by Thomas O. Wells and Jordi Guso

Asset Protection Proofing Your Limited Partnership or LLC for the Bankruptcy of a Partner or Member

Doctors, entrepreneurs, and officers and directors of public companies with exposure to potential, future claims of creditors sometimes create family limited partnerships and family limited liability companies (collectively referred to as FLPs) for estate planning and wealth preservation purposes in order to minimize their exposure to claims of potential future creditors. Through a combination of Florida laws and contractual provisions, creditors' rights are limited against assets of an FLP, including rights to foreclose upon or monetize a debtor partner's interest in an FLP. In bankruptcy, however, those laws and contractual provisions may not be recognized or enforced if the partnership or operating agreement of the FLP is found *not* to be an "executory contract."

This article provides lawyers with an outline of asset protection benefits provided by an FLP, analyzes how a bankruptcy proceeding by a partner in the FLP affects these protections, and suggests language to address the issues raised in *In re Ehmann (Movitz v. Fiesta Investments, LLC)*, 310 B.R. 200 (Bank. D. Ariz. 2005).

Florida Law FLP Creditor Protections

An FLP has two types of creditors — inside creditors and outside creditors. Inside creditor claims arise from alleged actions or omissions of the FLP. Inside creditors may levy against the assets of an FLP, but generally cannot levy against the individual assets of limited partners or members of the FLP. Outside creditor claims arise from alleged actions or omissions by a debtor partner of the FLP. This article's focus is on the rights of outside creditors to the debtor partner's interest in the FLP.

Florida law generally restricts the rights of an outside creditor to a charging order imposed upon the debtor partner's FLP interest.[1] In contrast, in a general partnership, the debtor partner's interest may be judicially foreclosed if a debtor partner's interest is subject to a charging order. Therefore, practitioners often use limited partnerships or limited liability companies — and not general partnerships — to protect and maintain the integrity of the assets of the FLP. Another reason to use a limited partnership or a limited liability company for an FLP is that the parties may contractually restrict the transferability of a debtor partner's interest in the FLP.[2] Further, an assignee of the FLP interest is not allowed to become a new or substituted partner, review the books and records of the FLP, nor vote as a partner in the FLP.[3]

Bankruptcy Law Effects on an FLP

If a debtor partner files bankruptcy, both the FLP and the other partners of the FLP can be effected. Sections 541 (property of the estate) and 365 (executory contracts and unexpired leases) of the Bankruptcy Code are critical to the analysis. Both of these sections expressly restrict or override state law and contractual terms. For example, §541(c)(1) states:

> [A]n interest of the debtor in property becomes property of the estate...notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law —
>
> (A) that restricts or conditions transfer of such interest by the debtor; or
>
> (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title...and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.[4]

Similarly, §365(e)(1) provides in pertinent part:

> Notwithstanding a provision in an executory contract... or in applicable law, an executory contract... of the debtor may not be terminated or modified, and any right or obligation under such contract... may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on —
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
>
> (B) the commencement of a case under this title; or
>
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

On the authority of §365(e)(1) that ipso facto clauses are unenforceable in bankruptcy, some bankruptcy courts have essentially "red-penned" contractual terms in an underlying partnership or operating agreement or state law provisions to prevent the automatic withdrawal of a debtor partner in an FLP or termination of the debtor partner's interest in the FLP upon the bankruptcy filing of the debtor partner.[5] Other bankruptcy courts have interpreted §365 differently and allowed the state law and contractual provisions to take effect,[6] including by looking to subsection (c) of §365, which states:

> The trustee may not assume or assign an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.

Additionally, a few bankruptcy courts have found that a partnership agreement is an executory contract,[7] while other courts have concluded that a partnership agreement is not an executory contract.[8]

On top of this analysis, bankruptcy courts also consider the effect of §541. A recent case that brings the analysis under both §§541 and 365 to the forefront is *Ehmann*. In *Ehmann*, the court analyzed the duties owed by a bankrupt member to the LLC to determine whether the operating agreement was an executory contract. The court concluded that such duties must be so material that if the member did not perform such duties, the LLC would owe no further obligations to that member.[9]

For example, the purpose in creating the LLC in *Ehmann* was to remove assets from the parents' estates for estate tax purposes and to accumulate investments for the benefit of their children after the death of the parents. The bankrupt member was not a manager. The "Rights and Obligations of Members" in the operating agreement did not impose any obligations upon the bankrupt member.[10] The only provision in the operating agreement imposing an obligation on the nonmanaging bankrupt member was the agreement by such member not to voluntarily withdraw from the LLC as a member. The *Ehmann* court determined that an agreement to refrain from acting is not sufficient to create an executory contract.[11] The *Ehmann* court found that the operating agreement's duty not to withdraw did not create an executory contract because such duty was tantamount to an option by a member to withdraw and receive $1 in payment for his membership interest with the remaining portion of such membership interest being retained by the LLC as liquidated damages.

If the FLP's partnership or operating agreement *is not* an executory contract, the bankrupt trustee's rights to the interest in the FLP are governed by the general provisions of 11 U.S.C. §541(c).[12] Section 541(c)(1) provides that an interest of the debtor becomes property of the bankruptcy estate notwithstanding any agreement or applicable law that would otherwise restrict or condition transfer of such interest by the debtor. All limitations in the FLP's partnership or operating agreement and all provisions of Florida law that restrict or condition the transfer of a debtor partner's interest in the FLP are inapplicable pursuant to §541(c)(1). Accordingly, the bankruptcy trustee has all of the rights and powers with respect to the FLP that the debtor partner held as of the filing of bankruptcy and is not limited solely to a charging order or prohibited to review the books and records of the FLP or vote as a partner or member of the FLP. The key asset protection features of an FLP are sterilized if the partnership or operating agreement of the FLP is not an executory contract.

If the FLP's partnership or operating agreement *is* an executory contract, the bankruptcy trustee's rights to the interest in the FLP are governed by the general provisions of 11 U.S.C. §§365(c) and (e).[13] Although there is some judicial ambiguity, §§365(c)(1) and 365(e)(2) allow for the enforcement of state and contract law restrictions upon a bankruptcy trustee's rights to a bankrupt partner's interest in the FLP.[14] In other words, practitioners want the FLP partnership or operating agreement to constitute an executory contract so that their asset protection terms will likely be respected in the bankruptcy of one of its partners.

"Ehmannizing" the Partnership Agreement

The *Ehmann* court focused on the

following duties by nonmanaging members and provisions of the FLP partnership or operating agreement to cause it not to be an executory contract: a) the purpose of the FLP; b) the requirement of members to make future capital contributions; c) the requirement for members to be involved in the management of the FLP; and d) the imposition of fiduciary duties upon the members. In order to "Ehmannize" the FLP partnership or operating agreement, the authors suggest that operating and partnership agreements include the following provisions:

- A provision setting forth the business purpose of the partnership so that the bankruptcy court will not frustrate such purpose and adversely affect the rights of the nonbankrupt partners or members by disregarding the partnership or operating agreement and state partnership or limited liability company laws.
- A statement that the parties desire and agree that the partnership agreement constitute an executory contract under 11 U.S.C. §365 with a summary of each duty imposed upon a partner to create the executory contract.
- A duty to make future capital contributions by each partner to the partnership.
- An obligation for each partner to comply with certain fiduciary duties owed to the other partners and the partnership.
- An obligation that each partner be involved in the management of the partnership and attend regular partnership meetings.

Summary

Cases such as *In re Ehmann* and *Sampson v. Prokopf (In re Smith)*, 185 B.R. 285, 292-293 (Bankr. S.D. Ill. 1995), hold that if the partnership or operating agreement is not an executory contract under federal bankruptcy law, then the asset protection features generally applicable to a bankrupt partner or member's interest in the FLP under state and contract law will not apply to the bankrupt partner or member's bankruptcy trustee. In order to ensure that the FLP partnership or operating agreement is an executory contract and that such asset protection features continue to apply in a bankrupt partner or member's bankruptcy, certain obligations need to be imposed upon such bankrupt partner or member and incorporated into the FLP partnership or operating agreement. These obligations include the duty to make future capital calls and to be involved in the future management of the FLP. ❑

[1] *See* FLA. STAT. §§608.433(4) (limited liability company), 620.1703 (limited partnership), and 620.8504 (general partnership). *See also Asset Protection in the Partnership Context: What's All the Hoopla?*, 68 FLA. B.J. 43 (Feb. 1994), for a summary of judicial and statutory case law addressing asset protection provided by an FLP.

[2] *See* FLA. STAT. §§620.1702(6) (limited partnership) and 608.432 (limited liability company).

[3] *See* FLA. STAT. §§608.433(1) and 608.432(2)(a) (limited liability company), 620.1702(1)(c) (limited partnership), and

620.8503(1)(c) (general partnership).

[4] 11 U.S.C. §541(c).

[5] *See Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d 608, 614 (1st Cir. 1995) (§365(e)(1) exempts the ipso facto provision included in the partnership agreement); and *Weaver v. Nizny (In re Nizny)*, 175 B.R. 934, 939 (Bankr. S.D. Ohio 1994) (upon filing of a partner's Ch. 11 petition in reorganization, §365(e)(1) prevents the ipso facto dissolution of the partnership under state law). *See also* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994) (recommendations of the National Bankruptcy Commission).

[6] Certain courts have held that the ipso facto provision is not applicable to a partnership agreement that is an executory contract pursuant to 11 U.S.C. §365(e)(1) and the bankruptcy trustee cannot disregard dissolution provisions tied to the bankruptcy filing of a partner. *See In re Sunset Developers*, 69 B.R. 710, 712-713 (Bankr. D. Idaho 1987) (§365(c) prevented §365(e) from applying to a partnership agreement); *Finkelstein v. Security Properties, Inc.*, 888 P.2d 161 (Wash. App. 1995) (§365(e)(2) clarifies Congress' intention to prevent only private contracts from counteracting the Bankruptcy Code, not to prevent state law, such as partnership law, from determining the status of a partnership); and *In re Helms*, 10 B.R. 817, 821-822 (Bankr. D. Colo. 1981) (holding that limited partnership dissolved on the day of the general partner's bankruptcy filing because under §365(c), executory limited partnership agreements cannot be assumed by a debtor-in-possession without the consent of all of the limited partners).

[7] *Sampson v. Prokopf (In re Smith)*, 185 B.R. 285, 292-293 (Bankr. S.D. Ill. 1995) (stating that a majority of courts that have found limited partnership agreements to be executory contracts "have either accepted the executory contract characterization summarily or have dealt with limited partnership agreements under which the limited partner has continuing financial obligations to the partnership); *Calvin v. Siegel (In re Siegel)*, 190 B.R. 639, 643 (Bankr. D. Ariz. 1996); and *In re Sunset Developers*, 69 B.R. at 712 (in which an obligation to contribute capital to the partnership by the debtor partner creates an executory contract); *Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d at 614 (executory contracts apply to general partner debtors who have duties and obligations to the limited partnership); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr. E.D. Va. 1996) (executory contracts apply to debtors who were managers of a limited liability company with ongoing duties and responsibilities. Because debtors' personal identity and participation were material to the development project, 11 U.S.C. §365(e)(2) exception applies); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995) (operating agreements are executory contracts because there are material unperformed and continuing obligations among the members, including participation in management and contribution of capital).

Certain obligations need to be imposed upon such bankrupt partner or member and incorporated into the FLP partnership or operating agreement.

[8] *Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 319 B.R. 200 (Bankr. D. Ariz. 2005); *In re Smith*, 185 B.R. at 291-295 (limited partnership agreement was not an executory contract as to a limited partner/debtor who had no material obligations to perform; the Ch. 7 trustee steps into the shoes of the debtor and may exercise debtor's right to dissolve the partnership); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708-709 (Bankr. E.D.Va. 2000) (there is no executory contract and 11 U.S.C. §365 does not apply to an operating agreement that imposes no duties or responsibilities on its members, but merely provides for the structure of the management of the entity).

[9] *In re Ehmann*, 310 B.R. at 204.

[10] The "Rights and Obligations of Members" in the operating agreement: 1) limited a member's liability for the LLC's debts; 2) granted the member the right to obtain a list of the other members; 3) granted the member the right to approve, by majority vote, the sale, exchange, or other disposition of all or substantially all of the assets on the LLC; 4) granted the member rights to inspect and copy LLC documents; 5) granted the member the same priority as to return of capital contributions or profits and losses; and 6) granted the permissible transferee of a member's interest the right to require the LLC to adjust the basis of the LLC's property and the capital account of the affected member.

[11] *See In re Helms*, 10 B.R. at 706, which reformulated the executory contract test following the 1984 legislative changes to 11 U.S.C. §365(n) to provide that the test focuses only on affirmative performance or obligations.

[12] *In re Ehmann*, 310 B.R. at 206.

[13] 11 U.S.C. §365(e)(2) is as follows: "Paragraph (1) of this subsection [which provides that ipso facto provisions are not enforceable] does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment; or (B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor."

[14] The judicial ambiguity is whether §365(e)(1) (providing that ipso facto provisions are unenforceable) or §§365(c)(1) and 356(e)(2) controls the rights of the bankrupt partner's interest in a partnership agreement that is an executory contract. For contrasting holdings, compare *In re Corky Foods Corp.*, 85 B.R. 903 (Bankr. S.D. Fla. 1998) (Florida partnership law dissolving a limited partnership upon the bankruptcy filing of a general partner is disregarded under §365(e)(1)); *Summit Invest. and Dev. Corp. v. Leroux*, 69 F.3d at 614; *In re Siegel*, 190 B.R. at 646; and *In re Ninzy*, 175 B.R. at 939; and *In re Cardinal Indus., Inc.*, 116 B.R. 964, 981-82 (Bankr. S.D. Ohio 1990); with *In re Sunset Developers*, 69 B.R. at 713 (§365(e) does not apply to partnership agreement and the debtor-in-possession is not entitled to assign or assume the partnership contract); *Skeen v. Harms (In re Harms)*, 10 B.R. 817, 821 (Bankr. D. Colo. 1981) (the trustee cannot assume the position of general partner of a limited partnership since he or she is not the person with whom the limited partners contracted. Thus, the partnership dissolved when the trustee was appointed); and *In re Morgan Sangamon Partnership*, 269 B.R. 652, 654 (Bankr. N.D. Ill. 2001) (reasoning that the Uniform Partnership Act general partner cannot be compelled, without consent, to accept a new partner and, therefore, ipso facto clause in the partnership agreement is enforceable).

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This column is submitted on behalf of the Business Law Section, Diane Noller Wells, chair, and Samuel A. Lewis, editor.