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Two Recent Decisions Invalidate LLC Agreement Provisions Requiring Consent for LLC Bankruptcy Filings

By Jason W. Harbour and Shannon E. Daily*

The authors of this article discuss the recent decisions of two bankruptcy courts that have refused to enforce limited liability company ("LLC") agreement provisions requiring the respective LLCs to obtain the unanimous consent of their members in order to seek bankruptcy relief.

Since April, two bankruptcy courts have refused to enforce limited liability company ("LLC") agreement provisions requiring the respective LLCs to obtain the unanimous consent of their members in order to seek bankruptcy relief.[1] On June 3, 2016, the U.S. Bankruptcy Court for the District of Delaware (the "Delaware Bankruptcy Court") relied on federal public policy to invalidate an LLC agreement provision requiring unanimous member consent to file bankruptcy where the member at issue owed no fiduciary duties to the LLC and the member's primary relationship to the LLC was as a creditor. The Delaware Bankruptcy Court held that the provision was void as contrary to federal public policy because it was tantamount to an absolute waiver of the LLC's right to seek bankruptcy relief.[2] Less than two months earlier, on April 5, 2016, the Bankruptcy Court for the Northern District of Illinois (the "Illinois Bankruptcy Court") held that an LLC agreement's bankruptcy consent provision was unenforceable because it purported to eliminate fiduciary duties and any need for the special member to consider the interests of the LLC.[3] These cases underscore the importance of thoughtfully drafting LLC agreement provisions for special purpose entities ("SPEs") to avoid potential enforceability issues.

GENERAL BACKGROUND

An SPE is a structure lenders often require in a wide variety of financing

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[1] *See In re Intervention Energy Holdings, LLC, et al.*, No. 16-11247, 2016 Bankr. LEXIS 2241, at *17 (Bankr. D. Del. June 3, 2016) ("*Intervention Energy*"); *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. Apr. 5, 2016) ("*Lake Michigan*").

[2] *See* Intervention Energy, 2016 Bankr. LEXIS 2241, at *17.

[3] *Lake Michigan,* 547 B.R. at 914.

transactions for the purpose of isolating assets from the potential bankruptcy estates and creditors of individuals or operating entities. The organizational documents of SPEs often require SPEs to have a single or special purpose, and to comply with other special purpose provisions designed to maintain the separateness of the SPEs from their owners.[4] The organizational documents of SPEs also may contain provisions that require unanimous consent by members and/or the appointment of, and consent by, "Special Members," "Independent Managers," or "Independent Directors" to certain material actions, including the commencement of a voluntary bankruptcy case. As a result, if such a member, manager or director withholds consent, the terms of the LLC agreement prohibit the SPE from filing a voluntary bankruptcy petition. These provisions mitigate the risk of an abusive bankruptcy filing by the LLC.

INTERVENTION ENERGY

Intervention Energy Holdings, LLC ("IE Holdings") and Intervention Energy, LLC ("IE"); and together with IE Holdings, the "IE Debtors") are Delaware LLCs.[5] On January 6, 2012, the IE Debtors entered into a Note Purchase Agreement with their senior secured lender, EIG Energy Fund XV-A, L.P. ("EIG"). After EIG declared an event of default in October, on December 28, 2015, the IE Debtors and EIG entered into a forbearance agreement.[6] Among other things, the forbearance agreement required IE Holdings to amend its LLC Agreement to admit EIG or its affiliate as a member of IE Holdings with one common unit and to require approval of each holder of common units prior to any bankruptcy filing by IE Holdings.[7] Contemporaneously with the forbearance agreement, IE Holdings amended its LLC Agreement to this effect.[8]

On May 20, 2016, the IE Debtors filed voluntary Chapter 11 petitions in the Delaware Bankruptcy Court.[9] Four days later, EIG filed a motion to dismiss the jointly administered bankruptcy cases, asserting, among other things, that IE Holdings did not have authority to file a bankruptcy petition because it did not obtain EIG's consent prior to filing as required by the unanimous consent

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[4] *Id.* at 911.

[5] *Intervention Energy,* 2016 Bankr. LEXIS 2241, at *4.

[6] *Id.* at *5–6.

[7] *Id.* at *6.

[8] *Id.* at *6–7.

[9] *Id.* at *1–2.

provision.[10]

Although the parties argued about the ability of LLC members to limit certain duties under applicable Delaware state law, the Delaware Bankruptcy Court concluded that it was unnecessary to address Delaware law because federal public policy controlled. The Delaware Bankruptcy Court held that the unanimous consent provision was unenforceable because it violated the well-established federal public policy that a debtor may not waive its right to seek bankruptcy relief. Specifically, the Delaware Bankruptcy Court concluded that:

> 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.[11]

Notably, the Delaware Bankruptcy Court also indicated that the federal policy that prohibits waiving the right to seek bankruptcy relief applies to business entities, including LLCs.[12]

LAKE MICHIGAN

The LLC agreement provision at issue in *Lake Michigan* established the senior secured lender, BCLBridge Funding LLC ("BCL"), as a "Special Member" with the right to approve or disapprove any material action by the LLC, including the filing of a voluntary bankruptcy petition. The third amendment to the operating agreement (the "Third Amendment") of the Lake Michigan debtor (the "LM Debtor") also purported to waive BCL's fiduciary

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[10] EIG's motion to dismiss also sought to dismiss the case on the grounds that there is no possibility for a successful reorganization and that the IE Debtors filed their petitions in bad faith. The Delaware Bankruptcy Court bifurcated the determination of the issues raised in EIG's motion to dismiss, addressing only the consent issue in its June 3 opinion. *Id.* at *2–3. The Delaware Bankruptcy Court subsequently scheduled a status conference on the remaining issues in EIG's motion to dismiss for July 26, 2016. *See In re Intervention Energy Holdings, LLC, et al.*, No. 16-11247 (Bankr. D. Del. June 9, 2016) [Doc. No. 90].

[11] *Intervention Energy,* 2016 Bankr. LEXIS 2241, at *16–17.

[12] *Id.*

obligations to the LM Debtor and provided that BCL did not need to consider the interests of the LM Debtor in making decisions as a Special Member.[13]

On December 16, 2015, the day before a scheduled non-judicial foreclosure sale, the LM Debtor filed a voluntary bankruptcy petition and attached to the petition a consent to the bankruptcy filing signed by all of the LM Debtor's members except for BCL. BCL moved to dismiss the LM Debtor's bankruptcy case, arguing that the case was filed in bad faith and that the filing was unauthorized because BCL, as a Special Member, did not consent to the filing.[14]

After rejecting the bad faith argument, the Illinois Bankruptcy Court addressed whether the LM Debtor's bankruptcy petition was properly authorized in light of the blocking director provision in the Third Amendment. The Illinois Bankruptcy Court's analysis began with a general discussion of blocking director provisions and blanket prohibitions against filing bankruptcy.[15] Consistent with the Delaware Bankruptcy Court's statements, the Illinois Bankruptcy Court noted that blanket prohibitions against filing bankruptcy are void as against public policy.[16] The Illinois Bankruptcy Court also noted, however, that corporate formalities and applicable state corporate law must be satisfied to commence a bankruptcy case, and that improperly authorized corporate bankruptcy filings generally are infirm.[17]

The Illinois Bankruptcy Court discussed the interplay between the unenforceability of blanket bankruptcy prohibitions and the often permissible limitations blocking director provisions impose on filing bankruptcy, stating that generally a blocking director provision "has built into it a saving grace: the blocking director must always adhere to his or her general fiduciary duties to the debtor in fulfilling the role. That means that, at least theoretically, there will be situations where the blocking director will vote in favor of a bankruptcy filing, even if in so doing he or she acts contrary to purpose of the secured creditor for whom he or she serves."[18] The Illinois Bankruptcy Court also

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[13] The Third Amendment provided that the Special Member "shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interests of or factors affecting the Company or the Members." *Lake Michigan*, 547 B.R. at 914.

[14] *Id.* at 905.

[15] *See id.* at 911–12.

[16] *See id.*

[17] *See id.* at 912.

[18] *Id.* Similarly, the Illinois Bankruptcy Court stated that "[t]he essential playbook for a successful blocking director structure is this: the director must be subject to normal director

noted that the fiduciary duty and public policy concerns related to blocking director provisions involving corporations extend to blocking director provisions involving LLCs.[19]

The Illinois Bankruptcy Court then addressed the specific terms of the blocking director provision in the Third Amendment, noting that the Third Amendment "results in BCL as the Special Member having no duties to the Debtor, despite otherwise being a member of the Debtor."[20] The Illinois Bankruptcy Court concluded that under Michigan law, "BCL, as a member of a Michigan limited liability company, the Debtor, must consider the interests of the Debtor."[21]

Before concluding its analysis, the Illinois Bankruptcy Court addressed the savings clause in the Third Amendment's blocking director provision. The savings clause stated that the purported elimination of duties to consider the interests of the LM Debtor was only "to the fullest extent permitted by applicable law."[22] The Illinois Bankruptcy Court stated "[t]hat savings clause might cure the invalidity of the prohibition, but only by rendering it meaningless. The prohibition has no application other than which is impermissible under Michigan law."[23] The Illinois Bankruptcy Court's treatment of the savings clause, however, raises questions because the Illinois Bankruptcy Court's ruling invalidated more than the elimination of BCL's duties. The Illinois Bankruptcy Court's ruling also invalidated the requirement that BCL consent to the LM Debtor's bankruptcy filing even though, as the Illinois Bankruptcy Court noted earlier in the opinion, a blocking director provision that does not eliminate fiduciary duties generally is enforceable.[24] Could the Illinois Bankruptcy Court have enforced the savings clause to invalidate the purported elimination of fiduciary duties in the blocking director provision, while simultaneously enforcing the requirement that BCL must approve a

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fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor that they were chosen by." *Id.* at 913.

[19] *Id.* at 913.

[20] *Id.* at 914.

[21] *Id.* Although Michigan law imposes obligations on members to consider the interests of an LLC, other states provide that certain obligations may be eliminated, including Delaware, which provides that duties other than the implied contractual covenant of good faith and fair dealing may be eliminated. Mich. Comp. Laws Ann. §§ 450.4401, 450.4404(1); Del. Code Ann., tit. 6, § 18-1101(c).

[22] *Lake Michigan*, 547 B.R. at 914.

[23] *Id.*

[24] *See id.* at 912–13.

bankruptcy filing as long as BCL acted in accordance with its fiduciary duties? Would such a ruling have complied with applicable Michigan law? The *Lake Michigan* decision does not answer these questions.

Ultimately, the Illinois Bankruptcy Court concluded that by excluding the LM Debtor's interests from BCL's consideration when acting as Special Member, the Third Amendment "expressly eliminated the only redeeming factor that permits the blocking director/member construct."[25] The Illinois Bankruptcy Court then held that the blocking director provision was void and unenforceable, and that there was valid consent to the LM Debtor's bankruptcy petition.[26]

CONCLUSION

The facts and relevant LLC agreement provisions in *Intervention Energy* and *Lake Michigan* are different from those related to many SPEs with independent managers or directors. Specifically, both *Intervention Energy* and *Lake Michigan* involve provisions where the relevant party had no fiduciary obligations to the LLC. In addition, both *Intervention Energy* and *Lake Michigan* involve "members" that were substantial creditors of the respective LLCs. Nevertheless, despite these potentially distinguishing facts, *Intervention Energy* and *Lake Michigan* serve as important reminders that SPE provisions should be drafted carefully and with an eye towards avoiding potential enforceability concerns while achieving transaction party goals.

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[25] *Id.* at 914.

[26] *Id.* The LM Debtor's victory in *Lake Michigan*, however, was short lived. On May 18, 2016, the court entered Orders lifting the automatic stay as to BCL, and dismissing the LM Debtor's bankruptcy case for cause. *See In re Lake Michigan Beach Pottawattamie Resort, LLC*, No. 15-42427 (Bankr. N.D. Ill. May 17, 2016) [Doc. Nos. 64 and 65].