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Pre-Petition Waivers of Bankruptcy Protection: Typically Unenforceable

By Stuart I. Gordon and Matthew V. Spero*

Recent decisions by two bankruptcy courts illustrate the difficulty of persuading a judge to enforce a pre-petition waiver of a debtor's rights under the Bankruptcy Code.

Debtors negotiating out-of-court restructurings with their creditors often are asked, and sometimes agree, to limit their right to file for bankruptcy or to limit their ability to rely on protections that would be afforded to them by the Bankruptcy Code in the event they were to seek bankruptcy protection. Recent decisions in Delaware and North Carolina, however, make it clear that bankruptcy courts are not prepared to permit these kinds of pre-bankruptcy waivers.

INTERVENTION ENERGY

First, consider the ruling by the U.S. Bankruptcy Court for the District of Delaware in *In re Intervention Energy Holdings, LLC*.[1]

The case involved Intervention Energy Holdings, LLC ("IE Holdings") and Intervention Energy, LLC ("IE"), both limited liability companies ("LLCs"). IE Holdings and IE, a wholly-owned subsidiary of IE Holdings, were private, non-operating oil and natural gas exploration and production companies.

As the bankruptcy court explained, on January 6, 2012, IE Holdings, IE, and EIG Energy Fund XV-A, L.P. ("EIG"), an institutional investor specializing in private investments in global energy and related infrastructure projects and companies, entered into a note purchase agreement pursuant to which EIG provided up to $200 million of financing evidenced by senior notes that were secured by liens on certain assets of IE Holdings and IE. The parties amended

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[1] *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016).

the note purchase agreement several times and, in October 2015, EIG declared an event of default based on the failure of IE Holdings and IE to comply with certain covenants in the agreement.

On December 28, 2015, IE Holdings, IE, and EIG negotiated and entered into a further amendment of the note purchase agreement. This amendment provided that EIG would waive all defaults if IE Holdings and IE raised $30 million of equity to pay down a portion of the existing secured notes by June 1, 2016.

As a condition of this amendment to the note purchase agreement, IE Holdings and IE agreed, among other things, to require the unanimous consent of IE Holdings' common members before IE Holdings could seek relief under the Bankruptcy Code. IE Holdings then issued a single common unit to EIG for a common capital contribution of $1.00, making EIG the sole common member of IE Holdings. Also, the IE Holdings operating agreement was amended to require the "approval of all Common Members [to] commence a voluntary case under any bankruptcy" law (the "Consent Provision").

On May 20, 2016, IE Holdings and IE filed voluntary Chapter 11 bankruptcy petitions in the U.S. Bankruptcy Court for the District of Delaware. Days later, EIG filed a motion to dismiss the Chapter 11 cases. EIG argued that, absent EIG's consent to commence a Chapter 11 case, IE Holdings lacked authority to file the petitions since EIG was the sole common member of IE Holdings.

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court denied EIG's motion to dismiss.

In its decision, the bankruptcy court did not decide whether LLC members had the authority under Delaware law to agree to require unanimous consent for filing a bankruptcy petition.[2] Instead, the bankruptcy court decided the motion to dismiss under federal public policy.

In doing so, the bankruptcy court ruled that a provision in an LLC governance document obtained by contract, "the sole purpose and effect of which was to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief," was void as "contrary to federal public policy" where the

[2] In 2006, a federal bankruptcy court in Texas upheld a unanimous consent requirement for a bankruptcy filing in a limited liability company operating agreement. *See, In re Orchard at Hansen Park, LLC*, 347 B.R. 822 (Bankr. N.D. Tex. 2006).

nature and substance of the minority equity holder's relationship with the debtor was that of creditor—not equity holder—and where the minority equity holder owed "no duty to anyone but itself."

The bankruptcy court ruled that, even if such a provision was permitted by state law, it was void as contrary to federal public policy.

The bankruptcy court added that to characterize the Consent Provision as anything but "an absolute waiver by the LLC of its right to seek federal bankruptcy relief" would directly contradict the unequivocal intention of EIG to reserve for itself the decision of whether IE Holdings should seek bankruptcy relief. Accordingly, the bankruptcy court concluded, IE Holdings and IE possessed the necessary authority to commence their Chapter 11 proceedings and it denied EIG's motion to dismiss.

BENFIELD NURSERY

Next, consider the recent decision by a North Carolina bankruptcy court in *In re Jeff Benfield Nursery, Inc.*[3] Jeff Benfield Nursery, Inc. ("Benfield Nursery") operated a commercial wholesale nursery that grew trees, shrubs, and similar agricultural products on approximately 1,000 acres in western North Carolina.

On or about October 28, 2013, Benfield Nursery entered into a "Contract Grow Agreement" with Shemin Nurseries, Inc., a wholesale distributor of nursery stock. Benfield Nursery entered into a second "Contract Grow Agreement" with Shemin on or about April 9, 2015 (together, the "Grow Contracts").

The Grow Contracts contained certain terms and conditions, including the following provision:

> [I]f Benfield files for relief under Title 11 of the Bankruptcy Code, or is otherwise subject to an order for relief under the Bankruptcy Code:
>
> > (a) Shemin immediately thereupon shall be entitled to relief from the automatic stay imposed by Bankruptcy Code Section 362 on or against the exercise of any and all rights and remedies otherwise available to Shemin under this Agreement or applicable law. Benfield specifically acknowledges that "cause" exists for such relief within the meaning of Section 362(d) of the Bankruptcy Code, that Benfield does not own the [nursery stock] and that the [nursery stock] are not property of Benfield's bankruptcy estate and are not needed for reorganization of Benfield.

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[3] *In re Jeff Benfield Nursery, Inc.*, 2017 Bankr. LEXIS 196 (Bankr. W.D.N.C. Jan. 24, 2017).

Benfield Nursery ultimately filed for protection under Chapter 11 of the Bankruptcy Code in the U.S. Bankruptcy Court for the Western District of North Carolina on August 26, 2016. PNC Bank, N.A., asserted a secured claim in the debtor's bankruptcy case for approximately $6.1 million, alleging a perfected pre-petition security interest in substantially all assets of Benfield Nursery, including its accounts, inventory, equipment, and crops.

Similarly, Century Services LP asserted a secured claim against the debtor's bankruptcy estate of approximately $540,000. Century alleged that it, too, had a valid pre-petition lien against all of the debtor's assets, including crops, and that PNC's security interest was subordinate to Century's.

After the bankruptcy filing, SiteOne sought relief from the automatic stay. Among other things, it alleged that the debtor had waived the protections of the automatic stay in the Grow Contracts.

The debtor and PNC objected to SiteOne's motion for relief from the stay.

THE BANKRUPTCY COURT'S DECISION

The bankruptcy court denied SiteOne's motion, finding that the pre-petition waiver of the stay was "unenforceable as a matter of public policy" because it "effectively render[ed] the automatic stay meaningless."

According to the bankruptcy court, upholding a pre-petition waiver of this kind would deprive the debtor of the "breathing spell" contemplated by the Bankruptcy Code and would thwart the congressional intent underlying the imposition of the automatic stay. The bankruptcy court further held that "prepetition agreements purporting to interfere with a debtor's rights under the Bankruptcy Code are not enforceable."

Although it adopted a *per se* rule against enforcing these kinds of waivers, the bankruptcy court observed that the pre-petition waiver in the Grow Contracts "was a single term in a much broader agreement dealing with an entirely different subject matter." It did not appear to the bankruptcy court that there had been any bargained-for exchange with respect to the waiver language or that the debtor had received significant consideration in return for the inclusion of the provision.

The bankruptcy court then pointed out that the debtor also had submitted valuation evidence showing there was substantial equity in the estate, indicating there was a reasonable prospect of reorganization within a reasonable time-frame.

It concluded by pointing out that enforcing a stay waiver in this context would negatively impact other creditors, particularly those secured creditors

asserting blanket liens on all of the debtor's assets.

THE CASE LAW

To a large extent, the bankruptcy court decisions in *Intervention Energy* and *Benfield Holdings* should not be surprising.

Although a handful of courts have upheld pre-petition waivers[4] on the ground that enforcing such agreements furthered the legitimate public policy of encouraging out-of-court restructuring and settlements,[5] the majority of courts addressing this issue have reached a different conclusion.[6]

In particular, numerous courts have held that a debtor may not contract away the right to a discharge in bankruptcy.[7] One court stated, "[i]f any terms in the [c]onsent [a]greement . . . exist that restrict the right of the debtor parties to file bankruptcy, such terms are not enforceable."[8] Another court stated that "any attempt by a creditor in a private pre-bankruptcy agreement to opt out of the collective consequences of a debtor's future bankruptcy filing is generally unenforceable. The Bankruptcy Code pre-empts the private right to contract around its essential provisions."[9] Other courts have indicated that, "it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply"[10] and that "[i]t is a well settled principal that an advance agreement to waive the benefits conferred by the

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[4] *See, e.g., In re Powers*, 170 B.R. 480 (Bankr. D. Mass. 1994) (enforcing pre-petition waiver agreement); *In re Cheeks*, 167 B.R. 817 (Bankr. D.S.C. 1994) (same); *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) (same); *In re Citadel Properties, Inc.*, 86 B.R. 275 (Bankr. M.D. Fla. 1988) (same).

[5] *See, e.g., In re Cheeks*, *supra* ("Perhaps the most compelling reason for enforcement of the [pre-petition waiver] is to further the public policy in favor of encouraging out-of-court restructuring and settlement. . . . Bankruptcy courts may be an appropriate forum for resolving many of society's problems, but some disputes are best decided through other means.") (citation omitted).

[6] *See, e.g.*, *In re Jenkins Court Assocs. Ltd. Partnership*, 181 B.R. 33 (Bankr. E.D. Pa. 1995) (refusing to enforce a pre-petition waiver agreement); *Farm Credit of Cent. Florida, ACA v. Polk*, 160 B.R. 870 (M.D. Fla. 1993) (same); *In re Sky Group Int'l, Inc.*, 108 B.R. 86 (Bankr. W.D. Pa. 1989) (same).

[7] *See, e.g., Klingman v. Levinson*, 831 F.2d 1292 (7th Cir. 1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy.").

[8] *In re Cole*, 226 B.R. 647 (B.A.P. 9th Cir. 1998).

[9] *In re Pease*, 195 B.R. 431 (Bankr. D. Neb. 1996).

[10] *In re 203 N. LaSalle St. P'ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

bankruptcy laws is wholly void as against public policy."[11]

A district court in Arizona was even more emphatic: "If a contractual term denying the debtor parties the right to file bankruptcy is unenforceable, then a contractual term prohibiting the non-debtor party that controls the debtors from causing the debtors to file bankruptcy is equally unenforceable. Parties cannot accomplish through 'circuity of arrangement' that which would otherwise violate the Bankruptcy Code."[12]

The rationale of these courts holding against the enforceability of pre-petition waivers can be separated into two categories. First, in the context of a "single asset case," one bankruptcy court focused on the practical similarity between bargained-for pre-petition waivers of the automatic stay and consensual restraints against filing for bankruptcy in the first place.[13] The bankruptcy court pointed out that *ipso facto* clauses precluding a debtor's right to file for bankruptcy are *per se* invalid. The bankruptcy court then explained how, in a single asset case, a waiver of the automatic stay was functionally equivalent to a blanket prohibition against a bankruptcy filing:

> If the Debtor's single asset, i.e., the Project, passes from the bankruptcy estate through foreclosure, the Debtor, it can easily be seen, will have no realistic opportunity to attempt to formulate a repayment or reorganization plan.

Second, in the particular case of pre-petition waivers of the automatic stay, other courts have based their decisions not to uphold the waivers on the ground that the automatic stay was designed not only to protect debtors, but to protect creditors and ensure that all creditors are treated equally.

As one court explained, "the automatic stay provision is intended to preclude the opportunity of one bankruptcy creditor to pursue a remedy against the debtor to the disadvantage of other bankruptcy creditors and thus to promote the orderly administration of the bankrupt's estate."[14] In other words, if courts were willing to enforce pre-petition waivers of the automatic stay for the benefit of a single creditor, the protections provided by the Bankruptcy Code for the benefit of all other creditors would be jeopardized.

The decisions in *Intervention Energy* and *Benfield Nursery* are the latest

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[11] *In re Tru Block Concrete Prods., Inc.*, 27 B.R. 486 (Bankr. S.D. Cal. 1982).

[12] *NHL v. Moyes*, No. CV-10-01036-PHX-GMS, 2015 U.S. Dist. LEXIS 153262 (D. Ariz. Nov. 12, 2015).

[13] *In re Jenkins Court Assoc. Ltd. Partnership*, *supra.*

[14] *Farm Credit of Cent. Florida*, *supra.*

decisions by courts making it clear that pre-petition waivers—whether of the right to file for relief under the Bankruptcy Code or to waive the automatic stay once in bankruptcy—will not be upheld by the courts.