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Limited Liability Company Operating Agreements: Can Creditors Restrict A Borrower's Ability to File for Bankruptcy Protection?

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LIMITED LIABILITY COMPANY OPERATING AGREEMENTS: CAN CREDITORS RESTRICT A BORROWER'S ABILITY TO FILE FOR BANKRUPTCY PROTECTION?

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In a relatively recent, unassuming opinion issued by the United States Bankruptcy Appellate Panel for the Tenth Circuit (the "B.A.P."), the B.A.P. held that members of a limited liability company ("LLC") may limit an entity's ability to file a bankruptcy petition through restrictive provisions set forth in a company's operating agreement.[2] Although the opinion is unpublished and is therefore of questionable persuasive value,[3] the B.A.P.'s opinion seemingly allows members of an LLC to prohibit management from seeking the protections afforded by the United States Bankruptcy Code (the "Code").

CASE BACKGROUND AND PROCEDURAL POSTURE

After a failed real estate venture located in Aspen, Colorado, DB Capital, LLC ("DB Capital") was insolvent and in default of its loan agreement with WestLB AG, a German bank ("WestLB").[4] WestLB sought the appointment of a receiver in Colorado state court.[5] Aspen HH Ventures, LLC ("Aspen"), DB Capital's Class A member, intervened in the state court receivership proceeding, seeking a complete dissolution of DB Capital.[6] The manager of DB Capital subsequently filed a voluntary petition under Chapter 11 of the Code.[7]

Aspen moved to dismiss the Chapter 11 bankruptcy case pursuant to 11 U.S.C. § 1112(b), asserting bad faith[8] and that DB Capital's amended

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2. *See* DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (*In re* DB Capital Holdings, LLC), 463 B.R. 142, 2010 WL 4925811 (B.A.P. 10th Cir. 2010) (unpublished disposition).

3. Pursuant to rules of the B.A.P., an unpublished opinion may be cited for its persuasive value but is not precedential, except under the doctrines of law of the case, claim preclusion, and issue preclusion. 10th Cir. BAP L.R. 8018-6.

4. DB Capital Holdings, LLC, 2010 WL 4925811, at *1.

5. *Id.*

6. *Id.* at *2.

7. *Id.*

8. Although bad faith is not an enumerated factor under 11 U.S.C. § 1112(b), numerous courts have held that a debtor's case must be filed in good faith. *See, e.g.*, Nursery Land Dev., Inc. v. Fed. Deposit Ins. Corp. (*In re* Nursery Land Dev., Inc.), 91 F.3d 1414, 1416 (10th Cir. 1996); Pacific Rim Inv., LLP v. Oriam, LLC (*In re* Pacific Rim Inv., LLP), 243 B.R. 768, 771–72 (Bankr. D. Colo. 2000).

operating agreement specifically provided that the company could not seek bankruptcy relief.[9] DB Capital responded that any provision contained in the amended operating agreement that limited its access to the bankruptcy courts was unenforceable as a matter of public policy and that the particular provision was "executed at the demand, and for the sole benefit of . . . WestLB."[10] DB Capital's amended operating agreement also precluded further amendment without permission from WestLB.[11] After extensive briefing, the United States Bankruptcy Court for the District of Colorado granted Aspen's motion to dismiss the Chapter 11 bankruptcy case.[12] DB Capital filed an appeal with the B.A.P.

The B.A.P. framed the issue on appeal as follows: "The only issue is whether or not [the] Manager had authority to file a Chapter 11 bankruptcy petition on Debtor's behalf."[13] The Court initially noted that DB Capital was organized under Colorado's Limited Liability Company Act (the "Act"), and the operating agreement and the amended operating agreement specifically provided that Colorado law applied.[14] Accordingly, the B.A.P. looked to the Act, which indicates, *inter alia*, that "an operating agreement governs the rights and duties of a limited liability company's members and managers."[15] The operative provisions of DB Capital's amended operating agreement included the following provision:

> The Company (v) to [the] extent permitted under applicable Law, will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization of relief under any applicable federal or state law relating to bankruptcy . . . .[16]

DB Capital, however, argued that, notwithstanding language included in the operating agreement, any rule limiting a borrower's access to bankruptcy protection was unenforceable as a matter of public policy.[17] DB Capital further asserted that the provisions of the operating agreement violated the *ipso facto* rule against restrictive bankruptcy covenants, citing numerous cases concluding that contractual provisions that

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9. *Id.*
10. *Id.* at *3.
11. Reply Brief for Appellant at 10–11, DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (*In re* DB Capital Holdings, LLC), 463 B.R. 142, 2010 WL 4925811 (B.A.P. 10th Cir. 2010) (B.A.P. No. CO-10-046).
12. In re DB Capital Holdings, LLC, No. 10-23242 (Bankr. D. Colo. June 21, 2010) (order dismissing the case).
13. DB Capital Holdings, LLC, 2010 WL 4925811, at *2.
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at *3.

prospectively prohibit bankruptcy protection are generally unenforceable.[18]

Notwithstanding the Debtor's arguments, the B.A.P. found in favor of Aspen, stating that "the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy," was not supported by existing case law.[19] The B.A.P. also noted that the *ipso facto* rule only applied to agreements between the debtor and third parties, not to organizational agreements between members of a limited liability company.[20] The B.A.P. indicated that no evidence had been presented to the bankruptcy court that the operating agreement was "coerced by a creditor,"[21] which it implied might render similar terms in an operating agreement to be unenforceable.[22]

The B.A.P. was also not persuaded by DB Capital's attempts to analogize the provision in the operating agreement to the "independent director" rule, which rule allows creditors to require borrowers to place independent directors on their boards.[23] Several courts have prohibited this practice when the appointed director's purpose is to prevent a bankruptcy filing, considering directors' fiduciary duties to the organization.[24]

IMPLICATIONS OF DB CAPITAL

Though the B.A.P.'s opinion invites speculation and intrigue as to what additional limiting provisions members of a limited liability company may include in an operating agreement, the case appears to stand for the proposition that LLC members can agree to limit a company's rights to bankruptcy relief.[25]

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18. *Id.*
19. *Id.*
20. *Id.*
21. The manager of DB Capital argued that the inclusion of the provision restricting bankruptcy was the product of coercion. *Id.* The manager pointed to the fact that the loan agreement with the lender had recently been amended and contained similar language. Opening Brief for Appellant at 10, DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (*In re* DB Capital Holdings, LLC), 463 B.R. 142, 2010 WL 4925811 (B.A.P. 10th Cir. 2010) (B.A.P. No. CO-10-046). The B.A.P. dismissed the argument because it did not believe that the record supported such an allegation. *Id.* at *3.
22. *Id.*
23. Reply Brief for Appellant, *supra* note 11 at 11–12.
24. *See, e.g.*, In re General Growth Properties, Inc., 409 B.R. 43, 64–65 (Bankr. S.D.N.Y. 2009).
25. The proposition that LLC members can agree to limit bankruptcy relief must be distinguished from a creditor's ability to restrict a bankruptcy filing by taking a secured interest in a LLC as a form of collateral. In *In re Crossover Financial I, LLC*, Judge Sidney B. Brooks of the United States Bankruptcy Court for the District of Colorado explained, "neither the pledging of membership rights as security nor the declaration of a breach by the secured party is sufficient to divest the pledging member of the right to vote." 477 B.R. 196, 206 (Bankr. D. Colo. 2012) (quoting In re Lake Cnty. Grapevine Nursery Operations, 441 B.R. 653 (Bankr. N.D. Cal. 2010)) (internal quotation marks omitted). Judge Brooks held that the secured creditor could not block the LLC manager from filing for bankruptcy after a default by redeeming its secured interest in the LLC. *Id.*

Based on the foregoing discussion, the question invariably arises as to whether a *lender* can request and enforce an agreement from the borrower that it will not file a bankruptcy petition, or whether a *lender* can condition financing upon the acceptance of a bankruptcy limiting provision. Until *DB Capital*, the answer had almost always been "no." However, based on the *DB Capital* opinion, whether such a concession can be extracted from a borrower may have changed from "no" to "maybe," at least where the borrower is a LLC.

Whether *DB Capital* extends beyond the confines of the organizational structure of an LLC is unclear. However, it is foreseeable that bankruptcy courts may find enough similarities in the organizational structure of other corporate forms to justify extending the *DB Capital* rationale to other legal entities.

Nevertheless, based on the B.A.P.'s limited endorsement of its unpublished opinion and the question of whether the same determination would apply to third-party creditors, banks and other lenders should proceed with caution when attempting to incorporate provisions in a company's organizational agreements that prohibit a borrower from filing for bankruptcy protection. Moreover, the strength of the limitation upheld in *DB Capital* is questionable, considering LLC members can amend organizational agreements after procuring the requested credit. Although it is not outside a creditor's right to restrict the amending of organizational agreements, such amendment paired with a provision restricting bankruptcy protection may cause a court to pause, and, therefore, deviate from the rationale set forth in *DB Capital*.[26]

A final consideration for creditors and their attorneys is that a provision imbedded in a company's organizational agreements limiting bankruptcy in no way precludes a debtor's other creditors from initiating involuntary bankruptcy proceedings. Consequently, depending on the importance of handling matters outside of bankruptcy court, a secured creditor that has effectively limited bankruptcy may find its bargaining position weakened by other potential creditors of the estate.

26. Notably, the B.A.P. in *DB Capital* stated "the Court declines to opine whether, under the right set of facts, a LLC's operating agreement containing terms coerced by a creditor would be unenforceable." *DB Capital Holdings, LLC*, 2010 WL 4925811, at *3.