Serving Two Masters: When 'Bankruptcy-Remote' Meets Public Policy

Structured financing transactions make extensive use of entities formed for the specific purpose of reducing the likelihood that assets will be involved in a potential bankruptcy proceeding. Known as "bankruptcy-remote entities," or "BREs," these entities are subject to structures and covenants in financing documents and their own formation documents, which are designed to reduce the likelihood that the BRE will file for bankruptcy protection.

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One such common provision is a requirement that the BRE have an outside director or member whose vote is required for approval of any bankruptcy filing by the BRE. While a contractual provision prohibiting an entity from filing for bankruptcy protection has long been considered void as against public policy, recent cases evaluate situations where the debtor is not contractually prohibited from making a filing, but where a director or member of the debtor who is beholden to the creditor holds the ultimate power to veto a bankruptcy.

Courts are asked to consider these established financing structure variations in light of the public policy aspects of bankruptcy law and fiduciary duties imposed by corporate law. This article examines two recent cases, and suggests practices that lenders to BREs can use to reduce the risk of a debtor bankruptcy without compromising the policies underlying bankruptcy and corporate laws.

Securitization: Background

A typical transaction form that uses BREs involves the securitization of receivables. Here, an originator sells its receivables assets, such as equipment leases, to a special-purpose entity created solely to hold and manage the receivables assets. Additional restrictions are imposed on the special-purpose entity to isolate the cash flow from those assets, making it a BRE. In virtually all securitization transactions, the BRE acquires its assets from the originator in a transaction designed to be a “true sale” and the BRE’s organizational documents restrict its activities to minimize the risk of “substantive consolidation” in bankruptcy (*i.e.*, the risk that its assets will be used to meet the obligations of the originator’s creditors in the event of the originator’s bankruptcy).

To prevent this substantive consolidation, the BRE should be legally and functionally separate from the originator. The BRE must agree to operate separately from the originator and abide by “separateness covenants,” such as avoiding commingling assets, keeping separate corporate governance documents, maintaining separate financial statements, observing corporate formalities, and paying a fair value for the purchased assets. To further reduce bankruptcy risk, the BRE will be permitted neither to incur other indebtedness, nor to engage in any business other than buying, holding and selling the specific assets being financed. With no other operations or creditors, the risk of a BRE bankruptcy is reduced.

Modifying corporate governance documents creates an additional hurdle to a BRE’s filing for bankruptcy protection. When a debtor files a bankruptcy petition, its creditors are stayed from pursuing debts and claims that arose prior to the petition without authorization of the bankruptcy court. Accordingly, lenders may desire to amend a BRE’s organizational documents to establish a special or independent director or member whose consent is required for the BRE to seek bankruptcy protection. Two recent court decisions, however, have called into question the lender’s use of this sort of blocking director or member.

Recent Decisions

In *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899, 913 (Bankr. N.D. Ill. 2016), the court held that a bankruptcy petition filed by the debtor, a BRE, without its lender’s approval was nonetheless authorized because the lender failed to fulfill its fiduciary duties to the debtor. How the lender’s approval came to be required, and how its fiduciary duties arose, are at the heart of the decision.

The lender provided a loan to the debtor that was secured by a mortgage on the debtor’s vacation resort. When the debtor defaulted on its monetary obligations to the lender, the lender agreed not to pursue remedies for the default in exchange for the debtor’s execution of a forbearance agreement that, among other things, stipulated that the debtor, a Michigan limited liability company, amend its operating agreement to add the lender as a “Special Member.” The amendment expressly: 1) disclaimed the Special Member’s fiduciary duties, giving the lender, as Special Member, the right to veto any vote to file for bankruptcy relief; and 2) provided no duty or obligation for the Special Member to consider any interests other than its own.

The court expressly noted that the public policy against contracting away the right to file for bankruptcy "is not necessarily controlling when what defeats the rights in question is a corporate control document" such as a blocking director provision. The court went on to note, however, that the "saving grace" of a blocking director structure — and the very aspect that makes it successful — requires that a blocking director adhere to "normal director fiduciary duties," which are defined under Michigan law to mean acting in good faith with the care an ordinarily prudent person in a similar position would use, and in a manner the director reasonably believes to be in the best interest of the entity.

In other words, a successful blocking structure requires that a director may, in some circumstances, vote in favor of a bankruptcy filing even if it may not be in the best interests of the creditor appointing such director. The lender violated these precepts when it forced the appointment of itself as Special Member solely to represent its own interests and vote "no" to a bankruptcy filing. The court therefore found that the blocking member provision was unenforceable both as a matter of Michigan corporate governance and bankruptcy public policy.

The bankruptcy court in *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 265 (Bankr. D. Del. 2016), did not reach the fiduciary duty question but held that a provision inserted in a forbearance agreement by the debtor's lender was unenforceable on public policy grounds alone. The lender provided debt financing to the debtor, a BRE formed as a Delaware limited liability company, and in return, the debtor granted the lender liens in certain collateral of the debtor. When the debtor defaulted, it entered into a forbearance agreement with the lender.

Included as conditions of the lender's forbearance were requirements for the debtor to issue an equity interest to the lender, making it a member of the limited liability company, and to obtain the unanimous consent of all members of the debtor prior to any voluntary bankruptcy filing. The debtor issued the equity interest to the lender, but subsequently filed for bankruptcy without the lender member's consent despite the requirement of unanimous consent of the members. Unlike the agreement in *Lake Michigan Beach*, the Intervention limited liability company agreement did not explicitly disclaim fiduciary duties on the part of the lender member, but simply required a unanimous vote of the members to authorize a bankruptcy filing.

The court nevertheless found that the limited liability company provisions were intended to place into the hands of the creditor the "ultimate authority to eviscerate the right of [the debtor] to seek federal bankruptcy relief" and were therefore "tantamount to an absolute waiver of that right" in violation of federal public policy which assures the rights of persons, including business entities, to seek federal bankruptcy relief.

Perception of Lender As Self-Interested

While it is typical for lenders and rating agencies to require a blocking director as part of the structure of a BRE, the import of the *Lake Michigan Beach* case is that the lender went too far by insisting on appointing itself to play that role. Clearly, the lender was self-interested, and it was not plausible that it could or would ignore that interest when presented with a bankruptcy scenario. In fact, insisting on this role as a condition to a forbearance agreement following a default indicates that preventing a bankruptcy was a primary goal.

Had the lender chosen to add the blocking director prior to a forbearance agreement, the court's decision may very well have turned out differently. Further, this lender explicitly disclaimed any fiduciary duties, leaving no doubt that it would act in its own best interest, rather than that of the company or other stakeholders. The judge made clear that a requirement of unanimity among directors or members for a bankruptcy filing is appropriate where the directors are subject to customary fiduciary duties. *Lake Michigan Beach* can thus be viewed as a reaction to a particularly egregious use of a typical financing technique.

The *Intervention* case similarly focused on the creditor's self-interest, listing three facts that comprised the improper waiver of the debtor's right to bankruptcy relief: 1) the minority equity holder's ultimate veto right; 2) the debtor/creditor relationship; and 3) the disclaimer of fiduciary duties. The court emphasized that the blocking member's primary relationship with the debtor was that of a creditor, not an equity holder, without fiduciary duties to anyone but itself. The provision in question was therefore equivalent to a contractual agreement not to file bankruptcy that courts have long held void as against public policy. The *Intervention* court's use of the conjunction "and" to join the three concepts, however, suggests an argument that public policy may not be injured when one or more of these facts are absent.

At bottom, the two cases highlight courts' willingness to intervene when a lender exerts excessive control over the debtor, or when public policy is threatened, making it imperative that lenders focus closely on how and when a blocking director is used and that the director's duties comport with relevant state law.

Governing Law

Lenders should consider variances in state law when the BRE is formed as the applicable statute may offer more or less flexibility for a blocking director to act. The Michigan Limited Liability Company Act imposes an affirmative duty of care and loyalty on members, which duty obligates the lender, in its role as a member, to consider the interests of the debtor as well as its own. Mich. Comp. Laws Ann. § 450.4404(1). Because the debtor in *Lake Michigan Beach* was incorporated in Michigan, the court applied Michigan corporate governance law in interpreting those fiduciary duties.

Unlike the Michigan statute, which prohibits any limitation on the duty of care and loyalty, N.Y. Ltd. Liab. Co. Law § 417 (McKinney 1996) broadly allows for members of limited liability companies to eliminate or limit "the personal liability of managers to the limited liability company or its members for damages for any breach of duty in such capacity." However, the statute also imposes substantial exceptions to limiting liability for breach of duties, including when the "manager's acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law" or if the manager personally gained a "financial profit or other advantage to which he or she was not legally entitled."

Delaware limited liability companies are more commonly chosen for securitization transactions. Delaware state law aims to give "maximum effect" to freedom of contract and the enforceability of limited liability company agreements. However, even though the Delaware statute provides more flexibility in this regard compared to both the Michigan and New York statutes, that flexibility did not prevent the court in the *Intervention* case from concluding that the blocking director provision in that case violated federal law.

Moreover, Delaware law does not allow for a member of a limited liability company to be exculpated from the duty of loyalty. Under 6 Del. Code Ann. § 18-1101(c), certain fiduciary duties to a limited liability company "may be expanded or restricted or eliminated by provisions in the limited liability company agreement" so long as the agreement does not "eliminate the implied contractual covenant of good faith and fair dealing." Because members remain subject to the duty of loyalty, it may be likely that the blocking member's veto right on bankruptcy filings would still fail if she has conflicting loyalties to both the debtor and the lender. As a result, the scope of the freedom to contract for the prevention of a bankruptcy filing remains ambiguous under Delaware law. In light of this uncertainty, lenders should keep in mind that changing the forum to Delaware alone may not be enough.

What's a Lender to Do?

Moving forward, lenders may wish to also consider some or all of the following:

- If a blocking director is desired, implement the director at the start of a transaction. In both the *Lake Michigan Beach* and *Intervention* cases, the blocking director was forced on the debtor as a condition for waiving existing defaults, at a time when the debtor had little to no bargaining power, which influenced the courts' decisions to treat the blocking director as the equivalent of a third-party contract.

- Appoint an independent director unaffiliated with the BRE and unaffiliated with the BRE's creditors. Placing a lender's own employee on the board creates a conflict of interest between both parties since the appointed member will understand she is meant to vote in the lender's best interests. An unaffiliated independent director, however, will not have the same issue. Moreover, that director should be authorized to consider the best interests of the BRE and its other stakeholders as well as those of its creditors when deciding whether or not to seek bankruptcy protection, and, further, should document her decision. While a truly independent director creates some risk for the lender that a bankruptcy petition not in the lender's interest will be approved, that risk, as noted by the *Lake Michigan Beach* case, may be essential for enforceability of the blocking director's right.

- Expand and enforce separateness provisions such that the risk of substantive consolidation is significantly decreased. Instead of merely reciting the separateness provisions in the organizational documents, the lender may require the BRE to permit an audit of its activities to ensure that there is no commingling of assets with affiliates, misrepresentation to other creditors, or noncompliance with corporate formalities and to document the audit findings.

Conclusion

In sum, while there are well-established practices to make bankruptcies of a BRE less likely, it will behoove the lender to remember that "bankruptcy-remote" is not the same as 'bankruptcy-proof."

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