10}

\textsuperscript{8} Id. § 303(a) (providing that “[a]n involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced”); id. § 303(b) (specifying the number of creditors holding the requisite amount of unsecured claims that may file an involuntary petition); id. § 303(h):

If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed. Otherwise, after trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if (1) the debtor is generally not paying such debtor’s debts as such debts become due unless such debts are the subject of a bona fide dispute as to liability or amount; or [a custodian is appointed].

\textsuperscript{9} Id. §§ 701–703.

\textsuperscript{10} Id. § 1101(1) (defining the debtor in possession as the debtor except if an independent trustee is appointed); id. § 1107(a) (providing that the debtor in possession has substantially all of the rights and powers of and shall perform all of the duties and functions of a bankruptcy trustee); id. § 1108 (“Unless the court, on request of a party in
The commencement of a case by the filing of a petition creates a bankruptcy estate, which under Section 541(a)(1) consists of “all legal or equitable interests of the debtor in property as of the commencement of the case” \(^\text{11}\) and other specified interests in property. \(^\text{12}\) The bankruptcy trustee, including the debtor in possession, becomes the representative of the estate \(^\text{13}\) and has the power to use, sell or lease property of the estate either in the ordinary course of business or with court approval. \(^\text{14}\) In addition, the bankruptcy trustee also may with court approval assume or reject executory contracts, \(^\text{15}\) which are contracts under which both parties have material obligations to perform. \(^\text{16}\) Rejection of the executory contract means rejection of the debtor’s obligations, which allows the other party to terminate the contract. Assumption means assuming the obligations, which requires the other party to continue to perform the contract. \(^\text{17}\)

\(^{11}\) Id. § 541(a)(1).

\(^{12}\) Id. § 541(a)(2) (certain interests of the debtor and the debtor’s spouse in community property); (defining the debtor in possession as the debtor except if an independent trustee is appointed); id. § 1107(a) (providing that the debtor in possession has substantially all of the rights and powers of and shall perform all of the duties and functions of a bankruptcy trustee); id. § 1108 (“Unless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee [including the debtor in possession] may operate the debtor's business.”).

\(^{13}\) Id. § 323(a).

\(^{14}\) Id. § 363(b), (c).

\(^{15}\) Id.

\(^{16}\) See In re Crippin, 877 F.2d 594, 596–97 (7th Cir. 1989); In re Terrell, 892 F.2d 469, 471–72 (6th Cir. 1989).

Further, as a general rule, neither non-bankruptcy law nor contractual provisions forfeiting or conditioning the interest of the debtor upon the commencement of a bankruptcy case—known as “*ipso facto*” clauses or provisions—are effective to prevent the debtor’s property interests from becoming property of the estate or to prevent the trustee from using or selling the property of the estate.\(^{18}\) However, for some

\(^{18}\) 11 U.S.C. §§ 541(c)(1) & 363(l) (2012). Section 541(c)(1) governs inclusion of property interests upon commencement of the case:

[With exceptions not relevant] an interest of the debtor in property becomes property of the estate under § 541(a)(1), (a)(2), or (a)(5) notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy 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.

*Id.* § 541(c)(1). Section 363(l) governs the trustee’s ability to use or sell property of the estate notwithstanding *ipso facto* provisions:

(l) Subject to the provisions of section 365 [governing executory contracts], the trustee may use, sell, or lease property under subsection (b) or (c) of this section, or a plan under chapter 11, 12, or 13 of this title may provide for the use, sale, or lease of property, notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfei-
types of property items, the trustee’s power to use property may be con-
strained by non-bankruptcy legal limits.\textsuperscript{19} Also, except in the case of per-
sonal services contracts and certain other executory contracts that under
non-bankruptcy law a third party is excused from accepting performance
from someone other than the debtor,\textsuperscript{20} the trustee’s ability to assume
executory contracts cannot be constrained by \textit{ipso facto} provisions.\textsuperscript{21}

\begin{quote}
\textit{Id.} § 363(f).
\end{quote}

\textsuperscript{19} \textit{See, e.g.}, Bd. of Trade of City of Chi. v. Johnson, 264 U.S. 1, 9–10, 15 (1924) (holding
that the membership interest in the Chicago Board of Trade became property of the
estate notwithstanding a Chicago Board of Trade rule prohibiting transfer if an unpaid
creditor objects, but not free of the rights of the creditors protected by the right to pre-
vent transfer).

\textsuperscript{20} 11 U.S.C. § 365(c) (2012):

The trustee may not assume or assign any execu-
tory contract or unexpired lease of the debtor,
whether or not such contract or lease prohibits or
restricts assignment of rights or delegation of du-
ties, if--

(1)(A) applicable law excuses a party, other than
the debtor, to such contract or lease from accept-
ing performance from or rendering performance
to an entity other than the debtor or the debtor in
possession, whether or not such contract or lease
prohibits or restricts assignment of rights or dele-
gation of duties; and

(B) such party does not consent to such assump-
tion or assignment . . . .

\textsuperscript{21} \textit{Id.} § 365(e):

(1) Notwithstanding a provision in an executory
contract or unexpired lease, or in applicable law,
an executory contract or unexpired lease of the
debtor may not be terminated or modified, and
II. MEMBER BANKRUPTCY AND AUTOMATIC LLC DISSOLUTION

There is a currently a very small chance that a bankruptcy of a member of an LLC would cause the dissolution of an LLC. In the early days of LLCs, applicable state law provided that a bankruptcy of a member caused the LLC to dissolve unless otherwise agreed in the LLC agreement or by the other members, for the federal income tax reasons that Professor Moll describes. These provisions, however, have not survived. When the federal income tax regulations changed in 1996, legislatures removed the automatic dissolution upon bankruptcy in most cases.

any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on--

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

(2) Paragraph (1) of this subsection does not apply to an executory contract [to the same extent as provided in Section 363(e)(1), quoted supra note 20].

22 See Moll, supra note 1, at 82, 106–07; see, e.g., Delaware Limited Liability Company Act, Del. Laws ch. 434 (H.B. 608) (1992) (amending title 6 of the Delaware Code to add sections 18-101 through 18-1107, section 18-801(a)(4) of which provided that an LLC is dissolved if among other events the bankruptcy of the member unless the business of the LLC were continued within 90 days by consent of the other members or the provisions of the LLC agreement).

Nevertheless, there is still a risk that the bankruptcy of the member of an LLC that had only one member could lead to the dissolution of the LLC. LLC Acts provide that if there are no members, the LLC can be dissolved. Nonetheless, some LLC Acts provide that a member is disassociated from the LLC upon bankruptcy. Therefore, a single member LLC potentially could be dissolved either because, as discussed below, the state law provisions for disassociation of the member upon bankruptcy may be enforceable in bankruptcy or the bankruptcy trustee for the member (including the debtor in possession) takes no action to prevent dissolution of the LLC. For this reason, creditors and rating agencies involved with credit transactions that seek to eliminate or severely curtail the risk of bankruptcy for the creditors of an LLC will generally require that the LLC Agreement expressly provide that the bankruptcy of a member not cause disassociation. In addition, the LLC Agreement will often provide for the appointment of a special member with no economic interest for the sole purpose of ensuring the continuation of the LLC.

III. MEMBER INTEREST IN BANKRUPTCY AND JUDICIAL DISSOLUTION

If an LLC member becomes a debtor in bankruptcy, the member’s economic interest in the LLC becomes property of the estate under


25 See infra note 28.

26 The rating agency Standard and Poor’s has published criteria stating that it may request a legal opinion to the effect that the bankruptcy of the sole member of a single member LLC would not cause the dissolution of the LLC. See Standard & Poor’s, Legal Criteria for U.S. Structured Finance Transactions 50 (5th ed. 2006). A contractual provision that bankruptcy of a member will not cause disassociation is typically included in the LLC Agreement to provide a legal basis for giving such opinion.

Section 541(a)(1), and the bankruptcy trustee (including the debtor in possession) can use or sell those economic interests. Courts, however, disagree on whether the non-economic interests of a member in the LLC consisting of any rights to manage the LLC and voting rights become part of the property of the estate and the extent to which the bankruptcy trustee can exercise those rights.

In my view, neither the applicable LLC state law nor any contractual provisions in the LLC agreement forfeiting or conditioning the membership interest upon bankruptcy of a member should be effective to prevent the member’s non-economic LLC interest from becoming property of the estate or to prevent the trustee from exercising the management rights of the member. Nevertheless, several courts have held that these state law provisions remain effective upon bankruptcy. For example, the court in In re Garrison-Ashburn, L.C., distinguishing between a bankrupt member’s economic interests in the LLC and the non-economic interests relating to voting and control of the LLC, held that upon filing a bankruptcy petition, the economic interests of the member became property of the estate but the non-economic rights did not. The court therefore held that the member lost its right to participate in the management of the LLC upon becoming a debtor and had no authority under the LLC Agreement to prevent sale of property of the LLC.

28 See, e.g., DEL. CODE ANN. tit. 6, § 18-304 (2013 and Supp. 2016) (providing that, unless otherwise provided in the LLC agreement, a person ceases to be a member of an LLC if the person files a voluntary bankruptcy petition, consents to or acquiesces in an adjudication in an insolvency proceeding, or fails to contest an involuntary bankruptcy petition); UNIF. LTD. LIAB. CO. ACT § 602(8) (2006) (amended 2013) (providing that a person is dissociated as a member of a member-managed LLC if the member becomes a debtor in bankruptcy).


30 See, e.g., Nw. Wholesale, Inv. v. Pac Organic Fruit, LLC, 357 P.3d 650, 657 & n.10 (Wash. 2015) and cases cited therein.


32 Id. at 704, 708. The court ignored the express language of Section 541(c)(2), and then erroneously reasoned that, although both the economic interests and the non-economic interests became property of the estate, the non-economic interests remained burdened with the non-bankruptcy law attributes that eliminated the member’s right to participate
The court in Garrison-Ashburn disregarded the express language of Section 541(c)(2) that overrides state law ipso facto clauses and addressed only Section 541(c)(1), a provision that abrogates anti-assignment clauses in agreements or applicable state law. Although the United States Supreme Court stated in Butner v. United States\textsuperscript{33} that state law normally controls what interests of the debtor are property that can become property of the estate, the Court in Butner expressly stated that this rule applies unless “some federal interest requires a different result.”\textsuperscript{34} The abrogation of ipso facto clauses is intended, and is necessary, to prevent non-debtors from interfering with the operation of the federal bankruptcy law.\textsuperscript{35} Courts should honor the express language of the Bankruptcy Code that overrides ipso facto clauses.

In addition, some courts have used a different rationale for holding that a member’s non-economic management rights cannot become part of property of the estate upon the commencement of the case when the LLC agreement is treated as or held to be an executory contract.\textsuperscript{36} As noted above, if one party to the executory contract becomes a debtor in bankruptcy, the court therefore held that the member had no authority under the LLC Agreement to prevent sale of property of the LLC, which itself was a debtor in bankruptcy, by the manager of LLC. The court further held that the LLC agreement was not an executory contract and therefore the abrogation of ipso facto clauses in 11 U.S.C. § 365(e) did not apply. \textit{Id.} at 709. The court did not address the right to use property of the estate under 11 U.S.C. § 363(l).

\textsuperscript{33} 440 U.S. 48, 55 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”).

\textsuperscript{34} \textit{Id.}


\textsuperscript{36} See, e.g., Horizons A Far, LLC v. Webber (\textit{In re Soderstrom}), 484 B.R. 874, 880–81 (M.D. Fla. 2013); Nw. Wholesale, Inc., 357 P.3d at 662–63 (Wash. 2015) (relying on the
debtor in bankruptcy, the contract cannot be terminated for that reason.\textsuperscript{37} If the trustee assumes the executory contract, the other party is obligated to perform unless the nature of the contract falls within the exceptions under Section 365(c)(1) and Section 365(c)(2) that excuse other parties from accepting personal services and certain other types of performance from the debtor.\textsuperscript{38} In the case of non-economic managing rights, some courts give effect to the state law LLC acts and LLC agreements that provide for disassociation upon bankruptcy of the member on the grounds that other members do not have to accept performance from the member in bankruptcy.

To the extent that in a particular jurisdiction a bankruptcy trustee (including the member as debtor in possession in a Chapter 11 reorganization) cannot exercise the member’s non-economic voting or management rights, the bankruptcy trustee could neither initiate nor contest a judicial dissolution action.

Other courts, however, have held that the bankruptcy trustee (including the debtor in possession) succeeds to the non-economic interests as well. According to one case, \textit{Klingerman v. ExecuCorp, LLC},\textsuperscript{39} these rights include the right to petition for a judicial dissolution. The bankruptcy court in \textit{Klingerman} held that a member's non-economic interests in participating in the management of an LLC became property of the estate when the member became a debtor in bankruptcy under Chapter 11 notwithstanding the provision in the LLC agreement and the then existing North Carolina Limited Liability Act.\textsuperscript{40} Therefore, the debtor in possession retained his status as a member authorized by North Carolina law and had standing to seek dissolution of the LLC.\textsuperscript{41}

\begin{footnotesize}
\begin{enumerate}
\item See supra note 21 and accompanying text.
\item 11 U.S.C. § 365(c)(1) (2012) (quoted supra note 20); id. § 365(c)(1) (cited supra note 21).
\item Id. at 679.
\item Id.
\end{enumerate}
\end{footnotesize}
IV. BANKRUPTCY AS A SHIELD AGAINST DISSOLUTION

A member of an LLC that seeks to stop a judicial dissolution may use the Bankruptcy Code to thwart the effort. First, the commencement of a bankruptcy case automatically stays, among other acts, “the commencement or continuation . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case.”42 Therefore, if a member of an LLC becomes a debtor in bankruptcy, or if any member of an LLC can cause the LLC to become a debtor in bankruptcy either by having the LLC commence a voluntary bankruptcy case or by filing an involuntary petition against the LLC, any pending or imminent proceeding for judicial dissolution will be stayed.

In addition, the commencement of a bankruptcy case stays “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.”43 Hence, in the case of a bankruptcy case in which a member is the debtor, the membership interest becomes property of the estate and the trustee has the right to use or sell property of the estate. Therefore, a bankruptcy court may conclude that the judicial dissolution proceeding may adversely affect the membership interest or interfere with the trustee’s use of the membership interest.44 In addition, if the LLC itself were to become a debtor in bankruptcy, the stay against acts to control property of the estate would prevent the disposition of any property of the LLC in a judicial dissolution proceeding.

43 Id. § 362(a)(3).
44 Cf. Walro v. Lee Grp. Holding Co., LLC (In re Lee), 524 B.R. 798, 804–05 (Bankr. S.D. Ind. 2014) (holding that a member’s voting rights became property of the estate upon filing of member’s bankruptcy petition and action of other members to remove member after filing was an act to control property of the estate that violated the automatic stay).
The automatic stay is only a stay. It does not determine the ultimate outcome of any judicial dissolution proceeding. Nevertheless, the stay could be a powerful tool to enhance the bargaining power of the different parties to such a proceeding.