

## **THE ASSOCIATION OF COMMERCIAL FINANCE ATTORNEYS, INC.**

### **LENDING TO LIMITED LIABILITY COMPANIES: Relevant Statutory Provisions Based Upon The Uniform Limited Liability Company Act (1994)**

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The following is a summary of various limited liability company statutory provisions with which counsel for a lender to a limited liability company should be familiar. These statutory provisions may in form or substance vary from state to state depending upon the text of a particular state's limited liability statute. For purposes of presentation, the Uniform Limited Liability Company Act (1994)(the "ULLCA"), approved by the National Conference of Commissioners on Uniform State Laws, is used as an illustrative model of a typical state limited liability company statute.

#### **I. ENTITY FORMALITIES**

##### **A. Entity Formation and Existence**

1. A limited liability company is a distinct legal entity.  
*ULLCA §201*

2. Unless the articles of organization provide for a delayed effective date, the existence of the limited liability company begins when the articles are filed with the [Secretary of State]. *ULLCA §202(b)*
3. Articles of organization filed with the [Secretary of State] are conclusive proof that the organizers have satisfied all conditions precedent to the creation of the limited liability company. *ULLCA §202(c)*
4. The [Secretary of State] is to furnish upon request a certificate of existence for a limited liability company. *ULLCA §208(a)*.

B. Entity Power to Incur and Secure Credit Obligations

1. Subject to state law governing or regulating business, a limited liability company may be organized for any lawful purpose. *ULLCA §112(a)*
2. A limited liability company has the same powers as an individual to do all things necessary or convenient to carry on its business. *ULLCA §112(b)*. These powers include
  - a. The power to borrow and to guaranty. *ULLCA §112(b)(5)*

- b. The power to mortgage and grant security interests in all or part of its property. *ULLCA §112(b)(4)*
- 3. A limited liability company would have the power to guaranty, and to mortgage and grant security interests in all or part of its property to secure, the debts of another person, even if to do so is not necessary or convenient to the limited liability company carrying on its own business, but only if the power to do so is set forth in its articles of organization. *See ULLCA §203(b) ("Articles of a limited liability company may set forth ... (2) other matters not inconsistent with law.")*
- 4. After dissolution, the powers of a limited liability company are limited to the purpose of winding up its business. *ULLCA §802(a)*

C. Entity Approval of Credit Transactions

- 1. An operating agreement may govern the relations among the members, managers and the limited liability company. The operating agreement need not be in writing. *ULLCA §103(a)*. The operating agreement may not restrict the rights of third parties that are not members, managers or their transferees. *ULLCA §103(b)(7)*

2. The operating agreement may not eliminate the duty of loyalty. *ULLCA §103(b)(2)*. But it may
  - a. If not manifestly unreasonable, identify certain activities that do not violate the duty of loyalty. *ULLCA §103(b)(2)(i)*
  - b. Provide for a vote of members or of disinterested managers to authorize a specific transaction after full disclosure. *ULLCA §103(b)(2)(ii)*
3. The operating agreement may vary the following provisions. *ULLCA §103(a)* ("To the extent the operating agreement does not provide, this [Act] governs relations among the members, managers and the limited liability company.")
  - a. In a member-managed limited liability company any matter relating to the business of the company may be decided by a majority of the members. *ULLCA §404(a)(2)*
  - b. In a manager-managed limited liability company
    - i. A manager is elected by a majority of the members. *ULLCA §404(b)(3)(i)*
    - ii. Any matter relating to the business of the company may be decided by the manager

or, if more than one, by a majority of the managers. *ULLCA §404(b)(2)*

4. Authorization or ratification of acts which would violate the duty of loyalty, unless otherwise excepted in the articles of organization, require the consent of all members. *ULLCA §404(c)(2)*

D. Authority of Member or Manager to Sign Credit Documents

1. In a member-managed limited liability company
  - a. An act of a member in the apparent ordinary course of the business of the company binds the company unless (i) the member did not have authority and (ii) the person with whom the member was dealing knew or had notice of the member's lack of authority. *ULLCA §301(a)(2)*
  - b. An act of a member which is not in the apparent ordinary course of the business of the company binds the company only if the member had authority. *ULLCA §301(a)(3)*
2. In a manager-managed limited liability company
  - a. A member who is not a manager has no authority to bind the company. *ULLCA §301(b)(1)*

- b. An act of a manager in the apparent ordinary course of the business of the company binds the company unless (i) the manager did not have authority and (ii) the person with whom the manager was dealing knew or had notice of the member's lack of authority. *ULLCA §301(b)(3)*
  - c. An act of a manager which is not in the apparent ordinary course of the business of the company binds the company only if the manager had authority. *ULLCA §301(b)(4)*
3. What constitutes "knowledge" and "notice"?
- a. "Knowledge" means actual knowledge. *ULLCA §102(a)*
  - b. A person has "notice" when the person knows or has reason to know. *ULLCA §102(b); see ULLCA §102(e)(dealing with notice to an entity)*
4. *Real estate exception:* unless otherwise provided in the articles of organization, the act of a member in a member-managed limited liability company, or of a manager in a manger-managed limited liability company, in granting a mortgage over real estate binds the company in favor of a person who gives value without knowledge of the lack of authority of the member or manager. *ULLCA §301(c)*

## II. FOREIGN QUALIFICATIONS

### A. Recognition of Limited Liability Company as a Distinct Legal Entity in the Foreign State

1. The laws of the jurisdiction of organization of the limited liability company govern its organization, internal affairs and the liability of its members, managers and their transferees. *ULLCA §1001(a)*
2. Same result even if the limited liability company law is different in the foreign state than in the state of the limited liability company's organization. *ULLCA §1001(b)*
3. A limited liability company in the foreign state may not exercise any power that a limited liability company organized in the foreign state cannot exercise in the foreign state. *ULLCA §1001(c)*

### B. Evidence of Authority to Transact Business in a Foreign Jurisdiction

1. Limited liability company may apply for certificate of authority to transact business in foreign jurisdiction. *ULLCA §1002(a)*

2. The [Secretary of State] of the foreign state is to furnish upon request a certificate of authority for a limited liability company. *ULLCA §208(a)*
- C. Failure to Obtain Authority to Transact Business in the Foreign Jurisdiction
1. Certain activities do not constitute transacting business in the foreign jurisdiction. *ULLCA §1003*
  2. If transacting business in the foreign jurisdiction without a certificate of authority,
    - a. The limited liability cannot maintain a lawsuit in the foreign jurisdiction.  
*ULLCA §1008(a)*
    - b. The [Attorney General] of the foreign jurisdiction may enjoin the limited liability company from transacting business in the foreign jurisdiction. *ULLCA §1009*
    - c. But
      - i. Validity of contracts by the limited liability company are not impaired.  
*ULLCA §1008(b)*

ii. The limited liability company may defend a lawsuit in the foreign state. *ULLCA §1008(b)*

iii. Limitations on the personal liability of members, managers and their transferees are not affected. *ULLCA §1008(c)*

iv. Failure to qualify may be cured for purposes of bringing a lawsuit in the foreign jurisdiction. *See ULLCA §1008(a)*

### **III. MONETARY LIABILITIES AND CLAIMS OF MEMBERS AND MANAGERS WITH RESPECT TO THE LIMITED LIABILITY**

**COMPANY**

#### **A. Recourse of Members**

1. A member or manager is not generally liable for the debts of the limited liability company. *ULLCA §303(a)*
2. But a member or manager may be liable for the debts of the limited liability company if the articles of organization so provide and the member or manager consents to that provision. *ULLCA §303(c)*

3. Where a partnership converts to a limited liability company, the liability of a general partner of the partnership who becomes a member of the limited liability company after conversion is that of a member.  
*ULLCA §902(h)*

B. Capital Contribution Obligations of a Member

1. Capital contribution provisions are enforceable notwithstanding death or disability of the member.  
*ULLCA §402(a)*
2. A creditor that extends credit in reliance upon such a provision may enforce it directly. *ULLCA §402(b)*

C. Liability of a Member for Equity Distributions

1. A limited liability company may not make an equity distribution if the company will, following that distribution, be insolvent in the bankruptcy (balance sheet) or "equity" sense. *ULLCA §406(a)*.
  - a. Whether the company may pay such a distribution is a determination that may be made by reference to financial statements, fair valuation of the company's assets or any other method that is reasonable under the circumstances. *ULLCA §406(b)*

- b. The determination is made
  - i. At the time of redemption if a member's interest is redeemed. *ULLCA §406(c)(1)*
  - ii. In other cases
    - (a) 120 days after authorization if payment is made in that 120-day period. *ULLCA §406(c)(2)(i)*
    - (b) If payment is made outside of that 120-period, then on the date of payment. *ULLCA §406(c)(2)(ii)*
- 2. Where the limited liability company incurs a permitted obligation to make an equity distribution to a member, the member becomes a creditor of the company for the amount of that distribution. *ULLCA §406(d)*
  - a. The member's creditor claim is at parity with the claims of the company's general unsecured creditors. *ULLCA §406(d)*
  - b. Incurrence of indebtedness for a distribution not otherwise permitted is permitted if payment of interest and principal is limited to payments that would at the time be permitted. *ULLCA §406(e)*

3. A member of a member-managed limited liability company or a member or manager of a manager-managed limited liability company who votes in favor of or assents to an equity distribution which is not permitted is generally personally liable to the company.

*ULLCA §407(a)*. But

- a. A member of a manager-managed limited liability company who is not a manager is liable for an unlawful distribution only if the member knew that the distribution was unlawful.

*ULLCA §407(b)*

- b. An action against a member or manager who received an unlawful distribution must be brought within two years after the date of distribution. *ULLCA §407(d)*

D. Rights of Member for Compensation and Indemnification from the Limited Liability Company

1. Absent a provision in the articles of organization or the operating agreement to the contrary, a member is not entitled to reumuneration for services performed merely as a member, except for reasonable compensation for services in the winding up of the business. *ULLCA §403(d)*

2. A member is entitled to compensation and indemnification for payments made for the benefit of the limited liability company relating to the ordinary course of its business or its preservation. *ULLCA §403(a)*
- E. Rights of Member To Receive Repayment of the Member's Loans to the Limited Liability Company
1. Where a member makes an advance to a limited liability company in excess of his agreed capital contribution or is entitled to compensation or indemnification for payments, the advance or amount is considered an interest-bearing loan by the member to the company. *ULLCA §403(c)*
  2. The interest rate applicable to the loan is, absent agreement to the contrary, at a statutory rate. *ULLCA 104(b)*
  3. On winding up the member's loan is treated on a parity with claims of general, unsecured creditors of the company. *See ULLCA §806(a)*

#### **IV. THE GRANTING OF A SECURITY INTEREST IN A MEMBER'S INTEREST IN A LIMITED LIABILITY COMPANY**

A. Nature and Evidence of A Member's Interest in a Limited Liability Company

1. A member's interest in a limited liability company is personal property. *ULLCA §501(b)*
2. The operating agreement may provide for a member's interest to be evidenced by a certificate of company interest. *ULLCA §501*
3. Characterization under the Uniform Commercial Code
  - a. 1991 Official Text
    - i. A member's interest in a limited liability company evidenced by a certificate of company interest would likely be viewed to be a "certificated security" under Article 8. *UCC §8-102(1)(a)*
    - ii. A member's interest in a limited liability company *not* evidenced by a certificate of company interest would likely be viewed to be a "general intangible" under Article 9. *UCC §9-106.*
      - (a) The interest would be unlikely to be viewed as an "uncertificated security" under Article 8 since

limited liability company interests do not currently appear to be "of a type commonly dealt in on securities exchanges or markets." *UCC §8-102(1)(b)*

(b) A careful practitioner advising a lender taking a security interest may nevertheless require perfection on the basis that the interest might be viewed as either a general intangible or an uncertificated security.

b. 1994 Official Text (incorporating Revised UCC Article 8 (1994))

i. A member's interest in a limited liability company would not be considered a "security" (even if evidenced by a certificate) governed by Revised Article 8 unless (i) the interest were dealt in or traded on a securities exchange or in a securities market or (ii) the articles of organization (or possibly the operating agreement) provided that members' interests in the company would be governed as securities under Revised Article 8. *Rev. UCC §8-103(c)*

- ii. A member's interest in a limited liability company that is not governed as a security under Revised Article 8 would
  - (a) If evidenced by a certificate, be considered an "instrument" governed by Article 9. *Rev. UCC §9-105(1)(i)*
  - (b) If not evidenced by a certificate, be considered as a "general intangible" governed by Article 9. *Rev. UCC §9-106*

B. Transferability of a Member's Interest in a Limited Liability Company

- 1. A member's interest in a limited liability company is generally transferable. *ULLCA §501(b)*
- 2. But
  - a. Absent admission of the secured party as a member,
    - i. The grant of a security interest entitles the secured party only to receive distributions to which the member would have been entitled. *ULLCA §502*

- ii. The secured party is not entitled to participate in the management of the company, receive financial information or have access to the books and records of the company. *ULLCA §503(d)*
- iii. The secured party is entitled
  - (a) To seek a judicial winding up of the company if the term of the company has expired. *ULLCA §503(e)(2)*
  - (b) To a recent statement of account of a winding up agreed to by all members. *ULLCA §503(e)(1)*
- b. A secured party or its transferee on foreclosure may not be admitted as a member unless otherwise provided in the operating agreement or unless all other members consent. *ULLCA §503(a)*
- c. Upon the foreclosure of the security interest the member ceases to be a member of the limited liability company. *ULLCA §502*
- d. A transferee who becomes a member is not liable for pre-admission liabilities but is liable for the transferor's capital contribution obligations and

unlawful distribution obligations if known to the transferee. *ULLCA §503(b)*

- e. A secured party that obtains a judgment against the member must follow the procedures of the ULLCA for a judgment creditor to obtain and exercise rights under a judicial charging order in order for the secured party to foreclose on the member's interest. *ULLCA §504(e)*

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**Limited Liability Companies – Anticipating the Bankruptcy Issues**

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The limited liability company has swept the country with tremendous speed and shortly every state will have some version of an LLC statute on its books. Already there are thousands of LLCs doing business around the country. The spread of the LLC has yet to reach the bankruptcy courts, however. Thus, while LLCs give rise to certain new issues in bankruptcy law, none of the issues have been addressed as of today in the reported cases. The following outline raises some of the questions that can be anticipated and, in some cases, suggests what the correct answer should be

Over the short-term of at least the next five years, there is likely to be uncertainty in several important areas of bankruptcy law as it applies to bankrupt LLCs and LLC members and managers. This is principally because the relationships among LLCs

and their members and managers do not fit neatly into the established molds for either corporations or partnerships. An LLC is truly distinct from both corporations and partnerships in fundamental respects. Likewise, a member's interest in an LLC is different from the relationship of a shareholder to a corporation or of a partner to a partnership. Most commentators to date have assumed that courts will define the relationships among the parties to LLCs in the bankruptcy context by drawing analogies from both corporations and partnerships. Although that is probably an accurate prediction, a party to a bankruptcy case whose position is not helped by such analogies should be able to argue that the court must look at novel LLC issues afresh, in terms of the economic and control relationships that are unique to LLCs, rather than solely by drawing analogies from the corporate and partnership contexts.

## **I. Commencement of Bankruptcy Case**

### **A. Eligibility to be a Debtor**

1. Section 101 (9) of the Bankruptcy Code defines "corporation" as follows:

- (9) "corporation" -
- (A) includes -
    - (i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;
    - (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;
    - (iii) joint-stock company;
    - (iv) unincorporated company or association; or
    - (v) business trust; but
  - (B) does not include limited partnership;

2. Both corporations and partnerships are within the definition of a "person" eligible to file a petition under Chapters 7 and 11, so an LLC presumably is eligible to do so, too. See 11 U.S.C. §§ 101 (41), 109.

## B. Venue

1. A bankruptcy case may be commenced in the district “in which the domicile, residence, principal place of business in the United States, or principal assets in the United States” of the debtor have been located for the 180 days preceding the commencement of the case. 28 U.S.C. § 1408 (1).

2. Under the foregoing statute it is clear that an LLC can file (or have a petition filed against it) in the state where its principal place of business is located or where its principal assets are located.

3. Wherever the case is filed, the law of the state of formation will govern the rights of members and managers among themselves.

### 4. Brainteasers:

a. Can an LLC be a debtor in the state under whose laws it was formed if neither the principal place of business nor the assets nor any members or managers are located there? By analogy to corporate law the answer would be yes. *See Suttle v. Reich Bros. Co.*, 33 U.S. 163 (1947). Drawing an analogy from the partnership context would lead to the opposite conclusion. *See, e.g., In re Washington, Perito & Dubuc*, 154 B.R. 853, 857 (Bankr. S.D.N.Y. 1993); *In re Vienna Park Properties*, 120 B.R. 320 (Bankr. S.D.N.Y. 1990).

b. Does the answer to (a) change if all or most of the members or managers are located in the state of formation but the assets and principal place of business are somewhere else?

c. If assets and members are evenly split between two states and there is no principal place of business, where should the bankruptcy case be filed? In which court within the state? What happens if the filing is made in the “wrong” court?

## C. Authority to file a petition on behalf of an LLC

1. Where the operating agreement provides an answer, that will control.

2. Who has authority to file where the operating agreement does not supply an answer? The answer will be supplied by the LLC statute under which the entity was organized but the statute might not provide a clear answer. For instance, if the filing of a petition is viewed as equivalent to a dissolution, the consent of all members may be required. *See, e.g.*, Del. Code Ann. § 18-801. On the other hand, a majority vote of the members may be all that is necessary. *See, e.g.*, Del. Code Ann. § 18-402.

3. What evidence of authority needs to be filed with the Bankruptcy Court under local rules of procedure at the time the petition is filed?

## **II. Who is a Party in Interest?**

A. The usual approach to determining who is a party in interest is to look to Bankruptcy Code § 1109 (b). Under that “definition”, there is no doubt that members and managers are parties in interest in a bankruptcy of the LLC. Likewise, an LLC will be a party in interest in the bankruptcy of one of its members or managers. But will other members or managers of the LLC be parties in interest in the bankruptcy of one member or manager? A corporate analogy would suggest not but a partnership analogy leads in the opposite direction.

B. A member or manager may be a party in interest in the LLC’s bankruptcy, but what are their interests? The answers to this question are not self-evident. A member may be sort of like a shareholder, sort of like an officer and may also be an employee at the same time that he or she can be viewed merely as a party to an executory contract (the operating agreement of the LLC). It is likely that for a number of years Bankruptcy Courts will not know exactly what to make of such parties when they appear in LLC bankruptcies, particularly in cases involving disputes over control.

## **III. Executory Contract Issues**

A. Are LLC operating agreements executory contracts? Does the answer depend on whether the debtor is the LLC itself as opposed to a member or manager? If the agreement is an executory contract and it is rejected, what are the consequences both on issues of control and with respect to the rejection claim? Is the claim of a member whose membership interest is rejected on a par with the claims of general unsecured creditors? If not, why not?

B. Issues involving bankruptcies of members or managers

1. In bankruptcies involving LLC members or managers there will be a question as to whether the filing terminates the debtor's interest in the LLC because operating agreements or the relevant state statute may so provide by an *ipso facto* clause. Thus, one question likely to be addressed by Bankruptcy Courts soon in the context of LLCs is whether such provisions are enforceable in light of the general prohibition of *ipso facto* clauses under Section 365 of the Bankruptcy Code. Commentators appear to believe that the courts will look to bankruptcy cases involving partnerships for the answer but there is not a consistent answer in the partnership context. *See generally*, Note, 77 Minn. L. Rev. 953 (1993).

2. What will be the effect of a manager's bankruptcy on management of the LLC? What if the bankrupt manager is an LLC itself with its own creditors?

3. What is the effect of rejection on the pledgee of a bankrupt member's interest in the LLC?

C. Issues involving bankruptcies of LLCs

1. The potentially executory nature of the LLC operating agreement raises interesting questions (i.e., creates uncertainty) in fundamental areas of control and economics.

2. Can the managers of a manager-managed LLC reject the operating agreement early in the case and thereby cut off members' control/voting rights in the LLC? Can the managers alter their fiduciary obligations (whatever they may be) to members by this device? Can members force assumption or rejection of the operating agreement? In a control fight among members and managers, who should the court listen to? All of these questions and others like them will require courts to examine and define the relationships among parties to LLCs.

3. If an LLC debtor rejects the operating agreement, what is the nature of a member's or manager's rejection claim? What priority does the rejection claim have as against general unsecured creditors? Should an LLC be permitted to reject its own operating agreement during a case or should the rejection/assumption issue always be a plan issue?

4. What are members' voting rights on a plan of reorganization? What about managers? During the debtor's exclusive period who has the right to file a plan on the debtor's behalf?

5. Cramdown under Section 1129(b) is another area in which the way to treat LLC debtors is not clear. One question is whether an LLC debtor can alter its operating agreement pursuant to a plan over the objection of a dissenting class of members. Although the intuitive answer is yes, if the operating agreement is an executory contract this result runs contrary to cases holding that debtors must assume executory contracts "as is" and do not have the unilateral power to alter them. In addition, it is not entirely clear how the various tests under Section 1129(b) should be applied to a dissenting class of members or managers.

6. The nature of the fiduciary obligations that run among an LLC and its members and managers in bankruptcy contexts is also not self-evident.

7. In real estate cases, uncertainty as to the status of members and managers may create new opportunities for debtors to create friendly impaired classes under plans of reorganization intended to cram down lenders.

#### **IV. State Law Insolvency Issues**

##### **A. Piercing the "LLC veil"**

1. Because of the limited liability of members that is likely to be a feature of virtually every LLC, creditors of insolvent LLCs will want to avail themselves of common law corporate veil-piercing theories whenever there is a deep pocket that can thereby be reached.

2. The undercapitalization approach to piercing the corporate veil is likely to be applied in the same fashion in the context of LLCs as it would in the case of a corporation. The alter ego/failure to observe “corporate” formalities theory may require some adaptation to LLCs as courts determine what the “corporate” formalities of an LLC are.

3. It is hard to see a way in which managers and members of an insolvent LLC will face the potential exposure that limited partners who have participated in management face under Section 723(a) of the Bankruptcy Code.

B. Can conversion from a partnership to an LLC be a fraudulent conveyance? Is it a conveyance at all?

1. The applicable LLC statute may make it easy for partnerships to convert to LLCs. For instance, the Connecticut statute makes conversion effective upon the filing of LLC articles of organization that include certain statutorily prescribed statements. Conn. Gen. Stat. § 34-199. The Connecticut statute further provides that after conversion, the resulting LLC “shall be deemed for all purposes the same entity that existed before the conversion . . . .” Conn. Gen. Stat. § 34-200.

2. In light of the foregoing, does the act of conversion constitute a conveyance? Suppose the conversion occurred as part of a scheme to hinder, delay or defraud creditors? Such an intent could exist even though it is clear that conversion does affect the entity’s obligations to any pre-conversion creditor.

## **V. Multi-State Issues**

A. In the case of an LLC with members in more than one state, one of which does not yet have an LLC statute, do members in the non-LLC state enjoy the same limited liability as members in the LLC state? Does the answer depend on where the creditor in question is located or where the bankruptcy case is filed?

B. If members in the non-LLC state are more exposed than members in the LLC state, how much protection do they get from pre-existing creditors of the LLC when their state subsequently adopts an LLC statute?