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LLC Agreement Prohibiting Bankruptcy Filing Held Enforceable

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The authors analyze a recent appellate ruling enforcing provisions contained in a limited liability company agreement that expressly barred the company, and restricted the manager, from filing a bankruptcy petition.

Courts generally agree that prepetition agreements to forgo the protections of bankruptcy are invalid as against public policy. A recent Tenth Circuit Bankruptcy Appellate Panel decision, in *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*,[1] calls this accepted premise into question by holding that provisions contained in a limited liability company agreement that expressly barred the company, and restricted the manager, from filing a bankruptcy petition were enforceable.

BACKGROUND

DB Capital Holdings, LLC ("DB Holdings") is a manager-operated Colorado limited liability company, which was formed to develop and sell a time share project in Aspen, Colorado.[2] DB Holdings has one Class A member, Aspen HH Ventures, LLC ("Aspen") and one Class B member, Dancing Bear Development, LP ("DB Development"). DB Develop-

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ment has two partners, including Thomas DiVenere. Dancing Bear Management, LLC ("Manager") is the sole manager of DB Holdings, and is owned and controlled by Mr. DiVenere. The Manager has no membership or other interests in DB Holdings.

In March 2010, DB Holdings' lender asked a Colorado state court to appoint a receiver for the company, and in May 2010 Aspen intervened in that proceeding, requesting that DB Holdings be dissolved. On the day of the hearing to consider Aspen's request, the Manager filed a Chapter 11 bankruptcy petition on behalf of DB Holdings. Mr. DiVenere signed the petition as managing member of the Manager. Shortly thereafter, Aspen filed a motion to dismiss the bankruptcy on the grounds that DB Holdings' operating agreement prohibited DB Holdings from filing a bankruptcy petition and did not authorize the Manager to file a petition for the company. The bankruptcy court granted the motion to dismiss and the Tenth Circuit Bankruptcy Appellate Panel ("BAP") affirmed.[3]

THE APPELLATE DECISION

Prohibition on Bankruptcy Filing

The LLC agreement in question provided that DB Holdings "to the extent permitted by 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 or relief under any applicable federal or state law relating to bankruptcy."[4]

DB Holdings argued that the provision, preventing it from filing for bankruptcy, was unenforceable as a matter of public policy relying on various cases finding contractual provisions prospectively prohibiting a bankruptcy filing unenforceable. It further alleged that the provision in question was coerced by the lender. Both the bankruptcy court and the BAP rejected DB Holdings' argument that the provision was unenforceable, since all of the cases relied on by DB Holdings involved agreements between a debtor and third parties. "Debtor has not cited any cases standing for the proposition that members of an LLC cannot agree among them-

selves not to file for bankruptcy, and that if they do, such agreement is void as against public policy, nor has the court located any."[5]

The courts also found no evidence of lender's coercion leading to the adoption of the provision. Yet, the BAP noted that it does not opine as to the result in cases where such a provision would be coerced by a creditor.[6]

Manager's Authority

Assuming the courts were required to disregard the provision prohibiting DB Holdings from filing a bankruptcy petition, Aspen argued that under DB Holdings' LLC agreement, the Manager lacked authority to file a bankruptcy petition for DB Holdings. The bankruptcy court held that the LLC agreement at issue precluded the Manager from commencing a bankruptcy case for DB Holdings and the BAP affirmed.

DB Holdings argued that several provisions of the LLC agreement support the Manger's authority to file a bankruptcy petition for DB Holdings. The courts rejected these arguments. First, the courts relied on the provision requiring the Manager to "conduct and operate [DB Holdings'] business as presently conducted."[7] The BAP found that "[f]iling a Chapter 11 proceeding, with the attendant (and oftentimes expensive and time-consuming) statutory duties placed on debtors-in-possession…essentially makes it impossible to conduct and operate a business as it was being conducted immediately before the filing of the petition."[8]

Next, the BAP relied on the combined effect of the provision discussed above (requiring the Manager to operate DB Holdings' business as presently conducted) and the provision of the LLC agreement providing that the Manger ceases to act in its manager capacity "upon the dissolution or bankruptcy" of DB Holdings. Because the Manager ceases to act in such capacity, the bankruptcy filing results in a complete change in management, which "is the exact opposite of 'business as presently conducted.'"[9]

DB Holdings argued that the provision granting the manager the power "required or appropriate to the management of the Company's business" authorized the manager to file the petition.[10] The BAP rejected this argument holding that "the filing of a Chapter 11 bankruptcy proceeding represents a radical departure from how any entities carries on its business

outside bankruptcy."[11]

Finally, following the same logic noted above, the BAP also held that the provision in the LLC agreement providing that the Manager has no authority, without the consent of the members, to "do any act that would make it impossible to carry on the ordinary business of the Company" acts as a de-facto restriction on the Manager's authority to file a bankruptcy case for DB Holdings without members' consent.[12] That is so the BAP held, because the bankruptcy filing "constitutes an act preventing the carrying on of ordinary business of the debtor."[13]

ANALYSIS

Agreements to prospectively prohibit future bankruptcy filings, or waive substantive bankruptcy rights, are typically found to be unenforceable as a matter of public policy.[14] While the BAP's decision can be viewed as inconsistent with this generally accepted premise, it is unclear how far the holding extends to assure lenders or other creditors that all varieties of provisions disallowing bankruptcy protection in corporate governance documents would be enforceable.

Certainly, the decision makes clear that members can agree among themselves to restrict the company from filing, and the manager's power to file, bankruptcy. But the decision should not be viewed as granting *carte blanche* approval to pre-petition agreements waiving bankruptcy protection. Nor did the court address other "bankruptcy proofing" mechanisms, such as requiring independent directors to approve a bankruptcy filing or requiring lenders to consent to amendments to operating agreements. The BAP did make one thing clear: the restriction on bankruptcy in the LLC agreement was enforceable and not void as against public policy because members are free to contract as they choose.[15]

Additionally, the court declined to "opine on whether, under the right set of facts, an LLC's operating agreement containing terms coerced[16] by a creditor would be enforceable,"[17] which begs the question why members would ever restrict themselves in this manner other than at the behest of a lender or another third party. We suspect that members are likely to place restrictions on filing bankruptcy in order to make their operating docu-

ments compliant with their lender's requirements. Therefore, in practice, the *DB Holdings* decision may not reach as far as it appears on its face, because it is likely that courts will recognize such "internal" decision making as being for the *de facto* benefit of a third party. As *DB Holdings* shows, however, one must present evidence in support of such an argument, rather than rely on conjecture.

A more interesting question may be why such a distinction is relevant to begin with. If an internal corporate governance document contains a prohibition on filing for bankruptcy, and such prohibition in and of itself is not against public policy as *DB Holdings* holds, why does the existence of a third party who may or may not receive a benefit from such provision alter the analysis? It should be obvious that the practical effect of a provision restricting a bankruptcy filing is often for the lender's benefit, and that effect is the same whether it is implied or explicit, such as by being set forth in a third party beneficiary clause. In other words, if members of an LLC are free to contract as they choose, they should also be free to confer a benefit on a third party if they deem it in the company's best interest.[18] This issue was not explored in the *DB Holdings* case.

CONCLUSION

Until the *DB Holdings* decision, it has been generally accepted that bankruptcy is virtually impossible to prevent via contract. Although it is unclear how far this decision will reach to permit broad prohibitions against filing bankruptcy, at the very least it creates an opportunity for members of an LLC to draft provisions that would maintain the LLC as "bankruptcy proof" by prohibiting a filing and restricting managers from filing. Creative drafters of internal operating documents may get some encouragement from this opinion, but ultimately the bankruptcy court has the power to determine the validity and enforceability of any such provision. Nevertheless, it can now be said that provisions prohibiting a company from filing for bankruptcy are not automatically against public policy.

NOTES

[1] No. 10-046, 2010 Bankr. LEXIS 4176 (B.A.P. 10th Cir., Dec. 6, 2010).

[2] DB Holdings' operating agreement is governed by Colorado law and is subject to the Colorado Limited Liability Act (Colo. Rev. Stat. §§ 7-8-101-1101 (West 2010)).

[3] DB Holdings is, however, the subject of an involuntary bankruptcy petition, which was filed against it in June, 2010, by five of its creditors. This serves as a reminder that having an operating agreement that makes a company "bankruptcy remote" will not prevent the successful filing of an involuntary petition.

[4] *DB Holdings*, at *6.

[5] *DB Holdings*, at *6-7.

[6] *DB Holdings*, at *7.

[7] *DB Holdings*, at *7.

[8] *DB Holdings*, at *7.

[9] *DB Holdings*, at *8.

[10] *DB Holdings*, at *10.

[11] *DB Holdings*, at *10.

[12] *DB Holdings*, at *10.

[13] *DB Holdings*, at *11.

[14] *See In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Penn. 1995) (holding that a prepetition agreement to waive a debtor's right to file further bankruptcies within 180 days from the filing of the debtor's last bankruptcy petition was unenforceable because it violated public policy); *Giaimo v. Detrano (In re Detrano)*, 222 B.R. 685, 688 (Bankr. E.D.N.Y. 1998) ("As a matter of superseding federal bankruptcy policy ..., a prepetition waiver of a discharge of a particular debt or of all debts is against public policy and unenforceable").

[15] As a natural consequence of this freedom of contract, the members can always amend the LLC agreement to authorize a bankruptcy filing. Should a lender wish to restrict the right to amend, however, it may run into the "coercion" problem discussed below.

[16] It is not clear what the term "coercion" means in this context; *i.e.* whether it implies an inequitable conduct, or rather a grave imbalance in the parties' negotiating powers.

[17] *DB Holdings*, at *7.

[18] The interplay between a contract prohibiting a bankruptcy filing and the fiduciary duties of the parties authorized to act for a company, is another issue left unexplored by the *DB Holdings* court.