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Note

Member Bankruptcy Under the New Minnesota Limited Liability Company Act: An Executory Contract Analysis

James M. Jorissen

Following a growing national trend, Minnesota introduced its version of the Limited Liability Company Act (Act) on January 1, 1993.1 A hybrid business entity comprised of attributes from both the corporation2 and the partnership,3 the Limited

1. 1992 Minn. Laws Ch. 517, Art. 2 (codified at MINN. STAT. §§ 322B.01-.955 (Supp. 1993)).
2. The Act's governance and management provisions are derived from the Minnesota Business Corporation Act (MBCA). MINN. STAT. §§ 302A.001-.917 (1992). A limited liability company (LLC) differs from a corporation in three major respects. First, the LLC inherits the termination devices of dissolution and winding up from partnership law. Compare MINN. STAT. §§ 322B.80-.873 (Supp. 1993) (Minnesota Limited Liability Company Act dissolution and winding up provisions) with MINN. STAT. §§ 323.28-.31 (1992) (Minnesota Uniform Partnership Act dissolution and winding up provisions). Second, the Act limits company duration to 30 years and provides for dissolution any time a member departs, in stark contrast to the perpetual duration of a corporation. MINN. STAT. ANN. § 322B.01, at 30 (West Supp. 1993) (Preface and Overview Comments to Reporter's Notes). Compare MINN. STAT. § 322B.115(1)(4) (Supp. 1993) (specifying a maximum 30 year existence for the LLC from the time of filing articles of organization with the secretary of state) with MINN. STAT. § 302A.161(2) (1992) ("A corporation has perpetual duration."). Third, the Act places certain restraints on the alienation of membership interests, most notably divesting an assignee or transferee of such interest of governance rights unless all members of the company consent to assignment thereof. See generally MINN. STAT. §§ 322B.306 (Supp. 1993) (termination of a membership interest); 322B.31 (assignment of financial rights); 322B.313 (assignment of a complete membership interest and of governance rights coupled with an assignment of financial rights); 322B.873 (disposition of assets on dissolution). Other differences between the Act and the MBCA are primarily of form and not substance.

The Act inherits most of the MBCA's governance rules. The Act alters terminology where appropriate to "reflect . . . character differences between a corporation and a limited liability company." MINN. STAT. ANN. § 322B.01, at 26 (West Supp. 1993) (Preface and Overview Comments to Reporter's Notes). Thus, the LLC does not have "shares" of stock, "shareholders," "directors," or "officers," but rather, "membership interests," "members," "governors," and
Liability Company (LLC)\textsuperscript{4} affords entrepreneurs the most desirable traits of both forms—the conduit taxation of a partnership\textsuperscript{5} and the limited liability of a corporation.\textsuperscript{6} Its attributes

\textquote{managers.}\textsuperscript{7} Id. at 535-36. Semantic quirks aside, similarities between the entities far outweigh differences.

**FORMATION**

One or more organizers may form the LLC by filing articles of organization with the secretary of state. MINN. STAT. § 322B.105 (Supp. 1993); MINN. STAT. § 302A.101 (1992). The LLC, like a corporation, may be organized for \textquote{any [lawful] business purpose or purposes.} MINN. STAT. § 322B.20 (Supp. 1993). The LLC's articles of organization, like articles of incorporation, require minimal information. By way of comparison, both the MBCA and the Act require the articles to state the entity's name, address, and the name and address of a registered agent. See id. § 322B.115; MINN. STAT. § 302A.111 (1992). The MBCA further requires the name and address of the incorporator(s) and a statement as to the aggregate number of shares authorized for issue. Id. § 302A.111. As a reflection of its divergent character, the LLC's articles must state the limited duration of the company, an election of member's power to avoid dissolution in the event of a member's termination, and a statement as to whether the members have the power to formulate a business continuation agreement. MINN. STAT. § 322B.115(1)(4)-(6) (Supp. 1993).

**ARTICLES OF ORGANIZATION**

Beyond the foregoing mandatory provisions, the Act operates to impose statutory provisions unless specifically excluded in the articles of organization. Id. § 322B.115(2). Thus, if not excluded or modified in the articles, the Act incorporates into the articles provisions pertaining to powers, purposes, voting, membership interests, distributions, profits and losses, and expulsion of a member. MINN. STAT. § 302A.111(2) (1992) (listing statutory provisions that may be modified only in articles of incorporation).

3. The partnership's major contribution to the LLC is its engraftment of partnership dissolution and winding up procedures on the corporate form. Figuratively speaking, the LLC lives the life of a corporation and dies the death of a partnership. See discussion supra note 2; infra notes 26-28, 41-45 and accompanying text.


Conduit taxation aside, partnership classification harbors a number of other tax advantages to members of the LLC. In the event of business loss, members can use such loss to shelter other income. Furthermore, members can allocate losses to those having the highest income, thereby minimizing the taxable income of that member. For a complete discussion of the federal income tax advantages of partnership status, see Gazur & Goff, supra note 4, at 439-54.

6. Compare MINN. STAT. § 322B.303(1) (Supp. 1993) (providing that \textquote{[a] member, governor, manager or other agent of a limited liability company is not, merely on account of this status, personally liable for the acts, debts, liabilities, or obligations of the limited liability company}) with MINN. STAT.
promise to make the LLC the business vehicle of choice for entrepreneurs well into the next century.\textsuperscript{7}

As welcome as the LLC may be to the business community, it inherits from the partnership form a possible legal infirmity. The Internal Revenue Code requires enterprises seeking partnership tax classification to resemble partnerships. The Act brings LLC's into conformity for tax purposes by annexing, from the partnership laws, limitations on the transfer of member interests and the life span of the LLC. Critically, like the Uniform Partnership Act (UPA), the Act effects divestiture of a member's all-important governance interest on filing for bankruptcy.\textsuperscript{8} The inclusion of these partnership attributes to evade federal income taxes raises complications in the bankruptcy context.

Bankruptcy courts treat partnership agreements as "executory contracts."\textsuperscript{9} The executory classification derives from the

\textsuperscript{7} For a discussion of the LLC's significant tax and non-tax advantages over the subchapter S corporation, see MINN. STAT. ANN. § 322B.01, at 28 (West Supp. 1993) (Preface and Overview Comments to Reporter's Notes).

When compared to a general partnership, the LLC's most obvious benefit is limited liability. Partners of a general partnership are jointly and severally liable not only for the debts and other monetary obligations of the partnership, but in addition for damages caused by partner malfeasance or misfeasance in the course of partnership business resulting in injury to the person or property of another. \textit{See, e.g.,} MINN. STAT. §§ 323.12 (1992) (partnership liable for partner's wrongful act); 323.13 (partnership liable for partner's breach of trust); 323.14 (nature of partner's liability).

Limited partnerships also pale in comparison to limited liability companies. At least one of the partners in a limited partnership is a general partner, and as such is personally liable for partnership debts. Moreover, limited partners who participate in partnership management risk liability exposure akin to that of a general partner. The Act shields members of the LLC from liability while providing for unlimited member participation in management. MINN. STAT. ANN. § 322B.01, at 28-29 (West Supp. 1993) (Preface and Overview Comments to Reporter's Notes).

8. \textit{See} MINN. STAT. § 322B.80 (Supp. 1993). The law generally disfavors clauses purporting to modify or destroy debtors' rights on filing of bankruptcy. \textit{See} 11 U.S.C. § 365(c) (1988) (invalidating contractual clauses and non-bankruptcy laws modifying or terminating a debtor's rights on bankruptcy). The ill-light cast upon such provisions originates in the general policies of bankruptcy. Briefly, allowing the non-bankrupt party to the contract a unilateral termination power prejudices other creditors, whose main interest is maximization of the pool of assets available for distribution. The debtor is also damaged because the other party's continued contractual performance may be critical to the debtor's continued economic viability, especially where a particular contract contains terms favoring the debtor.

9. \textit{See generally} Lawrence J. La Sala, Note, \textit{Partner Bankruptcy and
existence of mutual duties and obligations between partners at the time of filing for bankruptcy which, if unperformed by either party, would constitute a material breach of the partnership agreement. The Act imposes on LLC members, and the LLC as an entity, mutual duties and obligations similar to those of partners. Therefore, LLC agreements are in most cases executory contracts.

Section 365 of the Bankruptcy Code (Code) empowers the trustee or debtor-in-possession (DIP) to assume or reject an executory contract within sixty days of a debtor’s petition for relief. The Code safeguards this power of assumption by invalidating contractual clauses or non-bankruptcy laws which purport to eliminate or modify a debtor’s contractual rights on bankruptcy. The Code, however, carves out exceptions to the general rule of assumability where applicable state law precludes non-consensual substitute performance.

Authorities divide on the assumability of a bankrupt partner’s partnership interests. One line of cases invalidates ipso...
facto or bankruptcy termination clauses in a partnership agreement. An ipso facto clause forces partnership dissolution and terminates a bankrupt partner's management interest in the partnership on such partner's filing for bankruptcy. The cases hold that ipso facto clauses are inconsistent with overriding federal bankruptcy law, thereby preventing partnership dissolution and permitting assumption of the debtor's entire interest in the partnership.

Another line of cases examines the exceptions to executory contract assumability and concludes that applicable non-bankruptcy law excuses the non-bankrupt partners from substitute performance. Courts following this line of reasoning uphold partnership dissolution and divestiture of the bankrupt partner's management interest.

The Act embraces the UPA's ipso facto provisions, dissolving the LLC and dispossessing the bankrupt member's governance rights on filing for bankruptcy. The critical question thus is whether bankruptcy tribunals should allow the trustee to assume the LLC agreement. The question requires a careful weighing of competing interests.

The non-bankrupt members may have a compelling pecuniary stake in continuing the business, and a strong desire to be free from unwanted interference with company operations. Under the Act, the non-bankrupt LLC members can carry on the business in the event of a member's bankruptcy if there are two or more remaining members and all such members consent to continuation. Allowing assumption of the LLC agreement would enable the trustee or DIP to exercise a member's ever present right to terminate the LLC, or to tread on the management prerogative of the non-bankrupt members.

In contrast, the estate has a strong interest in assuming the LLC agreement. The primary goal of the bankruptcy estate is to maximize assets of the estate, fostering the debtor's fresh start and optimizing compensation of creditors. Assumption and retention of the bankrupt's governance interest would permit the trustee to assume the LLC agreement and to interpose himself in the shoes of the debtor and actively participate in enterprise management.

This Note considers whether the Code authorizes assumption of a bankrupt member's interest in the LLC. Part I introduces Act provisions relevant to the bankruptcy context and

17. MINN. STAT. § 322B.80 (Supp. 1993).
18. Id.
compares them to UPA provisions. Part II establishes the bankruptcy framework, describes the powers of the bankruptcy trustee, and discusses section 365 of the Code. Part III examines case law on partnership agreements in the executory contract context, discussing cases invalidating *ipso facto* clauses, and cases reaching the exceptions. Finally, Part IV prescribes a methodology for examining LLC agreements as "executory contracts," suggesting that courts should defer to the statutory scheme for member bankruptcy embodied in the new Minnesota Limited Liability Company Act. The note concludes that courts should not allow the trustee to assume the LLC agreement.

I. ACT PROVISIONS ENGENDERING PROBLEMS IN BANKRUPTCY

The Act's drafters sought to maximize tax advantage while minimizing member exposure to liability. Therefore, the drafters adopted certain partnership attributes to avoid corporate taxation. The Act further imposes mutual duties and obligations on LLC members analogous to those of general partners. These attributes, duties, and obligations reveal that in the bankruptcy context, the LLC closely resembles a partnership.

A. AVOIDING CORPORATE TAXATION: LIMITED LIFE SPAN AND BIFURCATION OF INTERESTS

To qualify for partnership taxation, the LLC must possess no more than two of the following "corporate" attributes: limited liability, centralized management, and continuity of


20. The treasury regulations provide in part that an organization has limited liability "if under local law there is no member who is personally liable for the debts of or claims against the organization." Treas. Reg. § 301.7701-(2)(d)(1) (as amended in 1977) (emphasis added). Personal liability means that creditors of the organization may seek satisfaction for claims or debts from individual members of the organization to the extent the organization's assets fail to satisfy the claim. *Id*.

21. Management is centralized where an individual or group of individuals possess authority to make decisions with regard to the day-to-day business op-
life, free transferability of interest. Recognizing that limited liability is important and that centralized management is an attractive mechanism for owner participation in small businesses, the Act’s drafters focused on excising continuity of life and free transferability of interest.

The Act bestows partnership tax classification on the LLC through two devices. One such device limits LLC continuity. The Act restricts the life-span of the LLC to thirty years and adopts partnership dissolution events. The occurrence of any of a number of statutorily specified events, including the bankruptcy of any member, dissolves the company. Like a partnership, the company ceases to exist legally after winding up. In the event of bankruptcy dissolution, however, the LLC may continue operations if two or more members remain and unanimously consent within ninety days of case commencement to carry on the company.

The Act also limits the transferability of member interests by stratifying such interests into financial and governance

22. Generally, an organization has continuity of life when “the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.” Id. § 301.7701-2(b)(1).

23. An organization’s interests are freely transferrable if members are free to alienate interests so as to substitute another in their stead without the consent of other members. See id. § 301.7701-2(e)(1).


26. See MINN. STAT. § 322B.80 (Supp. 1993) In adopting the dissolution events of a partnership, the Act’s drafters were no doubt mindful of the provisions of Treasury Regulations § 301.7701-2(b)(1). The regulation states that “if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist.”

27. MINN. STAT. § 322B.80 (Supp. 1993). Bankruptcy terminates “the continued membership of a member of the limited liability company.” Id. Recall also that bankruptcy is one of the litany of events under the Treasury Regulations which, if it causes dissolution, defeats an organization’s continuity of life. See Treas. Reg. § 301.7701-2(b)(1) (as amended in 1977).

28. See MINN. STAT. §§ 322B.80, .813 (Supp. 1993). In this sense, the LLC differs significantly from a corporation. Corporate dissolution legally terminates business operations. Dissolution of the LLC, like the dissolution of a partnership, merely constitutes “the beginning of the end followed by a period of winding up and eventual termination.” MINN. STAT. ANN. § 322B.01, at 27 (West Supp. 1993) (Preface and Overview Comments to Reporter’s Notes).

29. MINN. STAT. § 322B.80(1) (Supp. 1993).

30. A member’s “financial rights” are the rights to share in profits and
rights. An assignee of a membership takes only a financial interest in the LLC, unless all of the other LLC members consent to assignation of the accompanying governance interest. In bankruptcy, the Act correspondingly limits non-consensual assignment. Thus, if on a member's bankruptcy the LLC avoids dissolution through consent, the bankrupt member (and therefore the bankruptcy estate) forfeits all governance rights. The bankrupt retains only his economic rights as an assignee of his share of profits and surplus.

B. COMPARISON WITH THE UNIFORM PARTNERSHIP ACT

The Act draws extensively from the Uniform Partnership Act (UPA) in defining the nature of a member's interest in the LLC and in prescribing the mechanisms of dissolution and winding up. Under the UPA, a partner holds three types of interest, and to receive interim, regular, and termination distributions. Minn. Stat. § 322B.03(19)(1)-(4) (Supp. 1993).

31. "Governance rights" encompass all of a member's non-financial rights, excluding the right to assign financial rights. Id. § 322B.03(22).

32. The bifurcation of financial and governance rights flows from the language of Treasury Regulations § 301.7701-2(e)(1), which provides in part:

[T]he [corporate] characteristic of free transferability of interests does not exist in a case in which each member can, without the consent of other members, assign only his right to share in profits but cannot so assign his rights to participate in the management of the organization.

The Act's drafters suggest that in most instances, these restraints on alienation will have little or no effect. Alluding to subchapter S corporations, they point out that such restrictions frequently arise at the insistence of the shareholders. The purpose of such restraints in the S corporation context is to confer upon shareholders the power to exclude persons unacceptable to existing shareholders. Because memberships in the LLC, like shares of an S corporation, are not traded publicly, the drafters sought to maintain in the owners the power to select their business associates. More significantly, the drafters sought to minimize the impact of eliminating corporate attributes. In the weighing process, they deemed centralized management and limited liability the more important interests. Minn. Stat. Ann. § 322B.01, at 26 (West Supp. 1993) (Preface and Overview Comments to Reporter's Notes).

33. See Minn. Stat. § 322B.313(2) (Supp. 1993). The treasury regulations, however, render minuscule the likelihood of the LLC lifting restraints on the alienation of governance interests, since free transferability of such interests destroys the LLC's partnership status for tax purposes. See Treas. Reg. 301.7701-2(e)(1) (as amended in 1977).

34. See supra note 29 and accompanying text.

35. Minnesota Statutes § 322B.306(3)(1) (1993) provides in part that "if dissolution under section 322B.80, subdivision 1, clause (5) [which includes a member's bankruptcy], is avoided through dissolution avoidance consent, then the member whose membership has terminated loses all governance rights and will be considered merely an assignee of the financial rights owned before the termination of membership."

36. Id.
LIMITED LIABILITY COMPANIES

interests:37 an economic interest,38 a management interest,39 and an interest in partnership property.40 A partner’s conveyance of his partnership interest does not cause dissolution,41 but the assignee, like the assignee of a membership interest in the LLC,42 has no right to interfere in partnership management.43 Moreover, a partner’s bankruptcy, like a member’s bankruptcy under the Act, dissolves the partnership,44 terminating the partner’s authority to act on behalf of the partnership.45

LLC members and partners possess duties and obligations to the other individuals in their respective organizations, some arising from status, and some from the mere fact of membership in an aggregation.46 Thus, in recognition of a general partner’s broad powers to conduct transactions on behalf of the partnership,47 the law imposes fiduciary obligations, including a

37. Minnesota Statutes § 323.23 (1992) provides: “The property rights of a partner are rights in specific partnership property, an interest in the partnership, and the right to participate in the management.”

38. The partner’s economic interest in the partnership includes his share of profits and partnership surplus. This interest is in the nature of personal property. MINN. STAT. § 323.25 (1992).


40. The partner holds partnership property with other partners as a “tenant in partnership.” Incidents of the tenancy include the right to possess partnership property in furtherance of partnership purposes, MINN. STAT. § 323.24(1) (1992), but the partner may not use the property in furtherance of personal aims, nor assign the property without assigning each of the partner’s interests concomitantly. Id.


42. See MINN. STAT. § 322B.313(2) (Supp. 1993).

43. MINN. STAT. § 323.26 (1992).

44. MINN. STAT. § 323.30(d)(5) (1992).


46. See Robert R. Keatinge et al., The Limited Liability Company, A Study of the Emerging Entity, 47 BUS. LAW. 375, 401 (1992) (noting that while early versions of the LLC do not specify the fiduciary obligations of members or managers because of their adoption of several limited partnership attributes, “[t]he rule for LLCs probably will evolve toward general partnership type duties for members in member-managed LLCs, and toward corporate director type duties for managers in manager-managed LLCs”)

47. With respect to a partner’s power to bind the partnership, the UPA provides in part:

Every partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . for apparently carrying on in the usual way the business of the partnership binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom the partner is dealing has knowledge of the fact that partner has no such authority.

MINN. STAT. § 323.08 (1992).
duty of loyalty and fair dealing. Similarly, vested with authority to dispose of LLC property and bind constituents in dealings with third parties, a member serving as a manager or governor (officer) of the LLC must discharge positional duties in "good faith" and in a manner consistent with the "best interests" of the LLC.

Other duties place restraints on partners, member-officers and non-officer members alike. These duties implicitly recognize the aggregate welfare of the enterprise as superior to an individual's interest. Consequently, both the Act and the UPA prohibit retirement or resignation in contravention of the articles of organization or partnership agreement. Both statutes also enjoin non-consensual assignment of management interests. Partners' duties under the UPA are more stringent and specific, but both statutes impose ongoing fiduciary obligations.

Both statutes also create duties flowing from the aggregate enterprise to the individual. Thus, like a partnership, the LLC must comply with the LLC agreement when making dis-
tributions or allocating profits, and render an accounting to any member on reasonable demand.57

Given the similarity of partnership and membership interests, the existence of mutual duties and obligations in both contexts, and the identical consequences of an individual’s bankruptcy on the remaining partners and members, courts considering parties’ rights on a member’s bankruptcy should follow the course chartered in partner bankruptcy cases.

II. RECOVERY OF ESTATE PROPERTY: POWERS OF THE BANKRUPTCY TRUSTEE OR DEBTOR IN POSSESSION

General bankruptcy law presumes that the trustee “stands in the shoes of the debtor” and assumes all of the debtor’s rights with respect to property of the estate. The Code defines property of the estate to include “all legal and equitable interests of the debtor in property as of the commencement of the case.” Such property accedes to the estate “notwithstanding any provision in an agreement, transfer instrument, or ap-

shall be determined, subject to any agreement between them, by the following rules:

(1) Each partner shall be repaid any contributions, whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities.

Functionally, the statute reads a right to share profits and distributions of partnership property into the partnership agreement unless the partners specify otherwise. In any case, the partnership must comply with the express or implied-in-law terms of the partnership agreement.

56. See Minn. Stat. § 322B.50 (Supp. 1993) (providing that distributions of LLC cash or assets must be made in conformity with articles or action of board of governors, or distributed proportionally according to member’s ownership interest in the absence of such directives); Minn. Stat., § 322B.326 (Supp. 1993) (same for LLC profits); see also Minn. Stat. § 323.17(1) (1992) (giving partner a right to share equally in partnership profits unless partnership agreement otherwise provides, in which case partner shares per terms of agreement).

57. See Minn. Stat. § 322B.376 (Supp. 1993) (Providing for an accounting upon demand for LLC member); Minn. Stat. § 323.21 (1992) (same for partner). In the case of the LLC, due process further requires strict company compliance regarding meetings, see Minn. Stat. §§ 322B.33, .36 (Supp. 1993); notice of meetings, see Minn. Stat. § 322B.34 (Supp. 1993); and voting at meetings. Minn. Stat. §§ 322B.353–.37 (Supp. 1993).

58. See 11 U.S.C. § 544(a) (1988) (“The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is avoidable . . . .”)

The trustee holds a duty to maximize the assets of the bankruptcy estate. To facilitate estate maximization, the Code gives the trustee broad powers to avoid transfers of property of the estate. Closely related to these avoidance powers is the trustee's power to assume or reject executory contracts.

A. THE MEANING OF “EXECUTORY CONTRACT”

Executory contracts are those “under which the obligations of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” The appropriate time for measuring

60. Id. § 541(c)(2).
61. See 11 U.S.C. § 704(1) (1988) (requiring the trustee to “collect and reduce to money the property of the estate . . . as is compatible with the best interests of parties in interest”).
62. For a comprehensive explanation of the bankruptcy trustee’s avoidance powers, see GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 137-91 (2d ed. 1988).
63. The meaning of performance, though generally assumed in the literature and case law, becomes critical to defining whether a contract is executory. Generally, “performance” is “The fulfillment or accomplishment of a promise, contract, or other obligation according to its terms.” BLACK’S LAW DICTIONARY 1137 (6th ed. 1990). Within the contemplation of this definition, there are two types of performance under a contract, positive and negative. Thus, to “perform” may consist of “action on the part of the person bound by the contract [positive performance] or in omission to act [negative performance], according to the nature of the subject matter.” Id. (emphasis added); cf. In re Fryar, 99 B.R. 747, 750 (Bankr. W.D. Tex. 1989) (finding debtor had not fully performed contract, in part, because debtor “had a duty not to plant crops” on certain land).
64. The Second Restatement of Contracts provides guidelines for determining when failure to perform rises to the level of material breach:

In determining whether a failure to render or to offer performance is material, the following circumstances are significant:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;
(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

65. Countryman, supra note 10, at 460. Professor Vern Countryman, in his seminal article Executory Contracts in Bankruptcy, proffered the definiti-
whether a contract is executory is at the time of filing for bankruptcy.66 To date, bankruptcy courts have uniformly treated partnership agreements as executory contracts.67 The executory contract designation brings partnership agreements in bankruptcy under the auspices of Code section 365.

The executory contract now employed by a majority of United States Bankruptcy Courts and the Eighth Circuit Court of Appeals. See Speck v. First Nat'l Bank of Sioux Falls (In re Speck), 798 F.2d 279, 279-80 (8th Cir. 1986) (per curiam).

Presently, a debate rages among courts and scholars about the continuing vitality of the Countryman test. Several other definitions of "executory contract" currently clutter the cases. One school draws on the legislative history of § 365. Both the Senate and House reports state: "Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides." H.R. REP. No. 595, 95th Cong., 1st Sess. 347 (1977); S. REP. No. 989, 95th Cong., 2d Sess. 58 (1978), reprinted in 1978 U.S.C.C.A.N., 5787, 5844, 6303. This definition differs from the Countryman definition in that it eliminates the "material breach" requirement. Cf. In re Rovine Corp., 6 B.R. 661, 664 (Bankr. W.D. Tenn. 1980) (suggesting that a contract is executory when, at the time of filing for bankruptcy protection, both parties have an obligation to perform).

Another formulation of the definition holds a contract executory where there exists merely a "contingent obligation," such as an obligation of a patent licensor to bring suit on behalf of a licensee against third party infringement. See Lubrizol Enters. v. Richmond Metal Finishers (In re Richmond Metal Finishers), 756 F.2d 1043, 1046 (4th Cir. 1985).

A third definition takes a functional approach to what constitutes an executory contract, looking to Code policies and the efficacy of finding an executory contract with respect to the parties in interest. See generally La Sala, supra note 9, at 624-25 n.30 (compiling cases and discussing the various definitions of "executory contract").


67. While one court has rejected finding partnership agreements executory per se, see, e.g., In re Cardinal Indus., Inc., 116 B.R. 964, 972-73 (Bankr. S.D. Ohio 1990) (trustee conceded partnership agreement was an executory contract, but court, in absence of circuit precedent on subject, refused to rule on whether an executory contract existed), finding an executory contract is normally a matter of course. See, e.g., Vindicator Group, Inc. v. Laval (In re Laval), 144 B.R. 897, 898 (Bankr. D.N.M. 1992); In re Corky Foods Corp., 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988); In re Harms, 10 B.R. 817, 820 (Bankr. D. Colo. 1981).

The factors giving rise to "executoriness" depend on the contents of the partnership agreement. The few courts venturing to discuss the issue typically elaborate a list of the mutual obligations existing at the time of filing to demonstrate the agreement's executory nature. In re Harms, 10 B.R. at 821 (applying legislative history definition of "executor" and finding that "[t]he general partner has a multitude of services to perform and the limited partners are obligated to make substantial future payments").
B. SECTION 365: RULES FOR ASSUMING EXECUTORY CONTRACTS

1. The General Rule

Section 365(a) of the Code states the general rule for a debtor's executory contracts. The trustee, with court approval, may "assume or reject any contract . . . of the debtor." The alternatives "assume or reject" envision an economically expedient election, allowing the trustee to assume beneficial and reject detrimental contracts. The trustee retains this power "to relieve the estate from burdensome obligations while the debtor is trying to recover financially." The trustee is constrained, however, to assume or reject the entire contract.

Augmenting the broad power of executory contract assumption is section 365(e)(1), which invalidates certain ipso facto clauses and non-bankruptcy laws that operate to destroy a debtor's rights based solely on the debtor's petition for bankruptcy relief. Together, these Code provisions foster the primary purpose of maximizing the pool of assets at the estate's disposal.

Once assumed, the executory contract inures to the benefit of the estate, which is free to exercise any and all of the debtor's contractual rights, including the right to assign the


69. See Jay L. Westbrook, A Functional Analysis of Executory Contracts, 74 MINN. L. REV. 227, 231 (1989) ("The trustee is given broad discretion to assume or reject, whichever course will maximize the value of the bankruptcy estate and minimize claims against it.") (footnote omitted); see also supra notes 11-12, 61 (discussing fiduciary duties of the trustee and debtor in possession).


71. See In re Rovine Corp., 6 B.R. 661 (Bankr. W.D. Tenn. 1980) (holding that trustee's rejection of a franchise agreement with Burger King caused rejection of the whole contract, including a covenant executed by the debtor agreeing not to compete with Burger King during the duration of the franchise agreement and for several years thereafter).

72. 11 U.S.C. § 365(e)(1) (1988). This section provides: Notwithstanding a provision in an executory contract . . . or in applicable law, an executory contract . . . of the debtor may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . . . that is conditioned on—

. . . (B) the commencement of a case under this title . . .

73. See supra notes 11-12, 61 and accompanying text.
contract. Congress, however, expressly recognized that exercise of the debtor's contract rights may in some circumstances severely infringe the rights of other parties to the contract. Thus, the Code circumscribes narrow situations in which an executory contract falls beyond the estate's reach.

2. Exceptions to the General Rule

A primary exception to section 365(a) eradicates the trustee's power to assume a personal services executory contract where state law excuses the non-bankrupt party from accepting non-consensual substitute performance. Consistent with the legislative history of section 365(c), bankruptcy courts read this exception to prohibit assumption of personal services contracts, contracts which necessarily contemplate performance by a specific party, unless performance is to continue in the debtor or DIP.

Section 365(e)(2) further constrains assumption of personal services contracts by giving effect to a contract's ipso facto provisions. Functionally, the contract by its own terms ceases ef-

74. See Westbrook, supra note 69, at 231.
76. See id. § 365(c). This section provides in part:
  The trustee may not assume or assign any executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if— (1)(A) applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment . . .
77. See infra Part III.B.
79. See 11 U.S.C. § 365(e)(2) (1988). This section provides in part:
  Paragraph (1) [invalidating ipso facto provisions] of this subsection does not apply to an executory contract . . . of the debtor, whether or not such contract . . . 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 . . . from accepting performance from or rendering perform-
fect between the parties at case commencement.

III. PARTNERSHIP AGREEMENTS AS EXECUTORY CONTRACTS

Partner bankruptcy cases stratify along two distinct lines. Some cases conclude that partnership agreements harboring *ipso facto* clauses, though authorized by a state’s version of the UPA, are invalid. These cases hold that the Supremacy Clause, overriding bankruptcy policies, and the plain language of Code Section 365(e)(1) preclude enforcement of *ipso facto* clauses. The effect is that the partnership does not dissolve, the debtor partner retains *all* pre-bankruptcy interests, and the estate is free to assume the partnership agreement.

Other cases overcome the hurdle of *ipso facto* provisions and consider the applicability of the exceptions to the right of assumption or rejection. Generally, these cases hold that partnership agreements are non-assumable personal services contracts under applicable state law. The trustee is thus precluded from assuming the contract and takes as a mere assignee of the bankrupt's economic rights pursuant to the UPA.

80. Id.


82. Article I, § 8, clause 4 of the Constitution, empowers Congress to promulgate laws relating to bankruptcy. Laws promulgated by the Congress under the cloak of constitutional authority are the “supreme Law of the Land,” see U.S. CONST. art. VI, and preempt state law to the contrary. Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 22 (1824).

83. See *In re* Sunset Developers, 69 B.R. 710 (Bankr. D. Idaho 1987); *In re* Minton Group, Inc., 27 B.R. 710 (Bankr. S.D.N.Y. 1983), aff’d 46 B.R. 222 (S.D.N.Y. 1985); *In re* Harms, 10 B.R. 817 (Bankr. D. Colo. 1981). These cases implicitly recognize that partnership agreements are personal services contracts because the fiduciary duties of good faith and fair dealing to other partners under the contract are non-delegable. See La Sala, *supra* note 9, at 629 & nn.60-66.

84. See *supra* notes 44-45 and accompanying text.
A. REJECTION AT THE THRESHOLD: CASES HOLDING IPSO FACTO CLAUSES INVALID

Most states, like Minnesota, have adopted the UPA and the Uniform Limited Partnership Act (ULPA). These statutes contain *ipso facto* provisions calling for dissolution of the partnership "by the bankruptcy of any partner." Thus, one line of cases has explored whether an *ipso facto* clause effectively dissolves a partnership.

Several cases hold that section 365(e)(1) overrides state law and partnership agreements which dissolve the partnership on a partner's bankruptcy. Courts have applied this principle to cases arising in the context of business reorganization bankruptcies under Chapter 11 and liquidation bankruptcies under Chapter 7.

1. The Chapter 11 Context

Chapter 11 debtors are most frequently corporations. The executory contract issue arises in the context of a corporate-DIP attempting to assume a partnership agreement written under the UPA.

One rationale for denying effect to *ipso facto* dissolution in Chapter 11 pivots on interpretation of the UPA's legislative his-

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85. MINN. STAT. §§ 323.01-.43 (1992) (Uniform Partnership Act); MINN. STAT. §§ 322A.01-.87 (1992) (Uniform Limited Partnership Act).

86. See MINN. STAT. § 323.30(d)(5) (1992). Note that the Minnesota ULPA does not provide for dissolution of a limited partnership on the bankruptcy of a partner unless the partnership agreement specifies dissolution as such. See MINN. STAT. § 322A.63(2) (1992). Limited partnerships nevertheless retain their partnership tax classification because the ULPA makes the general partner personally liable for claims in excess of the assets of the enterprise. See supra note 21-36 and accompanying text.


88. See supra note 87 and cases cited therein.

89. See WARREN & WESTBROOK, supra note 66, at 427. Professors Warren and Westbrook assert that although individuals are eligible for Chapter 11 relief, Chapter 13 is better suited for most individuals. Chapter 13 affords the debtor much broader discharge provisions than Chapter 11. Thus individuals in Chapter 11 are typically persons with extraordinarily large debt loads who exceed the statutory maximum for filing under Chapter 13. *Id.*
tory. The court in In re Hawkins90 examined whether a partner's petition for relief under Chapter 11 caused dissolution of the partnership.91 Both the partnership agreement in question and Texas's version of the UPA contained bankruptcy termination clauses.92

The court used imaginative reconstruction to determine the UPA drafters' intent.93 The UPA was promulgated in 1914,94 and at the time of its enactment, liquidation constituted the sole form of bankruptcy relief.95 Congress did not authorize business reorganization bankruptcies until twenty years later.96 Therefore, the UPA's drafters could not have intended that the filing of a Chapter 11 case trigger dissolution.97 The court denied a partner's motion to lift the automatic stay and terminate the partnership.98

2. The Plain Meaning of Section 365(e)(1) and the Supremacy Clause

Other cases refusing dissolution because of the existence of an ipso facto provision in both the Chapter 7 and Chapter 11 contexts have rested on the plain meaning of Code section

91. Id. at 316.
92. Id.
93. Imaginative reconstruction directs judges to act as faithful agents of the enacting legislature. Where legislative intent is not altogether clear, "judges should put themselves in the minds of the enacting legislature and imaginatively reconstruct what the legislature would have done had it considered and resolved the issue." Phillip P. Frickey, From the Big Sleep to the Big Heat: The Revival of Theory in Statutory Interpretation, 77 MINN. L. REV. 241, 251-52 (1992) (citing Richard A. Posner, Statutory Interpretation—in the Classroom and in the Courtroom, 50 U. CHI. L. REV. 800, 817-20 (1983)). While the court in Hawkins made no explicit mention of this technique, it used the method by concluding that the drafters could not have anticipated Chapter 11 bankruptcy which was not in existence at the time the UPA was enacted. Hawkins, 113 B.R. at 316.
95. Id.
96. Id.
97. Id. (citing In re Safren, 65 B.R. 566, 569 (Bankr. C.D. Cal. 1986)). The court in Hawkins borrowed its analysis from In re Safren, 65 B.R. 566 (Bankr. C.D. Cal. 1986). There, the court held that the filing of a Chapter 11 petition by a general partner did not dissolve the partnership, again holding the ipso facto clause unenforceable on the basis of statutory construction and public policy. Id. at 569-70. But see In re Phillips, 966 F.2d 926, 931 (5th Cir. 1992) (disputing the Safren analysis and concluding that the relevant intent was not the intent of the UPA's drafters, but rather the intent of the adopting legislature).
365(e)(1) and the Supremacy Clause of the Constitution. The Code invalidates *ipso facto* clauses and state laws terminating a debtor's interest on the basis of a bankruptcy filing. Under the Supremacy Clause, federal law controls over conflicting state laws.

The result of these cases, regardless of the chapter under which the debtor files for bankruptcy, is to allow the trustee to assume the contract. The cases never address the policies affecting the relational aspects of partnerships, which would compel courts to look more closely at the exceptions to sections 365(a) and 365(e)(1).

B. PARTNERSHIP AGREEMENTS AS PERSONAL SERVICE CONTRACTS PROHIBITING SUBSTITUTE PERFORMANCE

By refusing to uphold bankruptcy termination clauses, the preceding cases fail to consider two exceptions to the general rule of assumability of executory contracts. Specifically, section 365(c) suspends the trustee's power to assume or assign personal services contracts where applicable law excuses a non-debtor partner from accepting substituted performance. Similarly, section 365(e)(2) compels specific enforcement of *ipso facto* clauses under identical circumstances.

Courts applying the exceptions to assumability of executory contracts follow a common linear mode of decision. The courts examine the interests and obligations flowing from the partnership agreement. Normally, a partner has three types of interests in the partnership: a management interest, a property interest, and an economic interest. The analysis then shifts to the effect on the non-bankrupt partners of allowing assump-

100. The court in *In re Rittenhouse Carpet, Inc.*, 56 B.R. 131 (Bankr. E.D. Pa. 1985) invoked the Supremacy Clause argument, in conjunction with the plain language of Code § 365(e)(1) in similar fashion. There, the court examined whether filing for Chapter 11 relief caused dissolution of a partnership, again in the face of partnership agreement and state law bankruptcy termination provisions. Id. at 132. In conclusory fashion, the court dispensed with the remaining partner's arguments, enunciating as its basis for decision the fact that "the alleged elimination of the debtor from the partnership... [was] predicated solely on the filing of a petition under the Code, [and therefore] the purported ejection of the debtor was not effective because of § 365(e) and the Supremacy Clause, and we held so several years ago." Id. at 133 (citations omitted).
103. See supra notes 37-40 and accompanying text.
tion of a given interest. Under the UPA, a partner's right to share profits and surplus is personal property and therefore property of the estate.\textsuperscript{104} Discussion therefore centers on the assumability of the debtor's contractual management rights.\textsuperscript{105}

Courts upholding dissolution and divestment of a partner's management rights pursuant to the Code's exceptions advance three rationales for preventing the trustee or DIP from assuming the contract.\textsuperscript{106} The first rationale is the "identity" rationale.\textsuperscript{107} On principles similar to those disfavoring "involuntary servitude,"\textsuperscript{108} the identity rationale holds that the non-bank-

\textsuperscript{104} See MINN. STAT. § 323.25 (1992); see also 11 U.S.C. § 541(a)(1) (1988) (providing that bankruptcy estate consists of "all legal or equitable interests of the debtor in property as of commencement of the case"); In re Priestley, 93 B.R. 253, 257 (Bankr. D.N.M. 1988) ("A partner's interest in a partnership is his share of the profits and surplus, and is personal property. . . . It is estate property and the trustee may sell it.") (citations omitted).

\textsuperscript{105} See Priestly, 93 B.R. at 257.


\textsuperscript{107} The identity rationale originates in the language of the Code. Section 365(c) prohibits assumption or assignment of an executory contract when applicable law excuses a non-bankrupt party from accepting substitute performance. Section 365(e)(2) gives effect to \textit{ipso facto} clauses in the same circumstances. Section 365(c) is broader than its sister provision in the sense that it includes as parties due performance the "debtor," while § 365(e)(2) treats all persons other than the debtor as substitutes. Compare 11 U.S.C. § 365(c) (1988) \textit{with id.} § 365(e)(2).

\textsuperscript{108} The identity rationale originates in the language of the Code. Section 365(c) prohibits assumption or assignment of an executory contract when applicable law excuses a non-bankrupt party from accepting substitute performance. Section 365(e)(2) gives effect to \textit{ipso facto} clauses in the same circumstances. Section 365(c) is broader than its sister provision in the sense that it includes as parties due performance the "debtor," while § 365(e)(2) treats all persons other than the debtor as substitutes. Compare 11 U.S.C. § 365(c) (1988) \textit{with id.} § 365(e)(2).

\textit{In re Harms}, 10 B.R. 817 (Bankr. D. Colo. 1981), examined the effect of § 365(c) in the context of a general partner's bankruptcy, where the non-bankrupt limited partners interposed an objection to accepting substitute performance from a new general partner. The court, upholding the limited partners' objection, expressed the identity rationale in its most basic form, stating "[i]t is obvious that the Trustee cannot assume the position of general partner of these limited partnerships, since he is not the person with whom the limited partnerships contracted." \textit{Id.} at 821.

\textsuperscript{108} Involuntary servitude is "[t]he condition of one who is compelled by force, coercion, or imprisonment, and against his will, to labor for another, whether he is paid or not." BLACK'S LAW DICTIONARY 828 (6th ed. 1990). Arguably, framed in the context of a bankruptcy court ordering the non-bankrupt partners to incorporate into the partnership a trustee with whom they have no previous business or personal contact, permitting assumption of the bankrupt's management interest imposes involuntary servitude on the partnership. See \textit{In re Waldron}, 36 B.R. 633, 641 (Bankr. S.D. Fla. 1984); see also La Sala, supra note 9, at 641 (suggesting that a requirement that non-consenting, non-bankrupt partners carry on the business with a surrogate performer may violate the Constitution's prohibition against involuntary servitude).
rupt partners should not be thrust into the midst of an unwanted business association.

Accentuating and strengthening the identity rationale is the "fiduciary" rationale.\(^{109}\) Partnerships resemble families, often forged on a foundation of personal affinity and trust.\(^{110}\) Loyalty and demonstrated business acumen fuel the relationship. Non-consensual substitution of a partner compromises these foundational elements.

A final and closely related rationale is the "conflict of interest" rationale. Allowing assumption of management interests places the trustee in the position of playing two roles, often in diametric opposition.\(^{111}\) The trustee is duty bound as representative of the estate to observe the creditor's best interests.\(^{112}\) A trustee as a general partner would owe to the other partners a duty of loyalty and an obligation to manage partnership assets

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109. Partners stand in a fiduciary role to co-partners. A partnership agreement "is a contract based upon personal trust and confidence." Harms, 10 B.R. at 821; see also Manor Place, 144 B.R. at 682; Sovereign Group, 88 B.R. at 329; Sunset, 69 B.R. at 711; La Sala, supra note 9, at 637-38 (footnotes omitted) ("A partnership is among the most intimate of all business relationships. It is an association for co-owners, formed by consent and imbued with fiduciary obligation. It is, in short, the business form most closely resembling a 'family' or marriage.")

110. The court in Sovereign Group described a partnership agreement as "unique in law because it is not only a legal relationship that is created but it reflects a personal relation or status somewhat akin to the relationship of individuals in a marriage." 88 B.R. at 329. The UPA recognizes the fiduciary and unique nature of a partnership by prohibiting an assignee of a partner's interest from interfering in management of the enterprise. Manor Place, 144 B.R. at 682.

111. See In re Phillips, 996 F.2d 926, 929 (5th Cir. 1992) ("Creditors are wholly dependent upon the party controlling an estate in bankruptcy proceedings to protect their interests. Likewise, partners . . . must rely on general partners to protect all partners' interests in partnership property. Both the creditors and the partners are interested in the same partnership property."). The fiduciary ties of the trustee and DIP to the debtor and creditors bolster the premise of a serious conflict of interest. The trustee owes a duty to the creditors to manage estate properties for the benefit of the creditors. The trustee is bound to ensure fair protection of the debtor's interests by objecting to unsubstantiated claims and, where appropriate, protecting exempt property and the debtor's right to surplus estate property. The trustee or DIP in Chapter 11 must assist the debtor in becoming a newly viable enterprise. Further exacerbating the problem, the interests of the debtor and creditors often coincide. To the extent the estate's assets are maximized, the debtor's prospects of reorganization and the corresponding likelihood of completion of payments under a plan increase. Estate maximization also fosters optimal compensation to creditors in the event the debtor fails or liquidates. Therefore, the debtor, out of pure self interest, may be just as unscrupulous in carrying on partnership duties as a trustee. See Sulmeyer et al., supra note 11, ¶¶ 4.02, 20.05(2).

112. See supra notes 17-18, 61 and accompanying text.
Obviously, such dual role playing threatens neglect of one party's interests.

IV. A PRESCRIPTION FOR TREATMENT OF LLC MEMBER BANKRUPTCY

The following prescribes a methodology for examining the LLC member's bankruptcy. In most instances, LLC agreements will be executory contracts. Courts must then examine the validity of the Act's *ipso facto* clauses, whether the LLC agreement fits within either of the exceptions to the general rule of assumability of executory contracts, and whether the policies of the exceptions apply in the context of the LLC agreement. After undertaking such an examination, a court should find that the LLC agreement is an executory personal services contract and permit LLC dissolution but prohibit the trustee's assumption of the debtor's governance interest.

A brief exploration of two alternative analytical methods then ensues, primarily to establish the range of possible outcomes and the gravity of the court's initial characterization of the agreement. A court could find the LLC agreement is not an executory contract. Consequently, the member-debtor's legal and equitable rights would become property of the bankruptcy estate notwithstanding an *ipso facto* clause in the LLC agreement. Although the Act's provisions purport to transfer the member-debtor's management interest, the Code empowers the trustee to avoid such post-petition transfers.

Alternatively, a court could classify the LLC agreement as an executory contract but invalidate the LLC's dissolution and the transfer of a member's governance rights under section 365(e)(1). Under either set of circumstances, the trustee could assume performance and exercise all of the debtor's rights under the agreement. Neither course of action is particularly satisfactory to the remaining members or beneficial to the LLC.

The alternative methods fail in each case, the first in failing to recognize that LLC agreements are executory contracts and the second, although reaching the proper characterization, in failing to recognize that LLC agreements fall within the personal services exception of section 365(e)(2) to the assumability of executory contracts.

114. The author is unaware of any case law addressing whether the trustee can assume a member's governance interest in the LLC. The two proposed alternative methods envision normal operation of normal bankruptcy rules.
A. LLC AGREEMENTS ARE EXECUTORY CONTRACTS

The basic LLC agreement will be an executory contract for all of its members. Typically, the LLC will be closely held. Each member will assume a management role as well as duties and obligations commensurate with managerial status. Members in the aggregate will owe one another compliance with the LLC agreement. Therefore, it is practical to assume that ordinary LLC agreements are executory contracts.

As to governors and managers, the LLC agreement will always be executory. LLC officers operate the company, maintain a standard of conduct appropriate to the fiduciary nature of those duties, and must act consistently with the terms of the operating agreement. In consideration for those services, the LLC makes distributions, allocates profits, and may provide additional compensation. Failure of either side to perform permits the other side to refuse further performance.

Whether the LLC agreement is executory as regards a non-

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115. See, e.g., MINN. STAT. ANN. § 322B.01, at 26 (West Supp. 1993) (Preface and Overview Comments to Reporter’s Notes). Several factors point to the conclusion that LLCs will be closely held in most cases. First, because of Act restrictions on transfers of membership interests, LLC interests may not be publicly traded. For a large entity, such restrictions may severely restrain the ability to raise capital. Second, the numerous dissolution events act as a barrier to the formation of extraordinarily large LLCs, since the comparative detachment of members in a large organization leads to uncertainty regarding the willingness of other members to comply with the articles of organization and operating agreement. Finally, the legislature specifically tailored the Act to small businesses so that investors who heretofore may have been limited partners could actively participate in enterprise management. See id. (stating that “the limited partnership model utilized by other states [as the basis of their limited liability company statutes] was largely out of date and functionally unworkable for a small closely held business”)

116. Along these lines, the absence of specific management duties in the bankrupt should not preclude finding that the LLC agreement is an executory contract. The significance of the members’ duties, no matter how minuscule, would appear to be inversely proportional to the number of members in the company. In other words, a member’s wrongful termination of the LLC in a company comprised of 500 members and the corresponding problems of dissolution and possible winding up is potentially far more devastating than the impact of wrongful dissolution on a five person enterprise.

117. See MINN. STAT. § 322B.663(1) (Supp. 1993).

118. See supra note 56 and accompanying text (discussing MINN. STAT. § 322B.50 (Supp. 1993)).

119. See Keatinge, supra note 46, at 401 (suggesting that in member-managed LLC’s, members will likely be held to the more stringent fiduciary duties of general partners).

120. Minnesota Statutes § 322B.636(2)(1) (Supp. 1993) provides that “A governor may be removed at any time, with . . . cause.” See also MINN. STAT. § 322B.686(2) (Supp. 1993) (same for managers). As a consequence, if the gov-
officer member raises a more difficult theoretical question. Lacking a participative role in management, the non-officer member may have little control over financial and property-related policy making. Because of the non-officer member's limited powers, the Act correspondingly limits this member's duties.  

These limited duties, however, arguably give rise to executory obligations. The Act prohibits alienation of any member's governance rights without all other members' unanimous consent.  The Act further proscribes wrongful withdrawal from the company. Compliance with these obligations, though negative in nature, is a form of performance under the contract which endures with the LLC agreement.  

The non-officer member's duties are material components of performing the agreement. Indeed, the Act provides specific remedies for the unauthorized conveyance of a member's governance interest and for wrongful withdrawal from the LLC. The remedies excuse other members' continued performance, in the first case destroying the non-consensual transferor's management interest. Thus, the relationship of a non-officer member to the company is executory.

Even casting aside the notion of "negative performance," the LLC agreement will almost invariably constitute an executory contract because the LLC itself will be a closely held, member-managed enterprise.

\footnote{121} By negative implication, because the non-officer member is not acting in a managerial capacity, such member has no positional responsibilities and no duty to carry out such responsibilities in good faith and in the "best interests" of the LLC. \textit{See}, \textit{e.g.}, MINN. STAT. § 322B.69 (Supp. 1993) (standard of conduct for managers).

\footnote{122} MINN. STAT. § 322B.313(2) (Supp. 1993).

\footnote{123} MINN. STAT. § 322B.306(4) (Supp. 1993).

\footnote{124} \textit{See supra} note 63 (noting that the accepted definition of "performance" includes omission to act, or negative performance).

Wrongful termination of the agreement destroys the terminator's continuing membership interest, rendering such person a mere assignee of her rights to profits and surplus. MINN. STAT. § 322B.306(3)(1) (Supp. 1993). Thus, the remaining members need no longer perform by allowing such person to participate in LLC management.

\footnote{125} Clearly, a member's wrongful termination of the LLC agreement, under any prevailing notions of contractual obligation, is a material breach. \textit{See RESTATEMENT (SECOND) OF CONTRACTS} § 241(a) (1981).

\footnote{126} MINN. STAT. §§ 322B.306(4), 313 (Supp. 1993).

\footnote{127} \textit{See} MINN. STAT. § 322B.313(2) (Supp. 1993).

\footnote{128} \textit{See supra} note 118 and accompanying text. This analysis assumes the
B. CASES HOLDING *IPSO FACTO* CLAUSES INVALID SHOULD NOT APPLY TO THE BANKRUPTCY OF THE LLC MEMBER

Once a court determines the LLC agreement is an executory contract, the court should examine partner bankruptcy cases to ascertain whether their reasoning and policy analysis hold true in the LLC context. Some courts have invalidated partnership *ipso facto* clauses in the Chapter 11 and Chapter 7 contexts, relying on statutory interpretation and federal supremacy.\(^1\) Courts should reject their reasoning.

1. The Chapter 11 Context

The allure of partnership tax status induced the Act’s drafters to include an *ipso facto* clause as a means of defeating the LLC’s continuity of life.\(^2\) The *ipso facto* provision has the dual effect of dissolving the LLC and terminating a member’s governance interest on such member’s commencement of a bankruptcy case.\(^3\) Courts have invalidated *ipso facto* clauses in partnership agreements specifically because of the Chapter 11 context, arguing the UPA’s drafters did not contemplate reorganizations as acts of bankruptcy.\(^4\)

The Fifth Circuit has effectively refuted the legislative history argument espoused in *In re Hawkins*\(^5\) and its progeny.\(^6\)


\(^{130}\) See supra notes 19-29 and accompanying text (setting forth the requirements for obtaining partnership tax classification and the means through which the Act’s drafters secured this classification for LLC’s); MINN. STAT. § 322B.80(1)(b)(viii) (Supp. 1993) (providing for LLC dissolution on the bankruptcy of any partner).

\(^{131}\) See supra notes 27-28, 33 and accompanying text.

\(^{132}\) See e.g., *Hawkins*, 113 B.R. at 316.

\(^{133}\) See id.

\(^{134}\) The Fifth Circuit Court of Appeals recently repudiated the reasoning of *Hawkins* in *In re Phillips*, 966 F.2d 926 (5th Cir. 1992). Specifically, the
Moreover, this argument clearly does not apply to member-debtors under the Act. The intent relevant to interpreting the Act is that of the enacting Minnesota legislature\textsuperscript{135} which is plainly cognizant of Chapter 11. Business reorganization bankruptcy under Chapter 11 has existed for more than sixty years;\textsuperscript{136} petitioners under Chapter 11 are now treated identically with other Code petitioners and properly classified as bankrupt.\textsuperscript{137} The legislature could have excluded Chapter 11 petitioners from the class of members whose bankruptcy causes dissolution of the LLC, but did not and therefore must be assumed to have contemplated their inclusion. Therefore, bankruptcy courts should treat LLC ipso facto clauses uniformly irrespective of the chapter under which a member seeks bankruptcy protection.

2. Code Section 365(e)(1) and the Supremacy Clause Should not Invalidate the Act's Ipso Facto Provision

Applying a unified analysis to LLC agreements as executory contracts, courts should refuse to invalidate the Act's ipso facto provisions in cases under Chapter 7 or Chapter 11. Read

court critiqued \textit{In re Safren}, 65 B.R. 566 (Bankr. C.D. Cal. 1986), from which \textsc{Hawkins} drew its analysis. \textit{See supra} note 97. Discussing the \textit{Safren} court's method of statutory interpretation and its attempt to uphold debtors' rights under state law, the court explained:

The court's entire policy argument concerns how to interpret state law to effectuate a federal objective: partnership reorganization. But the purpose of the state law construed by the court is not to preserve the life of partnerships; as we have previously explained, that law mandates partnership dissolution on partner bankruptcy to protect the conflicting interests of the many interested parties when the legal nature of the parties' relationships change as a result of a federal law. \textit{Phillips}, 966 F.2d at 931.

The court also criticized the \textit{Safren} analysis for its reliance on the intent of the UPA's drafters. \textit{Id.} Because California adopted the UPA 11 years after business reorganization came into being, the adopting legislature's understanding of the term "bankrupt" included Chapter 11 petitioners. \textit{Id.}

\textit{See, e.g., Phillips}, 966 F.2d at 931 (criticizing the analysis of the \textit{Safren} court for failing to take into consideration the intent of the California legislature, which had full knowledge of Chapter 11 bankruptcy when adopting the UPA, and yet made no attempt to disqualify Chapter 11 petitioners from the class of bankrupt persons enumerated in the UPA).

\textit{Id.} Congress enacted the antecedents to Chapter 11 during the depression years of the 1930s to allow for the business reorganizations of various types of enterprises. \textit{Phillips}, 966 F.2d at 930.

\textit{See Phillips}, 966 F.2d at 931 ("Thus, we side with the many bankruptcy courts that have interpreted various states' versions of the Uniform Partnership Act to include Chapter 11 petitioners as 'bankrupts' under those states' partnership laws").
in isolation, the plain language of Code section 365(e)(1) prevents dissolution and the corresponding termination of the LLC member's governance interests. The Supremacy Clause would therefore require deference to overriding federal bankruptcy law, invalidating the Act's *ipso facto* termination clause. Supremacy Clause analysis, however, presupposes a conflict between state and federal law. Where, as is the case with personal services contracts such as LLC agreements, federal law allows for bankruptcy termination clauses, there is no conflict between state and federal law. When courts conduct a Supremacy Clause analysis to determine the validity of the Act's *ipso facto* clause, they must consider sections 365(e)(2) and 365(c) of the Code. Failing to conduct such an analysis contravenes the express will of Congress.

C. APPLICABLE LAW EXCUSES NON-BANKRUPT MEMBERS FROM SUBSTITUTE PERFORMANCE

The exceptions to the general rule invalidating *ipso facto* clauses and allowing the trustee or DIP to assume an executory contract apply to LLC agreements. The new Act excuses remaining non-bankrupt members from accepting substitute performance from the trustee and the DIP. Section 365(e)(2) ratifies *ipso facto* clauses where assumption of the contract would entail rendering or accepting performance to or from the "trustee or an . . . assignee." Several cases in the partnership context have held that the DIP becomes a legal entity different from the debtor. The DIP assumes all of the trustee's pow-

138. Based on the second line of partner bankruptcy cases, this note concludes that LLC agreements are personal services contracts.

139. Code § 365(e)(2) sanctions *ipso facto* clauses where applicable state law excuses the remaining members from accepting non-consensual substitute performance. The Act clearly prohibits substitute performance of the LLC agreement. See MINN. STAT. § 322B.80 (Supp. 1993); see also La Sala, supra note 9, at 634-35 (describing the lack of conflict between UPA and Code provisions).


141. 11 U.S.C. § 365(c)(1)(A) (1988). The trustee or DIP may assume an executory contract which would require a non-debtor to accept performance from the "debtor or the debtor-in-possession." Id.

142. Id. § 365(e)(2).

143. See La Sala, supra note 9, at 633 & nn.82-86. The DIP assumes all of the trustee's duties, and thus would obtain on assumption of the LLC agree-
ers, and is thus a trustee, unable to assume the contract.\textsuperscript{144} If the contract survives the scrutiny of section 365(e)(2), the trustee may assume the contract under section 365(c), provided that performance continues in the debtor or debtor in possession.\textsuperscript{145} A bankrupt member's governance interests, however, are terminated consistent with federal law;\textsuperscript{146} therefore, there is no contract to assume.\textsuperscript{147} Thus, if LLC agreements constitute "personal services" executory contracts, section 365(e)(2) will apply and preclude assumption of the LLC agreement.

\textbf{D. THE PRINCIPLES EMBODIED IN THE EXCEPTIONS TO ASSUMABILITY OF EXECUTORY CONTRACTS OBTAIN IN THE LLC CONTEXT}

Application of the two exceptions to the general rule of assumability of executory contracts requires a finding that the contract in question is a personal services contract. Courts holding that partnership agreements are personal services contracts have engaged in a multifaceted policy analysis to examine relational aspects of the enterprise. Exploration of the same policies leads to the conclusion that LLC agreements are personal services contracts.

LLCs will typically be closely held. Thus, like a partnership, the task of choosing members will often rest on considerations of trust: trust in a person's judgment and business acumen, trust in a person's integrity, and trust based on personal friendship. Unlike a publicly traded corporation, the LLC can exclude external ownership through mechanisms other than stock price.\textsuperscript{148} Thus, the fiduciary rationale embod-

\begin{itemize}
\item \textsuperscript{144} Id. at 633.
\item \textsuperscript{145} 11 U.S.C. § 365(c) (1988).
\item \textsuperscript{146} As § 365(e)(2) authorizes termination of the member-debtor's contract rights, there is no conflict between the state and federal laws. Section 365(c) must be read to allow assumption only where there exists a contract. If the LLC agreement dissolves and a member's governance interest terminates lawfully under § 365(e)(2), it follows that § 365(c) never enters into the analysis.
\item \textsuperscript{147} See Lewis R. Kaster & Jeffrey K. Cymbler, The Impact of A General Partner's Bankruptcy Upon the Remaining Partners, 21 REAL PROP. PROB. & TR. J. 539, 546-51 (1986) (discussing the relationship between sections 365(e)(2) and 365(c) and concluding that if the court gives effect to the \textit{ipso facto} clause, the contract is terminated along with the debtor's right to participate in enterprise management).
\item \textsuperscript{148} See MINN. STAT. ANN. § 322B.01 (West Supp. 1993), at 30 (Preface and Overview Comments to Reporter's Notes).
\end{itemize}
ied in case law construing partnership agreements in light of Code section 365(e)(2) applies with equal vigor to the LLC agreement.

Equally, allowing the trustee to assume a member's governance interest promises to construct a significant conflict of interest. The interests of bankruptcy creditors and LLC members wishing to carry on the company diverge. Duty bound to hold the LLC interest for the benefit of creditors, the trustee thus faces the dilemma of serving two incompatible masters, and acts favoring one may be quite detrimental to the other.149

Finally, substituting the trustee or DIP for the bankrupt member would violate the identity principle. LLC members did not contract with the trustee, nor the DIP, and should not be compelled to accept performance from him. Allowing non-consensual substitution of a member would in many cases involve interference from an unknown, and unwanted, entity. Prevailing law prohibits imposing a sentence of involuntary servitude.

149. No cases have presented these specific issues yet. Courts in partner bankruptcies presume a conflict of interest between the bankruptcy trustee and the non-bankrupt partners because the trustee owes fiduciary duties to both the estate and the partnership. It is relatively simple to construct hypothetical situations raising conflicts of interest in the LLC context as well.

For example, consider the scenario of the non-bankrupt LLC members attempting to incur long term debt. The Act authorizes LLC's to borrow money and to secure the loan with encumbrances on LLC property. See Minn. Stat. § 322B.20(7) (Supp. 1993). Acquisition of secured debt is vital to the survival of many enterprises. From the trustee's perspective, however, the return on investment may not occur for several years. Meanwhile, the terms of the Chapter 11 plan call for payment of creditors on a regular schedule. If the acquisition of debt reduces profitability in the short term, the trustee may be forced to choose between the best interests of the LLC and the bankruptcy estate.

Furthermore, to the extent the debt is secured, it creates further encumbrances on LLC property, to which the bankrupt member has rights if the LLC dissolves and winds up in the future. See Minn. Stat. § 322B.873 (Supp. 1993) (providing for liquidation and distribution of LLC assets to members after satisfaction of creditors). This may correspondingly reduce the value of the bankrupt member's proportional share in those assets, and provide another layer of creditors who might enter into the dispute over disposition of the bankrupt's assets.

An even more clear cut example is a situation where the LLC members wish to donate to charity. See Minn. Stat. § 322B.20(11) (Supp. 1993) (authorizing charitable donations). Charitable donations may be advantageous to the company from a tax standpoint, and also enhance the LLC's goodwill. To the extent of such donations, however, the LLC deprives the estate of property, and the trustee may have a duty as its representative to object to the donation, even though it may be in the best interest of the LLC.
CONCLUSION

The new Minnesota Limited Liability Company Act presents an attractive business form for the entrepreneur, providing limited liability and classification as a partnership for tax purposes. The bankruptcy of the LLC member presents a dire problem because of the conflicting interests of the bankruptcy estate and the remaining non-bankrupt members.

When considering a member's bankruptcy, courts should apply an analysis congruent to that applied in the partnership context. The existence of mutual duties and obligations between members of the LLC renders the LLC an executory contract; the similarity of such duties and obligations to those of partners in a partnership context makes analogy to the treatment of partnership agreements in bankruptcy appropriate.

Courts should refuse to invalidate the Act's ipso facto clause. Though the clause operates to dissolve the LLC and divest the bankrupt member's governance in the company, the Act, in harmony with federal bankruptcy law, excuses non-bankrupt members from accepting substitute performance. Reasoned policy analysis mandates a finding that LLC agreements are personal services contracts, wholly within the ambit of the two exceptions to the general rule of assumability of executory contracts. A member stands in a fiduciary relationship with other company members. Interposing a new person, either the trustee or the DIP, as a de facto trustee creates an insoluble conflict of interest, as the substituted member's allegiance will always lie with the bankruptcy creditors. Moreover, the substitute, even in the case of a DIP, is a new entity. The other members of the LLC did not contract with this person, and courts should not compel members involuntarily to conduct operations with him.

Consistent with the more well-reasoned line of partnership cases, courts should therefore conclude that LLC agreements are personal services executory contracts, apply the exceptions to the general rule of assumability, and uphold the Act's ipso facto provisions. A bankrupt member should stand as a mere assignee of an economic interest in the company, with all governance rights terminating on petition for bankruptcy relief.