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Bankruptcy Court Says Directors May Owe Fiduciary Duties to Debtor's Estate Despite Disclaimer in Partnership Agreement

Overview

A recent decision from the Bankruptcy Court in the Southern District of Texas concludes that directors of a non-debtor general partner may owe fiduciary duties to a limited partnership debtor in bankruptcy whether or not such duties exist (or have been disclaimed) under the debtor's and general partner's organizational documents or applicable state law.[1] In deciding whether to dismiss an involuntary petition filed against Houston Regional Sports Network, L.P. (the "Network"), the court considered whether the directors of the general partner that managed the Network owed fiduciary duties to the Network, despite a provision in the underlying partnership agreement disclaiming all fiduciary duties. The court essentially concluded that, as a matter of federal law, once a debtor seeks protection under the Bankruptcy Code "management becomes duty-bound to meet fiduciary responsibilities" owed to the debtor's estate, regardless of contrary provisions in a partnership agreement or applicable state law.[2]

Background

The Houston Astros, Houston Rockets and Comcast formed the Network as a partnership to televise the teams' games. The Network was managed by its general partner, Houston Regional Sports Network, LLC (the "General Partner"), which was also owned by the Astros, Rockets and Comcast. The General Partner had four directors, the Astros and Rockets each selected one and Comcast selected the other two. The four directors managed the Network's affairs. The Network's primary assets consisted of media rights agreements with the Astros and Rockets, each of which granted the Network the exclusive right to broadcast its programming in exchange for the Network's payment of certain fees.

In July and August 2013, the Network missed required payments to the Astros under the parties' media rights agreement (the "Media Rights Agreement"). Each time, the Astros sent a notice of default and ultimately declared that the team would terminate the Media Rights Agreement unless the Network cured its defaults by September 29, 2013. The Astros were eager to terminate the Media Rights Agreement, believing there was potential for a better deal in the open market. Comcast, on the other hand, wanted to preserve its investment in the Network by having it maintain the Media Rights Agreement.

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[1] *In re Houston Regional Sports Network, L.P.*, 2014 WL 554824 (Bankr. S.D. Tex. Feb. 12, 2014).

[2] *Id.* at *11.

To prevent the Astros from terminating the Media Rights Agreement, Comcast arranged the filing of an involuntary Chapter 11 petition against the Network. The petitioning creditors (primarily other Comcast affiliates with trade claims against the Network) filed the involuntary petition on September 27, 2013 – two days before the Astros were set to terminate the Media Rights Agreement.[3]

The Astros moved to dismiss the involuntary petition, arguing that the petition was filed in bad faith and that efforts to reorganize the Network would be futile.

"Bad Faith" Filing

The Astros first argued that the involuntary petition against the Network should be dismissed because Comcast acted in bad faith by arranging the filing.[4] The partnership agreement governing the General Partner required the unanimous consent of directors for any "liquidation, dissolution, winding up or voluntary filing of a petition for bankruptcy" against the Network.[5] Recognizing that the director appointed by the Astros would not consent to (or authorize) a voluntary bankruptcy filing for the Network, Comcast instead arranged for an involuntary petition. The Astros argued that this amounted to an "end run" around the unanimity provision of the partnership agreement, which itself implied that Comcast had acted in bad faith. The court noted that it was a "close call," but concluded that Comcast did not act in bad faith. The court found that the plain language of the partnership agreement only applied to voluntary petitions, not involuntary petitions. Moreover, the court found that, while Comcast may have breached the terms of the partnership agreement, "not every contractual breach is done in bad faith," especially where Comcast arranged the involuntary petition "for the purpose of preserving value and rehabilitating the Network."[6] Nevertheless, the court noted that, to the extent Comcast made an "end run" (or breached) the partnership agreement, it may be liable for damages.

Chance of Successful Reorganization

The Astros also argued that the case should be dismissed because any attempt at reorganization would be futile.[7] The Astros maintained that pursuant to the partnership agreement, any significant restructuring

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3 *Id.* at *2. Section 303 of the Bankruptcy Code provides that an involuntary case may be commenced by three or more creditors holding undisputed and non-contingent claims in the aggregate of at least $15,325.

4 Section 1112(b) of the Bankruptcy Code authorizes the dismissal of a case for "cause," which has been judicially construed to include, among other factors, a "bad faith" filing.

5 *In re Houston Regional Sports Network, L.P.*, 2014 WL 554824 at *8.

6 *Id.* at *9.

7 Section 1112(b)(4)(A) of the Bankruptcy Code provides for the dismissal of a case where there is "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation."

of, or change to, the Network's business required the unanimous consent of all directors. They further argued that the partnership agreement permits the Astros to vote in their own best interest and expressly disclaims all fiduciary duties that the General Partner or its directors held with respect to the Network. Therefore, the Astros contended, their director-appointee would veto any plan of reorganization, regardless of whether such plan would benefit creditors, to ensure that the Astros are freed from their obligations under the Media Rights Agreement.[8] Given that, the Astros maintained that there was no reasonable chance that the Network could be reorganized.

The court rejected the Astros' futility argument. It found that the Network, if properly managed, could be profitable. Accordingly, "the issue is whether the Network's state-law structure renders a bankruptcy estate incapable of taking advantage of its own profitability."[9] The court held that, upon entry of the order placing the Network in bankruptcy, "management becomes duty-bound to meet fiduciary responsibilities," and "implementation of such a wholesale threat would be a breach of the Astros-appointed-director's fiduciary duty."[10] The court pointed to Supreme Court precedent holding that a debtor-in-possession's directors bear the same fiduciary obligations to the estate as a bankruptcy trustee.[11] The court said that it was unaware of any case in which a court held that the individuals managing a debtor were not required to act in the estate's best interest. The court would not "turn decades of bankruptcy law on its head to allow the Astros to pre-empt the reorganization process" and thus held that "the fiduciary duties to a bankruptcy estate may not be absolved by any state-law concepts to the contrary."[12]

The court also noted that the Astros were not without a remedy. They could have their director resign, or appoint an independent third party to serve as their appointee. But any individual who chose to serve on the board "must honor fiduciary responsibilities." Moreover, the court ruled that the fiduciary obligations were owed by the director selected by the Astros, and not the Astros organization. Therefore, the Astros

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8 *In re Houston Regional Sports Network, L.P.*, 2014 WL 554824 at *9-10.

9 *Id.* at 10.

10 *Id.* at 11. The court noted, however, that it was not making a "final determination" on the existence or extent of the directors' fiduciary duties, but merely concluding, on a "preliminary basis," that fiduciary responsibilities exist toward the Network. *Id.* at n.3.

11 *Id.* at 11 (citing *Commodity Futures Trading Comm'n* v. *Weintraub*, 471 U.S. 343 (1985)).

12 The court also stated its unwillingness to dismiss a case "based on futility that is engineered by the party seeking the dismissal." *Id.* at 13.

could oppose any action that the Network sought in bankruptcy court and were not forced to "leave their armor at the Courthouse door."[13]

Conclusion

Agreements governing partnerships and LLCs created as part of a joint-venture often contain provisions that require unanimous consent for significant actions and transactions and disclaim fiduciary duties to the partnership. The *Houston Networks* decision suggests that directors may not be able to rely on the protection of such provisions if their partnership becomes the subject a bankruptcy proceeding. Provisions that are valid under applicable state law may no longer operate, and instead directors may face the imposition of fiduciary duties like those of a trustee to the debtor's estate.

The ultimate impact of *Houston Networks* remains to be seen as the Astros are appealing the decision.[14]

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[13] Comcast later raised an additional flaw with the Astros' futility argument: the court could simply terminate the Network's exclusive right to file a plan and allow another party in interest, such as Comcast, to file a plan of reorganization.

[14] *See Houston Astros, LLC* v. *Houston Regional Sports Network, L.P.*, Case No. 4:14-00304 (S.D. Tex. 2014).