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Fifth Circuit Allows Shareholder-Creditor To Block Bankruptcy Filing

On May 22, 2018, the U.S. Court of Appeals for the Fifth Circuit (the "Court") upheld a bankruptcy court's ruling that a shareholder could exercise the right granted to it in the debtor's organizational documents to block a bankruptcy filing even though the shareholder was also a creditor of the debtor.[1] The holding is important because the fact that an investor also holds a claim against the company will not, in and of itself, invalidate a bankruptcy-consent provision found in a debtor's organizational documents.

BACKGROUND AND THE BANKRUPTCY COURT DECISION

Franchise Services of North America ("FSNA") was once one of the biggest North American car rental companies. In 2012, FSNA purchased a subsidiary of Hertz Corporation—Advantage Rent-A-Car ("Advantage"). To finance the transaction, FSNA issued $15 million of preferred stock to Boketo, LLC (the "Investor"). The Investor's stake in FSNA would amount to a 49.76% equity interest if converted to common stock, making it the single largest investor in FSNA and the sole preferred shareholder. As a condition of the investment, FSNA reincorporated in Delaware and adopted a new certificate of incorporation—providing that FSNA could not file for bankruptcy without the approval of a majority of holders of each class of stock. Such arrangements are commonly referred to as "blocking provisions" or "golden shares."

In June 2017, FSNA filed a voluntary petition for chapter 11 bankruptcy relief with the Southern District of Mississippi (the "Bankruptcy Court"). However, FSNA failed to obtain or even request shareholder consent for the bankruptcy filing.

The Investor filed a motion to dismiss the bankruptcy petition, arguing that FSNA lacked corporate authority to file for bankruptcy because the Investor had not consented. The Investor also held an unsecured claim against FSNA in the amount of $3 million. FSNA argued that the consent provision was void as a matter of public policy because it effectively gave a

creditor the ability to block the bankruptcy filing.[2] The Bankruptcy Court determined that the consent provision was valid and did not violate public policy and granted the motion to dismiss. FSNA then appealed to the U.S. Court of Appeals for the Fifth Circuit.

DECISION ON APPEAL

Preliminarily, the Court rejected the Bankruptcy Court's request that it opine regarding the legality of blocking provisions and golden shares generally. Instead, the Court confined its analysis to whether federal and Delaware law permitted the enforcement of a corporate charter provision requiring the affirmative vote of a shareholder, that also happens to be an unsecured creditor, to authorize a voluntary bankruptcy filing. The Court noted that state law determines who has the authority to file a voluntary petition on behalf of a corporation. Where a petitioner lacks corporate authority under state law, a bankruptcy court must dismiss the petition. FSNA argued that federal law prohibits the enforcement of the consent provision in the charter arrangement because it violates the federal public policy against relinquishing the protections of the Bankruptcy Code.

Noting that the case did not involve the contractual waiver of the right to file for bankruptcy, the Court found that the Investor was a legitimate equity investor. The Court distinguished this case from those where a lender extracts an amendment to a borrower's organic documents granting the lender a veto right over a bankruptcy filing. Unlike those cases, there was no evidence here that the Investor's equity investment was merely a ruse to ensure that the debt would be paid—in fact, the equity investment was five times the size of the Investor's claim. Accordingly, the Court held that bankruptcy law would not invalidate the preferred equity holder's consent right (even where the holder also happens to be a creditor).

Still, FSNA maintained that even if a shareholder-creditor could hold a bankruptcy veto power, the exercise of such right in this instance constituted a breach of fiduciary duties. Rejecting this theory, the Court concluded that, under Delaware law, the Investor did not owe fiduciary duties to FSNA because it did not constitute either a majority shareholder or a minority controlling shareholder. The Investor's equity stake was less than 50%, and the Investor only had the ability to appoint two members of a five-member board of directors. Moreover, even assuming the Investor owed a fiduciary duty to the company or other shareholders, permitting the bankruptcy case to proceed in contravention of the provisions of the certificate of incorporation would not be the appropriate remedy for a breach of those duties.

CONCLUSION AND LESSONS LEARNED

This case should give comfort to investors that seek to negotiate consent rights with respect to a bankruptcy filing. The fact that the investor also holds a claim against the company will not, in and of itself, invalidate the bankruptcy-consent provision. Still, the Court expressly limited its decision to the facts presented—holding simply that federal bankruptcy law does not prevent a *bona fide* equity holder from exercising its voting rights to prevent a bankruptcy filing just because it is a creditor. As noted above, the debt at issue, $3 million, followed a much more substantial equity investment of $15 million in FSNA. It is unclear whether the Court's decision would have been the same if the Investor's debt claim was substantially larger than the equity investment.

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[1] The unsecured claim was in fact held by a separate affiliate of the Investor. However, the Court treated them as a single entity for purposes of its analysis.