

# Court refuses to enforce Delaware statutory provision stripping LLC interests upon bankruptcy filing

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In *In re Envision Healthcare Corp.*, No. 23-90342, the United States Bankruptcy Court for the Southern District of Texas (Judge Christopher Lopez) addressed a “direct conflict” between the Bankruptcy Code and the Delaware Limited Liability Company Act (the LLC Act).

While section 541 of the Bankruptcy Code creates an estate of all of a debtor’s legal and equitable interests as of the bankruptcy commencement date, section 18-304(1)(b) of the LLC Act strips an LLC member of its LLC membership interest upon a bankruptcy filing.

The court concluded that section 18-304 of the LLC Act must give way to section 541 of the Bankruptcy Code. In reaching its decision, the court also made clear that a member of a Delaware LLC who starts a bankruptcy case keeps all legal and equitable interests in the LLC that it held as of the bankruptcy commencement of the case. As a result, the debtor in *Envision*, who had allegedly been stripped of its membership interest and management rights in a Delaware LLC, had its rights “restore[d].”

## Background

Pre-petition, one of the debtors, Amsurg Holdings LLC (the debtor), Gastroenterology Medical Clinic, Inc. (GMC), and a third entity were the members of Folsom Endoscopy Center (FEC), a Delaware LLC. The debtor held both management and voting membership interests in FEC.

Section 18-304(1)(b) of the LLC Act provides: “A person ceases to be a member of a limited liability company” when it “files a voluntary petition in bankruptcy.” In reliance on this provision of the LLC Act, after the debtor’s bankruptcy filing, GMC and the other FEC member proceeded to amend the FEC operating agreement to reflect that the debtor no longer held a voting or related managerial interest in FEC.

Thereafter, the debtor filed a motion in the bankruptcy court to enforce the automatic stay. The debtor argued that it was stripped of voting and manager rights, which constituted an improper attempt to control property of the estate that was protected by the bankruptcy automatic stay. In response, in addition to opposing the debtor’s stay violation motion on the merits, GMC filed a motion to compel arbitration.

## The court refused to compel arbitration of a core proceeding

The court denied GMC’s motion to compel arbitration, even though the LLC agreement contained a valid arbitration provision.

While the Federal Arbitration Act (FAA) generally requires a court to compel arbitration where the underlying agreement contains an arbitration provision, the court recognized that a bankruptcy court may decline to enforce an arbitration provision (1) involving a proceeding “whose underlying nature derives exclusively from the provisions of the Bankruptcy Code,” and (2) “when arbitration would conflict with the purposes of the [Bankruptcy] Code.”

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The court found that the proceeding before it was “core” under 28 U.S.C. § 157(b)(2)(A). A core proceeding “derives exclusively from the provisions of the Bankruptcy Code.” Because the proceeding was to determine whether a debtor’s interest in property was property of the estate, it was “as core of a proceeding as it gets in bankruptcy.”

The court did not directly address whether enforcement of the arbitration clause would conflict with the purpose of the bankruptcy code. However, it noted that “this is not a contract dispute that should be arbitrated” because there was nothing in the LLC Agreement for an arbitrator to interpret. Instead, the dispute was “really about what legal rights [the debtor] held in FEC” as of the date the bankruptcy was commenced.

## The conflict between Bankruptcy Code Section 541 and LLC Act Section 18-304

Having denied the motion to compel arbitration, the court proceeded to address the direct conflict between section 541 of the Bankruptcy Code and section 18-304(1)(b) of the LLC Act.

Pursuant to section 541(a)(1) of the Bankruptcy Code, an estate is created upon the commencement of a bankruptcy case that

is comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.”

Congress’ intent that the estate should include *all* of a debtor’s legal or equitable interests in property is reinforced by section 541(c)(1)(B), which states that “an interest of the debtor in property becomes property of the estate ... notwithstanding any ... applicable nonbankruptcy law ... that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title ... and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor’s interest in property.”

While federal bankruptcy law determines the scope of a debtor’s bankruptcy estate, a debtor’s pre-bankruptcy rights in property are determined according to state law.

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Section 18-304 of the LLC Act provides that “[a] person ceases to be a member of a limited liability company” when it “files a voluntary petition in bankruptcy.” Delaware case law interpreting this provision holds that, even if a debtor ceases to be a member of an LLC upon its bankruptcy filing, the member still retains certain economic rights. Indeed, *Envision* observed that several Delaware cases have found that “statutory *ipso facto* provisions similar to section 18-304 are not preempted by the Bankruptcy Code to the extent that they divest members who file for bankruptcy of the right to participate in the management of the company but not of their economic rights.”

In reliance on the LLC Act and Delaware case law, GMC argued that the debtor’s voting and related managerial interests in FEC were not property of the estate because the act of filing the petition automatically revoked the debtor’s membership in the LLC under the LLC Act. As a result, the debtor only held an economic interest in FEC as of the commencement of the bankruptcy case.

The court rejected this argument, finding that it “need not opine on whether ‘ceases to be a member’ under Section 18-304 means keeping economic, but not other rights.” That is because “[n]othing in the Bankruptcy Code renders the economic v. managerial distinction meaningful in the context of the creation of the estate.” Any interest of a debtor — vis-à-vis managerial or voting rights —

came into the bankruptcy estate upon the commencement of the bankruptcy case. Thus, whether the debtor retained economic or management rights, did not change the fact that Bankruptcy Code section 541 and LLC Act section 18-304 are in direct conflict.

The court rejected the notion that there is a window between the filing of the bankruptcy case and the formation of the bankruptcy estate in which section 18-304 could strip an LLC member’s rights so that they never become property of the bankruptcy estate under section 541 of the Bankruptcy Code. The court found that “[t]here is no metaphysical moment in time for state law to alter or modify any prepetition legal rights between the filing of the petition and creation of the estate.” These events “occur simultaneously and instantaneously.”

The court concluded that “[t]his decision clarifies that a member of a Delaware LLC who starts a bankruptcy case keeps all legal and equitable interests in the LLC that it held as of the commencement of the case.” Thus, “[the debtor] was improperly stripped of rights simply because it sought relief under federal bankruptcy law” and those rights were “restore[d]” consistent with the decision.

### Conclusion

*Envision* is an important decision that reinforces the property rights of debtors who are LLC members pre-petition and is relevant to closely held LLCs and large LLCs alike. While the decision itself focuses on ensuring that a debtor who is a member of an LLC enters bankruptcy with its membership interests intact, this line of reasoning is likely also to make it more difficult for an LLC and its members to block any transfer of membership interests from one member in bankruptcy to a third party.

If a member/debtor files for bankruptcy, the member could continue to be a member post-petition if the member remains a debtor-in-possession. However, if the member/debtor files a Chapter 7 bankruptcy case, and a Chapter 7 trustee is appointed, the trustee — a stranger to the LLC — would accede to the member’s interest and exert control over the member’s interest. Because a Chapter 7 trustee has a fiduciary interest to the creditor body — and not the LLC’s members — the trustee could pursue litigation or other remedies against LLC members that a debtor-in-possession may not otherwise pursue.

*Envision* makes it difficult for states to enact laws — or LLC members to voluntarily contract for protections — to block this scenario. Accordingly, LLC members must factor this counterparty risk into their business dealings moving forward and think creatively about other ways to protect themselves and their membership interests in an LLC in the event of a co-member or manager bankruptcy.

*The writers are regular, joint contributing columnists on bankruptcy law for Reuters Legal News and Westlaw Today.*

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