The Fifth Circuit Renders Important Real Estate Lending Decision Regarding Golden Shares

*Lawrence Mittman and Geoffrey Raicht**

This article discusses a U.S. Court of Appeals for the Fifth Circuit decision affirming a bankruptcy court decision dismissing a Chapter 11 petition made without the consent of the majority of the holders of its Class A Preferred Stock, as required by the company's amended charter.

The U.S. Court of Appeals for the Fifth Circuit affirmed a bankruptcy court decision dismissing a Chapter 11 petition made without the consent of the majority of the holders of its Class A Preferred Stock, as required by the company's amended charter. Unlike the classic context in real estate financings where, at the time the loan is made, the lender is provided 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, here the holder of the Class A Preferred Stock, Boketo LLC, acquired its interest by making a $15 million investment into the company. At the same time the investment was made, the company's charter was amended to require Boketo's (as the holder of the majority of the Class a Preferred Shares) consent for any bankruptcy filing. The following year, Boketo's direct parent, Macquarie, asserted a $3 million claim against the company resulting from investment banking and consulting services. When the company determined it needed to file for Chapter 11, it did not seek Boketo's consent. Instead, the company filed the petition on the basis that the charter provision granting Boketo the right to consent to a bankruptcy filing was a "golden share" and void against public policy because Macqurie (Boketo's parent) also held a claim against the company.

The Fifth Circuit's decision was straight forward. "Federal law does not prevent a bona fide shareholder from exercising its right to vote against a bankruptcy petition just because it is also an unsecured creditor."

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However, the most important statement of this decision came in its first footnote:

> Our holding goes no further. This case involves a bona fide shareholder. The equity investment made by the shareholder at issue here was $15 million and the debt just $3 million. We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy where the equity interest is just a ruse.

We believe the Fifth Circuit's footnote to mean that had the facts been more like those in the classic real estate lending context of a lender receiving a "golden share" at the time the loan is made, as a means of thwarting a bankruptcy filing, the court might well have reversed the bankruptcy court and reinstated the Chapter 11 petition. Accordingly, we caution lenders from reading this decision as a rebirth of the golden share as the sole means of preventing a bankruptcy filing by its borrower.

Introduction

In 2016, the U.S. Bankruptcy Court for the District of Delaware refused to invalidate a bankruptcy filing made without the consent of its lender which held a "Golden Share" as void against federal public policy.[1] Then, in 2018, the U.S. Bankruptcy Court for the District of Mississippi (the "Mississippi Bankruptcy Court") dismissed a bankruptcy filing made without the consent of a party holding a "Golden Share."[2] The decision was appealed directly to the Fifth Circuit Court of Appeals and on May 22, 2018, the Fifth Circuit issued its opinion affirming the Mississippi Bankruptcy Court's dismissal of the Chapter 11 petition filed by Franchise Services of North America ("FSNA").[3] While these decisions are not in the real estate context, they are nonetheless important to those (especially those engage in real estate financing) who may seek to rely upon use of a "Golden Share."

The Fifth Circuit opinion posed a single question: "when the certificate of incorporation requires the consent of a majority of the holders of each class of stock, does the sole preferred shareholder lose its right to vote against (and therefore avert) a voluntary bankruptcy petition if it is also a creditor of the corporation?"[4] The Fifth Circuit declined to make any broad, sweeping statements regarding the general enforceability of "golden shares" or "blocking rights" in governance documents and, instead, issued a fact-driven and narrow opinion which simply held "[f]ederal law does not prevent a bona fide shareholder from exercising its right to vote against a bankruptcy petition just because it is also an unsecured creditor."[5] The Fifth Circuit immediately noted, "our holding goes no further. This case involves a bona fide shareholder. The equity investment made by the shareholder at issue here was $15 million and the debt just $3 million. We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy where the equity interest is just a ruse."[6]

Factual Background

To reach its conclusion, the Fifth Circuit distinguished the facts before it from those cases which have squarely held "golden shares" to be invalid. Therefore, an understanding of the key facts is critical.

In 2013, prior to the commencement of its Chapter 11 case, FSNA 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"), who 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 to appoint several members to FSNA's board of directors.

At the time of the transaction, FSNA (originally a Canadian company) 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, 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. In August 2017, Macquarie (as creditor) and Boketo (as the holder of the Class A Preferred Shares) filed motions seeking the dismissal of FSNA's Chapter 11 case for failing to gain the consent of Boketo as required under Section 4(j).

The Mississippi Bankruptcy Court granted Boketo's motion to dismiss concluding that courts will uphold "golden shares" if it is held by an equity holder and not a creditor. Although Boketo was 100 percent indirectly owned by Macquarie who was owed $3 million on account of advisory fees, Boketo 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 further opined 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. 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.[7]

Oral Argument

At oral argument before the Fifth Circuit, Judges Graves, King and Jones intensely questioned FSNA about whether Boketo's conduct was improper since (1) it did not have any fiduciary duties as a minority shareholder; and (2) was entitled to negotiate the terms it would make a $15 million investment into FSNA including the rights granted to it under the charter. Much of the discussion with FSNA focused around Judge Jones' observation that FSNA did not comply with corporate formalities and never afforded Boketo the opportunity to consent to the bankruptcy filing—it was only told contemporaneous with the filing. During its presentation, Boketo acknowledged that public policy prohibits making a pre-petition

agreement for a company not to file for bankruptcy. However, based on the facts by which Boketo acquired its equity interest (in exchange for $15 million cash), Boketo argued that no such agreement existed here.

Analysis of the Fifth Circuit Opinion

As noted above, the Fifth Circuit narrowly stated the issue before it as "whether U.S. and Delaware law permit the parties to . . . amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition."[8] With respect to U.S. law, the Fifth Circuit cited those cases which have consistently held that a "pre-petition waiver of the benefits of bankruptcy is contrary to federal law and therefore void."[9] This case, the Fifth Circuit stated, "does not involve a contractual waiver of the right to file for bankruptcy . . . Instead, this case involves an amendment to a corporate charter, triggered by a substantial equity investment, that effectively grant[ed] a preferred shareholder the right to veto the decision to file for bankruptcy."[10] There was no evidence, the court observed, that Boketo's Class A shares were issued as a "ruse to ensure that FSNA would pay Macquarie's [$3 million claim]."[11] Rather, the shares were issued to Boketo in exchange for a $15 million cash investment and, the following year, Macquarie issued an invoice for its unpaid fees.[12] The Court concluded "[t]here is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill."[13]

Therefore, this case was not akin to the "slew" of bankruptcy court cases involving "arrangements whereby a lender extracts an amendment to the organization's foundational documents granting the lender a veto right in exchange for forbearance."[14] With respect to whether Delaware law allows Boketo to exercise a "blocking right" or "golden share," the Fifth Circuit sought to answer two questions: (1) Whether Delaware law allows parties to provide in the certificate of incorporation that the consent of both classes of shareholders is required to file a voluntary petition for bankruptcy?; and (2) whether Delaware law would impose a fiduciary duty on a minority shareholder with the ability to prevent a voluntary bankruptcy petition?[15]

The Fifth Circuit noted that while there were no Delaware cases on point regarding the first question, FSNA had waived the argument on appeal. However, for these purposes, the Fifth Circuit assumed that Delaware law would allow parties to provide in the certificate of incorporation that the consent of both classes of shareholders is required to file a voluntary petition for bankruptcy.[16] Likewise, the Fifth Circuit declined to impose a fiduciary duty on a minority shareholder under Delaware law, who does not otherwise exert control over the business affairs of the company. In such cases, as was present here, the shareholder is free to act in its self-interest.[17] The Fifth Circuit rejected FSNA's argument that Boketo exercised control over FSNA by virtue of its ability to prevent a voluntary bankruptcy filing. The Fifth Circuit noted that the argument was hypothetical since Boketo was never in fact asked for its consent. Finally, the Fifth Circuit noted that any claim for breach of fiduciary duty is not cured by reversal of the Mississippi Bankruptcy Court's decision. Rather, FSNA's

remedy would be to bring a claim under state law in state court.

NOTES:

[1]*See In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 62 Bankr. Ct. Dec. (CRR) 179 (Bankr. D. Del. 2016).

[2]*See In re Franchise Servs. of N. Am., Inc.*, No. 1702316EE, 2018 WL 485959 (Bankr. S.D. Miss. Jan. 17, 2018), aff'd, 891 F.3d 198 (5th Cir. 2018).

[3]*See In re Franchise Servs. of N. Am., Inc.*, 891 F.3d 198 (5th Cir. 2018).

[4]Fifth Circuit Opinion at 1–2.

[5]*Id.* at 2.

[6]*Id.* at n.1.

[7]*In re Franchise Services* at 26.

[8]*Fifth Circuit Opinion* at 8.

[9]*Id.* at 9 (citations omitted).

[10]*Id.* at 10.

[11]*Id.* at 11.

[12]*Id.*

[13]*Id.* at 12 (citations omitted).

[14]*Id.* at 10 (citing *In re Lexington Hospitality Group, LLC*, 577 B.R. 676, 679–81, 684–86, 688 (Bankr. E.D. Ky. 2017) (denying motion to dismiss where lender conditioned financing on grant of equity interest and appointment of non-fiduciary blocking director with right to prevent bankruptcy); *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 at 261, 266 (Bankr. D. Del. 2016) (denying motion to dismiss where lender conditioned forbearance on issuance of single common unit in exchange for $1 and amendment of operating agreement to require unanimous consent for bankruptcy); *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 at 903–04, 911–15 (Bankr. N.D. Ill. 2016) (denying motion to dismiss where lender conditioned forbearance on appointment of lender as nonfiduciary "special member" with right to prevent bankruptcy but without right to distributions or obligation to make capital contributions); *In re Bay Club Partners-472, LLC*, No. BR 14-30394-RLD11, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014) (denying motion to dismiss where lender requested provision in operating agreement prohibiting filing voluntary petition before all debts were paid in full).

[15]*Id.* at 15.

[16]*Id.* at 15–16.

[17]*Id.*