SPECIAL PURPOSE VEHICLES IN BANKRUPTCY LITIGATION

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This Article reports on an investigation of the consequences of a parent corporation's bankruptcy for its special purpose vehicles ("SPVs"). An SPV is designed under the law to be a bankruptcy-remote investment entity, such that if its parent is forced to file for bankruptcy, the SPV will be evaluated on its independent merits. However, some court decisions hold that an SPV structure may be pierced or legally modified to provide funds to satisfy the creditor and investor claims of its insolvent originator. The court decisions in In re LTV Steel Co., In re Pacific Lumber Co., *and* In re General Growth Properties Inc. *have direct impacts on the attractiveness of an SPV for creditors and investors, and they suggest actions that the originator and the SPV can take to preserve the SPV's bankruptcy-remote status.*

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I. INTRODUCTION

Securitization is a financial process of pooling and repackaging debt into securities that are sold to investors.[1] Through securitization, a corporation conveys discounted cash-flow-producing assets to a financial intermediary, SPV, which combines them with similar assets and sells them as securities to investors.[2] An SPV is a subsidiary of the

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1. *See* Jason H.P. Kravitt, *Introduction*, *in* ASSET-BACKED SECURITIZATION IN EUROPE 1, 1 (Theodor Baums & Eddy Wymeersch eds., 1996) (noting that securitization is commonly defined as "the pooling of assets and the issuing of securities to finance the carrying of the pooled assets"); SECURITIZATION: ASSET-BACKED AND MORTGAGE-BACKED SECURITIES 1-3 (Ronald S. Borod ed., 1991) (noting that securitization is "the aggregation and pooling of assets with similar characteristics in such a way that investors may purchase interests or securities backed by those assets").

2. Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1663 (2004). SPVs in securitization are also often referred to as special purpose entities ("SPEs"), variable interest entities ("VIEs"), issuer, issuing entity, or trust (in the prospectus). *See* 17 C.F.R. § 229.1101(f) (2011); Mei Feng et al., *Special Purpose Vehicles:*

corporation (the "originator") that is created to isolate the financial risk of assets that previously belonged to the originator.[3] Generally, an SPV has no employees, no physical location, and makes no substantive economic decisions.[4] An SPV maintains a legal status that is intended to make its obligations secure even if the parent company goes bankrupt.[5] Thus, an SPV is commonly referred to as a "bankruptcy-remote" entity.[6] By converting future cash flows into present cash, securitization permits the originator to benefit from isolating itself from financial risk, creating new means of raising capital, and providing lowered costs to lenders and consumers.[7] The investors in these securities benefit from competitive interest rates and a lowered composite default probability.[8]

The origins of securitization in the United States are traced to the 1970s when the Government National Mortgage Association ("Ginnie Mae") developed mortgaged-back securities collateralized by single-family Federal Housing Administration and Veterans Administration mortgage loans.[9] Since then, commercial banks, savings and loan associations, and other entities have participated in securitization of a variety of assets such as residential and commercial loans, automobile

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Empirical Evidence on Determinants and Earnings Management, 84 ACCT. REV. 1833, 1834 (2009); Gary B. Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization* 7 (FRB Phila., Working Paper No. 05-21, 2005), *available at* http://papers.ssrn.com/sol3/papers .cfm?abstract_id=713782.

3. *See* Feng et al., *supra* note 2, at 1834, 1838. *See also* Plank, *supra* note 2, at 1662.

4. *See* Gorton & Souleles, *supra* note 2, at 2 ("SPVs are essentially robot firms that have no employees, make no substantive economic decisions, have no physical location, and cannot go bankrupt.").

5. Feng et al., *supra* note 2, at 1834 ("SPVs can serve legitimate business purposes by raising capital for their sponsors and by isolating and homogenizing cash flows and business risks of a specific asset class.").

6. Plank, *supra* note 2, at 1663. *See* Zachary J. Gubler, *The Financial Innovation Process: Theory and Application*, 36 DEL. J. CORP. L. 55, 77 (2011) ("Unlike the case of corporate bonds, where the credible threat of bankruptcy helps overcome the coordination problems of a unanimous vote requirement, securitizations are shielded from bankruptcy.").

7. Plank, *supra* note 2, at 1656-57. *See also* CHRISTINE A. PAVEL, SECURITIZATION: THE ANALYSIS AND DEVELOPMENT OF THE LOAN-BASED/ASSET-BACKED SECURITIES MARKETS 13-16 (1989).

8. *See* Paul Lund, *Is Corporate Securitization Set to Take Off?: Why the Structuring Technique May Prove Important in the Current Turbulent Market Conditions*, J. STRUCTURED FIN., Summer 2008, at 46, 46 ("Corporate securitizations therefore provide borrowers with necessary leverage and offer lenders and investors a transaction that is attractive from a credit perspective, which is particularly crucial given current market conditions and the rise of new issue institutional spreads.").

9. *See* Barbara Kavanagh et al., *Asset-Backed Commercial Paper Programs*, 78 FED. RES. BULL. 107, 107-08 (1992) (noting the history of securitization). *See also* Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119-21 (1996) (reporting on the history of securitization); Kyle Richard & Melissa Kosiba, *Securitization: A Platform to Debate Accounting*, CPA J., Oct. 2005, at 10, 10.

loans, credit card receivables, equipment leases and loans, student loans, trade receivables, computer and truck leases, intellectual property rights,[10] and other receivables.[11] Securitization has even extended to taxicab medallions,[12] unpaid real estate taxes,[13] and David Bowie's music royalties.[14] All of these asset receivables share a similar characteristic: proceeds that can be used as collateral for asset-backed securities ("ABS").[15]

Securitization is acknowledged as "one of the most significant legal and business innovations of the last 30 years"[16] because of its importance to the growth of the national economy.[17] In late 2009, the total value of securitized assets in the United States exceeded $2.48 trillion.[18] Despite this popularity, recent legal developments have revealed that securitization has one important drawback that creates risk for all interested parties. While the process of securitization is designed and intended to create a bankruptcy-remote vehicle, case law demonstrates that in bankruptcy proceedings of the originator its SPVs are bankruptcy-remote and not bankruptcy proof.[19] Thus, an SPV cannot

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10. *See* F. Scott Kieff & Troy A. Paredes, *An Approach to Intellectual Property, Bankruptcy, and Corporate Control*, 82 WASH. U. L.Q. 1313, 1325 (2004). *See also* Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 606-07 (1998).

11. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 152 (1994) ("Securitization opportunities are no longer limited to the financing of receivables.").

12. Lupica, *supra* note 10, at 602.

13. *See id.* at 606 & n.25 ("New York City raised $208 million in a AAA-rated public bond offering backed by $1.5 billion in unpaid real estate taxes. In 1993, Jersey City, New Jersey was the first municipality to raise funds in the markets backed by unpaid real estate taxes."). Further, Lupica noted that "[i]t has been predicted that the 'municipal tax lien securitization market will grow to at least $5 billion a year,' as governments get out of the tax collection business." *Id.* at 606 n.25 (quoting Amy B. Resnick, *Tax-Lien Market is Set to Take Off, Industry Players Say*, BOND BUYER, Nov. 18, 1996, *available at* 1996 WLNR 736274).

14. Martin Waller, *Bankers and Old Rockers Aim to Reap the Play-It-Again Sum*, TIMES (London), Feb. 14, 1998, at 30. *See also* Jennifer Burke Sylva, *Bowie Bonds Sold for Far More Than a Song: The Securitization of Intellectual Property as a Super-Charged Vehicle for High Technology Financing*, 15 SANTA CLARA COMPUTER & HIGH TECH. L.J. 195, 200-06 (1999).

15. *See* Kavanagh et al., *supra* note 9, at 108-09 (noting that ABS programs use SPVs to issue commercial paper).

16. Plank, *supra* note 2, at 1656.

17. *See Enron Aside, Special Purpose Vehicles (SPVs) Are Legal, Innovative and Widely Used*, KNOWLEDGE@WHARTON (May 17, 2006), http://knowledge.wharton.upenn.edu/articlepdf/1483.pdf?CFID=169299392&CFTOKEN=73138482&jsessionid=a830dacab14db22521ad2517428301e49331 [hereinafter *Enron Aside*].

18. *Outstanding U.S. Bond Market Debt: $ Billions*, SIFMA, http://www.investinginbonds.com/assets/files/SIFMA_USBondMarketOutstanding.xls (last visited Mar. 1, 2012) (displaying that in the third quarter of 2009, asset backed securities amounted to $2484.3 billion).

19. Jason Lynch, *Reevaluating Bankruptcy Remoteness: Transfers of Risk, Implications of the GGP Reorganization*, AM. BANKR. INST. J., July–Aug. 2010, at 58, 58-60 (noting that during "the resulting recessionary period, structured investment vehicles demonstrated why they were termed

always provide absolute protection against the originator's creditors and investors who pursue securitized assets as means of recovery.

Court decisions suggest that the separate legal structures of SPVs created during securitization may be pierced or legally modified to satisfy creditor and investor claims when their originating entities become insolvent. In light of the financial crisis of 2007–2009 and ensuing corporate bankruptcies, the practice of disregarding corporate formalities and substantively consolidating SPVs to satisfy creditors started to gain traction.[20] Specifically, the court decisions in *In re LTV Steel Co.*,[21] *In re Pacific Lumber Co.*,[22] and *In re General Growth Properties*, *Inc.*[23] have directly impacted the ability of creditors and investors to recover their investments.

Because they remain a popular investment structure, SPVs' creditors and investors need to be aware of the risks that affect the practice of securitization and SPVs' overall investment results. This awareness of potential risks associated with SPVs allows investors and creditors to make informed investment decisions. For legal counsel, knowledge of probable risks and recent court rulings allows for implementation of proper precautions and planning techniques to mitigate current dangers associated with SPVs.

This Article proceeds in six parts. Part I introduces the concept of securitization, its importance in finance, and defines the scope of this Article. Part II offers a detailed explanation about the process of securitization, lists the parties involved and their duties, and presents an overview of securitization's benefits and costs. Part III provides an in-depth coverage of recent developments in SPV bankruptcy litigation. Part IV summarizes the effects of case law on the practice of securitization and suggests that SPV is not a bankruptcy proof or removed vehicle. Part V provides multiple litigation strategies to enhance an SPV's bankruptcy-remoteness based on properly structuring the securitization process, implementing enhancements of external credit, and conducting adequate due diligence. Finally, Part VI

bankruptcy-remote rather than bankruptcy-proof").

20. Matt Wirz & Mike Spector, *Three-Way Battle Over Lehman Brothers Assets Intensifies*, DAILY BANKR. REV. (Dow Jones, New York, N.Y.), Apr. 26, 2011, https://www.fis.dowjones.com/article.aspx?ProductIDFromApplication=10&aid=DJFDBR0020110426e74q0002t&r=Rss&s=DJFDBR (noting the creditor's desire to employ substantive consolidation technique to help asset recovery).

21. 274 B.R. 278 (Bankr. N.D. Ohio 2001).

22. Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229 (5th Cir. 2009).

23. 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

summarizes the challenges presented by SPVs to originators, creditors, and investors.

II. SECURITIZATION AND SPVS

Securitization is a viable alternative to the conventional issuance of bonds.[24] An entity seeking debt financing may issue a security backed by a pool of loans or receivables, known as an ABS,[25] which is created through a securitization process.[26] The collateral for asset-backed securitization can emanate from two types of assets: existing receivables and future receivables.[27] Securitized assets are either commercial or consumer ABS,[28] or subprime residential mortgage-backed securities ("MBSs").[29]

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24. A corporation, municipality, or government seeking to borrow money has an option to issue bonds. *See* David W. Cornell & J. Gregory Bushong, *The Use of Bonds in Financial Planning: How to Structure An Investment Portfolio to Meet Long-Term Needs*, J. ACCT., May 1992, at 46, 47-48 (defining bonds as fixed-income securities, where the bond contract, commonly called an indenture, requires the borrower to make periodic payment of interest and to repay the principal at maturity). *See also* Frank J. Fabozzi, *The Structured Finance Market: An Investor's Perspective*, FIN. ANALYSTS J., May–June 2005, at 27, 27 (noting that after the secured bonds are issued, the bondholder relies on the issuer to generate cash to repay the obligation); Stav Gaon, Essays in Securitization 86-87 (2007) (unpublished Ph.D. dissertation, Columbia University) (on file with Columbia University) (noting that securitized ABS are different from bonds because they generally achieve higher ratings, have a different sources of repayment, and have a different methods of resolving financial distress).

25. Fabozzi, *supra* note 24, at 27. *See* 17 C.F.R. § 229.1101(c)(1) (2005) (defining ABS as "a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders; provided that in the case of financial assets that are leases, those assets may convert to cash partially by the cash proceeds from the disposition of the physical property underlying such leases"). *See also* Kenneth M. Ayotte & Stav Gaon, Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness" 2 (Oct. 11, 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=813847 (stating that "ABS most resemble secured debt").

26. FRANK J. FABOZZI, BOND MARKETS, ANALYSIS, AND STRATEGIES 354-55, 378 (Donna Battista et al. eds., 7th ed. 2010) (noting that this process excludes residential prime mortgage loans and commercial mortgage loans).

27. *Id.* at 354 (referencing that securitization is based on receivable assets).

28. *Id.* at 355 (noting that commercial ABS are composed of trade receivables, equipment leasing, franchise loans, operating assets, small business loans, and entertainment assets). *See also* Richard & Kosiba, *supra* note 9, at 10 (noting that other receivables assets include "automobile loans, outstanding credit card balances, student loans, small-business loans, lawsuit settlements, and future revenue generated by royalties").

29. Richard & Kosiba, *supra* note 9, at 10 (stating that MBS "groups together first-mortgage loans, termed home-equity loans, home-equity lines of credit, and tax liens placed on residential property").

The key participants in the securitization process include the originator[30] who is seeking to raise money, the SPV, and the servicer. Additional parties that are involved in securitization are the investment bankers, trustee, credit rating agencies, and investors.[31] An originator is a legal entity that has financing needs and possesses assets that are appropriate for structured financing.[32] Common originators are financial institutions, insurance companies, automakers, airlines, computer companies, mortgage companies, and other businesses that originate receivables.[33] In securitization, originators create and often become the servicer of the assets utilized as collateral for the ABS.[34] To obtain structured financing, the originators must completely relinquish their ownership and control rights in the assets.[35]

Servicers manage and maintain assets and the cash flows from an ABS.[36] Servicers collect principal and interest payments on the assets when they are due, pursue collection of delinquent accounts, and issue trustee and certificate holders with reports concerning the portfolio of assets sold or used as collateral.[37] Servicers also ensure that the collected cash is distributed in accordance with the financial agreement.[38]

ABS transactions additionally involve an investment banker who underwrites the securities for the public offering or for private sale.[39] In the public offering, the underwriting bank buys securities for resale from the SPV.[40] However, if securities are sold privately, the bank acts only as an agent for the SPV by matching the seller with the interested parties.[41]

An SPV enables "the sale of . . . assets or . . . issuance of collateralized debt instruments."[42] The SPV has three major functions in securitization: (1) it is a pass-through vehicle that allows the originator's assets to be securitized and sold to investors; (2) it provides protection against the SPV becoming insolvent for investors of the securitized

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30. Originators are also commonly referred to as sponsors or sellers. *See* FABOZZI, *supra* note 26, at 356.

31. *See* Richard & Kosiba, *supra* note 9, at 10. *See also* Comm. on Bankr. & Corporate Reorganization of The Ass'n of the Bar of the City of N.Y., *Structured Financing Techniques*, 50 BUS. LAW. 527, 581 (1995) [hereinafter *Structured Financing Techniques*].

32. *Structured Financing Techniques*, *supra* note 31, at 529.

33. *Id.* at 530 tbl.1.

34. *See id.* at 529.

35. *See id.*

36. PAVEL, *supra* note 7, at 22.

37. *Id.*

38. *Structured Financing Techniques*, *supra* note 31, at 529.

39. PAVEL, *supra* note 7, at 25.

40. *Id.*

41. *Id*.

42. *Id*. at 23-24.

assets; and (3) it protects the securitized assets from the originator's creditors.[43]

An SPV must obtain a favorable credit rating to entice investors' interest.[44] Credit rating agencies, such as Standard & Poor's Rating Services, Duff & Phelps Corp., Fitch Ratings, Ltd., and Moody's Investor Services, Inc. assign ratings to an ABS based on its risk.[45] In issuance of an ABS, the default probability is not connected to an issuer's creditworthiness but rather to the credit quality of the assets that underlie the SPV's securities.[46] As a result, the credit agencies rate an ABS by measuring whether the SPV's assets can generate adequate cash flows to pay the investors.[47]

The ABS rating is based on five general criteria: (1) the SPV's default probability on its obligations, (2) the essence of the obligation's provisions, (3) the effect of bankruptcy on the obligation, (4) the SPV's quality of the assets, and (5) the transaction's structure.[48] The credit

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43. Kenneth N. Klee & Brendt C. Butler, *Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues*, 35 UCC L.J. 23, 26 (2002). *See also* Thomas J. Gordon, *Securitization of Executory Future Flows as Bankruptcy-Remote True Sales*, 67 U. CHI. L. REV. 1317, 1322-23 (2000) (noting that SPVs also serve three purposes: (1) allowing transformation of originator's assets into liquid marketable securities; (2) protecting own investors from SPV bankruptcy; and (3) protecting securitized assets from creditor claims).

44. Hyun Jin Lee, Essays on Asset Securitization, Bank Production Costs, and the Credit Card Market 43 (Fall 2003) (unpublished Ph.D. dissertation, University of California, Berkeley) (on file with University of California, Berkeley) ("The securitization process involves rating agencies since ratings are essential for all securities not guaranteed by the U.S. government or government sponsored agencies.").

45. *See* Elizabeth Devine, *The Collapse of an Empire?: Rating Agency Reform in the Wake of the 2007 Financial Crisis*, 16 FORDHAM J. CORP. & FIN. L. 177, 183 (2011) (noting that Moody's Investors Services, Inc., Standard & Poor's Rating Services, and Fitch Ratings, Ltd. control approximately ninety-five percent of the rating agency market).

46. *See* Plank, *supra* note 2, at 1667.

47. *See id.* at 1662 ("The investment return on the securities depends on the receivables themselves and does not depend upon the creditworthiness of the originator of the receivables or the issuer of the securities." (footnote omitted)).

48. PAVEL, *supra* note 7, at 32. *See also* Jerome F. Festa, *Introduction*, *in* SECURITIZATIONS: LEGAL AND REGULATORY ISSUES 1-1 (2011) ("The asset-backed security is normally rated to an investment grade level by one or more rating agencies based on the strength of the underlying assets, the amount of credit enhancement, and legal structure."); Elizabeth Smith-Avery, *Equipment Lease Asset-Backed Securities: Gaining Access and Better Pricing*, J. EQUIP. LEASE FIN., Spring 2003, at 13, 14 (stating that rating agencies standards look at the following factors: "originator's strength, underwriting standards, past performance, concentrations, pool characteristics, servicer's quality and backup, residual cash flows and valuation, seasoning with a minimum of one payment, [and] legal issues"); Tribar Opinion Comm., *Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions*, 46 BUS. LAW. 717, 720 (1991) (noting that rating agencies "in determining whether to grant a rating based on the credit quality of the independent credit support or the segregated asset pool, analyze proposed financings in terms of both certainty of payment and timeliness of payment" and use legal opinions addressing the structure of the transaction).

ratings standardize and quantify the investment risks in the ABS allowing the investor to compare the offered products to other investments.[49]

To receive a high credit rating, an originator may employ services of a credit enhancer, which employs internal and external measures to reach the desired rating goal.[50] A well-structured transaction involving quality collateral is likely to obtain a high credit rating. A high rating enables the SPV to place the securities at a lower interest rate,[51] which allows it to reserve a smaller amount of cash for repaying the debt.[52] As a result, the originator receives a higher purchase price for its assets from the SPV, which lowers the originator's discount rate.[53]

With an ABS, the trustee serves as an intermediary between the servicer and investors, and between the credit enhancer and the investors.[54] The trustee represents the interests of the bond classes by monitoring compliance with covenants and enforcing specific remedies allowed by the governing documents if there is a default.[55] The trustee also has responsibility "for determining the sufficiency of the various reports made by the servicer to the investors and for passing the reports on to the investors."[56] If the servicer withdraws or becomes unable to perform its duties, a trustee must be willing and able to fulfill the servicer's role.[57]

Investors are entities or individuals that acquire an ABS.[58] Depending on the nature of the transaction, investors may include financial institutions, businesses, individual investors, and banks. Regardless of the investor type, all rely on the credit rating issued by the credit rating agencies when investing in SPV securities.[59]

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49. Gordon, *supra* note 43, at 1322. *See also* Schwarcz, *supra* note 11, at 136.
50. *Structured Financing Techniques*, *supra* note 31, at 533-34.
51. Robert Stark, *Viewing the LTV Steel ABS Opinion in Its Proper Context*, 27 J. CORP. L. 211, 214 (2002). *See also* Lee, *supra* note 44, at 43 ("The rating agencies require additional credit enhancement to be certain that the cash flows from the bundle of rights in a securitized issue are of sufficient quality to meet the promised payments of interest and principal, should the underlying loan default.").
52. Gordon, *supra* note 43, at 1322.
53. *Id.*
54. PAVEL, *supra* note 7, at 35.
55. FABOZZI, *supra* note 26, at 356.
56. PAVEL, *supra* note 7, at 36.
57. *Id.*
58. *Structured Financing Techniques*, *supra* note 31, at 529.
59. Stark, *supra* note 51, at 214.

A. Benefits of Securitization

Securitization is an efficient form of capital market financing that provides a myriad of benefits for financial firms, investors, participating third parties, and the public.[60] Companies utilize securitization and issuance of ABS to provide their investors with safety,[61] competitively high returns,[62] access to capital markets,[63] and low funding costs.[64] SPVs have also been used to facilitate transactions involving sales and acquisitions of plants and equipment under long-term lease contracts and funding of research and development activities.[65]

Originators benefit from securitization by being able to attract long-term funds more profitably than with conventional tools and by accessing a new source of income by originating and servicing the securitized assets.[66] Some academics have referred to securitization as a highly effective method of borrowing.[67] Securitization permits isolation of an ABS from the originator's credit risk[68] and allows the ABS to

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60. *See* Kravitt, *supra* note 1, at 2. *See also* Patricia M. Dechow & Catherine Shakespeare, *Do Managers Time Securitization Transactions to Obtain Accounting Benefits?*, 84 ACCT. REV. 99, 99 (2009) ("Securitizations are a form of financing that has several advantages over traditional bank financing.").

61. *Enron Aside*, *supra* note 17.

62. *Id.*

63. Schwarcz, *supra* note 11, at 151. *See* Aleksandar Nikolic, *Securitization of Patents and its Continued Viability in Light of the Current Economic Conditions*, 19 ALB. L.J. SCI. & TECH. 393, 403-04 (2009) ("Securitization is a system that can benefit all parties involved. Investors potentially get a viable asset protected by the existence of a valid asset, originators get an upfront sum of money to pursue their company goals, and the [SPV] becomes a new entity with ownership of cash flows stemming from valid patents which it owns.").

64. As discussed by Fabozzi:

> There are four principal reasons why a corporation may elect to raise funds via a securitization rather than a corporate bond. They are:
>
> 1. the potential for reducing funding costs
> 2. to diversify funding sources
> 3. to accelerate earnings for financial reporting purposes
> 4. for regulated entities, potential relief from capital requirements . . . .

FABOZZI, *supra* note 26, at 358.

65. Al L. Hartgraves & George J. Benston, *The Evolving Accounting Standards for Special Purpose Entities and Consolidations*, 16 ACCT. HORIZONS 245, 246 (2002) (listing additional uses of SPVs).

66. PAVEL, *supra* note 7, at 13. *See also* Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 249 & n.25, 250 (5th Cir. 2009) (discussing how the originator retained the right to service the sold to SPV asset).

67. *See* Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 230-31 (2000).

68. Walter Henry Clay McKay, Commentary, *Reaping the Tobacco Settlement Windfall: The Viability of Future Settlement Payment Securitization as an Option for State Legislatures*, 52 ALA. L. REV. 705, 715-16 (2001) (noting that securitization passes the risk while providing for "an immediate infusion of cash").

receive their own investment grade rating, which will be given irrespective of the creditworthiness of the originator of the receivables.[69]

Asset securitization adds liquidity to unrated receivables that enables them to be sold in the capital markets,[70] which attracts investors who might not be interested in the company's separate receivables to purchase an ABS.[71] As a result, an ABS allows for inexpensive funding for a company[72] whose credit rating may be lower than the credit rating on its receivables.[73] Securitization provides originators with a moderately priced source of funds independent from an inelastic supply of receivables.[74] Thus, securitization may be utilized to manage risk-based capital requirements imposed by financial institutions such as banks and insurance companies.[75]

Additionally, for accounting purposes, securitization allows the originator to remove assets and liabilities from its balance sheets.[76] To comply with the generally accepted accounting principles ("GAAP") the transfer of assets in securitization must qualify as a sale under Financial Accounting Standards No. 140 ("FAS 140").[77] This allowed financial

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69. Plank, *supra* note 2, at 1667 (suggesting that even large credit-worthy originators of receivables utilize securitization to maintain favorable debt-equity ratios and to lower costs).

70. *See* OHC Liquidation Trust v. Credit Suisse (*In re* Oakwood Homes Corp.), 356 F. App'x. 622, 624 (3d Cir. 2009) (describing the use of securitization to increase company's liquidity). *See also* Lee, *supra* note 44, at 42 (noting that pooling of assets increases liquidity).

71. *See* Mortensen v. AmeriCredit Corp., 123 F. Supp. 2d 1018, 1021 (N.D. Tex. 2000) ("If the SPVs are bankruptcy remote from the originator, the debt will not carry the risk of delayed payment or default that may be associated with debt issued from a leveraged originator. Therefore, investors are willing to pay more for the less risky securities, which translates into a lower cost of capital for the originator.").

72. Klee & Butler, *supra* note 43, at 24 ("Asset securitization is a species of disintermediation inasmuch as it permits a company to acquire reduced-cost financing through the removal of intermediaries, such as bank lenders, that previously stood between a company and the ultimate source of money, the financial markets. Through asset securitization, a company avoids the increased transaction costs charged by middlemen financial institutions. It also enables a company to raise funds cheaply based on allocation of risks that are assessed by parties having the most expertise, such as rating agencies.").

73. Nikolic, *supra* note 63, at 402 ("[I]nvestors will look to cash flow of the SPE and not the creditworthiness of the originator to determine whether to invest.").

74. PAVEL, *supra* note 7, at 15.

75. Fabozzi, *supra* note 24, at 28.

76. *See* ACCOUNTING FOR TRANSFERS & SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, 7, 9-11 (Fin. Accounting Standards Bd. 2000). Compare securitization to secured financing. In secured financing, the originator preserves the assets on its balance sheet along with any additional liability in the amount of the secured financing. *See* Nikolic, *supra* note 63, at 408 (noting the appeal of securitization to companies because it allows for "an off-balance sheet transaction").

77. Klee & Butler, *supra* note 43, at 29. "The basic idea of FAS 140 is that to achieve a 'true sale' characterization for accounting purposes the transferor must surrender control of the transferred assets or, in other words, structure the transaction so that the transferred assets are separated from the transferor." *Id.* at 29-30. According to the Financial Accounting Standards

companies to remove toxic assets from their balance sheets during the 2007–2009 recession in the United States.[78] For instance, by removing unwanted risky assets from the balance sheets, insurance companies lowered the amount of capital they needed to hold to cover the risk.[79] Further, since the originator's and SPV's financial statements are not consolidated, any debt incurred by the SPV does not appear on the originator's consolidated balance sheet.[80]

Asset securitization may also help financial institutions manage interest rate risk by removing unwanted items from their balance sheets.[81] This removal directly benefits the financial company with an appropriate legal risk management technique that may improve its overall asset portfolio.[82] Securitization can help to improve bank

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Board:

> A transfer of financial assets . . . in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership . . . .
>
> b. Each transferee (or, if the transferee is a qualifying SPE . . . , each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor . . . .
>
> c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity . . . or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call . . . .

ACCOUNTING FOR TRANSFERS & SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, 9 (emphasis omitted).

78. Kenneth E. Scott & John B. Taylor, *Why Toxic Assets Are So Hard to Clean Up*, WALL ST. J., July 20, 2009, at A13. *See also* Pacholder High Yield Fund, Inc. v. Cucuz (*In re* Hayes Lemmerz Int'l, Inc. Equity Sec. Litig.), 271 F. Supp. 2d 1007, 1016 (E.D. Mich. 2003) (discussing a company which created an SPV to "remove certain accounts receivable and corresponding reserves for bad debt off its balance sheet").

79. *See* Dan Ozizmir, *Securitization: Buzz or Real Solution?*, NAT'L UNDERWRITER, July 24, 2006, at 14, 16 ("By selling risks to investors, insurance companies will no longer need to hold as much capital.").

80. Food Holdings Ltd. v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 684 F. Supp. 2d 453, 459-60 (S.D.N.Y. 2010) ("[S]tructured transactions can be attractive means of raising capital because . . . the SPE's financial statements are not consolidated with those of the originator. Hence, the debt incurred by the SPE does not appear on the originator's consolidated balance sheet.").

81. Fabozzi, *supra* note 24, at 28 ("A financial institution can securitize assets that expose the institution to higher interest rate risk and retain certain customized parts of the asset securitization transaction to attain an improved asset/liability position. In this respect, the financial institution serves as both issuer and investor.").

82. *See* Lupica, *supra* note 67, at 210 (noting the benefits from the perspective of the

profitability,[83] provide a bank with a competitive advantage in attempts to increase market share,[84] and improve its asset-liability ratio.[85] Securitization may increase the liquidity of a bank loan portfolio by facilitating the packaging and sale of otherwise illiquid assets to interested third parties.[86] Securitization can provide banks with an inexpensive source of funds because it may allow avoidance of reserve and capital requirements and deposit insurance premiums.[87] Finally, banks and their investors can benefit from the increased liquidity and risk diversification provided by asset securitization.[88]

An ABS contains risk-transfer, credit-risk, and liquidity-generation innovations.[89] An ABS permits the transfer of the price risk of a pool of loans or receivables from the originators to investors, alteration of exposure to interest rate risk, and creation of securities with different liability-matching profiles.[90] Through an ABS, an originator can redistribute multiple levels of risk through tranching and third party guarantees, and thereafter pass the credit risk to the interested

originator, which "include improved liquidity, increased diversification of funding sources, a lower effective interest rate, improved risk management and accounting-related advantages"). *See also* Michael S. Gambro & Scott Leichtner, *Selected Legal Issues Affecting Securitization*, 1 N.C. BANKING INST. 131, 132 (1997) ("If the originator funds its portfolio of assets with liabilities having differing maturities and does not otherwise hedge its funding obligations, the originator assumes the risk that its cost of funding the assets will not match the earnings attributable to such assets. The securitization of a pool of assets can alleviate this problem by allowing the originator to perfectly match the duration of its assets and its liabilities.").

83. *See* Everette D. Hull & Leslie Annand, *Time to Jump on the Securitization Bandwagon?*: *As the Asset-Backed Securities Market Rolls on, Bankers Should Consider Its Potential*, A.B.A. BANKING J., Oct. 1987, at 137, 137.

84. *Id.* at 138 (noting that if a bank's loan origination capabilities exceed funding growth, securitization permits bank to expand loan volume faster than deposit growth).

85. Lee, *supra* note 44, at 45 (stating that "securitization may be used to better manage interest rate risk by improving a bank's asset-liability mix").

86. Richard & Kosiba, *supra* note 9, at 10.

87. PAVEL, *supra* note 7, at 16.

88. *See* Lee, *supra* note 44, at 11 (stating that securitization provides "banks with means for low cost funding and risk diversification").

89. Fabozzi, *supra* note 24, at 28 ("Price risk-transferring innovations provide market participants with efficient means for dealing with price or exchange rate risk. Reallocating the risk of default is the function of credit risk-transferring instruments. Liquidity-generating innovations do three things: (1) increase the liquidity of the market, (2) allow borrowers to draw on new sources of funds, and (3) allow market participants to circumvent capital constraints imposed by regulations and rating agencies.").

90. *See id.*

purchasers.[91] Thus, when properly implemented, asset securitization results in:

- securities whose liquidity is greater than that of an unsecuritized portfolio of loans or receivables,
- borrowing from ultimate investors who would not ordinarily want to hold a portfolio of loans or receivables, and
- reduction by depository institutions of their capital requirements by transferring assets off their balance sheets.[92]

B. Costs of Securitization

Despite its benefits, the process of securitization carries several costs. First, securitization of assets and creation of SPVs entails transactional costs such as registration fees, attorneys' fees, costs associated with credit enhancements, and rating agency fees.[93] An SPV's formation may take significant start-up time,[94] and after the formation phase is over, operational expenses are incurred on a regular basis.

Second, securitization can lead to abusive transactions.[95] Enron Corporation ("Enron") enabled such problems when it compromised the independence of its SPV transactions.[96] Enron created over 3000 SPVs, many of which were designed for the purpose of asset securitization.[97]

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91. *Id*. *See also Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing Before the Subcomm. on Sec. & Ins. & Inv. of Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 94 (2009) (testimony of Kurt Eggert, Professor of Law, Chapman University School of Law) (commenting on the utilization of strips, often to referred to as tranches, in securitization and stating how tranches are used to define priority in repayments due to risk characteristics). Professor Kurt Eggert gave an example of how "one tranche might have the right to the first repayment of principal until the claims of that tranche are satisfied," while another tranche "might not be entitled to any payment until the rights of all other tranches have been satisfied." *Id.*

92. *See* Fabozzi, *supra* note 24, at 28. *See also* Lee, *supra* note 44, at 42-43 (noting that claims against assets are often set "into tranches with differing rights to the cash flows, which increases the market value of claims sold to investors").

93. Plank, *supra* note 2, at 1668. *See also* Devine, *supra* note 45, at 184 (stating that average cost of rating agency services "ranged between $30,000 and $100,000" and that "[i]n some instances, Wall Street paid as much as $1 million for ratings").

94. Jennifer S. Myers, *Asset Securitization Goes International*, METROPOLITAN CORP. COUNS., July 1995, at 23, 23.

95. Neal F. Newman, *Enron and the Special Purpose Entity. Use or Abuse? The Real Problem—The Real Focus*, 20, 26 (Tex. Wesleyan Law Sch., Paper No. 1165, 2006), *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=5550&context=expresso (noting the negative effects Enron had on SPVs).

96. Jenny B. Davis, *The Enron Factor: Experts Say the Energy Giant's Collapse Could Trigger Changes in the Law That Make it Easier to Snare Professionals*, A.B.A. J., Apr. 2002, at 40, 42.

97. Klee & Butler, *supra* note 43, at 31; Jonathan C. Lipson, *Enron, Asset Securitization and Bankruptcy Reform: Dead or Dormant?*, 11 J. BANKR. L. & PRAC. 101, 102 (2002).

Enron retained the risks it was trying to relinquish by failing to maintain a necessary level of corporate independence from its SPVs.[98] Subsequent investigations revealed that Enron created SPVs to minimize losses on its financial statements, artificially increase the value of the assets, accelerate profits, and avoid incurring debt on its balance sheet.[99] As a result, Enron's abuse of the process and fraudulent practices undermined billions of dollars of investments in the ABS transactions.[100]

Third, the protections that securitization provides for investors do not always safeguard subprime borrowers.[101] Securitization allows thinly capitalized lenders and brokers to enter the subprime market, where some originators commit loan abuses perhaps because they perceive inadequate regulation, and low capital operations that allow them to be judgment-proof.[102] Securitization increases the price of subprime loans because investors require premium returns for investing in risky markets.[103]

Finally, creation of a new regulation is likely to increase compliance costs associated with securitization, restrict its use, and limit its array of previously noted benefits. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") exemplifies how new laws and regulations may change an existing business practice.[104] The Dodd-Frank Act forces issuers to have "[s]kin

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98. Davis, *supra* note 96, at 42 (noting how Enron compromised independence of SPVs).

99. Klee & Butler, *supra* note 43, at 31 (citing WILLIAM POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. 4, 68, 78, 97 (2002)). Klee & Butler described Enron's SPVs as follows:

> In a typical SPV transaction, Enron would transfer its own stock to an SPV in exchange for a note or cash. Enron would also guarantee the SPV's value. The SPV, in turn, would hedge the value of a particular investment on Enron's balance sheet, using the transferred Enron stock as the principal source of payment. Enron's faulty assumption, however, was that the risk of having to pay on the guarantees was minimal based on the strength of its stock. However, when Enron's stock price subsequently crashed, the SPV's value also fell. This confluence triggered the guarantees, which in turn further reduced Enron's stock value, triggering additional guarantees. The SPVs lacked sufficient assets to perform its hedge, when . . . the value of both Enron's investment and Enron's stock price dropped simultaneously. Additionally, these drops in value caused the SPVs to breach the 3% (now 10%) independent equity requirement for non-consolidation, which in turn brought the SPV's debt onto Enron's balance sheet. These transactions were initially beneficial to Enron for accounting purposes, because they allowed it to recognize the value of the loan immediately and avoid recognizing on an interim basis any future losses.

Id. at 31-32 (footnotes omitted).

100. *Id.* at 32.

101. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007).

102. *Id.*

103. *Id*.

104. *See* Moorad Choudhry & Gino Landuyt, *Securitization: Restoring Confidence in the*

in the game" by making them retain an economic interest of at least five percent of the credit risk of assets that are conveyed through the ABS issuance.[105] The law further prohibits securitization and removal of the amount associated with the five percent credit risk retention.[106] The possibility of future regulation to heighten control over the financial industry's handling of ABS should be a consideration for all parties involved in securitization.[107]

C. The Legal Structure and SPVs' Bankruptcy-Remoteness

In securitization, the assets to be securitized are transferred on an absolute basis to an SPV,[108] a separate legal entity, which thereafter sells claims on the assets to outside investors in turn for liquid funds.[109] This absolute transfer calls for a complete divestiture of ownership, a true sale, after which the originator no longer retains any rights, title, or interest in the property.[110]

Market, J. STRUCTURED FIN., Summer 2009, at 60, 64 ("[A] recessionary environment brought on by a banking crisis and credit crunch" had a negative effect on the investors which "will impact structured finance products such as ABS ahead of more plain vanilla instruments. Market confidence is key to re-starting markets such as that for ABS.").

105. *See Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SENATE COMMITTEE ON BANKING, HOUSING & URB. AFF., http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf (last visited Mar. 1, 2012).

106. *See id*.

107. *See* Lois L. Weinroth & Richard L. Fried, *Securitization Provisions of the Dodd-Frank Act*, J. STRUCTURED FIN., Fall 2010, at 38, 38 (noting that the remainder of the Dodd-Frank Act provisions "will not become effective until after rulemaking by applicable federal banking agencies, the U.S. SEC, and other regulatory authorities").

108. VINOD KOTHARI, SECURITIZATION: THE FINANCIAL INSTRUMENT OF THE FUTURE 11 (2006).

109. Ayotte & Gaon, *supra* note 25, at 3. *See also In re* Innkeepers USA Trust, 448 B.R. 131, 142 (Bankr. S.D.N.Y. 2011) (stating that "in a securitization, the investors' relationship is with the special purpose vehicle holding the assets . . . [where the] right to payment comes from the cash generated by the assets, not from the originator of the assets itself." (citation omitted)).

110. *Structured Financing Techniques*, *supra* note 31, at 541-42. This transaction is different from a secured debt sale, in which assets are sold by the originator to the third-party investors directly. *See* Lupica, *supra* note 10, at 599-601. Securitization is also different from factoring. In factoring, the factor realizes profits by buying receivables directly from clients at a discount, while securitization involves the creation of a bankruptcy-remote SPV that purchases receivables from the originator and issues ABS into the capital markets. *See* Schwarcz, *supra* note 11, at 144 (noting the differences between securitization and factoring). Schwarcz notes:

> Factoring . . . involves . . . the purchase of accounts receivable . . . by the factor from the party (called the "client") with whom it has a factoring contract. The client assumes all risks of nonpayment of the receivable except the "financial inability of the account debtor (customer) to pay." . . . The factor agrees to pay on a monthly basis for purchased receivables at a rate computed under the contract . . . . The customer is immediately notified of the sale of the receivable to the factor and is instructed to make all payments directly to the factor.

1. Securitization

There are five steps in a single SPV securitization process. First, the originator must identify a pool of assets with foreseeable income that it desires to securitize.[111] The income is required to assure principal and interest payments.[112] After an appropriate asset pool is selected, the originator isolates and prepares to transfer these assets to the SPV.[113] The second step involves creation of a subsidiary conduit entity, an SPV, which purchases the identified assets for securitization.[114] In the third step, contemporaneous with creating an SPV, the originator attempts to make SPV bankruptcy as remote as possible.[115] Fourth, the originator transfers the identified and isolated assets to the SPV.[116] In the fifth and final step, the SPV issues an ABS to pay the originator for the purchase of the assets.[117]

Companies seeking to ensure that their securitization transaction is a true sale often sell and transfer assets to the first subsidiary SPV, which is called an intermediate SPV.[118] Next, the intermediate SPV sells the assets to the ABS-issuing SPV.[119] To avoid any potential risk of being associated with the originator's bankruptcy, the asset transfers are structured as true sales.[120] The intermediate SPV has specific restrictions on its activities such as being only allowed to engage in purchasing, owning, and selling originator's assets and is restricted from declaring

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Id. (citation omitted).

111. Richard & Kosiba, *supra* note 9, at 10 ("The originator pools together a diverse group of receivables of varying durations, maturities, interest rates, and risk ratings, and moves them to a special purpose entity (SPE), or trust, established by the originator for this specific purpose only.").

112. Klee & Butler, *supra* note 43, at 26.

113. *See id. See also* KOTHARI, *supra* note 108, at 11.

114. Klee & Butler, *supra* note 43, at 26. *See also* Food Holdings Ltd. v. Bank of Am. Corp. (*In re* Parmalat Sec. Litig.), 684 F. Supp. 2d 453, 459 (S.D.N.Y. 2010) ("Structured finance transactions typically involve an 'originator' that transfers one or more assets to an SPE for the purpose of raising capital.").

115. *See* Jeffrey E. Bjork, Comment, *Seeking Predictability in Bankruptcy: An Alternative to Judicial Recharacterization in Structured Financing*, 14 BANKR. DEV. J. 119, 124 (1997) ("Securitization allows the Seller to 'isolat[e] a defined group of assets and creat[e] a structure for those assets that is legally separate from all others,' thereby insulating the assets from the effects of the Seller's bankruptcy." (footnote omitted)).

116. *See* Schwarcz, *supra* note 11, at 135 ("After identifying the assets to be used in the securitization, the originator transfers the receivables to a newly formed special purpose corporation, trust, or other legally separate entity—often referred to as a special purpose vehicle, or 'SPV.'").

117. Klee & Butler, *supra* note 43, at 26.

118. *See* ACCOUNTING FOR TRANSFERS & SERVICING OF FIN. ASSETS AND EXTINGUISHMENTS OF LIABS., Statement of Fin. Accounting Standards No. 140, 46 (Fin. Accounting Standards Bd. 2000) (describing the two-step process). *See also* FABOZZI, *supra* note 26, at 357 (noting that an intermediate SPV may also be referred to as depositor).

119. FABOZZI, *supra* note 26, at 357.

120. Klee & Butler, *supra* note 43, at 27.

voluntary bankruptcy.[121] The second sale may be conducted as a sale for accounting purposes and not as a true sale.[122]

Multiseller Securitization Conduit ("MSC")[123] is another approach that originators may utilize to benefit from an SPV.[124] Through use of MSCs, rather than multiple SPVs, originators can lower their transactional costs and sell their assets to an existing SPV.[125] An MSC provides some protection against substantive consolidation if an originator files for bankruptcy.[126] However, MSCs are not as bankruptcy-remote as SPVs, since MSCs involve originators who may become their creditors and commence involuntary bankruptcy proceedings against the SPV.[127]

2. Legal Structure

SPVs assume various legal forms depending on the jurisdiction of their incorporation. In the United States, an SPV generally takes the form of a limited liability corporation ("LLC"), a trust, or a limited liability partnership ("LLP").[128] In Europe, an SPV can be organized as an LLC, a limited purpose corporation under domestic or offshore law with a charitable trust owner, while in Canada an SPV may take the form

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121. FABOZZI, *supra* note 26, at 357 & n.2.

122. *See* Angela Petrucci, Note, *Accounting for Asset Securitization in a Full Disclosure World*, 30 J. LEGIS. 327, 333 (2004) (noting that a second transfer might not be judged to be a true sale at law). *See also* Klee & Butler, *supra* note 43, at 27 (summarizing that the first asset transfer to the SPV in a true sale can have the sole purpose of protecting the assets from the originator's bankruptcy, while the second transfer can be used to provide internal credit enhancements to second-tier investors).

123. *See* Gordon, *supra* note 43, at 1325 (stating that a "merger of SPVs creates a 'multiseller securitization conduit' ('MSC')"). *See also* Zern-shun Adam Chen, Note, *Securitizing Microcredit: The Implications of Securitization for Microcredit Institutions' Human Rights Missions*, 39 COLUM. HUM. RTS. L. REV. 757, 779 (2008) (stating that MSC is a "securitization technique [that] allows several originators to pool their assets into a single SPV").

124. *See* Neil Campbell & Balbir Bindra, *Securitization in Asia*, INT'L. FIN. L. REV., Oct. 2002 (Supp.), at 25, 25 (noting the popularity of multiseller conduits).

125. *See* Adam Grant, Note, *Ziggy Stardust Reborn: A Proposed Modification of the Bowie Bond*, 22 CARDOZO L. REV. 1291, 1310 (2001) ("The primary benefit of the multiseller securitization conduit is that it allows originators who would not traditionally be able to afford the transaction costs of one-off securitizations to engage in securitization." (footnote omitted)). *See also* Malcolm S. Dorris & Anna E. Panayotou, *Multi-Seller Commercial Paper Conduits and Securitization: A Brief History and Current Challenges*, J. STRUCTURED FIN., Winter 2004, at 21, 21.

126. Klee & Butler, *supra* note 43, at 27.

127. *Id.* at 40-41 (discussing *In re* Kingston Square Assocs., 214 B.R. 713, 714-15 (Bankr. S.D.N.Y. 1997), where the creditors brought an involuntary petition against an SPV).

128. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, THE JOINT FORUM: REPORT ON SPECIAL PURPOSE ENTITIES 65-66 app. 2 (2009) [hereinafter BANK FOR INT'L SETTLEMENTS].

of a charitable trust.[129] Other common legal forms used in other jurisdictions include an unincorporated entity and a multi-user structure such as a protected cell company.[130]

3. Bankruptcy-Remoteness

An SPV is a bankruptcy-remote entity with the limited purpose of facilitating the securitization.[131] To ensure an SPV's bankruptcy-remoteness when its corporate parent becomes insolvent, certain protective measures are implemented.[132]

First, securitization permits an originator to obtain funds at reduced cost when a lender secures the loan with assets that are transferred from the originator to the SPV.[133] Securitization allows the lender to exclude its collateral from the originator's estate.[134] Thus, in the event of the originator's bankruptcy, the automatic stay should stop the investors and creditors from foreclosing on the assets due to the difference in asset ownership.[135]

Second, additional protections can be implemented through proper documentation associated with creating, operating, and transacting with an SPV. These documents expressly limit the SPV's authority and purpose to owning and managing the collateral, entering into the transaction closing documents, and engaging in activities restricted to those necessary or incidental to financing.[136] As a separate legal entity, an SPV must maintain its own corporate books, records, and accounts, and observe all other corporate necessities.[137]

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129. *Id.* at 65 app. 2.

130. *Id.*

131. *Id.* at 47 app. 1.

132. *See In re* Am. Bus. Fin. Servs., Inc., No. 05-10203 (MFW), 2008 WL 1702095, at *7 (Bankr. D. Del. Apr. 10, 2008). An SPV is formed with a purpose "to isolate the financial assets from the potential bankruptcy estate of the original entity, the borrower or originator" by "adequately insulat[ing] from the consequences of any related party's insolvency, thus reducing the likelihood of the SPE's being involved in a bankruptcy proceeding." *Id.* (quoting David B. Stratton, *Special-Purpose Entities and Authority to File Bankruptcy*, AM. BANKR. INST. J., Mar. 2004, at 36, 36).

133. *In re* LTV Steel Co., 274 B.R. 278, 280 (Bankr. N.D. Ohio 2001).

134. *Id.*

135. *See* A. Brent Truitt & Bennett J. Murphy, *Bankruptcy Issues in Securitizations*, *in* SECURITIZATIONS: LEGAL AND REGULATORY ISSUES 2-6 (2011) (noting that after the securitization process the assets will belong to the SPV and not the originator).

136. Stark, *supra* note 51, at 216.

137. *See* Paloian v. LaSalle Bank, N.A., 619 F.3d 688, 695-96 (7th Cir. 2010) (providing an example where the court stated that the SPV was not independent of the debtor because it did not have the usual attributes of a bankruptcy-remote vehicle). In *Paloian*, the court stated that the SPV was not bankruptcy-remote because it did not have an office, a phone number, a checking account, or stationery, all of its letters were written on the debtor's stationery, it did not prepare financial statements or tax returns, took only a small cut of the proceeds to cover costs of operation, and the

To protect against bankruptcy, an SPV must be limited in its acquisition of any additional debt to those that carry the same security rating as the ABS.[138] An SPV's debt must be limited to ABS and obligations to credit enhancers and liquidity providers,[139] or incurred in the ordinary course of business activities related to ownership and management of the collateral.[140] Documents specify that assets transferred to the SPV must be free of liens and other interests that favor parties external to the securitization.[141] The documents must also indicate that for as long as the ABS are outstanding, the SPV is prohibited from dissolving, liquidating, consolidating, merging, or selling assets.[142]

An SPV's documents must impose certain corporate governance restrictions. For instance, the documents must require the SPV to employ an independent director who is unaffiliated with the SPV or the originator.[143] The provisions must make it very difficult for the SPV to file for voluntary bankruptcy by requiring a unanimous consent of all members of the SPV's board of directors and a favorable vote of the independent director.[144] After an ABS issuance, any amendment to the SPV's originating documents is required to have the approval of investors and confirmation from rating agencies that such an amendment would not result in a downgrade or withdrawal of qualification rating.[145]

Finally, an SPV becomes bankruptcy-remote if it is structured in a way that it will not be subject to substantive consolidation if the operating company files for bankruptcy protection.[146] The purpose of the structure is to ensure that the financial assets of the SPV will not be part of that bankruptcy estate.[147]

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debtor continued to list the entity's accounts receivable as its own corporate asset. *Id.*

138. *See* PAVEL, *supra* note 7, at 24.

139. *Structured Financing Techniques*, *supra* note 31, at 554.

140. Stark, *supra* note 51, at 216.

141. *Structured Financing Techniques*, *supra* note 31, at 555.

142. Stark, *supra* note 51, at 216.

143. *See* W. Rodney Clement, Jr. & H. Scott Miller, *General Growth: Special Purpose Entities (Barely) Survive First Bankruptcy Test*, PROB. & PROP., Mar.–Apr. 2011, at 31, 31-32 ("There are two distinct aspects to an SPE: separateness of identity and the role of an independent director.").

144. *See id.* (stating that "the purpose of an independent director is to prevent a borrower from filing for bankruptcy in a mere attempt to gain leverage; the independent director is supposed to provide for a rational, independent review").

145. Stark, *supra* note 51, at 216.

146. *Id.* at 212.

147. Ayotte & Gaon, *supra* note 25, at 3.

D. True Sale Doctrine

In a securitization's true sale, the originator must absolutely assign, transfer, and divest of all ownership rights, title, or interest in its assets to the SPV.[148] All securitization transactions "are premised on the idea that the transfer of the underlying financial asset will be recognized as a 'true sale' to the" SPV.[149] However, the factual determination of whether the assignment was a loan or a true sale may provide any court with a difficult challenge.[150]

Courts have broad discretion in ruling on whether a transaction constitutes a true sale or just a loan.[151] As a result, depending on the particular jurisdiction or judge, the transfer of assets to the SPV may be upheld as a true sale or declared a loan.[152] Due to these broad discretionary powers, which have been freely exercised by bankruptcy courts, there is a lack of certainty in the securitization industry.[153]

In determining whether a transfer of assets or receivables constitutes a true sale, courts consider neither a prescribed list of factors, nor a consistently assigned weight of certain factors over others. Instead, the courts consider different factors and give those factors different weights on a case-by-case basis.[154] Additionally, the courts apply a

148. LaSalle Nat'l Bank Ass'n v. Paloian, 406 B.R. 299, 315 n.11, 341 (N.D. Ill. 2009) ("At a minimum, a true sale must be a sale in substance, as opposed to a mere transfer for security.").

149. Doctors Hosp. of Hyde Park, Inc. v. Desnick (*In re* Doctors Hosp. of Hyde Park, Inc.), 360 B.R. 787, 848 (Bankr. N.D. Ill. 2007).

150. *See LaSalle Nat'l Bank Ass'n*, 406 B.R. at 315 n.11, 340 ("The use of a 'true sale' in the specific context of a securitization is a relatively recent development, and a dearth of case law has made the requirements of a 'true sale' of assets to a special purpose entity somewhat uncertain."). *See also In re* Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004) ("Whether to deem a transaction a sale or a loan when a financial asset—a right to payment—has changed hands is an old legal problem for which there has never been an easy solution.").

151. *LaSalle Nat'l Bank Ass'n*, 406 B.R. at 341.

152. Bjork, *supra* note 115, at 126.

153. *Id*.

154. *See id. See also* Thomas E. Plank, *The True Sale of Loans and the Role of Recourse*, 14 GEO. MASON U. L. REV. 287, 290 (1991) ("[C]ourts do not rely upon any universally accepted set of factors . . . ."). For example, the language of the parties' contract has mattered little to some courts. *See* Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 543 (3d Cir. 1979). To others, it has been more or less dispositive. *See* Hatoff v. Lemons & Assocs., Inc. *(In re* Lemons & Assocs., Inc.), 67 B.R. 198, 209-10 (Bankr. D. Nev. 1986). Some courts find critical the purchaser's retention of some recourse against the seller. *See* Ratto v. Sims *(In re* Lendvest Mortg., Inc.), 119 B.R. 199, 200 (B.A.P. 9th Cir. 1990). Others deem it merely relevant or choose to ignore it altogether. *See, e.g., Major's Furniture Mart, Inc.*, 602 F.2d at 544-45; Carter v. Four Seasons Funding Corp., 97 S.W.3d 387, 398 (Ark. 2003). With no "discernible rule of law or analytical approach" evident from the decisions, a court "could flip a coin, and find support in the case law for a decision either way." Robert D. Aicher & William J. Fellerhoff, *Characterization of a Transfer of Receivables as a Sale or a Secured Loan upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 206-07 (1991). The absence of any set legal analysis, along with the annoying tendency of decisions to turn on their facts, makes predicting the outcome of a loan/true sale dispute nearly

"totality of the circumstances test" by looking at the intent and the relationship between the parties.[155] As a result, some courts may rely entirely on the language of the parties' contract, where others may regard that language as inconsequential.[156] As a general inquiry, the courts regularly consider three issues:

1. Did the parties intend for the transaction to be a sale or to create only a security interest in favor of the transferor?
2. Regardless of intent, have the risks and benefits of ownership truly been transferred? Does the transferor or the transferee bear the risk of loss to the assets being transferred? The greater the recourse to the transferor, the more likely the transfer will not be upheld as a true sale.
3. Did the transferee acquire an interest in identifiable assets?[157]

In *In re Jersey Tractor Trailer Training, Inc.*,[158] the court summarized factors considered by other courts as follows:

1. Language of the documents and conduct of the parties.
2. Recourse to the seller.
3. Seller's retention of servicing and commingling of proceeds.
4. Purchaser's failure to investigate the credit of the account debtor.
5. Seller's right to excess collections.
6. Purchaser's right to alter pricing terms.

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impossible. *See Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 189-90 (1999) (statement of Seth Grosshandler, Esq., Partner, Cleary, Gottlieb, Steen & Hamilton) (observing that the legal analysis is "highly subjective" and that issuing "true sale opinion[s]" in connection with some transactions is therefore "extremely difficult, costly, and in a few cases, impossible to render" (internal quotation marks omitted)).

155. *In re Commercial Loan Corp*., 316 B.R. at 700 (internal quotation marks omitted) (stating that when "[c]onfronted with loan/true sale questions, courts typically adopt something resembling a 'totality of the circumstances' test, declaring that the sale determination depends on the intent of the parties and requires an examination of the parties' relationship").

156. *See id.*

157. *Asset Securitization*, [2011] 4 Debtor-Creditor L. (MB) § 41.04[1], at 41-36. *See also* Peter V. Pantaleo et al., *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 159 (1996) ("Transfers of financial assets in which the parties state that they intend a sale, and in which all the benefits and risks commonly associated with ownership are transferred for fair value in an arm's-length transaction, are easily identifiable as sales. The issue becomes complicated if the buyer retains recourse to the seller such that less than all of the risks of ownership are transferred.").

158. Wawel Savings Bank v. Jersey Tractor Trailer Training, Inc. (*In re* Jersey Tractor Trailer Training, Inc.), Bankr. No. 06-12743 (MBK), 2007 WL 2892956 (Bankr. D.N.J. Sept. 28, 2007), *aff'd*, Bankr. No. 06-12743 (MBK), 2008 WL 2783342 (D.N.J. July 15, 2008).

7. Seller's retention of right to alter or compromise unilaterally the terms of the transferred assets.
8. Seller's retention of right to repurchase asset.[159]

If the court determines that the sale was "untrue," it can reclassify the sale as a secured loan for the purpose of creditors' rights.[160] The consequences of such a ruling may be devastating for the SPV investors, creditors, and lenders. If the transfer of assets is not classified as a true sale, the bankruptcy court has the discretion to "delay payments to the transferee, or to force a liquidation of assets and repayment of claims, thereby depriving investors of the continuing benefits of their investment."[161] Further, if the sale is classified as a loan, the originator's bankruptcy would allow the bankruptcy court to impose a stay on the SPV's activities associated with obtaining access to the receivables.[162]

III. SPV LITIGATION

In the event of the bankruptcy of its originator, an SPV should be fully protected from creditors of the seller of the collateral.[163] After the collateral is transferred to the SPV in the true sale, the SPV, not the seller, holds legal and equitable title to the property.[164] Even if the seller remains the servicing agent after the sale, the SPV is considered to own legally purchased assets.[165] Thus, if the seller subsequently declares bankruptcy, the bankruptcy court should not have justification to penetrate the SPV to recuperate the collateral or obtain cash from the collateral.[166] However, the theory of an SPV's remoteness from bankruptcy proceedings has not been confirmed absolutely by the courts. Ambiguity exists as to when an SPV structure can be pierced or modified to allow recovery for investors and creditors because the major legal decisions show that SPVs are bankruptcy-remote, not bankruptcy proof.[167]

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159. *Id.* at *7 (citing Aicher & Fellerhoff, *supra* note 154, at 186, 191-94).

160. *See* Principal Life Ins. Co. v. United States, 70 Fed. Cl. 144, 165 (2006) (quoting JAMES M. PEASLEE & DAVID Z. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS 61 (3d ed. 2001)) (internal quotation marks omitted).

161. *Id.* (quoting PEASLEE & NIRENBERG, *supra* note 160, at 61).

162. Nikolic, *supra* note 63, at 403.

163. LaSalle Nat'l Bank Ass'n v. Paloian, 406 B.R. 299, 336-37 (N.D. Ill. 2009) (noting that securitization isolates "the financial assets of the special purpose entity in the event that the operating company files for bankruptcy").

164. *See* DVI Fin. Servs., Inc. v. Nat'l Med. Imaging, LLC (*In re* DVI, Inc.), 305 B.R. 414, 417 (Bankr. D. Del. 2004) (citation omitted).

165. *Id.* at 417-18 (citation omitted).

166. FABOZZI, *supra* note 26, at 365.

167. *See* Robert K. Rowell, *Single Purpose Entities (SPEs) Offer Lenders Security & Leverage*,

A. In re LTV Steel Co.

As "one of the largest manufacturers of wholly-integrated steel products in the United States," the LTV Steel Co. ("LTV") produced "flat rolled steel products, hot and cold rolled sheet metal, mechanical and structural tubular products, and bimetallic wire."[168] In October 1994, Abbey National ("Abbey"), a large financial institution located in the United Kingdom, commenced an ABS transaction with LTV.[169] LTV began by forming a wholly owned subsidiary, LTV Sales Finance Co. ("Sales Finance").[170] LTV and Sales Finance entered into an agreement in which LTV would continuously sell all of its rights in accounts receivable to Sales Finance, while Abbey obtained a security interest in those receivables in exchange for a $270 million loan to Sales Finance.[171]

In 1998, LTV entered into an ABS financing agreement in which LTV created LTV Steel Products, LLC ("Steel Products").[172] LTV then entered into an agreement with Steel Products in which it sold all of its "right[s], title and interest[s] in its inventory to Steel Products on a continuing basis."[173] Steel Products gave a security interest in its inventory to Chase Manhattan Bank ("Chase") and other banking institutions in exchange for a $30 million loan.[174]

On December 29, 2000, LTV along with its forty-eight subsidiaries, filed voluntary Chapter 11 bankruptcies.[175] On its bankruptcy filing date, as part of the first day hearings, LTV sought an interim court order permitting it to use cash collateral, which consisted of accounts receivable and inventory that were owned by Sales Finance and Steel Products.[176] LTV argued that without ability to use the cash collateral, it

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DEBT[3], July/Aug. 2005, at 40, 40.

168. *In re* LTV Steel Co., 274 B.R. 278, 279-80 (Bankr. N.D. Ohio 2001) (noting that this is not the first time LTV filed for bankruptcy relief). LTV "previously filed a voluntary Chapter 11 petition in the Bankruptcy Court for the Southern District of New York on July 17, 1986. . . . [LTV] successfully emerged from Chapter 11 on June 28, 1993." *Id.* at 280.

169. *Id.*

170. *Id*.

171. *Id*.

172. *Id*.

173. *Id.*

174. *Id*. "Abbey National [was] not involved in this ABS facility, and it had no interest in pre-petition inventory allegedly owned by Steel Products." *Id.*

175. *Id.* at 279-80 (noting that at the time of the bankruptcy, LTV employed approximately 17,500 individuals and was responsible for providing medical coverage and other benefits to approximately 100,000 retirees and their dependents).

176. *Id.* at 280. Neither Sales Finance nor Steel Products were a debtor in this proceeding. *Id*. Abbey was not present at the hearing; Chase was present at the December 29, 2000 hearing. *Id.* at 280-81.

would be forced to cease operations.[177] The bankruptcy court determined that the interim order allowing use of the accounts receivable sold to Sales Finance and of the inventory sold to Steel Products was necessary to permit LTV to continue its business operations.[178] The bankruptcy court also determined that the interim order adequately protected Abbey's and its creditors' interests in the cash collateral and that it was in the best interest of all parties involved.[179]

On February 5, 2001, the bankruptcy court ruled on Abbey's emergency motion for modification of the interim order that allowed LTV the use of cash collateral.[180] Abbey's key request for an order modification consisted of three arguments: (1) it was denied due process; (2) the bankruptcy court lacked jurisdiction to enter an interim order because the accounts receivable that constituted Abbey's collateral were not the property of LTV's bankruptcy estate; and (3) even if accounts receivable were the property of LTV's bankruptcy estate, Abbey's interests were not adequately protected because pre-petition accounts receivable were diminishing at a rapid rate and soon would be depleted.[181]

The bankruptcy court found that Abbey had received adequate notice of the cash collateral hearing and that its due process rights were not denied.[182] The bankruptcy court also declined to accept Abbey's

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177. *Id*. at 280.

178. *Id*. at 281. Cash collateral consisted of accounts receivable and inventory. *Id.* at 280.

179. *Id*. at 281. On its filing date, LTV and Chase reached an agreement regarding the interim order, which allowed LTV to use the cash collateral. *Id.* Since Chase could not obtain Abbey's consent to the form of the order, Chase did not formally consent to the entry of this order. *Id.* Chase negotiated some of the order's terms and did not raise an objection to its entry by the bankruptcy court. *Id*. Consequently, the bankruptcy court entered an order, summarized as follows:

> 1. Recognition that there is a dispute between Debtor and the secured lenders of Sales Finance and Steel Products as to whether the transactions between Debtor and those entities were true sales or disguised financing vehicles;
>
> 2. An order requiring the secured lenders to turn over to Debtor the cash proceeds of the inventory and receivables which are to be used to provide working capital for Debtor;
>
> 3. Recognition that in the event the Court determines these transactions to be true sales, the secured lenders whose cash collateral was used will be entitled to administrative expense claims against the estate;
>
> 4. Adequate protection was provided to the secured lenders in the form of senior liens on the inventory and receivables and weekly interest payments to the lenders at pre-petition non-default rates.

Id.

180. *Id*. at 278-79.

181. *Id*. at 282.

182. *Id.* at 283. Abbey argued that its due process rights were violated as "it did not have 'effective notice' of the cash collateral hearing and that Chase . . . , as Abbey National's agent, supported the entry of the interim order without its consent." *Id.* The bankruptcy court recognized Abbey's meaningful right to a hearing and its significant interest in the cash collateral. *Id.* Although Abbey was not present at the cash collateral hearing, the court noted that Abbey had actual notice of

argument that the accounts receivable were not part of LTV's estate.[183] Abbey contended that the transaction between LTV and Sales Finance was a true sale, which meant LTV sold its interest in the accounts receivable to Sales Finance, and no longer had any interest in the receivables.[184] Accordingly, Abbey argued that since LTV had no remaining interest in the accounts receivable, they could not be part of LTV's bankruptcy estate.[185]

In its reasoning, the bankruptcy court relied on Section 541(a) of the Bankruptcy Code.[186] Section 541(a) states that upon the filing of bankruptcy petition an estate is created, which consists of "all legal or equitable interests of the debtor in property as of the commencement of the case."[187] The filing of a Chapter 11 petition creates a very broad estate, where "property may be included in [the] Debtor's estate even if [the] Debtor does not have a possessory interest in that property."[188]

Because LTV's business operations required it to purchase, melt, mold, and cast various metal products, the bankruptcy court found that LTV retained equitable interest in the cash collateral.[189] The bankruptcy court concluded that LTV had equitable interest in the inventory and accounts receivable that were part of its bankruptcy estate.[190] Further, the bankruptcy court noted that Abbey's relief from the interim cash collateral order would be "highly inequitable" for LTV's business and its employees.[191]

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the hearing. *Id.* The first notice was provided in the form of an e-mail sent by a Chase employee to Abbey on December 28, 2000. *Id.* at 280. The second notice came in the form of a telephone call made from a Chase employee to Abbey on December 29, 2000. *Id.* at 280-81. Additionally, the bankruptcy court stated that LTV had given advance notice of its intention to file for bankruptcy protection to Chase, Abbey's agent, in the week prior to December 29, 2000. *Id.* at 281. The bankruptcy court further noted that Abbey had a full and fair opportunity to appear before the court and object to the entry of the order, and could not be unduly surprised by the entry of the interim order. *Id.* at 284. Accordingly, the bankruptcy court stated there is no basis for granting relief from the interim order on Abbey's due process argument. *Id.* at 285.

183. *Id.*

184. *Id*.

185. *Id*. The bankruptcy court found Abbey's argument regarding the true sale to be "circular," because, as Abbey admitted in its pleadings and in oral argument, the ultimate issue of whether LTV actually sold the receivables to Sales Finance was a fact-intensive issue that could not be resolved without extensive discovery and an evidentiary hearing. *Id.* Thus, the court could not determine whether the accounts receivable were part of LTV's bankruptcy estate until an evidentiary hearing could be held. *Id.*

186. *Id.*

187. *Id.* (quoting 11 U.S.C. § 541(a)(1) (2006)) (internal quotation marks omitted).

188. *Id.* (citing United States v. Whiting Pools, Inc., 462 U.S. 198, 204-06 (1983)).

189. *Id*.

190. *Id*.

191. *Id*. at 285-86.

The court also stated that the interim order was necessary to enable LTV to operate and meet its obligations to its employees, customers, retirees, and creditors.[192] Modification of the interim order would put all of these stakeholders at risk because it might allow Abbey to exercise its state law rights as a secured lender to look to the collateral in satisfaction of its debt.[193] The bankruptcy court stated that such a result "would put an immediate end to [LTV's] business, would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have more far reaching economic effects on the geographic areas where [LTV] does business."[194] The bankruptcy court stated that modification of the interim order would shut down LTV's business, thus leading to the termination of thousands of its employees, eliminating benefits to its 100,000 retirees, and negatively affecting geographic areas where LTV conducts business.[195] Accordingly, LTV's equitable interest in the cash collateral and the high inequity that might result from a modification of the current order was sufficient to stay the bankruptcy court's prior entry of the interim order and to deny Abbey's request.[196]

In its third and final argument, Abbey contended that its collateral was not adequately protected because its pre-petition accounts receivable were depleting at a rate of $10 million per day and that all accounts receivable would be consumed in a short period.[197] Additionally, Abbey stated that the interim order had diminished the value of its liens.[198] Again, the bankruptcy court disagreed with Abbey. First, the court found Abbey's contention that its collateral was being consumed and depleted at $10 million per day to be "disingenuous."[199] Second, the bankruptcy court noted that pre-petition accounts receivable were being used by LTV to purchase and manufacture more steel, which in fact should increase the value of post-petition accounts receivable and inventory, in which Abbey had a secured interest.[200] Finally, the bankruptcy court found that Abbey's interest and collateral were adequately protected by an equity cushion and by the current terms of the interim order.[201]

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192. *Id*. at 286.
193. *Id*.
194. *Id.*
195. *Id*.
196. *Id.* at 284, 286.
197. *Id*. at 286.
198. *Id*.
199. *Id*.
200. *Id*.
201. *Id*. at 287.

The case was settled. Settlement included a summary finding that LTV's securitizations were true sales.[202] However, the court's decision to permit LTV to use the cash flows prior to the settlement sends a warning to investors.[203] It sets a persuasive precedent for other originators to argue when they operate near or in insolvency and have sold assets they require for operations, an attempt for a successful reorganization to an SPV might be mandated.[204]

The assets that the parent-originator sells to the SPV, and the assets the originator retains for its operations, are important to investors. The critical considerations are the value of the collateral remaining for operations and the originator's ability to convert this collateral into cash as needed.[205] In LTV's case, the assets sold to the SPV consisted of accounts receivable and inventories, which included "raw materials to be manufactured into salable goods."[206] The only remaining assets owned by the originator were large physical assets, such as an aged steel mill, that were hard to convert into cash through liquidation and were not the type of assets banks wanted to take as collateral.[207] As a result, LTV put itself in a situation where it had no easily marketable assets to obtain the cash that it needed for reorganization, and its liquid assets had been sold to the SPV.[208] The LTV case demonstrates that despite financially damaging effects for the SPV's investors, a bankruptcy court may allow the parent-originator to use liquid assets it previously sold to a bankruptcy-remote SPV to prevent negative consequences that the originator's bankruptcy would have on its employees, retirees, and regional economics.[209]

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202. FABOZZI, *supra* note 26, at 365.

203. *See id.*

204. *See* Stark, *supra* note 51, at 224.

205. *Id.* at 215.

206. *Id.* at 227.

207. *Id.*

208. *See id.*

209. *See* Klee & Butler, *supra* note 43, at 57-58 ("The LTV case illustrates the stress that can be placed on a securitization transaction if any of the following are true: (i) the debtor has no or inadequate sources of working capital other than the collateral and/or its cash flow; (ii) the collateral includes operating assets required for the continuation of the debtor's business, not just pure financial assets (i.e. inventory); and (iii) cessation of the debtor's business would result in the loss of many jobs and create other widespread personal hardships."). *See also* Frank J. Fabozzi & Vinod Kothari, *Securitization: The Tool of Financial Transformation* (Yale Int'l Ctr. for Fin., Working Paper No. 07-07), *available at* http://ssrn.com/abstract=997079 ("For investors in the securities issued in a securitization, however, what was troubling about [the LTV] case is that the court decided to permit LTV to use the cash flows prior to the settlement." (footnote omitted)).

B. Doctrine of Substantive Consolidation

The doctrine of substantive consolidation originated from the common law concept of equity.[210] This equitable power given to the bankruptcy courts arises from the broad equity jurisdiction conferred by Section 105 of the bankruptcy code.[211] Similarly, consolidations may also be accomplished through utilization of Section 502(j) and Section 542(a).[212] The bankruptcy court has the equitable power to order substantive consolidation of separate corporate entities to reach assets that are needed to satisfy a related corporation's debts.[213] Bankruptcy cases may also be consolidated for administrative purposes.[214] Substantive consolidation can combine paralleling claims of shareholders against the associated organizations, use combined assets of the companies to satisfy any obligations, eliminate intercompany claims, and combine the creditors of the two companies to form the creditors' committee needed to approve reorganization plans that might enable the firm to emerge from bankruptcy.[215] In effect, substantive consolidation combines separate legal entities and assigns their cumulative assets and liabilities to the resulting organization, which allows creditors' claims against either of the previously separate debtors to be combined against the consolidated survivor.[216]

Although substantive consolidation is regarded as "an extreme and unusual remedy,"[217] courts have allowed consolidation between the debtor and a non-debtor entity.[218] Interconnected corporate structures

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210. Principal Life Ins. Co. v. United States, 70 Fed. Cl. 144, 164 n.41 (2006) (citation omitted). *See also In re* Cent. European Indus. Dev. Co., 288 B.R. 572, 576 (Bankr. N.D. Cal. 2003) ("[S]ubstantive consolidation is one of 'the bankruptcy court's general equitable powers . . . .'" (emphasis omitted) (citation omitted)).

211. *See Principal Life Ins. Co.*, 70 Fed. Cl. at 164 n.41.

212. *See In re* Cyberco Holdings, Inc., 431 B.R. 404, 424 (Bankr. W.D. Mich. 2010) (stating that consolidations may "now . . . be accomplished through the application of actual Code sections—to wit, Sections 542(a) and 502(j)—as opposed to through amorphous notions of equity and dubious interpretations of Section 105").

213. Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 447 (2d Cir. 1964) ("A bankruptcy court has the power to adjudicate summarily rights and claims to property which is in the actual or constructive possession of the court." (quoting Cline v. Kaplan, 323 U.S. 97, 98 (1944) (internal quotation marks omitted))).

214. *See* Fed. R. Bankr. P. 1015(b).

215. Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 249 (5th Cir. 2009). *See also In re* New Century TRS Holdings, Inc., 390 B.R. 140, 161 (Bankr. D. Del. 2008) ("Typically, substantive consolidation takes a form in which separate entities are merged into a single survivor, which is then left with the assets and liabilities of all.").

216. *Principal Life Ins. Co.*, 70 Fed. Cl. at 164 n.41.

217. Gandy v. Gandy (*In re* Gandy), 299 F.3d 489, 499 (5th Cir. 2002) (footnote omitted).

218. Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987).

have led the courts to use their equitable and flexibility powers to order limited to substantial substantive consolidation.[219] Because the doctrine of substantive consolidation is based on equity, the judicially developed standards control whether substantive consolidation requests should be granted or denied in any given case.[220] Since the substantive consolidation analysis employed by courts is highly fact-specific and decisions are rendered on a case-by-case basis, this area of the law remains highly volatile.[221]

1. The Elements Test

The Elements Test is one of three tests developed by the courts for determining whether two entities may be substantively consolidated. The Elements Test employs factors that are often used by courts in their decision of whether to pierce the corporate veil. Because a corporation is a separate entity, its shareholders, management, and other related entities are generally not responsible for the corporate liabilities.[222] If a corporate form is abused by individuals or entities, an exception in the law disallows liability protection provided by the incorporation process.[223] Piercing of the corporate veil by the court exposes to liability those who disregard the corporate form to commit wrongdoing for their own benefit.[224] In substantive consolidation, the courts utilize the following elements for "piercing the corporate veil test":

1. [p]arent corporation owns all or a majority of the capital stock subsidiary,
2. parent corporation and subsidiary have common directors and officers,

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219. *In re* Colfor, Inc., No. 96-60306, 1997 WL 605100, at *2 (Bankr. N.D. Ohio Sept. 4, 1997). *See also* White v. Creditors Serv. Corp. (*In re* Creditors Serv. Corp.), 195 B.R. 680, 691-92 (Bankr. S.D. Ohio 1996) (indicating the authority and ability to substantively consolidate); *In re* Standard Brands Paint Co., 154 B.R. 563, 566-67 (Bankr. C.D. Cal. 1993).

220. *See In re* Gyro-Trac (USA), Inc., 441 B.R. 470, 487 (Bankr. D.S.C. 2010) ("The doctrine of substantive consolidation is based strictly on equity; as a result, courts have broad discretion in determining whether to substantively consolidate bankruptcy cases." (citation omitted)).

221. *See In re* Crown Mach. & Welding, Inc., 100 B.R. 25, 27-28 (Bankr. D. Mont. 1989); Comm. on Structured Fin. & Comm. on Bankr. & Corp. Reorg. of The Ass'n of the Bar of the City of N.Y., *Special Report on the Preparation of Substantive Consolidation Opinions*, 64 BUS. LAW. 411, 414 (2009) [hereinafter *Special Report*] (noting that despite the "decisions in *Owens Corning* (2005), *Augie/Restivo* (1988), and *Auto-Train* (1987)," much law remains unsettled due to the new cases). *See also* Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992) (stating substantive consolidation analysis requires "a searching review of the record, on a case-by-case basis").

222. Laborers' Pension Fund v. Lay-Com, Inc., 580 F.3d 602, 610 (7th Cir. 2009) (citation omitted).

223. *Id.* (citation omitted).

224. *Id.*

3. parent corporation finances subsidiary,
4. parent corporation is responsible for the incorporation of the subsidiary,
5. subsidiary has grossly inadequate capital,
6. parent corporation pays salaries or expenses or losses of subsidiary,
7. subsidiary has substantially no business except with parent corporation or no assets except those conveyed to it by parent corporation,
8. parent refers to subsidiary as such or as a department or division,
9. directors or executives of subsidiary do not act in the interests of subsidiary, but take directions from the parent,
10. the formal legal requirements of the subsidiary as a separate and independent corporation are not observed.[225]

Other courts used the following elements for piercing of the corporate veil to determine if substantive consolidation should be allowed:

1. the degree of difficulty in segregating and ascertaining individual assets and liability,
2. the presence or absence of consolidated financial statements,
3. the profitability of consolidation at a single physical location,
4. the commingling of assets and business functions,
5. the unity of interests and ownership between the various corporate entities,
6. the existence of parent and inter-corporate guarantees on loans,
7. the transfer of assets without formal observance of corporate formalities.[226]

This second group of elements has become popular in recent case law.[227] The court's decision to allow substantive consolidation is not governed by a single element.[228] Even an assembly of elements suggesting the existence of a substantial relationship among the debtors

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225. *In re* Tureaud, 45 B.R. 658, 662 (Bankr. N.D. Okla. 1985), *aff'd*, 59 B.R. 973 (N.D. Okla. 1986). *See also* Fed. Deposit Ins. Corp. v. Hogan (*In re* Matter of Gulfco Inv. Corp.), 593 F.2d 921, 928-29 (10th Cir. 1979); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

226. *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980). *See also In re* E'Lite Eyewear Holding, Inc., No. 08-41374, 2009 WL 349832, at *3 (Bankr. E.D. Tex. Feb. 5, 2009); *In re* Optical Techs., Inc., 221 B.R. 909, 913 (Bankr. M.D. Fla. 1998); *In re* Donut Queen, Ltd., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984); *In re* Manzey Land & Cattle Co., 17 B.R. 332, 337 (Bankr. D.S.D. 1982).

227. *In re E'Lite Eyewear Holding, Inc.*, 2009 WL 349832, at *3.

228. *Id.*

is only one of the grounds required for substantive consolidation.[229] Sometimes the court requires proof of additional elements to establish substantive consolidation.[230] However, the presence of a common theme involving additional elements such as poor recordkeeping, commingling of assets or liabilities, and the existence of inter-affiliate transactions that make it hard to establish correct distribution of assets and liabilities will likely result in an order for substantive consolidation.[231]

For instance, the Second Circuit in *Chemical Bank New York Trust Co. v. Kheel*[232] ordered substantive consolidation because all creditors would have realized benefits upon consolidation.[233] In its ruling, the court stated:

> [W]here the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.[234]

When there is an absence of opposition and consolidation would promote reorganization rather than liquidation, the court may order substantive consolidation without evidence of entanglement or inability to separate assets and liabilities.[235]

In addition to a commingling of assets and liabilities, supplementary factors may need to be present. These factors may include "failure to comply with corporate formalities in connection with interaffiliate transfers, third party transactions, or conduct of directors and shareholder meetings, inadequate differentiation among affiliated entities in dealing with and representations made to third parties, or noncompliance with any other formal conduct required by corporate law."[236]

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229. *Id*.

230. *Id*.

231. *Id*. at *3-4 (citations omitted).

232. 369 F.2d 845 (2d Cir. 1966).

233. *Id.* at 847.

234. *Id.* However, interests of creditors who would be adversely affected by substantive consolidation must be protected as long as separate accounting can be accomplished. 2 COLLIER ON BANKRUPTCY ¶ 105.09[2][a], at 105-96 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) (citing Flora Mir Candy Corp. v. R. S. Dickson & Co. (*In re* Flora Mir Candy Corp.), 432 F.2d 1060, 1063 (2d Cir. 1970)).

235. *See In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410-12 (Bankr. E.D. Va. 1980).

236. 2 COLLIER ON BANKRUPTCY, *supra* note 234, ¶ 105.09[2][a], at 105-97. *See also* Eastgroup Props. v. S. Motel Ass'n, Ltd., 935 F.2d 245, 250 (11th Cir. 1991) ("Additional factors that could be presented in some cases include: (1) the parent owning the majority of the subsidiary's stock; (2) the entities having common officers or directors; (3) the subsidiary being grossly undercapitalized; (4) the subsidiary transacting business solely with the parent; and (5) both entities

2. The Balancing Test

The second approach used to determine substantive consolidation by courts is a balancing of equities, which looks at the impact the consolidation may have on the creditors.[237] This test helps the court evaluate a proposed substantive consolidation to determine whether the cost-benefit analysis of keeping the parent corporation separate and distant from the SPV is preferred to consolidating the two organizations.[238] A court must inquire to ensure that the benefits of substantive consolidation outweigh the harm it causes the opposing parties.[239]

The court in *Eastgroup Properties* adopted a four-part test to determine if substantive consolidation should be allowed.[240] Under this test, substantive consolidation should be permitted only if: (1) there is a substantial identity between the entities to be substantively consolidated; (2) consolidation is essential to evade some harm or to realize some benefit;[241] (3) the objecting creditor did not rely on the separate credit of one of the entities to be consolidated and thereby would not be prejudiced by consolidation;[242] and (4) the objecting creditor would be prejudiced by substantive consolidation or by an objecting creditor who has made a showing that consolidation benefits heavily outweigh the

disregarding the legal requirements of the subsidiary as a separate organization." (citing Pension Benefit Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1093 (1st Cir. 1983)).

237. *In re* Cyberco Holdings, Inc., 431 B.R. 404, 430 (Bankr. W.D. Mich. 2010) (noting that the "[c]ourt must be convinced that a harm or prejudice to creditors will occur in the absence of substantive consolidation by weighing the equities favoring consolidation against the equities favoring the debtor remaining separate from the entities and the individual" (quoting White v. Creditors Serv. Corp. (*In re* Creditors Serv. Corp.), 195 B.R. 680, 690 (Bankr. S.D. Ohio 1996))).

238. *See* Nickless v. Avnet, Inc. (*In re* Century Elecs. Mfg.), 310 B.R. 485, 489 (Bankr. D. Mass. 2004).

239. Woburn Assocs. v. Kahn (*In re* Hemingway Transp., Inc.), 954 F.2d 1, 12 (1st Cir. 1992) ("Since consolidation can cause disproportionate prejudice among claimants required to share the debtors' pooled assets, the party requesting substantive consolidation must satisfy the bankruptcy court that, on balance, consolidation will foster a net benefit among all holders of unsecured claims." (emphasis omitted) (footnote omitted)).

240. *Eastgroup Props*., 935 F.2d at 249 ("The D.C. Circuit has elaborated a standard, which we adopt today, by which to determine whether to grant a motion for substantive consolidation.").

241. *Id.* (citations omitted).

242. Drabkin v. Midland-Ross Corp. (*In re* Auto-Train Corp.), 810 F.2d 270, 276 (D.C. Cir. 1987) ("[A] creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation.").

harm.[243] This balancing test has been adopted explicitly[244] or implicitly[245] by several courts.

3. The Alter Ego Test

An originating corporation and an SPV may also be substantively consolidated under the alter ego theory. A corporation is "an entity separate and distinct from its owners or shareholders."[246] However, to protect the public and in the interest of fairness and equity, the existence of a corporate form should be ignored when the corporation merely acts as its owner's alter ego.[247] When a corporation exists solely to serve as its owner's alter ego, the courts will disregard the entity and deal with the substance of the transaction as if the corporation never existed.[248]

The grounds for disregarding the corporate form under the alter ego test are similar to those under the substantive elements tests, and are determined by state law.[249] While the courts do not have a determinative, unilaterally applied criterion, a combination of some or all of the following ten factors are generally used to determine if the corporation is a mere alter ego of its shareholders and owners: (1) "the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, *i.e.*, issuance of stock, election of directors, keeping of corporate records and the like"; (2) "inadequate capitalization"; (3) "whether funds are put in and taken out of the corporation for personal rather than corporate purposes"; (4) "overlap in ownership, officers,

243. *Eastgroup Props*., 935 F.2d at 249 (noting "that [the] objecting creditor 'has looked solely to the credit of its debtor' and 'is certain to suffer more than minimal harm as a result of consolidation' constitutes a defense to substantive consolidation" (footnote omitted) (quoting *In re* Snider Bros., Inc., 18 B.R. 230, 238 (D. Mass. 1982))).

244. *See In re* The Leslie Fay Cos., 207 B.R. 764, 780 (Bankr. S.D.N.Y. 1997); *In re* Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988); *In re Auto-Train Corp.*, 810 F.2d at 276; *In re* Baker & Getty Fin. Servs., Inc., 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987); Holywell Corp. v. Bank of N.Y., 59 B.R. 340, 347 (S.D. Fla. 1986), *appeal dismissed*, Miami Ctr. Ltd. P'ship v. Bank of N.Y., 838 F.2d 1547 (11th Cir. 1988); *In re* DRW Prop. Co. 82, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); *In re* Donut Queen, Ltd., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984); *In re* F.A. Potts & Co., 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982); *In re* Lewellyn, 26 B.R. 246, 251 (Bankr. S.D. Iowa 1982).

245. *See In re* Silver Falls Petroleum Corp., 55 B.R. 495, 498 (Bankr. S.D. Ohio 1985) (considering "[w]hether the benefits of consolidation outweigh the harm to creditors . . . ."). *See also In re* J.L. Helms, 48 B.R. 714, 717 (Bankr. D. Conn. 1985) (finding that balancing interests is another important factor in determining if substantive consolidation is appropriate); *In re* N.S. Garrott & Sons, 48 B.R. 13, 18 (Bankr. E.D. Ark. 1984) (adopting *Snider Bros.* principles as important factors); *In re* Luth, 28 B.R. 564, 567 (Bankr. D. Idaho 1983) (citing the test from *Snider Bros.* as another "element").

246. Flynn v. Greg Anthony Constr. Co., 95 F. App'x 726, 733 (6th Cir. 2003) (citing Quinn v. Butz, 510 F.2d 743, 757 (D.C. Cir. 1975)).

247. *See id.* at 733-34 (quoting *Quinn*, 510 F.2d at 758).

248. *Id*. at 733.

249. *Id.* at 734.

directors, and personnel"; (5) "common office space, address and telephone numbers of corporate entities"; (6) "the amount of business discretion displayed by the allegedly dominated corporation"; (7) "whether the related corporations deal with the dominated corporation at arms length"; (8) "whether the corporations are treated as independent profit centers"; (9) "the payment or guarantee of debts of the dominated corporation by other corporations in the group"; and (10) "whether the corporation in question had property that was used by other of the corporations as if it were its own."[250] Courts have used the alter ego analysis in combination with other factors such as fraud and commingling of assets and liabilities to justify and order substantive consolidation.[251]

C. In re Pacific Lumber Co.

In *In re Pacific Lumber Co.*,[252] the Fifth Circuit U.S. Court of Appeals addressed the possibility of substantive consolidation of special purpose vehicles into parents for purposes of paying debts of the bankrupt parent corporation.[253] The bankruptcy involved six affiliated entities (the "Debtors") whose main businesses were growing, harvesting, and processing redwood timber (collectively, the "Timberlands").[254] The bankruptcy court procedurally consolidated and jointly administered the Debtors' cases.[255] The appeal brought by The

250. Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 139 (2d Cir. 1991). *See also* IBP, Inc. v. Yeager & Sullivan, Inc., No. 3:01-CV-362 PS, 2004 U.S. Dist. LEXIS 20961, at *19-20 (N.D. Ind. Oct. 12, 2004) ("In deciding whether the plaintiff has met its burden of proof, the Indiana Supreme Court requires consideration of eight factors: (1) undercapitalization; (2) absence of corporate records; (3) fraudulent representation by corporation shareholders or directors; (4) use of the corporation to promote fraud, injustice or illegal activities; (5) payment by the corporation of individual obligations; (6) commingling of assets and affairs; (7) failure to observe required corporate formalities; or (8) other shareholder acts or conduct ignoring, controlling, or manipulating the corporate form.").

251. *See* Lumax Indus., Inc. v. Aultman, 669 A.2d 893, 895 (Pa. 1995). *See also* Cashman Scrap & Salvage LLC v. Bois D'Arc Energy, Inc., 413 F. App'x 758, 763 (5th Cir. Feb. 22, 2011) (noting that "courts have held that 'fraud or deceit' can justify piercing the corporate veil in an alter-ego case" (emphasis omitted)); Dusharm v. Elegant Custom Homes, Inc., 302 F. App'x. 571, 572 (9th Cir. 2008); Offenbacher v. Ahart, No. 07-CV-326-BR, 2009 WL 523097, at *7 (D. Or. Feb. 25, 2009) ("Commingling of assets constitutes improper conduct for purposes of piercing the corporate veil.").

252. Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229 (5th Cir. 2009).

253. *Id.* at 249-50.

254. *Id.* at 236. (The Debtors were "involved in the growing, harvesting, and processing of redwood timber in Humboldt County, California [and] filed separate Chapter 11 bankruptcy petitions on January 18, 2007, in the Southern District of Texas (a venue [that is] not known for its redwood forests).").

255. *Id.*

Bank of New York ("Indenture Trustee")[256] only concerned the reorganization of principal debtors Pacific Lumber ("Palco") and Scotia Pacific ("Scopac").[257] Palco owned and operated a sawmill and a power plant.[258] Marathon Structured Finance ("Marathon"), one of Palco's creditors, held a secured claim against Palco's assets.[259]

Scopac was a Delaware SPV, which was wholly owned by Palco.[260] Although Palco and Scopac maintained separate corporate structures, they were an "integrated company."[261] One of Scopac's three directors sat on Palco's board of directors, and both companies had the same chief operating officer, chief financial officer, and general counsel.[262]

In 1998, Palco transferred ownership of more than 200,000 acres of the Timberlands to Scopac, which facilitated the sale of $867.2 million in notes secured by prime redwoods and other Scopac assets.[263] Palco retained the sole right to harvest Scopac's timber, which Palco then processed and sold to various buyers.[264] Scopac was to repay its noteholders with Palco's proceeds from the sales of timber.[265] At the time of Palco's bankruptcy filing, Scopac owed noteholders approximately $740 million in principal and interests.[266]

Two plans for reorganization were ultimately proposed to the bankruptcy court.[267] At the plan confirmation stage of the bankruptcy case, the court held that the plan proposed by Marathon and Mendocino

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256. *Id.* Bank of New York represented the noteholders in the bankruptcy cases, although some of the noteholders retained separate legal counsel and were named appellants. *Id.* at 236-37.

257. *Id.* at 236. The court noted that:

> The other four debtors were Britt Lumber Company, Inc., a manufacturer of fencing and decking products; Scotia Inn, Inc., operator of the inn in Scotia, California; Salmon Creek, LLC, a holding company owning roughly 1,300 acres of timberland; and Scotia Development Corp., LLC, a development corporation for exploring and facilitating development opportunities with respect to commercial, industrial, and residential properties in California and Texas. These four entities and Scopac are all wholly owned by Palco.

Id. at 236 n.2.

258. *Id.* at 236.

259. *Id.* Marathon's secured claim was about $160 million including pre and post-petition financing. *Id.* Marathon estimated that Palco's assets were worth only $110 million at the time of the bankruptcy filing. *Id.*

260. *Id.*

261. *Id.* at 237.

262. *Id.*

263. *Id.* at 236.

264. *Id.* at 237.

265. *Id.*

266. *Id.* ("Scopac also owed $36.2 million to Bank of America on a secured line of credit with a right to payment ahead of the Noteholders.").

267. *Id.* One plan was proposed by Indenture Trustee and the other by Marathon and MRC, a competitor of Palco. *Id.*

Redwood Company ("MRC") was confirmable, while rejecting Indenture Trustee's plan.[268] The court held that Indenture Trustee's plan only covered the Scopac assets and was a plan of liquidation rather than reorganization, while the plan proposed by Marathon and MRC ("MRC/Marathon plan") sought to reorganize all of the Debtors.[269] The MRC/Marathon plan proposed dissolution of all six entities, cancellation of inter-company debts, and creation of two new entities, Townco and Newco.[270] The newly formed Townco would have almost all of Palco's assets, while Newco would possess the Timberlands and the sawmill assets.[271] The MRC/Marathon plan also proposed to contribute $580 million to Newco to pay claims against Scopac.[272] Marathon offered to convert its secured claim of $160 million into equity for full ownership in Townco and fifteen percent ownership in Newco, and a new note for the amount of the sawmill's working capital.[273] MRC proposed eighty-five percent ownership of Newco along with its right to manage and run the company.[274] These proposals were accepted by the bankruptcy court and the reorganization plan was confirmed.[275]

The Indenture Trustee and certain noteholders appealed the bankruptcy court's decision confirming the Chapter 11 reorganization plan.[276] On appeal, the Indenture Trustee challenged three elements of

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268. *Id.*

269. *Id.* at 237 & n.3 ("The [Indenture Trustee's] plan provided for a six-month period to market and sell Scopac's assets. As evidence of the plan's feasibility, the Indenture Trustee solicited a 'stalking horse' bid for $603 million, but the bankruptcy court found that the bid's term sheet contained numerous contingencies. Further, even the Indenture Trustee did not accept the term sheet, which, the court found, suggested the bid's unreliability. The court also found no evidence that the bidder, were it to win, was capable of operating the Timberlands or complying with a multitude of environmental regulations."). The Indenture Trustee did not appeal the bankruptcy court's rejection of its plan. *Id.* at 237.

270. *Id.*

271. *Id.*

272. *Id.*

273. *Id.*

274. *Id.*

275. *Id*. at 238 ("The plan created 12 classes, seven of which were eligible to vote, and four of which contained claims against Scopac. Class 5 proposed to pay Bank of America, the sole class member, $37.6 million, consisting of the principal ($36.2 million), accrued post-petition interest, unpaid fees, and approximately $1 million in default interest paid over 12 months, thus impairing the class. Class 6 proposed to pay the Noteholders' secured claim the value of their collateral and a lien on proceeds from pending unrelated litigation against the state of California, which the parties refer to as the Headwaters Litigation. Class 8 proposed to pay unsecured claims against Scopac by former employees and trade vendors not previously deemed 'critical,' but these amounts were exposed to ongoing litigation regarding assumption and rejection of executory contracts, thus impairing the class. Class 9 was tailored to pay Scopac's remaining general unsecured claims, consisting of the Noteholders' deficiency claim for over $200 million with a recovery estimated as 'unknown.'" (footnotes omitted)).

276. *Id.* at 236. It should be noted that the debtor, Scopac, was initially joined in the appeal, but

the reorganization plan: treatment of its security interests, the plan's confirmation procedures, and specific plan terms.[277] In relation to SPV treatment in bankruptcy proceedings, Indenture Trustee argued that the MRC/Marathon plan created a substantive consolidation of Scopac and Palco.[278]

In its ruling, the Fifth Circuit Court of Appeals stated that substantive consolidation "is of special concern" in cases involving [SPVs] such as Scopac because of their intended bankruptcy-remote structure.[279] The court held that Indenture Trustee failed to prove that substantive consolidation occurred, because Indenture Trustee's allegations that unsecured Palco claims were paid with Scopac assets subject to its lien were insubstantial to constitute substantive consolidation.[280] Other evidence of substantive consolidation based on the erroneous contention that the plan commingled inter-company administrative claims also failed to persuade the court.[281]

In its opinion, the court noted that the SPV structure is designed to decrease the likelihood that the originator's insolvency will affect the SPV's assets, which serve as collateral for issued notes.[282] However, the court left open the possibility that a court may substantively consolidate an SPV and the originating entity, using the value of the investors' collateral to satisfy the originator's debts.[283] In the court's opinion, such substantive consolidation of the SPV with its originator will have a negative effect on investors' confidence in the practice of securitization.[284]

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was dissolved as part of the reorganization plan and moved to be dismissed. *Id.* at 236 n.1.

277. *Id.* at 239. The bankruptcy court found that the MRC/Marathon plan did not effect a substantive consolidation. *Id.* at 249.

278. *Id.* at 239 ("The issues raised are that the confirmed MRC/Marathon reorganization plan: (1) violates the absolute priority rule by paying junior Palco and Scopac creditors with the Noteholders' collateral; (2) is not 'fair and equitable' because the plan sold the Timberlands collateral without providing the Noteholders a right to credit bid; (3) values the Noteholders' collateral too low and by an improper judicial process; (4) creates an illegal substantive consolidation of Scopac and Palco; (5) fails to pay inter-company administrative priority claims in cash; (6) artificially impaired the claim owed to Bank of America and illegally gerrymandered the voting classes of unsecured claims in Classes 8 and 9; (7) discriminates unfairly in its treatment of the Noteholders' Class 9 deficiency claim; and (8) includes unauthorized third-party release and exculpation provisions.").

279. *Id.* at 249 n.25.

280. *Id*. at 249-50.

281. *Id*. at 250.

282. *Id.* at 249 n.25.

283. *Id.* ("Nevertheless, there is a danger that a court will substantively consolidate the two entities, using the value of the investors' collateral to satisfy the originator's debts.").

284. *See id.* ("If courts are not wary about substantive consolidation of special purpose entities, investors will grow less confident in the value of the collateral securing their loans; the practice of securitization, a powerful engine for generating capital, will become less useful; and the cost of

The effect of substantive consolidation can be significant for investors, debtors, and other parties involved, as is evident in *In re Pacific Lumber Co*.[285] The investment in a separate bankruptcy-remote SPV can be undone by the courts, resulting in a common pool of assets and liabilities of an insolvent originator.[286] In such a case, there is a clear risk of a complete loss of the invested capital.[287] Substantive consolidation may eliminate inter-company claims, combine entities for purposes of reorganization, combine assets and liabilities on the common balance sheet, and eliminate duplicative claims of joint and several liability and guarantees.[288] Once entities are consolidated, it is almost impossible to untangle them.[289] As a result, debtors and investors may end up in a costly fight with the consolidated originator and/or SPV and each other in order to receive the return of their loaned or invested funds.[290]

D. In re General Growth Properties, Inc.

The General Growth Properties, Inc. ("GGP") was a publicly traded real estate investment trust ("REIT") and a parent company of approximately 750 wholly owned Debtor and non-Debtor subsidiaries, joint venture subsidiaries, and affiliates (the "GGP Group").[291] The GGP Group's properties were managed from its Chicago, Illinois headquarters, and it directly employed about 3700 people, exclusive of those employed at the various property locations.[292] The GGP Group's primary business was shopping center ownership and management, and

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capital will increase.").

285. *See id.* at 249.

286. *See id.*

287. *Id.* at 249 n.25.

288. Klee & Butler, *supra* note 43, at 62. *See also* Eastgroup Props. v. S. Motel Ass'n, Ltd., 935 F.2d 245, 248 (11th Cir. 1991); *In re* Cooper, 147 B.R. 678, 682 (Bankr. D.N.J. 1992); *In re* Augie/Restivo Baking Co., 84 B.R. 315, 320 (Bankr. E.D.N.Y. 1988), *rev'd sub nom*, Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking, Co.), 860 F.2d 515 (2d Cir. 1988).

289. Neil Cummings & Martin Zohn, *Debtors Face Rising Costs if* Owens Corning *Upheld*, INT'L FIN. L. REV., Mar. 2005, at 40, 40.

290. *See id.*

291. *In re* Gen. Growth Props., Inc., 409 B.R. 43, 47 (Bankr. S.D.N.Y. 2009). The court called GGP Group's structure "extraordinarily complex." *Id.* at 48. GGP was a general partner and ninety-six percent owner of GGP Limited Partnership ("GGP LP"), the company through which the GGP Group's business was primarily conducted. *Id.* at 48 & n.9. The other four percent was owned by outside parties. *Id.* at 48 n.9. The GGP LP controlled directly or indirectly three other entities: GGPLP, L.L.C., The Rouse Company LP ("TRCLP"), and General Growth Management, Inc. ("GGMI"). *Id.* at 48. GGP LP, GGLP, L.L.C., and TRCLP were each debtors, while GGMI was a non-debtor affiliate that provides management services to the GGP Group, the joint ventures, and other unrelated third parties. *Id.* at 48 n.10.

292. *Id.* at 47-48.

it owned and managed over 200 shopping centers in forty-four states.[293] GGP Group operated as a unified entity with an integrated approach to developing, operating, and managing a nationwide platform of retail properties.[294] At the time of its bankruptcy filing on April 16, 2009, GGP was the second-largest shopping mall operator and largest REIT in the United States.[295] The GGP Group reported consolidated revenue of $3.4 billion, $29.6 billion in assets, and $27.3 billion in liabilities as of December 31, 2008.[296]

A total of 388 entities in the GGP Group filed for Chapter 11 protection in 2009.[297] In this largest-ever real estate bankruptcy case, more than 160 of GGP's bankruptcy-remote SPVs were involved in the bankruptcy filing.[298] SPVs held most of GGP's real estate properties and directly guaranteed the loans.[299] GGP created an SPV to protect each of its real estate assets, the resulting cash flows, and the lenders' interests in the assets and cash flows from their own and every other subsidiary's credit risk.[300]

In the past, the GGP Group satisfied its capital needs through mortgage loans obtained from banks and insurance companies, and then increasingly through commercial mortgage backed securities ("CMBS")

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293. *Id.* at 47 ("These include joint venture interests in approximately 50 properties, along with non-controlling interests in several international joint ventures. The GGP Group also owns several commercial office buildings and five master-planned communities, although these businesses account for a smaller share of its operations." (footnote omitted)).

294. *Id.* at 48 & n.11 ("Accounting, business development, construction, contracting, design, finance, forecasting, human resources and employee benefits, insurance and risk management, property services, marketing, leasing, legal, tax, treasury, cash management and other services are provided or administered centrally for all properties under the GGP Group's ownership and management.").

295. Brian M. Resnick & Steven C. Krause, *Not So Bankruptcy-Remote SPEs and* In re General Growth Properties Inc., AM. BANKR. INST. J., Oct. 2009, *available at* http://www.davispolk.com/files/uploads/Insolvency/NotSoBankruptcy-RemoteSPEs_InReGeneralGrowthPropertiesInc.pdf.

296. *In re Gen. Growth Props., Inc.*, 409 B.R. at 48. GGP Group's liabilities included its share of indebtedness of its joint ventures. *Id.* at 48 n.12. The court noted that:

> [A]pproximately $24.85 billion of its liabilities accounted for the aggregate consolidated outstanding indebtedness of the GGP Group. Of this, approximately $18.27 billion constituted debt of the project-level Debtors secured by the respective properties, $1.83 billion of which was secured by the properties of the Subject Debtors. The remaining $6.58 billion [is] of unsecured debt . . . .

Id. at 48 (footnote omitted). "The total debt of the ING Clarion and Helios Debtors was $1,264,938,617. . . . The total debt of the Metlife Debtors was $568,090,030." *Id.* at 48 n.13.

297. *Id.* at 47 n.6.

298. Resnick & Krause, *supra* note 295.

299. *In re Gen. Growth Props., Inc.*, 409 B.R. at 49-50 ("Although each of the mortgage loans was typically secured by a separate property owned by an individual debtor, many of the loans were guaranteed by other GGP entities.").

300. *See id.* at 49.

market transactions.[301] These loans were secured by "shopping center properties and structured with three to seven-year maturities, low amortization rates and balloon payments due at maturity."[302] GGP's business model was built on the premise that the company would be able to refinance its debts before maturity.[303]

The GGP Group's secured debt consisted primarily of conventional mortgage debt[304] that was secured on over 100 properties separately owned by SPVs, CMBS,[305] and mezzanine debt.[306] The GGP Group also

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301. *Id.* at 50, 53.

302. *Id*. at 53.

303. *Id*.

304. *Id.* at 49. MetLife held the conventional mortgage debts of three mortgages. *Id.* Each mortgage was "an obligation of a separate GGP subsidiary." *Id.* Some of the subject debtors that issued MetLife mortgages were intended to function as SPVs. *Id.* "Although each of the mortgage loans was typically secured by a separate property owned by an individual debtor," GGP guaranteed many of the loans. *Id.* at 50. The GGP Group members' typical mortgage loan had a three to seven-year term, which included "low amortization and a large balloon payment at the end." *Id.* However, some of the GGP Group members' mortgage loans had a significantly longer nominal maturity date. *Id.* As a trade-off, these loans "had an anticipated repayment date ("ARD"), at which point the loan became 'hyper-amortized,' even if the maturity date itself was as much as thirty years in the future." *Id*. A failure to repay or refinance the loan at the ARD caused "a steep increase in interest rate[s], a requirement that cash be kept at the project-level, with excess cash flow being applied to principal, and a requirement that certain expenditures be submitted to the lender for its approval." *Id.* (footnote omitted).

305. *Id.* at 48. GGP Group's mortgage loans were also financed in the CMBS markets. *Id.* at 50. "In a typical CMBS transaction, multiple mortgages are sold to a trust qualified as a real estate mortgage conduit ("REMIC") for tax purposes. The REMIC in turn sells certificates entitling the holders to payments from principal and interest on this large pool of mortgages." *Id.* at 51. The CMBS securities holders have different rights to the income stream and bear different interest rates; they may or may not have different control rights. *See id. See also* Ronald Greenspan & William Nolan, *Description of the Mortgage and Asset-Backed Securities Markets, Roles of Principal Participants and Key Terms*, *in* MORTGAGE AND ASSET BACKED SECURITIES LITIGATION HANDBOOK § 1:6 (2008). The court in *In re General Growth Properties* described the REMIC transfer process as follows:

> The REMIC is managed by a master servicer that handles day-to-day loan administration functions and services the loans when they are not in default. A special servicer takes over management of the REMIC upon a transfer of authority. Such transfers take place under certain limited circumstances, including: (i) a borrower's failure to make a scheduled principal and interest payment, unless cured within 60 days, (ii) a borrower's bankruptcy or insolvency, (iii) a borrower's failure to make a balloon payment upon maturity, or (iv) a determination by the master servicer that a material and adverse default under the loan is imminent and unlikely to be cured within 60 days. While a master servicer is able to grant routine waivers and consents, it cannot agree to an alteration of the material terms of a loan or mortgage. A special servicer has the ability to agree to modify the loan once authority has been transferred, but often only with the consent of the holders of the CMBS securities, or in some cases the holders of certain levels of the debt.

In re Gen. Growth Props., Inc., 409 B.R. at 51 (footnote omitted).

306. *In re Gen. Growth Props.*, 409 B.R. at 51. In this case, the debtors were obligors on the mezzanine loans from at least four lenders, including MetLife. *Id.* In mezzanine loan transactions, including the MetLife mezzanine loan:

had unsecured debt, which mostly consisted of trade debt and other financial obligations owned by one of its holding companies.[307] GGP's other debt included five interest-rate swap agreements,[308] outstanding letters of credit, surety bonds,[309] and promissory notes.[310]

During the latter half of 2008, the crisis in the credit markets spread to CMBS markets, which affected the GGP Group's ability to refinance its maturing debt on commercially acceptable terms.[311] The constriction in the credit markets and CMBS markets created insurmountable liquidity problems for GGP.[312] The liquidity crisis was significant for GGP Group, because its pre-bankruptcy CMBS debt was nearly $15 billion out of its $27.3 billion, making it the largest CMBS borrower.[313] This was a critical development as GGP relied on access to capital markets, which became extremely difficult in 2008 due to the economic recession in the United States.[314]

The GGP Group executives made numerous unsuccessful attempts to refinance by contacting dozens of banks, insurance companies, pension funds, regional brokers, and investment banking firms like

> [T]he lender is the holder of a mortgage on the property held by one of the Subject Debtors. The lender makes a further loan, ordinarily at a higher interest rate, to a [SPE] formed to hold the equity interest in the mortgage-level borrower. The loan to the [SPE] is secured only by the stock or other equity interest of the mortgage level borrower. The [SPE] typically has no other debt and its business is limited to its equity interest in the property-owning subsidiary.

Id.

307. *Id.* Members of GGP Group were obligated to pay approximately $6.58 billion of unsecured debt on the bankruptcy petition date. *Id.*

308. *Id.* at 52 ("The GGP Group had entered into five interest-rate swap agreements as of December 31, 2008. The total national amount of the agreements was $1.08 billion, with an average fixed pay rate of 3.38% and an average variable receive rate of LIBOR. The Company made April 2009 payments to only one of the counterparties, and two of the swaps have been terminated.").

309. *Id.* ("[A]s of December 31, 2008, the Company also had outstanding letters of credit and surety bonds in the amount of $286.2 million.").

310. *Id.* at 52-53 ("GGP LP is the promissor on a note in the principal amount of $245 million, payable to the Comptroller of the State of New York, as trustee for the New York State Common Retirement Fund . . . . Additionally GGP LP is the promissor on a note in the amount of $93,712,500, . . . payable to Ivanhoe Capital, LP, and secured by a pledge of GGP LP's shares in the GGP Ivanhoe, Inc. joint venture.").

311. *Id.* at 53.

312. *Id.* at 53-54. ("As additional mortgage loans began to mature, [GGP's] liquidity problems grew worse. For example, two large loans from Deutsche Bank matured on November 28, 2008. In return for brief extensions of the maturity date, Deutsche Bank required the Debtors to increase the rate of interest 3.75%, from LIBOR plus 225 basis points to LIBOR plus 600 basis points, 75 basis points over the prior default interest rate. Additionally, Deutsche Bank required excess cash flow from the properties to be escrowed in a lockbox account and applied entirely to the relevant properties, with surplus used to amortize the principal on the relevant loan.").

313. Resnick & Krause, *supra* note 295.

314. *See id.*

Goldman Sachs and Morgan Stanley.[315] The GGP Group attempted to find refinancing for its unsecured debt, but its efforts to raise debt or equity capital were unsuccessful.[316] GGP hired an investment bank that specialized in debt restructuring to renegotiate the debt, but lenders were unwilling to consent to additional forbearances, which caused defaults and cross-defaults.[317] GGP's attempts to sell assets to generate cash to pay down its debts also failed because potential purchasers were unable to acquire financing.[318]

Despite the financial crisis, the GGP Group's shopping centers had steady cash flows.[319] However, the GGP Group faced approximately $18.4 billion in outstanding debt that had matured or would mature by 2012.[320] Based on the state of the financial and credit markets and facing defaults on several loans, the GGP Group believed that its capital structure had become unmanageable and began to contemplate Chapter 11 filing.[321] However, at the time of the Chapter 11 petition filing, most of debtor's CMBS loans, including most owed by the SPVs, were not in default, were not experiencing financial distress, were adequately collateralized, and some had excess cash flows.[322] Some loans were due or hyper-amortizing as of the petition date, and others had due dates of 2011, 2012, and later.[323]

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315. *In re Gen. Growth Props., Inc.*, 409 B.R. at 53. GGP Group finally obtained refinancing through Teachers Insurance. *Id.* at 50. "The borrowers under the Teachers Loans [were] all non-Debtor entities, and the maturity dates range[d] from five to seven years, with an option for the lender to extend maturity for an additional three years. The Teachers Loans were not in default as of the Petition Date." *Id.* at 50 n.17.

316. *Id.* at 53.

317. *Id.*

318. *Id.*

319. *Id.* at 55 & n.23. ("The Company's [Net Operating Income ("NOI")] for its operations involving the operating, development and management of its shopping centers, office buildings and commercial properties totaled $2.59 billion in 2008, which was a 4.5% increase over the year before.").

320. *Id.* at 55.

321. *Id.* at 54.

322. *Id*. at 57-58; Resnick & Krause, *supra* note 295.

323. *In re Gen. Growth Props., Inc.*, 409 B.R. at 55, 57-58 ("[I]ndividual debtors that are the subject of these Motions were in varying degrees of financial distress in April 2009. Loans to four of the Subject Debtors had cross-defaulted to the defaults of affiliates or would have been in default as a result of other bankruptcy petitions. Of the loans to the remaining sixteen Subject Debtors, one had gone into hyper-amortization in 2008. Interest had increased by 4.26%. Five of the Subject Debtors had mortgage debt maturing or hyper-amortizing in 2010, two in 2011, and one in 2012. The remaining seven Subject Debtors were either guarantors on maturing loans of other entities or their property was collateral for a loan that was maturing, or there existed other considerations that in the Debtors' view placed the loan in distress, such as a high loan-to-value ratio." (footnote omitted)).

On Chapter 11 petition date, GGP requested to use cash collateral and sought approval of debtor-in-possession ("DIP") financing.[324] Project-level lenders objected based on various concerns: (1) that security of their loans would be adversely affected, (2) that such a financing facility arrangement would be a violation of separateness of individual SPVs from originator or parent-level entity,[325] and (3) that the approval of DIP facility would constitute a de facto substantive consolidation of estates.[326] Despite these objections, GGP was able to secure a $400 million DIP facility from various lenders,[327] without providing guarantees by SPVs or a pledge of their assets.[328] Adequate protection was provided for the project-level lenders including "the payment of interest at the non-default rate, continued maintenance of the properties, a replacement lien on the cash being upstreamed from the project-level Debtors and a second priority lien on certain other properties."[329]

In addition, the bankruptcy court considered several motions to dismiss certain Chapter 11 cases filed by one or more debtors ("Subject Debtors") that were owned directly or indirectly by GGP.[330] The motions to dismiss claimed that the premature filings for bankruptcy by Subject Debtors' were in bad faith and that one of GGP's entities was ineligible to petition.[331] The debtors that filed for bankruptcy and the official committee of unsecured creditors objected to the Subject Debtors' motions.[332]

The court in *In re General Growth Properties* held that grounds for dismissal of a bankruptcy petition exist "if it is clear on the filing date that 'there was no reasonable likelihood that the debtor intended to

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324. *Id.* at 55.

325. *Id.*

326. Resnick & Krause, *supra* note 295.

327. *In re* Gen. Growth Props., Inc., 412 B.R. 122, 123 (Bankr. S.D.N.Y. 2009).

328. *In re Gen. Growth Props., Inc.*, 409 B.R. at 55 ("DIP financing was arranged, but the DIP lender did not obtain liens on the properties of the project-level Debtors that could arguably adversely affect the lien interests of the existing mortgage lenders . . . .").

329. *Id.*

330. *Id.* at 46-47 ("One of the Motions was filed by ING Clarion Capital Loan Services LLC ('ING Clarion'), as special servicer to certain secured lenders; one of the Motions was filed by Helios AMC, LLC ('Helios'), as special servicer to other secured lenders; and three of the Motions were filed by Metropolitan Life Insurance Company and KBC Bank N.V. (together, 'Metlife', and together with ING Clarion and Helios, the 'Movants'). Each of the Movants [was] a secured lender with a loan to one of the Subject Debtors." (footnotes omitted)).

331. *Id.* at 47. Movants also contended that "Debtors had a good faith obligation to delay Chapter 11 filing until they were temporally closer to an actual default." *Id.* at 59. "Movants [did] not contend that the parent companies acted in bad faith in filing their own Chapter 11 petitions." *Id.* at 62.

332. *Id*. at 46-47.

reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings.'"[333] The court noted that the petition must be dismissed if two conditions exist: "'objective futility of the reorganization process *and* subjective bad faith in filing the petition . . . .'"[334] The totality of the circumstances determines whether good faith for filing a bankruptcy petition exists.[335]

The court also held that under the Bankruptcy Code, the debtor is not required to be insolvent before filing for bankruptcy,[336] and that there is no prerequisite in the law that requires a specific level of financial distress before a bankruptcy petition may be filed.[337] Thus, many courts have denied motions to dismiss, despite the fact that the subject debtors were able to meet current expenses.[338]

ING Clarion Capital Loan Services LLC, Helios AMC, LLC, Metropolitan Life Insurance Company, and KBC Bank N.V. (collectively, the "Movants") presented several arguments before the bankruptcy court. First, they argued that the bankruptcy-remote structure of the project-level SPV debtors required that financial distress of each SPV be analyzed exclusively from the SPV's perspective.[339] The Movants argued that the court "should consider only the financial circumstances of the individual [SPV], and that consideration of the financial problems of the [GGP] Group in judging the good faith of an individual filing would violate the purpose of the [SPV] structure."[340]

The bankruptcy court rejected the Movants' argument and concluded that in deciding to file for Chapter 11 bankruptcy each SPV was justified in considering its independent need for restructuring as

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

334. *Id.* (quoting *In re* Kingston Square Assocs., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997)). *See also In re* RCM Global Long Term Capital Appreciation Fund, Ltd., 200 B.R. 514, 520 (Bankr. S.D.N.Y. 1996). "Case law recognizes that a bankruptcy petition should be dismissed for lack of good faith only sparingly and with great caution." *In re Gen. Growth Props., Inc.*, 409 B.R. at 56 (citing Carolin Corp. v. Miller, 886 F.2d 693, 700 (4th Cir. 1989); *In re* G.S. Distrib., Inc., 331 B.R. 552, 566 (Bankr. S.D.N.Y. 2005)).

335. *Id.* (quoting *In re Kingston Square Assocs.*, 214 B.R. at 725).

336. *Id.* at 61 (citing *In re* The Bible Speaks, 65 B.R. 415, 424 (Bankr. D. Mass. 1986)).

337. *Id.* (quoting United States v. Huebner, 48 F.3d 376, 379 (9th Cir. 1994)).

338. *Id.* (citing *In re* Century/ML Cable Venture, 294 B.R. 9, 35-36 (Bankr. S.D.N.Y. 2003); *In re* Cent. Jersey Airport Servs., 282 B.R. 176, 181 (Bankr. D.N.J. 2002); *In re* Chris-Marine U.S.A., Inc., 262 B.R. 118, 125 (Bankr. M.D. Fla. 2001)). In *In re Century/ML Cable Venture*, the debtor was able to meet its current expenses but had a substantial financial liability that could not be met from its current cash flow or without substantial asset liquidation. 294 B.R. at 35-36. The bankruptcy court denied a motion to dismiss based on those facts. *Id.* at 35.

339. *In re Gen. Growth Props., Inc.*, 409 B.R. at 61.

340. *Id.*

well as the financial distress of GGP as a whole.[341] The bankruptcy court reasoned that the Movants should have been aware that given the large and integrated corporate structure of GGP, the financial situation of the originator-parent company would impact its subsidiaries, which included SPVs.[342]

The bankruptcy court also considered the actions of the SPVs' independent managers. The operating agreements stated that the independent managers should consider the interests of GGP, including its respective creditors.[343] These interests were to be expressed through the unanimous written consent of independent managers when voting, and compliance with General Corporation Law of the State of Delaware that extends directors and managers' duties to the corporation and its shareholders.[344] When considered in light of GGP's financial condition, the SPVs' filings were not premature.[345] As a result, the bankruptcy court denied Subject Debtors' motions and held that Chapter 11 bankruptcy filings by SPVs were not premature.[346]

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341. *See id.* at 60.

342. *Id.* at 61 ("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.").

343. *Id.* at 63; *In re* Kingston Square Assocs., 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) ("[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors. Nearly all states' law is in accord . . . ."). *See also* Clarkson Co. Ltd. V. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) (noting a fiduciary duty to creditors in New York); Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787-88 (Del. Ch. 1992) (noting a fiduciary duty to creditors in Delaware); Tampa Waterworks Co. v. Wood, 121 So. 789, 791 (Fla. 1929) (noting a fiduciary duty to creditors in Florida); Francis v. United Jersey Bank, 432 A.2d 814, 824 (N.J. 1981) (noting a fiduciary duty to creditors in New Jersey).

344. *In re Gen. Growth Props., Inc.*, 409 B.R. at 63. The court found that Delaware law requires directors of a solvent corporation to consider the interests of the shareholders in exercising their fiduciary duties. *Id.* at 64. The court discussed one case in particular to support this conclusion:

> In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 930 A.2d 92[, 101] (Del. 2007), the Delaware Supreme Court held for the first time that the directors of an insolvent corporation have duties to creditors that may be enforceable in a derivative action on behalf of the corporation. But it rejected the proposition . . . that directors of a Delaware corporation have duties to creditors when operating in the "zone of insolvency," stating "[w]hen 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*."

Id. (alteration in original) (quoting N. Am. Catholic Educ. Programming Found., Inc. v. Gheewala, 930 A.2d 92, 101 (Del. 2007)).

345. *Id.* at 65.

346. *See id.*

The bankruptcy court also analyzed the second element of whether the Chapter 11 petition was filed in subjective good faith.[347] The Movants argued that the SPV acted in subjective bad faith because "(i) they failed to negotiate prior to filing, and (ii) the initial 'Independent Managers' of several of the [SPV]'s were fired and replaced shortly before the Petition Date."[348] In response, the bankruptcy court first stated that nothing in the Bankruptcy Code requires that a borrower negotiate with its lender before filing for Chapter 11 petition and that no evidence was presented to conclude that discussions prior to the filing would have provided an adequate solution to the problem.[349] Second, the bankruptcy court dismissed the arguments that independent directors were fired in bad faith, because relevant organizational documents of the SPVs did not prohibit the dismissals, and the replacements had appropriate experience to determine whether the bankruptcy filing was necessary.[350]

This case is significant because it allowed GGP's SPVs to file for bankruptcy prior to being insolvent.[351] The holding of the bankruptcy court challenges the effectiveness of the SPV structure as a means of ensuring that a subsidiary will be isolated from its originator's bankruptcy filing.[352] Through this ruling, the court challenges the bankruptcy-remote requirements, such as whether independent directors' unanimous vote is necessary in order to petition for bankruptcy.[353] The decision that SPVs' directors must consider shareholders' interests when deciding whether to file for bankruptcy may make it more difficult "to create an [SPV] structure that fully isolates assets from the financial difficulties of corporate parents."[354]

E. Fraudulent Conveyance Attack on SPVs

In addition to litigation risks, securitization is susceptible to being classified as a fraudulent conveyance under federal bankruptcy or state law. A fraudulent transfer law is a tool that can be used to avoid asset securitization transactions.[355]

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347. *Id.* ("The test [prescribed] in *C-TC 9th Ave. P'ship* is a two-fold test, requiring proof of subjective bad faith as well as objective futility." (citing C-TC 9th Ave. P'ship v. Norton Co. (*In re* C-TC 9th Ave. P'ship), 113 F.3d 1304, 1309-10 (2d Cir. 1997))).

348. *Id.* at 66.

349. *Id.*

350. *Id.* at 68.

351. *See id.* at 69. *See also* Jesse Cook-Dubin, *New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11: Part I*, AM. BANKR. INST. J., Nov. 2009, at 28, 28.

352. Cook-Dubin, *supra* note 351 at 28.

353. *See id.*

354. Resnick & Krause, *supra* note 295.

355. *See* Klee & Butler, *supra* note 43, at 66. Klee & Butler note that:

Section 548 of the Bankruptcy Code defines a conveyance as fraudulent if (1) it is voluntarily or involuntarily made "with actual intent to hinder, delay, or defraud" creditors,[356] or if the assets were transferred for less than their reasonably equivalent value,[357] and (2) "as a result of [a] transfer, the Originator is left undercapitalized, or has insufficient assets to pay its debts as they come due, or is insolvent at the time the transfer is made, or becomes insolvent as a result of the transfer."[358] Thus, if the originator files for bankruptcy, a sale of assets from the originator to SPV is a "transfer . . . of an interest of the debtor in property," and is subject to fraudulent transfer scrutiny.[359] Section 544(b) of the Bankruptcy Code also extends the authority to the trustee to avoid any pre-petition transfer that would be invalid under the applicable state law.[360]

> It is the view of some scholars that fraudulent transfer law is not very applicable to asset securitization transactions because market forces will prevent such a transaction from occurring. Market forces, however, will not always prevent a fraudulent transfer from occurring simply because the asset securitization is in the form of a financing transaction. The Originator will always receive cash for the transactions. In addition, credit rating agencies, credit enhancement devices and other market participants might help to ensure that the transaction is for reasonably equivalent value. However, credit ratings focus exclusively on the SPV and its assets, and whether they are sufficient to protect the interests of the SPV's investors. Credit rating agencies do not focus on protecting the interests of the Originator or its creditors. Similarly, credit enhancement devices are designed to provide protection for the investors of the SPV, not the Originator or its creditors.

Id. (footnote omitted). *See also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1588 (2008) ("[I]t is easy to see that the constructive fraud rules pose little threat to the prototypical securitization transaction. The transfer of the securitized assets from the Originator to the SPE reduces the value of the Originator's assets, but that reduction is balanced by a commensurate increase in the value of the Originator's equity interest in the SPE. If the SPE is solvent—which should be a safe assumption if it conducts no other operations and the assets transferred to it are sufficient to garner a high credit rating for the securitized debt that it issues—the net effect of the transfer on the value of the Originator should be nil, or close to it. So constructive fraud has, quite reasonably, gotten short shrift as a threat to the prototypical securitization transaction.").

356. 11 U.S.C. § 548(a)(1)(A) (2006).

357. *Id.* § 548(a)(1)(B)(i).

358. Klee & Butler, *supra* note 43, at 65-66 (citing 11 U.S.C. § 548).

359. 11 U.S.C. § 548(a)(1). S*ee also* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 854 (1985) ("Fraudulent conveyance law should never apply to arms-length transactions, even if it appears after the fact that the debtor's actions injured the creditors."); Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 115 (1997) ("The focus in fraudulent transfer analysis is whether the transaction creates value from the perspective of all of the firm's investors—that is, whether the reason for the transfer is efficiency-based or only distributional.").

360. *See* 11 U.S.C. § 544(b).

IV. THE IMPORTANCE OF LEGAL DECISIONS ON SPVS

The use of an SPV as a bankruptcy-remote entity has provided uneven results because of numerous judicially created exceptions to the treatment of an SPV as a separate legal entity. For instance, *In re LTV Steel Co.* held that the originator could use assets that were sold and belonged to a bankruptcy-remote SPV for its reorganization.[361] In *In re Pacific Lumber Co.*, the court left the possibility that in the future it may substantively consolidate an SPV and the originating entity, and used the value of investor's collateral to satisfy the originator's outstanding debts.[362] Further, the court in *In re General Growth Properties Inc.* stated that SPVs must consider the interests of their originators.[363] Due to GGP's integrated corporate structure where the originator's bankruptcy would affect its subsidiaries, the court allowed solvent SPVs to file for bankruptcy along with their insolvent originator.[364]

Court findings reveal a variety of circumstances when the general principal of an SPV's bankruptcy-remoteness has been ignored to satisfy a judicially created goal, such as saving an originator's workers from unemployment and preventing an originator's bankruptcy from having an adverse impact on the community.[365] Recent case law developments suggest that the practice of securitization and the formation of SPVs should address questions of how, when, and under what circumstances the SPV may be pierced, substantively consolidated, or ignored as a separate legal entity.

The tests for determining whether the originator and the SPV are substantively consolidated, replete with their abundant elements, introduce uncertainty to any securitization transaction.[366] Due to the lack of specific statutory guidance,[367] there is uncertainty about when a bankruptcy court will employ a substantive consolidation test and, if it does, which elements it will consider relevant to its analysis.[368] Courts

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361. *See In re* LTV Steel Co., 274 B.R. 278, 287 (Bankr. N.D. Ohio 2001).

362. *See* Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 249-50, 249 n.25 (5th Cir. 2009).

363. *See In re* Gen. Growth Props., Inc., 409 B.R. 43, 61-65 (Bankr. S.D.N.Y. 2009).

364. *Id.* at 64-65. In addition, the court challenged the certainty of the operating agreement provisions of an SPV, such as the requirement of a unanimous vote of independent directors to file bankruptcy. *Id.* at 63.

365. *See, e.g.*, *In re Pac. Lumber Co.*, 584 F.3d at 249-50; *In re Gen. Growth Props.*, 409 B.R. at 55-56, 60; *In re LTV Steel Co.*, 274 B.R. at 286.

366. *See In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 723, 763-65 (Bankr. S.D.N.Y. 1992) (noting the importance of an evaluation of consolidation factors).

367. *See* E. Kristen Moye, *Non-Consolidation and True Sale/Transfer Opinions In Securitized Real Estate Loan Transactions*, PRAC. REAL EST. LAW., May 2005, at 7, 9-10.

368. *See* Richard D. Jones & Richard A. Bendit, *Practical Advice on the Preparation of the Substantive Non-Consolidation Opinion in Real Estate Transactions*, DECHERT LLP, at 3-5, 15

list thirty-two optional considerations of the element, balancing, and alter ego tests that it may include in the substantive consolidation analysis.[369] This list of possible elements and unlimited discretionary judgment that a bankruptcy court may apply during any substantive consolidation analysis makes the consequences of securitization unpredictable.

V. SPV SOLUTIONS AND BEST PRACTICES

The odds of creating a bankruptcy-remote SPV that can perform the function of securitizing selected assets of a corporation can be increased. A useful approach is to study the successes of other corporations and the judicial decisions of federal and state cases that have been brought by plaintiffs who sought to have a corporation and its SPV consolidated. Three topics deserve scrutiny: the structure of the transaction, external credit enhancements, and the special need for investor due diligence.

A. Structure of the Transaction

An originator, an SPV, and their respective attorneys must structure the transaction to reduce the threat of substantive consolidation. Transaction planning must reflect the current existing case law regarding the substantive consolidation and recurring themes that permit courts to employ their equitable powers to order consolidation between two separate legal entities.[370] Each transaction should be examined for:

- Compliance with SPV formalities.
- Separateness of SPV decision-making.
- Separateness of SPV operations.
- SPV's possession of its assets.
- SPV's management of its liabilities.
- Separateness of SPV's offices.
- Separateness of SPV's financial statements.
- Arms-length nature of SPV's transactions with originator (and affiliates).
- Disclosure of the separateness of the SPV and its assets.
- Separateness of the relationship between the SPV and third-parties (contracting parties, creditors, certificate holders).[371]

(2003), *available at* http://www.dechert.com/library/Practical_Advice_on_the_Preprartion_RJones_6-0.pdf ("[It] is equally uncertain which judicial test or tests will be applied by any given court.").

369. *See supra* Part III.B.

370. *Structured Financing Techniques*, *supra* note 31, at 559-60.

371. *Id.*

Unique facts and circumstances must be considered in the overall context of the transaction and addressed separately.

Documents expressly stating and limiting duties, obligations, and powers of each separate entity will prevent commingling of assets, confusion of responsibilities, and other costly misunderstandings.[372] Separateness and limitation covenants will further address issues regarding what type of assets an entity may have, what kind of indebtedness it may incur,[373] and the type of transactions SPVs may conduct with other entities.[374]

SPVs should have specific rules relating to their governance. An SPV's board of directors[375] and stockholders should hold regular meetings to conduct corporate business, where a quorum is present in person for at least one meeting per year.[376] Securitization agreements should require at least twenty-five percent of the SPV's directors to be independent.[377] SPV's business and operations decisions should be made independently and without influence from the originator or its other entities.[378] Dealings between an SPV and any of its affiliates should be on arms-length terms, and should receive approval from the majority of

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372. *Special Report*, *supra* note 221, at 415 (noting the steps to establish and maintain separateness of an SPV). *See also In re* FiberMark, Inc., No. 04-10463 cab, 2005 Bankr. LEXIS 2472, at *8-9 (Bankr. D. Vt. Dec. 2, 2005) (noting reasons for the court's consolidation of entities).

373. Resnick & Krause, *supra* note 295.

374. JAN JOB DE VRIES ROBBÉ, SECURITIZATION LAW AND PRACTICE IN THE FACE OF THE CREDIT CRUNCH 17 (2008) ("The constituent documents of the SPV will also place strict limits on what business dealings the SPV can engage in, so as to minimize the incurrence of liabilities by the SPV . . . .").

375. *See Structured Financing Techniques*, *supra* note 31, at 593 app. C ("At least one senior officer of the SPV (who may also be a member of the Board of Directors of the SPV) will be, or have the same qualifications as, an independent director.").

376. *See id.* The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York suggests regular meetings of directors should be held at least quarterly. *Id.* The SPV should keep and safeguard complete minutes of the SPV's Board of Directors and stockholder meetings. *Id.*

377. *Id.* The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York suggests that at least one fourth of SPV directors be independent. *Id. See also* STANDARD & POOR'S, STRUCTURED FINANCE: LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 51 (2004), http://www.mbaa.org/files/ResourceCenter/RegAB/RegAB-LegalCriteriaforStructuredFinance(S&P).pdf ("'[I]ndependent director' means a duly appointed member of the board of directors of the relevant entity who should not have been, at the time of such appointment or at any time in the preceding five years, (a) a direct or indirect legal or beneficial owner in such entity or any of its affiliates (excluding *de minimus* ownership interests), (b) a creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or its affiliates, or (c) a person who controls (whether directly, indirectly, or otherwise) such entity or its affiliates or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.").

378. *See* Mark S. Indelicato, *Securitization Provides Means to Protect* Assets, N.Y. L.J., Feb. 19, 2002, at 9 (suggesting that SPVs should preferably have two independent members of its originator).

the board of directors, including each independent director.[379] The SPV should "act solely in its own corporate name and through its own authorized officers and agents."[380] The board of directors, including every independent director, should approve any declaration of SPV's dividends, while the SPV should manage the payment of its own payroll, operating expenses, and other liabilities.[381]

The SPV should be physically and financially separate from its originator, as indicated by separate offices, separate records, and separate financial statements that conform to GAAP and are audited annually.[382] The SPV's debt security holders should receive the audited annual financial statements as well as un-audited quarterly financial reports.[383] Neither the originator nor its other subsidiaries should guarantee an SPV's debts and vice versa.[384] The SPV should not acquire any obligations, securities, or make loans to its originator or originator's affiliates.[385] The SPV must keep its money and assets separate from its originator's money and assets, including keeping separate bank accounts.[386] If the originator or any of its affiliates include the SPV in its consolidated financial statements, "the existence of the SPV and the ownership of its assets [should] be disclosed in a footnote."[387]

The nature of assets retained by the originator and the types that are being sold to the SPV also must be considered. The originator should retain assets needed for operations and some that provide a liquidity-cushion if cash needs to be raised to finance the originator's operations.

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379. *See Structured Financing Techniques*, *supra* note 31, at 593 app. C. Transactions must be "on terms that are not more or less favorable to the SPV than terms and conditions available at the time to the SPV for comparable transactions with unaffiliated persons . . . ." *Id.*

380. *Id.*

381. *Id.* "Investment guidelines and criteria will be established by a majority of the Board of Directors including at least one . . . independent director. Investments will be made by the SPV directly or by brokers engaged and paid by the SPV. Investments will be carried by the SPV in its own name . . . ." *Id.* at 594. "In the event employees of the SPV participate in pension, insurance and other benefit plans of the parent or any affiliates thereof, the SPV will on a current basis reimburse the parent or such affiliate, as the case may be, for the SPV's *pro rata* share of the costs thereof." *Id.* at 593-94.

382. *See In re* Richton Int'l Corp., 12 B.R. 555, 558 (Bankr. S.D.N.Y. 1981) (noting the importance of observing corporate formalities and avoidance of commingling of assets and business functions).

383. *Structured Financing Techniques*, *supra* note 31, at 594 app. C.

384. *Id*.

385. *Id*.

386. *Id*.

387. *Id*.

B. External Credit Enhancement

Efficient credit-enhancement strategies minimize the total cost of raising funds while maximizing the proceeds that an issuer realizes from a transaction.[388] SPV structures that are most attractive for investment include credit enhancements that protect against damage from high-risk events such as substantive consolidation of originator and SPV, premature SPV bankruptcy filing, or allowance to use SPV funds in DIP financing.

Each SPV can implement two forms of credit enhancement: internal and external. The internal credit enhancements can include reserve funds, over-collateralization, and senior/subordinate structures.[389] They improve the rating awarded by the rating agencies and help protect the investor from loss based on their priority in the repayment schedule of the SPV.[390] Thus, for example, if there is a shortfall of cash in any given period, senior bondholders receive their principal and interest prior to the bondholders with junior interest.[391] Since this structure does not fully protect junior bondholders against the risk of loss, they should seek external protection methods. Common forms of external protection include credit enhancements such as letters of credits ("LOCs"), surety bonds, and guarantees.[392] They provide protection to bond classes against default from third-party guarantees, such as insurance,[393] which relies on the credit quality of a third party.[394]

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388. Chris Ames, *Credit Enhancement Alternatives*, CORP. FIN., Oct. 1994, at 12, 12.

389. FABOZZI, *supra* note 26, at 379.

390. *Id.*

391. *Id.* at 359. The cash that remains after all scheduled period payments are made is called excess spread. *Id.* This excess spread is the first line of defense against collateral losses. *Id.* When the excess spread has been depleted, absent third-party external insurance, the next lowest rated class will be to be negatively affected by the loss. *Id. See also* Anand K. Bhattacharya, et al., *The Interaction of MBS Markets and Primary Mortgage Rates*, J. STRUCTURED FIN., Fall 2008, at 16, 19-20 ("Private credit enhancement is most commonly created in the form of subordination, which means that a portion of the deal is subordinate or 'junior' in priority of cash flows, and is the first to absorb non-recoverable losses in order to protect the remaining (or 'senior') bonds. A common technique is to divide the subordinated part of the deal into different bonds, each with different ratings (which typically range from double-A to unrated first-loss pieces) and degrees of exposure to credit losses. For example, the non-rated 'first loss' bond class is the first to absorb losses; if this bond class is exhausted, the losses are then allocated to the bond class that is second-lowest in initial priority and so forth. Subordinate tranches trade at significantly higher yields than the senior bonds to compensate investors for the incremental riskiness and greater likelihood of credit related losses.").

392. *Structured Financing Techniques*, *supra* note 31, at 549.

393. FABOZZI, *supra* note 26, at 379. *See also* MBIA Ins. Corp. v. Spiegel Holdings, Inc., [2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,902 (S.D.N.Y. Aug. 31, 2004) (discussing insurer's standing and right to sue insolvent originator on behalf of noteholders for violations of federal securities law).

394. Ames, *supra* note 388, at 12.

These insurance policies are generally written to cover losses up to a specified amount from an asset pool.[395] The investment can also be insured against substantive consolidation and SPV insolvency. Since the insurer takes the first-loss position if the SPV becomes insolvent, and because the processing of claims can be an arduous task, the insurance entails high costs.[396] However, especially during periods of high volatility in financial markets and associated high levels of corporate bankruptcies, insurance provides an important means of protecting investment in an SPV.

Bond insurance is a financial guarantee from an AAA-rated monoline insurance company such as Capital Markets Assurance Corporation, Financial Guaranty Insurance Company, Assured Guaranty Municipal Corp. (formerly FSA), and MBIA Inc., which guarantees that the insurer will receive timely payments of all principal and interest on its investment.[397] The payments will come from the cash flow of the underlying asset pool or from the insurer.[398] These bond insurers guarantee one hundred percent of the principal and interest payments of a transaction.[399] Bond insurers provide additional diligence through their scrutiny of the issuer's operations and assets, their specialization and familiarity with many asset types, and their adaptability to each customer's reporting requirements.[400]

An LOC is another common form of external credit enhancement. LOCs guarantee that a specified amount of funds will be available to the issuer in case of cash shortfalls from the collateral.[401] SPVs may utilize triggered LOCs if certain events occur. Triggered LOCs are designed to be borrowed against in full, with the borrowed funds deposited into a trust account.[402]

C. Investor Due Diligence

Given the risks of investing in an SPV, originators and their SPVs need to anticipate the concerns of potential investors. First, potential

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395. *Id*. at 13.

396. *Id*.

397. *Id.*

398. FABOZZI, *supra* note 26, at 359. Bond insurance is also referred to as surety bond or a wrap. *Id*. The principal payments are generally made without acceleration, unless insurer agrees or elects to do so. *Id.* The risk of a rating downgrade for a bond provider is small. *See id.*

399. Ames, *supra* note 388, at 13.

400. *Id*.

401. *Id*. at 12.

402. *Id*. The most common trigger is the downgrade of the LOC provider. *Id.* This mandatory drawdown of the LOC converts the LOC to cash, insulating the ABS from the provider's downgrade. *Id.*

investors may be concerned with the nature of the assets controlled by the SPV, and with the SPV's financial, liquidity, and solvency conditions, and those of the originator. The originator should prepare for the fact that when buying an ABS, professional investors will look beyond the rating assigned to it by the rating agency and engage in their own thorough due diligence for each investment.[403]

ABS investors will be principally concerned with the quality of the assets that back the debt rather than the quality of the originator's overall assets.[404] The *In re LTV Steel Co.* opinion demonstrates that investors should be aware of the type of assets the originator sells to the SPV and of the value and liquidity of assets the originator retains for its operations.[405] Therefore, the investor is likely to consider whether the originator liquidated assets to the SPV and only retained illiquid assets that may be hard and unprofitable to liquidate on a short notice. The investor is also likely to consider whether circumstances exist that might prompt the bankruptcy court to use its equitable powers and allow the originator to use SPV's assets to prevent massive layoffs, cancellation of retirement benefits, or negative economic impact on the originator's local region.

In re General Growth Properties teaches that investors will be encouraged to pay careful attention to the financial conditions of a parent-originator that may have a direct effect on a solvent bankruptcy-remote SPV.[406] As the holding of the case indicates, a solvent SPV may file for bankruptcy prior to reaching insolvency if the SPV is deemed by the court to be integrated into the corporate structure of the originator who becomes insolvent.[407] The decision also suggests that investors should be cautious about the reliability and enforceability of bankruptcy-remote provisions, such as the requirement of the unanimous vote of independent directors to file for bankruptcy.[408]

Given the opinion of *In re Lancelot Investors Fund, L.P.*,[409] investors or their agents will be more inclined to investigate the originator, the SPV, and the lending institutions to assure the

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403. *See* Louise Bowman, *Securitization: The S Word*, EUROMONEY, Nov. 2007, at 78, 79. *See also* BANK FOR INT'L SETTLEMENTS, *supra* note 128, at 4 ("It was also observed that some investors did not seem to have conducted adequate independent due diligence to understand the risk profiles of SPE transactions that they had invested in.").

404. Ayotte & Gaon, *supra* note 25, at 2-3.

405. *See In re* LTV Steel Co., 274 B.R. 278, 286-87 (Bankr. N.D. Ohio 2001).

406. *See In re* Gen. Growth Props., Inc., 409 B.R. 43, 57-58, 60-61 (Bankr. S.D.N.Y. 2009).

407. *See id.* at 64-65.

408. *See id.* at 63-64.

409. Peterson v. Ellerbrock Family Trust, LLC (*In re* Lancelot Investors Fund, L.P.), 408 B.R. 167 (Bankr. N.D. Ill. 2009).

authenticity of their business operations.[410] Further, the investors can be expected to research the type of assets that are being sold to the SPV, the quality of assets sold, and the assets' past and current performance. Sophisticated investors recognize that the risk of sponsoring a deal varies with the size, financial history, leadership, and visibility of the company, and will factor these issues into their investment decisions.[411]

Finally, investors will attempt to protect themselves against the potentially devastating consequences of substantive consolidation, as occurred in *In re Pacific Lumber Co.*[412] They are likely to seek the reassurance of external credit enhancements as means to reduce losses if the assets and liabilities of insolvent originators and solvent SPVs are consolidated in the bankruptcy proceeding.

VI. CONCLUSION

Despite the separate legal structure of an SPV, recent legal decisions have reinforced the position that an SPV is bankruptcy-*remote*, not bankruptcy-*proof*, when its parent-originator becomes insolvent. Thus, an SPV's assets are likely to survive challenges to its independence, but they are not certain to be excluded from recovery attempts.

As determined by the courts, an SPV's structure may be pierced, substantively consolidated, or legally modified to satisfy creditor and investor claims when its originating entity becomes insolvent. Consequently, the court decisions in *In re LTV Steel Co.*, *In re Pacific Lumber Co.*, and *In re General Growth Properties Inc.* have direct impacts on creditors and investors' ability to recover their investments. The judgments are also instructive because they provide a set of issues that the originator and the SPV should consider when designing and managing an SPV that can be judged as deserving of its continued independence in the event of the originator's bankruptcy or a claim by investors to recoup their investments.

Specifically, originators who engage in securitization through the creation of an SPV must consider the use of ever-more elaborate methods of protection. This will include external credit enhancements and careful structuring and managing of the underlying transaction to maximize the expectation that an SPV will deliver the benefit of being

410. *Id.* at 172.

411. *See* Anne Schwimmer, *Private Investors Carve Out 'Emerging Asset' ABS Niche: Some Investors Get Junk-Like Yields on Secured Deals*, INVESTMENT DEALERS' DIG., Mar. 20, 1995, at 11, 11.

412. *See* Bank of N.Y. Trust Co. v. Official Unsecured Creditors Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 249-50 (5th Cir. 2009).

bankruptcy-remote. Such precautions and augmentations are necessary because, despite their continuing popularity as an investment structure, SPVs present risks for creditors and investors that affect the practice of securitization and the overall investment results.