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Feature

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The Missing Page of the Playbook

"Blocking Directors" Can't Escape Fiduciary Duty

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As every commercial bankruptcy practitioner knows, a voluntary petition must be properly authorized by a company's governing body, otherwise it will be vulnerable to dismissal. This requirement is so important that evidence of such authorization is generally filed in support of a voluntary petition, as is required by the local bankruptcy rules in several districts.[1]

However, for so-called "bankruptcy-remote" companies, it can be difficult — if not impossible — to obtain all of the necessary consents due to governance provisions that often grant control (or veto power) over the decision to file for bankruptcy to lender-controlled directors (called the "blocking directors"). These companies typically require unanimous director consent, or the consent of the blocking director, to authorize filing a bankruptcy petition.

While there is nothing inherently improper about lender-controlled directors, a recent decision by the U.S. Bankruptcy Court for the Northern District of Illinois in *In re Lake Michigan Beach Pottawattamie Resort LLC*[2] serves as a cautionary tale. In this case, the bankruptcy court refused to dismiss a voluntary petition that was admittedly filed without the approval of a blocking director. The court held that provisions in the governance documents granting the blocking director with complete self-interested veto power over bankruptcy filings were unenforceable because they relieved the blocking director of fiduciary duties to the company and its members.

Background

The facts of *Lake Michigan Beach* fit within a familiar framework: a troubled borrower making concessions to a lender in connection with a workout. Prior to the bankruptcy, Lake Michigan Beach Pottawattamie Resort LLC (the debtor) granted a mortgage and other security to BCL-Bridge Funding LLC (the lender) to secure a $1.34 million loan and a $500,000 line of credit.[3] Its collateral included a vacation resort with seasonal rentals and undeveloped land.[4]

A few months after the original financing transaction, the debtor defaulted on its monetary obligations to the lender. To avoid foreclosure, the debtor entered into a forbearance agreement in which it stipulated to a default and promised to (and did) amend its operating agreement so that the lender became a "special member" of the debtor, without any economic interest but "with the right to approve or disapprove of any" bankruptcy filing.[5] In other words, the lender became a blocking director. As the court observed,

> when exercising its rights under the [amended operating agreement], [the lender] is not obligated to consider any interests or desires other than its own and has "no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members."[6]

Shortly thereafter, the debtor defaulted again, and the lender started foreclosure proceedings.[7] Predictably, the day before a foreclosure sale, the debtor filed a chapter 11 petition, which prevented the foreclosure sale and led to the lender's motion to dismiss in which it contended that the petition was an "unauthorized filing."[8] The following facts appear to have been uncontested:

1 *See, e.g.*, Rule 1002-1(b) of the Local Rules for the U.S. Bankruptcy Court for the District of Delaware; Rule 1074-1 of the Local Bankruptcy Rules for the U.S. Bankruptcy Court for the Southern District of New York; Rule 1002-1(b)(1) of the Local Rules for the U.S. Bankruptcy Court for the District of Maine.
2 547 B.R. 899 (Bankr. N.D. Ill. 2016).
3 *Id.* at 903.
4 *Id.* The collateral also included some nondebtor property.
5 *Id.* at 904. While it might be more accurate to say that the lender became a "blocking member" of the debtor, the term "blocking director" is widely used.
6 *Id.*
7 *Id.*
8 The lender also argued that the petition was a bad-faith filing. In the absence of the "unauthorized filing" argument, the bad-faith issue "could have been handled summarily" because such motions are routine. The court rejected these arguments. *Id.* at 905.

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> Attached to the Debtor's petition is a consent to file [for] bankruptcy signed by four members of the Debtor. A signature on behalf of [the lender], as the Special Member, was not included. The Debtor agrees that [the lender] has not consented to the Debtor's bankruptcy petition and that this case was filed on the eve of the foreclosure sale.[9]

In response, the debtor argued that the blocking-director provision in its operating agreement was "void as against public policy because it amounts to a prohibition of the Debtor's right to exercise its right to bankruptcy relief and, alternatively, is not valid under Michigan law."[10]

The Court's Decision

The bankruptcy court ultimately agreed with the debtor that a complete self-interested veto power over a bankruptcy filing was unenforceable under Michigan and federal bankruptcy law. Thus, the court denied the lender's motion to dismiss.

The court reviewed the provision of the operating agreement requiring unanimous director consent to authorize a bankruptcy filing under Michigan law to see if it actually prohibited the bankruptcy filing. As the court pointedly observed, "if the operating agreement, as amended, does not prohibit the filing as effectuated, then the argument with respect to the validity of the provision is unfounded."[11] While Michigan law generally calls for "a vote of the majority in interest of the members entitled to vote" on a given issue, it also allows "for operating agreements to override the default majority of interests requirement set forth in section 450.4502(8)."[12] Thus, the unanimous-consent provision of the operating agreement was not inherently invalid, and the debtor's bankruptcy petition was presumptively unauthorized because it lacked the lender's consent.

However, the court then considered whether the blocking-director provisions were void as a matter of public policy under state or federal law. The court acknowledged the tension between two competing public policies: on the one hand, protecting the fundamental, federal right to invoke bankruptcy protection (which the court characterized as including rights "so seminally important that they were specifically authorized under the Constitution"), and on the other hand, respecting "corporate formalities and state corporate law ... in commencing a bankruptcy case."[13] For example, while outright prohibitions against bankruptcy filings in corporate governance documents have uniformly been rejected as being contrary to public policy, that is not the case for governance provisions creating bankruptcy remote corporate structures, even though they are aimed at reaching the same result, with one caveat: Blocking directors must be required to act in the best interests of the business they govern.[14] Thus:

> Even though the blocking director structure ... impairs or in operation denies a bankruptcy right ... [i]t has built into it a saving grace: the blocking director must always adhere to his or her general fiduciary duties to the debtor in fulfilling the role.... The essential playbook for a successful blocking director structure is this: the director must be subject to normal director fiduciary duties and there in some circumstances vote in favor of a bankruptcy filing, even if not in the best interests of the creditor that they were chosen by.[15]

Blocking directors serve a valuable purpose by providing a lender additional influence over a troubled borrower, but a lender cannot make an end-run around the Bankruptcy Code by trying to relieve blocking directors of their state law fiduciary duties.

Unfortunately for the lender, its "playbook was ... missing this page."[16] Specifically, Article 12.4(iv) of the debtor's operating agreement eliminated the fiduciary duties owed to the debtor and its members by the lender in its capacity as a blocking director:

> Notwithstanding anything provided in the Agreement (or other provision of law or equity) to the contrary, in exercising its rights under this Section, *the Special Member shall be entitled to consider only such interests and factors as it desires, including its own interests*, and shall to the fullest extent permitted by applicable law, have *no duty or obligation to give any consideration to any interests of or factors affecting the Company or the Members*.[17]

The bankruptcy court ruled that this provision was "unenforceable, both as a matter of Michigan corporate governance and bankruptcy law."[18] Importantly, "[b]y excluding the Debtor's interests from consideration by [the lender] ... thereby allowing [it] to consider only its own best interests, the Third Amendment also expressly eliminates the only redeeming factor that permits the blocking director ... construct."[19] As a result, the provision of the debtor's operating agreement requiring the blocking director's consent to a bankruptcy filing was unenforceable, the consent of all remaining directors to the filing was sufficient, and the lender's motion to dismiss was denied.

Analysis

Following this decision, the playbook should now be clear for lenders looking to block borrowers from filing for bankruptcy. While outright prohibitions against bankruptcy filings in corporate governance documents will not withstand

9 *Id.* at 904.
10 *Id.* at 905.
11 *Id.* at 909.
12 *Id.* at 910 (quoting Mich. Comp. Laws Ann. § 450.4502(8)), 911.
13 *Id.* at 911-12 (citing, *inter alia*, *Gen. Growth Props. Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), and *NNN 123 N. Wacker LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014)).
14 *Id.* at 912 ("[C]ommon wisdom dictates that the corporate control documents should not include an absolute prohibition against bankruptcy filing.") (citing *Trans World Airlines Inc.*, 261 B.R. 103 (Bankr. D. Del. 2001), and *In re Tru Block Concrete Prods. Inc.*, 27 B.R. 486 (Bankr. S.D. Cal. 1983)).
15 *Id. See also Gen. Growth Props.*, 409 B.R. at 64 ("[I]f [the] Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken."); *In re Kingston Sq. Assocs.*, 214 B.R. 713, 735-36 (Bankr. S.D.N.Y. 1997) (blocking director "completely ignored the limited partners' plight in the face of foreclosure actions instituted by the group which placed him on the boards of directors of these and other companies and saw to it that he was paid fees").
16 *Lake Michigan Beach*, 547 B.R. at 913.
17 *Id.* at 914 (quoting Article 12.4(iv) of debtor's operating agreement) (emphasis added).
18 *Id.*
19 *Id.*

scrutiny, blocking directors can be used to exert influence, provided they do not eliminate directors' fiduciary duties to the companies they govern. In fact, in *Lake Michigan Beach*, the debtor's own bankruptcy-remote structure might have been respected had the lender not overreached by eliminating its state law fiduciary duties to the debtor.

This decision should remind debtors that they are not powerless against blocking directors' intransigence. If a blocking director ignores an existential threat to a company's continued operations (such as foreclosure of substantially all of the company's core assets), then the debtor may have state law breach-of-fiduciary-duty claims. This is the trade-off for bankruptcy-remote structures. While such claims may not be a quick fix to a director's intransigence, the fact that fiduciary duties cannot be contracted around to eliminate the right to file for bankruptcy may avoid the problem in the first place.

Conclusion

The court's decision provides clear guidance for debtors and lenders considering governance provisions aimed at making a business "bankruptcy remote."[20] Blocking directors serve a valuable purpose by providing a lender additional influence over a troubled borrower, but a lender cannot make an end-run around the Bankruptcy Code by trying to relieve blocking directors of their state law fiduciary duties. abi

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20 The decision was recently followed in a case involving a "golden shareholder" with blocking rights akin to *Lake Michigan Beach. In re Intervention Energy Holdings LLC*, Case No. 16-11247, Opinion, D.E. 69 (Bankr. D. Del. June 3, 2016).