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# A Golden Share and the Conflict Between Freedom of Contract and Federal Policy

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The use of special purpose entities in structured finance transactions has become increasingly common. Special purpose entities, which are designed to protect assets from becoming part of a bankruptcy estate, are sometimes structured so that a lender (or other party in interest) is given a “golden share” in a limited liability company (LLC). A “golden share” refers to a noneconomic membership interest which is issued to the lender for the sole purpose of allowing it to vote on a voluntary bankruptcy filing by the borrower. The “golden share” is accompanied by a provision in the borrower’s operating agreement which requires the unanimous consent of all members of the LLC to commence a voluntary bankruptcy filing. In essence, the “golden share”



gives the lender a say in any subsequent decision by the borrower to seek bankruptcy protection. Lenders have long considered the “golden share” to be an effective mechanism for safeguarding their investments.

Recent rulings, however, have cast doubt on the effectiveness of the “golden share” structure. See *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016); *In re Lake Michigan Beach*

*Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016). At their core, these cases suggest that a “golden share” is only enforceable if the holder thereof has a fiduciary duty to consider the entity’s best interests. The fiduciary duty requirement is particularly noteworthy in Delaware, where state law explicitly allows for the elimination of the fiduciary duties of the members of a LLC. This is in stark contrast

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to Delaware law on traditional corporations, which prohibits waiver of the duty of loyalty. The case of *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), is instructive of the tension that the fiduciary duty requirement has created between two core legal principles: (1) the freedom of contract under state corporate law and (2) the fundamental constitutional right to seek bankruptcy protection.

The stated policy of the Delaware Limited Liability Company Act is to “give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” Del. Code Ann. tit. 6, §18-1101(b). In that vein, the Delaware Limited Liability Company Act explicitly permits the elimination of the fiduciary duties of the members of a Delaware LLC. Del. Code Ann. tit. 6, §18-1101(c). The only limitation on the parties’ freedom to abdicate their fiduciary duties is the implied contractual covenant of good faith and fair dealing. *Id.*

In *In re Intervention Energy Holdings, LLC*, Judge Kevin Carey of the Bankruptcy Court for the District of Delaware held that a provision in a Delaware LLC operating agreement, which gave a single member owing no fiduciary duties to the company, the power to determine the LLC’s right to file for bankruptcy, was void and unenforceable as a matter of public policy. By way of

background, prior to the petition date, Intervention Energy Holdings, LLC (Intervention) and Intervention Energy LLC (together, the debtors), oil and natural gas exploration and production companies, had entered into a note purchase agreement with institutional investor, EIG Energy Fund XV-A, L.P. (EIG). Pursuant to the note purchase agreement, EIG committed to provide the debtors with up to \$200 million in financing evidenced by senior secured notes. When the debtors defaulted under the notes, EIG entered into a forbearance agreement pursuant to which it agreed to waive all defaults if the debtors raised \$30 million of equity capital, the proceeds of which would be used to pay down a portion of its debt. As a condition to the effectiveness of the forbearance agreement, the parties agreed that the LLC operating agreement of Intervention would be amended (1) to admit EIG as a member of Intervention, (2) to issue to EIG one common unit of Intervention and (3) to require the approval of all holders of common units of Intervention to any voluntary bankruptcy filing. Just days before the expiration of the forbearance period, the debtors filed for bankruptcy protection. Intervention did not obtain EIG’s consent to the commencement of its Chapter 11 case.

In its motion to dismiss Intervention’s case, EIG argued that Intervention lacked the corporate authority

to seek federal bankruptcy protection without the unanimous consent of its members. EIG stressed that the determination of whether an entity has authority to commence a bankruptcy proceeding is a question of state law, and in the case of a limited liability company is governed by the operating agreement. EIG argued that Intervention did not, as was required under the LLC operating agreement, obtain the consent of all members to the bankruptcy filing, and therefore, its Chapter 11 petition was void. EIG stressed that Delaware courts seek to give maximum effect to the principle of freedom of contract including with respect to LLC members’ fiduciary duties. The parties to the Intervention operating agreement expressly eliminated fiduciary duties, and in such context EIG argued, its right to vote on a bankruptcy filing, even if exercised in its own best interest, could not conflict with any state law fiduciary duties.

The debtors, on the other hand, argued that contractual provisions that prevent a company from availing itself of rights under federal bankruptcy law are void as against public policy. The debtors relied on *In re Lake Michigan Beach Potawatamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016), in which the Bankruptcy Court for the Northern District of Illinois held a blocking member structure to be unenforceable, where the members of the LLC

were not subject to normal fiduciary duties and, therefore, did not have a duty to consider the interests of the entity. Importantly though, the members of the LLC in *Lake Michigan Beach* had an affirmative duty under applicable Michigan law to consider the interests of the entity. Accordingly, the *Lake Michigan Beach* court held the structure in that case to be unenforceable as a matter of Michigan corporate governance law. The debtors argued that similar to *Lake Michigan Beach*, here, too, the elimination of EIG's fiduciary duties was fatal to the enforcement of the "golden share" provision.

The Bankruptcy Court for the District of Delaware declined 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)," relying instead on federal public policy as an alternate basis for decision. *In re Intervention Energy Holdings, LLC*, 553 B.R. at 262. The Bankruptcy Court held:

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."

*Id.* at 265 (emphasis added). Other courts have explicitly rejected a public policy exception to the unanimous member consent requirement in a LLC operating agreement and dismissed the debtor's voluntary bankruptcy filing. See, e.g., *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, No. 10-046, 2010 WL 4925811, at \*3 (B.A.P. 10th Cir. Dec. 6, 2010).

The Bankruptcy Court's determination not to enforce EIG's consent right squarely conflicts with Delaware's well-settled policy in favor of enforcing bargained for rights among the members of a Delaware LLC. Under Delaware law, the members of a Delaware LLC can, by contract, determine (1) to require the unanimous consent of all members to commence a voluntary bankruptcy proceeding and (2) to eliminate the fiduciary duties of the members. The combination of these two factors can, in certain circumstances, result in the exercise by a member, which owes no fiduciary duties to

the LLC, of its contractual right to withhold consent to the LLC's bankruptcy filing. The Bankruptcy Court did not address the scope of the LLC members' freedom to contract under Delaware law. Significantly, though, the authority of an entity to commence a bankruptcy proceeding is determined by the state law governing such entity. The question then becomes whether Chapter 11's goal of facilitating reorganizations is a valid basis for disregarding applicable state law which governs the authority of a corporate entity to seek bankruptcy protection in the first place. And, moreover, whether there are circumstances in which the scale should tip in the other direction (e.g., where the holder of the golden share is the debtor's only creditor). The Bankruptcy Court has spoken. It remains to be seen whether the Delaware legislature will respond.