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Enforceability of Golden Directors with Bankruptcy Consent Right

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The appointment of an independent director is a powerful tool for private credit lenders. The appointment is designed to introduce a voice of neutrality and fairness into the board's decision-making process with the hope and expectation that independence from the controlling shareholder enables the board to drive toward viable value-maximizing strategies. Often times, the independent director is vested with exclusive authority (or veto rights) over a range of significant corporate decisions, including a sale, restructuring and the decision to file a bankruptcy case. The negotiations over the appointment of these directors – often referred to as "golden directors" – and the scope of their power typically occurs during time of under-performance and in the context of either a forbearance agreement, credit agreement amendment, or exercise of remedies. The appointment and attendant powers sometimes highlight a clash between freedom of contract and public policy.

A recent decision from the U.S. Bankruptcy Court for the Northern District of Illinois, *In re 301 W North Avenue, LLC*, No. 24-02741 (Bankr. N.D. Ill. Jan. 6, 2025) upheld the enforceability of a golden director (technically a manager of a Delaware LLC) with approval rights over the Borrower's decision to file bankruptcy. We break down the key takeaways and offer some practical considerations.

Facts

A lender ("Lender") loaned $26 million to a borrower ("Borrower") secured by a mortgage. As a condition of the loan, the Lender required, and the Borrower agreed, to appoint to its board of managers one independent manager reasonably acceptable to the Lender (the "Independent Manager"), whose consent was required for any bankruptcy filing.

The Borrower's limited liability company agreement (the "LLCA") was amended to require the appointment of the Independent Manager and memorialized the agreed-upon consent rights. The LLCA also imposed upon the Independent Manager certain fiduciary duties and expressly required the Independent Manager to consider only the interests of the Borrower and its creditors (solely to the extent of their respective economic interests in the Borrower).

Three years later, the Borrower defaulted. Facing imminent foreclosure, the Borrower's members and its other manager authorized a bankruptcy filing without obtaining the Independent Manager's consent. The Lender moved to dismiss the bankruptcy case because the bankruptcy filing was not duly authorized.

Ruling

1. Unauthorized Bankruptcy Filing. The court held the bankruptcy filing was unauthorized. A Delaware LLC can act only through the authorization provided by its LLC agreement. The LLCA was clear that the Borrower could not file without the Independent Manager's consent.[1] The court found that the LLCA's provision requiring the Independent Manager's consent to a bankruptcy filing was permissible as a matter of law.
2. Consent Right Over Filing Was Enforceable. The court noted, however, that provisions that "effectively nullify or eliminate" a company's right to file bankruptcy could violate public policy and be unenforceable. It added, however, that "if an operating agreement creates a structure in which a director's fiduciary duties are respected and that complies with non-bankruptcy statutes or law, it is enforceable." The court contrasted the case at issue (in which the Independent Manager had fiduciary duties to the Borrower and its creditors) with other cases in which a creditor was granted a direct veto right over a bankruptcy filing with no fiduciary duties to anyone. The Borrower attacked the LLCA's formulation of fiduciary duties, but the court agreed with the Lender that (i) limiting the interests that the Independent Manager must consider to the Borrower's "economic interests" was sufficient and (ii) imposing no express fiduciary duties on the Independent Manager with respect to the Borrower's equity was consistent with Delaware law and not in contravention of public policy. The court also rejected the argument that the Independent Manager's fiduciary duties were illusory as a result of the Borrower's agreement to indemnify the Independent Manager coupled with a promise not to sue. The court found that these provisions were "in compliance with Delaware law" because the LLCA did "not permit indemnification if the Independent Manager acted in bad faith or engaged in willful misconduct."

3. Independence Was Not Compromised. The court also rejected the Borrower's contention that requiring the Independent Manager to (i) be acceptable to the Lender, (ii) remain in place while the debt is outstanding, and (iii) give notice to the Lender before resigning indicated that the Independent Manager was not independent and served solely for the benefit of the Lender. Those conditions did not undermine the independence or create a bias making the Independent Manger beholden to the Lender.
4. Case Dismissed. Because the bankruptcy filing was unauthorized, the court dismissed the case without prejudice to the Borrower's right to file again if the Borrower obtained proper consent. As result of the dismissal, there was no automatic stay, and the Lender was free to pursue foreclosure.

Practical Considerations

This decision is beneficial for private credit lenders and reaffirms the efficacy of an important tool in the restructuring toolbox. Here are three practical considerations. *First*, courts are more likely to enforce bankruptcy consent/veto rights granted to an independent director (a golden director) as opposed to veto or consent rights granted directly to a creditor (a golden share). *Second*, courts are more likely to respect an independent director's actions where independence is not tainted with any colorable undue bias or favoritism towards the appointing lender. Thus, the selection process is critical. *Finally*, the existence and scope of fiduciary duties and indemnification provisions should be carefully considered when appointing an independent director.

There are many factors that should be considered when appointing a lender-required independent director. While the fiduciary duty point does not fit neatly into a "one-size fits all" approach, when these restructuring tools are skillfully deployed, they can meaningfully impact creditor recoveries.

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[1] There was also a dispute about whether the Independent Manager resigned, making consent irrelevant. The court rejected the Borrower's argument that the filing was nevertheless authorized as a result of the Independent Manager's resignation (which was backdated to a date prior to the filing date but not submitted until after the filing) or her acquiescing to or ratifying the filing through her action or inaction post-filing.

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