Recent Court Decision Highlights That Not All ‘Golden Shares’ Are Created Equal

Client Advisories

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All too often in business-partner disputes, one partner threatens to place the company into bankruptcy without the consent of the other partners. Does such a threat really have any “teeth?” A recent decision from the United States Bankruptcy Court for the District of New Jersey provides some guidance. The Court dismissed a chapter 11 debtor’s bankruptcy case because, under the term of the company’s operating agreement, the debtor lacked the requisite corporate authority to file bankruptcy. The case provides an interesting look into the way courts view so-called “golden share” provisions, which give certain creditors the power to block a company from filing for bankruptcy.

In In re 3P Hightstown, LLC, --- B.R. --- (Bankr. D.N.J. 2021), the sole common member and manager of 3P Hightstown, LLC filed a voluntary petition under chapter 11 to stop certain creditors from commencing or continuing actions against the company. Shortly thereafter, the alleged holder of the company’s preferred equity interests, Hightstown Enterprises, LLC, moved to dismiss the case on the grounds that the company’s operating agreement specifically required consent of preferred equityholders before a voluntary bankruptcy petition could be filed. Hightstown contended, and the manager did not dispute, that the manager had never obtained – or even sought – such consent, and that the case should be dismissed on that basis alone.

The parties disputed whether Hightstown had standing to move to dismiss the case, but the Court ultimately concluded that the issue was immaterial because section 1112(b) of the Bankruptcy Code vests the Court with the authority to dismiss a case *sua sponte* provided “cause” was established. Alternatively, the Court held that section 1112(b) was not even necessary to its determination because, “should a court find that a debtor, who acts on behalf of a corporation, filed bankruptcy without the prerequisite authority, ‘the Court ... would be required to dismiss [that] unauthorized filing even if § 1112(b) were not in the Bankruptcy Code.’” The Court concluded that the manager’s failure to obtain consent from the preferred equityholder was in plain violation of the terms of the company’s operating agreement.

That did not end the Court’s analysis. The Court recognized that some courts, such as the bankruptcy courts in the Eastern District of Kentucky and District of Delaware, had “stricken similar contractual provisions which inhibit or preclude the ability to file for bankruptcy" as a result of a public policy consideration that the right to file bankruptcy should not be impeded or abrogated. However, other courts, such as the Fifth Circuit Court of Appeals, have upheld a freely negotiated provision requiring minority shareholder consent to commence bankruptcy proceedings, even where that minority shareholder was also a creditor. The Court considered these decisions and determined that the proper framework for the broader public policy analysis was to weigh the constitutional right of a party to avail itself of the right to file bankruptcy against that same party's right to freely contract and negotiate with creditors and other stakeholders.

In this case, the Court determined that the provision of the operating agreement requiring consent controlled, and therefore the manager needed to obtain the preferred equityholders' consent before filing for bankruptcy. Because the manager did not do so, the Court dismissed the case. The Court distinguished the operative provision from a "golden share" situation where creditors seek to prevent bankruptcy filings in exchange for forbearance or additional financing, because in this case, the preferred equityholder of the company simply received certain protections in the form of amendments to the operating agreement *at the time of its equity investment in the company*, as opposed to in connection with a default sometime thereafter.

The 3P Hightstown decision serves as an important reminder that, notwithstanding a recent trend among courts to look to public policy grounds in order to invalidate "golden share" provisions in favor of lenders exercising post-default leverage, members of an LLC must otherwise comply with the terms of their operating agreements. If parties freely contract for certain protections, including bona fide equityholders' consent as a prerequisite to filing bankruptcy, then in certain circumstances, such provisions will be respected under applicable state law. A member – even managing member – purporting to act on behalf of the LLC who fails to obtain such consent risks the bankruptcy case being dismissed as a result.

For questions on bankruptcy and corporate restructuring, and debtor/creditor rights, please contact Douglas Leney at 215-246-3151 or dleney@archerlaw.com.

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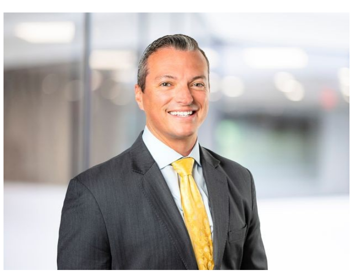

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