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WHEN WORLDS COLLIDE:

SARBANES-OXLEY ACT § 308 VS. BANKRUPTCY CODE §§ 510 AND 1129

BY JAY TEITELBAUM AND WENDY WALKER

Enacted in 2002 in response to an apparent epidemic of corporate frauds, including *Enron*, the Corporate and Auditing Accountability, Responsibility and Transparency Act of 2002 (15 U.S.C. §7246), better known as the Sarbanes-Oxley Act, contains numerous provisions designed to hold corporate officers, directors and auditors responsible for violations of the federal securities laws.¹ Tucked away in this legislation is §308, captioned, "Fair Funds for Investors" (FFI), which provides:

If in any judicial or administrative action brought by the [SEC] under the securities laws . . . the [SEC] obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the [SEC] also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the [SEC], be added to and become part of the disgorgement fund for the benefit of the victims of such violation.²

Pursuant to this provision, the Securities and Exchange Commission (SEC) may pursue civil enforcement actions and recover civil penalties for the benefit of shareholders, although the source of the funds may be property of a debtor in bankruptcy.

The fact that Congress anticipated that targets of such proceedings may seek the protection of the bankruptcy laws to avoid these penalties is reflected in the 2005 amendments to the Bankruptcy Code which

provide that individual and corporate debtors who propose to liquidate cannot obtain a discharge of these obligations.³ However, these amendments fail to address a conflict between the ability of the SEC to rely upon the FFI to transform shareholder interests into claims with the priority scheme established under the Bankruptcy Code.⁴ This omission has allowed the SEC to take the position that its power to seek civil penalties under Sarbanes-Oxley trumps the Bankruptcy Code such that it may recover property of a debtor's estate for the benefit of equity securityholders before creditors are paid in full.⁵

Such a position conflicts with a basic tenet of bankruptcy laws, the "absolute priority rule." Under this rule, in order to confirm a plan, each class of unsecured claims will either receive payment in full, or creditors with junior claims and equity interestholders cannot receive any property on account of such junior claims or interests.⁶ Thus, unless otherwise agreed, creditors must be paid in full before shareholders may receive any distribution. In furtherance of this rule, Bankruptcy Code §510(b) provides that a claim arising from or in connection with the purchase or sale or retention of a debtor's stock is treated as an equity interest.⁷

The Sarbanes-Oxley Act does not expressly override this priority scheme, and there is no indication in the legislative history of an intent to do so. Thus, the analysis under the Bankruptcy Code should be that a claim asserted by the SEC, rather than the shareholder, is a claim that "arises from the

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purchase or sale of securities” and must be treated as an equity interest in the hierarchy at bankruptcy distribution.⁸

Although presented with the opportunity to rule on this matter, the courts in *In re WorldCom* and *In re Adelphia Commc'ns*⁹ did not decide whether an SEC claim for disgorged funds and/or penalties under FFI (i) should be classified as a general unsecured claim, (ii) should be treated as a stock interest pursuant to Bankruptcy Code §510(b), or (iii) could be distributed to shareholders before creditors were paid in full.

In *SEC v. WorldCom*, the SEC commenced a securities fraud action against WorldCom in the United States District Court for the Southern District of New York. The SEC alleged, among other things, that *WorldCom* overstated its income by approximately \$11 billion, overstated its net worth by more than \$75 billion, and caused a loss to shareholders estimated at \$200 billion.¹⁰ The penalty sought by the SEC effectively threatened to force the conversion of *WorldCom's* pending bankruptcy reorganization into a liquidation, resulting in the loss of thousands of jobs and minimal returns for creditors. Faced with this doomsday scenario, the District Court approved a settlement, supported by WorldCom and its creditors' committee that allowed the penalty claim as a general unsecured claim in the amount of \$2.25 billion that was to be paid to the SEC for the benefit of equity securityholders in a combination of cash and stock pursuant to a plan of reorganization.¹¹

The district court noted the potential clash between the securities and bankruptcy laws, stating:

[W]hile [FFI] gives the [SEC] the opportunity to pay any penalty it recovers to the shareholder victims rather than to the U.S. Treasury, a penalty that was premised primarily on that basis might arguably run afoul of the provisions of the Bankruptcy Code that subordinate shareholder claims below all others. As a general rule, defrauded shareholders cannot expect to recover one penny in

bankruptcy; and nothing in Section 308(a) suggests that Congress intended to give shareholders a greater priority in bankruptcy than they previously enjoyed.

This is not to say, however, that the Commission cannot give its penalty recovery to the shareholders, as Section 308(a) so laudably prescribes, or that it cannot take some account of shareholder loss in formulating the size of the penalty. . . . What the [SEC] may not do, at least in a case in which the company is in bankruptcy, is determine the size of the penalty based primarily on the basis of how much shareholder loss will thereby be recompensed, for this would not only be adverse to the priorities established under the bankruptcy laws but also would run contrary to the primary purpose of [SEC] fraud penalties themselves.¹²

However, as this was a fully consensual arrangement, the court did not decide the issue.

In *Adelphia*, the SEC again threatened the debtor with the DOJ's criminal indictment and forfeiture powers, coupled with crippling civil penalties, which would have left the debtor with no choice but to liquidate. Ultimately, pursuant to Bankruptcy Rule 9019, the Bankruptcy Court approved a settlement, over the creditors' committee's objection, pursuant to which the SEC was granted a \$715 million general unsecured claim to be paid in a combination of stock, interests in a litigation trust, and, in the event of a sale of the company, cash.¹³ As in *WorldCom*, the settlement payment was for the benefit of shareholders, who would otherwise have received no recovery since unsecured creditors were not being paid in full.¹⁴

In approving the settlement, the Bankruptcy Court focused primarily on the otherwise potentially catastrophic consequences to the estate.¹⁵ The court acknowledged the conflict between Sarbanes-Oxley and the Bankruptcy Code but avoided a determination of the issue. Although this case did not involve a plan, the court rationalized the distribution scheme along the lines employed in decisions such as *In re SPM Mfg.*,¹⁶

and *In re Iridium Operating LLC*,¹⁷ in which secured creditors were permitted to distribute proceeds of their claims to creditors with lower priority claims on the theory that such distributions were not distributions of property of the estate. The Bankruptcy Court noted:

[H]ere equity holders and defrauded note holders would not be sharing in assets of the estate under a plan Rather, they would be sharing a fund to be created and owned by the Government, sharing in assets the Government would be obtaining as a consequence of the totality of its bargaining power in this case – which bargaining power in turn derives from the DOJ's indictment power, the DOJ's forfeiture power, and the SEC's ability to bring an enforcement action and to file a proof of claim.

Thus, while defrauded equity holders will plainly have to confront the Absolute Priority Rule and Section 510(b) when trying to share in assets of the estate *in this Court*, what I am asked to approve here is twice removed from that scenario. Not only does this motion not involve a reorganization plan contemplating a distribution to equity; it does not even involve an objection to the SEC's claim, or the merits of the Creditors' Committee adversary proceeding, with its related subordination issues. Rather it is a 9019 motion, raising fundamentally different issues

Whether the SEC's claim would have been allowed under these circumstances, and/or subordinated, is a matter of fair debate. The issue is one that bankruptcy judges, practitioners and scholars have discussed amongst themselves for some time, without a definitive answer.¹⁸

On appeal, the district court affirmed, stating:

Finally, appellants object strenuously to the settlements on the ground that the government is likely to distribute the victim restitution fund in part to equity security holders who could not take ahead of appellants in a plan of reorganization in light of the absolute priority rule. Their premise is correct, as the court below recognized. The conclusion, however,

does not follow. As Judge Gerber held, any payments from the restitution fund would be from “a fund to be created owned by the Government,” not a distribution of assets of the debtors’ estates as part of a plan of reorganization. They, therefore, would not come within the language of Sections 510(b) and 1129 of the Code. Moreover, it is worth noting that if *Adelphia* had rejected the government’s proposal and the government succeeded in forfeiting its assets, the government’s interest in the assets would have been superior to those of creditors in any case.¹⁹

Appellants’ unhappiness at the idea of a substantial distribution of assets that originated in the estate to equity holders who would have been subordinate to them had the assets been distributed as part of a plan of reorganization is entirely understandable. The proper focus for any complaint, however, is Congress, which alone is empowered to alter the terms of the Code to achieve the end that appellants desire.²⁰

Clearly, both the *WorldCom* and *Adelphia* cases were heavily result - oriented. While the courts identified the absolute priority rule

issues, such potential problems were circumvented by, among other things, suggesting that the proceeds of the SEC’s civil enforcement actions could properly be distributed to shareholders because the funds were property of the SEC rather than the estate. However, this does not address the fact that, at best, the SEC’s civil penalty claim was a general unsecured claim (as opposed to a forfeiture claim under the DOJ’s indictment powers or the secured claims at issue in both *SPM* and *Iridium*). Thus, it would appear that a more appropriate analogy would be one consistent with the Third Circuit’s decision in *In re ArmstrongWorld Indus., Inc.*²¹ The *Armstrong* court specifically rejected the ability of a debtor and unsecured creditor to evade the absolute priority rule with a scheme whereby the unsecured creditor shared its distribution of estate assets with junior creditors without the consent of all intervening creditors.²²

Both *WorldCom* and *Adelphia* demonstrate that, thanks to Sarbanes-Oxley, the SEC, backed by the DOJ, may be the “800 lb gorilla” in significant corporate Chapter 11 cases. The threat of instituting a quagmire of criminal and civil litigation that could ultimately result

in indictment, forfeiture of assets, and/or extraordinary civil damages has created considerable uncertainty as to the interplay between the Bankruptcy Code and the Sarbanes-Oxley Act.

If a violation of the securities laws gives rise to a civil remedy entitled to general unsecured claim status when asserted by the SEC, but only treatment as an equity interest when asserted by a shareholder, then, as suggested by District Judge Kaplan in *WorldCom*, Congress may have partially rewritten, intentionally or otherwise, a portion of the Bankruptcy Code upon which creditors rely in assessing the risks of lending. The fallout from the conflicting statutory provisions may be severe. Can creditors continue to rely upon the premise that their debts will be repaid before shareholders receive any recovery? How will the uncertainty regarding priorities affect the availability and cost of pre-petition and post-petition credit? Congress and/or the courts must clarify “who’s on first.”

Endnotes:

¹ 15 U.S.C. §7246(a); see *Sarbanes Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745 (2002).

² The “victims” identified in this section are the shareholders who were allegedly injured by the violations. The targets of the enforcement actions have included business entities as well as individuals. The Securities Act definition of the term “person” includes both natural persons and commercial entities.

³ 11 U.S.C. §§523(a)(19), 727(a)(12)(B) and 522(g)(1)(B).

⁴ 11 U.S.C. §1129 and 510(b).

⁵ *In re Adelphia Commc’ns*, 327 B.R. 143, 155 (Bankr. S.D.N.Y. 2005). The SEC has bootstrapped its leverage to impose civil penalties by joining forces with the Department of Justice’s (DOJ’s) broad criminal indictment, seizure and forfeiture powers. While a discussion of government’s authority to seize property of the estate in furtherance of its criminal enforcement or police powers is beyond the scope of this article; it is worth noting that under federal law, the government’s forfeiture powers over the proceeds (and property traceable thereto) of securities law violations may result in significant assets being excluded from the definition of property of the estate and from being available to satisfy claims. Federal forfeiture statutes do not recognize the standing of unsecured creditors to assert

an interest in seized or forfeited property. See, e.g., 18 U.S.C. §983(d)(6) (2000); 21 U.S.C. §853. See also *United States v. Watkins*, 320 F.3d 1279, 1282 (the majority of circuits, including the Second Circuit, do not recognize the standing of an unsecured creditor to assert the rights of a bona fide purchaser or innocent owner). Thus, to the extent that the government is exercising its police powers, whether through the imposition of civil or criminal penalties, creditors may have some due process claims, but apparently will be funding such payments. In addition, enforcement of the government’s police powers may not require an order of the bankruptcy court granting relief from the automatic stay pursuant to the police and regulatory exception set forth in §362(b)(4).

⁶ 11 U.S.C. §1129(b)(2)(B).

⁷ 11 U.S.C. §510(b).

⁸ See *In re Geneva Steel Co.*, 281 F.3d 1173, 1179 (10th Cir. 2002) (the language, legislative history and “embodied legislative policy choices” of §510(b) “reflect strong congressional disapproval of investor fraud claims in bankruptcy”); *In re Telegroup, Inc.*, 281 F.3d 133, 141 (3rd Cir. 2002) (“Section 510(b) . . . represents a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy.”); *In re Granite Partners, L.P.*, 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997) (“When an investor seeks *pari passu* treatment

with the other creditors, he disregards the absolute priority rule, and attempts to establish a contrary principle that threatens to swallow up this fundamental rule of bankruptcy law. . . . [H]e also disregards the purposes of section 510(b).”).

⁹ *SEC v. WorldCom, Inc.*, 273 F. Supp. 2d 431 (S.D.N.Y. 2003); *In re Adelphia Commc’ns Corp.*, 327 B.R. 143, 155 (Bankr. S.D.N.Y. 2005).

¹⁰ 273 F. Supp. 2d at 431.

¹¹ *Id.* at 435.

¹² *Id.* at 434.

¹³ 327 B.R. at 155.

¹⁴ *Id.* at 168.

¹⁵ *Id.* at 160-62.

¹⁶ 2005 WL 756900 (S.D.N.Y. 2005).

¹⁷ 984 F.2d 1305 (1st Cir. 1993).

¹⁸ *Id.* at 169 (emphasis in the original).

¹⁹ The Government’s ability to obtain forfeiture of assets is uncertain. See footnote 3, *supra*.

²⁰ 327 B.R. 475, 478

²¹ 432 F.3d 507 (3d Cir. 2005).

²² *Id.* at 515.

DIVERSITY JURISDICTION:

THE SUPREME COURT DECIDES WHERE NATIONAL BANKS LIVE

BY JAY TEITELBAUM

Access to the federal courts is predicated upon the existence of either a federal question (i.e., a claim arising under the laws of the United States) or diversity jurisdiction. On January 17, 2006, the Supreme Court, in *Wachovia Bank, N.A. v. Schmidt*,¹ held that national banks must have the same access to federal courts through diversity jurisdiction as any state bank or other corporation. The Supreme Court's decision resolves the meaning of a single word—"located"—as it pertains to citizenship of a national bank.

Federal courts may adjudicate civil disputes that do not involve questions of federal law, if such disputes are "between citizens of different states" and the amount in controversy exceeds \$75,000.² This is diversity jurisdiction. Where a party to the litigation is a corporation, 28 U.S.C. §1332(c)(1) provides that the corporation is "deemed to be a citizen of any state by which it has been incorporated and of the state where it has its principal place of business." (Emphasis added). Thus, state chartered corporations, including state banks, may be citizens "of at most two states."³

In 1863, Congress authorized the formation of national banks as a creature of federal law but did not permit such banks to operate branches other than at the place designated in their organization certificates and articles of association as the place where operations of discount and deposit are to be carried on.⁴ Initially, Congress authorized suits by or against national banks in the federal district courts without regard to diversity.⁵ In contrast, state banks, like other corporations, had access to federal courts only for matters involving federal questions or that satisfied the diversity requirements.

Congress slowly permitted national banks to conduct branch and interstate banking activities. First, in 1865, Congress permitted state banks that converted to national banks to maintain their branches.⁶ Then, in 1927 and 1933, under the McFadden Act and the Glass-Steagall Act, respectively, national banks were granted additional limited grandfathered rights to operate branches in their home states.

Finally, in 1994, the Riegle-Neal Interstate Banking and Branching Efficiency Act (Riegle-Neal Act) granted national banks broad authority to establish interstate branches.

These changes prompted Congress to treat national banks more like state banks and corporations with respect to federal court access. In 1882, Congress ended the automatic qualification for federal jurisdiction for national banks, intending to place national banks on the same jurisdictional footing as state banks. The 1882 statute provided:

[T]he jurisdiction for suits hereafter brought by or against any association established under any law providing for national-banking associations . . . shall be the same as, and not other than, the jurisdiction for suits by or against banks not organized under any law of the United States which do or might do banking business where such national-banking associations may be doing business when such suits may be begun. . . .⁷

Subsequently, in 1887, Congress replaced the foregoing 1882 provision with the following language, which, for the first time, used the word "located":

[A]ll national-banking associations established under the laws of the United States shall, for the purposes of all actions by or against them, real, personal or mixed, and all suits in equity, be deemed citizens of the States in which they are respectively located; and in such cases the circuit and district courts shall not have jurisdiction other than such as they would have in cases between individual citizens of the same State.⁸

Again, the intent of Congress was to provide national banks with the same access to federal courts as state banks. Finally, in 1948, Congress enacted 28 U.S.C. §1348, which provides, in pertinent part:

All national-banking associations shall, for the purpose of all other actions by or

against them, be deemed citizens of the States in which they are respectively located.⁹

Prior to 1992, district courts uniformly held that a national bank's "location" referred only to its principal place of business as set forth in its organization certificate. This view was actually consistent with practice, as prior to the Riegle-Neal Act, interstate branches of national banks were not common.¹⁰ In 1992, however, a few district courts interpreted a national bank's "location" to include any location where it operated a branch, thus severely limiting a national bank's access to federal courts.¹¹ The stage for Supreme Court review was set when the United States Courts of Appeal for the Seventh and Fourth Circuits split on the issue. In *Firststar Bank, N.A. v. Faul*,¹² the court held that "located", as used in 28 U.S.C. §1348, was limited to the place designated in the national bank's organization certificate and where its principal place of business was situated. The Fourth Circuit, in *Wachovia v. Schmidt*,¹³ however, adopted the broad construction of "located" to include any state where the national bank operated a branch.

In *Wachovia v. Schmidt*, the Supreme Court recognized that the intent of Congress, from as early as 1882, was to provide national banks with the same jurisdictional access to federal courts as enjoyed by state banks, and that the Fourth Circuit's broad construction of "located" would severely constrict a national bank's access to the federal courts as compared to that of state banks and corporations in general. The Supreme Court distinguished its prior holding in *Citizens & Southern National Bank v. Bougas*,¹⁴ which involved the interpretation of "located" in a venue statute. In *Bougas*, the Court held that venue for an action involving a national bank was proper in any county or city where a branch was "located". Refusing to extend that interpretation to determine citizenship in diversity cases, the Court noted that "[located] is a chameleon word; its meaning depends on the context in and purpose for

which it is used".¹⁵ Thus, the Court reasoned that broadly interpreting "location" for determining venue once jurisdiction was established was consistent with determining the appropriate venue for actions involving state banks and corporations; however, a similarly expansive construction of "location" in the context of citizenship for diversity jurisdiction would potentially render national banks citizens of multiple

states, thereby effectively curtailing their access to federal courts in comparison to that enjoyed by state banks.¹⁶

It seems that the Supreme Court has put to rest an issue that had been brewing since 1887. However, the Court went a bit further than to treat national banks on a par with state banks that may have two "locations" for diversity jurisdiction. The Court reversed the decision of the Fourth Circuit, holding

that, for diversity purposes, a national bank is a citizen of the state identified in its organization certificate as the *locus* of its main office. Perhaps a lingering question is whether this is what was truly intended, or did the Court go too far by foreclosing the possibility that a national bank may have a principal place of business in a second state?

Endnotes:

¹ 126 S.Ct. 941, 74 USLW 4085 (2006).

² 28 U.S.C. §1332(a)(1).

³ *Wachovia v. Schmidt*, 126 S. Ct. at 944.

⁴ 12 U.S.C. § 22; *Wachovia v. Schmidt*, 126 S. Ct. at 945 nn.1-2.

⁵ Act of Feb. 25, 1863, §59.

⁶ Act of Mar. 3, 1865, §7, 13 Stat. 484.

⁷ Act of July 12, 1882, §4, 22 Stat. 163.

⁸ Act of Mar. 3, 1887, §4, 24 Stat. 554-55 (emphasis added).

⁹ 28 U.S.C. §1348 (emphasis added).

¹⁰ *Eastman Kodak Co. v. Wachovia Bank, N.A.*, (W.D.N.Y. 02-CV-6441T, November 1, 2002); *Bank of Am. v. Johnson*, 186 F. Supp. 2d 1182 (W.D. Okla. 2001) (citations omitted); *Baker v. First Am. Nat'l Bank*, 111 F. Supp. 2d 799 (W.D. La. 2000). In a prescient, albeit unreported decision, Judge Telesca of the United States District Court for the Western District of New York, in the face of contrary decisions in the Southern District of New York, expressed an almost identical rationale as the Supreme Court, in holding that Wachovia was "located" only in the states identified in its certificate of organization and of its principal place of business. The author presented this issue to the district court on behalf of Wachovia in *Eastman*

Kodak Co. v. Wachovia Bank, N.A., (W.D.N.Y. 02-CV-6441T, November 1, 2002).

¹¹ *Connecticut Nat'l Bank v. Iacomo*, 785 F. Supp. 30 (D.R.I. 1992); *LaSalle Bank, N.A. v. Nomura Asset Capital Corp.*, 180 F. Supp. 2d 465 (S.D.N.Y. 2001).

¹² 253 F.3d 982 (7th Cir. 2001).

¹³ 388 F.3d 414 (4th Cir. 2004).

¹⁴ 434 U.S. 35, 36 (1977).

¹⁵ *Wachovia v. Schmidt*, 126 S.Ct. at 951.

¹⁶ *Id.*

LLC MEMBERSHIP INTERESTS IN BANKRUPTCY

BY TERRENCE L. DUGAN

Although the first limited liability company (LLC) statutes were enacted in the late 1970s, the pervasiveness of the LLC as a form of business organization for private companies dates from the wave of enactments of state LLC statutes in the early 1990s. These statutes followed clearly upon the 1988 Internal Revenue Service ruling establishing LLCs as pass-through entities for federal income tax purposes.¹ Congress has not yet responded to calls for clarification regarding the effect of bankruptcy law on LLCs.² Although it is well established that an LLC may be a debtor³, unsettled issues remain, such as the transferability of an LLC membership interest in bankruptcy and management rights of an LLC when one or more of its members are in bankruptcy. These issues have elements that are common to the analytical conundrums that occasionally arise in bankruptcy: provisions of the Bankruptcy Code that arguably dictate opposite results, state law provisions that may or may not be superseded by the Bankruptcy Code, and ambiguity in the characterization of the interest being adjudicated.

LLCs Under State Law

Flexibility of administration and governance is one of the reasons for the popularity of LLCs. Most LLC statutes permit management of an LLC by all of the members together – a governance structure similar to that of a partnership; by nonmember managers – a structure similar to a corporation; manager – a structure similar to that of a limited partnership.⁴ This flexibility gives rise to difficulty in characterizing the LLC form for analytical purposes.

State statutes also provide flexibility by allowing parties to modify certain statutory presumptions by contract. For example, LLC statutes typically provide rules governing the assignability of membership interests and the removal of managers that may be modified by the operating agreement.

To confuse matters further, there are variations among state LLC enabling statutes. For example, the New York statute provides that the bankruptcy of a member does not result in the dissolution of an LLC⁵ and that when a

corporate, trust, or other business entity member is "dissolved or terminated," its powers may be exercised by its legal representative or successor.⁶ Delaware's LLC statute, on the other hand, expressly provides that, upon an insolvency or bankruptcy of a member, it ceases to be a member but retains its rights to distributions.⁷

The threshold issue in analyzing an LLC membership interest under the Bankruptcy Code is to characterize the interest. Under the Butner doctrine⁸, this is a question of state law. Some cases fail to distinguish between a member's interest and a member's rights and obligations⁹ arising under the operating agreement. Further, the "member's interest" can be divided into the economic right to distributions and the right to vote and exercise the other noneconomic rights of a member. The Delaware LLC Act (among others) makes this distinction express by defining "limited liability company interest" as a member's share of profits and losses and its right to receive distributions. Delaware LLC Act § 18-701 states that a "limited liability company interest" is personal

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property; the implication is that the noneconomic rights of an LLC member are contractual rights rather than property interests. Taking the opposite approach, New York LLC Law § 102(r) defines “membership interest” as including both economic rights and voting rights. The New York provision stating that membership interests are personal property¹⁰ thus creates the opposite implication, namely that the entire bundle of economic and voting rights is a unitary property right.

The character of LLC member interests is further clouded by state law provisions limiting the assignability of members’ interests. LLC statutes typically provide that a member’s economic interest in an LLC is freely assignable, but the assignee does not become a member (and hence have voting or management rights) until it is voted into membership or otherwise complies with the procedure set forth in the operating agreement.¹¹

The Bankruptcy Code

The following questions raise issues applicable to LLCs:

- Is a member’s interest in an LLC property of the estate under Bankruptcy Code § 541, or an executory contract governed by Bankruptcy Code § 365?
- What is the effect of Bankruptcy Code § 541(c)(1)(A), which provides that an interest of a debtor in property becomes property of the estate notwithstanding any contractual provision or applicable nonbankruptcy law that restricts or conditions transfer of such interest? Does this mean that the debtor in possession (DIP) or trustee immediately accedes to all of the rights and obligations of the debtor as a member, notwithstanding the fact that state law requires further action for an assignee to become a member? Alternatively, is a member’s interest in an LLC a bundle of rights and obligations, only some of which constitute “property of the estate”?
- Does the right to use or sell property of the estate under Bankruptcy Code § 363 give the DIP or trustee the right to exercise all of a debtor member’s rights under the operating agreement?
- Is an LLC’s operating agreement an

executory contract that the DIP or trustee may optionally assume and assign under Bankruptcy Code § 365?

- Do the state law limitations of assignability of a member’s interest in an LLC bring it within Bankruptcy Code § 365(c), which provides that the DIP or trustee may not assume or assign an executory contract if applicable nonbankruptcy law would excuse a counterparty from accepting performance from or rendering performance to a party other than the debtor, or § 365(e)(2), which exempts such contracts from the general rule against enforceability of ipso facto clauses?

The Case Law

The earliest reported case in this area is *In re Daugherty Constr., Inc.*, 188 B.R. 607 (Bankr. D. Neb. 1995) (*Daugherty*). The facts of that case were simple: Daugherty Construction was a member of several Nebraska LLCs. When Daugherty commenced its Chapter 11 case, the other members elected, as permitted under Nebraska law, to treat the bankruptcy as having dissolved the LLC and to continue the LLC with only the remaining members. The bankruptcy court held that the statutory provision providing for dissolution of the LLC upon the bankruptcy of a member was unenforceable because it conflicted with Bankruptcy Code §§ 541(c) and 363(l). In addition, the court found that the certificate of formation and operating agreement of each LLC constituted an executory contract¹² so that Bankruptcy Code § 365(e)(1) prevented termination or modification of the contract based on an ipso facto clause or statute.¹³

Daugherty was followed by a case that reached the opposite conclusion, based on a very similar Virginia statute. In two companion opinions, *In re DeLuca*, 194 B.R. 65 (*DeLuca I*) and 194 B.R. 79 (*DeLuca II*) (Bankr. E.D. Va. 1996), the court held that although an operating agreement constituted an executory contract, a member’s interest in a member-managed LLC, such as a real estate development company, in which the identity of the managing member is “material to the very existence of the enterprise,” was a “personal services contract” falling under Bankruptcy Code § 365(e)(2). Thus, the DIP was subject to the dissolution provisions of state law.¹⁴ In reaching this

conclusion, the court relied on partnership cases, including a Fourth Circuit case that held that a partnership was per se a personal service contract.¹⁵ Interestingly, the court cited approvingly another partnership case, *In re Antonelli*, 148 B.R. 443 (D. Md. 1992), *aff’d*, 4 F.3d 984 (4th Cir. 1993) implying (consistent with the pragmatic approach in *Antonelli*¹⁶) that a different result might apply in the case of an LLC with more fungible management.

These early cases must be read in context with then applicable federal income tax law. State LLC statutes provided for automatic dissolution upon bankruptcy of a member to avoid the characterization of “unlimited life,” subjecting the entity to taxation as a corporation rather than a partnership under Federal income tax law. This rationale ceased to apply when the “check the box” tax rules were adopted in 1996. Subsequently, many state statutes were amended to eliminate the provision for automatic dissolution upon a member’s bankruptcy.¹⁷ It is worth noting that this change did not render the analytical framework of the earlier cases moot: the avoidance of a second corporate characteristic was embedded in most pre-1996 LLC statutes, i.e., limited transferability of membership interests. This provision was apparently viewed as less undesirable and remained in many LLC statutes when the “limited life” provisions were eliminated. Thus, similar arguments could be made under Bankruptcy Code §§ 365(c) and 365(e)(2) that applicable nonbankruptcy law prevents a DIP or trustee from assuming the noneconomic aspects of a membership interest or assigning them to a third party.

In *In re Garrison-Ashburn, L.C.*, 253 B.R. 700 (Bankr. E.D. Va. 2000) (*Garrison-Ashburn*), the court addressed the amended Virginia statute (without the automatic dissolution provision) and concluded that although Bankruptcy Code § 541(c) was sufficiently broad to include both economic and noneconomic rights of a debtor member in property of the estate, those rights were burdened by all of the accompanying duties and obligations, including the inability to exercise voting rights. The court then examined the operating agreement that included no ongoing funding commitments, no obligation to participate in management, and no requirement to remain in office as manager until a substitute manager could be found. In addition, unlike a

partnership, there were no fiduciary duties among members. Thus, the court concluded that the operating agreement effectively put the members in the same relationship as shareholders of a corporation and did not constitute an executory contract. Accordingly, Bankruptcy Code §§ 365(c) or 365(e)(2) was inapplicable, and the debtor's right to exercise its interest in the LLC was limited to the rights of an assignee under state law.

Recently, however, the court in *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005) (*Ehmann*)¹⁸ adopted a diametrically opposite view of Bankruptcy Code § 541. *Ehmann* involved an estate-planning LLC, created by parents to hold and accumulate assets for the benefit of their children, one of whom, a member of the LLC, became a Chapter 7 debtor. The Chapter 7 trustee sought a declaration that, under § 541(a), he had been vested with all rights of the debtor as a member and, under § 541(c)(1), took those rights free of certain conditions and restrictions that would apply outside bankruptcy.

The *Ehmann* court determined that there were no obligations on the part of members and therefore the operating agreement was not an executory contract. Further, the court stated that under § 541(c), the restrictions on transfer that the *Garrison-Ashburn* court viewed as inherent in the property were unenforceable. The court held that the trustee had established a sufficient prima facie case regarding its rights as a member to survive a motion to dismiss.¹⁹

The difference between *Ehmann* and *Garrison-Ashburn* would appear to depend on categorization. Is a membership interest in an LLC a single indivisible property interest such that, in the absence of an executory contract, the entire res - rights and restrictions alike - flows through § 541? Or, is it a bundle of property rights and contractual restrictions, with only the rights constituting property of the estate under § 541 with the restrictions stripped away pursuant to § 541(c)(1)?²⁰

Conclusions and Recommendations

One Delaware Chancery Court referred to the case law in this area as “conflicting and confusing,” about which “[t]housands of pages of judicial, lawyerly, and academic writings on the subject have tried to instill some predictability and coherence . . . but no

consensus has resulted.” Despite calls for a clear categorical rule regarding treatment of LLC member interests in bankruptcy, absent Congressional action, the case law will likely continue to be mixed and conclusion-oriented. Although courts have not settled on a pragmatic approach à la *Antonelli*, the outcomes of the cases may be so viewed: passive LLC membership interests are likely to follow *Ehmann* and *Daugherty*; when the relationship of the members is closer to that of general partners, *DeLuca* and *Garrison-Ashburn* may be the rule (either because the operating agreement is deemed executory or because the “personal service” aspects of the relationship are deemed inherent in the property interest).

What, then, constitutes best practice in selecting a form of business organization and drafting an LLC operating agreement? The flexibility, tax transparency, and structural simplicity of LLCs dictates that they will remain a preferred form in many cases. However, when the assertion of noneconomic rights by a bankrupt member would have catastrophic consequences, bankruptcy remote corporate or trust structures instead of an LLC should be considered.

Further, given *Ehmann*, it would appear preferable to structure the operating agreement as an executory contract; the longer the list of bi-lateral duties, the better. A combination of express fiduciary duties and recitals as to the particular qualifications of the manager or managing member may, in addition to taking the LLC out of the *Ehmann* analysis, bolster an argument that a member's rights are not assignable pursuant to § 365(c).

If possible and consistent with the commercial goals, it may also be advisable to provide for dismissal of the manager (whether or not a member) without cause by a majority vote of the members and to structure the manager's role so that it is not lucrative. This may eliminate the perceived need for an ipso facto clause since the manager may find it difficult to resist a lift-stay motion. Rights of first refusal that are not conditioned on bankruptcy may also be useful.²¹

Finally, although not discussed in any of the cases examined here, the definition of “limited liability company interest” under the Delaware LLC Act and similar provisions in the LLC statutes of a number of other states, which limit

the interest to an economic one, would appear more conducive to an argument against the *Ehmann* analysis than the broader definition in the New York LLC Law.

Endnotes:

¹ App. Pt. 44 National Bankruptcy Review Commission Final Report—Bankruptcy: The Next Twenty Years § 2.3.20 *Treatment of LLC Member or LLC Manager Under the Bankruptcy Code*, reprinted in App. F. Collier on Bankruptcy §2.3.20 (15th ed. revised).

² *Id.* at §2.3.20 et seq.

³ 2 *Collier on Bankruptcy* ¶ 301.04[1] fn2 (15th Ed. Rev. 2005).

⁴ See, e.g., Del. Code Ann. tit. 6, § 18-101 et seq. (Delaware LLC Act) at §18-402 (2005); New York Limited Liability Company Law § 401 et seq. (2005) (New York LLC Law).

⁵ New York LLC Law § 701(b).

⁶ New York LLC Law § 608.

⁷ Delaware LLC Act § 18-304.

⁸ *Butner v. United States*, 440 U.S. 48, 56, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136, 142 (1979).

⁹ The creation of an LLC typically requires filing of a “certificate of formation” with a state office. See Delaware LLC Act § 18-201. This is analogous to filing articles of incorporation or the certificate of formation of a limited partnership. The members may (and invariably do) enter into an agreement known as an “operating agreement” (or in the Delaware LLC Act as a “limited liability company agreement”) to govern their rights and obligations.

¹⁰ New York LLC Law § 601.

¹¹ See, e.g., New York LLC Law §§ 603-604; Delaware LLC Act § 18-702.

¹² In so holding, the court rejected the line of cases including *In re Hams*, 10 B.R. 817 (Bankr. D. Colo. 1981), which held that partnerships dissolve upon bankruptcy of a partner, and followed by analogy the cases holding that a limited partnership is an executory contract. See *Daugherty*, 188 B.R. at 614.

¹³ The court rejected the nondebtor members' argument that because the clause in question was in the Nebraska statute rather than in the Operating Agreement, §363(e)(1) did not by its terms apply.

¹⁴ *DeLuca I*, 194 B.R. at 75-77; *DeLuca II*, 194 B.R. at 90-91. The facts of *DeLuca I* and *DeLuca II* are somewhat complex, involving a two-tier LLC structure. The issue revolved around whether the nondebtor upper tier LLC was dissolved by the bankruptcy of its principals, and consequently could no longer act as the managing member of the lower-tier debtor LLC.

¹⁵ *In re Catron*, 158 B.R. 624, 626 (Bankr. E.D. Va. 1992), *aff'd*, 158 B.R. 629 (E.D. Va. 1993), *aff'd*, 25 F.2d 1938 (4th Cir. 1994).

¹⁶ 148 B.R. at 448.

¹⁷ 2 *Ribstein and Keatinge on Limited Liability Companies* 2d ed. § 14.4 (text accompanying n.17).

¹⁸ For a more extensive analysis of *Ehmann* and some other cases not discussed here, see Geu and Rutledge, *Guess Who's Coming to Dinner? The Bankruptcy Trustee's Ability to Become a Member of an LLC and the Ehmann Decision*, 7 No. 2 Bus. Entities 32 (W.G. & L. 2005)

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¹⁹ The court's subsequent opinion on the trustee's motion for summary judgment was vacated by the court as part of a settlement agreement. See *In re Ehmann*, 337 B.R. 228 (Bankr. D. Ariz. 2006).

²⁰ *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 749 (Del. Ch. 2004). Although this case analyzed the continuing effect of the ipso facto

protection after dismissal of a bankruptcy case, the analysis included a finding that the state law restrictions on an LLC member acting as a member after a bankruptcy filing are enforceable under §§ 365(c) and 365(e)(2), citing with approval the bankruptcy court order in *In re IT Group* (see endnote 23).

²¹ *In re IT Group, Inc.*, 302 B.R. 483 (D. Del. 2003) held

that a right of first refusal to purchase the economic interest of a member was enforceable in bankruptcy because it applied generally and was not an ipso facto provision. Although not at issue in that case, it appears from the opinion that the bankruptcy court had ruled that the Delaware restriction on assignment of a member's noneconomic interest was enforceable in bankruptcy under Bankruptcy Code § 365(c).

RECENT NOTEWORTHY DECISIONS

>> *In re Quaker City Castings, Inc.*, 45 BCD 178 (Bankr. 6th Cir. 2005), Bankruptcy Appellate Panel dismissed appeal from order approving sale of debtor's assets to alleged insider as moot under Section 363(m), holding that insider purchaser does not lose good-faith status absent a showing of collusion with the debtor or conduct that was intended to control the sale price or take unfair advantage of other bidders.

>> *In re Greater Southeast Community Hosp. Corp.*, 2005 WL 3036507 (Bankr. D.D.C. 2005), Court dismissed deepening insolvency claims against debtor's former directors, officers, and outside counsel, finding such claims redundant of the breach of fiduciary duty and malpractice claims also asserted in the action. Further, noting a split in authority, the court held that as a "hypothetical lien creditor" under Section 544(a), the trustee could only assert claims belonging to the estate and not any claim that a judgment lien creditor might possess, including breach of fiduciary duty claims.

>> *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005), Although transferee of claim purchased the claim for value and in good faith, and the alleged inequitable conduct of the transferor was unrelated to the claim, the court held that the claim may be equitably subordinated under Section 510(c).

>> *In re Hedstrom Corp.*, 333 B.R. 815 (Bankr. N.D. Ill. 2005), Court denied in entirety an oversecured lender's request for payment of its financial consultant's fees and expenses under Section 506(b), finding that the lender had failed to comply with Bankruptcy Rule 2016 by failing to file a detailed statement of the services rendered, expenses incurred, or other information necessary to determine whether the fees were reasonable.

>> *In re Nittolo Land Dev.Ass'n, Inc.*, No. 333 B.R. 237 (Bankr. S.D.N.Y. 2005), Court held that definition of account under revised Article 9 of the UCC included a right to payment of proceeds from sale of real property, and accordingly, lender would be entitled to such proceeds provided it had filed a valid financing statement.

>> *A&L Labs., Inc. v. Bou-Matic LLC*, 429 F.3d 775 (8th Cir. 2005), Court of Appeals held that Section 365(g)(1), which treated executory contract rejections as pre-petition breaches, was not determinative of the parties' rights under a post-petition trademark license agreement. Thus, the debtor's rejection of the contract entitled the other party to continue using the trademarks under the terms of the contract.

>> *In re The Ground Round, Inc.*, 335 B.R. 253 (B.A.P. 1st Cir. 2005), Debtor's rejection of lease did not terminate landlord's state law right of specific performance obligating the debtor to transfer back the liquor license it was permitted to use under the lease. Specific performance remedy was not dischargeable in bankruptcy.

>> *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006), Secured lenders at Section 363 sale of debtor's assets were entitled to credit bid the full face value of their secured claims and were not capped by the economic value of the collateral.

>> *In re Jimenez*, 335 B.R. 450 (Bankr. D.N.M. 2005), Noting split in authority, court held noncreditor bank, which had received no notice but had actual knowledge of the bankruptcy case, to have willfully violated the automatic stay by placing an administrative freeze on debtor's account. Although bank asserted that it merely wanted to preserve the status quo pending instruction from the Chapter 7 trustee, it should have closed the account and turned the funds over to the trustee.

>> *In re Vartec Telecom, Inc.*, 335 B.R. 631 (Bankr. N.D. Tex. 2005), In action by creditors committee against secured creditor, court held that deepening insolvency would not be recognized as a separate tort under Texas law, since the injury is substantially duplicated by already established torts such as breach of fiduciary duty or malpractice, and there were no allegations that secured creditor controlled the debtor so as to create a duty of care under state law.

>> *Central Virginia Community College v. Katz*, 126 S.Ct. 990 (2006), Supreme Court, in 5-4

decision, held that even without the enactment of Section 106(a), the Bankruptcy Clause of the Constitution gave Congress the power to abrogate states' sovereign immunity and authorize courts to avoid and recover preferential transfers to states and their agencies.

>> *In re Plymouth Rubber Co.*, 336 B.R. 16 (Bankr. D. Mass. 2005), Debtors' employees' severance claims qualified for administrative priority even where amount of the benefit was related to employees' pre-petition service but entitlement resulted from post-petition service.

>> *In re Friedman's Inc.*, 336 B.R. 880 (Bankr. S.D. Ga. 2005), Notwithstanding Section 365(d)(3), court had authority to abrogate lease provision prohibiting store closing sales on the premises. However, such landlords are entitled to additional adequate protection beyond regular rental payments.

>> *In re Miles*, 436 F.3d 291 (1st Cir. 2006), Although bankruptcy court lifted the automatic stay to permit mortgagee to exercise its rights, district court could reimpose stay based on later changed circumstances arising from debtor's institution of adversary proceeding challenging the validity of the lien.

>> *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006), Addressing an issue of first impression for the court, the Fifth Circuit followed the "actual" as opposed to "hypothetical" approach in determining whether nonbankruptcy law, such as the Anti-Assignment Act, is applicable within the meaning of Section 365(e)(2)(A). In absence of an assignment, the contract's ipso facto clause is invalid.

>> *In re Trico Marine Servs., Inc.*, 337 B.R. 811 (Bankr. S.D.N.Y. 2006) Irrespective of whether equitable mootness applied to Chapter 11 plan confirmation order allegedly procured by fraud, where millions of shares of new stock had been distributed and sold in reliance of the plan, revocation of the confirmation order was not possible because of the need to protect the investing public.