NOTE

EXPLORING THE ENFORCEABILITY OF PRE-PETITION HINDRANCE MECHANISMS TO PREVENT BANKRUPTCY

INTRODUCTION

Insolvency and bankruptcy pose great risks to a creditor's investments. Although business entities can never be truly bankruptcy-proof, creditors and practitioners have devised and employed a multitude of "hindrance mechanisms"[1] to significantly discourage bankruptcy petitions.[2] Creditors initially began insisting on provisions to prevent bankruptcy for three underlying reasons: (1) the protections the Bankruptcy Code afforded debtors, (2) the related litigation costs involved, and (3) the fact that decisions were often left up to a judge's whims.[3] However, as a rule of law, courts will render a hindrance mechanism *per se* invalid if the agreement operates as an ipso facto clause,[4] violates state law or case law, or otherwise violates the Bankruptcy Code.

As the title suggests, this Article examines five commonly used hindrance mechanisms. Each part explores one of the mechanisms, describes how it is used in practice, reviews recent relevant case law, and considers the advantages and flaws of the mechanism. Part I discusses bankruptcy remote provisions in organizational documents, specifically provisions that require a unanimous vote by the board of directors to authorize a voluntary bankruptcy filing and provisions that absolutely prohibit the debtor from filing for bankruptcy. Part II examines pre-petition waivers, which are contracts "entered into by the debtor and a creditor where the debtor voluntarily waives a right guaranteed in

---

[1] "A 'hindrance mechanism' is any sort of contractual device between the debtor and creditor that creates a disincentive for the debtor to file voluntarily for bankruptcy." Michael D. Fielding, *Preventing Voluntary and Involuntary Bankruptcy Petitions by Limited Liability Companies*, 18 BANKR. DEV. J. 51, 52 (2001).

[2] *See id.* at 51–52 (noting creditors require companies to sign contractual provisions, which allow creditors to repossess their collateral before bankruptcy is filed).

[3] Julie Satow, *'Bad Boy' Guarantees Snarl Billions in Real Estate Debt*, N.Y. TIMES, Jan. 18, 2011, http://www.nytimes.com/2011/01/19/business/19guarantee.html?pagewanted=all&_r=0.

[4] "An ipso facto clause is a 'contract clause[] or state law[] designed to effect a forfeiture or modification of the [d]ebtor's rights when a bankruptcy is filed.'" Fielding, *supra* note 1, at 53 (quoting Joyce A. Dixon & T. Randall Wright, *Bankruptcy Issues in Partnership and Limited Liability Company Cases*, SD83 ALI – ABA 189, 194 (May 13, 1999). The Bankruptcy Code does not expressly prohibit ipso facto clauses. *See* 11 U.S.C. §§ 101–1532 (2012).

bankruptcy in exchange for consideration by the creditor."[5] This Article discusses two types of pre-petition waivers: (1) the automatic stay waiver, and (2) the bad faith agreement. An automatic stay waiver is a promise by the debtor to waive the automatic stay protections once bankruptcy is filed. A bad faith agreement is a stipulation by the debtor that any bankruptcy petition subsequently filed shall be considered made in "bad faith" and warrant *for cause* dismissal of the case. Finally, Part III explores "bad boy" guaranties, which are personal guaranties, usually made by a person or party in control of the debtor, that are contingent upon the voluntary filing of bankruptcy.

I. BANKRUPTCY REMOTE PROVISIONS IN ORGANIZATIONAL DOCUMENTS

Bankruptcy is a major event in any company's existence. The authority to file a voluntary bankruptcy petition on behalf of a corporation or limited liability company is dictated by state law and the entity's governance instrument.[6] Typically, unless the entity's governance instrument provides otherwise, ratification by the board of directors is required to file a voluntary petition on behalf of the company.[7] To minimize the risk of bankruptcy, a creditor may require that the company amend its bylaws to either (a) require a unanimous directorial vote to authorize a voluntary bankruptcy filing, or (b) completely bar the voluntary filing of bankruptcy.[8]

A. Provisions Requiring Unanimous Directorial Vote to File Bankruptcy

Under section 141(b) of Delaware's General Corporations Law, a vote by the majority of directors shall constitute an act by the board of directors, *unless the corporation's bylaws require otherwise*.[9] Courts have generally found unanimous vote provisions enforceable under this corporate law proposition

---

[5] Fielding, *supra* note 1, at 61 n.67.

[6] *See, e.g.*, Price v. Gurney, 324 U.S. 100, 106 (1945); *In re* Gen-Air Plumbing & Remodeling, Inc., 208 B.R. 426, 430 (Bankr. N.D. Ill. 1997).

[7] *See* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 702 (2009).

[8] *See, e.g., In re* Minor Emergency Ctr. Of Tamarac, Inc., 45 B.R. 310, 311 (Bankr. S.D. Fla. 1985) (holding that bankruptcy was filed without authority because required unanimous vote was not reached). However on rare occasion, a court will permit a corporation to file for voluntary bankruptcy without a unanimous director vote, despite the corporate bylaws requiring otherwise. *See In re* Buckhead America Corp., 1992 Bankr. LEXIS 2506 (Bankr. D. Del. Aug. 13, 1992) (granting permission to corporation to file voluntary petition without unanimous director vote, even though corporation's bylaws required such a vote) (unpublished opinion) (discussed in Kenneth N. Klee & Brendt C. Butler, *Asset-Baked Securitization, Special Purpose Vehicles and Other Securitization Issues*, 35 UCC L.J. 23, 38–39 n.65 (2002)).

[9] *See* DEL. CODE ANN. tit. 8, § 141(b) (2006) (codifying default rule in Delaware which requires vote by majority of directors to constitute act of directors).

since the company's bylaws are specifying a specific act for which the directors must obtain unanimous approval by directors, as opposed to majority approval.[10] Courts have further rationalized the enforcement of unanimous vote provisions by holding that it is not unreasonable to require that all of the directors support a decision that will substantially affect the company's short and long-term performance and profitability.[11]

Although unanimous vote provisions are valuable in enhancing a company's bankruptcy remoteness, alone they are not particularly effective in protecting a specific creditor's interests. Therefore, to further amplify bankruptcy remoteness, creditors will often negotiate the right to place at least one "independent" director on the board of directors.[12] This essentially grants the creditor "veto power over board actions that jeopardize the bankruptcy remoteness" of the corporation.[13] Using this veto power, the "independent" director can act as a check on the debtor's board of directors to ensure that the board acts in the creditor's best interests.

Three potential disadvantages for either the corporation or sponsor-creditor[14] may arise from this "independent" director model. First, "independent" directors may owe conflicting duties to the debtors' shareholders and creditors, and the sponsor-creditor. Corporate directors owe fiduciary duties to the corporation's shareholders.[15] However, when the corporation is insolvent, a director's fiduciary duties extend to the corporation's creditors as well.[16] This duality gives rise to inherent conflicts of interest for the "independent" director, who statutorily owes fiduciary duties to shareholders and all creditors, but contractually has an obligation to act in the sponsor-creditor's best interest. The result can be catastrophic. Shareholders, creditors, or the sponsor-creditor may file a derivative or direct lawsuit depending on the "independent" director's actions, potentially resulting in liability for any of the

---

[10] *See* Klee & Butler, *supra* note 8, at 38–39 n.65 (comparing case where court honored corporation's unanimous vote provision with case where court did not).

[11] *See, e.g.*, Sutton v. Sutton, 637 N.E.2d 260, 262 (N.Y. 1994) (upholding corporation's unanimity provision for corporate decisions).

[12] *See* Fielding, *supra* note 1, at 66 n.91 (discussing importance of carefully crafted agreements between sponsoring-creditor and debtor-corporation to dissuade and prevent debtor-corporation from removing "independent" director or amending concerned provisions in bylaws).

[13] *See* Klee & Butler, *supra* note 8, at 39.

[14] For purposes of this paper, "sponsor-creditor" refers to the creditor that appoints the "independent" director to the debtor's board.

[15] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986). The "independent" director's allegiance to the creditor does not automatically disqualify him from serving as a director. In the wake of the recent economic recession however, an increasing number of shareholder proposals have recommended that corporations amend bylaws to require a minimum percentage of directors be disinterested.

[16] *See, e.g.*, RSL Commc'ns PLC v. Bildirici, 649 F. Supp.2d 184, 202 (S.D.N.Y. 2009).

parties involved.[17] Also, bankruptcy courts have historically refused to honor these unanimous voting provisions where a single dissenting director has breached fiduciary duties by voting against a resolution to file for bankruptcy.[18]

The ability of a debtor to bypass a dissenting director's vote in opposition of bankruptcy was analyzed in detail in *In re General Growth Properties, Inc.*[19] In *In re General Growth Properties*, the corporate debtor owned 160 single-purpose entities ("SPEs"), each of which had an operating agreement that required "unanimous written consent" by managers to file for bankruptcy.[20] When the parent-debtor filed bankruptcy, it included all 160 SPEs in the chapter 11 filings, despite not obtaining the consent of each SPEs' managers.[21] In response, the SPEs' creditors moved to dismiss the SPEs' bankruptcy, claiming that they were filed in "bad faith."[22] One creditor even testified that independent SPE board members were hired to make the SPEs bankruptcy-remote by preventing bankruptcy filings and that allowing the bankruptcy would disturb directors' abilities to prevent bankruptcy in the future.[23] The bankruptcy court in the Southern District of New York disagreed, however.[24] The court held that since the SPEs were still solvent or only within the "zone of insolvency," the directors' fiduciary duties were wholly owed to the SPEs' shareholders, which was the parent-debtor.[25]

Second, the sponsor-creditor may be considered an insider for property avoidance purposes. If the corporation defaults on the loan and the sponsor-creditor subsequently repossesses the securitized asset, the board of directors will vacate the "independent" designee's position as a director. This in turn allows the board to unanimously vote in favor of a voluntary bankruptcy

[17] *See* Fielding, *supra* note 1, at 67 & n.94. There are "several reasons why creditors and 'independent' voters may want to seriously consider the implications of their actions. First, both the creditor and 'independent' designee are subject to substantial liability and/or punitive damages. Second, attorneys should be particularly wary of playing the role of the independent designee because of the serious ethical dilemmas created by the conflicting fiduciary duties." *Id.* at 67 n.94.

[18] *See* Bussel & Klee, *supra* note 7, at 702–03.

[19] 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[20] *Id.* at 63.

[21] *See id.* at 59.

[22] *Id.* at 47.

[23] *Id.* at 64.

[24] *See id.* at 64–65.

[25] *See id.* A key factor in deciding this case was whether the SPEs were insolvent. The court cited to *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* in holding that directors only owe fiduciary duties to the debtor's creditors when the debtor is insolvent and rejecting the proposition that directors owe creditors heightened duties when operating in the "zone of insolvency." *Id.* at 64 (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007)). It is worth noting that by rejecting the "zone of insolvency" proposition, the Delaware Supreme Court has left open issues of "[w]hen and how a corporation should be determined to be insolvent." *Id.*

petition, thereby permitting the trustee to avoid the repossession,[26] since the sponsor-creditor will likely be considered an insider under the Bankruptcy Code.[27] Under section 547(b)(4)(A), "the trustee may avoid any transfer of an interest of the debtor in property . . . made . . . on or within 90 days before the date of the filing of the petition[.]"[28] This preferential-grace period is extended to one year for insiders.[29] In the context of a corporation-debtor, the Bankruptcy Code defines an "insider" to include a "director of the debtor" or "person in control of the debtor."[30] The sponsor-creditor may avoid the insider designation, however, by including a provision in the security agreement that requires the "independent" director to remain on the board for at least one-year following repossession. Although this would further the sponsor-creditor's goal of bankruptcy-proofing its collateral interest, the debtor's other creditors may still defeat the sponsor-creditor's scheme by filing an involuntary bankruptcy petition.

The problems inherent in the creditor-appointed "independent" director model were discussed at length in *In re U.S. Medical, Inc.*[31] In *U.S. Medical*, the debtor entered into a "strategic alliance" with the creditor, whereby the creditor agreed to serve as debtor's sole manufacturer of lasers, was given the right to appoint a member of debtor's board of directors, and acquired a 10.6% equity interest in the debtor for $2 million in cash and $2 million in inventory-purchase credit.[32] The creditor's CEO was ultimately appointed to debtor's board.[33] Following financial difficulties, the debtor voluntarily filed for chapter 7 bankruptcy.[34] During proceedings, the trustee sought to avoid several transfers made to the creditor prior to the one-year preferential-grace period by proving that the creditor was an "insider."[35] Although the Tenth Circuit held that the creditor was not an insider,[36] the court thoroughly analyzed when a creditor should be classified as an insider. According to the court, there are two types of

---

[26] It is worth noting that even if a one-year provision is included, other creditors may still file an involuntary petition for bankruptcy before the twelve-month preferential-grace period expires. *See* 11 U.S.C. §§ 301, 303 (2012).

[27] *See* 11 U.S.C. § 101(31)(B)(iii) (2012). *See also* Bussel & Klee, *supra* note 7, at 675 n.47.

[28] 11 U.S.C. § 547(b)(4)(A) (2012).

[29] *See* 11 U.S.C. § 547(b)(4)(B).

[30] 11 U.S.C. § 101(31)(B)(i), (iii).

[31] Anstine v. Carl Zeiss Meditec AG (*In re* U.S. Med., Inc.), 531 F.3d 1272 (10th Cir. 2008).

[32] *See id.* at 1274.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] The court explained that because the CEO-director "did not participate in any vote concerning the Creditor," delegated "[a]ll day-to-day business between Debtor and Creditor" to the Creditor's CFO, remained "sensitive to 'potential conflicts of interest' and . . . 'attended to the kinds of formalities one would expect to see in dealings between third parties at arm's length,'" the creditor did not have a sufficiently close relationship with the debtor to be classified as an insider. *Id.* (citations omitted).

insiders under the Code: (1) *per se* insiders (directors and officers) and (2) individuals with "a sufficiently close relationship with the debtor" (family members, creditors who control the decisions of an "independent" director).[37] Three factors are considered to determine whether "a sufficiently close relationship" exists. The court will look to (1) closeness of the relationship between creditor and debtor, (2) whether transactions between the parties were conducted at arm's length, and (3) whether the creditor asserted undue influence or control over the debtor.[38] If the court finds that a creditor controls a debtor, for instance, an "independent" director that vetoes voluntary bankruptcy based on his relationship with the creditor, without concern for his fiduciary duties to shareholders and other creditors, then the sponsor-creditor will likely be found to be an insider.[39] In *U.S. Medical*, since the creditor's CEO refused to participate in board decisions in which he had conflicted interests, the court held that the creditor did not have a "sufficiently close relationship" to be considered an insider.[40]

There is at least one more downside to the "independent" director model. Companies that require unanimous consent to file a voluntary bankruptcy petition still face the possibility of other creditors filing involuntary bankruptcy petitions. This leaves open the opportunity for debtor's insiders to circumvent the corporate bylaws or a dissenting director, and coordinate a "friendly" involuntary petition by other creditors. This is precisely what happened in *In re Kingston Square Associates*.[41] In *Kingston Square*, the creditor-appointed director refused to consent to bankruptcy, despite the debtor's severe insolvency.[42] In an effort to protect the debtor-company and other creditors, one of the debtor's insiders coordinated with the other creditors for the filing of a friendly involuntary bankruptcy petition.[43] In a seminal and frequently cited decision, the bankruptcy court denied the creditor's motion to dismiss for collusion and bad faith.[44] The court explained that while the orchestration was "suggestive of bad faith," this fact alone was insufficient grounds for

[37] *See* Rupp v. United Sec. Bank (*In re* Kunz), 489 F.3d 1072, 1078–79 (10th Cir. 2007).

[38] Anstine v. Carl Zeiss Meditec AG (*In re* U.S. Medical, Inc.), 531 F.3d 1272, 1276–77 (10th Cir. 2008).

[39] *Cf. id.* at 1277 (holding close relationship alone is sufficient to deem creditor non-statutory insider).

[40] *Id*. at 1274; *see also supra* note 36.

[41] 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

[42] *Id.* at 722. The Creditor had initiated foreclosure proceedings to recover its secured assets. *Id.* at 717.

[43] *Id.* at 714.

[44] *See id.* at 714–15.

dismissal.[45] Moreover, the court expressly declined to address whether the bankruptcy remote provisions might be "void against public policy."[46]

B. Absolute Prohibitions on Voluntarily Filing Bankruptcy

In recent years, Wall Street has become increasingly unwilling to lend money to companies without certain provisions in the debtor's bylaws that reduce the possibility that bankruptcy will be filed.[47] In response, many companies have taken the initiative to increase their own bankruptcy remoteness in hopes of attracting creditors by including a provision in the bylaws that prohibits directors and management from filing a voluntary bankruptcy petition. The problem, however, is determining whether such provisions are ipso facto clauses or will otherwise be found unenforceable by a bankruptcy court.[48]

To answer this, we must remember that debtors are not required to file for bankruptcy; it is a *right* belonging to the company.[49] The company, through ratification by directors and shareholders, has the right to include in its bylaws specific activities that are and are not allowed, with the exception of those provided by law.[50] Theoretically, an insolvent company could avoid bankruptcy and continue to operate in the red or until it depletes all its resources and must shut its doors. Unfortunately, it is not this simple—the debtor-company and its directors (and management) would likely face financial and legal repercussions.

The enforceability of provisions that absolutely prohibit the filing of bankruptcy is often contingent on two factors: (1) corporate law issues, specifically whether fiduciary duties are owed and violated if the board of directors decides not to file for bankruptcy, despite insolvency,[51] and (2)

---

[45] *Id.* at 734.

[46] *Id.* at 737.

[47] William H. Schorling, *Debtor May Avoid Bankruptcy Remote Provisions by Orchestrating Filing of Involuntary Bankruptcy*, MARTINDALE.COM, May 30, 2003, http://www.martindale.com/bankruptcy-law/article__10672.htm (citing two instances where banks required debtors to amend bylaws to prohibit bankruptcy filings without unanimous board approval).

[48] Although the Bankruptcy Code does not expressly prohibit such clauses, courts generally refuse to enforce them. *See In re* L.A. Lumber Prods. Co., 24 F. Supp. 501, 515 (S.D. Cal. 1938), *aff'd*, 100 F.2d 963 (9th Cir. 1939), *rev'd on other grounds sub nom.*, Case v. L.A. Lumber Prods. Co., 308 U.S. 106 (1939) (holding bond indenture provision which prohibited debtor's bankruptcy filing was void as against public policy); *see also In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (stating that an agreement to waive the benefits of bankruptcy is "wholly void as against public policy.").

[49] *See* 11 U.S.C. § 301. Of course, any creditor or interested party may file an involuntary bankruptcy petition under section 303 of the Code, assuming certain minimum contingencies are met. *See* 11 U.S.C. § 303.

[50] DEL. CODE ANN. tit. 8, § 102 (2006) (stating provisions allowed in bylaws).

[51] Recall that if the debtor is within the "zone of insolvency," directors' fiduciary duties are only owed to the company and shareholders. *See supra* note 25.

whether the company or its directors were coerced into including the provision.[52] Determining what fiduciary duties are owed depends on two key elements: (1) the business organization of the company, i.e., whether the debtor is a corporation or a limited liability company, and (2) the bylaws, i.e., whether the directors' fiduciary duties are expressly limited or eliminated by the company's bylaws or operating agreement.[53]

Under Delaware General Corporation Law section 102(b)(7), a corporation may include in the certificate of incorporation a provision "eliminating or limiting personal liability of a director to the corporation or its stockholders . . . for breach of fiduciary duty" of care, but not for the duty of loyalty or good faith.[54] Moreover, courts have extended this exculpatory clause exception to duties owed to creditors when the organization is insolvent.[55] If, for instance, an insolvent corporation's bylaws eliminate the duty of care and directors vote not to file for bankruptcy because of a provision in the bylaws prohibiting such, would the directors be liable? The answer is that it depends. If the voting-directors' interests were not conflicted or otherwise in breach of their duties of loyalty and good faith, there should be no liability for not filing for bankruptcy. However, if the directors knew that serious harm would result to the corporation, its shareholders, or its creditors, then liability would depend on the

---

[52] *See In re* DB Capital Holdings, LLC, No. CO-10-046, 2010 WL 4925811, at *3 (B.A.P. 10th Cir. 2010) (holding that company was not coerced into including provision).

[53] *See In re* USDigital, Inc., 443 B.R. 22, 43 (Bankr. Del. 2011) (stating if corporation's bylaws contain provision exculpating its directors from monetary liability for breach of duty of care, then duty of care violations are actionable only if directors acted with gross negligence).

[54] DEL. CODE ANN. tit. 8, § 102(b)(7) (2011). The duty of care focuses on the substance and procedural adequacy of the decision—did the directors make their decision in good faith and in an informed manner, by conducting reasonable investigation and exercising due deliberation. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). The duty of loyalty focuses on whether directors placed their own interests ahead of the corporation's and its shareholders' (and if insolvent, its creditors') interests. Typically, loyalty breaches arise in three situations: (1) when the directors' interests are conflicted, (2) when the directors self-deal by acting to the exclusion of and detriment to the corporation and shareholders (and creditors, if insolvent), and (3) if directors usurp corporate opportunities. *See, e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120–21 (Del. 2006); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). The duty of good faith focuses on whether directors acted in an adequate and reasonable manner in dealing with conflict or loyalty issues. The key question in determining if good faith was breached is whether the director acted either (1) with an intent to cause harm or to violate laws, or (2) with scienter in purposeful dereliction (or disregard) for his/her responsibilities to the corporation, shareholders and creditors. *See, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009); *In re* Walt Disney Co., 906 A.2d 27, 65 (Del. 2006); Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006); *In re* Caremark Int'l Inc., 698 A.2d 959, 967 (Del. Ch. 1996).

[55] *See* Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 723 (2011) ("[U]pon insolvency, creditors become the beneficiaries of duties owed to the company. With a blanket waiver in place, however, partners and managers of insolvent businesses would . . . be free of fiduciary duty constraints, even though creditors had not consented, or . . . had notice that duties had been waived.") (citations omitted).

situation—though an act with intent to cause harm would likely be considered a breach of good faith. Similarly, as discussed above, in the "independent" director model the "independent" director owes conflicting duties to the sponsor-creditor and the corporation, its shareholders and its other creditors. In that case, the "independent" director would more than likely be held in breach of the duty of loyalty.[56]

This issue of breaching fiduciary duties is particularly unclear when creditors require that a corporation include a bankruptcy prohibition provision in its bylaws in order to approve a loan. The circumstance in which the board accepted such terms might seriously impact whether the directors are in breach of their fiduciary duties. For example, if the corporation was in dire need of a loan and had no other choice but to accept a creditor's terms, which included a mandate that the corporation adopt a bankruptcy prohibition provision, then a court would likely hold that the directors acted with due care and loyalty for the shareholders and the corporation at the time the loan was accepted. However, if the board of directors later ratified a vote to voluntarily file for bankruptcy, it is not entirely clear based on precedent whether a bankruptcy court would grant a creditor's motion to dismiss a bankruptcy petition for bad faith filing.[57] Most likely a court would deny the motion and proceed with the bankruptcy if the debtor (or another interested party) could establish that the debtor was coerced into accepting the bankruptcy prohibition provision. Conversely, if the board of directors had other loan options and could have borrowed under terms that did not include a bankruptcy prohibition requirement, then, depending on the circumstances,[58] a court might find that the directors were in breach of their fiduciary duties. This also explains why Wall Street is more willing to lend to corporations that already include provisions that prohibit the filing of bankruptcy in their bylaws since the issue of coercion or conflicting loyalties will likely not be raised should the provision be questioned in court later down the road.

The above analysis on the enforceability of bankruptcy prohibition provisions is much simpler for limited liability companies ("LLCs") and limited partnerships ("LPs"). Under Delaware law, an LLC's operating agreement (and LP's partnership agreement) may expand, restrict or eliminate the members' or managers' fiduciary duties, provided that the agreement does not eliminate the implied contractual covenant of good faith and fair dealing.[59] Therefore, if a

---

[56] *See supra* Part I.A.
[57] *See infra* Part II.B.
[58] An example would be where the board had a long-standing relationship with the specific creditor and believed that accepting the creditor's terms and not borrowing from another creditor was in the best interest of advancing the goals of the corporation and profitability for shareholders.
[59] DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2011). The operating agreement *must* include explicit language reducing or eliminating fiduciary duties. If a company's operating agreement is silent

LLC's (or LP's) operating agreement eliminates managers' and members' fiduciary duties, then a court's evaluation of the enforceability of a bankruptcy prohibition provision would solely depend on the circumstances in which that provision was included. As discussed above, if a creditor required that such a provision be included in the operating agreement, then a bankruptcy court might deny a motion to dismiss the bankruptcy petition for lack of authority by the LLC's (or LP's) members or management to file for bankruptcy. However, if the LLC (or LP) included such a provision on its own accord, without coercion by a creditor, then a bankruptcy court would likely grant that motion to dismiss, as the Tenth Circuit Bankruptcy Appellate Panel ("B.A.P.") did in *In re DB Capital Holdings, LLC*.[60]

In re DB Capital is a case of first impression that held a provision in a LLC's operating agreement prohibiting the LLC's members and management from filing a bankruptcy petition is valid.[61] The B.A.P. explained that although the Colorado LLC Act does not explicitly countenance provisions that prohibited bankruptcy, it provides that the operating agreement governs the rights and duties of a LLC's members and managers.[62] Therefore, since the bankruptcy case was filed on behalf of the debtor without authority under the debtor's operating agreement or state law, the bankruptcy case must be dismissed.[63] The B.A.P. also acknowledged the case law holding that a contractual provision with a third-party to waive bankruptcy protection is unenforceable, but could not locate any case "standing for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy[.]"[64] Furthermore, the B.A.P. noted that there was no evidence of coercion by a creditor that led the members to adopt the bankruptcy prohibition provision and explicitly refused to opine whether a similar provision coerced by a creditor would be enforceable.[65]

---

as to the duties controlling members, then they will owe traditional fiduciary duties to the company. *See* Kelly v. Blum, No. 4516-VCP, 2010 WL 629850, at *13 (Del. Ch. Feb. 24, 2010). The operating agreement may also limit the good faith obligation owed by members and managers by identifying specific procedures by which a company may fulfill its duties and rebut a claim of breach of the implied covenant of good faith. *See* Gerber v. Enter. Prods. Holdings, LLC, No. 5989-VCN, 2012 WL 34442, at *11 (Del. Ch. Jan. 6, 2012).

[60] No. CO-10-046, 2010 WL 4925811, at *5 (B.A.P. 10th Cir. 2010).

[61] *Id.*

[62] *Id.* at *2.

[63] *See id.* at *5.

[64] *Id.* at 3. The manager that filed the voluntary petition argued that the B.A.P. should have invalidated the bankruptcy prohibition provision because it "was executed at the demand, for the sole benefit of the Debtor's main secured creditor," and therefore, the provision was unenforceable as a matter of public policy. However, the B.A.P. rejected this argument for the reasons described in the text above. *Id.*

[65] Precedent implies that a bankruptcy prohibition provision coerced by a creditor would be impermissible as a matter of public policy. *See id.*

Although it is uncertain whether other jurisdictions will definitely follow the Tenth Circuit B.A.P.'s analysis of the enforceability of bankruptcy prohibition provisions, precedent and several states' laws, Delaware included, indicate that most would.[66] For now, the best way for lenders to protect themselves is to lend to debtors who have bankruptcy prohibition provisions in their bylaws *prior to* contracting for the loan. This way the creditor is in no way involved with the debtor's inclusion of the provision in its bylaws, thereby preventing an issue of coercion from being raised should the provision be questioned in a bankruptcy court later down the road.

II. PRE-PETITION WAIVERS OF RIGHTS

Although the Bankruptcy Code contains no provisions making a debtor's pre-petition waiver of bankruptcy protection unenforceable,[67] courts have almost universally held that an *absolute* waiver of the right to file a voluntary bankruptcy petition is invalid as against public policy.[68] As a result, several pre-petition waivers, or hindrance mechanisms, have been crafted to make filing a voluntary petition more difficult for debtors. This section will focus on two such pre-petition waivers: (1) automatic stay waivers, and (2) bad faith stipulations. As used in this article, a pre-petition waiver "constitutes a *contract* entered into by the debtor and a creditor where the debtor voluntarily waives a right guaranteed in bankruptcy in exchange for consideration by the creditor."[69] While these waivers do not completely eliminate the risk of bankruptcy, they reduce the possibility of unwanted filings.[70]

Courts are split on the enforceability of pre-petition waivers.[71] Some courts have explained that "since bankruptcy is designed to produce a system of

---

[66] For cases noting trend among courts supporting Tenth Circuit B.A.P.'s analysis, *see, e.g., In re* FKF Madison Park Grp. Owner, LLC, Bankr. No. 10–11867, 2011 WL 350306, at *3 (Bankr. D. Del. Jan. 31, 2011); *In re* 210 West Liberty Holdings, LLC, No. 08–677, 2009 WL 1522047, at *4 (Bankr. N.D. W. Va. May 29, 2009); Willoughby Rehab. & Health Care Ctr., LLC v. Webster, No. 12431–04, 2006 WL 3068961, at *3 (N.Y. Sup. Ct. Oct. 26, 2006).

[67] *See generally* 11 U.S.C. §§ 101–1532 (2012).

[68] *See, e.g.*, *In re* Cole, 226 B.R. 647, 651 & n.6 (B.A.P. 9th Cir. 1998); *In re* Detrano, 222 B.R. 685, 688 (Bankr. E.D.N.Y. 1998), *vacated*, 266 B.R. 282 (E.D.N.Y. 2001), *aff'd*, 326 F.3d 319 (2d Cir. 2003); *In re* Minor, 115 B.R. 690, 694–96 (D. Colo. 1990); *In re* Ethridge, 80 B.R. 581, 586 (Bankr. M.D. Ga. 1987); *In re* Halpern, 50 B.R. 260, 262 (Bankr. N.D. Ga. 1985), *aff'd*, 810 F.2d 1061 (11th Cir. 1987); *In re* Bisbach, 36 B.R. 350, 352 (Bankr. W.D. Wis. 1984); *In re* Kriger, 2 B.R. 19, 23 (Bankr. D. Or. 1979).

[69] Fielding, *supra* note 1, at 61 n.67 (emphasis added).

[70] *See id.* at 61–62.

[71] *Compare, e.g.*, *In re* Frye, 320 B.R. 786, 795 (Bankr. D. Vt. 2005) (holding waivers enforceable), *with In re* Shady Grove Tech. Ctr. Assocs. Ltd. P'ship, 216 B.R. 386, 390 (Bankr. D. Md. 1998) (stating that "prohibitions against the filing of a bankruptcy case are unenforceable"), *In re* Madison, 184 B.R. 686, 690–92 (Bankr. E.D. Pa. 1995), *In re* Freeman, 165 B.R. 307, 312 (Bankr. S.D. Fla. 1994), *and In re* Gulf Beach Dev. Corp., 48 B.R. 40, 43 (Bankr. M.D. Fla. 1985) ("[T]he Debtor

reorganization and distribution different from what would obtain under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply."[72] Other courts, however, enforce certain pre-bankruptcy contractual provisions based on a case-by-case fact-specific balancing of several judicially established considerations.[73] Those courts rationalize the enforcement of pre-petition agreements by explaining that the benefits and utilities of enforcement outweigh the concerns.[74]

A. Automatic Stay Waivers

An automatic stay waiver is a promise by the debtor to waive the Bankruptcy Code's automatic stay protections once the petition is filed.[75] The waiver is often formulated as a waiver of the right to defend against a motion to lift the stay. Although courts generally agree that stay waivers are not self-executing and creditors must petition the court for relief from the stay,[76] courts are split on the enforceability of these pre-petition waivers.[77]

---

cannot be precluded from exercising its right to file Bankruptcy and any contractual provision to the contrary is unenforceable as a matter of law.").

[72] *In re* 203 North LaSalle St. P'ship, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000).

[73] *See, e.g.*, *In re* Frye, 320 B.R. at 795 (holding waiver enforceable if equities favor enforcement), *In re* Shady Grove Tech Ctr. Assoc. Ltd. P'ship, 216 B.R. 386, 388 (Bankr. D. Md. 1998) (holding that "cause for relief from stay is not limited to a lack of adequate protection or a finding of bad faith motive for filing the bankruptcy case."). *See also infra* Part II lists of factors to determine the enforceability of certain pre-petition waivers.

[74] *See infra* Part II.B. for discussion of three underlying considerations courts balance to determine the general enforceability of pre-petition waivers.

[75] Under section 362 of the Code, when a bankruptcy petition is filed, all of a debtor's creditors are *automatically* enjoined from commencing or continuing proceedings against the debtor, enforcing judgments, perfecting liens, collecting debts, and repossessing any of the bankruptcy estate's property. 11 U.S.C. § 362 (2012). "Thus, the automatic stay enjoins a secured lender from taking action to realize the value of its collateral." Harold S. Novikoff & Barbara S. Kohl, *Bankruptcy "Proofing": Bankruptcy Remote Vehicles and Bankruptcy Waivers*, SE71 ALI– ABA 1, Feb. 2000, at 12. The stay "continues until the bankruptcy case is closed, dismissed, or discharge is granted or denied, or until the bankruptcy court grants some relief from the stay." Mar. Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1206 (3d Cir. 1992). Any party in interest may obtain relief from the stay after notice, a hearing, and sufficient cause is provided. 11 U.S.C. § 362(d).

[76] *See, e.g.*, *In re Shady Grove*, 216 B.R. at 390; *In re* Darrell Creek Assocs., L.P., 187 B.R. 908, 912 (Bankr. D. S.C. 1995); *In re* Powers, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *see also* Novikoff & Kohl, *supra* note 75, at 13–14.

[77] *Compare, e.g.*, *In re Shady Grove*, 216 B.R. at 386 (automatic stay waivers are enforceable), *In re* Atrium High Point Ltd. P'ship, 189 B.R. 599, 607 (Bankr. M.D. N.C. 1995), *In re Darrell Creek*, 187 B.R. at 910, *In re* Cheeks, 167 B.R. 817, 818 (Bankr. D. S.C. 1994), *and In re Powers*, 170 B.R. at 483, *with In re* Pease, 195 B.R. 431, 433 (Bankr. D. Neb. 1996) (automatic stay waivers are not enforceable), *In re* Jenkins Court Assocs., 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995), Farm Credit of Cent. Fla., ACA v. Polk, 160 B.R. 870, 873–74 (M.D. Fla. 1993), *and In re* Sky Grp. Int'l, Inc., 108 B.R. 86, 89 (Bankr. W.D. Pa. 1989).

Courts for and against enforcing automatic stay waivers frequently root their reasoning in the Code's underlying and competing public policy. Recently, in *In re Frye*,[78] the bankruptcy court in Vermont examined the enforceability of automatic stay waivers. In that case, the court set out ten factors key to determining stay waiver enforceability.[79] The factors included: (1) the sophistication of the party making the waiver; (2) the consideration given by the creditor for the waiver; (3) whether other parties, such as unsecured creditors, are or will be affected by the waiver; (4) the feasibility of the debtor's plan; (5) whether there is evidence the waiver was obtained by coercion, fraud, or mutual mistake of material facts; (6) whether enforcing the agreement will further the legitimate public policy of encouraging out-of-court restructuring and settlement; (7) the likelihood of reorganization; (8) the extent to which the creditor would otherwise be prejudiced if the waiver is not enforced; (9) the proximity in time between the waiver date and the bankruptcy filing date (and whether there was a compelling change in circumstances during that time); and (10) whether the debtor has equity in the property and the creditor is otherwise entitled to relief from the stay under section 362(d).[80] The court also noted that "[t]he weight given to each factor will vary on a case-by-case basis and must be left to the sound discretion of the court[.]"[81]

The factors set forth in *In re Frye* were recently applied in *In re DB Capital Holdings, LLC*.[82] In *DB Capital*, the creditor agreed to forego exercising remedies against its collateral, to extend the debtor's deadline for completion of a creditor financed project, and to provide an additional $11,964,331 to fund the debtor's obligations.[83] As consideration, the debtor agreed not to oppose any creditor motion for relief from an automatic stay.[84] The bankruptcy court in Colorado granted the creditor's motion for relief, explaining that although stay waivers should seldom be enforced, the factors for granting the creditor relief

[78] 320 B.R. 786 (Bankr. D. Vt. 2005).
[79] *See id.* at 790–91.
[80] *Id.*
[81] *Id.* at 791. In addition, courts ruling against enforcing stay waivers often cite factors such as: (1) the ipso facto clause effect of the stay waiver; (2) debtor's lack of capacity to bind the bankruptcy estate; (3) the Code's prohibitions on pre-petition agreements to forego any *essential* provision of the Code; and (4) that granting stay relief would "ignore[] the fact that . . . [the Code] also is designed to protect all creditors and to treat them equally," and creditors' reliance on their Code-provided rights when contracting with debtor. *In re Sky Grp. Int'l*, 108 B.R. at 89 (emphasis omitted). *See* Ass'n of St. Croix Condominium Owners v. St. Croix Hotel Corp., 682 F.2d 446, 448 (3d Cir. 1982); Klee & Butler, *supra* note 8, at 37. *See also* Schorling, *supra* note 47.
[82] 454 B.R. 804 (Bankr. D. Colo. 2011).
[83] *Id.* at 813.
[84] *Id.*

outweighed those against enforcement.[85] Conversely, in *In re Deb-Lyn, Inc.*, the district court for the Northern District of Florida refused to enforce an automatic stay waiver.[86] The court explained that because the debtor was a significant business enterprise that operated twelve franchises, employed hundreds of individuals and generated significant income, this case was designed for chapter 11.[87]

Unfortunately, the conflicting views among courts regarding the enforceability of automatic stay waivers cannot be reconciled. A sharp divergent view among courts has developed regarding the utility, benefits, and desirability of enforcing automatic stay waivers.[88] As a result, the applicability of a stay waiver relies heavily on the specific facts of each individual case.

B. "Bad Faith" Stipulations

A bad faith agreement is a stipulation that any bankruptcy petition subsequently filed shall be considered made in "bad faith" and warrant *for cause* dismissal of the case. Although not *per se* enforceable,[89] many courts enforce bad faith agreements based on the underlying facts and circumstances that would otherwise warrant a finding of bad faith.[90] Therefore, to increase the likelihood that a court will grant a motion to dismiss for bad faith, creditors will often have debtors stipulate to factual findings of bad faith filings.[91]

The principle that a bankruptcy case can be dismissed for a bad faith filing is a judge-made doctrine.[92] "[G]rounds for dismissal exist if it is clear on the filing date that 'there was no reasonable likelihood that the debtor intended to

---

[85] *Id.* at 812–20, 824. It should be noted that *DB Capital* is a single asset real estate case. Historically, courts will often enforce automatic stay waivers in single asset real estate cases. *See id.* at 814.

[86] No. 03-00655-GVL1, 2004 WL 452560, at *2 (Bankr. N.D. Fla. Feb. 20, 2004) ("[P]re-petition agreements providing for the lifting of the automatic stay are not per se binding on the debtor, as a public policy position.") (citations omitted).

[87] *Id.* at *3.

[88] Klee & Butler, *supra* note 8, at 37.

[89] *See, e.g.*, *In re* Aurora Invs., Inc., 134 B.R. 982, 985 (Bankr. M.D. Fla. 1991) ("The term 'bad faith' is not defined by the Bankruptcy Code, and there is no single fact, the presence or absence of which compels the finding of bad faith."); *In re* Orange Park S. P'ship, 79 B.R. 79, 82 (Bankr. M.D. Fla. 1987).

[90] Novikoff & Kohl, *supra* note 75, at 12 (citing *In re* S. E. Fin. Assocs., 212 B.R. 1003, 1005 (Bankr. M.D. Fla. 1997)) (discussing case where bad faith stipulation was invalidated because the filing would not have otherwise been in bad faith).

[91] *See In re* Jenkins Court Assocs., 181 B.R. 33, 35–36 (Bankr. E.D. Pa. 1995) (stating that pre-petition waivers are enforceable where there is either a factual finding the debtor has acted in bad faith or where reorganization is effectively impossible). When filing for a motion to dismiss for bad faith, creditors and debtors should be wary of the possibility of being accused of a Rule 11 violation for misrepresentations made to the court. *See* FED. R. CIV. P. 11(b) (2010).

[92] *In re* Gen. Growth Props., 409 B.R. 43, 55–56 (Bankr. S.D.N.Y. 2009).

reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings.'"[93] Typically, "a bankruptcy petition will be dismissed if *both* objective futility of the reorganization process *and* subjective bad faith in filing the petition are found."[94] No one factor is determinative of good faith. Instead, courts examine the facts and circumstances of each case in light of several established factors, such as: (1) the number of unsecured creditors; (2) the existence of a previous bankruptcy petition by the debtor or a related entity; (3) whether the debtor has more than one asset; (4) whether the timing of the petition filing evidences an intent to delay or frustrate legitimate efforts of secured creditors to enforce their rights; (5) whether the petition was filed on the eve of foreclosure of debtor's sole or major asset; (6) whether the petition effectively allows the debtor to evade court orders; (7) whether there was improper pre-petition conduct by debtor; (8) whether reorganization essentially involves the resolution of a two-party dispute; (9) whether there is any possibility of reorganization; (10) whether the debtor has little or no cash flow; (11) whether the debtor has insufficient income to operate or meet current expenses; (12) whether the debtor has any employees; and (13) whether the debtor filed solely to create the automatic stay.[95] Moreover, courts have historically given considerable weight to the presence of pre-petition bad faith stipulations and automatic stay waivers in findings of bad faith.[96] Nevertheless, "[i]t is the totality of circumstances, rather than any single factor," that will help determine whether bad faith exists.[97]

The factors critical to determining the enforceability of bad faith agreements were discussed at length in *In re Jenkins*.[98] In that case, the creditor failed to introduce any factual evidence of bad faith, besides the debtor's pre-petition bad faith stipulation.[99] The bankruptcy court for the Eastern District of Pennsylvania refused to dismiss the case, holding that the determination of whether a bankruptcy petition has been filed in bad faith is fact intensive.[100] Although a

[93] *Id.* at 56 (quoting C-TC 9th Ave. P'ship v. Norton Co. (*In re* C-TC 9th Ave. P'ship), 113 F.3d 1304, 1309 (2d Cir. 1997)).

[94] *Id.* (citing *In re* Kingston Square Assocs., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997) (emphasis in original)).

[95] *See, e.g.*, *In re* Gen. Growth Props., 409 B.R. 43, 56 (Bankr. S.D.N.Y. 2009); Carolin Corp. v. Miller, 886 F.2d 693, 698–99 (4th Cir. 1989); Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (*In re* Phoenix Piccadilly, Ltd.), 849 F.2d 1393, 1394–95 (11th Cir. 1988); Little Creek Dev. Co. v. Commw. Mortg. Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1072–73 (5th Cir. 1986).

[96] *See, e.g.*, *In re Jenkins Court Assocs.*, 181 B.R. at 37 (denying enforcement to pre-petition waiver of automatic stay).

[97] *In re* Kingston Square Assocs., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).

[98] *In re Jenkins*, 181 B.R. at 35–36.

[99] *See id.* at 36 (finding pre-petition settlement agreement alone was insufficient to establish bad faith).

[100] *Id.* at 36–37.

bad faith stipulation may be a contributing consideration, alone it is *not* sufficient to find that good faith is absent.[101]

In the end, the enforceability of pre-petition waivers relies on a balancing of three important considerations.[102] The first and most important consideration is public policy. This is usually measured by evaluating the abovementioned factors to determine whether lifting a stay or dismissing a bankruptcy petition outweighs the potential social and economic harm to other creditors, stakeholders (i.e. employees, the community, etc.), and judiciary dockets. The second consideration is reliance on contractual agreements. The debtor specifically agreed to the waiver, often with the advice of counsel who is market-wise and knowledgeable of the ramifications of pre-petition agreements.[103] The waiver is a basis for part of the creditor's bargain.[104] Therefore, the debtor should be held responsible and not be given a free pass to vitiate the agreement by filing for bankruptcy. The third and final consideration is bad faith. The debtor contractually agreed and received reciprocal consideration to waive certain rights, such as the right to the automatic stay, if the debtor became insolvent and filed for bankruptcy. However, when the debtor filed a petition for bankruptcy, it sought protection under the stay anyway. Thus the debtor either agreed to a contract in bad faith or filed a petition in bad faith.[105]

III. "BAD BOY" GUARANTIES

Another method to deter an unwanted bankruptcy is to obtain a personal guaranty that is contingent upon bankruptcy filings. Lenders have used "bad boy" guaranties[106] to prevent egregious conduct such as fraud, misappropriation of funds, willful misconduct, gross negligence, and unauthorized transfers of collateral since the 1980s.[107] However, in recent times, lenders have begun using

---

[101] *Id.* at 35–37.

[102] *See* Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1, 10 (1996) (explaining that waivers of automatic stay protections are primarily upheld because either pre-petition agreements create cause to lift automatic stays or petitions are filed in bad faith).

[103] *See id.*

[104] If a creditor knew that a bankruptcy court would not enforce its end of the bargain with the debtor, the creditor would likely have charged higher interest or entirely reconsidered its dealings with the debtor.

[105] *See id.* at 10.

[106] Bad boy guaranties are also known as guaranties of recourse obligations and springing guaranties. The term "bad boy" guaranty is derived from the specified "bad" actions that they are supposed to curtail.

[107] Todd Etshman, *'Bad Boy Guaranty' Case Good for Lenders*, N.Y. DAILY REC., Mar. 24, 2011, http://nydailyrecord.com/blog/2011/03/24/%e2%80%98bad-boy-guaranty%e2%80%99-case-good-for-lenders/.

more conspicuous "bad boy" terms in loan agreements to prohibit voluntary bankruptcy filings.

By imposing personal liability on a guarantor, which is usually a person in control of the borrower, bad boy guaranties create a financial disincentive for the guarantor to cause, or even permit, the borrower to impede the lender's collateral enforcement action by filing a bankruptcy petition.[108] The resulting liability for breach depends on the negotiated terms. A bad boy guaranty can simply provide for consequential damages resulting from the breach, full recourse liability amounting to the entire liquidated debt amount, or anything in between.[109]

In recent years, guarantors have asserted that when "the bad act did not cause damage commensurate to the full recourse liability," a damages calculation amounting to full recourse liability is an unenforceable penalty.[110] Courts generally disagree.[111] Those courts that have ruled on this issue, which granted is a limited number of jurisdictions, have held that full recourse damages is enforceable based on contract law. A common feature in guaranty agreements is language that makes enforcement of the guaranty unconditional and waives the guarantor's right to assert defenses.[112] Since courts are unwilling to amend "freely entered into contractual arrangements [that are] in accordance with common law precedent and the rules of legislative interpretation,"[113] courts enforce liquidated damages clauses. This is not an absolute rule, however. In *ING Real Estate Finance (USA) LLC v. Park Avenue Hotel Acquisition LLC*,[114] for example, the New York County Supreme Court refused to enforce a full recourse damages provision.[115] The court explained that a "contractual provision fixing damages in the event of breach will be sustained if the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable . . . of precise estimation."[116] But, if "the amount fixed is . . . grossly

---

[108] Sebastian F.C. Kaufmann & Arthur J. Steinberg, *New Decision Offers Lessons on Bad Boy Guarantees*, N.Y. L.J., Mar. 12, 2012, at 1.

[109] *See id.* at 11 (discussing one court's finding that liquidated damage clauses are not properly related to contemplated measure of damages are generally not enforceable).

[110] *Id.* at 11.

[111] *See, e.g.*, UBS Commercial Mortg. Trust 2007–FL1 v. Garrison Special Opportunities Fund L.P., No. 652412/2010, 2011 WL 4552404, at *6 (N.Y. Sup. Ct. Mar. 8, 2011); Bank of Am., N.A. v. Lightstone Holdings, LLC, No.601853/09, 2011 WL 4357491, at *2 (N.Y. Sup. Ct. Jul. 14, 2011) (quoting *UBS Commercial Mortg.*, 2011 WL 4552404 at *6) (finding Guaranty was not unenforceable penalty or against public policy).

[112] Kaufmann & Steinberg, *supra* note 108, at 11.

[113] *Id.*

[114] No. 601860/09, 2010 WL 653972 (N.Y. Sup. Ct. Feb. 24, 2010).

[115] *Id.* at *1.

[116] *Id.* at *5 (quoting Truck Rent–A–Ctr., Inc. v. Puritan Farms 2nd, Inc., 361 N.E.2d 1015, 1018 (N.Y. 1977)).

disproportionate to the probable loss, the provision calls for a penalty and will not be enforced."[117]

The rationale in *ING Real Estate Finance* presents another possible explanation for enforcing full recourse damages, however. Once the guarantor pays the full debt amount, the lender will assign its rights to related claims against the borrower's estate in bankruptcy to the guarantor. Therefore, upholding the guaranty would not violate public policy since the guarantor's financial loss should be equal to what the lender otherwise would have lost. In other words, by signing the bad boy guaranty, the guarantor has effectively assumed financial responsibility for the creditor's losses should the debtor file for bankruptcy.

Perhaps the most obvious argument against the enforcement of bad boy guaranties is that they "create[] a conflict of interest between the guarantor's self-interest[s] and the fiduciary dut[ies] that guarantor owes to borrower's [shareholders and] creditors as the borrower edges toward insolvency."[118] As a matter of state law, "[b]reach of fiduciary duty is a tort, and it is elementary contract law that an agreement intended to induce the commission of a tort violates public policy and is not enforceable."[119] Therefore, the question is whether the guaranty is a breach of fiduciary duties.[120] This depends on whether the potential conflict is "viewed from an *ex ante* perspective, from which the 'conflict' is a deliberate decision by the firm to bind its managers to a particular approach to insolvency, or from an *ex post* perspective, which examines the situation as a conflict of interest arising at the point of insolvency."[121] In other words, if, at the time of financing, the guaranty was entered into with the intention of avoiding bankruptcy regardless of the firm's, shareholders' or other creditors' best interests, then the fiduciary duty breach is inexcusable and incurable.[122] However, if the board of directors determines that entering the guaranty would best advance the firm's goals, then an insider may sign a personal guaranty with the creditor upon ratification by a majority of disinterested directors (or proof that the guaranty is intrinsically fair) without

---

[117] *Id.*

[118] UBS Commercial Mortg. Trust 2007–FL1 v. Garrison Special Opportunities Fund L.P., No. 652412/2010, 2011 WL 4552404, at *6 (N.Y. Sup. Ct. Mar. 8, 2011).

[119] Marshall E. Tracht, *Will Exploding Guaranties Bomb?*, 117 BANKING L.J. 129, 132 (2000) (analyzing enforceability of springing and exploding guaranties); *see also* Rest. (2d) of Contracts § 192 cmt. a (1981) ("A promise to commit a tort is plainly unenforceable on grounds of public policy.").

[120] As discussed above, LLCs and LPs may waive directors' fiduciary duties in the operating agreement; therefore this discussion only applies to corporate-debtors. *See supra* note 58 and accompanying text.

[121] Tracht, *supra* note 119, at 132–33.

[122] *See id.*

breaching any fiduciary duties.[123] The insider subject to a bad boy guaranty still faces quite the conundrum should the firm become insolvency. In order to avoid liability for breach of fiduciary duty, the insider must abstain from voting on whether the firm should file for bankruptcy. However, if the firm ends up filing for bankruptcy, then the insider will be held personally liable anyways.

Although this corporate law argument has considerable merit, no courts have followed it. In *UBS Commercial Mortgage Trust v. Garrison Special Opportunities Fund L.P.*,[124] the guarantor introduced a similar corporate law argument, but was unsuccessful.[125] In *Garrison*, the guarantor argued that "[g]uaranties . . . create a conflict of interest" by inducing guarantors "to refrain from filing the borrower into Chapter 11, to the detriment of the borrower's creditors and in breach of the manager's fiduciary duties to those creditors."[126] The court held that no distinction exists between a bad boy guaranty and a parent corporation guarantying a subsidiary's debt, which is never questioned on public policy grounds.[127] The *Garrison* holding embodies the general consensus across most jurisdictions about the enforceability of bad boy guaranties.[128] Despite whatever deterrent or disincentive effect bad boy guaranties were designed to have, or whatever liability they create for the individual guarantors, bad boy guaranties do not *absolutely* prohibit debtors from seeking protections afforded by the Bankruptcy Code. As a result, it remains to be seen whether any public policies, bankruptcy policies or other arguments exist that would prevent a court from enforcing a bad boy guaranty.

---

[123] *See id.*
[124] No. 652412/2010, 2011 WL 4552404 (N.Y. Sup. Ct. Mar. 8, 2011).
[125] *Id.* at *6.
[126] *Id.* at *6.
[127] *Id.*
[128] *See, e.g.*, FDIC v. Prince George Corp., 58 F.3d 1041, 1047 (4th Cir. 1995); *In re* Extended Stay, Inc., 418 B.R. 49, 58 (Bankr. S.D.N.Y. 2009); 111 Debt Acquisition LLC v. Six Ventures, Ltd., No. C2-08-768, 2009 WL 414181, *11 (S.D. Ohio 2009).

CONCLUSION

The enforceability of pre-petition hindrance mechanisms and agreements is questionable at best. Debtors, creditors, and practitioners should be wary of the local jurisdiction's stance on agreements where consideration is given in exchange for the waiver of certain Bankruptcy Code provided rights. Likewise, parties should be conscious of the repercussions of including certain provisions in organizational documents that require actions in breach of fiduciary duties.

Joshua L. Eisenson[*]

[*] The author is currently an associate at Brown Rudnick LLP in the White Collar Defense and Government Investigations Group. He thanks his advisor at St. John's University School of Law, Professor Keith Sharfman, for his assistance in organizing this paper. He also thanks the staff and executive board of the *American Bankruptcy Institute Law Review* for their dedication and effort in editing this paper. The views expressed in this Article are solely those of the author and in no way represent the views of Brown Rudnick LLP.