Bankruptcy Restrictions in Operating Agreement Held Unenforceable

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In *In Re Lexington Hospitality Group, LLC*, the United States Bankruptcy Court for the Eastern District of Kentucky thwarted a lender's efforts to control whether its borrower could file bankruptcy. As a condition to the loan, the lender mandated that the borrower's operating agreement have certain provisions that require the affirmative vote of an "Independent Manager" and 75% of the members to authorize a bankruptcy. The lender also included a failsafe veto provision that prohibited the borrower from filing for bankruptcy without the advance, written affirmative vote of the lender even if the borrower had obtained the vote of the Independent Manager and 75% of the members.

Janee Hotel Group formed Lexington Hospitality Group (LHG) and acted as its manager. Under LHG's original operating agreement, Janee managed the business and affairs of LHG. The operating agreement did not address bankruptcy.

Janee acquired a hotel with acquisition financing provided by PCG Credit Partners (PCG). In connection with the loan, LHG amended its operating agreement to admit a 30% member, 5532 Athens, which PCG owned. LHG also admitted two additional members totaling 10%, thereby reducing Janee's ownership interest to 60%.

PCG also required LHG to include certain "Bankruptcy Restrictions" in its operating agreement, to wit: LHG may declare bankruptcy only so long as an "Independent Manager" authorizes such action, and then only upon a 75% vote of the members. The Independent Manager's role was restricted to participating in bankruptcy matters and, when considering such matters, was required to weigh the costs/benefits of the decision on LHG, LHG's creditors and 5532 Athens. Additionally, the operating agreement prevented LHG from filing bankruptcy "without the advance, written affirmative vote of [PCG] and all members of [LHG]."

Eventually, LHG filed for bankruptcy without satisfying the above requirements. Instead, Janee, as the sole manager of LHG, signed the filing resolution, which contained no vote by the Independent Manager or the other members, nor had LHG obtained PCG's "advance, written affirmative vote" for the filing. PCG moved to dismiss the bankruptcy as unauthorized.

The court recognized that state law governs whether LHG is authorized to file for bankruptcy, but federal law governs whether the Bankruptcy Restrictions are enforceable as a matter of public policy. Generally, parties have the freedom to agree to the terms of an operating agreement; however, attempts to contract away the right to file for bankruptcy generally are unenforceable.

Here, the court found that Kentucky law authorized LHG to file bankruptcy, since filing bankruptcy is a business decision connected to the business affairs of a company and within the expansive decisional authority reserved to managers under the Kentucky limited liability company act. Turning to the Bankruptcy Restrictions, the court noted that LHG included these provisions in its operating agreement only because PCG required them as a condition to loan. The court found that the inclusion of an Independent Manager was "merely a pretense to suggest that the right to file bankruptcy is not unfairly restricted." While "[a] requirement that an independent person consent to bankruptcy relief, property drafted, is not necessarily a concept that offends federal public policy," limiting the independence of that manager is problematic. One such limitation was that the Independent Manager needed to consider the interest of creditors and 5532 Athens when deciding on bankruptcy, a restriction that abrogated the Independent Manager's fiduciary duty to LHG. Another constraint on the Independent Manager's ability to act independently was that, notwithstanding the Independent Manager's vote for bankruptcy, a properly authorized filing still required a 75% member vote that could not be achieved without the vote of 5532 Athens (which was controlled by PCG). Moreover, the Independent Manager requirement ceased once LHG repaid the loan, clearly tying the Independent Manager to PCG and further eroding its "independence." Thus, the court concluded that the Independent Manger provisions were not adequately drafted to preserve the Bankruptcy Restrictions.

The court also took issue with the requirement that PCG consent to any LHG bankruptcy. Most troubling was that "PCG [had] no restrictions and no fiduciary duties to LHG that might limit self-interested decisions that ignore the best interest of [LHG]." The court, therefore, held that the Bankruptcy Restrictions as a whole "serve[d] only one purpose: to frustrate LHG's ability to file bankruptcy;" and accordingly, were unenforceable.

Bankruptcy is a risk of doing business. Courts will scrutinize documents that purport to limit a borrower's ability to utilize bankruptcy as a business strategy. Such limitations are rarely, if ever, countenanced. Lenders must understand this risk and underwrite accordingly.

Authors