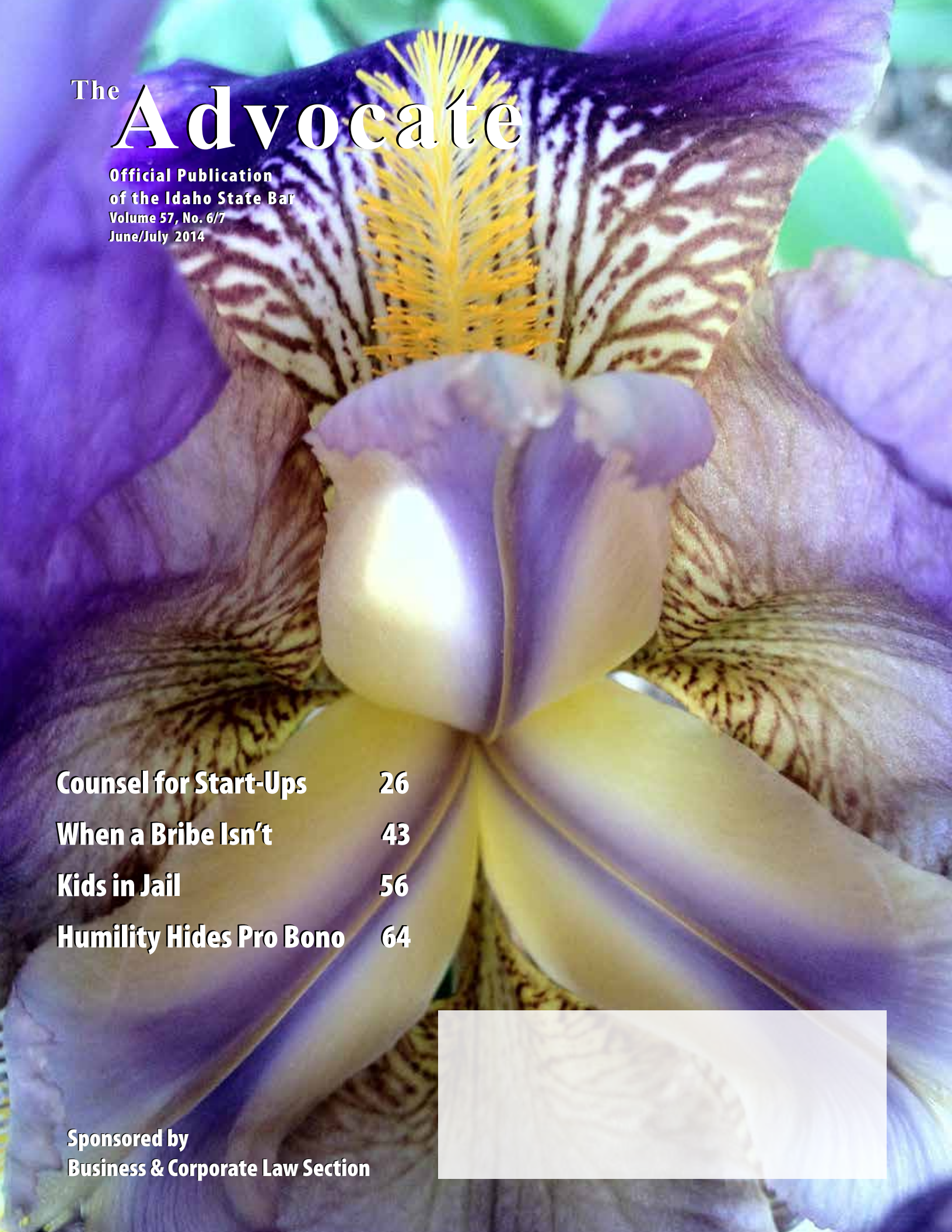

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"Is the Trustee Really my New Business Partner?!" Chapter 7 Bankruptcy Trustees and Membership/Shareholder Interests

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Who has the authority to direct the activities of a company or corporation after a Chapter 7 bankruptcy estate is created? The member/debtor might believe that he retains the right to continue to operate or wind-up the business and make distributions. The Chapter 7 Trustee, however, has significant rights to "interfere." This article examines how the bankruptcy court in Idaho is dealing with these issues by analyzing a line of court cases to determine that the Chapter 7 Trustee could act as a new business partner (or even the owner of the business) when a debtor files a Chapter 7 bankruptcy.

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The history of *Gugino v. NELMAP, LLC (In re Wallace)*

Leonard Wallace wanted ownership of a cattle-product patent. He knew of a company, owned by Norman and Rodney Hayes, which owned the patent, and Wallace invested a significant sum of money in a membership interest in that company. Later, Wallace alleged that Hayes had embezzled money from the company, and Wallace decided to sue Hayes to try and recover some of the funds. Hayes counterclaimed by arguing that Wallace himself had infringed on the patent. An arbitrator awarded Hayes damages in excess of $2.5 million.

Wallace appealed this arbitration award, and spent the next few years in various Montana and Idaho courts litigating the ownership of the patent and the arbitration award against him. While the litigation progressed, Wallace decided to protect his other assets and created a complicated web of corporations, limited liability companies, and revocable trusts to own his other real estate and valuable assets.

Ultimately, Wallace (together with his wife) filed bankruptcy in the District of Idaho, and their case ended up in a Chapter 7 proceeding, with Jeremy J. Gugino appointed as their Chapter 7 Bankruptcy Trustee.[1] As a significant portion of the Wallaces' valuable assets were transferred into this web of companies, Gugino asserted the bankruptcy estate's interest in those companies. Wallace questioned, however, the actual interest that the estate held in the companies. To determine the estate's interest in the companies, the bankruptcy court turned to a line of bankruptcy cases, largely from other districts, which had previously determined the extent of a bankruptcy estate's interest in companies owned by debtors when they file bankruptcy petitions.

Background cases

In re Albright[2]

Ashley Albright was the sole member and manager of Western Blue Sky, LLC, on the day she filed a Chapter 7 bankruptcy petition in the District of Colorado. Under Colorado law, a membership interest in a limited liability company is personal property, and therefore her Western Blue Sky interest became property of her bankruptcy estate.[3] Western Blue Sky owned certain unencumbered real property. The Chapter 7 Trustee sought to manage Albright's interest in Western Blue Sky by selling the real property and dissolving the company.

Albright argued that as a representative of her creditors, the Chapter 7 Trustee had only the same tools a creditor would have — a charging order against distributions made from the company but not management of the company itself. The bankruptcy court ruled, however, that, because the Western Blue Sky interest was personal property, ownership of that interest transferred to the bankruptcy estate automatically upon the filing of the bankruptcy petition.

Further, the court ruled that a charging order was to protect other members of a limited liability company from being forced to deal with new members. Because there were

no other members of Western Blue Sky, a charging order would serve no purpose. As the sole member of the company, the bankruptcy trustee was the only individual with the authority to liquidate assets and dissolve the company and had full authority to take those steps.

In re A-Z Electronics, LLC[4]

Ron Ryan and his wife were 100% owners of A-Z Electronics, LLC, when they filed a Chapter 7 bankruptcy petition on November 21, 2003. While their individual Chapter 7 case was still open, Ryan caused A-Z Electronics, LLC, to file its own Chapter 11 bankruptcy petition. Ryan signed all documents related to the Chapter 11 petition. The United States Trustee moved to dismiss the Chapter 11 case, arguing that the only individual with the ability to authorize the filing of the Chapter 11 petition was the Chapter 7 Trustee, Lois Murphy, and that she had not authorized the filing.[5] Citing *Albright*, Judge Terry L. Myers, Chief Bankruptcy Judge for the District of Idaho, agreed and dismissed the Chapter 11 petition.

Fursman v. Ulrich
(In re First Protection)[6]

On the same day that David and Laura Fursman filed a Chapter 11 petition, they caused their 100% owned company, First Protection, Inc., to file its own Chapter 11 petition. The two cases were later consolidated. At the time of their filing, the Fursmans were also the 100% owners of Redux Development, LLC ("Redux"). Redux, in turn, owned certain real property and a 2002 Cadillac Escalade: these assets had a total asserted value of $340,000.

During the Chapter 11 portion of the cases, the Fursmans transferred 50% of their interest in Redux to Mrs. Fursman's mother, Gale Thompson. In return, Thompson agreed to "loan" Redux funds as agreed upon by her and the Fursmans, so Redux could develop the real property it owned. Thompson ultimately loaned Redux approximately $70,000, the vast bulk of which was used to pay the Fursmans' personal expenses, not any development of the Redux property.

The cases were later converted to Chapter 7 proceedings, and a Chapter 7 Trustee was appointed. The Chapter 7 Trustee sought to recover the 50% interested in Redux that the Fursmans had transferred to Thompson.[7] The bankruptcy court ordered that the Trustee could recover the interest. The Fursmans appealed the bankruptcy court's decision to the Ninth Circuit Bankruptcy Appellate Panel.[8]

The Fursmans argued on appeal that the only thing of value held by the estate was the economic rights in Redux, not the management rights they had previously held. The Fursmans' argument was based on Arizona state law and the language in Redux's operating agreement which stated that after the transfer of the interest from the Fursmans to the bankruptcy estate, the bankruptcy estate's interest was simply as an assignee.

The Ninth Circuit BAP disagreed with the Fursmans' position.[9] The BAP stated that certain portions of the Bankruptcy Code made those provisions of the operating agreement and Arizona state law ineffective against the bankruptcy estate. Specifically, the BAP cited section 541(c)(1)(A)[10] of the Bankruptcy Code and found that this section

> overrides both contract and state law restrictions on the transfers or assignment of Debtors' interest in Redux in order to sweep all their interests into their estate … As a result, the trustee was not a mere assignee, but stepped into Debtors' shoes, succeeding to all of their rights, including the right to control Redux.

As a result, the bankruptcy trustee was able to recover the entire interest, and liquidate and dissolve the company.[11]

Movitz v. Fiesta Investments, LLC
(In re Ehmann)[12]

Movitz presents a new wrinkle — a multi-member limited liability company. At the time of his bankruptcy filing, Gregory Ehmann owned a minority interest in Fiesta Investments, LLC ("Fiesta"). Ehmann's parents had created Fiesta as a tax-shelter and "to accumulate investments for the benefit of [their] children after [the parents'] deaths."

Fiesta moved to dismiss the Complaint, arguing that the Trustee simply held economic rights in the company and did not have the authority to seek judicial dissolution of the company.

All of the members of Fiesta were related to Ehmann. Shortly after Ehmann's bankruptcy case was filed, Fiesta received an influx of $837,000 in cash when one of its assets was sold. Additionally, it had regular quarterly income from its other asset, a 25% interest in a different company. Fiesta would regularly "lend" the other members of the company funds (in excess of $374,000), gifted $42,500 to one member, and redeemed another member's interest for $124,000.[13]

The bankruptcy trustee filed a complaint against Fiesta, seeking a declaration that the Trustee had the status of a member in Fiesta, a determination that the assets of Fiesta were being wasted, misapplied or diverted for improper purposes, and an order for dissolution and liquidation of Fiesta or the appointment of a receiver for Fiesta. Fiesta moved to dismiss the Complaint, arguing that the Trustee simply held economic rights in the company and did not have the authority to seek judicial dissolution of the company. Fiesta based its position on the argument that the Fiesta operating agreement was an "executory contract," and therefore the restrictions in the operating agreement on transferring one's interest were enforceable.[14]

The bankruptcy court disagreed with Fiesta's argument, stating that the operating agreement in this case was not an executory contract, and therefore the membership interest became property of the estate pursuant to Section 541.[15] Because the Trustee could prove facts to support his Complaint, the motion to dismiss was denied. The court went on to recite the various remedies that would be available to the Trustee (and included all of those originally sought by the Trustee). The parties later settled the case, which resulted in a 100% payment to Ehmann's creditors.

Idaho's decisions

In re Hoyle[16]

Richard Hoyle owned a myriad of properties, many in his own name. Two significant parcels of real property, however, were owned through limited liability companies in which he was the sole member — Brundage Inn, LLC, and Hoyle Investment, LLC. After his Chapter 11 bankruptcy was converted to Chapter 7, the Chapter 7 Trustee sought confirmation from Judge Myers that she had 100% authority over the two LLCs.

The concepts in these cases could still be used to argue that the Chapter 7 Trustee has the same rights the debtor held pre-petition (i.e., the Trustee could attend meetings and even vote on issues presented for votes).

Citing the various decisions discussed herein, Judge Myers issued an oral opinion, specifically ruling that "Hoyle's 100% membership interest in the two single member LLC's … is property of the estate and the Trustee is entitled to both the economic interest and the right to control and management of those entities."[17] The Trustee then took over the entities, and liquidated the property owned by Hoyle Investment, LLC.[18]

Gugino v. NELMAP, LLC (In re Wallace)[19]

Reviewing each of these cases, Judge Myers ruled that Gugino had full authority to liquidate assets of the Wallace's entities and make distributions to the bankruptcy estate through winding-up the business of the entities. Gugino has done just that: he has replaced the Wallaces as managers or officers of the various entities and sold the assets of the entities. Gugino is now in the process of winding up and dissolving the entities and making distributions to the bankruptcy estate.

Conclusion

As to single-member companies or single-shareholder corporations, the Chapter 7 Trustee becomes the sole person with authority to direct the activities of those companies after a Chapter 7 bankruptcy estate is created. Of course, the Chapter 7 Trustee must still comply with all relevant state law and operating agreement[20] procedures for winding up the business of the company and making distributions.

What remains less clear is the Chapter 7 Trustee's authority over multi-member companies or corporations. The concepts in these cases could still be used to argue that the Chapter 7 Trustee has the same rights the debtor held pre-petition (i.e., the Trustee could attend meetings and even vote on issues presented for votes). However, the executory contract or charging order analysis may hold much greater sway in a multi-member situation.

In any case, if a soon-to-be chapter 7 debtor holds any membership or shareholder interests at all, that debtor (and any attorneys involved for the debtor or the companies) should take a hard look at the com-

panies, and evaluate whether they are at risk of "interference" by their new partner and/or owner — the Chapter 7 Trustee.

Endnotes

1. When a debtor files bankruptcy, a bankruptcy estate is created. In a Chapter 7 bankruptcy case, a Trustee is appointed as the representative of the bankruptcy estate.

2. *In re Albright*, 291 B.R. 538 (Bankr. D. Col. 2003).

3. Colo. Rev. Stat. §7-80-702; 11 U.S.C. §541(a)(1).

4. *In re A-Z Electronics, LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006).

5. *A-Z Electronics* also suffered from a lack of briefing from either party, and the Debtor did not even file a written response to the Motion. Additionally, neither party produced any documentary or testimonial evidence at the hearing on the Motion to Dismiss, instead simply relying on what had actually been filed in the case. A substantial issue may have arisen if Ryan had argued that he was the manager of the LLC; had never been replaced as manager; and had authority, pursuant to the company Operating Agreement and as the manager, to authorize a bankruptcy petition.

6. 440 B.R. 821 (9th Cir. BAP 2010).

7. *See 11 U.S.C. §549*, which allows a Chapter 7 Trustee to recover property that was transferred during the pendency of a Chapter 11 case, if it was transferred without proper authorization.

8. The Ninth Circuit Bankruptcy Appellate Panel is an alternative court for appeals from bankruptcy court decisions. In the Ninth Circuit, all appeals from bankruptcy court decisions are automatically referred to the BAP, unless a party opts out of having the BAP hear the appeal, in which case the appeal reverts back to the District Court. A large portion of bankruptcy appeals are handled by the BAP, who hear cases in panels of three judges. All six BAP judges are also sitting bankruptcy judges throughout the Ninth Circuit, and are appointed for a seven-year term as a BAP judge (subject to a three-year extension).

9. Judge Jim D. Pappas, Idaho's other bankruptcy judge, sat on the BAP panel that decided *Fursman v. Ulrich*.

10. 11 U.S.C. §541(c)(1)(A) provides that "an interest of the debtor in property becomes property of the estate … notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law that restricts or conditions transfer of such interest by the debtor."

11. It appears that, notwithstanding the asserted value, the real property owned by Redux was actually valued at less than $40,000.00.

12. 319 B.R. 200 (Bankr. D. Ariz. 2005). This opinion was later withdrawn at the request of the parties. *See Movitz v. Fiesta Investments, LLC (In re Ehmann)*, 337 B.R. 228 (Bankr. D. Ariz. 2006).

13. In the original factual recitation in the opinion, after citing these various payments, the bankruptcy judge foreshadows his coming opinion: "[The] outflow of over half a million dollars does not seem to be consistent with the original goal to accumulate investments for the benefit of our children after our deaths." 319 B.R. at 202.

14. *Compare* 11 U.S.C. 365(e) *with* 11 U.S.C. §541(c)(1)(A). In the Ninth Circuit, a contract is executory if the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other. *See Unsecured Creditors' Comm v. Southmark Corp (In re Robert Helms Constr. And Dev. Co., Inc.)*, 139 F.3d 702 (9th Cir. 1998) (*citing* Vern Countryman, *Executory Contracts in Bankruptcy, Part 1*, 57 Minn L. Rev. 439, 460 (1973)).

15. The court's decision was largely based on a review of the operating agreement at issue, and the fact that the Debtor was not a manager of the company and had virtually no obligations under the operating agreement – just rights. *See* 319 B.R. at 204-05.

16. District of Idaho Bankruptcy Case No. 10-01484-TLM.

17. As Judge Myers' decision was an oral ruling, no written decision on the initial motion exists. However, Hoyle later sought clarification of Judge Myers' opinion, which resulted in a written order confirming the previous oral ruling. *See* Case No. 10-01484-TLM, Summary Order dated April 4, 2013.

The Ninth Circuit Bankruptcy Appellate Panel is an alternative court for appeals from bankruptcy court decisions.

18. The Trustee later determined that the assets held by Brundage Inn, LLC, did not exceed the liabilities of the company, and she abandoned the bankruptcy estate's interest in that company.

19. 13.2 IBCR 61 (Bankr. D. Idaho 2013).

20. Although, as the sole member, the Trustee has the sole ability to amend the Operating Agreement if necessary.

About the Author

Matthew T. Christensen *received his JD and LLM degrees from Duke Law School, and is presently an associate attorney at Angstman Johnson in Boise. Matt has practiced law in Idaho since 2005, and currently focuses on bankruptcy, real estate and business-related matters. Matt is a member of the Governing Council of the Business and Corporate Law Section and also teaches real estate, international law and law practice management courses as an adjunct professor.*