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Creditors Ask Court to Enforce Bankruptcy Blocking Provision and Approve Creditor Created Plan During Exclusivity Period in *PWM Management*

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I. Introduction

The economic upheaval caused by the outbreak of COVID-19 was unprecedented in the United States and abroad. Employees were furloughed, businesses were mothballed or shut down altogether. The effects of the COVID-19 pandemic were as far-reaching as the commercial real estate market. The demand for corporate space has been altered by guidelines enacted relating to social distancing, quarantining, remote work, layoffs, and much more. All of these factors have shifted, if not reduced the need for, commercial real estate, raising questions, among others, surrounding whether now is a good time to invest, to move, and/or to downsize/upsize a space for a commercial property. PWM Property Management faced similar questions when deciding whether the company needed to utilize chapter 11 to reorganize their business, which purportedly held significant equity value in two commercial office towers located in both Chicago and New York. PWM Property Management did in fact file for chapter 11 and attributed the bankruptcy filing to "a challenging commercial real estate market engendered by the COVID-19 pandemic, resulting in vacancies and depressed rents and the purported failure of its 'conflict-riddled' property manager S.L. Green Management Corp. ("SLG") to properly perform its primary duty of recruiting 'world-class' tenants for the property."

This article analyzes the chapter 11 bankruptcy filing of *PWM Property Management,* to (i) explain the impact of the use of corporate governance blocking provisions contained within LLC agreements and other corporate governance documents and (ii) the impact of a creditor filed proposed plan of reorganization and a corresponding cooperation agreement on a debtor's exclusive right to file a chapter 11 plan as provided under bankruptcy code sections 1121(b) and 1125.

II. Background

PWM Property Management (referred herein as “PWM” or “Debtor”) owns a commercial office tower located at 245 Park Avenue in New York City, as well as a commercial office tower located at 181 West Madison in Chicago. On October 31, 2021, PWM filed for Chapter 11 protection in the Bankruptcy Court for the District of Delaware. At the time of filing, PWM reported having $1 billion to $10 billion in both assets and liabilities. HNA Group North America, LLC owns one-hundred percent (100%) of the equity interests of PWM. HNA Group North America (“HNA”) appointed two independent fiduciaries, who authorized PWM’s filing. In filing, PWM sought to reject the property management agreement with SLG, who was currently the property manager of the 245 Park Avenue commercial building in New York. SLG is a forty-nine percent (49%) preferred equity holder in the Debtor and further holds fifty percent (50%) of the mezzanine C loans. As a basis for rejecting the agreement, PWM claimed SLG failed to bring in a new tenant, after losing 245 Park Avenue’s largest tenant, the Major League Baseball (the “MLB”), remedy billing errors or take any other steps to make the building competitive in the New York market. If SLG did not find a replacement tenant for MLB by October 31, 2021, a “Tenant Trigger Event” would be triggered under the 245 Park Avenue building pre-petition mortgage loan documents, which would permit the servicer to sweep certain excess cash flows, which would leave PWM unable to afford to pay SLG their required quarterly dividend payments for their equity contribution. To prevent liquidation prospectively as a result of the Tenant Trigger Event, PWM filed for bankruptcy.

III. Corporate Governance: Bankruptcy Blocking Provisions and their Enforceability

One tool that has been utilized to prevent an unwanted bankruptcy is a so-called "Golden Share" arrangement. Simply put, the Golden Share is a term to describe a class of equity interests issued to a capital provider which grants the holder consent rights over certain decisions the company may make, including a decision to file for bankruptcy protection. [1] The Golden Share may be given to lenders in exchange for a new loan, a preferred equity investment, or even in exchange for forbearance from a waiver of a loan default. For example, when entering into a forbearance agreement following an event of default, the borrower and lender may agree that a new class of stock will be issued to the lender and that the borrower's charter or organizational documents will be amended to require consent from the holder of this Golden Share to authorize a subsequent bankruptcy filing. The LLC Agreement entered into between SLG and the Debtor had a similar such provision, which SLG relied on when attempting to have PWM's bankruptcy filing dismissed.

SLG filed a motion to dismiss PWM's bankruptcy filing as a bad faith bankruptcy filing. In the Second Amended LLC Agreement (the "Agreement"), entered into between SLG and PWM, SLG's approval was necessary for any action constituting a "Major Decision," and further, "neither the Managing Member nor any Member may cause 245 Park JV, LLC nor any Subsidiary to take any action in furtherance of any Major Decision without the approval of 245 Park Members." Included in the definition of "Major Decision" within the Agreement was the "changing, dismissing, engaging professionals to render services for 245 Park or any of its subsidiaries." SLG argued that appointing the independent agents was in contravention of the Agreement because appointing the independent agents constituted a "Major Decision," which required the prior approval of SLG.

Bankruptcy Judge Walrath denied SLG's motion to dismiss, concluding that the bankruptcy filing was properly authorized by the independent agents appointed by HNA. In deciding, Judge Walrath considered solely, "whether blocking rights are enforceable in bankruptcy where a creditor uses its rights to protect its interests as a creditor." Judge Walrath explained, "courts have held that where a party, principally a creditor, is giving a blocking right to the filing of a bankruptcy case, the court must consider the public policy and balance of rights of entities to provide a proper taking of corporate action in their corporate governance documents against the right of entities to file bankruptcy; however in exercising that balancing the courts have made it clear that only in the instance where a blocking right is obtained by a creditor in order to protect its interest as a creditor through its actions as equity is something that should be subject to this balancing." The courts therefore must strike a balance between a debtor's right to utilize the bankruptcy process to reorganize and an entities' rights provided for under corporate governance documents. In determining the proper balance, Judge Walrath looked to and analogized *PWM Management* to *In re Intervention Energy* and *In re Lake Michigan Beach Pottawattamie Resort LLC*, as discussed below, where the presiding bankruptcy judges over those cases also held the blocking action of a bankruptcy to be invalid. Judge Walrath ultimately found that SLG's actions as both a creditor and equity holder barred enforcement of the consent provision in the Agreement and PWM's bankruptcy filing was therefore properly authorized and should not be dismissed.

The efficacy of the concept of a bankruptcy blocking provision has been the subject of controversy in recent years. In *In re Intervention Energy Holdings, LLC*, which Judge Walrath analogized to in *PWM,* the bankruptcy court for the District of Delaware court struck down a Golden Share arrangement that gave a lender the ostensible power to prevent a bankruptcy filing by its borrower. 553 B.R. 258, 265 (Bankr. D. Del. 2016). As a condition to entering into a forbearance agreement, the lender insisted upon a Golden Share arrangement whereby a new class of equity was issued to the creditor. *Id.* at 261. The borrower's charter was also amended to require the consent of all equity classes to authorize a bankruptcy filing. *Id.* Thereafter, the borrower commenced a Chapter 11 bankruptcy case. *Id.* at 260. In response, the lender filed a motion to dismiss, arguing that the bankruptcy filing was unauthorized because the unanimous consent of all unitholders was not obtained. *Id.* After briefing and oral argument, Bankruptcy Judge Kevin Carey denied the lender's motion to dismiss holding that:

> A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief…is tantamount to an absolute waiver of that right and…is void as contrary to federal public policy. *Id.* at 265.

In *In re Lake Michigan Beach Pottawattamie Resort LLC*, which Judge Walrath also used as a comparison to *PWM*, a borrower defaulted on a real estate loan from its primary lender, BCL-Bridge Funding, LLC ("BCL"). 547 B.R. 899, 903 (Bankr. N.D. Ill. 2016). In connection with a forbearance agreement, the parties agreed to add the lender as a special member of the borrower. *Id.* at 903-904. As a special member of this member managed LLC, BCL had no interest in profits or losses of the borrower, no right to distributions, and no obligation to make capital contributions. *Id.* at 904. Rather, BCL was granted approval rights over certain material business decisions, including the decision to file for bankruptcy protection. *Id.* Notably, in the amendment appointing BCL as a special member, the operating agreement was revised to expressly allow BCL to exercise its rights without consideration of any other interests but its own. *Id.* Except for this limited role as a special member, BCL's relationship to the borrower was solely that of lender. The debtor thereafter defaulted under the forbearance agreement and filed for bankruptcy. *Id.* The decision to file bankruptcy was approved by all of the debtor's members except for BCL. *Id.*

In its decision on BCL's motion to dismiss, the bankruptcy court observed that BCL's argument for dismissal is "grounded in the well-established commercial practice of using 'blocking directors.'" *Id.* at 911. Although waivers and other mechanisms that create an absolute prohibition against the commencement of bankruptcy by a debtor are impermissible, Bankruptcy Judge Timothy Barnes acknowledged that blocking director arrangements are permissible, but **only** in situations where the director owes a duty to consider the interests of all stakeholders in fulfilling her role: "the essential playbook for a successful blocking director is this: the director must be subject to normal director fiduciary duties and therefore in some circumstances vote in favor of a bankruptcy filing, even if it is not in the best interests of the creditor they were chosen by…BCL's playbook was, unfortunately, missing this page." *Id*. at 913. Notably, the court found that the disclaimer allowing BCL to consider only its own interests in making decisions as a member of the debtor violated Michigan law, which imposes a fiduciary duty on all managers of a Michigan limited liability company.[2] *Id.* at 914. For these reasons, the court struck down the blocking director provisions of the operating agreement and denied BCL's motion to dismiss. *Id.* at 915.

However, contrary to the Court's decision in *In re Lake Michigan Beach Pottawattamie Resort LLC* due to Michigan law regarding fiduciary duties, Delaware and most other states allow LLC's to explicitly disclaim fiduciary duties in their corporate documents. If fiduciary duties are disclaimed in LLC agreements and corporate governance documents, how does this impact the enforceability of a golden share provision?

In *In re 3P Hightstown, LLC*, the debtor sought and obtained capital investments from four individuals (collectively referred to as the "4J Group"), who collectively invested $500,000 in exchange for preferred membership units. 631 B.R. 205, 207-208 (Bankr. D.N.J. 2021). Simultaneously, the 4J Group made a $125,000 subordinated loan to the debtor. *Id.* at 208. The 4J Group's admission as an equity member of 3P Hightstown was memorialized in the company's operating agreement. *Id.* At the same time, the operating agreement was modified to require the consent of the company's preferred equity members to authorize a voluntary bankruptcy filing. *Id.* 3P Hightstown subsequently filed a Chapter 11 case without the required preferred members consent. *Id.* The purchaser of the 4J Group's equity and debt investments in the debtor moved to dismiss the bankruptcy filing as unauthorized. *Id.* The court found the LLC agreement's plain language expressly prohibited the filing due to the lack of preferred member consent. *Id.* at 214.

The judge here upheld the golden share provision regardless of fiduciary duties, and was persuaded by the fact that the Golden Share and related consent rights were granted to the preferred members in exchange for a substantial equity investment and that it was ***not*** "merely a ruse to ensure" that the debtor repaid its subordinated loan. *Id.* at 212. The court distinguished *3P Hightstown* from a recent bench decision by the Delaware bankruptcy court in *In re Pace Industries, LLC* where Bankruptcy Judge Mary Walrath refused to enforce a Golden Share held by a preferred shareholder. *See In re Pace Industries, LLC*, Case No. 20-10927 2020 (MFW), 2020 WL 5015839 (Bankr. D. Del. May 29, 2020). In part, Judge Walrath grounded her ruling on the fact that the preferred shareholder's refusal to consent to an otherwise consensual pre-packaged bankruptcy filing conflicted with its fiduciary duty to other shareholders and creditors. *Id.* In his opinion in *3P Hightstown*, Judge Kaplan expressed "serious reservations" that non-controlling minority shareholders had fiduciary duties to other stakeholders. *In re 3P Hightstown, LLC*, 631 B.R. at 213. He noted that even if fiduciary duties might otherwise exist, the debtor's operating agreement disclaimed any such duties. *Id.* at 214. For these reasons, the court in *3P Hightstown* found that the member consent requirements did not violate public policy and were, therefore, enforceable. *Id.*

The key takeaways from the enforceability of Golden Share arrangements are that they are more likely to be enforced (i) when they are established in connection with a substantial equity investment that is more than nominal in comparison to the holder's debt position and the equity investment is viewed as more of an equity investment in substance than it is as a debt, and (ii) when Golden Share provisions are used to facilitate a value maximizing transaction, rather than as obstruction purely for hold-up value.

IV. Exclusivity Period to File and Solicit a Plan and A Third Party's Ability to Intervene

Under Section 1121(b) of the Bankruptcy Code, "the debtor may file a plan with a petition commencing a voluntary case, or at any time in a voluntary or an involuntary case." 11 U.S.C. §1121(a). Section 1121 provides for an initial 120 day period after the commencement of a chapter 11 case where the debtor has the exclusive right to file a chapter 11 plan. 11 U.SC. §1121(b). From a plain reading of Section 1121(b), the debtor is the only party capable of filing a plan during the exclusivity period. There is case law, which further echoes this principle.

Courts have found Section 1121(b) creates not only a bright line but a "third rail" for third parties to not be able to don't file a plan during the exclusivity period permitted by Section 1121(b) of the Bankruptcy Code. *In re Charles St. African Methodist Episcopal Church of Boston*, 499 B.R. 126, 132 (Bankr. D. Mass. 2013). Accordingly, filing a plan that identifies terms of a competing plan during the exclusivity period would then be presumed to be a violation of Bankruptcy Code section 1121(b). *See Id.* at 132–33 (finding a motion to terminate exclusivity, which included a competing plan as an attachment, not of the debtors' violated exclusivity). This would therefore lead to the conclusion that any plan filed by a third party, or any party other than the debtor, during the exclusivity period, or during the pendency of a ruling granting or denying an extension for the exclusivity period to file a plan would be a violation of Section 1121(b), since only a debtor is allowed to file a plan during this period. It would appear to be permissible and encouraged to begin negotiations, but anything further would appear to cross the line of improper.

Further, section 1125(b) of the Bankruptcy Code also provides the debtor with even greater benefits, by barring solicitation of an “acceptance or rejection of a plan…after the commencement of the case under [title 11] from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.” 11 U.S.C. § 1125(b). The Bankruptcy Code provision does not provide for the breadth of what constitutes solicitation. However, courts have consistently narrowly interpreted the meaning of “solicitation” under section 1125(b), to determine a filed pleading or other similar document that is distributed to a wide group of parties in interest that summarizes a competing plan constitutes an improper solicitation. *See Duff v. U.S. Trustee* (*In re Cal. Fidelity, Inc.),* 198 B.R. 567, 574 (B.A.P. 9th Cir. 1996) (finding that even under the “narrowest definition of ‘solicitation,’ a party in interest’s letter to other constituencies was an improper solicitation because it described the material terms of competing plans and the strengths and weaknesses of the debtor’s plan.”). Prior to the termination of the exclusivity period, any document created by a third party, or party other than the debtor, that appears to summarize a competing plan would put the party at risk of violating section 1125(b) of the Bankruptcy Code.

In *PWM Management,* PWM filed a motion to extend the exclusivity period to develop a plan and solicit votes for the plan because PWM still had yet to develop a plan and absent an extension, the exclusive plan filing and solicitation period would have ended on February 28, 2022 and April 29, 2022. The mezzanine lenders and SLG subsequently filed an objection to the debtors’ motion to extend the exclusive period for development of a plan of adjustment and the solicitation period. Included as an exhibit to the objection by the creditor group was a proposed chapter 11 plan, developed by the creditor group. The creditor group filed the proposed plan under seal, and stated in their objection that, “since the exclusive periods have yet to expire or be terminated prior to the filing, the debtors request the Creditor Plan be filed under seal to prevent any perceived violation of sections 1121(c) or 1125 of the bankruptcy code.” However, the creditor group affirmatively represented the creditor proposed plan was ready for immediate filling and solicitation after a disclosure statement was approved.

After, PWM learned that in connection with the creditors' proposed plan of adjustment, the creditors also entered into a cooperation agreement that largely prohibited them from considering, supporting, or discussing any plan of reorganization other than the plan they proposed under seal to the court. Essentially, the cooperation agreement was an agreement to only approve the plan proposed by the creditor group under seal. As a result, the Debtors filed an objection to the proposed plan stating the sealed plan constitutes an attack on the debtors' exclusivity period, granted to the debtor by the Bankruptcy Code, to file and solicit a chapter 11 plan, arguing further that this prevents the Debtors from engaging with some of largest creditors due to their contractual binding to the credit plan. The Debtors further argued the plan being filed under seal should not in any way alter the court's analysis because section 1121 applies to any filing that describes the existence and terms of a competing plan, while noting the sealed proposed plan was still filed on the public court docket in full view of all major parties of interest. PWM further argued the filing of the sealed proposed plan and entrance into the cooperation agreement constituted improper solicitation under 1125(b) of the Bankruptcy Code, pointing to the cooperation agreement which provides that the parties would not consent to any transaction other than the approved transaction, which was the proposed creditor plan.

The creditor group argued in response they did not violate Bankruptcy Code Section 1121(b) by submitting an alternative proposed plan nor did they violate Section 1125 because the creditor group did not solicit votes in support of their proposed plan. In support of their argument, the creditors argued the creditor proposed plan of adjustment was on the public docket, but no one besides the court, the Debtor, and trustee could see the contents within the plan because it was sealed, and only provided to those parties, therefore, they could not have possibly solicited support for the plan when the movants have not shared it with any other voting creditor. Further, the creditors argued the Bankruptcy Court could not properly evaluate termination of exclusivity without the filing of the plan, since this would provide proof that a plan could have already been prepared. The creditors further argued they did not violate section 1125 of the Bankruptcy Code by entering into the cooperation agreement because courts support creditor negotiations during the debtors' exclusive period. The cooperation agreement also expressly provides in a disclaimer that the proposed creditor plan is still subject to higher or better offers so the cooperation agreement and proposed plan do not constitute improper solicitation, nor does the cooperation agreement constitute a post-petition lock up agreement.

Ultimately, Judge Walrath granted PWM's motion to extend the debtor exclusivity period through June 28, 2022 and August 27, 2022, even though she was not pleased with PWM's current progress and timeline relating to the development of a plan. Judge Walrath held the filing of the creditor proposed plan of adjustment during the exclusive period violated the debtors' exclusive rights to file a plan, as permitted by Bankruptcy Code section 1121. In addition, Judge Walrath found sealing the creditor proposed plan of adjustment did not constitute proper protection because filing on the public docket itself was improper and further, section 107 of the Bankruptcy Code is inapplicable to seal the creditor proposed plan of adjustment because it does not contain "trade secrets, confidential research, development, or commercial information," as section 107 requires. Judge Walrath also found the creditors' entry into the cooperation agreement in connection with the proposed plan violated section 1125. The court found that the creditors could discuss acceptable terms before a debtor filed a plan, however, by filing the proposed plan with the court, the creditors stepped over the line regarding soliciting votes prior to approval of a disclosure statement. The court noted that filing the plan on the docket, even if the contents weren't disclosed was enough to "whet the appetite of interested parties," and it was wholly irrelevant that the cooperation agreement provided a disclaimer that it was not soliciting votes for the plan. Simply adding a provision in the agreement does not change the fact this is still by and large solicitation of votes for a plan of adjustment.

The key takeaways from *PWM Management* are (i) creditor negotiations are likely to be supported during the debtors' exclusivity period and/or during the pendency of a grant or denial of an extension of the exclusivity period, but any document filed with the court containing terms of a plan, whether sealed or not, is likely a step too far and an encroachment on the debtors' rights provided by Section 1121(b) of the Bankruptcy Code and (ii) cooperation agreements, or similar other agreements still resemble solicitation for purposes of section 1125 and are therefore, a violation of the Bankruptcy Code.

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[1] *See* Peter Antoszyk, *"The Golden Share": All that Glitters Is Not Gold*, JDSupra (May 18, 2020), The "Golden Share": All That Glitters Is Not Gold | Proskauer Rose LLP - JDSupra.

[2] By contrast, under Delaware law, fiduciary duties may be disclaimed for managers of a limited liability company. 6 Del. C. § 18-1104 (2013).

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