PARTNERSHIPS

PARTNERSHIP AS DEBTOR

The partnership is an ancient business form that comes in all shapes and sizes, running the gamut from a simple two-person enterprise to a huge professional partnership.[900] Certain partnership traits, however, are consistent regardless of a partnership's complexity. For example, under state law, general partners are liable (with certain exceptions) for the debts of the partnership.[901] When a partnership is in bankruptcy, the estate has a claim against each general partner for some or all of the partnership debts. Due to the interlocking liability between the general partners and the partnership, encouraging consensual negotiations and exchange of information between general partners, the estate (either represented by a trustee or by the debtor in possession), and creditors inures to the benefit of all parties in interest. Clarifying and balancing the rights and liabilities between these three competing groups in a partnership bankruptcy case is the focus of the recommendations in this area.

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[900] Sally S. Neely, *Partnerships and Partners and Limited Liability Companies and Members in Bankruptcy: Proposals for Reform*, 71 AM. BANKR. L.J. 271, 271-272 (1997) (tracing the existence of partnerships "'from Babylonian sharecropping through classical Greece and Rome to the far-flung trading enterprises of the Renaissance'") (quoting ALAN R. BROMBERG & LARRY E. RIBSTEIN, PARTNERSHIP §1.02(a), at 1:19) (1996)).

[901] U.P.A. § 15; R.U.P.A. § 306 (indicating that all partners are jointly and severally liable for the obligations chargeable to the partnership).

RECOMMENDATIONS

2.3.1 *Defining the term "General Partner"*

A "general partner" should be defined under 11 U.S.C. § 101 as any entity that as a result of an existing or former status as an actual or purported general partner in an existing, former, predecessor, or affiliated partnership, is liable under applicable nonbankruptcy law for one or more debts of the partnership.

2.3.2 *Consent of Former Partners*

The Bankruptcy Code and Rules should be amended to clarify that, notwithstanding Recommendation 1 (defining "general partner"), a former general partner of a partnership is not, absent a specific court order to the contrary, required to consent to a voluntary petition by a partnership, to be served with a petition or summons in an involuntary case against a partnership, or to perform the duties of disclosure or procedural duties imposed on a general partner of a debtor partnership.

2.3.3 *Bankruptcy Court Jurisdiction*

The court in which a partnership case is pending should have jurisdiction under 28 U.S.C. § 1334(b) to determine who is or may be liable as a general partner for the debts of the partnership and may determine the rights among the general partners with respect to the debts of the partnership. Such matters should constitute core proceedings under 28 U.S.C. § 157(b).

2.3.4 *Liability of General Partner for Deficiency in Partnership Case*

If there is a deficiency of property of the partnership estate to pay in full all allowed claims in a case under title 11, the estate should have a claim against each general partner to the extent that, under applicable nonbankruptcy law, such general partner is personally liable for such deficiency. The amount of the deficiency claim should not be reduced on account of any right of contribution or indemnity among general partners. The claim should be estimated if its determination would

unduly delay the administration of the case. Any action or proceeding to enforce liability under this section should be commenced no later than four years after the entry of the order for relief in the case concerning the partnership.

2.3.5 *Power of the Court to Assure Payment of the Deficiency*

Renumbered section 723(b) of the Bankruptcy Code should be amended to provide that the court in a partnership case may, after notice and a hearing, order any general partner that is not a debtor in a case under this title (1) to provide the estate, in such amount as the court shall determine to be appropriate under the circumstances, with indemnity for, or assurance of payment of, any deficiency recoverable from such general partner, or (2) not to incur obligations or transfer property except under specified circumstances.

2.3.6 *Trustee's Recovery against the Estate of a Debtor General Partner*

Renumbered section 723(c) of the Bankruptcy Code should be amended to provide that notwithstanding section 728(c), the trustee of a partnership has a claim against the estate of each general partner in such partnership that is a debtor in a case under title 11 for (1) the full amount of all claims allowed in the case concerning the partnership for which such general partner would otherwise be personally liable as a general partner under applicable nonbankruptcy law; and (2) administrative claims which have been assessed against such general partner. Notwithstanding section 502 of this title, there shall not be allowed in such partner's case a claim against the partner on which both the general partner and the partnership are liable, except to the extent that such claim is allowable and secured only by property of such general partner and not by property of such partnership.

2.3.7 *Repeal of the "Jingle Rule" in All General Partner Bankruptcy Cases*

Chapter 5 of the Bankruptcy Code should be amended in order to provide that the claim of a trustee of a partnership debtor, or the claim of a creditor of a nondebtor partnership, is entitled to share in the distribution in a general partner's bankruptcy case in the same manner and to the same extent as any other claim of the same class of a creditor of such general partner.

2.3.8 *Allocation of Expenses of Administration of a Partnership Case*

Chapter 5 of the Bankruptcy Code should be amended to provide that the expenses of administration of a partnership case under section 503 of the Bankruptcy Code may be assessed against general partners or paid from the property constituting recoveries from general partners under this section and from other property of the estate in such proportions as the court shall determine are fair and reasonable after notice and hearing.

2.3.9 *Distribution of Recoveries from General Partners*

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Bankruptcy Code (except as provided in Recommendation 2.3.8 above), the trustee should apply any recovery obtained from a general partner or the estate of a general partner only to the payment of deficiencies on claims for which such general partner is personally liable as a general partner under applicable nonbankruptcy law. Any property constituting recoveries from general partners or the estates of general partners under this Recommendation not applied to the proper deficiencies as herein provided or to administration expenses (as provided in Recommendation 2.3.8 above), should be equitably distributed by the trustee to such general partner or to such general partners' estates as may be ordered by the court after notice and hearing.

2.3.10 *Distribution of Property of the Partnership Estate*

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Code, and except as set forth in Recommendation 2.3.8 above (treatment of expenses of administration), the trustee should distribute property of the partnership estate which is not recovered from general partners or the estates of debtor general partners to allowed claims against the partnership in accordance with otherwise applicable provisions of this title without considering distributions of property from general partners or general partners' estates.

2.3.11 *Trustee's Power to File Involuntary Cases*

Section 303(b)(3) of the Bankruptcy Code should be amended to permit the trustee of a partnership in a case commenced under title 11 to file an involuntary petition against a general partner without regard to the

number of creditors, nature of the claims or dollar amount of the claims otherwise required under section 303(b)(1) and (2).

2.3.12 ***Appointment of Committee of General Partners***

Chapter 11 of the Bankruptcy Code should be amended to provide that, on request of a party in interest, the court may authorize the United States trustee to appoint a committee of general partners that is fairly representative of the interests of all general partners.

2.3.13 ***General Partner Liability on Nonrecourse Partnership Debt under 11 U.S.C. § 1111(b)***

Section 1111(b) of the Bankruptcy Code should be amended to clarify that, except as otherwise provided in a confirmed plan of a partnership debtor or the order confirming the plan, a general partner is not liable on a nonrecourse claim against the partnership except to the extent that the general partner is personally liable on such claim under applicable nonbankruptcy law.

2.3.14 ***'Temporary' Injunction of Proceedings or Acts against Nondebtor General Partners***

The Bankruptcy Code should be amended to permit the court for cause, upon motion of a party in interest and after notice and hearing, to temporarily enjoin actions of creditors or general partners of a debtor partnership against nondebtor general partners or their property on account of partnership obligations. No injunction should be granted under this Recommendation unless the nondebtor general partner (1) consents to the jurisdiction of the bankruptcy court; (2) makes or undertakes to make the disclosures required by Recommendation 2.3.18 below; and (3) the order granting the injunction precludes the protected general partner from incurring obligations or transfers of property except under specified circumstances.

2.3.15 ***Relief from the Temporary Injunction***

The Bankruptcy Code should be amended to provide that the court, upon request of a party in interest and after notice and hearing, may, for cause, grant relief from the temporary injunction provided pursuant to Recommendation 2.3.14. The relief available would include the termination, annulment, modification or conditioning a continuation of the injunction.

2.3.16 *'Postconfirmation' Injunction of Proceedings or Acts against Nondebtor General Partners Who Contribute to Plans*

The Bankruptcy Code should be amended to permit the court, in connection with the confirmation of a plan of reorganization in a partnership case, to enjoin partnership creditors and general partners from actions or proceedings against a general partner or its property to collect on partnership-related claims where the general partner has contributed or made an enforceable commitment to contribute an amount to the payment of debts in accordance with the plan or the order confirming the plan. The court, after notice and hearing, must determine that the plan complies with otherwise applicable requirements for confirmation in light of the personal assets of the nondebtor contributing partners and that the injunction will not discriminate unfairly or inequitably with respect to creditors of the partnership or the claims of the general partners for contribution or indemnity.

2.3.17 *Revocation of Injunction*

The Bankruptcy Code should be amended to provide that the injunction issued with respect to any nondebtor general partner under Recommendation 2.3.16 above should be terminated or revoked on the request of a party in interest if, after notice and hearing, the court determines (1) that the protected nondebtor general partner has failed to perform a material commitment under the plan; (2) that the order confirming the plan in which the injunction was issued is revoked under sections 1144 or 1230 of the Code; or (3) that the nondebtor general partner has procured the injunction by fraud. The Bankruptcy Code should be further amended to provide that a request for revocation for fraud under provision (3) should be made at any time within two years after the date of the entry of the confirmation order.

2.3.18 *Duty of Disclosure by Nondebtor General Partners*

The Bankruptcy Code should be amended to provide that, unless otherwise ordered by the court for cause, each nondebtor general partner shall, within 30 days after the entry of the order for relief in a partnership case or within such time as the court shall fix, produce information concerning such partner's financial condition and affairs similar to that provided by a debtor, together with such additional information and periodic reports as may be required by the court from time to time.

2.3.19 *Access to Disclosed Information*

The Bankruptcy Code should be amended to provide that the trustee, debtor in possession or other entity designated by the court in a partnership bankruptcy case should maintain and promptly provide to parties in interest in the case, on reasonable request, certain important information regarding the nondebtor general partners of the debtor partnership.

DISCUSSION

Under the Bankruptcy Act of 1898, few partnerships sought bankruptcy relief.[902] As a result, "[a]n opportunity was missed in the 1970s to do something about partners and partnerships. At that time the issues were mostly academic."[903] The 1970 Commission focused on the three partnership issues that required clarification: (1) the test for filing an involuntary petition against the partnership; (2) the definition of partnership insolvency; and (3) the abolition of the "jingle rule."[904]

Since the 1978 Bankruptcy Code, the use of partnerships as well as the partnership form has changed substantially[905] and the Bankruptcy Code does not adequately address the complex issues that can arise when a bankruptcy petition is filed by or against a partnership. Indeed, the Code makes a few brief references aimed at issues arising in connection with the bankruptcy of a partnership.[906] The proposals and analysis with respect to the Recommendations adopted by the Commission are set forth below and represent a comprehensive framework to deal with partnership bankruptcies.

Three fundamental principles provide the basic framework for the Recommendations. First, it is axiomatic that under state law general partners are personally liable for some or all of the debts of the partnership.[907] A creditor of the partnership therefore has special recourse against a general partner transcending the

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[902] Gerald K. Smith, *Issues in Partnership and Partner Bankruptcy Cases and Reorganization of Partnership Debtors*, ALI-ABA, PARTNERSHIPS, LLCS, AND LLPS: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY 648 (1996). Gerald Smith was the Deputy Director of the Commission on the Bankruptcy Laws of the United States 1970-1973.

[903] *Id.*

[904] *Id.*

[905] Neely, *supra* note 900, at 284 ("Because of the rapid and substantial evolution of the usages, characteristics and incidence of partnerships during the 1980's and 1990's, it is understandable that the statutes governing bankruptcy have not kept up.").

[906] *See, e.g.*, 11 U.S.C. §§ 303(b) (3), 548(b), 723 (1994).

[907] U.P.A. § 15 (1992); R.U.P.A. § 306 (1996) (indicating that all partners are jointly and severally liable for the obligations chargeable to the partnership).

relief ordinarily available to the general creditors of a corporation. It is essential for the Bankruptcy Code to recognize the obligations of general partners to the partnership creditors and to one another. Currently, the Bankruptcy Code fails to adequately address the rights and liabilities of general partners where the partnership is a debtor under Chapter 11 or 12.[908] With the exception of a single subsection, all of the Code provisions relating to the rights and liabilities of the partners and the partnership are generally limited to Chapter 7 cases.[909] A clear mechanism is needed for providing a complete resolution of the liability of general partners to partnership creditors (and the related contribution and indemnity claims of and against general partners[910]) in connection with the bankruptcy case of the partnership. Such a mechanism should provide rules that govern both liquidation and reorganization.

Second, creditors of the partnership should first look to the assets of the partnership before proceeding against general partners under certain circumstances. This is particularly true if such sequencing can be accomplished with minimal risk to the partnership creditors. While the individual liability of general partners to the partnership creditors must be recognized and protected, there are often sound reasons to sequence the rights of partnership creditors.

Third, where the general partners have sufficient resources to satisfy any portion of the deficiency of partnership assets to pay partnership obligations, providing general partners with the incentive to contribute to a plan of reorganization can provide a greater return for creditors. Thus, a collective proceeding in which the liability of nondebtor general partners can be resolved is advantageous. The alternative is that the partnership trustee and partnership creditors remain relegated under nonbankruptcy law to engage in the costly pursuit of individual general partners in an attempt to recover from nonexempt assets. The often inevitable result is the bankruptcy filing of general partners who may be located in different jurisdictions, increasing the cost of collection.

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[908] Frank R. Kennedy & Gerald K. Smith, *Some Issues in Partnership and Partner Bankruptcy Cases and Recommendations for Legislative Change*, 1990 NORTON ANN. SURV. BANKR. L. 19.

[909] 11 U.S.C. § 508(b) (1994).

[910] *See* U.P.A. § 18(a), (b) (1992) (requiring the partnership to indemnify partners on account of any personal liability incurred in connection with the operation of the partnership and, if the partnership has insufficient assets, the partner would have a right of contribution against the other partners).

2.3.1 *Defining the term "General Partner"*

A "general partner" should be defined under 11 U.S.C. § 101 as any entity that as a result of an existing or former status as an actual or purported general partner in an existing, former, predecessor, or affiliated partnership, is liable under applicable nonbankruptcy law for one or more debts of the partnership.

Rationale. Although the Bankruptcy Code declares that a partnership is a "person"[911] and as such is eligible for relief,[912] nowhere is the term "general partner" defined despite the Code's repeated reference to a "general partner".[913] Indeed, the Bankruptcy Code, among other things, specifically authorizes an involuntary case to be commenced against a partnership by less than all of the general partners.[914] The law is simply unclear as to whether the Code's provisions aimed at addressing the liabilities and claims by or against a general partner are applicable in specific contexts.[915] The Commission's Recommendations for the treatment of debtor partnerships provide a comprehensive framework to establish the rights and liabilities in bankruptcy of these often complicated relationships.[916] A necessary step to

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[911] 11 U.S.C. § 101(41) (1994). *Contra In re* C-TC 9th Avenue Partnership v. Norton Co., 113 F.3d 1304 (2d Cir. 1997)(ruling that a partnership in dissolution is not a "person" eligible for relief under Chapter 11 of the Bankruptcy Code).

[912] 11 U.S.C. §§ 109, 303 (1994).

[913] *See, e.g., id.* §§ 303(b)(3), (d), 723.

[914] *Id.* § 303(b)(3).

[915] *See* Marshack v. Mesa Valley Farms, L.P. (*In re* Ridge II), 158 B.R. 1016, 1023-24 (Bankr. C.D. Cal. 1993), *aff'd in part*, 1996 WL 285445 (9th Cir. 1996)(finding that it is unclear whether a limited partner that would be ineligible for limited liability under applicable nonbankruptcy law should be treated as a general partner under section 723(a)).

[916] The Ad Hoc Committee on Partnerships in Bankruptcy of the Business Section of the American Bar Association was created in 1991 and Morris W. Macey and Professor Frank R. Kennedy served as the chairman and the reporter, respectively. Morris W. Macey & Frank R. Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879 (1995) (setting forth the Ad Hoc Committee's Proposals on partnership bankruptcy) [hereinafter, the *ABA Ad Hoc Committee Report*]. The Ad Hoc Committee proposed this definition of a general partner in section 101(26A) of its report.

The National Bankruptcy Conference ("NBC") began reviewing partnership bankruptcy issues as part of its comprehensive review of bankruptcy law. On May 1, 1997, the NBC issued its Final Report, Revised Edition, which contains proposed reforms to the Bankruptcy Code on debtor partnerships as well as debtor partners. This definition of "general partner" was also proposed by

achieving this clarification is a definition of those persons to whom these provisions apply. The Recommendation is aimed at providing clarity and certainty by defining "general partner."

The term "general partner" under the Recommendation would include any entity that is liable for the debts of the partnership by virtue of applicable nonbankruptcy law. Whether an entity was a general partner at the time of the partnership's bankruptcy filing is not material. As long as an entity has general partner liability for a prepetition debt, that entity qualifies as a general partner under the Recommendation. Because the definition is a status-based definition, the term does not include an entity that may be liable solely by virtue of guaranteeing a partnership obligation. Partnership guarantors are not generally considered "partners" under state law and the Recommendation is consistent with that state law result. Included within the definition of the term "general partner," however, is any entity liable as a general partner by estoppel,[917] as an implied general partner or otherwise under nonbankruptcy law. A limited partner, as a consequence of exercising management control or by virtue of estoppel, is also included in the definition if liability for partnership debts would attach under nonbankruptcy law.[918]

Designation under the Recommendation as a "general partner" does not alter the general partner personal liability rules under nonbankruptcy law.[919] As a result, a person that is admitted as a general partner in an existing partnership generally would not, under nonbankruptcy law, be personally liable for partnership obligations incurred prior to admission.[920] Similarly, the personal liability of a former partner for

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the NBC. REFORMING THE BANKRUPTCY CODE: NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT, FINAL REPORT, 207-08 (rev. ed. 1997) [hereinafter *NBC Final Report*].

[917] *See* U.P.A. §§ 7, 16 (1992) (partnership by estoppel; imposing partnership liability where such a relation in fact may not exist since equitable principles dictate that an apparent partner should be estopped from denying the existence of the relation).

[918] *See* U.L.P.A. § 303 (1996) (imposing general liability upon a limited partner if the limited partner participates in the general control of the business). *See, e.g.*, Hoffman v. Ramirez (*In re* Astroline Communications Co. Ltd. Partnership), 161 B.R. 874, 879 (Bankr. D. Conn. 1993)(indicating that limited partners who would be liable to partnership creditors under state law can be pursued by a partnership trustee under section 544 or section 723(a)).

[919] *See infra*, Recommendation 2.3.4 (limiting the liability of a general partner for any deficiency in the assets of the partnership "to the extent that, under nonbankruptcy law, such general partner is personally liable for such deficiency").

[920] *See* U.P.A. §§ 17, 41 (1992) (delineating the liability of an incoming partner).

the obligations of the partnership or any deficiency arising after withdrawal is generally limited.[921]

Competing Considerations. It may be argued that the Bankruptcy Code should *not* provide a specific definition of a "general partner" because the determination of who is liable as a general partner is governed by nonbankruptcy law.[922] Moreover, the authorities appear to be generally in accord with respect to such a determination.[923] There may be a risk that a Bankruptcy Code definition could create problems and uncertainty and that any definition of partner should, accordingly, be left up to state law.

2.3.2 *Consent of Former Partners*

The Bankruptcy Code and Rules should be amended to clarify that, notwithstanding Recommendation 1 (defining "general partner"), a former general partner of a partnership is not, absent a specific court order to the contrary, required to consent to a voluntary petition by a partnership, to be served with a petition or summons in an involuntary case against a partnership, or to perform the duties of disclosure or procedural duties imposed on a general partner of a debtor partnership.

Rule 1004(a) of the Federal Rules of Bankruptcy Procedure requires "all" general partners to consent to a voluntary petition filed by or on behalf of the partnership. Similarly, Rule 1004(b) requires a copy of an involuntary bankruptcy petition filed against a partnership under section 303 of the Bankruptcy Code and the summons to be served on "each" general partner who is not a petitioner.[924] Rule 1007(g) imposes various procedural requirements on general partners of a debtor partnership, such as preparing and filing the partnership schedules.

Rationale. This Recommendation is animated by the broad definition of a "general partner" set forth in Recommendation 1, which includes "former" partners in certain circumstances. Bankruptcy Rule 9001(5) defines a debtor for purposes of

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[921] *See id.* § 36.

[922] *See, e.g.*, R.U.P.A. § 308 (1996) (defining the liability of a purported partner) and U.P.A. § 16 (1992).

[923] *See generally In re* Invig, 118 B.R. 993 (Bankr. N.D. Iowa 1990).

[924] FED. R. BANKR. P. 1004 (1995).

administrative responsibility to include "any or all general partners or, if designated by the court, any other person in control."[925]

The Recommendation clarifies that the expanded definition of "general partner" is not intended to encumber the commencement of voluntary or involuntary bankruptcy cases by or against a partnership by involving partners that have withdrawn from the partnership in the pleadings and service of process.[926] Likewise, the Recommendation does not impose disclosure duties on former partners. The Recommendation does, however, give the court the discretion to direct such former partners to comply with the procedural and disclosure requirements of the Code and Rules in appropriate circumstances.

Competing Consideration. Under state partnership law, former partners are not usually considered general partners for any purpose other than determining partnership liability. Thus, it is arguable that this Recommendation is unnecessary. However, given the general partner definition proposed in Recommendation 1 as well as the Recommendations requiring disclosure, this Recommendation clarifies the obligations of former partners.

2.3.3 *Bankruptcy Court Jurisdiction*

The court in which a partnership case is pending should have jurisdiction under 28 U.S.C. § 1334(b) to determine who is or may be liable as a general partner for the debts of the partnership and may determine the rights among the general partners with respect to the debts of the partnership. Such matters should constitute core proceedings under 28 U.S.C. § 157(b).

Rationale. Values are maximized by providing a single, unitary forum for resolving the obligations of the general partners to the debtor partnership, the partnership creditors, and to each other.[927] The Recommendation confers jurisdiction on the bankruptcy court in which a partnership case is pending to determine the obligations of general partners to the trustee (or the partnership as debtor in possession) and to each other by reason of contribution or indemnification in connection with partnership liabilities. The Recommendation also provides that the

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[925] FED. R. BANKR. P. 9001(5) (1995).

[926] The NBC did not address this Recommendation. The Recommendation was developed by the ABA Ad Hoc Committee. *See ABA Ad Hoc Committee Report supra* note 916, § 561, at 906.

[927] Section 5d of the Bankruptcy Act purported to vest jurisdiction over all the general partners in the bankruptcy court which had jurisdiction over any general partner. This provision was, however, generally construed as a venue provision.

determination of liability of general partners for partnership debts is a core proceeding.

General partners are individually liable for the full amount of any deficiency in partnership assets to pay the claims of partnership creditors. As a result, a Chapter 7 partnership trustee has a claim against each general partner for this deficiency amount. Current law does not facilitate (and may undermine) the trustee's recovery of the deficiency amount from general partners.[928] General partners have been able to avoid liability for partnership debts for a variety of reasons, including

> (1) delays inherent in the Chapter 11 process; (2) obtaining a section 105 injunction against actions against general partners on debts of or related to the partnership; (3) uncertainty regarding the ability of a partnership trustee to pursue general partners with respect to their obligations to partnership creditors; (4) failure of the partnership debtor in possession to pursue the estate's rights against its general partners; and (5) confirmation of plans which attempt (whether or not effectively) to prevent pursuit by partnership creditors of their claims against general partners by various discharge, injunction or compromise provisions.[929]

The logical place to centralize determination of the rights and liabilities of partners to partnership creditors as well as to each other is in the partnership's bankruptcy case. Commentators agree that granting the bankruptcy court authority to hear and determine these issues would centralize the process in a cost-effective manner by preventing general partners from circumventing or delaying payment of their obligations to partnership creditors.[930] The Recommendation centralizes this authority in the bankruptcy court in an effort to reduce the cost of collecting deficiency amounts from general partners.

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[928] *NBC Final Report supra* note 916, at 206 (concluding "that the present state of the law has actually undermined the principle of general partner liability to partnership creditors. This is because as a practical matter, general partners have often been able to escape their obligations to partnership creditors. . . .").

[929] *Id.*

[930] *Id. citing* Morris Macey & Frank Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879, 882-94 (1995) (stating that this conclusion is supported by five notable Chapter 11 cases for professional service partnerships: *In re* Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, Case No. 88 B 10377 (PBA) (Bankr. S.D.N.Y.); *In re* Myerson & Kuhn, Case No. 89 B 13346 (PBA) (Bankr. S.D.N.Y.); *In re* Laventhol & Horvath, Case No. 90 B 13830 (CB) (Bankr. S.D.N.Y.); *In re* Heron, Burchette Ruckert & Rothwell, Bankr. No. 91-00697 (SMT) (Bankr. D.D.C.); *and In re* Gaston & Snow, Case No. 91-B-14594 (CB) (Bankr. S.D.N.Y.)).

Competing Consideration. The Recommendation confers broad jurisdiction on the bankruptcy court to adjudicate claims by or against the general partnership estate as well as disputes among nondebtor general partners, by designating such matters core proceedings. Constitutional concerns may arise in the context of adjudicating contribution claims among nondebtor general partners who have not filed proofs of claim or otherwise consented to the jurisdiction of the bankruptcy court.[931] This concern would, however, be substantially vitiated if Congress adopts the Commission's Recommendation with respect to reconstituting bankruptcy courts under Article III of the Constitution.

2.3.4 *Liability of General Partner for Deficiency in Partnership Case*

If there is a deficiency of property of the partnership estate to pay in full all allowed claims in a case under title 11, the estate should have a claim against each general partner to the extent that, under applicable nonbankruptcy law, such general partner is personally liable for such deficiency. The amount of the deficiency claim should not be reduced on account of any right of contribution or indemnity among general partners. The claim should be estimated if its determination would unduly delay the administration of the case. Any action or proceeding to enforce liability under this section should be commenced no later than four years after the entry of the order for relief in the case concerning the partnership.

Rationale. A basic principle of partnership law is that general partners are personally liable for some or all of the debts of the partnership.[932] Section 723 explicitly recognizes and preserves this principle in Chapter 7 cases filed by or against a partnership. This Recommendation is an adaptation of section 723(a) and holds general partners responsible to the extent liable under nonbankruptcy law. A number of clarifications to existing law are made and the Recommendation clarifies its application to Chapters 11 and 12 of the Code. For clarity and efficiency, section 723 should be repealed in its entirety and reincorporated into Chapter 5 of the Code.[933]

The Recommendation has four components:

a. Contribution or Indemnity Claims Not Considered

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[931] *See* Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

[932] U.P.A. §§ 15, 17 (1992).

[933] References in the language of the specific recommendations to renumbered section 723 are designed to clarify the various recommendations in light of existing law.

The Recommendation delineates the rights of the partnership trustee against a general partner upon the commencement of a case by or against a partnership. The first sentence of the Recommendation is virtually identical to section 723(a), except that contribution or indemnity claims by or against general partners are not to be considered in determining the partnership trustee's claim against a particular general partner. Thus, the liability of a general partner to a partnership creditor is not affected by that partner's rights against the other general partners. This is consistent with the result under nonbankruptcy law that does not limit the liability of a partner to a partnership creditor. A partner who satisfies a judgment greater than the amount of the partner's liability has a separate claim for contribution or indemnification against the other partners.

b. Estimation of Deficiency Claim of the Estate

Recovery from a general partner under section 723(a) of the Code (and this Recommendation) is limited by the amount of the deficiency of the partnership assets to pay allowed claims against the partnership estate. Thus, a final determination of that deficiency must await until an advanced stage of the case. A determination generally becomes possible only after the administration of the estate. The Recommendation therefore amends the statute and permits the court to estimate the amount of the deficiency *of the estate* when deferral of that determination would either unduly delay the administration of the estate or unduly prejudice the trustee's ability to recover on the claim.[934]

This aspect of the Recommendation is not a foreign concept but, rather, employs the same standard used in connection with the estimation of unliquidated or contingent claims *against the estate* for purposes of allowance under section 502(c)(1) of the Code.[935] Estimation is used in bankruptcy cases to estimate claims for purposes of plan negotiation, voting, and distribution under a plan. The Recommendation contemplates that estimation of a partnership estate's claim would be binding on the parties to the same extent that estimation of a claim against the estate would be binding in other contexts under the Bankruptcy Code.

c. Statute of Limitations

The Recommendation resolves the conflict in the courts as to the applicable limitations period under section 723(a) of the Code. Some courts have treated the

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[934] *See infra* Recommendation 2.3.5 (granting the bankruptcy court the authority to issue orders to assure payment of the estate's deficiency claim).

[935] 11 U.S.C. § 502(c)(1) (1994). It is worth noting, however, that section 502(c)(1) serves as a mechanism for estimating claims "against" the bankruptcy estate. The Recommendation contemplates the estimation of claims "of" the bankruptcy estate.

partnership trustee's claim as one asserted under section 544(a), and thus subject to the two-year limitations period provided for avoidance actions under section 546.[936] The Recommendation adopts a four-year limitations period because a claim under section 723(a) does not accrue until after the trustee has had an adequate opportunity to determine the assets of, and the claims against, the partnership's bankruptcy estate. As previously indicated, the determination of the deficiency only becomes clear in most cases at an advanced stage of the case after a considerable amount of time has elapsed. A four-year statute of limitations should allow enough time for a trustee to determine the amount of a section 723(a) claim against the general partner.

Competing Consideration. The determination of the deficiency claim generally is made at an advanced stage of the case, after all partnership assets have been distributed to creditors and the trustee is able to calculate any deficiency. It may be argued that a "four-year" statute of limitations will not encourage early resolution of claims against the partnership. The Recommendation under subsection (b) *supra* should limit delay as a result of a long statute of limitations.

d. Application of Section 723(a) Principles to All Chapters of the Code

The Recommendation expressly clarifies the application of section 723(a) under current law. Section 723 currently applies only in Chapter 7 partnership cases.[937] The "best interests of creditors" test embodied in sections 1129(a)(7) and 1225(a)(4), however, makes the principles embodied in section 723 relevant in Chapter 11 and 12 cases. The best interests test requires, as a condition of plan confirmation, that each holder of an impaired claim either accept the plan or "receive or retain" as much as the holder would receive had the case been liquidated under Chapter 7. If a partnership reorganization case is commenced under Chapter 7, the Chapter 7 trustee would have the authority to seek payment from the general partners on behalf of the partnership estate. As a result of this interplay, a number of courts determine the extent of recovery that would be available to a Chapter 7 trustee against

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[936] *Compare* Andrew v. Coopersmith (*In re* Downtown Inv. Club III), 89 B.R. 59, 65 (BAP 9th Cir. 1988)(holding that the trustee's claim for a deficiency under section 723(a) is a chose in action to be asserted under section 544(a)); McGraw v. Betz (*In re* Bell & Beckwith), 112 B.R. 863, 868-70 (Bankr. N.D. Ohio) (opining that since a trustee's claim under section 723(a) is a chose in action that is to be asserted under section 544(a), it is subject to the limitations period provided in section 546), *amended in other part*, 112 B.R. 871 (Bankr. N.D. Ohio), *amendment denied*, 112 B.R. 876 (Bankr. N.D. Ohio 1990) *with* Miller v. Spitz (*In re* CS Associates), 156 B.R. 755 (Bankr. E.D. Pa. 1993), *aff'd sub. nom.*, 167 B.R. 368 (E.D. Pa. 1994)(ruling that the statute of limitations period provided for avoidance actions in section 546 should not be "borrowed" for purposes of section 723(a)). The court in *McGraw* aptly observed that "[r]equiring the exact deficiency to be determined prior to allowing a trustee to file a complaint would result in § 723(a) being unavailable in all but the most uncomplicated liquidations." *McGraw*, 112 B.R. at 868-69.

[937] 11 U.S.C. § 103(b) (1994).

the general partners and require that objecting partnership creditors actually receive at least as much or more in order to satisfy the "best interest of creditors" test.[938] Other courts have concluded that recovery under section 723(a) need not be considered if the plan preserves the right of partnership creditors to enforce their state law rights against the general partners.[939]

The case law is unclear with respect to whether the debtor partnership estate (under any chapter of the Code) includes the right to enforce the obligation of general partners to contribute to the partnership in order to satisfy its liabilities. Some courts have construed the broad language of section 541(a) and the joint and several liability provisions of the uniform partnership laws to empower a debtor in possession in a partnership case to compel contributions from each general partner to satisfy the claims of the partnership.[940] Other courts refuse to grant relief against general partners to partnership creditors in reorganization cases.[941]

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[938] *See, e.g., In re* Union Meeting Partners, 165 B.R. 553, 575-76 (Bankr. E.D. Pa. 1994), *aff'd*, 52 F.3d 317 (3d Cir. 1995); *In re* Gramercy Twins Assocs., 187 B.R. 112, 125 (Bankr. S.D.N.Y. 1995); *In re* Eber-Acres Farm, 82 B.R. 889, 893 (Bankr. S.D. Ohio 1987)(decided under section 1225(a)(4)); *In re* Monetary Group, 55 B.R. 297 (Bankr. M.D. Fla. 1985)(requiring general partners to file information regarding their personal assets and liabilities since the information was relevant to determining whether the best interests of creditors test of section 1129(a)(7) could be satisfied); Mbank Corpus Christi v. Seikel (*In re* I-37 Gulf Ltd. Partnership), 48 B.R. 647, 650 (Bankr. S.D. Tex. 1985)(concluding that section 1129(a)(7) must be read in conjunction with section 723 and therefore requires the court to make an assessment of "the net worth of each of the partners of the partnership"). *See also* FED. R. BANKR. P. 1007(g) (providing that the bankruptcy court may order general partners to file a statement of personal assets and liabilities).

[939] *See, e.g., In re* Duval Manor Assocs., 191 B.R. 622, 636-37 (Bankr. E.D. Pa. 1996).

[940] *See, e.g.*, Litchfield Co. of S.C. Ltd. Partnership v. Anchor Bank (*In re* Litchfield Co. of S.C. Ltd. Partnership), 135 B.R. 797, 803 (W.D.N.C. 1992)(holding that under sections 18(a), and 40(a), (d) of U.P.A., the assets of the partnership include the contributions of the general partners necessary to satisfy the liabilities of the partnership and empower a debtor in possession to compel such a contribution); Tatge v. Chandler (*In re* Judiciary Tower Assocs.), 175 B.R. 796, 802-03 (Bankr. D.D.C. 1994)(opining that the right of the partnership to seek contribution from a general partner is property of the bankruptcy estate under section 541(a)); Commercial Bank v. Price (*In re* Notchcliff Assocs.), 139 B.R. 361, 370-71 (Bankr. D. Md. 1992)(ruling that a Chapter 11 partnership trustee is entitled to proceed against nondebtor general partners in order to satisfy the indebtedness of the partnership). *Accord* H.R. REP. NO. 95-595, at 199-200 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6160.

[941] *See generally* Russell, Jarvis, Estabrook & Dashiell v. Kaveney (*In re* Kaveney), 60 B.R. 34 (BAP 9th Cir. 1985)(opining that section 723(a) principles are applicable only in Chapter 7 cases); Mbank Corpus Christi v. Seikel (*In re* I-37 Gulf Ltd. Partnership), 48 B.R. 647, 650 (Bankr. S.D. Tex. 1985).

Current law is ambiguous as to whether general partners must pay partnership obligations for which they are personally responsible in connection with partnership bankruptcy cases filed under any chapter other than Chapter 7.[942] The Recommendation clarifies the present uncertainty by extending the principles embodied in section 723(a) to Chapters 11 and 12. The general partner's nonbankruptcy law liability is preserved and subject to administration in the partnership bankruptcy case.

By providing a single forum to resolve outstanding disputes, the Recommendation affords the debtor partnership, the general partners and the creditors an opportunity to effectuate a complete adjudication of their rights and responsibilities in connection with the partnership.

Competing Consideration. In a Chapter 7 proceeding, the trustee is generally *required* to pursue the nondebtor general partners to satisfy deficiency claims.[943] The Recommendation, although applicable in reorganization cases, is not couched in mandatory language as applied in the context of a reorganization. It can be argued that it is doubtful that a debtor in possession will diligently pursue deficiency claims against the general partners of the debtor partnership. The argument and concern is similar to that raised where avoidance actions are not pursued against insiders, affiliates or significant creditors. However, partnership creditors are afforded a number of protections. First, as noted, the Recommendation resolves the present uncertainty with respect to the "best interests of creditors" test. Second, the requirement that the plan be proposed in "good faith" can serve as a realistic check against undue self-interest. Third, creditors may seek the appointment of a trustee or seek to prosecute such actions for the benefit of the estate. Thus, objecting creditors will have the ability to force the debtor in possession to pursue claims against partners.

2.3.5 *Power of the Court to Assure Payment of the Deficiency*

Renumbered section 723(b) of the Bankruptcy Code should be amended to provide that the court in a partnership case may, after notice and a hearing, order any general partner that is not a debtor in a case under this title (1) to provide the estate, in such amount as the court shall determine to be appropriate under the circumstances, with indemnity for, or assurance of payment of, any deficiency recoverable from such

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[942] The NBC has concluded that the lack of statutory guidance in bankruptcy has actually eroded the protection state law affords creditors of a general partnership. *See NBC Final Report, supra* note 916, at 206.

[943] *See* 11 U.S.C. §§ 723(a), 704(1) (1994).

general partner, or (2) not to incur obligations or transfer property except under specified circumstances.

Section 723(b) governs the determination of a deficiency claim in a partnership bankruptcy case. The statute directs the trustee first to seek recovery of any deficiency from a nondebtor general partner. The purpose of such a requirement is to direct the trustee toward nonbankrupt general partners first, to the extent that recovery is possible, prior to seeking recovery from debtor general partners. Section 723(b) requires a trustee to seek recovery against nondebtor general partners, however, only "to the extent practicable."[944]

The statute is designed to preserve the status quo. In order to preserve the value of the estate's claim against the general partner's assets, the court must be able to exercise a certain amount of control over those assets. Section 723(b) grants the court authority to order, in appropriate circumstances, any general partner to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from the partner. Therefore, the bankruptcy court has the authority to require a nondebtor partner to post a bond or security to ensure that the rights of the partnership trustee do not materially deteriorate during the pendency of the partnership case. The section also permits the court to issue an injunction ordering the nondebtor general partner "not to dispose of property."[945] The bankruptcy court's power to restrain a nondebtor general partner from depleting assets pending the administration of the partnership case is generally recognized.[946]

Rationale. The Recommendation is an adaptation of current law.[947] The rights of a partnership trustee against nondebtor general partners for the claims of partnership creditors are preserved during the pendency of the case.[948] The changes to current law are essentially two-fold. First, the first sentence of section 723(b) and the requirement that the trustee must first seek recovery of any deficiency against nondebtor general partners is deleted. The remaining aspects of other

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[944] 11 U.S.C. § 723(b) (1994).

[945] *Id.* § 723(b).

[946] *See, e.g.*, Jonas v. Newman (*In re* Comark Ltd. Partnership), 53 B.R. 945 (Bankr. C.D. Cal. 1985).

[947] Both the NBC Final Report and the ABA Ad Hoc Committee Report recommended this change. *See NBC Final Report*, *supra* note 916, at 210; *ABA Ad Hoc Committee Report*, *supra* note 916, at § 562(c) at 907.

[948] Thus, the Recommendation is consonant with current law by providing the bankruptcy court with the power to assure that the trustee's right of recovery does not unfairly diminish before the deficiency attributable to a general partner is adjudicated or estimated.

Recommendations make a requirement that the trustee pursue deficiency claims against nondebtor partners first unnecessary. Second, the Recommendation expands the reach of the current statute by giving the court the authority to order nondebtor general partners not to make any "transfers," as defined under the Code, *or* to incur any obligations other than in the ordinary course of the partner's business or for reasonably equivalent value. For example, the court could order the nondebtor partner to post a bond or other security in order to ensure payment of the deficiency. This modifies the current statute, which grants the court the authority to enjoin unauthorized dispositions of property. The Recommendation preserves the rights of partnership creditors to recover the partnership's deficiency claim against a general partner's assets. The Recommendation also is in accord with the requirements of Recommendation 16, *infra*, that provides for temporary injunctive relief for nondebtor general partners under certain circumstances. The rationale is that to the extent a general partner can obtain temporary injunctive relief staying the actions of partnership creditors, partnership creditors should be able to protect their interest in the general partner's assets by preventing certain types of transfers and the occurrence of certain obligations. This is the purpose of the Recommendation.

2.3.6 *Trustee's Recovery against the Estate of a Debtor General Partner*

> **Renumbered section 723(c) of the Bankruptcy Code should be amended to provide that notwithstanding section 728(c), the trustee of a partnership has a claim against the estate of each general partner in such partnership that is a debtor in a case under title 11 for (1) the full amount of all claims allowed in the case concerning the partnership for which such general partner would otherwise be personally liable as a general partner under applicable nonbankruptcy law; and (2) administrative claims which have been assessed against such general partner. Notwithstanding section 502 of this title, there shall not be allowed in such partner's case a claim against the partner on which both the general partner and the partnership are liable, except to the extent that such claim is allowable and secured only by property of such general partner and not by property of such partnership.**

The financial condition of a general partnership and the concomitant personal liabilities of general partners for the obligations of the partnership often forces a general partner to seek personal relief under the Bankruptcy Code when the partnership fails. Section 723(c) currently provides that a trustee has a claim against the estate of each debtor general partner in the partnership for the "full amount of all claims of creditors" notwithstanding section 728(c).[949] The trustee's rights against the

[949] 11 U.S.C. § 723(c) (1994). Section 728(c) provides for the treatment of a governmental unit's tax claim against a general partner for state and local taxes owed by the partnership if

estate of a debtor general partner in bankruptcy follow from the right of a trustee to pursue a nondebtor general partner for a deficiency claim under section 723(a).

Rationale. In order to resolve the uncertainty of treatment that exists under current law, the Recommendation has three-prongs. First, section 723(a) provides that the trustee may seek recovery from a nondebtor general partner only to the extent of claims against the partnership for which a partner is personally liable under nonbankruptcy law.[950] Section 723(c) contains no such explicit limitation.[951] The law is unclear and arguably provides for a dichotomous treatment of partnership claims depending upon whether or not the general partner is a debtor in bankruptcy. The limitations placed on the trustee's right to recover a deficiency claim under section 723(a) were added by Congress after the promulgation of that provision. Section 723(c) was inexplicably unaltered. There is some indication, however, in the legislative history, that the failure to amend paragraph (c) was inadvertent and that Congress intended that the limitations provided in paragraph (a) would also apply to paragraph (c).[952] The Recommendation makes the two provisions consistent as it clarifies that a claim of a partnership trustee against the estate of a debtor general partner is limited to those claims that are allowed under applicable nonbankruptcy law.

Second, the Recommendation expands the trustee's claim against the general partner's estate to include the amount of administrative expense claims for which the debtor general partner would otherwise be liable.[953] As noted above, the statute currently limits the trustee's claim to the "full amount of all claims *of creditors*" and therefore does not include the amount of administrative expenses incurred in the

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bankruptcy cases are pending for both a general partner and a partnership. The government's claim is "a claim only in the partnership's bankruptcy case and not in the partner's bankruptcy case" to the extent that the claim arose from inclusion in the general partner's taxable income of earnings that were not withdrawn by the partner. *Id.* § 728(c).

[950] 11 U.S.C. § 723(a) (1994).

[951] *Id.* § 723(c) (1994).

[952] *See* H.R. REP. NO. 103-835, at 47 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3356 ("This section clarifies that a partner of a registered limited liability partnership would only be liable in bankruptcy to the extent a partner would be personally liable for a deficiency according to the registered limited liability statute under which the partnership was formed.") *Accord* 6 COLLIER ON BANKRUPTCY ¶ 723.04[1][a], at 723-15 (Lawrence P. King et al. eds., 15th ed. 1996).

[953] *See* Recommendation 2.3.8.

Chapter 7 case.[954] The Recommendation provides that the trustee has a claim against "all allowed claims" in order to include administrative expense claims.

Third, the Recommendation deletes the last sentence of section 723(c), which abrogates the "jingle rule" in Chapter 7 cases. Recommendation 2.3.7, below, addresses this issue as a separate Proposal.

2.3.7 *Repeal of the "Jingle Rule" in All General Partner Bankruptcy Cases*

Chapter 5 of the Bankruptcy Code should be amended in order to provide that the claim of a trustee of a partnership debtor, or the claim of a creditor of a nondebtor partnership, is entitled to share in the distribution in a general partner's bankruptcy case in the same manner and to the same extent as any other claim of the same class of a creditor of such general partner.

The "jingle rule" is a rule of priority which evolved from the common law during the nineteenth century and was codified in section 5g of the Bankruptcy Act. The jingle rule was later incorporated into the Uniform Partnership Act when promulgated in 1914, so that state partnership law would correspond to bankruptcy law.[955] The rule provided that the partnership assets were to be distributed first to creditors of the partnership; and the assets of an insolvent general partner were to be distributed first to the personal creditors of the general partner.[956] Partnership creditors would be allowed to receive a distribution only if a surplus remained. Therefore, partnership creditors were, under the jingle rule, effectively subordinated to personal creditors of the general partner.

Congress specifically abrogated the jingle rule in Chapter 7 cases in the last sentence of section 723(c).[957] It provides that the claim of a trustee is entitled to share

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[954] *See* 11 U.S.C. § 101(10)(A) (1994) (defining "creditor" to mean an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor").

[955] U.P.A. § 40 (1992) (setting forth the distributional rules for the assets and liabilities of the partnership and the distribution of a partner's property upon insolvency).

[956] *Id.* § 40(i).

[957] The legislative history to section 723(c) provides:

> The final sentence of 11 U.S.C. [§] 723(c) makes clear that the jingle rule is abolished with respect to the partnership creditor's rights in the assets of a partner; the trustee of the partnership is entitled to share pro rate with unsecured creditors of a partner in dividing the partner's estate. This recognizes the

equally in the bankruptcy case of the general partner under section 726(a), the same as any other claim of a kind specified in that provision. The trustee's claim in the debtor general partner's bankruptcy case is not subordinate to the claims of other creditors of the general partner but, rather, has an equal priority for purposes of distribution in a Chapter 7 case. However, section 723(c) does not effectuate a wholesale repeal of the jingle rule. The provision is only applicable in Chapter 7 cases and only becomes operative when a partnership and one of its general partners is a debtor.

Rationale. The Recommendation implements the legislative intent of the drafters of section 727(c) by extending the application of the statute to the claims of partnership creditors against a debtor general partner of a partnership that is *not* in bankruptcy. Eliminating the "jingle rule" in all cases results in *pari passu* treatment of a partnership trustee with the debtor general partner's nonpartnership creditors. The proposed Recommendation provides this same treatment to creditors of a debtor general partner of a partnership that is not in bankruptcy. The same recommendation for repeal of the "jingle rule" was made by the NBC and the ABA Ad Hoc Committee.[958] The Recommendation also definitively extends the application of the principles of section 727(c) and the repeal of the jingle rule to all other chapters of the Code.[959] It therefore simplifies the application of the "best interests of the creditors" and facilitates plan confirmation.

2.3.8 *Allocation of Expenses of Administration of a Partnership Case*

Chapter 5 of the Bankruptcy Code should be amended to provide that the expenses of administration of a partnership case under section 503 of the Bankruptcy Code may be assessed against general partners or

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> traditional rights of creditors of the partnership to share on an equal basis with other creditors of a partner under some bankruptcy laws adopted before the Uniform Partnership Act. On the other hand, . . . the jingle rule still applies in principle with respect to the partners [sic] interest in the partnership. The partners [sic] interest is worthless until all administrative expenses and partnership claims have been paid.

H.R. REP. NO. 95-595, at 200-01 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6161.

[958] *See NBC Final Report*, *supra* note 916, at 212-13; *ABA Ad Hoc Committee Report*, *supra* note 916, at 907.

[959] *Compare In re* Safren, 65 B.R. 566, 574-75 (Bankr. C.D. Cal. 1986)(holding that section 723(c) indicates a Congressional intent to abolish the jingle rule in bankruptcy and applying the statute when the partnership was in Chapter 11) *with* Frank R. Kennedy, *Partnerships and Partners Under the Bankruptcy Code: Claims and Distributions*, 40 WASH. & LEE L. REV. 50, 59-60 (1983)(opining that the abrogation of the jingle rule in section 723(c) does not, absent a strained construction, affect the applicability of the jingle rule in any cases other than Chapter 7).

paid from the property constituting recoveries from general partners under this section and from other property of the estate in such proportions as the court shall determine are fair and reasonable after notice and hearing.

Rationale. Under current law, the expenses of administering a partnership estate are paid out of property of the estate prior to any distributions to creditors. The Recommendation adopts the view that it may be appropriate, in certain instances, to impose a share of the expenses of administration upon former or current general partners. It is derived largely from section 5f of the Bankruptcy Act.[960] Disputes over responsibility for administrative costs have arisen in several of the large professional partnership cases. Creditors argue that the partnership bankruptcy case serves as a vehicle to marshal the assets of general partners in order to satisfy the claims against the general partnership as well as an avenue for resolving claims among former and current partners. Because partners benefit from this collective proceeding, the costs of administration should be borne by those who benefit. General partners often argue that "it is unfair to increase a general partner's contribution amount in situations where creditors' committee activity has been responsible for the high cost of the case."[961] The Recommendation gives the court the discretion to apportion the expenses of administration among such nondebtor partners and creditors where appropriate. This Recommendation is supported by both the ABA Ad Hoc Committee and the NBC.[962]

The power to allocate administrative expenses should also serve as a disincentive for general partners to withdraw from the partnership when the bankruptcy case of a partnership is being contemplated or commenced. By assessing administrative costs against former partners where appropriate, the Recommendation discourages partners from exiting the partnership just prior to bankruptcy and thereby avoiding those costs. The Recommendation is consistent with the bankruptcy maxim that the expenses of administration should, whenever possible, be borne by the assets administered.[963]

Competing Considerations. Guidelines for the allocation of administrative expenses among nondebtor parties are difficult to pinpoint. Assessing relative benefit of the administration of the case among these parties may be difficult. Current law

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[960] Bankruptcy Act of 1898, ch. 541, § 5f, 30 Stat. 544 (repealed 1979).

[961] *ABA Ad Hoc Committee Report*, *supra* note 916, at 911.

[962] *See NBC Final Report*, *supra* note 916, at 212-13; *ABA Ad Hoc Committee Report*, *supra* note 916, at 911.

[963] *See, e.g.*, 11 U.S.C. § 506(c) (1994).

avoids this problem by assessing the property of the estate. The Recommendation recognizes the inequity to creditors (usually unsecured creditors) in bearing the costs of administration and reallocates some of these costs in accordance with the benefit received by the nondebtor parties.

2.3.9 *Distribution of Recoveries from General Partners*

Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Bankruptcy Code (except as provided in Recommendation 2.3.8 above), the trustee should apply any recovery obtained from a general partner or the estate of a general partner only to the payment of deficiencies on claims for which such general partner is personally liable as a general partner under applicable nonbankruptcy law. Any property constituting recoveries from general partners or the estates of general partners under this Recommendation not applied to the proper deficiencies as herein provided or to administration expenses (as provided in Recommendation 2.3.8 above), should be equitably distributed by the trustee to such general partner or to such general partners' estates as may be ordered by the court after notice and hearing.

Rationale. The Recommendation outlines the manner by which the trustee allocates and distributes the recoveries obtained from a nondebtor general partner in a partnership bankruptcy case. Additionally, the Recommendation further implements the policy of conforming the partnership/partner provisions of the Code to the respective rights of partnership creditors and general partners under applicable nonbankruptcy law. This Recommendation has two main features:

First, the application of recoveries on account of a deficiency by a trustee from each general partner or the partner's estate is limited to the claims supporting the right to a recovery. In other words, the Recommendation specifically limits the application of any recovery on account of a general partner's deficiency to those claims that the general partner is personally liable for under applicable nonbankruptcy law, plus a proportionate share of the expenses of administration, if any, allocated by the court. The Recommendation thus recognizes that a general partner may not be liable under applicable nonbankruptcy law for all of the obligations of the partnership.

Under section 723, recoveries from a general partner or a general partner's estate are added to the bankruptcy estate of the partnership under section 541(a)(3) and included in the distributions to creditors holding allowed claims against the

partnership in accordance with section 726.[964] There may, however, be claims against the debtor partnership for which a particular general partner is not liable under applicable nonbankruptcy law.[965] In such instances, the recovery from a general partner under section 723 may be used to pay claims for which the general partner is not personally responsible. Moreover, the effect of section 1111(b) on the personal liability of a general partner for a nonrecourse deficiency claim of the partnership may effectively require the general partner to pay twice.[966]

The Recommendation preserves the principle of equality of distribution among similarly situated creditors. As a result, however, partnership creditors may receive different distributions in the partnership bankruptcy case based upon differences in their rights against general partners. Taking into account Recommendation 2.3.10 (below), governing the distribution of property of the partnership estate, each creditor of the partnership would have the right to share in two funds upon the commencement of a case by or against a partnership under Chapter 7: (1) a *pro rata* share in the assets of the partnership estate based upon the priority scheme set forth in the Bankruptcy Code; and (2) a *pro rata* share in the recovery obtained against the general partner in proportion to the partner's liability to the specific creditor under state law. Under the second fund, only those recoveries from general partners that are personally liable to that creditor would be available to pay its claim. The disparity between a creditor's rights against a general partner under applicable nonbankruptcy law in relation to other creditors determines its right to a distribution from the recovered deficiency claim. A contrary result (embodied by present law) could effectively enable a partnership creditor to enhance its recovery in bankruptcy to the detriment of other creditors.

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[964] *See* 11 U.S.C. § 541(a)(3) (1994) (specifically including deficiency recoveries under section 723 in the definition of property of the estate).

[965] The personal liability of a general partner for the debts of the partnership may be limited in several ways: (1) by the existence of a contract or statute which limits the partner's liability; (2) by virtue of the fact that the liability arose prior to the admission of the general partner to the partnership; or (3) by virtue of the fact that the liability arose after the withdrawal of the general partner from the partnership.

[966] The NBC Final Report explains:

> [I]n applying the principles of current section 723 to Chapter 11, where an undersecured creditor's nonrecourse deficiency claim is treated as a recourse claim under section 1111(b)(1)(A), recoveries from general partners could be used to pay the undersecured creditor, leaving significant unpaid claims of creditors to whom the partner could remain liable.

NBC Final Report, *supra* note 916, at 214.

Second, the last sentence of the Recommendation is an adaptation of current section 723(d) of the Code. The trustee may recover more from the general partners and from the estates of debtor general partners than is necessary to pay the costs of administration and the allowed claims of the partnership creditors in full. The Recommendation therefore provides a mechanism by which the court may allocate the surplus in an equitable manner based on the relative liability of each of the general partners under the partnership agreement or applicable nonbankruptcy law.[967]

2.3.10 *Distribution of Property of the Partnership Estate*

> **Renumbered section 723 of the Bankruptcy Code should be amended to provide that notwithstanding section 726 of the Code, and except as set forth in Recommendation 2.3.8 above (treatment of expenses of administration), the trustee should distribute property of the partnership estate which is not recovered from general partners or the estates of debtor general partners to allowed claims against the partnership in accordance with otherwise applicable provisions of this title without considering distributions of property from general partners or general partners' estates.**

Rationale. The estate of the debtor partnership may be comprised of property resulting from the recoveries by the trustee against the general partners together with partnership assets. Recommendation 2.3.6 above sets forth the distributional rules with respect to claims against the general partners on account of a deficiency. This Recommendation contemplates that, as under current law, property of the partnership is to be distributed to the holders of allowed claims against the partnership in accordance with the distributional scheme in the Bankruptcy Code. It, however, excludes recoveries obtained from general partners or the estates of debtor general partners on account of each partner's deficiency. Consistent with Recommendation 2.3.9, which allocates a general partner's liability to a creditor in accordance with state law, this Recommendation preserves the distribution scheme under the Bankruptcy Code for property of the partnership estate. Each partnership creditor's deficiency claim would be determined after distribution under this Recommendation. Recoveries for these deficiency claims would be in accordance with Recommendation 2.3.9. Both the NBC and the ABA Ad Hoc Committee proposed the above Recommendation.[968]

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[967] An allocation of the surplus among the general partners based upon their respective "liability" is more appropriate than an allocation based upon profit sharing since the redistribution of any surplus is akin to mitigating a loss rather than a distribution of profit. *See* 4 COLLIER ON BANKRUPTCY ¶ 723.05[1], at 723-20 (Lawrence P. King et al. eds., 15th ed. 1996).

[968] *See NBC Final Report*, *supra* note 916, at 212-13; *ABA Ad Hoc Committee Report*, *supra* note 916, at 911.

2.3.11 *Trustee's Power to File Involuntary Cases*

Section 303(b)(3) of the Bankruptcy Code should be amended to permit the trustee of a partnership in a case commenced under title 11 to file an involuntary petition against a general partner without regard to the number of creditors, nature of the claims or dollar amount of the claims otherwise required under section 303(b)(1) and (2).

Section 303 of the Bankruptcy Code authorizes creditors of a general partner to commence an involuntary case under Chapter 7 or Chapter 11.[969] Although section 303 permits an otherwise qualified partnership creditor to file an eligible involuntary petition against a general partner,[970] the statute does not give standing to a trustee of a partnership to initiate such a filing. A trustee of a partnership is, by virtue of section 723, a creditor of each general partner for the full amount of all allowed claims of creditors in the partnership bankruptcy case. The trustee, therefore, may proceed against the general partners to enforce their liability for the deficiency. It may, however, be more administratively efficient and effective for the partnership trustee to administer the liabilities of general partners within the confines of the Bankruptcy Code.

The Recommendation gives the partnership trustee standing to commence an involuntary Chapter 7 or Chapter 11 case against a general partner regardless of the number of creditors, nature of the claims, or dollar amount of the claims that the trustee represents.[971] The other requirements and safeguards otherwise applicable in involuntary cases would remain applicable, such as not paying undisputed debts as they become due.[972] Additionally, the right of partnership creditors to commence an involuntary case against a general partner remains unabridged by this Recommendation. The Recommendation provides further incentive for nondebtor general partners to voluntarily participate in the partnership's bankruptcy case.

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[969] 11 U.S.C. § 303 (b)(3) (1994).

[970] *See, e.g., In re* Elsub Corp., 66 B.R. 172 (Bankr. D.N.J. 1986)(indicating that partnership creditors should be counted as creditors for determining the requisite number of creditors in connection with an involuntary filing against the general partner); *In re* Lamb, 40 B.R. 689, 692-93 (Bankr. E.D. Tenn. 1984).

[971] This Proposal was also made by the NBC and the ABA Ad Hoc Committee. *See NBC Final Report*, *supra* note 916, at 217-18; *ABA Ad Hoc Committee Report*, *supra* note 916, at 906.

[972] *See* 11 U.S.C. § 303(h) (1994)(requiring a trial and the entry of the order of relief against a debtor in an involuntary case only if "the debtor is generally not paying such debtor's debts as such debts become due unless such debts are the subject of a bona fide dispute").

Competing Considerations. The requirements of section 303(b) of the Code are very specific and require "three or more" creditors with noncontingent, undisputed claims which must "aggregate at least $10,000."[973] The statutory requirements reflect the policy that an involuntary case should not serve as vehicle for aggressive creditors to harass an honest debtor.[974] It could be argued that dispensing with the number of creditors and the monetary requirements of the statute undermines the protection the Code affords debtors and gives a trustee in a partnership case too much leverage. The Recommendation would, for instance, ostensibly permit a trustee to commence an involuntary petition against an entire law firm, to the extent the other requirements of section 303 were met in each instance. The other protections in section 303 provide a certain amount of protection for nondebtor general partners. Moreover, increased leverage for the trustee to collect deficiency claims from nondebtor general partners would inure to the benefit of the partnership's creditors. Giving a trustee more leverage than creditors under these circumstances is logical because a trustee is a fiduciary and is not similar to other creditors who may have an improper agenda.

2.3.12 *Appointment of Committee of General Partners*

Chapter 11 of the Bankruptcy Code should be amended to provide that, on request of a party in interest, the court may authorize the United States trustee to appoint a committee of general partners that is fairly representative of the interests of all general partners.

Chapter 11 authorizes the appointment of a committee of creditors and, upon the request of a party in interest, a committee of equity security holders.[975] The appointment of a committee of equity security holders is rare and typically authorized by the court only in the larger Chapter 11 cases involving publicly-traded corporations. A fundamental committee formation consideration is whether a particular committee is more likely to accelerate or impede the reorganization process.

The ABA Ad Hoc Committee and the NBC do not agree whether the appointment of a committee of general partners should be permitted in certain circumstances. The ABA has embraced the view that the Code should authorize the appointment of such a committee. The NBC considered a Recommendation permitting the appointment of a committee of general partners, but disapproved such a measure.

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[973] 11 U.S.C. § 303(b) (1994).

[974] *In re* Skye Mktg. Corp., 11 B.R. 891, 897 (Bankr. E.D.N.Y. 1981) (indicating that the numerosity requirement alleviates the concern that an involuntary bankruptcy not serve as an "engine of oppression").

[975] 11 U.S.C. § 1102 (1994).

Rationale. The Bankruptcy Code does not authorize the appointment of a committee of general partners and such interests have been represented through the formation of unofficial committees.[976] Some of the same considerations that apply to the formation of committees of equity security holders in corporate cases are applicable in the context of large, professional partnership cases. A committee of general partners can, in certain instances, facilitate the collection of partnership receivables and other assets of the business. A partnership committee could also aid in the determination of appropriate allocations with respect to the liability of the general partners for the deficiency of partnership assets to pay partnership debts. Additionally, the uniqueness of problems arising in partnership cases which involve a large number of general partners renders a committee of general partners especially suited to facilitate the resolution of differences and disputes with the partnership, among the partners themselves, and with partnership creditors.

The Recommendation sanctions the appointment and status of a committee of general partners in a partnership case where appropriate, but does not mandate it. The court retains the discretion to determine whether the formation of a committee of general partners will facilitate or impede the reorganization process and whether the benefits of formation outweigh the concomitant expenses.

Competing Considerations. The NBC rejected a similar proposal, concluding that the self-interest of general partners will provide the necessary incentive for partners to assist the partnership trustee in marshaling partnership assets since the success of their efforts will reduce any deficiency for which the partners would be liable. The NBC also expressed the concern that the appointment of an official committee of general partners could exacerbate the conflicting interests of general partners in certain circumstances. The NBC contends that informal committees could serve the appropriate function in the large, professional partnership cases in which the perceived need for such a committee is the greatest.[977]

2.3.13 *General Partner Liability on Nonrecourse Partnership Debt under 11 U.S.C. § 1111(b)*

Section 1111(b) of the Bankruptcy Code should be amended to clarify that, except as otherwise provided in a confirmed plan of a partnership debtor or the order confirming the plan, a general partner is not liable on a nonrecourse claim against the partnership except to the extent that

[976] *See In re* Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 85 B.R. 13, 17 (Bankr. S.D.N.Y. 1988).

[977] *See NBC Final Report, supra* note 916, at 218.

the general partner is personally liable on such claim under applicable nonbankruptcy law.

Section 1111(b) provides that the undersecured deficiency of a nonrecourse claim secured by property of the estate shall be treated as a recourse claim.[978] The purpose of the provision is to assure equitable treatment for the undersecured nonrecourse lender in a Chapter 11 plan. The Bankruptcy Code is not clear on whether the transformation from nonrecourse to recourse has an effect on the personal liability of general partners, although the cases that have addressed this issue have all found that additional rights for nonrecourse creditors are not created under section 1111(b).[979] While all of these courts have arrived at the right result, it is unclear under the Bankruptcy Code whether the conversion of a nonrecourse claim against the property of the partnership creates a recourse claim against the individual general partners who are liable for the partnership obligations under state law. The Recommendation provides clarity and certainty with respect to desirable financing transactions. Thus, a claim remains a nonrecourse claim against the individual general partners who are not liable under nonbankruptcy law, although the claim becomes recourse against the debtor partnership by operation of section 1111(b).

2.3.14 *'Temporary' Injunction of Proceedings or Acts against Nondebtor General Partners*

The Bankruptcy Code should be amended to permit the court for cause, upon motion of a party in interest and after notice and hearing, to temporarily enjoin actions of creditors or general partners of a debtor partnership against nondebtor general partners or their property on account of partnership obligations.[980] No injunction should be granted

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[978] 11 U.S.C. § 1111(b)(1) (1994). The exceptions to the conversion or recourse treatment are (i) if the class of which such claim is a part elects otherwise, or (ii) if the property is sold. *Id.*

[979] The few reported decisions which have addressed the issue have concluded that a nonrecourse deficiency claim does not result in personal liability for nondebtor general partners. *See, e.g.*, Travelers Ins. Co. v. Bryson Properties, XVIII (*In re* Bryson Properties, XVIII), 961 F.2d 496, 502 n.12 (4th Cir.), *cert. denied*, 506 U.S. 866 (1992); *In re* Montgomery Court Apartments of Ingham County, Ltd., 141 B.R. 324, 331 (Bankr. S.D. Ohio 1992) (section 1111(b)(1) analysis of nonrecourse deficiency claim in partnership case not relevant in Chapter 7 case); *In re* Greystone III Joint Venture, 102 B.R. 560, 570 (Bankr. W.D. Tex. 1989) (operation of section 1111(b) does not create a claim against the partners), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd on other grounds*, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992); *In re* DRW Property Co. 82, 57 B.R. 987, 992 (Bankr. N.D. Tex. 1986) (section 1111(b) does not provide rights to nonrecourse creditors under state law).

[980] The ABA Ad Hoc Committee Report details the requirements of the scope of the contemplated injunction:

under this Recommendation unless the nondebtor general partner (1) consents to the jurisdiction of the bankruptcy court; (2) makes or undertakes to make the disclosures required by Recommendation 2.3.18 below; and (3) the order granting the injunction precludes the protected general partner from incurring obligations or transfers of property except under specified circumstances.

The personal liability of general partners for some or all of the obligations of the partnership under nonbankruptcy law[981] can create problems in bankruptcy cases where the debtor is a partnership. Although the automatic stay protects a debtor partnership from creditor action, the general rule is that it has no application to nondebtor partners.[982] As a result, creditors may proceed against nondebtor general partners or their assets to satisfy partnership debts. These actions may distract general partners who are attempting to reorganize the partnership to the detriment of all partnership creditors. Under these circumstances, some courts have looked beyond the literal language of the statute and extended the protection of the automatic

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(a) The court in which a partnership case is pending may, without the filing of an adversary proceeding, on motion of a party in interest, after notice and a hearing, enjoin--

(1) the commencement or continuation of an action or proceeding against a general partner to recover on a claim against the partnership debtor that arose before the commencement of the partnership case;

(2) the enforcement against a general partner, or against property of a general partner, of a judgment obtained against the partnership before the commencement of the partnership case;

(3) any act by the holder of a claim against the partnership debtor to obtain possession of or from, to exercise control over, or to create, perfect, or enforce a lien against the property of a general partner for the purpose of collection or enforcing the holder's claim against the partners; or

(4) the commencement or continuation of any action or proceeding by any entity other than the partnership to enforce contribution or indemnification with respect to any liability arising out of the general partner's relation to the partnership and any other general partner.

ABA Ad Hoc Committee Report, *supra* note 916, at 911.

[981] U.P.A. § 15 (1992); R.U.P.A. § 306 (1996).

[982] 11 U.S.C. § 362 (1994). *See, e.g.*, Patton v. Beardon, 8 F.3d 343, 348-40 (6th Cir. 1993); *In re* Two Appeals Arising Out of the San Juan DuPont Plaza Hotel Fire Litig., 994 F.2d 956, 969 (1st Cir. 1993); Teachers Ins. & Annuity Ass'n v. Butler, 803 F.2d 61, 65 (2d Cir. 1986), *appeal dismissed*, 816 F.2d 670 (2d Cir. 1987). Unlike Chapters 12 and 13, Chapters 7 and 11 contain no provision which explicitly protects nondebtors who are jointly liable on a debt with the debtor. *See* 11 U.S.C. §§ 1201, 1301 (1994)(providing for a co-debtor stay).

stay to nonbankrupt general partners.[983] Other courts have resorted to section 105 in order to augment the protection of the automatic stay in certain circumstances.[984] Indeed, the legal relationships between a partnership and its general partners have required courts to frequently address the propriety of enjoining creditor action against nondebtor general partners.[985]

Rationale. The Bankruptcy Code generally resolves the tension between the rights of individual creditors and creditors as a group in favor of the rights of the collective creditor body. A temporary injunction, much like the automatic stay, would serve to protect the property of nondebtor partners from the dismemberment that would otherwise occur during the formulation of the partnership plan. Plan contributions and plan formulation cooperation from general partners usually benefits all partnership creditors. Rather than permitting one creditor to recover against a

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[983] *See, e.g.*, Litchfield Co. of S.C. Ltd. Partnership v. Anchor Bank (*In re* Litchfield Co. of S.C. Ltd. Partnership), 135 B.R. 797 (W.D.N.C. 1992) (holding, among other things, that creditors' actions against general partners are barred by the automatic stay); Madison Assocs. v. Baldante (*In re* Madison Assocs.), 183 B.R. 206, 214, 215 n.11 (Bankr. C.D. Cal. 1995) ("the litigation of individual creditor claims against the partners would undoubtedly adversely impact upon the Debtor's pursuit of its own claim against the Partners on behalf of the estate."), *but see* Kona Hawaiian Assocs. v. FDIC (*In re* Kona Hawaiian Assocs.), 41 B.R. 191 (Bankr. D. Haw, 1984)("the automatic stay protecting the debtor [partnership] cannot be extended to protect general partners of debtor from foreclosure," *citing* First Hawaiian Bank v. Hugh Menefee Dev. Corp. (*In re* Airport Assocs.), 462 F. Supp. 320 (D. Haw. 1978) (case under Chapter XII of the Bankruptcy Act of 1898)).

[984] *See, e.g.*, Laventhol & Horvath v. Adkisson (*In re* Laventhol & Horvath), 1992 WL 88184 at *2 (S.D.N.Y. Apr. 17, 1992) ("There is no substantial disagreement within this circuit that a bankruptcy court has the power, in . . . partnership bankruptcy cases, to grant a preliminary injunction staying litigation against non-debtors when such actions have a significant impact on the Debtor or its ability to reorganize, and where the non-debtors are not using the bankruptcy in bad faith as a shield against suits"); *In re* Litchfield Co., 135 B.R. at 805-07 (section 105 injunctions to protect nondebtor general partners (including guarantors) should be issued "when [it] is necessary to protect the debtor's successful reorganization, to ensure ratable distribution to similarly situated creditors, or otherwise to protect the court's ability to carry out the provisions of the Code"); Myerson & Kuhn v. Brunswick Assocs. Ltd. Partnership (*In re* Myerson & Kuhn), 121 B.R. 145 (Bankr. S.D.N.Y. 1990) (suits by debtor partnership creditors against nondebtor general partners temporarily enjoined); Marley Orchards Income Fund I, Ltd. Partnership v. Walker (*In re* Marley Orchards Income Fund I, Ltd. Partnership), 120 B.R. 566 (Bankr. E.D. Wash. 1990); Jonas v. Newman (In re Comark), 53 B.R. 945 (Bankr. C.D. Cal. 1985) (enforcement of judgment held by debtor partnership's creditor enjoined); St. Petersburg Hotel Assocs. v. Royal Trust Bank (*In re* St. Petersburg Hotel Assocs.), 37 B.R. 380 (Bankr. M.D. Fla.), *injunction dissolved*, 51 B.R. 18 (Bankr. M.D. Fla. 1984) (injunction issued protecting general partners to enhance debtor's financing opportunities; injunction dissolved when debtor obtained alternate financing).

[985] *See, e.g.*, Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 761 (5th Cir. 1995); Litchfield Co. of S.C. Ltd. Partnership v. Anchor Bank (*In re* Litchfield Co. of S.C. Ltd. Partnership), 135 B.R. 797, 805-07 (W.D.N.C. 1992); Myerson & Kuhn v. Brunswick Assocs. Ltd. Partnership (*In re* Myerson & Kuhn), 121 B.R. 145, 153-54 (Bankr. S.D.N.Y. 1990).

nondebtor partner to the detriment of all creditors, the Recommendation promotes limited injunctive protection in order to encourage cooperation and contribution from general partners. The injunction afforded nondebtor general partners under the Recommendation would therefore halt the "race to the courthouse" under state law in favor of furthering the bankruptcy policy of equality of distribution in the partnership case. The Recommendation is designed to preserve asset values from dissipation through creditor action and provide nondebtor partners with a breathing spell in order to focus on rehabilitation or reorganization.

The injunction provided by the Recommendation, while operating to temporarily stay creditor action, does *not* operate automatically. Automatic relief would essentially give nondebtor partners the same protection afforded debtors under the Bankruptcy Code without requiring the general partners to file a petition and otherwise submit to the bankruptcy process. This idea was considered and rejected by the NBC.[986]

Rather, under the Recommendation it is incumbent upon the party requesting the relief to demonstrate its entitlement to such extraordinary protection.[987] The

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[986] The issue of whether an injunction in favor of a nondebtor general partner should automatically arise at the commencement of the partnership's bankruptcy case was considered. *Cf.* 11 U.S.C. §§ 1201, 1301 (1994)(providing for a co-debtor stay). The concept has been rejected due to the concern that it would be tantamount to providing nondebtor general partners with one of the most significant benefits of bankruptcy without imposing the restrictions and burdens. *See NBC Final Report, supra* note 916, at 222.

[987] The Recommendation necessitates a showing of "cause" as a prerequisite to the imposition of a temporary injunction. The ABA has recommended that the court employ a nonexhaustive set of factors in determining whether to issue a temporary injunction:

> (1) whether the failure to enter an injunction would impact adversely on the partnership's ability to formulate a plan; (2) whether the failure to enter an injunction would adversely impact on the partnership's property; (3) whether entry of an injunction is necessary to protect the partnership's interest in the property or property interests of the general partners; (4) whether the general partners will contribute assets to the partnership through a plan; (5) whether entry of an injunction would prevent a multiplicity of litigation between and among creditors, general partners, and the partnership; (6) whether entry of an injunction would assist in an efficient and equitable administration of the estate's assets; (7) whether entry of an injunction would maximize return to creditors; (8) whether absent an injunction, a general partner's willingness to contribute voluntarily toward a plan would be diminished; (9) whether absent an injunction, the partnership's capacity to marshal assets necessary for its plan would be diminished; or (10) whether the general partners are involved with the management of the debtor's business.

ABA Ad Hoc Committee Report (Supp. VI-C), *supra* note 916, at 913. *Accord NBC Final Report, supra* note 916, at 221.

discretionary nature of this protection ensures that it will only be granted under circumstances warranting such treatment. Any injunctive relief granted may also be tailored to fit the specific needs of the case. Consistent with this policy goal, the injunction is designed to operate only for a limited duration.[988] The Recommendation would also make explicit that the court has the authority to issue a temporary injunction, not only with respect to obligations for which a nondebtor general partner is statutorily liable under nonbankruptcy law, but also those debts that the general partner has guaranteed.[989] The court in all cases has, however, the discretion to balance the respective interests of the parties in light of bankruptcy policy and fashion relief (including posting a bond) as may be appropriate under the circumstances. Indeed, the court has the discretion to condition the injunction and impose constraints on the ability of a nondebtor general partner to manage assets that are subject to the debts of the partnership.[990]

A request for injunctive relief under section 105 is governed by Part VII of the Federal Rules of Bankruptcy Procedure.[991] The case law has been consistent in ruling that the commencement of an adversary proceeding is therefore a prerequisite to obtaining injunctive relief.[992] The Recommendation dispenses with the adversary proceeding requirement in favor of a more expeditious and less cumbersome mechanism for obtaining injunctive relief. Under the Recommendation, while injunctive relief may be limited in scope depending on the circumstances, relief by motion after appropriate notice and a hearing will reduce costs without impinging on the enjoined parties' rights.

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[988] The ABA recommends that the injunction issued under this Recommendation be terminated "sixty days after the commencement of the partnership case unless, after notice and hearing, it is extended or otherwise modified" by court order. *ABA Ad Hoc Committee Report*, *supra* note 916, at 913.

[989] A competing consideration should be noted. The courts have generally required a compelling justification prior to interfering with a bargained-for nonbankruptcy right to pursue a nondebtor guarantor. *See generally* Chase Manhattan Bank v. Third Eighty-Ninth Assocs. (*In re* Third Eighty-Ninth Assocs.), 138 B.R. 144 (S.D.N.Y. 1992); Old Orchard Inv. Co. v. A.D.I. Distribs., Inc. (*In re* Old Orchard Inv. Co.), 31 B.R. 599 (W.D. Mich. 1983).

[990] *See, e.g.*, Recommendation 2.3.5 (permitting the court to restrict property transfers and assure the payment on account of a deficiency); Recommendation 2.3.18 (permitting the court to require nondebtor partners to make comprehensive disclosures).

[991] FED. R. BANKR. P. 7001(7) (1995).

[992] *See, e.g.*, State Bank of Southern Utah v. Gledhill (*In re* Gledhill), 76 F.3d 1070, 1080 (10th Cir. 1996); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 762 (5th Cir. 1995); Wedgewood Inv. Fund, Ltd. v. Wedgewood Realty Group, Ltd. (*In re* Wedgewood Realty Group, Ltd.), 878 F.2d 693, 701 (3d Cir. 1989); Ramirez v. Whelan (*In re* Ramirez), 188 B.R. 413, 416 (B.A.P. 9th Cir. 1995).

The Recommendation would alter the current requirements with respect to standing to obtain injunctive relief under section 105. The courts have generally limited standing to commence an adversary proceeding to enjoin the actions of nondebtor third parties to the debtor, the debtor in possession or the trustee.[993] The Recommendation would permit "any party in interest," including nondebtor general partners, to request relief.

Finally, the injunctive relief authorized by the Recommendation would *not* impair separate creditor action against nondebtor general partners on account of their separate obligations, but would enjoin only creditor action arising in connection with partnership obligations.

Competing Consideration. An extended injunction may also afford a nondebtor general partner with the time to place assets beyond the reach of the creditors and the court. It could also increase the costs of the bankruptcy proceeding and reduce the incentive of nondebtor general partners to work toward a consensual resolution.[994]

The ABA Recommendation providing for the termination of the temporary injunction within 60 days, subject to renewal, might obviate some of these concerns. Recommendation 2.3.15, following, achieves the same result as the ABA proposal, but on a discretionary basis rather than a fixed statutory deadline.

2.3.15 *Relief from the Temporary Injunction*

The Bankruptcy Code should be amended to provide that the court, upon request of a party in interest and after notice and hearing, may, for cause, grant relief from the temporary injunction provided pursuant to Recommendation 2.3.14. The relief available would include the termination, annulment, modification or conditioning a continuation of the injunction.

Rationale. As noted in Recommendation 14 above, injunctive relief should be provided to protect nondebtor general partners under certain circumstances. This Recommendation provides the grounds to seek relief from the temporary injunction, acting like a safety valve to ensure that too much protection is not granted to nondebtor partners.

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[993] *See, e.g., In re* Munoz, 73 B.R. 283, 285 (Bankr. D.P.R. 1987).

[994] *See* Larry E. Ribstein, *The Illogic and Limits of Partners' Liability in Bankruptcy*, 32 WAKE FOREST L. REV. 31, 52 (1997).

The Recommendation is an adaptation of section 362(d) of the Bankruptcy Code and recognizes that circumstances may warrant granting relief from the temporary injunction issued pursuant to Recommendation 2.3.14 above. Therefore, a court is permitted to grant appropriate relief under the Recommendation for cause. "Cause" would include the "absence of any reasonable likelihood of reorganization, inability to effectuate a plan within the time fixed by the court, denial of confirmation . . . revocation of an order of confirmation, inability to effectuate substantial consummation of a confirmed plan, material default with respect to a confirmed plan, termination of a plan by reason of the occurrence of a condition specified in the plan, or the nonpayment of fees or charges."[995] "Cause" warranting relief from the temporary injunction would also exist if the creditor establishes that it would suffer irreparable harm or "if the reasons for the injunction or the protections afforded partnership creditors and other general partners in conjunction with the injunction do not, or cease to, exist in the case with respect to the nondebtor general partner."[996]

2.3.16 *'Postconfirmation' Injunction of Proceedings or Acts against Nondebtor General Partners Who Contribute to Plans*

The Bankruptcy Code should be amended to permit the court, in connection with the confirmation of a plan of reorganization in a partnership case, to enjoin partnership creditors and general partners from actions or proceedings against a general partner or its property to collect on partnership-related claims where the general partner has contributed or made an enforceable commitment to contribute an amount to the payment of debts in accordance with the plan or the order confirming the plan. The court, after notice and hearing, must determine that the plan complies with otherwise applicable requirements for confirmation in light of the personal assets of the nondebtor contributing partners and that the injunction will not discriminate unfairly or inequitably with respect to creditors of the partnership or the claims of the general partners for contribution or indemnity.

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[995] *ABA Ad Hoc Committee Report*, *supra* note 916, at 913.

[996] *NBC Final Report*, *supra* note 916, at 221. Thus, relief from the injunction should be afforded if, among other things:

> (a) the partnership creditor or creditors or other general partner or partners would be irreparably harmed by continuation of the injunction, (b) maintenance of the injunction is not meaningfully furthering either the reorganization of the debtor partnership or maximization of value available to pay creditors, [or] (c) the protected general partner fails to comply with the terms and conditions of the injunction.

Id.

The confirmation of a partnership's plan of reorganization generally operates to discharge all prepetition obligations of the partnership.[997] The discharge of a debtor in bankruptcy does not, however, operate to discharge the liability of a nondebtor liable on the same obligation.[998] The rationale for the rule is based on the fundamental principle that the bankruptcy laws are not intended to benefit those who have not submitted themselves or their assets to the burdens of the bankruptcy process.[999]

Under the Bankruptcy Act, courts generally construed the narrow language of the discharge provision as barring a discharge or release in favor of third parties under a plan of reorganization.[1000] A substantial number of courts under the Bankruptcy Code have adhered to the strict rule and interpret section 524(e) as prohibiting permanent injunctions and third-party releases in a plan of reorganization.[1001] Some courts, however, have recognized the value of a permanent

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[997] 11 U.S.C. § 1141(d)(1)(A) (1994).

[998] *See* 11 U.S.C. § 16 (1976) (repealed) ("The liability of a person who is a co-debtor with, or guarantor or in any manner a surety for, a bankrupt shall not be altered by the discharge of such bankruptcy."). *See also* 11 U.S.C. § 524(e) (1994) (providing that a "discharge of a debtor of a debtor does not affect the liability of any other entity on, or the property of any other entity for such debt").

[999] *See, e.g.*, First Nat'l Bank v. Poland Union, 109 F.2d 54, 56 (2d Cir.), *cert. denied*, 309 U.S. 682 (1940).

[1000] *See, e.g.*, Union Carbide Corp. v. Newboles, 686 F.2d 593, 595 (7th Cir. 1982)("This case is no different because the plan expressly purports to discharge guarantors of the bankrupt. The import of Section 16 is that the mechanics of administering the federal bankruptcy laws, no matter how suggestive, do not operate as a private contract to relieve co-debtors of the bankrupt of their liabilities."); R.I.D.C. Indus. Dev. Fund v. Snyder, 539 F.2d 487, 490 n.3 (5th Cir. 1976), *cert. denied*, 429 U.S. 1095 (1977)("The bankruptcy court can affect only the relationships of debtors and creditor. It has no power to affect the obligations of guarantors."); Consolidated Motor Inns v. BVA Credit Corp. (*In re* Consolidated Motor Inns), 666 F.2d 189, 191 (5th Cir.), *cert. denied*, 457 U.S. 1140 (1982)(holding that "debts of nonpetitioning individual partners . . . to non-assenting creditors cannot be discharged by a partnership's plan"); *Poland Union*, 109 F.2d at 56.

[1001] *See, e.g.*, Landsing Diversified Properties II v. First Nat'l Bank & Trust Co (*In re* Western Real Estate Fund), 922 F.2d 592, 601 (10th Cir. 1990), *modified*, 932 F.2d 898 (10th Cir. 1991); American Hardwoods, Inc. v. Deutsche Creditor Corp. (*In re* American Hardwoods, Inc.), 885 F.2d 621, 624, 626 (9th Cir. 1989); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985); Seaport Automotive Warehouse v. Rohnert Park Auto Parts, Inc. (*In re* Rohnert Part Auto Parts, Inc.), 113 B.R. 610, 616-17 (BAP 9th Cir. 1990). The Ninth Circuit Court of Appeals in *Underhill* held that "the bankruptcy court has no power to discharge the liabilities of a non-debtor pursuant to the consent of creditors as part of a reorganization plan." *Underhill*, 769 F.2d at 1432.

injunction and have made limited exceptions.[1002] Congress has also recently recognized the virtue of channeling injunctions to augment the discharge of debtors in Chapter 11 cases.[1003] The Commission discusses the benefits of this type of injunction in the Report Section on Mass Future Claims.[1004]

The prospect of obtaining extended or permanent injunctive relief from partnership creditors and other general partners provides nondebtor general partners with the incentive to contribute substantially to a Chapter 11 or Chapter 12 plan of reorganization. The Recommendation contemplates that recoveries of partnership creditors would, in a significant number of cases, be enhanced. Since plan contributions on account of partnership obligations would often come from postpetition earnings, exempt property and other assets not otherwise available to partnership creditors, the *quid pro quo* of permanent injunctive relief would maximize recoveries by encouraging individual contributions. Indeed, it has been noted that:

> The direct result of [a permanent injunction] is that creditors are able to receive from general partners on a consensual basis funds that would otherwise be difficult, if not impossible, for them to recover.
>
> Without [the permanent injunction,] individual creditors would sue individual general partners, and general partners would then cross-claim against each other for contribution and sue the debtor for indemnification. The probable result would be a costly and time-consuming web of litigation replete with attendant attachments, garnishments and executions. Personal bankruptcy would be a likely

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[1002] *See, e.g.*, SEC v. Drexel Burnham Lambert Group (*In re* Drexel Burnham Lambert Group), 960 F.2d 285 (2d Cir. 1992), *cert. dismissed*, 506 U.S. 1088 (1993); A.H. Robins Co. v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694 (4th Cir. 1988), *cert. denied*, 493 U.S. 959 (1989); MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988); *In re* Heron, Burchette, Ruckert & Rothwell, 148 B.R. 660, 667 (Bankr. D.D.C. 1992)(opining that the permanent injunction was "essential to provide a maximum payout and a fair distribution under the plan"). *See generally* Peter E. Melzer, *Getting Out of Jail Free: Can the Bankruptcy Plan Process be Used to Release Nondebtor Third Parties?*, 71 AM. BANKR. L.J. 1 (1997); Morris Macey & Frank Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879 (1995); Paul R. Glassman, *Third-Party Injunctions in Partnership Bankruptcy Cases*, 49 BUS. LAW. 1081 (1994); Howard C. Buschmann II & Sean P. Madden, *The Power and Propriety of Bankruptcy Court Intervention in Actions between Nondebtors*, 47 BUS. LAW. 913 (1992).

[1003] *See* 11 U.S.C. § 524(g), (h) (1994). *See also* McArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). The Commission has made specific Recommendations with regard to channeling injunctions in the mass future claims context. *See* Treatment of Mass Claims and Mass Future Claims in Bankruptcy, Recommendation 2.1.1-.5.

[1004] *See* Mass Future Claims Recommendations 2.1.1-.5.

> consequence for many. By preventing a haphazard scramble for the assets of general partners, and by facilitating an orderly distribution scheme, the permanent injunction...ensures that general partners will be protected and that creditors' recoveries will be maximized.[1005]

The Recommendation would not necessarily require full payment plans in all instances.[1006] It would, however, furnish partnership creditors with the protections provided in the confirmation requirements of sections 1129 and 1225 of the Code and therefore require substantial creditor agreement. Therefore, as under current law, the existence of the injunction and the required confirmation requirements would often entail a compromise of outstanding claims. The Recommendation would also clarify that the "best interests of creditors" test would require the court to assess, as part of plan confirmation, the personal assets and liabilities of nondebtor general partners.

The Recommendation (postconfirmation injunction) would *not* preclude the enforcement of claims of a partnership creditor against a nondebtor general partner, or against the property of a nondebtor general partner, who has *not* contributed or assumed a commitment to contribute to the payment of debts of the partnership in accordance with the confirmed plan. Similarly, the Recommendation would not preclude nondebtor partners from reserving the right under the plan to pursue nonparticipating general partners for their proportionate share of the distribution to the partnership creditors. The Recommendation also gives the court the discretion to impose conditions on the statutory injunction, including limitations on asset transfers[1007] and the requirement of ongoing disclosure.

The policy choice in the Recommendation favors a collective proceeding maximizing the return to partnership creditors. The underlying premise is that nondebtor partners will voluntarily contribute more to ensure confirmation of the partnership plan if provided protection from future creditor claims. Encouraging a consensual resolution and plan formulation should reduce administrative costs and increase the return to creditors. The Recommendation is narrowly-tailored to provide relief only to nondebtor partners who warrant protection.

[1005] Michael J. Crames & Joseph T. Moldovan, *Section 105 Injunctions Offer Protections to Members of Professional Partnerships*, 209 N.Y.L.J. 5 (March 29, 1993).

[1006] The NBC appears to favor limiting the extension of the permanent injunction to cases in which there is either a full payment plan or cases in which a settlement is reached with partnership creditors as part of a plan of reorganization. *See NBC Final Report, supra* note 916, at 225. The Commission should consider whether a "best efforts" plan, *i.e.*, anything less than full payment, would justify a nonconsensual, permanent injunction.

[1007] *See* Recommendation 2.3.5, *infra*.

Competing Consideration. The Recommendation is carefully structured to avoid the appearance that what nondebtor partners are really getting is a discharge, though one may argue that a permanent injunction is essentially a discharge and that the difference is semantic. Moreover, the interests of creditors are protected by requiring the plan to pay claims in full before an injunction protecting nondebtor partners will issue. In the event injunctive protection is unwarranted, unwinding an injunction under the procedure in Recommendation 2.3.17 for failure to perform a material plan commitment should eliminate doubt that the injunction provided is a veiled discharge for nondebtor parties.

In addition, the court should take into account the personal assets and liabilities of the nondebtor partners. The required liquidation analysis necessitated by the best interests of creditors test would enable partners to take advantage of generous state law exemptions and prebankruptcy planning since the calculation is made with reference to the nondebtor general partner's nonexempt assets. This concern may, however, be vitiated if Congress adopts the Commission's Recommendation with respect to uniform exemptions.

2.3.17 *Revocation of Injunction*

> **The Bankruptcy Code should be amended to provide that the injunction issued with respect to any nondebtor general partner under Recommendation 2.3.16 above should be terminated or revoked on the request of a party in interest if, after notice and hearing, the court determines (1) that the protected nondebtor general partner has failed to perform a material commitment under the plan; (2) that the order confirming the plan in which the injunction was issued is revoked under sections 1144 or 1230 of the Code; or (3) that the nondebtor general partner has procured the injunction by fraud. The Bankruptcy Code should be further amended to provide that a request for revocation for fraud under provision (3) should be made at any time within two years[1008] after the date of the entry of the confirmation order.**

The Recommendation reflects the policy that the injunction issued pursuant to a confirmed plan is available *only* if the nondebtor general partner performs in accordance with the terms of the confirmed plan and has made candid disclosure to the court and to creditors. While the revocation of an injunction is within the discretion of the court under current law, the Recommendation gives the court guidance on what conditions must be met in order for injunctive relief to continue.

[1008] The ABA Ad Hoc Committee Report recommends a *four-year* statute of limitations for revoking the permanent injunction.

In addition, nondebtor general partners as well as stayed creditors will know what is required for the injunction to continue.

2.3.18 *Duty of Disclosure by Nondebtor General Partners*

> **The Bankruptcy Code should be amended to provide that, unless otherwise ordered by the court for cause, each nondebtor general partner shall, within 30 days[1009] after the entry of the order for relief in a partnership case or within such time as the court shall fix, produce information concerning such partner's financial condition and affairs similar to that provided by a debtor, together with such additional information and periodic reports as may be required by the court from time to time.**

When a bankruptcy petition is filed by or against a general partnership, it is probable that there will be a deficiency in the assets to satisfy the claims of partnership creditors. The personal liability of nondebtor general partners for that deficiency requires that the partnership and partnership creditors be informed of the extent and location of individual partner's assets. It is imperative that creditors and other parties in interest have the same type of financial information for partners as that made available by the debtor partnership.

Bankruptcy Rule 1007(g) provides that "[t]he court may order any general partner to file a statement of personal assets and liabilities within such time as the court may fix."[1010] Some courts construing Rule 1007 have required nondebtor general partners to file information regarding nonpartnership assets and liabilities in connection with determining whether to confirm the plan of a debtor partnership.[1011] Rule 1007(g) is, however, discretionary. In addition, the information required to be provided under the Rule is limited.

[1009] The NBC Final Report was not specific as to time within which the required disclosures were to be made. The Rules require debtors to file most of the schedules and statements within *fifteen days* of the petition if the petition is accompanied by a list of the debtor's creditors. FED. R. BANKR. P. 1007 (1995).

[1010] FED. R. BANKR. P. 1007(g) (1995).

[1011] *See, e.g., In re* Monetary Group, 55 B.R. 297, 299 (Bankr. M.D. Fla. 1985); MBank Corpus Christi, N.A. v. Seikel (*In re* I-37 Gulf Ltd. Partnership), 48 B.R. 647, 650 (Bankr. S.D. Tex. 1985)(authority opining that the "best interests of creditors" test of section 1129(a)(7) requires the court to make an assessment of "the net worth of each of the partners of the partnership" which, in turn, requires personal disclosure).

Rationale. The Recommendation makes personal and comprehensive disclosure by nondebtor general partners the general rule, rather than the exception, when a partnership seeks relief under title 11. The disclosures contemplated by nondebtor general partners would be made under penalty of perjury and be in substantially the same form and made at substantially the same time as presently required under the Code and Rules.[1012] The court could also require the information to be supplemented on a periodic basis. Under the Recommendation, the court has the discretion, for cause, to modify the disclosure requirements and to prescribe conditions for the examination of the information provided by general partners. This provision comports with present bankruptcy law and policy.

The Recommendation strengthens the power of the partnership trustee or debtor in possession to require contributions from nondebtor general partners on account of their liability for any deficiency.[1013] A provision requiring the prompt disclosures contemplated by this Recommendation expedites the administration of the partnership estate for the benefit of partnership creditors by providing the trustee, creditors and other parties in interest with extensive, current and accurate information. The information is necessary not only to enable the partnership trustee or debtor in possession to allocate to the nondebtor partners their respective shares of the deficiency but also to prepare a plan of reorganization. Indeed, the financial information provided would serve to establish the liquidation value of the individual partner's assets. The information furnished by a nondebtor general partner under the Recommendation would also be of critical importance to the court in ascertaining whether or not to grant a temporary injunction under Recommendation 2.3.14, above.

Competing Consideration. It may be argued that the information disclosed by nondebtor partners will be impossible to verify and will therefore be unreliable. The fact that information about the financial condition or affairs of individual partners may often be unreliable and difficult, if not impossible, to verify raises serious concerns. Requiring a general partner to submit financial information on penalty of perjury may ameliorate the problem of unreliability.

[1012] *See* 11 U.S.C. § 521 (1994) (requiring debtors to file "a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and current expenditures, and a statement of the debtor's financial affairs"); FED. R. BANKR. P. 1007 (setting forth the required filings and time parameters).

[1013] *See* Recommendations 2.3.4 & 2.3.5 (setting forth the allocation of any deficiency, permitting estimation and granting the court the authority to issue an order to assure payment of account of deficiency claims).

2.3.19 *Access to Disclosed Information*

The Bankruptcy Code should be amended to provide that the trustee, debtor in possession or other entity designated by the court in a partnership bankruptcy case should maintain and promptly provide to parties in interest in the case, on reasonable request, certain important information regarding the nondebtor general partners of the debtor partnership.

All debtors are required to disclose all financial information and submit to the open inquiry by the court as well as all parties in interest. Recommendation 2.3.18 requires certain financial information from nondebtor general partners. This Recommendation does *not* require the information provided by a nondebtor partner under Recommendation 2.3.18 above to be filed with the court. If such information were required to be filed with the court, it would be of public record and "open to examination by an entity at reasonable times without charge."[1014] During the Commission's deliberations on this issue, privacy concerns were raised about making this type of information on nondebtor partners available to the public. The Recommendation, therefore, proposes to provide this information to parties in interest in the case on request only.

The trustee, debtor in possession or other entity designated by the court in a partnership case would, under the Recommendation, be charged with the responsibility of serving as the custodian of information disclosed by nondebtor general partners and other important information.[1015] The information should be easily accessible to parties in interest without the need for unnecessary litigation. Such information would enable creditors to protect their interests during the partnership case. The information furnished would not, however, be made publicly available. The court should also have the discretion under the Recommendation to establish conditions for access as appropriate to protect reasonable and legitimate confidentiality concerns of nondebtor general partners.

Competing Consideration. As noted above, the Recommendation does not require any specific financial information to be filed with the court. The court, however, may direct the types of disclosures that would be appropriate. The decision

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[1014] 11 U.S.C. § 107(a) (1994). *See id.* § 107(b); FED. R. BANKR. P. 9018 (1995) (providing the court with the authority to protect certain confidential information).

[1015] The other information contemplated by the Recommendation includes a list of the names and addresses of the general partners that are protected by the automatic stay or the temporary injunction issued in connection with Recommendation A above; the disclosure requirements that may be applicable to such general partners; and what orders have been issued by the court to assure the recovery of any deficiency from nondebtor general partners.

of what types of information to disclose would therefore not be left entirely up to the nondebtor partner.

In addition, it may be argued that the parties seeking the benefits of a collective proceeding that provides a permanent injunction should be required to bear the burdens of compliance by filing the information required under Proposal with the bankruptcy court. The court would have the ability to protect confidential information in appropriate circumstances. The delay and problems associated with policing compliance with the disclosure provisions would also be minimized if the documents were required to be filed with the court.

PARTNER AS DEBTOR

The appropriate effect of a general partner's bankruptcy filing is a hotly-debated and divisive issue. Conflict often exists between the result of a partner's bankruptcy filing under state partnership law, the result under the Bankruptcy Code, and the result under the partnership agreement itself. Courts and commentators generally acknowledge three aspects of a partner's relationship with the partnership: (1) specific rights in partnership property; (2) share of the partnership profits and surplus; and (3) the right to participate in the management of the partnership.[1016] Clarifying the effect of a partner's bankruptcy filing on each of these three aspects of the partner relationship is the focus of the Commission's "partner as debtor" recommendations.

[1016] Cardinal Indus., Inc. v. Buckeye Fed. Sav. & Loan Ass'n (*In re* Cardinal Indus., Inc.), 105 B.R. 834, 848 (Bankr. S.D. Ohio), *supplemented*, 109 B.R. 738 (Bankr. S.D. Ohio 1989).

RECOMMENDATIONS

2.3.20 ***Treatment of LLC Member or LLC Manager Under the Bankruptcy Code***

Debtor LLC members in member-managed LLCs should be treated like general partners under the Bankruptcy Code. Similarly, debtor managers of manager-managed LLC's should be treated like general partners under the Bankruptcy Code. This treatment should be limited to three aspects of the LLC member or LLC manager relationship: (1) continuity of LLC after LLC member's or manager's bankruptcy filing; (2) transferability of LLC ownership interest; and (3) management rights in the LLC.

2.3.21 ***Exclusion of a Partnership or LLC Relationship from Treatment under 11 U.S.C. § 365***

The Bankruptcy Code should be amended to exclude partnership and LLC governing documents and relationships from treatment under 11 U.S.C. § 365. A new section concerning partnership and LLC governing documents and relationships should be added to the Bankruptcy Code.

2.3.22 ***Ipso Facto Provisions in Partnership or LLC Governing Documents Rendered Unenforceable***

***Ipso facto* provisions relating to partnerships, LLCs, and the rights or interests of partners or LLC members or managers should not be enforceable under the Bankruptcy Code. *Ipso facto* provisions include any provision in a partnership agreement, LLC operating agreement, or applicable nonbankruptcy law that operates to terminate or modify the rights of a partner or LLC member based on insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or appointment of a trustee or custodian. Non-*ipso facto* provisions that limit a partner's or LLC member's rights, relationship, interest, or permit expulsion on the basis of something other than insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or the appointment of a receiver would remain enforceable.**

2.3.23 *Property of the Estate, Transferability, and Valuation of a Partnership or LLC Interest*

"Property of the estate" for a partner or LLC member should include all rights attendant with the partnership or LLC interest, including management rights, voting rights, and economic rights (including goodwill, the right to share in profits and losses, and any other right to payment). Except as provided below, the Recommendation does not alter the effect of section 541(a)(6), to the extent it is applicable. In the case of an individual partner or LLC member who (1) continues employment (in whatever capacity) with the partnership or LLC after the order for relief, *and* (2) whose estate receives or is more likely than not going to receive the "buyout price" as defined below, all partnership or LLC interest amounts arising, accruing, or payable after the order for relief are deemed to be on account of personal services rendered by the partner or LLC member and do not become property of the estate. There should be a presumption, in a case of an individual debtor, that the estate is more likely than not going to receive the "buyout price," upon which presumption the parties should be entitled to rely and function until the court orders to the contrary, after notice and hearing, on motion of the trustee or any party in interest.

The court should have the power to authorize a sale under section 363 of the partnership or LLC interest and order the admission of the buyer to the partnership or LLC with all rights and duties the debtor had, except that if the governing documents preclude transfer under a non-*ipso facto* provision, the anti-transfer clauses will be given effect, but only if the partnership or LLC pays the "buyout price" to the estate. The court should retain the power to (1) fashion reasonable payment terms which balance the needs of the estate for receipt of cash as rapidly as possible with the needs of the entity for liquidity and working capital to conduct its operations in a prudent manner; and (2) ensure receipt of the buyout price by the estate.

The "buyout price" means the highest price (including a calculation or appraisal method), if any, provided in the governing documents in the case of a buyout of an interest not on account of the bankruptcy of, insolvency of, financial condition of, commencement of a voluntary or involuntary case under title 11 for, or appointment of a trustee or custodian for, a partner or LLC member or manager. If no such price is provided, the court should determine a fair buyout value.

2.3.24 *Treatment of Partnership and LLC Management Rights*

During any period when an estate administered in a bankruptcy case includes a partnership or LLC interest, the management and voting rights of the partner or LLC member are to be exercised as follows:

- **A debtor in possession under Chapter 11 or a debtor under either Chapter 12 or Chapter 13 should exercise all management and voting rights, subject to the applicable non-*ipso facto* provisions of the partnership or LLC governing documents and applicable nonbankruptcy law, and the other applicable provisions of the Bankruptcy Code;**
- **Where (a) there is more than one general partner or LLC managing entity and at least one of such partners or entities is not a debtor in a case under the Bankruptcy Code, and (b) a Chapter 7 or Chapter 11 trustee has been appointed, then the trustee should not exercise any management rights except to the extent necessary to constitute a quorum or to meet a minimum majority required by the governing documents or applicable nonbankruptcy law;**
- **In all other cases where a Chapter 7 or Chapter 11 trustee has been appointed, the trustee shall exercise all management and voting rights.**

Regardless of the foregoing, in all cases where (1) an individual debtor continues to function as a partner or member after the order for relief, and (2) the estate receives or is more likely than not going to receive, the "buyout price," then the individual should have the sole power to exercise management and voting rights attributable to periods after the order for relief.

2.3.25 *11 U.S.C. § 523 and Imputed Conduct or Liability*

11 U.S.C. § 523 should be amended to provide that nothing in this section shall preclude the discharge of a general partner from a debt (otherwise nondischargeable in a copartner's or agent's bankruptcy case) arising solely as a result of imputing to the general partner the conduct or liability of a copartner or agent.

2.3.26 *Subordination of Claims Arising from the Purchase or Sale of a Partnership Interest*

11 U.S.C. § 510(b) should be amended to subordinate the claims "arising from the rescission of a purchase or sale" of their partnership interests

or "for damages arising from the purchase or sale" of their partnership interests to all claims and interests that are senior or equal to the claim or interest represented by such security or other interest in the bankruptcy case of a general partner.

DISCUSSION

Outside bankruptcy, partnerships are governed by state law. Partnership law in virtually all states[1017] is governed by one of two uniform partnership acts, the Uniform Partnership Act ("UPA") or the Revised Uniform Partnership Act ("RUPA").[1018] Both of these uniform laws reference the agreement between the partners as governing the partnership relationship.[1019] As a result, a majority of the provisions of the UPA or the RUPA apply only in the absence of agreement between the partners. In other words, the partnership agreement can alter the result under the UPA or the RUPA. Certain aspects of the partnership relationship, however, cannot be altered by agreement, including: the fiduciary duty of a partner;[1020] the right of a partner to inspect partnership books and records;[1021] and the liability of a partner for partnership debts.[1022]

The primacy of the agreement between the partners under both the UPA and the RUPA reflects the importance of the consensual nature of the partnership relationship. "In general, a partner cannot be forced to continue as part of a partnership, nor can a partner be forced to accept a new partner."[1023] Under both

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[1017] Louisiana, the District of Columbia, the Virgin Islands, and Guam are the only states and territories that have not adopted one of the uniform partnership laws.

[1018] The U.P.A. was originally promulgated in 1914 and by 1986, it had been adopted (with some modifications) in every state except Louisiana. In 1994, the Revised Uniform Partnership Act was promulgated and as of September 1, 1997, it had been adopted in approximately 12 states.

[1019] *See, e.g.*, R.U.P.A. § 101(5) (1992) (defining partnership agreement as "the agreement, whether written, oral or implied, among the partners concerning the partnership"); U.P.A. § 18 (1992) ("The rights and duties of partners in relation to the partnership shall be determined, subject to any agreement between them by the following rules....").

[1020] U.P.A. § 21 (1992); R.U.P.A. § 103(b)(3) - (5) (1996).

[1021] U.P.A. § 19 (1992); R.U.P.A. § 103(b)(2) (1996).

[1022] U.P.A. § 15 (1992).

[1023] Neely, *supra* note 900, at 276-77 (citing U.P.A. § 18(g) (1992)) ("[n]o person can become a member of a partnership without the consent of all partners") and U.P.A. § 27(1) (governing the assignment of the right to receive partnership profits but no ability to assign the right to participate in partnership management or require an accounting, absent the agreement of the other

statutory schemes, whether to continue a partnership once a partner files for bankruptcy is completely within the discretion of the nondebtor partners.[1024] The bankruptcy of a partner triggers an automatic alteration of the relationship between the debtor partner and the partnership.[1025] This "automatic" forfeiture of certain partnership interests under state partnership law appears to conflict with certain provisions of the Bankruptcy Code and forms the basis for the confusion over the treatment of debtor partners in bankruptcy.

Under the Bankruptcy Code, provisions in agreements that are triggered by "insolvency, financial condition, commencement of a voluntary or involuntary case under Title 11, or appointment of a trustee or custodian in bankruptcy" are not generally enforceable.[1026] These types of provisions are commonly referred to as "*ipso facto*" provisions. The provisions under state partnership law, discussed above, that protect the sanctity of the partnership relationship and are triggered upon a partner's bankruptcy filing or financial condition may not be enforceable under the Bankruptcy Code.

The Commission's recommendations on the relationship between a debtor partner and the partnership attempt to reconcile the tension between the policy under state partnership law to preserve the voluntary nature of the partnership relationship and the policy under the Bankruptcy Code to prevent an automatic forfeiture of a

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partners).

[1024] U.P.A. § 31(5) (1992) (providing that the bankruptcy of any partner or the partnership automatically causes the dissolution of the partnership); U.P.A. § 35(3)(b) (1992) (a bankrupt partner no longer has the authority to bind the partnership); R.U.P.A. § 601(6)(i) (1996) (providing that a partner who becomes a debtor in bankruptcy is automatically dissociated from the partnership); R.U.P.A. §§ 603(b)(1) & 803(a) (1996) (a dissociated partner does not have the right to participate in partnership management, and if dissolution occurs, the dissociated partner has no right to participate in the winding up of the partnership).

[1025] *See* U.P.A. § 31(5) (1992) (automatic dissolution upon partner's bankruptcy); R.U.P.A. § 603(b)(1) (1996) (bankrupt partner loses right to participate in partnership management).

[1026] There are five specific subsections in the Bankruptcy Code that render these types of provisions unenforceable. *See* 11 U.S.C. § 363(l) (1994) (providing that the trustee may use, sell, or lease property notwithstanding an otherwise applicable *ipso facto* provision that would divest the debtor's interest in the property); 11 U.S.C. § 365(e)(1) (1994) (providing that an executory contract or unexpired lease can not be altered or modified after the commencement of the case solely because of an *ipso facto* provision); 11 U.S.C. § 365(f)(1) (1994) (empowering the trustee to assign an executory contract or lease regardless of a provision that would restrict, prohibit, or condition such assignment); 11 U.S.C. § 365(f)(3) (1994) (prohibiting termination or modification of an agreement due to its assumption and assignment); 11 U.S.C. § 541(c)(1)(B) (1994) (providing that an interest of the debtor in property becomes property of the estate notwithstanding an *ipso facto* clause in the underlying agreement or applicable nonbankruptcy law that restricts or conditions such transfer).

debtor's interest in property as a result of a bankruptcy filing in order to preserve the value of the bankruptcy estate for creditors. In addition, the Commission's recommendations include specific treatment for new business organizations that are not referred to in the Bankruptcy Code, such as limited liability companies.

Both the Ad Hoc Committee on Partnerships in Bankruptcy of the Business Section of the American Bar Association and the National Bankruptcy Conference spent a great deal of time and resources studying partner and partnership-related bankruptcy issues.[1027] Only the National Bankruptcy Conference made specific proposals with regard to the effect of a general partner's bankruptcy filing.[1028]

2.3.20 *Treatment of LLC Member or LLC Manager Under the Bankruptcy Code*

Debtor LLC members in member-managed LLCs should be treated like general partners under the Bankruptcy Code. Similarly, debtor managers of manager-managed LLC's should be treated like general partners under the Bankruptcy Code. This treatment should be limited to three aspects of the LLC member or LLC manager relationship: (1) continuity of LLC after LLC member's or manager's bankruptcy filing; (2) transferability of LLC ownership interest; and (3) management rights in the LLC.

A principal advantage of the partnership form over the corporate form is that partnership income is not subject to two layers of tax. Corporate income is taxed twice: as income at the corporate level; and at the shareholder level in the form of a dividend. Partnership income, on the other hand, is distributed to the partners and is taxed only at the partner level. Conversely, a principal advantage of the corporate form over the partnership form is that corporate shareholders are not personally liable for the debts of the corporation, whereas partners are personally liable to partnership creditors, with certain limitations, for the debts of the partnership.

[1027] The ABA Ad Hoc Committee was created in 1991 and Morris W. Macey and Professor Frank R. Kennedy served as the chairman and the reporter, respectively. Morris W. Macey & Frank R. Kennedy, Partnership Bankruptcy and Reorganization: Proposals for Reform, 50 BUS. LAW. 879 (1995) (setting forth the Ad Hoc Committee's Proposals on partnership bankruptcy) (Hereinafter *ABA Ad Hoc Committee Report*).

The National Bankruptcy Conference ("NBC") began reviewing partnership bankruptcy issues as part of its comprehensive review of bankruptcy law. On May 1, 1997, the NBC issued its Final Report, Revised Edition, which contains proposed reforms to the Bankruptcy Code with respect to debtor partnerships as well as debtor partners.

[1028] REFORMING THE BANKRUPTCY CODE: NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 200 (rev. ed. 1997).

A desire to combine the best of both of these worlds–the tax treatment of a partnership with the limited liability of a corporation–led to the enactment of the first limited liability company ("LLC") statute in Wyoming in 1977.[1029] Commentators agree that the sudden popularity of the LLC as a business form is due to a 1988 revenue ruling by the Internal Revenue Service treating a Wyoming LLC as a partnership for tax purposes.[1030]

> The importance of Revenue Ruling 88-76 to the development of LLCs is illustrated by a few statistics. By 1988, eleven years after the enactment of the Wyoming statute, only one other state (Florida) had enacted an LLC statute, and there were only twenty-six LLCs in Wyoming. By the end of 1994, forty-six additional statutes had been passed and tens of thousands of LLCs had been formed.[1031]

LCCs combine the limited liability of the corporate form with the pass-through tax treatment of a partnership.[1032] LLC statutes have been enacted in every state and the District of Columbia.[1033] Similar to corporations, LLCs can be governed by statute, articles of organization, and an operating agreement (which is similar to a partnership agreement and delineates the business purpose and the relationship between the members, the managers (if any) and the company). Certain LLC aspects under state law may be modified by agreement between the LLC members.[1034] LLC

[1029] *See* Neely, *supra* note 900, at 281.

[1030] *See* Rev. Rul. 88-76, 1988-2 C.B. 360; *see also* Neely, *supra* note 900, at 281 ("The success of the nascent LLC business form depended, however, on whether it would be taxed as a partnership. Therefore, it languished from birth in 1977 until the IRS ruled in 1988 that it would classify a Wyoming LLC as a partnership for tax purposes.").

[1031] Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 3 (1995).

[1032] New Treasury regulations, effective January 1, 1997, significantly simplify the ability of an entity to obtain pass-through tax treatment. Referred to colloquially as the "check-the-box" regulations, all or most LLCs may now determine their tax treatment by election. Treas. Reg. § 301.7701-2 (replaced 1996). Prior to this Regulation, LLCs had to satisfy the requirements of the Kintner Regulations, which required the LLC to have certain partnership attributes with regard to transferability of interests and continuity of life. The Kintner Regulations no longer apply to the tax treatment of LLCs under the "check-the-box" Regulations.

[1033] Neely, *supra*, note 900, at 281 (citing RIBSTEIN & KEATINGE, LIMITED LIABILITY COMPANIES, § 1.06, at 1-8 (1996) (LLC statute count as of August 1996)(hereinafter cited as Ribstein & Keatinge)).

[1034] Neely, *supra* note 900, at 282.

members are insulated from general liability for LLC debts, similar to shareholders.[1035] LLC's can be managed by members or by managers; the distinction being that "members have partner-like authority to bind a member-managed LLC, managers have similar authority to bind manager-managed LLCs, and members have no authority as such to bind manager-managed LLCs."[1036] Thus, LLC members are akin to general partners in member-managed LLCs and LLC members that are not managers are akin to limited partners or shareholders in manager-managed LLCs. A critical distinction between limited partners and LLC members, however, is that a LLC member does not forfeit limited liability by participating in the management of the LLC, even if the LLC is manager-managed.[1037]

Due to the relatively recent enactment of LLC statutes, the Bankruptcy Code does not specifically refer to LLCs or LLC members. The Bankruptcy Code definition of "corporation" arguably includes an LLC "as its members have limited liability (like corporate shareholders), it appears to be an unincorporated company or association, and it is not a limited partnership."[1038] However, the nature of the relationship of a member in a member-managed LLC and a manager in a manager-managed LLC is closer to that of a general partner in a partnership than an equity security holder in a corporation. A few cases have addressed certain issues that arise when an LLC member or manager files for bankruptcy.[1039] Recognizing the similarities between LLC members and managers and general partners, these courts have applied partnership-type analysis to the LLC circumstances and have arrived at differing results.[1040]

[1035] *Id.* (*citing* Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 6 (1995)). Certain LLC statutes, however, permit members to provide for the assumption of personal liability in the articles.

[1036] *Id.* (quoting RIBSTEIN & KEATING, at 10). Members can, however, be given explicit limited authority, without incurring liability.

[1037] *Id.* (quoting RIBSTEIN & KEATING, at § 1.05, at 1-4).

[1038] *Id.* at 25-26.

[1039] *See* JTB Enter., LC v. D & B Venture L.C. (*In re* DeLuca), 194 B.R. 79 (Bankr. E.D. Va. 1996) ("DeLuca II"); Broyhill v. DeLuca (*In re* DeLuca), 194 B.R. 65 (Bankr. E.D. Va. 1996) ("DeLuca I"); *In re* Daugherty Constr., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995).

[1040] *Compare In re* Daugherty Constr., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995) (holding that the automatic dissolution provisions under the state LLC statute were unenforceable *ipso facto* clauses) *with* JTB Enter., L.C. v. D & B Venture, L.C. (*In re* DeLuca), 194 B.R. 79, 91 (Bankr. E.D. Va. 1996) (enforcing the provisions of the LLC operating agreements despite the fact that the LLC member's bankruptcy caused the dissolution of the LLC under state law; the court relied on a Fourth Circuit case that had held that a partnership agreement is a personal services contract and therefore falls into an exception to the anti-*ipso facto* provisions of the Bankruptcy Code).

Rationale. Due to the recent enactment of LLC statutes, the Bankruptcy Code does not refer to them specifically. The popularity of the LLC form mandates specific reference in the Bankruptcy Code to avoid confusion over the treatment of LLC member and LLC manager relationships in bankruptcy.[1041] The nature of the LLC member or LLC manager/LLC relationship for the most part mirrors that of a general partner to a partnership. Fiduciary duties and tax treatment all conform to those of a general partnership.[1042] A major difference, however, is that LLC members are protected from liability for LLC debts.

The similarities between the fiduciary and managerial roles of a general partner and a LLC member or LLC manager make uniform treatment under the Bankruptcy Code a logical choice. The principal advantage of the Recommendation is that by providing similar treatment for these similar legal relationships, statutory clarification of partnership relations will also clarify the treatment of LLC relationships in bankruptcy. The Recommendation does not alter the overall treatment of debtor LLCs in bankruptcy, but only provides specific treatment of the LLC relationship for LLC member or LLC manager debtors. Tax-driven developments in LLC statutes, for example, make a blanket designation for LLCs under the Bankruptcy Code undesirable.[1043] The Recommendation thus preserves treatment of LLCs like corporations and their members like equity security holders under circumstances warranting such treatment. An example is the interests of LLC members of manager-managed LLCs. Members of this type of LLC generally do not have day-to-day managerial responsibility and have limited liability for the debts of the LLC. In this respect, these LLC members have interests that mirror those of equity security holders.[1044] The Recommendation narrowly defines the scope of general partner

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[1041] The Recommendation, by implication, supports the view that LLC's should be eligible for relief under title 11 to the same extent as partnerships and corporations.

[1042] Ribstein, *supra* note 1031, at 18-21.

[1043] Letter from Sally S. Neely, on behalf of herself, to Stephen H. Case et al., Adviser, National Bankruptcy Review Commission (May 5, 1997). The elimination of the Kintner Regulations, for example, may lead to corresponding changes in LLC characteristics with regard to continuity of life and transferability of interests. A flexible rule is necessary in order to avoid future conflict with different LLC characteristics.

[1044] Neely, *supra* note 900, at 286-87. Ms. Neely argues that depending on certain characteristics of the LLC relationship, treatment of an LLC member or an LLC manager under the Bankruptcy Code should either be as a general partner or as an equity security holder. *Id.* In certain instances, LLC members in member-managed LLCs and LLC managers in manager-managed LLCs should be treated like general partners under the Bankruptcy Code. Conversely, members in manager-managed LLCs have interests that are more closely aligned with equity security holders and therefore their interests should be treated accordingly under the Bankruptcy Code. *Id.* Ms. Neely goes on to point out the significance of this designation under the Bankruptcy Code. For example, equity security holders may: (i) have a meeting convened by the U.S. trustee (11 U.S.C. § 341(b)

treatment for LLC members and managers and preserves flexible treatment for LLC interests as equity security interests.

Competing Considerations. LLCs are hybrid entities, incorporating certain corporate attributes and certain partnership attributes. One could argue that the limited liability of an LLC member renders the LLC interest closer to that of an equity security than a general partnership interest. As stated above, however, the relationship of a LLC member in a member-managed LLC and the relationship of a LLC manager in a manager-managed LLC more closely tracks the rights and obligations of a general partner than that of an equity security holder. The popularity of these vehicles ensures an increase in the appearance of LLC members and LLC managers in bankruptcy cases and necessitates specific bankruptcy treatment. The Recommendation accomplishes this goal without hamstringing future flexibility as state LLC statutes evolve.

2.3.21 *Exclusion of a Partnership or LLC Relationship from Treatment under 11 U.S.C. § 365*

The Bankruptcy Code should be amended to exclude partnership and LLC governing documents and relationships from treatment under 11 U.S.C. § 365. A new section concerning partnership and LLC governing documents and relationships should be added to the Bankruptcy Code.

The three characteristics of a partnership interest and relationship–(1) specific rights in partnership property; (2) share of the partnership profits and surplus; and (3) the right to participate in the management of the partnership–are not specifically treated under the Bankruptcy Code. These interests and relationships are generally defined in a partnership or LLC operating agreement and if the applicable agreement is silent, then under state law. Partnership and LLC operating agreements are currently subject to the provisions of 11 U.S.C. § 365 governing the treatment of executory contracts.

Treatment under current section 365 is dependent on a contract's "executoriness."[1045] Partnership agreements are generally treated in the case law as

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(1994)); (ii) have a representative committee appointed by the U.S. trustee (11 U.S.C. § 1102); (iii) apply for a "substantial contribution" administrative expense under section 503(b)(3)(D); and (iv) have their interests and preferences considered by the court in the context of, among others, leaving a prepetition receiver in place under section 543(d), or approving the officers and directors of a reorganized debtor under section 1129(a)(5)(A)(ii). *Id.*

[1045] The Commission's Recommendations on section 365 eliminate the "executoriness" requirement. *See* Recommendation 2.4.4. Consistent with this approach, some courts have moved away from a strict executoriness requirement and take a more functional approach. *See, e.g., In re* General Dev. Corp., 84 F.3d 1364 (11th Cir. 1996) (affirming determination that executoriness

"executory" and are, therefore, subject to the rules governing assumption or rejection under section 365.[1046] Section 365(c) limits a trustee's power to assume certain contracts depending on the nature of the agreement and whether the other party to the agreement could refuse performance from one other than the debtor or debtor in possession under applicable nonbankruptcy law.

Treatment of partnership relationships under this provision of section 365 is unclear. Section 365(c) links assumption and assignment and does not distinguish between contractual obligations and other terms of a relationship. A partnership relationship is much more than a contract, it is a business relationship that combines economic obligations and individual performance. Consistent with this view, the UPA, the RUPA, and the Uniform Limited Liability Company Act ("ULLCA") all preclude the assignment of noneconomic rights, in the absence of a contrary provision in the partnership or LLC agreement. Limitations on assignment therefore cloud the issue of assumption. Conflicting precedent exists regarding whether a trustee or debtor in possession can assume a partnership agreement or LLC operating agreement under section 365(c)(1)(A).[1047] Because of limitations in underlying agreements and

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definition has been expanded); *In re* Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992).

Expansion of this definition has been criticized by some courts as going against the fundamental purpose of section 365. *See, e.g., In re* Riodizio, 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997) (functional analysis is more efficient, but "ignoring executoriness rewrites statute in a fundamental way"); *In re* Child World, Inc., 147 B.R. 847, 851 (Bankr. S.D.N.Y. 1992) ("manifestly, [functional] approach ignores statutory requirement that the contract to be assumed or rejected must be executory").

[1046] *See* Summit Inv. & Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608 (1st Cir. 1995); Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem*., 25 F.3d 1038, 1994 WL 258400 (4th Cir. 1994); Calvin v. Siegal, 190 B.R. 639, 643 (Bankr. D. Ariz. 1996); *In re* Cutler, 165 B.R. 275, 278 (Bankr. D. Ariz. 1994); *In re* Clinton Court, 160 B.R. 57, 60 (Bankr. E.D. Pa. 1993); *In re* Preistley, 93 B.R. 253, 258 (Bankr. D.N.M. 1988); *In re* Corky Foods Corp., 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988). *Compare* Phillips v. First City, Texas-Tyler, N.A. (*In re* Phillips), 966 F.2d 926 (5th Cir. 1992) (partnership agreement not executory following dissolution triggered by sole general partner's Chapter 11 petition).

[1047] For conflicting cases addressing the partnership issues, *see* Summit Inv. & Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608 (1st Cir. 1995) (permitting debtor in possession to assume partnership agreement); Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038 (4th Cir. 1994) (prohibiting debtor in possession from assuming partnership agreement). Fewer cases have been decided in the LLC context, but at least two have arrived at opposite results on this issue. *See In re* Daugherty Constr., Inc., 188 B.R. 607 (Bankr. D. Neb. 1995) (debtor in possession permitted to assume the LLC agreements in question; attempts by nondebtor LLC members to enforce state dissolution provisions violated anti-*ipso facto* provisions of section 365(e)); Broyhill v. DeLuca (*In re* DeLuca), 194 B.R. 65 (Bankr. E.D. Va. 1996) (LLC dissolved upon member's bankruptcy filing; *ipso facto* provisions of section 365(e) do not apply to personal

applicable nonbankruptcy law, some courts have determined that the partnership or LLC agreement cannot be assumed, even by the debtor in possession.[1048]

Rationale. The Recommendation would greatly simplify the analysis of partnership and LLC management rights in bankruptcy. Provisions that are specifically tailored to the needs of partnership and LLC relationships will have more equitable bankruptcy results for both debtors and creditors. Treatment under section 365 is inadequate because it treats the entire partnership agreement like a contractual obligation and fails to adequately address the subtler aspects of the partnership relationship and economic interests. The Recommendation refers to both the governing documents as well as the overall relationship because certain partnership and LLC relationship terms are statutory and are not included in the governing documents. This is necessary because to the extent that a partnership or LLC agreement is silent, state partnership law or LLC statute will provide the default rule governing the conduct and obligations of the parties.[1049]

The Recommendation assumes that section 365 remains unchanged. As interpreted, section 365 creates problems for partnership and LLC agreements for two principal reasons: (1) it links assumption by the debtor in possession or the trustee with assignment to a third party;[1050] and (2) it exempts certain agreements from application of the anti-*ipso facto* provisions.[1051] By taking partnership and LLC governing documents and relationships out of section 365 and providing specially tailored treatment, these problems can be solved. Specially-tailored treatment would also include appropriate rules for "assumption" (or election to remain a partner or member), "rejection" (or election not to remain a partner or member), and treatment during the interim period of partnership and LLC relationships.

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services agreement).

[1048] *See, e.g.*, *Breeden*, 25 F.3d at 1040; *Broyhill*, 194 B.R. at 68.

[1049] *See* Neely, *supra* note 900, at 278-279 (asserting that state partnership statutes provide a "standard form contract" for the small "archetypal" partnership and also permit large complicated partnerships to draft "around the statute") (citations omitted).

[1050] *See* 11 U.S.C. § 365(f)(1) (1994) (providing that a trustee may assign an executory contract "[e]xcept as provided in subsection (c) of this section"), *and* 11 U.S.C. § 365(c)(1)(A) (1994) (providing that a "trustee may not assume or assign any executory contract . . . if applicable law excuses a party, other than the debtor, . . . from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession . . . .").

[1051] *See* 11 U.S.C. § 365(e)(2) (1994) (providing that the anti-*ipso facto* provisions of section 365(e)(1) do not apply if applicable nonbankruptcy law excuses a party from accepting performance from the trustee or assignee of such contract).

Effect of Commission's Proposals to Amend Section 365. The Commission's recommendations to amend section 365 will solve a number of the problems for partnership and LLC relationships under current section 365. For example, under the section 365 recommendations, "executoriness" will no longer be a prerequisite for a debtor in possession or trustee to assume or reject a prepetition contract; assumption will become an election to perform; and rejection will become an election to breach. Particularly with regard to the election to perform, the Commission's section 365 Recommendation clarifies that postpetition performance by the debtor in possession is not a "transfer" or assignment under section 365.[1052] By separating the act of assumption from the act of assignment, election by a debtor in possession to perform a partnership or LLC operating agreement will not trigger the same underlying state law impediments to the assignment of management rights. For example, where a general partner is in Chapter 11 and seeks to "assume" the partnership agreement and continue performing all managerial obligations, the fact that the underlying agreement precludes assignment would have no bearing on whether the debtor general partner would be able to assume the agreement.[1053]

Competing Considerations. It has been argued that partnerships and LLCs do not require a separate section of the Bankruptcy Code, but rather only those problematic sections should be amended.[1054] As discussed above, the Commission section 365 recommendations have already solved a number of the partnership and LLC problems. Separating assumption from assignment may alleviate the confusion surrounding partnership agreements. In the remaining areas, minor tinkering with existing provisions may adequately resolve these issues without a wholesale rewriting of the law governing partnerships and LLCs in bankruptcy.

[1052] *See*, *e.g.*, Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir.) (assumption not dependent on whether contract is assignable), *cert. denied*, 117 S. Ct. 2511 (1997).

[1053] *See generally* Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038, 1994 WL 258400 (4th Cir. 1994) (The district court in *Catron* applied a hypothetical test under section 365 to determine whether Catron (the debtor general partner) could assume the partnership agreement. Under the hypothetical test, if the nondebtor could refuse performance from an entity other than the debtor or the debtor in possession under applicable nonbankruptcy law, then the nondebtor can refuse performance from the debtor in possession. Consequently, because under the hypothetical test the nondebtor party can refuse performance, the debtor in possession is precluded from exercising rights or powers under or ultimately assuming the partnership agreement).

[1054] Letter from Richard Levin to Stephen H. Case, Adviser, National Bankruptcy Review Commission (April 29, 1997).

2.3.22 *Ipso Facto Provisions in Partnership or LLC Governing Documents Rendered Unenforceable*

Ipso facto provisions relating to partnerships, LLCs, and the rights or interests of partners or LLC members should not be enforceable under the Bankruptcy Code. _Ipso facto_ provisions include any provision in a partnership agreement, LLC operating agreement, or applicable nonbankruptcy law that operates to terminate or modify the rights of a partner or LLC member based on insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or appointment of a trustee or custodian. Non-_ipso facto_ provisions that limit a partner's or LLC member's rights, relationship, interest, or permit expulsion on the basis of something other than insolvency, financial condition, commencement of a voluntary or involuntary case under title 11, or the appointment of a receiver would remain enforceable.

Under the Bankruptcy Code, provisions in agreements that are triggered by "insolvency, financial condition, commencement of a voluntary or involuntary case under Title 11, or appointment of a trustee or custodian in bankruptcy" are not enforceable.[1055] These types of provisions are referred to as "*ipso facto*" provisions.[1056] The policy reason behind rendering *ipso facto* agreements unenforceable in bankruptcy is to prevent an automatic forfeiture of a debtor's interest in property as a result of a bankruptcy filing in order to preserve the value of the bankruptcy estate for creditors.

Generally, *ipso facto* provisions play an important partnership role outside of bankruptcy, effecting, among others, a dissolution of the partnership or LLC, a forfeiture of management rights, or a transformation of a general partnership interest to a limited partnership interest or a right to payment. For example, the UPA provides that the bankruptcy of a general partner dissolves the partnership.[1057] Similarly, the RUPA provides that a bankrupt general partner is dissociated from the

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[1055] *See supra* note 1026.

[1056] *Id.*

[1057] U.P.A. § 31(5) (1992). Morris W. Macey and Professor Frank R. Kennedy note that when the Uniform Partnership Act was first promulgated, bankruptcy meant that a petition seeking liquidation had been filed and did not include reorganization under the Bankruptcy Act. Morris W. Macey and Frank R. Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879, 901 (1995).

partnership.[1058] The same dissociation occurs under the ULLCA when a LLC member files for bankruptcy protection.[1059]

Problems arise when the nondebtor partner(s) or LLC member(s) do not want to continue in business with the debtor partner or LLC member. Provisions in the underlying agreement or state law accomplishing this result are generally unenforceable as *ipso facto* provisions. The Bankruptcy Code, however, provides an important exception designed to protect the interests of a nondebtor party who entered the prepetition agreement in reliance upon the personal skills of the other party. The nondebtor party to an executory contract is excused from accepting performance from an entity other than the debtor if applicable nonbankruptcy law would excuse the nondebtor party from accepting such performance.[1060] In addition, the Bankruptcy Code permits the postbankruptcy enforcement of *ipso facto* provisions in these types of agreements.[1061] The types of contracts protected under these provisions of the Bankruptcy Code are generally referred to as "personal services contracts."[1062]

Utilizing the above analysis, the nondebtor party in the partnership or LLC context argues that the underlying agreement is a personal services contract and as such, the nondebtor party can refuse performance from the debtor in possession as well as enforce any *ipso facto* provisions in the underlying agreement.[1063] The "personal services" nature of a partnership or LLC agreement is supported under state partnership and LLC law because nondebtor partners and members are given complete discretion (unless altered by agreement) over whether to admit someone as a partner or LLC member. It is important to remember, however, that some partnerships and LLCs are closer to true personal service arrangements than others. For example, a partner in a law firm is specifically chosen for personal qualities. On the other hand, the corporate general partner of a mature real estate development has a less personal relationship with the other partners or limited partners.

[1058] R.U.P.A. § 601(6)(i) (1996).

[1059] U.L.L.C.A. § 601(7) (1996).

[1060] *See* 11 U.S.C. § 365(c)(1)(A), (e)(2)(A) (1994).

[1061] 11 U.S.C. § 365(e)(2)(A) (1994).

[1062] 2 COLLIER ON BANKRUPTCY ¶ 365.05, at 365-54 (Lawrence P. King et al. eds. 15th ed. 1996). The statutory definition is dependent on state law and may, as a result, include more agreements than what is considered a "personal services" agreement in the classic sense.

[1063] *See* Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038 (4th Cir. 1994) (debtor in possession could not assume partnership agreement).

Difficulty reconciling these complex issues arises, for the most part, under two subsections of section 365. Section 365(c)(1) provides that a trustee is unable to assume or assign an agreement if applicable nonbankruptcy law excuses the nondebtor party(s) from accepting performance from an "entity other than the debtor or debtor in possession."[1064] The threshold issue under this section is whether the debtor in possession is a distinct entity from the prepetition debtor. If the debtor in possession is a distinct entity, then the debtor in possession is precluded from assuming the agreement if applicable nonbankruptcy law excuses the nondebtor party(s) from accepting the debtor in possession's performance.[1065]

The second subsection that requires interpretation is the *ipso facto* carve-out provision of section 365(e)(2). Section 365(e)(2) provides that *ipso facto* provisions (otherwise unenforceable under section 365(e)(1)) are enforceable even in bankruptcy if the nondebtor party(s) to the contract could refuse performance from the trustee or from an assignee, regardless of the agreement between the parties.[1066] Confusion

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[1064] 11 U.S.C. § 365(c)(1)(A) (1994).

[1065] An example of the confusion that can arise under this subsection is the case of Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038, 1994 WL 258400 (4th Cir. 1994). In *Catron*, the debtor in possession was one of three general partners engaged in the development of a shopping center. Catron contributed the undeveloped land and another partner was to develop and manage the shopping center. Catron filed a Chapter 11 petition and the other partners sought relief from the stay in order to exercise a buyout option in the partnership agreement, triggered by the bankruptcy filing. The bankruptcy court granted relief from the stay and Catron appealed. Catron argued that the bankruptcy court erred in finding that as a debtor in possession he was a distinct legal entity from the prepetition debtor and therefore could not assume the partnership agreement. The district court affirmed on the grounds that because the debtor in possession stands in the shoes of the trustee, "Catron's status as a debtor in possession subjects him to the restrictions imposed by § 365(c)." *Id.* at 633. Thus, Catron, as debtor in possession, was precluded from assuming the prepetition partnership agreement on the grounds that he was a separate legal entity. The district court also applied a hypothetical test that prevented Catron from assuming the partnership agreement. Under the hypothetical test, if the nondebtor could refuse performance from an entity other than the debtor or the debtor in possession under applicable nonbankruptcy law, then the nondebtor can refuse performance from the debtor in possession. Consequently, because under the hypothetical test the nondebtor party can refuse performance under the hypothetical test, the debtor in possession is precluded from assuming the executory contract.

[1066] 11 U.S.C. § 365(e)(2) (1994). Some confusion over the interpretation of section 365(e)(2) arose when section 365(c)(1)(A) was amended in 1984. Prior to 1984, section 365(c)(1)(A) prohibited assumption by the trustee if the nondebtor party could refuse performance from an entity other than "the trustee." This language was deleted and "an entity other than the debtor or debtor in possession" was inserted, emphasizing that the debtor in possession was not to be treated as a separate entity from the debtor for purposes of assumption. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984). Section 365(e)(2) was not similarly amended, leaving some question as to whether enforcement of *ipso facto* provisions should be treated differently from anti-assumption provisions. Some commentators conclude that *ipso facto* provisions should only be enforced under section 365(e)(2) when substituted performance would occur. 2

arises over whether the nondebtor party is permitted to refuse performance from the *debtor in possession* under applicable nonbankruptcy law, thereby preserving the effect of the *ipso facto* clauses in the agreement. By contrast, some courts enforce the anti-*ipso facto* provisions of the Code. Under this reasoning, the debtor in possession is not a separate entity from the prepetition debtor and therefore (1) the other party(s) to the agreement can not refuse performance under section 365(e)(2) or (c)(1); and (2) the debtor in possession can assume the agreement under section 365(b) notwithstanding section 365(c)(2).[1067]

Rationale. The case law is divided on the effect of *ipso facto* provisions in general partner bankruptcy cases.[1068] The Recommendation adopts the view that, as a matter of public policy, *ipso facto* provisions in partnership or LLC operating agreements or applicable nonbankruptcy law should not be enforceable in bankruptcy. This position is consistent with the Bankruptcy Code treatment of *ipso facto* provisions in other types of property interests.[1069] Just because a partner or LLC member has sought relief under the Bankruptcy Code, there is no compelling interest served by mandating an automatic dissolution of the partnership or buyout of the debtor partner's interest. The anti-forfeiture considerations preserved by the Recommendation maintain the debtor's status quo while balancing the interests of all creditors and parties in interest without preferring certain creditors or parties in interest over others.

COLLIER ON BANKRUPTCY ¶ 365.06 at 365-60 (Lawrence P. King et al. eds., 15th ed. 1994) ("The wording of section 365(e)(2) is perhaps unnecessarily broad and suggests that a bankruptcy termination clause might be asserted against a debtor in possession when the contract is one for personal services, although it seems clear that the intent was to permit termination only when substituted performance would occur.")

[1067] *See, e.g.*, Summit Inv. & Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608 (1st Cir. 1995) (prepetition debtor is the same entity as the debtor in possession; *ipso facto* exception under section 365(e)(2) did not apply).

[1068] *Compare* Breeden v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038, 1994 WL 258400 (4th Cir. 1994) (applicable nonbankruptcy law (the UPA) precluded assumption under section 365(c)(1) thus precluding nullification of *ipso facto* provisions under section 365(e)(1); buy-out provision was enforceable due to debtor in possession's inability to assume partnership agreement); *with* Summit Inv. & Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608 (1st Cir. 1995) (invalidating RULPA provisions divesting a debtor general partner from the partnership as *ipso facto* clause; court refused to treat debtor in possession as separate entity); *and In re* Antonelli, 148 B.R. 443 (D. Md. 1992), *aff'd mem.*, 4 F.3d 984, 1993 WL 321584 (4th Cir. 1993) (anti-assignment provisions of UPA overridden by anti-*ipso facto* provisions of section 365(f)(1); court permitted assignment of management rights to committee in violation of applicable nonbankruptcy law).

[1069] *See, e.g.*, 11 U.S.C. §§ 363(l), 541(c)(1) (1994).

It is important to remember that an *ipso facto* provision purports to alter a party's rights on the basis of bankruptcy, insolvency or other financial straits. Other provisions in a partnership agreement that limit or otherwise regulate a party's rights under the agreement will remain enforceable unless they contravene some other Bankruptcy Code provisions. For example, generally-applicable, bankruptcy-neutral provisions in an agreement that limit an individual's management responsibilities would still be enforceable under the Recommendation against both a debtor in possession and a trustee.

The Recommendation is consistent with the position taken by the NBC Committee on Partnerships. The NBC Final Report on Partnerships proposes that "[t]he commencement of a case or entry of an order for relief with respect to a general partner under title 11 (or other *ipso facto* condition) should not automatically cause, or provide the other partners with the option to cause, the dissolution of the partnership," and that "[t]he filing of a petition by or against a general partner under any chapter of title 11 (or any other *ipso facto* provision) should not result in the loss to the estate of the value of the general partner's 'interest in the partnership.'"[1070]

Competing Considerations. The important role that *ipso facto* provisions play in the partnership context outside of bankruptcy has led certain commentators to conclude that these provisions should be enforceable regardless of the bankruptcy filing. Most notably, the Ad Hoc Committee of the ABA proposed (but later withdrew) a provision that would have enforced applicable nonbankruptcy law requiring a dissolution or dissociation when a general partner filed for bankruptcy.[1071] Some courts have also enforced *ipso facto* provisions in bankruptcy.[1072] Other courts find the forfeiture of a partner's interest that would occur under state law is not enforceable in bankruptcy.[1073]

[1070] REFORMING THE BANKRUPTCY CODE: NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 228 (rev. ed. 1997).

[1071] Morris W. Macey & Frank R. Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform,* 50 BUS. LAW. 879, 905 (1995) (proposed (but later withdrawn) section 569 provided that applicable nonbankruptcy law would control the treatment of partnership agreements in bankruptcy except that a buyout price would not be determined by the agreement or applicable nonbankruptcy law if such price was conditioned on the financial straits of the debtor partner.)

[1072] *See, e.g.,* Phillips v. First City, Texas-Tyler (*In re* Phillips), 966 F.2d 926 (5th Cir. 1992) (enforcing state partnership provision that "bankrupt" general partner did not have authority to file bankruptcy petition on behalf of partnership); *In re* Sunset Dev., 69 B.R. 710 (Bankr. D. Idaho 1987) (general partner's filing dissolved partnership under state law notwithstanding section 365(e)).

[1073] *See, e.g.,* Summit Inv. & Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608 (1st Cir. 1995) (*ipso facto* provisions of section 365 overruled provisions in agreement and Massachusetts limited partnership statute); Cardinal Indus., Inc. v. Buckeye Fed. Sav. & Loan Ass'n (*In re* Cardinal

2.3.23 *Property of the Estate, Transferability, and Valuation of a Partnership or LLC Interest*

"Property of the estate" for a partner or LLC member should include all rights attendant with the partnership or LLC interest, including management rights, voting rights, and economic rights (including goodwill, the right to share in profits and losses, and any other right to payment). Except as provided below, the Recommendation does not alter the effect of section 541(a)(6), to the extent it is applicable. In the case of an individual partner or LLC member who (1) continues employment (in whatever capacity) with the partnership or LLC after the order for relief, *and* (2) whose estate receives or is more likely than not going to receive the "buyout price" as defined below, all partnership or LLC interest amounts arising, accruing, or payable after the order for relief are deemed to be on account of personal services rendered by the partner or LLC member and do not become property of the estate. There should be a presumption, in a case of an individual debtor, that the estate is more likely than not going to receive the "buyout price," upon which presumption the parties should be entitled to rely and function until the court orders to the contrary, after notice and hearing, on motion of the trustee or any party in interest.

The court should have the power to authorize a sale under section 363 of the partnership or LLC interest and order the admission of the buyer to the partnership or LLC with all rights and duties the debtor had, except that if the governing documents preclude transfer under a non-*ipso facto* provision, the anti-transfer clauses will be given effect, but only if the partnership or LLC pays the "buyout price" to the estate. The court should retain the power to (1) fashion reasonable payment terms which balance the needs of the estate for receipt of cash as rapidly as possible with the needs of the entity for liquidity and working capital to conduct its operations in a prudent manner; and (2) ensure receipt of the buyout price by the estate.

The "buyout price" means the highest price (including a calculation or appraisal method), if any, provided in the governing documents in the case of a buyout of an interest not on account of the bankruptcy of, insolvency of, financial condition of, commencement of a voluntary or involuntary case under title 11 for, or appointment of a trustee or

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Indus.), 105 B.R. 834, 849 (Bankr. S.D. Ohio 1989); *In re* Corky Foods Corp., 85 B.R. 903, 904 (Bankr. S.D. Fla. 1988).

custodian for, a partner or LLC member or manager. If no such price is provided, the court should determine a fair buyout value.

These Recommendations propose specific treatment in bankruptcy for the partnership interest, including a partner's management rights. When a general partner files for bankruptcy protection, the partnership interest becomes property of the estate and the partner's creditors are entitled to realize its prepetition value. Determining this value can be tricky when the partner is an individual, because amounts earned postpetition on account of postpetition services are not property of the estate. In addition, partnership agreements and underlying state law often provide differing values for the partnership interest. Moreover, a price triggered on the bankruptcy of the partner is an unenforceable *ipso facto* provision. The Recommendations attempt to balance the three competing interests in this area: those of the partner's creditors to receive the value of the interest; those of the nondebtor partners to choose their partners; and those of the debtor to exempt postpetition earnings in order to facilitate a fresh start.

Property of the Estate. Section 541(a)(6) provides that property of the estate includes "[p]roceeds, product, offspring, rents or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case." In the case of an individual partner or LLC member, the effect of this provision is that property of the estate does not include postpetition earnings for services rendered. The division of partnership income under section 541(a)(6) is between those earnings for services rendered and those earnings attributable to a return on the partnership interest.[1074] Property of the debtor becomes property of the estate regardless of an *ipso facto* provision that would limit the debtor's estate's interest in the property.[1075]

Transferability of Partnership or LLC Interest. A debtor general partner's partnership interest can be transferred by the trustee, subject to the conditions specified in the underlying partnership agreement.[1076] Section 363(l) provides the

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[1074] *See, e.g.*, Fitzsimmons v. Walsh (*In re* Fitzsimmons), 725 F.2d 1208, 1211 (9th Cir. 1984) (refuting contention by sole proprietor debtor in possession that all postpetition earnings were within the section 541(a)(6) exception; "the earnings exception applies only to services performed personally by an individual debtor"); *but see*, *In re* Altcheck, 124 B.R. 944, 956-57 (Bankr. S.D.N.Y. 1991) (all postpetition earnings of a sole proprietorship fell into section 541(a)(6) exception and were not property of the estate).

[1075] 11 U.S.C. § 541(c)(1) (1994).

[1076] *See, e.g.*, Rice v. Shoney's, Inc. (*In re* Dean), 174 B.R. 787 (Bankr. E.D. Ark. 1994) (trustee bound by sale restrictions and option to purchase debtor's joint venture interest); *In re* Todd, 118 B.R. 432 (Bankr. D.S.C. 1989) (Chapter 7 trustee bound by right of first refusal provisions in partnership agreement).

terms under which a trustee may use, sell or lease property of the estate.[1077] *Ipso facto* provisions are not enforceable under section 363(l). However, courts have generally enforced non-*ipso facto* provisions in partnership agreements that restrict the alienability of the interest or otherwise give the remaining partners a right of first refusal.[1078]

Valuation. Both the Uniform Partnership Act and the Revised Uniform Partnership Act provide valuation formulas under certain circumstances for partnership interests. For example, the UPA provides that partners continuing a partnership after a wrongful dissolution must pay the partner causing the wrongful dissolution the liquidation value of the interest, less any damages resulting from the dissolution.[1079]

Under the RUPA, if a partner files for bankruptcy and the partnership continues, the remaining partners must buyout the bankrupt partner's interest. The RUPA buyout price is "the amount that would have been distributable to the dissociating partner...if... the assets of the partnership were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner....Interest must be paid from the date of dissociation to the date of payment."[1080] While the buyout policy under the RUPA is consistent with the buyout policy under the Recommendation, the buyout under the

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[1077] 11 U.S.C. § 363(l) (1994)(providing that the trustee, subject to section 365, may use, sell or lease property of the estate notwithstanding an *ipso* facto provision in the underlying agreement or applicable law). The Bankruptcy Code does not distinguish between a partner's right to receive partnership distributions and the partner's right to participate in the partnership management. Under current law, the partnership agreement (inclusive of all rights, relationships and interests) is treated under sections 363 and 365.

[1078] This view has been countenanced by both commentators and the courts. *See* Gerald K. Smith, *Issues in Partnership and Partner Bankruptcy Cases and Reorganization of Partnership Debtors,* in course materials for ALI-ABA, PARTNERSHIPS, LLCS, AND LLPS: UNIFORM ACTS, TAXATION, DRAFTING, SECURITIES, AND BANKRUPTCY, at 685 ("contractual provisions regulating who may buy partnership interests and the price, such as, Buy/Sell Agreements and Rights of First Refusal, have generally been considered enforceable. An agreement which is general, that is, a partner withdrawing or dissociating for any reason can be bought out based on a formula should be enforceable. However, if the buyout is triggered by bankruptcy it should not be enforceable unless that is compelled by § 365(e)(2)." *citing* Calvert v. Bongards Creameries (*In re* Schauer), 62 B.R. 526 (Bankr. D. Minn. 1986), *aff'd* 835 F.2d 1222 (8th Cir. 1987); *In re* Farmers Markets, Inc., 792 F.2d 1400 (9th Cir. 1986); *In re* Todd, 118 B.R. 432 (Bankr. D.S.C. 1989); *In re* Baquet, 61 B.R. 495 (Bankr. D. Mont. 1986)).

[1079] U.P.A. § 38(2)(b) & (2)(c)(II) (1992). It is not clear, however, that bankruptcy is a wrongful dissolution and this formula may not be applicable.

[1080] R.U.P.A. § 701(b) (1996).

Recommendation is not mandatory. Determination of the value under the RUPA is likely to result in a market value. The buyout price under the Recommendation is either the highest price provided in the underlying documents or else a fair price as determined by the court.

Rationale. The tension that this tripartite Recommendation attempts to resolve is between preserving the going concern value of the debtor's general partner interest (*i.e.*, the economic value) for the estate and enforcing the benefit of the nondebtor partners' bargain or the result under state law. Section 541(a)(6) protects creditors by ensuring that the estate includes income attributable to estate property.[1081] Courts have grappled with the effect of this provision on an individual debtor's postpetition earnings.[1082] The Recommendation preserves the effect of section 541(a)(6) except under a limited circumstance: (1) where the partner or LLC member continues working for the partnership or LLC; and (2) a non-*ipso facto* provision in the agreement effects a buyout of the partner's or LLC member's interest at the buyout price.

Interpretation and enforceability of "buyout" provisions in a general partner's bankruptcy have been the subject of a few cases.[1083] The difficult issue in these cases is whether to enforce the lower "bankruptcy" buyout price provided in the underlying agreement.[1084] The Recommendation eliminates argument over which "buyout price" is proper; under the Recommendation the highest price provided in a non-*ipso facto* provision of the governing documents is the buyout price. The buyout price provisions in the Recommendation attempt to reconcile the need to maximize estate

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[1081] *See* 4 COLLIER ON BANKRUPTCY ¶ 541.19, 541-94 (Lawrence P. King et al. eds. 15th ed. 1996).

[1082] *Compare In re* Powell, 187 B.R. 642 (Bankr. D. Minn. 1995) (holding that post-petition earnings under section 541(a)(6) were not property of individuals' Chapter 11 estate; wages were derived exclusively in debtors' capacity as employees); *In re* Vedia, 150 B.R. 393 (S.D. Tex. 1992) (100% of doctor/DIP's postpetition earnings within section 546(a)(1) exception); *with In re* Angobaldo, 160 B.R. 140 (Bankr. N.D. Cal. 1993) (splitting postpetition earnings between those attributable to debtor's post-petition services and those attributable to profits from estate assets).

[1083] *See* Connolly v. Nuthatch Hill Assoc. (*In re* Manning), 831 F.2d 205 (10th Cir. 1987); Cutler v. Cutler (*In re* Cutler), 165 B.R. 275 (Bankr. D. Ariz. 1994).

[1084] The facts in *Cutler* provide a good example of the different buyout alternatives in partnership agreements. In the event of bankruptcy under the *Cutler* agreement, the other partners could buy out the interest at book value. *Cutler*, 165 B.R. at 276. In the event of a voluntary withdrawal from the partnership, the agreement provided for a buy out price at 87.5% of fair market value. *Id.* In the event of death, disability, or incompetence of a partner, the same agreement provided for a fair market value buyout price. *Id.* Under the Recommendation, the fair market value buy out price would apply in bankruptcy notwithstanding the alternative provision requiring book value.

assets for creditors with the interest in enforcing the benefit of the nondebtor partner's bargain. The buyout price is intended to provide a fair and predictable price to the creditors who will be cutoff under certain circumstances, as of the order for relief, from receiving income generated by an estate asset. Requiring a buyout at the highest price calculated under the agreement and if none, then at a fair price, should provide as close to a predictable price as possible. Thus, creditors, debtors, and nondebtor partners and LLC members should be able to predict with a modicum of certainty what the buyout price would be in bankruptcy.

The Recommendation also mitigates the possible hardship suffered by an entity that must buyout a debtor member's interest by authorizing the court to permit a flexible payment schedule, if necessary.

Under the Recommendation, the court would be able to order a sale of the partnership or LLC interest including any attendant management rights under section 363. For the majority of professional partnerships, this provision is likely to have an *in terrorem* effect, compelling the partnership to "buyout" the interest in accordance with the terms of the Recommendation. Otherwise, the court may transfer all of the debtor partner's rights (including management rights) to a third party. Most partnerships would rather buy-out the interest than risk a court-ordered sale of the partnership interest to a third person.

The Recommendation further encourages a buyout by the partnership by enforcing non-*ipso facto* transfer restrictions in the underlying partnership or LLC governing documents. Restrictive transfer provisions are enforced only if the partnership or LLC pays the buyout price to the estate. Enforcing such a restrictive sale provision or a right of first refusal provision in a partnership agreement preserves the benefit of the nondebtor partners' bargain during a partner's or LLC member's bankruptcy case, by preventing the forced entry of a third party to the partnership or LLC. This portion of the Recommendation is consistent with the withdrawn recommendation of the ABA Ad Hoc Committee that the underlying agreement and applicable state law should govern the treatment of partnership agreements in bankruptcy.[1085]

Professor Ribstein recommended that the treatment of partnership and LLC interests in bankruptcy be determined under state law in order to avoid conflicting

[1085] Morris W. Macey & Frank R. Kennedy, *Partnership Bankruptcy and Reorganization: Proposals for Reform*, 50 BUS. LAW. 879, 905 (1995) (proposed (but later withdrawn) section 569 provided that applicable nonbankruptcy law would control the treatment of partnership agreements in bankruptcy except that a buyout price would not be determined by the agreement or applicable nonbankruptcy law if such price was conditioned on the financial straits of the debtor partner.)

incentives and policy goals.[1086] Enforcing private agreement in the case of transferability of the partnership or LLC interest satisfies a number of the concerns raised by Professor Ribstein.[1087] In preserving these results, however, the Recommendation does not abandon the bankruptcy interest of maximizing estate value.

Competing Considerations. It has been argued that enforcing a contractual buyout price may lead to collusive valuation by the nondebtor and debtor partners.[1088] The Recommendation addresses this concern by providing that the highest price for an interest in the underlying agreement will be the "buyout price." This would include the price (or the calculation of a price) that a partner would receive upon voluntary withdrawal or the partner's estate would receive upon death. While collusive price terms might be tempting in bankruptcy, undervaluing would not be tempting in the above two scenarios.

2.3.24 *Treatment of Partnership and LLC Management Rights*

During any period when an estate administered in a bankruptcy case includes a partnership or LLC interest, the management and voting rights of the partner or LLC member are to be exercised as follows:

- **A debtor in possession under Chapter 11 or a debtor under either Chapter 12 or Chapter 13 should exercise all management and voting rights, subject to the applicable non-*ipso facto* provisions of the partnership or LLC governing documents and applicable nonbankruptcy law, and the other applicable provisions of the Bankruptcy Code;**
- **Where (a) there is more than one general partner or LLC managing entity and at least one of such partners or entities is not a debtor in a case under the Bankruptcy Code, and (b) a Chapter 7 or Chapter 11 trustee has been appointed, then the trustee should not exercise any**

[1086] Letter from Professor Larry E. Ribstein, GMU Foundation Professor of Law, George Mason University to Stephen H. Case, Adviser, National Bankruptcy Review Commission (May 27, 1997).

[1087] *Id.* at 3 ("partners or LLC members should be able to expel bankrupt partners or members and to fix the buyout price *regardless* of the management responsibilities of the partner or member and *regardless* of whether the firm is an LLC or partnership or whether the bankrupt is personally liable for the firm's debts.")

[1088] Letter from Richard Levin to Stephen H. Case, Adviser, National Bankruptcy Review Commission at 4 (April 29, 1997).

management rights except to the extent necessary to constitute a quorum or to meet a minimum majority required by the governing documents or applicable nonbankruptcy law;

- **In all other cases where a Chapter 7 or Chapter 11 trustee has been appointed, the trustee shall exercise all management and voting rights.**

Regardless of the foregoing, in all cases where (1) an individual debtor continues to function as a partner or member after the order for relief, and (2) the estate receives or is more likely than not going to receive, the "buyout price," then the individual should have the sole power to exercise management and voting rights attributable to periods after the order for relief.

The Bankruptcy Code does not differentiate between management rights and other contract rights of a partner or member of an LLC. Sections 365(c) and (e), however, refer to applicable nonbankruptcy law to determine whether a trustee can assume an executory contract.[1089] Applicable law in the partnership context distinguishes between the general partner's "interest in the partnership" (the right to receive profits and distributions from the partnership) and the right to participate in the management of the partnership enterprise. Only the "interest in the partnership" may be assigned without the consent of the other partners under the UPA.[1090] The RUPA rule is similar, requiring the consent of all partners before admission of a partner and limiting the management rights of assignees.[1091] The transferability provisions for LLCs mirror those for partnerships.[1092] Most state law provisions regarding transferability apply only in the absence of agreement between the parties. Thus, the parties can override state law and provide that managerial rights are freely transferable.

[1089] 11 U.S.C. § 365(c), (e) (1994). Section 365(c) provides that a trustee may not assume or assign an executory contract if applicable law excuses the nondebtor party(s) from accepting performance from someone other than the debtor or the debtor in possession. Section 365(e) renders certain *ipso facto* provisions unenforceable and permits the enforcement of *ipso facto* provisions if applicable law excuses the nondebtor party from accepting performance from the trustee or an assignee of the trustee. 11 U.S.C. § 365(e)(2)(A)(i) (1994).

[1090] U.P.A. § 27(1) (1992). An assignee of the economic rights of a partnership can not exercise management rights, access partnership information, or demand an accounting without the consent of the other partner(s).

[1091] R.U.P.A. §§ 401(i), 503 (1996).

[1092] Neely, *supra* note 900, at 283-284 (noting that the elimination of the Kintner requirements for LLCs may alter, among other things, the transferability provisions under current state LLC statutes).

It is expected that in most cases where the debtor's property includes a partnership or LLC interest, such interest will either be (1) dealt with in a Chapter 11 plan (either by being retained by the debtor or disposed of), (2) sold or otherwise "bought out" during the pendency of the case, or (3) abandoned. During the "gap" period, before one of these dispositions is achieved, questions will arise about who exercises the management or voting rights that the debtor has under the applicable partnership or LLC governing documents and applicable nonbankruptcy law and whether those rights may be transferred. The Recommendation clarifies this uncertainty by providing guidelines for the exercise of management rights when a partner or LLC member is in bankruptcy.

Rationale. Confusion over the treatment of management rights in bankruptcy arises where courts look to applicable nonbankruptcy law to determine under section 365(c) whether the trustee (or debtor in possession) can perform management duties. Some courts find that the debtor in possession is unable to assume the partnership agreement because applicable nonbankruptcy law excuses the nondebtor partners from accepting performance from anyone other than the prepetition debtor.[1093] Other courts find that applicable nonbankruptcy requirements are *ipso facto* provisions and are invalid under sections 365(c),(e) and (f).[1094] The Recommendation adopts the approach taken by the latter courts that the debtor in possession is not a separate entity from the prepetition debtor and should be able to exercise the same management rights as the prepetition debtor.[1095] Chapter 12 and Chapter 13 debtors should be able to exercise all postpetition management rights, despite the appointment of a trustee, due to the debtor's ongoing financial obligations to fund the plan.

A thornier problem is the exercise of management rights by a trustee under Chapter 7 or under Chapter 11. The Recommendation advocates that a trustee should not exercise management rights (except to establish a quorum or to meet a minimum majority required by the governing documents) under the following two circumstances: (1) where there is at least one other nondebtor general partner or LLC

[1093] *See, e.g.*, Breedon v. Catron (*In re* Catron), 158 B.R. 629 (E.D. Va. 1993), *aff'd mem.*, 25 F.3d 1038, 1994 WL 258400 (4th Cir. 1994) (UPA provisions excused nondebtor party(s) to agreement from accepting performance from debtor in possession; DIP was unable to assume agreement under section 365(c)).

[1094] *See, e.g.*, Summit Inv. and Dev. Corp. v. Leroux (*In re* Leroux), 69 F.3d 608, 614 (1st Cir. 1995) (refuting the argument that "the postpetition 'change' in contract performance is sufficiently substantial -- in and of itself -- to deprive parties . . . the full benefit of their bargain."); *In re* Antonelli, 148 B.R. 443 (D. Md. 1992), *aff'd mem.*, 4 F.3d 984, 1993 WL 321584 (4th Cir. 1993) (UPA restrictions on transferability invalidated under section 365(c)(1) and 365(f); certain management rights properly transferred to creditors' committee in Chapter 11 plan).

[1095] The Supreme Court adopted this position in the collective bargaining context. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

member to operate the partnership or LLC; or (2) where an individual debtor continues to function as a partner or member after the order for relief and whose estate receives or is more likely than not going to receive the "buyout price." For example, where the debtor continues to serve the partnership or LLC after the commencement of the case, the situation is akin to a DIP and the debtor should be able to exercise all management rights subject to all non-*ipso facto* provisions.

The Recommendation seeks to protect partnerships as voluntary associations and the right of partners to choose their fellow partners. Imposition of a stranger to the partnership–the trustee–by operation of federal law invades this principle. Accordingly, the Recommendation allows the trustee to exercise management rights only when there is no other choice. In the few cases where the debtor is the only general partner, the trustee should be able to exercise all management rights in order to preserve the value of the estate.[1096]

Competing Considerations. Concerns with the exercise of management rights by debtors in possession focus on the shift in fiduciary duties between a solvent partner and a debtor in possession.[1097] The Recommendation adopts the approach that performance by the debtor in possession preserves the benefit of the bargain for the nondebtor party while maximizing assets available to other creditors by preventing a forfeiture of property of the estate. Concerns relating to a trustee exercising management rights focus on the language of section 365(c)(1)(A) and the fact that applicable nonbankruptcy law permits refusal of a trustee's performance. The Recommendation addresses the state law concerns by permitting the trustee to exercise management rights except under two circumstances. The trustee is still

[1096] A different test for whether a trustee should exercise management rights was offered by Laurence D. Cherkis to determine this issue. Mr Cherkis proposed that a trustee should be able to exercise management rights where (i) nondebtor partners "are not relying on the professional or business reputation of the debtor or the debtor's particular knowledge, experience or expertise, to the exclusion of others, and (ii) the trustee or its representatives have the knowledge, expertise and experience necessary to enable the business of the partnership to continue in the ordinary course in accordance with past practice." This test would not be satisfied in a family, a professional, or any other partnership where the relationship of the partners is an important aspect of the business. An example of the type of partnership where this test would be satisfied is a fully matured real estate development partnership. Letter from Sally S. Neely, on behalf of herself, to Stephen H. Case et al., Adviser, National Bankruptcy Review Commission (May 5, 1997).

[1097] Larry E. Ribstein, The Federalization of Partnership Breakup: Expelling Bankrupt Partners, Law & Economics Working Paper No. 97-01, 3 (May 19, 1997) (unpublished manuscript) (arguing that a bankrupt partner's fiduciary duty to creditors conflicts with those of the solvent partners).

subject to non-*ipso facto* provisions reducing the risk of harm to the nondebtor partners and LLC members.[1098]

2.3.25 *11 U.S.C. § 523 and Imputed Conduct or Liability*

11 U.S.C. § 523 should be amended to provide that nothing in this section shall preclude the discharge of a general partner from a debt (otherwise nondischargeable in a copartner's or agent's bankruptcy case) arising solely as a result of imputing to the general partner the conduct or liability of a copartner or agent.

Rationale. Bankruptcy law is grounded upon the public policy of freeing the "honest" debtor from the financial burdens of prepetition indebtedness and thereby allowing the debtor to make an unencumbered fresh start.[1099] One principle embodied by section 523 is that the benefit of the discharge should not inure to the dishonest.[1100] Partnership law, by contrast, prescribes vicarious liability for partners to remain mutually liable for partnership debts incurred by *any* partner in the ordinary course of partnership business.[1101] Mutual or vicarious liability imposed under partnership law is applicable regardless of whether or not the acting partner incurred the debt in a manner that was reasonable, negligent or fraudulent.[1102] Thus, state law holds passive partners vicariously liable for the intentional wrongdoing of an active partner.

The United States Supreme Court in *Strang v. Bradner*[1103] ruled that an obligation of an individual general partner for fraudulent misrepresentations of a copartner could be imputed to all of the other general partners of the firm despite their

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[1098] Letter from Sally S. Neely, on behalf of herself, to Stephen H. Case et al., Adviser, National Bankruptcy Review Commission 4 (May 5, 1997) ("the exercise of management rights [by the trustee] would be subject to non-*ipso facto* provisions. Therefore, the risk of harm to other partners is minimal to nonexistent, while the rewards to the estate (substantial management fees and prospect for increased value of partnership interest) are probably greater.").

[1099] *See* Neal v. Clark, 95 U.S. 704 (1877); Local Union Co. v. Hunt, 292 U.S. 234, 244 (1934).

[1100] This principle is consistent with the other policy goals contained in the exceptions to discharge under section 523. For example, the following debts are not dischargeable: fraud (section 523(a)(2)(A)); fiduciary defalcation (section 523(a)(4)); child support and alimony (section 523(a)(5)) and willful and malicious injury (section 523(a)(6)).

[1101] U.P.A. § 15 (1992).

[1102] *Id.* § 13.

[1103] 114 U.S. 555 (1885).

lack of knowledge.[1104] Although the debtor in *Strang* personally benefitted from the fraud of his copartner, a significant number of courts following *Strang* have relied upon the principle of vicarious liability to deny the discharge of a partner's obligation without requiring a showing that the debtor partner benefitted from the fraud.[1105]

Commentators have criticized the result in *Strang* with respect to the nondischargeability of vicarious liabilities where the debtor partner has engaged in no wrongdoing. "The denial of discharge in bankruptcy is punitive, both in purpose and effect, and is based on the debtor's moral culpability for fraudulent conduct. Consequently, a judicial rule denying discharge should examine the moral culpability of individual debtors."[1106] The effect of *Strang* and its progeny is to withhold the benefit of a bankruptcy discharge to an honest debtor general partner that had no knowledge of the partner's fraudulent acts and may not have benefitted from it.

The imposition of vicarious liability in such circumstances frustrates the Code's fresh start policy while it provides no meaningful deterrent for intentional misconduct. Moreover, such liability is inconsistent with the treatment in recent reported decisions that permits the discharge of vicarious obligations arising under other provisions of the Code.[1107]

It should be noted that this Recommendation is narrowly tailored to address a specific issue arising in the context of partnerships and agency relations. However, the rationale for this Recommendation is equally applicable to any obligation for which any debtor is vicariously liable.[1108]

[1104] *See id.*

[1105] *See, e.g.*, BancBoston Mortgage Corp. v. Ledford (*In re* Ledford), 127 B.R. 175, 181-85 (M.D. Tenn. 1991), *aff'd*, 970 F.2d 1556 (6th Cir. 1992), *cert. denied*, 507 U.S. 916 (1993).

[1106] Steven H. Resnicoff, *Is it Morally Wrong to Depend on the Honesty of Your Partner or Spouse? Bankruptcy Dischargeability of Vicarious Debt*, 42 CASE W. RES. L. REV. 147 (1992).

[1107] *See, e.g.*, Jones v. Whitacre (*In re* Whitacre), 93 B.R. 584, 585 (Bankr. N.D. Ohio 1988)(refusing to impute a child's intent to parents); Ordmann v. Hoppa (*In re* Hoppa), 31 B.R. 753, 754-55 (Bankr. E.D. Wis. 1983)(finding that an employer's obligation for drunk driving liability of his employee is dischargeable); Thatcher v. Austin (*In re* Austin), 36 B.R. 306, 309-11 (Bankr. M.D. Tenn. 1984)(opining that there is nothing in the legislative history of section 523 to suggest that the nonbankruptcy vicarious liability rule should be "appended to the statutory exceptions to discharge in bankruptcy"). *But see, e.g.*, McIntyre v. Kavanaugh, 242 U.S. 138 (1916); Bear, Stearns & Co. v. Powell (*In re* Powell), 95 B.R. 236, 240 (Bankr. S.D. Fla.), *aff'd*, 108 B.R. 343 (S.D. Fla. 1989), *aff'd*, 914 F.2d 268 (11th Cir. 1990).

[1108] At least one of the groups that has appeared before the Commission has recommended an addition to the Code which would eliminate from the purview of section 523 *all* vicarious liability. *See* PROFESSOR JEFFREY W. MORRIS ET AL., REPORT OF DISCHARGE AND DISCHARGEABILITY 27-28

Competing Considerations. It may be argued that while the debtor partner may not have engaged in any wrongdoing, the co-liable partner still may have benefitted from the nondischargeable conduct of the partner's agent. Thus, the obligation should not be dischargeable in the co-liable partner's bankruptcy case. This argument, however, substitutes benefit for the moral culpability theme that permeates section 523. Without a conduct requirement for nondischargeability under section 523, no deterrent purpose is served.

2.3.26 *Subordination of Claims Arising from the Purchase or Sale of a Partnership Interest*

11 U.S.C. § 510(b) should be amended to subordinate the claims "arising from the rescission of a purchase or sale" of their partnership interests or "for damages arising from the purchase or sale" of their partnership interests to all claims and interests that are senior or equal to the claim or interest represented by such security or other interest in the bankruptcy case of a general partner.

Rationale. The purpose of this Recommendation is to expand section 510(b) of the Bankruptcy Code to include claims filed in the bankruptcy case of a general partnership.[1109] Section 510(b) is designed to ensure that the holders of *securities* of the *"debtor or an affiliate of the debtor"* would not be permitted to elevate their equity interests to general unsecured claims through rescission. It therefore mandates the automatic subordination of a claim for rescission or damages in connection with the purchase or sale of a "security" until the claims of that class of creditors have been satisfied.[1110]

As presently enacted, the statute does not apply to claims asserted in a general partner's bankruptcy case.[1111] The rationale for section 510(b) is that the general unsecured creditors rely on having priority over equity interests in the event of a bankruptcy. Stated differently, the statute reflects the differences in risks taken by investors and creditors in an enterprise. The Recommendation reflects the view that the same rationale should apply to claims on interests asserted in the bankruptcy case

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(May 30, 1997).

[1109] This Proposal was also made by the National Bankruptcy Conference. *NBC Final Report*, *supra* note 916, at 235.

[1110] 11 U.S.C. § 510(b) (1994).

[1111] *See id.* § 101(49) (defining a "security").

of a debtor general partner as those asserted in the partnership's bankruptcy case.[1112] The proposed amendment to section 510(b) clarifies that a general partner is an affiliate of the partnership and the same subordination of claims arising from the purchase or sale of interests in the debtor partnership should apply to claims asserted in the bankruptcy case of the debtor general partner.

[1112] The ABA has not taken a position with respect to this Proposal.