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Kentucky Bankruptcy Court Questions Validity of Independent Managers and Other Bankruptcy Restrictions

A recent decision by the U.S. Bankruptcy Court for the Eastern District of Kentucky has raised some questions about the enforceability of bankruptcy restrictions imposed by lenders on borrowers, including the common requirement to appoint an independent manager/director whose affirmative vote must be obtained for the borrower to file bankruptcy.

PCG Credit Partners, LLC made a \$6,150,000.00 secured loan to Lexington Hospitality Group, LLC, a limited liability company formed in Kentucky. As part of its consideration for making the loan, a PCG subsidiary obtained a 30% (later increased to 50%) equity interest in Lexington Hospitality Group, referred to as the "Equity Kicker." PCG also required Lexington Hospitality Group to amend its operating agreement to incorporate the following "Bankruptcy Restrictions:" (1) Borrower was required to have at least one independent manager; (2) the independent manager's authorization was required for a bankruptcy filing; (3) an affirmative vote by 75% of the Borrower's membership was required for a bankruptcy filing (another conflicting provision said 100%); and (4) Lender's consent was required for a bankruptcy filing. Despite the Bankruptcy Restrictions, Lexington Hospitality Group's manager unilaterally filed bankruptcy without obtaining any authorizations or affirmative votes. PCG filed a motion to dismiss on grounds that the Bankruptcy Restrictions were not followed. Lexington Hospitality Group argued that the Bankruptcy Restrictions were against public policy and unenforceable.

The court began by noting that state law determines whether an entity has authority to file bankruptcy, but federal law determines whether bankruptcy restrictions should be struck down on public policy grounds. It then went on to say that operating agreement provisions resulting in an absolute prohibition of the right to file

bankruptcy without a creditor's consent are void, and then proceeded to examine whether the restrictions that had been imposed on Lexington Hospitality Group rose to the level of an absolute prohibition.

The court expressed general support for the concept of a "properly drafted" requirement that an independent manager consent to bankruptcy. However, to be enforceable, the court stated that the independent manager "cannot exist simply to vote 'no' to a bankruptcy filing." Independent managers should have "normal fiduciary duties" to the members rather than just considering the interests of creditors. Although the court seemed to view PCG's independent manager requirements in a negative light, it stopped short of a full analysis of whether the independent manager in this situation was structured properly or improperly.

The court's decision ultimately rested on the requirements that Lexington Hospitality Group obtain PCG's consent to a bankruptcy. Not only could PCG directly block the filing by withholding its consent, it could also indirectly block a bankruptcy vote by the membership via its ownership and control of the subsidiary that held the Equity Kicker. Taken together, these provisions resulted in an unenforceable prohibition on Lexington Hospitality Group's right to file bankruptcy. The court struck down the Bankruptcy Restrictions and denied PCG's motion to dismiss.

For lenders who want to impose bankruptcy restrictions on their borrowers, there are two primary takeaways from the decision:

First, avoid any restrictions that directly require the borrower to obtain lender's consent to file bankruptcy. Also avoid taking an equity interest in borrowers, at least to the extent that it allows the lender to block a vote by the members to file bankruptcy. It seems clear that such absolute restrictions will be deemed contrary to public policy and struck down.

Second, if requiring an independent manager at the borrower-level, stipulate that the borrower be formed in Delaware and require the membership to waive the independent manager's fiduciary duties. Delaware's LLC statute, unlike that in Kentucky and many other

states, is very clear that a company's members can waive the fiduciary duties owed by a manager, thereby removing at least one potential angle from which the validity of an independent manager could be attacked. Although a bankruptcy court could still theoretically strike down an independent manager bankruptcy restriction on public policy grounds, it would be unlikely in the absence of other overreaching restrictions.

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