The Fifth Circuit is Asked to Consider the Validity of the 'Golden Share'

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PRACTICES Commercial Real Estate Leasing, Distressed Real Estate, Real Estate, Restructuring

As we described in our **client alert dated September 14, 2016**, in the aftermath of the real estate downturn from 1989 to 1993, when real estate mortgage lenders began to contemplate making new mortgage loans, they sought to create new legal structures to prevent their prospective borrowers from filing for Chapter 11, and to ameliorate the adverse consequences, if such a filing were to occur. One such structure is a device commonly referred to as the "Golden Share." The essence of this device is to provide the lender, at the time the loan is made, with a non-economic equity interest, whose affirmative vote would be necessary, and presumably not forthcoming, for its borrower to file Chapter 11 in order to stymie the lender's mortgage enforcement remedies following a loan default or maturity.

In our prior alert, we discussed the decision of the United States Bankruptcy Court for the District of Delaware in *In re Intervention Energy Holdings, LLC*, which refused to invalidate a bankruptcy filing made without the consent of its lender, and which held a "Golden Share" as void against federal public policy. As stated by the Bankruptcy Court in *In re Intervention Energy Holdings, LLC*:

> "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."

In re Intervention Energy Holdings, LLC, 553 B.R. 258, 265-66 (Bankr. D. Del. 2016) (emphasis added).

In December 2017, the United States Bankruptcy Court for the District of Mississippi issued a decision in *In re Franchise Services of North America, Inc.*, no. 1702316EE (Bankr. S.D. Miss., Dec. 18, 2017), which dismissed a bankruptcy filing made without the consent of a party holding a "Golden Share." In the context of real estate financing, a "Golden Share" is, in essence, designed to provide the lender, at the time the loan is made, with a non-economic equity interest, whose affirmative vote would be necessary, and presumably not forthcoming, for its borrower to file Chapter 11 in order to stymie the lender's mortgage enforcement remedies following a loan default or maturity. In January 2018, the Mississippi Bankruptcy Court certified the appeal of its decision directly to the United States Court of Appeals for the Fifth Circuit. The Fifth Circuit would be the highest court to consider the validity of "Golden Shares." While *In re Franchise Services of North America, Inc.* is not a decision in the real estate context, the decision (and the forthcoming ruling from the Fifth Circuit) is nonetheless important to those (especially those engage in real estate financing) who may seek to rely upon this device.

In 2013, prior to the commencement of its Chapter 11 case, Franchise Services of North America, Inc. ("FSNA"), then a Canadian company, acquired the Advantage rent-a-car business from Hertz through a multi-step M&A process orchestrated by Macquarie Capital (USA), Inc. ("Macquarie"). In simple terms, Boketo LLC ("Boketo"), which is 100 percent indirectly owned by Macquarie, invested $15 million for a preferred equity interest in FSNA and, in return, Boketo received all of FSNA's Class A Preferred stock which, if converted to common stock, would make Boketo the owner of 49.76 percent of FSNA's common stock. As part of the acquisition of Advantage, Macquarie was also entitled to receive advisory and arrangement fees from FSNA in the amount of $3 million (which was unpaid as of the petition date) and Boketo was entitled (and in fact) appointed several members to FSNA's board of directors.

In addition, FSNA was redomiciled as a Delaware corporation and its certificate of incorporation included a provision ("Section 4(j)") which required the affirmative vote of the holders of a majority of the Class A Preferred Stock and the holders of a majority of the holders of common stock in order to file a petition for bankruptcy. Accordingly, Boketo held a "golden share" and, as a matter of its corporate formation documents, was required to consent to any FSNA bankruptcy filing.

On June 26, 2017, FSNA filed a Chapter 11 petition in the Mississippi Bankruptcy Court along with an undated certificate of resolution from its board of directors authorizing the filing.[1] In August, 2017, Macquarie filed a motion seeking the dismissal of FSNA's Chapter 11 case for failing to gain the consent of Boketo as required under Section 4(j). Boketo, the holder of the Class A Preferred Shares, filed a joinder to Macquarie's motion. FSNA opposed the motions arguing, among other things, that any provision restricting the right of a company to file for bankruptcy is void as a matter of public policy. See *Response and Objection of Franchise Services of North America Inc. to the Motion of the Macquarie Parties to Dismiss the Chapter 11 Case and the Joinder of Boketo LLC*, Case No. 17-2316 at Docket No. 186, p. 21) (citing *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 262 fn. 2 (Bankr. D. Del. 2016); *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016); *In re Bay Club Partners-472, LLC*, Case no. 14-30394, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014)). As discussed below, the Mississippi Bankruptcy Court denied Macquarie's motion, but granted Boketo's motion to dismiss and enforced the validity of the "Golden Share."

The Mississippi Bankruptcy Court reviewed the seven (7) existing decisions, including that of the Delaware Bankruptcy Court in *In re Intervention Energy*, regarding the validity of "Golden Shares" and concluded that courts will uphold "golden shares" if it is held by an equity holder and not a creditor. *In re Franchise Services* at 11-18 (citing *In re Global Ship Sys., LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007); *In re Bay Club Partners-472, LLC*, Case no. 14-30394, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014); *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016); *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016); *In re Tara Retail Group, LLC*, Case no. 17-57, 2017 WL 1788428 (Bankr. N.D. W. Va., May 4, 2017); *In re Squire Court Partners Ltd. P'ship*, 574 B.R. 701 (Bankr. E.D. Ark. 2017); *In re Lexington Hospitality Group, LLC*, Case no. 17-51568, 2017 WL 4118117 (Bankr. E.D. Ky., Sept. 15, 2017)).

The Mississippi Bankruptcy Court first denied Macquarie's motion to dismiss because Macquarie was a pre-petition creditor of FSNA being owed $3 million on account of its advisory and arrangement fees. The Mississippi Bankruptcy Court determined, however, that, although Boketo was 100 percent indirectly owned by Macquarie, it wore only the hat of an equity holder on account of its Class A Preferred Shares which it received in exchange for its $15 million equity investment. The Mississippi Bankruptcy Court refused to view Macquarie and Boketo as the same entity despite Macquarie's acknowledgement that it completely controlled Boketo. The Mississippi Bankruptcy

Court reasoned that even if Boketo and Macquarie were one in the same, the result would not change. The Court stated, "Macquarie [is] wearing 'two hats.' Macquarie's one hat is as the creditor owed $3,000,000.00, and the other hat as the equity holder Boketo with a $15,000,000.00 stake in [FSNA]. '[S]ince [Macquarie] wears two hats in this case . . . it has the unquestioned right to prevent, by withholding consent, a voluntary bankruptcy case." *In re Franchise Services* at 20 (citing *In re Global Ship Sys., LLC*, 391 B.R. at 203).

In reaching its conclusion, the Mississippi Bankruptcy Court reasoned that the board of directors of FSNA acted in good faith and on an informed basis when it decided to grant the "golden share" to Boketo by incorporating Section 4(j) into its certificate of incorporation. See *In re Franchise Services* at 20-21. The Court further determined that, as a minority shareholder of a corporation, Boketo did not owe a fiduciary duty to FSNA or any of the members of the board of directors and could therefore vote in its own interest. See *In re Franchise Services* at 21-22. The Mississippi Bankruptcy Court then determined that Delaware law (specifically section 102(b)(1) of the Delaware General Corporations Law) permits a corporation to delegate authority to file for bankruptcy from the board of directors to an equity holder. See *In re Franchise Services* at 22-25.

Ultimately, the Mississippi Bankruptcy Court concluded as follows:

> The FSNA Board made the decision to take the authority to file for bankruptcy from the FSNA Board and give it to one if its substantial equity holders, Boketo. The Debtor failed to prove that [Section 4(j)] contravenes Delaware law and failed to provide the Court with case law which holds that a golden share/blocking provision is contrary to Delaware law. Consequently, the Court finds that [Section 4(j)] is not contrary to Delaware law and is valid.

In re Franchise Services at 26.

The Mississippi Bankruptcy Court essentially concluded that Macquarie's intent at the time it acquired the rights under the "golden share" was to protect its equity investment – and impliedly – not to protect Macquarie's potential unsecured claim. Likewise, its subsequent intent to enforce its "golden share" rights was on account of its Class A Preferred Shares and not its much smaller $3 million general unsecured claim. Indeed, at the time the Advantage transaction took place, no claim in favor of Macquarie had in fact accrued. This is factually distinguishable from *In re Intervention Energy Holdings, Inc.* and other cases which did not dismiss the pending bankruptcy cases, where a lender, at the time the loan was made, was also given a non-economic equity interest in the debtor as part of a restructuring of its existing debt and did not contribute funds for its equity stake.

The decision raises several interesting questions:

- What if Boketo was granted the "golden share" as part of an initial equity investment, but over a multi-year period Boketo provided loans to FSNA in excess of its equity investment to provide vital liquidity. Would the Mississippi Bankruptcy Court still have found that Macquarie was using its "equity hat" when relying upon its consent rights under the golden share?

- The Mississippi Bankruptcy Court's finding that Boketo was acting as a shareholder also suggests that "preferred shares" are in fact equity instruments although they sometimes have features similar to debt financing. Would the decision be different if the Class A Preferred shares had provisions that looked more like debt?

- The Mississippi Bankruptcy Court did not reach the question of whether the "golden share" is void as a matter of federal public policy (i.e. bankruptcy law) and, instead, found it was not

contrary to Delaware law. Will the Fifth Circuit take a view on whether federal policy is at issue and not just Delaware law?

Whether the Fifth Circuit Court of Appeals determines that “golden shares” are invalid per se or simply on these facts, its decision will be important to lenders in the real estate space which rely, in whole or in part, upon and seek to enforce its rights under a “golden share” to prevent its borrowers from filing a bankruptcy petition.

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[1] Prior to FSNA’s chapter 11 filing, the FSNA subsidiary that owned that Advantage rent-a-car assets had filed for bankruptcy, sold its assets and had its case dismissed.