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Golden Shares or Simply Gold Plated?

By

Penelope Parmes & Hugh McDonald

Is it possible for a creditor to block a company from filing bankruptcy? In two recent court decisions (Delaware and Illinois), the debtor companies were allowed to file for bankruptcy relief over the objection of creditors who held blocking votes.

Special purpose entities (commonly referred to as SPEs) are frequently created as part of various types of financing transactions -- from real estate loans to more complex securitization structures. The benefits of utilizing such entities are widely understood, such as asset isolation and the attendant lower borrowing costs. These entities are eligible to file for relief under US bankruptcy laws. Lenders try to eliminate this risk by having borrowers structure the entities in ways that make it difficult or impossible for the entity to file for bankruptcy. One structure is when the lender is given equity interests, with the SPE agreeing that all shareholders/members must consent to a bankruptcy filing. This blocking right is referred to as a "Golden Share". In theory, if the company files for bankruptcy, the non-consenting holder of the Golden Share can seek dismissal of the case based on the bylaws and shareholder agreements.

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In the two recent cases, the bankruptcy courts concluded that Golden Share provisions were unenforceable as violations of public policy**.** The Delaware court explained that "[a] provision in a … governance document …, the sole purpose 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 … is tantamount to an absolute waiver of that right, and … is void as contrary to federal public policy." *In re Intervention Energy Holdings, LLC,* No. 16-11247, 2016 WL 3185576 at 5 (Bankr. D. Del. June 3, 2016).

Two critically important public policies are implicated in these cases – the fiduciary obligations of corporate leaders and the constitutionally authorized ability to seek federal bankruptcy relief. The ability of one equity holder to block the exercise of these duties, as well as the right to seek bankruptcy protection, is what the courts found the most troubling in each situation. However, where a creditor has an equity interest separate from the debt, a court might view the parties' interests as being more aligned and enforce a Golden Share provision. Or, where the agreement is entered into prior to the borrower facing financial distress, a court may view the transaction more favorably as the parties will have more equal bargaining power.

Further, borrowers may now have persuasive authority to challenge agreements that limit exercise of fiduciary duties by directors or members, which otherwise exist under state law. For example, if a director (who is also a creditor) uses her/his blocking vote to prevent the company from filing for bankruptcy, this too may be considered a violation of public policy – as well as a breach of fiduciary duty by the director.

While these decisions may be viewed as another step down the road in a series of cases frustrating efforts to make entities bankruptcy-proof, the benefits of utilizing special purpose entities in financing transactions still outweigh this additional risk, which can, and likely will, be priced into the deals. These decisions also raise the bar for lenders and their counsel to generate more creative techniques to provide lenders with assurances that their borrowers will not file bankruptcy.

Penelope Parmes is a partner in the firm's Orange County office where she practices all aspects of restructuring including workouts, bankruptcy and related issues and bankruptcy-related litigation. She can be reached at 949.622.2714 orpenelope.parmes@troutmansanders.com.

Hugh McDonald is a partner in the firm's New York office and focuses his practice on all aspects of restructuring including workouts, bankruptcy and related issues and bankruptcy-related litigation. He can be reached at 212.704.6281 or hugh.mcdonald@troutmansanders.com.

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