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Fifth Circuit Affirms Shareholder Veto of Chapter 11 Petition

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"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," held the U.S. Court of Appeals for the Fifth Circuit on May 22, 2018. *In re Franchise Services of North America, Inc.*, 2018 WL 2325909, 1 (5th Cir. May 22, 2018). According to the court, applicable Delaware law would not "nullify the shareholder's right to vote against the bankruptcy petition." *Id.*

Relevance

Appellate courts have regularly rejected creditors' attempts to contract away the debtor's right to seek bankruptcy relief. *In re Thorpe Insulation Co.*, 677 F.3d 869, 1026 (9th Cir. 2012) ("… prohibition of prepetition waiver has to be the law …"); *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1981) (*dicta*, same); *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) (*dicta*, same). But this case, on its facts, does not fall into that category.

Facts

The debtor hired an investment bank (M) to help it acquire a subsidiary. 2018 WL at 2. M's subsidiary, "B," also invested $15 million with the debtor in exchange for 100% of the debtor's preferred stock. B's stake would amount to a 49.76% equity interest, if converted, making it the debtor's single largest investor. As a condition of B's investment, the debtor reincorporated in Delaware and adopted a new certificate of incorporation essentially providing that a majority of each class of the debtor's stock had to consent to the filing of a bankruptcy petition. Also, the debtor agreed to pay M, B's parent, roughly $3 million in fees for its services, but those fees remained unpaid and were the subject of litigation between the parties in other courts.

The debtor later encountered financial difficulties and filed a Chapter 11 petition in June, 2017, without obtaining the consent of its shareholders, including B, for it feared "that its shareholders might nix the filing." *Id.*, at 1. In response to a motion by M and B to dismiss the bankruptcy petition on the ground that the debtor had failed to seek shareholder authorization, the debtor argued that the "shareholder consent provision was an invalid restriction" on its right to file a bankruptcy petition and also violated Delaware law.

The Bankruptcy Court

The bankruptcy court rejected the debtor's argument, finding that no federal bankruptcy policy barred a shareholder's conditioning a bankruptcy filing on its consent. It declined to "deem the shareholder consent provision contrary to Delaware law, leaving that for Delaware courts to decide in the first instance." *Id.* at 2.

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Direct Appeal to Fifth Circuit

The bankruptcy court certified a direct appeal of its order to the Fifth Circuit. The Fifth Circuit addressed the following three certified questions: 1) Is a "golden share" provision giving a party the ability to prevent a bankruptcy filing enforceable under federal law or public policy? 2) When a party is both a creditor and a shareholder with a blocking provision or golden share, does that violate federal public policy? and 3) Is a certificate of incorporation with a blocking provision or golden share valid under Delaware law, and if so, does Delaware law impose on the holder of the provision a fiduciary duty to exercise it in the best interest of the corporation? *Id.*, at 3.

No Blocking Provision Or Golden Share

The Fifth Circuit defined a 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." *Id.* A golden share "controls more than half of a corporation's voting rights and gives the shareholder veto power over changes to the company's charter." *Id.* 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." *Id.*

The court stressed that "this case [does not involve] a 'blocking provision' or a 'golden share,' [for the] facts do not fit neatly into either definition." *Id.* B simply made a $15million equity investment and received in return convertible preferred stock that carried with it the right to vote on certain corporate matters. *Id.* The Fifth Circuit thus avoided rendering an advisory opinion on the general enforceability of blocking provisions and golden shares. It limited its 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 [*i.e.*, M] to prevent a voluntary bankruptcy petition." *Id.*, at 4.

State Law Governs Corporate Authority

The parties agreed that a debtor "cannot contract away the protections of bankruptcy." *Id.* at 5. According to the Fifth Circuit, though, "this case does not involve a contractual waiver of the right to file for bankruptcy or to a discharge." *Id.* "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." *Id.*

Even assuming that B and M were a single entity, there was "no evidence that their arrangement was merely a ruse to insure that [the debtor] would pay [M's] bill." *Id.*, at 6. B acquired a substantial equity position in the debtor for $15 million one year before M even sent a bill to the debtor for its services. M hardly made a $15 million equity investment "just to hedge against the possibility that [the debtor] might not pay a $3 million bill." *Id.* In short, "[t]here 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." *Id.*

No Imposition of Fiduciary Duty on B

The court rejected the debtor's argument that would impose a fiduciary duty on a shareholder with a bankruptcy veto right. According to the court, "[n]o statue or binding case law licenses this court to … 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 …. 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." *Id.* In this case, no creditor without a "stake in the company held the right" to veto the bankruptcy petition. *Id.*,

at 7. Also, no "creditor took an equity stake simply as a ruse to guarantee a debt." *Id*.

Consent to Seek Bankruptcy Relief

The court assumed, without deciding, that Delaware law would permit a certificate of incorporation to condition a corporate debtor's right to seek bankruptcy relief upon shareholder consent. *Id*., at 8. In fact, the debtor waived any contrary argument. *Id*.

B Was Not Subject to Any Fiduciary Obligation

The Fifth Circuit also rejected the debtor's argument that B's "controlling minority shareholder" status entailed fiduciary obligations that would invalidate B's vetoing the bankruptcy petition here. *Id*. "[A Delaware] shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation." *Id*., quoting *Ivanhoe Partners v. Newmont Min. Corp*., 535 A.2d 1334, 1344 (Del. 1987). Not only did B lack majority control here, reasoned the court, but the debtor offered no evidence that B's "influence was so pervasive that it would qualify as a controlling shareholder under Delaware law." *Id*. at 9. Indeed, the debtor's "apparent ability and willingness to act without [B's] consent undercuts the case for control." *Id*. at 10.

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State Law Governs Any Breach of Fiduciary Duty Claim

The debtor's asserted breach of fiduciary claim should have been brought "under state law," held the court. *Id*. The claim did not belong in the context of a response to "an otherwise meritorious motion to dismiss the bankruptcy petition." *Id*.

Comment

Franchise Services is eminently correct. It properly avoided general legal maxims (*e.g.*, "pre-bankruptcy bankruptcy waivers are void as a matter of public policy."). Instead, the Fifth Circuit focused on the facts to reach a sensible, practical result. *See also*, *DB Capital Holdings LLC*, 2010 Bankr. LEXIS 4176 (B.A. P. 10th Cir. 2010) (bankruptcy prohibition in operating agreement not void; no creditor coercion; state law and operating agreement governed).

The Fifth Circuit also undermined the infamous *Kingston Square Associates* decision handed down by a New York bankruptcy court in 1997, which this author succeeded in losing. *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (*held*, debtor may orchestrate involuntary bankruptcy petition to avoid bylaw provisions requiring unanimous vote of directors to file voluntary bankruptcy petition and appointment of independent non-insider director; debtor's principal solicited and funded "friendly" creditors (two trade creditors and five professionals) to prosecute involuntary petition; petitioning creditors had "no interest" in the bankruptcy case). *See*, Note, "Asset Securitization: How Remote Is Bankruptcy Remote?," 26 Hofstra L. Rev. 929, 939, 944 (1998) (*Kingston Square* court failed to "consider how ill-suited the case may be for [bankruptcy] adjudication … and reached what many will argue is an erroneous decision, a model of form over substance …. These orchestrated petitions were 'ripe' for dismissal."); NY City Bar, "New Developments in Structured Finance" 56 Bus. Law. 95, 162 (2000) (*Kingston Square* raises "questions concerning the viability of corporate governance mechanisms in bankruptcy remote vehicles.").

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