

BY BRANDON J. WILSON

The Sword and the Shield

Section 541 and Debtor's LLC Membership as Property of Estate

With the passage of limited liability company (LLC) acts throughout the country (the Uniform Limited Liability Company Act (ULLCA) was initially proposed in 1995), it has become more common for debtors to list their interests in LLCs. To be sure, the LLC "is now undeniably the most popular form of new business entity in the United States."¹ It is increasingly common for individual debtors in bankruptcy to have membership interests in LLCs that have assets. Many individuals perceive the LLC as an entity suited for protecting assets from creditors.

The question for creditors and their counsel then becomes, what, if any, portion of the debtor's LLC and the LLC's assets are property of the debtor's bankruptcy estate? The answer has consequences for what, if anything, unsecured creditors will be entitled to receive on their claims, and what recourse they may have in the event that a debtor causes an LLC to file for bankruptcy.



Brandon J. Wilson
Howard & Howard
Attorneys PLLC
Royal Oak, Mich.

Brandon Wilson is an attorney with Howard & Howard Attorneys PLLC in Royal Oak, Mich.

The Code's Definition of "Property of the Estate"

The starting point is the Bankruptcy Code's definition of "property of the estate." Section 541(a) defines "property of the estate" as "all legal or equitable interest of the debtor in property as of the commencement of the case."² Section 541(c)(1) further provides:

Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section *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.³

While federal law creates the bankruptcy estate, the determination of a debtor's property rights is controlled by state law.⁴

Property Owned in the Name of the Debtor's LLC

It is generally the rule in most states that the member of an LLC has no interest in specific LLC property — that is property owned solely in the name of the LLC.⁵ The individual debtor's bankruptcy estate ordinarily has no interest in property, real or personal, owned by his or her LLC. This is the case even where the debtor is the sole member of the LLC.⁶

The Debtor's Membership Interest as "Property of the Estate"

The debtor's membership interest *is* property of the bankruptcy estate.⁷ As one court explained, "[e]ach member of an LLC has an 'interest' in the LLC, which represents both a financial stake in the LLC's profits and losses and right to receive distributions," as well as "broader governance rights, which include the member's right to participate in management and control of operations and inspect the books and records of the LLC."⁸ The idea that a debtor's governance rights are property of his or her LLC estate is critical for creditors.

To get around this fact, debtors have tried analogizing the rights of the bankruptcy estate to those of a judgment creditor under state law. Under many state LLC acts, judgment creditors are limited, as their sole remedy, to placing a charging order on the judgment debtor's membership interest in the LLC. For example, Michigan's LLC act provides in part:

- (5) A charging order is a lien on the membership interest of the member that is the subject of the charging order. However,

³ 11 U.S.C. § 541(c)(1) (emphasis added).

⁴ *Butner v. United States*, 440 U.S. 48, 54-55, 99 S. Ct. 914 (1979).

⁵ See, e.g., 805 ILCS 180/30-1(a) (Illinois); MCL § 450.4504(2) (Michigan); ULLCA §§ 501 and 102(21).

⁶ See, e.g., *In re John Donald Rodio*, 257 B.R. 699 (Bankr. D. Conn. 2001).

⁷ *LaHood v. Covey (In re LaHood)*, 437 B.R. 330, 336 (C.D. Ill. 2010) ("[The] bankruptcy estate received debtor's economic and noneconomic rights."); *In re Klingerman*, 388 B.R. 677, 679 (Bankr. E.D.N.C. 2008); *Movitz v. Fiesta Inv. LLC (In re Ehmann)*, 319 B.R. 200, 206 (Bankr. D. Ariz. 2005) ("[The] Trustee has all of the rights and powers ... that the Debtor held as of the commencement of the case.").

⁸ *Herbach v. Anderson (In re Anderson)*, Case No. 01-33143, Adv. No 02-2163, at 4 (Bankr. E.D. Wis. Dec. 16, 2002).

¹ Rodney D. Chrisman, "LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006," 15 *Fordham J. Corp. & Fin. L.* 459 (2010).

² 11 U.S.C. § 541(a)(1).

a person may not foreclose on that lien or on the membership interest under this act or any other law, and the charging order is not an assignment of the member's membership interest for purposes of section 505(4).

(6) *This section provides the exclusive remedy by which a judgment creditor of a member may satisfy a judgment out of the member's membership interest in a limited liability company.* A court order to which a member may have been entitled that requires a limited liability company to take an action, provide an accounting, or answer an inquiry is not available to a judgment creditor of that member attempting to satisfy a judgment out of the member's membership interest, and a court may not issue an order to a judgment creditor.⁹

A debtor may deduce that under applicable state law, the bankruptcy estate is only entitled to receive the member's share of the LLC's profits and is not entitled to participate in the management of the LLC. This argument has been rejected by several bankruptcy courts for the reason that bankruptcy law, and specifically § 541 — which defines property of the estate — pre-empts state law.¹⁰ The reason is that under § 541(c), all of the debtor's interest in an LLC passes to the estate, notwithstanding applicable nonbankruptcy law.¹¹ As a result, a bankruptcy trustee has rights and remedies as it pertains to an LLC membership interest not otherwise available to a state judgment creditor.¹²

Debtors have also argued that an anti-assignment provision in the LLC operating agreement prevents a membership interest from passing to the bankruptcy estate. However, even where the LLC's operating agreement or state law purports to prohibit a transfer of an interest in the LLC, § 541(c) "overrides state and contract law restrictions on the transfer of [the] Debtor's interests in order to transfer all property interests into the bankruptcy estate."¹³ Under the Code, the bankruptcy estate is not simply an assignee of the debtor's membership interest, "but steps into a debtor's shoes as to all rights, including the rights to control a single-member LLC."¹⁴

The Sword

If the debtor's economic and company governance rights in his or her LLC are property of the estate, what can be done to bring value to the estate? Case law suggests that the LLC may be dissolved, its property sold and proceeds distributed to the debtor's estate. There are several examples of how this process works.

In *In re Modanlo*,¹⁵ the debtor was the 100 percent owner of a Delaware LLC. The trustee in the debtor's case filed a chapter 11 petition for the LLC that was jointly administered with the debtor's case. The LLC owned a majority interest in

a Maryland corporation that received an \$11 million verdict in a jury trial. The trustee sought approval from the bankruptcy court to cause the Maryland corporation to hold a shareholder meeting in order to oust the debtor and others from the Maryland corporation's board. The debtor argued that under Delaware law, his bankruptcy filing caused him to cease being a member of the LLC and, therefore, the trustee was precluded from being a member of the LLC. The debtor also disputed that he held any management rights in the LLC after the bankruptcy filing and maintained that his and the trustee's interests in the LLC were limited only to economic rights. Relying on Delaware state law concerning LLCs, the court found that the trustee had authority to exercise management rights over the LLC:

Accordingly, the Court finds that the Trustee had the power to place [the LLC] into bankruptcy upon his appointment and standing in the shoes of the Debtor and complying with the mandates of the Delaware Act, possesses both the economic and governance rights to participate in the management of [the LLC] that the Debtor himself enjoyed prior to his bankruptcy filing.¹⁶

The perception of an LLC as an asset-protection tool is largely misplaced in the context of bankruptcy. Bankruptcy courts have routinely allowed trustees to meddle in the affairs of the debtor LLC, irrespective of perceived protections under state law and in the LLC's operating agreement.

In *In re Garbinski*,¹⁷ the bankruptcy court held that the trustee could even force the dissolution of a multi-member LLC that was only partly owned by the debtor. In this case, the debtor owned a 49.5 percent interest in one LLC and 50 percent interests in two other LLCs. The court opined that § 541(c) permitted the trustee to "exercise rights as a partner/member seeking to obtain judicial dissolution and winding up of the entities by invoking state law remedies involving dissolution or liquidation of [the] LLC or limited partnership entities."¹⁸

Finally, in *In re Klingerman*,¹⁹ the bankruptcy court also authorized the debtor in possession to pursue an action to dissolve an LLC that he jointly owned with another individual. The court held that "Mr. Klingerman's rights and interest in the LLC, economic and noneconomic, became property of the estate upon the filing of his petition. As a member of the LLC, the estate has standing to ask for dissolution of ExecuCorp."²⁰

16 *Id.* at 731.

17 465 B.R. 423, 427 (Bankr. W.D. Pa. 2012).

18 *Id.* at 427 (citing *In re Smith*, 185 B.R. 285 (Bankr. S.D. Ill. 1995)); *In re Baldwin*, Case No. E0-05-114, 2006 WL 2034217, at *2 (B.A.P. 10th Cir. 2006) (affirming bankruptcy court's determination that trustee stepped into shoes of debtor and that he "may assert whatever rights the debtor has as a partner under the partnership agreement and state law, including the right to seek dissolution").

19 388 B.R. 677.

20 *Id.* at 679.

9 MCL § 450.4507 (emphasis added).

10 *See, e.g., In re B & M Land and Livestock LLC*, 498 B.R. 262 (Bankr. D. Nev. 2013) ("The Court concludes that § 541 trumps any conflicting analysis or rules in state law relating to the control of LLCs or partnerships.")

11 *Klingerman*, 388 B.R. at 679.

12 *In re Blixseth*, 484 B.R. 360, 369 (B.A.P. 9th Cir. 2012).

13 *In re First Protection Inc.*, 440 B.R. 821, 830 (B.A.P. 9th Cir. 2010).

14 *B & M Land and Livestock*, 498 B.R. at 267 (citing *First Protection*, 440 B.R. at 830); *but see In re Garrison-Ashburn LC*, 253 B.R. 700, 708 (Bankr. E.D. Va. 2000) (holding that trustee was merely assignee of debtor's membership interest).

15 412 B.R. 715 (Bankr. D. Md. 2006).

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Section 541 vests the bankruptcy estate with a debtor member's entire membership interest. As a result, bankruptcy trustees have succeeded in participating in the affairs of the debtor's LLC, including selling the LLC's property, moving to dissolve the LLC and even removing existing members from management.

The Shield

In some cases, a debtor may take the opposite tack and attempt to keep creditors of an LLC at arm's length by filing a petition on behalf of his or her LLC after having filed an individual petition. Again, the estate's interest in the debtor's membership interest is beneficial. Creditors of the LLC should move to dismiss the LLC's petition.

In *In re A-Z Electronics LLC*,²¹ the debtor was the sole member of an LLC. Subsequent to filing for bankruptcy, the individual debtor, purporting to act as the managing member of the LLC, caused the LLC to file a voluntary chapter 11 petition. The court found that the LLC's petition had not been filed properly because the individual debtor's authority to act on behalf of the LLC was vested in the trustee of the individual debtor's chapter 7 estate at the time that the petition was signed.

²¹ 350 B.R. 886 (Bankr. D. Idaho 2006).

On the date [that] the petition herein was filed, [the individual debtor's] interests in [the LLC] were property of the bankruptcy estate.... As such, they were subject to the sole and exclusive authority of the [individual debtor's] trustee, and that trustee was the only one entitled to manage [the LLC] and decide, *inter alia*, whether the LLC would or would not file [for] bankruptcy.²²

Section 541 can be used defensively in cases where an individual attempts to protect the assets of his or her LLC by bringing that company into bankruptcy. If the petition is filed by a member or manager that is a debtor under the Bankruptcy Code, the petition should be dismissed.

Conclusion

Under § 541, the bankruptcy estate receives all of the debtor's rights and powers associated with his or her membership interest in an LLC. The perception of an LLC as an asset-protection tool is largely misplaced in the context of bankruptcy. Bankruptcy courts have routinely allowed trustees to meddle in the affairs of the debtor LLC, irrespective of perceived protections under state law and in the LLC's operating agreement. Creditors should be mindful of the broad scope of § 541 when pursuing an individual debtor or an LLC that has filed for bankruptcy. **abi**

²² *Id.* at 891.

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