Alerts & Publications

Courts Differ on Enforcement of "Bankruptcy Remote" Provisions

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For over 30 years, a cat and mouse game has played out among debtors, creditors, and courts over the enforceability of "bankruptcy remote" provisions in structured finance and other contracts that limit recourse to bankruptcy by requiring consent from specified directors or approval from a majority, supermajority, or even all of the equity holders. Although several appellate courts have tolerated such "bankruptcy remote," "bankruptcy blocking," or "golden share" provisions so long as they are not shown to be improperly used, bankruptcy courts continue to refuse to enforce provisions they deem as blocking the door to "worthy" bankruptcy filings. In *In re Pace Industries*, Judge Walrath of the US Bankruptcy Court for the District of Delaware refused to enforce a provision requiring a preferred shareholder's consent to a bankruptcy filing. She based her decision upon federal policy preserving the right to seek bankruptcy relief and the debtors' showing of the need for bankruptcy protection. Judge Walrath's decision in *In re Pace Industries* may signal the bankruptcy courts' heightened desire to retain "worthy" filings in the wake of the COVID-19 pandemic.

In re Pace Industries[1]

Pace Industries and its subsidiaries filed for chapter 11 on April 12, 2020 to implement a pre-packaged plan of reorganization.[2] A dissident preferred shareholder moved to dismiss the cases because one of the debtors' certificate of incorporation required that holders of a majority of the preferred stock consent to the filing of bankruptcy, which had not been obtained prior to the filing. Judge Walrath refused to dismiss the case, finding the blocking right invalid under the circumstances. Judge Walrath emphasized that the COVID-19 pandemic severely disrupted the debtors' operations, that the debtors were insolvent and lacked the ability to pay debts as they come due, and that the proposed plan of reorganization would offer a better prospect for creditor recovery than dismissing the cases. While highlighting the federal public policy favoring access to bankruptcy, Judge Walrath noted that irrespective of whether a creditor or shareholder held the blocking right, such party would owe a fiduciary duty to the debtor. Because the preferred shareholder acted solely out of self-interest, Judge Walrath invalidated the blocking right as a breach of the preferred shareholder's fiduciary duty to the company.

Decisions Favoring Bankruptcy Access

Pace Industries follows a line of lower court decisions invalidating or disregarding similar provisions that bar access to bankruptcy court unless strict conditions are met. Courts have held that "[i]t is a well settled principal [sic] that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."[3] Otherwise, waiver of bankruptcy would be boilerplate in every loan agreement, thereby defeating the purpose of the statute.

More recently, structured financing has been a primary arena in which parties seek "bankruptcy remoteness" through less "offensive" structures. Bankruptcy courts have often resisted such efforts. *In re Kingston Square Assocs.*,[4] is an early example that involves mortgage-backed securitization and bylaw provisions that prevented the debtors from seeking voluntary bankruptcy protection without the unanimous consent of the board of directors, one of whom was a so-called independent director appointed by noteholders. Facing a dispute with the secured creditors and imminent foreclosure on the debtors' real properties, the debtors' principal orchestrated the filing of involuntary bankruptcy petitions by enlisting a group of friendly creditors. The US Bankruptcy Court for the Southern District of New York denied the lenders' motion to dismiss the cases, holding that orchestration alone did not warrant dismissal without evidence that the debtors had no chance at rehabilitation through the chapter 11 process. The court noted that dismissal of the cases would only benefit the movants and wipe out the unsecured creditors and equity holders. The court observed that the orchestration of involuntary filings was an apparent attempt to salvage some value from the estates. The court then emphasized the lack of independence of the "independent" director, noting that he was wholly withdrawn from the debtors' affairs despite the debtors' overwhelming financial distress. In particular, the board of directors did not meet until the court strongly suggested that it do so. The court concluded from the director's testimony that he violated his fiduciary duties and was nothing more than a pawn for the lender group. Importantly, concerned about the debtors' deteriorating properties and mismanagement, the court appointed a chapter 11 trustee who took over the debtors' affairs.

Practitioners structuring deals responded to *Kingston Square* with narrower provisions but not necessarily greater success. For example, during the Great Recession, numerous shopping malls owned by General Growth Properties, Inc. sought bankruptcy relief. The operating agreements of many of the project-level debtors required the appointment of two independent managers, whose unanimous consent was a precondition for the filing of a bankruptcy petition.[5] In some instances, the independent managers accepted that their duties demanded a bankruptcy filing and consented; where they did not, the debtors simply replaced them with new amenable independent directors. The secured lenders argued that the debtors' replacement of the two "independent managers"[6] with new amenable managers supportive of filing constituted subjective bad faith sufficient to require dismissal. The court rejected the opposition, holding that the independent managers did not have a duty to keep any of the debtors from filing a bankruptcy case and that the managers had a *prima facie* fiduciary duty to act in the interests of the corporation and its shareholders.

Thus, state-of-the-art provisions now require consent of the securitized noteholders to replace the independent directors. Nonetheless, concern about the directors' fiduciary duty to the corporation and shareholders remains. In a troubled situation, will the directors find themselves compelled to support a bankruptcy filing? To address this problem, practitioners resorted to limited liability companies in Delaware, where the statute permits limiting fiduciary duties to specified creditor classes or even eliminating fiduciary duties entirely.

Judge Carey of the Delaware Bankruptcy Court addressed the issue of fiduciary duty in *In re Intervention Energy Holdings, LLC*,[7] where a limited liability company agreement conditioned the debtor's bankruptcy filing on the unanimous approval of all common shareholders. The requirement of unanimous approval makes each share a "golden" share as a dissenting shareholder has the power to veto a voluntary bankruptcy filing. Judge Carey denied a motion to dismiss by the holder of such a "golden" share, who was also a creditor. He found the provision is "tantamount to an absolute waiver of [the right to file bankruptcy], and, even if arguably permitted by state law, is void as contrary to federal public policy."[8] Judge Carey highlighted the federal public policy safeguarding the right of a person, including a business entity, to seek federal bankruptcy relief as authorized by the Constitution and enacted by Congress, and refused to allow bankruptcy to be blocked by a creditor with no fiduciary duty to the debtor.

Decisions Dismissing Improperly Filed Cases

While bankruptcy courts are reluctant to block the bankruptcy courthouse door, appellate courts have shown a willingness to limit access absent a showing of abuse. For example, *In re DB Capital Holdings, LLC*,[9] involved a limited liability company agreement containing an express waiver of the debtor's right to file bankruptcy. The bankruptcy court granted a motion to dismiss, and the Tenth Circuit Bankruptcy Appellate Panel ("BAP") affirmed the decision. The debtor's manager—who authorized the bankruptcy filing—argued that the bankruptcy waiver should be invalidated because it was part of an amendment that was executed at the demand and for the sole benefit of the debtor's secured lender. The BAP disagreed, finding no evidence that the waiver resulted from coercion of a creditor. The BAP noted that the debtor failed to support the proposition that members of a limited liability company cannot agree among themselves not to file bankruptcy, and if they do, such agreement is void as against public policy. Accordingly, the BAP held that the bankruptcy waiver was enforceable and declined to decide as to whether an operating agreement containing terms coerced by a creditor would be unenforceable.

In re Franchise Servs. of N. Am., Inc.,[10] involved a certificate of incorporation that conditioned the filing of bankruptcy on the consent from the holders of a majority of each class of stock. After an ill-fated acquisition, the debtor filed bankruptcy without putting the matter to a vote. The holder of 100% of the debtor's preferred stock, who was also an unsecured creditor, moved to dismiss the bankruptcy petition as unauthorized. The bankruptcy court granted the motion to dismiss, holding that conditioning the debtor's right to file a voluntary petition on consent from specified parties is not contrary to federal bankruptcy

policy. On direct appeal, the Fifth Circuit affirmed the bankruptcy court's decision. Despite the debtor's characterization that the creditor was masquerading as a bona fide equity owner, the Fifth Circuit reasoned that "[i]t strains credulity to believe that [the unsecured creditor] made a $15 million equity investment just to hedge against the possibility that [the debtor] might not a pay a $3 million [debt]."[11] Otherwise, the creditor "was just throwing good money after bad" in making the equity investment.[12] The Fifth Circuit emphasized that "federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty to the corporation or its fellow shareholders."[13] Importantly, the Fifth Circuit limited its holding to the facts and circumstances of the case, noting that a creditor with no equity in the company or who took an equity interest simply as a ruse to guarantee a debt may warrant a different outcome.

Conclusion

A consistent theme is the fact-driven nature of the courts' analyses of provisions governing the filing of bankruptcy. Neither federal public policy favoring bankruptcy access nor "bankruptcy blocking provisions" seems to have a definitive upper hand. Absent a finding of improper motives, appellate courts have endorsed such provisions, whereas bankruptcy courts have shown a tendency to discern improper motives and emphasize the federal public policy in favor of bankruptcy relief. In *Pace*, the bankruptcy court accepted the debtors' argument that the "blocking" equity holder was in fact seeking a recovery to which it was not entitled. The court refused to grant this "hold-up value." The circumstances in *Pace* are not unique; many businesses continue to face dwindling liquidity, severe disruption, and a genuine need for access to bankruptcy. In the wake of the COVID-19 pandemic, bankruptcy courts may be keener on retaining "worthy" bankruptcy filings and inquiring into whether the parties with blocking rights have fulfilled their fiduciary duties by considering the debtor's interests.

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[1] Case No. 1:20-10927 (Bankr. D.Del. 2020).

[2] On May 29, 2020, the bankruptcy court entered an order confirming the debtors' prepackaged plan. See Docket No. 215.

[3] *In re Tru Block Concrete Prods., Inc.,* 27 B.R. 486, 492 (Bankr. S.D.Cal. 1982); *In re Citadel Properties, Inc.,* 86 B.R. 275, 275 (Bankr. M.D.Fla. 1988) ("The Court pauses to suggest that a total prohibition against filing for bankruptcy would be contrary to Constitutional authority as well as public policy.").

[4] 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

[5] *See In re Gen. Growth Props., Inc.,* 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009).

[6] *See id*. at 67 ("As articulated by Debtors' counsel, the assumption by the lenders was that the independent director was not really independent.").

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[7] 553 B.R. 258 (Bankr. D. Del. 2016).

[8] *Id*. at 265.

[9] 463 B.R. 142 (B.A.P. 10th Cir. 2010).

[10] 891 F.3d 198 (5th Cir. 2018).

[11] *Id*. at 208.

[12] *Id*.

[13] *Id*. at 209.

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