

Bankruptcy Corner

Practical Tips When Filing Bankruptcy Cases Involving Delaware LLCs

By Vincent C. Thomas and Justin P. Duda*

Delaware has long been one of the preeminent jurisdictions in the field of business entity formation. As of the end of 2016, more than 1.2 million legal entities were formed or incorporated under Delaware law, including 66.8% of all Fortune 500 companies.¹

Since the enactment of the Delaware Limited Liability Company Act in 1992,² an increasing number of business entities, including both holding and operating companies, have been formed as or converted into Delaware limited liability companies (“Delaware LLCs”).³ In 2016, of the approximately 189,500 business entities formed in Delaware, approximately 72% were Delaware LLCs.⁴

With the increase in the use of Delaware LLCs by the business community, an increasing number of Delaware LLCs have filed and will continue to file petitions for relief under the U.S. Bankruptcy Code.⁵ Therefore, it is important for business professionals to be aware of and plan for a number of governance and other issues that may arise in the context of a bankruptcy filing involving a Delaware LLC.

Authorizing the Bankruptcy Filing of a Delaware LLC

As a baseline, the Delaware LLC Act provides that, by default, a Delaware LLC shall be managed by its members in proportion to the interests of such members in the profits of the Delaware LLC.⁶ However, within the confines of the Delaware LLC Act, a Delaware LLC is predominantly a creature of contract, and the parameters of the management of a Delaware LLC are controlled by the terms of its LLC Agreement. The Delaware LLC Act serves as gap filler, setting forth default rules that apply in instances where an LLC Agreement is silent on a matter. Thus, the management of a Delaware LLC may be vested in one or more members, one or more managers, or a combination thereof, with certain parties (who need not be members, managers, or interest holders) having consent or veto rights for specific actions, or with specific actions requiring a certain level of member or manager approval. The filing of a petition under the Bankruptcy Code often is one of the actions that is explicitly discussed and limited in the LLC Agreement of a Delaware LLC.⁷

From a practical standpoint, and while it may seem simple, it is important to review the LLC Agreement of a Delaware LLC carefully prior to filing a bankruptcy petition, and to make sure that all the company formalities are being followed or waived (if permissible) with regard to such filing, including,



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without limitation, any notice, meeting, or other approval requirements.

Specifically, the U.S. Bankruptcy Courts for both the District of Delaware and the Southern District of New York require that duly authorized consents or resolutions for each debtor entity filing a bankruptcy petition in those jurisdictions be filed with the petition.⁸

When multiple affiliated entities file petitions commencing bankruptcy cases that ultimately will be administered jointly (following approval of the relevant bankruptcy court), whether they are Delaware LLCs or other types of entities, it is important that each entity is following the appropriate bankruptcy authorization procedures based on its relevant governing documents. In many cases, a single omnibus consent may not be appropriate, even if it is executed by the direct parent of all relevant entities.

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The Ability of a Bankruptcy Court to Effect Changes to a Delaware LLC

As compared to a Delaware LLC, a corporation incorporated in Delaware (a “Delaware Corporation”) is predominantly a creature of statute, rather than a creature of contract.⁹ To simplify any corporate governance issues that may arise in the context of a Delaware Corporation in bankruptcy, the Delaware legislature enacted in 1937 the predecessor of current Section 303 (“Section 303”) of the DGCL.¹⁰ Generally speaking, Section 303 permits an officer (or other representative) of a Delaware Corporation that is a debtor in a bankruptcy case to effect changes to or actions by the Delaware Corporation pursuant to orders of the bankruptcy court (*e.g.*, orders confirming a plan of reorganization or liquidation, or authorizing a sale of all or substantially all of the Delaware Corporation’s assets) without the consent of the Delaware Corporation’s board of directors or stockholders, as may be otherwise required by the DGCL or the Delaware Corporation’s Certificate of Incorporation or By-Laws. This is particularly useful

when time is of the essence to effect a sale of the Delaware Corporation’s assets or in a particularly contentious bankruptcy case.

With regard to a Delaware LLC, however, there is no analogue to Section 303 in the Delaware LLC Act. A Delaware LLC’s LLC Agreement may have various procedures and requirements to authorize actions or events that arise in the context of a bankruptcy (*e.g.*, the sale of assets, the transfer of equity interests, the appointment of a new manager or officer) that may be unwieldy (or even impossible) to meet in such case. Furthermore, the scope or limits of the ability of a bankruptcy court to authorize or effect actions governed by an LLC Agreement are unsettled. Consequently, in light of a pending bankruptcy of a Delaware LLC, it may be beneficial to amend the relevant LLC Agreement (paying attention, of course, to the requirements of the LLC Agreement governing its amendment) to include a provision that would serve as a proxy for Section 303 of the DGCL with regard to the Delaware LLC. This may save time and governance headaches when a sale of assets or a plan of reorganization must be put into effect.

An Entity’s Bankruptcy Filing and Delaware LLC Subsidiaries

In the context of a bankruptcy filing of any entity (not just a Delaware LLC), it is important to be cognizant of the possible effects of such a filing on the entity’s Delaware LLC subsidiaries.

An entity’s bankruptcy filing may affect that entity’s ability to participate in the management or other membership rights with regard to a multi-member Delaware LLC of which the entity is a member.

Section 18-304 of the Delaware LLC Act provides, in relevant part:

A person ceases to be a member of a limited liability company upon the happening of any of the following events: (1) Unless otherwise provided in a limited liability company agreement, or with the consent of all members, a member: ... (b) Files a voluntary petition in bankruptcy.¹¹

Thus, if a filing entity is a member of a multi-member Delaware LLC, the relevant LLC Agreement should be reviewed to determine how the entity’s bankruptcy filing will affect its status as a member of the Delaware LLC. Unless the relevant LLC Agreement provides that the filing entity remains a member of the Delaware LLC following a

bankruptcy filing, or the filing entity obtains the consent of each of the non-filing members, the filing entity may find itself divested of its management, voting, or other rights as a member of the Delaware LLC. As a result, the filing entity will retain only an economic interest in the Delaware LLC.¹²

Similarly, if a filing entity is the sole member of a single-member Delaware LLC, the bankruptcy filing may work unintended consequences for the Delaware LLC. If the filing entity ceases to be a member of the Delaware LLC pursuant to Section 18-304 of the Delaware LLC Act, Section 18-801(a)(4) of the Delaware LLC Act will cause a dissolution under the Delaware LLC Act. Section 18-801(a)(4) of the Delaware LLC Act provides, in relevant part:

A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following: ... (4) At any time there are no members ...¹³

While Sections 18-801(a)(4) and 18-806 of the Delaware LLC Act provide certain mechanisms for, respectively,

preventing or revoking such a dissolution, the matter can be remedied in advance by amending the LLC Agreement of the Delaware LLC to provide that any member shall not cease to be a member following its bankruptcy filing.¹⁴ It should also be noted that if a dissolution is triggered as the result of the sole member of a Delaware LLC filing for bankruptcy, it is possible to revoke the dissolution pursuant to Section 18-806 of the Delaware LLC Act.

Conclusion

In preparing a Delaware LLC for bankruptcy, practitioners should be cognizant of not only the issues surrounding the Delaware LLC's valid authorization of the bankruptcy filing but also should consider the ability of the Delaware LLC to effectuate the orders of the bankruptcy court and the impact the bankruptcy filing will have on the Delaware LLC and any of its subsidiaries. Proper bankruptcy preparation for a Delaware LLC accordingly requires careful consideration of the LLC Agreement, the Delaware LLC Act, and the Bankruptcy Code.

ENDNOTES

* Among other things, in conjunction with the firm's bankruptcy practice group, Vince and Justin regularly assist distressed entities with governance issues, sales of assets, financing issues, and other related matters.

¹ Delaware Division of Corporations, 2016 Annual Report.

² 6 Del. C. §18-101, *et seq.* (as amended, the "Delaware LLC Act").

³ There are numerous reasons for this including the availability of limited liability for the members of an LLC, passthrough tax status for state and federal tax income tax purposes for multi-member LLCs, non-recognition as an entity separate from its member for tax purposes for single-member LLCs, and the freedom of members of an LLC to define their rights and obligations in the limited liability company agreement (the "LLC Agreement") that governs the LLC. It remains to be seen, however, how the changes to corporate tax rates and implementation of the passthrough entity provisions of the Tax Cuts and Jobs Act of 2017 will affect the choice of utilizing the C corporation or a flow-through form of doing business by both existing and newly formed business entities.

⁴ Delaware Division of Corporations, 2016 Annual Report.

⁵ 11 USC §101, *et seq.* (as amended, the "Bankruptcy Code").

⁶ 6 Del. C. §18-402.

⁷ It should be noted that courts have held under certain circumstances that a unanimous member consent requirement for a bankruptcy

filing in an operating agreement of a limited liability company may be void as against public policy when such requirement is part of a lender's attempt to prevent a borrower from filing for bankruptcy protection. *See, e.g., In re Intervention Energy Holding, LLC*, 553 BR 258 (Bankr. D. Del. 2016) (denying motion to dismiss bankruptcy case for lack of unanimous member authorization, where court found unenforceable as against public policy a provision in a Delaware LLC Agreement, negotiated by a lender/LLC member, that required unanimous consent of members for LLC to file bankruptcy); *but see In re Tara Retail Group, LLC*, No. 17-bk-57, 2017 WL 1788428, at *3 (Bankr. N.D. W.V. May 4, 2017) (rejecting argument that provision in a Georgia limited liability company agreement requiring unanimous member consent and consent by Independent Director for bankruptcy filing violated public policy).

⁸ *See* Rule 1002-1(b) of the Local Rules of Bankruptcy Practice and Procedure of the U.S. Bankruptcy Court for the District of Delaware; Rule 1074-1 of the Local Bankruptcy Rules of the U.S. Bankruptcy Court for the Southern District of New York.

⁹ The Certificate of Incorporation and By-Laws of a Delaware Corporation certainly may be customized, but the scope of permissible customization is far more limited by the provisions of the General Corporation Law of the State of Delaware, 8 Del. C., §101, *et seq.* (as amended, the "DGCL"), than customization of an LLC Agreement is limited by the Delaware LLC Act.

¹⁰ Section 303 of the DGCL provides, in relevant part, as follows:

(a) Any corporation of this State, an order for relief with respect to which has been entered pursuant to the Federal Bankruptcy Code ... may put into effect and carry out any decrees and orders of the court or judge in such bankruptcy proceeding and may take any corporate action provided or directed by such decrees and orders, without further action by its directors or stockholders. Such power and authority may be exercised, and such corporate action may be taken, as may be directed by such decrees or orders, ... by designated officers of the corporation ... , with like effect as if exercised and taken by unanimous action of the directors and stockholders of the corporation.

(b) Such corporation may ... without limiting the generality or effect of the foregoing, alter, amend or repeal its bylaws; constitute or reconstitute and classify or reclassify its board of directors, and name, constitute or appoint directors and officers in place of or in addition to all or some of the directors or officers then in office; amend its certificate of incorporation, and make any change in its capital or capital stock, or any other amendment, change, or alteration, or provision, authorized by this chapter; be dissolved, transfer all or part of its assets, merge or consolidate

as permitted by this chapter, in which case, however, no stockholder shall have any statutory right of appraisal of such stockholder's stock; change the location of its registered office, change its registered agent, and remove or appoint any agent to receive service of process; authorize and fix the terms, manner and conditions of, the issuance of bonds, debentures or other obligations, whether or not convertible into stock of

any class, or bearing warrants or other evidences of optional rights to purchase or subscribe for stock of any class; or lease its property and franchises to any corporation, if permitted by law.

¹¹ 6 Del. C. §18-402.

¹² See, e.g., *Milford Power Company, LLC v. PDC Milford Power, LLC*, 866 A2d 738 (Del. Ch. 2004) (holding that a debtor-member of a Delaware LLC could lose its management rights in the Delaware LLC, but not its economic interest,

pursuant to Section 18-304 of the LLC Act).

¹³ 6 Del. C. §18-801(a)(4).

¹⁴ Arguably, since Section 18-304 provides that a bankruptcy filing by an LLC member will not cause it to cease to be member if all members consent, a sole member that files bankruptcy could cause itself to continue as a member by consenting to its own filing. Note, moreover, that Section 18-304 does not state that such consent must be obtained *before* the bankruptcy filing.

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