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Analyzing a Creditor's Ability to Exercise its Shareholder Rights to Prevent a Bankruptcy Filing by a Company

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Introduction

Title 11 of the United States Code (the "Bankruptcy Code") operates as a tool allowing an honest, struggling debtor to gain a fresh start absent of their burdensome debts.[1] Generally, when a company is about to enter bankruptcy, shareholders and creditors of the insolvent company play two distinct roles. Shareholders, those with an ownership stake in the company, have voting rights enumerated in their shareholder agreement, allowing them to vote on certain actions, including the company's bankruptcy filing.[2] On the other hand, creditors generally have a claim (i.e., a right to payment) against the company, which typically has arisen from receiving inadequate value in return for the value the creditor gave to the debtor.[3] Thus, while a shareholder may have input into a company's decision to file for bankruptcy, a creditor typically will not. However, in certain circumstances, a party may serve dual roles—it may be both a shareholder *and* a creditor. Ultimately, in such a circumstance, conflict arises as a creditor is now

[1] *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).
[2] *See*, 26 I.R.C. § 7701(a)(8) (2018); *see also* Shareholder, Black's Law Dictionary (10th ed. 2014); *see In re* Franchise Services of North America, Incorporated, 891 F.3d 198, 205 (5th Cir. 2018).
[3] *See*, 11 U.S.C. § 101(10) (2012); *see also* Creditor, Black's Law Dictionary (10th ed. 2014).

afforded the ability to exercise shareholder voting rights and prevent a company from filing for bankruptcy.

Courts have recognized two central ways in which a creditor/shareholder attempts to block a company from filing for bankruptcy: (1) a golden share, and (2) blocking provisions. A golden share is a "share that controls more than half of the corporation voting rights and gives the shareholder veto power over changes to the company charter."[4] The term blocking provision "is a catch-all to refer to various contractual provisions through which a creditor reserves a right to prevent a debtor from filing for bankruptcy."[5] Ultimately, both golden shares and blocking provisions give a creditor/shareholder the ability to prevent a company with which they do business from entering into bankruptcy, eliminating the possibility of having their claims discharged.[6]

Part I of this memorandum discusses whether a creditor/shareholder may use its shareholder voting power to prevent a company from entering bankruptcy, while analyzing the difficulty courts have with uniformly deciding the issue. Part II of this memorandum examines the conclusion of many courts, that from a policy standpoint, when a party is both a shareholder and creditor, it should not have the ability to prevent a company from filing for bankruptcy.

Discussion

I. Different Interpretations

It is well established that companies are able to voluntarily file for bankruptcy.[7] However, a company may not file a bankruptcy petition without the requisite authority.[8]

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[4] *See In re* Franchise Services, 891 F.3d at 205.
[5] *Id.*
[6] *Id.*
[7] 11 U.S.C. § 301
[8] *See* Price v. Gurney, 324 U.S. 100, 106 (1945); *see also In re* N2N Commerce, Inc., 405 B.R. 34, 41 (Bankr. D. Mass. 2009) ("It is well-settled that a bankruptcy filing is a specific act requiring specific authorization.").

Authority to file a bankruptcy petition "must be found in the instruments of the corporation and applicable state law."[9] A company is free to place the requisite authority governing their ability to file bankruptcy in their instruments of incorporation.[10] Despite this freedom, it is generally accepted that a company may not waive its rights to the benefits of bankruptcy prepetition.[11] Thus, preprepetition agreements purporting to interfere with a debtor's rights under the Bankruptcy Code are not enforceable.[12] Ultimately, courts must ask whether or not the actions of the party blocking the bankruptcy from going forward constitute an impermissible prevention of the debtor's ability to file for bankruptcy.

A. "Bankruptcy-Proof Provisions" that Violate the Bankruptcy Code

i. Golden Share

A golden share is a token equity unit that is contracted for by a creditor, granting the creditor voting control over a company's ability to file for bankruptcy.[13] Courts invalidate golden shares by stressing that business entities have a right to file for bankruptcy.[14] In *In Re Intervention Energy*, the court rooted its analysis of the parties' actions on the premise that "the Bankruptcy Code preempts the private right to contract around its essential provisions."[15] There, the parties entered into a contract prescribing that the lender would receive a "common unit" of the company in exchange for forbearance of his loan.[16] Along with the common unit, the company agreed to amend its LLC agreement, requiring the consent of all holders of common

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[9] 116 B.R. 775, 778 (Bankr. D. Idaho 1990).
[10] *See* Wank v. Gordon, 505 B.R. 878, 887 (9th Cir. BAP 2014).
[11] *Id.*
[12] *See generally In re* Intervention Energy Holdings, 553 B.R. 258, 263 (D. Del. 2016); *see Wank*, 505 B.R. at 887 (stating that a debtor may not waive its rights to the benefits of bankruptcy in a prepetition waiver).
[13] *See In re* Intervention Energy, 553 B.R. at 264.
[14] *Id.* at 263 ("[I]t is axiomatic that a debtor may not contract away the right to discharge in bankruptcy.").
[15] *Id.* at 263.
[16] *Id.* at 261.

units prior to filing for bankruptcy.[17] Since a negative vote could essentially prevent a bankruptcy from occurring, the court concluded that this was a clear example of a "blocking" (golden) share, and "an attempt to contract away the right to seek bankruptcy relief."[18]

ii. Blocking Provisions

A blocking provision is a contractual provision in which a creditor limits a company's right to seek bankruptcy relief as a condition of supplying credit.[19] Essentially such a provision constitutes a prepetition waiver of a company's right to file for bankruptcy.[20] An example of a court invalidating a creditor/shareholder's attempt to prevent a bankruptcy in the form of a blocking provision can be seen in *In re Bay Club Partners*.[21] There, the debtor company entered into an operating agreement stating that the company was unable to initiate an insolvency proceeding until such a time that the lender was paid off in full.[22] Despite the language being consistent with Oregon State LLC law, the Court deemed the issue a matter of federal law, rejecting the provision as a "maneuver of an 'astute creditor' to preclude [company] from availing itself of the protections of the Bankruptcy Code prepetition."[23]

iii. Blocking Directors

Finally, a third heavily scrutinized creditor attempt at avoiding the bankruptcy process is the "blocking director."[24] Blocking directors sit on the boards of companies established by creditors.[25] These companies have few operations and generally only do business with one

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[17] *Id.*
[18] *Id.* at 264; *See also In re* Franchise Services, 891 F.3d at 205 (specifically acknowledging golden shares in the context of corporations, as well as LLC's).
[19] *See In re* Squire Court Partners, 574 B.R. 701, 707 (E.D. Ark. 2017).
[20] *Id.*
[21] *In re* Bay Club Partners-472, LLC, No. 14-30394-rld11, 2014 WL 1796688 (D. Or. 2014).
[22] *Id* at *3.
[23] *Id.* at *5.
[24] *See In re* Lake Michigan Beach Pottawattamie Resort, LLC, 547 B.R. 899 (Bankr. ND. Ill. 2016).
[25] *Id.*

particular creditor.[26] The key to the blocking director's power is that the company needs unanimous consent from its director's to file for bankruptcy.[27] This business structure allows "one specific director, chosen by the secured creditor, [to] withhold its vote and thus block . . . a voluntary bankruptcy petition."[28] Because the company has little operations an involuntary bankruptcy petition is just as unlikely.[29]

The court in *In re Lake Michigan*, struck down a blocking director provision when it was established by the debtor that the creditor's appointed board member violated his fiduciary duties by failing to consider the interest of the company, solely relying on his own interests.[30] The court implied that a blocking director provision can only ever be valid if the director adheres to his fiduciary duties; absent that, as was the case here, the blocking provision is void.[31] Similarly, the court in *In Re Lexington Hospital Group, LLC*, struck down an "independent manager" provision because the manager had no fiduciary duties to the company that might limit self-interested decisions.[32] Ultimately these cases are examples that when an agreement clearly attempts to take away a potential debtor's right to file for bankruptcy, the court will find the agreement void.

B. *Provisions that* Do Not *Violate the Bankruptcy Code*

i. Minority Approach

In 2018, the Fifth Circuit in *In re Franchise Services*, took a different approach than the cases cited above, declaring that "there is no prohibition in federal bankruptcy law against

[26] *Id.* at 911.
[27] *Id.*
[28] *Id*.
[29] *Id.*; An Involuntary bankruptcy proceeding can be brought by either a single qualifying creditor if the debtor has less than 12 creditors, or by 3 or more qualifying creditors if the debtor has more than 12 creditors. *See* 11 U.S.C. § 303
[30] *Id*. at 913.
[31] *Id.* at 914 ("The essential playbook for a successful blocking director structure" requires normal director fiduciary duties.").
[32] *In re* Lexington Hospital Group, LLC, 577 B.R. 676, 686 (Bankr. E.D. Ky. 2017).

granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor."[33] There, the court avoided the negative connotation of golden shares and blocking provisions, by determining that the shareholder consent provision present constituted neither.[34] The court seemingly centered its determination on the fact that there was no evidence of bad faith when the creditor took an equity stake in the company in exchange for forbearance.[35] Ultimately the Fifth Circuit kept the door open for future creditor/shareholders to prevent a company from filing bankruptcy holding "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."[36]

Other courts have also found contracted for operating agreement clauses prohibiting bankruptcy without the consent of all parties to be permissible. The Southern District of Georgina in *In re Global Ship Systems, LLC*, answered the question of whether a creditor/shareholder could prevent a bankruptcy by finding that a creditor/shareholder "wears two hats."[37] To this extent, the court separated the creditor/shareholder's roles, stating that a shareholder's right in the LLC Agreement to "prevent a bankruptcy filing to which it does not consent is dependent solely on its status as an equity holder."[38] In concluding that the creditor/shareholder retained his equity right to prevent a bankruptcy case, the court deferred to

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[33] *In re* Franchise Services, 891 F.3d at 208.
[34] *Id.* at 205.
[35] *Id.* at 209.
[36] *Id.*
[37] *In re* Global Ship Systems, LLC, 391 B.R. 193, 203 (Bankr. S.D. Ga. 2007).
[38] *Id.* at 200.

Georgia's legislative determination that LLC's should be granted broad in the discretion and management of their affairs.[39]

ii. General Partners & Managing Members

Courts have upheld bankruptcy filing restrictions when the party preventing the filing is a general partner in a partnership or managing member in an LLC.[40] In *In re Squire*, the court described the unique circumstances of this situation, stating:

> "it is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor's decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy."[41]

Similarly, in *In re DB Capital Holdings*, the court found that there was no support "for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy."[42] These courts placed great emphasis on the fact that partners and managing members have strong, contracted for, ownership rights in their respective companies.[43] The court in *In re DB Capital Holdings*, placed very little emphasis on the arguments of the pro-bankruptcy party, who alleged that the company's managing member only voted against the bankruptcy filing in support of, and for the benefit of, the debtor's main secured creditor.[44]

II. Allowing Creditor/Shareholders to prevent a company from filing for bankruptcy is against public policy.

When analyzing the policy rationale behind preventing or allowing a creditor/shareholder party to prevent a potential debtor from filing bankruptcy, two conflicting concepts must be balanced: (1) the fact that the Bankruptcy Code is premised on the idea of a fresh start, against

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[39] *Id.* at 204.
[40] *See generally In re* Squire Court Partners, 574 B.R. 701 (E.D. Ark. 2017); *In re* DB Capital Holdings, LLC, 463 B.R. 142 (B.A.P. 10th Cir. 2017).
[41] *In re Squire*, 574 B.R. at 708.
[42] *In re* DB Capital Holdings, 463 B.R. at *3.
[43] *See In re* Squire, 574 B.R. at 709.
[44] *In re* DB Capital Holdings, 463 B.R. at *3.

(2) the idea that bankruptcy proof provisions are legitimate contractual arrangements between two well informed and educated business parties. First, Congress made it "a central part of the bankruptcy code to give debtors a fresh start in life and a clear field for future effort unburdened by the existence of old debts."[45] This idea governs a majority of the Bankruptcy Code, and thus courts have held that it is "against public policy for a debtor to waive the prepetition protection of the Bankruptcy Code."[46] Second, when courts have stressed the importance of recognizing legitimate contractual agreements between parties, which prevent a bankruptcy, those courts have analyzed the agreements made by equity holders, not creditors.[47] The court in *Squire* stated that "allowing a creditor to contract for control of a debtor's decision whether to file a bankruptcy petition would undermine the most fundamental purposes of the bankruptcy. The limited partners, however, are owners, not creditors [of the corporation]."[48]

Seemingly, the crux of the *Squire* court's reasoning, is that in *Squire*, the bankruptcy preventing party was simply an equity holder, not a creditor.[49] Thus, the *Squire* court implied that its reasoning would not apply when a creditor accepts equity in lieu of repayment or a lower interest rate because allowing a creditor to control a company's bankruptcy filing would "undermine the most fundamental purpose of bankruptcy."[50] In a situation where equity is exchanged in return for repayment, similar to *In re Franchise Services*, the idea that two parties were smart businessmen operating under their own volition needs to be weighed against the potential abuse that may result.[51] If creditors knew that they had the ability to ensure they would

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[45] *In re* Bogdanovich, 292 F.3d 104, 107 (2d Cir. 2002).
[46] *See* Bank of China v. Huang, 275 F.3d 1173, 1177 (9th Cir. 2002).
[47] *See generally In re* Squire, 574 B.R. 701; *In re* DB Capital Holdings*,* 463 B.R. 142.
[48] *In re* Squire, 574 B.R. at 708.
[49] *See id*.
[50] *See id*.
[51] *See In re* Intervention Energy, 553 B.R. at 265 ("The federal public policy to be guarded here is to assure access to the right of a person, including a business entity, to seek federal bankruptcy relief as authorized by the Constitution and enacted by Congress.").

never be forced to have their claims subjected to the bankruptcy process, they would ensure that with every loan given, they received a small amount equity in return.[52] This would allow creditors an unfettered ability to deny bankruptcy access to potential debtors, directly contradicting the purpose of the bankruptcy code and federal public policy.[53]

Conclusion

"It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."[54] In certain circumstances, such creditor/shareholder agreements have been permitted. However, these circumstances remain the exception, not the norm.[55] A contrary policy would be unworkable, ultimately leading to the conclusion that "prohibition of preemption waiver has to be the law; otherwise, astute creditors would routinely require their debtors to waive."[56]

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[52] *See id*. at 264.
[53] *See id.* at 263.
[54] *Id*.
[55] *See In re* Franchise Services*,* 891 F.3d at 208; *In re* Global Ship Systems, LLC, 391 B.R. at 203.
[56] *See* Bank of China v. Huang, 275 F.3d 1173, 1177 (9th Cir. 2002).