

VIII. *Bankruptcy Control Tools: Good News for Creditors*

A. Introduction

Creditors have long had an interest in developing a mechanism to control debtors' ability to file for bankruptcy.¹ Historically, courts have not been friendly to "creditor-imposed contractual restrictions on the right to file," but this has not stopped creditors from testing various methods to keep debtors from filing.² For example, the "golden share" method is often utilized.³ A golden share "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."⁴ Enforceability of golden shares has been in question due to concerns about taking control from managers and board members who have a fiduciary duty and giving that power to shareholders—and potentially creditors—who will likely prioritize self-interest.⁵

Over the past few years, the golden share issue has been litigated on numerous occasions, but the outcomes have varied.⁶ In January 2018, the Fifth Circuit Court of Appeals accepted an appeal from the U.S. Bankruptcy Court for the Southern District of

¹ See Shmuel Vasser, *Opinion: Fool's Gold? Circuit Court Taking Up Alternative Bankruptcy Proofing Mechanism*, *Asset Securitization Report*, AM. BANKER: ASSET SECURITIZATION REP. (Mar. 27, 2018, 6:21 AM), <https://asreport.americanbanker.com/opinion/golden-shares-may-yet-shine-as-bankruptcy-proofing-mechanism> [<https://perma.cc/T8M4-J3KV>] (stating that financial engineers have long been searching for bankruptcy control mechanisms).

² Special Bulletin by Stroock & Stroock & Lavan LLP, Mark A. Speiser & Harold A. Olsen, *In Re Franchise Services of North America, Inc.*: The Fifth Circuit Explores Restrictions on Bankruptcy Filing (July 17, 2018), <https://www.stroock.com/siteFiles/Publications/InReFranchiseServicesOfNorthAmericaInc.pdf> [<https://perma.cc/DAZ7-8KSB>].

³ See *id.*

⁴ *Franchise Servs. of N. Am., Inc. v. U.S. Trs. (In re Franchise Servs. of N. Am., Inc.)*, 891 F.3d 198, 205 (5th Cir. 2018).

⁵ See Vasser, *supra* note 1.

⁶ See, e.g., *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 265 (Bankr. D. Del. 2016) (holding the blocking provision void because the creditor only held one share in equity); *In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911–12 (Bankr. N.D. Ill. 2016) (holding that an entity wearing "two hats in this case," as creditor and equity holder, it can withhold consent for bankruptcy).

Mississippi.⁷ Three questions were certified for appeal, including whether golden shares are “valid and enforceable.”⁸ The Fifth Circuit would be the highest court to rule on this issue to date.⁹ After years of uncertainty, banking and finance attorneys were eager to have the golden share question resolved once and for all.¹⁰ Five months later in May 2018, the Fifth Circuit Court of Appeals released an opinion, *In re Franchise Service of North America, Inc. (In re FSNA)*, affirming the lower court’s opinion.¹¹

This article is organized into four sections. First, Part B will discuss the various tools creditors most commonly use to control bankruptcy filings. Then, Part C will provide further detail on the “golden share” method and how it has become a common bankruptcy control tool. In Part D, the article will discuss the background and holding of *In re FSNA*, the first golden share case to be considered at the circuit level. The article will then discuss the implications and potential consequences of the *In re FSNA* decision in Section E.

B. Background: Tools to Control Bankruptcy Filing

Control is critical to a creditor when a debtor goes into bankruptcy as a way to ensure repayment.¹² In general, courts will not enforce contractual agreements between creditors and debtors where

⁷ *In re Franchise Servs. of N. Am., Inc.*, 891 F.3d at 204.

⁸ *Id.*

⁹ Corinne Ball, *A Case to Watch: The Fifth Circuit Accepts Direct Appeal Respecting Enforcement of Corporate Restraints Preventing Bankruptcy*, N.Y. L.J. (Feb. 21, 2018, 3:05 PM), <https://www.law.com/newyorklawjournal/2018/02/21/a-case-to-watch-the-fifth-circuit-accepts-direct-appeal-respecting-enforcement-of-corporate-restraints-preventing-bankruptcy>.

¹⁰ *See, e.g., id.*; Vasser, *supra* note 1 (discussing the uncertainty of the golden share and other bankruptcy control provisions).

¹¹ *In re Franchise Servs. of N. Am., Inc.*, 891 F.3d at 214.

¹² *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 804 (2004) (“[C]ontrol of the process as recovery has become at least as important as rules of priority.”). *See, e.g.,* Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 COLUM. BUS. L. REV. 610, 620 (2008) (“During the bankruptcy proceeding and because of its control position as a creditor, investor may use several tactics to delay and frustrate the Chapter 11 process . . .”).

the debtor waives its right to file for bankruptcy.¹³ However, case law does not prevent creditors and debtors from developing mechanisms outright by which the creditor limits or influences the debtor's ability to file.¹⁴ This gray area has led to creditors and debtors experimenting with "creative structures" to find work-arounds to the ban on bankruptcy waivers.¹⁵

One method that has been explored is the pre-bankruptcy waiver of the automatic stay, which allow creditors to move forward with actions against the debtor to collect despite the debtor's bankruptcy petition.¹⁶ Courts have found these prebankruptcy automatic stay waivers "sometimes enforceable," particularly when part of a forbearance agreement rather than part of the original loan documents.¹⁷ However, some courts reject waivers altogether, and many are unsympathetic where the debtor is a single-asset debtor.¹⁸

With the rise of non-recourse financing, in which creditors may only collect out of a debtor's collateral, another mechanism to control bankruptcy has emerged: the "bad boy" guarantee.¹⁹ Initially, with a bad boy guarantee, a debtor in non-recourse financing would be found liable for losses suffered by the creditor if the debtor behaved badly.²⁰ Today, non-recourse creditors have been utilizing the bad boy guarantee to "impose personal liability on any person controlling the borrower upon the occurrence of events that were not traditionally deemed "bad acts," such as a bankruptcy filing by (or against) the borrower, the borrower's opposition to foreclosure, or the borrower's

¹³ Samuel Newman et al., *Minimizing Risk of Borrower Bankruptcy*, LAW360 (Oct. 11, 2017, 12:55 PM), <https://www.law360.com/articles/973095/minimizing-risk-of-borrower-bankruptcy>.

¹⁴ *Id.* ("[T]here remains no definitive test that prevents a lender from limiting the right of a borrower to commence a bankruptcy.").

¹⁵ *Id.*

¹⁶ See Mark A. Cody, *A Look at 3 Bankruptcy Remedies Lenders Commonly Use*, LAW360 (Sept. 2, 2016, 12:20 PM), <https://www.law360.com/articles/835929/a-look-at-3-bankruptcy-remedies-lenders-commonly-use> (observing that automatic stays have been the subject of "substantial litigation").

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.* (discussing guarantees which give lenders recourse where the debtor has behaved badly).

²⁰ Memorandum from Herrick Feinstein LLP, John C. St. Jeanos, *Understanding the Scope of a Bad Boy Guaranty* (Sept. 2017), www.herrick.com/publications/understanding-the-scope-of-a-bad-boy-guaranty [<https://perma.cc/A4Y4-GJRW>].

failure to maintain its status as an SPE.”²¹ Courts have generally found bad boy guarantees enforceable.²²

Bankruptcy remote is another common tool to control bankruptcy filings by debtors.²³ Bankruptcy remote, or special purpose, entities (SPEs) have traditionally been used in mortgage-backed transactions.²⁴ SPEs hold a certain amount of debtor assets and “are intended to separate the credit quality of assets upon which financing is based from the credit and bankruptcy risks of the entities involved in the financing.”²⁵ These entities are often structured such that the board of directors must unanimously approve bankruptcy filings and the creditor nominates a director, giving the creditor “the power to prevent a bankruptcy filing by withholding consent.”²⁶ However, bankruptcy remote is far from bankruptcy-proof, and courts have recently ruled unfavorably on the use of this tool.²⁷ Courts have “forced bankruptcy-remote entities into bankruptcy through substantive consolidation with the bankruptcy estates of affiliated entities.”²⁸ Courts have also ruled against SPEs on the grounds that a creditor-appointed director owes a fiduciary duty to both the creditor and the shareholder, and that vetoing bankruptcy violated that duty.²⁹

Because none of the preceding tools have proven to be entirely bankruptcy-proof, creditors and debtors have continued to experi-

²¹ Cody, *supra* note 16.

²² *Id.*

²³ *Id.*

²⁴ STANDARD’S & POOR, U.S. CMBS LEGAL AND STRUCTURED FINANCE CRITERIA 89–90 (2003), http://1stss.com/referencematerials/SP_CMBS_Legal_and_Structured_Finance_Criteria.pdf [<https://perma.cc/AKR4-2JE6>].

²⁵ Sarah K. Kam, *Bankruptcy-Remote Does Not Mean Bankruptcy-Proof*, LAW360 (Feb. 25, 2015), <https://www.law360.com/articles/624838/bankruptcy-remote-does-not-mean-bankruptcy-proof>.

²⁶ Cody, *supra* note 16.

²⁷ *Id.*; Kam, *supra* note 25.

²⁸ Kam, *supra* note 25.

²⁹ *In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 912–13 (Bankr. N.D. Ill. 2016) (stating that “the blocking director must always adhere to his or her general fiduciary duties to the debtor in fulfilling the role”).

ment.³⁰ Recently, the golden share has become popular as a tool to control bankruptcy.³¹

C. Golden Shares

Broadly defined, a golden share is “[a]share that controls more than half of a corporation’s voting rights and gives the shareholder veto power over changes to the company’s charter.”³² Historically, governments have held golden shares, giving that government “special, exclusive, and nontransferable corporate-governance rights in privately owned enterprises.”³³ Governments used golden shares in the 1980s to maintain national control over private enterprises and to minimize disruption as certain social services became privately controlled.³⁴ These golden shares gave governments “disproportionate voting power with respect to the election of the company’s directors and various strategic decisions affecting the operation of the company.”³⁵

Unsurprisingly, the golden shares intrigued creditors and has been adopted for use in the context of bankruptcy control.³⁶ As used by debtors and creditors, a golden share gives a creditor the power to “prevent a voluntary bankruptcy petition.”³⁷ Creditors are given trivial amounts of a special class of stock, and the debtors organizational documents provide that the debtor “cannot file for bankruptcy protection without the consent of each holder of any golden shares.”³⁸ Put

³⁰ See Vasser, *supra* note 1 (declaring that that, in the context of bankruptcy control mechanisms “the search for a better one is never ending”).

³¹ See *id.* (reporting on the recent litigation involving the use of the golden share).

³² *Franchise Servs. of N. Am., Inc. v. U.S. Trs. (In re Franchise Servs. of N. Am., Inc.)*, 891 F.3d 198, 205 (5th Cir. 2018) (citing *Golden Share*, BLACK’S LAW DICTIONARY (10th ed. 2014)).

³³ Saule T. Omarova, *Bank Governance and Systemic Stability: The “Golden Share” Approach*, 68 ALA. L. REV. 1029, 1043–45 (2017).

³⁴ *Id.* (discussing the benefits of golden shares for the government, including its flexibility to allow company-specific solutions).

³⁵ *Id.*

³⁶ See Vasser, *supra* note 1.

³⁷ *In re Franchise Servs. of N. Am., Inc.*, 891 F.3d at 205.

³⁸ Sara G. Duran & Aaron J. Rigby, *The Impact of Your Partner’s Bankruptcy on Your Joint Venture*, 2 BUS. & BANKR. L.J. 11, 30 (2014).

simply, the creditor becomes an equity holder with special authority to approve or deny bankruptcy filing.³⁹

While golden shares are appealing to creditors, their value and enforceability are unclear.⁴⁰ Decided in 2007, *In re Global Ship Systems, LLC* was the “first case to address the validity of golden shares or blocking provisions.”⁴¹ In *In re Global Ship Systems, LLC*, the creditor was also an equity holder and the debtor’s operating agreement gave the creditor veto power in filing for bankruptcy.⁴² The court determined that the provision in the operating agreement was valid because the creditor also held shares.⁴³ However, in 2016, the U.S. Bankruptcy Court for the Southern District of Mississippi ruled against a creditor and voided a golden share because the creditor, as a member of the debtor’s LLC through the share, had a fiduciary duty to the debtor and could not veto bankruptcy against the interests of the debtor.⁴⁴ Since 2016, the decisions in additional cases have yielded inconsistent results.⁴⁵ However, a general trend does emerge from the collection of the case law: where the creditor looks more like an equity holder, the golden share is typically valid, and where the creditor looks more like a creditor, it is not.⁴⁶

³⁹ See Vasser, *supra* note 1.

⁴⁰ *Id.* (arguing that the golden share may not be enforceable based on public policy, and not useful if it were enforceable because it can be manipulated easily).

⁴¹ *In re Franchise Servs. of N. Am., Inc.*, No. 17-02316-EE, 2018 WL 485959 2018 (Bankr. S.D. Miss. Jan. 17, 2018).

⁴² *In re Glob. Ship Sys., LLC*, 391 B.R. 193, 196–97 (Bankr. S.D. Ga. 2007) (stating that debtor’s operating agreement granted a blocking provision to creditor).

⁴³ *Id.* at 203.

⁴⁴ *In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 912–13 (holding that creditor’s status as an LLC member created a fiduciary duty to the debtor).

⁴⁵ See, e.g., *In re Squire Court Partners Ltd. P’ship*, 574 B.R. 701 (Bankr. E.D. Ark. 2017) (finding for the creditor); *In re Tara Retail Grp., LLC*, No. 17-bk-57, 2017 WL 1788428 (Bankr. N.D. W. Va. May 4, 2017) (finding for the debtor); *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016) (finding for the debtor).

⁴⁶ *In re Franchise Servs. of N. Am., Inc.*, 2018 WL 485959, at *18 (observing the pattern in case law that golden shares are upheld if held by an equity holder and will be struck down if held by a creditor).

No golden share cases had been heard at a Circuit Court of Appeals until *In re FSNA*, and scholars and commentators were eager for a court to clear up the validity of the golden share.⁴⁷

D. *In re Franchise Services of North America, Inc.*

In re FSNA originated when Franchise Services of North America (FSNA), a large rental car company, decided to purchase Advantage-Rent-A-Car (Advantage) from the Hertz Corporation.⁴⁸ Investment bank Macquarie Capital (Macquarie) helped finance FSNA's purchase of Advantage.⁴⁹ Macquarie created a wholly-owned subsidiary, Boketo, to finance the transaction.⁵⁰ Boketo invested 15 million dollars in FSNA in exchange for one hundred percent ownership of FSNA's preferred stock and a new certificate of incorporation with a consent provision, requiring approval from both the preferred stock holders and common stock holders before FSNA could initiate any liquidation event.⁵¹ The following year, FSNA filed a voluntary petition for Chapter 11 Bankruptcy in the U.S. Bankruptcy Court for the Southern District of Mississippi.⁵² FSNA filed this petition "without requesting or securing the consent of a majority of its preferred and common shareholders."⁵³ Boketo and Macquarie filed a motion to dismiss based on FSNA's "failure to seek authorization."⁵⁴ FSNA argued that the consent provision violated public policy by restricting its right to file a voluntary petition.⁵⁵ After an evidentiary hearing, the bankruptcy court determined that the consent provision did not violate public policy.⁵⁶ The court also declined to consider

⁴⁷ See Vasser, *supra* note 1.

⁴⁸ *Franchise Servs. of N. Am., Inc. v. U.S. Trs. (In re Franchise Servs. of N. Am.)*, 891 F.3d 198, 203.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* ("Boketo's stake in FSNA would amount to a 49.76% equity interest if converted, making it the single largest investor in FSNA.").

⁵² *Id.* at 204.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* (describing FSNA's argument that the provision was an "invalid restriction").

⁵⁶ *Id.* (stating that the lower court found no violation of federal bankruptcy law).

whether the consent provision violated Delaware law because it was an issue of first impression and should be left to the Delaware courts.⁵⁷

The Fifth Circuit Court of Appeals accepted a direct appeal of the order with three certified questions: whether a golden share is valid and enforceable or contrary to federal public policy; whether a golden share held by a party that is both a creditor and equity holder is valid and enforceable or contrary to federal public policy; and whether Delaware law allows certificates of incorporation to contain a golden provision and, if so, does Delaware law impose a fiduciary duty on the holder.⁵⁸ The Court, however, narrowed its decision to a single issue: whether federal bankruptcy law prevents a *bona fide* equity holder from exercising its voting rights and blocking a corporation from filing a voluntary petition because it is also a creditor of the corporation.⁵⁹

The Court side-stepped the first question by determining that FSNA's charter provision was not a golden share.⁶⁰ It differentiated by noting that golden shares generally refer to shares given to creditors to prevent bankruptcy, while this was a charter provision giving preferred stockholders the right to vote on certain corporate issues.⁶¹ This differentiation allowed the Court to avoid answering whether golden shares are enforceable because *In re FSNA* was "not an advisory opinion, and our holding is limited to the facts actually presented in this case."⁶² The Court also declined to resolve the final issue—whether Delaware law and policy prohibit the structure—but suggested that Delaware would likely be tolerant of it, because Delaware courts should be left to make the determination.⁶³

After declining to answer the broad questions certified, the Court determined that "federal bankruptcy law does not prevent a *bona fide* equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition just because it also holds a debt owed by the corporation and owes no fiduciary duty

⁵⁷ *Id.* (explaining that the lower court preferred to have the Delaware courts decide the issue in the first instance).

⁵⁸ *Id.*

⁵⁹ *Id.* at 206.

⁶⁰ *Id.* at 205 (determining that Boketo's ownership of 100% of the preferred stock was not a golden share because golden shares involve the transfer of a "trivial number of shares" which carry the right to block bankruptcy).

⁶¹ *Id.*

⁶² *Id.* at 209.

⁶³ *Id.* at 211 (declining to consider the issue of Delaware law because no precedents exist in Delaware law).

to the corporation or its fellow shareholders.”⁶⁴ Still, many critical questions remain: whether provisions allowing creditors who are not equity holders of the company or creditors who only purchase equity as a ruse to block liquidation are prevented under federal law, whether Delaware courts will find these provisions contrary to public policy, and whether we will see an increase in creditors structuring financings this way.⁶⁵

E. Looking Forward

While many questions remain unanswered, aspects of the decision are telling for the future of the golden share. Creditors now have some assurance that bankruptcy blocking powers will not be held invalid merely because the creditor also has a claim against the debtor.⁶⁶ Creditors “should make every effort to demonstrate that it is a bona fide investor and that the consent right is a material condition to the investment” to boost their chances of having the provisions upheld.⁶⁷ Finally, the court’s determination that, despite the veto power, the creditor owed no fiduciary duty because it was merely a shareholder, is good news for creditors with provisions similar to that at issue in *In re FSNA*.⁶⁸ While the decision was narrow, the structure used in *In re FSNA* may prove to be a useful resource and “blueprint”

⁶⁴ *Id.* at 203.

⁶⁵ *Franchise Servs. of N. Am., Inc. v. U.S. Trs. (In re Franchise Servs. of N. Am., Inc.)*, 891 F.3d 198, 209 (5th Cir. 2018); see also Shmuel Vasser, *Opinion: Fifth Circuit Avoids Deciding the Enforceability of ‘Golden’ Shares*, *Asset Securitization Report*, AM. BANKER: ASSET SECURITIZATION REP. (May 31, 2018, 6:29 AM), <https://asreport.americanbanker.com/opinion/fifth-circuit-avoids-deciding-the-enforceability-of-golden-shares> [<https://perma.cc/3FZ4-DGBG>] (musing about the implications of *In re FSNA*, including whether and when public policy may be implicated).

⁶⁶ Sarah Borders et al., *Defining A Shareholder’s Bankruptcy Veto Power*, LAW360 (June 7, 2018, 1:19 PM), <https://www.law360.com/articles/1051203/defining-a-shareholder-s-bankruptcy-veto-power> (highlighting the significance of *In re FSNA* for creditors because investors now know bankruptcy consent provisions are not *per se* invalid).

⁶⁷ *Id.* (suggesting that investors should be comforted by this decision because *In re FSNA* suggest that these types of provisions will be upheld going forward).

⁶⁸ See *In re Franchise Servs. of N. Am.*, 891F.3d at 211, 214 (holding that the creditor did not qualify as a minority controlling shareholder and thus did not owe a fiduciary duty despite its bankruptcy blocking powers).

to other creditors looking to effectively retain bankruptcy veto power moving forward.⁶⁹

F. Conclusion

Creditors have been seeking an effective bankruptcy control tool for years. Mechanisms such as the prepetition waiver, the automatic stay waiver, the bad boy guarantee, and bankruptcy remote have all been tested and litigated by companies to varying degrees of success. In the last ten years, a new tool has emerged: the golden share. Prior to 2018, its enforceability was questionable and its usefulness unclear. The decision of the Fifth Circuit Court of Appeals in May 2018 was anticipated to clarify the obscurities surrounding the golden share. While the decision was not the sweeping answer some had hoped for, the ruling should leave creditors feeling confident about possible ways to structure bankruptcy control going forward. The enforceability of golden shares remains unclear, but *In re FSNA* provides a detailed explanation of another type of arrangement will best protect a creditor under federal law. The opinion also leaves the door open for exploration of other related issues: whether Delaware courts will be friendly to these sorts of arrangements, and whether a creditor with no equity stake will be able to utilize the golden share. As other creditors adopt the *In re FSNA* model, courts will likely develop broader and more clear-cut.

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⁶⁹ Jay Krystinik, *Fifth Circuit Affirms Dismissal of Bankruptcy Case Due to Lack of Corporate Authority to File (and Provides a Blueprint for Veto Powers over Bankruptcy Filings?)*, BRYAN CAVE LEIGHTON PAISNER LLP (Aug. 1, 2018), <https://bclpgrid.com/fifth-circuit-affirms-dismissal-of-bankruptcy-case-due-to-lack-of-corporate-authority-to-file-and-provides-a-blueprint-for-veto-powers-over-bankruptcy-filings> [https://perma.cc/5UGY-5S5R].

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