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Feature

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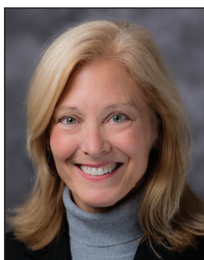
Considerations in Evaluating LLC Operating Agreement Constraints on Voluntary Filings



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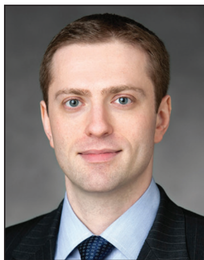

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Corporate entities may voluntarily commence bankruptcy only with valid authorization as determined by applicable state law.[2] Bankruptcy-remote entities (special-purpose entities (SPEs) or special-purpose vehicles) are specifically structured to isolate credit risk to the SPE assets and minimize bankruptcy risk. The limited liability company (LLC) is a form of organization that is often used to deter bankruptcy filings through provisions in the operating agreement such as the requirement for unanimous votes. While recent decisions have invalidated certain such constraints on federal public policy grounds when implemented at a creditor's request, future decisions could view the various policy considerations differently and reach other conclusions, particularly with other transaction structures.

Background

The recent *Lake Michigan* and *Intervention Energy* decisions have received significant attention by addressing the validity of such corporate authority constraints.[3] Both decisions dealt with LLC borrowers, organized under Michigan and Delaware law (respectively), that defaulted on their loans and, in exchange for forbearance from their senior secured lenders, amended their operating agreements to give their lenders *de minimis* membership interests and require unanimous member consent to authorize a voluntary bankruptcy. In both situations, the amended operating agreements attempted to eliminate any duties of the lenders in their capacities as LLC members to other members or the corporate entity.[4] After the borrowers failed to recover, voluntary bankruptcy cases were commenced without lender consent. In both cases, motions to dismiss were filed and ultimately denied, but on different grounds.

The *Lake Michigan* decision concluded that the operating agreement amendment was unenforceable "both as a matter of Michigan corporate governance and bankruptcy law."[5] The Michigan law holding was based on an identified conflict between the non-waivable duty under state law for managers to act in good faith in the best interests of the LLC and the explicit disclaimer of any duties for the lender/member under the operating agreement,[6] while the bankruptcy law holding was based on the reasoning that a blocking director or manager structure may be valid as a matter of bankruptcy law — only if such person remains subject to "normal ... fiduciary duties" that enable a vote for bankruptcy even if contrary to the lender's interests.[7]

In contrast, the *Intervention Energy* decision denied dismissal solely on federal grounds.[8] Starting from the proposition that debtors may not contract away bankruptcy rights, the court concluded that the amendment to the operating agreement, by giving the ability to block bankruptcy to an entity in

1 The authors published supporting materials for ABI's Views from the Bench 2017, *available at* abi.org/education-events/sessions/special-issues-involving-llcs, with certain similarities or overlaps on this article.

2 *See, e.g., Keenihan v. Heritage Press Inc.*, 19 F.3d 1255, 1258 (8th Cir. 1994) (citing *Price v. Gurney*, 324 U.S. 100, 106 (1945)).

3 *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016); *In re Intervention Energy Holdings LLC*, 553 B.R. 258 (Bankr. D. Del. 2016).

4 *Cf. In re Gen. Growth Props. Inc.*, 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009) (with operating agreement language imposing fiduciary duties on independent managers "similar to that of a director of a [Delaware] business corporation," holding that those managers properly considered interests of parents and that their authorization to voluntarily commence bankruptcy was not objectively bad faith).

5 547 B.R. at 914.

6 *Cf.* M.C.L.A. § 450.4401 (LLC members have manager duties if the operating agreement does not provide for a manager).

7 547 B.R. at 914.

8 553 B.R. at 265-66.

primarily a creditor's relationship with the debtor and with no duties to anyone else, was "tantamount to an absolute waiver of [the] right" to seek federal bankruptcy relief and was therefore void under federal public policy, even if permitted under state law.[9]

More recently, the *Lexington Hospitality* decision addressed a similar situation with an LLC borrower organized under Kentucky law.[10] The borrower obtained financing involving, among other things, operating agreement amendments to (1) provide the lender with a 30 percent membership interest until the repayment of the loan and certain additional fees, (2) prohibit filing for bankruptcy without the consent of at least 75 percent of member interests and (3) appoint an "independent manager" responsible solely for providing or withholding consent to a voluntary filing after considering the interests of creditors and without fiduciary duties to any LLC members.[11]

Agreeing with *Intervention Energy* that provisions in an operating agreement that essentially prohibit a bankruptcy filing without creditor consent are void, and with the *Lake Michigan* position that the power to approve or deny a bankruptcy filing must be exercised by fiduciaries, the court concluded that the provisions gave the lender the ability to prevent the LLC from filing for bankruptcy without consideration of the best interests of the LLC and were therefore unenforceable on federal public policy grounds.[12] To date, there have been few other decisions on point, and a consensus approach to such issues has not yet developed.

In *In re Global Ship Sys. LLC*,[13] the court dismissed the case after finding that the LLC debtor had engaged in bad faith by soliciting creditors to file an involuntary petition when its operating agreement prohibited filing a voluntary petition without the consent of the Class B equity member. The Class B equity, comprising 20 percent of the LLC equity, had been acquired by the LLC's secured creditor in the initial financing (along with 18 percent annual interest plus fees) three years previously.[14] Although the petition was to forestall a lender foreclosure that would yield no equity recoveries, the court characterized the lender as wearing "two hats" and affirmed its right as a Class B member to withhold consent to a bankruptcy filing.[15]

In *In re DB Capital Holdings LLC*,[16] the court affirmed dismissal of a voluntary petition filed by the LLC manager without unanimous member consent as required by the amended operating agreement. Despite allegations that the amendment was executed at the demand and for the sole benefit of the secured creditor (five months after formation and more than two years before financial difficulties), the court rejected the public policy argument due to the lack of supporting authority. The court reasoned that cases "involv[ing] a debtor's agreement with third parties to waive the benefits of bankruptcy" do not "stand ... for the proposition that members of an LLC cannot agree among themselves not to file [for] bankruptcy" or that "such [an] agreement [would be] void as against public policy").[17]

In *In re Bay Club Partners–472 LLC*,[18] the court addressed motions to dismiss that were filed by the secured creditor and an LLC member after the LLC voluntarily filed for bankruptcy, nine years after being formed with an operating agreement that barred filing for bankruptcy with any secured indebtedness outstanding. With testimony that the provision had been included at the secured creditor's request, the court applied prior case law on pre-petition contractual waivers of specific bankruptcy protections to conclude that the provision was unenforceable on public policy grounds.[19]

> **[P]arties seeking improved bankruptcy remoteness might benefit from factually distinguishing their structures from those at issue in *Lake Michigan, Intervention Energy* and *Lexington Hospitality*.**

In *In re Squire Court Partners Ltd. P'ship*,[20] the court affirmed dismissal of a voluntary petition filed by the general partner of a limited partnership without the consent of the limited partners as required by the partnership agreement. The court distinguished the *Lake Michigan* conclusion that blocking structures required fiduciary duties to be valid, noting that corporate directors have decision-making authority because of delegation rather than fiduciary duties, and held that non-fiduciary owners may have a controlling role in the bankruptcy decision-making process.[21]

Discussion

The scarcity of pertinent decisions might suggest that such provisions have been largely effective in keeping borrowers out of the bankruptcy courts. Alternatively, such provisions might be more likely in situations where the economics after default do not incentivize the borrower to fight a motion to dismiss the bankruptcy case; notably, neither of the *Lake Michigan* and *Intervention Energy* debtors were able to successfully reorganize, and both bankruptcy cases were dismissed for cause within months of those decisions being issued. Regardless, such decisions might prompt further litigation.

Future decisions on such provisions might be called upon to further explore the intersection of bankruptcy policies with other federal policies, such as deference on corporate authority issues to state law.[22] In addition, while denials of motions to dismiss will generally be interlocutory and without appeal rights, future litigants might consider whether the validity of operating agreement provisions is a question existing outside of bankruptcy, or is a core matter such that a final judgment might be entered by the bankruptcy court.

9 *Id.* at 265.
10 *In re Lexington Hospitality Grp. LLC*, No. 17-51568 (GRS), 2017 WL 4118117 (Bankr. E.D. Ky. Sept. 15, 2017).
11 *Id.* at *2-3.
12 *Id.* at *6-7.
13 391 B.R. 193 (Bankr. S.D. Ga. 2007).
14 *Id.* at 197.
15 *Id.* at 203.
16 No. 10-046, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010).
17 *Id.* at *3.
18 No. 14-30394 (RLD), 2014 WL 1796688 (Bankr. D. Ore. May 6, 2014).
19 *Id.* at *4-5.
20 No. 16-00935 (JLH), 2017 WL 2901334 (E.D. Ark. July 7, 2017).
21 *Id.* at *4.

Future decisions might also find it necessary to further develop the bridge, if any, between the public policies at issue with contractual waivers of specific bankruptcy rights (such as the automatic stay or the discharge) and those at issue with restricting voluntary filings, or between the public policies at issue with preserving a fresh start for individuals with preserving going-concern value for creditors of a corporate entity and may also consider prior case law on decision-making by corporate fiduciaries in other bankruptcy-related contexts. For example, courts have held that (1) bad-boy/springing guaranties are not unenforceable on public policy grounds,[23] (2) lenders can validly enforce pledge agreements to obtain voting control of defaulting borrowers and thereby prevent valid authorization of a voluntary bankruptcy,[24] and (3) in certain circumstances, a borrower might be prohibited from voluntarily commencing bankruptcy to repudiate post-default restructuring agreements with its lender.[25]

Both borrowers and lenders will continue to have incentives when arranging financing to pursue bankruptcy remote structures as a credit enhancement to manage risks and lower borrowing costs.[26] In certain situations, both borrowers and lenders will also continue to have incentives to implement bankruptcy remote structures to induce additional extensions of credit or forbearance as an alternative to bankruptcy or the exercise of lender remedies.

Accordingly, courts might eventually be required to engage in an increasingly complex balancing of competing policies when considering such arrangements. At the margins, courts might be called upon to determine whether under any circumstances (1) a fiduciary may bargain away any consent rights over a voluntary filing to a creditor, (2) a creditor may acquire the otherwise-valid rights of a non-fiduciary to consent to a voluntary filing, and (3) corporate authority to voluntarily commence bankruptcy might be conditioned on non-fiduciary member or creditor consent.

Structural Features

Parties seeking to improve the bankruptcy remoteness of their financing arrangements might be better to distinguish certain prior decisions with structural features like the following:

- The operating agreement should limit the manager to act in the ordinary course, with other actions (explicitly including bankruptcy) requiring independent director or unanimous/supermajority member consents.
- The operating agreement should be structured to validly eliminate fiduciary duties for the blocking director, manager or member (and other duties between members in making such decisions, to the extent possible). Such persons should be required to consider only the interests of the LLC itself (and its creditors), not the interests of other members, parents/affiliates or guarantors, in making the bankruptcy decision. The circumstances for removal of such persons should be constrained, with associated requirements for lender notification and consent.
- As an alternative to a blocking-director structure, the LLC might be structured with multiple classes of shares/interests, with the consent of each class being required to voluntarily file, and with one class being held by independent third parties without other managerial responsibilities.
- Lender interests in the LLC should have equity characteristics rather than being ineligible for economic participation or automatically reverting to the LLC or other members upon loan satisfaction. Other rights, such as tagalong rights or put options, might facilitate lenders' exit upon repayment.
- If the LLC may seek financing in the future, members or sponsors should consider forming the LLC with features facilitating bankruptcy remoteness in advance of any such creditor request.
- The lender may obtain a pledge or transfer of key LLC interests or voting rights upon default, with associated powers of attorney or automatic effectiveness.
- Bad-boy/springing guaranties should remain enforceable and effective means of disincentivizing voluntary filings. Such guaranties could also be structured to become effective upon court order, voiding other lender protections, such as the blocking director structure.
- The lender or blocking director could seek a declaratory judgment in state/federal court, in advance of bankruptcy, on authority to file without operating agreement compliance. Obtaining a confession of judgment to hold pending default might facilitate such relief.

Conclusion

In advance of further development of the relevant public policy questions, parties seeking improved bankruptcy remoteness might benefit from factually distinguishing their structures from those at issue in *Lake Michigan*, *Intervention Energy* and *Lexington Hospitality*. Regardless, borrowers and lenders can be expected to continue pursuing bankruptcy remoteness to realize mutual benefits. **abi**

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22 *See, e.g., Price v. Gurney*, 324 U.S. 100 (1945) (holding that chapter X petition filed by shareholder was without authority and requiring dismissal despite allegations of substantial conflicts due to majority of debtor stock being held in voting trust controlled by bondholders, noting availability of state law remedies for such conflicts); *Chicago Title & Trust Co. v. Forty-One Thirty-Six Wilcox Bldg. Corp.*, 302 U.S. 120 (1937) (holding that corporation in dissolution proceedings and lacking authority under state law to initiate proceedings could not file voluntary petition). *See also, e.g.*, Bruce A. Markell, "Fool's Gold?: Opting Out of Bankruptcy by Manipulating State Entity Law," 36 No. 8, *Bankruptcy Law Letter* (August 2016) (questioning application of bankruptcy policies to override LLC authority limitations valid under state law in light of *Price* and *Chicago Title* decisions); Marshall E. Tracht, "Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law," 82 *Cornell L. Rev.* 301, 308-09 (1997) (noting "missing analysis" from decisions invalidating contractual provisions prohibiting voluntary filings on public policy grounds).

23 *See, e.g., F.D.I.C. v. Prince George Corp.*, 58 F.3d 1041, 1046 (4th Cir. 1995) (holding that springing guaranty upon bankruptcy is not unenforceable as against public policy since "the [guaranty] did not prohibit [the guarantor] from resorting to bankruptcy") (quoting *Twin City Pipe Line Co. v. Harding Glass Co.*, 283 U.S. 353, 356-57 (1931) ("The principle that contracts in contravention of public policy are not enforceable should be applied with caution and only in cases plainly within the reasons on which that doctrine rests.")).

24 *See, e.g., Keenihan*, 19 F.3d at 1258 (where borrower had pledged controlling equity stake to its lender as collateral, with voting proxy for such shares and power of attorney to record transfer after default, court held that lender had prevented borrower from validly filing for bankruptcy after exercising on pledged shares, recording such transfers and displacing officer attempting to file).

25 *See, e.g., United States v. Royal Bus. Funds Corp.*, 724 F.2d 12, 15-16 (2d Cir. 1983) (where borrower attempted to file for bankruptcy after having defaulted on its Small Business Administration (SBA) loans and agreeing to substantial additional financing from SBA and receivership by SBA, court reasoned that "no public or private interest is served by allowing [the borrower] to repudiate the arrangements it made with the SBA" and rejecting "absolute right to file a bankruptcy petition" under circumstances). *Cf. United States v. Kras*, 409 U.S. 434, 446-47 (1973) ("There is no constitutional right to obtain a discharge of one's debts in bankruptcy.").

26 *See generally, e.g., In re Doctors Hosp. of Hyde Park Inc.*, 507 B.R. 558, 701, 704-05 (Bankr. N.D. Ill. 2013) (discussing potential benefits of bankruptcy remote financing for borrowers and lenders).