# Individuals and Passthrough Entities

*By Susan Kalinka*

## *In re Allentown:* Does the Dissociation of a Member from an LLC upon the filing of a Bankruptcy Petition Violate the Automatic Stay Provisions of the U.S. Bankruptcy Code?



In the case of *In re Allentown Ambassadors, Inc.*,[1] the Bankruptcy Court for the Eastern District of Pennsylvania was called upon to determine whether the dissolution of an LLC on the bankruptcy of a member and the reconstitution of a new LLC whose members included all of the members of the dissolved LLC, except the bankrupt member, violated the automatic stay provisions of the Bankruptcy Code. The *Allentown* court declined to reach a conclusion on the merits of the case because the court treated the parties' contentions as motions for summary judgment and the parties had not provided sufficient facts to support an award of summary judgment.

In reaching its conclusion, however, the court engaged in a lengthy analysis of the relevant Bankruptcy Code provisions and relevant state statutes and case law, thereby offering a framework for deciding the issue. Thus, the case offers some guidance concerning an important issue for LLCs and their members when a petition in bankruptcy is filed for an LLC member. The *Allentown* case may offer guidance for members of an LLC even if the applicable LLC statute does not require an LLC to dissolve on the bankruptcy of a member.

Many LLC statutes provide that the bankruptcy of a member triggers the member's dissociation from the LLC.[2] "Dissociation" is a term of art used by many LLC statutes to refer to a change in the relationship between a member and the LLC. In some cases, the dissociation of a member can terminate all of the rights and responsibilities that attach to a member's interest. In other cases, dissociation will result in the termination of a member's management rights (*e.g.*, the right to participate in the management of LLC,

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vote on LLC matters, and exercise any of the rights of a member) but leave intact the member's economic rights (*e.g.*, the right to share in the LLC's profits, losses and distributions).[3]

As a practical matter, the dissociation of a member upon the filing of a bankruptcy petition may have the same effect as the dissolution of the LLC and the reconstitution of a new LLC with all of the members, except the bankrupt member. If, as in *Allentown*, the member's bankruptcy estate is not entitled to receive distributions from the LLC or cannot sell its interest in the LLC, the dissociation of a bankrupt member from an LLC could constitute a violation of the automatic stay provision under the Bankruptcy Code. This column discusses the *Allentown* opinion and how it may be relevant in determining whether state law triggering the dissociation of an LLC member upon the filing of a bankruptcy petition will be enforced by a bankruptcy court.

## Background: LLC Operating Agreements and the Anti–*Ipso Facto* Provisions Under the Bankruptcy Code

The Bankruptcy Code provides that upon the filing of a petition in bankruptcy, the debtor's property is transferred to the bankruptcy estate.[4] The transfer of an LLC interest to a bankruptcy estate may trigger the provisions of the applicable LLC statute that restrict the powers of a transferee of a member's interest. Under most LLC acts, the transferee (or "assignee") of a member's interest in an LLC may not exercise the rights of a member or participate in the management of the LLC unless the nonassigning members agree to admit the assignee as a member.[5] Thus, the nondebtor members of an LLC may be able to prevent a trustee in bankruptcy from exercising the debtor member's management powers by withholding their consent to admit the trustee as a member.[6]

In most cases, the Bankruptcy Code should not override state law restrictions on the transfer of a member's management rights when a trustee has been appointed to manage the member's bankruptcy estate.[7] Because state law prohibits the assignment of a member's management rights, the nondebtor members generally should not be required to accept the trustee as a managing member of the LLC.

Where, as in *Allentown*, a trustee is not appointed, the debtor member becomes a so-called debtor in possession. In that case, a court might hold that the member retains all of the member's pre-bankruptcy management rights with respect to the LLC interest. A trustee is appointed in a Chapter 11 case only when a trustee is needed.[8] As the debtor in possession, the debtor remains the representative of the bankruptcy estate and has the rights (other than the right to compensation), powers, and duties of a trustee.[9] Where a member remains a debtor in possession, there has been no transfer of the member's LLC interest. In *N.L.R.B. v. Bildisco and Bildisco*,[10] the U.S. Supreme Court held that the filing of a bankruptcy petition does not cause the debtor in possession to become a different legal entity from the pre-bankruptcy debtor.

The nondebtor members might prefer the management rights of a member to terminate upon the member's bankruptcy even if the member is a debtor in possession. While a member of an LLC has fiduciary duties to exercise management rights in the best interests of the LLC and its members, a member who is a debtor in possession will have fiduciary duties to the member's creditors that may conflict with the member's fiduciary duties under LLC law.[11] By triggering the dissociation of a member upon the filing of a bankruptcy petition, most LLC acts prevent a conflict of interest between a debtor member's fiduciary duties to the other members and the debtor's fiduciary duties to its creditor. Some courts, however, have held that a member who is a debtor in possession may continue to exercise the member's management rights, notwithstanding state law to the contrary.

The legislative history of the Bankruptcy Code indicates that the determination of whether a debtor in possession who is a member of an LLC should be permitted to continue to manage the LLC should be based on the facts and circumstances of each case.[12] The Bankruptcy Code, however, provides rules that sometimes are interpreted literally to deny a debtor in possession the right to continue to exercise management rights if state law excuses the nondebtor members and the nondebtor members refuse to allow the debtor to continue to manage the LLC.[13] Courts have reached differing conclusions on this issue.[14]

There are two alternative theories under which a court may hold that bankruptcy law preempts state law with respect to a debtor member's right to continue to participate in the management of an LLC. On the one hand, a court may hold that an LLC's operating agreement constitutes an executory contract that may be assumed by the trustee or debtor in possession, notwithstanding state law or a provision in the oper-

ating agreement to the contrary. On the other hand, a court may hold that state law or a provision in an operating agreement requiring the LLC interest of a member to terminate on the member's bankruptcy constitutes an unenforceable *ipso facto* clause. An *ipso facto* clause is a clause in a contract or lease that requires a person to forfeit rights under the contract or lease in the event of bankruptcy.

The Bankruptcy Code does not define the term "executory contract." Under nonbankruptcy law, the term "executory contract" refers to contracts on which performance remains due by either party. Most bankruptcy courts have adopted the definition suggested by Professor Vern Countryman, that an executory contract is a contract under which the obligations of the debtor and the other party are both so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.[15] Where a member has an obligation to contribute capital in the future or has an obligation to manage the LLC, the operating agreement is likely to fall within the definition of an executory contract.[16]

Alternately, if the operating agreement contains a provision stating that the LLC dissolves on the bankruptcy of a member or that the bankruptcy of a member terminates the member's interest in the LLC, a court may find that the provision is an "*ipso facto*," or forfeiture, clause and is unenforceable under section 365(e)(1) of the Bankruptcy Code. Section 365 of the Bankruptcy Code overrides statutory or contractual arrangements that prohibit the modification of a contract where the contract is contingent on the bankruptcy of a party. Under section 365, a trustee or debtor in possession may reject, assume, or assign an executory contract of the debtor.[17] Notwithstanding any provision in an executory contract or in applicable law to the contrary, an executory contract generally may not be terminated or modified, and any right or obligation under such a contract may not be terminated or modified solely because of a provision in the contract that is conditioned on (a) the insolvency or financial condition of the debtor; (b) the commencement of a bankruptcy case; or (c) the appointment of a trustee or custodian.[18]

The Bankruptcy Code contains a number of anti–*ipso facto* provisions in addition to section 365(e)(1). In general, the anti–*ipso facto* provisions render ineffective contractual or statutory provisions that would modify or terminate a debtor's rights in the event of bankruptcy. Section 541(c)(1) of the Bankruptcy Code provides that an interest of the debtor becomes property of the estate, notwithstanding any provision that restricts or conditions the transfer of the interest by the debtor or that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case, or on the appointment of, or taking possession by, a bankruptcy trustee or a custodian. Section 363(b)(l) provides that in general, the trustee may use, sell or lease property, notwithstanding any provision in a contract, lease, or applicable law that is conditioned on the financial condition or bankruptcy of the debtor. Finally, section 365(f)(3) renders ineffective a provision in an executory contract or unexpired lease that permits a party other than the debtor to terminate or modify the contract, lease or any right or obligation thereunder on account of the assignment of the lease or contract where the lease or contract is assigned to the trustee.

Unless the personal contract exception applies, the other anti–*ipso facto* provisions of the Bankruptcy Code may render ineffective a statute that prohibits an assignment of a member's right to participate in the management of an LLC. A personal contract is a contract as to which applicable law excuses a party to the contract, other than the debtor, from accepting performance from or rendering performance to the trustee or an assignee of the contract.[19] If a contract is a personal contract, a party may withhold consent to the assumption or assignment of the contract.[20] Thus, a provision in the operating agreement or under state law triggering the dissolution of an LLC or the dissociation of a member upon the member's bankruptcy may be enforceable if the provision constitutes a personal contract.[21]

Bankruptcy courts have disagreed on the effect of the personal contract exception where the debtor is a member of an LLC. A similar issue arises in the partnership context. Courts also have disagreed as to whether a provision in a partnership agreement or under state law triggering dissolution of the partnership upon the bankruptcy of a partner or terminating the bankrupt partner's interest in the partnership constitutes an unenforceable *ipso facto* clause.[22] Most, if not all, of the cases concerning whether bankruptcy law overrides state LLC laws have been based on analogous partnership cases.[23] In *Allentown*, the court was required to determine whether the anti–*ipso facto* provisions, as well as the automatic stay provisions, of the Bankruptcy Code applied to prohibit the other members of the LLC from dissolving the LLC and forming a new LLC that did not include the debtor as a member.

## Facts in *Allentown*

Allentown Ambassadors, Inc. ("Allentown"), was a corporation that had held a franchise to operate a minor league baseball team as a member of the North American Baseball, LLC (the "NAB LLC"), an independent, minor league baseball league. The NAB was organized under the North Carolina LLC Act. Allentown also had been a member of several baseball leagues that had been predecessors of NAB, including the so-called Combined League. Allentown had been experiencing financial difficulties and asked Miles Wolff, the commissioner of the league, for permission to "go dark" (*i.e.*, not field a team to play) during the 2002 and 2003 season and had asked for assistance in selling its franchise to a group of potential investors. Allentown alleged that Mr. Wolff denied its requests to go dark while allowing other teams to go dark and that the commissioner had opposed the sale of its franchise, but assisted another team and member of the LLC in selling the other team's franchise. Allentown also alleged that during Mr. Wolff's tenure, the following five events occurred that were material to Allentown's claims in the bankruptcy litigation:

1. The Combined League ownership "stipulated" that, prospectively, the value of a league franchise would be $750,000.
2. The Combined League surcharged its members some unstated amount of money to assist one of its members, the Albany Diamond Dogs, which was allegedly experiencing financial difficulties.
3. Another team experiencing financial difficulties, the Massachusetts Mad Dogs, was permitted to go dark for two seasons and retain its franchise in the Combined League pay paying only its "annual dues."
4. Still another team experiencing financial difficulties, the Adirondack Lumberjacks, was permitted to go dark for a season without losing its franchise in the Combined League (without even being required to pay its annual dues during the period of "darkness"—while the other League members were assessed $150,000 in order to provide financial assistance to the Adirondack team.
5. [Allentown] allegedly received disparate treatment from Defendant Wolff in addressing its financial difficulties.[24]

On May 4, 2004, Allentown filed a petition under Chapter 11 of the Bankruptcy Code. A few months after Allentown filed its bankruptcy petition, the Team Members of the NAB LLC, other than Allentown, voted to dissolve the LLC. Then the Team Members formed a new league which included all of the other members of the NAB LLC, except Allentown.

Allentown brought an action against the Team Members, Mr. Wolff, several individuals, and the NAB LLC, asserting claims for, *inter alia*, violation of the automatic stay by the LLC and the Team Members. The defendants filed a motion to dismiss the claims, which the court treated as a motion for summary judgment.

## The Parties' Arguments

As explained earlier, Allentown argued that the Team Members of the NAB LLC violated the automatic stay provisions of the Bankruptcy Code by dissolving the LLC and excluding Allentown from the reconstituted LLC after Allentown filed its bankruptcy petition. Section 362(a)(3) of the Bankruptcy Code[25] provides that the filing of a bankruptcy petition "operates as a stay, applicable to all entities, of ... any act to obtain possession of property of the [bankruptcy] estate or of property from the estate or to exercise control over property of the estate." The U.S. Court of Appeals for the Ninth Circuit has held that (1) the stay applies to prevent unilateral termination of contracts between the debtor and third parties even if a contract is unassumable and contains a valid *ipso facto* clause and (2) the stay must be modified before the *ipso facto* clause may be invoked.[26] Courts have described the purpose of the automatic stay provision as:

> … one of the fundamental debtor protections provided by the bankruptcy law. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy. The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property.[27]

Allentown alleged that the Team Members of the NAB LLC exercised possession or control over Allentown's rights as a member of the LLC by (1) dissolving the

NAB LLC and (2) reconstituting the LLC under a new name without Allentown as a member. The defendants agreed that Allentown's membership in the LLC was not terminated before Allentown filed a petition in bankruptcy and that Allentown's membership interest constituted property of the bankruptcy estate. However, the defendants argued that under the LLC's operating agreement and North Carolina law, the commencement of the bankruptcy case terminated Allentown's membership in the LLC and altered Allentown's status to that of an assignee of a member's interest.

The defendants also reasoned that, as an assignee, Allentown had no management or voting rights and that Allentown's only interest in the LLC was the right to receive its proportionate share of any distribution made by the LLC. According to the defendants, Allentown's economic interest in the LLC was not affected by the dissolution of the LLC because Allentown's bankruptcy estate still had the right to receive its pro-rata share of whatever ultimately would be distributed on account of Allentown's economic interest in the LLC. The defendants also argued that Allentown had no right to be included in the new LLC that was formed by the Team Members.

Furthermore, the defendants contended that even if the formation of a new LLC violated Allentown's rights, their conduct only gave rise to a post-petition cause of action under state law for breach of contract or perhaps for some business tort. They maintained that their conduct, even if wrongful, did not create an actionable claim for violation of section 362(a)(3).

## The Court's Opinion

To resolve the issue in *Allentown*, the court was required to interpret the language of section 362(a)(3). As explained earlier, section 362(a)(3) of the Bankruptcy Code[28] provides that the filing of a bankruptcy petition "operates as a stay, applicable to all entities, of ... any act to obtain possession of property of the [bankruptcy] estate or of property from the estate or to exercise control over property of the estate." The *Allentown* court determined that the scope of section 362(a)(3) depended on the meaning of the following terms: (1) "property of the estate"; (2) "obtain possession of"; and (3) "exercise control."

Defining the first two terms did not present a problem. Property of the bankruptcy estate generally consists of "all legal and equitable interests of the debtor in property as of the commencement of the case,"[29] including the debtor's interest in an LLC. The definition of the second term, "to obtain possession of," property of the estate often is straightforward, especially when the property in question is tangible property. For example, the *Allentown* court noted that the post-petition repossession of a debtor's automobile is an obvious violation of section 362(a)(3).

The scope of section 362(a)(3), however, is uncertain when the property in question, like an interest in an LLC, is intangible. The *Allentown* court did not distinguish between "obtaining possession of" and "exercising control over" a debtor's intangible property rights.

The words "to exercise control" were not part of the Bankruptcy Code in 1978 when the Code became effective. The term "to exercise control" is not defined in the Bankruptcy Code, and there is no legislative history clarifying Congress' intent in adding that term to the statute.[30] The *Allentown* court sought to reconcile inconsistent case law concerning what acts constitute exercising control over intangible property of the bankruptcy estate.

A number of courts have suggested that a nondebtor's actions may so interfere, directly or indirectly, with the intangible rights of a debtor (or trustee), or so substantially diminish the value of the bankruptcy estate's intangible property rights, that such actions violate section 362(a)(3).[31] For example, In *Hills Motors, Inc. v. Hawaii Automobile Dealer's Association*,[32] the U.S. Court of Appeals for the Ninth Circuit held that a state agency's post-petition dissolution of a corporate debtor constituted "exercise of control" over the estate's property in violation of section 362(a)(3) and that the agency's actions were void *ab initio* so that the corporation had standing to pursue an antitrust action after the bankruptcy court had confirmed the debtor's plan of reorganization. In *dicta*, the Third Circuit has indicated that section 362(a)(3) even may apply to prohibit actions directed against third parties, not only actions directed against the debtor.[33]

Other courts have noted that not every post-petition action taken by a third party that reduces the value of property of the estate constitutes the exercise of control of property of the estate in violation of section 362(a)(3).[34] The *Allentown* court described two rationales courts have used in declining to hold that the conduct of others that diminishes the value of property of the estate constitutes a violation of the automatic stay. Some courts have declined to apply section 362(a)(3) where the conduct at issue did not directly target discrete property rights of the estate.[35]

Even where the conduct at issue constituted a direct impairment of the debtor's property rights, other courts have declined to apply section 362(a)(3) treating the debtor's claim solely as a post-petition cause of action arising under applicable law giving rise to the debtor's property interest.[36]

The *Allentown* court found unsatisfactory both of the principles that other courts have applied to limit the scope of section 362(a)(3). The court expressed its concerns in adopting either approach as follows:

> With respect to the first rationale, it may be very difficult to distinguish between actions which "directly" impair the intangible property rights of the debtor (or trustee) from actions which only have an "indirect" impact on the estate. Moreover, the approach fails to address the underlying purpose of §362(a)(3), the preservation of the estate for the benefit of creditors. I also find the second rationale unconvincing. Consider the case of a creditor who repossesses a debtor's automobile post-petition in violation of the debtor's contractual rights (the contractual rights having been violated because the debtor was in compliance with all of his obligations under the agreement). As a matter of either policy or statutory construction, I fail to see why the existence of a non-bankruptcy remedy for a violation of the debtor's rights under applicable non-bankruptcy law precludes the debtor from invoking other remedies available under the Bankruptcy Code for the violation of §362(a)(3).[37]

Nevertheless, the *Allentown* court identified a worthy policy reason for declining to apply the automatic stay provisions to prohibit third parties from engaging in conduct that could reduce the value of the property of the bankruptcy estate. The court observed that when courts limit the scope of section 362(a), they do so to avoid giving the bankruptcy estate an undue legal advantage in its relationship with other parties.[38] The court concluded that the determination of whether a court should apply the automatic stay to prohibit the post-petition conduct of third parties requires the court to balance competing interests—the interests of the bankruptcy system in protecting the value of the bankruptcy estate against the interests of other parties who seek to engage in commercial conduct in the ordinary course of business that might have negative consequences for the bankruptcy estate.

## Determining Whether a Nondebtor's Acts Constitute "Exercise of Control Over" Intangible Property Rights in Violation of the Automatic Stay–Three Steps

In *Allentown*, the court adopted a three-step process for determining whether a nondebtor's acts constitute the exercise of control over the intangible property rights of the bankruptcy estate in violation of section 362(a)(3). The steps are as follows:

> First, the court must determine whether the bankruptcy estate has a property right under applicable non-bankruptcy law. Next, the court must determine whether those property rights are property of the bankruptcy estate and the scope of the estate's property interests. Third, if the non-debtor's actions will adversely impact the estate's property interests, the court must then evaluate (1) the nexus between the conduct at issue and the property interests of the bankruptcy estate, (2) the degree of impact on the bankruptcy estate and (3) the competing legal interests of the non-debtor parties.[39]

When it attempted to apply the three-step test, the court determined that the parties had not provided sufficient facts to support an award of summary judgment to either party. The North Carolina LLC Act provided that unless otherwise provided in an LLC's articles of organization or written operating agreement, upon the filing of a bankruptcy petition, a member ceased to be a member of the LLC and had only the rights of an assignee.[40] Section 4.4 of the NAB LLC Operating Agreement provided that upon bankruptcy filing, a member would cease to have any power as a member or manager and would only have the rights of an assignee. The *Allentown* court concluded that because it terminated a member's status upon a bankruptcy filing, section 4.4 of the Operating Agreement constituted an *ipso facto* provision.

Under the North Carolina LLC Act, an assignee was entitled to receive only the distributions and allocations to which the assignor was entitled.[41] Both the LLC Act and the Operating Agreement provided that the filing of a bankruptcy case on behalf of a member did not cause the LLC to dissolve.[42]

Like most LLC statutes, the North Carolina LLC Act provided that, except as otherwise provided in the articles of organization or a written operating agreement, a member had the right to assign its membership interest, "in whole or in part."[43] As explained above, the statute

provided that an assignee was entitled to receive only the distributions and allocations to which the assignor was entitled.[44] Under the North Carolina LLC Act, an assignee could become a member of an LLC only if the members unanimously consented, unless otherwise provided in the LLC's articles of organization or operating agreement.[45] The NAC LLC Operating Agreement did not alter any of the statutory default rules concerning the assignment of a member's interest.[46]

Allentown argued that it remained a member of the NAB LLC after the filing of its bankruptcy petition because the *ipso facto* provision of the Operating Agreement purporting to terminate its interest in the LLC was not enforceable under section 365(e) of the Bankruptcy Code. As explained earlier, section 365(e)(1) prohibits the termination or modification of an executory contract after the commencement of a bankruptcy case due to a contractual provision conditioned on the commencement of a bankruptcy case. However, section 365(e)(2) overrides section 365(e)(1) if local law excuses a party, other than the debtor, to the contract from accepting performance from or rendering performance to the trustee or to an assignee of the contract, regardless of whether the contract prohibits or restricts assignment of rights or delegation of duties, and the party does not consent to the assumption or assignment.[47]

Thus, it was necessary for the court to determine whether the Operating Agreement was an executory contract before considering whether section 365(e) applied to the termination of Allentown's membership interest.[48] Like other bankruptcy courts, the *Allentown* court adopted the Countryman standard, which provides that a contract is executory when "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[49] The court concluded that the NAB LLC Operating Agreement was an executory contract because the members of the LLC had ongoing, material, unperformed obligations to one another and the LLC as of the commencement of Allentown's bankruptcy case, including (1) the duty to manage the LLC; and (2) the duty to make additional cash contributions if needed by the LLC.

Once the court determined that the Operating Agreement was an executory contract, it still had to determine whether applicable law excused the Team Members from accepting performance from or rendering performance to a trustee or to an assignee of the contract. Section 365(e)(2) closely tracts the language of section 365(c), which governs the assignment of executory contracts. Under section 365(c)(1), a trustee may not assume or assign an executory contract if applicable law excuses a party from accepting performance from an entity other than the debtor or debtor in possession and that party does not consent to the assumption or assignment.[50]

Because of the similarity in the language of both subsections, the *Allentown* court concluded that the extent to which a court will enforce an *ipso facto* provision under section 365(e)(2) largely depends on whether the court would permit the debtor to assume the contract.[51] The court noted, however, that section 365(f) raises questions concerning the interpretation of section 365(c)(1).[52] Section 365(f) provides that except as provided in section 365(b) and (c), a trustee may assign an executory contract, notwithstanding a contractual provision or "applicable law" that prohibits, restricts, or conditions the assignment of the contract.[53] Thus, section 365(f), allowing a trustee to assign an executory contract, notwithstanding "applicable law," is expressly subject to section 365(c)(1), which states that "applicable law" excusing a party from accepting performance from an entity other than the debtor renders an executory contract non-assignable (and nonassumable).

The language of section 365 is circular and confusing. Section 365 seems to say that an executory contract is assignable notwithstanding "applicable law" prohibiting assignment but, at the same time, is not assignable if applicable law excuses a party performing or accepting performance from a person other than the debtor. Most courts, however, have resolved the apparent conflict between sections 365(c) and 365(f) by ascribing a different meaning to the term "applicable law" appearing in each subsection.

For example, the U.S. Court of Appeals for the First Circuit has held that the term "applicable law" in section 365(f) applies only to state laws that enforce contract provisions that prohibit, restrict, or condition assignment, and the term "applicable law" in section 365(c)(1) applies to state laws that, on their own terms, prohibit, restrict, or condition assignment of a particular type of contract.[54] Similarly, the U.S. Courts of Appeals for the Fourth, Sixth, Ninth and Eleventh Circuits have held that the term "applicable law" in section 365(f)(1) applies to general prohibitions against assignment, and the term "applicable law" in section 365(c)(1) applies to specific laws that excuse a contracting party from rendering performance to, or accepting performance from, a third party.[55] The *Allentown* court concluded that under this construction, section 365(c)(1) applies when the identity of the original contracting party is material.

The *Allentown* case was appealable to the U.S. Court of Appeals for the Third Circuit. In *Matter of West Electronics, Inc.*,[56] the Third Circuit adopted the "hypothetical test" for determining whether a debtor in possession may assume an executory contract under section 365(c)(1).[57] Under the hypothetical test, an *ipso facto* clause is enforceable if applicable law would require the nondebtor party to an executory to consent the assignment, regardless of whether the contract actually has been assigned or will be assigned to a person other than the debtor. For example, if the court applied the hypothetical test in *Allentown*, the provision in the Operating Agreement dissolving the LLC on the bankruptcy of a member would be enforceable even though Allentown did not seek to assign the Operating Agreement to a third party if state law prohibited the assignment of the Operating Agreement to a third party without the consent of the other members.

*Matter of West Electronics, Inc.* illustrates the application of the hypothetical test. West Electronics, Inc. was a defense contractor that had entered into a contract with the United States to supply a substantial number of AIM-9 missile launcher power supply units to the Air Force. After West suffered a computer malfunction which destroyed its accounting records, the government suspended progress payments to West pending a review of West's financial status.

Later, West filed a petition for relief under Chapter 11 of the Bankruptcy Code and became a debtor in possession. The filing triggered the automatic stay provisions under section 362 of the Bankruptcy Code.

West petitioned the bankruptcy court to issue an order compelling the government to make progress payments under the contract. The government filed a cross-motion seeking an order permitting it to terminate the contract.

The U.S. Court of Appeals for the Third Circuit held that the automatic stay should have been lifted to allow the government to terminate the contract.[58] Under the Third Circuit's hypothetical test, West, as the debtor in possession, was not entitled to assume the contract for providing the government the units (which was an executory contract) if applicable law excused the government from accepting performance from an entity other than the debtor or the debtor in possession, regardless of whether the contract has been transferred to a third party.

The "applicable law" in *West* was the federal Anti-Assignment Act.[59] The Anti-Assignment Act provides, in part:

> No [government] contract or order, or any interest therein, shall be transferred by the party to whom such contract or order is given to any other party, and any such transfer shall cause the annulment of the contract or order transferred, so far as the United States is concerned.[60]

In analyzing the Anti-Assignment Act, the Third Circuit observed that the statute is "meant to secure to the government the personal attention and services of the contractor."[61] Thus, the court construed "applicable law" as treating government contracts as *per se* classic "personal service contracts" that traditionally may not be assigned without consent.

West argued that the Anti-Assignment Act should not be construed to foreclose an assignment of a contract from a debtor to a debtor in possession because the debtor and the debtor in possession are such closely related entities. The Third Circuit held that West had misconstrued section 365(c)(1). Under the Third Circuit's hypothetical test, the relevant inquiry was not whether the Anti-Assignment Act would preclude an assignment from West as a debtor to West as a debtor in possession, but whether the act would foreclose an assignment by West to another defense contractor.[62] Accordingly, the Third Circuit held that section 361(c)(1) prevented assignment of West's contract and the assumption of the contract by West as the debtor in possession.[63]

The *Allentown* court concluded that, in applying the hypothetical test, the ultimate question under section 365(c)(1) is whether the qualified power to assign an LLC interest under the North Carolina LLC Act constituted applicable law that "excuses a party, other than the debtor ... from accepting from or rendering performance to an entity other than debtor or the debtor in possession."[64] Because the North Carolina statute differed from the federal Anti-Assignment Act that was at issue in *West*, the *Allentown* court looked to other case law for guidance.

In the case of *In re ANC Rental Corp.*,[65] the debtor in possession sought to assume executory contracts permitting the operation of car rental concessions at several different airports. In some locations, local ordinances provided generally that no commercial activity could take place at the airport without the written permission of the airport authorities. In *ANC Rental*, the Bankruptcy Court for the District of Delaware held that section 365(c)(1) did not apply and that the debtor in possession could assume the contracts, reasoning as follows:

> Although the concessions are located at the airports, public safety concerns are not implicated by the question of who runs a car rental service, as opposed to who operates an airline. ... Furthermore, none of the statutes applicable to the Concession Agreements ... preclude assignment of those Agreements or even require the Airport Authorities' consent to such an assignment. Thus, the statutes themselves do not demonstrate any overriding concern for the exact identity of the party with whom the Airport Authorities contract.[66]

In general, courts have held that for section 365(c)(1) to apply to preclude assignment of an executory contract, the applicable law must specifically state that the contracting party is excused from accepting performance from a third party under circumstances where it is clear from the statute that the identity of the contracting party is crucial to the contract or public safety is at issue.[67]

The *Allentown* court also looked to *In re IT Group, Inc.*,[68] for guidance. In *IT Group*, the debtor was a member of a Delaware LLC. Like the North Carolina LLC Act, the Delaware statute provided that an LLC interest was assignable only upon the approval of all of the members of the LLC unless the operating agreement provided otherwise.[69] Under the Delaware LLC Act, a member ceased to be a member on assignment of the member's LLC interest, but the assignee was entitled to share in the LLC's profits and losses.[70] The Delaware Act also provided that a member ceased to be a member upon the filing of a bankruptcy petition.[71]

After the debtor in *IT Group* filed its bankruptcy petition, the debtor sought to assign its economic interests in the LLC (*i.e.*, the right to share in the LLC's profits and losses) to a third party. The issue in *It Group* was whether the court should enforce a provision in a contract purportedly giving the other members of the LLC the right to purchase the debtor's interest under a formula that would have reduced the value of the interest. Under the terms of the contract, the buy-out provision became effective upon a bankruptcy filing by a member. The bankruptcy court held that the buy-out provision was an unenforceable *ipso facto* clause within the meaning of section 365(e)(1).

On appeal, the District Court for the Disctrict of Delaware concluded that the statute permitting a member of an LLC to assign its economic rights did "not excuse the Members from rendering economic performance to an assignee."[72] Consequently, the court affirmed the bankruptcy court's decision that the buy-out provision under the contract was an unenforceable *ipso facto* provision.

The *Allentown* court found the *IT Group* opinion instructive because it suggests that the determination of whether an executory contract may be assumed by a debtor in possession should be applied to each separate property interest that arises under a single contract, rather than to the contract as an inseverable whole. However, the *IT Group* opinion concerned only the issue of whether the debtor in possession could assign its economic interest in an LLC, as permitted under the Delaware LLC Act, but prohibited by the *ipso facto* clause in a contract. In contrast, the *Allentown* case concerned the issue of whether the membership interest itself could be assigned, including both the debtor's economic interest in the LLC and the debtor's right to participate in the management of the LLC.

The *Allentown* court also reviewed the bankruptcy court's opinion in *Broyhill v. DeLuca (In re DeLuca)*.[73] As in *Allentown*, the issue in *DeLuca* concerned the validity of a provision in an LLC operating agreement that purported to dissolve the LLC upon the bankruptcy of a member. The *DeLuca* court adopted a test that asks whether the nondebtor party to a contract is excused from performance if the identity of the debtor is a material condition of the contract when considered in the context of the obligations which remain to be performed under the contract.[74]

## Second Three-Step Process for Determining Whether an *Ipso Facto* Provision Is Effective

After reviewing the cases, the *Allentown* court adopted another three-step process for determining whether the *ipso facto* provision in the NAB Operating Agreement was effective to terminate Allentown's interest in the LLC. The court described the process as follows:

> First, I must identify the specific nature of the contractual property rights that are at issue. Second, I must consider whether the contractual rights are assignable under applicable law, by evaluating whether the governing LLC statute or common law expresses a clear policy that the identity of the contracting party is crucial to the contract or to public policy with respect to the type of contract at issue. If so, the contract is not assignable and any *ipso facto* provision is enforceable. If, on the other hand, the governing statute or common law is equivocal, I go to a third step: determining

whether the identity of an assignee would be material to the non-debtor, taking into consideration the nature of the enterprise in which the debtor and the non-debtor are engaged.[75]

Under Step 1 of its analysis, the court identified Allentown's rights as a member of the NAB LLC as (1) a right to share in the profits and losses of the LLC; (2) a right to vote on LLC matters; and (3) a right to participate in the management of the LLC. Allentown's economic rights were not at issue because the Operating Agreement did not purport to modify Allentown's economic rights based on the bankruptcy filing.

Under Step 2 of the process, the court agreed with *In re ANC Rental* that section 356(c)(1) requires a clear, unambiguous prohibition against assignment without the consent of the other parties to the contract. The court characterized the applicable North Carolina law governing the assignment of a member's management rights as treating the membership interest as "somewhat assignable."[76] The North Carolina LLC Act begins with a statement that an LLC interest is assignable in whole or in part.[77] The court found it significant that the statute could have been drafted to say that a member's membership rights are not assignable. The *Allentown* court opined that by framing the policy with a positive statement of assignability, the statute suggested that any anti-assignment policy embodied in the statutory provisions is not absolute. Furthermore, the court noted that to the extent the other provisions of the North Carolina LLC Act restrict the assignment of the rights of a membership interest, those statutory provisions are subject to exceptions that may be set forth in the LLC's articles of organization or an operating agreement.

The court acknowledged that the North Carolina LLC Act could be construed to mean that a member's management rights are not assignable because the same provision that renders membership interests assignable also states that an assignee does not become a member. Moreover, the statute requires the unanimous consent of the other members to admit an assignee as a member of the LLC (except as otherwise provided in the articles of organization or operating agreement). Nevertheless, the court concluded that the North Carolina LLC Act lacked the unequivocal expression of nonassignability required to give it the force of "applicable law excus[ing] a party ... from accepting performance from or rendering performance to" an assignee under the strict standard of section 365(c)(1) of the Bankruptcy Code.

Under Step 3, the court found the record in *Allentown* inadequate to determine whether the operations of the NAB LLC were such that a change in the identity of an assignee would be a material impairment of the rights of the other members. Certain indicia in the record suggested to the court that memberships in the NAB LLC did not carry with them the type of nondelegable duties that should render the operating agreement nonassignable. For example, the record suggested that in the past, team membership in the LLC might have been assigned with some regularity. The court also opined that the business operations of the LLC might have been relatively modest as compared to the level of business activity conducted by the member teams in fielding their individual teams. Moreover, the appointment of a President who was "responsible for day-day management of the Company" under the terms of the Operating Agreement suggested to the court that the LLC was, at least to some degree, a manager-centric LLC. The court opined that the management structure of the LLC might minimize the degree of personal trust and confidence that each member need necessarily place in the other members of the LLC.

Finally, the *Allentown* court determined that the dissolution of the NAB LLC adversely affected Allentown's economic rights in the LLC because dissolution terminated the potential generation of profits in the future and their distribution to Allentown in its capacity as an assignee. Thus, the court concluded that there was a direct nexus between the defendants' conduct and the negative impact on the property interests of the bankruptcy estate. Furthermore, the court found nothing in the record suggesting any business exigency requiring the dissolution of the LLC without first obtaining relief from the automatic stay or the existence of any other competing interests to justify overriding the routine application of the automatic stay. Accordingly, the court found that Allentown's claim that the defendants' acts constituted the exercise of control of property of the estate was not subject to dismissal by way of summary judgment.

The *Allentown* court found a second, independent basis for denying the motion for summary judgment. When Allentown filed its petition in bankruptcy, the Team Members dissolved the LLC without allowing Allentown to exercise its voting rights. If Allentown had been permitted to vote, the LLC would not have been dissolved because the Operating Agreement required a unanimous vote of the members to dissolve the LLC.

The alleged facts indicated that, in dissolving the LLC, the Team Members effectively eliminated Allentown's interest in the LLC, which might have been more valuable than Allentown's rights as an assignee to receive distributions from the LLC. In its complaint, Allentown alleged that at least one minor league team had been

sold for $500,000, and the defendants had not presented any evidence to the contrary. While the court did not conclude that the value of Allentown's LLC interest was $500,000 because the record did not support such a conclusive finding, the court saw a direct connection between the conduct of the Team Members and a potentially valuable property right of the bankruptcy estate.

## What Does *Allentown* Mean for LLCs and a Bankrupt Member?

No cases other than *Allentown* could be found in which a court considered the issue of whether the dissolution of an LLC or the dissociation of a member of an LLC upon the filing of a bankruptcy petition constituted a violation of the automatic stay provisions of the Bankruptcy Code. *Allentown* provides a thorough analysis of the issue, as well as a number of factors that a court should consider in deciding the issue. Under *Allentown*, the determination of whether the dissolution of an LLC or the dissociation of an LLC member upon the filing of a bankruptcy petition violates the automatic stay by depends, in part, on whether the LLC's operating agreement constitutes an executory contract that may be assumed by the member who is a debtor in possession.

The *Allentown* court found a number of facts, that if verified, would prohibit the Team Members from dissolving the NAB LLC upon Allentown's filing of a bankruptcy petition. It is not certain whether other courts will be more willing or less willing than the *Allentown* court to allow a debtor in possession to continue to exercise its management rights with respect to an LLC interest.

The *Allentown* court applied the Third Circuit's hypothetical test for determining whether the applicable LLC statute excused the other members of an LLC from accepting performance from or rendering performance to the bankrupt member. The courts are split on the issue of whether the "hypothetical test" applies in determining whether a court will enforce an *ipso facto* clause in an executory contract. The United States Courts of Appeals for the Third, Fourth, Ninth and Eleventh Circuit have adopted the hypothetical test.[78] The First and Fifth Circuits have rejected the hypothetical test and instead, have applied the "actual test" for determining whether an executory contract may be assumed by a debtor in possession.[79]

## Hypothetical Test vs. Actual Test

As explained earlier, the *Allentown* case was appealable to the Third Circuit which had adopted the hypothetical test for determining whether applicable law intervened to allow a party to an executory contract to refuse to render performance to or accept performance from a debtor in possession. Other courts have adopted the actual test, rather than the hypothetical test. The application of the actual test is likely to allow an LLC member that is a debtor in possession to continue to exercise its management rights even if the applicable LLC statute provides that the member is dissociated from an LLC upon the filing of a bankruptcy petition and has only the rights of an assignee.

*In re Mirant Corp.*[80] illustrates the difference between the hypothetical and the actual tests. The dispute in *Mirant* concerned whether the automatic stay under section 362(a) of the Bankruptcy Code precluded a federal agency from terminating a contract with a subsidiary of Mirant Corporation pursuant to a clause in contract providing that the contract terminated upon the bankruptcy of a party to the contract.

Mirant Corporation was an international energy company that produced and sold electricity in the United States and abroad. Mirant Americas Energy Marketing, L.P. ("Mirant") was a subsidiary of Mirant Corporation that engaged in asset risk management, including commodities, energy and financial product trading. Mirant was responsible for procuring fuel and selling power for Mirant Corporation's operating facilities.

Bonneville Power Administration ("BPA") was a federal power marketing agency within the U.S. Department of Energy. BPA had entered into certain contracts with Mirant related to the marketing of federal power (the "Agreement").

The Agreement included an *ipso facto* clause authorizing BPA to terminate the contract and claim liquidated damages if Mirant petitioned for bankruptcy before the option period expired. Under the terms of the Agreement, default by the institution of a bankruptcy proceeding triggered the nondefaulting party's "right to terminate all transactions between the Parties under this Agreement upon written notice" and the nondefaulting party's right to a termination payment equal to the market-based cost of replacing the option contract.

Mirant had experienced some financial difficulties and filed a petition under Chapter 11 of the Bankruptcy Code. Shortly thereafter, BPA terminated the Agreement with Mirant. Mirant argued that BPA's termination of the contract violated the automatic stay and the anti–*ipso facto* provisions of the Bankruptcy Code. At issue in *Mirant* was whether the federal Anti-Assignment Act, the same law that was at issue in *West*, prohibited a debtor in possession from assuming an executory contract between the debtor and the federal government.

Unlike the Third Circuit, the Fifth Circuit held that Anti-Assignment Act did not prohibit the debtor from assuming the contract. The *Mirant* court reached this conclusion by applying the actual test for determining whether "applicable law" excused the government from accepting performance from or rendering performance to the trustee or an assignee of the contract.

Under the Third Circuit's hypothetical test, a court would be required to ask whether BPA could refuse to accept performance of the Agreement from *any* assignee because the Anti-Assignment Act made the Agreement unassignable as a matter of law. If so, then it would be irrelevant that the debtor did not actually assign, or attempt to assign, the contract. In that case, the contract would be terminable under section 365(c) of the Bankruptcy Code.

In contrast, the actual test (sometimes referred to as the "as-applied" test) requires a case-by-case showing that the nondebtor party's contract will actually be assigned or that the nondebtor party will in fact be asked to accept performance from or render performance to a party—including the trustee—other than the party with which the nondebtor originally contracted.[81] In a case where no assignment has taken place, the actual test contemplates that the exception under section 365(e)(2) does not apply, and as such, an *ipso facto* clause is invalidated. Because Mirant did not assign the Agreement and had no intention of assigning it, the Fifth Circuit held that the BPA had violated the automatic stay in terminating the Agreement.

As a matter of statutory construction, the actual test is superior to the hypothetical test. In *Mirant*, the Fifth Circuit noted that the plain text of section 365(e)(2)(A) requires a court to apply the actual test for determining whether a law is "applicable" under the exception, permitting the enforcement of an *ipso facto* clause.[82] Section 365(e)(2) provides that an *ipso facto* clause in an executory contract may be enforced if "applicable law excuses a [nondebtor] party ... from accepting performance from or rendering performance to ... an assignee of such contract" and the nondebtor party does not consent to "such assumption or assignment."[83] The Fifth Circuit opined:

> Congress might have chosen the exception to apply if any law prohibited the assignment, but instead Congress tethered the exception to "applicable" law that "excuses a party." It is axiomatic that an applicable law must apply to a set of circumstances; BPA creates smoke and erects mirrors when it argues that a contract not assignable as a matter of law, even if no such assignment existed in fact and no excuse existed in fact for the nondebtor party to refuse acceptance or performance in a particular situation, satisfies the language chosen by Congress in drafting the §365(e)(2)(A) exception. The law that releases a nondebtor from the general rule foreclosing the enforcement of an ipso facto clause must apply to something and must excuse the nondebtor from some specific performance *see* §365(e)(2)(A); thus if the debtor demonstrates that no application exists or that no excuse obtains on a given record, then the congressional language announces such a circumstance is material, making the §365(e)(2)(A) exception unavailable. The applicability of the law under §365(e)(2)(A) is determined not in the abstract but on the record at hand.
>
> That applicability is determined based upon the case is supported also by the congressional choice to structure the exception as a two-part test, the second portion of which requires a fact-based showing. *See* 11 U.S.C. §365(e)(2)(A)(i)-(ii). Subsection (ii) provides that the §365(e)(2)(A) exception lies only where "such [nondebtor] party does not consent to such assumption or assignment." ... The combination of the plain text and the overall structure of the test that must be met in order for the exception to arise communicates that Congress intended §365(e)(2)(A) to apply to a given factual situation rather than to a class of executory contracts, as BPA argues.[84]

The Fifth Circuit also held that the automatic stay must precede any enforcement of an *ipso facto* clause that might be permitted under section 365(e)(2)(A). The court noted that the broad application of the automatic stay reflects Congress's intent that courts presume a protection of property of a debtor's estate when faced with uncertainty or ambiguity.[85] Because a debtor's interest in an executory contract becomes property of the estate when the debtor files its petition in bankruptcy, the stay requires a party with an interest in the executory contract to come before the bankruptcy court to move for a modification or lift of the stay in order to effect the terms of an *ipso facto* clause. Even if a bankruptcy court ultimately permits a nondebtor party to terminate an executory contract, the stay requires the parties to present their arguments to a judge for a determination of whether it would be more equitable to enforce the *ipso facto* clause or to disregard the clause and thus, provides for the orderly administration of the estate.

## Conclusion

The *Allentown* case provides an excellent framework for determining whether a member of an LLC that is a debtor in possession should be entitled to continue to exercise its management rights under an LLC operating agreement, notwithstanding a provision under state law requiring the dissociation of a member on the filing of a bankruptcy petition. The first step in the analysis requires the court to determine whether an LLC operating agreement is an executory contract. Where an operating agreement is not an executory contract, there is no reason for the court to determine whether the operating agreement may be assumed or rejected by a member who is a debtor in bankruptcy.

However, in cases where an LLC operating agreement is an executory contract, a court in a circuit that has not adopted the hypothetical test or the actual test must determine which test should apply. If a court adopts the hypothetical test or is located in a jurisdiction where the hypothetical test has been adopted, then the *Allentown* opinion states that the court must determine whether the applicable LLC statute or common law expresses a clear policy that the identity of the contracting party is crucial to the contract or to public safety. If so, the court is likely to hold that a member of an LLC who becomes a debtor in possession may not participate in the management of the LLC. On the other hand, where a bankruptcy court determines that the applicable LLC law is equivocal, the *Allentown* opinion suggests that the court should then ascertain whether the identity of assignee would be material to the nondebtor members of the LLC or the LLC, taking into consideration the nature of the LLC's enterprise.

In contrast, a court that adopts the actual test or is located in a circuit that has adopted the actual test, is likely to hold that an LLC member who becomes a debtor in possession may continue to participate in the management of the LLC, notwithstanding any *ipso facto* provision under state LLC law or an operating agreement triggering the dissolution of the LLC or the dissociation of a member upon the member's bankruptcy.

Regardless of whether a court adopts the hypothetical or actual test, *Mirant* indicates that members of an LLC who would like to dissolve the LLC, terminate a member's management powers, or expel a member when the member files a bankruptcy petition should file a motion requesting the court to lift the automatic stay before acting in any way that might be adverse to the debtor member's interests. A person who willfully violates the automatic stay may be liable for damages, including costs and attorney's fees, and in appropriate cases, punitive damages.[86] Once the members have filed such a motion, the court then must consider whether the operating agreement is an executory contract and whether the debtor member may continue to exercise the management powers with respect to its interest in the LLC by assuming the operating contract.

Then, as the *Allentown* opinion indicates, a bankruptcy court must carefully weigh the equities, on a case-by-case basis, before deciding whether an LLC member who becomes a debtor in possession may continue to exercise its management rights with respect to the LLC. Bankruptcy courts are courts of equity.[87] The U.S. Supreme Court has admonished bankruptcy courts to balance the interests of the affected parties in determining whether to allow the debtor in possession to assume or reject an executory contract.[88] No matter which of the two tests (the hypothetical test or the actual test) is applied, it is hoped that in all cases in which a member of an LLC becomes a debtor in possession, the court presiding over the bankruptcy case will carefully weigh all of the equities and the interests of all the parties, including the nondebtor members and the LLC, before allowing the bankrupt member to continue to exercise its management rights with respect to the LLC's business or allowing the nondebtor members to dissolve the LLC or expel the debtor member.



### Endnotes

1 *In re Allentown Ambassadors, Inc.*, 361 BR 422 (Bankr. E.D. Pa. 2007).

2 *See, e.g.*, Rev. Unif. Ltd. Liab. Co. Act §602(7)(A) (2006) (dissociation of a member of a member-managed LLC when the member becomes a debtor in bankruptcy); Unif. Ltd. Liab. Co. Act §601(7)(1) (1996) (dissociation of a member upon the member's becoming a debtor in bankruptcy).

3 Rev. Unif. Ltd. Liab. Co. Act §603(a)(1) (2006); Unif. Ltd. Liab. Co. Act §603(b)(1) (1996).

4 11 U.S.C.A. §541.

5 *See, e.g.*, Rev. Unif. Ltd. Liab. Co. Act §502(a)(3)(A) (2006) (transfer of a transferable interest in an LLC does not entitle the transferee to participate in the management of the LLC); Unif. Ltd. Liab. Co. Act §503(d) (1996) (transferee who does not become a member of an LLC not entitled to participate in the management of the LLC).

6 At least two bankruptcy courts have held that a trustee could assume the debtor's management rights as a member of an LLC. *See, e.g.*, *In re Ehmann*, 337 BR 228 (Bankr. D. Ariz. 2006); *In re Albright*, 291 BR 538 (Bankr. D. Colo. 2003). The facts in *Ehmann* and *Albright* indicated that the courts reached equitable results. For a discussion of the *Albright* opinion, *see* Susan Kalinka, Individuals and Passthrough Entities, *In re Albright: Bankruptcy Court Decision Portends Problems for Single-Member LLCs*, Taxes, July 2003, at 15. For a discussion of *Ehmann*, *see* Susan Kalinka, Individuals and Passthrough Entities, *In re Ehmann: Bankruptcy Court Decision Portends Problems for Manager-Managed LLCs*, Taxes, Jan. 2006, at 17. The *Ehmann* court later vacated its opinion because the parties had reached a settlement agreement of the case, conditioned on the court's withdrawal of

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its opinion. *In re Ehmann*, 337 BR 228 (Bankr. D. Ariz. 2005) ("*Ehmann II*"). In vacating its opinion, the *Ehmann* court did not repudiate its earlier conclusions concerning the propriety of allowing the trustee to assume the debtor's management rights. For a discussion of *Ehmann II*, *see* Susan Kalinka, Individuals and Passthrough Entities, *What, if Anything, Does the Bankruptcy Court's Decision to Vacate its Opinion in In re Ehmann Mean for LLC Members?* TAXES, Jan. 2007, at 13.

[7] Bankruptcy law generally overrides provisions contained in contracts and state law that automatically alter a person's rights in an "executory contract" if the person becomes a debtor in bankruptcy. *See* 11 U.S.C.A. §§365(e)(1), (f)(3), 541(c). An operating agreement may fall within the definition of an executory contract if it requires a member or members to perform services or contribute property in the future. A managing member's authority to manage an LLC's business provided in an operating agreement usually causes the operating agreement to be considered an executory contract. The prohibition on termination or modification of an executory contract, however, does not apply if applicable law excuses a party, other than the debtor, to such contract from accepting performance from or rendering performance to the trustee or an assignee of such contract and the party does not consent to the assignment. 11 U.S.C.A. §365(c).

[8] *See* 11 U.S.C.A. §1104(a)(1) (authorizing the appointment of a trustee for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management).

[9] 11 U.S.C.A. §1107(a).

[10] *N.L.R.B. v. Bildisco and Bildisco,* 465 US 513, at 528, 104 SCt 1188, at 1197 (1984).

[11] *See Skeen v. Harms (In re Harms),* 10 BR 817, 822 (Bankr. D. Colo. 1981) (sole general partner of a limited partnership who becomes a debtor in possession generates an inherent conflict of interest that precludes him from remaining as a general partner because partners owe fiduciary duty to co-partners and debtors in possession owe fiduciary duty to creditors). *See also In re Map 1978 Drilling Partnership*, 95 BR 432, 435 (Bankr. N.D. Tex. 1989); *In re Royal Gorge Assoc.*, 77 BR 277, 278 (Bankr. D. Colo. 1987).

[12] *See* Comm'n on the Bankr. Laws of the U.S., Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, at 198 (1973).

[13] 11 U.S.C.A. §365(e)(1).

[14] *Compare In re DeLuca*, 194 BR 79 (E.D.Va. 1996) (member's bankruptcy caused member's interest in an LLC to terminate in accordance with state law) *with In re Daugherty*, 188 BR 607 (Bankr. D. Neb. 1995) (notwithstanding state law to the contrary, member's bankruptcy did not cause member's interest in the LLC to terminate).

[15] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, at 460 (1973).

[16] *See, e.g., In re DeLuca*, 194 BR 79 (Bankr. E.D. Va. 1996); *In re DeLuca*, 194 BR 65 (Bankr. E.D. Va. 1996); *In re DeLuca*, 194 BR 79 (Bankr. E.D. Va. 1996); *In re Daugherty Construction, Inc.*, 188 BR 607 (Bankr. D. Neb. 1995).

[17] 11 U.S.C.A. §365(a), (f)(1).

[18] 11 U.S.C.A. §365(e)(1).

[19] *See* 11 U.S.C.A. §365(e)(2).

[20] *Id.*

[21] *Id.*

[22] For cases holding that the bankruptcy of a general partner dissolves the partnership and strips the debtor general partner of management rights, *see, e.g., Breeden v. Catron (In re Catron),* CA-4, 25 F3d 1038 (1994) *aff'g* 158 BR 629 (E.D. Va. 1993), *aff'g* 158 BR 624 (Bankr. E.D. Va 1992); *Phillips v. First City, Texas-Tyler, NA (In re Phillips)*, CA-5, 966 F2d 926 (1992); *In re Doddy*, 164 BR 276 (Bankr. S.D. Ohio 1994); *Normadin v. Normadin (In re Normadin),* 106 BR 14 (Bankr. Mass. 1989); *In re Tip O Texas RV Village,* 87 BR 195 (Bankr. M.D. Fla 1988); *In re Sunset Developers,* 69 BR 710 (Bankr. D. Idaho 1987); *In re Minton Group*, 27 BR 385 (Bankr. S.D.N.Y. 1983), *aff'd.*, 46 BR 222 (S.D.N.Y. 1985). For cases holding that a general partner's bankruptcy does not dissolve the partnership or strip the general partner of management rights, *see, e.g., In re Clinton Court,* 160 BR 57 (Bankr. E.D. Pa. 1993); *In re Corky Foods Corp*, 85 BR 903 (Bankr. S.D. Fla. 1988); *In re BC & K Cattle Co*, 84 BR 69 (Bankr. N.D. Tex. 1988); *In re Rittenhouse Carpet, Inc.,* 56 BR 131 (Bankr. E.D. Pa. 1985); *Quarles House Apts. v Plunkett (In re Plunkett),* 23 BR 392 (Bankr. E.D. Wis. 1982).

[23] *See, e.g., J.T.B. Enterprises, L.C. v. D & B Venture, L.C. (In re DeLuca)*, 194 BR 79 (Bankr. E.D. Va. 1996); *Broyhill v. DeLuca (In re DeLuca),* 194 BR 69 (E.D. Va. 1996); *In re Daugherty Construction, Inc.,* 188 BR 607 (Bankr. D. Nev. 1995).

[24] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 429–30 (Bankr. E.D. Pa. 2007). (Footnotes omitted.)

[25] 11 U.S.C.A. §362(a)(3).

[26] *Computer Commc'ns, Inc. v. Codex Corp. (In re Computer Commc'ns),* CA-9, 824 F2d 725, at 729–30 (1987).

[27] *In re Krystal Cadillac Oldsmobile GMC Truck, Inc.*, CA-3, 142 F3d 631, at 637 (1998) (*citing* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 340 (1977), 1978 U.S. Code Cong. & Admin. News, 5963, 6297 (1978)). *See also Constitution Bank v. Tubbs*, CA-3, 68 F3d 685, at 691 (1995).

[28] 11 U.S.C.A. §362(a)(3).

[29] 11 U.S.C.A. §541(a)(1).

[30] *See, e.g., United States v. Inslaw, Inc.,* 932 F2d 1467, 1473 (D.C. Cir. 1991); *In re Albion Disposal Inc.*, 217 BR 394, at 404–05 (W.D.N.Y. 1997).

[31] *See* cases cited at *In re Allentown Ambassadors, Inc.*, 361 BR 422, 436, note 34 (E.D.Pa. 2007).

[32] *Hills Motors, Inc. v. Hawaii Auto. Dealer's Ass'n*, CA-9, 997 F2d 581, at 594 (1993).

[33] *Acands, Inc. v. Travelers Casualty and Surety Co.*, CA-3, 435 F3d 252 (2006), (*per* Alito, J.) (stating post-petition entry of award in arbitration could diminish the bankruptcy estate's insurance coverage in violation of section 362(a)(1) and(3)).

[34] *See, e.g., In re Gyncor, Inc.*, 251 BR 344, 355 (Bankr. N.D. Ill. 2000) (*quoting In re Continental Air Lines*, 61 BR 758 (S.D. Tex. 1986); *In re Levitz Furniture, Inc.*, 267 BR 516, 522 (Bankr. D.Del. 2000).

[35] *See* cases cited at *In re Allentown Ambassadors, Inc.*, 361 BR 422, 438, note 35 (E.D.Pa. 2007).

[36] *See* cases cited at *In re Allentown Ambassadors, Inc.*, 361 BR 422, 439, note 36 (E.D.Pa. 2007).

[37] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 439 (Bankr. E.D. Pa. 2007).

[38] *Id.*

[39] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 440 (Bankr. E.D. Pa. 2007). (Citations omitted.)

[40] N.C. Gen. Stat. Ann. §57C-3-02.

[41] N.C. Gen. Stat. Ann. §57C-5-02.

[42] N.C. Gen. Stat. Ann. §57-5-02; NAB LLC Operating Agreement §8.1.

[43] N.C. Gen. Stat. Ann. §57C-5-02. *See* Rev. Unif. Ltd. Liab. Co. Act §502(a)(1) (2006) ("A transfer, in whole or in part, of a transferable interest is permissible").

[44] N.C. Gen. Stat. Ann. §57C-5-02. *See also* Rev. Unif. Ltd. Liab. Co. Act §501(b) (2006); Unif. Ltd. Liab. Co. Act §502 (1996).

[45] N.C. Gen. Stat. Ann. §57C-5-04(a).

[46] The NAB LLC Operating Agreement, however, included two conflicting provisions concerning the admission of an assignee as a member of the LLC. On the one hand, §7.3(b) of the Operating Agreement provided that an assignee would be admitted as a member if certain conditions were met, one of which was the consent of a "Majority in Interest of the Disinterested Members." On the other hand, §4.5 of the Operating Agreement provided that a person who acquired an interest in the LLC would be admitted as a member only if, *inter alia*, "[a]ll Members have unanimously consented in writing ... the granting or denial of which consent shall be in the sole discretion of such Members." *In re Allentown Ambassadors, Inc.*, 361 BR 422, 443 n. 44 (Bankr. E.D. Pa. 2007).

[47] 11 U.S.C.A. §365(e)(2)(A).

[48] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 443–44 (Bankr. E.D. Pa. 2007).

[49] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L.REV. 439, 460 (1973).

[50] 11 U.S.C.A. §365(c)(1).

[51] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 445–46 (Bankr. E.D. Pa. 2007), *citing In re Woskob*, CA-3, 305 F3d 177, at 186 (2002); Michelle Morgan Harner, Carl E. Black & Eric R. Goodman, *Debtors*

*Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 Am. Bankr. Inst. L.Rev. 187, at 253 (2005).

[52] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 446 (Bankr. E.D. Pa. 2007).

[53] 11 U.S.C.A. §365(f)(1).

[54] *See, e.g., In re Pioneer Ford Sales, Inc.*, CA-1, 729 F2d 27 (1984).

[55] *See, e.g., In re Sunterra Corp.*, CA-4, 361 F3d 257, at 266–67 (2004); *In re Catapult Entertainment, Inc.*, CA-9, 165 F3d 747, *cert. dismissed*, 528 US 924, 120 SCt 369 (1999); *In re James Cable Partners, L.P.*, CA-11, 27 F3d 534 (1994); *In re Magness*, CA-6, 972 F2d 689, at 695 (1992). *Cf. In re Catron*, 158 BR 629, 637 (E.D. Va 1993), *aff'd*, CA-4, 25 F3d 1038 (1994) (suggesting that 11 U.S.C.A. §365(c) and (f) are irreconcilable).

[56] *Matter of West Electronics, Inc.*, CA-3, 852 F2d 79 (1988).

[57] *Id.*

[58] *Id.*

[59] 11 U.S.C.A. §15(a).

[60] 41 U.S.C.A. §15(a).

[61] *In re West Electronics, Inc.*, CA-3, 852 F2d 79, at 83 (1988), *quoting M. Thompson*, CA-3, 53-1 USTC ¶9424, 205 F2d 73.

[62] *In re West Electronics, Inc.*, CA-3, 852 F2d 79, at 83 (1988).

[63] *Id.*, at 83–84 (1988).

[64] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 459 (Bankr. E.D. Pa. 2007).

[65] *In re ANC Rental Corp.*, 277 BR 226 (Bankr. D.Del. 2002).

[66] *In re ANC Rental Corp.*, 277 BR 226, 237 (Bankr.D. Del. 2002).

[67] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 449 (Bankr. E.D. Pa. 2007), *quoting ANC Rental Corp.*, 277 BR 226, 236 (Bankr. D.Del. 2002). *See also* authorities cited in *In re Allentown Ambassadors, Inc.*, 361 BR 422, 449, note 65 (Bankr. E.D. Pa. 2007).

[68] *In re IT Group, Inc.*, 302 BR 483 (D.Del. 2003).

[69] 6 Del. C. §18-702(a).

[70] 6 Del. C. §18-702(b).

[71] 6 Del. C. §18-301.

[72] *In re IT Group, Inc.*, 302 BR 483, 487 (D.Del. 2003).

[73] *Broyhill v. DeLuca (In re DeLuca)*, 194 BR 65 (Bankr. E.D. Va. 1996).

[74] *Broyhill v. DeLuca (In re DeLuca)*, 194 BR 65, 77 (Bankr. E.D. Va. 1996).

[75] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 453-454 (Bankr. E.D. Pa. 2007). (Citations and footnotes omitted.)

[76] *In re Allentown Ambassadors, Inc.*, 361 BR 422, 455 (Bankr. E.D. Pa. 2007).

[77] N.C. Gen. Stat. Ann. §57C-5-02.

[78] *See, e.g., In re Sunterra Corp.*, CA-4, 361 F3d 257, at 266-267 (2004); *In re Catapult Entertainment, Inc.*, CA-9, 165 F3d 747, *cert. dismissed*, 528 US 924, 120 SCt 369 (1999); *In re James Cable Partners, L.P.*, CA-11, 27 F3d 534 (1994); and *In Matter of West Electronics, Inc.*, CA-3, 852 F2d 79 (1988).

[79] *See, e.g., In re Mirant Corp.*, CA-5, 440 F3d 238, at 248 (2006); *Summit Inv. & Dev. Corp. v. Leroux*, CA-1, 69 F3d 608, at 613 (1995). *See also Cajun Elec. Members Comm. v. Mabey (In re Cajun Elec. Power Co-op., Inc)*, 230 BR 693, 705 (Bankr. M.D. La. 1999); *In re Lil'Things, Inc.*, 220 BR 583, 587 (Bankr. N.D. Tex. 1998); *Texaco, Inc. v. La. Land & Exploration Co.*, 136 BR 658, 669 (Bankr. M.D. La. 1992); *In re Hartec Enters., Inc.* 117 BR 865, 871 (Bankr. W.D. Tex. 1990) (concluding that the *West* hypothetical test "does not fulfill the purposes of the non-assignment statutes it seeks to enforce, creates inherent inconsistencies in the language of ... the Code, and fails to adequately account for" amendments to the Code), *vacated by settlement*, 130 BR 929 (W.D. Tex. 1991).

[80] *In re Mirant Corp.*, CA-5, 440 F3d 238, at 251 (2006).

[81] *Id.*, at 248.

[82] *Id.*, at 249.

[83] 11 U.S.C.A. §365(e)(2)(A).

[84] *In re Mirant Corp.*, CA-5, 440 F3d 238, at 249–50 (2006).

[85] *Id.*, at 251.

[86] 11 U.S.C.A. §362(k)(1). *But see* 11 U.S.C.A. §362(k)(2) (limiting the amount of damages to actual damages in certain cases).

[87] *N.L.R.B. v. Bildisco and Bildisco*, 465 US 513, 527, 104 SCt 1188 (1984).

[88] *Id.*