

# Freedom of Contract in LLC Structure Is Not Absolute Where Parties Seek Bankruptcy Relief

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## Delaware Law Update

07.21.2016

*In re Intervention Energy Holdings, LLC*, Case No. 16-11247 (D. Del. June 3, 2016), the Bankruptcy Court for the District of Delaware dealt with the issue of whether a Delaware LLC lacked authority to file a Chapter 11 petition under the Bankruptcy Code because the limited liability company agreement of the LLC in question required the consent of all members and one member did not consent to the filing.

The dispute involved Intervention Energy Holding, LLC ("IE Holdings"), and Intervention Energy, LLC ("IE," together with IE Holdings, the "Debtors"), and the EIG Energy Fund XV-A, L.P. ("EIG"). The Debtors are both Delaware limited liability companies.

The Debtors and EIG initially entered into a Note Purchase Agreement whereby EIG provided funds to the Debtors in the form of senior secured notes that were secured by liens on certain of the Debtors' assets. A few years into the debtor/creditor relationship, the parties amended the Note Purchase Agreement to expand EIG's funding commitment. Shortly thereafter, EIG declared an event of default based on the Debtors' failure to meet certain debt covenants in the funding documents. EIG and the Debtors negotiated and entered into a Forbearance Agreement, which provided that EIG would waive all defaults if the Debtors raised capital in the form of equity to pay a portion of the existing secured notes held by EIG. As a condition to the effectiveness of the Forbearance Agreement, the Debtors were required to, among other things, admit EIG as a member of IE Holdings as well as amend its limited liability company agreement to require approval of each holder of common units of IE Holdings prior to any voluntary filing for bankruptcy protection for IE Holdings of IE. Despite the amended provision in the operating agreement, the Debtors voluntarily filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code.

EIG challenged the Debtors' voluntary bankruptcy filing asserting that absent its consent, IE Holdings lacked authority to file the petition under the amended operating agreement. EIG argued that a Delaware LLC may contract away its right to file bankruptcy at will, and cited to cases in which courts have upheld consent provisions in similar agreements. EIG cited to *In Re Avalon Hotel Partners, LLC*, 302 B.R. 377, 381 (Bankr. D. Or. 2003) (LLC debtor), as evidence of a court "upholding 75% member consent requirement in an LLC operating agreement." The Debtors in

return relied upon *In re Lake Michigan Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016), and argued that because EIG was given a “golden share” (meaning that it had certain veto powers), it retained a duty to vote its units in the best interest of the Debtors in order to comport with federal bankruptcy policy. Reluctant to decide what the judge referred to as a question of first impression of state law (determining the scope of LLC members’ freedom to contract), the court instead found an alternate rationale for its decision.

The court indicated that *Avalon Hotel Partners* (as cited by EIG) actually ran contrary to EIG’s argument and that the bankruptcy filing in that case was subsequently ratified and approved. The court in *Avalon Hotel Partners* held that “[upholding] a promise not to file a chapter 11 petition made by an LLC would be analogous to upholding a covenant not to file bankruptcy, and that...the promise was unenforceable as a matter of public policy.” Furthermore, the court affirmed that it is a well-established rule that “a debtor may not contract away the right to a discharge in bankruptcy.” The court repeatedly cited United States Bankruptcy Court decisions, all holding that the right of debtors to file for bankruptcy must not be restricted. The court reiterated that a waiver of the benefits created by bankruptcy laws is “wholly void as against public policy.”

EIG argued that the intent of both parties was clear and that state legislatures are in favor of LLC members having the freedom to contract agreements among themselves, and that the intent between EIG and the Debtors was a clear agreement to block any voluntary bankruptcy filing. However, the court found that the federal public policy at play in this case should be guarded and ensure access to the right of a person, including a business entity, to seek federal bankruptcy relief. The court ultimately held that the consent provision in the Debtors’ limited liability company agreement had the sole purpose and effect of eliminating the right to seek federal bankruptcy relief, which was essentially a waiver of the right and void as contrary to federal public policy.

The key takeaway from this case is that while Delaware law permits parties in an LLC structure to freely contract among themselves, if such contract runs afoul of federal public policy, any such agreement among the members may not be enforceable.