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Creditors Cannot Contract Around Their Fiduciary Duties and Withhold Their Consent from a Debtor to File for Bankruptcy

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Creditors Cannot Contract Around Their Fiduciary Duties and Withhold Their Consent from a Debtor to File for Bankruptcy

Samantha Guido, J.D. Candidate 2018

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INTRODUCTION

Many courts have found that a debtor may not contract away their right to voluntarily file for bankruptcy.[1] However, debtors and creditors have implemented creative measures to avoid this principle. For example, a creditor may seek the appointment of a so-called "blocking director" on a company's board of directors, who would control the company's bankruptcy filing.[2] Additionally, some creditors seek a "golden share" in order to have veto power over changes to the company's charter, including veto power over whether the company can file for bankruptcy.[3] In determining whether these mechanisms are void under public policy, courts will

[1] *See In re Pease*, 195 B.R. 431, 435 (Bankr. D. Neb. 1996) ("[A]ny attempt by a creditor in a private pre-bankruptcy agreement to opt out of the collective consequences of a debtor's future bankruptcy filing is generally unenforceable."); *see also In re Tru Block Concrete Prods., Inc.*, 27 B.R. 486, 492 (Bankr. S.D. Cal. 1982) ("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").

[2] Darren Azman & Michael Galen, *Blocking a Bankruptcy Filing Still A Remote Possibility*, Law360 (May 6, 2016), http://www.law360.com/articles/792943/blocking-a-bankruptcy-filing-still-a-remote-possibility.

[3] *See In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 262 n.9 (Bankr. D. Del. 2016).

consider whether the director or member retains a fiduciary duty to the debtor. This memorandum explores what these mechanisms are and when they are void against public policy in a fourfold approach. Part I addresses the public policy issues that courts must consider when dealing with a creditor's efforts to control a company's bankruptcy filing. Part II examines what a blocking director is and when it is used. Part III explains what a golden share member is and when it is used. Finally, Part IV concludes that a creditor cannot generally block a debtor from filing for bankruptcy unless the creditor's designee retains a fiduciary duty to the debtor.

I. A Natural Person and Corporate Entity Have a Right to File for Bankruptcy.

Because corporate entities, like a natural person as defined in section 101(41) of the United States Bankruptcy Code ("Code"), have the right to voluntarily file for bankruptcy,[4] "prohibiting such entities from availing themselves of the bankruptcy laws . . . is generally considered bad form."[5] In *In re General Growth Properties, Inc.*, the United States Bankruptcy Court for the Southern District of New York decided whether a business trust was eligible to file for chapter 11 bankruptcy.[6] Under the Code, a person, which includes a corporation, may be a debtor under chapter 7 and 11.[7] In *General Growth*, a creditor challenged the eligibility of the debtor, a business trust, to file for bankruptcy.[8] The court was reluctant to find that a business trust was not a corporation and thus ineligible to file for bankruptcy.[9] The court held that a

[4] *See Klingman v. Levinson*, 831 F.2d 1291, 1296 (7th Cir. 1987),
[5] *In re Lake Mich. Beach Pottawattamie Resort, LLC*, 547 B.R. at 911-12 (citing *In re Gen. Growth Properties, Inc.*, 409 B.R. 43, 49 (Bankr. S.D.N.Y. 2009)).
[6] *Gen. Growth*, 409 B.R. at 70.
[7] 11 U.S.C. § 101(41); 11 U.S.C. § 109(d).
[8] *Gen. Growth*, 409 B.R. at 55.
[9] *Gen. Growth*, 409 B.R. at 72.

business trust is a corporation for purposes of bankruptcy and rejected the argument that the debtor was unable to file for bankruptcy.[10]

Courts are reluctant to find that a corporation or a person as defined within the Code is ineligible to file for bankruptcy.[11] The public policy courts are protecting is to "assure access to the right of a person, including a business entity, to seek federal bankruptcy relief."[12] Some corporations create devices, such as single-purpose entities ("SPE"), to eliminate the risk that a borrower will file for bankruptcy. "Bankruptcy-remote structures [or SPEs] are devices that reduce the risk that a borrower will file bankruptcy or, if bankruptcy is filed, ensure the creditor procedural advantages in the proceedings."[13] An SPE is an entity that is created with assets but has limited or no operations.[14] The entity may not file for bankruptcy without the unanimous consent of all of its directors.[15] The entity also acts as the borrower and the guarantor of the loan.[16] Additionally, "the organizational documents of the entity provide that the prohibited actions may not be taken if a specific director's seat is vacant, and that director is nominated by the secured creditor."[17]. Although filing for bankruptcy must be done in accordance with state corporate law and corporate formalities,[18] courts will invalidate SPE provisions if they eliminate the debtor's the right to voluntarily file for bankruptcy.[19]

II. What is a Blocking Director and When is it Used in Bankruptcy?

[10] *Id.* at 71-71.
[11] *See generally Gen. Growth*, 409 B.R. at 72.
[12] *In re Intervention Energy Holdings, LLC*, 553 B.R. at 265.
[13] Michael T. Madison, et. al., *The Law of Real Estate Financing*, § 13:38 (2008).
[14] *In re Lake Mich. Beach Pottawattamie Resort, LLC*, 547 B.R. at 911.
[15] *Id.*
[16] *Id.*
[17] *Id*
[18] *In re N. Wacker, LLC*, 510 B.R. 854, 858 (Bankr. N.D. Ill. 2014),
[19] *See In re Lake Mich. Beach Pottawattamie Resort, LLC*, 547 B.R. 899.

In general, a corporation's bylaws will provide that the corporation may file for bankruptcy only upon a majority vote of its directors. In some instances, a corporation's bylaws may require unanimous vote by its directors. A creditor that has leverage over a corporation may insist on the appointment of a blocking director on the corporation's board. A blocking director, while having no statutory basis in bankruptcy, is a common tool used by creditors to reduce the risk that a debtor will file for bankruptcy.[20] The purpose of a blocking director is apparent: to withhold its vote and block a voluntary bankruptcy petition.[21] "One specific director, chosen by the secured creditor, may withhold its vote and this block, hence the name, a voluntary bankruptcy petition."[22] The blocking director is the cornerstone of a SPE or a "bankruptcy remote entity."[23] However, a blocking director is not limited to an SPE.[24] In *In re Lake Michigan Beach Pottawattamie Resort, LLC*, the debtor, after defaulting on its loan to the creditor, contracted for the creditor to have blocking director on the debtor's board approximately ten months after their lender/lendee relationship began in order for the creditor to forbear pursuing remedies for the default.[25] Companies go through with this method because most other simpler prohibitions against filing for bankruptcy are void as against public policy.[26]

III. What is a Golden Share Member and When is it Used?

A golden share is "a type of share that gives its shareholder veto power over changes to the company's charter."[27] The holder of the golden share obtains the right "to veto certain critical

[20] Michael T. Madison, et. al., *The Law of Real Estate Financing*, § 13:38.
[21] *In re Lake Mich. Beach Pottawattamie Resort, LLC*, 547 B.R. at 911.
[22] *Id.*
[23] *Id.*
[24] *See Id.* at 903-04.
[25] 547 B.R. at 903.
[26] *Id.* at 911.
[27] *In re Intervention Energy Holdings, LLC*, 553 B.R. at 262 n.9.

company decisions."[28] A golden share member has the ability to control a company.[29] The holder can "overrule the wishes of all of the other shareholders, even if those other shareholders constitute a majority of the ownership."[30] One of the veto rights of a golden share member generally is the right to veto a bankruptcy filing by the debtor.[31]

The term "golden share" was first used in the United Kingdom during the 1980s.[32] A golden share was mainly used to refer to a government retaining control over newly privatized companies.[33]

IV. Parties Cannot Contract Away the Fiduciary Duty Owed From a Creditor to a Debtor in an SPE Provision Without Violating Both State and Federal Public Policy.

Courts are reluctant to enforce contractual provisions and bylaws that eliminate the fiduciary duty owed from the director to the debtor. In *In re Lake Michigan Beach Pottawattamie Resort, LLC*, the United States Bankruptcy Court for the Northern District of Illinois held that a blocking director provision was invalid because it impermissibly eliminated the fiduciary duty owed by the creditor to the debtor, and thus, was void as against public policy.[34] The debtor granted a mortgage and assignment of rents to BCL – Bridge Funding ("BCL") to secure a loan and a line of credit given by BCL to the debtor.[35] The debtor defaulted on its payment and the

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[28] *Id.*
[29] *InvestingAnswers – Golden Share*, INVESTINGANSWERS, http://www.investinganswers.com/financial-dictionary/businesses-corporations/golden-share-3623.
[30] *Id.*
[31] Eric L. Johnson & Mark G. Stingley, *First Glance: Feature, Intervention Energy Holdings: Good Public Policy, or Unnecessary Intrusion into State Law?* 35 ABIJ 20 (2016).

[32] Christine O'Grady Putek, *Comment: Limited But Not Lost: A Comment on the ECJ's Golden Share Decisions*, 72 FORDHAM L. REV. 2219, 2222 (2004).
[33] *Id.*
[34] 547 B.R. at 914.
[35] *Id.* at 903.

debtor and creditor created a Forbearance Agreement.[36] At BCL's request, the debtor agreed to execute an amendment to its operating agreement (the "Third Amendment") establishing BCL as a "Special Member" with the right to approve or disapprove any material action by the debtor.[37] The provision requires the debtor to obtain BCL's consent, which could be withheld for any reason, before filing for bankruptcy.[38] The agreement also contained a waiver of the fiduciary duty owed by the special member to the debtor by stating that BCL was not obligated to consider any interests but their own and has no obligation to give any consideration to the debtor's interests.[39] When the debtor filed for bankruptcy, four out of five directors voted in favor of the filing, with BCL withholding its vote.[40] BCL, in its motion to dismiss the debtor's chapter 11 case, argued that the debtor was not authorized to file for chapter 11 bankruptcy because the debtor did not have the consent of the blocking director.[41]

The court determined that the use of a blocking director and the requirement of a unanimous vote by the directors in order for a debtor to file for bankruptcy was permissible under Michigan law.[42] The court then analyzed whether the blocking director described in the Third Amendment was against public policy.[43] Relying on case law, the court noted that a corporate entity cannot contract away its right to file for bankruptcy.[44] A director, including a blocking director has a fiduciary duty to the corporate entity.[45] The prohibition on the debtor to be unable to file for bankruptcy without consent from the blocking director, as noted in the Third

[36] *Id.* at 903.
[37] *Id.* at 903-04.
[38] *Id.* at 904.
[39] *Id.*
[40] *Id.*
[41] *Id.* at 909.
[42] *Id.* at 910.
[43] *Id.* at 911.
[44] *Id.* at 912.
[45] *Id.*

Amendment, is impermissible as against public policy because it (1) provided that BCL did not have a fiduciary duty to the debtor, and (2) allowed BCL (as the blocking director) to block the debtor's bankruptcy filing.[46]

In *In re Intervention Energy Holdings, LLC*, the United States Bankruptcy Court for the District of Delaware held that a provision requiring the consent of a creditor for a bankruptcy filing is "tantamount to an absolute waiver" of the right to file for bankruptcy and is "void as contrary to federal public policy" where the creditor did not have a fiduciary duty to the debtor.[47] In this case, the debtor and the creditor entered into a Note Purchase Agreement whereby the creditor "provided up to $200 million in senior secured notes."[48] The secured notes were secured by liens on the debtor's assets.[49] The debtor and the creditor then entered into Amendment No. 3 to the original Note Purchase Agreement that contained several Maintenance Covenants.[50] When the debtor failed to comply with those Maintenance Covenants, the creditor and the debtor entered into Amendment No. 5, Forbearance Agreement, and Contingent Waiver.[51] "As a condition to the effectiveness of the Forbearance Agreement," the debtor issued a common unit to EIG (the creditor). Under the company's limited liability company agreement, a bankruptcy filing was subject to the unanimous approval of the holder of common units.[52] The United States Bankruptcy Court for the District of Delaware noted that "but for the Amendment, [the debtor] would have been authorized to seek federal bankruptcy relief."[53]

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[46] *Id.* at 913-14.
[47] 553 B.R. at 265.
[48] *Id.* at 261.
[49] *Id.*
[50] *Id.*
[51] *Id.* at 261.
[52] *Id.*
[53] *Id.*

The debtor in *In re Intervention Energy Holdings, LLC*, relying on the holding in *In re Lake Michigan Beach Pottawattamie Resort LLC*, argued that the "golden share" given to the creditor is similar to the blocking director in *In re Lake Michigan*.[54] The debtor further argued that because the creditor did not owe the debtor a fiduciary duty, the provision requiring unanimous consent from all creditors before the debtor could file for bankruptcy should be void as against federal public policy.[55] The court agreed.[56] The court, citing to several cases, noted that a debtor may not contract away their right to file for bankruptcy.[57] The Bankruptcy Court stated that the federal public policy is to "assure access to the right of a person, including a business entity, to seek federal bankruptcy relief."[58] Because the sole purpose of the provision was to place in the hands of a single creditor the authority to block the debtor from filing for bankruptcy without a owing a fiduciary duty to said debtor, the provision, the court held, is void as against federal public policy even though it may be permitted by state law.[59]

Conclusion

Blocking directors, golden shares, and SPE's are generally permissible under state law. However, courts have been reluctant to enforce a provision, such as a blocking director or a golden share provision, where the parties contract away the fiduciary duty owed by the creditor because the provision and the withholding of consent denies the debtor the right to voluntarily file for bankruptcy and, thus, is void as against both state and federal public policy. Because of

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[54] *Id.* at 262; *see In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899.
[55] *In re Intervention Energy Holdings, LLC*, 553 B.R. at 262.
[56] *Id.* at 265.
[57] *Id.* at 263; *see also Klingman v. Levinson*, 831 F.2d 1292 n.3 (7th Cir. 1987) ("For public policy reasons, a debtor may not contract away the right to discharged in bankruptcy."); *see also Hayhoe v. Cole*, 226 B.R. 647, 651-54 (9th Cir. BAP 1998) ("If any terms in the Consent Agreement . . . exist that restrict the right of the debtor parties to file bankruptcy, such terms are not enforceable.").
[58] *Id.* at 265.
[59] *Id.*

the fiduciary duty owed by the director, the director, albeit appointed by a creditor, cannot withhold consent without having the best interest of the debtor in mind. Therefore, a creditor may only withhold consent from a debtor to file for bankruptcy when they find that it is in the best interest of the debtor to not file for bankruptcy.