

## Debtor in Bankruptcy Retains Its Membership Interest in a Delaware LLC - Bankruptcy Code Trumps Conflicting Provision of the Delaware LLC Act

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The Bankruptcy Court for the Southern District of Texas (the “*Bankruptcy Court*”) recently issued a decision in *In re Envision Healthcare* holding that a debtor did not forfeit its rights (including voting and managerial rights) in a Delaware limited liability company (an “*LLC*”) by filing for bankruptcy, notwithstanding the fact that Delaware state law terminates a person’s membership interest in an LLC upon the member’s bankruptcy.<sup>1</sup>

Section 18-304 of the Delaware Limited Liability Company Act (the “*Act*”) provides that a person ceases to be a member of an LLC when that person commences a voluntary bankruptcy case.<sup>2</sup> Section 541 of the Bankruptcy Code provides that all of a debtor’s legal and equitable interests in property becomes property of the debtor’s estate upon the commencement of a bankruptcy case, notwithstanding any provision in an agreement or applicable nonbankruptcy law that effects a forfeiture, modification or termination of a debtor’s interest in property in the event of the commencement of a bankruptcy case.<sup>3</sup>

The Bankruptcy Court addressed the conflicting provisions between Delaware state law and the Bankruptcy Code and held that “Section 18-304 of the Act directly conflicts with, and must give way to, Section 541 of the Bankruptcy Code.”<sup>4</sup>

### Background

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AmSurg Holdings, LLC, one of the debtors in the *Envision* proceeding, commenced its bankruptcy case in May 2023. At the time of the bankruptcy filing, AmSurg held a 25% interest in a Delaware LLC, which granted it managerial and voting rights in the LLC. In August 2023, relying on Section 18-304 of the Act, the other two members of the LLC amended the LLC’s operating agreement without AmSurg’s vote to strip AmSurg of its voting and related managerial rights.

AmSurg brought a motion in September 2023 to enforce the automatic stay under Section 362 of the Bankruptcy Code, arguing that the actions of the other two members of the LLC to divest AmSurg of its managerial and voting rights constituted an improper attempt to control property of the estate.

### The *Envision* Decision

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The Bankruptcy Court in *Envision* noted that although some courts looking at the interplay between section 541 of the Bankruptcy Code and state law provisions, such as Section 18-304 of the Act, made a distinction between economic rights and other rights, the Bankruptcy Court did not need to opine on that issue as such a distinction was not meaningful in the context of the creation of a bankruptcy estate.<sup>5</sup> The simple issue for the Bankruptcy Court was whether all of the debtor’s rights, including its voting and managerial interests in the LLC, became estate property.

Because an estate is automatically and immediately created upon a bankruptcy filing under federal bankruptcy law, the Bankruptcy Court found that there was “no metaphysical moment in time for state law to alter or modify any prepetition legal rights between the filing of the petition and creation of the estate.”<sup>6</sup> Accordingly, the Bankruptcy Court voided the August 2023 amendment of the LLC’s operating agreement, stating that “[t]his decision clarifies that a member of a Delaware LLC who starts a bankruptcy case keeps *all* legal and equitable interest in the LLC that it held as of the commencement of the case.”<sup>7</sup>

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## *Ipsa Facto* Provisions and Conflicting Case Law

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Section 18-304 of the Act is not an unusual provision, and many other states have similar statutory provisions.<sup>8</sup> Such provisions represent a default rule that terminates a member's interest in an LLC upon the member's bankruptcy filing. The rationale for this default rule is based on the public policy view that, absent a contractual provision to the contrary, solvent members of an LLC should not be forced into relationships with a bankruptcy trustee or other parties they did not choose that result from the bankruptcy of one of their chosen co-investors.<sup>9</sup>

The conflict between state law *ipso facto* provisions terminating a member's interest in an LLC upon the member's bankruptcy filing and the Bankruptcy Code's prohibition against such provisions have generated many disputes and conflicting decisions. Some courts, like the Bankruptcy Court in *Envision*, have held that a member's bankruptcy filing does not terminate its LLC membership interests. Those courts have ruled that all of a member's rights in an LLC (including voting and managerial rights) become property of the debtor's estate, and any attempt to modify or terminate such rights violates the automatic stay.<sup>10</sup>

Other courts, including the Delaware Court of Chancery, have made a distinction between economic and other rights in an LLC and concluded that a once a member of an LLC files for bankruptcy, it loses whatever voting or managerial rights it had but retains certain economic rights.<sup>11</sup>

Many of the cases that make the distinction between economic and other rights in an LLC also look at the issue of whether an LLC's operating agreement is an executory contract or not. If the operating agreement is determined not to be an executory contract, then those courts apply Section 541 of the Bankruptcy Code and generally find that statutory or contractual *ipso facto* provisions are not enforceable. But if an operating agreement is determined to be an executory contract, then such courts find that Section 365 of the Bankruptcy Code, which deals with executory contracts and unexpired leases, governs the debtor's rights related to its membership interests rather than Section 541 of the Bankruptcy Code. And because Section 365(c) and (e) of the Bankruptcy Code provide for certain restrictions on assumption and assignment of executory contracts (e.g. for personal services contracts), analysis of the issue under Section 365 of the Bankruptcy Code often results in a finding that a member's bankruptcy filings divests the member of its voting and governance rights in an LLC, leaving it with only economic rights.<sup>12</sup>

Finally, some courts have held that the protection afforded by the Bankruptcy Code's prohibition against *ipso facto* provisions are lost after a bankruptcy case is dismissed and *ipso facto* provisions are enforceable outside of bankruptcy.<sup>13</sup>

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## Conclusion

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The *Envision* decision addresses the question of what constitutes the property of the debtor's estate under Section 541 of the Bankruptcy Code and whether Delaware state law provision that terminates a member's interest in an LLC upon the member's bankruptcy filing is preempted by federal bankruptcy law. Although courts looking at similar conflicts between statutory *ipso facto* provisions and the Bankruptcy Code have generated conflicting decisions, the *Envision* decision makes it clear that Section 541 of the Bankruptcy Code preempts Section 18-304 of the Act and any attempts to amend an LLC's operating agreement to divest a debtor of any of its rights violates the automatic stay.<sup>14</sup>

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## For More Information

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We are available at any time to answer questions, discuss scenarios, and provide guidance. Please do not hesitate to reach out to us with any questions or concerns.

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- 1 *In re Envision Healthcare Corp., et al.*, No. 23-90342, 2023 WL 8607444 \*1 (Bankr. S.D. Tex. Dec. 12, 2023).
  - 2 Del. Code Ann. title 6, § 18-304(1)(b).
  - 3 11 U.S.C. §§ 541(a)(1) and 541(c)(1)(B). Provisions that waive the right to seek bankruptcy relief, declare a default in the event of bankruptcy or insolvency, or would otherwise affect or terminate the rights of a debtor in bankruptcy are referred to as *ipso facto* provisions and are generally unenforceable in bankruptcy proceedings. See *In re Atrium Highpoint Ltd. Partnership*, 189 B.R. 599, 606 (Bankr. M.D. Fla. 1985); *In re Madison*, 184 B.R. 686, 691 (Bankr. E.D. Pa. 1995); *Matter of Pease*, 195 B.R. 431, 435 (Bankr. D. Neb. 1996); *In re South East Financial Associates Inc.*, 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997).
  - 4 *In re Envisions Healthcare*, at \*6.
  - 5 *In re Envisions Healthcare* at \*4.
  - 6 *Id.* at \*5.
  - 7 *Id.* at \* 5 (emphasis in original).
  - 8 See, e.g., *Washington Limited Liability Company Act*, RCW 25.15.131; General Statutes of North Carolina § 57D-3-02; Virginia Limited Liability Company Act § 13.1-1040.1; W. Va. Code § 31B-6-601(7); Oregon Limited Liability Company Act § 63.265.
  - 9 *Milford Power Co., LLC v PDC Milford Power, LLC*, 866 A.2d 738, 754 (Del. Ch. 2004).
  - 10 See, e.g., *Pearce v. Woodfield (In re Woodfield)*, 602 B.R. 747, 756 (Bankr. D. Or. 2019) (debtor's governance rights as an LLC member could not be terminated just because of a bankruptcy case); *Weiss v. All Year Holdings Ltd. (In re All Year Holdings Ltd.)*, 648 B.R. 434 (S.D.N.Y. 2022) (when a member of an LLC declares bankruptcy, section 541(c) of the Bankruptcy Code provides that the estate shall succeed to its interest and expressly preempts conflicting state law); *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 647, 656 (Bankr. N.D. W. Va. 2012) (“[b]ecause non-economic rights are property of the estate and fit under the canopy of § 362(a)(3), the provision in the Defendants' Resolution that disassociates the debtor is void.”).
  - 11 See, e.g., *Milford Power Co., LLC v. PDC Milford Power LLC*, 866 A.2d 738, 762 (Del. Ch. 2004) (a bankruptcy filing divests a debtor of its right to participate in the management of an LLC and debtor only retains the economic rights); *Zachman v. Real Time Cloud Servs. LLC*, 251 A.3d 115 (Table), 2021 WL 1561430 (Del. Supr. 2021) (affirming Court of Chancery's decision and finding that statutory *ipso facto* provisions similar to section 18-304 are not preempted by the Bankruptcy Code to the extent they divest members who file for bankruptcy of the right to participate in the management of the company but not of their economic rights); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 704 (Bankr. E.D. Va. 2000) (a debtor's bankruptcy estate retains the economic interest of LLC membership interest but debtor was disassociated from the LLC upon bankruptcy filing pursuant to Virginia law and no longer retained management rights); *Nw. Wholesale, Inc. v. Pac Organic Fruit, LLC*, 357 P.3d 650, 662 (Wash. 2015) (Bankruptcy Code does not preempt the state law's dissociation provisions).
- The Bankruptcy Court in *Envision* referenced the existence of Delaware Chancery Court cases that make a distinction between economic and other rights but noted that such cases “never directly confronted the broad ‘all legal and equitable interests’ requirement under § 541(a)(1) or the prohibition on ipso facto clauses based on a bankruptcy filing in § 541(c)(1) that reinforces 541(a)(1).” The Bankruptcy Court went on to state that it did not need to opine on the distinction between economic and other rights, finding that “[n]othing in the Bankruptcy Code renders the economic v. managerial distinction meaningful in the context of the creation of the estate.” *In re Envisions Healthcare* at \*4.
- 12 See, e.g., *Sheehan v. Warner (In re Warner)*, 480 B.R. 641, 649 (Bankr. N.D. W. Va. 2012) (if an LLC agreement is an executory contract, the panopoly of rules in section 365 apply to affect or alter a debtor's rights and powers in an LLC); *Weiss v. All Year Holdings Ltd. (In re All Year Holdings Ltd.)*, 648 B.R. 434, 457 (federal interest in section 541(c) of the Bankruptcy Code is notably different for preemption purposes than section 365 of the Bankruptcy Code; Section 365 considerations are not present here because the LLC is a single-member LLC, with the debtor as its only member, and section 541 vests in the bankruptcy estate all legal and equitable interest of the debtor); *Nw. Wholesale, Inc. v. Pac Organic Fruit, LLC*, 357 P.3d 650, 660 (Wash. 2015) (if the operating agreement is an executory contract, Section 365 governs the trustee's rights rather than section 541).
  - 13 See, e.g., *Miller v Parlor Furniture of Hickory, Inc.*, 79 N.C. App. 639, 641 (1986) (when a bankruptcy case is dismissed, there no longer exists any reason to benefit the debtor or preserve the assets of the bankruptcy estate by prohibiting enforcement of an otherwise valid bankruptcy termination clause); *Chrysler Financial Corp v. Fruit of the Looms, Inc.*, 1993 WL 19659 at \*4 (Del. Super. Jan. 12, 1993 (although *ipso facto* provisions are unenforceable in bankruptcy, they are enforceable outside of bankruptcy).
  - 14 We have not found any cases that have held that a member that commences a bankruptcy case loses both economic rights and managerial rights in an LLC. Cases that make the economic vs. managerial distinction generally use the rationale that a bankruptcy estate takes the former member's interests as an assignee and does not become a member of the LLC absent the consent of the other existing members; absent such consent, the estate is treated simply as an assignee with only economic rights in the LLC. See, e.g., *Nw. Wholesale, Inc. v. Pac Organic Fruit, LLC*, 357 P.3d 650, 657 (bankruptcy estate attains the status of an assignee, retaining the right to share in profits and losses but losing any management rights); *Milford Power Co., LLC v PDC Milford Power, LLC*, 866 A.2d 738, 762 (member who files for bankruptcy ceases to be a member, but becomes an assignee with economic rights).

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