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Questioning Prepetition Bankruptcy Bans

While courts have generally held that provisions in prepetition agreements prohibiting bankruptcy filings are void as against public policy, a recent unpublished decision by the Tenth Circuit Bankruptcy Appellate Panel in In re DB Capital Holdings LLC, No. 10-046, 2010 WL 4925811 (B.A.P. 10th Cir., Dec. 6, 2010), calls this principle into question.

Facts

DB Capital Holdings LLC, a manager-operated Colorado limited-liability company, was created to develop and sell a luxury condominium project in Aspen, Colo. DB Capital has one Class A member and one Class B member, which is a Colorado limited partnership. The general partner (the manager) of the limited partner manages DB Capital pursuant to its operating agreement. The manager, solely owned by Thomas DiVenere, has no membership or other interest in DB Capital.

As of January 2009, DB Capital had no funds to continue the condominium project, and was both insolvent and in breach of its loan obligations. In March 2010, DB Capital's lender asked a Colorado state court to appoint a receiver to take charge of, maintain and protect the company. In May 2010, DB Capital's Class A member intervened in the receivership action and asked the state court to dissolve the company. Shortly thereafter, DiVenere filed a Chapter 11 petition in U.S. Bankruptcy Court for the District of Colorado on behalf of DB Capital.

Prior to filing the Chapter 11 petition, neither DiVenere nor the manager sought or obtained the prior written consent of DB Capital's Class A member. DB Capital's Class A member filed a motion to dismiss the Chapter 11 case on the grounds that, among other things, the petition was filed without proper authorization pursuant to DB Capital's operating agreement. Bankruptcy Judge Michael Romero granted the motion to dismiss the voluntary Chapter 11 case and the Tenth Circuit Bankruptcy Appellate Panel (BAP) affirmed.

Three days after the Bankruptcy Court's order dismissing the bankruptcy case, an involuntary Chapter 11 petition was filed by several petitioning creditors of DB Capital. The Class A member opposed the filing, arguing that it was improperly engineered by DiVenere to stall litigation and ward off foreclosing proceedings prompted by the Class A member and DB Capital's lender. Nevertheless, the Bankruptcy Court, in a 12-page order, ruled that it was in the best interests of DB Capital and its creditors to remain in bankruptcy.

Tenth Circuit BAP's Analysis

Colorado, like most states, has adopted a Limited Liability Company Act, which provides, among other things, that an operating agreement governs the rights and duties of an LLC's members and managers. In reviewing DB Capital's operating agreement, the BAP noted that the agreement contained a provision expressly prohibiting the filing of a bankruptcy petition.[1]

The manager argued, inter alia, that the BAP should invalidate the provision prohibiting a bankruptcy filing because it "was executed at the demand, and for the sole benefit of" DB Capital's lender and, for that reason, the provision is unenforceable as a matter of public policy. In support, the manager cited numerous cases holding that contractual provisions prospectively prohibiting bankruptcy protection are unenforceable.

Both the bankruptcy court and the BAP rejected the manager's argument. The BAP stated that DB Capital "has not cited any cases standing for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy, nor has the court located any."[2]

In addition, the BAP noted that there was no evidence in the record that the lender coerced DB Capital and its members and manager into adopting the language in the operating agreement prohibiting a bankruptcy filing. For that reason, the BAP stated that it "decline[d] to opine whether, under the right set of facts, an LLC's operating agreement containing terms coerced by a creditor would be unenforceable."[3]

Even if the BAP were to disregard the operating agreement's express prohibition on bankruptcy filings as against public policy, the BAP looked to other provisions in DB Capital's operating agreement, including a provision that requires the manager to "conduct and operate its business as presently conducted."[4]

The BAP opined that "[f]iling a Chapter 11 proceeding, with the attendant (and oftentimes expensive and time-consuming) statutory duties placed on debtors-in-possession, and thus their management, essentially makes it impossible to conduct and operate a business as it was being conducted immediately before the filing of the petition."[5]

In addition, the BAP pointed to a provision in the operating agreement that expressly called for the manager to cease operating in that capacity "upon the dissolution or bankruptcy" of DB Capital, and it was clear to the BAP that the manager would no longer be eligible to manage the LLC after a petition was filed. "Because a complete change in management is the exact opposite of 'business as presently conducted,' this portion of the parties' agreement further buttresses the bankruptcy court's decision that manager did not have authority to file this bankruptcy without consent of both members of debtor."[6]

Implications of the BAP's Opinion

Although it is well-settled that prepetition agreements to forego bankruptcy or its benefits are unenforceable,[7] the BAP's opinion, on its face, seems entirely inconsistent with that general principle. A closer look at the opinion, however, may draw that inconsistency into question.

First, as an initial matter, it should not go without noting that the BAP's opinion is unpublished so parties should be cautious when looking to DB Capital Holdings for guidance.

Second, although the BAP ruled that the provisions in DB Capital's operating agreement prohibiting the filing of a voluntary bankruptcy were enforceable, it is somewhat ironic that just three days after the bankruptcy court's ruling, an involuntary bankruptcy was filed against DB Capital. Thus, just

because an LLC's operating agreement may prohibit the filing of a voluntary bankruptcy case, it does not necessarily prohibit creditors from forcing the LLC into an involuntary proceeding.

Third, while the BAP's opinion seems to say that parties are free to agree with third parties to "waive the benefits of bankruptcy," what is not clear is how far this waiver extends in the context of an LLC's operating agreement. Did the BAP really intend to provide LLCs with the ability to bankruptcy-proof themselves?

Finally, although the BAP declined to opine about whether an LLC's operating agreement containing terms coerced by a creditor would be unenforceable, it is not beyond reason that, under the right set of facts and with enough evidence in the record, a court could find such provisions unenforceable.

Thus, it is not clear just how influential or widespread the BAP's opinion will be in sanctioning the prohibition on bankruptcy filings but this is certainly a significant and developing area of law that is worth monitoring.

--By Debra L. Felder, Orrick, Herrington & Sutcliffe LLP

Debra Felder (dfelder@orrick.com) is a senior associate in Orrick's restructuring group in the firm's Washington, D.C., office.

[1] DB Capital's operating agreement provides, among other things, that DB Capital "to the extent permitted under applicable law, will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy." See DB Capital Holdings, LLC, 2010 WL 4925811, at *2.
[2] Id. at *3.
[3] Id.
[4] Id.
[5] Id.
[6] Id.
[7] See, e.g., Peterson-Marone Constr. LLC v. McKissack (In re McKissack), 320 B.R. 703, 721 (Bankr. D. Colo. 2005) (citing Hayhole v. Cole (In re Cole), 226 B.R. 647, 651 n.6 and 652 n.7 (9th Cir. B.A.P. 1998) ("agreements to prospectively prohibit future filings are typically found to be unenforceable as a matter of public policy")); In re Shady Grove Tech. Ctr. Assocs., 216 B.R. 386, 390 (Bankr. D. Md. 1998) ("Prohibitions against the filing of a bankruptcy case are unenforceable."); In re Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (citing Fallick v. Kehr, 369 F.2d 899, 904 (2d cir. 1966)) (holding that an agreement not to file bankruptcy is unenforceable because it violates public policy).