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Bankruptcy-remote transactions and bankruptcy law—a comparative approach (part 2): can parties validly waive bankruptcy proceedings?

David Ramos Muñoz*

Key points

- Bankuptcy-remote transactions are sophisticated, but no longer a rarity, and should stop being considered as an oddity, or 'marginal' case. Rather, they challenge some of bankruptcy law's most basic assumptions, on a practical, rather than theoretical, level.
- This article explores how bankruptcy-remote transactions are used as a waiver to bankruptcy proceedings. While academic debate has been discussing whether bankruptcy rules should be a matter of choice transaction parties have made that proposal a reality, by combining different mechanisms that effectively exclude the possibility that a vehicle enters bankruptcy proceedings . . . or so they try.
- The article analyses such mechanisms in light of existing bankruptcy law, corporate law and private law, using a comparative perspective that considers the law of common law jurisdictions, such as the United States and United Kingdom, but also examples from civil law countries, like France, Spain, Italy or Germany. This analysis shows a mixed picture, with cases where 'contract' or 'mandatory policy' perspectives alternate, but also where it is sometimes difficult to apply the law s underlying assumptions to the peculiarities of bankruptcy-remote entities.
- The conclusions are relevant if the techniques used in this specific type of transactions become more widespread in an effort to carve-out ever-larger pieces to statutory bankruptcy proceedings.

1. Introduction

Bankruptcy-remote transactions are the current means by which sophisticated players insulate assets and cash flows from the risk associated with a sponsor; and from the complex and protracted nature of bankruptcy proceedings. Yet most studies focus on them as a peculiarity of financial markets, and paint their relationship with bankruptcy law with big brushstrokes, with less attention to the meaning of bankruptcy-remoteness, both as a matter of semantics and as a matter of the challenge it poses to bankruptcy law's underlying axioms.

It is my plan to study the meaning of bankruptcy-remote transactions, and their significance for bankruptcy law and bankruptcy policy, in light of comparative bankruptcy, corporate and private law, including existing case law. I began this effort in a previous paper, where I analysed the importance of 'vehicle shielding', in terms of the

* David Ramos Muñoz, Universidad Carlos III de Madrid.

tension between the interest of the vehicle's creditors, and that of the sponsor creditors,[1] because this is the aspect more often addressed by the scholars, and thus the one more in need of a systematic study and confrontation between theory and practice.

In that paper, however, I already indicated that 'vehicle shielding', despite having concentrated all academic attention, is only a 'basic' form of bankruptcy-remoteness. Actual transactions aim further than this, by trying to achieve 'enhanced' bankruptcy-remoteness, and insulate the vehicle not only from the bankruptcy proceedings of the sponsor, but from bankruptcy proceedings altogether. It is important to pause a moment to see that the significance of this feat is not merely in its characterization as 'enhanced' bankruptcy-remoteness: it means that the transaction is pre-programmed from the beginning to stay clear of bankruptcy (in the sense of proceedings regulated by statute). This instinctively creates a tension for those accustomed to the fact that bankruptcy law is not a matter of choice, but public policy. How can the parties exclude it by contract? The fact is that they do, but not by means of a single clause that excludes bankruptcy, which would most likely be held void: sophisticated parties use a combination of mechanisms that block the avenues to bankruptcy, and that, considered in isolation, can be legally accepted. But while this may dodge the question of validity, it does not make the contradiction disappear: a specific clause, considered in isolation, may be valid but together with the rest has the aim to waive bankruptcy proceedings and this goes against the general principle that bankruptcy cannot be contracted out.

This tension between validity in terms of rules and contradiction in terms of policy is analysed in the present article. Section 2 lays out the relevant elements, such as the meaning of 'bankruptcy-remoteness' (especially its 'enhanced' conception), the relevance of its 'contractarian' approach for the debate on bankruptcy policy, and the significance as a 'bankruptcy waiver'. Section 3 analyses the different means by which bankruptcy-remote transaction parties can block access to bankruptcy proceedings, and how bankruptcy, corporate and private law may react, and have reacted to them, using a comparative perspective and trying to pave the way for some general conclusions which are laid out in Section 4.

2. Bankruptcy-remote transactions as a test case for contractarian solutions in bankruptcy

This section provides the context under which the inquiry will be conducted. First, we analyse the meaning of 'bankruptcy-remoteness' in what we term its 'enhanced' conception; and its meaning as a means to contract-out bankruptcy proceedings (see below ''Enhanced'' bankruptcy-remoteness and its context: a contract solution to bankruptcy in the debate over bankruptcy policy'). Then, we circumscribe the scope of the inquiry, which will be focused on how bankruptcy-remote transactions block the

1 David Ramos Muñoz 'Bankruptcy-remote Transactions in a Comparative Perspective (Part 1). Changing the Focus on Vehicle Shielding' (2015) 10(2) CMLJ 239.

access to bankruptcy proceedings, ie a case of 'bankruptcy waiver' (see below 'Bankruptcy-remote transactions and bankruptcy waivers').

'Enhanced' bankruptcy-remoteness and its context: a contract solution to bankruptcy in the debate over bankruptcy policy

'Bankruptcy-remote' is more a term of market practice; and, as such, its legal implications are unclear. From different opinions and court decisions one can infer that, as a concept, bankruptcy-remoteness can have two different conceptions, with different legal consequences, which we described in a previous article but which it will be useful to recap here. A more 'basic' conception of bankruptcy-remoteness, on which studies have more often focused, emphasizes the role of the vehicle to insulate the assets subject to the transaction (which back investors' rights) from the bankruptcy of the sponsor.[2] In this regard, the basic idea is different from that of the 'entity shielding' or 'affirmative asset partitioning' used to give economic sense to corporate legal personality:[3] by partitioning the assets their value is enhanced, which facilitates financing.[4]

The 'enhanced' conception of bankruptcy-remoteness, however, which can also be called 'bankruptcy-proofing', emphasizes the role that bankruptcy-remote provisions have in excluding the possibility of statutory bankruptcy proceedings.[5] Transaction documents try to achieve this by restricting the vehicle's activities, to control for unexpected sources of indebtedness, and by planning the amount of assets that will be transferred to the vehicle, to ensure that they do always exceed liabilities.[6] But, just in case these measures are not enough, the documents also try to prevent bankruptcy filing by blocking different avenues to it.[7] Unlike the 'partitioning' conception, here the assumption is that statutory bankruptcy proceedings impose an extra cost that renders the outcome inefficient, and respond to principles that may sit badly with the interest of the parties, especially senior creditors.

It is tempting to conclude that, given their specificity and sophistication, bankruptcy-remote transactions should be treated as an isolated or 'borderline' case, whose solution should not have broader implications for bankruptcy policy. This would be a mistake. Bankruptcy-remote transactions provide the most complete experiment there is where the parties have tried to waive their right to access bankruptcy proceedings. It is a direct challenge to the argument that the law in situations of insolvency should respond to

2 ibid.

3 For a further analysis of the 'entity shielding' or 'affirmative asset partitioning' concept, see Henry Hansmann, Reinier Kraakman and Richard Squire, 'Law and the Rise of the Firm' (2006) 119 Harv L Rev 1335, 1335ff; Henry Hansmann and Reinier Kraakman 'The Essential Role of Organizational Law' (2000) 110 Yale LJ 387. See also Reinier Kraakman and others, *The Anatomy of Corporate Law. A Comparative and Functional Approach* (2nd edn, OUP 2009) 6–7.

4 Kraakman and others, ibid 10; cf Hansmann, Kraakman and Squire (n 3) 1335.

5 The point is illustrated by the distinction made in the *Eurosail* case between 'insolvency-remoteness' (ie avoiding the possibility of the vehicle becoming insolvent) and 'bankruptcy-remoteness' (ie avoiding the possibility of the vehicle entering proceedings resulting from the insolvency). *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc and others*, [2010] EWHC 2005 (Ch) (Morritt J); *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc and others* (*BNY Ltd v Eurosail plc* (CA)) [2011] EWCACiv 227. See also *Re Golden Key Ltd (In Receivership) v Re the Insolvency Act 1986* [2009] EWHC 148 (Ch) at 47.

6 *Re Doctors Hospital of Hyde Park, Inc*, 2013 WL 5524696 (Bankr ND Ill 2013) 149 and 203.

7 See David Ramos Muñoz, *The Law of Transnational Securitization* (OUP 2010) 96.

certain goals that cannot be encapsulated by a contractarian logic; and to the argument that, as a result, bankruptcy law should be composed of mandatory, and not merely default rules that can be contracted out.

Both challenges echo the debate on the goals of bankruptcy law between traditional and contractarian views. Contractarians, who label contrary views 'traditionalist' argue that the goal of bankruptcy law must be to enforce pre-existing contractual arrangements:[8] since companies rise and fall subject to market dynamics, lawmakers should not try to know better, but to facilitate the enforcement of pre-existing contractual arrangements and maximizing creditors' collection value.[9] More 'procedural' views argue that bankruptcy law is procedural law, not imbued with particular substantive policies, whose purpose is the enforcement of creditors' rights.[10] Naturally, for contractarians bankruptcy rules should be default rules, and not mandatory rules: since their purpose is to be useful to further the contractual bargain, creditors should be able to opt out of them.[11]

The views that defend (American) bankruptcy law's traditional equilibrium between debtor and creditor rights argue that contractarian solutions have never been tested in practice,[12] and that the purported efficiency gains are not such, when put in the context of other socially desirable goals (such as corporate rescue).[13] More specifically, they argue that the multiplicity of creditors make contractarian solutions unfeasible; a problem that is compounded by the existence of non-adjusting creditors (eg victims of torts) whose interests would simply be ignored.[14] This results in contractarian alternatives that would be 'pseudo-contractarian' at best,[15] which would strengthen the position of secured

8 Barry Adler, 'Bankruptcy Primitives' (2004) 12 Am Bankr Inst L Rev 219, 219–44; and, Barry Adler, 'Financial and Political Theories of American Corporate Bankruptcy' (1993) 45 Stan L Rev 311, 311–46; and Barry Adler, 'A Theory of Corporate Insolvency' (1997) 72 NYU L Rev 343, 434–382; see also Douglas G Baird, 'Bankruptcy's Uncontested Axioms' (1999) 108 Yale LJ 573, 573–99; Douglas G Baird and Robert K Rasmussen, 'The End of Bankruptcy' (2002) 55 Stan L Rev 751; Lucian Arye Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101 Harv L Rev 775; Thomas H Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 Yale LJ 857; Robert K Rasmussen, 'Debtor's Choice: A Menu Approach to Corporate Bankruptcy' (1992) 71 Tex L Rev 51; Robert K Rasmussen, 'An Essay on Optimal Bankruptcy Rules and Social Justice' (1994) 1 U Ill L Rev 42; Alan Schwartz, 'A Contract Theory Approach to Business Bankruptcy' (1998) 101 Yale LJ 1807; Steven L Schwarcz, 'Rethinking Freedom of Contract: A Bankruptcy Paradigm' (1999) 77 Texas L Rev 515.

9 Douglas G Baird and Thomas H Jackson, 'Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 U Chi L Rev 97.

10 See, for example, Charles Mooney Jr, 'A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure' (2004) 61 Wash Lee L Rev 931.

11 Adler, 'Financial and Political Theories' (n 8) 314–22, 346; Bebchuk (n 8) 775ff; Rasmussen, 'Debtor's Choice' (n 8) 67ff; Schwartz (n 8) 1807ff.

12 Elizabeth Warren and Jay Lawrence Westbrook, 'Contracting Out of Bankruptcy: an Empirical Intervention' (2005) 118 Harv L Rev 1197, 1201, 1253; Jay Lawrence Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82 Tex L Rev 795, 859–62.

13 Elizabeth Warren, 'Bankruptcy Policy' (1987) 54 U Chi L Rev 775, 785–89.

14 Warren and Westbrook (n 12) 1219–53.

15 On the face of the unfeasibility of the contractualist solution as such, contractualists have suggested all sorts of original and interesting solutions. Mainly, the (i) *automatic* approach, under which, upon insolvency, the control of a firm passes to the creditors with the priority adequate to the debtor's financial condition, and the other (normally less senior) creditors, or equity holders, can simply bid for that right of control (if, say, an unsecured creditor, or an equity holder thinks the firm is worth more than secured debt, the creditor or equity holder will offer to redeem that debt), see Bebchuk (n 8) 775ff; Adler 'Financial and Political Theories' (n 8) 327ff; (ii) the 'menu' approach, under which firms would opt, at the moment of inception, for a bankruptcy regime within a menu of options, so that creditors would know that 'before' calculating the interest and other terms of the funding, and every amendment of that part of the charter would require the consent of all creditors, see Rasmussen, 'Debtor's Choice' (n 8) 51–121; or (iii) the *changing arrangement* approach, under which a debtor may change the bankruptcy arrangement

creditors, and weaken that of unsecured ones (especially if they are of the non-adjusting sort). Such a balance of interest makes mandatory bankruptcy rules necessary: otherwise, some of the relevant interest would be unprotected.

Bankruptcy-remote transactions and bankruptcy waivers

The debate on policy described above is mostly normative, ie it focuses on how the system 'should be'. But, focusing on a descriptive perspective, ie how the system is, most people can agree that bankruptcy fits the traditional view of a court-governed process, which combines the interest of different constituencies (including the debtor). Most important, bankruptcy rules are mandatory, and cannot be contracted out, or be the subject of waiver.

Yet, this did not prevent Marshall Tracht from writing a very thought-provoking article, with both a descriptive and a normative perspective, which argued, first, that despite court pronouncements against it, parties found ways to waive bankruptcy proceedings in practice; and, secondly, that such waivers were desirable, and should not be seen as contrary to any basic public policy.[16]

Tracht could not have anticipated the phenomenal growth experienced by bankruptcy-remote transactions, and the significance of their use as a means to carve out entire (and, sometimes, large) asset pools not only from the bankruptcy of the sponsoring entity, but also from bankruptcy proceedings altogether.[17] Also, at that time there was not much experience with bankruptcy-remote transactions which could provide information about how the bankruptcy waiver, and the contractually regulated mechanisms for the administration and liquidation of assets, and distribution of proceeds, worked in practice.

Now the ample experience with bankruptcy-remote transactions permits at least a preliminary assessment to be made. Some authors have hurried to vindicate the need for the recognition of a bankruptcy waiver in the case of bankruptcy-remote SPVs.[18] This article does not go as far as that: it merely examines how the contract mechanisms fit within the existing principles of bankruptcy law, but also corporate and private law. To do so the article makes a comparative approach that takes note not only of the law of the USA, but also the law of the UK, as well as the law and/or examples from civil law countries, such as France, Spain, Germany or Italy, to show that the problem is significant regardless of jurisdiction.

for all creditors if the debtor so agrees with the last of the creditors (to avoid value-decreasing strategies, a payment is made to the firm's managers), see Schwartz (n 8) 1811–25.

16 Marshall E Tracht, 'Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law' (1997) 82 Cornell L Rev 301, 301–55.

17 ibid 411. Tracht refers to securitization SPVs as bankruptcy-remote in the traditional sense (ie the vehicle's insulation from the sponsor). However, securitization's posterior evolution has given rise to the widespread use of vehicles, some with asset pools sufficiently large and complex to make their exclusion from bankruptcy proceedings a challenge for bankruptcy law as interesting as their insulation from the sponsor.

18 Forrest Pearce, 'Bankruptcy-Remote Special Purpose Entities and a Business' Right to Waive its Ability to File for Bankruptcy' (2012) 28 Emory Bankr Dev J 507.

In this article, we focus on the mechanisms used in bankruptcy-remote transactions to waive bankruptcy proceedings (the analysis of the mechanisms used to regulate an alternative procedure by contract provisions should be the subject matter of a different article). On this issue, bankruptcy-remote transactions offer a very interesting test case. In the cases where courts declared bankruptcy waivers invalid the parties had made a direct and comprehensive exclusion of bankruptcy proceedings,[19] an approach that would be doomed under most legal systems. Unlike those cases, however, the documents regulating bankruptcy-remote vehicles do not bluntly waive bankruptcy, but, rather, use different mechanisms to effectively block all avenues for statutory bankruptcy proceedings (playing with the vehicle's eligibility for bankruptcy proceedings, blocking voluntary filing by SPV directors and blocking non-voluntary filing by investors–creditors).

The chance that courts are asked to analyse the combined effect of those mechanisms is low, which means that the effectiveness of the bankruptcy waiver will depend on the courts' ability or willingness to see the broader implications of each isolated mechanism when considered in the transaction's context and purpose. It also means that not being confronted with a direct question over the validity of a full bankruptcy waiver (which would lead to its invalidity) the courts are freer to see the problem from different angles, as an issue concerning simply the interpretation of contract provisions, or as an issue concerning mandatory principles, such as bankruptcy law principles, but also principles of company law, or debtor–creditor relationships. Freeing the law from the constraint of the direct, broader, question, is a better way to test its predisposition towards letting the parties exclude statutory bankruptcy proceedings to resolve bankruptcy-like problems. Finally, it gives the courts (and everyone) some space to reason about the adequacy of applying existing principles of bankruptcy, company and private law, to bankruptcy-remote SPVs, an odd type of entities that often do not fit the assumptions that justify bankruptcy law principles in the first place.

3. Blocking access to bankruptcy proceedings: a subtle nudge or a bankruptcy waiver

Rather than including an express and absolute waiver of bankruptcy proceedings (which most likely would be deemed invalid), bankruptcy-remote transactions' documents use subtler devices to block access to statutory bankruptcy proceedings. In the following subsections, we analyse the mechanisms used to exclude bankruptcy, which operate over: (i)

19 For example, in *Re Citadel Properties, Inc* 84 BR 275, 276 (Bankr MD Fla 1988), or *Merritt v Mt Forrest Fur Farms of Am, Inc*, 103 F 2d 69, 71 (6th Cir 1939), *cert denied*, 308 US 583 (1939) the issue analysed was the full prohibition to go to bankruptcy, which the courts stated that could be unconstitutional (something Tracht criticizes as groundless). In *Los Angeles Lumber Products Co*, 24 F Supp 501 (SD Cal 1938), *aff'd*, 100 F 2d 963 (9th Cir 1939) the court failed to dismiss a voluntary reorganization on the basis of a provision in a bond indenture, which barred the company from invoking any law that would alter, impair or impede bondholders' rights and remedies. In two post-Code cases, the situations were similar. In *Re Tru Block Concrete Products, Inc* 27 BR 486 (Bankr SD Cal 1983) shareholders and creditors had agreed to create a liquidating trust to dispose of the assets of the corporation in five months, leaving creditors the possibility, if liquidation were not completed in that time, to foreclose without bankruptcy filing, and the court declined to dismiss a petition of voluntary filing after the five months had passed; and, in *Re Adana Mortgage Bankers, Inc*, 12 BR 989 (Bankr ND Ga 1980), *vacated as moot*, 687 F 2d 344 (11th Cir 1982) the court failed to declare a bankruptcy filing void, and thus refused to enforce a clause that required notification by the debtor to the Government National Mortgage Association (GNMA, or Ginnie Mae) of any bankruptcy filing.

the vehicle's eligibility for bankruptcy; (ii) the voluntary filing by the vehicle's directors; and (iii) the non-voluntary filing by the vehicle's investors. Their success or failure will depend on whether they are seen as isolated provisions which may 'nudge' away from bankruptcy, but otherwise fall within the parties' contract freedom, or as a combined effort to challenge bankruptcy law's mandatory nature (bankruptcy waiver). It will also depend on how the courts apply the logic of existing legal principles to bankruptcy-remote SPVs.

Bankruptcy eligibility: can a bankruptcy-remote vehicle be an 'insolvent debtor'?

To armour plate the vehicle against bankruptcy one can operate over the most basic premise; that is, the vehicle's eligibility for bankruptcy. The underlying question is a broad one, ie whether rules that were initially conceived for operational 'businesses' or 'entrepreneurs' can apply to entities that are, essentially, 'passive' (ie they typically receive the returns from assets previously transferred to them) and 'instrumental' (ie without an autonomous and general purpose). More specifically, the question raises two issues for statutory interpretation: (i) whether the SPV can be a 'debtor'; and (ii) whether an SPV can be 'insolvent' in a statutory sense.

(i) Starting with the first issue (a) in common law countries the problem does not arise with corporate SPVs. In the UK, statutory proceedings are contemplated for insolvent 'companies';[20] and, in theUSA, '[t]he term ''debtor'' means person',[21] and 'The term ''person'' includes individual, partnership, and corporation.'[22]

Trust structures are a different matter. English law only has provisions for 'unregistered companies',[23] which leaves trusts out. A purely trust structure in the UK would thus not be eligible for insolvency proceedings (though UK securitization structures may involve an SPV as the trustee of a trust).

In the USA, the broad definition of 'corporation' includes 'business trusts',[24] but this provides no definitive answer. The definition reflects the compromise between traditional views, which see 'trusts' and 'estates' as passive structures,[25] and modern ones, which acknowledge their use as vehicles of business activity. But then, should one focus on 'form', and thereby admit as 'business trusts' only those registered with that denomination in the states with specific 'business trust' provisions (eg Massachusetts or Delaware);[26] or on 'substance', and thereby accept as a 'business trust', akin to a corporation, any trust that performs business activities?[27]

20 The First Group of Parts. *Company* Insolvency; *Companies* Winding-up; Insolvency Act 1986.

21 11 USC para 101 – *Definitions* no (13).

22 11 USC para 101 – *Definitions* no (41).

23 S220 Insolvency Act 1986.

24 11 USC para 101 – *Definitions* no. (9).

25 Steven L Schwarcz, 'Commercial Trusts as Business Organizations: Unraveling the Mystery' (2003) 58 Bus Law 562; Steven L Schwarcz, 'Commercial Trusts as Business Organizations: An Invitation to Comparatists' (2003) 13 Duke J Comp & Int L 323.

26 See *Re Heritage North Dunlap Trust*, 120 BR 252 (Bankr Dist Mass 1990).

27 *Shawmut Bank Conn v First Fidelity Bank (Re Secured Equip Trust of Eastern Air Lines)*, 38 F 3d 86, 89 (2d Cir 1994) *'a basic distinction between a business trust and other trusts is that business trusts are created for the purpose of carrying on some kind of*

Even under an approach based on substance, however, the problem is not entirely solved. A 'business trust' can exist when a trust escapes its traditional purpose of holding assets, and develops some kind of profit-making business.[28] In *General Growth Properties* (*GGP*), the court considered a Real Estate Investment Trust (REIT) used as securitization SPV as eligible for bankruptcy because there was 'ample evidence in the record that Lancaster Trust is a profit-making enterprise and that its purpose goes beyond merely conserving a trust res or holding title to land'.[29] The same logic could apply to a securitization revolving master trust structure. The problem remains unresolved with static, one-off structures (such as a grantor trust).[30] Also problematic is the qualification of some entities as 'profit-making', if their surplus is not used as 'profit' (ie to be distributed) but, rather, as a sort of 'cushion' for credit enhancement purposes, for the benefit of secured creditors. In such case, it is hard to argue that the vehicle's activity is 'directed' to that end.

(b) In civil law countries, the question of the 'debtor' nature of an SPV for purposes of bankruptcy law is even more vexing, because many of those countries have passed 'enabling' statutory rules that facilitate securitization transactions (as Spain, France, Italy, Portugal or Luxembourg[31]). Those rules contemplate SPVs with a corporate or trust/fund nature.[32] This creates a duality between (1) 'statutory' vehicles, ie those set up according to the specific statutory rules,[33] and (2) 'atypical', or 'non-statutory' vehicles.

(1) For statutory vehicles some of the rules exclude them from bankruptcy proceedings (most clearly France,[34] though securitization rules in Spain and Luxembourg refer to

business, whereas the purpose of a non-business trust is to protect and preserve the res'. See also *Brady v Schilling (Re Knight Trust)*, 303 F 3d 671, 679 (6th Cir 2002). See Muñoz (n 7) 94.

28 ibid 91. See also *Re GGP* 409 BR 43 (Bankr SDNY 2009); *Merrill v Allen (Re Universal Clearing House Co)* 60 BR 985, 992 (D Utah 1986); *Westchester County Civil Ser Employees Assn Benefit Fund v Westchester County (Re Westchester County Civil Serv Employees Assn Benefit Fund)* 111 BR 451, 456 (Bankr SDNY 1990); *Re Cooper Properties Liquidating Trust, Inc*, 61 BR 531, 536 (Bankr WDTenn 1986).

29 *'As the Park City Mall owner and operator, it is an active participant in various business activities aimed at earning a profit. It is the named lessor in leases with its tenants, the borrower under a loan agreement, party to various service contracts, and explicitly authorized to conduct business in Pennsylvania.'* See *Re GGP*, ibid 71–72.

30 Some decisions have denied the corporate nature to trusts used for holding assets as security. See *Re North Shore Nat Bank of Chicago, Land Trust No 362,* 17 BR 869 (land trust), where the court held that it *'is not . . . an active business or commercial entity . . . It is merely a legal device whose primary function is to hold legal and equitable title to real estate*'. See also *Re Dolton Lodge Trust No 35188,* 22 BR 918 (Bankr NDIll 1982); *Re Woodsville Realty Trust,* 120 BR 2 (Bankr DNH 1990).

31 Spanish Act 19/1992 and Royal Decree 926/1998; arts L214-42-1–L214-49-14 and R214-92–R214-114 (decretal part) of French Financial and Monetary Code; Italian Act 130/1999; Portuguese Decree Law 453/99; Luxembourg Securitization Act of 2004.

32 To make the assimilation easier, some countries assimilated securitization SPVs to collective investment entities, already known in civil law systems, with the structure of a fund with a management company, as in Spain, Luxembourg or Portugal. See art 6 Spanish Act 19/1992, and art 12ff Spanish Royal Decree 926/1998; arts 2 and 6(2) Luxembourg Securitization Act 2004; arts 9(1) and 15(1) Portuguese Decree-Law 453/99. Portugal even introduces the role of the depository; arts 23ff Portuguese Decree-Law 453/99. See also art 7(b) of Italian Act 130/1999, which, however, refers to securitization by means of transfer to a collective investment institution as a secondary possibility. France went even further, by regulating securitization entities as a specific type of collective investment undertaking. See arts L214-49-1ff of French Financial and Monetary Code. French law also regulates the role of the depository institution. See arts L214-49-2, L214-49-6 or L214-49-7 para II of French Financial and Monetary Code.

33 They typically include a checklist of minimum contents the deeds and bylaws of the case entities must contain, as well as registration requirements with the national securities commission.

34 See art L214-48 of French Financial and Monetary Code.

'liquidation', not 'bankruptcy'),[35] thereby leaving ample margin for contractarian solutions.

(2) For 'atypical' vehicles the first question is whether they can be 'validly' set up outside statutory rules. The answer is 'yes' if the aim of the rules is to 'facilitate' the transaction (the parties are free to achieve a similar outcome outside the rules) as seems to be the case in Spain, Italy or Luxembourg. The answer seems to be 'no' if the purpose of the rules is to 'regulate' the transaction, as seems to be the case in France (the problem would exist with vehicles domiciled in a different country, but acquiring assets located in France).[36] Subject to this, corporate SPVs are valid, but trusts depend on whether the figure is admitted in the country. The trust is not contemplated in civil law countries as a general institution of private law, and only recently have some countries (such as France[37] or Italy[38]) introduced some figures akin to it, though the status of vehicles not set up in express compliance with the rules' formalities is unclear.

The second question is whether the SPV can be considered a 'debtor' in bankruptcy. There has been discussion about corporate SPVs where, to be eligible, bankruptcy rules (eg the Italian *Legge Fallimentare*) require that the entity is a 'business' that undertakes a 'commercial activity'[39] (it is interesting how the debate resembles the US one over business trusts). Commentators consider that the concept of 'commercial activity' should be flexible and encompass SPVs used in multiple issuances,[40] but also in a single one,[41] but this is a matter for discussion (as the *Coeur Defense* saga before French courts, discussed below, shows).

(ii) A second way to raise the same problem, and a second avenue to block statutory insolvency proceedings, is to ask whether a bankruptcy-remote vehicle can be 'insolvent' in a statutory sense. The issue can arise in relation to corporate vehicles, which, being legal persons, are clearly 'debtors'; and is tantamount to asking whether bankruptcy law contains an implicit requirement that the debts that give rise to the vehicle's insolvency are 'operational debts'; which, in turn, involves an even deeper question about the finality of corporate bankruptcy rules. The issue was addressed in the French saga of *Coeur Défense.*[42]

35 See art 11 of Spanish Royal Decree 926/1998; arts 32ff of Luxembourg Law of 22 March 2004 on Securitization. In Italy, default Civil-law rules on trust-like *patrimoni destinati* and *finanziamenti destinati* also suggest liquidation (art *2447-novies* of Italian Civil code) but that is only for the case where such device is used for the purposes of a bankruptcy-remote transaction.

36 See Muñoz (n 7) 277–78. Under this analytical framework, it is concluded that securitization outside statutory rules is possible in Spain, Italy or Luxembourg, but not likely in France. Whether the absence of specific statutory rules could render the structure more vulnerable and less advantageous in some cases is a different matter, to be weighed only by the transaction parties.

37 French Civil code, arts 2011ff.

38 Italian Civil code, arts 2447-*bis* ff.

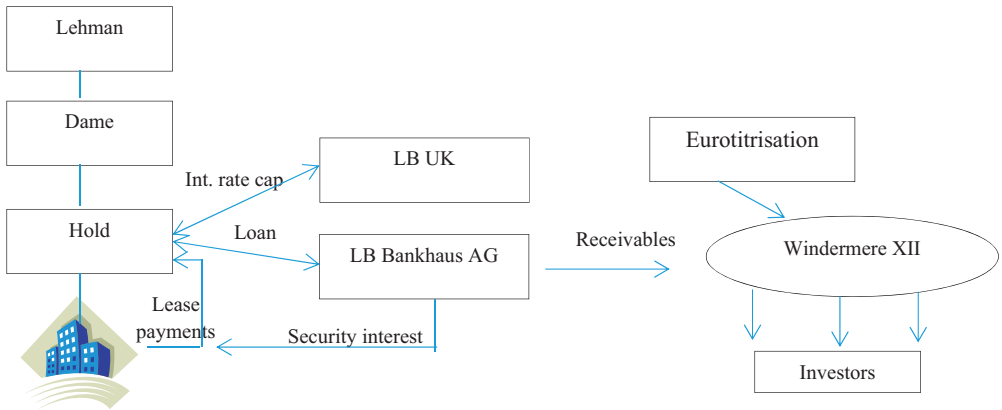
39 art 1 of the *Legge Fallimentare* states that: *'Sono soggetti alle disposizioni sul fallimento e sul concordato preventivo gli imprenditori che esercitano una attività commerciale, esclusi gli enti pubblici.'*

40 Danillo Galletti, Gianluca Guerrieri and Andrea Carinci, *Legge 30 Aprile 1999, N 130. Disposizioni sulla Cartolarizzazione dei Crediti*, 1055. See also Muñoz (n 7) 92.

41 And this because the nature of a 'business' or 'entrepreneur' is based on the attribution of commercial activities, rather than the actual performance of those activities, and, in this regard, servicing, cash management, collateral management, etc, even if performed by third parties, are attributable to the SPV (ie servicers, cash and collateral managers, etc, act *on behalf of* the SPV). See Galletti, Guerrieri and Carinci (n 40) 1056. In the same sense, see Cosimo Rucelai, 'I problemi legati allo sviluppo della Securitization in Italia: prospettive di soluzione' (1995) I Giurisprudenza Commerciale 116. See also Muñoz (n 7) 92.

42 Paris Commercial Court 3 November 2008, RG no 2008077996, Dame Luxembourg and RG no 2008077997, SAS Coeur de La Defense; Paris Court of Appeal 25 February 2010, RG no 09/22756, Coeur de La Defense (HOLD); French Supreme Court (Cour de

The Coeur Défense complex was a 39-story glass office tower in the centre of the Paris La Défense financial district, owned by an SPV, Hold, registered in Paris; which was owned by Dame, a Luxembourg holding company, part of the Lehman Brothers group. Hold funded the acquisition with two loans from Lehman Brothers Bankhaus AG, subject to an interest rate cap granted by Lehman Brothers UK; and were later (the loans) securitized.[43] Graphically:



With the collapse of Lehman Brothers' American unit, Lehman Brothers UK was downgraded, and Hold failed to find a suitable replacement for the interest rate cap, which triggered an Event of Default. Both Hold and Dame filed for rescue-type 'safeguard' proceedings (*procédure de sauvegarde*), to strengthen their position *vis-à-vis* secured creditors. To be subject to *sauvegarde* French law requires that the firm encounters 'difficulties that it is unable to overcome'.[44] The first instance court decided that both Hold and Dame fulfilled this requirement and that the loans' maturity had to be rescheduled;[45] but its decision was challenged by the securitization vehicle (the *fond commun de titrisation*). *Coeur Defense* is interesting not only because the bankruptcy of two vehicles was challenged because their passive-financial status made *sauvegarde* inappropriate; it is also ironic because it was another (securitization) vehicle, acting not as debtor, but as secured creditor, which put forward the argument about the debtor's passive-financial status.

The appeal was granted by the *Cour d'Appel* of Paris.[46] First, the Court held that debtors could not use safeguard proceedings to impose on the lenders a modification of

cassation) – Commercial financial and economic chamber (Chambre commercial, financière et économique) decision no 240 of 8 March 2011 (10-13.988/10-13.989/10-13.990).

43 The securitization was effected through a transfer to the *Fond Commun de Titrisation* Windermere XII FCT, managed by Eurotitrization, a securitization management company, which issued commercial mortgaged-backed securities (CMBS), which were purchased by several financial institutions. The loans were secured (among other things) by a security interest over all claims from leases of the property and a limited-recourse pledge by Dame over its shares in Hold. Since the loans were at a floating interest rate, Lehman Brothers UK provided an interest rate cap.

44 art L620-1 of French Commercial Code.

45 Paris Commercial Court (n 42).

46 ibid.

the loan agreement.[47] This meant construing the statute with an implied requirement to evaluate the request's motives. Secondly, the Court held that the subsequent onerosity of Hold's hedging agreement did not qualify as 'difficulties that could not be overcome' in running the business[48] because the statutory provisions for restructuring proceedings were meant to address companies' 'operational' difficulties arising from 'operating' activities; not 'passive' financial activities.[49] Interestingly, the decision was not taken pursuant to contract provisions blocking access to bankruptcy, but pursuant to the statutory interpretation of bankruptcy rules themselves, and their adequacy for financial vehicles.

The *Cour de Cassation* (French Supreme Court), however, reversed the *Cour d'Appel* decision.[50] On the issue of the motives behind filing the Court held that, if the debtor fulfils the statutory threshold, the opening of bankruptcy proceedings cannot be refused because they will allegedly be used to escape contractual obligations, beyond cases of fraud.[51] Secondly, and more important, the Court held that, whereas safeguard proceedings allow reorganization of a business activity, their opening is not limited to difficulties strictly related to that activity;[52] and that, by asking for 'operational' difficulties, the appellate court had added requirements that were not part of the law.[53]

What is interesting to note is that the courts in all jurisdictions are reluctant to apply bankruptcy rules to 'passive' vehicles. Yet, except in some cases (eg trusts in the UK, or statutorily regulated vehicles in civil law countries) such reluctance seems to be gradually disappearing. The fact that a vehicle is excluded from bankruptcy rules should not be an automatic cause for comfort, however: the vehicle's form has to be legally admissible under the laws of the country; and, if bankruptcy rules do not apply only because it is outside the categories contemplated under those laws (eg a trust in civil law countries), the vehicle may be invalidated, or fall into legal limbo. The chance of this occurring should be small if the vehicle is domiciled in a jurisdiction where its form is admitted, but less so if the courts of another country declare themselves competent over the vehicle because the assets are domiciled in their territory. The menu of options is sufficiently complex to merit a flowchart, included below. As a preliminary conclusion, tinkering with the vehicle's bankruptcy eligibility may be a one-off solution to guarantee its bankruptcy remoteness, 'if' it is one of the cases clearly excluded. Otherwise, the parties

47 ibid.

48 As for Dame, the Court held that it had not assumed obligations other than granting a pledge over its stake in Hold; an obligation that would be discharged when it transferred those shares to the securitization fund.

49 The decision came amidst concerns over whether French courts were sufficiently business friendly. See Anousha Sakoui 'France Revokes Local Insolvency For Bond Issuer' *Financial Times* (25 February 2010).

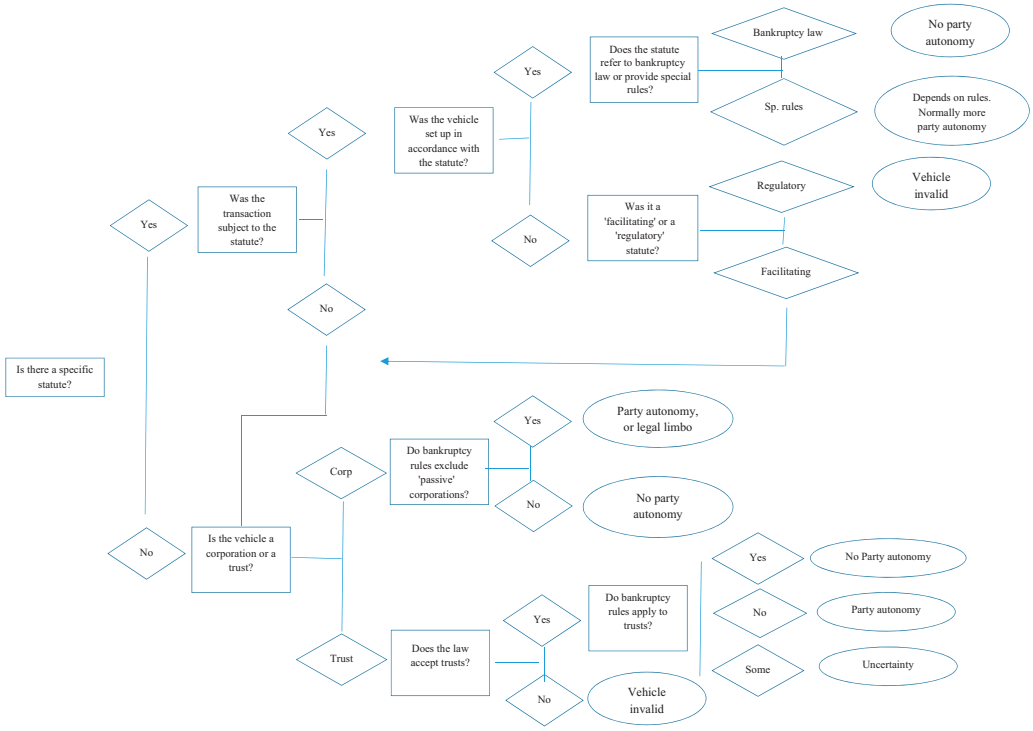
50 French Supreme Court Arrét no 240 8 March 2011 (10-13.988 / 10-13.989 / 10-13.990) - Cour de cassation - Chambre commerciale, financiére et économique (n 42).

51 ibid. Analysis of the 2nd count, 8th branch and 3rd, 3rd branch, of the appeal by the Court.

52 ibid. Analysis of 2nd count, 4th and 5th branches, and 3rd count, 1st branch, of the appeal.

53 ibid.

risk the impromptu application of bankruptcy rules, or an unpredictable outcome in the absence of clear rules.



Blocking voluntary filing by directors

If the vehicle is eligible for bankruptcy, the parties need to use other ways to rule bankruptcy out; and the first step is to limit voluntary filing by directors. The way this can be done is by appointing at least an independent director (ie not linked to the sponsor) and requiring unanimity on the decision to file for bankruptcy (or any other relevant restructuring decisions, such as liquidation, merger, division, spin-off, etc.). From a mechanism to prevent interference from the sponsor, however, the independent director turns into a device to block bankruptcy proceedings altogether. This suits the holders of super senior and senior tranches, who will be interested in foreclosing the assets, but could sit badly with other, more junior, creditors. This raises deep questions about the nature of directors' fiduciary duties, and whom they are owed (section 'Bankruptcy (non-) filing by SPV directors (I): fiduciary duties for SPVs as a fish out of water') which have been subject to the test of court practice, with unclear results (section 'Bankruptcy (non-) filing by SPV directors (II): specific examples').

Bankruptcy (non-) filing by SPV directors (I): fiduciary duties for SPVs as a fish out of water

The validity of contractual mechanisms to ensure that the SPV's independent director will block the decision to file for bankruptcy proceedings depends on whether the SPV

director can refuse, under any circumstances, to file for bankruptcy. This, in turn, depends on what the director's duty of undivided loyalty means and to whom it is owed.

Pursuant to a strict interpretation, duties are owed to the company, or to shareholders. While subject to much criticism,[54] the principle is part of corporate law of all known jurisdictions. Yet bankruptcy-remote SPVs are often 'orphan' vehicles, with capital (nominal or little) held by a charitable trust,[55] and investors' interests are represented by limited recourse 'debt' notes,[56] and often not even the residual interest is contemplated as a shareholding, but a contractual arrangement. The question is whether the association among fiduciary duties–company interest–shareholder value, traditional in corporate law, is to be maintained, despite its awkwardness in the context of SPVs, or should be reinterpreted. The answer depends, to a great extent, on whether the concept of fiduciary duties and company interest may encompass the interest of creditors; and whether such interest and duties are enforceable. The answer may vary between (i) common law jurisdictions and (ii) civil law jurisdictions.

(i) In the USA or the UK it is clear that, in general, directors' duties do not include the need to take creditors' interest into consideration.[57] The exception may only arise for companies in distress or insolvent; but there is no clear rule as to the moment when the duty arises. There is strong evidence that fiduciary duties exist 'once' the company has become insolvent;[58] but British specific provisions on wrongful trading impose liability for breach of standard of care in cases where bankruptcy proceedings have become 'inevitable',[59] and Canadian or New Zealand courts have held that creditors' interests must be taken into consideration when the company was 'doubtfully solvent'[60] or in a 'course of action that would jeopardize solvency'.[61]

54 See the summary and authorities cited in Muñoz (n 7) 143–48. See specifically Jonathan C Lipson, 'Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation' (2003) 50 UCLA L Rev 1189; Steven L Schwarz, 'Rethinking a Corporation's Obligation to Creditors' (1996) 17 Cardozo L Rev 647; Ann E Conway Stilson, 'Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors' (1995) 20 Del J Corp L 1.

55 Fitch Ratings, *Criteria for Special-Purpose Vehicles in Structured Finance Transactions* (May 2012) 4. Available at: <http://www.fitchratings.co.jp/ja/images/RC_20120530_Criteria%20for%20Special%20Purpose%20Vehicles%20in%20SF%20Transactions_EN.pdf>.

56 The importance of limited recourse and similar clauses will be addressed later. See *infra* p. 18.

57 In the UK, the reformed Companies Act 2006 includes in its s172 a general 'duty to promote the success of the company' for '*the benefit of its members as a whole*', and in so doing, to have regard to '*(a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company*'. Any alert reader will notice that, even in this hodgepodge provision there is no mention whatsoever to the interests of creditors.

58 Particularly in the USA this is justified under the 'trust fund' theory. Stuart C Gilson and Michael R Vetsaypens, 'Creditor Control in Financially Distressed Firms: Empirical Evidence' (1994) 72 Wash U L Q 1005; Myron M Sheinfeld and Judy Harris Pippitt, 'Fiduciary Duties of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case' (2004) 60 Buss Law 88. See also *Federal Deposit Ins Corp v Sea Pines Co*, 692 F 2d 973, 976–77 (4th Cir 1982), *cert denied*, 461 US 928, 103 SCt 2089, 77 L Ed 2d 299 (1983); *CarrAmerica Realty Corp v nVIDIA Corp*, No 05–00428, 2006 WL 2868979, 2006 US Dist LEXIS 75399 (ND Cal 29 September 2006); *Re JTS Corp* 305 BR 529, 535–36 (Bankr ND Cal 2003), in line with the general doctrine set forth in *Pepper v Litton* 308 US 295, 306–07, 60 SCt 238, 84 L Ed 281 (1939) concerning directors' good faith duties (which need to serve the community of interest), which, conversely, justifies setting aside the transactions undertaken if the company becomes insolvent.

59 See s214 of the Insolvency Act 1986.

60 *Brady v Brady* [1988] BCLC 20, 40, CA.

61 *Nicholson v Permala-aft (NZ) Ltd* [1985] 1 NZLR 242. These cases could arguably have some effect within the UK, since s173(3) of the Companies Act 2006 preserves existing statutory law, or *rules of law* with the effect prescribed in the section (ie

In America, the Delaware Chancery Court in *Credit Lyonnais* suggested that the duty of loyalty begins switching in the vicinity of insolvency;[62] but it did so in a very nuanced way, by indicating that loyalties have to encompass a wider 'community of interests', and thus directors cannot be sued by shareholders for refusing to undertake a course of action that might benefit them, but endanger creditors' position. That holding did not intend to create new rights for creditors; as the court clarified in a *dicta* in *Production Resources Group*;[63] and the Delaware Supreme Court ratified in *North American Catholic*; which overruled even the milder proposal in *Credit Lyonnais*,[64] and excluded fiduciary duties absent insolvency.

Even if duties were held to exist it is unclear whether they can be characterized as a duty of undivided loyalty, or a duty of care (which involves discretion).[65] Also, when the company is 'in the zone' or 'in the vicinity' of insolvency, the standard is not more than one of care;[66] and even in insolvency, it does not entail a 'duty to liquidate' the company.[67]

An argument can be made that the doctrines that contemplate the switching of duties in cases of impending insolvency do so because the company's equity, and shareholders' interest, become irrelevant; and thus, the same criterion should apply to SPVs, where equity is irrelevant from the outset.[68] But this depends on whether the argument for a switching of duties is the 'relevance' of the interest, in quantitative terms, or the 'probability' of insolvency.

Still, even if such construction were successfully made, any duty to take creditors' interests into consideration would be owed to the company and not to individual creditors,[69] who cannot enforce it through a derivative claim.[70] Even upon insolvency, in the UK the rights can only be enforced by an insolvency administrator on behalf of all creditors;[71] and, in the USA, the courts have only recently admitted derivative claims by

imposing on directors the duty to promote the success of the company). In other words, the statute refers to common law for any additional duties on the side of directors. See Paul Davies, 'Gower and Davies Principles of Modern Company Law' (8th edn Sweet&Maxwell 2008) para 16–34, 521.

62 *Credit Lyonnais Bank Netherland, N V v Pathe Communications Co,* 1991 (Del Ch 1991).

63 *Production Resources Group, LLC v NCTGroup, Inc*, 863 A2d 772 (Del Ch 2004).

64 In *North American Catholic Educational Programming Foundation Inc v Gheewalla,* 2007 Del LEXIS 227 (Del Supr 18 May 2007) the court held that when a solvent corporation is '*navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners*'. See also *Re Ben Franklin Retail Stores, Inc* 225 BR 646, 655 (1998).

65 Davies (n 61) para 16–35, 521–22. Also, courts that have accepted their existence tend to limit them. See *Berg & Berg Enterprises LLC v Boyle et al* 178 Cal App 4th 1020, 100 Cal Rptr 3d 875 (2010) where the court held that the duty was restricted to avoiding acts that dissipate the company's assets.

66 *Welfab Engineers Ltd, Re* [1990] BCLC 833.

67 *Berg & Berg Enterprises LLC* (n 65); *Re RSL Com Primecall Inc, 2003 WL 22989669* (Bkrtcy SDNY 2003).

68 David Ramos Muñoz, 'In Praise of Small Things: Securitization and Governance Structure' (2010) 5(5) CMLJ 378.

69 See *Credit Lyonnais Bank Netherland* (n 62); *North American Catholic Educational Programming Foundation Inc v Gheewalla,* 2007 Del LEXIS 227 (Del Supr 18 May 2007); *Sycotex Pty Ltd v Baseler* (1994) 122 ALR 531, 550. See also Davies (n 61) para 16–35, 522.

70 Creditors cannot initiate any derivative claim even when the company is in the vicinity of insolvency. In the USA, this view was highlighted by the Delaware Supreme Court in *North American Catholic Educational Programming Foundation Inc*, (n 64).

71 s214 UK Insolvency Act; and also *Liquidator of West Mercia Safetywear v Dodd* [1988] BCLC 250, CA.

individual creditors of an insolvent company.[72] This gives rise to a scenario, where the only way to hold the SPV director accountable for blocking bankruptcy proceedings would be by means of those bankruptcy proceedings that may never start because they are blocked by the director.

(ii) Continental European countries and Japan provide for stronger creditor protection, and make directors responsible for damages resulting from acts contrary to the law, the company's bylaws, or in breach of duty (negligence-based liability); and a right of action is normally given to the company, its shareholders and its creditors.[73] The duties are part of the directors' general duties, and, as such, they are operative before insolvency. Also, in cases of financial distress, directors must exercise certain acts (typically to stop trading, followed by dissolution and liquidation) promptly after the company's capital reaches a certain level of deterioration;[74] or the value of net assets falls to zero,[75] which, if they are not complied with, give creditors a right of action.[76]

Based on the above, even if courts reinterpret fiduciary duties to accommodate creditors' interests in case of SPVs (where shareholders' interest is irrelevant) other fundamental questions remain open. Would the directors' duties towards creditors arise upon the vehicle's inception, or when the vehicle approaches insolvency? Should the directors consider about the interest of all creditors, or give preference to the interest of a particular class? If giving preference to a particular class, would that preference be determined by fixed rules or depend on the transaction? If subject to fixed rules, should one prioritize junior or senior creditors? If the former, would it be fair to give preference to creditors with residual claims (which would fulfil a role akin to that of shareholders) considering that, in most cases, a bankruptcy-remote transaction is not structured to maximize, but to preserve, value, and that residual claims are held as a 'cushion' (often by the sponsor itself)? If the latter, are the senior and super senior interests not sufficiently protected by that seniority? If, on the contrary, the priority depends on the transaction's substance, will a court be in a good position to decide whether, in light of all the complex and lengthy documents, the transaction leans towards a particular class of creditors? If, finally, the directors are asked to take into consideration the interest of 'all' creditors to exercise their fiduciary duties, is such a thing even possible, in light of the seemingly irreconcilable preferences of different classes of creditors?

72 *North American Catholic Educational Programming Foundation Inc* (n 69).

73 See arts 133–35 of the Spanish Corporations Act; art L225-251 of French Commercial Code; ss93 and 116 of German Corporations Act; arts 2392–95 of Italian Civil code; or art 429 of Japanese Companies Act. See also Kraakman and others (n 3) 136.

74 Arts L 223-42, 225-248 of French Commercial Code, arts 2447 and 2482(3) Italian Civil code; paras 15 and 19 German Insolvency Act.

75 arts L 223-22, 225-251 of French Commercial Code, art 2394 Italian Civil code; paras 93 and 116 German Corporations Act (Aktiengesetz).

76 If the company becomes insolvent, liability actions can ensue if the actions of the debtor and its legal representatives (eg company directors) contributed to the insolvency. See arts 363 and 367 of the Spanish Company Act, and 167ff of the Spanish Insolvency Act; arts 651-1 and 652-1 of French Commercial Code; art 146 of Italian Insolvency Act.

Bankruptcy (non-) filing by SPV directors (II): specific examples

The above issues have been put to test in at least two cases: *Re Kingston Square*[77] and *Re GGP.*[78] In *Re Kingston Square*, the vehicles were used for real estate financing: each property was controlled by one SPE, and each SPE was controlled by the same three directors: Morton Ginsberg, a sort of 'sponsor', his own straw man (Joseph Kazarnowsky) and an independent director (Laurence Richardson). The properties were refinanced by a loan from Chase Manhattan Bank and by REFG, a securitization SPV owned by the DLJ Group. REFG issued pass through certificates that were purchased by investors; and then repurchased by DLJ acting through REFG. A default occurred and Chase and REFG, as secured creditors, began foreclosure proceedings. However, Ginsberg convinced unsecured creditors (with rights arising from ancillary services) to request bankruptcy proceedings.[79] Bankruptcy petitions were made, but not ratified by the directors.

To facilitate foreclosures a bankruptcy-remoteness clause had been inserted in the transaction documents, requiring unanimous consent from the directors to file for bankruptcy; and the independent director, Richardson, abstained. In the following proceedings, one of the issues examined was whether Richardson had complied with his fiduciary duties. On this count, the court held that Richardson had not fulfilled his fiduciary duties towards unsecured creditors; which, in the court's view, put into question his independence.[80] Unfortunately, the court did not explain why such fiduciary duties were owed 'precisely' to unsecured creditors, and not to other constituencies, thus leaving the above general questions unanswered.

In *GGP*, the homonymous company (GGP), a REIT, replicated the *Kingston Square*'s arrangement many times over, giving rise to an extremely complex corporate structure. When GGP could not rollover its debt, it filed for bankruptcy, and its entities 'were in varying degrees of financial distress'.[81] A team of advisors was hired, who made an analysis 'of the entire group'; as well as each entity separately, classifying them from A to G pursuant to 10 factors that indicated the convenience of filing for bankruptcy to restructure. Bankruptcy filing required the unanimous vote of every Board, including the independent directors, who were supposed to exercise fiduciary duties required by the law, and, in so doing, to consider the company's interest 'including its respective creditors'.[82]

The original two independent directors were supplied by Corporation Service Company (CSC) and served in the board of more than 150 project-specific entities,

77 *Re Kingston Square Associates et al* 214 BR 713 (Bankr SDNY 1997).

78 *Re GGP* (n 28).

79 *Re Kingston Square Associates et al* (n 77).

80 ibid.

81 ibid 58.

82 The sample of clauses that the decision reproduced included one that made reference to the fact that *'in the case . . . the Independent Managers shall consider only the interests of the Company, including its respective creditors, in acting or otherwise voting on the matters referred to in Article XIII (p)'*. art XIII (p) required the 'unanimous written consent of the Managers of the Company, including both of the Independent Managers' for the SPE to file for bankruptcy. Then, the Operating Agreements indicated that, '*in exercising their rights and performing their duties under this Agreement, any Independent Manager shall have a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware*'. See *Re GGP* (n 28) 64.

before being replaced 'without any prior indication' by two other independent directors, who voted affirmatively to the bankruptcy filing, including for entities that were not in default in their payments. Secured creditors filed a motion to dismiss, based on the argument that petitions had been filed in bad faith (the filing was premature for entities still solvent, and the replacement of directors showed subjective bad faith). The court dismissed all these allegations with interesting arguments.

First, it held that, in addition to the situation of each individual entity, the entities were part of a 'group' (and could depend upon the parent company for a bailout, for example); and that, given that the group's financial structure was seriously imperiled,[83] this could be considered when deciding to file for bankruptcy.[84] Secondly, it held that the need of directors to take into account the interest of creditors was limited by the configuration of their fiduciary duties in corporate law. The law only required directors to take such creditors' interests into consideration after the company became insolvent, whereas before it asked them to consider only the interests of shareholders;[85] which, in this case, meant those of the parent company. The court seemed disturbed by the creditors' contention that the directors' role was to serve their interest by preventing a bankruptcy filing, and dismissed the argument in a stern way:

> The record at bar does not explain exactly what the Independent Managers were supposed to do. It appears that the Movants may have thought the Independent Managers were obligated to protect only their interests. ... However, if Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken. As the Delaware cases stress, directors and managers owe their duties to the corporation and, ordinarily, to the shareholders. Seen from the perspective of the Group, the filings were unquestionably not premature.[86]

Both decisions raise interesting points. The most important is the courts' difficulty to re-shape the concept of 'company interest', which defines the directors' duties, beyond generalities. In *Re Kingston Square*, it seemed close to the interest of unsecured creditors, whereas in *Re General Growth*, the court refused to go beyond the conventional position that assimilates company interest with shareholders' interest. But is the 'company interest' concept an abstraction, one-size-fits-all companies, or is it malleable to adjust to the 'actual' interest of a company?

83 The court stated that *'There is no question that the SPE structure was intended to insulate the financial position of each of the Subject Debtors from the problems of its affiliates, and to make the prospect of a default less likely. There is also no question that this structure was designed to make each Subject Debtor ''bankruptcy remote''. Nevertheless, the record also establishes that the Movants each extended a loan to the respective Subject Debtor with a balloon payment that would require refinancing in a period of years and that would default if financing could not be obtained by the SPE or by the SPE's parent coming to its rescue. Movants do not contend that they were unaware that they were extending credit to a company that was part of a much larger group, and that there were benefits as well as possible detriments from this structure. If the ability of the Group to obtain refinancing became impaired, the financial situation of the subsidiary would inevitably be impaired'*.

84 The court drew heavily on *Heisley v UIP Engineered Prods Corp* (*Re UIP Engineered Prods Corp*) 831 F 2d 54 (4th Cir 1987); and *Re Mirant Corp*, 2005 WL 2148362 (Bankr ND Tex 26 January 2005).

85 In holding so the court referred to *North American Catholic Educational Programming Foundation Inc* (n 69); and to *Credit Lyonnais Bank Netherland* (n 62).

86 *Re GGP* (n 28) 65–66.

The construction of the concept in abstract terms makes sense to shape a general principle valid when society's goal is to promote wealth creation and profit maximization, which requires a general presumption that companies are created to make profits. But does the system have no room for an exception when the presumption does no longer hold true? The purpose of bankruptcy-remote SPVs is normally to insulate and preserve assets for the benefit of investors/creditors. This means that company law would not be protecting the only constituency with an interest at stake: investors. In *Re General Growth* the court acknowledged the specificity of the situation where there is only an asset and a creditor;[87] and thus admitted that the issue 'is, in essence, a two party dispute between the debtor and secured creditors which can be resolved in the pending state foreclosure action'; but still was incapable of weighing those factors in the decision over fiduciary duties and bankruptcy filing.[88] The laws of civil law countries provide pre- and post-insolvency protection for creditors, but focus too much (especially in Europe) on the preservation of legal capital (not solvency), which is irrelevant in case of SPVs.[89]

Despite some features of the system being objectionable for their rigidity, on the contrary, the excessive focus by transaction parties and lawyers on the advantages of corporate legal personality has diverted their attention from the fact that the implications of such principle may be a misfit when legal personality is used for purposes akin to those of a secured transaction.

In either case, the situation is one of extremes. If controls in the form of liability actions are concentrated 'after' the company is in bankruptcy, directors may be unaccountable if the system's goal is to avoid bankruptcy. But, conversely, the focus on shareholder interest can also result in bankruptcy filing when it is in the interest of the sponsor (if it happens to control the entities' capital, or otherwise have influence over directors), not the interest of investors, which is the opposite of what it should be.

A final reflection, though, is that the system's principles should be interpreted to make sure the actual interest of the SPV (ie that of investors) are given due consideration, but that does not mean that the directors' role should be to block bankruptcy without exercising their judgment. Company law requires directors to exercise their judgment, and grants them discretion to do so, expressly, in common law countries, through the 'business judgment rule',[90] and more implicitly in civil law countries.[91]

87 This could potentially be extrapolated to cases (as in securitization) where the whole asset pool is considered as a single element, and creditors act by means of a single trustee, though, as we will see later, once we move to the liquidation stage, interests diverge again between senior and junior creditors, or even senior creditors with liquid and illiquid debts.

88 In so doing, it relied on *C–TC 9th Ave P'ship v Norton Co (In re C–TC 9th Ave P'ship)*, 113 F 3d 1304 (2d Cir 1997); *Baker v Latham Sparrowbush Assocs (Re Cohoes Indus. Terminal, Inc)*, 931 F 2d 222 (2d Cir 1991).

89 The 'cushion' can be in the form of a 'residual' interest, 'interest only' (IO) or 'principal only' (PO) notes; overcollateralization, or other credit and liquidity enhancement mechanisms. David Ramos Muñoz, 'In Praise of Small Things: Securitization and Governance Structure' (2010) 5 CMLJ 379.

90 *Re The Walt Disney Co Derivative Litig (Disney IV)*, No CIV.A. 15452, 2005 WL 2056651, (Del Ch 9 August 2005). See also *North American Catholic Educational Programming Foundation Inc* (n 69).

91 See decision from the Provincial Court of Appeal of Madrid, of 13 September 2007 (JUR\2007\330370). See also the decision of the Spanish Supreme Court of 7 December 2011 (RJ 2012/3521).

A director's decision, thus, must respect some guarantees,[92] but it is not predetermined: the fact that the company's interest is close to investors' interests does not mean that the director should never file for bankruptcy. It is (or should be) impossible to completely shield a transaction from bankruptcy filing by its directors; and *Re CEIDCO*[93] is a useful reminder of that. In that case, the court rejected a request to consolidate estates, but it did not reject the bankruptcy petitions by the SPEs.[94] In fact, unlike the decision 'not to file', which can be corrected if it goes against the company's interest, a decision 'to file' can only be undone if made in bad faith.

Blocking filing by creditors: non-petition and non-recourse clauses

Even if filing by directors is blocked, bankruptcy proceedings can also be initiated at the request of creditors, hence the need for the parties structuring the transaction to block that avenue as well. They do that by means of 'no-action', 'non-petition' clauses;[95] by which 'none of the secured parties is to institute any form of bankruptcy or insolvency proceedings against the Company'.[96] This type of clause has been the subject of controversy in recent times. Especially the validity, enforceability and efficiency of 'collective action clauses' (CACs) have been widely discussed in connection with sovereign bonds issued under English or New York law, first in relation to Latin American countries (which began this practice);[97] and then, in relation to EU countries affected by the sovereign debt crisis.[98]

The problem of collective action (and whether and how it can be structured by means of clauses that restrict individual access to justice) has received less attention in relation to bankruptcy-remote structures;[99] but it is of outmost importance. Such clauses are included as a routine matter in trust indentures to avoid the problems of collective action by individual bond- or noteholders.[100] The clauses do not pose problems of validity in

92 It is arguable whether there is also a control of the contents if the directors were negligent (David Rosenberg, 'Galactic Stupidity and the Business Judgment Rule' (2007) 32 J Corp L 301); or when the decisions are not operational, but structural (see Stephen M Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' (2004) 57 Vanderbilt L Rev 83).

93 *Re Central European Industrial Development Company LLC d/b/a CEIDCO*, 288 BR572 (Bankr ND Calif, 2003).

94 ibid.

95 See Muñoz (n 7) 98–100.

96 *Re Golden Key Ltd (In Receivership)* (n 5) 148 (Ch).

97 Joy Dey, 'Collective Action Clauses: Sovereign Bondholders Cornered?' (2009) 15 Law & Bus Rev Am 485; Sergio J Galvis and Angel L Saad, 'Collective Action Clauses: Recent Progress and Challenges Ahead' (2004) 35 Geo J Intl L 713; Elmar B Koch, 'Collective Action Clauses: The Way Forward' (2004) 35 Geo J Intl L 665; Robert Gray 'Collective Action Clauses: Theory and Practice' (2004) 35 Geo J Intl L 693; Mark Gugiatti; Anthony Richards 'The Use of Collective Action Clauses in New York law Bonds of Sovereign Borrowers' (2004) 35 Geo J Intl L 815.

98 Michael Bradley and Mitu Gulati, 'Collective Action Clauses for the Eurozone: An Empirical Analysis' Third Draft, 7 May 2012 <http://scholarship.law.duke.edu/faculty_scholarship/2455/> accessed 11 June 2015; Jason B Gott, 'Addressing the Debt Crisis in the European Union: The Validity of Mandatory Collective Action Clauses and Extended Maturities' (2012) 12 Un Chi J Intl L 201; Public Debt Management Network Working Paper <http://www.publicdebtnet.org/public/CORE-TOPIC/trasparenc/resourceDetail.jsp?id=20120518095304&tab=RES_PAPER> accessed 11 June 2015.

99 See, however, Nancy P Jacklin, 'Addressing Collective-Action Problems in Securitized Credit' (2010) 73 L & Contemp Prob 175. Though most of the analysis is focused on the experience of CACs in sovereign debt issuances there are useful remarks on how the stiff restriction of activities of the trustee or representative appointed to act on behalf of investors prevents socially desirable ends, such as loan restructuring, which, in the end, may end up causing harm to investors as well. See ibid 186–91.

100 See eg *Elektrim SA v Vivendi Holdings 1 Corp Law Debenture Trust Corp plc v Vivendi Holdings 1 Corp* [2008] EWCA Civ 1178 2–3.

the law of the UK,[101] USA[102] or Canada.[103] German law has traditionally been more problematic. The 1899 Bondholders Act included limited provisions regarding collective action, and it only applied to bond issuances made in Germany by German issuers. International offerings were not covered, and were subject to the general provisions of the Civil Code (BGB) including the mandatory provisions on consumer protection, or general conditions, which could result in the non-enforceability of provisions that did not meet a certain standard of fairness.[104] A similar problem was present under Japanese law.[105] Thus, a reform was passed in Germany in 2009 (the New Bondholder Act), which was applicable to bond issuances subject to German law (regardless of the domicile of the issuer, SPVs included) and rationalized the exercise of collective rights (matters that could be decided by the representative, matters that could be decided by a majority of bondholders and matters requiring a supermajority),[106] whereas in Japan a specific mandatory regime in the Commercial code applies for bonds subject to Japanese law.[107]

This experience is important in determining the effectiveness of no-action clauses in sealing off a vehicle's 'bankruptcy remoteness'.[108] Even if such clauses are valid to prevent individual judicial actions in general, can they prevent bankruptcy filing? In the UK, for example, courts are inclined to accept that no-action clauses can bar individual claims in insolvency proceedings.[109] Such was the case especially in *Elektrim SA v Vivendi Holdings 1*, where the discussion turned on an interpretation of the scope of the clause;[110] not its

101 *Acevedo v Imcopa Importacao* [2012] EWHC 1849 (Comm); *Elektrim SA*, ibid; *Elliott International LP et al v Law Debenture Trustees Limited* [2006] EWHC 3063 (Ch); *Highberry Ltd v Colt Telecom Group Plc (No 1)* [2002] EWHC 2503(Ch).

102 *Akanthos Capital Management, LLC v Compucredit* Holdings Corp, F 3d, [2012] WL 1414247, *1 (11th Cir 25 April 2012); *McMahan & Co v Wherehouse Entertainment, Inc*, 859 F Supp 743, 749 (SDNY 1994); *Feldbaum v McCrory Corp*, 1992 WL 119095 (Del Ch 2 June 1992).

103 *Casurina Ltd Partnership v Rio Algom Ltd* (2004) 40 BLR (3d) 112.

104 German practitioners and market participants were thus wary that this could threaten enforceability. See IMF Legal Department *Design and Effectiveness of Collective Action Clauses* 6 June 2002, 7–8.

105 ibid 8–9.

106 Jason Grant, 'Allen More Than a Matter of Trust: The German Debt Securities Act 2009 in International Perspective' (2011) 7(1) CMLJ 55ff.

107 IMF Legal Department, *Design and Effectiveness of Collective Action Clauses* 6 June 2002, 8.

108 The description of one of the receivers of the SIV in *Golden Key*, as reproduced by the court, summarizes it: *'It is an essential feature of the SIV structure that it is "insolvency remote" in the sense that the Company's creditors have agreed, by way of various different contractual mechanisms, only to look to the assets secured under the CTSA and Deed of Charge for repayment of their claims, and then only in accordance with the terms of the Limited Recourse provisions set out in the documentation governing the Company's operations.'* See *Re Golden Key Ltd (In Receivership)* (n 5) 148 (Ch) at 47.

109 See *Re Golden Key Ltd*, ibid; *Elektrim SA* (n 100) 92–94, and 100. In *Highberry Ltd v Colt Telecom Group Plc (No 1)* [2002] EWHC 2503(Ch) the judge seemed keen to accept the effectiveness of a no-action clause to preclude claims by investors (a vulture fund, or, as they preferred to be called, a hedge fund) of sensitive information of the company, which, investors believed, would show that the company was insolvent. The company preferred that the court decided publicly on the absence of grounds for the request regardless of the clause (the whole issue seemed to turn on the fund having shorted the company stock, and then making moves to turn it into a self-fulfilling prophecy).

110 The case is far too complex, and with too many ramifications. Suffice it to say that it was part of the legal battle between Deutsche Telecom and Vivendi for the control of a Polish telecommunications company (PTC). Elektrim had a joint venture agreement with Vivendi (Telco), whose purpose was, apparently, the posterior transfer of Elektrim's holding in PTC. Yet Elektrim then transferred the holding to DT; and a long legal battle ensued, where Vivendi tried to claw it back. Its interest was severely damaged when DT paid the price to Elektrim (which was in bankruptcy proceedings in Poland); and the latter agreed to transfer the money to the bondholders' trustee. Vivendi acquired the bonds of a bondholder (and the legal actions associated to them) and tried to undo the money transfer by an action before Florida courts. English courts (to which the trust deed and the debt document were subject) found against Vivendi. Since the no-action clause referred to the actions that could be undertaken by the trustee to 'enforce performance' of the Bond Conditions, it turned out on an interpretation of the scope of the clause. The High Court chose

validity or enforceability pursuant to public policy: if the scope of the clause covers insolvency proceedings it operates as a bar for individual creditors who want to make a separate filing.

In *Elliott International et al v Law Debenture Trustee*, the Court allowed individual debtors to appear before a French court in the context of safeguard (*sauvegarde*) proceedings, 'because' it considered that the purpose of this action was 'not' to 'enforce the terms of the bonds' (where individual action was barred in favour of the trustee's action on behalf of all bondholders).[111] The *Elliot* decision should not cast any doubts over the enforceability of such clauses under English law because (i) the issue concerned the interpretation of the clause; (ii) both the trustee and individual bondholders agreed on the latters' appearance; and (iii) the purpose of such appearance was to institute opposition proceedings, to have the French court declare itself incompetent. At issue was not the existence of a bondholders' right to request, or participate in bankruptcy proceedings despite what the clause said. Yet, the court also concluded that:

> Even if the Opposition Proceedings are to be regarded as part and parcel of the safeguard proceedings (much as an application within a company insolvency in this court could properly be viewed as part of the same proceedings), the safeguard proceedings themselves are not proceedings to enforce the terms of the bonds; rather they are proceedings the purpose of which is to achieve or assist in achieving a restructuring of the Issuer's debt.[112]

The court's distinction between 'enforcement' and 'restructuring' seems a bit artificial (given the multi-faceted nature of insolvency/bankruptcy proceedings), but, if used as precedent, could lead to the conclusion that a no-action clause only bars individual creditors from enforcing the security; but not from appearing before court with the aim to restructure payments (a possibility that, in bankruptcy-remote transactions, given the divergence of interests between senior and junior creditors, the latter may be inclined to use). It also shows the uncertainty surrounding a case-by-case approach, where courts may give different interpretation to similar clauses.

Also, bankruptcy-remote SPVs add one further aspect that needs to be considered. In case of 'normal' companies, it is unclear how much the enforceability of no-action clauses depends on the implicit assumption that individual actions are 'replaced' by a single action, an action on behalf of all investors 'of the debt offering' and 'before the courts';[113] as happened in all the cases examined above. In transactions with SPVs, however, the trustee acts as the sole representative of 'all' creditors of the entity; and as such, it may

to give the clause a wide meaning, focusing on its substance, by holding that *'A claim designed to compensate a bondholder for the loss of something that would have belonged to him in his capacity as a bondholder was caught by the prohibition, whether the cause of action was pleaded in contract or tort.'* Furthermore, it added that *'the claimed loss was predicated on Elektrim having been declared bankrupt. If that had happened, the only way of recovering the value attributable to the equity kicker would have been by proving in Elektrim's bankruptcy. Proving in bankruptcy was one of the species of proceedings whose conduct in accordance with the Trust Deed and the Bond Conditions was exclusively within the control of the Trustee*' The Court of Appeal then confirmed this interpretation. See *Elektrim SA* (n 100) 92, 94 and 100–01 (Lawrence Collins J).

111 *Elliott International LP et al* (n 101) 47.

112 ibid para 47.

113 In *Elektrim SA v Vivendi Holdings 1*, for example, the acted in the Polish proceedings until they requested the hearings to be adjourned as a result of DT's payment to Elektrim, and Elektrim's composition proposal, and subsequent payment to the trustee, on behalf of bondholders.

resort to court proceedings, or may simply 'take over' control of the SPV's assets, manage and administer them on behalf of its creditors (investors) and then liquidate it and satisfy creditors,[114] with or without court supervision. Waiving individual rights of access to courts in favour of collective action is an apt choice; but how about a waiver of a right to court-supervised proceedings in exchange for an extrajudicial procedure where court control comes in the form of directions sought 'voluntarily' by trustees or receivers?[115] Even liberal minded and pro-contract English courts skipped the discussion in *Golden Key* in light of the fact that the clause's validity had not been challenged on grounds of public policy.[116]

In the USA, despite the enforceability of no-action clauses is widely admitted,[117] section 316(b) of the Trust Indenture Act (TIA) 1939 provides that a holder of indenture securities has an individual right to sue for payment of principal and interest on the (or after) due dates set out in the note.[118] This mandatory provision[119] implies that a bondholder's debt cannot be reduced, or its term extended, without that debtholder's consent,[120] which shows a concern against retail bondholders being forced to relinquish part of their rights in out-of-court debt restructurings.[121] The individual petition right, which cannot be excluded, can be a money-collection claim, or, according to some courts, a bankruptcy petition.[122] Even though bankruptcy proceedings constitute an exception to section 316(b) TIA, as bankruptcy can result in the reduction of the holder's right to payment without her consent, it is justified by the presence of proceedings that carefully balance individual and collective interests under judicial review.[123]

114 Muñoz (n 7) 100. See *BNY Ltd v Eurosail plc* (CA) [2011] EWCACiv 227; See *Re Golden Key Ltd (In Receivership) v Re the Insolvency Act 1986* [2009] EWHC 148 (Ch); *Re Cheyne Finance plc (No 2)* [2007] EWHC 2402 (Ch); *The Bank of New York v Montana Board of Investments, Party A, Party B*, [2008] EWHC 1594 (Ch); *Re Whistlejacket Capital Ltd* (in rec) v [2008] BCC 826; Re *Sigma Finance Corporation (in administrative receivership)* [2009] UKSC 2. This provision by which the trustee takes over the management of the vehicle, or, at least, is consulted in all major decisions, is based on the fact that it represent *all* the entity's creditors.

115 See authorities cited in the previous note.

116 *'The important point is that all of the noteholders, by virtue of this and other similar provisions in the contractual documentation, have agreed to limit their rights of recourse against the Company and its assets to their entitlement under the documentation, and not to pursue any insolvency procedures against the Company. In other words, the usual rights of an unsatisfied creditor to initiate insolvency proceedings are ousted in favour of the rights, whether sounding in contract or trust, provided by the documentation. No party has submitted that there is any objection, from a public policy point of view, in investors agreeing to make their investment upon such a basis.' Re Golden Key Ltd (In Receivership)* (n 5).

117 *Akanthos Capital Management, LLC* v *Compucredit* Holdings Corp, F 3d, 2012 WL 1414247, 1 (11th Cir 25 April 2012); *Re Enron Corporation Securities and ERISA Litigation* Not Reported in F Supp 2d, 2008 WL 744823, 70 Fed R Serv 3d 113 (SD Tex 2008); *McMahan & Co v Wherehouse Entertainment, Inc*, 859 F Supp 743, 749 (SDNY 1994); *Feldbaum v McCrory Corp*, 1992 WL 119095 (Del Ch 2 June 1992). This includes claims for fraudulent conveyance. See *Akanthos Capital Management,* ibid; *Feldbaum v McCrory Corp*, 1992 WL 119095 (Del Ch 2 June 1992).

118 See para 316(b) TIA 1939. See George W Shuster, Jr 'The Trust Indenture Act and International Debt Restructurings' (2006) Am Bankr Inst L Rev 432.

119 *Re Enron Corporation Securities and ERISA Litigation* Not Reported in F Supp 2d, 2008 WL 744823, 70 Fed R Serv 3d 113, 11 (SD Tex 2008); *Great Plains Trust Co v Union Pacific Railroad Co*, 492 F 3d 986, 991 (8th Cir 2007); *Cruden v Bank of NY*, 957 F 2d 961, 968 (2d Cir 1992).

120 ibid 442.

121 Shuster (n 118) 439.

122 *Envirodyne Indus, Inc v Conn Mut Life Co (Re Envirodyne Indus, Inc)* 174 BR 986, 996 (Bankr ND Ill 1994); *Grey v Federated Group, Inc, Re Federated Group, Inc)*, 107 F 3d 730, 733 (9th Cir 1997). See Shuster (n 118) fn 14 and accompanying text.

123 ibid 441.

Some court decisions reflect a similar view of creditors' interest. The case *Re Zais Investment Grade Limited VII*, involved the bankruptcy petition for a securitization SPV used for a CDO squared issuance.[124] Oddly, the petition was filed by senior creditors, who found it impossible to achieve the 2/3 majority vote of all noteholders required in the indenture to approve any debt restructuring plan. They argued that the assets left would barely satisfy the interest of senior noteholders; hence their plan was to liquidate them and give the cash to senior creditors. The debtor SPV did not contest the bankruptcy filing. Junior creditors opposed, as they had more leverage under the requisite majorities of the indenture, and asked the court to abstain itself and dismiss the case, pursuant to section 305(a)(1) of the Bankruptcy Code, which permits it when 'the interests of creditors and the debtor would be better served by such dismissal'.

The court rejected the junior creditors' arguments.[125] Filing in the Cayman Islands was rejected since the entity had no actual presence there;[126] there were no other proceedings pending; the out-of-court settlement had been brought to a stalemate; and the option letting the assets runoff was rejected too, because a plan had been suggested: if the plan was inequitable, as suggested by junior creditors, that should be decided in the confirmation stage, but not by prematurely dismissing the bankruptcy filing.[127]

In the *General Growth* case, examined before (section 'Bankruptcy (non-) filing by SPV directors (II): specific examples'), the creditors' request that the filing be dismissed was based on the argument that SPVs are a special case, where bankruptcy law may be contrary to creditors' interest. The court refused to make the leap of faith; and stuck to the traditional notion that 'Bankruptcy is historically a creditors' remedy allowing for the orderly liquidation of assets for the collective benefit of all creditors.'[128] The court also dismissed the out-of-court settlement as a valid alternative to bankruptcy, given the existing gridlock.

Neither case analysed the enforceability of a no-action or collective action clause, but they both applied to SPVs the deeply ingrained assumption that bankruptcy is in the interest of creditors, and that they cannot be deprived of that remedy. The question is what would happen if the out-of-court procedure envisaged in the documents can work as a suitable alternative, with a better chance of achieving a solution than the bankruptcy proceedings regulated by statute: should the *General Growth* or *Re Zais* courts have been

124 Zais was incorporated in the Cayman Islands. It issued Secured Notes in the Irish Stock Exchange; and used the money to acquire securities, which were pledged for its obligations against noteholders, with Bank of New York Mellon being appointed as trustee. The vehicle also issued junior 'Income' notes, which were unsecured, and treated as equity in the indenture. *Re Zais Investment Grade Ltd VII,* 455 BR 839 (Bkrtcy DNJ 2011).

125 The junior creditors had constructed their request for dismissal around the decision in *Re Monitor Single Lift I, Ltd*, 381 BR 455 (Bankr SDNY 2008). There the court listed seven elements that had to be considered in the assessment of the dismissal, namely: '*1. the economy and efficiency of administration. 2. whether another forum is available. 3. whether federal proceedings are necessary. 4. whether there is an alternate means of achieving an equitable distribution of assets. 5. whether the debtor and creditors can do an out-of-court work out. 6. whether a non-federal insolvency proceeding is far advanced. 7. the purpose for which bankruptcy jurisdiction has been sought*'. ibid 464–65.

126 For this point the court relied on *Re Bear Stearns High–Grade Structured Credit Strategies Master Fund, Ltd*, 374 BR 122 (Bankr SDNY 2007) aff'd 389 BR 325 (SDNY 2008).

127 *Re Zais Investment Grade Ltd VII,* 455 BR 839 (Bkrtcy DNJ 2011) at 847.

128 ibid.

more willing to dismiss the petition, uphold the no-action (or collective-action) clause and direct the parties to resolve the issue pursuant to the contract clauses?

In *Re Zais*, the court also dismissed the junior creditors' argument that the petition was filed in bad faith. Not only was the entity 'in distress';[129] even if senior creditors' purpose was to circumvent the limits of the indenture, those limitations, held the court, were introduced for their benefit, as the indenture prohibited filing to the trustee and junior creditors, but not senior creditors.[130] But, again, if the indenture had prohibited all parties from filing, should the court have enforced it?

A second, similar way to block bankruptcy proceedings at the instance of creditors is through limited recourse provisions; which do not act upon creditors' 'procedural' rights to sue, or to file for; but upon their 'substantive' rights against the vehicle: if rights are limited to the underlying assets creditors cannot make further claims against the vehicle, or file for bankruptcy. A slight variation of non-recourse mechanisms, introduced in the UK for tax reasons[131] were the 'post enforcement call option' agreements (PECO); under which, once the security is enforced over collateral assets and found insufficient, a company associated with the issuer will have a call option over all the notes at a nominal price. Thus, an issuer that owes nothing (the purchaser would not exercise the rights under the notes) cannot be insolvent.

PECO clauses were examined in the case *Eurosail*,[132] decided in the UK. A request was filed before the court to determine whether the entity was 'insolvent'; not in a purely statutory sense, but pursuant to the contract clause that contemplated an 'Event of Default' in case the vehicle was insolvent. The High Court thus differentiated between the statutory insolvency of the vehicle, and the (contractual) insolvency 'event of default' in the document,[133] whereas the Court of Appeal distinguished between 'insolvency remoteness', and 'bankruptcy remoteness'.[134]

Both courts concluded that the entity was not insolvent, in the sense of 'unable to pay its debts';[135] and thus the pronouncements on the PECO clause were *obiter*, but interesting notwithstanding. A PECO clause, said the Court of Appeal, could prevent the entity from entering bankruptcy proceedings, but it could not prevent it from being insolvent (hence the importance of the distinction between 'insolvency remote' and 'bankruptcy remote').[136] According to Lord Neuberger, noteholders' rights were full recourse until the security was enforced and the collateral found insufficient (which is

129 An event of default had occurred, with the consequent acceleration. This distinguished the case from cases where filing had been made in bad faith against a solvent company. See *Re SGL Carbon Corp,* 200 F 3d 154, 159–63 (3d Cir1999)*; NMSBPCSLDHB, LP v Integrated Telecom Express, Inc (Re Integrated Telecom Express, Inc),* 384 F 3d 108, 118 (3d Cir 2004).

130 *Re Zais Investment Grade Ltd VII* (n 127) 849.

131 Limited recourse implied the levy of stamp duty on the issue, and compromised the deductibility of interest paid on the securities. This was modified with the Taxation of Securitization Companies Regulations 2006.

132 *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc and others* [2010] EWHC 2005 (Ch), (Morritt J); *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL plc and others* (*BNY Ltd v Eurosail plc* (CA)) [2011] EWCACiv 227.

133 *BNY Corporate Trustee Services Ltd* [2010] (n 132) para 41.

134 *BNY Corporate Trustee Services Ltd* [2011] (n 132) para 28.

135 Pursuant to s123 of the Insolvency Act 1986.

136 *BNY Corporate Trustee Services Ltd* (n 134) paras 28 and 90.

when the PECO clause became active). This included the moment when the insolvency 'Event of Default' had to be appraised to serve enforcement notice.[137]

On the broader issue of confronting the contract clause with bankruptcy policy, thus, the court had presumably no objection to enforcing the PECO clause, and depriving a filing creditor from access to bankruptcy proceedings, based on the fact that it would have no personal claim against the vehicle. However, even for the standards of pro-contract England, it is unclear whether the court would be as willing to consider the problem as one of contract construction if the parties had not agreed upon a contract-regulated liquidation proceeding, triggered by the 'insolvency' Event of Default, which acted as a substitute to the bankruptcy proceedings regulated by statute.

Final reflections on bankruptcy waivers: outcome versus procedure

The enforcement of non-petition and non-recourse clauses brings back the *leit motiv* of the present article, ie the issue of bankruptcy waivers and provides a better perspective for the analysis. Under that perspective there are two approaches to the issue of bankruptcy waivers, which, in turn, will determine the relevant arguments, and the decision on their validity: an 'outcome' approach, and a 'procedure' approach.

Scholars who favour the enforceability of bankruptcy waivers focus on the outcome of the process: bankruptcy waivers save the costs of an expensive bankruptcy process;[138] and promote more efficient results, since creditors and debtors can evaluate better than judges the prospects for the entity (rescue or liquidation) and the costs.[139] In the case of bankruptcy-remote SPVs the argument is strengthened, since many of the issues that render bankruptcy waivers problematic in normal cases [prejudice to (non-adjusting) unsecured creditors, asymmetric information and unsophisticated borrowers][140] are absent in the case of SPVs, where all creditors are contractual, adjusting (and normally sophisticated) creditors with a security interest over the collateral assets (ranking senior or junior depending on the contract terms) who had full access to the information before entering the transaction.

However, bankruptcy is also a 'procedure', which is justified not only by the efficiency of the outcome, but also by the fairness of the 'process itself'. Under this assumption, if the logic to enforce no-action or collective action clauses is that they resolve the

137 Otherwise, the whole insolvency test, and the Event of Default provision, would not have made much sense. *'There is nothing commercially insensible in the conclusion that, for the purpose of condition 9(a)(iii), the noteholders' rights against the issuer are treated as full recourse, notwithstanding the PECO. The purpose of the PECO was to render the issuer bankruptcy remote, in the sense of ensuring that it could not be wound up. But this conclusion does not cut across that purpose: it merely entitles the noteholders and trustee to invoke a ground which would support a winding up petition to justify the service of an enforcement notice. Further, whatever else may be in doubt, it is hard to argue against the view that the parties envisaged an enforcement notice being served if the issuers' liabilities were not met, as condition 9(a)(i) provides.'* BNY Corporate Trustee Services Ltd (n 134) para 100 (Neuberger LJ).

138 Tracht (n 16) 315–28.

139 ibid 328–34.

140 ibid 335–44. Such potential risks lead advocates of bankruptcy waivers to introduce nuances in the process (such as a presumption in favour of waivers that can be rebutted in limited circumstances: *'First that the secured creditor and equity holders negotiated the waiver in order to reallocate value away from unsecured creditors. Second, that the waiver represents overreaching by the lender at the expense of an unsophisticated borrower. Third, that a substantial and unpredictable change in circumstances warrants the conclusion that the ex ante judgment of the firm and its creditor has been superseded by events. And fourth, that extraordinary public interests override the contractual waiver.'* See Tracht (n 16) 349–50.

'collective action' problem by replacing many 'individual proceedings' with a single set of 'collective proceedings', this logic does not apply when the purpose is to replace different individual proceedings by 'no proceedings at all' (not in the sense of court-supervised proceedings) but out-of-court arrangements that replace bankruptcy's collective proceedings.[141]

Partial waivers are already admissible in bankruptcy law for pre-packaged bankruptcy plans;[142] and, outside bankruptcy law, in alternative dispute resolution mechanisms, such as arbitration. But either of these mechanisms is an exception subject to specific requirements, and expressly contemplated in statutory rules,[143] which regulate the expression of consent, and judicial intervention and review. In the specific example of arbitration, as the most consolidated mechanism through which access to court is waived (ie it is an 'alternative' to court proceedings, rather than a 'facilitation', as a pre-packaged plan may be) the same procedural guarantees of the judicial process are not required,[144] but not everything is admissible.[145]

Thus, once the different mechanisms by which access to bankruptcy proceedings is blocked are seen in their broader perspective it is important to state from the outset whether we see bankruptcy law in terms of outcome, or in terms of procedure. If the procedure and its fairness are relevant, the question on the validity of bankruptcy waivers can no longer be circumscribed to analysing whether bankruptcy proceedings can be excluded, but what it is that should replace them.

4. Conclusions

Bankruptcy-remote transactions have been mostly analysed as a curiosity of financial markets, rather than a pivotal example to examine bankruptcy law's stance on fundamental issues. Yet, bankruptcy-remote transactions challenge some of bankruptcy's

141 In other words, the enforceability of no-action clauses poses no problem when it binds a number of the firm's creditors, and replaces many individual actions with one collective action. The implications are different when the clause binds *all* creditors, and replaces individual actions with no action before the courts.

142 Kurt A Mair, 'Enforcing Prepackaged Restructurings of Foreign Debtors under the US Bankruptcy Code' (2006) 14 Am Bankr Inst L Rev 469, 469–525; Marc S Kirschner and others, 'Prepackaged Bankruptcy Plans: the Deleveraging Tool of the 90's in the Wake of OID and Tax Concerns' (1991) 21 Seton Hall L Rev 643, 643–77.

143 For an example of the former, see s1126(b) US Bankruptcy Code. For an example of the latter, see the arbitration acts of the many countries that have enacted the UNCITRAL Model Law on International Commercial Arbitration 1985 (amended in 2006), the Federal Arbitration Act, or the English Arbitration Act 1996.

144 It is interesting to examine the case law of the European Court of Human Rights (ECtHR) in this regard. In *Regent Company v Ukraine* no 773/03 (ECHR, 3 April 2008) where it held that the enforcement of the award was part of the right of due process of a party, and *Transado – Transportes fluviais do Sado, SA v Portugal* no 35943/02 the court did not distinguish much between court and arbitral proceedings. It did so in *Deweer v Belgium* no 6903/75 (ECHR, 27 February 1980); *Pastore v Italy* no 46483/99 (ECHR, 25 May 1999); *Jakob Boss Söhne v Germany* no 18479/91 (ECHR, 2 December 1991); or *Suovaniemi and others v Finland* no 31737/96 (ECHR, 23 February 1999), establishing that some procedural rights may be waived through the recourse to arbitration, but without a clear indication of where the limit lies.

145 art V of the New York Convention 1958 on the Recognition and Enforcement of Foreign Arbitral Awards, which is regarded as a sort of standard in this matter, permits a court to refuse recognition and enforcement of an arbitral award in case a party was not properly notified or did not have the opportunity to present its case; in case the arbitral award deals with matters not subject to the arbitration, or in case of procedural irregularities, among other reasons.

crucial underlying assumptions. This article explores the significance of bankruptcy-remote structures as a test case for contractarian solutions in bankruptcy; and, more specifically, as a challenge to the assumption that bankruptcy law cannot be waived.

Bankruptcy-remote transactions try to accomplish such waiver of bankruptcy rules through a combination of mechanisms that effectively block all access to bankruptcy proceedings. No court has been directly asked the question of whether a seamless combination of structuring choices and clauses whose effect is to completely block access to bankruptcy proceedings is in accordance with the law; and, if not, what are the consequences. Since the courts get asked more concrete questions, related to the particular mechanisms, the answers will largely depend on the courts' characterization of the issue, and their willingness to see the bigger picture. Some courts may only see a problem of contract interpretation, others may see it as a problem of bankruptcy law, or corporate law, others may even question the need to adjust corporate or bankruptcy principles to the reality of bankruptcy-remote SPVs.

These questions arise on the issue of the vehicle's eligibility for bankruptcy. Transaction parties may use the vehicle's legal form to waive bankruptcy proceedings, but should be careful to ensure that there is some form of alternative liquidation available. Furthermore, there is still some controversy over whether bankruptcy rules should be applied strictly (and consider the entity eligible based solely on its form) or based on the substance of the activity (which would mean a finalistic restriction of bankruptcy rules to 'active' or 'operating' entities only).

The doubts over the adequacy of the principles underpinning corporate and bankruptcy law in case of bankruptcy-remote SPVs pervades the issue of SPV directors' fiduciary duties when the vehicle is in distress. Whether directors may be obliged to file for bankruptcy determines the effectiveness of mechanisms designed to block voluntary filing. For 'normal' companies the law distinguishes between cases where the company is insolvent, and directors should consider shareholders' interest, cases where the company is insolvent, where they should consider creditors' interests, and cases in the vicinity of insolvency, where it is unclear. This division is inadequate for bankruptcy-remote SPVs, where shareholders' interests are irrelevant, creditors' interests are different depending on their seniority, and statutory bankruptcy may be in the interest of some creditors, but not others, who may prefer an out-of-court liquidation.

The contrast between such out-of-court liquidation contemplated in contract documents and statutory bankruptcy proceedings plays an important role, albeit an implicit one, in the analysis of non-petition and non-recourse clauses. The views of different jurisdictions diverge, though most accept that such clauses are enforceable on one or another level, with English courts being the most inclined to see the issue as one of contract interpretation, and American courts being more inclined to see the policy side. However, all the laws and courts make the implicit assumption that a party waives its 'individual' right to sue, and to have access to court, 'in exchange for' another right of access to court, normally within a collective action, ie there must be an alternative. The

issue that has been less explored is whether 'any' alternative suffices, including an out-of-court alternative, provided it is accepted by contractual consent.

This connects back to the issue of bankruptcy waivers, where the disagreement largely stems from the different angles from which the issue may be examined. For proponents of the enforceability of bankruptcy waivers what matters is the efficiency of the outcome. For detractors, the fairness of the process also matters, which increases the importance of the alternative to statutory bankruptcy envisaged in contract documents.

Analysing such alternative exceeds the scope of this article (and will be the subject of another one), but we have made important progress in establishing bankruptcy-remote transactions real significance: the answer to the admissibility of their mechanisms to block access to bankruptcy proceedings can give an indication of the law's broader stance towards bankruptcy waivers. To give a complete answer, however, one not only needs to consider whether the parties can exclude bankruptcy proceedings, but also what they pretend to replace them with.