Can Lenders Prevent LLC Bankruptcy Filings? A Recent Decision Highlights the Debate

On December 6, 2010, in an unpublished opinion, the Bankruptcy Appellate Panel ("BAP") of the Tenth Circuit Court of Appeals addressed significant issues with respect to commonly found provisions in LP and LLC agreements limiting the authority of such entities to file bankruptcy petitions.[1] The Court declined to invalidate provisions of a limited liability company operating agreement that restricted the right of a manager, without unanimous consent of the LLC's members, to take steps to institute a bankruptcy.

The opinion is the latest in a long line of decisions considering who is authorized to file bankruptcy petitions on behalf of business entities.[2] While the decision fails to break new ground, discussing it provides a good opportunity to review organizational document drafting considerations relevant to secured lenders.

Background

The debtor, DB Capital Holdings, LLC ("DB"), was a Colorado limited liability company formed to develop two condominium buildings. Its LLC agreement ("Operating Agreement") contained two provisions that are central to the decision. The first was an express bar to the filing of a bankruptcy, which had been added to the Operating Agreement by an amendment that likely incorporated covenants from a secured loan agreement.[3] The second was what appears to be a standard "boiler-plate" provision requiring the manager ("Manager") to operate the business in the ordinary course and granting it authority to take actions deemed required or appropriate to accomplish that objective.

DB defaulted on its secured loans, the secured lender filed a receivership proceeding in Colorado state court, and then DB sought relief under Chapter 11 of the Bankruptcy Code through a petition signed by the Manager (one of two members in the LLC). In response, the LLC's other member "filed a motion to dismiss the Chapter 11 case pursuant to 11 U.S.C. § 1112(b), alleging that Manager had filed the petition both without authorization and in bad faith."[4] The Bankruptcy Court agreed that the Manager did not

1 *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC, and WestLB AG*, BAP No. CO-10-046 (B.A.P. 10th Cir. December 6, 2010) ("DB BAP Opinion").

2 For another recent example, *see In re Cabernet Holdings, LLC*, 2010 WL 2540116 (Bankr. M.D. N.C. June 21, 2010) (bankruptcy filing "beyond day-to-day management" and, because filed by a single manager, "unauthorized under the operating agreement and under state LLC law").

3 We reach this conclusion based on the form of the amendment and reference in that amendment to loan documents for the definition of capitalized terms. The amendment is available at *In re DB Capital Holdings, LLC*, Case No. 10-23242 [Docket No. 11, Exhibit E] (Bankr. D. Co. June 3, 2010).

4 DB BAP Opinion at 4.

have authority to file the case, and DB, through the Manager, appealed. The 10th Circuit BAP considered the issues on appeal.

Agreement Among LLC Members Not to File Bankruptcy

The first issue considered was the absolute bar against filing bankruptcies contained in the Operating Agreement.[5] The opinion noted that pursuant to Colorado law, the Operating Agreement governs whether the Manager by itself can file a bankruptcy petition.

While the Operating Agreement did not allow the Chapter 11 petition, the Manager argued that the bar against filing bankruptcies should not be enforced on public policy grounds — specifically, because a third party had required the condition as part of a commercial transaction. The BAP found the evidentiary record offered was insufficient to address the question of "whether, under the right set of facts, an LLC's operating agreement containing terms coerced by a creditor would be unenforceable."[6] Perhaps significantly, neither the BAP nor the Bankruptcy Court agreed that the *ipso facto* case law cited by the Manager "[stands] for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy ...."[7]

The BAP decision raises an interesting question — should lenders insist on such provisions in organizational documents? The question was not discussed in detail by the BAP or Bankruptcy Court, other than to note the lack of on-point opinions or relevant evidence, nor were the BAP or Bankruptcy Court forced to rely on the provision under the circumstances of this case (as discussed below, the Operating Agreement's restrictions on manager activities were held to preclude a unilateral bankruptcy filing). We believe that while the BAP's decision raises an interesting question, it cannot be relied on for the proposition that "no-bankruptcy" language placed in organizational documents as part of a transaction with lenders can be enforced.

Filing Bankruptcy Petitions is Not Management of the Company's Business

The second issue related to whether the Manager had authority, notwithstanding the provision discussed above barring bankruptcy filings in general, to file a bankruptcy petition on behalf of DB. The BAP found that it did not because: (i) Colorado law "requires each member's consent to authorize an act of the LLC that is not in the ordinary course of the business of the LLC, unless the operating agreement provides otherwise;"[8] (ii) the Operating Agreement only authorizes the Manager to take actions consistent with carrying on the ordinary business of the company; and (iii) the Court noted that the Operating Agreement required unanimous prior written consent of all members for any act taken by the Manager that would make it "impossible to carry on the ordinary business of the company."[9]

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5 The provision in question states: "The Company ... to [the] extent permitted under applicable Law, will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy ...." *In re DB Capital Holdings, LLC*, Case No. 10-23242 [Docket No. 11, Exhibit E] (Bankr. D. Co. June 3, 2010).

6 DB BAP Opinion at 7.

7 *Id* at 6-7. It may also be significant that the challenge to the bankruptcy filing in this case was brought by a member of the LLC, not a creditor (though the secured lender filed a joinder to the creditor's motion to dismiss the bankruptcy case), which made it easy for the court to analyze the issue as a dispute over internal governance.

8 *Id* at 5-6.

9 *Id* at 5-6.

The Manager argued that a debtor still conducts business under Chapter 11, but the BAP emphasized that operating in Chapter 11 was well outside of the ordinary course of business due to the myriad of requirements imposed by the Code.

Our Thoughts

The circumstances surrounding this decision reinforce several concepts that may be useful in structuring loans to LLCs and similar entities. First, it is clear that the BAP and Bankruptcy Court were inclined to enforce the terms of the Operating Agreement. Second, lenders must always assume that any protections in organizational documents they negotiate can be removed by a requisite number of equity holders or circumvented by creditors. We provide guidance below based on our reading of the BAP's decision in conjunction with other cases and experience:

Provisions barring bankruptcy filings

We believe reliance on this type of clause alone is dangerous — at best, it may subject lenders to a "facts and circumstances test" to determine their role in its adoption.[10] Further, in the event that the LLC's members agree a bankruptcy filing is appropriate, as the Bankruptcy Court in this case pointed out, they could simply amend the provision.[11]

Reasonable restrictions on extraordinary actions, including filing bankruptcy petitions

A better way to protect against a Chapter 11 filing is to place reasonable restrictions on the authority to file. One such tactic is to require that a supermajority of members vote to permit certain significant events. These events might include amending the management agreement, selling the project, dissolving the LLC, and filing a bankruptcy petition. By including a number of activities, it is clear that the provision is designed to rest major decision making power in the members, leaving only day-to-day management to a manager. By failing to single out the filing of a bankruptcy petition, it makes it less likely that a court will consider the provision to be an invalid *ipso facto* clause.[12]

Independent directors or managers

The approach outlined above is of limited utility where there are only a small number of members. In such circumstances it may be too easy to obtain the requisite supermajority. If that is a real concern, an alternative technique may be preferable.

In this circumstance, a lender might require that (i) the borrower's board of directors or managers contain at least one independent director or manager and (ii) certain key decisions be approved by a unanimous vote of the directors or managers.

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[10] It is clear that if the coerced prohibition or restriction is contained in a separate agreement it will not be enforced. While there are no cases directly on point, it is likely that if a court determines that a similar provision in an Operating Agreement was obtained via coercion, and if it violates public policy, it will be deemed unenforceable.

[11] *In re DB Capital Holdings, LLC*, Case No. 10-23242, June 21, 2010 hearing transcript at 11:24 [Docket No. 71] (Bankr. Co. 2010).

[12] If state law is favorable, as in this case, lenders could consider drafting language that clearly indicates that aside from those specific activities listed, others are subject to that state law (in this case, the unanimous consent requirements under Colorado LLC law).

While these provisions might be viewed as having been coerced, they should not run afoul of the prohibition against *ipso facto* clauses so long as the director or manager is truly independent and not merely a "shill" for the lenders. Accordingly, in the event the LLC encounters financial difficulty, the independent director or manager will be required to act as a fiduciary to the LLC and, if it has entered into the zone of insolvency, to its creditors.

Thus, there remains the possibility that even with independent directors or managers, the borrower may choose to file a Chapter 11 petition.[13]

No method is guaranteed to work

We generally note that these methods are unlikely to protect against a unified, organized member body filing bankruptcy petitions. Also, an independent director's or manager's fiduciary duties are to the company and its shareholders (or creditors, depending on the company's solvency), not to the secured lender.[14] Similarly, independent directors or managers could be replaced, and an anti-bankruptcy provision could be amended, by the borrower.[15]

Further, under the facts and circumstances of a particular case, a court may disregard corporate requirements either based on the parties' prior course of conduct or on the equities in that case. *In re American Globus Corp.*, 195 B.R. 263 at 265 (Bankr. S.D.N.Y. 1996) (under New York Law, organizational requirements can be modified through course of use/non-use, and "whether to honor corporate formalities is an equitable one"). *See also Windels Marx Lane & Mittendorf, LLP v. Source Enterprises, Inc., et al.*, 392 B.R. 541 at 555 (D. S.D.N.Y. August 12, 2008). The lesson here is that lenders should make sure that corporate formalities are being followed even when there is no sign of trouble.

Finally, even where a voluntary bankruptcy filing is avoided, an involuntary bankruptcy is still possible. In the case of DB, the Bankruptcy Court judge ended up entering an order for relief under Chapter 11, based on an involuntary petition, on November 29, 2010.[16] Thus, if there are three creditors who agree with the manager and desire a bankruptcy, they can be used to avoid the restrictions in an operating agreement.

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13 Independent directors or managers could also be replaced during the run-up to bankruptcy. *See, e.g., In re General Growth Properties, Inc.*, 409 B.R. 43 at 67-70 (Bankr. S.D.N.Y. August 11, 2009).

14 Fiduciary duties of members and managers of an LLC can be modified to a degree that would not be possible with a corporation. *See* Delaware Limited Liability Company Act § 1101.

15 *See supra* notes 11 and 13.

16 *In re DB Capital Holdings, LLC,* Case No. 10-25805 [Docket No. 91] (Bankr. Co. November 29, 2010).

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