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Business Law

LLC Members by Default?

Suppose an LLC member loses his or her shares to a creditor outside the company - does the creditor then stand in the former member's shoes, complete with voting rights? Not without other members' consent, says the LLC Act. Make sure you draft operating agreements accordingly.

By Lin Hanson

A recent opinion in a Chapter 7 Bankruptcy in the Northern District of Illinois, Eastern Division teaches important lessons about the nature of a membership interest in an LLC and how to draft operating agreements. The opinion, *In re Adams, Debtors*, No 08 B 20217, 424 BR 434 (ND Ill 2010) also reached the correct result. The court's memorandum opinion states the issue(s) and decision concisely:

This matter is before the court on the motion of John Gierum, trustee of the bankruptcy estate of debtors Douglas M. Adams and Leanne Adams, for leave to sell the estate's interest in certain property. The Adamses have objected to the motion. The objection raises a question that appears

to be one of first impression in this circuit: when a chapter 7 trustee in a non-surplus case proposes to sell estate assets, does the potential distribution of the proceeds to creditors holding nondischargeable claims, a distribution that would reduce the debtor's post bankruptcy liability to those creditors, give the debtor standing to object to the sale? The answer to that question is no. The Adamases accordingly lack standing to object to the sale, and Gierum's motion will be granted.

The proposed sale of the estate's interest in the LLC was to another member of the LLC. This might or might not have been significant. The debtors sought to object to the sale on the grounds that the sale price was too low. Since the proceeds would go to pay non-dischargeable debt, they wanted to see to it that the price was as high as possible.

The case highlights the interrelationship of sections 363, 365 and 541 of the Bankruptcy Code (Title 11 US Code) and sections 10 and 30 of the Illinois Limited Liability Company Act, 805 ILCS 180/1-1 et seq. The Illinois Act, at 805 ILCS 180/10-1, indicates that unanimous consent is required to admit a new member to the company: "Admission of members. After the filing of the articles of organization, a person who acquires a membership interest directly from the limited liability company or is a transferee of a membership interest may be admitted as a member *with unanimous consent of the members*" (emphasis added).

At 805 ILCS 180/15-1(c), that act provides as follows: "The only matters of a member or manager-managed company's business *requiring the consent of all of the members* are the following:...(6) *the admission of a new member.*" (Emphasis added).

Drafting tips

Because the *Adams* case deals with the standing of bankrupt members to object to the sale, and since the sale was to another member of the LLC, it provides no insight into the issue of what the buyer of the interest would receive. More to the point, it raises the question whether a creditor-buyer would be buying a right to play a role in the management of the LLC.

Full membership in an LLC includes both the right to distributions and the right to participate, in concert with other members, in the governance of the company. The LLC Act distinguishes between economic rights and those related to governance. Clearly they are separate. Look at the provisions of Article 30:

805 ILCS 180/Art. 30. Assignment of Membership Interests

30-5 Transfer of a distributional interest. A transfer of a distributional interest does not entitle the transferee to become or to exercise any rights of a member. A transfer entitles the transferee to receive, to the extent transferred, only the distributions to which the transferor would be entitled.

30-10. Rights of a transferee. (a) A transferee of a distributional interest may become a member of a limited liability company if and to the extent that the transferor gives the transferee the right in accordance with authority described in the operating agreement *or all other members consent* (emphasis added).

...d) *A transferee who does not become a member is not entitled to participate in the management or conduct of the limited liability company's business, require access to information concerning the company's transactions, or inspect or copy any of the company's records* (emphasis added).

Sec. 30-20. Rights of creditor.

(a) On application by a judgment creditor of a member of a limited liability company or of a member's transferee, a court having jurisdiction may charge the distributional interest of the judgment debtor to satisfy the judgment. The court may appoint a receiver of the share of the distributions due or to become due to the judgment debtor and make all other orders, directions, accounts, and inquiries the judgment debtor might have made or which the circumstances may require to give effect to the charging order.

(b) A charging order constitutes a lien on the judgment debtor's distributional interest. The court may order a foreclosure of a lien on a distributional interest subject to the charging order at any time. A purchaser at the foreclosure sale has the rights of a transferee.

(c) at any time before foreclosure, a distributional interest in a limited liability company that is charged may be redeemed: (1) by the judgment debtor; (2) with property other than the company's property, by one or more of the other members; or (3) with the company's property, but only if permitted by the operating agreement

....

(e) This Section provides the exclusive remedy by which a judgment creditor of a member or a transferee may satisfy a judgment out of the judgment debtor's distributional interest in a limited liability company.

Typically, the members of a limited liability company prefer not to have a stranger forced upon them as a fellow member without their consent. Keeping in mind the sections of the LLC Act set forth above, drafters of operating agreements should consider including provisions to create a right of first refusal for shares or, alternatively, a right to redeem an interest purchased at a creditor's sale.

Drafters should also consider including language that provides that a creditor, or a purchaser at a creditor's sale, acquires only the distributional interest of the member, not his right to participate in governance and inspect books and records. Wise counsel will add questions about these issues to their drafting checklist and review it with clients.

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