Illinois Bankruptcy Court Nullifies Lender's Right To Block Debtor's Bankruptcy Filing

By Scott N. Schreiber / Apr 18, 2016

Often, as part of a forbearance agreement, a lender will obtain a provision requiring its consent to any subsequently filed bankruptcy; the theory being that if the business debtor subsequently defaults under its restructured obligations the lender can avoid a protracted fight in bankruptcy court by arguing that the borrower never had authority to file for bankruptcy in the first place.

In *In re Lake Michigan Beach Pottawattamie Resort LLC*, this blocking mechanism was incorporated into the Third Amendment to the Debtor's Operating Agreement. *Lake Michigan* was a Michigan LLC. The Third Amendment designated the lender as a Special Member to the LLC and stated, in part, that Lake Michigan was not authorized to file for bankruptcy absent consent of its Special Member. When Lake Michigan filed for chapter 11, the lender sought to dismiss the case because, among other reasons, the Debtor failed to obtain its Special Member's consent to the bankruptcy filing.

The Illinois Bankruptcy Judge denied the motion to dismiss and in the process, invalidated the blocking power in the Third Amendment as violative of both Michigan corporate law and bankruptcy law. Finding that the Special Member owed a fiduciary duty to all of the Debtor's creditors, the fulfillment of which duty took precedence over the protection of the Special Member's own pecuniary interest, the Court held that the Special Member provision was unenforceable because it enabled the Special Member to withhold bankruptcy consent on consideration of only its own best interests. In the absence of such blocking provision, the Court concluded that the consent provided pursuant to the remaining corporate governance provisions was valid consent to the Debtor's bankruptcy petition.

What's the effect of *Lake Michigan* on existing agreements with blocking mechanisms?

Most bankruptcies occur when the lender is owed more than the value of the property securing the lenders. Because the *Lake Michigan* Court determined that the lender was over secured and sought to protect this excess equity for the benefit of the Debtor's creditors, confined to its unique facts, *Lake Michigan* is distinguishable and should have limited effect in most cases.

Lake Michigan, however, sets adverse precedent for lenders who try and protect themselves in risky loans. Had Lake Michigan's lender succeeded in blocking the bankruptcy and sold the assets outside of bankruptcy, it could have obtained a significant return. Some would argue that the possibility of such a return is fair consideration for making a loan to a high risk borrower. Others would argue that the Lake Michigan Court overstepped its bounds by failing to uphold a contractual agreement made between sophisticated parties, thus causing jitters in the commercial lending market.

The *Lake Michigan* decision is further undermined by the fact that other than the sole lender, there was one other unsecured creditor of the Debtor. Consequently the *Lake Michigan* Court was protecting the equity interest holders, not the creditors, as it professed.

In short, *Lake Michigan* creates risk for lenders who have negotiated an exit path to avoid a subsequent bankruptcy after a workout. Whether the impact of *Lake Michigan* is confined to its narrow facts will be determined by subsequent opinions, but in the meantime, lenders should be aware of *Lake Michigan* and be prepared to distinguish it if confronted with it in court.

If you have any questions about this alert, please contact Scott Schreiber at sschreiber@clarkhill.com | 312.985.5595.

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