By Sidney P. Levinson, Elie J. Worenklein and Mitchell Carlson

Can "Golden Shares" and "Blocking Directors" Actually Prevent Filings?

Sidney P. Levinson
Debevoise & Plimpton LLP; New York

Elie J. Worenklein
Debevoise & Plimpton LLP; New York

Mitchell Carlson
Debevoise & Plimpton LLP; New York

Sidney Levinson is a partner and co-chair of Debevoise & Plimpton LLP's Restructuring Group. Elie Worenklein is corporate counsel and Mitchell Carlson is a corporate associate. They are based in New York.

Not surprisingly, lenders generally view a borrower's ability to file for bankruptcy as an unwelcome intrusion on their exercise of remedies in the event of default. Most lenders would, if able, require borrowers to waive their right to seek bankruptcy relief entirely. That said, it is well settled that a contractual waiver of an entity's right to file for bankruptcy is invalid as a matter of public policy.[1]

Lenders have sought to circumvent this prohibition in a variety of ways, including by limiting the debtor's authority to file for bankruptcy under its governing organization documents. Two common devices used in this context are "golden shares" and "blocking directors."

A golden share is a type of share that gives its holder consent/veto power over major transactions, such as an acquisition or merger, but also a bankruptcy filing.[2] While typically provided to large shareholders, golden shares have been issued as shares to lenders for the purpose of granting them the equivalent of a consent/veto right over bankruptcy.

Similarly, a blocking director is a director handpicked by a lender, whose consent is then required for any bankruptcy filing or other major transaction.[3] The corporate governance documents often provide that a blocking director owes no fiduciary duty to the borrower and/or need not take into account the best interests of the borrower or its stakeholders in its decision-making.

Bankruptcy courts, wary of efforts to circumvent public policy, have questioned the enforceability of golden shares and blocking directors in governing organizational documents to forestall a bankruptcy filing. In *Intervention Energy*, the bankruptcy court denied a motion to dismiss the case by a party holding a golden share, holding that "[t]he Bankruptcy Code pre-empts the private right to contract around its essential provisions."[4] Likewise, in *Lake Michigan*, the bankruptcy court found that a blocking director's consent was not required to commence a chapter 11 case.[5]

In rejecting efforts by lenders to prevent bankruptcy through the use of golden shares or blocking directors, courts have zeroed in on the absence of any fiduciary duty that such shareholders or directors owe to the borrower or its stakeholders.[6] For example, in *Lake Michigan*, the debtor's limited liability company (LLC) agreement provided that the blocking director had "no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members," leading the court to conclude that such a provision conflicted with Michigan law's requirement that directors consider the interests of the entity. The court observed:

> The essential playbook for a successful blocking director structure is this: the director must be subject to normal director fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor that they were chosen by.[7]

Notwithstanding the public policy concerns previously articulated, courts also afford deference to corporate governance rights under applicable local law that imbue a company with authority to seek bankruptcy protection. Indeed, corporate formalities and applicable state law must be satisfied for a company to commence a bankruptcy case.[8]

In balancing the competing concerns previously described, courts have been more tolerant of golden shares and blocking directors in the context of bankruptcy filings when such rights are exercised by *bona fide* equityholders, even if those shareholders also happen to be creditors of the borrower. In *In re Franchise Services of North America*,[9] a shareholder purchased $15 million in convertible preferred equity and received the equivalent of a veto right to any bankruptcy. An affiliate of the shareholder also earned $3 million in fees that remained unpaid when the company filed for bankruptcy. In affirming dismissal of the bankruptcy on the basis of the shareholder's

1 *See, e.g., Cont'l Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1026 (9th Cir. 2012) ("This prohibition of prepetition waiver has to be the law; otherwise, astute creditors would routinely require their debtors to waive.") (internal citation omitted).
2 *See In re Intervention Energy Holdings LLC*, 553 B.R. 258, 262, n.9 (Bankr. D. Del. 2016).
3 *See In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911 (Bankr. N.D. Ill. 2016).
4 *In re Intervention Energy*, 553 B.R. at 261.
5 *See Lake Michigan*, 547 B.R. at 911-13.
6 *See, e.g., Intervention Energy*, 553 B.R. at 265 (granting creditor "which owes no duty to anyone but itself" the ability to block bankruptcy filing is "tantamount to an absolute waiver of that right").
7 *Lake Michigan*, 547 B.R. at 913; *see also In re Gen. Growth Props. Inc.*, 409 B.R. 43, 64 (Bankr. S.D.N.Y. 2009) ("[I]f [the secured lenders] 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.").
8 *See, e.g., Lake Michigan*, 547 B.R. at 912 ("Bankruptcy law, however, is equally clear that corporate formalities and state corporate law must also be satisfied in commencing a bankruptcy case."); *In re NNN 123 N. Wacker LLC*, 510 B.R. 854, 858 (Bankr. N.D. Ill. 2014) ("The authority to file a bankruptcy petition on behalf of a corporation must derive from state corporate governance law.").
9 891 F.3d 198 (5th Cir. 2018).

refusal to consent to the filing, the Fifth Circuit held that "there is no compelling federal law rationale for depriving a *bona fide* equityholder of its voting rights just because it is also a creditor of the corporation," and that any ruling to the contrary would be, under the facts presented, "the tail ... wagging the dog."[10] The court reached this outcome even though the shareholder who sought dismissal "owe[d] no fiduciary duty to the corporation or its fellow shareholders."[11] The court cautioned:

> A different result might be warranted if a creditor with no stake in the company held the right. So too might a different result be warranted if there were evidence that a creditor took an equity stake simply as a ruse to guarantee a debt. We leave those questions for another day.[12]

Similarly, in *In re 3P Hightstown LLC*,[13] the entity seeking dismissal of the case (the "movant") held preferred membership units and preferred unit capital contributions totaling $500,000, along with a secured loan for $425,000 and a subordinate loan for $125,000. In connection with the purchase of the preferred membership units, the operative LLC agreement had been amended to require a majority of holders of preferred units to consent to any bankruptcy filing. Relying heavily on the Fifth Circuit's decision in *Franchise Services*, the court noted that the movant had not, in connection with its debt, extracted an amendment to the LLC agreement, and it distinguished cases in which golden shares or related bankruptcy veto rights were conditions to obtaining debt financing.[14]

In contrast to these courts, the U.S. Bankruptcy Court for the District of Delaware remains hesitant to recognize the validity of golden shares and blocking directors as a device to prevent bankruptcy filings. In *In re Pace Indus. LLC*,[15] a preferred shareholder filed a motion to dismiss the chapter 11 case, arguing that the company's certificate of incorporation required the consent of a majority of preferred stockholders to any voluntary bankruptcy filing, and that the debtor did not obtain the necessary approvals. The court denied the motion to dismiss the chapter 11 case, noting that it was "prepared to be the first court to" find that a shareholder's blocking right was invalid under the facts of the case.[16] The court explained that it saw "no reason to conclude that a minority shareholder has any more right to block a bankruptcy — the constitutional right to file a bankruptcy by a corporation — than a creditor does."[17]

In distinguishing the Fifth Circuit's decision in *Franchise Services*, the court found that by virtue of its golden share, the shareholder owed fiduciary obligations to the company and its shareholders under Delaware law. Moreover, given that the debtor was "clearly in the zone of insolvency," the court held that such fiduciary duties are also owed to the company's creditors. Because the shareholder had clearly stated that it was "not considering the rights of others in its decision to file the motion to dismiss," the court ruled against the shareholder.[18]

More recently, in *In re PWM Property Management LLC*,[19] the bankruptcy court declined to dismiss a bankruptcy filing by an equityholder who was also a creditor. In this case, an equityholder filed a motion to dismiss the chapter 11 case, arguing, among other things, that certain of the debtors required its consent prior to the bankruptcy filing under the terms of the applicable LLC agreement that was put in place at the time of its equity investment. The court denied the motion to dismiss and based its decision on three factors.

First, the equity investment was made at a time when the investor was already a substantial creditor. Second, the investment contemplated that the investor would be hired as a property manager, creating a creditor relationship. Third, and most importantly, "the equity investment, though substantial, was structured in a manner to make it more akin to debt than to equity," given the mandatory redemption obligation, the fixed return on the investment with no right to share in profits or excess, and the right to foreclose and force a sale.[20] Having found that the equity investment was in substance debt, the court declined to recognize the investor's blocking right.

Conclusion

It is evident from these cases that creditors who obtain golden shares or the right to nominate blocking directors (especially those who are not required to assume fiduciary obligations to the borrower and its shareholders) should not expect bankruptcy courts to enforce those corporate governance rights. In circumstances when an entity with such rights is a *bona fide* equityholder, the exercise of such rights may be permitted, but any determination will be heavily fact-intensive based on the relative size of the equity interest, the circumstances under which the blocking rights were obtained and the venue in which any dispute arises. abi

10 *Id.* at 208-09, 213.
11 *Id.* at 209.
12 *Id.*
13 631 B.R. 205 (Bankr. D.N.J. 2021).
14 *Id.* at 212.
15 Case No. 20-10927 (MFW) (Bankr. D. Del.).
16 *Pace Indus.*, ECF No. 148 (transcript of hearing held May 5, 2020), at 38:14-16.
17 *Id.* at 40:14-19.
18 *Id.* at 41:5-8.
19 No. 21-11445 (MFW) (Bankr. D. Del.).
20 *PWM Prop.*, ECF No. 248 (transcript of hearing held Dec. 13, 2021), at 154:22-155:7.