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Feature

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Intervention Energy Holdings

Good Public Policy, or Unnecessary Intrusion into State Law?

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Provisions purporting to restrain a debtor's ability to file for bankruptcy and prohibitions against the same are nothing new on the bankruptcy landscape. However, such prohibitions have not stopped lenders in their quests to form truly bankruptcy-remote entities. While much of the recent case law on this issue has been rooted in traditional state law concepts,[2] the U.S. Bankruptcy Court for the District of Delaware in *Intervention Energy Holdings LLC*[3] recently rejected the "golden share" method of restricting bankruptcy filings solely on the grounds that such a method violates federal public policy. This ruling highlights the delicate tension between state corporate and federal bankruptcy law and begs the following question: Did the decision demonstrate good public policy or an unnecessary intrusion into state law?

A Brief History of the Golden Share

A "golden share" gives an owner veto power over certain actions that a business can take. The British government first used the golden-share concept in the 1980s[4] by selling state-held firms and retaining a share that would allow the government to outvote all shareholders.[5] The same concept was then adopted by banks to make their debtors more bankruptcy-remote. Lenders asked for golden shares in order to make the possibility of bankruptcy less likely[6] by requiring the borrower to amend organizational documents to require unanimous shareholder consent to approve a bankruptcy filing.[7] Lenders would then be granted a share in exchange for forbearance,[8] which gave lenders veto power over any proposed bankruptcy filing.

Limits on Contracting Away Bankruptcy Rights

Any debtor may file for bankruptcy by filing a petition with the bankruptcy court,[9] but a business entity must have the authority to properly file a voluntary petition.[10] Whether a business entity has authority to act is a question of state law.[11] A filing without corporate authority is invalid and must be dismissed.[12] Therefore, a bankruptcy court must look to state substantive law to determine whether a business has the proper authorization to file a voluntary bankruptcy petition.

Generally, creditors and debtors cannot agree to prohibit a bankruptcy filing through a pre-petition agreement. Indeed, a debtor may not contract away the right to a discharge in bankruptcy for public policy reasons.[13] Creditors cannot require debtors to sign pre-petition waivers because "[t]he Bankruptcy Code pre-empts the private right to contract around its essential provisions[.]"[14] Debtors cannot waive the right to file for bankruptcy because it would undermine the purpose of the Bankruptcy Code.[15]

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2 *See, e.g., In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016); *DB Capital Holdings LLC v. Aspen HH Ventures LLC (In re DB Capital Holdings LLC)*, No. CO-10-6, 2010 Bankr. LEXIS 4176 (B.A.P. 10th Cir. Dec. 6, 2010).

3 *In re Intervention Energy Holdings LLC*, No. 16-11247 (KJC), 2016 Bankr. LEXIS 2241 (Bankr. D. Del. June 3, 2016).

4 Christine O'Grady Putek, Comment, "Limited But Not Lost: A Comment on the ECJ's Golden Share Decisions," 72 *Fordham L. Rev.* 2219, 2221 (2004).

5 *Id.*

6 Michael H. Torkin and Douglas P. Bartner, "Major Legal and Financial Factors Impacting Chapter 11 Restructuring in 2011," Bankruptcy and Financial Restructuring Law 2011: Top Lawyers on Trends and Key Strategies for the Upcoming Year (Thomson Reuters/Aspatore eds., 2011), *available at* 2011 WL 586140 at *7.

7 *See id.*

8 *See id.*

9 *See* 11 U.S.C. § 301(a).

10 *In re Real Homes LLC*, 352 B.R. 221, 225 (Bankr. D. Idaho 2005).

11 *Id.*

12 *See Hager v. Gibson*, 108 F.3d 35, 38 (4th Cir. 1997) (citing *Price v. Gurney*, 324 U.S. 100, 106 (1945)).

13 *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987).

14 *In re Pease*, 195 B.R. 431, 435 (Bankr. D. Neb. 1996).

15 *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1177 (9th Cir. 2002), *but see DB Capital*, 2010 LEXIS 4176 at *10.

Fiduciary Obligations of Members and Managers of an LLC

Controlling members of a limited liability company (LLC) owe fiduciary duties of care and loyalty under Delaware law, unless otherwise agreed. The Delaware LLC Act states that "in any case not provided for in this chapter, the rules of law and equity, including ... fiduciary duties ... shall govern."[16] This means that a member or manager of an LLC can have fiduciary duties depending on their role in the LLC and the LLC agreement.[17] A member or manager owes fiduciary duties when they are active in the management of the business.[18] However, even if a member or manager owes fiduciary duties, the LLC agreement can still limit or eliminate fiduciary duties.[19] The Delaware LLC Act gives members broad discretion in formulating the LLC and organizing the relationships between members or managers,[20] and members or managers of an LLC will owe fiduciary duties unless the agreement unambiguously states otherwise.[21] Therefore, members or managers will owe fiduciary duties if they take an active role in the LLC and the operating agreement does not state otherwise.

Both LLC members and managers who are active in a business and corporate directors have the fiduciary duties of loyalty and care. The duty of loyalty imposes an affirmative obligation on members or managers to protect the interests of the business and act in good faith.[22] A member or manager of an LLC breaches his/her duty of care when acting with gross negligence.[23] When an entity is insolvent, creditors have derivative standing to enforce fiduciary duties.[24]

DB Capital Holdings LLC

In *DB Capital Holdings LLC*, the Bankruptcy Appellate Panel (BAP) for the Tenth Circuit considered, on appeal, whether members of an LLC could contract away their rights to file for bankruptcy.[25] The debtor was a Colorado manager-managed LLC where the manager had no ownership interest in the debtor.[26] Under the operating agreement, the rights and powers given to the manager pertained only to managing the affairs of the debtor in the ordinary course.[27] The debtor's operating agreement was subsequently amended to include, among other things, a complete bar from filing for bankruptcy.[28] There is no indication that the operating agreement was amended at a time when the debtor was experiencing financial difficulty.

Several years after the amendment, the debtor fell on troubled financial times, which ultimately caused the manager to file chapter 11 on the debtor's behalf. One of the members filed a motion to dismiss, arguing, in part, that the operating agreement prohibited the filing of a bankruptcy case.[29] The manager argued that such a provision should be invalidated on public policy grounds because the provision was included at the lender's behest. The bankruptcy court ultimately dismissed the case, and the manager appealed.[30]

In affirming the bankruptcy court's ruling, the BAP first noted that it could find no law that would prohibit members of an LLC from agreeing among themselves to file for bankruptcy. Further, the BAP found that there was no evidence indicating that the lender coerced the provision. For this reason, the BAP declined to opine whether such a provision could be unenforceable if coerced by a lender.[31] Finally, the BAP found that the dismissal was warranted — even if the amendment was disregarded — reasoning that the manager had taken an unauthorized action under the original agreement because bankruptcy was not in the ordinary course of business.[32]

Lake Michigan Beach Pottawattamie Resort LLC

In *Lake Michigan*, a Michigan LLC was in default of its obligations to its lender and entered into a forbearance agreement. As part of the forbearance agreement, the debtor amended its operating agreement to incorporate a golden share concept under which its lender would become a fifth "special" member with the right to approve or disapprove any "material" action, including the right to file for bankruptcy. As a special member, the lender would have no rights in profits or losses, distributions, or tax consequences, and would not have any duties to the debtor or the other members.[33]

The debtor ultimately filed for chapter 11 without the lender's consent, and the lender sought to dismiss the case.[34] The bankruptcy court denied the motion to dismiss and, in addition to addressing public policy concerns, found that the amendment to the operating agreement was void under Michigan law because the special member was not required to consider the debtor's interests.[35]

Intervention Energy Holdings LLC

In *Intervention Energy Holdings*, the Delaware bankruptcy court invalidated a golden-share provision solely on grounds that it violated federal public policy. The debtors, which were Delaware LLCs, entered into a note purchase agreement with their lender. The debtors failed to comply with the agreement terms, and the lender declared default. The parties negotiated a forbearance agreement that was conditioned on (1) allowing the lender to become a member with one common unit and (2) amending the operating agreement to require the approval of each holder of common units before any voluntary bankruptcy filing. The debtors amended their operating agreement accordingly and

16 6 Del. Code Ann. § 18-1104 (2013).
17 *Feeley v. NHAOCG LLC*, 62 A.3d 649, 662-63 (Del. Ch. 2012).
18 *Id.*
19 *See id.*; 6 Del. Code Ann. § 18-1101(e).
20 *Elf Atochem N. Am. Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999).
21 *Bay Ctr. Apartments Owner LLC v. Emery Bay PKI LLC*, No. 3658-VCS, 2009 WL 1124451, at *8 (Del. Ch. April 20, 2009).
22 *See, e.g., Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939); *Auriga Capital Corp. v. Gatz Properties LLC*, 40 A.3d 839, 843 (Del. Ch. 2012); *Feely*, 62.A.3d at 664 (citing *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006)).
23 *Auriga Capital*, 40 A.3d at 876.
24 *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 101-02 (Del. 2007).
25 2010 Bankr. LEXIS 4176, at *7.
26 *Id.* at *1.
27 *Id.* at *13, 14.
28 *Id.* at *3.
29 *Id.* at *6.
30 *Id.*
31 *Id.* at *10.
32 *See id.* at *10-19.
33 *Lake Mich.*, 547 B.R. at 903-04.
34 *Id.* at 904, 905.
35 *Id.* at 914. For a more-detailed analysis of the *Lake Michigan* case, *see* Andrew C. Helman and Jeremy R. Fischer, "The Missing Page of the Playbook: 'Blocking Directors' Can't Escape Fiduciary Duty," XXXV *ABI Journal* 8, 12, 58-59, August 2016, *available at* abi.org/abi-journal.

issued a single common unit to the lender in exchange for a $1 capital contribution.[36]

The debtors ultimately sought chapter 11 protection with the consent of all unit-holders except the lender. The lender filed a motion to dismiss the bankruptcy — arguing, in part, that the debtors lacked authority to file for bankruptcy.[37] The lender warned that if the bankruptcy court declared the agreement as void, it would cause confusion in regard to the breadth of an LLC's right to contract.[38] Conversely, the debtors argued that if the provision was enforced, debtor/creditor relationships would dramatically change and future lenders would demand similar provisions in future transactions.[39]

Ultimately, the court concluded that the debtors did possess the necessary authority to commence their chapter 11 proceedings without the lender's consent. In doing so, the court found that the amendment was an absolute waiver of the LLC's right to file for bankruptcy and was void as being against federal public policy.[40] Although the above-described decisions appear to represent two opposing viewpoints with respect to golden-share provisions, it is important to consider the nuances of the cases to better understand the significance of a court's sole reliance on federal public policy in evaluating such provisions.

Good Public Policy or Unnecessary Intrusion on State Law?

Both *DB Capital* and *Intervention Energy* discuss whether members can ultimately contract away their ability to file for bankruptcy, but the cases are distinct in several ways. In *Intervention Energy*, the anti-bankruptcy provision was clearly added at the lender's behest and as part of a forbearance agreement. In *DB Capital*, the anti-bankruptcy provision appears to have been inserted several years before the debtor began experiencing financial difficulty. Further, the BAP in *DB Capital* found that there was ultimately no evidence that the provision was inserted at the lender's behest, and specifically reserved the issue of whether such a provision could be invalidated if it had been coerced by a lender.

More importantly, the BAP found that dismissal was warranted on traditional state law grounds because the manager was acting outside the scope of his authority, even if the challenged provision was disregarded. The *Lake Michigan* decision was similarly grounded in state law (*i.e.*, the prohibition of the eliminating fiduciary duties under Michigan law). Since Delaware law allows for such elimination of fiduciary duties, the bankruptcy court in *Intervention Energy* likely could not rely on a similar rationale in reaching its decisions. Since it found that such a provision was void against federal public policy, the bankruptcy court in *Intervention Energy* did not address the role of state law in limiting the scope of an LLC member's freedom of contract, which would have likely been a question of first impression under Delaware LLC law.[41] The court's refusal to ground its decision in traditional notions of state law is what makes the decision so notable.

While the bankruptcy court in *Intervention Energy* was presented with an extreme set of facts, the decision also raises several thorny questions that future courts will need to resolve. For example, would the outcome be different if the requirement of unanimous consent to file for bankruptcy existed at the time of creation and the creditor subsequently purchased one share from another member for fair value? In addition, would it be a different outcome if filing for bankruptcy required unanimous consent and an existing member was also a creditor?[42] Finally, *Intervention Energy* could be used for the proposition that any provision denying a business entity the ability to file for bankruptcy is invalid for federal public policy purposes:

> 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. It is beyond cavil that a state cannot deny to an individual such a right. I agree with those courts that hold the same applies to a "corporate" or business entity, in this case an LLC.[43]

Such an interpretation could have a profound impact on the internal corporate affairs of a struggling company where there is a good-faith dispute among its owners as to whether bankruptcy is appropriate.

Conclusion

It is well established that whether a business entity is authorized to file for bankruptcy is a matter generally left for state law. As such, when evaluating provisions concerning whether a business entity has the requisite authority to file, courts should first look to state law. Further, courts should be wary of relying on or expanding the *Intervention Energy* decision beyond its facts. Doing so creates a very slippery slope from good public policy to an unnecessary intrusion into state law. abi

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36 *Intervention Energy*, 2016 Bankr. LEXIS 2241, at *5.
37 *Id.* at *1-2.
38 *Id.* at *14-15.
39 *Id.* at *15.
40 *Id.* at *17-18.
41 *See id.* at *10.

42 *See, e.g., In re Global Ship Sys. LLC*, 391 B.R. 193, 203 (Bankr. S.D. Ga. 2007) (finding that since lender was also an equityholder, it had "the unquestioned right to prevent, by withholding consent, a voluntary bankruptcy case").
43 *Intervention Energy*, 2016 Bankr. LEXIS 2241, at *17) (footnotes omitted).