THE IMPACT OF YOUR PARTNER'S BANKRUPTCY ON YOUR JOINT VENTURE

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This article contains a general overview of the law, but consideration of the facts and circumstances must be given to each situation. The views expressed in this article are solely those of the authors, and the statements made in this article may not reflect positions that have been, or may be, taken by Sidley Austin LLP or its partners.

I. INTRODUCTION

In a joint venture, a bankruptcy filing by your co-venturer can present serious consequences to your interest in the joint venture. Under § 365(a) of Title 11 of the United States Code (the "Bankruptcy Code"), a debtor in bankruptcy has the ability to assume or reject its executory contracts, subject to certain limitations. Often, a joint venture's operating agreement will be characterized as an executory contract and, thus, subject to assumption or rejection under the Bankruptcy Code by the co-venturer that filed for bankruptcy protection.[1] This article examines the effect of such assumption or rejection on the non-filing joint venture members.[2]

For purposes of this article, assume the following hypothetical: Prosper, who has a long history of developing widgets, has a new and long-awaited widget but lacks the financial capital to fully develop it on its own. Flounder, on the other hand, is a successful marketer and distributor of products such as the widget and also happens to be looking for an investment. Prosper and Flounder decide to form a joint venture under which Prosper contributes a few widget-related patents, employees, and its know-how, and Flounder contributes its marketing and distribution processes, employees, and cash.

Prosper and Flounder organize their joint venture as a Delaware limited liability company (the "Joint Venture") and enter into an operating agreement (the "Operating Agreement") that includes the following customary provisions: (1) The Joint Venture is to be manager managed, with Flounder as the initial manager; (2) the manager of the Joint Venture will be charged with the power to take all actions which may be necessary or appropriate for the continuation of the Joint Venture's valid existence as a limited liability company and the accomplishment of the Joint Venture's purposes (subject to certain limitations described herein); (3) Prosper can remove Flounder as the manager in the event Flounder fails to observe any material term, covenant, or agreement to be performed or observed by Flounder under the Operating Agreement, *provided*, *however*, that such removal shall constitute a liquidating event, at which point the Joint Venture will dissolve and commence winding up; (4) the bankruptcy of the Joint Venture, or any member thereof, will be a liquidating event, at which point the Joint Venture will dissolve and commence winding up; and (5) no member may transfer, pledge, or assign all or any portion of its interest in

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1. *See infra* Part III. An agreement is generally determined to be executory if there are ongoing performance obligations (other than obligations merely involving the payment of money) on the part of both parties to the agreement.

2. For purposes of this article, assume the joint venture is formed under the laws of the State of Delaware as a limited liability company. As a practical matter, the joint venture could be formed as a Delaware limited partnership, and the results would be substantially similar.

the Joint Venture without the consent of the other member, unless such transfer is to an affiliate of such member.

While Prosper and Flounder initially had 49% and 51% interests in the Joint Venture, respectively, a series of capital infusions resulted in Flounder's interest in the Joint Venture growing to 65%. As things turn out, the Joint Venture is wildly successful, and Flounder's interest therein is its most valuable asset. But Flounder's other investments have all done poorly, and Flounder is now forced to file a voluntary petition under the Bankruptcy Code. As is commonly the case when entities voluntarily file for bankruptcy, Flounder needs time to restructure some of its debt obligations that have become unmanageable and anticipates using the protections afforded under the Bankruptcy Code to do so.

Prosper, upon learning of Flounder's action, is surprised and worried about what this means for the Joint Venture. Prosper has devoted almost all of its time and resources to the Joint Venture, and its interest therein has become its most valuable asset as well. Now faced with the possible dissolution of the Joint Venture, Prosper wonders what its rights and remedies will be.

Because they organized the Joint Venture under the laws of the State of Delaware, the interpretation of the terms of the Operating Agreement and the effect that Flounder's bankruptcy filing will have on the Joint Venture will be determined under Delaware law and applicable bankruptcy law. Part II analyzes the salient provisions of the Operating Agreement and the applicable provisions of the Delaware Limited Liability Company Act (the Delaware Act),[3] while Part III addresses the effect of bankruptcy laws on the applicable provisions of the Operating Agreement and the Delaware Act.[4] Finally, Part IV concludes with a practitioner's guide that contains certain considerations and recommendations for advising clients that are either forming a new joint venture or facing a joint venture partner's looming bankruptcy.[5]

II. RELEVANT PROVISIONS OF THE OPERATING AGREEMENT AND APPLICABLE DELAWARE LAW

A. Dissociation of Flounder from the Joint Venture

The Delaware Act provides that, unless otherwise provided in the limited liability company operating agreement or with the written consent of all members, a person ceases to be a member of a limited liability company if such person, among other things, "(i) [m]akes an assignment for

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3. *See infra* Part II.
4. *See infra* Part III.
5. *See infra* Part IV.

the benefit of creditors; (ii) [*f*]*iles a voluntary petition in bankruptcy*; [or] (iii) [i]s adjudged bankrupt or insolvent . . . ."[6] While the Operating Agreement provides for the dissolution of this hypothetical Joint Venture in the event of a member's bankruptcy filing, it does not expressly address the disassociation of a bankrupt member; therefore, the default provision under the Delaware Act will govern.[7] Accordingly, Flounder will cease to be a member of the Joint Venture absent a contrary outcome resulting from the application of applicable bankruptcy law.[8] Although Flounder will lose its membership interest in the Joint Venture under Delaware law, such loss will not affect Flounder's right to receive the economic benefits of its membership interest (e.g., the right to receive distributions or dividends).[9]

B. Effect of Bankruptcy on Managerial Rights

Flounder is appointed under the Operating Agreement as the managing member of the Joint Venture and afforded very broad powers to act as the Joint Venture's manager. The Delaware Act does not provide for the immediate cessation and removal of a manager of a limited liability company from its managerial position upon its filing for bankruptcy.[10] Instead, the Delaware Act provides that "*a manager shall cease to be a manager as provided in the limited liability company agreement.*"[11] Where, as here, the Operating Agreement does not expressly provide that the debtor-member shall cease to be a manager upon filing bankruptcy, the debtor-member may, in theory, continue serving as manager of the Joint Venture in the event the debtor-member files for bankruptcy.[12]

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6. DEL. CODE ANN. tit. 6, § 18-304 (2014) (emphasis added).
7. *See supra* Part I.
8. *See infra* Part II.B.
9. *See infra* Part II.D.
10. Note, however, that if the joint venture formed as a limited partnership, many states' limited partnership statutes would provide for a loss of a general partner's partnership rights when the general partner files a petition in bankruptcy. *See* ALASKA STAT. ANN. § 10.50.225(a) (2012); CAL. CORP. CODE § 15906.03 (West 2012); DEL. CODE ANN. tit. 6, § 17-402(a)(4) (2012); KAN. STAT. ANN. § 56-1a252 (2011); N.Y. P'SHIP LAW § 121-402(d) (McKinney 2012) ("A person ceases to be a general partner of a limited partnership . . . unless otherwise provided in the partnership agreement or approved by all partners, [if] the general partner . . . is the subject of an order for relief under Title 11 of the United States Code [or] files a petition or answer seeking for himself any reorganization, arrangement, composition, readjustment, liquidation, dissolution, or similar relief under any statute, law or regulation . . . ."); TEX. BUS. ORGS. CODE ANN. § 153.155(a)(4) (West 2013).
11. DEL. CODE ANN. tit. 6, § 18-402 (emphasis added).
12. *See id.*; *see also supra* Part I.

C. Dissolution and Winding Up

1. Dissolution of the Joint Venture

The Delaware Act states the following:

> [U]nless otherwise provided in the limited liability company agreement, the . . . bankruptcy or dissolution of any member [of a limited liability company] shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution.[13]

Similar to the case under the Delaware Act with respect to the dissociation of members of limited liability companies, an operating agreement may vary the Delaware Act's default provision and provide for a different outcome.[14]

In this example, the Operating Agreement expressly provides that the Joint Venture shall dissolve and commence winding up and liquidating upon the bankruptcy of any member.[15] As a result, absent a different outcome resulting from the operation of bankruptcy law, Flounder's bankruptcy filing will cause the dissolution and liquidation of the Joint Venture.

2. Winding Up and Liquidation of the Joint Venture

If a liquidation event occurs and such provision is operative under applicable law, the joint venture will be liquidated in accordance with the terms of its operating agreement. In this example, the Operating Agreement provides that all remaining assets of the Joint Venture, after payment to the Joint Venture's creditors, shall be distributed by the Joint Venture to its members on a pro rata basis, in accordance with each member's percentage interest in the Joint Venture.[16]

D. Transfer and Pledge of a Member's Membership Interest

While the Operating Agreement generally restricts a member's ability to transfer its membership interests, as is commonly the case in operating

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13. DEL. CODE ANN. tit. 6, § 18-801(b).

14. *See id.* at § 18-1101.

15. *See supra* Part I. Although generally not enforceable during the pendency of a bankruptcy unless certain exceptions apply, this provision is fairly common in joint venture agreements. Parties to a joint venture will likely want to avoid—or at least maximize their opportunity to avoid—dealing with a financially insolvent member with economic incentives that ultimately harm the long-term prospects of the venture and its members and the reputational risk arising from an association with such a member.

16. *See supra* Part I.

agreements, a member may transfer its membership interests without the consent of other members if the transfer is to an affiliate of such member.[17] Under this provision, Flounder is technically permitted to transfer its interests in the Joint Venture to a non-filing affiliate (i.e., an affiliate not filing a bankruptcy petition) to avoid the effects of a bankruptcy filing (e.g., its potential dissociation as a member and the dissolution of the Joint Venture).[18] Even so, Flounder is unlikely to do so if it needs to use its interest in the Joint Venture to pay creditors as part of its reorganization. Moreover, if Flounder had (with Prosper's consent) pledged its interest in the Joint Venture as security for its other obligations, it would most certainly not transfer its interest in the Joint Venture to a non-filing affiliate.

Assuming Flounder's purpose for filing bankruptcy is to restructure its debt, Flounder must subject itself to the jurisdiction of a bankruptcy court so that its property will be subject to the protections of the bankruptcy court's automatic stay.[19] That is, if Flounder pledges its assets as collateral (i.e., the membership interests in the Joint Venture) absent a bankruptcy filing by Flounder, the protections of the automatic stay afforded a debtor in a Chapter 11 case will not protect Flounder's membership interests in the Joint Venture.[20] As a result, Flounder's secured lenders could proceed to exercise their remedies with respect to the collateral.[21] In such a scenario, transferring Flounder's interests in the Joint Venture to a non-filing affiliate would not prevent Flounder's interests from being foreclosed upon or pressure Flounder's lenders to restructure or reduce Flounder's debt.

In sum, absent bankruptcy law providing for a different outcome, the Delaware Act and the Operating Agreement provide that the initiation of a Chapter 11 case by Flounder will result in (1) the dissociation of Flounder from the Joint Venture; (2) the potential cessation of Flounder's managerial rights despite the literal or theoretical protection of such rights under the Delaware Act; (3) the dissolution and liquidation of the Joint Venture; and (4) the distribution of the Joint Venture's property and assets in accordance with the Operating Agreement.[22]

III. EFFECT OF BANKRUPTCY LAW ON THE OPERATING AGREEMENT

Before turning to the effect of bankruptcy law on the specific provisions of the Operating Agreement and the Delaware Act, we first note

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17. *See supra* Part I ("[N]o member may transfer, pledge, or assign all or any portion of its interest in the Joint Venture without the consent of the other member, unless such transfer is to an affiliate of such member.").

18. Note that if such a transfer to a non-filing affiliate is contemplated, the transferor must avoid such transfer being construed as an actual or constructive fraudulent transfer.

19. *See* 11 U.S.C. § 362 (West 2014); *see also infra* Part III.

20. *See infra* Part III.B.

21. *See infra* Part III.B.

22. *See* DEL. CODE ANN. tit. 6, § 18; *see also supra* Part I.

some basic principles of bankruptcy law. First, upon the filing of a bankruptcy petition, an automatic stay takes effect.[23] The stay, which is codified under § 362 of the Bankruptcy Code, generally precludes the commencement or continuation of any action against the debtor and any act to obtain possession of property of the debtor's estate.[24] In a case under Chapter 11, the automatic stay remains in effect until the bankruptcy court enters an order modifying the automatic stay on request or when a Chapter 11 plan becomes effective.[25] As long as the stay is in effect, parties are precluded from taking actions against the debtor absent a lifting of the stay by the bankruptcy court; this includes the exercise of remedies under contracts with the debtor (e.g., the Operating Agreement).[26]

In addition to being afforded the protections of the automatic stay, a debtor has the ability to "assume or reject executory contracts and unexpired lease[s] of the debtor" under § 365(a) of the Bankruptcy Code.[27] Although the test to determine whether a contract is "executory" may vary slightly depending on the jurisdiction in which the bankruptcy case is filed, a court will generally characterize a contract as executory if there are ongoing future performance obligations on the parts of both the debtor and the counterparty to the contract that do not merely involve the payment of money by one party to the other.[28] If, for example, the debtor owes future performance obligations under the terms of the contract, but the other party has no future performance obligations, the court will not characterize the contract as executory; accordingly, the debtor will not have the ability to assume or reject the contract under Bankruptcy Code § 365(a).[29] If the court finds that the contract is non-executory, the debtor is not afforded the option in bankruptcy to assume or reject the contract, and the court will

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23. 11 U.S.C. § 362.

24. *Id.* Although § 362(b) of the Bankruptcy Code contains a number of exceptions to the applicability of the automatic stay, none are relevant to the analysis contained in this article.

25. 11 U.S.C. § 362(c). Upon the effectiveness of a Chapter 11 plan, the automatic stay is replaced by the discharge and injunction provisions of §§ 1141(d) and 524(a) of the Bankruptcy Code. Section 1141(d) provides for the discharge of all debts that arose before confirmation of the plan of reorganization, except as otherwise provided in the plan itself or in the order confirming the plan. Additionally, § 524(a) effectuates the discharge of claims by operating as an injunction against the commencement or continuation of any act to collect or recover a discharged claim.

26. 11 U.S.C. § 362.

27. *Id.* § 365. A debtor is not forced to assume or reject each of its executory contracts and, in fact, can chose to let an executory contract pass through the bankruptcy, in many jurisdictions, unaffected. The so-called "pass through" doctrine is a creation of case law and, while useful in certain circumstances, can result in numerous adverse consequences to the debtor. This article does not attempt to address the pass through doctrine or the potential effects of its use.

28. *See infra* Part III.A.

29. *See infra* Part III.A. For example, ongoing service or consulting contracts are generally viewed as executory contracts because the consultant has the continuing obligation to provide the agreed upon services, and the hiring party has the continuing obligation to pay the agreed upon fees. In contrast, promissory notes and guaranties are generally not deemed executory contracts because performance is due by only one party (in this case by the borrower or the guarantor) and merely involves the payment of money.

treat the debtor's obligations under the agreement as claims under the Chapter 11 plan.[30]

If the debtor elects to assume an executory contract, it must cure all defaults under the contract, if any, at the time of its assumption. The effect of such assumption is to elevate any claims arising under the contract to administrative claim status.[31] If, on the other hand, the debtor elects to reject an executory contract, the court will treat the rejection as a breach of the contract that occurred immediately prior to the filing of the bankruptcy petition; although somewhat dependent on the law of the federal circuit where the case was filed, rejection generally is not considered a complete termination of the contract.[32] Upon the rejection of a contract, the non-debtor counterparty to the contract will have a claim for its damages resulting from the rejection (i.e., breach) of the contract, and the claim will be treated as an unsecured prepetition claim, which is not entitled to priority as an expense of the administration of the estate.[33]

A. Characterization of the Operating Agreement as Executory and Introduction to Bankruptcy Code §§ 365(c) and (e)

Limited liability company operating agreements that impose duties and responsibilities upon the members (e.g., obligations to vote on major decisions, ongoing management obligations, inability to withdraw as a member, or obligations to make additional capital contributions), as opposed to merely providing structure for the management of the company, are generally characterized as executory contracts and, thus, are subject to a debtor's assumption or rejection in bankruptcy under § 365 of the Bankruptcy Code.[34] Assuming the court finds the Operating Agreement to

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30. *See* 11 U.S.C. § 365.

31. *Id.* § 503(b). An administrative claim is one that has priority over the payment of all of the debtor's unsecured prepetition claims. *Id.*

32. *See generally* Eastover Bank for Sav. v. Sowashee Venture (*In re* Austin Dev. Co.), 19 F.3d 1077, 1082 (5th Cir. 1994) ("[The Fifth, Eighth and Sixth Circuits] have held that [§ 365(g) of the Bankruptcy Code] does not mean that the executory contract or lease has been terminated, but only that a breach has been deemed to occur."). *See also* Med. Malpractice Ins. Ass'n v. Hirsch (*In re* Lavigne), 114 F.3d 379, 386–87 (2d Cir. 1997) ("[R]ejection of the debtor's executory contract constitutes a breach of the contract [and,] [w]hile rejection is treated as a breach, it does not completely terminate the contract."); *In re* Fleming Cos., Inc., No. 03-10945, 2007 WL 788921 (D. Del. Mar. 16, 2007) (upholding a bankruptcy court's ruling that rejection under § 365(g) of the Bankruptcy Code constitutes a breach of the rejected contract, not a termination); Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992).

33. *See In re Lavigne*, 114 F.3d at 379.

34. *See In re* Daugherty Constr., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995); Broyhill v. DeLuca (*In re* DeLuca), 194 B.R. 65 (Bankr. E.D. Va. 1996) (holding that limited liability company agreements are executory contracts where parties have ongoing duties and responsibilities); Milford Power Co. v. PDC Milford Power, LLC, 866 A.2d 738, 750 (Del. Ch. 2004) ("[T]he substantial weight of federal authority . . . treats agreements for the operation of entities like limited partnerships and LLCs as executory contracts when those agreements contemplate an important, on-going role for the debtor in management."); *In re* Strata Title, LLC, No. 12-24242, 2013 WL 1773619 at *2 (Bankr. D. Ariz. April

be executory, Flounder will be able to either assume or reject the Operating Agreement absent the operation of other subsections of § 365 of the Bankruptcy Code.[35]

In particular, two provisions of § 365 of the Bankruptcy Code that may modify the debtor's right to assume a contract include § 365(e)(1) and (2), and § 365(c). Section 365(e)(1) and (2) provides that a contractual provision requiring the termination of the agreement based upon a debtor's bankruptcy filing (a so-called *ipso facto* clause) will *not* be given effect *unless* (a) applicable law excuses the counterparty to the contract from accepting performance from the trustee or assignee of such contract, and (b) the counterparty to the contract objects to the debtor's efforts to assume or assign the applicable contract. Similarly, § 365(c) provides that, although a debtor may generally assume and assign an executory contract, it may not assume a contract if (a) applicable law would excuse the counterparty to the contract from accepting performance from a person other than the debtor, and (b) the counterparty objects to the debtor's effort to assume or assign the contract.[36]

In accordance with these provisions, bankruptcy law generally overrides contractual provisions requiring the termination of a contract upon a party's bankruptcy filing or limiting a debtor's ability to assume and assign its contracts.[37] The exceptions to these provisions, which hinge on applicable non-bankruptcy law and the absence of a counterparty's

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25, 2013) (holding an operating agreement to be executory and stating that "a contract is executory if the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other"). *But see In re* Garrison-Ashburn, L.C., 253 B.R. 700 (Bankr. E.D. Va. 2000) (holding that where a limited liability company agreement merely provides structure for the management of a company but imposes no duties or responsibilities on the members, the agreement is not executory); Movitz v. Fiesta Inv., LLC (*In re* Ehmann), 319 B.R. 200 (Bankr. Ariz. 2005) (holding that an operating agreement is not executory and is not governed by § 365 of the Bankruptcy Code when there are no material obligations imposed by the operating agreement that must be performed by the members of a limited liability company).

Although there is limited case law on the application of § 365(c) or (e) on limited liability company agreements, courts have reasoned by analogy to general partnership case law in deciding limited liability company issues. The court in *In re Daugherty Constr., Inc.* noted that its "conclusions that an LLC and debtor's membership interest therein do not terminate upon commencement of a Chapter 11 case by a member and that [the operating agreement] constitute[s] an executory contract are supported, in analogy, by bankruptcy court interpretations in the area of partnership law." *In re Daugherty Constr., Inc.*, 188 B.R. at 614 (citing several partnership cases, including *In re* Nizny, 175 B.R. 934 (Bankr. S.D. Ohio 1994) (Clark, J.) and *In re* Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990) (Sellers, J.), *abrogated on other grounds*, *In re* DeLuca, 194 B.R. 65 (Bankr. E.D. Va. 1966)).

35. *See generally* 11 U.S.C. § 365.

36. *Id.* § 365(c). For example, when the performance required of a party to a contract is unusual, special, or unique and cannot be performed in the same manner by another person (e.g., performance by an artist, a writer, or under a personal services contract), the counterparty to the contract may be excused from accepting performance under the contract from another person (which, in certain jurisdictions, may include a debtor in possession after its bankruptcy filing).

37. *See id.*

objection, are of particular significance in a joint venture context because most states (including Delaware) have applicable laws addressing the effect of a member's bankruptcy filing on a joint venture.[38] Where, as here, the Delaware Act addresses these issues, courts must determine whether such state laws alter the bankruptcy rules that are otherwise generally applicable to executory contracts, such as the Operating Agreement.

Courts have varied widely in their interpretation of the applicability of the exceptions contained in § 365(e) and (c) of the Bankruptcy Code. In particular, with respect to § 365(c), some courts have taken a narrower view of the exceptions and, thereby, allowed debtors to assume and continue operating under their agreements during the postpetition period (the "actual test" jurisdictions).[39] Other courts have taken a more expansive view of the exceptions and, thereby, prohibited debtors from assuming and continuing to operate under the agreements during the postpetition period (the "hypothetical test" jurisdictions).[40]

The First Circuit Court of Appeals and a large number of bankruptcy courts (including courts in the Fifth, Sixth, Eighth, and Eleventh Circuit

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38. *See* DEL. CODE ANN. tit. 6, § 18-801. Such laws, for example, may address one or more of the following: (1) the dissolution of the joint venture, (2) the debtor-member's dissociation from the joint venture, (3) the debtor-member's loss of managerial rights, and (4) the debtor-member's ability to assign its membership interests in full.

39. In the context of assignability under § 365(c), the "actual test" is based on reasoning that "Congress did not intend to bar debtors in possession from assuming [executory contracts] where no assignment is contemplated." For example, "the statute bars assumption by the debtor in possession only where the reorganization in question results in the nondebtor *actually* having to accept performance from a third party." Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 751 (9th Cir. 1999). The actual test interprets § 365(c) to allow assumption where there is no assignment to a third party contemplated.

40. In the context of assignability under § 365(c), the "hypothetical test" is based on a plain language analysis that § 365(c)(1) prohibits assumption of an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party. *In re Catapult Entm't, Inc.*, 165 F.3d at 750. The hypothetical test interprets § 365(c) to prohibit assumption by a debtor in possession *regardless* of whether assignment to a third party is contemplated (i.e., if assignment would be prohibited, even if not actually contemplated at the time of assumption, the debtor in possession may not assume the contract). *See id.* at 751 (concluding that the plain language of § 365(c) barred an assumption of nonexclusive patent licenses because federal patent law rendered such licenses personal and undelegable, and because the nondebtor party withheld his consent); *see also* N.C.P. Mktg. Grp., Inc. v. Blanks (*In re* N.C.P. Mktg. Grp., Inc.), 337 B.R. 230 (D. Nev. 2005) (holding that, under the hypothetical test, trademarks could not be assumed because federal trademark law rendered trademarks personal and unassignable and the nondebtors did not give consent); Breedon v. Catron (*In re* Catron), 158 B.R. 624 (Bankr. E.D. Va. 1992), *aff'd*, 158 B.R. 629 (E.D. Va. 1993), *aff'd*, 25 F.3d 1038 (4th Cir. 1994) (noting that because a partnership agreement is essentially a personal services contract, the nondebtor partners were excused from accepting substitute performance from the now debtor in possession partner). *But see In re* Nizny, 175 B.R. 934, 938–39 (Bankr. S.D. Ohio 1994) (distinguishing *Catron* by concluding that a Chapter 11 filing "should not provide a fortuitous event which excuses the nondebtor party from further performance if that performance is beneficial to the estate and if the estate can otherwise meet the tests for assumption") (quoting *In re* Cardinal Indus., Inc., 116 B.R. 964, 982 (Bankr. S.D. Ohio 1990)).

Courts of Appeals) have adopted the actual test.[41] The Third, Fourth, and Ninth Circuit Courts of Appeals,[42] as well as a few bankruptcy courts, have adopted the hypothetical test.[43] The Tenth Circuit Court of Appeals is undecided on whether to apply the actual or hypothetical test, with bankruptcy courts in its jurisdiction applying both tests.[44] In fact, this divergent case law may significantly impact Flounder's decision as to where to initiate its Chapter 11 case.[45]

A non-filing member of a joint venture (e.g., Prosper) may wish to object to a debtor's efforts to assume or assign the operating agreement and, thus, seek to enforce the limitations provided in § 365(e) and (c) of the Bankruptcy Code for a number of reasons, including (1) a desire to avoid partnering with a debtor subject to financial turmoil and uncertainty; (2) concern regarding the debtor's ability to continue as a going concern or to perform its future contractual obligations; (3) a desire to avoid the reputational risk that may arise from being associated with a debtor; (4) a desire to avoid being forced to partner with the debtor's possible successors (e.g., the debtor's creditors or another acquirer); or (5) a desire to use the opportunity to get out of an unprofitable or otherwise undesirable contract.[46] Accordingly, it is important to at least generally understand the operation of the exceptions contained in Bankruptcy Code § 365(e) and (c), and the differences in its application based on the judicial circuit in which the bankruptcy case was filed.[47]

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41. *See* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997) (rejecting the hypothetical test in favor of the actual test), *abrogated on other grounds*, Hardemon v. City of Boston, No. 97-2010, 1998 WL 148382 (1st Cir. April 6, 1998). *See, e.g.*, *In re Cardinal*, 116 B.R. at 979 (following the actual test); Texaco Inc. v. La. Land & Exploration Co., 136 B.R. 658, 668–71 (M.D. La. 1992); *In re* GP Express Airlines, Inc., 200 B.R. 222, 231–33 (Bankr. D. Neb. 1996); *In re* Am. Ship Bldg. Co., 164 B.R. 358, 362–63 (Bankr. M.D. Fla. 1994); *In re* Fastrax, 129 B.R. 274, 277 (Bankr. M.D. Fla. 1991). In addition, the Fifth Circuit applies the actual test to § 365(e)(2) but has left undecided the question of which test applies to § 365(c). *See In re* Mirant Corp., 440 F.3d 238 (5th Cir. 2006).

42. Note that the State of Delaware is in the Third Circuit.

43. *See In re Catapult*, 165 F.3d at 750 ("[A] debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to any such third party."). *See also In re* W. Elec., Inc., 852 F.2d 79, 83 (3d Cir. 1988) (basing its decision on a plain language analysis of § 365 that prohibits assumption of an executory contract without the nondebtor's consent where applicable law precludes assignment of the contract to a third party), *abrogated on other grounds*, *In re Catapult*, 165 F.3d 747. *See also In re Catron*, 158 B.R. at 633–38; City of Jamestown v. James Cable Partners, L.P. (*In re* James Cable Partners, L.P.), 27 F.3d 534, 537 (11th Cir. 1994).

44. *In re* Aerobox Composite Structures, LLC, 373 B.R. 135, 142 (Bankr. D.N.M. 2007).

45. A Chapter 11 debtor may initiate a bankruptcy case in any district in which it has had principal assets or a principal place of business for 180 days prior to the initiation of the bankruptcy case, in any state in which it is incorporated, or in any district where the bankruptcy case of an affiliate is pending. 28 U.S.C. §1408 (2014).

46. 11 U.S.C. § 365(c), (e).

47. *See id.*

B. Assumption of the Operating Agreement

1. Sections 365(e)(1) and (2) – The Ipso Facto *Exception*

To determine whether Flounder may assume the Operating Agreement under § 365(a) of the Bankruptcy Code, a court must analyze § 365(e)(1) and (2).[48] Section 365(e)(1) (the *ipso facto* exception) invalidates *ipso facto* clauses (i.e., contractual provisions requiring the termination of a contract or the dissolution of a joint venture upon a debtor's bankruptcy filing) by providing that an executory contract may not be terminated or modified merely because a provision in the contract effects termination of the contract upon a party's filing of a Chapter 11 case.[49] While the *ipso facto* exception generally invalidates *ipso facto* clauses contained in an operating agreement (which provide for the dissolution and liquidation of the joint venture upon the bankruptcy of any member), the *ipso facto* exception is limited by § 365(e)(2).[50] Under that subsection, an *ipso facto* clause will be given effect (and the contract *will* terminate or be modified) where (1) applicable non-bankruptcy law allows the non-debtor party to the contract to refuse to accept performance from (or render performance to) a party other than the debtor or its assignee (regardless of whether the contract prohibits or restricts the assignment of such rights or the delegation of such performance), and (2) the non-debtor party to the contract does not consent to the debtor's assumption or assignment of rights or obligations under the contract.[51]

48. *Id.* § 365(a).
49. *Id.* § 365(e)(1).
50. *Id.* § 365(e)(2).
51. Section 365(e) of the Bankruptcy Code states:

> (1) Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease 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.
>
> (2) Paragraph (1) of this subsection 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.

As applied to the Operating Agreement, if a bankruptcy court determined that Delaware law does not require Prosper to accept performance from Flounder as a Chapter 11 debtor in possession (as distinct from prepetition, non-debtor Flounder) or its assignees, and if Prosper did not consent to Flounder's attempt to assume the Operating Agreement, then Flounder could not assume the Operating Agreement.[52]

a. Dissolution of the Joint Venture

As such, if § 365(e)(2) applies (for example, because Flounder files for bankruptcy in a jurisdiction that requires Prosper's consent to Flounder's assumption of the Operating Agreement), the *ipso facto* exception will not invalidate the provision of the Operating Agreement that provides for liquidation of the Joint Venture upon a member's bankruptcy filing, and the Joint Venture may be dissolved pursuant to the terms of the Operating Agreement.[53] Accordingly, Prosper's consent to the continuation of the Joint Venture may be critical in such an instance. Conversely, if

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52. *See* DEL. CODE ANN. tit. 6, § 18-702. Section 18-702 of the Delaware Act, for example, could provide a basis for such a determination. The relevant portion of that section states:

> The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement [and] upon the [approval] of all of the members of the limited liability company [other than the member assigning the limited liability company interest and unless] otherwise provided in a limited liability company agreement: (1) [a]n assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member, [and] (2) [a]n assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

Under § 18-702, the assignment of a membership interest results only in the transfer of the economic interest associated with such membership interest (unless the operating agreement states otherwise) and not the transfer of any underlying rights associated with the membership. *See id.* In the instant case, the Operating Agreement expressly requires that all Joint Venture members must approve any transfer of a membership interest. Because a court could construe postpetition debtor in possession Flounder as the transferee or assignee that is an entity distinct from the prepetition Flounder, a court could conclude that Delaware law permits Prosper to refuse to accept the performance of postpetition Flounder's managerial duties under the Operating Agreement. *See In re* IT Grp., 302 B.R. 483, 487 (D. Del. 2003) (concluding that the debtor-members were barred from transferring their full membership interests in a limited liability company because Delaware law excused the nondebtors from accepting substitute performance from the debtor-members' assignees); *In re Catron*, 158 B.R. at 638–39 (noting that the debtor in possession partner is a separate entity from the prepetition partner, and as a partnership agreement is in nature a personal services contract, the nondebtor partners are excused from accepting substitute performance thereunder); *In re W. Elec., Inc.*, 852 F.2d at 82–83 (applying the hypothetical test and also stating that the use of the words "debtor or debtor in possession" in § 365(c)(1)(A) reflected Congress' "judgment that in the context of the assumption and assignment of executory contracts, a solvent [pre-petition debtor] and an insolvent debtor in possession going through bankruptcy are materially distinct entities," and the insolvent debtor in possession "could not force the [contract's counterparty] to accept the 'personal attention and services' of a third party").

53. *See* 11 U.S.C. § 365(e)(2).

§ 365(e)(2) does not apply, the *ipso facto* exception will invalidate the liquidation provision of the Operating Agreement upon a member's bankruptcy filing, and the Joint Venture may not be dissolved pursuant to such provision.

b. Flounder's Membership Interests

As discussed above, under the Delaware Act (and absent any consideration of bankruptcy law), Flounder will cease to be a member of the Joint Venture upon its bankruptcy filing and will lose all noneconomic member benefits that are otherwise enjoyed by members of the Joint Venture, including the right to consent to actions of the Joint Venture.[54] Under applicable bankruptcy law, however, the loss of a member's interest as a result of a bankruptcy filing will not (even in most hypothetical test jurisdictions) cause the member to lose the economic benefit of its ownership interest in the Joint Venture.[55] Although the jurisdiction in which Flounder files for bankruptcy may determine whether it is dissociated as a member (depending on whether the *ipso facto* provisions calling for such dissociation are invalidated under the *ipso facto* exception), each member will remain entitled to any economic interests related to its membership in the Joint Venture, including its proportionate share of any distributions made by the Joint Venture.

2. Section 365(c) – The Anti-Assignment Provision

To further determine whether Flounder may assume the Operating Agreement and maintain its membership interest and managerial rights, a court must also analyze § 365(c) of the Bankruptcy Code.[56]

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54. *See supra* note 52; DEL. CODE ANN. tit. 6, § 18-702.

55. *See generally* Milford Power Co. v. PDC Milford Power, LLC, 866 A.2d 738 (Del. Ch. 2004) (relying on a bankruptcy court decision to rule that the *ipso facto* clause in a limited liability company agreement, which requires the immediate expulsion and forfeiture by a member of its membership interests upon its filing for bankruptcy, is preempted only to the extent that it would deprive the member of its economic rights, which are retained by the debtor); *In re IT Grp.*, 302 B.R. 483 (interpreting the Delaware Act and holding that members of limited liability companies can assign their bare economic rights).

56. Section 365(c) of the Bankruptcy Code states:

> The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts the 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 of delegation of duties; and
>
> (B) such party does not consent to such assumption or assignment . . . .

As a practical matter, because of the close relationship between the anti-assignment provision and the *ipso facto* exception, a court may evaluate the applicability of the anti-assignment provision and the *ipso*

Under § 365(c) of the Bankruptcy Code (the anti-assignment provision), if applicable law would excuse Prosper from accepting performance from, or rendering performance to, an entity other than Flounder under the Operating Agreement, then the anti-assignment provision would apply, and Flounder would be unable to assume or assign the Operating Agreement unless it had Prosper's consent to do so.[57] Similarly, if state law otherwise prevents the assignment of a personal services contract to a third party outside of the bankruptcy context, then, irrespective of whether the contract actually contains a restriction on assignment, the anti-assignment provision would preclude an assignment by the consultant if he or she was a debtor in bankruptcy. Of course, if the Operating Agreement contained a provision expressly permitting assignment, Flounder would be able to do so.

Similar to the *ipso facto* exception, courts vary widely in their application of the anti-assignment provision. In a hypothetical test jurisdiction, if, under applicable Delaware law, the interests in a limited liability company operating agreement may not be assigned without the non-debtor party's consent, then the debtor cannot assign the agreement; and further, it cannot even assume the agreement in bankruptcy.[58] Courts applying the actual test, however, merely hold that a limitation on the assignability of a contract will preclude the debtor from assuming *and* assigning the agreement to a third party, but it will not prevent the debtor from simply assuming the agreement itself.[59]

a. Flounder's Assumption of the Operating Agreement

Prosper, as the non-debtor party to the Operating Agreement, does appear to be excused under applicable Delaware law from accepting performance from an assignee (i.e., a new member or manager) without its consent.[60] Thus, whether or not Flounder would be prohibited from

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facto exception together. If a contract cannot be assumed under the anti-assignment provision, the same "applicable law" will provide the basis for enforcement of an *ipso facto* provision. *See* Allentown Ambassadors, Inc. v. Ne. Am. Baseball, LLC (*In re* Allentown Ambassadors, Inc.), 361 B.R. 422, 448 (E.D. Pa. 2007) (stating that if § 365(c)(1) is applicable, so is § 365(e)(2)).

57. *See supra* notes 34–35 and accompanying text.

58. *See generally* Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 750 (9th Cir. 1999) ("[A] debtor in possession may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession has no intention of assigning the contract in question to [a] third party.").

59. *See generally* Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997) (holding that the debtor in possession would be permitted to assume an executory contract, so long as an assignment of such contract to a third party was not contemplated).

60. *See In re IT Grp.*, 302 B.R. 483 (interpreting Delaware law and determining that managerial (noneconomic) interests may not be assigned); *Milford Power Co.*, 866 A.2d at 760 ("[U]nder the Delaware LLC Act, other members of [the limited liability company] are—as a matter of default law—excused from accepting substitute performance of governance rights and duties . . . [and] Delaware's default law specifically distinguished between those aspects of an LLC Agreement that should not be

assuming the Operating Agreement by the anti-assignment provision would depend on how the anti-assignment provision was interpreted in the judicial circuit where Flounder filed its bankruptcy case.[61] If the bankruptcy court viewed a debtor in possession as a separate and distinct entity from a prepetition debtor, it is likely the assumption by Flounder would be prohibited.[62] Likewise, in a jurisdiction where the bankruptcy court analyzed the issue in terms of whether or not the debtor would be permitted, hypothetically, to both assume and assign the Operating Agreement to a third party, the assumption of the Operating Agreement would likely be prohibited.[63] However, in an actual test jurisdiction where the court did not view the debtor and debtor in possession as separate entities and looked only to whether the debtor in possession actually intended to assign the Operating Agreement to a third party, the anti-assignment provision would likely not prohibit the assumption of the Operating Agreement by Flounder.[64]

Notably, as was also the case with the *ipso facto* exception discussed above, the limitations of the anti-assignment provision only apply if the non-debtor party to the contract (i.e., Prosper) does not consent to the assumption or assignment of the executory contract.[65] If Prosper desires the Joint Venture to continue in its ordinary course, it only has to consent to the assumption of the Operating Agreement by Flounder, and the limitations provided by the anti-assignment provision would not apply. In such a case, Flounder could assume the Operating Agreement and remain as both member and manager of the Joint Venture upon its emergence from bankruptcy.

b. Managerial Rights

As previously noted, the Delaware Act is silent as to the effect that a manager's bankruptcy has on its managerial rights and, instead, defers to the operating agreement for the proper treatment of such rights (which, in the Joint Venture's example, is also silent).[66] Regardless of such silence, if Flounder is able to assume the Operating Agreement as a debtor in

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freely transferable because substitute performance should not be imposed on the other members absent their express consent (i.e., the managerial powers and duties) and those aspects that should be freely transferable (i.e., the passive right to share in profits and losses).").

61. *See supra* Part III.B.2.
62. *See supra* Part III.B.2.
63. *See supra* note 40 and accompanying text.
64. *See supra* note 39 and accompanying text.
65. *See* 11 U.S.C. § 365(e)(1), (2); *see also supra* Part III.B.1.
66. *See supra* notes 40, 42–43 for case law holding that the Delaware Act excuses the other members from accepting substitute performance of governance rights and duties—such law constitutes "applicable law" that would prevent a debtor from assigning (and in jurisdictions such as Delaware, assuming) any governance rights under the operating agreement.

possession (because the bankruptcy case is determined in an actual test jurisdiction or because Prosper consents to such assumption in a hypothetical test jurisdiction), it is unlikely that Flounder would be precluded from continuing to serve as manager of the Joint Venture (i.e., Prosper would be unsuccessful in arguing that the anti-assignment provision prevents Prosper from having to accept Flounder as a manager).

In a hypothetical test jurisdiction where Prosper did not consent to Flounder's assumption of the Operating Agreement, as discussed above, it is likely that Flounder would be unable to assume the Operating Agreement and its attendant managerial rights.[67] In that situation, Flounder would be able to maintain its economic interest in the Joint Venture but may lose its rights to participate in the governance of the Joint Venture.[68] What happens next would seem to be highly dependent on the facts and circumstances of the particular case at issue. In this Operating Agreement, although silent regarding managerial rights during bankruptcy, because it provides that Flounder's removal as manager by Prosper under specified circumstances is a liquidating event, there is at least an arguable claim in favor of dissolution and liquidation of the Joint Venture once Flounder is removed as manager (even though not for the reasons specified in the Operating Agreement).[69] Alternatively, the management rights could be vested in Prosper as the sole remaining member of the Joint Venture.[70]

C. Rejection of the Operating Agreement

Instead of assuming the Operating Agreement is an executory contract, Flounder may alternatively attempt to reject it under § 365(a) of the Bankruptcy Code.[71] A debtor may seek to reject an executory contract for a number of reasons, including where the contract is no longer economically advantageous or of strategic benefit. The rejection of the Operating Agreement by Flounder would be deemed a breach of contract occurring immediately before the filing date of the bankruptcy petition; such rejection, however, generally would not be considered a complete

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67. *See supra* note 40.

68. *See supra* note 43.

69. Section 18-802 of the Delaware Act would also seem to provide support for the dissolution of the joint venture; it provides that a member or manager may apply to the Delaware Court of Chancery seeking dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement. *See* DEL. CODE ANN. tit. 6, § 18-802. While a member would be prevented by the automatic stay from seeking dissolution from the Delaware Court of Chancery during the pendency of the bankruptcy case, it could petition the bankruptcy court for dissolution (citing such provision of the Delaware Act in support of its request) or to have the automatic stay lifted for the purposes of allowing Prosper to petition the Delaware Court of Chancery for dissolution. *See id.* Prosper could also wait until after Flounder emerged from bankruptcy, then petition the Delaware Court of Chancery. *See id.*

70. *See id.*

71. *See* 11 U.S.C. § 365(a).

termination of the Operating Agreement.[72] Whether the statutory breach resulting from a debtor's rejection of an executory contract excuses or justifies the counterparty's failure to perform after the date of rejection is a question to be decided by the applicable court of law applying the relevant state's contract law.[73] Thus, justification for a counterparty's non-performance due to the debtor's rejection of the contract in bankruptcy hinges on whether such rejection is found to be material by the relevant court of law.[74]

Typically, the effect of a rejection is to relieve the debtor of its obligations under the rejected contract, even though it does not operate to terminate the agreement. In this Operating Agreement, however, the potential effect of a rejection is unclear. While there is case law addressing a debtor's ability to reject a limited liability company operating agreement, these authorities do not directly address the effect of such a rejection on the limited liability company at issue.[75] From a practical standpoint, however, it is highly improbable that the Joint Venture could continue once Flounder rejects its obligations under the Operating Agreement because, essentially, the very purpose of the Joint Venture would no longer exist (e.g., Flounder would have no obligation to provide the financing and marketing assistance which was the initial basis for the formation of the Joint Venture).[76] To reject the Operating Agreement without its termination would saddle Prosper with 100% of the obligations under the Operating Agreement, while leaving Prosper with less than 100% of the benefits (e.g., the profit)—clearly not the bargain Prosper made or even a practical way to carry on the business. Accordingly, the rejection of the Operating

72. *See* O'Neill v. Cont'l Airlines, Inc. (*In re* Cont'l Airlines), 981 F.2d 1450, 1459 (5th Cir. 1993) ("Significantly, § 365(g)(1) speaks only in terms of 'breach.' The statute does not invalidate the contract, or treat the contract as if it did not exist.").

73. *See* Med. Malpractice Ins. Ass'n v. Hirsch (*In re* Lavigne), 114 F.3d 379, 387 (2d Cir. 1997) ("[The Bankruptcy Code] does not determine parties' rights regarding the contract and subsequent breach. To determine these rights, we must turn to state law."). *See also In re* Yasin, 179 B.R. 43, 50 (Bankr. S.D.N.Y. 1995) ("Under section 365, rejection constitutes a statutory breach, but does not repudiate or terminate the lease. The parties must, therefore, resort to state law to determine their rights as a result of the breach . . . ."). With respect to the general principles of contract law that a state court would apply in such a situation, *see* RESTATEMENT (SECOND) OF CONTRACTS § 237 ("[I]t is a condition of each party's remaining duties to render performances to be exchanged under an exchange of promises that there be no uncured material failure by the other party to render any such performance due at an earlier time.").

74. *See supra* note 73.

75. *See supra* note 73.

76. Even assuming that Prosper was able to bring in a third party to provide the necessary financing and marketing assistance—unless the bankruptcy court found that such rejection resulted in Flounder's loss of its economic rights in the Joint Venture (a highly unlikely result)—Prosper could not offer such third party economic benefits of the Joint Venture equivalent to those provided to Flounder in exchange for Flounder's performance (and Flounder would receive economic benefits while under no obligation to perform under the Operating Agreement).

Agreement would likely result in the dissolution and liquidation of the Joint Venture or some other equitable remedy awarded by the bankruptcy court.[77]

In the event of a rejection, the non-debtor party to the contract (e.g., Prosper) is entitled to assert a claim for damages arising from such rejection, and the damages claim is treated as having arisen immediately before the bankruptcy filing. The damages will be calculated based upon the party's substantive rights under the contract (e.g., specific measures of damages or amounts owed under the contract) and applicable law, and may include any damages (including consequential damages to the extent not precluded by the Operating Agreement), claims, costs, or liabilities contributed to or caused by Flounder's rejection of the Operating Agreement.

A claim for rejection damages is treated as an unsecured prepetition claim; as such, it is not entitled to priority as an expense of the administration of the estate.[78] Instead, claims for rejection damages are entitled to receive a pro rata distribution on the face amount of the allowed damage claim under the debtor's Chapter 11 plan.[79] This distribution may be (and often is) significantly less than 100% of the full value of the unsecured claim. If Prosper owed a prepetition debt to Flounder, Prosper could likely offset against its claim for rejection damages, on a dollar-for-dollar basis, the amount of its prepetition debt to Flounder.[80] But if Prosper does not owe any debt to Flounder, it will be entitled only to a pro rata distribution along with other general unsecured claims. Importantly, in the event Flounder's bankruptcy estate can pay anything above a *de minimis* amount on unsecured claims, a sizeable claim for damages by Prosper may deter Flounder from rejecting the Operating Agreement.

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77. The Delaware Act provides for the dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement. *See supra* note 69. The impracticability of the Joint Venture continuing after Flounder rejected the Operating Agreement leaves little doubt that the Joint Venture would need to be dissolved—whether by the bankruptcy court or by the Delaware Court of Chancery upon lifting of the automatic stay or after Flounder's emergence—or its terms substantially renegotiated. *See supra* note 69.

78. *See In re* Trafford Distrib. Ctr., Inc., 414 B.R. 858, 867 (Bankr. S.D. Fla. 2009) (holding that damages arising from rejection of an executory contract are deemed a prepetition claim and, thus, subject to setoff against other prepetition claims pursuant to § 553 of the Bankruptcy Code); *In re* Commc'n Dynamics, Inc., 382 B.R. 219, 224, 231–33 (Bankr. D. Del. 2008) (finding that the nondebtor party to a rejected executory contract could permissibly file a secured proof of claim for the portion of rejection damages matched by amounts such party owed to the debtor prepetition). *But see In re* Delta Air Lines, Inc., 341 B.R. 439, 443 (Bankr. S.D.N.Y. 2006) (stating that § 553 of the Bankruptcy Code "does not create a federal right of setoff, nor does it enhance, diminish, or otherwise modify any state law right of setoff").

79. *See supra* note 78.

80. *See supra* note 78.

IV. PRACTICAL CONSIDERATIONS

With an understanding of the impact that a joint venture member's bankruptcy could have on the remaining non-filing members, potential joint venture partners may wonder what, if anything, they can do to protect themselves.

A. Prior to a Bankruptcy

Prior to a bankruptcy, whether at the time of forming the joint venture or amending its operating documents, there are a number of protections and considerations that the parties may put into practice: (1) consider forming a new entity to serve as the joint venture entity in order to limit liability for past operations; (2) require that each joint venture member holds its interests therein through a newly formed holding company which has no (and is prohibited from having any) operations, assets, or liabilities other than ownership of its interests in the joint venture (a so-called special purpose entity); (3) require each special purpose entity to issue a single share of preferred stock (sometimes referred to as a "golden share") to each other member of the joint venture and provide in the organizational documents of such special purpose entity that it cannot file for bankruptcy protection without the consent of each holder of any golden shares; (4) consider what should happen upon a change of control of the member in the joint venture;[81] (5) carefully consider the amendment provisions in the operating agreement and other key documents to be sure that the protective provisions cannot be amended out from under the non-filing parties by the potential filer; and (6) include express provisions in the operating agreement which (a) prevent a member from pledging its interests in the joint venture as collateral for debts, other than debts of the joint venture; (b) require consent of all members (or a super-majority) in order for the joint venture to make a voluntary filing for bankruptcy; (c) provide for the liquidation of the joint venture upon the insolvency of, or filing for bankruptcy by, any member of the joint venture, its direct or indirect equity holders, or the joint venture itself; (d) require the manager of the joint venture (if manager-managed, as opposed to member-managed) to be a member of the joint venture, with the insolvency or filing for bankruptcy of such manager resulting in the loss of the member's managerial rights; and (e) in the event of a liquidation, provide for the distribution of certain key

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81. *E.g.*, If a parent entity of a member files for bankruptcy protection, should that be a terminating event? What impact might there be on the joint venture if the parent entity is ultimately controlled by its creditors or another acquirer with different interests than those of the initial parent entity? If a filing for bankruptcy by a parent entity of a member should be a terminating event for the joint venture, ensure that the joint venture's organizational documents refer to the bankruptcy of a member or its direct or indirect affiliates.

assets of the joint venture (e.g., intellectual property rights) in a specified manner.[82]

B. When Financial Trouble Strikes

If a current joint venture partner appears to be in financial distress, and it is possible the partner may attempt to seek protection from its creditors by filing a voluntary petition for relief under the Bankruptcy Code, the non-filing joint venture partner may also wish to (1) review all applicable joint venture operating documents (including provisions regarding liquidation or dissolution, removal from managerial positions, and dissociation of members) in light of the law of the jurisdiction in which the distressed joint venture partner has filed (or is likely to file) for a petition for bankruptcy relief;[83] and (2) consider the preferences of the non-filing joint venture partner going forward, as the preferences of non-filing partner will impact the effect of the Bankruptcy Code on the joint venture's operating agreement.[84]

V. CONCLUSION

The application of the *ipso facto* exception and the anti-assignment provision of the Bankruptcy Code and their likely effect on certain provisions of the Operating Agreement is dependent on the jurisdiction in which Flounder's bankruptcy case is filed. Regardless of the jurisdiction, however, if Prosper desires for the Joint Venture to continue to operate in the ordinary course going forward, and if Flounder elects to assume the Operating Agreement, then Prosper's consent to such assumption will negate those provisions of the Operating Agreement, the *ipso facto* exception, or the anti-assignment provision, which might result in a different outcome. Therefore, Flounder could assume its membership interest in, and continue as manager of, the Joint Venture. If Flounder attempted to assume the Operating Agreement over Prosper's objections, its success would depend upon the application of the *ipso facto* exception and the anti-assignment provision under the relevant law of the jurisdiction where Flounder files for bankruptcy.

If, however, Flounder chooses to reject the Operating Agreement, the effect would be to (1) treat the Operating Agreement as breached by Flounder immediately prior to its bankruptcy filing, and (2) provide Prosper an unsecured claim for damages resulting from such rejection. Any

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82. *See supra* Parts II–III.

83. *See supra* note 45.

84. If possible, does the non-filing partner want the joint venture to continue in the ordinary course, or would the non-filing partner prefer to liquidate and dissolve the joint venture in light of its partner's bankruptcy filing? *See supra* Parts III.A, C.

damages would be treated as a prepetition unsecured claim, and Prosper may receive less than the full value of its claim, depending on the amount of money available for distributions to unsecured creditors. However, the more sizeable the amount of Prosper's claim for damages resulting from a rejection of the Operating Agreement, the more likely Flounder would be deterred from making such a rejection so long as it expected to make at least some distributions to unsecured creditors. Further, it seems the likely additional effect of such a rejection would be the dissolution and liquidation of the Joint Venture or, perhaps, another equitable remedy designed to give Prosper the benefit of its bargain.