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SPECIAL BULLETIN

In Re Franchise Services of North America, Inc.: The Fifth Circuit Explores Restrictions on Bankruptcy Filing

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The authority to file a bankruptcy petition for a company is generally governed by state law and the company's organizational documents. As a matter of public policy, creditor-imposed contractual restrictions on the right to file bankruptcy are generally not enforceable.[1] Creditors have long sought to devise workarounds, with limited success. These include the use of independent directors whose vote is required to authorize a bankruptcy filing of the company, as well as the so-called "golden share," a class of equity issued to the creditor, typically with only de minimis value, but granted the right to withhold consent to a bankruptcy filing.[2] In its recent ruling in *In re Franchise Services of North America, Inc.*,[3] the United States Court of Appeals for the Fifth Circuit held that an investor was not prevented from exercising its voting rights to prevent a corporation from filing for bankruptcy, even though that investor was controlled by a creditor of the company. However, the ruling is not a general stamp of approval for the "golden share" or other "blocking position" creditor strategies – in fact, the court was careful to point out that it did not view the case as involving a golden share at all. The court limited its holding to the facts presented; namely, that the creditor-affiliated shareholder made a $15 million equity investment, whereas its creditor/parent was owed only $3 million from the company.

Franchise Services of North America ("FSNA"), the debtor, had been one of the leading rental car companies in North America. Macquarie Capital (U.S.A.) ("Macquarie") incurred advisory fees totaling approximately $3 million in assisting FSNA with a merger and the acquisition of various competitors. To help finance these transactions, Macquarie created a fully-owned subsidiary, Boketo, LLC ("Boketo"), to make a $15 million preferred equity investment in FSNA. This made Boketo the single largest investor in FSNA.

As a condition of the investment, FSNA reincorporated in Delaware and adopted a new certificate of incorporation, requiring the consent of a majority of each class of the debtor's common and preferred shareholders to "effect any

[1] *See Price v. Gurney*, 324 U.S. 100, 106 (1945).
[2] *See In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 261-62 (Bankr. D. Del. 2016); *In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899, 911 (Bankr. N.D. Ill. 2016).
[3] *In re Franchise Servs. of N.Am., Inc.*, 891 F.3d 198 (5th Cir. 2018).

Liquidation Event."[4] In other words, Boketo, as the sole preferred shareholder with 49.76% equity interest in FSNA, possessed a right to withhold consent on order to block a voluntary bankruptcy filing by FSNA.

As a result of a financially-disastrous acquisition, FSNA filed a voluntary chapter 11 bankruptcy petition, without seeking or obtaining the consent of Boketo. As a result, both Macquarie and Boketo filed a motion to dismiss the bankruptcy petition as an *ultra vires* filing.

FSNA argued that the shareholder consent provision was invalid and that Macquarie was "a wolf in sheep's clothing."[5] Macquarie, according to FSNA, was a creditor that was masquerading as a *bona fide* equity owner through its control of Boketo. The bankruptcy court granted Boketo's motion to dismiss because it found that "conditioning FSNA's right to file a voluntary petition on Boketo's consent was not contrary to federal bankruptcy policy"[6] or to Delaware law.

On FSNA's motion, the bankruptcy court then certified a direct appeal to the Fifth Circuit on three questions:

> "1. Is a provision, typically called a blocking provision or a golden share, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy valid and enforceable or is the provision contrary to federal public policy?
>
> 2. If a party is both a creditor and an equity holder of the debtor and holds a blocking provision or a golden share, is the blocking provision or golden share valid and enforceable or is the provision contrary to federal public policy?
>
> 3. Under Delaware law, may a certificate of incorporation contain a blocking provision/golden share? If the answer to that question is yes, does Delaware law impose on the holder of the provision a fiduciary duty to exercise such provision in the best interests of the corporation?"[7]

The Fifth Circuit declined to address the first question regarding the general validity or enforceability of golden share provisions. However, the Fifth Circuit did determine under question two that "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."[8] The court held that "it strains credulity"[9] that Macquarie would, through Boketo, make a $15 million equity investment so that Macquarie could collect on its $3 million claim. There was no other evidence that the arrangement between Macquarie and Boketo was simply a ruse for Macquarie to collect on the $3 million claim. But the court did specify that this was limited to the facts as presented, and that a different result would be possible in a case where, for example, "a creditor with no stake in the company held the right"[10] or where "there was evidence that a creditor took an equity stake simply as a ruse to guarantee a debt."[11]

On question three, the court declined to resolve if under Delaware law a certificate of incorporation can contain a golden share provision. In addition, the court held that Boketo would not qualify as a controlling minority shareholder under Delaware law. To qualify as a controlling minority shareholder, Boketo would have to exercise "actual control" and "dominate" FSNA. The shareholder's command over a board would have to be so powerful that independent directors would fear exercising their own judgement for fear of retaliation. There also must be evidence demonstrating this control. Boketo did not have "actual control" simply by virtue of being able to prevent the board of FSNA from filing for

4 *Id.* at 203.
5 *Id.* at 207.
6 *Id.* at 204.
7 *Id.*
8 *Id.* at 203.
9 *Id.* at 208.
10 *Id.* at 209.
11 *Id.*

bankruptcy. As the court held that Boketo was not a controlling shareholder, the court did not need to decide if Boketo breached a fiduciary duty.

While at first glance *In re Franchise Service of North America, Incorporated* could be viewed as a favorable decision for creditor bankruptcy blocking strategies, the decision is limited to an unusual set of facts, in which the creditor indirectly held a bona fide equity position that was five times larger than its claim.

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