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Bankruptcy Remote Special Purpose Entities Are Not Necessarily Bankruptcy Proof

In *In re Lake Michigan Beach Pottawattamie Resort LLC.*,[1] Judge Timothy A. Barnes of the Northern District of Illinois addressed an issue that is crucial to many business transactions—to what extent are entities protected against a bankruptcy filing by restrictive provisions placed in the entities' organizational documents? The restrictions often include the creation of a special purpose entity ("SPE") which holds collateral, the appointment of an independent director of the SPE by the lender, and the requirement that all directors unanimously consent before the SPE can file a voluntary petition under the United States Bankruptcy Code.[2] This organizational structure is designed to ring fence the assets of the SPE from the claims of creditors other than the lender and is often a condition to the lender's willingness to make the loan. Although *Lake Michigan Beach* dealt with restrictions arising in connection with a loan workout rather than a structure created in connection with the origination of the loan, the principles discussed therein are applicable to all SPEs.

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The Facts

In January 2015, BCL-Bridge Funding LLC ("BCL") extended a $1.3 million term loan and a $500,000 line of credit secured by a mortgage on Lake Michigan Beach's vacation resort in Coloma, Michigan. The debtor defaulted in July 2015 and, in connection with a forbearance agreement, BCL required an amendment to the debtor's Operating Agreement which provided for the appointment of a Special Member who had the right to approve or disapprove any "Material Actions" taken by the debtor. Material Actions were defined to include the filing of a petition in bankruptcy. The Special Member had no interest in profits or losses of the debtor, no right to distributions and was not required to make capital contributions. Significantly, the amendment provided that, in exercising its rights, BCL was not obligated to consider any interests other than its own, and had "no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members."[3]

When the debtor failed to pay the obligations owed to BCL by the October 21, 2015 deadline specified in the forbearance agreement, BCL commenced a foreclosure action. The day before BCL was scheduled to conduct a non-judicial foreclosure sale under Michigan law, the debtor filed a petition for relief under

Chapter 11 of the Code based upon the consent of only the non-BCL Members. BCL moved to dismiss the petition as being filed in bad faith because it was filed on the eve of the foreclosure sale and because it was invalid as it lacked the consent of all of the members, including BCL as Special Member, as required by the Operating Agreement.

The Claim That The Petition Was Filed In Bad Faith

Regarding the claim that the petition was filed in bad faith and therefore should be dismissed pursuant to Code section 1112(b), Judge Barnes applied the 14 factors enumerated in *In re Tekena USA, LLC*[4] decided by the bankruptcy court in the Northern District of Illinois in 2009. Judge Barnes found that BCL distorted some of the facts to attempt to fit within *Tekena,* and also found that other factors were simply not applicable. Based upon *Tekena,* the court concluded that the petition was not filed in bad faith.[5]

The Validity of the Bankruptcy Filing

The court then turned to the issue of whether the petition was not validly filed because of the lack of consent of the Special Member. Because the debtor was formed in Michigan, the court concluded that Michigan corporate governance law must be applied to determine whether the filing constituted a valid corporate action.[6] The court also observed that under the terms of the original Operating Agreement and the amendments preceding the forbearance agreement imposed Third Amendment, the company was authorized to act pursuant to consent of a majority of the Sharing Ratios of the members (based upon capital interests in the company). The court noted that the bankruptcy would have been authorized prior to the Third Amendment. However, as BCL intended, the Third Amendment required that 100% consent was required for certain actions, including the filing of a voluntary bankruptcy petition. The court also noted that Michigan law permits provisions of the Operating Agreement to override the statutory default voting provisions of a majority of interests voting being required for valid entity action. Therefore, the validity of the Third Amendment under bankruptcy and Michigan law was the linchpin to whether 100% member consent was necessary for a properly filed bankruptcy petition.[7]

The Use of Blocking Directors

Turning to the Third Amendment, the court noted that the use of "blocking directors" in an entity's organization is a common device to prevent a borrower

from filing a voluntary bankruptcy petition absent the consent of the lender. Utilizing SPEs and restrictions in organizational documents to prevent unwanted bankruptcy filings is necessary, said the court, because outright contractual prohibitions on filings would likely be deemed void as against public policy,[8] citing *Citizens United*.[9] Also at play in the analysis is the bankruptcy law precept that corporate formalities and state corporate law must be satisfied in commencing a bankruptcy case.[10] Reconciling these two concepts, the court concluded that "the policy against contracting away bankruptcy benefits is not necessarily controlling when what defeats the rights in question is a corporate control document instead of a contract."[11]

Fiduciary Duties Apply

However, said the court, the blocking powers imbedded in organizational documents must be subject to the strictures of an independent director's or manager's fiduciary duties. Application of those duties may compel an independent director or manager appointed by a secured creditor to authorize a filing, even if that action is contrary to the secured creditor's interests. The court cited the *General Growth Properties*[12] chapter 11 cases, where that court, stated "If Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of the secured creditor, they are mistaken."[13] Building upon *General Growth Properties,* Judge Barnes said: "The essential playbook for a successful blocking director structure is this: the director must be subject to normal director 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 they were chosen by. BCL's playbook was, unfortunately, missing this page."[14]

Because the Third Amendment directed the Special Member to consider only its own interests and not those of the company or the other members, it ran afoul of Michigan's Limited Liability Company Act, which requires a manager to discharge his duties in a manner he believes to be in the best interests of the limited liability company. Consequently, the court concluded that the petition was properly filed because the Third Amendment violated both Michigan corporate governance and bankruptcy law, and therefore was void.[15]

Conclusion

The decision confirms that, while contractual prohibitions against seeking relief under the Code are likely void as against public policy, the insertion of restrictive

provisions in entity organizational documents empowering a director appointed by the secured creditor to potentially block a filing will be respected, so long as the special director acts in accordance with his fiduciary duties to act in the best interests of the entity. While the court makes clear that restrictive provisions which purport to override the requirement that a director fulfill his fiduciary duties will be void and unenforceable, it does not provide much guidance about the circumstances under which a special director must consent to a filing to fulfill those duties. The case nonetheless serves as a useful reminder that "bankruptcy remote" is not necessarily "bankruptcy proof."

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[1] *In re Lake Mich. Beach Pottawattamie Resort LLC.,* 547 B.R. 899 (Bankr. N.D. Ill. 2016).

[2] 11 U.S.C. §§ 101-1532 (hereinafter the "Code").

[3] *Id.* at 904.

[4] *In re Tekena USA, LLC,* 419 B.R. 341, 346 (Bankr. N.D. Ill. 2009). The factors are:

1. The debtor has few or no unsecured creditors.
2. There has been a previous bankruptcy petition filed by the debtor or a related entity.
3. The pre-petition conduct of the debtor has been improper.
4. The petition effectively allows the debtor to evade court orders.
5. There are few debts to nonmoving creditors.
6. The petition was filed on the eve of foreclosure.
7. The foreclosed property is the sole or major asset of the debtor.
8. The debtor has no on-going business or employees.
9. There is no possibility of reorganization.
10. The debtor's income is not sufficient to operate.
11. There is no pressure from nonmoving creditors.
12. Reorganization essentially involves the resolution of a two-party dispute.

13. A corporate debtor was formed and received title to its major asset immediately before the petition.

14. The debtor filed solely to create the automatic stay.

[5] *In re Lake Mich. Beach Pottawattamie Resort, LLC,* 547 B.R. at 909.

[6] *Id.*

[7] *Id.* at 911..

[8] *Id.*

[9] *Citizens United v. Fed. Election Comm'n,* 558 U.S. 310 (2010) (holding that corporate entities have been held to have, in certain instances, rights akin to those of natural persons).

[10] *In re Lake Mich. Pottawattamie Resort LLC,* 547 B.R. at 912.

[11] *Id.*

[12] *In re Gen. Growth Props., Inc.,* 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[13] *Id.* at 64.

[14] *In re Lake Mich. Beach Pottawattamie Resort, LLC,* 547 B.R. at 913.

[15] *Id.* at 914. In a case which follows *In re Lake Beach Pottawattamie* involving a blocking director provision in an LLC operating agreement pursuant to a forbearance agreement, U.S. Bankruptcy Judge Carey goes even further. A provision which gives a creditor power which is tantamount to a an absolute waiver of the right to file for bankruptcy is void as contrary to federal public policy, even if it is arguably permitted by state law. *See In re Intervention Energy Holdings, LLC,* Case No. 16-11247(KJC), 2016 WL 3185576 (Bankr. D. Del. June 3, 2016) at *6.