American Bankruptcy Institute

VALCON 2025

Hot Topics

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Hot Topics Panel

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Hot Topics Panel

1. DIPs In Focus

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Private Credit Restructuring: DIPs in Focus

In most chapter 11 cases, existing first lien lenders provide post-petition financing to preserve collateral value and maximize recovery. In some situations, a stressed borrower may threaten to pursue a hostile chapter 11 path seeking to implement a restructuring without the existing lenders' consent. In that scenario, we hear threats of a "priming DIP loan." In response, our clients often ask us if the threat is credible. While facts matter, in most cases, even when threatened, a priming DIP never materializes due to its many legal and structural challenges. This is particularly so where the existing lenders have validly perfected liens on substantially all assets and value indicators—usually in the form of early indications from a sale process—suggest the value of the collateral is unlikely to clear the existing lenders' secured claim. We explain our view below, and the significant hurdles that a debtor must clear to thread this needle.

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Priming DIPs Generally

Post-petition debtor-in-possession (DIP) financing is the lifeblood of a chapter 11 case, allowing the debtor to fund its operating expenses, professional fees, and other administrative expenses incurred during the course of the case. DIP financing is necessary because, upon filing for bankruptcy, a debtor can no longer access any availability under its existing credit facilities.[1] Moreover, most debtors lack sufficient cash on hand or cash receipts from operations to fund the expense of a chapter 11 case. The Bankruptcy Code sets forth the legal standards for approving DIP financing and those standards differ depending on whether the DIP financing is secured or unsecured, and the priority of the DIP financing lien relative to existing prepetition liens. A priming DIP loan refers to financing secured by a lien that ranks senior to (or pari with) prepetition liens on the same collateral. To grant a priming DIP lien, the debtor must demonstrate that (1) it is unable to obtain financing without providing the pari or senior lien and (2) existing lienholders' interests in the collateral will be "adequately protected." 11 U.S.C. § 364(d)(1).

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Unpacking "Adequate Protection"

"Adequate protection" is intended to protect a pre-petition secured lender from any erosion of its interest in collateral. As Congress explained, the purpose of adequate protection is to ensure that secured creditors are not "deprived of the benefit of their bargain." *See* H.R. Rep. No. 95-595 (1977). Adequate protection is rooted in the Fifth Amendment of the United States Constitution, which protects property owners from a taking without just consideration. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 339 (1977) ("The concept is derived from the fifth amendment protection of property interests."). Adequate protection is intended to protect and compensate a secured party's constitutional right to have the value of its interest in its collateral, as it existed on the date of the bankruptcy filing, preserved. *See United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 370 (1988).

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Unpacking "Adequate Protection" (Cont.)

As a result, adequate protection "should as nearly as possible under the circumstances of the case provide the creditor with the value of his bargained for rights." *In re Swedeland Dev. Grp., Inc.*, 16 F.3d 552, 564 (3d Cir. 1994) (en banc). "Whether protection is adequate depends directly on how effectively it compensates the secured creditor for loss of value" caused by the debtor's use, sale, or lease of the property in which the creditor has an interest. *Id.* (citation and quotation omitted). This is not an easy burden to satisfy. The standard is exacting and demanding – evidence of the adequate protection must be concrete. "Congress did not contemplate that a creditor could find its priority position eroded and, as compensation for the erosion, be offered an opportunity to recoup dependent upon the success of a business with inherently risky prospects." *Id.* at 567; *see also In re Mosello*, 195 B.R. 277, 292 (Bankr. S.D.N.Y. 1996) ("A finding of adequate protection should be premised on facts, or on projections grounded on a firm evidentiary basis.").

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Unpacking "Adequate Protection" (Cont.)

The Bankruptcy Code does not define adequate protection, but Section 361 of the Bankruptcy Code provides three non-exclusive means of providing adequate protection: (1) periodic cash payments to the extent of any decrease in collateral value; (2) an additional or replacement lien to the extent of any decrease in collateral value; or (3) any other relief that provides the secured lender with the "indubitable equivalent" of its interest in the collateral. Adequate protection in the form of periodic cash payments is typically unavailable due to liquidity constraints. Similarly, additional or replacement liens are typically not an option when, as is common, the existing lender already has liens on substantially all assets. *See, e.g.*, *Swedeland.,* 16 F.3d at 564-65 ("We are at a total loss to understand how a court can suggest that a pre-petition creditor with a lien being subordinated to a super priority lien can be thought to have adequate protection because an asset encumbered by its lien will remain so encumbered."); 3 Collier on Bankruptcy ¶ 364.05 (16th ed., 2022) ("Providing a lender with a replacement lien on assets on which it already has a lien is illusory and will not support an adequate protection finding.").

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Unpacking "Adequate Protection" (Cont.)

Consequently, debtors try to show adequate protection by arguing that erosion of collateral value caused by priming is protected by an "equity cushion" – the amount by which the collateral value exceeds the amount of the primed secured claim. *See In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010) ("The exist[ence] of an equity cushion seems to be the preferred test in determining whether priming of a senior lien is appropriate under section 364.") (internal quotations omitted); *Wilmington Trust Co. v. AMR Corp.* (*In re AMR Corp.*), 490 B.R. 470, 478 (S.D.N.Y. 2013) ("[T]he existence of an equity cushion can be sufficient, in and of itself, to constitute adequate protection."). The equity cushion is generally expressed as a percentage of the secured debt to be primed. For example, if the secured claim is $100 million and the collateral is worth $150 million, the equity cushion is $50 million or 50%. Collateral valuation is at the heart of the bankruptcy court's determination of whether there is a sufficient equity cushion.

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Unpacking “Adequate Protection” (Cont.)

There is no bright-line test for the size of the equity cushion, but courts have generally held a roughly 20% cushion (after giving effect to the incurrence of the DIP Loan) to be sufficient, and anything below 10 percent to be insufficient. *See, e.g.*, *SunTrust Bank v. Den-Mark Const. Inc.*, 406 B.R. 683, 700 (E.D.N.C. 2009) (finding insufficient as adequate protection an equity cushion of approximately 11% and proposed improvements to the collateral); *see also R&J Contractor Servs., LLC v. Vancamp*, 652 B.R. 237, 244 (D. Md. 2023) (“Case law has almost uniformly held that an equity cushion of 20% or more constitutes adequate protection … [and] has almost as uniformly held that an equity cushion under 11% is insufficient to constitute adequate protection.”) (quotations omitted).

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Unpacking “Adequate Protection” (Cont.)

There is another adequate protection theory that is rarely made and usually unsuccessful. Under this theory, debtors argue that existing secured lenders are adequately protected when a non-consensual priming DIP loan is the only path to preserve the debtor’s going concern value. The thrust of this argument is that the existing lenders will not suffer diminution in the value of their interest in collateral because the third-party priming facility actually *preserves or enhances* collateral value which would otherwise be lost if the debtor were forced to liquidate. Most lenders argue that this “adequate protection” theory is highly suspect and often built on a speculative foundation devoid of sufficient evidence to meet the debtor’s heavy burden. *See, e.g.*, *SunTrust Bank*,406 B.R. 683 (E.D.N.C. 2009).

This argument was recently raised in Prospect Medical Holdings’ chapter 11 case in Dallas, Texas. There, the debtor sought approval of a $100 million third-party priming DIP loan.

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Unpacking "Adequate Protection" (Cont.)

The debtor argued that the existing lender's alternative self-priming DIP proposal was insufficiently sized to conduct its intended sale process, and the lender was adequately protected because the debtor "expected to have significantly higher recoveries if [Prospect] gains access to the DIP financing [which] provides [Prospect] the funding necessary to pay employees and vendors and continue their hospital operations while they pursue value-maximizing sale transactions." The existing secured lender forcefully and credibly objected to being primed, arguing that "the Bankruptcy Code does not allow debtors to prime their secured lenders any time they believe that recoveries will improve if only they can use a creditor's collateral to avoid a liquidity crisis." The bankruptcy court nonetheless held, at the interim DIP financing hearing, that the proposed adequate protection was temporarily sufficient "for purposes of today." We do not know if the interim ruling would have withstood further scrutiny on a final basis because the parties settled their dispute before the final hearing.

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Unpacking "Adequate Protection" (Cont.)

Conclusion

Incumbent lenders are incentivized and have significant structural advantages to provide DIP financing in a chapter 11 case. While facts matter and not every case is the same, we believe the risk of non-consensual priming is extraordinarily rare, particularly for a secured lender with a valid lien on substantially all assets and no credible evidence of a sizable equity cushion. That said, private credit lenders need to be knowledgeable about these risks because negotiating leverage in an out of court restructuring or in the lead-up to a chapter 11 filing is based upon what each party could realistically expect to win in a chapter 11 case.

[1] Bankruptcy Code § 365(e)(2)(B) provides an executory contract "to make a loan, or extend other debt financing or financial accommodation" can be terminated based on filing of the case. Bankruptcy Code § 365(c)(2) further provides the debtor cannot assume or assign an executory contract "to make a loan, or extend other debt financing or financial accommodation."

Hot Topics Panel

2. The Long Reach of U.S. Jurisdiction

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- Courts have increasingly opened the flood gates to support litigation in the U.S. with minimal connections.
- **General standard for jurisdiction:**
  - Specific Jurisdiction
    - Defendant purposefully directs certain activities at the residents of the forum; and
    - The underlying cause of action also arises out of such activities. Note, the latter requirement is not required in certain jurisdictions.
  - General Jurisdiction
    - Defendant conducts business in the forum.
  - Due Process
    - Jurisdiction would not offend traditional notions of fair play and substantial justice.

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- **Overarching policy goals:**
  - Allow U.S. courts to adjudicate claims that arise under the Bankruptcy Code so that creditors and debtors can obtain remedies and relief that Congress intended.
  - Courts may take jurisdiction over claims where creditor lends money to foreign entity with few U.S. contacts or where a transaction is effectuated in U.S. denominated currency.
  - Courts may find eligibility requirement established for filing a Chapter 15 foreign proceeding where attorney retainers are deposited by foreign debtors in the U.S.

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- **Significant examples:**
  - *Picard v. Chais* (*In re Bernard L. Madoff Investment Secs. LLC*), 440 B.R. 274 (Bankr. S.D.N.Y. 2010)
    - Finding jurisdiction because defendant maintained at least three U.S. correspondent accounts, transferred money through them, and appointed a New York-based financial agent.
  - *Off. Comm. of Unsecured Creditors of Arcapita v. Bahrain Islamic Bank*, 549 B.R. 56 (S.D.N.Y. 2016)
    - Finding jurisdiction because defendant funneled U.S. denominated dollars through a U.S. correspondent account.
  - *In re Zetta Jet USA, Inc.*, No. 2:17-BK-21386-SK, 2020 WL 7682136 (Bankr. C.D. Cal. July 29, 2020).
    - Distinguishing *Arcapita*, the court determined that the question of whether a transfer is extraterritorial is fact dependent, including consideration of the parties, transactions, choice of law provisions, and denomination of the payments, reaching the opposition conclusion from the *Arcapita* court.

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- *Spetner v. Palestine Inv. Bank,* 70 F. 4th 632 (2nd Cir. 2023).
  - Finding that although defendant had no offices, branches, or employees in New York, use of correspondent bank accounts in New York to electronically transfer dollar-denominated funds constituted the requisite benefit, knowledge and consent, and control to support U.S. jurisdiction.
- *In re Fairfield Sentry Ltd.*, 657 B.R. 362 (Bankr. S.D.N.Y. 2024).
  - Finding jurisdiction based on U.S. dollar investments and use of U.S. correspondent accounts.
- Chapter 15 Cases:
- *In re B.C.I. Fins Pty Ltd.*, 583 B.R. 288 (Bankr. S.D.N.Y. 2018).
  - Finding eligibility requirement established for filing Chapter 15 foreign proceeding where attorney retainers deposited by foreign debtors in U.S.
- *But see In re Al Zawawi*, 637 B.R. 663 (M.D. Fla. 2022).
  - Holding that Section 109(a) requirements for eligibility to file Chapter 15 does not apply in considering recognition of a foreign debtor.

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- **Strategic use of foreign proceedings:**
- There has been an increase in use of foreign proceedings followed by a Chapter 15 recognition proceeding to avoid US absolute priority rule and/or third-party release issues. Such may include a debtor reincorporating in a friendly foreign jurisdiction for purposes of "quick" bankruptcy filing, followed by Chapter 15.
- **Chapter 15 proceedings:**
  - Standard for recognizing foreign proceedings
  - In practice, courts recognize foreign proceedings 99% of the time.
- **Significant examples of use of foreign proceedings to avoid U.S. bankruptcy issues:**
  - Absolute priority rule
    - *In re Rede Energia S.A.*, 515 B.R. 69, 77 (Bankr. S.D.N.Y. 2014)
      - Court recognized a foreign-approved plan that contravened the absolute priority rule.

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- **Third-party releases pursuant to Chapter 15 recognition order:**
  - *In re Real*, No. 25-10208 (TMH), 2025 WL 977967 (Bankr. D. Del. Apr. 1, 2025)
    - Court recognized a foreign-approved plan that contained nonconsensual third-party releases, even though these releases would have been rejected under *Purdue Pharma as a matter of comity*.
  - *In re Avanti Commc'ns Grp. PLC*, 582 B.R. 603 (Bankr. S.D.N.Y. 2018).
    - Court enforced scheme of arrangement sanctioned by a court in England that included nonconsensual third-party releases.
  - *In re. Odebrecht Engenharia e Construcao S.A.* No. 25-10482 (MG), 2025 WL 1156607 (Bankr. S.D.N.Y. Apr. 21, 2025).
    - Court held bankruptcy courts have power to issue orders including non-consensual third-party releases even if such is not contained in foreign debtor's plan.
  - *In re Mega NewCo Limited* , No. 24-12031 (MEW), 2025 WL 601463 (Bankr. S.D.N.Y. 2025 Feb. 24, 2025)
    - Newly formed debtor which received approval of scheme of arrangement in the U.K., including releases to non-debtor parent from liability to creditors recognized under Chapter 15.

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- **Takeaways**
  - Be careful who you do business with as courts are increasingly willing to find jurisdiction over foreign defendants based on attenuated connections.
  - While the verdict remains outstanding on whether such is creative tool or goes too far, courts in recent decisions out of SDNY and Delaware continue to recognize foreign proceedings on grounds of comity even if doing so contravenes traditional U.S. bankruptcy principles.

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Hot Topics Panel

3. Valuation Angles On Third-Party Releases

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Is There Any Value to Valuation in the Post-Purdue Third-Party-Release World?

- Prior to *Harrington v. Purdue Pharma L.P.*, 603 U.S. 204 (2024) *(“Purdue*”), non-consensual third-party releases were permitted in specific, limited circumstances. One court summarized these circumstances as requiring:
  - An identity of interests exists between the debtor and the Third-Party, usually an indemnity relationship, where a suit against the Third-Party is in essence a suit against the debtor or will deplete assets of the estate.
  - The Third-Party has contributed **substantial assets** to the reorganization.
  - The release is essential to the reorganization, and without it there is little likelihood of success.
  - A substantial majority of the creditors agree to the release, specifically, the impacted class or classes, which have "overwhelmingly" voted to accept the proposed plan treatment.
  - The plan provides a mechanism to pay for all, or substantially all, of the claims of the class or classes affected by the release.

See In re Master Mortgage Investment Fund, Inc.,168 B.R. 930, 935 (Bankr. W.D. Mo. 1994).

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Is There Any Value to Valuation in the Post-Purdue Third-Party-Release World? (Cont.)

- A key consideration in this analysis was whether the nondebtor-party to be released has contributed "substantial value," necessitating a valuation-heavy inquiry.
- This was substantially the analysis used by the Second Circuit Court of Appeals in upholding nonconsensual third-party releases in *Purdue*.
- On further appeal, however, the Supreme Court sweepingly invalidated non-consensual releases. Does that mean that valuation issues are no longer relevant to third-party releases? One might think so. But recent cases are a mixed bag.
  - Post-*Purdue*, one approach to considering the permissibility of third-party releases involves consideration of the value allocated to a particular class.
  - A more nuanced approach involves consideration of the contribution to the Plan proposed to be made *by each potential Releasee*.

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Is There Any Value to Valuation in the Post-Purdue Third-Party-Release World? (Cont.)

- The recent ruling in *Spirit Airlines, Inc., et al.*. Case No. 24-11988 (SHL) (Bankr. S.D.N.Y) (March 7, 2025) identified the contribution of value as an important factor in assessing third-party releases and provides a template for how other courts may approach these issues.
  - In *Spirit Airlines*, the debtors were party to a restructuring support agreement ("RSA") with a sizable majority of their secured lenders.
  - A key term of the RSA was the inclusion in the chapter 11 plan of consensual third-party releases subject to an Opt-Out mechanism.
  - The US Trustee and the SEC objected to the characterization of the releases as "consensual" arguing that consent cannot be expressed by inaction.
  - The *Spirit Airlines* court disagreed and overruled the objection.
    - The court held that the plan solicitation documents provided a "a clear and prominent vehicle for opting out" and noted that the proposed releasees were contributing hundreds of millions of dollars to the reorganization (by equitizing a large amount of secured debt).

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Is There Any Value to Valuation in the Post-Purdue Third-Party-Release World? (Cont.)

- Following the *Spirit Airlines* approach, a determination of the propriety of a proposed third-party release should involve consideration of the value of the contribution by a proposed Releasee and the potential liability the Releasee may face.
  - If the value of the contribution is "substantial", the court, utilizing its equitable power, can make the release of the potential Releasee subject to an Opt-Out provision.
  - In contrast, if a potential Releasee fails to contribute sufficient value, the court can make the release of such potential Releasee subject to an opt-in provision.
- In addition, a potential Releasee can offer to make a contribution to a chapter 11 plan contingent on a sufficient number (or percentage) of voting creditors agreeing to grant a release to the potential Releasee.
  - The participation threshold would ensure that in exchange for a substantial contribution of value, the proposed Releasees could limit their potential future liability.
  - The participation threshold would also ensure that the proposed Plan enjoyed significant support from voting creditors.

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Purdue Update

- In the ongoing *Purdue* saga, following an extended mediation process, the parties have elected to sidestep further litigation over whether an Opt-Out third-party release is consensual (and supported by sufficient value) by utilizing an opt-in mechanism.
- As set forth in the *Disclosure Statement for the Thirteenth Amended Joint Chapter 11 Plan of Reorganization of Purdue Pharma L.P and Its Affiliated Debtors*:
  - the Plan will not contain non-consensual Third-Party Releases; and
  - the Plan will utilize opt-in releases giving public and private claimants the choice of whether to provide Third-Party Releases.
  - A claimant that Opts In will receive its pro rata share of both (a) the Estate Distributions and other estate cash allocated to its class and (b) the Shareholder Direct Settlement Portion for its class.

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Purdue Update (Cont.)

- A claimant that does not grant the Third-Party Releases will not receive a payment from the Shareholder Direct Settlement Portion allocable to its class.
- A claimant that does not grant the Third-Party Releases may bring litigation against any of the Sackler Covered Parties on account of its direct claims, if any, subject to certain terms and conditions described more fully in the Shareholder Settlement Term Sheet.
- By structuring the chapter 11 plan to make distributions of funds provided by the "Sackler Covered Parties" available only to creditors that opt-in to third-party releases, the plan requires claimants to choose between receiving a current distribution from the Sackler contribution or pursuing their claims separately.
- As noted, this approach eliminates litigation over whether an Opt-Out release is actually consensual, and leaves to each claimant the determination of whether the value of the proposed Releasees' contributions to the plan are sufficient.

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Other Post-*Purdue* Developments

- While *Purdue Pharma* prohibits the use of nonconsensual third-party releases in Chapter 11 cases, two recent rulings held that this proscription does not necessarily apply to an ancillary proceeding under Chapter 15 of the Bankruptcy Code.
  - In *In re Credito Real, S.A.B. de C.V., SOFOM, E.N.R.*, Case No. 25-10208 (TMH), 2025 WL 977967 (Bankr. D. Del. Apr. 1, 2025), the bankruptcy court held that an order granting recognition to a Mexican restructuring plan could contain nonconsensual third-party releases to the extent such releases were granted in support of enforcing the plan.
  - Similarly, in *Odebrecht Engenharia e Construção S.Em Recuperação Judicial, et al*., Case No. 25-10482 (MG) (Bankr. S.D.N.Y Apr. 21, 2025), adopting the reasoning of *Credito Real*, the bankruptcy court similarly held that nonconsensual third-party releases could be included in the order granting recognition to a Brazilian restructuring plan, even though neither the plan nor the Brazilian order approving the plan contained such releases.
- Both courts noted that *Purdue Parma* did not find that such releases were "manifestly contrary" to US public policy – and that Chapter 15 permits relief that may not be available in Chapter 11.
  - It is unclear whether courts will consider the value provided by the proposed releasees in analyzing the propriety of such releases under Chapter 15, as they often do in Chapter 11 cases.

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Post-Purdue Take Aways

- Opt-Out Releases generally should be permitted as consensual releases if:
  - The chapter 11 solicitation documents contain clear and prominent instructions for exercising an Opt-Out right;
  - The Opt-Out mechanism is easy to exercise; and
  - The plan allocates sufficient value to the class(es) of claims subject to the Opt-Out mechanism.
- If the value allocated to a class of claims is not substantial, third-party releases could be conditioned on creditors Opting In.
  - It is unclear whether unimpairment should be the benchmark of whether a contribution is "substantial."
  - However, when a class of claims is rendered unimpaired, there are sound arguments that the contribution easily meets the "substantial" threshold and third-party releases with an Opt-Out mechanism should be approved.

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Hot Topics Panel

4. Golden Shares, Golden Directors, and Board Flips: Value Destructive or Value Enhancing?

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Golden Shares, Golden Directors, and Board Flips: Value Destructive or Value Enhancing?

The **Golden Share** – An equity interest in the company that provides a lender or preferred shareholder a number of consent rights, most notably the ability to block a company from filing bankruptcy

Golden Director – An independent (often appointed as part of an amendment and/or forbearance) that has exclusive authority over major corporate actions such as sale processes, restructuring decisions, or the decision to file bankruptcy

Board Flip – The exercising of rights under a voting proxy (including in a pledge agreement) by a lender to replace a company's board of directors with a new independent board. This separates the economic interests of equity ownership from voting rights

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The Golden Share

Intervention Energy Holdings (2016)

+ Secured creditor received a "Golden Share" as part of a waiver of defaults. The company ultimately filed bankruptcy, and the creditor moved to dismiss the case, however, the **judge found that the secured creditor was only a nominal equityholder, had no fiduciary duties to the company, and a dismissal could infringe on the constitutional right to file bankruptcy and ruled the "Golden Share" unenforceable**

Franchise Services of North America (2018)

+ Preferred shareholder made a $15m investment which included an amendment to the corporate charter creating a "Golden Share" provision. **After the company filed bankruptcy and the shareholder moved to dismiss, the appeals court sided with the shareholder and upheld the right to exercise a Golden Share**

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The Golden Share (Cont.)

Pace Industries (2020)

+ Preferred shareholder made a $37m investment which resulted in a restatement of the corporate charter to include a "Golden Share". Following the COVID-19 pandemic, Pace filed for bankruptcy protection and proposed a plan of reorganization that was supported by the secured creditors and would pay unsecured creditors in full. **The preferred shareholder moved to enforce its Golden Share right and have the case dismissed but was ultimately denied by Judge Walrath.** The ruling centered around that fact that the preferred shareholder had not proposed any viable alternatives (and the current proposed plan would benefit the greatest number of stakeholders) and the dismissal would likely violate federal public policy by taking away a company's right to file bankruptcy.

3P Hightstown (2021)

+ Following the bankruptcy filing of Hightstown, LLC, the preferred shareholders sought to dismiss the case on the grounds that the operating agreement contained a provision requiring consent of the preferred shareholders prior to filing bankruptcy. The court ruled in favor of the preferred shareholders and dismissed the bankruptcy case. The court considered the rulings in Intervention Energy, Franchise Services, and Pace Industries and weighed the constitutional right to file bankruptcy against the right to freely negotiate and contract. The judge treated this case differently than those involving "Golden Shares" as the preferred shareholders received the rights included in the operating agreement at the time of investment and not as a result of a default

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Golden Director

In re 301 W North Avenue, LLC (Bankr. N.D. Ill. Jan. 6, 2025) – Lender loaned $26m and loan provided for one independent director whose consent was required for bankruptcy filings. The amendment to the LLC agreement imposed fiduciary duties on the director and required the independent director to only consider the interests of the borrower and its creditors. Facing financial difficulties, the company filed bankruptcy without obtaining the consent of the independent director and the ID moved to dismiss the case. The ruling found:

1. The bankruptcy filing was unauthorized given the independent director did not consent;
2. The court noted that while provisions that nullify a company's ability to file bankruptcy could violate public policy and be unenforceable, if the operating agreement creates a structure where the independent director's fiduciary duties are respected, it is enforceable;
3. While the borrower argued that the provisions that the independent director be acceptable to the lender and remain in place while the debt was outstanding meant that the director was not independent, the court found that these conditions did not undermine the independence of the director; and
4. **The judge dismissed the case and without the automatic stay in place, the lender was free to pursue foreclosure.**

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Board Flips

In re CII Parent, Inc. (Bankr. D. Del. April 12, 2023) – After the lender exercised its voting rights proxy against CII in December 2022 to replace the board, the company filed for Chapter 11 relief and made a written demand that the lender reverse its actions so that the company could reorganize in bankruptcy court. The borrower's argument argued that the lender's actions violated the automatic stay and by refusing to return control to the parent company, the lender was exercising control over property belonging to the bankruptcy estate. Judge Silverstein was tasked with determining whether the lender violated the automatic stay and the review concluded:

1. While the fact that the stock in the portfolio company was property of the estate was not disputed, the question was whether the voting rights associate with the stock were property of the estate;
2. The loan and security documents contained broad power of attorney provisions and authorized the lender to act in the parent company's "place and stead". The documents also included a proxy document that included a broad appointment provision;
3. Judge Silverstein noted that while Delaware courts have historically expressed concern over proxies that separate voting rights from economic interests, courts have recently broadened the rights of proxies in voting trusts and vote-buying arrangements;

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Board Flips (Cont.)

4. The loan and security documents only required the lender to provide notice substantially concurrently with the exercise of its proxy rights;
5. While Delaware law includes a three-year limit on voting proxies, it allows for longer duration if it is explicitly stated. The loan and security documents provided that the proxy rights would remain in place until the loan was paid in full;
6. While there were certain ambiguities in the loan documents around the use of written consent, there was enough for the court to rule that the lender acted properly; and
7. <u>Judge Silverstein ultimately ruled against the company and found that the lender did not commit a stay violation.</u>

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Exercise of Voting Rights Under Pledge Agreements

Given that usual UCC foreclosure process can be cumbersome and time consuming, giving debtors time to respond (e.g. bankruptcy filing), secured lenders.

Have added to their remedy tool box the exercise of pledge agreements provisions that allow lender to exercise of voting rights immediately upon Event of Default.

- Since not a formal UCC "disposition", pledgor is still owner of shares but lender can vote shares to (i) amend organic documents and (ii) put in place selected directors at level of pledged entity.
  - Stockholder consent may still be required to effect a sale of collateral pursuant to state law.
    - Note recently enacted (2023) Delaware GCL § 272 allowing lenders to override corporate restrictions in certain circumstances.
  - Increasingly common practice is to select an independent director and to simultaneously amend and restate charter to bolster power of independent director, including exclusive right to file for bankruptcy.

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Exercise of Voting Rights Under Pledge Agreements (Cont.)

- Experience of panel members is that many standard form pledge agreements are barely negotiated at outset of financing and "boiler plate" security documents often allow exercise of this remedy without meaningful advance notice to borrower.
  - Increasingly, sophisticated borrowers are directing attention to these documents.

- Propriety of remedy has been litigated with mixed results, with some Judges requiring strict adherence to provisions of pledge agreement and interpreting ambiguities against immediate notice board flips.
  - *In re MTE Holdings* (Bankr. D. Del. 2019) (invalidating flip due to requirement of additional debtor action prior to exercising voting proxy).
  - *Meidu Energy Corporation* (NY Supreme Court Index No. 652519/2020) (upholding validity of exercise of flip at level of pledged subsidiary).

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Exercise of Voting Rights Under Pledge Agreements (Cont.)

- Debtors may respond to this tool by being reluctant to delay bankruptcy absent forbearance in place.
- Debtors may also respond by filing after the board flip so as to put the issue before a bankruptcy court and "freeze" the new director while court decides the dueling board issue.

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Key Takeaways

While bankruptcy courts appear mixed on allowing creditors to impact the decision to file bankruptcy directly (Golden Shares), the use of independent directors with fiduciary duties (Golden Directors, Board Flips) has been more permissible.

Lenders always face some inherent risk when exercising remedies and asserting control over a distressed situation, however, well formulated legal documents can provide the tools a lender needs to protect its interests. On the other hand, nervous borrowers may commence proceedings prematurely to avoid losing control to an overnight board flip.

Golden Directors and Board Flips can also have a major impact on hirings and firings of professional advisors as seen recently in Red Lobster when the replacement of the board with a single director resulted in a full-scale swap of legal and financial advisors.

So, Value Destructive or Value Enhancing?

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Further Reading

https://www.proskauer.com/alert/enforceability-of-golden-directors-with-bankruptcy-consent-right

The "Board Flip": How Effective is the Pre-Petition Exercise of Proxy Rights in the Face of Bankruptcy? - Insights - Proskauer Rose LLP;

Pledged Equity Proxy Rights and the Rise of the Board Flip - Weil Restructuring

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