AMERICAN BANKRUPTCY INSTITUTE

2019 Winter Leadership Conference

The Continued Use of Blocking Directors and Managers in Bankruptcy-Related Transactions

Hosted by the Unsecured Trade Creditors and Secured Credit Committees

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CONCURRENT SESSION

2019

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December 7, 2019

Independent Directors for Bankruptcy Remote SPVs

General Characteristics

- Newly created SPV (Special Purpose Vehicle)
- Usually in the form of a Delaware LLC
- LLC is either Member Managed or managed by a Board of Managers
- Lender requirement – ring fences risk
- Borrower hires and pays the Independent Director

General Characteristics

- Independent Director is a party to the LLC Agreement
- Must have an Independent Director (ID) at all times as long as the Loan is outstanding.
- The ID may not resign until a successor is appointed.
- Indemnification from SPV and backup
- Standard of Care: gross negligence and willful misconduct
- ID has duty to Company AND its creditors

Types of Transactions

- CRE financings – one borrower, one asset, one lender
- ABS transactions – pool of assets such as mortgages, auto loans, student loans, etc., and many investors.

SPE Provisions

The SPV may not:

- engage in any other business or activity
- acquire or own any other assets
- merge or consolidate with any other entity
- incur any more debt
- commingle its assets
- dissolve, terminate or liquidate
- transfer, divide or sell the assets
- make any loans or act as Guarantor

Independent Director

Qualifications:

- Individual nor any immediate family may have any connection to the Company or any of its affiliates during the preceding (5) years
- Must be employed by a nationally recognized ID provider
- Shall have at least (3) years prior experience as an ID

Limitations:

- We incorporate explicit language in the LLC Agreement limiting the power, authority, & voting rights to ONLY Material Actions.

Material Actions

Material Actions is a defined term in the LLC Agreement, and is not limited to but generally always includes:

- Voluntary filing for bankruptcy
- Selling the Assets
- Taking on more debt
- Merge or consolidate

Springing / Special Member

- Springing Member - in the event the Member ceases to be the member, the Springing Member is there to essentially keep the entity in Good Standing until another member is appointed.
- The Springing Member has no equity interest in the entity.
- The Springing Member has no authority to bind the entity or take any actions other than keeping the entity in good standing.
- The ID often serves as the Springing Member as well.

Voting process & Real Life examples

- Decision process:
  - Is it a Material Action?
  - Is the Company insolvent?
  - Identify the Creditors – 1st lien, 2nd lien?
  - Seek approval from at least 66.67% of 1st lien creditors.
- How it should work… and not so much

Bankruptcy Remote… not Bankruptcy Proof

- Although bankruptcy remote SPV provisions help reduce the risk of a voluntary bankruptcy filing by the Borrower, it certainly doesn't eliminate it completely.

- The GGP (General Growth Properties) case is an example of how a bankruptcy remote SPV was still successfully able to voluntarily file for bankruptcy.

- GGP fallout:
  1. Notifications requirement:
     a. Borrower must notify the Lender of an upcoming ID change – usually 60 days
     b. Lender approval
  2. ID must be provided by a nationally recognized service provider

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Independent Directors in Bankruptcy

Use of Independent Directors in Chapter 11

- Good corporate governance
- Professional director with experience in restructuring
- Validation of past transaction/investigation and settlement powers
- Means to avoid appointment of trustee or examiner
- Means to preempt UCC requests for standing

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Blocking Directors: Foundational Cases and Themes

Early Cases

- In 1937, the Supreme Court held that a dissolved corporation can't file a bankruptcy petition unless that's a power reserved to a corporation in dissolution under state law
  - *Chicago Title & Trust Co. v. Forty-One Thirty-Six Wilcox Building Corp.*, 302 U.S. 120 (1937)
- In 1943, the Court held that the administrator of the estate of a deceased debtor can commence a bankruptcy case only if state law or the probate court authorizes the administrator to do so
  - *Harris v. Zion Savings Bank & Trust Co.*, 317 U.S. 447 (1943)

Western Tool & Manufacturing Company

- In the 1920s, Western Tool & Manufacturing Company defaulted on $73,000 of secured bonds
- A voting trust was formed to hold a majority of the company's stock, with the trustees selected by the bondholders
  - The trustees also elected the company's directors

Western Tool & Manufacturing Company

- In 1942, the bondholders filed a petition to foreclose their mortgage
  - The company admitted the allegations and consented to the receivership
  - One of the voting trustees was appointed as receiver
  - Judgment was entered for $143,000, including interest

Western Tool's Bankruptcy Petition

- James Gurney, who owned 7 shares of stock and represented other stockholders, filed a Chapter X petition on behalf of the company, alleging malfeasance and breach of fiduciary duty
- District Court dismissed the petition for lack of authorization, but Sixth Circuit reversed
- Supreme Court granted certiorari

Gurney's Derivative Argument

- Gurney acknowledged that only a debtor, an indenture trustee, or three creditors could file a Chapter X petition
- But he argued that because the directors had breached their duties, stockholders could act on behalf of the debtor in a derivative capacity
- The Court disagreed in *Price v. Gurney*, 324 U.S. 100 (1945):
  - A derivative action enforces a corporate cause of action and results in a judgment against a third person, or it permits a stockholder to intervene to defend an action that the company won't assert
  - Gurney's bankruptcy petition wasn't either of those things
  - And even if it were, jurisdiction was lacking; the parties weren't diverse, and bankruptcy powers don't permit adjustment of corporate governance until after a valid petition is granted

Price: Key Takeaways

- Unless a company is federally incorporated, power to act on behalf of the company "finds its source in local law"
  - "If the District 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."
  - "[N]owhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation."
- Also possible to view *Price* as an early case allowing things in a workout that might not be permissible in a loan agreement

Developments Since *Price*

- Holding has been applied in other contexts:
  - Dissolved general partnership lacks authority to file: *In re C-TC 9th Avenue Partnership*, 113 F.3d 1304 (2d Cir. 1997)
  - Assignee for the benefit of creditors lacks authority to file petition on behalf of assignor company, unless specifically granted that power: *In re Nica Holdings, Inc.*, 810 F.3d 781 (11th Cir. 2015)
- Other corporate-law concepts have been applied:
  - Express ratification of unauthorized filing:
    - *Boyce v. Chemical Plastics, Inc.*, 175 F.2d 839 (8th Cir. 1949)
  - Implied ratification or acquiescence in unauthorized filing:
    - *In re Martin-Trigona*, 760 F.2d 1334 (2d Cir. 1985)
    - *In re Atlas Supply Co.*, 857 F.2d 1061 (5th Cir. 1988)
    - *Hager v. Gibson*, 108 F.3d 35 (4th Cir. 1997)

Developments Since *Price*

- Pre-bankruptcy litigation may be dispositive:
  - State court's ruling as to who may vote shares controls: *Keenihan v. Heritage Press, Inc.*, 19 F.3d 1255 (8th Cir. 1994)
  - Directors removed by receiver can't authorize filing: *In re Sino Clean Energy, Inc.*, 901 F.3d 1138 (9th Cir. 2018)
- Separately, the courts established the principle that a debtor can't waive the right to file a bankruptcy petition:
  - *Fallick v. Kehr*, 369 F.2d 899 (2d Cir. 1966)
  - *Klingman v. Levinson*, 831 F.2d 1292 (7th Cir. 1987)
  - *In re Huang*, 275 F.3d 1173 (9th Cir. 2002)

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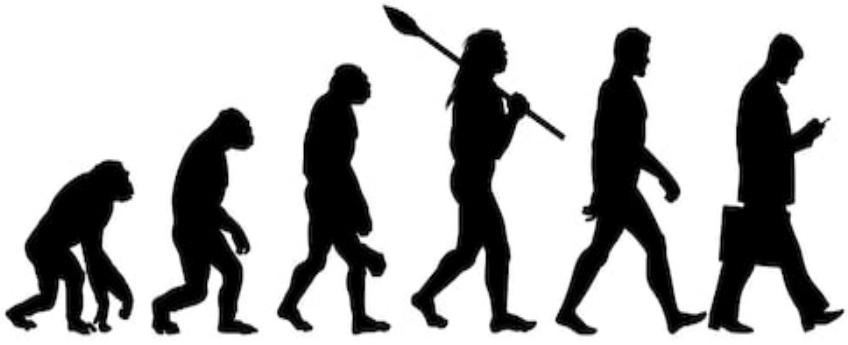
The Evolution: Blocking Provisions, SPEs, Golden Shares, and Bankruptcy Remote Structures



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Definition of Blocking Provisions

- "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." *Franchise Servs. of N. Am., Inc. v. U.S. Trustee (In re Franchise Servs. of N. Am., Inc.)*, 891 F.3d 198, 205 (5th Cir. 2018)
- Blocking provisions generally are inserted into governance documents by (1) requiring unanimous consent to file for bankruptcy, and (2) granting a party who may wish to block bankruptcy an equity unit or directorship entitled to vote on a bankruptcy filing.

Relevant Recent Cases

- *In re Global Ship Sys., LLC*, 391 B.R. 193 (2007)
- *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009)
- *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 463 B.R. 142 (B.A.P. 10th Cir. 2010)
- *In re Bay Club Partners-472, LLC*, No. 14-30394-rld11, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014)
- *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)
- *In re Tara Retail Grp., LLC*, No. 17-bk-57, 2017 WL 1788428 (Bankr. N.D.W.V. May 4, 2017)
- *In re Lexington Hospitality Grp., LLC*, 577 B.R. 676 (Bankr. E.D. Ky. 2017)
- *Squire Court Partners Ltd. P'ship v. Centerline Credit Enhanced Partners LP (In re Squire Court Partners Ltd. P'ship)*, 574 B.R. 701 (E.D. Ark. 2017)
- *Franchise Servs. of N. Am., Inc. v. U.S. Trustee (In re Franchise Servs. of N. Am., Inc.)*, 891 F.3d 198 (5th Cir. 2018)
- *In re Insight Terminal Solutions, LLC*, No. 32231-jal, D.E. 98 (Bankr. W.D. Ky. Sep. 23, 2019)

The "Primary Relationship" Test

- "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." *Intervention Energy*, 553 B.R. at 265 (emphasis added).

The "Primary Relationship" Test

	Primarily Creditor	Primarily Equity
Blocking Provision Enforced	General Growth Tara Retail	Squire Court DB Capital Global Ship Franchise Services
Blocking Provision Not Enforced	Bay Club Insight Terminal Lake Michigan Intervention Energy Lexington Hospitality	

Practice Pointers & Observations

- If the primary relationship of the party insisting on the blocking provision is truly equity, it is likely to be enforced. *See Squire Court*; *Franchise Servs.*

Practice Pointers & Observations

- Cases enforcing blocking provisions focus primarily on **state law**; cases refusing to enforce such provisions focus primarily on **federal law**.
- The best state law arguments focus on the freedom to contract under applicable LLC or corporation law **and** the adequate state law remedy if the blocking provision is utilized (breach of fiduciary duty claims).

Practice Pointers & Observations

- To maximize enforcement of blocking provisions, the structure should include:
  (1) the creditor should own more than a token amount of equity; *compare Intervention Energy* (1 unit out of 22,000,001 not enforced) to *Global Ship* (20% equity stake enforced); *but see Lexington Hospitality* (50% but not enforced)
  (2) the director or unit holder must be truly independent (e.g., Wilmington Trust, not someone picked by the creditor); *see Gen. Growth*
  (3) the director or unit holder must be subject to all applicable state law fiduciary duties; *see Lake Michigan*
  (4) blocking provisions should not cease when debt repaid; *compare Bay Club* (provisions ceased when debt repaid not enforced) to *Global Ship* (provisions continued after debt repaid enforced)

Practice Pointers & Observations

- Alternatives to Blocking Provisions
  - Plain old equity pledge
  - Consent to stay relief

Independent Director Issues – *General Growth*

- "[I]f 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. As the Delaware cases stress, directors and managers owe their duties to the corporation and, ordinarily, to shareholders." *Gen. Growth*, 409 B.R. 64-65.

Independent Director Issues – *Tara Retail*

- Court "rejected the Debtor's arguments that its corporate documents violated public policy and created a legal impossibility." *Tara Retail*, 2017 WL 1788428, at *3.
- However, independent director's "silence, particularly in light of a court order providing him with an opportunity to be heard, supports the inference that he too supports ratification" and "[t]hus, it is now undisputed that the Debtor obtained authorization from all its members to file." *Tara Retail*, 2017 WL 1788428, at *5.

Questions?

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