NORTH CAROLINA BAR ASSOCIATION
SEEKING LIBERTY & JUSTICE

NOTES BEARING INTEREST

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The Chair's Comments

Mark Davidson

What a great day!

There have been many, many moments for me to savor serving as chair of the Business Law Section these past two years, but none more so than June 4, 2007. On that day, NC LEAP opened for business.

Milan Pham, LEAP's director, presided over a brief ribbon-cutting ceremony at the Nussbaum Center in Greensboro. In attendance were North Carolina Bar Association Foundation President Clark Smith and representatives of many law firms, law schools and other organizations serving the entrepreneurial community. The ceremony was promptly followed by eight lawyers providing initial legal consultations to over 21 entrepreneurs.

Since that promising commencement, word that LEAP is open has spread among the entrepreneurial community, and applications are coming in. Based on surveys of our section's members we knew that there was a large unmet demand from our section members for an opportunity to provide pro bono services in our areas of expertise. We expected that this would be matched by a large demand for these services from low-income entrepreneurs, but it is very gratifying to have this

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In Re Ehmann

Member's Bankruptcy Is No Fiesta for Remaining LLC Members

By Stephen F. Later

Introduction

The disposition of limited liability company ("LLC") membership interests upon bankruptcy of a member is, in light of recent decisions under the Bankruptcy Code (the "Code"), subject to latent incongruities in the Code, state laws subject to federal preemption, and the variations in administration and governance among LLC operating agreements.

North Carolina Creditor Remedies

The North Carolina Limited Liability Company Act (the "Act") entitles a judgment creditor of an LLC member to obtain a charging order, which is the right of a judgment creditor to receive, until the payment in full of the judgment, distributions from the LLC otherwise due to the debtor member. Although the Act does not denote the charging order as an exclusive remedy, the Act includes no other provisions or remedies for judgment creditors of LLC members.

The North Carolina Court of Appeals considered the availability of additional remedies in **Herring v. Keasler,** 150 N.C.App. 598, 600-601, 563 S.E.2d 614, 615-616 (2002), *review denied,* 356 N.C. 435, 572 S.E.2d 431 (2002) and concluded that the "only remedy" available to a creditor of a LLC member is a charging order under N.C.G.S. Section 57C-5-03 (2001). The court reasoned that the charging order is the sole remedy included in the Act for creditors of LLC members, N.C.G.S. Section 57C-5-03 (2001), and that the Act requires the consent of all members for the admission of an additional member, N.C.G.S. Section 57C-3-03 (2001). In an implicit equation of ownership of a membership interest and full membership in a LLC despite statutory limitations upon admission, the court concluded that a sale under execution of a membership interest by a creditor results in admission of the purchaser to membership in the LLC.

The limited recourse of judgment creditors of an LLC member to the charging order thus protects the remaining members of the LLC from substitution of an uninvited, and likely incompatible, member and from interference thereby in company management. Further, the debtor member retains the ownership of his membership interest and, as the managers can withhold the distribution of profits under a properly structured operating agreement, the debtor member can, under certain circumstances, wait out the 20-year term of a judgment and its renewal. Consequently, as corporate stock remains subject to execution and sale in North Carolina, practitioners capitalized upon the inherent limitations of the charging order and have used LLCs for business and asset protection purposes.

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Please Note

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confirmed.

Like so many of our section's efforts, launching LEAP has been a multi-year project. Each year's council, officers and committees build on the work of the councils, officers and committees of previous years, resulting in a significant cumulative impact on our business laws, the business affairs of our clients, our own practices and our communities.

I look forward to joining with you to continue our section's efforts under the leadership of Bill Gwyn as new chair and the other new officers, council members and committee chairs. Please extend to them the same support that was so generously given by our section members these past two years. ❒

In Re Ehmann *from page 1*

LLC Interests in Bankruptcy

However, in the event of bankruptcy of a debtor member, in which the legal and equitable property interests of a debtor are channeled into a bankruptcy estate managed for the benefit of creditors, the disposition of LLC interests is further complicated. Section 541(c)(1)(A) of the Code permits a bankruptcy trustee to assume the property interests of a debtor free of contractual or statutory restrictions upon transfer. Section 363 of the Code empowers a trustee to use and sell the property of the bankruptcy estate, and, further, Section 365 of the Code permits a trustee to assume—or reject—contracts that are deemed to be executory (contracts are executory, under Fourth Circuit precedents, if obligations remain to be performed by all parties thereto).

The bankruptcy of a debtor member requires the characterization of his membership interest, which, pursuant to **Butner v. United States,** 440 U.S. 48 (1979), is determined under applicable state law. This analysis requires a distinction under state law between the economic rights of a LLC member and the administrative rights and obligations of a LLC member (and the potential division thereof) under the operating agreement.

North Carolina, like New York, defines membership interest to include a basket of both property rights (economic rights including the right to a share of profits and losses and to distributions) and contractual rights (administrative rights including the right to vote and to participate in the management of the company). N.C.G.S. Section 57C-1-03(15) (2006); N.Y. LIMITED LIABILITY COMPANY LAW Section 102(r) (2006). The Act further characterizes a membership interest as personal property, N.C.G.S. Section 57C-5-01 (2006), and thus implies that the economic and administrative rights of membership interest constitute a single unified property interest. Delaware, by contrast, limits its definition of membership interest to the economic rights of ownership and thus ostensibly distinguishes between economic property rights and non-economic contractual rights, DEL. CODE ANN. tit. 6, Section 18-101(8) (2006).

The character of membership interest is also effected by provisions of state LLC statutes that limit the assignment of LLC interests, as most statutes provide that, although the economic rights of membership interest are assignable, the admission of a new member—and thus the extension thereto of administrative rights—requires, in some form, the consent of the other members.

The goal of the trustee in bankruptcy is, of course, to liquidate the assets of the bankruptcy estate in order to raise cash for estate creditors. Accordingly, the trustee will attempt to sell the membership interest of the debtor member. Although the trustee may attempt to assert succession rights as an LLC member, state LLC statutes generally sanction restrictions, including conditions upon admission as a member, in the operating agreement vis à vis third parties. *See, e.g.,* N.C.G.S. Section 57C 3 01 (2006); DEL. CODE ANN. tit. 6, Section 18-301(b) (2006). The ambiguities about the rights of the purchaser from the trustee may, in fact, drive down the price realized by the trustee upon sale of the membership interest and, as the purchase by the LLC or its members thus becomes attractive from an economic perspective, accrue to their ultimate benefit.

In re Ehmann

Gregory Ehmann was a debtor in a Chapter 7 bankruptcy and a member of Fiesta Investments, LLC ("Fiesta"), which was organized by his parents for estate planning purposes including the removal of assets from their estates and the accumulation of investments for the benefit of the members after their deaths. Fiesta was organized under the Arizona Limited Liability Company Act, which, like the Delaware LLC act and unlike the North Carolina and New York statutes, limits the definition of LLC

membership interests to the economic rights thereof rather than the entire basket of economic and property rights. ARIZ. REV. STAT. ANN. Section 29-601(13) (2006).

His trustee in bankruptcy filed suit against Fiesta and sought (a) a determination that he succeeded, as trustee, to membership (including the full bundle of economic and property rights) in Fiesta and (b) an order for the liquidation of Fiesta—or the appointment of a receiver therefore—on the grounds that its incumbent management managed the company for the benefit of its other members in contravention of the terms of its operating agreement. **In re Ehmann (Movitz v. Fiesta Investments, LLC)**, 319 B.R. 200 (Bankr. D. Ariz. 2005) ("**Ehmann I**").

Fiesta responded that the operating agreement constituted an executory contract and that the rights of the trustee were thus limited to the economic rights of a transferee (the right to receive distributions to the extent that Fiesta approved distributions to Ehmann). Fiesta pointed to the provisions of its operating agreement that specified that, in the event a trustee in bankruptcy acquired the interests of a member in the LLC, the trustee was denied the right "to participate in the management of the business and affairs of the company" and to exercise membership rights.

The **Ehmann I** court assessed the operating agreement, and, in its assessment of the executory nature thereof, applied the Countryman test—the analysis propounded by Vern Countryman in "Executory Contracts in Bankruptcy: Part 1," 57 MINN. L. REV. 439, 460 (1973) pursuant to which a contract is executory if obligations remain to be performed by all parties thereto—also applicable in the Fourth Circuit. **In re Sunterra Corp.,** 361 F.3d 257 (4th Cir. 2004). The court held that, although the operating agreement imposed duties upon the company, it imposed no obligations upon the members and thus failed to constitute an executory contract.

Therefore, because Section 541(c) of the Code preempted provisions of state law that limited the rights of transferees and stripped the limitations of the operating agreement from the rights to which the trustee in bankruptcy succeeded, the court dismissed the contention that the interest of the trustee in the LLC was limited to the economic rights of Ehmann and, in fact, posited that the rights of the trustee "might include" rights in excess of those enjoyed by Ehmann prior to his bankruptcy.

The court in **In re Ehmann (Movitz v. Fiesta Investments, LLC)**, 334 B.R. 437 (Bankr. D. Ariz. 2005) ("**Ehmann II**"), upon a subsequent motion for summary judgment by the trustee, limited its opinion to the rights of the trustee to enforce the rights of the debtor to compel the administration of the LLC in accordance with the operating agreement. The Fiesta operating agreement permitted the manager to lend LLC funds to the members, in amounts not in excess of seventy percent of the value of their respective membership interests, and the **Ehmann II** court noted the extension of loans from Fiesta to a non-member manager and in excess of the seventy percent limitation.

The court concluded that the manager operated the LLC in violation of the terms of the operating agreement to the advantage of certain members of the LLC and to the detriment of the bankruptcy estate. The court noted the rights of members under the Arizona LLC statute to judicial action to compel enforcement of the operating agreement and, sidestepping the assumption of management rights by the trustee, ordered the appointment of a receiver.

The **Ehmann** court, in the appointment of a receiver and suggestion that the trustee was entitled to redemption rights, purported to extend remedies to the trustee well in excess of those available to other Fiesta members under its operating agreement and Arizona law. The decisions thus created an indeed incommodious situation for the general manager of Fiesta whose "principal occupation is as a tax lawyer who frequently advises clients in the use of limited liability companies for estate planning purposes." The general manager of Fiesta, in an effort to minimize the precedential value of the **Ehmann** opinions, indeed settled the unsecured claims and paid all administrative claims in full in consideration of the withdrawal of the **Ehmann II** decision in **In re Ehmann (Movitz v. Fiesta Investments, LLC)**, 337 B.R. 228 (Bankr. D. Ariz. 2006) ("**Ehmann III**")

The practical effect of the withdrawal order—for the general manager of Fiesta and for other parties—was not, however, lost on the court, which concluded in its order that "…a bankruptcy court opinion has essentially no precedential value beyond law of the case and the inherent logic of its analysis. And, regardless of what the Court does here, it cannot disagree with Judge Easterbrook's observation that 'History cannot be rewritten.' "

Ehmann was not, of course, the first case to address the personal bankruptcy of LLC members. The earlier cases are, however, inconsistent and further complicated by provisions of earlier LLC statutes that, in order to ensure characterization as "limited life" entities and partnership (rather than corporate) taxation prior to the adoption of the IRS "check the box" classification regulations in 1996, provided for automatic dissolution of an LLC upon the bankruptcy of a member thereof.

The court in **In re Garrison-Ashburn, L.C.,** 253 B.R. 700 (Bankr. E.D. Va. 2000), for example, declined—in light of the absence of member obligations to provide additional capital, to participate in management or to provide personal expertise or service to the LLC—to construe the operating agreement as an executory contract. However, the **Garrison-Ashburn** court, unlike the **Ehmann** court, characterized the transfer restrictions—the contractual rights that, pursuant to the operating agreement, supplement the economic rights—as inherent elements of the membership interests and indeed interpreted Section 541 of the Code to permit their survival of bankruptcy notwithstanding the limitation of membership interest to economic rights under the Virginia Limited Liability Company Act . VA. CODE ANN. Section 13.1-1002 (2000).

The Tenth Circuit considered similar issues, albeit in the context of a limited partnership, in **In re Baldwin,** - B.R. -, 2006 WL 2034217 (10th Cir. BAP (Okla.) July 11, 2006) and concluded that a limited partnership agreement that stripped the limited partner of any participation in management was not an executory contract and that her limited partnership interest was thus property of the bankruptcy estate. However, whereas the **Ehmann** court disregarded the provisions of the Fiesta operating agreement, the Tenth Circuit reversed the Bankruptcy Court and concluded that the trustee was bound by the limited partnership agreement and thus respected the delectus personae principles on which the limitation of remedies to a charging order is justified.

Drafting Considerations in Operating Agreements

It is thus advisable to consider the preparation of LLC operating agreements to include significant and continuing bilateral—and, to the extent possible, personal—duties between the LLC and its managing and non-managing members. The inclusion of bilateral obligations assists in the characterization of the operating agreement as an executory contract and, further, imposes duties upon a trustee in bankruptcy that can serve to deter the trustee from assertions of membership rights in the LLC. The imposition of these obligations requires a careful, and indeed well-informed, balance among (a) obligations requisite to constitute the operating agreement as an executory agreement, (b) the limitations upon the members and their activities inherent in assumed obligations to the LLC, and (c) potential exposure of LLC members to personal liabilities resulting from the failure to undertake their respective obligations.

The inclusion of mandatory capital contributions—especially those that require less than unanimous agreement of the members—will further bolster the bilateral nature of the obligations

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between the members and the LLC (and, in light of the resultant obligations, can serve to deter a trustee in bankruptcy from assertion of LLC membership rights). LLC members will expect predictable consequences resultant from a failure to satisfy capital call obligations, which can be addressed through, for example, dilution or redemption of its membership interest or specific performance, but the silence of the Act about remedies for defaults on capital requirements raises issues about enforcement of selected remedies, N.C.G.S. Section 57C-4-02 (2006). Delaware, by contrast, stipulates that the operating agreement shall govern the consequences of failure to make a required capital contribution, DEL. CODE ANN. tit. 6, Section 18-502 (2006).

The use of non-competition covenants offers yet another contribution towards characterization of an operating agreement as an executory contract. However, as non-competition agreements are not "viewed favorably" in North Carolina, *e.g.,* **Hartman v. W.H. Odell and Assocs., Inc.,** 117 N.C.App. 307, 311, 450 S.E.2d 912, 916 (1994), the construction of effective and enforceable non-competition provisions require significant care.

The imposition of a personal service obligation to the LLC, pursuant to which the members advise management in, for example, strategic and acquisition planning, business administration, and other related management services as reasonably requested by the LLC, creates a duty to the LLC that assists in the construction of the operating agreement as (a) a bilateral agreement and thus an executory contract and (b) a personal services contract exempt from assignment under Section 365 of the Code. However, in order to mitigate potential nonfeasance or related claims against the members related to this obligation, the operating agreement should cap the aggregate number of hours to be required of the members under this provision. The recitation of the qualifications and expertise of the managing members is likely to support the additional contention that the rights of the managing members are not assignable pursuant to Section 365 of the Code.

The adoption of requirements in the operating agreement pursuant to which non-managing members assume specific fiduciary duties—care, loyalty, and good faith—to the LLC, too, are helpful in the characterization of the operating agreement as executory. The establishment of an oversight board is, for example, a vehicle for the incorporation of these obligations into a LLC operating agreement. Obviously, the assumption of fiduciary and other obligations in excess of those under applicable law is not without significant risk and not to be undertaken without due consideration, and it is further critical to structure these fiduciary duties to avoid the extension of the benefit thereof to third parties.

It is common for LLC operating agreements to require periodic distributions of earnings—including for payment of estimated taxes—but non-discretionary distribution provisions, in the context of the succession to membership rights of a trustee in bankruptcy, assure the trustee, especially in the context of a Chapter 7 proceeding, of funds for the payment of applicable taxes. It is thus advisable, in an effort to dissuade a trustee from assertion of membership rights, to limit automatic distributions and require a supermajority vote for distributions.

There are additional provisions that, although unrelated to the construction of the operating agreement as an executory contract, offer additional protection to LLCs that face the prospect of a distressed member. It is likely that a call option (a contractual right to purchase the membership interests of the debtor member upon refuge to bankruptcy protection thereby) in the operating agreement will be unenforceable as an ipso facto clause. However, the inclusion of a right of first refusal (a contractual right to meet the terms of a third party purchase offer triggered by transfer rather than bankruptcy) offers the LLC members a potential route through which to mitigate the effects of the bankruptcy of a member. *See, e.g.,* **In re The IT Group, Inc., Co. (The IT Group, Inc., Co. v. The Shaw Group Inc.)**, 302 B.R. 483 (D.Del. 2003). It is important to draft the right of first refusal with especial attention to avoidance of construction as an ipso facto clause and with care in the valuation mechanism.

The establishment of explicit recoupment rights, pursuant to which creditors assert that claims resultant from single transactions are mutually extinguished or setoff, can permit the LLC to deduct sums owed thereto by the bankrupt member from distributions, if any, thereto. Further, recoupment operates as an equitable defense of the creditor, free from the effects of the automatic stay, rather than a claim for relief and is thus not limited by the conditions to setoff imposed under the Code. It will be incumbent upon the LLC, of course, to establish that the operating agreement constitutes a single contractual relationship and that the payment obligations between the debtor member and the LLC thus arise, for recoupment purposes, from the same transaction.

The recoupment rights complement the inclusion of an attorneys fees provision pursuant to which the debtor member is liable for payment of reasonable legal fees incurred by the LLC in protection of its interests in the bankruptcy of the debtor member. The LLC will be required to demonstrate that the contractual right to reimbursement of attorneys fees is lawful under applicable state law and that the attorneys actions represented efforts to enforce obligations under the operating agreement. **Three Sisters Partners, L.L.C. v. Harden (In re Shangra-La, Inc.)**, 167 F.3d 843 (4th Cir. 1999). The enforcement of contractual rights to recover attorneys fees in North Carolina requires statutory authorization therefore—reimbursement authorizations in North Carolina include, inter alia, attorneys fees upon evidence of indebtedness under N.C.G.S. Section 6-21.2 (2006)—and, pending legislative sanction of contractual attorneys fees provisions, the scope of reimbursable attorneys fees subject to recoupment will be limited.

Finally, the inclusion of a provision pursuant to which a managing member is subject to removal without cause, preferably resultant from the vote of a majority of the members, is likely to facilitate removal of the member from his managerial role in the event of his bankruptcy without resort to a potentially unenforceable ipso factor clause.

Conclusion

The succession of a trustee in bankruptcy to the rights of a LLC member, although perhaps less eventful in the context of a syndicated LLC than in a more closely held or familial LLC, is a potential source of significant disruption in a closely held LLC. The interests of a trustee in bankruptcy are unlikely to be oriented towards the long-term interests of the LLC and its business but, rather, towards the generation of cash for application towards the debts of the debtor member.

The caselaw is mixed and appears result-oriented, but, as a general rule, it appears that bankruptcy trustees are more likely to succeed to membership rights in cases that involve passive ownership, as in **Ehmann,** and are more likely to be limited to assignee rights in LLCs in which the members are involved in the operation of the LLC (resultant from the construction of the operating agreement as an executory contract or from the personal services exception). *See, e.g.,* **In re Garrison-Ashburn, L.C.,** 253 B.R. 700 (Bankr. E.D. Va. 2000) (declining to construe an operating agreement as an executory contract in light of the absence of member obligations to provide additional capital, to participate in management or to provide personal expertise or service). ❐

LATER IS A PARTNER AT ROBBINS MAY & RICH IN PINEHURST.