

RIGHTS TO PURCHASE A NON-PROFIT GENERAL PARTNER/MANAGING MEMBER INTEREST: ARE THEY A VIABLE STRUCTURING TOOL IN LOW INCOME HOUSING TAX CREDIT TRANSACTIONS WHEN THE ENTITY FILES BANKRUPTCY?

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I. INTRODUCTION AND BACKGROUND

The current economic times have had repercussions on businesses large and small. Businesses have dealt with these factors in numerous ways, including filing for bankruptcy protection, either to reorganize or to liquidate the business. In this new era, many provisions in business arrangements are under increased scrutiny. Low-income housing transactions have not been exempt from the issues arising from the changing financial climate. Elements of these transactions are carefully negotiated, particularly where the general partners or managing members responsible for the development and operation of the project are two or more joint venturers.

On January 1, 1987, the low-income housing tax credit (the “LIHTC”) became effective pursuant to the Tax Reform Act of 1986 (“TRA”).¹ Congress designed the LIHTC to provide an incentive for developers and investors in the form of an indirect federal subsidy to be used in financing low-income housing, thereby resulting in more affordable residential rental units.² The LIHTC program eased the government’s burden to provide housing by shifting the support of crucial urban redevelopment and renewal projects to private investors.³ Additionally,

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¹ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

² See I.R.C. § 42 (2009).

³ *Id.*

Congress included a set-aside for qualifying non-profit organizations to further encourage development.⁴

The subsidy is based on a percentage of certain costs.⁵ Specifically, it is a 30% subsidy for new construction and the costs of the acquisition of existing buildings for rehabilitation⁶ or a 70% subsidy for new construction projects that do not already receive other federal subsidies.⁷

While the LIHTC program is a federal program set forth in section 42 of the Internal Revenue Code, as amended (“IRC”) (“Section 42”), each state is allocated a specified dollar amount for a tax credit ceiling for each calendar year.⁸ The respective state housing credit agency is then responsible for creating and administering its own program for the allocation of the LIHTC.⁹ Each state creates a qualified allocation plan (“QAP”) for administering the LIHTC program, which sets forth the criteria for applications and other matters.¹⁰ Each state is also

⁴ *Id.* at § 42(I)(5).

⁵ *Id.* at § 42(b). The amount of the LIHTC is calculated using the “applicable percentage” of the “qualified basis” of each “qualified low-income building.” Each of these terms has a specific meaning set forth in I.R.C. § 42, as further defined in Treasury Regulations, Revenue Rulings, and private letter rulings. For purposes of this article, I did not attempt to define these further since the focus relates to a specific aspect of section 42 and non-profit organizations’ involvement in LIHTC developments.

⁶ *Id.* at § 42(b)(1)(B)(i).

⁷ *Id.* at § 42(b)(1)(B).

⁸ *Id.* at § 42(h)(3)(C).

⁹ *Id.* at § 42(h)(3). See subsection (C) for the formula for calculating a state’s housing credit ceiling.

¹⁰ *Id.* at § 42(m)(1)(B). A qualified allocation plan means any plan:

- (i) which sets forth selection criteria to be used to determine housing priorities of the housing credit agency which are appropriate to local conditions,
- (ii) which also gives preference in allocating housing credit dollar amounts among selected projects to –
 - (I) projects serving the lowest income tenants,
 - (II) projects obligated to serve qualified tenants for the longest periods, and
 - (III) projects which are located in qualified census tracts (as defined in subsection [I.R.C. § 42](d)(50(C)) and the development of which contributes to a concerted community revitalization plan, and
- (iii) which provides a procedure that the agency (or an agent or other private contractor of such agency) will follow in monitoring for noncompliance with the provisions of

responsible for monitoring compliance with the low-income use requirements.¹¹ Further, under Section 42 and within the QAP, the State housing credit agency must “set aside” at least ten percent of its housing credit ceiling to projects involving qualified non-profit organizations.¹²

While many issues arise with joint ventures between non-profits and for-profit entities, there are advantages for both types of entities in LIHTC housing developments. Allocations under the LIHTC are awarded under a competitive process. A for-profit developer can enhance its chances for receiving such an award by partnering with a qualified non-profit organization. For the non-profit organization, which may be unable, on its own, to provide the necessary financial requirements or have the staffing necessary for development, partnering allows more participation in fulfilling the non-profit’s mission of providing more affordable housing.¹³ However, this joint venture raises a new set of issues, including tax-exempt-use property concerns and the rights of the parties if one of the partners

this section and in notifying the Internal Revenue Service of such noncompliance which such agency becomes aware of and in monitoring for noncompliance with habitability standards through regular site visits.

Id.

¹¹ *Id.* at § 42(f)(10). The tax credits are generally claimed over a ten year period; however, the project must comply with the low income use requirements for 15 years (and usually 30 years if a longer extended use period was elected under the application) as set forth in the extended use agreement recorded and encumbering the real property (the “15 year compliance period”).

¹² *Id.* at § 42(h)(5)(A), (C). A “qualified nonprofit organization” means any organization that meets the following criteria:

- (i) such organization is described in paragraph (3) or (4) of [I.R.C.] section 501(c) and is exempt from tax under [I.R.C.] section 501(a),
- (ii) such organization is determined by the State housing credit agency not to be affiliated with or controlled by a for-profit organization; and
- (iii) [one] of the exempt purposes of such organization includes the fostering of low-income housing.

Id. at § 42(h)(5)(C).

¹³ There are many non-profit organizations that have the capabilities to serve as the developer and the general partner, and, in those instances, there is no need for a joint venture. Those types of developments are outside of the scope of this article. However, a non-profit may choose to form a joint venture in order to expand the number of developments, thereby furthering their mission and purposes.

becomes insolvent and seeks protection under the United States Bankruptcy Code (the “Bankruptcy Code”).¹⁴ This article attempts to review the current structure used by many joint ventures with for-profit and non-profit partners and analyzes the bankruptcy protections between such partners.

In this article, Part II details the structure of an LIHTC project. Part III contains illustrative provisions typically found in limited partnership and operating agreements. Part IV applies the provisions in Part III to a factual narrative of the life of a LIHTC project. Part V examines what constitutes an executory contract. Parts VI, VII and VIII examine whether a Managing Member Operating Agreement is an executory contract, whether the right of first refusal in such an operating agreement is enforceable and whether an option provision in such an operating agreement is enforceable, respectively. Finally, Part IX considers the usefulness of these types of provisions.

II. THE STRUCTURE

In the most basic sense, an LIHTC project is a real estate project. Generally, the preferred ownership entity is either a limited partnership or a limited liability company (“LLC”).¹⁵ The party submitting the LIHTC application to the state agency typically acts as the general partner in the case of the limited partnership, or the managing member in the case of the LLC.¹⁶ An investor who owns the largest interest in the limited partnership or LLC normally acts as the limited partner.¹⁷

¹⁴ Bankruptcy, Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in various sections of 11 U.S.C.).

¹⁵ Jeffery R. Pankratz & Craig A. Emden, *Section 704(B) Regulation and Tax Credit Transactions: Structuring Low-Income Housing Tax Credit Transactions to Avoid Reallocations of Tax Credits and Losses*, 11 J. AFFORDABLE HOUS. & CMTY. DEV. L. 339, 339 (Summer 2002). The use of a limited partnership or a limited liability company allows of the gains, losses and tax credits to “pass-through” to the partners or members.

¹⁶ *Cf.* Nancy Bernstine and Irene Basloe Saraf, *New Rental Production and the National Housing Trust Fund Campaign*, 12 J. AFFORDABLE HOUS. & CMTY. DEV. L. 389, 400 (Summer 2003). In this article, I use the terms “general partner” and “managing member” interchangeably because they usually serve the same roles in the ownership entity. In addition, state statutes govern the organization of the entities and should be considered in the structuring process.

¹⁷ Sharon C. Park, *Material on Federal Tax Incentives for Historic Preservation*, A.L.I.-A.B.A. CLE 809, 836 (2001). The investor’s role in these developments is to provide equity in return for an allocation of the LIHTC profits and losses. This equity provides a needed funding source that does not incur

Affiliates of the for-profit organization may also have other roles such as developer or management agent.¹⁸

When a qualified non-profit organization is involved, the non-profit may be part of the ownership of the general partner or managing member, or may be an “administrative general partner” or a “special member.”¹⁹ In this instance, subsidies or federal loan programs may require that the non-profit organization be “in control” or own a specific percentage of the controlling party of the limited partnership/LLC. Both alternatives meet this requirement.

In addition, the qualified non-profit organization may be part of the developer entity or may be a co-developer.²⁰ The development fee charged is typically calculated as a percentage of the total development costs (usually between 10% and 15%), is earned by completion of construction, and is paid partially during construction with the balance with cash flow from operations. This fee represents compensation to the parties for developing the project from conception through completion. A non-profit organization that is involved in the development may be entitled to share in that fee.²¹

Further, because ownership by the qualified non-profit organization in the general partner may create “tax exempt use property,”²² the non-profit organization

interest like a loan does and is therefore viewed as less expensive funding with no debt service to burden a development.

¹⁸ Steven P. Berman, *Tax Aspects of General Partner Guarantees*, 8 J. AFFORDABLE HOUS. & CMTY. DEV. L. 366, 366 (Summer 1999).

¹⁹ Park, *supra* note 17, at 836. While there are structures with the qualified non-profit organization or its taxable subsidiary as an administrative general partner, most projects have a single general partner, which is a joint venture of the for-profit and non-profit organizations.

²⁰ Sharon C. Park, *Material on Federal Tax Incentives for Historic Preservation*, A.L.I.-A.B.A. CLE 917, 1003-04 (2007).

²¹ The amount of development fee and the amount that can be deferred and paid after construction are determined in part by the governing state QAP, the lender requirements and the investor requirements. The limitations and requirements of the governing state are set forth in the yearly QAPs. *See, e.g.* Georgia Department of Community Affairs 2010 Qualified Allocation Plan, Developer Fee Limitation, at 22; Tennessee Housing Development Agency Low-Income Housing Tax Credit 2010 QAP, Part V, Section A, Limit on Developer Fee and Consultant Fee, at 7.

²² I.R.C. § 168(h) (2009). Tax exempt use property has implications on how the assets are depreciated. Residential rental property (not including the personal property and other assets that are separate categories from the building) is generally depreciated in an accelerated manner over 27.5 years. Unless a taxable subsidiary is utilized in the ownership (with the appropriate election made under I.R.C. §

may form or use a taxable subsidiary, completely owned by the qualified non-profit organization²³ to hold the interest in the general partner. The choice here depends on whether the property is being depreciated over a 40-year or 27.5-year depreciation schedule. As the yield to the investor is partially driven by losses from depreciation, this can affect pricing and in a transaction where the property is depreciated on a 27.5-year schedule, the investor will require qualified allocations²⁴ or that a taxable subsidiary be included in the ownership structure. However, the formation of a taxable subsidiary (and the filing of the appropriate election under I.R.C. Section 168(h)(6)) has tax implications to the non-profit organization since any income from the taxable subsidiary would be unrelated business income, which the non-profit organization should take into consideration.²⁵

168(h)), a portion of the depreciation of the building will shift to a 40-year depreciation schedule. The shift reduces the losses, thereby affecting the yield to the investor limited partner and creating a similar reduction in the price paid for the LIHTC.

²³ For purposes of this article, I did not distinguish between the qualified non-profit and its taxable subsidiary because any bankruptcy of the parent non-profit would likely involve the taxable subsidiary, and the results would not vary substantially from the analysis set forth herein.

²⁴ See I.R.C. § 168(h)(6)(B). This section defines a qualified allocation as any allocation to a non-profit organization entity which is consistent with such entity being allocated the same distributive share of each item of income, gain, loss, deduction, credit and basis and such share remains the same during the entire period the entity is a partner in the partnership, and has substantial economic effect within the meaning of I.R.C. § 704(b)(2). *Id.* This means that if there is a non-qualified allocation that the non-profit organization would receive, or would be entitled to receive, then its proportionate share of the property, equal to its highest share of any such items, would be classified as tax-exempt property and would have to be depreciated over a 40 year schedule.

For example, if the non-profit organization would receive a .5% interest of all items of income, loss, deduction, credit and basis and would also receive .5% of residual upon sale (and there are no other items that the non-profit organization shares in that would be considered in this analysis), then the allocations are likely qualified. However, using the same facts, but changing the residual so that the non-profit organization receives 50% of the general partner's interest (and assuming the general partner receives a 50% residual interest), then the non-profit organization is receiving a 25% allocation of an item and the allocations are non-qualified. In that instance, 25% of the building basis would have to be depreciated on a 40 year schedule and 75% of the building basis would be depreciated on a 27.5 year schedule.

²⁵ I.R.C. § 513(a). Unrelated business income is defined as income derived from (i) a trade or business, (ii) which is regularly carried on, and (iii) which is not substantially related to the performance of tax-exempt functions, i.e., it does not significantly contribute to the achievement of tax-exempt purposes. *Id.* The fact that income was produced for use in furthering exempt purposes

Once the structure is determined, the parties must negotiate the governing documents. In transactions with more than one principal party in the general partner, the parties must resolve how transfers will be handled, including, for example, (i) a transfer resulting from a bankruptcy or (ii) a transfer that is precipitated by a need or want of the non-profit to transfer its interest.²⁶ As for-profit and non-profit organizations usually take great care to evaluate their partners prior to entering into the transaction, controlling how, when, and whether a transfer may be made is a crucial consideration.²⁷ The provisions governing these types of situations have been more closely scrutinized due to the current financial environment in which bankruptcy filings, including non-profit organizations' bankruptcy filings, have increased.²⁸

The following represent examples of the types of provisions normally found in a limited partnership agreement or operating agreement, including: (1) a protective provision to ensure that interests are not transferred freely, thereby allowing the parties to carefully chose their partners; (2) a provision setting forth how offers received for interests are reviewed and the rights of the other partners in such event, and (3) a provision on how to handle dissolutions, death, and bankruptcy occurrences. Note that as the Section 42 allocation (made from the non-profit set-aside) requires material participation²⁹ by the non-profit organization throughout the

does not qualify the income as related; the income itself must be derived in the course of furthering an exempt purpose. *Id.*

²⁶ See *infra* Illustrative Provisions 1.5 and 1.6.

²⁷ See *infra* Illustrative Provision 1.6.

²⁸ According to the American Bankruptcy Institute, business filings for the 3-month period ending March 31, 2008, totaled 8,713, up 38.7% from the 6,280 business bankruptcy cases filed in the same period in 2007. John Hartgen, *Total Bankruptcies Increase Nearly 27 Percent Over First Quarter 2007*, ABI NEWSLETTER UPDATE, June 3, 2008, available at <http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=53093>.

²⁹ Temp. Treas. Reg. § 1.469-5T (1996) provides rules for determining the material participation for individuals. I.R.C. § 469(h)(4) and Treas. Reg. § 1.469-5T(g)(3) (2002) provide rules for determining the material participation of certain corporations. The rules provided help for illustration purposes, but, because neither of these provisions directly applies to non-profit organizations, practitioners should use the general facts and circumstances test of I.R.C. § 469(h)(1) when considering the applicability to non-profit organizations.

For purposes of the set-aside requirement, the non-profit organization must have an ownership interest in the project throughout the fifteen-year compliance period and must participate not only in the development but in the on-going operation of the project. This includes a requirement under

15 year compliance period, there are further restrictions on transfers directly relating to this requirement in sections 1.5(B) and 1.6(C) below. Failure to comply with the Section 42 requirements can result in a recapture of the LIHTC³⁰ and is therefore an important element of any transfer scenario. Moreover, there are two types of rights in these transactions: 1) a right of first refusal in the event of a bona fide third party offer, and 2) an option to purchase in certain instances. Both types of rights will be considered in the analysis. Finally, these particular rights are generally found in the operating agreement governing the two joint venturers; however, it is possible that one or both might be contained in a separate agreement. Therefore, the analysis that follows will consider this aspect as well.

I.R.C. § 469(h)(1) that the nonprofit participate on a *regular, continuous, and substantial* basis. Further, the analysis regarding whether there is material participation is a facts and circumstances analysis involving the following:

- a) participation in the activity for more than 500 hours during the year;
- b) where the individual's participation was substantially all of the participation of all individuals in the activity during the year; and
- c) participation in the activity for more than 100 hours during the year if the individual participated more than anyone else.

Id. at § 1.469-5T(a)(1-3).

³⁰ Recapture results in a loss of LIHTC that have been or would have been allocated to the partners. I.R.C. § 42(j) (2009). In LIHTC transactions, guaranties against recapture are heavily negotiated provisions, and, if there is recapture, it is not uncommon for the general partner or managing member (and its partners or members) to have the responsibility to compensate the other partner or member for the loss of the LIHTC that the other partner or member will incur due to the recapture. *Id.*

III. ILLUSTRATIVE PROVISIONS³¹

Transfers.

1.1 Prohibition Against Transfers.

A Member may sell, transfer, assign, dispose of, mortgage, hypothecate, or otherwise encumber or permit or suffer any encumbrance of all or any portion of the Member's Membership Interest (each a "Transfer") only if the Member has first complied with the provisions of this Section 1; in the event such provisions have not been complied with or such Transfer is prohibited, such Transfer of a Membership Interest shall be void *ab initio*. Transfers of any equity or beneficial interest in a Member shall be deemed to be a Transfer for purposes of this Section 1.

1.2 Third Party Offer.

- A. In the event that a Member receives a bona fide offer (as defined below) from a Third Party Offeror (as defined below) for all or any part of such Member's interest as a Member in the Company (the "Third Party Offer"), which such Member is willing to accept, the Company receiving the Third Party Offer shall promptly notify the other Members in writing. The other Members shall have thirty (30) days from the date of such notice ("Election Period") in which to elect to purchase the offering Member's Membership Interest which was the subject of the Third Party Offer at a price equal to that, and on the same terms as those, contained in the Third Party Offer. If more than one Member accepts said offer, the Membership Interest shall be allocated among the Members so accepting in accordance with their respective Percentages of Company Interest.

³¹ The provisions set forth in this article are illustrative only. Each operating agreement will differ. However, these serve to provide some reference point from which to conduct the analysis and discussion in this article. While these have been taken from real agreements, the provisions have been modified to facilitate the discussion. Any agreement between the two joint ventures may contain all or some portion of these provisions.

- B. If an offering Member does not receive an election from the other Members to purchase the entire Membership Interest offered for sale by it within the Election Period, then the offering Member shall be at liberty within a period of three (3) months from the last date of the Election Period to consummate the sale to the Third Party Offeror at a price and upon terms not more advantageous to the Third Party Offeror than the price and terms stated in the original offer by the Third Party Offeror and submitted to the other Members. If, however, such sale to the Third Party Offeror is not consummated within such three (3) month period, then any subsequent sale to any outside offeror shall also be subject to all the requirements of this Section 1.2.
- C. In the event that the other Members elect to purchase the entire Membership Interest offered for sale, then the transfer thereof and the closing of the transaction shall occur thirty (30) days after the exercise of the option to buy the Membership Interest, unless a different closing date is specified in the Third Party Offer, in which event such date shall be the closing date. The closing date shall take place at the office of the attorney for the offering Member, at which time and place the purchase price shall be paid in accordance with the terms and provisions of the Third Party Offer, and the necessary and appropriate instruments of transfer reasonably required by the purchasing Members shall be executed and delivered by the offering Member. All closing costs of the consummation of such transaction shall be equally divided between the offering Member on the one hand and the purchasing Members on the other hand (other than attorneys' fees which shall be borne by the party incurring them).
- D. Every offer between the Members in accordance with this [Operating] Agreement shall be in writing, sent by certified or registered mail, return receipt requested; it shall contain an offer to sell to the offerees all of the offering Member's Membership Interest in the Company at a price equal to the price and upon the same terms contained in the Third Party Offer, and shall be accompanied by a copy of the Third Party Offer, which shall set forth the name, home address, business address and business of the outside offeror. Such Third Party Offer, in order to be a bona fide offer within the

meaning of this Section, must be in writing, signed by the Third Party Offeror [who must be one or more persons (including entities) financially capable of carrying out the terms of the offer], must be in a form legally enforceable against the Third Party Offeror, and must be accompanied by a good faith deposit equal to at least five percent (5%) of the proposed purchase price. A Third Party Offeror may be any person not specified in Section 1.5.

- E. If the Membership Interest of any Member shall be transferred for any reason other than for reasons specified in Section 1.6(A) and 1.6(B), whether voluntary or involuntary, including, without limitation, a transfer made as a result of a pledge of any Membership interest becoming an absolute assignment, or in execution of a judgment by a judgment creditor, such transfer shall be subject to the provisions of Section 1.2 hereof such that the non-transferring Members shall have a right of first refusal; the same procedures shall apply as set forth above regarding sale of the property. The sale pursuant to the rights of the pledgor, creditor or otherwise shall be deemed to be a “Third Party Offer” for purposes of this Section 1.2, and the other Members shall have the rights set forth in this Section 1.2 to purchase such Membership Interests, at the same price as that established by the sale.

1.3 Transfer of Member’s Membership Interest.

Subject to Sections 1.5 and 1.6 below, a Member may not Transfer any of such Member’s Membership Interest without first obtaining the written consent of the Manager, in the Manager’s sole and absolute discretion.

1.4 No Right to Withdraw.

No Member shall have the right to withdraw from the Company without the prior written consent of all Members in their sole discretion, and any such purported withdrawal without consent shall be void *ab initio*.

1.5. Permitted Assignments.

Notwithstanding the provisions of 1.1., 1.2, or 1.3, but subject to Section 1.8, all or any part of the Membership Interest of any Member in the Company or in the property and assets of the Company, may be Transferred or disposed of by instrument or instruments, inter vivos or testamentary, to any of the following:

- A. A person or entity already a Member; and
- B. A business entity which is controlled by any member or members and in which one or more Members has at least a majority ownership interest; provided, however, that during the tax credit compliance period for the _____ [name of project] _____ project, _____ [name of qualified non-profit or taxable subsidiary] _____ shall not transfer any of its ownership interest to an entity which would cause a tax exempt use property issue for [owner entity name] _____.

1.6. Permitted Assignment of Membership Interest Upon Death, Dissolution, Insanity, Incompetency, or Bankruptcy.³²

- A. In the event of the death, dissolution, or adjudication of insanity or incompetency of a Member, the executors or administrators of the estate of the deceased Member, or the committee or other legal representatives of the estate of the insane or incompetent Member, or the successors in interest of the dissolved Member shall, for the purpose of settling the estate, have all the rights of the Member, including the rights (subject to the same limitations) that the deceased, dissolved, insane, or incompetent Member would have had under the provisions of this Section 1 to Transfer the Membership interest of the deceased, insane, dissolved, or incompetent Member and to provide in the instrument of Transfer that

³² Section 362(a) of the Bankruptcy Code provides for an automatic stay which is applicable to all entities and prevents the obtaining of any property of the estate or to exercise control over property of the estate, without relief granted by the court. In the event of a bankruptcy filing, the appropriate petition for relief from stay would need to be filed. In filing such a petition, the other partner or member would want to provide the court with information on the sales price (i.e., the calculation if set forth in the applicable agreement and any appraisal which might reflect the purchase price) as well as the anticipated losses from recapture (which would then be a claim against the estate).

the transferee may become a substituted Member in accordance with the provisions specified in this Section 1.

- B. If any Member shall take advantage of any bankruptcy or insolvency act, or if a bankruptcy or insolvency petition shall be filed against any member and a final adjudication of bankruptcy or insolvency entered thereon, or if a member shall make a general assignment for the benefit of such Member's creditors or take advantage or be subjected to any similar creditor's rights laws, the Manager shall have the option (exercisable by giving notice thereof to such bankrupt or insolvent Member or such Member's assignee, trustee in bankruptcy, receiver, executor, personal representative, or other legal representative) to purchase all (but not less than all) of such Member's Membership Interest (and assets distributable to such member on dissolution of the Company), within ninety (90) days after delivery of such notice, and at a price equal to the fair market value thereof at such time. The fair market value shall be the amount to which the parties agree. If the parties cannot agree upon a price within thirty (30) days from the date the Members elect so to purchase, the fair market value shall be determined by appraisal. Such appraisal shall be conducted by a committee of three (3) appraisers, each of whom shall be a member of the American Institute of Real Estate Appraisers (M.A.I.), chosen as follows: One such appraiser shall be chosen by the purchaser, a second appraiser shall be chosen by the seller, and the third appraiser shall be chosen by the two appraisers chosen as aforesaid. If either party does not select an appraiser within thirty (30) days after the date of the election and direction from the other party to so select an appraiser, then an appraiser will be selected for that party within an additional ten (10) days by the other party. Each appraiser shall make an independent appraisal, and, if there is more than one appraiser, the fair market value shall be the average of the two (2) appraisals closest in value. Expenses of appraisers shall be borne by the respective parties choosing the appraiser, except that the expenses of the third appraiser shall be borne one-half (1/2) by the seller and one-half (1/2) by the purchaser. For purposes hereof, the appraisers shall take into account the status and import of then current negotiations and/or agreements concerning offers, sale, leases, plans and specifications, financings and joint venture agreements, and other

relevant factors, all of which shall be made available to the parties and the appraisers. If the option is exercised, settlement shall be held within thirty (30) days from the date of such exercise. The terms of payment shall be all cash.

- C. Notwithstanding anything to the contrary in this Section 1.6, during the tax credit compliance period for the _____ [name of project] _____ project, _____ [name of qualified non-profit or taxable subsidiary] _____ shall not transfer any of its ownership interest to an entity which would cause a tax exempt use property issue for _____ [owner entity name] _____.

1.7 Right to Become a Member.

In addition to satisfying the other provisions of this Section 1, the assignee of a Member's Membership Interest shall become a Member only if (1) the assigning Member so provides in the instrument of assignment, and (2) the assignee agrees in writing to be bound by the provisions of this Operating Agreement, as amended, and to enter into any agreement contemplated by this Operating Agreement, and (3) if applicable under Section 1.3, the Manager consents. If the assigning Member so provides, the assignee shall have the right to become a Member upon payment to the Company of all costs and expenses of preparation and execution of an amendment to this Operating Agreement. In such event, the Manager shall prepare or cause to be prepared an amendment to this Operating Agreement to be signed by each of the Members, by the assigning member, and by the assignee. If an assignee of a Member's Membership Interest is not admitted as a Member, such assignee nevertheless shall be entitled to receive those distributions from the Company as the assigning Member would have been entitled to receive had the assigning Member retained such Membership Interest. Such assignee shall have no rights in the governance of the Company unless and until the assignee is admitted as a Member pursuant to the terms of this Operating Agreement.

1.8 Further Restrictions on Transfers.

Any Transfers of a Membership Interest shall be further conditioned upon the satisfaction of the following conditions: secure satisfactory opinion of counsel, register under applicable federal or state securities laws, refrain from causing a termination of the Company under Section 7098 of the Internal Revenue Code, refrain from causing the Company to be classified as any entity other than a partnership for federal income tax purposes.

1.9 Membership Interest as Security.

No Member may collaterally assign all or any portion of such Member's Membership Interest as security for an obligation without the consent of the Manager, which may be granted or withheld in the Manager's sole and absolute discretion.

IV. DISCUSSION AND ANALYSIS³³

For purposes of illustrating the application of the above-described provisions, suppose that a for-profit organization and a non-profit organization have entered into a business arrangement to provide low-income housing, and they have received an LIHTC allocation. Assume that an investor has agreed to become part of the ownership structure, and the organizational documents for the owner entity and the general partner entity have been negotiated. Further, assume that the general partner is an LLC consisting of the for-profit organization and the non-profit organization, and provisions similar to those detailed above are included in the operating agreement governing the general partner entity. The LIHTC project is constructed or rehabilitated and is now operational. All is well until the non-profit organization encounters some unexpected financial issues. The Executive Director of the non-profit organization telephones the president of the for-profit organization to advise him or her that the non-profit will be filing for bankruptcy protection. Most likely, the president will then ask legal counsel what this means for the organization and what its rights are.

³³ Note that the option and the right of first refusal in the above provisions may have a price below market or a set price determined at the time the agreements are negotiated and executed. This factor should be taken in account in considering the analysis below.

For businesses, filing for bankruptcy takes the form of either a Chapter 11 filing (a reorganization in which the filing entity will generally emerge from bankruptcy or, if not, may convert to a Chapter 7 filing) or a Chapter 7 filing (a liquidation of the filing entity).³⁴ A bankruptcy filing has many implications in a business transaction, but the issue addressed in this article is whether the operating agreement, (or a right of first refusal or option agreement if the provisions above have been memorialized in separate agreements), is an executory contract whereby the non-profit organization, as debtor (if under Chapter 11) or trustee (if under Chapter 7) has the discretion to assume or reject the executory contract.³⁵

V. WHAT CONSTITUTES AN EXECUTORY CONTRACT?

Although the Bankruptcy Code does not expressly define the term “executory contract,” the legislative history of section 365 of the Bankruptcy Code states: “[t]hrough there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.”³⁶ However, if the legislative history is taken literally, almost all agreements would be considered executory in nature due to unperformed obligations on either side.³⁷ The definition is effectively narrowed by consulting the case law of the jurisdiction in which the bankruptcy case is filed. Although this article does not address all circuits’ points of view (and some circuits, such as the D.C. Circuit, have very little case law on the issue), most circuits, including the Second,³⁸ Third, and Fourth Circuits, use the Countryman standard in considering whether an agreement is an executory contract.³⁹

³⁴ 11 U.S.C. §§ 701-707, 1101-1116 (2006).

³⁵ 11 U.S.C. § 365(a) states that the “trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.” *Id.*

³⁶ S. REP. NO. 95-989, at 58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844; H.R. REP. NO. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5693, 6303.

³⁷ *In re Spectrum Info. Techs., Inc.*, 190 B.R. 741, 746 (Bankr. E.D.N.Y. 1996); *In re Bluman*, 125 B.R. 359, 361-62 (Bankr. E.D.N.Y. 1990).

³⁸ See *In re Bradlees Stores, Inc.*, No. 00-16033, 2001 WL 1112308 (S.D.N.Y. Sept. 20, 2001) (noting that the Second Circuit has also tested agreements under a more flexible “functional approach”).

³⁹ See, e.g., *In re Riodizio, Inc.*, 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997); *In re W. Chestnut Realty of Haverford, Inc.*, 177 B.R. 501, 504 (Bankr. E.D. Pa. 1995); *In re Hardie*, 100 B.R. 284, 286 n.3 (Bankr. E.D.N.C. 1989) for the discussions of the applicable standards in each Circuit.

The Countryman standard is based on Professor Countryman's definition of an executory contract: a contract under which the obligation of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.⁴⁰ Case law provides numerous approaches for analyzing the existence of an executory contract examining whether the contract in question (1) is a prepetition contract where both sides are still obligated to render substantial performance,⁴¹ (2) requires performance on only one side, rendering it non-executory,⁴² (3) is examined as a matter of state law,⁴³ and (4) is subject to applicable non-bankruptcy law permitting either party to sue for breach because of the other party's failure to perform, thus making the contract executory.⁴⁴ Generally, the executory nature of a contract is determined as of the petition date of the bankruptcy filing.⁴⁵

However, some courts have found the "material breach" test of Countryman too constraining and static.⁴⁶ In response, these courts have moved to a functional analysis that removes the executory requirement.⁴⁷ Under a functional analysis approach, courts focus on the benefit to the estate, finding that "the question of

⁴⁰ Vern Countryman, *Executory Contracts in Bankruptcy, Part 1*, 57 MINN. L. REV. 439, 460 (1973); *accord* Enter. Energy Corp. v. United States (*In re Columbia Gas Sys., Inc.*), 50 F.3d 233, 239 (3d Cir. 1995); Cameron v. Pfaff Plumbing & Heating, Inc., 966 F.2d 414, 416 (8th Cir. 1992); *In re Streets & Beard Farm P'ship*, 882 F.2d 233, 235 (7th Cir. 1989); Pac. Express, Inc. v. Teknekron Infoswitch Corp. (*In re Pacific Express, Inc.*), 780 F.2d 1482, 1487 (9th Cir. 1986); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re Richmond Metal Finishers, Inc.*), 756 F.2d 1043, 1045 (4th Cir. 1985); *In re Spectrum Info. Techs., Inc.*, 193 B.R. 400, 404 (Bankr. E.D.N.Y. 1996); *In re 375 Park Ave. Assocs., Inc.*, 182 B.R. 690, 697 (Bankr. S.D.N.Y. 1995); *In re Child World, Inc.*, 147 B.R. 847, 851 (Bankr. S.D.N.Y. 1992); *In re Chateaugay Corp.*, 102 B.R. 335, 344-45 (Bankr. S.D.N.Y. 1989).

⁴¹ *In re Columbia Gas*, 50 F.3d at 239; *In re Streets & Beard*, 882 F.2d at 235; *In re 375 Park Ave. Assocs.*, 182 B.R. at 697.

⁴² *In re Chateaugay Corp.*, 102 B.R. at 345.

⁴³ *In re Columbia Gas*, 50 F.3d at 240 n.10.

⁴⁴ *In re Streets & Beard*, 882 F.2d at 235.

⁴⁵ *In re Columbia Gas*, 50 F.3d at 240.

⁴⁶ Jessica L. Kotary & Nicole L. Inman, Note, *Eliminating "Executory" from Section 365: The National Bankruptcy Review Commission's Panacea for an Ailing Statute*, 5 AM. BANKR. INST. L. REV. 513, 519 n.46 (1997).

⁴⁷ *Id.* at 517.

whether a contract is executory is determined by the benefits that assumption or rejection would produce for the estate.”⁴⁸ This test allows the court to consider how burdensome the contract would be on the estate in determining whether the contract is executory.⁴⁹ If the court determines that the contract is burdensome, then the court is more likely to find that the contract is executory and that the debtor may reject it.⁵⁰

There is no uniformly applied rule to the executory contract issue, as not all courts use the functional analysis approach. Some courts consider what objective the rejection of the contract is expected to accomplish. For example, “If [the] objectives have already been accomplished, or [if they] can[not] be accomplished through rejection, then [the] contract is not executory.”⁵¹ On the other hand, some courts consider the purposes of section 365 of the Bankruptcy Code⁵² in determining whether a contract is executory. In some instances, courts have analyzed contracts under both the Countryman standard and the functional approach.⁵³

⁴⁸ *Sipes v. Atl. Gulf Cmty. Corp. (In re Gen. Dev. Corp.)*, 84 F.3d 1364, 1375 (11th Cir. 1996) (affirming on the basis of the district court’s opinion in 177 B.R. 1000 (S.D. Fla. 1995)); *accord*, *Cohen v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.)*, 138 B.R. 637, 696 (Bankr. S.D.N.Y. 1992).

⁴⁹ *Kotary & Inman*, *supra* note 46, at 517.

⁵⁰ *In re Worldcom, Inc.*, 343 B.R. 486, 493 (Bankr. S.D.N.Y. 2006).

⁵¹ *See, e.g., Chattanooga Mem’l Park v. Still (In re Jolly)* 574 F.2d 349, 351 (6th Cir. 1978), cert. denied, 439 U.S. 929 (1978) (a pre-Bankruptcy Code case).

⁵² *See, e.g., In re Leibinger-Roberts, Inc.*, 105 B.R. 208, 211 (Bankr. E.D.N.Y. 1989) (The court collapsed the executory and functional analyses in stating that “when a debtor cannot reap any present or future benefits from a contract due to a change in circumstance, the contract’s life as an executory contract comes to an end and the contract becomes unilateral and enforceable against the parties in the absence of a valid defense.”).

⁵³ *Shoppers World Ctr., L.P. v. Bradlees Stores, Inc. (In re Bradlees Stores, Inc.)*, No. 00-16033, 2001 WL 1112308, at *7 (S.D.N.Y. Sept. 20, 2001).

VI. IS THE MANAGING MEMBER OPERATING AGREEMENT AN EXECUTORY CONTRACT?

LLCs are a relatively new type of business entity.⁵⁴ In 1997, Wyoming was the first state to pass a statute creating LLCs. But the LLC entity did not become widely used until the passage of the TRA⁵⁵ and the issuance of a 1988 revenue ruling providing that Wyoming LLCs would be treated as partnerships for tax purposes.⁵⁶ Therefore, few court decisions address whether LLC operating agreements are executory contracts.⁵⁷

Limited partnerships and general partnerships have a more complex history than LLCs.⁵⁸ Courts have generally held that partnership agreements are executory contracts.⁵⁹ However, these courts have either summarily accepted the executory contract characterization or they have found that the limited partnership agreement is not an executory contract when the partners have continuing financial obligations.⁶⁰ Because LLC operating agreements, like partnership agreements, delegate administrative and financial responsibilities to members, the apparent trend among bankruptcy courts is to treat operating agreements in the same manner as

⁵⁴ See Larry E. Ribstein, *LLCs: Is the Future Here? A History and Prognosis*, 13 BUS. L. TODAY, Nov.-Dec. 2003, at 11-13, for a brief history of the limited liability company.

⁵⁵ The Wyoming Limited Liability Company Act was codified in 1977 as WYO. STAT. ANN. §§ 17-15-101-136. Joseph P. Fonfara & Corey R. McCool, Comment, *The Wyoming Limited Liability Company: A Viable Alternative to the S Corporation and the Limited Partnership?*, 23 LAND & WATER L. REV. 523, 523 n.2 (1988). See pages 523-24 for an extended discussion of the Wyoming Limited Liability Company Act.

⁵⁶ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

⁵⁷ *Endeka Enters., LLC v. Meiburger (In re Tsiaoushis)*, No. 1:07cv436, 2007 WL 2156162, at *2 (E.D. Va. July 19, 2007).

⁵⁸ See Mitchell A. Stephens, Comment, *A Trap for the Rational: Simultaneous Removal and Appointment of a General Partner Under the Revised Uniform Limited Partnership Act*, 2007 UTAH L. REV. 521, 522-26 (2007), for a discussion of the development of the law of limited partnerships.

⁵⁹ *In re Daugherty Const. Inc.*, 188 B.R. 607, 612 (Bankr. D. Neb. 1995); *Cutler v. Cutler (In re Cutler)*, 165 B.R. 275, 279-80 (Bankr. D. Ariz. 1994).

⁶⁰ *Samson v. Prokopf (In re Smith)*, 185 B.R. 285, 292-93 (Bankr. S.D. Ill. 1995).

partnership agreements.⁶¹ However, despite this trend, some courts still decline to hold that an operating agreement is an executory contract.⁶² Courts have also considered whether the remaining obligation of the member to the company is material.⁶³

The foregoing material illustrates that whether an operating agreement will be considered an executory contract depends on whether there are continuing obligations of the members. In addition, the presence of continuing fiduciary obligations between members increases the likelihood that the court will find the operating agreement to be an executory contract that the debtor may assume or reject. Alternatively, if the non-profit organization has very few continuing obligations under the operating agreement—for example because the only remaining obligations are those of the for-profit organization—there is a distinct possibility the operating agreement will not be considered an executory contract. However, if the allocation of the LIHTC was from the non-profit set-aside, as previously described in the fact pattern, and the project was still within the 15-year compliance period, the argument that there are few continuing obligations is inconsistent with the requirement for the non-profit organization's material participation.⁶⁴ In such an instance, it is very likely that the operating agreement will be deemed an executory contract.

⁶¹ *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 750 (Del. Super. Ct. 2004); *see also* Thomas F. Blakemore, *Limited Liability Companies and the Bankruptcy Code: A Technical Review*, 13 AM. BANKR. INST. J. 12, 52 (1994).

⁶² *See In re Capital Acquisitions & Mgmt. Corp.*, 341 B.R. 632, 636-37 (Bankr. N.D. Ill. 2006) (holding that an operating agreement was non-executory since there were no present obligations of the members and the future obligations were contingent on uncertain events.); *In re Garrison-Ashburn, L.C.*, 253 B.R. 700, 708-09 (Bankr. E.D. Va. 2000) (holding that an operating agreement was not an executory agreement since it only provided for the structure of the management of the limited liability company and set forth no additional responsibilities or duties of the members such as providing capital or participating in management).

⁶³ *See, e.g., Movitz v. Fiesta Invs., LLC (In re Ehmann)*, 319 B.R. 200, 204 (Bankr. D. Ariz. 2005) (holding “[a] member’s obligation must be so material that if the member did not perform it, [defendant LLC] would owe no further obligations to that member”).

⁶⁴ *See supra* note 29.

VII. IS THE RIGHT OF FIRST REFUSAL PROVISION IN THE OPERATING AGREEMENT ENFORCEABLE?

If an operating agreement is determined to be an executory contract, and the debtor, in order to sell its interests in the general partner LLC, opts to assume and assign the operating agreement to a third party purchaser, the debtor may be able to avoid the mandates of the right of first refusal contained therein if the court holds that the right of first refusal is effectively an unenforceable restriction on assignment.⁶⁵ If, alternatively, the operating agreement is not deemed an executory contract, or it is an executory contract the debtor chooses to assume (such that the issue of non-assignability is not an issue),⁶⁶ in order for the debtor to exercise its right to sell the interest in the general partner, the court will likely have to respect the right of first refusal provision contained therein.⁶⁷ Further, if the court determines that the right of first refusal is a separate and material bargained-for provision in the operating agreement, the court will likely respect the provision.⁶⁸ Likewise, if the

⁶⁵Generally, contracts that limit the debtor's ability to assign an executory contract are unenforceable in bankruptcy. See 11 U.S.C. § 365(f) (2006). The exception to this rule is that if the applicable bankruptcy law would excuse a non-debtor party from accepting performance from anyone other than the debtor, then the bankruptcy court should give the same effect to the contract in bankruptcy under 11 U.S.C. § 365(c). See 11 U.S.C. §§ 365(e)(1), 365(e)(1) (2006); see also *Endeka Enters., LLC v. Meiburger (In re Tsiaoushis)*, 2007 WL 2156162, at *4 (E.D. Va. July 19, 2007); *In re Garrison-Asburn, L.C.*, 253 B.R. at 709; *Endeka Enters., LLC v. Meiburger (In re Tsiaoushis)*, 383 B.R. 616, 619-21 (Bankr. E.D. Va. 2007).

⁶⁶See *Northrop Grumman Technical Servs., Inc. v. The Show Group, Inc. (In re The IT Group, Inc., Co.)*, 302 B.R. 483, 488 (D. Del. 2003) (determining that "the right of first refusal is not an unenforceable restraint on assignment. . . . courts have enforced rights of first refusal in the bankruptcy context").

⁶⁷Note that the majority of cases addressing the right of first refusal concept have been decided in the context of a real property option agreement. See, e.g., *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45, 51 (Bankr. M.D.N.C. 2003) (holding that the lessor's right of first refusal was material and a bargained-for element of the lease and that the lessor would not receive its full benefit of the bargain without the right remaining in the lease); see also *In re Todd*, 118 B.R. 432, 435 (Bankr. D.S.C. 1989) (holding that a partner's right under the partnership agreement and state law to match the sales price offered by a third party for the debtor's partnership interest was enforceable in bankruptcy). But see *In re Adelphia Comms. Corp.*, 359 B.R. 65, 66 (Bankr. S.D.N.Y. 2007) (holding that the right of first refusal was an unenforceable non-assignment clause).

⁶⁸See, e.g., *In re E-Z Serve Convenience Stores*, 289 B.R. at 51.

right of first refusal is a separate agreement that was bargained for, the same analysis applies.⁶⁹

The question thus becomes how to best incorporate the right into the bidding and sale procedures for the interest “in a fair and equitable manner that still allows for the maximization of the value of the estate.”⁷⁰ The court will ultimately consider, however, what is in the best interests of the bankruptcy estate, and, if the right of first refusal is not consistent with those interests, there is a greater chance the court will not enforce that right against the debtor in bankruptcy.⁷¹

With respect to the right of first refusal, the best practical result is that the for-profit organization will be given the opportunity to “match” the highest offer received by the debtor in the sale of its assets. This would allow the for-profit organization to control a subsequent transfer to another non-profit organization, thereby allowing it to choose its partner and preserve the LIHTC by replacing the original qualifying non-profit organization with a new qualifying non-profit organization. On the other hand, the worst result would be that the right of first refusal provision is held to be an unenforceable non-assignment provision or a separate or severable contract that the debtor can reject. In that instance, the debtor would have the ability and authority to sell its interest to a third party. Thus the for-profit organization would not have a partner of its choosing and would be in a position of potential non-compliance with Section 42, possibly resulting in potential recapture of some or all of the LIHTC. In either case, the for-profit organization would have difficulty utilizing the right of first refusal to block the debtor from selling its interest in the general partner entity.

VIII. IS THE OPTION PROVISION IN THE OPERATING AGREEMENT ENFORCEABLE?

In considering option agreements and whether they are executory contracts within the meaning of section 365 of the Bankruptcy Code, courts have generally

⁶⁹ See, e.g., *In re Todd*, 118 B.R. at 435.

⁷⁰ *In re E-Z Serve Convenience Stores*, 289 B.R. at 51 (finding that numerous courts have recognized a right of first refusal and that the practical concern therewith is “not whether to enforce such [a] right, but how to incorporate [the] right . . . into the bidding and sale procedure”).

⁷¹ See, e.g., *In re Adelpbia Comms. Corp.*, 359 B.R. at 85-86.

applied the Countryman and functional approaches in finding in the affirmative.⁷² Alternatively, there are instances where courts held that an option was not executory in nature, for example when the option was deemed “a unilateral option contract requiring no further performance by either party unless [the debtor] seeks to exercise [the] option,”⁷³ when there were no material obligations owed the debtor under a stock option agreement,⁷⁴ and when the option agreement had been substantially performed with the only task remaining being the clerical act of the actual issuance of a stock certificate.⁷⁵ However, a large majority of cases addressing this issue arise in the context of a real property purchase option agreement, rather than a purchase of interests in an LLC or limited partnership.⁷⁶ As with the right of first refusal, the structure of the agreement, including whether independent consideration was given for the option and whether the option was exercised, is a factor taken into account in determining whether the option is an executory contract.⁷⁷

The analysis regarding how the option will be treated when the provisions are contained in the operating agreement is similar to the right of first refusal discussion above. If the option is contained in a separate agreement, it is likely to be considered an executory contract, particularly if the option has not been exercised as of the date the partner or member files for bankruptcy. Courts are apt to come to this conclusion because, at that time, the obligations of both parties to the agreement are materially underperformed. In such event, the debtor will have the authority to reject or assume the contract using the business judgment rule.⁷⁸

⁷² See *In re Riodizio, Inc.*, 204 B.R. 417, 423-24 (Bankr. S.D.N.Y.1997); *In re West Chestnut Realty of Haverford, Inc.*, 177 B.R. 501, 504 (Bankr. E.D. Pa. 1995); *In re Hardie*, 100 B.R. 284, 287 (Bankr. E.D.N.C. 1989) (holding that an unexercised purchase option constituted an executory contract subject to rejection by the debtor).

⁷³ *BNY, Capital Funding LLC v. US Airways, Inc.*, 345 B.R. 549, 552 (E.D. Va. 2006) (regarding a letter of intent).

⁷⁴ *In re Am. West Airlines, Inc.*, 179 B.R. 893, 895 (Bankr. D. Ariz. 1995).

⁷⁵ *Wootton v. Young Family Trust (In re Dixon)*, 990 F.2d 626 (5th Cir. 1993).

⁷⁶ See, e.g., *In re Adelphia Comms. Corp.*, 359 B.R. at 66; *In re E-Z Serve Convenience Stores*, 289 B.R. at 51; *In re Todd*, 188 B.R. at 435.

⁷⁷ See *In re III Enters., Inc.*, 163 B.R. 453, 461-62 (Bankr. E.D. Pa. 1994).

⁷⁸ *In re Bal Harbour Club, Inc.*, 316 F.3d 1192 (11th Cir. 2003). Under the business judgment rule, a debtor is presumed to have made its decision in the best interests of the estate, and the court will only disturb the decision upon a showing that the debtor is acting in a manner that would be detrimental to the estate. *Id.*

Notwithstanding the foregoing, relief from the automatic stay would also be necessary. Assuming relief from stay is available, in determining whether to assume such an agreement, the debtor would be guided by what is best for the bankruptcy estate, and the court would likely approve any such decision under the business judgment rule.⁷⁹ Therefore, if allowing the exercise of the option would give the debtor a market rate or better for the interests (or would result in a net better result after giving effect to any claims that would be made against the estate for recapture costs), the debtor would assume the contract, subject to all the burdens therein.⁸⁰ Alternatively, if by rejecting the option agreement, the debtor could sell the interests for a higher price than would be available under the option, then the court would likely approve a decision by the debtor to reject the option agreement. As with the right of first refusal, once the agreement is rejected, the other partner or member would have a rejection damages claim in the bankruptcy filing.⁸¹ This means that the other partner or member would have a prepetition unsecured claim against the debtor for monetary damages such that it would be entitled to recover under the option agreement pursuant to state law.

IX. CONCLUSION

With respect to operating agreements, the right of first refusal, and option agreements, it is difficult to determine whether a court would deem them executory contracts. If, as determined by a court, they are not executory, the other partner or member may be able to preserve its rights to purchase the debtor's interest. In such event, the other partner or member should be able to protect against recapture of tax credits. If, however, the court determines that the agreements are executory, the other partner or member has several options: (i) file a claim against the bankruptcy estate for losses from any recapture event, (ii) contact the applicable state agency (and IRS) regarding relief from recapture, and (iii) consider whether a qualified non-profit can be admitted by the sale of a portion of the other partner or member's interest or of the investor's interest.⁸²

⁷⁹ *Id.*

⁸⁰ *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

⁸¹ *See* 11 U.S.C. § 365(g) (2006).

⁸² The sale of a portion of the investor's interest would reduce its percentage interest in the LIHTC but the loss may be less than the recapture event, in which case such a sale might be preferable.

As noted above, some agreements provide for below market prices in these provisions, and, in a bankruptcy, such provisions likely would be determined not to be in the best interests of the estate. Likewise, even a fair market value appraisal may be less than the price that a debtor might receive from a third party. However, partnership interests and membership interests generally do not have a large market of purchasers as one would find with other types of security, such as a stock traded on a stock exchange, and prices tend to reflect this non-marketability factor, among others.

One possible provision in these agreements that might bolster the chances that these provisions would be accepted by the court would be a “matching” pricing structure that overrides the other pricing in the event of a bankruptcy. A practical issue with this type of provision is that, like the right of first refusal, the provision may have a chilling effect on bids, since any potential purchaser knows it is unlikely to win the bid since there is another party that has the final right to match the price. With this chilling effect in mind, a matching proxy structure may have little practical value.

Therefore, in drafting such provisions, legal counsel should consider the potential effects of a bankruptcy filing by a partner and discuss the possible ramifications with their clients. Depending on the jurisdiction, the outcome will be determined by applicable case law. Moreover, while it is possible that the agreements will be determined to be executory in nature and, therefore, will potentially be rejected in a bankruptcy filing, the provisions are valuable prior to such filing, and, if drafted with care, may be valuable in the event a bankruptcy filing occurs during the term of the agreement.

