

**JOHN CUNNINGHAM'S LLC NEWSLETTER
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**WHAT WILL HAPPEN TO AN LLC WHEN ONE OF ITS
MEMBERS BECOMES BANKRUPT?**

EXECUTIVE SUMMARY

When an individual who is a member of a multi-member LLC incurs a court judgment that the member cannot pay, LLC statutory "charging order protections" will provide the insolvent member, the LLC and the other members with substantial protection from creditors. However, if, because of the judgment, the insolvent member becomes bankrupt, the trustee in bankruptcy will be able to take over all of the bankrupt member's LLC membership rights and thus, if the bankrupt member controls the LLC, to force the liquidation of the LLC. But the other members can avoid this result if they are able to prove that the insolvent member, because of his or her business acumen or otherwise, offers unique advantages to the LLC that the trustee in bankruptcy cannot offer.

DISCUSSION

1) Charging order protections

Among the most powerful statutory provisions of the New Hampshire Limited Liability Company Act are the "charging order provisions" of Section 47. Section 47 provides, in effect, that when a creditor of an LLC member obtains a court judgment against the member, the only remedy available to the creditor with regard to the member's LLC membership is a "charging order." A charging order is a court order against an LLC requiring that any distributions of LLC profits that would normally go to an insolvent member of the LLC must go instead to the creditor. Section 47 prevents creditors from taking possession of any "management" rights of the insolvent member, including the member's voting rights. Virtually all other U.S. LLC acts contain similar provisions. Thus, under Section 47, if a creditor obtains a judgment against a member who has voting control of an LLC, this will not enable the creditor to force the sale of the LLC's assets and their distribution to the creditor in satisfaction of the judgment.

No corporate statute provides charging order protections. The availability of charging order protections under LLC statutes provides LLCs with one of their most important legal advantages over corporations.

2) Impact of member bankruptcy on LLC

However, it often happens that individuals who are members of an LLC and who incur judgments that they cannot pay decide that, in order to escape the burden of their debts, they must declare personal bankruptcy. In the event of such a bankruptcy, what will

happen to an LLC member's LLC membership rights, and what will happen to the LLC itself?

The first thing that LLC accountants and lawyers must understand about this situation is that, when an LLC member becomes bankrupt, Section 47 and the various protections it provides from creditors will not be available to the bankrupt member, the other members or the LLC as a source of protection from any trustee in bankruptcy that a court may appoint in the member's bankruptcy case to ensure payment of the member's creditors. This is because trustees in bankruptcy are not creditors of the member. Rather, under the federal bankruptcy act, they step into the shoes of the member and effectively become the owner of all of the member's property. This includes the member's LLC voting rights, agency rights, information rights and all other LLC membership rights the member may have under the governing LLC act and LLC operating agreement.

Thus, in general, if an individual who becomes bankrupt has majority voting rights in an LLC, the trustee in bankruptcy will take over those rights; and the trustee, unlike any mere creditor of the member, can vote to require the LLC to sell all of its assets and divide up the proceeds among the member's creditors and the non-bankrupt members.

3) Section 365(b)(1)(C)

However, there is a potential catch for the trustee in bankruptcy, and this catch can sometimes greatly benefit the bankrupt LLC member and the LLC itself. The catch arises under Section 365(b)(1)(C) of the federal bankruptcy act. As applicable to LLCs, this section provides, in effect, that if, after an LLC member has become bankrupt, the trustee in bankruptcy seeks to become a substitute member in place of the bankrupt member, the LLC can prevent this result if it can prove to the bankruptcy court that because of the bankrupt member's know-how or for other reasons, the bankrupt member provides significant value to the LLC that the trustee in bankruptcy cannot provide.

This showing will often be easy to make in the case of a majority member who manages an LLC; and in the case of a member whose only role is to vote on significant LLC matters, the very possibility that the LLC and the other member *might* be able to make such a showing may force the trustee in bankruptcy to cut a deal with the bankrupt member that will be far more favorable to the member and to the LLC than if the member were merely passive.

The lesson of Section 365(b)(1)(C) for accountants and lawyers who want to ensure that LLC members and their LLCs will have maximum legal protection if any member becomes bankrupt is to ensure that the relevant LLC agreement provides that each of the members, including non-manager members, has significant access to LLC information and a significant vote on all important LLC matters and thus, at the very least, is a continuing source of sound business judgment for the LLC.

Thus, for example, under the LLC agreement of an LLC that is managed by the wife but in which the husband is also a member, the husband should normally have the same voting power as the wife, and, ideally, the two members should actually vote on all significant LLC matters and should briefly record the fact and the outcome of their votes.