Legal Finance Insights

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Why Washington State is Good for Entrepreneurs:

State Supreme Court endorses the "associational rights" of LLC members.

AT the start of a new business, everyone expects the enterprise (and those involved in it) to succeed. They expect they will continue to get along as the business grows. Unfortunately, however, this does not always come to pass.

This raises important questions that entrepreneurs do not always examine before going into business with someone else. What happens when there is discord inside the business? What happens if one of the owners files for bankruptcy?

For limited liability companies (LLCs), most states – including Washington – have adopted a uniform set of laws that answer this question. Under these laws, a member who files for bankruptcy stops being a "member" in the LLC unless the parties have agreed otherwise. As a result, the bankrupt member loses all management rights - but is left with bare economic rights. In other words, the dissociated member retains the right to receive distributions but loses the right to participate in decision-making.

However, bankruptcy courts do not always enforce this principle in a consistent and reliable way.

While some bankruptcy courts enforce this principle, others interpret the federal Bankruptcy Code in a way that renders state dissociation statutes invalid. Courts in the latter category point to a few provisions in the Bankruptcy Code (known as "*ipso facto*" provisions) intended to protect the right to file for bankruptcy. In basic terms, these provisions invalidate state laws to the extent they penalize a party or alter its rights simply because it has filed for bankruptcy. These courts defer to the Bankruptcy Code's *ipso facto* provisions and refuse to enforce state dissociation statutes as written.

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For LLCs formed in Washington, though, our state's Supreme Court favorably settled this question in *Northwest Wholesale, Inc. v. Pac Organic Fruit, LLC, et al.*, and the United States Supreme Court recently decided not to disturb that decision. In Washington, a member who files for bankruptcy will be dissociated – that is, removed from the group of decision makers but not from the group of people entitled to distributions – unless the parties agree to different treatment in their LLC's governing documents. The Washington Supreme Court's analysis was fairly detailed, but the decision ultimately relies on two basic points. First, it recognized the well-established proposition that, though the Bankruptcy Code determines what property goes into a bankruptcy, state law defines what that property *is*. Second, it interpreted Washington's LLC Act as excluding from the definition of "membership interest" the right to act as a member once a party has filed for bankruptcy. The Washington Supreme Court's decision endorses the "associational rights" of LLC members. It frees LLC members from being compelled to do business with strangers – such as a bankruptcy trustee.

What does this decision mean for Washington LLCs? It is another reason why this is a great state in which to start a business. This decision limits how one member's financial problems affect others. It empowers LLC members to decide for themselves what happens if one of them files for bankruptcy. Certainly no one wants to face these types of challenges, but it is good to know that members of Washington LLCs at least have the power to control the effect of those challenges.

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