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The Tail of a Dog with Two Hats: Fifth Circuit Upholds "Golden Share" Held by Creditor Affiliate

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On May 22, 2018, the United States Court of Appeals for the Fifth Circuit issued its decision in *Franchise Services of North America v. United States Trustees (In re Franchise Services of North America)*, 2018 U.S. App. LEXIS 13332 (5th Cir. May 22, 2018). That decision affirms the lower court's holding that a "golden share" is valid and necessary to filing when held by a true investor, even if such investor is controlled by a creditor.

The backdrop of mergers and acquisitions leading up to this case need not be retold in detail to understand the holding's significance, but some context is helpful. Franchise Services of North America, Inc. ("FSNA"), one of North America's largest car rental companies, filed for chapter 11 bankruptcy without the required consent of its sole holder of preferred stock, Boketo, LLC ("Boketo"). Boketo was a minority shareholder that had invested $15 million in FSNA making it FSNA's single largest investor. Boketo is a wholly-owned subsidiary of investment bank Macquarie Capital (U.S.A.) ("Macquarie"), an unsecured creditor of FSNA's by virtue of an alleged $3 million claim for fees incurred in connection with the aforementioned transactions. When Boketo invested $15 million in FSNA, it required FSNA to re-incorporate in Delaware and add a "golden share" provision to its corporate documents, i.e. Boketo's affirmative vote of its preferred share was required for certain corporate events, such as filing bankruptcy. Nonetheless, FSNA eventually filed for chapter 11 in the Southern District of Mississippi without seeking Boketo's consent, fearing that shareholder Boketo—controlled by creditor Macquarie—would not consent to filing.

Macquarie and Boketo filed motions to dismiss the case for a lack of corporate authority under FSNA's amended corporate charter. In doing so, Macquarie donned two hats—that of a shareholder through Boketo and that of an unsecured creditor with a $3 million claim. FSNA asserted that Macquarie used Boketo as a "wolf in a sheep's clothing" to equip a creditor with shareholders' blocking rights under an allegedly unenforceable "blocking provision" or "golden share." FSNA implied the tail had been wagging the dog—that Macquarie made the $15 million investment through Boketo to avoid the cost and inconvenience of trying to collect some portion of its $3 million claim in FSNA's bankruptcy. The bankruptcy court denied Macquarie's motion because case law and public policy forbid a creditor from preventing a debtor's bankruptcy filing. However, it granted Boketo's motion, given its status as a voting shareholder. The Fifth Circuit affirmed, and found FSNA's theory that Macquarie chased $3 million with $15 million "strain[ed] credulity."

FSNA's various legal arguments each fell flat. First, FSNA sought a ruling that "blocking provisions" or "golden shares" (similar, but not identical, concepts), in general, are unenforceable under Delaware law. The Fifth Circuit declined to offer such an advisory opinion. Second, FSNA contended that even if Delaware law allowed these types of provisions, federal policy forbids them. This, too, failed to move the court, since the corporate charter did not eliminate FSNA's ability to file bankruptcy. Instead, it specified which parties' consent was necessary to authorize a bankruptcy filing, placing the decision with shareholders. Third, because authority to file bankruptcy is a matter of state law, FSNA argued that Boketo could not exercise its blocking right under Delaware law, and that Boketo had owed a fiduciary duty to facilitate the filing. The Fifth Circuit held that Delaware law, flexible by nature, allows a corporate charter to assign rights to shareholders that would ordinarily be assigned to directors/management, but declined to go so far as to determine whether such provision was valid under Delaware law. In addition, the court refuted FSNA's fiduciary duty argument because only *controlling* minority shareholders owe fiduciary duties, and here, Boketo was a non-controlling minority shareholder. The court

explained that the standard for minority control is a “steep one,” and that courts focus on control of the board—i.e., whether the minority shareholder can exert *actual control* over the company. While Boketo made a sizeable investment in FSNA, it only had the right to appoint 2 out of 5 directors and therefore could not exert actual control over the board. FSNA pointed to Boketo’s hypothetical ability to prevent bankruptcy as evidence of actual control, but the court distinguished such theoretical control from actual exertion thereof. The court keenly noted that FSNA defeated its own control argument when it filed bankruptcy without Boketo’s consent—if Boketo was a controlling shareholder, then once again the tail must have been wagging the dog.

Franchise Services highlights the potential for a creditor to essentially step into a shareholder’s shoes and assert shareholder rights pursuant to a corporate charter’s blocking provision or “golden share” by virtue of wearing two hats through a parent and subsidiary.