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Safety for Bankruptcy Remote Entities

After Franchise Services?

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"No statute or binding case law licenses this court to ignore corporate foundational documents, depriving a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor." In re Franchise Servs. of North America, Inc., 891 F.3d 198 (5th Cir. 2018).

While sounding like an endorsement of golden shares, a careful reading of the case will not be of comfort to structured finance creditors. Judge King in Franchise Services deftly distinguished the line of cases we wrote about two years ago. See In re Lake Mich. Beach Pottawattamie Resort, LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016) and In re Intervention Energy Holdings, LLC, 553 B.R. 676 (Bankr. D. Del. 2016); See also In re Lexington Hospital Group, LLC, 577 B.R. 676 (Bankr. E.D. Ky. 2017) and In re Bay Club Partners – 472, LLC, No. 14-30394-rld11, 2014 Bankr. LEXIS 2051 (Bankr. D. Or. May 6, 2014). All of these cases denied motions to dismiss a Chapter 11 petition by invalidating blocking director or golden share provisions in situations where the debtor and the creditor had intentionally arranged the capital stack prepetition, finding either an impermissible waiver of fiduciary duties under state law, or a violation of federal public policy in waiving the right to file, or both.

The facts in Franchise Services were different. Franchise Services acquired Advantage Rent-A-Car in 2012 and utilized a $15 million investment by Macquarie Capital through its sub, Boketo LLC, which received 100% of the preferred stock class in exchange. In May 2013, Franchise Services reincorporated in Delaware with articles of incorporation requiring both the common and preferred stock series to approve any bankruptcy petition. Franchise Services did not pay Macquarie's arrangement and financial advisory fees after the merger closed. Advantage soon went bankrupt, and other difficulties led Franchise Services to file a petition in 2017, based on a board of director's resolution without obtaining consent of both classes of shares as required by its articles.

The debtor argued that Boketo and Macquarie were one and the same, and because they were a creditor holding a blocking position, this violated either Delaware state law or federal public policy. The court declined to answer a certified question regarding the general enforceability of blocking provisions or golden shares, instead looking at the narrower question of state law applied to the facts of the case. The court distinguished the line of cases discussed above, finding those were all situations where a lender extracts an amendment to the organizational foundational documents granting a lender veto rights in exchange for forbearance and without any true equity. In Franchise Services, the shareholder made a real and substantial capital investment in the debtor and acquired rights as a controller of a class of shares which were not necessarily void under Delaware state law. The court found that Boketo/Macquarie put on a second hat as unsecured creditor sometime after the investment when it became apparent that debtor was not going to pay the $3 million arrangement fee. The court stated "There is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to

prevent a voluntary bankruptcy filing just because a shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill." The court further found that Delaware law is flexible and allows equity holders to make their own arrangements in the governing documents. The court declined to resolve whether the consent provision violated Delaware law, because the debtor had waived that argument in the bankruptcy court's earlier hearing. The court also disposed of the argument that Boketo owed a fiduciary duty to the debtor as a controlling minority shareholder.

The takeaway is that golden share or blocking director positions are not automatically invalidated because the shareholder is also a creditor, if that shareholder made a real equity investment in the debtor and did not abuse its position by ignoring fiduciary duties or using the golden share as a "ruse" to ensure payment of its secured claim. At the same time, Franchise Services is not a blanket endorsement of golden share arrangements. The court's dismissal of the petition was consistent with Delaware state law since the articles of incorporation were ignored by the officers and directors of the debtor in filing the petition, and there was no arrangement which violated state law or federal public policy through the waiver of fiduciary duties or rendering a bankruptcy impossible ab initio. Structured finance practitioners will have to continue to thread the needle to make sure that blocking directors continue to be subject to normal director fiduciary duty standards as applicable under state law, or that the use of a golden share is for a bona fide investment, and not a sham.