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A Primer on Limited Liability Companies in Bankruptcy

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A PRIMER ON LIMITED LIABILITY COMPANIES IN BANKRUPTCY*

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**Introduction**

The Bankruptcy Code, though often amended since its enactment in 1978, does not expressly deal with limited liability companies, which gained favor years later. As a result, the encounters between limited liability companies, which are designed to embody both the limited liability of corporations and the tax and owner-manager attributes of partnerships, and the Bankruptcy Code, which is designed to afford financial relief to deserving debtors¹ and maximize the value of assets available for distribution to creditors,² can lead to a thicket of problems for those not familiar with the workings of both structures. The Bankruptcy Code’s interference with business and contractual relations, such as the automatic stay,³ the transfer of control of property to a trustee or debtor in possession free of bankruptcy-related forfeitures or impediments (so-called “ipso facto” provisions),⁴ the ability to sell assets free and clear of interests in property,⁵

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the ability to assume irrespective of ipso facto provisions or reject executory contracts,\textsuperscript{6} the ability to assign executory contracts irrespective of anti-assignment clauses,\textsuperscript{7} can all potentially come into play when a member of a limited liability company enters bankruptcy, and that member, or that member’s trustee or creditors, wish to extract value from the membership interest. How a limited liability company is managed, wound up and reorganized is, of course, affected by the bankruptcy of the limited liability company itself. Some of these interactions will be examined below. Like many issues with limited liability companies, the key to analyzing bankruptcy issues is to examine whether there is an appropriate analogy to a corporation, partnership, or limited partnership, each of which is expressly treated by the Bankruptcy Code.

**The LLC in Bankruptcy**

**Eligibility to Be a Debtor**

There is little doubt that an LLC is eligible to be a debtor in a bankruptcy case. To be a debtor, an entity needs to be a “person” or a “municipality.”\textsuperscript{8} “Person” is defined in the Bankruptcy Code using the word “includes,”\textsuperscript{9} which the statute says in its rules of construction is “not limiting.”\textsuperscript{10} The three types of entities that are included in the

\begin{itemize}
  \item \textsuperscript{5} 11 U.S.C. § 363(f).
  \item \textsuperscript{6} 11 U.S.C. § 365(a) & (e).
  \item \textsuperscript{7} 11 U.S.C. § 365(f).
  \item \textsuperscript{8} 11 U.S.C. § 109(a).
  \item \textsuperscript{9} 11 U.S.C. § 101(41).
  \item \textsuperscript{10} 11 U.S.C. § 102(3).
\end{itemize}
definition of “person” are “individual, partnership, and corporation.”¹¹ The first two of these are undefined, although “individual” is usually taken to mean natural, human being.¹² The definition of “corporation” “includes” both a “partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association,” and “an unincorporated company or association.”¹³ Thus, an LLC is arguably a “corporation” for bankruptcy purposes.¹⁴ An even better reason is that an LLC is that it is sufficiently similar to a partnership and a corporation to be included in the definition of “person.”¹⁵ An LLC that has dissolved, however, is not an eligible debtor.¹⁶

Control During Bankruptcy

It is important to bear in mind some of the standard bankruptcy machinery. The filing of a bankruptcy petition creates “estate,” which consists of all legal and equitable interests of the debtor in property wherever located and by whomever held.¹⁷ Property comes into the estate notwithstanding any ipso facto restriction.¹⁸ The trustee is the


¹² See Jove Eng’g, Inc. v. IRS, 92 F.3d 1539, 1551 (11th Cir. 1996); In re Chateaugay Corp., 920 F.2d 183, 186 (2d Cir. 1990). But see In re Atlantic Bus. & Cnty. Corp., 901 F.2d 325, 329 (3d Cir. 1990) (regarding damages for violations of the automatic stay).


¹⁶ In re Midpoint Dev. L.L.C., 466 F.3d 1201 (10th Cir. 2006).
