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Bankruptcy Court Declines to Enforce Right of Minority LLC Member of Real Estate Holding Entity to Block Chapter 11 Filing

On October 31, 2021, PWM Property Management LLC and eight of its affiliates (collectively, "PWM" or the "Debtors") filed chapter 11 petitions in the United States Bankruptcy Court for the District of Delaware.[1] The Debtors hold direct or indirect interests in two real properties—245 Park Avenue in New York City ("245 Park") and 181 West Madison Street in Chicago (the "Chicago Property"). S.L. Green Management Corp. (collectively with its affiliates, "SL Green") was the property manager at 245 Park, a minority owner in one Debtor, and a mezzanine lender to another. HNA, a Chinese real estate conglomerate, is the majority owner of the Debtors and of the entity which favored a chapter 11 filing for the Debtors.

SL Green moved to dismiss all the chapter 11 filings on two grounds: the bankruptcy petitions were not properly authorized and were not filed in good faith. SL Green argued that HNA improperly empowered two newly appointed Independent Agents of the Debtors to authorize the bankruptcy filing and, more importantly, that the limited liability company agreement governing the Debtor in which SL Green was a minority member specifically required the SL Green member's consent to authorize a bankruptcy filing, which consent was not obtained. SL Green also argued that the solvent Debtors were not experiencing financial distress and had filed for chapter 11 protection (and moved to reject the management agreement for 245 Park) as leverage in a two-party dispute with SL Green, and thus had not filed for bankruptcy in good faith.

SL Green's motion to dismiss highlights a tension, addressed in a series of bankruptcy cases over the last decade, between two fundamental principles of bankruptcy law: (1) an entity must have proper corporate authority under its organizational documents to seek bankruptcy relief; and (2) prepetition agreements that prospectively prohibit bankruptcy filings may be void as against public policy, depending on the facts and circumstances in which they are invoked.

In what it called a "close decision," the bankruptcy court denied the motion to dismiss. The bankruptcy court did not dispute that the relevant limited liability company agreement required SL Green to consent to a bankruptcy filing of one of the Debtors and noted that, generally, a corporate entity's action contravening the authority in its constituent agreements is void. However, the bankruptcy court considered the public policy of promoting access to bankruptcy relief and balanced the right of a business to file for bankruptcy against any limits in its governing agreements on the corporate authority to do so. The bankruptcy court deemed such a balancing appropriate because SL Green was both a creditor

and equity owner of the Debtors, and had structured its equity investment, and control over PWM's ability to file for bankruptcy, primarily to protect its creditor status. The bankruptcy court concluded that SL Green could not invoke its rights, as an equity holder, under a limited liability agreement to defend its interests, as a creditor, to block the Debtors' bankruptcy filings. The bankruptcy court also found that PWM was in genuine financial distress and that the Independent Agents HNA had appointed days prior to the chapter 11 filings had sought bankruptcy protection in good faith.

SL Green has appealed the bankruptcy court's decision.

Background

PWM stated that its bankruptcy filing resulted from the effects of COVID-19 on the economy and commercial real estate markets, and mismanagement of 245 Park by SL Green. PWM alleged that SL Green let occupancy rates decline and failed to replace a major tenant set to vacate in 2022. PWM charged that SL Green's management of and interests in other commercial buildings in Manhattan incentivized it to not find new tenants for 245 Park. Additionally, the failure to locate new tenants would permit 245 Park's mortgage lenders to exercise certain cash dominion rights, leading to an accelerated mandatory redemption of SL Green's equity in the Debtors. Failure to make such redemption—a certainty given PWM's liquidity situation—would have triggered either a forced sale of 245 Park controlled by SL Green or multi-party litigation. HNA, relying on provisions in a limited liability company agreement (to which SL Green was a party) that authorized the majority member to appoint officers, hired two Independent Agents to assist the Debtors. These Independent Agents authorized the bankruptcy filing two days after their engagement. PWM also filed a motion to reject its management agreement with SL Green and replace it with the manager of the Chicago Property.

SL Green's pleadings and statements in court told a different story. SL Green, which had made a $141 million preferred equity investment in the Debtors, alleged that the Debtors were not in financial distress. SL Green noted that the Debtors have no operations or employees, and existed solely to own real property (or direct or indirect interests in the property-owning company) and issue mezzanine debt. SL Green highlighted its reputation as a top property manager and asserted that the vacancies at 245 Park resulted from the Debtors' failure to improve the property to make it attractive to tenants or competitive with other properties. SL Green charged that the Debtors filed for chapter 11 in bad faith to strong-arm SL Green in a two-party dispute over property management and SL Green's bargained-for rights to redeem its preferred stock and sell 245 Park, and that the allegations of a conflict of interest were merely an attempt to shift the blame for the chapter 11 cases away from where it belonged, on the Debtors.

The Motion to Dismiss

In its motion to dismiss, SL Green argued that the Debtors did not obtain the requisite consents to commence their chapter 11 cases.[2] SL Green made its preferred equity contribution into one of the Debtors, 245 Park JV LLC, a joint venture between SL Green and HNA (the "JV Debtor"). SL Green alleged that the limited liability company agreement of the JV Debtor required SL Green's approval for any "Major Decision" and that the definition of "Major Decision" includes: (i) filing any petition that would subject the JV Debtor or its subsidiaries to bankruptcy proceedings; (ii) terminating property management agreements; and (iii) engaging professionals to render services for the JV Debtor or its subsidiaries. SL Green cited Supreme Court precedent showing that a bankruptcy petition filed without legal authority must be dismissed, as well as Delaware case law indicating that corporate actions taken without authority under a company's organizational documents are voidable.

SL Green also noted that prior to the Debtors' bankruptcy filings HNA, as the majority member of the JV Debtor, (a) dismissed certain independent managers of that entity and (b) appointed two Independent Agents, whom HNA knew from a prior bankruptcy and who had experience serving in governance roles at distressed companies, as its representatives to act for the JV Debtor. SL Green charged that hiring these Independent Agents violated the JV Debtor's limited liability company agreement. SL Green also argued that any representatives acting on behalf of HNA could not authorize the chapter 11 filings on their own when HNA itself could not do so without SL Green's consent. Additionally, SL Green argued that because the limited liability company agreement expressly provided that HNA was not a fiduciary of the JV Debtor, the Independent Agents' decision to file for chapter 11 was not made (and, given the Independent Agent's limited time to consider strategic options, could not have been made) in the interests of the JV Debtor. Instead, SL Green alleged that the Independent Agents' decision to seek chapter 11 protection was done solely to benefit HNA.

The Debtors cited specific language in their constituent documents to counter SL Green's arguments regarding the propriety of the appointment of the Independent Agents. The limited liability company agreement governing the JV Debtor authorized HNA, as the majority member, to "appoint officers or agents of the Company who shall exercise such powers and perform such duties as shall be delegated to them from time to time by [the HNA Members], subject to the limitations on [the HNA Member's] powers and authority as set forth herein." Additionally, the limited liability company agreement provided specific remedies—redemption rights and control over a sale of 245 Park—to SL Green if HNA made a Major Decision without SL Green's consent. Because the limited liability agreement did not render a Major Decision void if obtained without SL Green's consent, the Debtors argued that SL Green could not seek to unwind the decision to file for bankruptcy. The Debtors also cited Delaware's limited liability statute, which allows a member or manager of a limited liability company to delegate power to run the company.

The Debtors did not, however, challenge the reading of the limited liability company agreement which gave SL Green consent rights over the JV Debtor's bankruptcy filing. Instead, the Debtors argued that prepetition waivers of the right to seek bankruptcy relief are unenforceable as a matter of public policy. They noted that courts foster the federal public policy of ensuring access to bankruptcy relief that the Constitution authorizes and Congress enacted, including when prohibitions appear in a business's governing documents. Otherwise, creditors holding the blocking right could prevent a bankruptcy filing in their own self-interest without deference to benefits and protections the Bankruptcy Code offers. Additionally, the Debtors argued that SL Green's equity investment included debt-like features such as mandatory redemption, a fixed return, and a right to foreclose, indicating that SL Green always intended to protect its rights as a creditor (including in its capacities as mezzanine lender and property manager). Absent SL Green's consent right, the Debtors argued that they, via the Independent Agents, unequivocally had the right to authorize the bankruptcy filings.

Bankruptcy Court Decision

In making her ruling, Judge Walrath said that it was a "close decision." She rejected the Debtors' argument that, even if the JV Debtor violated its governing documents, the aggrieved party can only avail itself of the remedy of dismissal if such remedy appears in those documents. The court stated that a corporate action contravening the authority in its governing agreements usually is void.

However, in considering whether SL Green's blocking rights were enforceable, the court found that it had to balance the JV Debtor's corporate and contractual obligations against its right to file for bankruptcy. That balancing of interests was required, notwithstanding SL Green's approval rights over

Major Decisions, because SL Green was not merely a minority member of the JV Debtor, but a creditor which obtained its right to block the bankruptcy filing to protect that creditor status. The bankruptcy court noted that SL Green already was a substantial creditor (as a holder of mezzanine debt) of the Debtors when it made its equity investment, which also contemplated that it would be hired as property manager (expanding the creditor relationship). The so-called equity investment was in substance akin to a debt instrument, with features that included mandatory redemption, a fixed return, and a right to foreclose. Because there was a "blurring of interests of [SL Green] between its shareholder and creditor rights" it could not, as a shareholder, block the right of the debtor to file for bankruptcy. The court cited the structure of the equity investment as a "major factor" in its decision.

The bankruptcy court added that HNA's delegation of authority to the Independent Agents was proper and that they did not file for bankruptcy protection in bad faith. The court found that the Debtors were in financial distress and the Independent Agents acted appropriately to preserve assets for the benefit of all stakeholders. The Debtors' lack of liquidity created risk of an imminent cash dominion event and a forced sale. Additionally, seeking to reject the management agreement with SL Green was a valid bankruptcy purpose.[3] The court also noted that insolvency is not a prerequisite for a bankruptcy filing. The court rejected the notion that the Debtors' bankruptcy was essentially a two-party dispute, finding that the Debtors' impending cash dominion event and a potential forced sale due to SL Green's alleged failures as property manager would have impacted many creditors' rights, and there was no need for the Debtors to wait for the events sure to precipitate insolvency to occur in order to seek bankruptcy protection.

Analysis

PWM's chapter 11 filing raises questions, familiar to restructuring, finance, and real estate professionals, about the structuring and effectiveness of mechanisms in a company's constituent documents that limit or condition its authority to file for bankruptcy. Limited liability company agreements and corporate charters are often drafted or amended to provide creditors and minority shareholders (or their designees) with consent rights over an entity's bankruptcy filing. Such rights may exist *ab initio* in certain real estate loans (including mezzanine loans) and structured financings. Further, parties providing funding to businesses in financial distress may condition their investments on obtaining control over bankruptcy filings similar to the control SL Green obtained over the JV Debtor.

Previous bankruptcy court rulings have already demonstrated that no corporate structure is bankruptcy-proof. For example, in *General Growth Properties*, property-level lenders sought to dismiss the chapter 11 cases of several of General Growth's property-level subsidiaries as bad faith filings (on similar grounds to PWM), but the motion was denied as the court found that the corporate documents did not prohibit the debtor from filing for bankruptcy under the facts and circumstances present there.[4]

More recently, in *In re Lake Michigan Beach Pottawatamie Resort LLC*, an Illinois bankruptcy court held that a lender's consent provision in a borrower's LLC agreement was unenforceable as a matter of federal public policy. The court found that bankruptcy-remote structures are only permissible as long as the "blocking" directors/members adhere to their general fiduciary duties to the company, so that there will be "at least theoretically, . . . situations where the blocking director will vote in favor of a bankruptcy filing," which could not have occurred as the secured lender had required that the borrower LLC enter into an amendment to its operating agreement (a) establishing the secured lender as a special member to the LLC, (b) requiring the consent of the special member to file bankruptcy, and (c) eliminating any duty on the part of the special member to give any consideration to the interests of the LLC or its members.[5] Because the fiduciary duties of the special member were eliminated under the amendment,

the court held that the consent provision imposed, in effect, an absolute bar against bankruptcy filing and was therefore unenforceable on public policy grounds.[6]

Similarly, in *Intervention Energy*, the Delaware bankruptcy court took issue with a lender which held a "golden share" whose consent was necessary for the debtor to commence a bankruptcy case. The court concluded that the lender owed no duty to anyone but itself and that such an arrangement—combined with the lender's intent to block any voluntary bankruptcy filing—was "tantamount to an absolute waiver" of its right to seek bankruptcy relief in violation of public policy.[7]

The bankruptcy court's ruling in PWM—if it is upheld on appeal—is another reminder that investors must take care in both drafting and relying on restricting an entity's access to bankruptcy protection. These restrictions could be undermined by other provisions in governing documents, such as the ability to remove managers of a business and replace them with individuals more willing to consider chapter 11. Additionally, PWM demonstrates the threats to a shareholder's (or member holder's) right to block a bankruptcy filing where that shareholder is also a creditor (and is acting to protect its creditor position). Finally, PWM shows that courts may promote access to bankruptcy relief over the clear rights of a minority shareholder to block a bankruptcy filing.

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1 *In re PWM Property Management LLC, et al.*, Case No. 21-11445 (Bankr. D. Del. Oct. 31, 2021).

2 A group of the Debtors' mezzanine lenders joined SL Green's motion to dismiss.

3 A week after issuing this decision, the bankruptcy court authorized the Debtors to reject their property management agreement with SL Green.

4 *In re General Growth Properties, Inc.*, 409 B.R. 43, 72 (Bankr. S.D.N.Y. 2009).

5 *In re Lake Michigan Beach Pottawattamie Resorts LLC*, 547 B.R. 899, 912 (Bankr. N.D. Ill. 2016). The LLC agreement had been amended to add the debtor's secured creditor as a "special member" and require the consent of such special member in order for the debtor to file for bankruptcy. *Id.* at 903-04.

6 *Id.* at 914.

7 *In re Intervention Energy Holdings, LLC*, 553 B.R. 258, 265 (Bankr. D. Del. 2016).