AMERICAN BANKRUPTCY INSTITUTE

2018 Winter Leadership Conference

An LLC's Path Through Chapter 11

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CONCURRENT SESSION

2018

AN LLC'S PATH THROUGH CHAPTER 11

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LIMITED LIABILITY COMPANY
BASIC CONCEPTS

LLC BASIC CONCEPTS[1]

1. Limited Liability Company ("LLC") Background

   - Statutorily created around 1977. An IRS decision in 1988 to tax LLCs as partnerships accelerated their use. LLCs have now become the most popular business entity of choice.
   - State LLC statutes control and vary significantly, but LLC basic characteristics and concepts are similar.

2. Characteristics of LLCs

   - LLC is a hybrid entity, combining some of the best features of partnerships and corporations.
   - Provides maximum liability protection for LLC members, similar to corporations.
   - Default tax treatment (either as a partnership if multiple members or sole proprietorship/disregard member if a single member) is favorable pass-through taxation (no double taxation like corporations). However, an LLC can elect to be treated as a C corp, or an S corp.
   - Flexible ownership, management and administration.
   - Much less governmental regulation and compliance required than corporations.
   - LLC operates much as a limited partnership without the requirement of a general partner who bears full liability for any partnership debts.

3. LLC Ownership

   - No limitation on number or type of members an LLC can have, unlike the 75 maximum in an S corporation (assuming S status hasn't been elected).
   - In some states, can have economic and non-economic membership – non-economic members have no transferable interests, no rights to distributions, nor any contribution obligations.
   - Unlike a limited partnership, any member or owner of the LLC can be allowed full participatory role in business operations.

[1] This is an outline of LLC basic concepts. Each state has its own LLC statutes which must be examined in any particular situation.

- Can classify membership interests into different classes with different rights and preferences.
- Distribution, liquidation and voting preferences can be specified in the Operating Agreement.
- Distributions do not need to be proportionate to LLC ownership.
- Some states do not allow LLCs for certain professional occupations.

4. Formation of LLC

- Easy formation.
- Formed by filing Articles of Organization/Certificate of Formation with Secretary of State.
- Most states have simple electronic filing requirements to form/register an LLC.
- Simple annual reports and filing fees due annually.

5. Series LLCs

- Number of states have statutes that authorize LLCs to be organized with "series" of members, managers, membership interests or assets. These are somewhat comparable to subsidiaries of a corporation. Used for any business desiring to divide its overall business with segregated assets/liabilities.
- Each series of a LLC may have characteristics of a separate LLC and its own business purpose or investment objective.
- An individual series of a series LLC will not be liable for debts and liabilities of the series LLC generally or any other series in the group.

6. Governing/Organizational Documents

- Operating Agreement ("OA") (closely resembles a partnership agreement).
- OA specifies how LLC will be governed, the financial obligations of members and how profits, losses and distributions are shared.
- In some states, OA may be oral or "implied."

7. Management/Management Delegation

- Management initially vested in members - "Member-Managed – (where all have equal authority).

- Members can delegate management to a "Manager-Member" (where all managers but not members have management authority).
- Manager(s) can designate officers to manage day to day operations.
- Certain major decisions typically must be approved by the Members.
- Default rule is LLCs are member-managed unless the Articles of Organization or OA expressly provides for one or more managers.

8. Third Party Rights

- In some states, OA may specify that third parties may have rights to vote or approve certain actions of the LLC, including amendment to the OA or the filing of a bankruptcy petition.
- In some states, "Springing Member" rights might also be granted to allow for a new member to be admitted upon the happening of specified events, and/or to block the filing of a bankruptcy petition.

9. Fiduciary Duties

- Unless provided othewise in the OA, managing members and managers generally owe the fiduciary duties of care and loyalty.
- The OA may expand, restrict or eliminate duties (including fiduciary duties) and limit or eliminate liability for breaches of certain duties.

10. Distributions[2]

- Unless provided otherwise in the OA, distributions are generally allocated:

  (i) On the basis of each member's agreed unreturned capital contributions.

  (ii) Next, equally amongst the members.

- Allows for "special allocation" of profits (in different percentages than respective percentages of ownership). A member can receive profits and write-off loss in excess of individual ownership percentage.
- Non-managing members share of profit not considered earned income, thus no self-employment tax.
- Each member's pro-rata share of profits is, however, taxable income, whether profits are distributed or not.

[2] The first four bullet points of ¶10 would only apply if corporate status hasn't been elected.

- A member entitled to distribution has the same status and remedies as a creditor of the LLC.

- Unless provided in the OA:

  (i) Members are not entitled to demand/receive distributions in any form other than cash, regardless of the nature of the contribution.

  (ii) A member can't be compelled to accept a distribution of any asset in kind to the extent that the percentage of the asset distributed exceeds the percentage in which the member shares in distributions.

- Distributions can't be made, if, after giving effect to the distributions, the LLC's liabilities (other than certain liabilities) exceed fair value of the assets (with the fair value of certain property excluded).

- A member knowingly receiving an improper distribution may be personally liable to the LLC for the amount of the distribution.

11. Disassociation of LLC Members

- Events of disassociation from an LLC are set forth in statutes, and generally include a member's resignation, bankruptcy, death, dissolution or expulsion, or upon happening of an agreed-upon event, contained in the OA.

- Members may also be disassociated by a transfer of their interest or may lose their transferable interests if a charging order is placed on their interests and not foreclosed.

12. Dissolution Upon Bankruptcy of Member

- Filing of bankruptcy by a member of an LLC may trigger the dissolution of the LLC causing a wind-up and liquidation.

- Some states, including Delaware and New York, an LLC is not automatically dissolved, unless the OA so states.

- However, other states provide the LLC automatically dissolved in event of a member's bankruptcy unless the OA provides otherwise.

- Bankruptcy Code may, however, invalidate these provisions as ipso facto provisions.

LIMITED LIABILITY COMPANY
MEMBERSHIP INTEREST DISPOSITION ISSUES

LLC Interest Disposition Issues

I. Is a sale of membership interest of bankruptcy member permissible?

1. Section 363 allows a debtor or trustee to sell property of the estate under certain circumstances and section 365 permits assumption and assignment of executory contracts.

a) LLC operating agreements are generally determined to be executory contracts and if they are executory, then all the restrictions of section 365 apply. *See, e.g.*, *Allentown Ambassadors, Inc. v. Northeast Am. Baseball, LLC (In re Allentown Ambassadors, Inc.)*, 361 B.R. 422, 444–47 (Bankr. E.D. Pa. 2007) (finding that the debtor's LLC operating agreement was an executory contract as of the chapter 11 petition date and applying section 365 thereto); *In re Daugherty Constr., Inc.*, 188 B.R. 607, 611 (finding that "the LLC Articles of Organization and the Operating Agreement among the LLC members . . . constitute . . . executory contracts which the debtor may attempt to assume under section 365.").

b) If an LLC operating agreement was not executory, such as where the bankrupt member had no obligations, then debtor or trustee may assume without 365 restrictions. *See Movitz v. Fiesta Inv., LLC (In re Ehmann)*, 319 B.R. 200, 203-06 (Bankr. D. Ariz. 2005) ("[I]f there are no material obligations that must be performed by the members of a limited liability company or the limited partners in a limited partnership, then the contract is not executory and is not governed by Code § 365").

2. Section 365(c)(1) limits assumption and assignment if applicable law excuses party from rendering/accepting performance from/to non-debtor and party does not consent

a) Some courts treat LLC operating agreements as similar personal service contracts. *See Northrop Grumann Tech. Servs., Inc. v. Shaw Grp. Inc. (In re IT Group, Inc., Co.)*, 302 B.R. 483, 486 (D. Del. 2003) (affirming the Bankruptcy Court's treatment of debtor's LLC membership interest under section 365(c)); *In re Weilnau*, No. 11-30467, 2012 WL 893264, at *3 (Bankr. N.D. Ohio Mar. 14, 2012) (finding an LLC operating agreement's "restriction requiring the consent of other members of the LLC in order for an assignee to become a member" to be permissible under applicable state law and, therefore, not an unenforceable restraint on alienation).

b) Some LLC statutes restrict the rights of an LLC member to transfer non-monetary rights without consent of other LLC members. *See, e.g.*, Del. Code. Ann. tit. 6, § 18-702.

c) Many LLC operating agreements permit the transfer of monetary interests but restrict the ability to assign management and voting rights.[1]

d) Consequently, often only monetary rights are transferable and the acquirer will not have management or voting rights. *See Horizons A Far, LLC v. Webber (In re Soderstrom)*, 484 B.R. 874, 880 (M.D. Fla. 2013)) (holding that the assignment of the debtor's interest in an LLC effectively transferred only the debtor's economic interest—and not the debtor's management interest—in the LLC to the transferee).

e) Courts distinguish between management and ownership interests in LLCs in the chapter 7 context as well. *See Minton v. Prillaman (In re BMA Ventures, LLC)*, 2017 WL 354319 at *3 (Jan. 23, 2017) ("Although the provisions of an operating agreement may alter the rights associated with an ownership interest in an LLC, the interest itself is not created by the operating agreement."); *Id.* (citing *Sullivan v. Mathhew*, 2015 WL 1509794 at *5, *8 (N.D. Ill. Mar. 30, 2015)) (distinguishing management rights arising from a partnership agreement from property rights in the partnership itself)).

II. Are restraints on sale of a bankrupt member's LLC interest permissible?

1. A sale or assignment may also trigger a right of first refusal (a "ROFR") in an LLC operating agreement

[1] Examples of typical provisions include: (i) "Unless admitted to the Company as a member, an assignee who has not been admitted as a substituted member is only entitled to receive the distributions and return of capital, and to be allocated the member's share of the profits, losses, gains deductions and credits of the Company and such member's right to receive distributions (liquidating or otherwise) of the Company's assets attributable to the limited liability company interest assigned to such assignee."; (ii) "An assignee of a limited liability company interest shall have no management rights hereunder, including but not limited to any right to vote, approve or to consent to matters as to which members have voting, approval or consent rights, shall have no right to appoint a manager or a representative on the management committee, if applicable, and shall not be entitled to become or to exercise any other rights or powers of a member but shall only be entitled to share in such profits and losses, to receive such distribution or distributions and to receive such allocation of income, gain, loss, deduction or credit or similar item to which to the assigning member would have been entitled or to exercise any other rights to which assignees are entitled under the [Act]."

a) A ROFR would permit the non-selling member the right to purchase the bankrupt/selling member's interest on the same terms and conditions as those set out in a third party offer. If the non-selling member does not exercise the ROFR, the third-party purchaser can acquire the interest with all rights and obligations of a member.

b) Section 365(f) permits assignment of a debtor's rights in any executory contract, despite any provision in the contract that prohibits, restricts, or conditions this assignment.

c) Limited case law exists regarding treatment of ROFRs in the LLC context.

   i. One court has held that a ROFR in an LLC operating agreement was unenforceable because it was an executory contract that either expired by its own terms or was deemed rejected based on the Chapter 7 trustee's failure to assume the contract within the required time period set out under section 365(d)(1) of the Bankruptcy Code. *See In re Ichiban, Inc.*, 2014 WL 2937088 (Bankr. E.D. Va. June 30, 2014)) (holding that "[t]he operating agreement is an executory contract and the right of first refusal, if it did not expire earlier, was rejected by the trustee's failure to [timely] assume it" and that "[t]he right of first refusal is not enforceable in this bankruptcy case as to the debtor").

   ii. Another court has held that a ROFR was enforceable, as it did not operate as an unreasonable restraint on assignment. The Court did imply, however, that if it a ROFR may not be enforceable if it impinged a debtor's ability to realize full value of the interest. *In re IT Grp., Inc., Co.*, 302 B.R. 483,488 (D. Del. 2003) (holding that the ROFR at issue was "not an unenforceable restraint on assignment," and further noting that the Court "was not persuaded that enforcing the [ROFR] would hamper the [d]ebtor's ability to assign the property or foreclose the estate from realizing the full value of the [d]ebtor's interest.").

   iii. Another court, assessing the effect of rejection of an operating agreement on ROFR provisions in such agreement in the context of a chapter 7 bankruptcy, found that rejection fo the operating agreement would not invalidate the ROFR provisions or otherwise affect the provisions in that agreement allocating each member's share of the interests in the LLC. *See Minton v. Prillaman (In re BMA Ventures, LLC)*, 2017 WL 354319 at *3

(Jan. 23, 2017) (noting further that "[r]ejection of the [o]perating [a]greement would therefore not change the fact that the estate owns a property interest" in the LLC at issue).

SECURED CREDITORS' RIGHTS ISSUES IMPACTING LIMITED LIABILITY COMPANIES

Selected Creditors' Rights Issues Impacting LLCs

There are a few notable differences in the treatment of LLCs as compared to corporations, resulting from the increased structural flexibility given to LLCs under state statutes and the lack of clarity regarding LLCs' treatment under the Bankruptcy Code.

A. Fiduciary Duties

- Under most state regimes, LLC members or managers, depending on the governance structure, typically owe fiduciary duties to the LLC itself and to other members/managers (if any).[1] In comparison, a corporation's directors owe duties to the corporation, which can be enforced by shareholders.
- The core fiduciary duties are:
  - *Duty of Care*: A fiduciary must act with the degree of care that an ordinarily careful and prudent person in that position would use under similar circumstances.
  - *Duty of Loyalty*: A fiduciary is prohibited from engaging in self-dealing or usurping corporate opportunities in the performance of his or her duties.
- States' LLC statutes may outline the scope of these duties and/or provide other clarifications . *See, e.g.*, Or. Rev. Stat. § 63.155 (describing the duty of loyalty and duty of care owed by members of member-managed LLCs); 805 Ill. Comp. Stat. 180/15-3(g) (stating that members of manager-managed LLCs do not owe fiduciary duties solely by reason of being a member).
- Most LLC statutes allow parties to draft or modify the LLC's operating agreement to limit members' fiduciary duties. *See, e.g.*, Colo. Rev. Stat. Ann. 7-80-108. This is a direct contrast to the treatment of corporations, where fiduciary duties apply under common law and cannot be waived. Delaware's LLC Act takes this further by allowing fiduciary duties, including the duty of loyalty, to be waived entirely, although parties cannot eliminate the implied contractual covenant of good faith and fair dealing. Del. Code Ann. tit. 6, § 18-1101(c).
- Once the LLC enters into bankruptcy, the trustee or debtor-in-possession owes fiduciary duties to the estate under federal common law.

[1] For ease of reading, this outline refers to member-managed LLCs, rather than referring to both structures, unless distinctions apply.

B. Breaches of Fiduciary Duties

- Fiduciaries' actions generally are protected by the business judgment rule, a series of judicially created presumptions that fiduciaries act on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company.
- Parties owed fiduciary duties (*e.g.*, a passive LLC member) can rebut the presumptions of the business judgment rule by pleading specific facts that show fiduciaries violated such duties.
- A key difference between Delaware corporations and LLCs is the treatment of creditors once the entity becomes insolvent.[2] While creditors can enforce directors' duties to the corporation upon and during insolvency, the Delaware Court of Chancery has interpreted the state's LLC Act to hold that (non-member) creditors do not have standing, including derivative standing, to sue the LLC for breach of fiduciary duties that occurred prepetition. *See CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011).
- In the bankruptcy context, *Bax* was cited in two recent cases as barring creditors from pursuing derivative claims:
  - In the first, the U.S. Bankruptcy Court for the District of Delaware held that the Official Committee of Unsecured Creditors did not have standing to pursue breach of fiduciary duty claims on behalf of debtor LLCs. *In re HH Liquidation*, No. 15-11874 (Bankr. D. Del. Jan. 22, 2018).
  - The second involved a dismissal of a Chapter 7 trustee's claim for alleged breaches of fiduciary duties owed to debtor LLCs, brought on behalf of the LLCs' creditors. The Court confirmed that a trustee does not have standing to sue on behalf of parties who themselves have no standing under Delaware's LLC Act (*i.e.*, who are neither members nor assignees). *See PennySaver USA Publ'g, LLC v. OpenGate Capital Grp.*, No. 17-50530 (Bankr. D. Del. Jul. 11, 2018).

C. Veil Piercing

- In general, members are not personally liable for the LLC's debts, obligations and liabilities. However, creditors may attempt to access members' personal

[2] Creditors of solvent corporations are not owed fiduciary duties; rather, creditors' interests are protected by their contract rights (and state law fraudulent transfer and similar creditors' rights laws).

assets through a "veil-piercing" claim, arguing that the LLC form should not be respected.

- Courts typically recognize LLC veil piercing as an available equitable remedy, but extraordinary. In many jurisdictions, courts have held that LLC veil piercing is appropriate by analogizing to common law piercing claims against corporations. *See, e.g.*, *Colonial Sur. Co. v. Lakeview Advisors, LLC*, 941 N.Y.S.2d 371, 373 (4th Dep't 2012). In some states, the governing statute expressly authorizes LLC veil piercing, often by referencing common law analogues. *See, e.g.*, Cal. Corp. Code § 17703.04.
- While states have developed individualized approaches to veil-piercing claims, typically courts will consider piercing the veil when the LLC has acted as the "alter ego" or "instrumentality" of its member(s), shielding them from liability for fraud or other malfeasance. *See, e.g.*, *In re Wolverine, Proctor & Schwartz, LLC*, 447 B.R. 1, 36 (Bankr. D. Mass. 2011).
- Courts may be less willing to grant LLC veil-piercing claims than corporate veil-piercing claims, due to the practical differences between how LLCs and corporations are managed. In addition, many LLC statutes that address veil piercing provide that failure to observe formalities or management requirements, a common basis for corporate veil piercing, is not a proper basis for LLC veil piercing. *See, e.g.*, Colo. Rev. Stat. Ann. § 7-80-107(2). This makes sense in light of the fact that LLCs are typically member managed.

D. Substantive Consolidation

- Substantive consolidation is an "extraordinary" equitable remedy available to bankruptcy courts, allowing entities with separate legal structures to be treated as a single entity with pooled assets and liabilities. Each entity's liabilities can then be satisfied out of the aggregated pool.
- While the remedy predates the LLC form, courts have been willing to apply substantive consolidation to LLCs in order to distribute property more equitably among creditors.
- When assessing whether substantive consolidation is appropriate, courts typically will consider the entities' pre-bankruptcy interrelationships, the balance of the benefits and harms of consolidation to creditors and other parties in interest and the impact that substantive consolidation would have on the bankruptcy estates.
- Parties should also be aware that there is no judicial consensus on whether a debtor may be consolidated with nondebtor entities. *Compare Bonham v. Compton (In re Bonham)*, 229 F.3d 750 (9th Cir. 2000), *with Audette v.*

Kasemir (In re Concepts America Inc.), No. 16-691 (Bankr. N.D. Ill. May 3, 2018).

E. Fraudulent Transfers

- Section 548 of the Bankruptcy Code provides that a trustee or debtor-in-possession may avoid certain transfers as fraudulent.
  - *Actual Fraud*: A transfer is made within two years before the date of the filing of a bankruptcy petition and the transfer is made with the intent to hinder or defraud a creditor or future creditors.
  - *Constructive Fraud*: Regardless of intent, the debtor received less than reasonably equivalent value for the property transferred and was insolvent at the time of, or rendered insolvent by, the transfer.
- Creditors have standing to pursue individual fraudulent transfer claims outside of bankruptcy under state law. In addition, Section 544(b) of the Bankruptcy Code authorizes trustees to pursue state-law fraudulent transfer claims collectively on behalf of the estate by stepping into the shoes of an unsecured creditor with an allowable claim.
- While LLCs and corporations are not treated differently under a fraudulent transfer analysis, LLCs may participate in unique types of transfers that might be targeted as fraudulent conveyances. As an example, Delaware recently amended its LLC Act to permit the division of LLCs into one or more newly formed LLCs. *See* Del. Ann. Code tit. 6 § 18-217. To effectuate the division, assets, debts, liabilities and duties may be allocated freely among the entities. Recognizing that parties might use the allocation process to shield assets from creditors, the statute provides that each division company becomes jointly and severally liable for any allocation that constitutes a fraudulent transfer. Del. Ann. Code tit. 6 § 18-217(l)(5).

F. Preference Claims

- A preference is a transfer of an interest of the debtor in property made to or for the benefit of a creditor, on account of an antecedent debt, while the debtor was insolvent, within 90 days before the filing of the bankruptcy petition (or one year if the transfer was made to an insider), and which enabled the creditor to receive more than it would have received in a chapter 7 liquidation. 11 U.S.C. § 547(b). Qualifying transfers that are not subject to an exception or defense may be avoided by a trustee, debtor-in-possession or other court-authorized party (*e.g.*, a litigation trust).

- To determine insider status, a court typically will look first to whether the entity appears in the definition of "insider" under Section 101(31) and therefore qualifies as a "statutory" insider. As Section 101(31) is non-exhaustive, a party may also qualify as a "non-statutory" insider under the court's chosen approach.
- While Section 101(31) describes insiders of corporations and partnerships and provides examples, there is no explicit equivalent for LLCs. Nevertheless, courts have interpreted the Code and state law to apply to LLCs in various respects, including as follows:
    - Using the "similarity" approach, the Seventh Circuit in *In re Longview Aluminum, L.L.C.* held that a managing member of an LLC can be a statutory insider within the meaning of Section 101(31)(B) by analogizing to a director of a corporation. *In re Longview Aluminum, L.L.C.*, 657 F.3d 507, 511 (7th Cir. 2011).
    - Courts have found that LLCs fall within the definition of "corporation" under Section § 101(9) and therefore may themselves qualify as statutory insiders. *See, e.g.*, *Sherron Assocs. Loan Fund XXI (Lacey) L.L.C. v. Thomas (In re Parks)*, No. 12-44011 (Bankr. W.D. Wash. Dec. 18, 2013); *Brooke Corp. v. CJD & Assocs., LLC (In re Brooke Corp.)*, 506 B.R. 560 (Bankr. D. Kan. 2014).

LIMITED LIABILITY COMPANY
CHARGING ORDERS – BASIC CONCEPTS

Charging Orders Basic Concepts[1]

With the increased use of LLCs since the 1990s, understanding "charging order" concepts is of increased importance.

A. Overview
- Charging order is a state statutory remedy.
- Allows a judgment creditor to obtain a judicial lien or charge on the judgment debtor's economic rights to distribution(s) as a member of LLC or partnership.
- "Exclusive remedy" in about 2/3 of the states of an LLC member judgment creditor.

B. Nature, Purpose, Effect and Use
- If an LLC member becomes a debtor, a creditor does not get the assets of the LLC or the debtor-member's LLC interest outright; only a lien against the debtor's "economic interest" in the LLC.
- Charging order is the method by which the lien is placed on the debtor-member's interest – it is not a lien itself. Must be served on the LLC.
- In many states it is the "exclusive remedy" a creditor can use to pursue the debtor-member's interest (versus personal property levy/execution, garnishments, etc.).
- If creditor has an alternative to attack, such as an assertion of an alter ego theory, then it may not be considered a "remedy" and not blocked by the "charging order exclusivity".
- Purpose is that other non-debtor members of the LLC would not be forced into an involuntary business relationship with another member-creditor or ex-spouse. Precludes a judgment creditor from interfering with the activities of the LLC as a going concern.
- It does not actually assign or convey the member's interest in the LLC to the judgment creditor. It also does not give the judgment creditor the right to participate in the management of the LLC or the right to dissolve the LLC.
- A charging order does, however, not force the LLC to make a distribution.

C. Procedure to Obtain Charging Order
- Judgment creditor identifies an LLC(s) in which the judgment debtor may have an interest (via pre-judgment discovery, post- judgment debtor exam, written interrogatories, or searches.)
- Most states require judgment creditor to apply to the state court requesting a charging order and serve debtor, LLC and all members. Most commonly done in post-judgment motion in case where judgment was rendered. Time consuming procedure.
- Some Courts allow appointment of a receiver to assure collection of distributions.

[1] This is an outline of Charging Orders basic concepts. Each state has its own Charging Order statutes which must be examined in any particular situation.

- Possible the court may include in an order a periodic accounting to the court of the LLC's distributions. It may also allow provisions to prevent making of loans to the debtor-member, paying personal debts, payment of wages or salary (if not paid before), consulting fees, etc., to circumvent the distributions.
- Many courts will not compel the LLC to disclose or allow inspection of its books/records by the judgment creditor.
- Often creates a stand-off between the creditor and judgment member of the LLC. Neither party can get at money. But creditor usually has greater staying power than a judgment debtor.

D. Foreclosure
- Some state statutes allow a Court to order the foreclosure of the debtor-member's interest in the LLC upon petition by the judgment creditor. Usually requires creditor show that the charging order will not pay the judgment in a reasonable time.
- If it forecloses, the creditor is entitled to all distributions after purchase, both interim distributions and liquidation distributions.
- If granted, the purchaser at the sale becomes the assignee of the member's interest.
- Before foreclosure sale, the judgment debtor-member, one or more other LLC members or the LLC itself can redeem the interest subject to foreclosure.
- If a creditor is already a "member" in the subject LLC foreclosure it is more likely to be advantageous to the creditor.
- If merely a non-member creditor, less advantageous, unless the LLC owns valuable assets and the purchase price is right.

E. Single-Member LLC's
- Charging order never intended to be an "asset protection" devise for judgment debtors, rather a decree to protect the interest of the judgment debtor's co-owners.
- Thus when a charging order against an LLC's sole member is foreclosed, the member's entire ownership interest is sold and the buyer replaces the judgment debtor as the LLC's sole member and entitled to exercise management control and sell the assets of the LLC.

F. Tax Issues
- Debtor continues to remain the tax partner after a charging order creditor receives a distribution. If charging order creditor receives a distribution it is merely receiving a debt payment. The judgment debtor pays the tax attributable to the creditor distribution.
- However, the purchaser of the debtor's interest at a foreclosure sale, then it may be liable for the member's share of taxes attributable to the LLC.

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G. Dissolution
- A few states permit judgment creditors of LLC owners to obtain a court order that the LLC be dissolved.

H. Distribution Clawbacks / Fraudulent Transfer
- If after judgment – other members distribute LLC assets only to themselves - does creditor have standing to bring a derivative action to clawback the funds?

LIMITED LIABILITY COMPANY
AUTHORITY TO FILE CHAPTER 11

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DECISIONAL LAW REGARDING "AUTHORITY TO FILE CHAPTER 11" TABLE OF CONTENTS		
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891 F.3d 198
United States Court of Appeals, Fifth Circuit.

IN RE: FRANCHISE SERVICES OF NORTH AMERICA, INCORPORATED, Debtor
Franchise Services of North America, Incorporated, Appellant
v.
United States Trustee; Macquarie Capital (USA), Incorporated; Michael John Silverton; Daniel Raymond Boland; Boketo, L.L.C., Appellees

No. 18-60093
|
May 22, 2018
|
Revised June 14, 2018

Synopsis
Background: Debtor filed voluntary Chapter 11 bankruptcy petition. Shareholder owned by unsecured creditor moved to dismiss on grounds that debtor had not sought shareholder authorization as required by its certificate of incorporation. The United States Bankruptcy Court for the Southern District of Mississippi, Edward Ellington, J., 2018 WL 485959, granted motion and certified appeal of order.

Holdings: The Court of Appeals, King, Circuit Judge, held that:

[1] federal law would not prevent shareholder from exercising its voting rights regarding bankruptcy filing, and

[2] under Delaware law, shareholder was not controlling shareholder.

Affirmed.

West Headnotes (38)

[1] **Bankruptcy**
⚖Conclusions of law; de novo review
Bankruptcy
⚖Clear error

The Court of Appeals reviews a bankruptcy court's findings of fact for clear error and its conclusions of law de novo.

Cases that cite this headnote

[2] **Bankruptcy**
⚖Representatives of corporations

"Golden share," as used in the bankruptcy context, generally refers to the issuance to a creditor of a trivial number of shares that gives the creditor the right to prevent a voluntary bankruptcy petition, potentially among other rights.

Cases that cite this headnote

[3] **Constitutional Law**
⚖Advisory Opinions

The oldest and most consistent thread in the federal law of justiciability is that the federal courts will not give advisory opinions.

Cases that cite this headnote

[4] **Constitutional Law**
⚖Advisory Opinions

The prohibition of advisory opinions is a constitutional limit on the power of the federal courts. U.S. Const. art. 3, § 2, cl. 1.

Cases that cite this headnote

[5] **Bankruptcy**

⇦Petition for leave; appeal as of right; certification

The bankruptcy court's statutory authority to certify questions to the Court of Appeals does not include the authority to request advisory opinions. 28 U.S.C.A. § 158(d)(2)(A).

Cases that cite this headnote

[6] **Constitutional Law**
⇦Advisory Opinions
Federal Courts
⇦Certification and Leave to Appeal

There is no prohibition against narrowing a certified question—particularly where doing so would avoid rendering an advisory opinion while still addressing an important question of law.

Cases that cite this headnote

[7] **Bankruptcy**
⇦Petition for leave; appeal as of right; certification

The Court of Appeals treats certified questions from bankruptcy courts essentially as it treats certified questions from district courts. 28 U.S.C.A. §§ 158(d)(2)(A), 1292(b).

Cases that cite this headnote

[8] **Federal Courts**
⇦Certification and Leave to Appeal

Review of a certified question from a district court looks to the entire certified order and is not tied to the particular question formulated by the district court. 28 U.S.C.A. § 1292(b).

Cases that cite this headnote

[9] **Corporations and Business Organizations**
⇦Corporation acts through officers or agents

A corporation cannot act on its own; it can act only if authorized by appropriate agents.

Cases that cite this headnote

[10] **Bankruptcy**
⇦Representatives of corporations

In absence of federal incorporation, the authority to file a voluntary bankruptcy petition on behalf of a corporation finds its source in local law.

Cases that cite this headnote

[11] **Bankruptcy**
⇦Representatives of corporations

State law determines who has the authority to file a voluntary bankruptcy petition on behalf of a corporation incorporated in the state.

Cases that cite this headnote

[12] **Bankruptcy**
⇦Representatives of corporations

If the petitioners for voluntary bankruptcy on behalf of a corporation lack authorization under the law of the state where the corporation is incorporated, the bankruptcy court has no alternative but to dismiss the petition.

Cases that cite this headnote

[13] **Bankruptcy**
Representatives of corporations

It is not enough that those who seek to speak for a corporation by filing a voluntary bankruptcy petition on its behalf may have the right to obtain the authority to do so; rather, they must have the authority at the time of filing.

Cases that cite this headnote

[14] **Bankruptcy**
Power and Authority

Absent a duly authorized petition, a bankruptcy court has no power to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims.

Cases that cite this headnote

[15] **Corporations and Business Organizations**
Limitation of personal liability of shareholders

There is nothing inherently improper or suspicious about creating a limited liability entity in order to facilitate an investment.

Cases that cite this headnote

[16] **Bankruptcy**
Representatives of corporations

There is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill.

1 Cases that cite this headnote

[17] **Bankruptcy**
Representatives of corporations
Corporations and Business Organizations
Fiduciary duty in general

As a matter of federal law, fiduciary duties are not required to allow a bona fide shareholder to exercise its right to prevent a voluntary bankruptcy petition.

Cases that cite this headnote

[18] **Bankruptcy**
Representatives of corporations

Federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty to the corporation or its fellow shareholders.

1 Cases that cite this headnote

[19] **Federal Courts**
Highest court

In evaluating issues of state law, federal courts look to the decisions of the state's highest courts.

Cases that cite this headnote

[20] **Federal Courts**
Anticipating or predicting state decision

In the absence of a controlling decision on an

issue of state law, a federal court makes an "*Erie* guess" as to how the state's highest court would resolve the issue.

Cases that cite this headnote

[21] **Federal Courts**
⚖Inferior courts

Unless persuaded that a state's highest court would decide the issue differently, federal courts defer to the decisions of the state's intermediate appellate courts on an issue of state law.

Cases that cite this headnote

[22] **Corporations and Business Organizations**
⚖Construction, operation, and effect

A certificate of incorporation provision is not contrary to Delaware law just because it withdraws traditional power from the board of directors. 8 Del. Code § 141(a).

Cases that cite this headnote

[23] **Federal Courts**
⚖Failure to mention or inadequacy of treatment of error in appellate briefs

When a party expressly waives an issue or argument, the Court of Appeals lacks the benefit of adversarial briefing and generally declines to consider the issue.

Cases that cite this headnote

[24] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, shareholder was not controlling shareholder, although it owned preferred stock convertible to 49.76% equity stake, had appointed two of five directors, and through its voting rights could prevent corporation from filing voluntary Chapter 11 bankruptcy petition, where corporation filed such petition without seeking shareholder authorization, and shareholder had to resort to filing motion to dismiss petition.

1 Cases that cite this headnote

[25] **Corporations and Business Organizations**
⚖Fiduciary duty in general

Under Delaware law, a shareholder is generally free to act in its self-interest, unencumbered by any fiduciary obligation.

Cases that cite this headnote

[26] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.

Cases that cite this headnote

[27] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Delaware law imposes fiduciary duties on two kinds of shareholders: majority shareholders and minority controlling shareholders.

Cases that cite this headnote

[28] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, potential control is not enough for a minority shareholder to be a minority controlling shareholder.

Cases that cite this headnote

[29] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, a minority shareholder must dominate the corporation through actual control of corporation conduct to be a minority controlling shareholder.

Cases that cite this headnote

[30] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

"Actual control" is exercised under Delaware law by a minority shareholder only when the shareholder has such formidable voting and managerial power that it, as a practical matter, is no differently situated than if it had majority voting control.

Cases that cite this headnote

[31] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, in determining whether a minority shareholder exercises the actual control required to be a minority controlling shareholder, courts focus on control of the board of directors.

Cases that cite this headnote

[32] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

Under Delaware law, for a minority shareholder to exercise the actual control required to be a minority controlling shareholder, the shareholder's command over the board of directors must be so potent that independent directors cannot freely exercise their judgment, fearing retribution.

Cases that cite this headnote

[33] **Corporations and Business Organizations**
⚖Controlling or majority shareholders and minority shareholders in general

A "minority controlling shareholder" under Delaware law has a combination of potent voting power and management control such that the shareholder can be deemed to have effective control of the board without actually owning a majority of stock.

Cases that cite this headnote

[34] **Corporations and Business Organizations**
⚖Evidence

Under Delaware law, a plaintiff who alleges domination of a board of directors or control of its affairs must prove it.

Cases that cite this headnote

[35] **Corporations and Business Organizations**
⇦Controlling or majority shareholders and minority shareholders in general

Under Delaware law, although the size of a minority shareholder's equity stake is a factor in the analysis of whether it is a minority controlling shareholder, it is not dispositive.

Cases that cite this headnote

[36] **Corporations and Business Organizations**
⇦Controlling or majority shareholders and minority shareholders in general

Under Delaware law, shareholder's appointment of a minority of directors on the board of a corporation—without more—is insufficient to demonstrate actual control.

Cases that cite this headnote

[37] **Corporations and Business Organizations**
⇦Controlling or majority shareholders and minority shareholders in general

Under Delaware law, what matters in determining whether a minority shareholder is a dominating shareholder is the shareholder's actual exercise of control, not just the theoretical possibility that it might do so.

Cases that cite this headnote

[38] **Corporations and Business Organizations**
⇦Controlling or majority shareholders and minority shareholders in general

Under Delaware law, the mere existence of the right to control is not enough for a minority shareholder to be a minority controlling shareholder.

Cases that cite this headnote

*202 Appeal from the United States Bankruptcy Court for the Southern District of Mississippi, Edward Ellington, U.S. Bankruptcy Judge

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Before KING, JONES, and GRAVES, Circuit Judges.

Opinion

KING, Circuit Judge:

Under longstanding Supreme Court precedent, state law dictates the procedures a corporation must follow to authorize a bankruptcy filing. When those procedures place the decision in the hands of the corporation's creditors, some courts have allowed the bankruptcy to proceed even though the creditors withheld consent. This case presents a related but distinct question: when the certificate of incorporation requires the consent of a majority of the holders of each class of stock, does the sole preferred shareholder lose its right to vote against (and therefore avert) a voluntary bankruptcy petition if it is also a creditor of the corporation?

In this case, the shareholder made a $15 million investment in exchange for 100% of the debtor's preferred stock. At the same time, the debtor reincorporated in Delaware and amended its certificate of incorporation. As a prerequisite to filing a voluntary bankruptcy petition, the amended certificate requires the consent of a majority of each class of the debtor's common and preferred shareholders. Following the ill-fated acquisition of a new subsidiary, the debtor filed for bankruptcy. Fearing that its shareholders might nix the filing, it never put the matter to a vote. The sole preferred shareholder filed a motion to ***203** dismiss the bankruptcy petition as unauthorized. But the debtor argued that the shareholder had no right to prevent the filing. The shareholder's parent company, explained the debtor, was an unsecured creditor by virtue of a $3 million bill the debtor refused to pay. The bankruptcy court disagreed and dismissed the petition. On appeal, the debtor asks us to reverse and to allow it to proceed with the bankruptcy.

We decline to do so. Federal law does not prevent a bona fide shareholder from exercising its right to vote against a bankruptcy petition just because it is also an unsecured creditor.[1] Under these circumstances, the issue of corporate authority to file a bankruptcy petition is left to state law. The debtor is a Delaware corporation, governed by that state's General Corporation Law. Finding nothing there that would nullify the shareholder's right to vote against the bankruptcy petition, we AFFIRM.

I.

The debtor in this case is Franchise Services of North America ("FSNA")—once one of the largest car rental companies in North America. Among FSNA's competitors is the Hertz Corporation. In 2012, the Hertz Corporation was trying to consummate a merger with Dollar Thrifty Automotive Group, Inc. Antitrust concerns prompted Hertz to sell one of its subsidiaries, Simply Wheelz, LLC, better known under its trade name, Advantage Rent–A–Car ("Advantage").

FSNA decided to buy Advantage. To do so, it enlisted the help of an investment bank, Macquarie Capital (U.S.A.), Inc. ("Macquarie"). Adreca Holdings Corporation ("Adreca"), one of Macquarie's subsidiaries, would first buy Advantage from Hertz and then merge into FSNA. Adreca bought Advantage in December 2012 and merged into FSNA in May 2013.

Macquarie created another fully-owned subsidiary to help finance the transaction. Boketo, LLC ("Boketo"), was formed in 2012 to make a $15 million investment in FSNA. In exchange for the capital infusion, FSNA gave Boketo 100% of its preferred stock in the form of a convertible preferred equity instrument. Boketo's stake in FSNA would amount to a 49.76% equity interest if converted, making it the single largest investor in FSNA. As a condition of the investment, FSNA in May 2013 reincorporated in Delaware and adopted a new certificate of incorporation. The new certificate provides that FSNA may not "effect any Liquidation Event" unless it has the approval of both "(i) the holders of a majority of the shares of Series A Preferred Stock then outstanding, voting separately as a class ..., and (ii) the holders of a majority of the shares of Common Stock then outstanding, voting separately as a class." Another section of the certificate clarifies that any "preparatory steps towards or filing a petition for bankruptcy" falls within the ambit of "Liquidation Event."

FSNA agreed to pay Macquarie a $2.5 million "arrangement fee" and a $500 thousand "financial advisory fee" for its services. Macquarie billed FSNA for the arrangement fee in March 2013, shortly before the merger closed. That fee remains ***204** unpaid and is the subject of litigation between the parties in other forums.[2]

Matters quickly took a turn for the worse. It turned out that FSNA had bought a lemon. Advantage went into bankruptcy within a year, and FSNA followed just a few years later. Advantage filed its petition under Chapter 11 of the Bankruptcy Code just six months after the acquisition. A sale of substantially all of Advantage's assets ensued, and the case was dismissed in January 2016. In June 2017, FSNA filed its own voluntary petition under Chapter 11. It did so without requesting or securing the consent of a majority of its preferred and common shareholders.

Therein lies the rub. Macquarie and Boketo filed a motion to dismiss the bankruptcy petition, citing FSNA's failure to seek shareholder authorization. FSNA countered that the shareholder consent provision was an invalid restriction on its right to file a bankruptcy petition. It also asserted that the provision violated Delaware law. The bankruptcy court held an evidentiary hearing on the matter during which it heard live testimony from two witnesses. Because Boketo was an owner, rather than creditor, of FSNA, the bankruptcy court determined that conditioning FSNA's right to file a voluntary petition on Boketo's consent was not contrary to federal bankruptcy policy. The court likewise declined to deem the

shareholder consent provision contrary to Delaware law. It instead opted to leave that issue for the Delaware courts to decide in the first instance. As a result, the court granted Boketo's motion to dismiss.

On FSNA's motion, the bankruptcy court certified a direct appeal of its order to this court pursuant to 28 U.S.C. § 158(d)(2)(A). After finding that FSNA's proposed questions were too narrow to warrant certification of a direct appeal, the bankruptcy court certified the following three questions to this court:

> 1. Is a provision, typically called a blocking provision or a golden share, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?
>
> 2. If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
>
> 3. Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?

This court authorized the appeal. *See* 28 U.S.C. § 158(d)(2)(A).

II.

[1]We review a bankruptcy court's findings of fact for clear error and its conclusions of law de novo. *Ad Hoc Grp. of Timber Noteholders, LLC v. The Pac. Lumber Co. (In re Scotia Pac. Co., LLC)*, 508 F.3d 214, 218 (5th Cir. 2007).

*205 III.

Before moving to the merits of this case, we must first narrow the questions presented. The bankruptcy court certified three broad questions to this court, each of them involving the enforceability of "a provision, typically called a blocking provision or a golden share." As an initial matter, these terms are not synonymous, nor have they been precisely defined. Courts appear to use the term "blocking provision" as a catch-all to refer to various contractual provisions through which a creditor reserves a right to prevent a debtor from filing for bankruptcy. *See, e.g., In re Squire Court Partners Ltd. P'ship*, 574 B.R. 701, 706–07 (E.D. Ark. 2017); *cf. In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911 (Bankr. N.D. Ill. 2016) (describing "blocking director" structures whereby secured creditors appoint directors with the ability to veto a voluntary bankruptcy petition).

[2]Generally speaking, a "golden share" is "[a] share that controls more than half of a corporation's voting rights and gives the shareholder veto power over changes to the company's charter." *E.g.*, Golden Share, Black's Law Dictionary (10th ed. 2014); *see also* Mariana Pargendler, *State Ownership and Corporate Governance*, 80 Fordham L. Rev. 2917, 2967 (2012) (noting that in the context of formerly stated-owned entities, "[g]olden shares are essentially a special class of stock issued to the privatizing government that grants special voting and veto rights that are disproportionate to, or even independent of, its cash-flow rights in the company"). As used in the bankruptcy context, the term generally refers to the issuance to a creditor of a trivial number of shares that gives the creditor the right to prevent a voluntary bankruptcy petition, potentially among other rights. *See, e.g., In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 261–62 (Bankr. D. Del. 2016).

We need not dwell on whether this case involves a "blocking provision" or a "golden share." The facts do not fit neatly into either definition. Boketo made a $15 million equity investment in FSNA. In return, FSNA issued convertible preferred stock to Boketo, amounting to 100% of its preferred stock. The preferred stock carried with it the right, granted in the certificate of incorporation, to vote on certain corporate matters.

[3] [4] [5]We must therefore narrow the certified questions. The bankruptcy court requested that we opine generally on the legality of "blocking provisions" and "golden shares." That we cannot do. "[T]he oldest and most consistent thread in the federal law of justiciability is that the federal courts will not give advisory opinions." *Flast v. Cohen*, 392 U.S. 83, 96, 88 S.Ct. 1942, 20 L.Ed.2d 947 (1968). The prohibition of advisory opinions is a constitutional limit on the power of the courts. *Id.*; *see* U.S. Const. art. III, § 2, cl. 1. The bankruptcy court's

statutory authority to certify questions to this court does not include the authority to request advisory opinions. True, in amending the law to allow direct appeal to the courts of appeal, Congress anticipated that our review would focus on "unresolved questions of law" rather than "fact-intensive issues." *See* H.R. Rep. 109-31(I), at 148–49 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 206. But this does not license us to answer a question of law divorced from the facts of the case before us and broader than necessary to resolve that case.

[6] [7] [8]We have declined to stray beyond the confines of the certified question in at least one case. ***206** *Peake v. Ayobami (In re Ayobami)*, 879 F.3d 152, 153 (5th Cir. 2018).[3] But there is no prohibition against narrowing the certified question—particularly where doing so would avoid rendering an advisory opinion while still addressing an important question of law. We treat certified questions under 28 U.S.C. § 158(d)(2)(A) "essentially as we treat certified questions from district courts" under 28 U.S.C. § 1292(b). *Crosby v. Orthalliance New Image (In re OCA, Inc.)*, 552 F.3d 413, 418 (5th Cir. 2008). Review under § 1292(b) looks to the entire certified order "and is not tied to the particular question formulated by the district court." *Yamaha Motor Corp., U.S.A. v. Calhoun*, 516 U.S. 199, 205, 116 S.Ct. 619, 133 L.Ed.2d 578 (1996). This is because § 1292(b) provides for an appeal "*from the order*" and, thus, it is the order that is appealable, not the certified question. *Id.* Just as § 1292(b) provides for an appeal "from the order," § 158(d)(2) provides for an "appeal of the judgment, order, or decree." 28 U.S.C. § 158(d)(2); *see Marshall v. Blake*, 885 F.3d 1065, 1072 n.6 (7th Cir. 2018).

In this case, we decline to answer the bankruptcy court's first certified question regarding the enforceability of "blocking provisions" and "golden shares" generally. "That question is appropriately reserved for a case in which it is not hypothetical." *Campbell-Ewald Co. v. Gomez*, —— U.S. ——, 136 S.Ct. 663, 672, 193 L.Ed.2d 571 (2016). Instead we confine our analysis to whether U.S. and Delaware law permit the parties to do what they did here: amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition.

IV.

[9]A bankruptcy case can be initiated in one of two ways. A qualified "debtor," *see* 11 U.S.C. § 109, can file a voluntary petition, *see Id.* § 301. Or, subject to certain requirements and limitations, creditors can file an involuntary petition against the debtor.[4] *See Id.* § 303(a)-(b). This case concerns a voluntary petition filed under Chapter 11 of the Bankruptcy Code. *Id.* §§ 1101-1174. A corporation like FSNA is a qualified debtor under Chapter 11. *See Id.* § 109(a)-(b), (d). It may therefore file a voluntary petition under that chapter. *See Id.* § 301. But a corporation cannot act on its own; it can act only if authorized by appropriate agents. *See, e.g., W.G. Yates & Sons Const. Co. Inc. v. Occupational Safety & Health Review Comm'n*, 459 F.3d 604, 607 (5th Cir. 2006). The Bankruptcy Code provides that an "entity that may be a debtor" may commence a voluntary case by filing a petition. *See* 11 U.S.C. § 301(a). Still, when the entity is a corporation that can act only through its agents, the Bankruptcy Code does not specify who may file a petition on its behalf.

[10] [11] [12] [13] [14]"In absence of federal incorporation, that authority finds its source in local law." *Price v. Gurney*, 324 U.S. 100, 106, 65 S.Ct. 513, 89 L.Ed. 776 (1945). State law thus determines who has the authority to file a voluntary petition on behalf of the corporation. *See id.* at 106–07, 65 S.Ct. 513; *In re Nica Holdings, Inc.*, 810 F.3d 781, 789 (11th Cir. 2015). If the petitioners lack authorization under state ***207** law, the bankruptcy court "has no alternative but to dismiss the petition." *Price*, 324 U.S. at 106, 65 S.Ct. 513. "It is not enough that those who seek to speak for the corporation may have the right to obtain that authority." *Id.* Rather, they must have it at the time of filing. *See id.* at 106–07, 65 S.Ct. 513. Absent a duly authorized petition, the bankruptcy court has no power "to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims." *Id.*

FSNA contends that even assuming Delaware law authorizes the arrangement here, federal law would forbid it. Federal law forbids the arrangement, in FSNA's view, not because it is contrary to any specific statute or binding caselaw, but instead because it violates a federal public policy against waiving the protections of the Bankruptcy Code. Several courts of appeals—though not this one—have opined that a pre-petition waiver of the benefits of bankruptcy is contrary to federal law and therefore void. *See 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." (quoting *Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1177 (9th Cir. 2002))); *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (stating in dictum that

"[f]or public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy"); *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) (stating in dictum that "an advance agreement to waive the benefits of the [Bankruptcy] Act would be void"). Boketo agrees that a debtor cannot contract away the protections of bankruptcy. Moreover, this case does not involve a contractual waiver of the right to file for bankruptcy or to a discharge. As this case is framed, we can assume without deciding that such a waiver is invalid. We leave the resolution of that issue for another case, one in which it is squarely presented.

Instead, this case involves an amendment to a corporate charter, triggered by a substantial equity investment, that effectively grants a preferred shareholder the right to veto the decision to file for bankruptcy. In FSNA's view, this is just a wolf in sheep's clothing—a creditor masquerading as a bona fide equity owner. Boketo is fully controlled by Macquarie, meaning the veto right in fact belongs to Macquarie—an unsecured creditor by virtue of its unpaid fees. In support of its argument, FSNA cites a slew of bankruptcy court cases. These cases all involve arrangements whereby a lender extracts an amendment to the organization's foundational documents granting the lender a veto right in exchange for forbearance. *See In re Lexington Hosp. Grp., LLC*, 577 B.R. 676, 679–81, 684–86, 688 (Bankr. E.D. Ky. 2017) (denying motion to dismiss where lender conditioned financing on grant of equity interest and appointment of non-fiduciary blocking director with right to prevent bankruptcy); *In re Intervention Energy Holdings*, 553 B.R. at 261, 266 (denying motion to dismiss where lender conditioned forbearance on issuance of single common unit in exchange for $1 and amendment of operating agreement to require unanimous consent for bankruptcy); *In re Lake Mich. Beach Pottawattamie Resort*, 547 B.R. at 903–04, 911–15 (denying motion to dismiss where lender conditioned forbearance on appointment of lender as non-fiduciary "special member" with right to prevent bankruptcy but without right to distributions or obligation to make capital contributions); *In re Bay Club Partners–472, LLC*, No. BR 14-30394-RLD11, 2014 WL 1796688, at *3–6 (Bankr. D. Or. May 6, 2014) (denying motion to dismiss where lender requested ***208** provision in operating agreement prohibiting filing voluntary petition before all debts were paid in full).

[15]None of these cases concerns the situation here. Even treating Boketo and Macquarie as a single entity,[5] there is no evidence that their arrangement was merely a ruse to ensure that FSNA would pay Macquarie's bill. In 2012, Macquarie, through Boketo, took a substantial equity stake in FSNA, buying convertible preferred stock for $15 million. In 2013, Macquarie issued an invoice for the $2.5 million arrangement fee.[6] FSNA would have us believe the tail wags the dog. It strains credulity to believe that Macquarie made a $15 million equity investment just to hedge against the possibility that FSNA might not pay a $3 million bill. We do not doubt that Macquarie would have preferred to avoid the cost and inconvenience of trying to collect some portion of its $3 million fee as an unsecured creditor in bankruptcy.[7] But if it was anxious about whether FSNA would fail to pay the fee, then it was just throwing good money after bad—$15 million of good money. FSNA points to no evidence that would allow us to set aside our incredulity and conclude that Macquarie invested $15 million in FSNA to ensure payment of a $3 million bill.[8]

[16]The Supreme Court held more than seventy years ago that corporate authority to file for bankruptcy "finds its source in local law." *See Price*, 324 U.S. at 106, 65 S.Ct. 513. FSNA has provided us no reason to depart from that general rule in this case. There is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill. "It is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor's decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy." *In re Squire Court Partners*, 574 B.R. at 708; *see also In re Glob. Ship Sys., LLC*, 391 B.R. 193, 199, 203 (Bankr. S.D. Ga. 2007) (holding that owner of 20% equity stake and $18 million debt "wears two hats" and may exercise a right to prevent a voluntary bankruptcy petition). In sum, there is ***209** no compelling federal law rationale for depriving a bona fide equity holder of its voting rights just because it is also a creditor of the corporation.

[17]FSNA urges that even if a shareholder-creditor could hold a bankruptcy veto right, such a right remains void in the absence of a concomitant fiduciary duty. But FSNA offers no good legal or logical rationale for such a holding. No statute or binding caselaw licenses this court to ignore corporate foundational documents, deprive a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor. *Cf. Price*, 324 U.S. at 106, 65 S.Ct. 513 ("[U]nder the Bankruptcy Act the power of the court to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims is strictly limited to those situations

where a petition has been approved."). The bankruptcy court opinions FSNA cites are not controlling and not to the contrary. They involve creditors' attempts to appoint non-fiduciary officers and directors with the ability to prevent a bankruptcy filing. *See In re Lexington Hosp. Grp.*, 577 B.R. at 684–86 (holding veto right of creditor-controlled LLC member invalid where the LLC's governing documents directed member to consider only the creditors' interests); *In re Lake Mich. Beach Pottawattamie Resort*, 547 B.R. at 913 ("The essential playbook for a successful blocking *director* structure is this: the *director* must be subject to normal *director* fiduciary duties ...." (emphasis added)).[9] As a matter of federal law, fiduciary duties are not required to allow a bona fide shareholder to exercise its right to prevent a voluntary bankruptcy petition.

[18]This is not an advisory opinion, and our holding is limited to the facts actually presented in this case. We hold simply that federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty to the corporation or its fellow shareholders. 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.

V.

We turn now to the main event: does Delaware law allow Boketo to exercise the blocking right? Authority to file for bankruptcy is, after all, a matter of state law. *See Price*, 324 U.S. at 106–07, 65 S.Ct. 513. This question has two parts. First, whether Delaware law allows parties to provide in the certificate of incorporation that the consent of both classes of shareholders is required to file a voluntary petition for bankruptcy. Second, whether Delaware law would impose a fiduciary duty on a minority shareholder with the ability to prevent a voluntary bankruptcy petition.

A.

[19] [20] [21]This is not a diversity case. But because we apply state law to determine whether a corporate bankruptcy petition was properly authorized, the same principles apply. In evaluating issues of state law, we look to the decisions of the ***210** state's highest courts. *Temple v. McCall*, 720 F.3d 301, 307 (5th Cir. 2013). In the absence of a controlling decision, we make an "*Erie*[10] guess" as to how the state's highest court would resolve the issue. *Id.* Unless persuaded that the state's highest court would decide the issue differently, we also defer to the decisions of the state's intermediate appellate courts. *Id.*; *see Howe ex rel. Howe v. Scottsdale Ins. Co.*, 204 F.3d 624, 627 (5th Cir. 2000). To determine corporate authority to file for bankruptcy, we apply the law of the state of incorporation—here, Delaware. *See Price*, 324 U.S. at 104 & n.1, 106, 65 S.Ct. 513.

B.

Under the Delaware General Corporation Law, a certificate of incorporation "may" contain:

> Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State.

Del. Code tit. 8, § 102(b)(1). As a default rule, "[t]he business and affairs of every corporation ... shall be managed by or under the direction of a board of directors." *Id.* § 141(a). There is, however, an exception to the default rule: the management prerogative rests with the board, "except as may be otherwise provided in this chapter or in its certificate of incorporation." *Id.* If the certificate departs from the default rule, then "the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation." *Id.*

[22]"Delaware's corporate statute is widely regarded as the most flexible in the nation." *Jones Apparel Grp., Inc. v. Maxwell Shoe Co.*, 883 A.2d 837, 845 (Del. Ch. 2004). Instead of dictating a rigid structure, "it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations, subject to relatively loose statutory constraints." *Id.* "Sections 102(b)(1) and 141(a) ... embody Delaware's commitment to private ordering in the charter." *Id.* In light of that commitment and the "broad effect" of these statutes, Delaware courts do "not lightly find that certificate provisions are unlawful." *Id.* at 845–46. A provision is not contrary to Delaware law just because it withdraws traditional power from the board. The "obvious purpose" of § 141(a) "is to permit (absent some conflict with Delaware public policy) certificate provisions to withdraw authority from the board." *Id.* at 852.

[23]We nonetheless decline to resolve whether the shareholder consent provision violates Delaware law. In the bankruptcy court, FSNA argued that the shareholder consent provision is invalid under Delaware law. On appeal, however, FSNA has expressly waived any such argument, stating that the "abstract question as to whether Delaware would ever allow a blocking provision need not be debated." When a party expressly waives an issue or argument, we lack the benefit of adversarial briefing and generally decline to consider the issue. *See Procter & Gamble Co. v. Amway Corp.*, 376 F.3d 496, 499 n.1 (5th Cir. 2004). We have all the more reason to do so here. The parties have not identified, ***211** and we have not discovered, any on-point Delaware cases. We decline to decide in the first instance whether the Delaware General Corporation Law would tolerate a provision in the certificate of incorporation conditioning the corporation's right to file a bankruptcy petition on shareholder consent.[11] For the purposes of this case, we assume it would.

C.

FSNA contends that Delaware law would classify Boketo as a controlling minority shareholder because of its ability to block a bankruptcy filing. As a result, fiduciary obligations would arise, invalidating any attempt to exercise the bankruptcy veto right. FSNA is wrong on both fronts.

1.

[24] [25] [26] [27]Under Delaware law, a shareholder is generally free to act in its self-interest, unencumbered by any fiduciary obligation. *See Ivanhoe Partners v. Newmont Min. Corp.*, 535 A.2d 1334, 1344 (Del. 1987). But there are two exceptions. "[A] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." *Id.* Delaware law thus imposes fiduciary duties on two kinds of shareholders: majority shareholders and minority controlling shareholders. *See Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1113–14 (Del. 1994); *Ivanhoe Partners*, 535 A.2d at 1344; *see also Lewis v. Knutson*, 699 F.2d 230, 235 (5th Cir. 1983) (applying Delaware law). Boketo owns convertible preferred shares that would amount to a 49.76% equity stake in FSNA if converted. That interest, though formidable, is just shy of majority control. Boketo could therefore only owe a fiduciary duty if it qualifies as a controlling minority shareholder. *See Weinstein Enters., Inc. v. Orloff*, 870 A.2d 499, 507–08 (Del. 2005); *Kahn*, 638 A.2d at 1113–14.

[28] [29] [30]The standard for minority control is a steep one. Potential control is not enough. *See In re Primedia Inc. Derivative Litig.*, 910 A.2d 248, 257 (Del. Ch. 2006). Instead, the shareholder must "dominat[e]" the corporation "through *actual control* of corporation conduct." *Kahn*, 638 A.2d at 1114 (emphasis added) (quoting *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989)); *see Lewis*, 699 F.2d at 235; *cf. Solomon v. Armstrong*, 747 A.2d 1098, 1117 n.61 (Del. Ch. 1999) ("[A] plaintiff must allege *literal control* of corporate conduct." (emphasis added)), *aff'd*, 746 A.2d 277 (Del. 2000) (unpublished table disposition). The "actual control test" is not easily satisfied. *See In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 992 (Del. Ch. 2014), *aff'd sub nom. Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015). A minority shareholder exercises "actual control" only when it has "such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control." *Id.* (quoting *In re PNB Holding Co. S'holders Litig.*, No. CIV.A. 28-N, 2006 WL 2403999, at *9 (Del. Ch. Aug. 18, 2006)).

[31] [32] [33]In making that determination, Delaware courts focus on control of the board. *See id.* at 992–93 (first citing *Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co.*, No. CIV.A. 1668-N, 2006 WL 2521426, at *4 (Del.

Ch. Aug. 25, 2006); then citing *In re Morton's Rest. Grp., Inc. S'holders Litig.*, 74 A.3d 656, 665 (Del. Ch. 2013)). The shareholder's command over the board must be "so potent that independent directors ... cannot freely exercise their judgment, fearing retribution." ***212** *In re Morton's Rest. Grp.*, 74 A.3d at 665 (alteration in original) (quoting *In re PNB Holding Co.*, 2006 WL 2403999, at *9). In short, a minority controlling shareholder must have "a combination of potent voting power and management control such that the s[hare]holder could be deemed to have effective control of the board without actually owning a majority of stock." *Corwin*, 125 A.3d at 307 (footnote omitted).

[34] [35]"A plaintiff who alleges domination of a board of directors and/or control of its affairs must prove it." *Kaplan v. Centex Corp.*, 284 A.2d 119, 122 (Del. Ch. 1971); *see* 12B William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Corporations* § 5811.50 (perm. ed., rev. vol. 2017) ("There must be some evidence demonstrating control, however, since the presumption is against it."). FSNA's argument for a finding of control boils down to this: Boketo owned preferred stock convertible to a 49.76% equity stake; it appoints two of the five directors (that is, a minority); and it is seeking to exercise its veto right (allegedly to squelch a lawsuit against its parent company). Although the size of the shareholder's equity stake is a factor in the analysis, it is not dispositive. *See In re PNB Holding Co.*, 2006 WL 2403999, at *9. "[T]he cases do not reveal any sort of linear, sliding-scale approach whereby a larger share percentage makes it substantially more likely that the court will find the stockholder was a controlling stockholder." *In re Crimson Expl. Inc. Stockholder Litig.*, No. CIV.A. 8541-VCP, 2014 WL 5449419, at *10 (Del. Ch. Oct. 24, 2014); *see also id.* at *10 n.50 (collecting cases); *compare, e.g., In re W. Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192, at *1, *29–30 (Del. Ch. May 22, 2000) (granting summary judgment based on finding that 46% shareholder did not exercise actual control), *with Kahn*, 638 A.2d at 1115 ("[N]otwithstanding its 43.3 percent minority shareholder interest, Alcatel did exercise actual control over Lynch by dominating its corporate affairs.").

In other words, the size of Boketo's stake is not enough. Instead, to demonstrate that Boketo is a controlling shareholder, FSNA must prove that Boketo *actually* dominated FSNA's corporate conduct. *See Kahn*, 638 A.2d at 1114; *Kaplan*, 284 A.2d at 122–23.

In *Kahn*—the "seminal" controlling shareholder case, *In re KKR Fin. Holdings*, 101 A.3d at 991—the Delaware Supreme Court found that a shareholder exercised actual control "*notwithstanding* its 43.3 percent minority shareholder interest." 638 A.2d at 1115 (emphasis added). The board in that case was considering both the renewal of management contracts and a proposed merger. *See id.* at 1114–15. In each case, the minority shareholder prevailed—"not because the [independent directors] decided in the exercise of their own business judgment that [its] position was correct," but because they felt powerless in the face of its opposition. *See id.* Indeed, one of the shareholder's appointed directors told the other board members, "You must listen to us. We are 43 [sic] percent owner. You have to do what we tell you." *Id.* at 1114. One of the independent directors testified that that statement "scared [the independent directors] to death." *Id.* Based on that evidence, the Delaware Supreme Court affirmed the Chancery Court's finding of actual control. *Id.* at 1115.

Likewise, the Chancery Court found that a 40% shareholder was a controlling shareholder in *In re Cysive, Inc. Shareholders Litigation*, 836 A.2d 531, 535, 552–53 (Del. Ch. 2003)—a case characterized by the Chancery Court as "its most aggressive finding that a minority blockholder was a controlling stockholder," ***213** *In re Morton's Rest. Grp.*, 74 A.3d at 665. In addition to his sizeable minority stake, the shareholder there was the company's founder, chief executive officer, and chairman. *In re Cysive, Inc.*, 836 A.2d at 552. "He [was], by admission, involved in all aspects of the company's business ...." *Id.* Moreover, several of his family members occupied high-level positions within the company. *Id.* The shareholder's "day-to-day managerial supremacy" distinguished the case from cases in which the Chancery Court had found that holders of even larger blocks of shares were not controlling shareholders. *Id.* (citing *In re W. Nat'l Corp.*, 2000 WL 710192, at *6).

[36]Despite Boketo's sizeable stake in FSNA, FSNA has pointed to no evidence that Boketo exercises *actual* control. FSNA cites Boketo's appointment of two of its five directors as evidence of control. But the appointment of a minority of directors—without more—is insufficient to demonstrate actual control. *Cf. In re Morton's Rest. Grp.*, 74 A.3d at 665 (finding that shareholder's 27.7% stake and control of two of ten board members, "without more, does not establish actual domination of the board"). FSNA has offered no evidence that, despite its minority board representation, Boketo's influence was so pervasive that it would qualify as a controlling shareholder under Delaware law. *See Corwin*, 125 A.3d at 307; *Kahn*, 638 A.2d at 1114–15; *In re KKR Fin. Holdings*, 101 A.3d at 992–93; *In re Morton's Rest. Grp.*, 74 A.3d at 665.

[37]FSNA also claims that Boketo exercises actual control

by virtue of its ability to prevent a voluntary bankruptcy filing by exercising its voting rights as a 100% preferred shareholder. But what matters is the dominating shareholder's *actual* exercise of control, not just the theoretical possibility that it *might* do so. *See Kahn*, 638 A.2d at 1114; *In re Primedia Inc.*, 910 A.2d at 257; *Solomon*, 747 A.2d at 1117 n.61. FSNA has not alleged domination of its day-to-day management. Instead, it claims only that Boketo *seeks* to exercise its veto right, which is enough to show control in FSNA's view. But the assertion is self-refuting. Boketo never did manage to exercise its right to vote one way or the other. FSNA's board never put the matter to a vote; instead, it simply adopted a resolution to file for bankruptcy without the shareholders' consent. A controlling shareholder's command of the board must be "so potent that independent directors ... cannot freely exercise their judgment, fearing retribution." *In re Morton's Rest. Grp.*, 74 A.3d at 665 (alteration in original) (quoting *In re PNB Holding Co.*, 2006 WL 2403999, at *9).

[38]Such was not the case here. The FSNA board's apparent ability and willingness to act without Boketo's consent undercuts the case for control. Boketo's inability to prevent the board from authorizing the filing—despite its right to do so—disproves the existence of the type of "potent voting power and management control" necessary to impose fiduciary obligations on a minority shareholder. The mere existence of the right to control is not enough; Boketo must have actually exercised it. *See Kahn*, 638 A.2d at 1114; *In re Primedia Inc.*, 910 A.2d at 257; *Solomon*, 747 A.2d at 1117 n.61. Nor does Boketo's intervention in the bankruptcy proceedings bolster the case for control. Indeed, the very fact that Boketo had to resort to filing a motion to dismiss the bankruptcy petition—an action hotly contested by FSNA in the bankruptcy proceedings and on appeal—only emphasizes its inability to control FSNA. To reuse a phrase: if Boketo is a controlling shareholder of FSNA, then the tail is wagging the dog.

***214 2.**

Even assuming Boketo were a controlling shareholder, there is a more fundamental defect in FSNA's argument. The proper remedy for a breach of fiduciary duty claim is not to allow a corporation to disregard its charter and declare bankruptcy without shareholder consent. Absent a properly authorized petition, the bankruptcy court has no "power ... to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims." *Price*, 324 U.S. at 106, 65 S.Ct. 513.

In *Price*, the debtor defaulted on its bonds and then struck a deal with its bondholders. *Id.* at 101, 65 S.Ct. 513. To placate them, it placed over 50% of its stock in a voting trust controlled by the bondholders. *Id.* The bondholders then controlled the company and elected its directors. *Id.* A majority of the shareholders tried to file a voluntary petition on the debtor's behalf. *Id.* at 102, 65 S.Ct. 513. The shareholders claimed that the voting trust was illegal and had expired by its own terms anyway. *Id.* They also claimed that the directors were unlawfully elected and had violated their fiduciary duties, thereby transferring to the shareholders the right to control the company. *Id.* at 104, 65 S.Ct. 513. The court acknowledged that the shareholders "may have [had] a meritorious case for relief." *Id.* at 107, 65 S.Ct. 513. But bankruptcy proceedings were not the appropriate venue to seek a remedy for their grievances. *See id.* at 106–07, 65 S.Ct. 513. Their remedy, if any, was under state law. *See id.* at 107, 65 S.Ct. 513.

Because we have already concluded that Boketo would not qualify as a controlling shareholder under Delaware law, we need not (and do not) decide whether it breached a fiduciary duty. Even if it had, the proper remedy is not to deny an otherwise meritorious motion to dismiss the bankruptcy petition. Instead, to the extent that Boketo breached any fiduciary duty owed as a controlling shareholder, FSNA must seek its remedy under state law.

VI.

For the foregoing reasons, we AFFIRM.

All Citations

891 F.3d 198, 65 Bankr.Ct.Dec. 196

Footnotes

1 As we note later in this opinion, our holding goes no further. This case involves a bona fide shareholder. The equity investment made by the shareholder at issue here was $15 million and the debt just $3 million. We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse.

2 The parties' briefing makes clear that the bankruptcy case is but one front in a larger conflict. In one case in New York state court, Macquarie is suing to collect its fees. FSNA has counterclaimed for its loss of capital value, blaming Macquarie for its tribulations. We need not dwell on the details of the various hostilities. They do not affect our analysis of federal bankruptcy law.

3 In *Ayobami*, "[w]e answer[ed] the certified question only," *declining* to address another question lurking in the background of the case. 879 F.3d at 153–55. We did not opine on our ability to answer that question.

4 Though not relevant to this case, the partners of a partnership or "a foreign representative of the estate in a foreign proceeding concerning" the debtor may also file an involuntary petition. *See* 11 U.S.C. § 303(b)(3)-(4).

5 The bankruptcy court found that Macquarie fully controlled Boketo and, as we do, assumed for the sake of argument that the companies were one and the same. Although FSNA derides Boketo as a "paper company," there is nothing inherently improper or suspicious about creating a limited liability entity in order to facilitate an investment. At the hearing on this motion, *both* parties' witnesses testified that this practice is "very common" and "typical."

6 It is not clear from the record when Macquarie billed FSNA for the $500 thousand financial advisory fee.

7 Boketo's position in bankruptcy is actually worse than Macquarie's. Shareholders are the residual claimants of the estate, *see* 11 U.S.C. § 726(a)(6), entitled only to whatever remains after payment of the various secured and unsecured creditors, *see id.* §§ 507, 726; *cf. Torch Liquidating Tr. ex rel. Bridge Assocs. L.L.C. v. Stockstill*, 561 F.3d 377, 385 (5th Cir. 2009) ("When a corporation is insolvent ... its creditors take the place of the shareholders as the residual beneficiaries of any increase in value." (emphasis removed) (quoting *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007))).

8 FSNA repeatedly alleges throughout its brief that Boketo was trying to force it to draw on a $7.5 million Boketo line of credit. FSNA therefore labels Boketo a "potential" creditor. But FSNA admits that it never drew on the line of credit, regardless of the pressure it may have felt to do so. Consequently, the existence of the untapped line of credit is immaterial to the outcome of this case.

9 Contrary to the representations in FSNA's brief, the bankruptcy court in *In re Intervention Holdings* expressly declined to consider this issue. *See* 553 B.R. at 262–63.

10 *Erie R. Co. v. Tompkins*, 304 U.S. 64, 58 S.Ct. 817, 82 L.Ed. 1188 (1938).

11 The bankruptcy court declined to decide this issue for the same reason.

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577 B.R. 676
United States Bankruptcy Court,
E.D. Kentucky,
Lexington Division.

IN RE LEXINGTON HOSPITALITY GROUP, LLC,
Debtor

CASE NO. 17–51568

Signed September 15, 2017

Synopsis

Background: Lender moved to dismiss Chapter 11 petition filed on limited liability company's (LLC's) behalf, on theory that the LLC's managing member was without authority to file such a petition.

Holdings: The Bankruptcy Court, Gregory R. Schaaf, J., held that:

[1] provisions in amended operating agreement to which members of LLC had to agree as prerequisite for loan to the LLC were plainly intended to give lender a veto power over the LLC's ability to seek bankruptcy relief, and were void as contrary to federal public policy, and

[2] while, as result of LLC's default on company loan, lender had given notice of its intent to take steps to remove the LLC's managing member by securing appointment of receiver and had actually sought appointment of receiver in state court, managing member was still manager when Chapter 11 petition was filed, with authority to file bankruptcy petition on the LLC's behalf.

Motion denied.

West Headnotes (9)

[1] **Bankruptcy**
⇐Who May Institute Case

State law governs whether a business entity is authorized to file a bankruptcy petition.

Cases that cite this headnote

[2] **Bankruptcy**
⇐Who May Institute Case

If limited liability company's (LLC's) managing member did not have authority, acting alone, to file bankruptcy petition on the LLC's behalf, then dismissal of the debtor-LLC's Chapter 11 case was required under "for cause" provision. 11 U.S.C.A. § 1112(b).

1 Cases that cite this headnote

[3] **Bankruptcy**
⇐Proceedings; Motion or Sua Sponte Action

Burden of demonstrating "cause" for dismissal of Chapter 11 case filed by managing member on behalf of limited liability company (LLC), based on managing member's alleged lack of authority, acting alone, to file such a petition, was on movant. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[4] **Bankruptcy**
⇐Who May Institute Case

Default provisions in the Kentucky Limited Liability Company Act control on question of managing member's authority to file bankruptcy petition on limited liability company's (LLC's) behalf, if there is no operating agreement or if operating agreement is silent on this matter. Ky. Rev. Stat. Ann. § 275.001 et seq.

Cases that cite this headnote

[5] **Bankruptcy**
⚖Debtor's Contracts and Leases

Prepetition agreements purporting to interfere with a debtor's rights under the Bankruptcy Code are not enforceable. 11 U.S.C.A. § 101 et seq.

Cases that cite this headnote

[6] **Bankruptcy**
⚖Who May Institute Case

Provisions in amended operating agreement to which members of limited liability company (LLC) had to agree as prerequisite for loan to the LLC, that entity designated by lender would receive a 30% membership interest in LLC until loan was repaid, and that LLC could file for bankruptcy only with approval of at least 75% of its members, and only if such a filing was approved by so-called "independent manager" who was relieved of any fiduciary duties to members and specifically directed to consider the interests of lender prior to any such filing, were plainly intended to give lender a veto power over the LLC's ability to seek bankruptcy relief, and were void as contrary to federal public policy.

1 Cases that cite this headnote

[7] **Bankruptcy**
⚖Who May Institute Case

Under Kentucky law, managing member of limited liability company (LLC) had authority to file Chapter 11 petition of the LLC's behalf, where, aside from unenforceable provisions of amended operating agreement, which purported to grant lender a veto power over the LLC's ability to pursue bankruptcy relief, and which were void as violative of federal public policy, operating agreement granted managing member broad authority to "manage the business and affairs of the Company," without specifically addressing whether that authority included, or did not include, the authority to file bankruptcy petition on LLC's behalf. Ky. Rev. Stat. Ann. § 275.001 et seq.

1 Cases that cite this headnote

[8] **Bankruptcy**
⚖Who May Institute Case

Provision of the Kentucky Limited Liability Company Act, providing that an "act of a manager or a member which is apparently not for the carrying on in the usual way of the business or affairs of the limited liability company shall not bind the limited liability company unless, at the time of the transaction or at any other time, the act is authorized in accordance with the operating agreement," dealt only with "apparent authority" of a limited liability company's (LLC's) managers and members, and had no bearing on whether an LLC's managing member had "actual authority" to file bankruptcy petition on the LLC's behalf in absence of any provision in operating agreement expressly stating that managing member could, or could not, place the LLC in bankruptcy. Ky. Rev. Stat. Ann. § 275.135.

Cases that cite this headnote

[9] **Bankruptcy**
⚖Who May Institute Case

While, as result of limited liability company's (LLC's) default on company loan, lender had given notice of its intent to take steps to remove the LLC's managing member by securing appointment of receiver and had actually sought appointment of receiver in state court, managing member was still manager when Chapter 11 petition was filed, with authority to file bankruptcy petition on the LLC's behalf.

Cases that cite this headnote

Attorneys and Law Firms

*678 Laura Day DelCotto, Jamie L. Harris, DelCotto Law Group PLLC, Sara A. Johnston, Lexington, KY, for Debtor.

MEMORANDUM OPINION AND ORDER

Gregory R. Schaaf, Bankruptcy Judge

**1 This matter is before the Court on Creditor PCG Credit Partners, LLC's Motion to Dismiss [ECF No. 19] and supplemental briefing [ECF Nos. 47, 64, and 72] and Debtor's Limited Response to PCG Credit Partners, LLC's Motion to Dismiss [ECF No. 45] and supplemental briefing [ECF No. 63]. The issue is whether Janee Hotel Corporation ("Janee"), the Company Manager of Debtor Lexington Hospitality Group, LLC ("LHG"), had authority to authorize LHG to seek chapter 11 relief. The Court held hearings on August 7 and August 17, 2017. Additional briefing was requested after each hearing [ECF Nos. 33 and 52], and the matter was then taken under submission.

For the reasons stated more fully below, Janee, as Company Manager of LHG, had authority to file a chapter 11 petition on behalf of LHG.

I. RELEVANT FACTS AND PROCEDURAL HISTORY.

The relevant documents are discussed below, and the following facts are undisputed.

A. The Original Operating Agreement.

LHG was organized on May 27, 2015, as a limited liability company in the Commonwealth of Kentucky. [*See generally* Articles of Organization available at http://apps.sos.ky.gov/ImageWebViewer/(S(fmplag55mtkmsk453gobzibd))/OBDBDisplayImage.aspx?id=6177113 (last visited Sept. 14, 2017).][1] The Articles of Organization indicate that LHG is managed by a manager. [*Id.*] The Articles of Organization do not include the name of a manager, but the Secretary of State's public records indicate that the manager is Kenneth Moore. [*See* Kentucky Secretary of State Online Business Records available athttps://app.sos.ky.gov/ftshow/(S(bce00qpcxyi1avqb32z1wotm))/default.aspx?path=ftsearch& id=0923470&ct=06&cs=99999 (last visited Sept. 14, 2017).]

The Operating Agreement of Lexington Hospitality Group LLC, a Kentucky Limited Liability Company (the "Original Operating Agreement"), indicates that Janee was the sole Initial Member at the time of organization. [Original Operating Agreement, ECF No. 45–1, at Sec. 1.1(l), 1.9, 2.2 and Exh. A.] Kenneth Moore is the President of Janee. [*Id.* at p. 17.]

The Original Operating Agreement vests the authority "to manage the business and affairs" of LHG in the "Company Manager," *679 further defined as Janee. [*Id.* at Sec. 1.1(i), 3.1(a).] The Original Operating Agreement also provides:

> (b) Subject to the ultimate authority of the Member, the Company Manager shall have the responsibility and authority to conduct and manage the day-to-day operations and affairs of the Company. The Company Manager's duties shall including the following matters:
>
> (i) Contracts in the ordinary course of business including the purchase and sale of real property without limitation to price or location;
>
> (ii) Personnel and employment matters;
>
> (iii) Reporting on a monthly basis to the Member as to the day-to-day operations of the Company;
>
> (iv) Borrowing up to $5,000,000.00;
>
> **2 (v) Purchases or sales of up to $5,000,000.00 of assets outside the ordinary course of business; and
>
> (vi) Encumbering the Company's assets.

[*Id.* at Sec. 3.1(b).][2]

The Company Manager is authorized to "manage the business and affairs of LHG" and "conduct and manage

the day-to-day operations," but it must have prior approval of the Member to change LHG's business operations, admit a new member, or conduct potential conflict of interest transactions without the prior approval of the members. [*Id.* at Sec. 3.1(c).] The Original Operating Agreement does not contain any provisions that expressly address the Company Manager's and/or Member's authority, or lack thereof, to file bankruptcy on LHG's behalf.

B. The Amended Operating Agreement and Addendum No. 1.

In late September 2015, LHG acquired the Lexington Clarion Hotel and Conference Center at 5532 Athens Boonesboro Road, Lexington, Kentucky. PCG Credit Partners, LLC ("PCG") provided financing through a Security Promissory Note dated September 28, 2014, in the amount of $6,150,000.00 (the "Note"). [Affidavit of Hal Johnson in Support of Motion for Appointment of Receiver and Related Relief, ECF No. 19–3, at ¶¶ 3–4.] The Note is secured by a Mortgage and Security Agreement and an All–Assets Security Agreement covering the hotel and the related property. [*Id.* at ¶¶ 5–6.] Collectively, the Note, Mortgage and Security Agreement, and All–Assets Security Agreement are hereinafter referred to as the "Loan."

The Amended and Restated Operating Agreement of Lexington Hospitality Group, LLC, a Kentucky Limited Liability Company (the "Amended Operating Agreement"), dated September 29, 2015, was executed contemporaneously with the Loan. The Amended Operating Agreement indicates that it was executed to reflect the admission of 5532 Athens LLC ("5532 Athens") as a member of LHG. [Amended Operating Agreement, ECF No. 45–2, at p. 1.] PCG admits that it owns and/or controls 5532 Athens and the 30% membership interest was given to 5532 Athens "in exchange for, among other things" financing that PCG provided for the acquisition of the hotel. [PCG Credit Partners, LLC's Supplemental Brief in Further Support of Motion to Dismiss, ECF No. 64 ("PCG Supp. Resp."), at pp. 1–2.] The interest of 5532 Athens is referred to as an "Equity Kicker" throughout the relevant documents.

***680** The Amended Operating Agreement provides that 5532 Athens is admitted as a 30% member "until such point that Lexington Hospitality Group, LLC has repaid the Loan Amount, Exit Fee...and Equity for funds." [Amended Operating Agreement at p. 1.] The Amended Operating Agreement also states that the membership interest of 5532 Athens cannot be diluted until the Loan is paid. [*Id.* at Sec. 2.5(c).] Upon payment of the Loan, 5532 Athens shall no longer have an interest in LHG. [*Id.* at Sec. 9.1.]

****3** Two other parties received an ownership interest at the same time as 5532 Athens, resulting in the following ownership interests when the Amended Operating Agreement was signed:

MEMBER	% INTERE
Janee Hotel Corporation	60%
5532 Athens LLC	30%
Dubrs Investments, LLC	5%
Mitul Patel	5%

[*Id.* at Sec. 2.2 and Exh. A.]

Janee remains the defined Company Manager under the Amended Operating Agreement, and the general provisions in Section 3.1 governing the management of the Company have not changed. [*Compare* Original Operating Agreement at Sec. 3.1(a)-(c) *with* Amended Operating Agreement at Sec. 3.1(a)-(c).] But the Amended Operating Agreement includes several new provisions that relate to and limit LHG's ability to file bankruptcy.

The Amended Operating Agreement includes a new provision that provides: "The Company may declare Bankruptcy only so long as the Independent Manager authorizes such action." [Amended Operating Agreement at Sec. 3.5.] The Independent Manager is defined as Julia A. McCullough. [*Id.* at Sec. 1.1(l).] Similar restrictions are found in Addendum No. 1 to Operating Agreement (Single Purpose Entity Provisions) for Lexington Hospitality Group LLC, a Kentucky Limited Liability Company ("Addendum No. 1"). Addendum No. 1 is attached to, and adopted and incorporated in, the Amended Operating Agreement. [Amended Operating Agreement at p. 1; Addendum No. 1, ECF No. 45–2.]

"Article Three: Independent Manager" of Addendum No. 1 requires LHG to have at least one Independent Manager and states: "In order for the Company to declare Bankruptcy or dissolve and liquidate its assets, the Independent Manager must provide authorization, and then only upon a 75% vote of the Members.". [Addendum No. 1 at p. 5.] Article Three includes a list of nine

requirements that attempt to preserve the independence of the Independent Manager. [*Id.* at p. 4.] It then limits the Independent Manager's ability to act, vote, or otherwise participate in Company matters to those specific matters required by the Agreement, which is only the consent to file bankruptcy. [*Id.* at p. 5.] The Independent Manager is also instructed to consider the interests of the Company in acting or otherwise voting, as well as the interests of creditors and the economic interests of 5532 Athens. [*Id.*] Article Three next eliminates any fiduciary duty or liability that the Independent Manager might have to other members or managers. [*Id.*] The Independent Manager's role is terminated upon repayment of the Loan ***681** and the Equity Kicker.[3] [*Id.*]

"Article Two: Restrictions/Limitations on Powers and Duties" of Addendum No. 1 contains another condition restricting LHG's right to file any bankruptcy petition. [*Id.* at p. 3.] It provides that LHG shall not file bankruptcy "without the advance, written affirmative vote of the Lender and all members of the Company." [*Id.* (subsection (u)).] The Lender is identified as PCG in the recitals to the Amended Operating Agreement. [Amended Operating Agreement at 1.] This provision directly conflicts with "Article Three: Independent Manager," which only requires a 75% vote of the Members.

The provisions restricting a bankruptcy filing in the Amended Operating Agreement and Addendum No. 1 described in this Section I.B are referred to herein as the "Bankruptcy Restrictions."

C. The Forbearance Agreement and Addendum No. 2.

****4** On February 9, 2017, LHG, as the "Borrower," entered into a Forbearance Agreement with PCG, defined as the "Lender," after LHG defaulted on the Note. [Forbearance Agreement, ECF No. 45–3.] The Forbearance Agreement obligated LHG (not the Members) to execute the attached Addendum to The Operating Agreement of Lexington Hospitality Group LLC ("Addendum No. 2"). [*See* Forbearance Agreement, ECF No. 45–3, at ¶ III.B.1; Addendum No. 2, ECF No. 45–3.] The Forbearance Agreement was executed by PCG, as Lender,[4] Janee, as Manager of LHG, and Moore and Monee Moore Williams, as guarantors.[5] Addendum No. 2 was signed only by PCG, as Lender, and Janee, for itself and not as manager of LHG, despite a requirement in the Amended Operating Agreement that all Members must consent to an amendment thereto. [Amended Operating Agreement at Sec. 9.7.]

This entity confusion exists in other areas, such that PCG and 5532 Athens are essentially treated as one entity. For example, as part of the Forbearance Agreement, LHG agreed to transfer an additional equity interest to PCG as the Lender equaling 20% of the Company. [Forbearance Agreement at ¶ III.B.1.] But Addendum No. 2 requires Janee (not LHG) to transfer 20% of its membership interests to PCG, "or to a subsidiary or Affiliate as Lender may direct." [Addendum No. 2 at p. 2, ¶ 3]. The recitals in Addendum No. 2 indicate that Janee's membership interests will be transferred to 5532 Athens. [*Id.* at p. 1.] Further, LHG's petition and the parties' arguments reflect the following membership interests on the petition date:

***682**

MEMBER	% INTERE
Janee Hotel Corporation	40%
5532 Athens LLC	50%
Dubrs Investments, LLC	5%
Mitul Patel	5%

[*See* Chapter 11 Petition, ECF No. 1, at p. 9.]

Janee also agreed in Addendum No. 2 to transfer units equal to an additional 1% equity interest to PCG (not 5532 Athens) if LHG did not meet certain financial benchmarks by June 30, 2017. [Addendum No. 2 at p. 3, ¶ 7.] On July 5, 2017, PCG notified LHG of its default and failure to timely cure. [Notice of Default, ECF No. 45–4.] PCG sued LHG in state court and, on July 31, 2017, filed a motion seeking appointment of a receiver. [Motion for Appointment of Receiver and Related Relief, ECF No. 45–5.] Nothing in the record suggests the 1% transfer occurred.

D. The Bankruptcy.

On August 3, 2017, LHG filed for chapter 11 relief. The petition was signed by "Kenneth Moore/Janee Hotel Corporation" as Manager. [Chapter 11 Petition at p. 9.] The Corporate Resolution, also dated August 3, 2017, is signed by Janee, as Manager. [Corporate Resolution, ECF No. 3.] The Corporate Resolution directs Moore, as the Authorized Person, to file for chapter 11 relief. [*Id.*] It further disclaims any knowledge as to the contact

information or whereabouts of the Independent Manager and does not indicate a member vote was taken. [*Id.*]

On August 6, 2017, PCG filed its motion to dismiss this proceeding, arguing that the Bankruptcy Restrictions were not followed. [PCG Credit Partners, LLC's Motion to Dismiss, ECF No. 19 ("PCG Motion to Dismiss").] PCG also argues that, even if the Bankruptcy Restrictions are excised, the Amended Operating Agreement and the default provisions of Kentucky Limited Liability Company Act, K.R.S. §§ 275.001 *et al.* (the "Kentucky Act") do not allow the Company Manager to authorize a bankruptcy filing. [*See generally* PCG Credit Partners, LLC's Reply in Further Support of Motion to Dismiss, ECF NO. 47 ("PCG Reply"); PCG Supp. Resp.; PCG Credit Partners, LLC's Reply in Further Support of Motion to Dismiss, ECF No. 72 ("PCG Supp. Reply").]

**5 The parties have fully briefed and argued the issues, and the matter is ripe for a decision.

II. DISCUSSION.

A. The Company's Authority to File Bankruptcy is Controlled by Kentucky Law, but the Validity of the Bankruptcy Restrictions is a Matter of Federal Law.

[1] [2] [3]State law governs whether a business entity is authorized to file a bankruptcy petition. *In re East End Dev., LLC*, 491 B.R. 633, 638 (Bankr. E.D. N.Y. 2013); *In re D & W Ltd., LLC*, 467 B.R. 427, 432 (Bankr. E.D. Mich. 2012); *In re ComScape Telecomms., Inc.*, 423 B.R. 816, 830 (Bankr. S.D. Ohio 2010). If Janee, as Manager, did not have authority to file the petition acting alone, dismissal is required. 11 U.S.C. § 1112(b); *see also East End Dev.*, 491 B.R. at 639 (lack of consent required by an operating agreement is cause for dismissal). The burden of demonstrating cause for dismissal for lack of *683 authority to file is on the movant. *In re Oregon, Homes, LLC*, No. 13-33349, 2014 WL 4794861, at *2 (Bankr. N.D. Ohio Sept. 25, 2014).

[4]LHG is organized as a Kentucky limited liability company pursuant to its Articles of Organization, and the Amended Operating Agreement states that Kentucky law controls. [Amended Operating Agreement at Sec. 9.3.] The Kentucky Act provides that an operating agreement governs the parties' conduct, unless the statutes require otherwise. *See, e.g.*, K.R.S. §§ 275.005, 275.165, and 275.175. The default provisions in the Kentucky Act control if there is no operating agreement or the operating agreement is silent. *Racing Inv. Fund 2000 v. Clay Ward Agency*, 320 S.W.3d 654, 657 (Ky. 2010).

The Amended Operating Agreement exists, and the Bankruptcy Restrictions call into question Janee's ability to act alone, as Company Manager, to authorize the bankruptcy filing. Janee admits it did not obtain the Independent Manager's authority to file, nor did it obtain at least a 75% majority vote in favor of the filing, much less unanimous consent. [*See* Corporate Resolution, ECF No. 3.] It is also undisputed that PCG did not give its authority to file.

LHG argues, however, that the Bankruptcy Restrictions are against public policy and unenforceable. Enforceability of the Bankruptcy Restrictions based on public policy is a question of federal law. *In re Bay Club Partners–472, LLC*, No. 14-30394-RLD11, 2014 WL 1796688, at *4 (Bankr. D. Or. May 6, 2014). If the Bankruptcy Restrictions are excised, Janee claims authority to file bankruptcy under the remaining provisions of the Amended Operating Agreement and the Kentucky Act.

B. The Bankruptcy Restrictions are Unenforceable as Against Federal Public Policy.

1. A Contract Term Imposed by a Creditor that Prohibits a Bankruptcy Filing is Void as Contrary to Federal Public Policy.

[5]Parties to an operating agreement generally have the freedom to contract limited only by the parameters in the relevant articles of organization and statutory law. But, there is a strong federal public policy in favor of allowing individuals and entities their right to a fresh start in bankruptcy. "It has been said many times and many ways. '[P]repetition agreements purporting to interfere with a debtors rights under the Bankruptcy Code are not enforceable.' " *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 263 (Bankr. D. Del. 2016) (quoting *MBNA Am. Bank, N.A. v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)*, 275 B.R. 712, 723 (Bankr. D. Del. 2002)).

**6 Thus, many courts have held that attempts to contract away the right to file bankruptcy are generally

unenforceable. *The Bank of China v. Huang (In re Huang)*, 275 F.3d 1173, 1177 (9th Cir. 2002); *Hayhoe v. Cole (In re Cole)*, 226 B.R. 647, 652 (9th Cir. BAP 1998). "Indeed, since bankruptcy is designed to produce a system of reorganization and distribution different from what [*sic*] would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply." *In re 203 N. LaSalle St. P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000).

Based on this public policy consideration, courts have held that contractual provisions in operating agreements that essentially prohibit a company's ability to file bankruptcy without a creditor's consent are void. *See* ***684** *Intervention Energy Holdings*, 553 B.R. at 263–264; *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899, 913 (Bankr. N.D. Ill. 2016); *Bay Club Partners–472, LLC*, 2014 WL 1796688 at *4–5. The bankruptcy court in *Intervention Energy Holdings* explained:

> A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.

553 B.R. at 265.

This is not to say that members of a business entity cannot freely agree among themselves not to file bankruptcy. *See, e.g., In re Squire Court Partners LP*, 574 B.R. 701, 707–08 (E.D. Ark. 2017) (holding it was not proper to ignore the corporate governance documents "when the owners retain for themselves the decision whether to file bankruptcy."); *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 463 B.R. 142, at *3 (B.A.P. 10th Cir. 2010) (unpublished) (an agreement forced on members by a creditor solely for its own interest is distinguishable from an agreement among members). Thus, the issue is whether the Bankruptcy Restrictions were imposed by PCG, as a creditor, to create an absolute waiver of LHG's right to file bankruptcy.

2. The Bankruptcy Restrictions are Void as Contrary to Federal Public Policy.

[6]The Bankruptcy Restrictions added to LHG's governing documents, and the dilution of Janee's membership interests to enable an entity controlled by PCG to carry the deciding vote, create an absolute waiver of LHG's right to file bankruptcy. Therefore, the Bankruptcy Restrictions violate federal public policy and are void as discussed below.

First, the record reflects that the Bankruptcy Restrictions were a necessary part of the Loan. The Original Operating Agreement contained none of the Bankruptcy Restrictions and had no provisions that addressed the authority to file bankruptcy. Further, PCG concedes that 5532 Athens, an entity it controlled, received the Equity Kicker as a condition of the financing. [PCG Supp. Resp. at pp. 1–2.]

Second, the purpose of the Bankruptcy Restrictions was to prohibit LHG's ability to file bankruptcy without PCG's consent. A requirement that an independent person consent to bankruptcy relief, properly drafted, is not necessarily a concept that offends federal public policy. The appointment of an independent person to help decide the need for a bankruptcy filing may suggest fairness on all sides. The input of a truly independent decision maker avoids the fear and risk that a member or manager will act in its own self-interest. But, Article Three of Addendum No. 1 shows that the Independent Manager is not a truly independent decision maker.

***7** Article Three sets forth criteria required of the Independent Manager that appear to require true independence. [Addendum No. 1 at p. 4 (subsections (a)-(i)).] The independence and impact of these provisions, however, are limited by the remaining paragraphs in Article Three. The Independent Manager is instructed to consider ***685** the interests of creditors and 5532 Athens, such that her duties to the Company and parties are abrogated. [*Id.* at p. 5.] An independent decision maker cannot exist simply to vote "no" to a bankruptcy filing, but should also have normal fiduciary duties. *See Lake Michigan Beach*, 547 B.R. at 911–913.

Article Three also limits the existence of the Independent Manager to payment of the Note and Equity Kicker, which links her directly to the Loan. This connection with the financing highlights the concern that the Independent Manager is not actually independent from the creditor who negotiated for her participation in a bankruptcy decision.

Regardless, there is no need to consider the independence of the Independent Manager because the penultimate sentence of Article Three confirms that the Independent Manager is merely a pretense to suggest that the right to file bankruptcy is not unfairly restricted. The sentence provides: "In order for the Company to declare Bankruptcy or dissolve and liquidate its assets, the Independent Manager must provide authorization, **and then only upon a 75% vote of the Members**." [Addendum No. 1 at p. 5 (emphasis supplied).]

A 75% majority vote gives the impression that LHG's Members may decide whether or not to file without outside influence, but the term is just another attempt to disguise the full impact of the restriction. Janee agreed as part of the Loan to dilute its 100% ownership interest to give a 30% membership interest to 5532 Athens and divide another 10% membership interest between two other minority members. Janee also agreed it would not dilute 5532 Athens' 30% membership interest, except upon payment of the Note and Equity Kicker. Janee's initial 100% membership interest was therefore reduced to only a 60% interest, making it impossible for Janee and the other minority members to achieve a 75% majority without an affirmative vote from 5532 Athens.

PCG admits that it owns and controls 5532 Athens. [*See* PCG Motion to Dismiss, at p. 1 n. 1 (PCG admits ownership or control).] Even without this admission, PCG's complete degree of control is underscored in the operating agreements and addendums as previously discussed in Section I.C of this Opinion.[6] Thus, even if the Independent Manager understands her duties and decides bankruptcy is the best option, PCG could always use its control of 5532 Athens to block a bankruptcy filing.[7]

PCG's power to prohibit a bankruptcy filing is even more direct in Article Two of Addendum No. 1. This section gives PCG veto power regardless of the Members' consent to a bankruptcy filing. [Addendum No. 1 at p. 3 (subsection (u)).] So, even if 5532 Athens understands its duties and votes with the other Members to seek bankruptcy relief, and the Independent Manager consents, PCG could still withhold its approval. Unlike a member or manager, PCG has no restrictions and no fiduciary duties to LHG that might limit self-interested decisions that ignore the ***686** best interests of the Company. *See Lake Michigan Beach*, 547 B.R. at 913 ("The essential playbook for a successful blocking director structure" requires normal director fiduciary duties.)

***8** Such provisions, alone or working in tandem, serve only one purpose: to frustrate LHG's ability to file bankruptcy. As a result, the Bankruptcy Restrictions are unenforceable.

C. The Company Manager has Authority to File Bankruptcy pursuant to the Amended Operating Agreement and the Kentucky Act.

1. The Duties of the Company Manager Do Not Exclude the Ability to File for Bankruptcy Protection.

[7]The parties have not argued against the validity of the remaining provisions of the Amended Operating Agreement if the Bankruptcy Restrictions are void and unenforceable. This result is required by the Amended Operating Agreement, which contains a clause that provides that the remaining provisions are valid even if some provisions are declared invalid. [Amended Operating Agreement at Sec. 9.6.]; *see also Patton v. 24/7 Cable Co., LLC*, No. N12C-01-177CLS, 2013 WL 1092147, at *3 (Del. Super. Ct. Jan. 30, 2013) (courts uphold remaining terms unless it must rewrite the agreement); *Cox v. Wagner*, 907 S.W.2d 770, 771 (Ky. 1995) (Kentucky courts will not set aside the entire contract unless "good and bad parts cannot be separated without altering [the contract's] purpose."). There is no basis to ignore the remaining terms of the Amended Operating Agreement.

Article III of the Amended Operating Agreement, titled "MANAGEMENT AND CONTROL OF COMPANY," gives the Company Manager broad authority to "manage the business and affairs of the Company." [Amended Operating Agreement at Sec. 3.1(a).] Section 3.1(b) includes a list of the day-to-day operations, and Section 3.1(c) contains a list of actions that require the unanimous consent of the members. Neither provision specifically addresses bankruptcy, nor does any other remaining provision in Article III.

LHG asserts that the omission of any mention of bankruptcy simply means that Janee has the power to file

bankruptcy under the Kentucky Act, which grants a manager broad authority and does not restrict a manager's ability to put a company into bankruptcy. In contrast, PCG argues for a more restrictive reading of the Amended Operating Agreement. PCG asserts the authority of the Manager in Section 3.1(b) is limited to "day-to-day operations" and LHG has admitted that filing bankruptcy is not part of a business' day-to-day operations. *See, e.g., In re Loverin Ranch*, 492 B.R. 545, 548 (Bankr. D. Or. 2013) ("Filing a voluntary bankruptcy case is a paradigm action outside the ordinary course of [business].") PCG concludes that the Amended Operating Agreement "is the only document that is relevant for the Court's consideration of the Manager's authority because it shows a clear intent to override the 'default provisions' of the Kentucky Revised Statutes...by expressly limiting the scope of the Manager's authority..." [PCG Supp. Reply at p. 5.]

PCG is reading too much into the Amended Operating Agreement. Section 3.1(a) specifically vests broad authority in the Company Manager "except as expressly provided otherwise in this Agreement." Except for the unenforceable Bankruptcy Restrictions, no other provision in the Amended Operating Agreement "expressly provides" that the Company Manager does, or does not, have authority to file bankruptcy.

**9 Further, courts look to Kentucky law when an operating agreement is silent, and *687 the Kentucky Act supports a manager's authority to file bankruptcy on the Company's behalf. *See Chapman v. Reg'l Radiology Assocs., PLLC*, No. 2010-CA-00131-MR, 2011 WL 1085999, at *6–7 (Ky. Ct. App. Mar. 25, 2011). The broad parameters of a manager's authority in a manager-managed limited liability company are found in § 275.165 and § 275.175 of the Kentucky Act. Section 275.165 outlines the manager's exclusive power to manage the overall business and affairs of the company:

> If the articles of organization vest management of the limited liability company in one (1) or more managers, except to the extent otherwise provided in the articles of organization, the operating agreement, or this chapter, the manager or managers shall have exclusive power to manage the business and affairs of the limited liability company. Unless otherwise provided in the articles of organization or the operating agreement, managers:
>
> (a) Shall be designated, appointed, elected, removed, or replaced by a vote, approval, or consent of the majority-in-interest of the members;
>
> (b) Shall not be required to be members of the limited liability company or natural persons; and
>
> (c) Unless they are sooner removed or sooner resign, shall hold office until their successors shall have been elected and qualified.

K.R.S. § 275.165(1).

The voting provisions of the Kentucky Act also show the expansive nature of a manager's ability to operate a company. A simple majority of managers is all that is necessary to decide "any matter connected with the business affairs" of the company, unless the articles of incorporation, written operating agreement, or the Act state otherwise. K.R.S. § 275.175(1). Section 275.175(2) imposes some limitations by requiring unanimous member consent for certain duties, but bankruptcy is not one of them. K.R.S. § 275.175(2). The manager's authority under the Kentucky Act is not limited to day-to-day operations or the ordinary course of business. *See* Thomas E. Rutledge, *The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member–Managed Versus Manager–Managed Distinction in the Limited Liability Company,* 93 KY. L.J. 737, 747 (2005) (citations omitted) (indicating the provisions of K.R.S. § 275.175(1)-(2) give a manager "extraordinary" authority to run the business of the company).

Filing bankruptcy may be outside the ordinary course, but it is a business decision and is connected to the business affairs of the Company. Thus, Janee had authority under the Amended Operating Agreement and the Kentucky Act to file the petition for LHG.

2. Any Limitation on the Apparent Authority of the Company Manager Does Not Limit Janee's Authority to File Bankruptcy.

[8]PCG also argues that a manager's authority in a manager-managed limited liability company is limited by K.R.S. § 275.135. [PCG Reply at p. 2.] The relevant parts of K.R.S. § 275.135 upon which PCG relies are:

> (2) ...
>
> (b) Every manager shall be an agent of the limited liability company for the purpose of its business or affairs, and the act of any manager, including, but not limited to, the execution in the name of the limited liability company of any instrument, for

> apparently carrying on in the usual way the business or affairs of the limited liability company of which he is the manager shall *688 bind the limited liability company, unless the manager so acting has, in fact, no authority to act for the limited liability company in the particular matter, and the person with whom the manager is dealing has knowledge or has received notification of the fact that the manager has no such authority.
>
> **10 (3) An act of a manager or a member which is apparently not for the carrying on in the usual way of the business or affairs of the limited liability company shall not bind the limited liability company unless, at the time of the transaction or at any other time, the act is authorized in accordance with the operating agreement.

PCG's argument is unavailing.

Section 275.135 is not applicable to this discussion because it deals with statutory *apparent* agency authority of members or managers of limited liability companies, not the manager's *actual* authority to make decisions in § 275.165 and § 275.175. *See* Thomas E. Rutledge, *The 2007 Amendment to the Kentucky Business Entity Statutes*, 97 KY. L. J. 229, 260 (2009) (citations omitted) (discussing the legislative decision to move a provision addressing delegation of actual authority from § 275.135 to § 275.165(3) because of the differences between actual authority and apparent authority). Section 275.135 has no bearing on whether a manager has actual authority to act on behalf of the limited liability company.

D. Janee was the Manager at the Time the Petition was Filed.

[9]PCG argues Janee was not the manager as of July 19, 2017, pursuant to the Forbearance Agreement and Addendum No. 2. Janee had agreed that it would transfer an additional 1% equity interest in LHG to PCG if it failed to timely cure a default. [Addendum No. 2 at p. 3, ¶ 7.] Janee also agreed to "take any necessary action to transfer to PCG, or its agents, affiliates subsidiaries or assigns, management and control of the Company." [*Id.*] LHG has not contradicted the existence of the defaults described in the July 5, 2017 default letter. [PCG Motion to Dismiss, at p. 4; *see also* Default Letter, ECF No. 19–2.]

The argument Janee was not the Company Manager on the petition date is not persuasive. The Forbearance Agreement and Addendum No. 2 are not self-executing. It is undisputed that Janee did not take any action to transfer management or control.[8] PCG notified Janee of its intent to take steps to remove Janee by the appointment of a receiver and sought appointment of a receiver in state court, but the process was interrupted by LHG's bankruptcy filing. Janee's default and failure to act did not automatically divest Janee of is status at the Company Manager.

III. CONCLUSION.

Janee had authority to approve a bankruptcy filing on behalf of LHG as Company Manager. Therefore, based on the foregoing, it is ORDERED that PCG's Motion to Dismiss [ECF No. 19] is DENIED.

All Citations

577 B.R. 676, 2017 WL 4118117

Footnotes

1 The Court takes judicial notice of the Kentucky Secretary of State's website and documents available thereby. *See Arvest Bank v. Byrd*, 814 F.Supp.2d 775, 787 n.4 (W.D. Tenn. 2011).

2 The "Company" is defined as LHG in the governing documents, and the term is used to reference LHG in this Opinion as well. [Original Operating Agreement at Sec. 1.1(h).]

3 The value of the Equity Kicker is $2,700,000.00. [Addendum No. 1 at pp. 7–8.]

4 The Amended Operating Agreement includes a signature line for 5532 Athens, as Member, but there is no signature. Similarly, the Forbearance Agreement includes a signature line for PCG, as Lender, but it is not executed. PCG has not suggested these are not actual copies of the operative documents, so the relevant signatures are assumed for the purpose of this Opinion.

5 The other members, 5532 Athens, Dubrs Investments, LLC, and Mitul Patel, did not sign.

6 PCG also periodically refers to PCG and 5532 Athens interchangeably in its briefing as "5532 Athens/PCG." [PCG Supp. Resp. at p. 2 ("Subsequent thereto and for good and valuable consideration, on or about February 9, 2017, Janee transferred twenty percent (20%) of its then membership interests in the Debtor to 5532 Athens/PCG thereby making Janee a minority owner of the Debtor and 5532 Athens a fifty (50%) percent owner.")].

7 The 75% membership vote requirement conflicts with the unanimous consent requirement also found in Addendum No. 1. *Supra* at Section I.B of this Opinion. Because the impact of 5532 Athens ownership interest affects the ability to file bankruptcy when only a 75% vote is required, it does not matter if unanimous consent is also required—the result is the same and 5532 Athens/PCG controls the vote.

8 It is also questionable whether Addendum No. 2 is even effective. Amending the governing documents to name a new Company Manager requires a unanimous written agreement of the members. [Amended Operating Agreement at Sec. 9.7.]

End of Document

574 B.R. 701
United States District Court, E.D. Arkansas, Western Division.

IN RE: SQUIRE COURT PARTNERS LIMITED PARTNERSHIP, Debtor
Squire Court Partners Limited Partnership and National Community Renaissance Development Corporation, Appellants/Cross–Appellees
v.
Centerline Credit Enhanced Partners LP Series J and Chartermac Credit Enhanced SLP LLC Series J, Appellees/Cross–Appellants
Wells Fargo Bank, N.A., Appellee

No. 4:16CV00935 JLH
|
Signed 07/07/2017

Synopsis
Background: General partner of Chapter 11 debtor, an Arkansas limited partnership formed for the purpose of acquiring, operating, and leasing a low-income apartment complex, filed bankruptcy petition on debtor's behalf, against the wishes of debtor's limited partners. Limited partners moved for dismissal of petition and for sanctions. Following evidentiary hearing, the Bankruptcy Court, Richard D. Taylor, J., granted the motion to dismiss, but denied sanctions. General partner, acting on behalf of debtor, and general partner's affiliate appealed. Limited partners cross-appealed.

Holdings: The District Court, J. Leon Holmes, J., held that:

[1] under Arkansas law, general partner lacked authority to file the bankruptcy petition without limited partners' consent;

[2] there was no reason to remand the matter to the bankruptcy court for another evidentiary hearing; and

[3] the bankruptcy court did not abuse its discretion in denying limited partners' motion for sanctions.

Affirmed.

West Headnotes (12)

[1] **Partnership**
⇨Fiduciary duty to partnership and limited partners
Partnership
⇨Limited Partners

Under Arkansas's Uniform Limited Partnership Act, limited partners owe the partnership a duty of good faith and fair dealing, and the general partner owes the partnership duties of good faith and fair dealing, care, and loyalty. Ark. Code Ann. §§ 4-47-305(b), 4-47-408.

Cases that cite this headnote

[2] **Bankruptcy**
⇨Conclusions of law; de novo review
Bankruptcy
⇨Clear error

District court sits as an appellate court when reviewing a bankruptcy court's judgment, reviewing legal questions de novo and factual findings for clear error.

Cases that cite this headnote

[3] **Bankruptcy**
⇨Who May Institute Case

Whether Chapter 11 debtor's general partner had authority to file its bankruptcy petition was a legal question.

3 Cases that cite this headnote

[4] **Bankruptcy**
⇨Representatives of corporations

Person filing a voluntary bankruptcy petition on a corporation's behalf must be authorized to do so, and the authorization must derive from state law.

Cases that cite this headnote

[5] **Bankruptcy**
⇐Who May Institute Case

Under Arkansas law, general partner of Chapter 11 debtor-limited partnership lacked authority to file voluntary bankruptcy petition on debtor's behalf where, although debtor's amended partnership agreement gave general partner exclusive authority to manage and control debtor's business, assets, and affairs, agreement required unanimous consent of partners before debtor could "file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy," both of debtor's limited partners declined to consent to filing of bankruptcy petition, and unanimous-consent clause was not void as violating federal public policy. Ark. Code Ann. § 4-47-110(a).

1 Cases that cite this headnote

[6] **Bankruptcy**
⇐Representatives of corporations
Corporations and Business Organizations
⇐Authority of directors

Corporation's board of directors has authority to decide whether entity will file for bankruptcy because that authority is delegated to the board.

1 Cases that cite this headnote

[7] **Partnership**
⇐General Partner

Just as the authority of a corporation's board of directors is delegated, a general partner has authority delegated to it to act on behalf of the partnership.

Cases that cite this headnote

[8] **Bankruptcy**
⇐Remand

On appeal from the bankruptcy court's dismissal of Chapter 11 petition filed by debtor-limited partnership's general partner without the unanimous consent of debtor's limited partners, there was no reason for the district court to remand the case for additional factual development where the bankruptcy court, prior to granting limited partners' motion to dismiss, had held an evidentiary hearing at which it placed no restriction on the parties' ability to introduce evidence.

Cases that cite this headnote

[9] **Bankruptcy**
⇐Good Faith; Motive

Whether a bankruptcy petition has been filed in bad faith is a question of fact.

Cases that cite this headnote

[10] **Bankruptcy**
⇐Discretion

Bankruptcy court's decision to impose or not impose sanctions is reviewed for an abuse of discretion.

Cases that cite this headnote

[11] **Bankruptcy**
⚖Frivolity or bad faith; sanctions

Bankruptcy court did not abuse its discretion in denying motion for sanctions filed by limited partners of Chapter 11 debtor-limited partnership, even though debtor's general partner was found to have filed a voluntary bankruptcy petition on behalf of debtor without authority, in violation of clause of amended partnership agreement requiring unanimous consent of the partners, where there were valid reasons to pursue bankruptcy, and a lack of evidence of bad faith.

Cases that cite this headnote

[12] **Bankruptcy**
⚖Cause in general

Because authority to file a voluntary bankruptcy petition is treated as a jurisdictional issue, once the bankruptcy court finds authority lacking, it must dismiss.

1 Cases that cite this headnote

Attorneys and Law Firms

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OPINION AND ORDER

J. LEON HOLMES, UNITED STATES DISTRICT JUDGE

Squire Court Partners Limited Partnership is an Arkansas limited partnership consisting of three partner-entities: Centerline Credit Enhanced Partners LP, Chartermac Credit Enhanced SLP LLC, and NHDC Texas Affordable Housing, Inc. Centerline is a limited partner, Chartermac is a special limited partner,[1] and NHDC Texas is the general partner of Squire Court. NHDC Texas, on behalf of Squire Court, petitioned for Chapter 11 bankruptcy in the bankruptcy court for the Eastern District of Arkansas. This was done without the consent of and against the wishes of the limited partners, who moved the bankruptcy court to dismiss the petition. After an evidentiary hearing, the bankruptcy court[2] granted that motion. NHDC Texas, acting on behalf of Squire Court, and National Community Renaissance Development Corporation, an affiliate of NHDC Texas, appealed. Centerline and Chartermac have cross-appealed. Wells Fargo Bank, N.A., the trustee with respect to revenue bonds issued by the Pulaski County Public Facilities Board secured by the assets of Squire Court, also is *704 an appellee. This Court affirms.[3]

Squire Court was originally formed on June 27, 2005, for the purpose of acquiring, operating, and leasing a low-income apartment complex. It had a single general partner and a single limited partner. Squire Court planned to purchase real estate and construct and lease 155 apartment units that would make the partnership eligible for low-income housing tax credits. On October 1, 2006, Squire Court took on new partners, and its partnership agreement was amended to reflect the changes. The original general and limited partner both withdrew from Squire Court. Centerline, then known as RCC Credit Facility, L.L.C., became a limited partner, committing to contribute $1,392,000 in accordance with specified terms and conditions. In return, Centerline was given a 99.98% interest in Squire Court. Chartermac, then known as Related Direct SLP LLC, also became a limited partner and was given a .01% interest in Squire Court. NHDC Texas became Squire Court's sole general partner and was given a .01% interest in Squire Court.

Under the amended partnership agreement, NHDC Texas was given exclusive authority to manage and control

Squire Court's business, assets, and affairs. The agreement, however, required unanimous consent of the partners before Squire Court could "file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy."

A "Development Deficit Guaranty Agreement" was also executed at this time. As its name suggests, the guaranty agreement obligated the guarantor to cover certain cost overruns. These costs included any "Development Deficit"—costs of acquiring and developing the apartment complex (most notably a $3,400,000 mortgage) that exceeded cash flow and other revenue streams—and "all expenses of operating and maintaining the Improvements in excess of the Gross Collections to the extent necessary to maintain Break–Even Operations."[4] National Community Renaissance Development Corporation, then known as National Housing Development Corporation, is the guarantor under terms of the agreement. National Community Renaissance is an affiliate of NHDC Texas, and the guaranty agreement sets out that it stood to benefit from the acquisition by the limited partners of a partnership interest in Squire Court. The guaranty agreement also states that the guaranty induced the limited partners to acquire their interests in Squire Court.

In March 2016, NHDC Texas ceased making payments on Squire Court's mortgage. Wells Fargo Bank, N.A., the mortgage servicer, accelerated the maturity date of the mortgage. Although the terms of the guaranty agreement required National Community Renaissance to pay the accelerated amount, it refused. In June 2016, the limited partners filed suit in Arkansas state court against National Community Renaissance to enforce the terms of the guaranty agreement. While that action was ongoing, NHDC Texas filed a voluntary petition for bankruptcy on behalf of Squire Court on September 12, 2016. Before filing that petition, NHDC Texas sought consent from Centerline and Chartermac, ***705** but they declined to consent. NHDC Texas then filed the petition anyway. Centerline and Chartermac filed a motion seeking to dismiss the petition.

Centerline and Chartermac argued that the bankruptcy petition should be dismissed because (1) NHDC Texas lacked corporate authority to file it, (2) NHDC Texas filed it in bad faith, and (3) the bankruptcy court should abstain and dismiss the case under 11 U.S.C. § 305(a). They also moved for sanctions based on their bad-faith-filing claim. The bankruptcy court held that NHDC Texas filed the petition without authority and granted the limited partners' motion to dismiss. The bankruptcy court found no evidence that NHDC Texas filed the petition in bad faith, and it rejected the limited partners' argument under 11 U.S.C. § 305(a). It therefore denied their motion for dismissal on those grounds as well as their motion for sanctions. NHDC Texas and guarantor National Community Renaissance appealed the dismissal. The limited partners cross appealed, arguing that the bankruptcy court erred in denying their motion as to bad faith, abstention under 11 U.S.C. § 305(a), and sanctions.

[1]The appellants principally argue on appeal that the provision in the amended partnership agreement requiring unanimous consent of the members to file for bankruptcy is void as a matter of federal public policy. They contend that federal public policy provides that only a fiduciary may decide whether an entity will or will not seek relief under the bankruptcy code. They interpret the unanimous-consent provision as a "veto" held in the hands of self-interested parties who have no obligation to put the partnership's interests ahead of theirs.[5] They also argue that the limited partners are unable to act in the best interests of the partnership because they stand in conflict with partnership by way of their contribution obligations and by way of their decision to enforce the guaranty agreement rather than seek bankruptcy. The combination of conflicting interests and a lack of fiduciary duties, they say, frustrates the partnership's constitutional right to seek bankruptcy relief. The appellants alternatively request that the case be remanded for additional factual development.

The limited partners' arguments relating to their cross appeal address the bankruptcy court's denial of their arguments below. They continue to request sanctions against the appellants. The limited partners, as they did before the bankruptcy court, allege a collusive scheme between NHDC Texas and National Community Renaissance that they argue proves bad faith and entitles them to sanctions.

[2] [3] [4]This Court sits as an appellate court when reviewing a bankruptcy court's judgment. *In re Falcon Prods., Inc.*, 497 F.3d 838, 841 (8th Cir. 2007). Legal questions are reviewed de novo, and factual findings are reviewed for clear error. *In re Vote*, 276 F.3d 1024, 1026 (8th Cir. 2002). Whether NHDC Texas had authority to file the bankruptcy petition is a legal question. *See Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255, 1258 (8th Cir. 1994). "A person filing a voluntary bankruptcy petition on a corporation's behalf must be authorized to do so, and the authorization must derive from state law." *Id.* (citing *Price v. Gurney*, 324 U.S. 100, 106, 65 S.Ct. 513, 516, 89 L.Ed. 776 (1945)); *see* ***706** *also* Collier on Bankruptcy ¶ 2–301 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) (explaining that "[n]either the Code nor the Federal Rules of Bankruptcy Procedure

identify which party to a partnership may file a voluntary bankruptcy petition on behalf of a partnership," and so "applicable state law or the governing partnership documents determine who has the authority to file a partnership's voluntary bankruptcy petition"). The Supreme Court long ago instructed that if a court "finds that those who purport to act on behalf of the corporation have not been granted authority by local law to institute the proceedings, it has no alternative but to dismiss the petition. It is not enough that those who seek to speak for the corporation may have the right to obtain that authority." *Gurney*, 324 U.S. at 106, 65 S.Ct. at 516.

[5]In Arkansas, "the partnership agreement governs relations among the partners and between the partners and the partnership." Ark. Code Ann. § 4–47–110(a). The amended partnership agreement here requires all partners to consent to a voluntary bankruptcy petition. All partners did not consent. The appellants seek to invalidate the unanimous-consent clause on the grounds that it violates federal public policy. Unless the clause is invalidated, the bankruptcy petition was filed without authorization and must be dismissed.

The appellants rely on three cases in support of their proposition: *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); and *In re Bay Club Partners–472, LLC*, 2014 WL 1796688, at *1 (Bankr. D. Or. May 6, 2014). These cases all begin with the uncontested premise that entities, like individuals, cannot contract away access to bankruptcy relief. *See Continental Ins. Co. v. 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." (quotation and citation omitted)); *In re Pease*, 195 B.R. 431, 434–35 (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. The Bankruptcy Code preempts the private right to contract around its essential provisions.").

In *Lake Michigan Beach*, the debtor defaulted on its debt to a creditor and agreed to give the creditor "special member" status if the creditor promised not to pursue remedies for the default. 547 B.R. at 903–04. The debtor amended its operating agreement to make the creditor a member of the debtor with the right to approve or disapprove of any "Material Action"—defined to include institution of bankruptcy proceedings—by the debtor. *Id.* As a special member, the creditor had no interest in the profits or losses of the debtor, no right to distributions, no tax consequences, and was not required to make capital contributions to the debtor. *Id.* The creditor "was kept separate and apart from the Debtor in all ways but for its authority to block the Debtor from petitioning for bankruptcy relief." *Id.* In *Intervention Energy*, the debtor defaulted on its debt to a creditor and agreed to make the creditor a common member if the creditor agreed to waive all defaults. 553 B.R. at 261. The debtor amended its operating agreement to require unanimous consent from its members to file for bankruptcy. *Id.* The debtor issued 22,000,001 "Common Units" to interest holders. *Id.* at 260. The creditor held 1 Common Unit. *Id.* In *Bay Club*, the debtor received a loan ***707** from a creditor to purchase a large apartment complex. 2014 WL 1796688, at *1. The creditor requested that a bankruptcy waiver provision be added to the debtor's operating agreement along with its requests for other restrictive covenants. *Id.* at *3. The provision recited that the debtor "intends to borrow money with which to acquire the Property, and to pledge the Property and related assets as security therefor." *Id.* It went on to state that the debtor "shall not institute proceedings to be adjudicated bankrupt or insolvent" until "the indebtedness secured by that pledge is paid in full." *Id.*

As the court in *Intervention Energy* noted, the form that such a contractual waiver takes is limited only by the resourcefulness of attorneys. *See* 553 B.R. at 264. While each case involves a different contractual provision, in all of the cases the provision amounted to a debtor agreeing to a prepetition waiver. Moreover, each case involved a creditor limiting a debtor's right to seek bankruptcy relief as a condition of supplying credit. Each of these blocking provisions violated federal public policy.

None of these cases, however, stands for the more general proposition that a nonfiduciary cannot have a controlling role in the decisionmaking process when an entity considers bankruptcy relief. The appellants support their argument with the court's description in *Lake Michigan Beach* of an acceptable "blocking director structure." There, the court said that "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." *In re Lake Michigan Beach*, 547 B.R. at 913. That statement applied in the context of an outside party—kept separate and apart from the entity seeking bankruptcy in all ways other than the authority to preclude that entity from filing a petition—attempting to control internal corporate matters. *See id.* at 904. As the court there recognized, allowing a creditor to contract for control of a debtor's decision whether to file a bankruptcy petition would undermine the most fundamental purposes

of the bankruptcy laws. *Id.* at 914. The limited partners, however, are owners, not creditors of Squire Court.

[6]The appellants have provided the Court with no case holding that a bona fide equity owner must hold a fiduciary position before it can vote on whether to file a bankruptcy petition. At oral argument, the appellants argued that their position is supported by decades of case law holding that authority to file for bankruptcy rests with a corporation's board of directors not the majority of shareholders. That example, though, undercuts their argument. A corporation typically delegates the board of directors authority to manage the business and affairs of the corporation. The authority does not originate with the board of directors but comes to it by corporate delegation, whether by default statutory provisions or corporate governance documents. Cases holding that the decision to file for bankruptcy rests with a corporation's board of directors focus on the delegation of authority, not the fact that the directors have fiduciary duties. *See, e.g., In re Arkco Properties, Inc.*, 207 B.R. 624, 628 (Bankr. E.D. Ark. 1997) (looking to state law and the corporation's by-laws to determine whether petitioner had authority to file for bankruptcy); *In re M & M Commercial Servs., Inc.*, 115 B.R. 212, 213 (Bankr. E.D. Mo. 1990) (holding that president acted beyond the scope of his authority when he filed the voluntary bankruptcy petition); *In re Giggles Rest., Inc.*, 103 B.R. 549, 553 (Bankr. D.N.J. 1989) (holding that "in the absence of restrictions, the power to file a voluntary petition in bankruptcy ***708** on behalf of a corporation rests with the Board of Directors"); *In re Al–Wyn Food Distributors, Inc.*, 8 B.R. 42, 43 (Bankr. M.D. Fla. 1980) (holding that president acted outside of his authority in filing bankruptcy petition where neither governing instruments of the corporation nor state law authorized the president to file a petition). In other words, a board of directors has authority to decide whether the entity will file for bankruptcy because that authority is delegated to the board. *See Boyce v. Chem. Plastics*, 175 F.2d 839, 843 (8th Cir. 1949) (analyzing "whether the board of directors of a Minnesota corporation organized under Minnesota law would have authority in the first instance to file a petition in voluntary bankruptcy" and holding that Minnesota law controlled the determination).

[7]Just as the authority of a board of directors is delegated, likewise a general partner has authority delegated to it to act on behalf of the partnership. Sometimes that authority may include the power to file for bankruptcy.[6] Here, however, Squire Court did not delegate to NHDC Texas the power to file for bankruptcy on its own initiative. Instead, the partners retained for themselves, acting by unanimous consent, the decision whether to file a bankruptcy petition.

It is one thing to look past corporate governance documents and the structure of a corporation when a creditor has negotiated authority to veto a debtor's decision to file a bankruptcy petition; it is quite another to ignore those documents when the owners retain for themselves the decision whether to file bankruptcy. It is one thing for the courts to overrule a creditor that seeks to block a debtor from filing bankruptcy; it is quite another for the courts to overrule the owners of the entity.

[8]The appellants alternatively seek remand to the bankruptcy court to determine whether the unanimous-consent provision was added after the inception of Squire Court, whether the limited partners acted as fiduciaries in withholding their consent, and whether National Community Renaissance was in fiscal distress. The bankruptcy court held an evidentiary hearing and placed no restriction on the parties' ability to introduce evidence. No ***709** reason exists to remand for another evidentiary hearing.

[9] [10] [11]The limited partners' cross appeal regarding 11 U.S.C. § 305(a) need not be reached because the Court affirms the bankruptcy court's dismissal of the petition. Their arguments relating to bad faith and sanctions have a steep hill to climb. They argue that NHDC Texas colluded with National Community Renaissance and filed the petition to obstruct the state court proceeding between the limited partners and National Community Renaissance. This collusion, they argue, warrants sanctions. Whether a bankruptcy petition has been filed in bad faith is a question of fact. *In re Cedar Shore Resort, Inc.*, 235 F.3d 375, 379 (8th Cir. 2000). A bankruptcy court's decision to impose or not impose sanctions is reviewed for an abuse of discretion. *In re Kujawa*, 270 F.3d 578, 581 (8th Cir. 2001). The bankruptcy court found that there were valid reasons to pursue bankruptcy and found no evidence of bad faith.

[12]The limited partners take another angle. The Eighth Circuit has held that a dismissal under 11 U.S.C. § 1112(b) for "cause" can include a bad-faith filing. *Cedar Shore*, 235 F.3d at 379. The limited partners argue that filing a petition without authority qualifies as a bad-faith filing that can be dismissed for cause under section 1112(b). The bankruptcy court considered this point as well but distinguished the type of bad faith required for sanctions and the bad faith that might attach to an unauthorized filing. The limited partners' argument, though, overlooks the fact that authority to file is treated by the Eighth Circuit as a jurisdictional issue, not under section 1112(b)'s cause-dismissal. *See Keenihan v.*

Heritage Press, Inc., 19 F.3d 1255, 1259 (8th Cir. 1994). As a jurisdictional issue, once the bankruptcy court finds authority lacking, it must dismiss. *Gurney*, 324 U.S. at 106, 65 S.Ct. at 516. Section 1112(b) assumes the bankruptcy court has jurisdiction but recognizes other reasons justifying dismissal, which is not the situation here.

The bankruptcy court's factual findings are not clearly erroneous, and it did not abuse its discretion in denying the limited partners' motion for sanctions.

CONCLUSION

For the foregoing reasons, the bankruptcy court's decision is AFFIRMED.

IT IS SO ORDERED this 7th day of July, 2017.

All Citations

574 B.R. 701

Footnotes

1 The Court will hereafter refer to Centerline and Chartermac simply as limited partners.

2 The Honorable Richard D. Taylor, United States Bankruptcy Judge.

3 Centerline and Chartermac moved this Court to strike the appellants' briefs and dismiss their appeal. The stated reason for this heavy-handed request was that the appellants failed to properly cite to the record. This motion is DENIED.

4 The appellants say that break-even operations were expected within the first year or so but have yet to be achieved. As a result, National Community Renaissance says that it has contributed more than $2,400,000 under the terms of the guaranty agreement.

5 Under Arkansas's Uniform Limited Partnership Act, limited partners owe the partnership a duty of good faith and fair dealing, Ark. Code Ann. § 4–47–305(b), and the general partner owes the partnership duties of good faith and fair dealing, care, and loyalty (*i.e.*, fiduciary duties). Ark. Code Ann. § 4–47–408.

6 The default rule under Arkansas's Uniform Limited Partnership Act differs from Arkansas's Business Corporation Act of 1987, which states that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors," subject only to limitations "in the articles of incorporation." Ark. Code Ann. § 4–27–801(b). The Uniform Limited Partnership Act permits partnerships to give general partners many powers, but it requires consent from each partner to:

> sell, lease, exchange, or otherwise dispose of all, or substantially all, of the limited partnership's property, with or without the good will, other than in the usual and regular course of the limited partnership's activities.

Ark. Code Ann. § 4–47–406(b)(3). Courts and commentators have applied similar statutory provisions to voluntary bankruptcy filings. *See, e.g.*, *In re Loverin Ranch*, 492 B.R. 545, 550 (Bankr. D. Or. 2013) (interpreting Oregon partnership law to require consent of all partners to file for voluntary bankruptcy); *In re Orchard at Hansen Park, LLC*, 347 B.R. 822, 827 (Bankr. N.D. Tex. 2006) (interpreting Washington law to require unanimous consent of LLC members to file for voluntary bankruptcy); *In re SWG Assocs.*, 199 B.R. 557, 560 (Bankr. W.D. Pa. 1996) (noting that under Pennsylvania law "commencement of a bankruptcy case can appropriately be viewed statutorily as an act generally requiring unanimous consent of partners"); Alan R. Bromberg, *Crane and Bromberg on Partnership*, § 91B(d) n.66 (1968) (noting that the Uniform Partnership Act "denies a partner's authority (without unanimous consent) to any act which will make it impossible to carry on the business. This probably covers a bankruptcy admission and consent [under the old Bankruptcy Act].").

End of Document

553 B.R. 258
United States Bankruptcy Court,
D. Delaware.

In re: Intervention Energy Holdings, LLC, et al.,[1]
Debtors.

Case No. 16–11247(KJC)
|
Signed June 3, 2016

Synopsis

Background: Creditor that had been granted a single common unit in limited liability company (LLC) moved to dismiss Chapter 11 case filed on behalf of the LLC on ground that, pursuant to amended limited liability company agreement, unanimous consent of all unit holders was required for commencement of bankruptcy petition on LLC's behalf.

[Holding:] The Bankruptcy Court, Kevin J. Carey, J., held that agreement between limited liability company (LLC) and creditor to which it was indebted, as prerequisite to creditor's forbearance in not exercising its rights in connection with LLC's default, whereby creditor was granted a single common unit interest in LLC and limited liability company agreement was amended to require unanimous consent of all common unit holders for commencement of bankruptcy case on the LLC's behalf, was void as against public policy.

Motion denied.

West Headnotes (7)

[1] **Bankruptcy**
⇨Who May Institute Case

Agreement between limited liability company (LLC) and creditor to which it was indebted, as prerequisite to creditor's forbearance in not exercising its rights in connection with LLC's default, whereby creditor was granted a single common unit interest in LLC and limited liability company agreement was amended to require unanimous consent of all common unit holders for commencement of bankruptcy case on the LLC's behalf, was void as against public policy; agreement was executed for sole purpose of granting right to creditor with no obligation to act in best interests of LLC a right block LLC from pursuing relief under the Bankruptcy Code. 11 U.S.C.A. § 101 et seq.

3 Cases that cite this headnote

[2] **Bankruptcy**
⇨Effect of Bankruptcy Relief; Injunction and Stay

Prepetition agreements purporting to interfere with debtor's rights under the Bankruptcy Code are unenforceable. 11 U.S.C.A. § 101 et seq.

2 Cases that cite this headnote

[3] **Bankruptcy**
⇨Who May Be a Debtor

Any terms in prepetition consent agreement purporting to restrict right of debtor parties to file for bankruptcy are unenforceable.

4 Cases that cite this headnote

[4] **Bankruptcy**
⇨Effect of Bankruptcy Relief; Injunction and Stay

Any attempt by creditor in private pre-bankruptcy agreement to opt out of collective consequences of debtor's future bankruptcy filing is generally unenforceable.

1 Cases that cite this headnote

[5] **Bankruptcy**
⇐Application of state or federal law in general
Bankruptcy
⇐Effect of Bankruptcy Relief; Injunction and Stay

Bankruptcy Code preempts the private right to contract around its essential provisions. 11 U.S.C.A. § 101 et seq.

1 Cases that cite this headnote

[6] **Bankruptcy**
⇐Effect of Bankruptcy Relief; Injunction and Stay

Advance agreement to waive benefits conferred by bankruptcy laws is wholly void as against public policy.

Cases that cite this headnote

[7] **Bankruptcy**
⇐Who May Be a Debtor

State cannot deny access to federal bankruptcy relief, whether to individual or to corporation or business entity.

1 Cases that cite this headnote

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OPINION[2]

KEVIN J. CAREY, UNITED STATES BANKRUPTCY JUDGE.

BACKGROUND

Before the Court is the EIG Energy Fund XV–A, L.P. Motion to Dismiss the Chapter 11 Cases of Intervention Energy Holdings, LLC and Intervention Energy, LLC (the "EIG MTD"). (D.I.27.)

***260 Procedural Background**

On May 20, 2016, Intervention Energy Holding, LLC ("IE Holdings") and Intervention Energy, LLC ("IE") (together, in these jointly administered proceedings, the "Debtors") filed a voluntary chapter 11 bankruptcy petition in the United States Bankruptcy Court for the District of Delaware (the "Voluntary Petition").[3] (D.I.1.) On May 24, 2016, EIG Energy Fund XV–A, L.P. (hereinafter referred to as "EIG")[4] filed the EIG MTD asserting, among other things, that IE Holdings was not authorized to file the Voluntary Petition. (EIG MTD ¶ 15.) EIG argues that, absent its consent to commence a chapter 11 case, IE Holdings lacked authority to file the Voluntary Petition under the Intervention Energy Holdings, LLC Second Amended and Restated Limited Liability Company Agreement (the "Operating Agreement") (D.I.27, Ex. H), which requires "approval of *all* Common Members ... [to] commence a voluntary case under any bankruptcy" (EIG MTD ¶ 15). For purposes of disposition of this part of the EIG MTD, the material facts are not in dispute.[5]

At the May 26, 2016, hearing on first day motions, the Court scheduled briefing and argument, limited to the issue of whether IE Holdings lacked authority to file its chapter 11 petition. The Debtors filed their response to the EIG MTD (the "Debtors' Response") on May 31, 2016. (D.I.52.) EIG filed its Reply in Support of the EIG MTD on June 1, 2016 (the "EIG Reply"). (D.I.58.) A hearing to consider the motion and response was held on June 2, 2006.

Factual Background

IE Holdings and IE are limited liability companies formed in 2007, and governed under the laws of the State of Delaware. (Zimmerman Decl. ¶ 9, Operating Agreement § 12.9.) They are private, non-operated oil and natural gas exploration and production companies, almost entirely located in North Dakota. (Zimmerman Decl. ¶ 9.) IE Holdings is owned as follows: 84.73%— Intervention Energy Investment Holdings, LLC ("IEIH"); 15.27%—various business and individual investors. (Zimmerman Decl. ¶ 21.) IE Holdings issued 22,000,001 Common Units: IEIH holds 22,000,0000 Common Units and EIG holds but one Common Unit. (Zimmerman Decl. ¶ 19.) IE is a wholly-owned subsidiary of IE Holdings. (Zimmerman Decl. ¶ 18.) EIG is an institutional investor specializing in private investments in global energy, resource, and ***261** related infrastructure projects and companies. (EIG MTD ¶ 11.)

On January 6, 2012, the Debtors and EIG entered into a Note Purchase Agreement (the "Note Purchase Agreement"), whereby EIG provided up to $200 million in senior secured notes (the "Secured Notes"). (Zimmerman Decl. ¶ 23, EIG MTD ¶ 14.) As of the date of the Voluntary Petition, the principal amount outstanding under the Secured Notes was approximately $140 million. (Zimmerman Decl. ¶ 24.) The Secured Notes are secured by liens on certain of the Debtors' assets, including, among other things, all inventory, accounts, equipment, fixtures, deposit accounts, and cash collateral. (Zimmerman Decl. ¶ 24, EIG MTD ¶ 14.) Specifically, with respect to cash collateral, the Debtors granted EIG a lien on all amounts held in any deposit account of the Debtors, as well as a lien on the Debtors' rights to payment under any contract. (Zimmerman Decl. ¶ 25, EIG MTD ¶ 14.)

On September 15, 2014, the Debtors and EIG entered into Amendment No. 3 to the Note Purchase Agreement (the "Third Amendment") to expand EIG's funding commitment from $110 million to $150 million. (Zimmerman Decl. ¶ 32, EIG MTD ¶ 18.) In connection with the Third Amendment, the parties amended certain elements of the positive debt covenant calculations (the "Maintenance Covenants"). (Zimmerman Decl. ¶ 32, EIG MTD ¶ 19.) In October 2015, EIG declared an event of default based on the Debtors' failure to comply with the Maintenance Covenants. (Zimmerman Decl. ¶ 33, EIG MTD ¶ 20.)

On December 28, 2015, the Debtors and EIG negotiated and entered into Amendment No. 5, Forbearance Agreement and Contingent Waiver (the "Forbearance Agreement"). (Zimmerman Decl. ¶ 34, EIG MTD ¶ 21, D.I. 27, Ex. N.) The Forbearance Agreement provided that EIG would waive all defaults if the Debtors raised $30 million of equity capital to pay down a portion of the existing Secured Notes by June 1, 2016. (Zimmerman Decl. ¶ 34, EIG MTD ¶ 22.) As a condition to the effectiveness of the Forbearance Agreement, the Debtors were required to fulfill the following conditions precedent:

> The Administrative Agent shall have received a fully executed amendment to the limited liability company agreement of the Parent in form and substance satisfactory to the Administrative Agent (i) admitting EIG or its Affiliate as a member of the Parent with one common unit and (ii) amending such limited liability company agreement to require approval of each holder of common units of the Parent prior to any voluntary filing for bankruptcy protection for the Parent of the Company.

(Forbearance Agreement § 7(b).) Also on December 28, 2015, IE Holdings enacted Amendment No. 1 to the Intervention Energy Holdings, LLC Second Amended and Restated Limited Liability Company Agreement (the "Amendment")[6] to include the unanimous consent requirement to file bankruptcy (the "Consent Provision"). (Zimmerman Decl. ¶ 34, EIG MTD ¶ 23, Amendment ¶ 4, D.I. 27, Ex. L.) To give effect to the Consent Provision, IE Holdings then issued a single common unit to EIG for a common capital contribution of $1.00, making EIG a common member. (Zimmerman Decl. ¶ 34, EIG MTD ¶ 23, Amendment, Schedule A.)

It is not disputed that, but for the Amendment, IE Holdings would have been authorized to seek federal bankruptcy relief.

262** ***DISCUSSION

[1]The parties have made several interesting arguments with respect to state law and contractual treatment of

fiduciary obligations. EIG argues that an LLC that has abrogated its fiduciary responsibilities to the extent permitted by Delaware law may contract away its right to file bankruptcy at will.[7] (EIG MTD ¶ 32.) EIG cites to cases in which courts have upheld consent provisions among LLC members.[8] (EIG MTD ¶¶ 34–35 & n.55.) In contrast, the Debtors, relying upon the recent case of *In re Lake Michigan Beach Pottawattamie Resort LLC,* draw a parallel between the "golden share"[9] given to EIG and a blocking director installed on the board of a special purpose entity (SPE), arguing that abrogating fiduciary duties is exactly what is fatal to EIG's argument—that the blocking member (or, in this case, holder of the "golden share") must retain a duty to vote in the best interest of the potential debtor to comport with federal bankruptcy policy.[10] (Debtors' Response 11–14.)

In light of my disposition of the federal public policy issue which follows, and reluctant to accept the parties' invitation to decide what may well be a question of first impression of state law (i.e., determining the scope of LLC members' freedom to contract under applicable state law provisions) ***263** when an alternate ground for decision is present, I find it unnecessary to address these arguments.

[2] [3] [4] [5] [6]The Debtors note in their Response that it is axiomatic that a debtor may not contract away the right to a discharge in bankruptcy.[11] (Debtor's Response 8.) It has been said many times and many ways. "[P]repetition agreements purporting to interfere with a debtor's rights under the Bankruptcy Code are not enforceable."[12] "If any terms in the Consent Agreement ... exist that restrict the right of the debtor parties to file bankruptcy, such terms are not enforceable."[13] "[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. The Bankruptcy Code pre-empts the private right to contract around its essential provisions."[14] "[I]t would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply."[15] "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."[16]

The rule is not new:

> The agreement to waive the benefit of bankruptcy is unenforceable. To sustain a contractual obligation of this character would frustrate the object of the Bankruptcy Act, particularly of section 17 (11 U.S.C. § 35). This was held by the Supreme Judicial Court of Massachusetts, *Federal Nat. Bank v. Koppel,* 253 Mass. 157, 148 N.E. 379, 380 (Mass.1925), where it was said:
>
> "It would be repugnant to the purpose of the Bankruptcy Act to permit the circumvention of its object by the simple device of a clause in the agreement, out of which the provable debt springs, stipulating that a discharge in bankruptcy will not be pleaded by the debtor. The Bankruptcy Act would in the natural course of business be nullified in the vast majority of debts arising out of contracts, if this were permissible. It would be vain to enact a bankruptcy law with all its elaborate machinery for settlement of the estates of bankrupt debtors, which could so easily be rendered of no effect. The bar of the discharge under the terms of the Bankruptcy Act is not restricted to those instances where the debtor has not waived his right to plead it. It is universal and unqualified in terms. It affects all debts within the scope of its words. It would be contrary to the letter of section 17 of the Bankruptcy Act as we interpret it to uphold ***264** the waiver embodied in this note. So to do would be incompatible with the spirit of that section. Its aim would largely be defeated."
>
> There are other grounds for sustaining the action of the referee, but the one mentioned is enough.[17]

Even so long ago as 1912, the United States Supreme Court was forced to address parties attempting to circumvent the bankruptcy laws by "circuity of arrangement."[18] Today's resourceful attorneys have continued that tradition.[19]

Yet, to contract away the right to seek bankruptcy relief is precisely what both parties here have attempted to accomplish. EIG "specifically negotiated Intervention's ability to file a voluntary bankruptcy proceeding." (EIG MTD ¶ 23.) Throughout the EIG MTD, EIG emphasizes and insists upon its "***contracted-for protections, including the Consent Provision***" indisputably meant to block any voluntary bankruptcy filing. (EIG MTD ¶ 32.) In its Reply, EIG again emphasizes that "EIG [ ] ***bought and paid*** for its Common Unit (including all rights related thereto)...." (EIG Reply ¶ 14.) Because § 7(b) of the Forbearance Agreement requires, as a condition to the effectiveness of the agreement, that IE both amend its LLC Agreement to institute the unanimous Consent Provision and grant the blocking share, the intent of the parties is unmistakable.

Both parties argue that, were I to decide this issue for the other side, systemic disruption will follow. EIG warns that if I were to declare the Consent Provision here void as contrary to federal public policy, not only would I vitiate the will of state legislatures that LLC members be free to contract, but also that confusion will reign about the breadth of an LLC's right to contract.[20]

The Debtors, on the other hand, argue that if I permit the enforcement of the Consent Provision, the landscape in debtor-creditor relations will be dramatically altered—that lenders will henceforth demand such a provision in every loan/forbearance agreement.[21] True, lenders usually are not reticent to demand provisions that borrowers may often consider oppressive, but, as EIG's counsel replied at argument, as unwelcome as the consequence of ***265** doing so may be, a borrower can always say, "No." A borrower can also choose to seek bankruptcy relief sooner than it would prefer, rather than agree to any provision in a forbearance agreement that a borrower finds unacceptable.

[7]The federal public policy to be guarded here is to assure access to the right of a person, including a business entity,[22] 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.[23] I agree with those courts that hold the same applies to a "corporate" or business entity, in this case an LLC.[24]

A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.[25] Under the undisputed facts before me, to characterize the Consent Provision here as anything but an absolute waiver by the LLC of its right to seek federal bankruptcy relief would directly contradict the unequivocal intention of EIG to reserve for itself the decision of whether the LLC should seek federal bankruptcy relief. Federal courts have consistently refused ***266** to enforce waivers of federal bankruptcy rights. I now join them, and conclude that the Debtors possessed the necessary authority to commence their chapter 11 proceedings.

CONCLUSION

For the reasons set forth above, the Motion to Dismiss is denied, in part.

An appropriate order will follow.

In re: INTERVENTION ENERGY HOLDINGS, LLC, et al.,[1] Debtors.

ORDER

AND NOW, this 3rd day June, 2016, upon consideration of the Motion to Dismiss the Chapter 11 Cases of Intervention Energy Holdings, LLC and Intervention Energy, LLC of EIG Energy Fund XV–A, L.P. (the "EIG MTD") (D.I.27), and the Debtors' Response thereto, and the EIG Reply, and after oral argument and a hearing thereon, and for the reasons set forth in the foregoing Opinion, it is hereby **ORDERED** that:

> the EIG MTD is **DENIED**, in part, with the respect to the issue of the Debtors' authority to file the chapter 11 cases;

AND, it is further **ORDERED** that a status hearing will be held on June 7, 2016, at 10:00am in Bankruptcy Courtroom No. 5, 824 Market St., Fifth Floor, Wilmington, Delaware, to consider further scheduling and the remaining needs of the parties.

cc: Stuart M. Brown, Esquire[2]

All Citations

553 B.R. 258, 62 Bankr.Ct.Dec. 179

Footnotes

1 By order dated May 25, 2016, this Court authorized joint administration of the following debtors in these chapter 11 cases: Intervention Energy Holdings, LLC; and Intervention Energy, LLC. D.I. 33. Items on the docket for Case No. 16–11247 are referred to as "D.I. ——."

2 This Opinion constitutes the findings of fact and conclusions of law required by Fed. R. Bankr. P. 7052. This Court has

jurisdiction over this matter pursuant to 28 U.S.C. §§ 1334 and 157(a). This contested matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(1) and (b)(2)(A) & (O).

3 The same day, the Debtors filed the Declaration of John R. Zimmerman in Support of Chapter 11 Petitions and First Day Motions (the "Zimmerman Decl."). D.I. 11. The Zimmerman Decl. was not admitted as part of the hearing record on June 2, 2016; however, I will take judicial notice of it for this purpose only and only for undisputed background facts. "Federal Rule of Evidence 201 authorizes a court to take judicial notice of an adjudicative fact if that fact is 'not subject to reasonable dispute' ... as long as it is not unfair to a party to do so and does not undermine the trial court's factfinding authority." *Nantucket Inv'rs II v. California Fed. Bank (In re Indian Palms Assocs.),* 61 F.3d 197, 205 (3d Cir.1995). The parties stipulated to the admission of the relevant documents. D.I. 61.

4 EIG Energy Fund XV, L.P., movant EIG Energy Fund XV–A, L.P., EIG Energy Fund XV–B, L.P., and EIG Energy Fund XV (Cayman), L.P. are funds managed and advised by EIG Management Company LLC. For ease of reference, the movant, EIG Energy Fund XV–A, L.P., is hereinafter referred to as "EIG."

5 In the EIG MTD, EIG also urges dismissal for two additional reasons: (1) the Debtors are unable to confirm a plan, and (2) the chapter 11 filings are made in bad faith. EIG MTD 3–5. I decided to bifurcate determination of the issues, reach first the corporate authority issue, and address only that here.

6 Amending § 5.1(d) of the Operating Agreement.

7 "A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." 6 Del. C. § 18–1101(e).

8 *See In re Orchard at Hansen Park, LLC,* 347 B.R. 822, 827 (Bankr.N.D.Tex.2006) (upholding unanimous consent provision in LLC operating agreement) (LLC debtor). EIG cites *In re Avalon Hotel Partners, LLC,* 302 B.R. 377, 381 (Bankr.D.Or.2003) (LLC debtor), as evidence of a court "upholding 75% member consent requirement in LLC operating agreement and dismissing voluntary case." EIG MTD ¶ 34 n.55. However, although the *Avalon Hotel Partners* court stated that it *would have* dismissed the case for violating the consent provision, the filing was subsequently ratified and the motion to dismiss denied. 302 B.R. at 381, 385.

Moreover, *Avalon Hotel Partners* runs counter to EIG's argument. There, the *Avalon Hotel Partners* court considered a promise not to file a chapter 11 petition made by an LLC and its manager to a state court. *Id.* at 383. The court considered the impact of the promise on the LLC's creditors and minority members who were not parties to the state court litigation. *Id.* The court held that to uphold the promise would be analogous to upholding a covenant not to file bankruptcy, and that, despite the principle of judicial estoppel, the promise was unenforceable as a matter of public policy. *Id.* at 382–83.

The court subsequently dealt with the broken promise as one factor in a bad faith analysis. *Id.* at 383. Finally, despite that the LLC and its manager "played fast and loose" with the state court, the court considered the subsequent ratification and held that the filing was in good faith. *Id.* at 383–384.

9 This term has been used mainly to refer to a government retaining control over privatized companies. *Investopedia—Golden Share,* INVESTOPEDIA, http://www.investopedia.com/terms/g/goldenshare.asp (last visited June 2, 2016). "A type of share that gives its shareholder veto power over changes to the company's charter. A golden share holds special voting rights, giving its holder the ability to block another shareholder from taking more than a ratio of ordinary shares. Ordinary shares are equal to other ordinary shares in profits and voting rights. These shares also have the ability to block a takeover or acquisition by another company." *Id.* Golden shares are now outlawed in the European Union. *Id.*

10 *See* 547 B.R. 899, 911–13 (Bankr.N.D.Ill.2016) (LLC debtor).

11 Citing, *inter alia, Klingman v. Levinson,* 831 F.2d 1292, 1296 n.3 (7th Cir.1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy.") (individual debtor).

12 *MBNA Am. Bank, N.A. v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.),* 275 B.R. 712, 723 (Bankr.D.Del.2002) (corporate debtor).

13 *Hayhoe v. Cole (In re Cole),* 226 B.R. 647, 651–54 (9th Cir. BAP 1998) (collecting cases) (individual debtor).

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

15 *In re 203 N. LaSalle St. P'ship,* 246 B.R. 325, 331 (Bankr.N.D.Ill.2000) (partnership debtor).

16 *In re Tru Block Concrete Prods., Inc.,* 27 B.R. 486, 492 (Bankr.S.D.Cal.1982) (corporate debtor); *Fallick v. Kehr,* 369 F.2d 899, 906 (2d Cir.1966) (Friendly, J., dissenting) (individual debtor). *See also In re Citadel Properties, Inc.,* 86 B.R. 275, 275 (Bankr.M.D.Fla.1988) ("The Court pauses to suggest that a total prohibition against filing for bankruptcy would be contrary to Constitutional authority as well as public policy.) (corporate debtor).

17 *In re Weitzen,* 3 F.Supp. 698, 698–99 (S.D.N.Y.1933) (individual debtor).

18 *Nat'l Bank of Newport v. Nat'l Herkimer Cnty. Bank,* 225 U.S. 178, 184, 32 S.Ct. 633, 56 L.Ed. 1042 (1912) ("To constitute a preference, it is not necessary that the transfer be made directly to the creditor. It may be made to another, for his benefit. If the bankrupt has made a transfer of his property, the effect of which is to enable one of his creditors to obtain a greater percentage of his debt than another creditor of the same class, circuity of arrangement will not avail to save it.").

19 *See, e.g., NHL v. Moyes,* No. CV–10–01036–PHX–GMS, 2015 WL 7008213, at *8 (D.Ariz. Nov. 12, 2015) (holding that "If a contractual term denying the debtor parties the right to file bankruptcy is unenforceable, then a contractual term prohibiting the non-debtor party that controls the debtors from causing the debtors to file bankruptcy is equally unenforceable. Parties cannot accomplish through 'circuity of arrangement' that which would otherwise violate the Bankruptcy Code.") (LLC debtor).

20 EIG urges consideration of *CML V, LLC v. Bax,* 28 A.3d 1037 (Del.2011), to emphasize the breadth of discretion afforded to Delaware LLCs. EIG Reply ¶ 12. *Bax* nowhere addresses federal bankruptcy law.

21 *See, e.g., Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.),* 671 F.3d 1011 (9th Cir.2012) ("[I]t is against public policy for a debtor to waive the prepetition protection of the Bankruptcy Code.... This prohibition of prepetition waiver has to be the law; otherwise, astute creditors would routinely require their debtors to waive.") (internal citations omitted) (corporate debtor).

22 Under the Bankruptcy Code, "person" is defined to include "individual, partnership, and corporation...." 11 U.S.C. § 101(41).

23 *See* Bankruptcy Code §§ 524(c) (discharge of debt may be waived only after post-petition procedures are followed), and 727(a)(10) (waiver of discharge of all debts is permitted only after bankruptcy court approval).

24 *See In re Lake Michigan Beach Pottawattamie Resort LLC,* 547 B.R. 899, 912 (Bankr.N.D.Ill.2016) ("In the same way that individuals may not contract away their bankruptcy rights, corporations should be similarly constrained.") (LLC debtor); *In re Bay Club Partners–472, LLC,* No. 14–30394–rld11, 2014 WL 1796688, at *4–5 (Bankr.D.Or. May 6, 2014) (holding prepetition waivers of bankruptcy protection are unenforceable as against public policy) (LLC debtor); *In re Shady Grove Tech Ctr. Assocs. Ltd. P'ship,* 216 B.R. 386, 390 (Bankr.D.Md.1998) *supplemented,* 227 B.R. 422 (Bankr.D.Md.1998) (corporate contractual "prohibitions against the filing of a bankruptcy case are unenforceable") (partnership debtor); *see also* Bankruptcy Code §§ 109, 302, 303 (clearly reflecting congressional intent about when, and under what circumstances, a person is entitled to relief under Title 11 U.S.C.).

25 EIG cites to *In re Global Ship Sys., LLC,* 391 B.R. 193 (Bankr.S.D.Ga.2007) (LLC debtor), and the unpublished case *In re DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC),* No. 10–046, 463 B.R. 142, 2010 WL 4925811 (10th Cir. BAP Dec. 6, 2010) (LLC debtor), as direct contrary authority. Closest on point is *Global Ship Sys.* in which a creditor who also owned Class B equity interests in the LLC valued initially at 20% was held to "wear two hats" and therefore could block a bankruptcy where an entity who is exclusively a creditor could not. *Global Ship Sys.,* 391 B.R. at 199, 203. However, the method by which the creditor in *Global Ship Sys.* received its equity interests was not subject to question or analysis. There is no way to compare that creditor's interests to EIG's contracting for one golden share solely for the purpose to control any potential filing. The *DB Capital Holdings* court upheld an absolute bar on filing for bankruptcy that the LLC's Manager alleged was " 'executed at the demand, and for

the sole benefit of Debtor's main secured creditor...." *DB Capital Holdings*, 2010 WL 4925811, at *2–3. The court held that, absent coercion, such agreement is not void as against public policy. I disagree.

1 By order dated May 25, 2016, this Court authorized joint administration of the following debtors in these chapter 11 cases: Intervention Energy Holdings, LLC; and Intervention Energy, LLC. D.I. 33. Items on the docket for Case No. 16–11247 are referred to as "D.I. ——."

2 Counsel shall serve copies of this Opinion and Order on all interested parties and file a Certificate of Service with the Court.

End of Document

KeyCite Yellow Flag - Negative Treatment
Distinguished by Heritage Partners LLC v. Stroock & Stroock & Lavan LLP, N.Y.A.D. 1 Dept., November 28, 2017

547 B.R. 899
United States Bankruptcy Court,
N.D. Illinois, Eastern Division.

In re: Lake Michigan Beach Pottawattamie Resort LLC, Debtor.

Case No. 15bk42427
|
Signed April 5, 2016

Synopsis
Background: Lender moved to dismiss Chapter 11 case filed on behalf of limited liability company (LLC) as allegedly filed in bad faith or as filed contrary to language in LLC's operating agreement that required lender to consent to any such bankruptcy filing.

Holdings: The Bankruptcy Court, Timothy A. Barnes, J., held that:

[1] lender failed to satisfy burden of showing that case was not filed in good faith solely because case was filed on eve of mortgage foreclosure sale in order to protect substantial equity that the LLC had in its resort property, and

[2] consent provision in operating agreement was void as against public policy.

Motion denied.

West Headnotes (20)

[1] **Bankruptcy**
⇐Particular proceedings or issues
Bankruptcy
⇐Bankruptcy judges

Bankruptcy judge, even as non-Article-III judge, had constitutional authority to enter final order on motion to dismiss Chapter 11 case under "for cause" dismissal provision. U.S. Const. Art. 3, § 1 et seq.; 11 U.S.C.A. § 1112(b).

1 Cases that cite this headnote

[2] **Bankruptcy**
⇐Proceedings

On motion to dismiss Chapter 11 case under "for cause" dismissal provision, bankruptcy court could take judicial notice of contents of its docket. 11 U.S.C.A. § 1112(b); Fed. R. Evid. R. 201.

2 Cases that cite this headnote

[3] **Bankruptcy**
⇐Proceedings

Burden of proof is on party seeking to dismiss Chapter 11 case under "for cause" dismissal provision, and party must satisfy that burden by preponderance of the evidence. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[4] **Bankruptcy**
⇐Good Faith; Motive

Lack of good faith in filing for Chapter 11 relief can constitute "cause" for dismissal of case under "for cause" dismissal provision. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[5] **Bankruptcy**

⇨'Bad faith.'

In deciding whether to dismiss Chapter 11 case as "bad faith" filing, courts look at each bankruptcy filing on case-by-case basis to determine whether factors indicative of debtor's good or bad faith are present. 11 U.S.C.A. § 1112(b).

1 Cases that cite this headnote

[6] **Bankruptcy**
⇨'Bad faith.'

In deciding whether to dismiss Chapter 11 case as "bad faith" filing, bankruptcy court would consider, as non-exhaustive, non-binding factors to guide its decision, the so-called *Tekena* factors: (1) whether debtor has few or no unsecured creditors; (2) whether there had been a previous bankruptcy petition by debtor or related entity; (3) any improper prepetition conduct by debtor; (4) whether petition effectively allowed debtor to evade court orders; (5) lack of debts to non-moving creditors; (6) whether petition was filed on eve of foreclosure; (7) that foreclosed property is sole or major asset of debtor; (8) debtor's lack of on-going business or employees; (9) lack of possibility of reorganization; (10) debtor's lack of sufficient income to operate; (11) absence of pressure from non-moving creditors; (12) that case is essentially a two-party dispute; (13) that corporate debtor was formed and received title to its major assets immediately prepetition; and (14) that petition was filed solely to create automatic stay. 11 U.S.C.A. § 1112(b).

2 Cases that cite this headnote

[7] **Bankruptcy**
⇨'Bad faith.'

Mortgagee moving to dismiss Chapter 11 case filed by limited liability company (LLC) as "bad faith" filing failed to satisfy burden of showing that case was not filed in good faith solely because case was filed on eve of mortgage foreclosure sale in order to protect substantial equity that the LLC had in its resort property, its only major asset, or because LLC, which ran a seasonal resort, did not currently have and business operations; LLC had at least two creditors other than mortgagee, had no prior history of bankruptcy filings, and was legitimately using bankruptcy system to obtain a breathing spell in order to become cash-flow positive when it was clearly balance-sheet solvent. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[8] **Bankruptcy**
⇨Presumptions and burden of proof

Claims scheduled by debtor in Chapter 11 case are presumptively valid until adjudicated otherwise. 11 U.S.C.A. § 1111(a).

Cases that cite this headnote

[9] **Bankruptcy**
⇨'Bad faith.'

Chapter 11 debtor's poor prepetition payment history, a factor symptomatic of most debtors, is of very limited relevance to decision whether to dismiss Chapter 11 case as "bad faith" filing. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[10] **Bankruptcy**
⇨'Bad faith.'

Filing of Chapter 11 petition on eve of a foreclosure or eviction does not, by itself, establish that petition is "bad faith" filing, so as to provide grounds for dismissing case under "for cause" dismissal provision. 11 U.S.C.A. §

1112(b).

Cases that cite this headnote

[11] **Bankruptcy**
⇨'Bad faith.'

Mere fact that Chapter 11 case is single asset real estate case does not render it subject to being dismissed as "bad faith" filing. 11 U.S.C.A. § 1112(b).

Cases that cite this headnote

[12] **Bankruptcy**
⇨Reorganization cases
Bankruptcy
⇨In general; nature and purpose

Chapter 11 relief is not reserved for only operating businesses; debtors in Chapter 11 cases may refinance debts or sell all or part of their assets in order to maximize value in an operational or nonoperational setting.

Cases that cite this headnote

[13] **Bankruptcy**
⇨'Good faith.'

Chapter 11 debtor may, in good faith, use bankruptcy system to give it a breathing spell to become cash-flow solvent when it is balance-sheet solvent.

Cases that cite this headnote

[14] **Bankruptcy**
⇨Who May Institute Case

Bankruptcy court had to apply Michigan corporate governance law in determining whether bankruptcy filing by Michigan limited liability company (LLC) was a valid corporate action.

1 Cases that cite this headnote

[15] **Corporations and Business Organizations**
⇨Organizing documents; operating agreement
Corporations and Business Organizations
⇨In general; rights and liabilities

Under Michigan law, language in limited liability company's (LLC's) operating agreement can override default rule that matters submitted for vote by members of LLC need be approved only by majority of members. Mich. Comp. Laws Ann. § 450.4502(8).

Cases that cite this headnote

[16] **Bankruptcy**
⇨Representatives of corporations

Corporate formalities and state corporate law must be satisfied in connection with corporate bankruptcy filings, and except in very specific circumstances, an improperly authorized corporate bankruptcy filing is infirm.

Cases that cite this headnote

[17] **Bankruptcy**
⇨Representatives of corporations

Long-standing policy against contracting away bankruptcy benefits is not necessarily controlling when what defeats the rights in question is corporate control document instead of contract.

Cases that cite this headnote

[18] **Bankruptcy**
⇨Representatives of corporations

Essential playbook for a successful "blocking director" structure, pursuant to which director chosen by corporate creditor may permissibly be granted power to block the filing of bankruptcy petition by corporation, is that director must be subject to normal fiduciary duties of corporate director, and therefore in some circumstances vote in favor of bankruptcy filing, even if it is not in best interests of creditor by which director was chosen.

3 Cases that cite this headnote

[19] **Bankruptcy**
⇨Who May Institute Case
Corporations and Business Organizations
⇨Organizing documents; operating agreement

Language in limited liability company's (LLC's) operating agreement, pursuant to which, in exchange for mortgage lender's forbearance in not exercising its rights upon LLC's default in its payment obligations under mortgage note, lender was installed as "special member" of the LLC whose consent was required for any major actions, including filing of bankruptcy petition on LLC's behalf, was void as against public policy, where operating agreement also provided that lender, in exercising its veto rights as "special member," would have "no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members."

2 Cases that cite this headnote

[20] **Corporations and Business Organizations**
⇨In general; rights and liabilities

Under Michigan law, members of limited liability company (LLC) have duty to consider interests of entity and not only their own interests.

Cases that cite this headnote

Attorneys and Law Firms

*902 Francisco Connell and Miriam R. Stein, Chuhak & Tecson, P.C., Chicago, IL, Attorneys for Debtor.

Jamie L. Burns, Levenfeld Pearlstein, LLC, Chicago, IL, Attorney for BCL-Bridge Funding LLC.

MEMORANDUM DECISION

TIMOTHY A. BARNES, Judge

The matter before the court arises out of the Motion To Dismiss Case [Dkt. No. 11] (the "*Motion* "), filed by BCL–Bridge Funding LLC ("*BCL* "), seeking dismissal for cause under section 1112(b) of the Bankruptcy Code (as defined below) of the chapter 11 case of Lake Michigan Beach Pottawattamie Resort LLC (the "*Debtor* "). BCL alleges that because the Debtor filed its bankruptcy petition on the eve of foreclosure and without BCL's approval as a member of the Debtor, the case was filed in bad faith and must be dismissed.

The matter was argued before the court on January 27, 2016 (the "*Hearing* ") and the court delivered its ruling orally on March 2, 2016. For the reasons set forth herein, the court holds that BCL failed to show that the Debtor filed this case in bad faith. Further, the Debtor was not prohibited from filing the case under its existing corporate control documents.

JURISDICTION

The federal district courts have "original and exclusive jurisdiction" of all cases under title 11 of the United States Code (the "*Bankruptcy Code* "). 28 U.S.C. § 1334(a). The federal district courts also have "original but not exclusive jurisdiction" of all civil proceedings arising under title 11 of the United States Code, or arising in or related to cases under title 11. 28 U.S.C. § 1334(b). District courts may, however, refer these cases to the bankruptcy judges for their districts. 28 U.S.C. § 157(a). In accordance with section 157(a), the District Court for the Northern District of Illinois has referred all of its bankruptcy cases to the Bankruptcy Court for the Northern District of Illinois. N.D. Ill. Internal Operating Procedure 15(a).

[1]A bankruptcy judge to whom a case has been referred may enter final judgment on any proceeding arising under the Bankruptcy Code or arising in a case under title 11. 28 U.S.C. § 157(b)(1). A proceeding for dismissal of a bankruptcy ***903** case under section 1112(b) may only arise in a case under title 11 and is a matter in which a bankruptcy judge has constitutional authority to enter a final order. 28 U.S.C. § 157(b)(2)(A); *In re NNN 123 N. Wacker, LLC,* 510 B.R. 854, 857 (Bankr.N.D.Ill.2014) (Schmetterer, J.).

Accordingly, final judgment is within the scope of the court's authority.

PROCEDURAL HISTORY

In considering the relief sought by BCL, the court has considered the evidence and argument presented by the parties at the Hearing, has reviewed the Motion, the attached exhibits submitted in conjunction therewith, and has reviewed and found each of the following of particular relevance:

(1) Voluntary Petition for Non–Individuals Filing for Bankruptcy [Dkt. No. 1];

(2) Debtor's Response to BCL–Bridge Funding LLC's Motion to Dismiss [Dkt. No. 25];

(3) Amended Chapter 11 or Chapter 9 Cases: List of Creditors Who Have the 20 Largest Unsecured Claims and Are Not Insiders [Dkt. No. 29];

(4) Amended Statement of Financial Affairs for Non–Individuals Filing for Bankruptcy [Dkt. No. 31];

(5) Amended Statement of Financial Affairs for Non–Individuals [Dkt. No. 32];

(6) Amended Schedules A/B, D, E/F, G, H [Dkt. No. 34]; and

(7) BCL–Bridge Funding LLC's Reply in Support of Motion to Dismiss Case [Dkt. No. 37].

[2]Though the foregoing items do not constitute an exhaustive list of the filings in the case, the court has taken judicial notice of the contents of the docket in this matter. *See Levine v. Egidi,* No. 93C188, 1993 WL 69146, at *2 (N.D.Ill. Mar. 8, 1993) (authorizing a bankruptcy court to take judicial notice of its own docket); *In re Brent,* 458 B.R. 444, 455 n. 5 (Bankr.N.D.Ill.1989) (Goldgar, J.) (recognizing same).

BACKGROUND

This case is essentially a fight over the main asset of the Debtor, a vacation resort in Coloma, Michigan that hosts multiple condominium units and a cabin that are seasonally rented, and undeveloped land, all on 15.5 acres (the "*Property* "). With respect to the Property, the Debtor granted a mortgage and assignment of rents to BCL on December 18, 2014 to secure a $1,336,000.00 loan and $500,000.00 line of credit given by BCL to the Debtor.[1] BCL recorded the mortgage on January 22, 2015.

The Debtor defaulted on its monetary obligations to BCL in July 2015. In exchange for a promise from BCL that it would forbear from pursuing remedies for the default until October 21, 2015, the Debtor signed an agreement (the "*Forbearance Agreement* ") on August 21, 2015 wherein the Debtor stipulated to a monetary default in the amount of $2,641,147.89 and promised to pay that amount in full by October 21, 2015. The Debtor also made further promises to BCL, one of which was to execute a third amendment to its operating agreement (the "*Third Amendment* ")[2] establishing BCL as the fifth ***904** member of the Debtor, the "Special Member," with the right to approve or disapprove any "Material Action" by the Debtor. Third Amendment, Articles 12.2(vii), 12.3(i), p.2. Material Action is defined by the Third Amendment to mean any action:

> (A) to consolidate or merge the Company with or into any person, (B) to sell all or substantially all of

> the assets of the Company, (C) to institute any litigation or other legal proceedings whatsoever, (D) *to institute proceedings to have the Company be adjudicated bankrupt or insolvent, or consent to the institution of bankruptcy or insolvency proceedings against the Company or file a petition seeking, or consent to, reorganization or relief with respect tot the Company under any applicable federal or state law relating to bankruptcy,* or consent to the appointment of a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the Company or a substantial part of its property, or make any assignment for the benefit of creditors of the Company, or admit in writing the Company's inability to pay its debts generally as they become due, or declare of effectuate a moratorium on the payment of any obligation, or take action in furtherance of any such action, or (E) to dissolve or liquidate the Company.

Id. at Article 12.2(vi), p.2 (emphasis added). BCL, in its capacity as the Special Member of the Debtor, has no interest in the profits or losses of the Debtor, no right to distributions or tax consequences and is not required to make capital contributions to the Debtor—essentially, BCL was kept separate and apart from the Debtor in all ways but for its authority to block the Debtor from petitioning for bankruptcy relief. *Id.* at Article 12.4(iii), p. 2. Further, when exercising its rights under the Third Amendment, BCL 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." *Id.* at Article 12.4(iv), pp. 2–3.

Shortly following the execution of the Third Amendment, the Debtor once again failed to fulfill its monetary obligations to BCL, by failing to meet the October 21, 2015 deadline under the Forbearance Agreement to pay BCL in full. Following this default, BCL filed a foreclosure complaint against the Third Party Property on November 2, 2015 and against the Property on November 3, 2015. With respect to the latter, BCL published notice of a December 17, 2015 non-judicial foreclosure sale for three weeks in the Berrien County Record, the local newspaper for where the Property is located.

On December 16, 2015 (the "*Petition Date* "), the Debtor petitioned for relief under chapter 11 of the Bankruptcy Code. As a result, the foreclosure sale was not held as scheduled. Attached to the Debtor's petition is a consent to file bankruptcy signed by four members of the Debtor. A signature on behalf of BCL, as the Special Member, was not included. The Debtor agrees that BCL has not consented to the Debtor's bankruptcy petition and that this case was filed on the eve of the foreclosure sale.

The Debtor has provided broker price opinions for each of the rental units and the undeveloped acreage that support a valuation of the Property, as of the Petition Date, exceeding the $6,000,000.00 value scheduled by the Debtor. BCL has not filed a claim, but given the amount set forth in the Forbearance Agreement less ***905** than six months prior to the Petition Date, there appears to be little doubt that there is equity in the Property, even if value of the Third Party Property were not considered. Unsurprisingly, therefore, BCL does not dispute the Debtor's allegation that there is equity in the Property or that any of the amounts due to it are unsecured by the value of the Property and the Third Party Property.

DISCUSSION

BCL argues that the Debtor's bankruptcy petition is a bad faith litigation tactic to stall the foreclosure process and, accordingly, grounds for dismissal exist. Such grounds are asserted on motions to dismiss on a regular basis in this court. Had that been the extent of BCL's argument, this matter could have been handled summarily, as will be seen below. The argument with respect to the validity of the Debtor's bankruptcy petition, however, requires more. The court will address all arguments in turn.

A. *Dismissal of a Chapter 11 Case for Cause*

[3]A court may dismiss a chapter 11 case if cause is established and such cause merits dismissal rather than conversion. 11 U.S.C. § 1112(b). The party seeking dismissal bears the burden of proof by a preponderance of the evidence. *In re Woodbrook Assocs.*, 19 F.3d 312, 317 (7th Cir.1994). Cause, however, is not definitely

established by the statute. Section 1112(b)(4) provides courts with a nonexclusive list of factors that may constitute cause for dismissal, 11 U.S.C. § 1112(b)(4), which list does not include bad faith.

1. *Bad Faith*

[4] [5]A chapter 11 case is infirm if not filed in good faith and, therefore, courts in this Circuit have found that the lack of good faith can constitute "cause" for dismissal of a case under section 1112(b). *In re Madison Hotel Associates,* 749 F.2d 410, 426 (7th Cir.1984); *In re Tekena USA, LLC,* 419 B.R. 341, 346 (Bankr.N.D.Ill.2009) (Cox, J.). As with intent, courts look at each bankruptcy filing on a case-by-case basis to determine whether factors indicative of a debtor's good or bad faith are present. *See Tekena USA, LLC,* 419 B.R. at 346; *In re S. Beach Sec., Inc.,* 341 B.R. 853, 857 (N.D.Ill.2006) (*citing In re Integrated Telecom Express, Inc.,* 384 F.3d 108, 118 (3d Cir.2004)) ("Each bankruptcy petition, however, arises under different circumstances and raises particular concerns, requiring a court to examine the debtor's unique situation to determine where 'a petition falls along the spectrum ranging from the clearly acceptable to the patently abusive.' ").

[6] [7]*Tekena* and the factors enumerated therein have been cited by many creditors seeking dismissal, including BCL, as the checklist that a court should use to examine whether a debtor acted in good or bad faith in filing its bankruptcy petition. 419 B.R. 341. The so-called "*Tekena* factors"[3] are not binding on this court, however, and are, as with the factors set forth in section 1112(b), neither exhaustive nor mandatory. The court will, nonetheless, consider them in the totality of this case. The factors are:

1. The debtor has few or no unsecured creditors.

*906 2. There has been a previous bankruptcy petition by the debtor or a related entity.

3. The pre-petition conduct of the debtor has been improper.

4. The petition effectively allows the debtor to evade court orders.

5. There are few debts to non-moving creditors.

6. The petition was filed on the eve of foreclosure.

7. The foreclosed property is the sole or major asset of the debtor.

8. The debtor has no on-going business or employees.

9. There is no possibility of reorganization.

10. The debtor's income is not sufficient to operate.

11. There was no pressure from non-moving creditors.

12. Reorganization essentially involves the resolution of a two-party dispute.

13. A corporate debtor was formed and received title to its major assets immediately before the petition.

14. The debtor filed solely to create the automatic stay.

Tekena, 419 B.R. at 346. The factors BCL relies on in making its bad faith argument in the Motion are factors 1, 2, 6, 7, 8, 9 and 12, though at the Hearing, counsel for BCC summarily argued that all *Tekena* factors were met and no clearer case for dismissal than this case could exist. The arguments made in the Motion are the grounds upon which BCL primarily relies and are, coincidentally, the only ones bearing any relation to this case. The court will, therefore, address only the factors enumerated in the Motion without considering the remaining *Tekena* factors.

a. Does the Debtor have few or no unsecured creditors? (*Tekena* factor # 1)

BCL argues that the first *Tekena* factor is satisfied because it is the only "real" secured creditor of the Debtor. BCL puts so much stock in this assertion that it italicizes the term "real" when using it in the Motion.

This assertion is, however, flawed. There is no test as to whether a creditor is "real" or not in the relevant statutory or case law. Further, concentrating on only secured creditors can lead to mistaken results.

BCL has not filed a claim in this case. Instead, other than the exhibits attached to the Motion, BCL relies on the Debtor's schedules, listing BCL as a secured creditor, to establish its status. The exhibits, of course, are not evidence, while the Debtor's schedules, signed under penalty of perjury, may be. Thus, the only evidence the court has is the Debtor's schedules.

[8]Concentrating on the schedules, however, leads to the unavoidable conclusion that BCL is not the only creditor. The Debtor also scheduled Pottawattamie Resort

Condominium Association as having a secured claim and Erica Friedman as holding an unliquidated, unsecured claim, based on pending litigation. No objections to the scheduling of these claims has been raised, and in a chapter 11 case, scheduled claims are presumptively valid until adjudicated otherwise. 11 U.S.C. § 1111(a). The Debtor, therefore, has at least three creditors.

BCL's argument that it is the only "real" creditor in this case, therefore, fails under the Bankruptcy Code and under its own analysis. The first *Tekena* factor is not satisfied.

*907 b. Has the Debtor or a related entity previously petitioned for bankruptcy relief? (*Tekena* factor # 2)

[9]BCL's argument regarding the second *Tekena* factor—whether there was a previous bankruptcy petition by the Debtor or a related entity—strains its credibility. BCL argues that the Debtor's default somehow equates to a prior bankruptcy. That the Debtor was in default to BCL is not indicative of bad faith.[4] If such were the case, most debtors would have filed their cases in bad faith. The Debtor has not filed any previous bankruptcy petitions and the second factor is clearly not satisfied.

c. Did the Debtor file this case on the eve of foreclosure? (*Tekena* factor # 6)

BCL repeatedly argues in the Motion and argued at the Hearing that the most compelling indication of bad faith is the timing of the Debtor's bankruptcy petition—on the eve of foreclosure. The Debtor does not dispute the timing but argues that the foreclosure would have resulted in a large windfall to BCL and that the petition for bankruptcy relief was filed to preserve equity in the Property.

[10]This is, in the court's view, the most abused of the *Tekena* factors. Parties presume that if this factor is satisfied, bad faith must exist. This is simply not correct. "It is well settled, of course, that the filing of a bankruptcy petition on the eve of a foreclosure or eviction does not, by itself, establish a bad faith filing." *In re Eclair Bakery Ltd.*, 255 B.R. 121, 137 (Bankr.S.D.N.Y.2000). Again, bad faith requires this court to review the totality of the circumstances regarding a petition for bankruptcy relied, not just an isolated factor. While BCL is correct that the sixth factor is satisfied, taken alone, this factor is unpersuasive.

d. Is the Property the sole or major asset of the Debtor? (*Tekena* factor # 7)

[11]BCL also is correct that the seventh factor is satisfied—the Property is the major asset of the Debtor. Again, this factor is not outcome determinative. Even assuming that this were the *only* asset of the Debtor, this alone would not suffice.

> [T]he fact that this is a single asset real estate case does not render it a bad faith filing. The Bankruptcy Code contains no provision to this effect, and, to the contrary, was recently amended to deal specifically with certain single asset real estate cases. *See* 11 U.S.C. §§ 101(51B) (defining 'single asset real estate') and 362(d)(3) (providing special grounds for relief from the automatic stay in single asset real estate cases), each added to the Code by Section 218 of the Bankruptcy Reform Act of 1994. *See also In re James Wilson Assocs.*, 965 F.2d 160 (7th Cir.1992) (affirming confirmation of Chapter 11 plan in single asset real estate case).

In re 203 N. LaSalle St. Ltd. P'ship, 190 B.R. 567, 590 (Bankr.N.D.Ill.1995) (Wedoff, J.), *aff'd Bank of Am., Illinois v. 203 N. LaSalle St. P'ship*, 195 B.R. 692 (N.D.Ill.1996), *aff'd In re 203 N. LaSalle St. P'ship*, 126 F.3d 955 (7th Cir.1997), *rev'd on other grounds*, *908 *Bank of Am. Nat. Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999). The court cannot conclude that a case is filed in bad faith simply because there is but one asset around which to reorganize.

e. Does the Debtor have on-going business? (*Tekena* factor # 8).

[12]The Debtor is not currently operating. Chapter 11 relief, however, is not reserved for only operating businesses. Debtors in chapter 11 cases may refinance debts or sell all or part of their assets in order to maximize value in an operational or nonoperational setting. *In re Chicago Const. Specialties, Inc.*, 510 B.R. 205, 215 (Bankr.N.D.Ill.2014) (Barnes, J.) ("Despite being entitled 'Reorganization,' chapter 11 expressly contemplates liquidating plans of reorganization."); *see also, e.g.*, 11 U.S.C. § 1123 (A plan may "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests.").

BCL does not dispute that there is equity in the Property. That equity may be used to reorganize the Debtor and/or pay its debts, and the Debtor has offered to provide evidence to BCO and the court of lenders willing to refinance the Property and pay BCL in full. BCL, however, believes there must be more, that the Debtor must actually be operating and generating cash flow. This argument mistakes both the essential nature of chapter 11 noted above and that, even if being nonoperational would equate to having no on-going business and thereby potentially end the inquiry (which it does not), being nonoperational on a seasonal basis would not.

[13]Among other things, a debtor may, in good faith, use the bankruptcy system to give it a breathing spell to become cash-flow solvent when it is, as the Debtor is in this case, balance-sheet solvent.

> Early on in a bankruptcy case, a debtor may be given a greater benefit of the doubt as to the success of a proposed feasible plan. *In re Cadwell's Corners P'ship*, 174 B.R. 744, 759 (Bankr.N.D.Ill.1994) (Katz, J.); *see also In re Morrow*, 495 B.R. 378, 386 (Bankr.N.D.Ill.2013) (Barnes, J.) (explaining that the filing of a bankruptcy case gives debtor's a "breathing spell," which allows a debtor time to attempt a reorganization plan).

In re Bovino, 496 B.R. 492, 507 (Bankr.N.D.Ill.2013) (Barnes, J.). While the Debtor's seasonal business may not be presently operating, that does not mean that there are no assets to operate an on-going business during the peak summer seasons. As a result, this factor is not satisfied.

f. Is there a possibility of reorganization without the consent of BCL, or is this, essentially, a two party dispute? (*Tekena* factors # 9, 12)

BCL has also not proven the ninth and twelfth *Tekena* factors. This is not solely a two party dispute and, as previously demonstrated by the Debtor's schedules, BCL is not the only creditor in this case. Reorganization of the Debtor through confirmation of a chapter 11 plan, thus, may be possible without BCL's consent. *See, e.g.*, 11 U.S.C. § 1129(b). Further, given the undeniable equity in the Property, other forms of chapter 11 relief may be available to the Debtor. Any specific finding on the likelihood of reorganization—and thus, dismissal—under the facts of this case and at this early point in the chapter 11 process, is premature. *See Bovino*, 496 B.R. at 499 (*citing In re Sal Caruso Cheese, Inc.*, 107 B.R. 808, 817 (Bankr.N.D.N.Y.1989)); *see also In re Gen. Growth Props., Inc.*, 409 B.R. 43, 65 (Bankr.S.D.N.Y.2009) ("There is no requirement in the Bankruptcy Code that a ***909** debtor must prove that a plan is confirmable in order to file a petition.").

After considering the foregoing, and after reviewing the facts of *Tekena* in comparison to those in this matter, the court determines that BCL's reliance on *Tekena* is misplaced. Some factors were distorted by BCL so as to fit within the facts of this case. Some factors are simply inapplicable. Those that remain, even when taken together, are not enough to establish bad faith.

In fact, this case is very similar to the case of *In re Clinton Fields, Inc.*, 168 B.R. 265 (Bankr.M.D.Ga.1994), which the court finds to be more helpful than *Tekena* for analyzing the faith of the Debtor in this case. In *Clinton Fields*, the Debtor's single asset was real property and the case was filed on the eve of foreclosure. Judge Walker did not dismiss the debtor's chapter 11 petition when faced with allegations of bad faith based on findings that "the presence of equity provides both a sound basis for reorganization and substantial evidence of the Debtor's good faith intent to reorganize." *Id.* at 269.

It is clear to the court, therefore, that BCL has failed to carry its burden that this case was commenced in bad faith and, absent the argument that the Debtor's bankruptcy petition is void, as discussed below, the court finds no

cause to dismiss this case under section 1112(b).

2. *Unauthorized Filing*

As noted above, if the foregoing had been BCL's only allegations, the Motion would have been denied without the need for further inquiry. BCL has also argued, however, that the Debtor's bankruptcy petition was not authorized because one member of the Debtor, BCL, did not approve it. This argument was made in bold and italics in the Motion[5] but not initially addressed by BCL at the Hearing. Only in response to questioning by the court did BCL press the argument. The Debtor argues, in response, that the provision in the Third Amendment requiring BCL's consent for the filing of a bankruptcy petition by the Debtor, is 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. The court will address each of the Debtor's arguments in light of the specific language of the Third Amendments only after examining the effect of the Third Amendment on the outcome under Michigan law.

a. Michigan corporate governance law for consent

Before examining whether the provision requiring BCL's consent contained in the Third Amendment is enforceable under bankruptcy or Michigan law, the court must determine whether such an inquiry is necessary. To put it plainly, 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.

In that regard, BCL argues that the provision in the Third Amendment requiring its consent, as the Special Member of the Debtor, to any material action, including bankruptcy relief, means that the Debtor's petition in this case is invalid because it was filed without its consent. ***910** The Debtor did not address the legal analysis for consent under this provision and, instead, argues that the provision requiring BCL's consent in the Third Amendment is void, thus, the Debtor obtained the requisite consent under the operating agreement without the alleged invalid provision.

[14] [15]The Debtor is a limited liability company created in Michigan, therefore, the court must apply Michigan corporate governance law in determining whether the filing was a valid corporate action. *See In re Gen–Air Plumbing & Remodeling, Inc.*, 208 B.R. 426, 430 (Bankr.N.D.Ill.1997) (Squires, J.) ("The authority to file a bankruptcy petition on behalf of a corporation must derive from state corporate governance law."). In Michigan, "[u]nless the vote of a greater percentage of the voting interest of members is required by this act, the articles of organization, or an operating agreement, a vote of the majority in interest of the members entitled to vote is required to approve any matter submitted for a vote of the members." Mich. Comp. Laws. Ann. § 450.4502(8). Thus, the operating agreement can require more than a majority vote.

The Debtor's original operating agreement provides that "[a]ll members shall be entitled to be vote on any matter submitted to a vote of the members," Operating Agreement for Lake Michigan Beach Pottawattamie Resort, LLC, Article 7.1, p. 7., and that the "affirmative core or consent of a majority of the Sharing Ratios of all the Members entitled to vote or consent on such matter shall be required." *Id.* at Article 7.2, p. 7. Sharing ratios are defined as the "interests of the respective Members in the total capital of the Company." *Id.* at Article 4.1, p. 3.

The first and second amendments to the operating agreement shift the sharing ratios between the three individual, original members of the Debtor (first amendment) and add the fourth individual member in exchange for a capital contribution (second amendment), but do not alter the voting requirements. The Third Amendment provides that BCL, as the Special Member, does not have any capital of the Debtor. Third Amendment, Article 12.4(iii), p.2. The four individual members constitute 100% of the sharing ratios, therefore, and consented to the Debtor's bankruptcy petition. But for the specific prohibitions in the Third Amendment, under Michigan law, the Debtor's petition would be authorized as a majority of the sharing ratios consented to the petition in this case.

Those prohibitions, however, change the analysis, and that undoubtedly was their intent.

Article XII of the Third Amendment is entitled "Special Member" and provides:

> This Article XII has been adopted in order to comply with certain provisions of the Loan Documents (as defined herein). This Section is written *for the express benefit of*

> *the Lender* (as defined herein) and shall *supersede any conflicting or inconsistent provision of this Agreement.* This Section shall apply until such time as no Obligations remain outstanding (including, without limitation, until such time as the Debt shall be paid in full), after which it will no longer have any fore or effect.

Third Amendment, Article 12.1, p. 1 (emphasis added). "Section" is not defined in the Third Amendment, but in context clearly refers to Article XII. Article XII is the entirety of the Third Amendment, which was executed in conjunction with the Forbearance Agreement, and establishes BCL as the Special Member and the provision requiring BCL's consent for the Debtor to petition for bankruptcy. *Id.* at 12.2(viii), 12.3(i), p. 2. Because the Third ***911** Amendment supersedes the previous provision in the Debtor's operating agreement requiring a majority of the sharing ratios for consent, *see infra,* and because Michigan allows for operating agreements to override the default majority of interests requirement set forth in section 450.4502(8), the provision requiring BCL to consent would result in the Debtor's petition in this case, filed without the consent of BCL, being infirm.

The court must, therefore, determine the validity of the prohibitions in the Third Amendment in order to determine whether this petition was authorized under the Debtor's operating agreement and Michigan law and, ultimately, bankruptcy law.

b. Blocking director

BCL's argument is grounded in the well-established commercial practice of using "blocking directors." A blocking director[6] is the lynchpin that holds together a bankruptcy remote special purpose entity,[7] formed to ring fence assets from creditors other than a secured creditor who is unwilling to lend otherwise and for whom the structure is made. In such instances, a business enterprise creates an entity that has assets but limited or no operations and may not, but for unanimous consent of its directors, file for bankruptcy, *Gen. Growth,* 409 B.R. at 49, and that entity acts as the borrower and often the guarantor of the loan. Actions of a similar nature to bankruptcy are likewise prohibited. 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. Last, the organizational documents of the entity provide that these prohibitions may not be altered but for unanimous consent of the directors (again, with an inability to act if the secured creditor's nominee's seat is vacant).

The import of such a structure is readily apparent. One specific director, chosen by the secured creditor, may withhold its vote and thus block, hence the name, a voluntary bankruptcy petition. Further, given the limited operations, an involuntary petition against the entity is highly unlikely.

c. Fiduciary duties and public policy concerns

Why go to such effort, one might ask? For one crucial reason: a simpler, absolute prohibition against filing for bankruptcy will likely be deemed void as against public policy. As corporate entities have been held to have, in certain instances, rights akin to that of natural person, *see, e.g., Citizens United v. Federal Election Comm'n,* 558 U.S. 310, 342, 130 S.Ct. 876, 175 L.Ed.2d 753 (2010), prohibiting such entities from availing themselves of the ***912** bankruptcy laws—laws so seminally important that they were specifically authorized under the Constitution—is generally considered bad form. *Gen. Growth,* 409 B.R. at 49. In the same way that individuals may not contract away their bankruptcy rights, corporations should be similarly constrained. *See, e.g.,* 11 U.S.C. 362(e); *Klingman v. Levinson,* 831 F.2d 1292, 1296 (7th Cir.1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy."); *In re Shady Grove Tech Ctr. Assocs. Ltd. P'ship,* 216 B.R. 386, 390 (Bankr.D.Md.1998), *supplemented,* 227 B.R. 422 (Bankr.D.Md.1998) (corporate contractual "prohibitions against the filing of a bankruptcy case are unenforceable").

[16]Bankruptcy law, however, is equally clear that corporate formalities and state corporate law must also be satisfied in commencing a bankruptcy case. *NNN 123 N. Wacker,* 510 B.R. at 858. Except in very specific circumstances not at play here,[8] an improperly authorized corporate bankruptcy filing is infirm. *Id.* (*citing Price v. Gurney,* 324 U.S. 100, 106, 65 S.Ct. 513, 89 L.Ed. 776 (1945)).

[17]Put another way, the long-standing policy against contracting away bankruptcy benefits is not necessarily

controlling when what defeats the rights in question is a corporate control document instead of a contract.[9] *See Klingman,* 831 F.2d at 1296; *see also 203 N. LaSalle St. P'ship,* 246 B.R. at 331 (As "bankruptcy is designed to produce a system of reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply.").

Nonetheless, common wisdom dictates that the corporate control documents should not include an absolute prohibition against bankruptcy filing.[10] Even though the blocking director structure described above impairs or in operation denies a bankruptcy right, it adheres to that wisdom. It 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. That means that, at least theoretically, there will be situations where the blocking director will vote in favor of a bankruptcy filing, even if in so doing he or she acts contrary to purpose of the secured creditor for whom he or she serves.

***913** As noted by Judge Gropper in *General Growth,* "if 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." 409 B.R. at 64. In *Kingston Square,* Judge Brozman was also clearly incredulous at the attempt by the parties to forswear applicable fiduciary duties so as to block an otherwise necessary bankruptcy filing. *In re Kingston Square Assocs.,* 214 B.R. 713, 735–36 (Bankr.S.D.N.Y.1997) ("Richardson [the blocking director] says he was unaware in his capacity as director of his fiduciary duties to creditors and that he only learned of his duties to creditors later.... Basic hornbook law provides that directors occupy a fiduciary relation to the corporation and its shareholders ... Richardson is an attorney who worked on sophisticated corporate financings. It is inconceivable that he would not understand that the corporate general partners of which he was a director bore fiduciary obligations to the limited partners. (That is the stuff of a basic corporate law course in law school.) Yet he 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."). Courts have clearly gone out of their way to enforce the basic public policy prohibition in such circumstance. *See Gen. Growth,* 409 B.R. at 64; *Kingston Square,* 214 B.R. at 736; *In re Spanish Cay Co., Ltd.,* 161 B.R. 715, 723 (Bankr.S.D.Fla.1993) (permitting insiders to also be involuntary petitioning creditors despite corporate control documents arguably prohibiting same).

The consideration of fiduciary duties and public policy concerns further extends to situations where the blocking position is a member of a limited liability company because the member of a limited liability company, such as the Debtor in this case, maintains the power to consent or block a bankruptcy petition. *NNN 123 N. Wacker,* 510 B.R. at 858 (*citing In re Avalon Hotel Partners, LLC,* 302 B.R. 377 (Bankr.D.Oregon 2003)).

[18]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.

BCL's playbook was, unfortunately, missing this page.

d. BCL as the special member and its fiduciary duties thereunder

[19]As previously stated, the Third Amendment establishes BCL as the "Special Member" of the Debtor. Third Amendment, Articles 12.2(vii), 12.3(i), p.2. BCL's role as the Special Member may enable it, therefore, to "block" the Debtor from taking any material action, including availing itself of bankruptcy relief, by withholding its required consent. *See id.* at Article 12.2(vi), p.2. This structure undoubtedly was negotiated by BCL to ensure that the Property was not to be administered in a bankruptcy.

The Debtor's bankruptcy petition was, nonetheless, consented to by the remaining members of the Debtor. The Debtor argues that the consent of the remaining members was sufficient because, despite BCL's insistence to the opposite, the blocking member provision in the Third Amendment is void. As noted above, from a bankruptcy perspective, that conclusion would not be inevitable if fiduciary duties are respected. That is not the case here, however.

***914** The Third Amendment limits BCL duties as the Special Member to those "rights and duties expressly set forth in this Agreement." Third Amendment, Article 12.2(viii), p. 2. Those rights and duties are then limited by Article 12.4(iv):

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.

Id. at Article 12.4(iv), p. 2–3 (emphasis added). This language results in BCL as the Special Member having no duties to the Debtor,[11] despite otherwise being a member of the Debtor.

[20]Under Michigan law, members of a limited liability company have a duty to consider the interests of the entity and not only their own interests. The Michigan Limited Liability Company Act, a subsection of the Michigan Business Corporate Act, much like the corporate governance laws of many other states, requires that

> (1) A manager shall discharge the duties of manager in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the manager reasonably believes to be in the best interests of the limited liability company.

Mich. Comp. Laws Ann. § 450.4404. Therefore, BCL, as a member of a Michigan limited liability company, the Debtor, must consider the interests of the Debtor.

The Third Amendment does provide, however, that these limited duties are allowed "to the fullest extent permitted by applicable law." Third Amendment at Article 12.4(iv), p. 2–3. That savings clause might cure the invalidity of the prohibition, but only by rendering it meaningless. The prohibition has no application other that which is impermissible under Michigan law.

By excluding the Debtor's interests from consideration by BCL when acting as the Special Member of the Debtor, thereby allowing BCL to consider only its own best interests, the Third Amendment also expressly eliminates the only redeeming factor that permits the blocking director/member construct. The Third Amendment provision that BCL's consent was required in order for the Debtor to petition for bankruptcy relief is, therefore, unenforceable, both as a matter of Michigan corporate governance and bankruptcy law.

What the court is left with is this—the blocking member provision of the Third Amendment is void. The remaining corporate governance provisions governing the Debtor, and analyzed in accordance with Michigan law, therefore, result in a valid consent to the Debtor's bankruptcy petition.

*915 CONCLUSION

For the foregoing reasons, BCL has failed to satisfy its burden of proof as to cause to dismiss the Debtor's bankruptcy petition. Accordingly, the Motion will be DENIED.

A separate Order will be issued concurrent with this Memorandum Decision.

ORDER

This matter comes before the court on the Motion To Dismiss Case (the "*Motion* ") of BCL–Bridge Funding LLC ("*BCL* ") to dismiss the bankruptcy of Lake Michigan Beach Pottawattamie Resort LLC [Dkt. No. 11]; the court having jurisdiction over the subject matter; all necessary parties appearing at the Hearing that took place from place on January 27, 2016 (the "*Hearing* "); the court having considered the evidence presented by all parties and the arguments of all parties in their filings and at the Hearing; and in accordance with the Memorandum Decision of the court in this matter issued concurrently herewith wherein the court found that BCL has not satisfied its burden of proof with respect to cause under 11 U.S.C. § 1112(b);

NOW, THEREFORE, IT IS HEREBY ORDERED:

(1) The Motion is DENIED.

All Citations

547 B.R. 899, 62 Bankr.Ct.Dec. 113

Footnotes

1 Property in Streamwood, Lemont, Bartlett and Roselle, Illinois held in title by other parties also secured the loan and line of credit (the "*Third Party Property*"). The value of the Third Party Property has not been addressed by the parties.

2 The Third Amendment, as provided to the court as an attachment to the Debtor's response to the Motion, was executed by all of the original members of the Debtor, but was not dated and was not executed by anyone for BCL as the Special Member.

3 Though commonly referred to as the "*Tekena* factors" in this jurisdiction, as noted in *Tekena*, these factors are actually set forth in an earlier opinion by Judge Lee of the District Court for the Northern District of Indiana. *In re Grieshop*, 63 B.R. 657, 663 (N.D.Ind.1986).

4 "Debtor's prepetition payment behavior is relevant only insofar as it would suggest that equally unimpressive postpetition payment behavior will ensue. However, it must be recalled that poor prepetition payment histories are systematic of most debtors and hence this factor is, in itself, of very limited relevance." *In re Tashjian*, 72 B.R. 968, 974 (Bankr.E.D.Pa.1987).

5 As noted above, this is not the only creative use of emphasis in the Motion. While court filings share little in common with email and other forms of modern, textual communication, in each medium parties are encouraged to exercise decorum and not to overuse emphasis. Just as all capital letters are deemed to be shouting in the latter, so goes bold plus italics in the former. The parties are cautioned against the overuse of textual modification for emphasis.

6 For the purpose of simplicity and because "blocking director" is more common in parlance than "blocking member," the term blocking director will be used *infra* except where used specifically in relation to the Debtor. However, the discussion and laws relating blocking directors apply equally to structures involving blocking members, as is discussed below.

7 Sometimes referred to as a "single-purpose entity" or "bankruptcy remote entity," an SPE has been described by one commentator as "an entity, formed concurrently with, or immediately prior to, the closing of a financing transaction, one purpose of which is to isolate the financial assets from the potential bankruptcy estate of the original entity, the borrower or originator." David B. Stratton, *Special–Purpose Entities and Authority to File Bankruptcy*, 23–2 Am. Bankr.Inst. J. 36 (March 2004). "Bankruptcy-remote structures 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." Michael T. Madison, et. al., *The Law of Real Estate Financing*, § 13:38 (2008).
Gen. Growth, 409 B.R. at 49.

8 *See, e.g., In re American Globus Corp.*, 195 B.R. 263 (Bankr.S.D.N.Y.1996) (case would not be dismissed despite failure to satisfy 100% shareholder authorization vote requirement, when dissenting shareholder was motivated by improper means to avoid bankruptcy); *see also Management Techs., Inc. v. Morris*, 961 F.Supp. 640 (S.D.N.Y.1997) (bankruptcy filed through improper corporate action would not be dismissed).

9 To be clear, it is not just contractual prohibitions that have been found to be void. *See, e.g., In re Auto. Professionals, Inc.*, 370 B.R. 161, 181 (Bankr.N.D.Ill.2007) (Doyle, J.) ("State law can suspend the operation of Title 11 only when a debtor is not eligible for relief under § 109 of the Bankruptcy Code."); *In reCorp. & Leisure Event Prods., Inc.*, 351 B.R. 724, 727 (Bankr.D.Ariz.2006) (state receivership law and state court order enjoining bankruptcy filing invalid prior restraint on filing for bankruptcy by corporate entity).

10 Bankruptcy courts are loathe to enforce any waiver of rights granted under the Bankruptcy Code because such a waiver "violates public policy in that it purports to bind the debtor-in-possession to a course of action without regard to the impact on the bankruptcy estate, other parties with a legitimate interest in the process or the debtor-in-possession's fiduciary duty to the estate." *In re Trans World Airlines, Inc.*, 261 B.R. 103, 114 (Bankr.D.Del.2001); *In re Tru Block Concrete Products, Inc.*, 27 B.R. 486, 492 (Bankr.S.D.Cal.1983).

11 While the duty of an officer or director to consider interests does not extend to the creditors of a corporation in normal circumstances, most states impose an additional fiduciary duty to consider the interests of all creditors when a corporate debtor is operating in insolvency. *DeWitt v. Sealtex Co.*, Case No. 273387, 2008 WL 2312668, at *10 (Mich. Ct.App. June 5, 2008) (*citing* 3A Fletcher Cyclopedia Corporations, § 1035.60, p 30). Michigan is one of the rare states

that does not impose this additional duty. *Id.* As noted in *Gen. Growth*, however, the duty to the debtor itself and, ultimately the debtor's collective equity holders, is what is paramount. 409 B.R. at 64. For these purposes, Michigan law is no different that such a duty is owed and may not be forsworn.

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