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Texas Bankruptcy Court Holds That Bankruptcy Code Overrides Delaware Limited Liability Company Act

*By Robert Klyman and Matthew Sarna**

In this article, the authors discuss a recent decision by a Texas bankruptcy court holding that the Bankruptcy Code automatically overrides a provision of the Delaware Limited Liability Company Act and prevents a member from losing any portion of its membership interest – whether economic or managerial – merely because the member commenced a bankruptcy case.

In *In re Envision Healthcare Corp.*,¹ Judge Christopher M. López of the U.S. Bankruptcy Court for the Southern District of Texas ruled that Section 541 of the Bankruptcy Code conflicts directly with and, therefore, trumps Section 18-304 of the Delaware Limited Liability Company (LLC) Act to prevent the termination of a member's interests in a Delaware LLC arising from such member's bankruptcy filing.

SECTION 18-304 OF THE DELAWARE LLC ACT

The Delaware LLC Act states that, unless otherwise provided in the relevant LLC agreement, the commencement of a bankruptcy case by a member of the LLC automatically divests that member of its membership interest in the LLC.

According to Section 18-304 of the LLC Act:

A person ceases to be a member of a limited liability company upon the happening of any of the following events:

- (1) Unless otherwise provided in a limited liability company agreement, or with the consent of all members, a member:
 - a. Makes an assignment for the benefit of creditors;
 - b. *Files a voluntary petition in bankruptcy;*
 - c. Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding. . . .²

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¹ *In re Envision Healthcare Corp.*, Case No. 23-90342 (Bankr. S.D. Tex. Dec. 12, 2023).

² 6 Del. C. § 18-304(1) (emphasis added).

Despite the language of Section 18-304, Delaware courts have distinguished a member's economic and managerial interests in an LLC and have limited the application of Section 18-304 to only divest a bankrupt member's managerial interests, leaving economic interests unaffected.

For example, in *Milford Power Co. v. PDC Milford Power, LLC*,³ the Delaware Court of Chancery held that federal bankruptcy law partially preempted Section 18-304, striking a balance between the application of the Bankruptcy Code and Delaware law:

I also conclude that the ipso facto clause⁴ is preempted to the extent that it would deprive [the debtor/member] of the economic rights available to an assignee of an LLC membership interest under § 18-702(b)(2) of the Delaware LLC Act. By contrast, the ipso facto clause is enforceable insofar as it divests [the debtor/member] of its right to participate as a member in the governance of Milford Power. This conclusion rests largely on my adoption of the reasoning of the United States District Court for the District of Delaware in *In re IT Group, Inc.*⁵

The Delaware Supreme Court in *Zachman v. Real Time Cloud Services, LLC*,⁶ followed *Milford Power's* reasoning. In *Zachman*, the court held that the application of Section 18-304 did not offend federal bankruptcy law, as it acts only to decouple a member's managerial interests from its economic interests in a Delaware LLC, leaving economic interests in place.⁷

THE TEXAS DECISION

Notwithstanding this established Delaware precedent regarding Delaware law, the Texas bankruptcy court recently took a different approach.

In a case of first impression for the Texas bankruptcy court, Judge López held that the Bankruptcy Code overrides Section 18-304 of the LLC Act automati-

³ *Milford Power Co. v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. 2004).

⁴ The reference to "ipso facto clause" refers to a contract term that permits its termination due to the bankruptcy, insolvency, or financial condition of a party. Such provisions in most contracts are rendered unenforceable in a bankruptcy case under Section 365(e)(1) of Title 11 of the U.S. Code (Bankruptcy Code).

⁵ *Milford Power*, 866 A.2d at 740.

⁶ *Zachman v. Real Time Cloud Services, LLC*, C.A. No. 9729-VCG (Del. Apr. 20, 2021).

⁷ *Id.* at *3 (citing similarly reasoned decisions from the Supreme Court of Washington and the U.S. Bankruptcy Court for the Eastern District of Virginia).

cally and prevents a member from losing any portion of its membership interest – whether economic or managerial – merely because the member commenced a bankruptcy case.

Background

In *In re Envision Healthcare Corp.*, AmSurg Holdings, LLC (AmSurg) held managerial and voting interests in Folsom Endoscopy Center (FEC), a Delaware LLC. FEC’s LLC agreement provided that its board of directors, of which AmSurg held two seats, could not take certain actions without AmSurg’s consent, including to amend the LLC agreement itself. In May 2023, AmSurg filed for chapter 11 protection. Later that year, FEC’s board voted to amend the LLC agreement without the consent of AmSurg.

AmSurg responded with a motion to enforce the automatic stay under Section 362 of the Bankruptcy Code to block that amendment to the LLC agreement. FEC contended, pursuant to Section 18-304 of the LLC Act, that AmSurg lost its membership interest in FEC automatically when AmSurg filed for bankruptcy – and therefore that FEC could proceed to amend the LLC without AmSurg’s consent.

Holding

The Texas bankruptcy court ruled in favor of AmSurg, finding that the Bankruptcy Code overrides Delaware law’s automatic termination of a member’s LLC interests when a member files for bankruptcy. In doing so, the Texas bankruptcy court held that both a member’s managerial and economic interests in a Delaware LLC constitute property of the estate under Section 541 of the Bankruptcy Code.

As such, any act to take possession or exercise control over those property interests, including FEC’s vote to amend the LLC Agreement without AmSurg’s post-petition consent, was blocked by the automatic stay imposed under Section 362 of the Bankruptcy Code.

Sections 541 and 362 of the Bankruptcy Code

Under Section 541 of the Bankruptcy Code, upon filing, “all legal or equitable interests of the debtor” become property of the debtor’s estate.⁸ Property of the debtor’s estate is contemporaneously protected by the automatic stay that comes into effect upon a filing under Section 362 of the Bankruptcy

⁸ 11 U.S.C. § 541(a)(1).

Code.⁹ Among other things, the automatic stay acts to shield property of the debtor's estate from "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."¹⁰

THE TEXAS BANKRUPTCY COURT CONFLICTS WITH DELAWARE PRECEDENT

The Texas bankruptcy court's decision is at odds with *Zachman* and *Milford Power*. Reviewing these two cases, the Texas bankruptcy court explained neither Delaware court had directly confronted the scope of Section 541 of the Bankruptcy Code. To that end, the bankruptcy court found no basis in in the Bankruptcy Code to render the economic vs. managerial distinction meaningful. Rather, the bankruptcy court found Section 541 of the Bankruptcy Code and Section 18-304 of the LLC Act to be in direct conflict, with the Bankruptcy Code taking priority. As the Texas bankruptcy court explained:

This 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. Managerial and voting rights are legal and equitable interests that AmSurg held as of the petition date, so they are included as property of its estate. . . . AmSurg was improperly stripped of rights simply because it sought relief under federal bankruptcy law. This decision restores AmSurg's rights.¹¹

CONCLUSION

In reaching this decision, the Texas bankruptcy court relied on persuasive authority from bankruptcy courts in West Virginia, Oregon, and New York, each of which reached similar decisions with respect to each state's respective statutes.¹²

While the Texas bankruptcy court's ruling is not binding authority on courts in Delaware, the *Envision Healthcare* decision adds to the body of authority invalidating the impact of Section 18-304 of the LLC Act.

⁹ 11 U.S.C. § 362(a).

¹⁰ 11 U.S.C. § 362(a)(3).

¹¹ In re Envision Healthcare Corp., Case No. 23-90342, at *7 (Bankr. S.D.T.X. Dec. 12, 2023) (emphasis in original).

¹² See *id.* (citing *Sheehan v. Warner* (In re Warner), 480 B.R. 641 (Bankr. N.D. W. Va. 2012), *Pearce v. Woodfield* (In re Woodfield), 602 B.R. 747 (Bankr. D. Or. 2019), and *Weiss v. All Year Holdings Ltd.* (In re All Year Holdings Ltd.), 648 B.R. 434 (S.D.N.Y. 2022)).