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Delaware Bankruptcy Court Invalidates on Public Policy Grounds a “Golden Share” Provision in LLC Agreement Designed to Limit LLC’s Ability to File for Bankruptcy

In a June 3, 2016 decision¹, the United States Bankruptcy Court for the District of Delaware (“the Bankruptcy Court”) invalidated, on federal public policy grounds, a provision in the debtor-LLC’s operating agreement that it viewed as hindering the LLC’s right to file for bankruptcy. Such provision provided that the consent of all members of the LLC, including a creditor holding a so-called “golden share” received pursuant to a forbearance agreement, was required for the debtor to commence a voluntary bankruptcy case. This case demonstrates that courts are likely to view with hostility prohibitions in organic documents that they view as tantamount to an outright prohibition of a debtor to file for bankruptcy, particularly where they have been insisted on by a creditor of the entity.

Background

Intervention Energy, LLC (“IE”) and its parent entity, Intervention Energy Holdings, LLC (“IEH”) (collectively, the “Debtors”), are privately-held Delaware LLC’s engaged in oil and natural gas exploration and production. Intervention Energy Investment Holding (“IEIH”) owns approximately 85% of IEH, and the remainder is owned by various businesses and individual investors.

EIG Energy Fund XV-A, L.P. (“EIG”) is an institutional investor focusing on private investments in energy resources and infrastructure. In January 2012, EIG entered into a Note Purchase Agreement with the Debtors for \$200 million in senior secured notes. In October 2015, EIG declared an event of default under the notes due to the Debtors’ failure to comply with certain maintenance covenants.

On December 28, 2015, the Debtors entered into a forbearance agreement and a contingent waiver with EIG. As a condition of EIG agreeing to forbear from exercising remedies on account of the event of default under the notes, IEH amended its operating agreement to admit EIG as a member, issued EIG a “golden share” to EIG in exchange for a common capital contribution of \$1.00 (i.e., essentially one common unit) and also amended the LLC agreement to provide that the consent of all members, including EIG as holder of the “golden share,” was required for EIG to commence a voluntary bankruptcy case.

On May 20, 2016, the Debtors filed voluntary chapter 11 bankruptcy petitions with the Bankruptcy Court. At the time of filing, IEH had issued 22,000,001 common units; 22,000,000 of the units were held by IEIH, while EIG held a

¹ In re *Intervention Energy Holdings, LLC, et al.*, Case 16-11247-KJC (Bankr. D. Del. 2016).

single unit. On May 24, 2016, EIG filed a motion to dismiss IEH's bankruptcy case, arguing, among other things, that IEH lacked the authority to file for voluntary Chapter 11 protection without the support of EIG's "golden share" given the terms of the unanimous consent provision in IEH's operating agreement.

In seeking dismissal of the chapter 11 petition, EIG argued that Delaware corporate law permits LLC consent provisions that, in effect, contract away an entity's right to voluntarily file for bankruptcy, citing to certain cases from other bankruptcy courts upholding consent provisions among LLC members. EIG claimed that it had negotiated validly and entered into a contractual arrangement with the Debtors, pointing out that it had "bought and paid" for the common unit to enforce its rights. EIG further asserted that it was vital to uphold the Delaware legislature's will to promote freedom of contract in the LLC business form. According to EIG, voiding the consent provision would also breed confusion about an LLC's right to contract, specifically the extent to which operators of an LLC are free to structure its form.

The Debtors argued against the validity of the golden share by citing to a recent decision from the Bankruptcy Court for the Northern District of Illinois, *In re Lake Michigan Beach Pottawatamie Resort LLC* ("Lake Michigan"),² which invalidated on public policy grounds a provision in an LLC agreement requiring the consent of an independent director that was not expressly subject to fiduciary duties to file the LLC for bankruptcy. The Debtors argued that like the independent director in *Lake Michigan*, the holder of the "golden share" in IEH lacked any fiduciary duty to act in the best interests of the potential debtor, thereby rendering its right to consent to a bankruptcy filing void as against federal bankruptcy policy. The Debtors also warned that upholding the "golden share" provision would alter debtor-creditor relations, as in the future creditors would insist on the creation of golden shares to safeguard their interests.

Decision

The Bankruptcy Court did not reach the arguments of each side regarding whether under state law LLC members may contract to limit the ability of an LLC to file for bankruptcy. Instead, the Bankruptcy Court voided the golden share arrangement on federal public policy grounds, noting its agreements with those courts holding that state law cannot deny the right of a corporate or business entity to file for bankruptcy. The court noted that while a straightforward waiver of bankruptcy rights was clearly improper, the parties in this case used a more attenuated, circular approach accomplish that very goal, rather than simply contracting away the Debtors' bankruptcy rights. EIG, a creditor, was given a golden share vote that could block a bankruptcy filing, which would be used precisely for the purpose of guarding its interests as creditor and preventing the Debtors from seeking bankruptcy protection, thereby cloaking the virtual waiver in the processes of corporate governance.

Discussion

While third-party arrangements to waive bankruptcy rights are contrary to public policy, instances in which the waiver is practically accomplished through changes to governance documents are more difficult to assess. There may be legitimate business reasons for an entity to restrict its ability to file for bankruptcy. Courts, nevertheless,

² 2016 BL 109205 (Bankr. N.D. Ill. Apr. 5, 2016).

courts seem to be hostile to bankruptcy waivers included in governance documents at the behest of a creditor or a lender, as was the case here.³ Yet some courts have upheld similar bankruptcy waivers where no lender coercion could be shown.⁴ Indeed, it is worth noting the unique facts surrounding the golden share in *Intervention Energy*, namely the receipt of the “golden share” by a party that was exclusively a creditor in connection with the entry into a forbearance agreement. It is possible the outcome of the *Intervention Energy* case may have been different had the “golden share” been issued to the creditor at the outset of the transaction where the creditor also received equity interests with real economic value or had it been issued to an equity holder and not a creditor.⁵

The *Intervention Energy* and *Lake Michigan* decisions signal the hostility of courts to certain attempts to use blocking directors and golden share provisions to limit the ability of an entity to file for bankruptcy. Rather than delving into the substantive arguments put forward by EIG and the Debtors as to whether the “golden share” provision was permissible under state law, the Bankruptcy Court foreclosed these points and reached its decision purely on the basis of federal public policy. It remains to be seen whether these decisions will be broadly followed to capture equity without economic or voting rights beyond blocking a bankruptcy filing regardless of when and to whom such golden shares are issued, or limited to their specific facts and applied only to golden shares issued to creditors in a distressed workout scenario.

³ The United States Bankruptcy Court for the District of Oregon, for example, struck down a bankruptcy waiver contained in an LLC operating agreement in LLC because it viewed its inclusion as a “cleverly insidious” maneuver undertaken by an “astute creditor”. See *In re Bay Club Partners-472*, Bankruptcy Case No. 14-30394-rld11 (Bankr. D. Or. May 6, 2014).

⁴ See *DB Capital Holdings LLC v. Aspen HH Ventures LLC (In re DB Capital Holdings LLC)*, 2010 Bankr. LEXIS 4176 (B.A.P. 10th Cir. Dec. 6, 2010) (unpublished)

⁵ The Bankruptcy Court in *Intervention Energy* distinguished one decision cited by EIG where an equity holder who was also a creditor was able to block an LLC’s bankruptcy filing. See footnote 25. The court noted that “the method by which the creditor received its equity interests was not subject to question or analysis. There is no way to compare that creditor’s interests to EIG’s contracting for one golden share solely to control any potential filing.”

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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