

Asset securitisation and the effect of insolvency on special purpose vehicles under US bankruptcy law

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Asset securitisations are transaction structures whereby assets are conveyed by the originator to an entity that then issues securities (either publicly or privately) secured by the transferred assets or obtains a loan from one or more financial institutions secured by such assets. In the United States, this entity – commonly referred to as a special purpose vehicle (SPV) or a special purpose entity – is often a subsidiary or other legal entity owned or controlled by the originator, and its business purpose and operations are limited to issuing the securitisation securities or debt and to owning and conducting business with respect to the transferred assets. The SPV conveys the proceeds of such securities issuance or loan to the originator, either in payment for the transferred assets, where the transfer is structured as a sale, or as an equity distribution on account of the originator’s equity interest, where the transfer is structured as a contribution to the equity of the SPV. The SPV then operates its business – which is limited to the ownership of the transferred assets – through contracting with another party, usually the originator itself in the first instance, for the servicing of the transferred assets.

In pursuing a securitisation transaction, the parties have usually made the judgement that the transferred assets are generally expected to perform better than the general credit rating of the originator would otherwise indicate. The business purpose of an asset securitisation is to unlock the higher relative value or strength of those assets for the benefit of the originator through isolating the assets to be securitised from the claims of the creditors of the originator, including from the insolvency risk of the originator. Where the originator enters into a conventional loan secured by the subject assets (instead of financing those assets in a securitisation transaction) and then becomes a US bankruptcy debtor, the lender is exposed to a number of risks:

- the lender that has a lien on such assets is automatically stayed from proceeding to liquidate such assets;
- the originator, under certain circumstances and over the objection of the lender, can continue to use the proceeds of such assets in the operation of its business;
- the bankruptcy court has the power to grant other (even superior) liens on such assets to other lenders or authorise the substitution of other (more illiquid) property as the lender’s collateral in order to facilitate continued lending to the originator while it is in bankruptcy; and
- a Chapter 11 plan of reorganisation that re-writes the tenor, interest rate and other terms of the lender’s claim ultimately can be approved over the lender’s objection in certain circumstances.

By attempting through a securitisation transaction to isolate the assets from these and other risks inherent in a bankruptcy of the originator, the assets can be financed on a standalone basis, and because the assets are considered to be stronger than the originator’s general credit rating, that financing is expected to be materially less expensive than financing generally

available directly to the originator. Thus, through an asset securitisation the originator is expected to obtain lower-cost financing than it would otherwise be able to obtain, which redounds to the benefit of the originator and its stakeholders. The utility of such a lower-cost funding structure has led to the emergence and exponential growth over the last 20 years of the securitisation market in developed countries. In the United States alone, securitisation is widely considered to have been a \$865 billion market in 2007.

Securitisation in the United States: bankruptcy fundamentals

Bankruptcy is a federal statute

Under the Constitution, government powers are exercised through the federal government, as well as by the states. In general, where the Constitution has empowered the federal government to act in an area, its laws take precedence. While many states have various types of insolvency law, bankruptcy is the domain of the federal government and securitisation market participants are principally concerned with the effect of the US Bankruptcy Code (11 USC Sections 101 and following) on SPVs in securitisation transactions.

However, only persons or entities that reside or have a domicile (which includes incorporation), place of business or property in the United States may be debtors under Section 109(a) of the code. While the code contains provisions providing for different types of relief, certain types of debtor are eligible only for certain types of relief – for example, a railroad is ineligible to be liquidated under Chapter 7 and can be subject only to its own special provisions under Chapter 11, and a stockbroker or commodity broker is ineligible for Chapter 11 relief and can be liquidated only under its own special provisions of Chapter 7. Others are ineligible for any type of relief under the code – for example, a domestic insurance company, a domestic bank, a foreign insurance company engaged in such business in the United States or a foreign bank that has a branch or agency (as defined in Section 1(b) of the International Banking Act of 1978) is ineligible for any relief under the code (11 USC Section 109(b), (d)). Such entities are ineligible for bankruptcy relief as they are all regulated under state and/or federal regulatory schemes which contain their own provisions and procedures for dealing with such entities when they are in financial distress. Parties entering into

securitisation transactions with these types of originator should become conversant with how these regulatory schemes may affect the transactions should their originators become financially distressed.

However, the bulk of US securitisation structures do involve originators and SPVs that are eligible to be debtors under Chapter 7 or Chapter 11 of the code.

Bankruptcy fundamentals of a typical US securitisation transaction

Securitisation transactions are not governed by an express provision of the code. Specifically, there is no statutory safe harbour that prescribes the steps that, if followed by market participants, will ensure that the desired goal of the isolation of the securitised assets from the credit (including bankruptcy) risks of the originator (known as ‘bankruptcy remoteness’) will be achieved.

Instead, the legal foundation of securitisation in the United States is premised on the ability of a person or legal entity (originally a corporation and now including entities such as partnerships, limited liability companies and business trusts) to convey assets to a separate legal entity, wholly or partly owned by the transferor, in a true sale or a true contribution transaction, that extinguishes any remaining property interest of the transferor in the assets themselves, such that in any subsequent bankruptcy of the transferor, the transferred assets themselves are not part of the transferor’s bankruptcy estate, but instead belong to the transferee. In such a subsequent bankruptcy of the transferor, only the transferor’s equity interest in the transferee (and not the assets themselves) is part of the transferor’s bankruptcy estate; the transferred assets belong to the transferee and are not generally subject to the claims of the transferor’s creditors.

In short, the legal foundation of securitisation is the recognised ability to create standalone limited liability entities. The twin legal concepts related to that foundation are true sale or true contribution and the doctrine of substantive consolidation. The former governs whether the originator, in purporting to transfer such assets to the SPV, has sufficiently parted with ownership of the assets such that they would be considered under applicable law to belong no longer to the originator (including in any subsequent bankruptcy), but instead to the SPV.

Notwithstanding that bankruptcy is a species

of federal law, non-bankruptcy law – usually state law – governs whether a particular transfer is a true sale or a true contribution. While the code generally includes in the bankruptcy estate “all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case” (11 USC Section 541(a)(1)), courts have consistently held that applicable non-bankruptcy law governs and defines the substantive parameters of those legal or equitable interests (see *Travelers Cas & Surety Co v Pacific Gas & Elec Co*, 127 S Ct 1199, 1205 (2007)). Although some states have sought to address the question through statute, the substantive law governing true sale and true contribution decisions is primarily comprised of judicial decisions or case law applying general principles. The state law governing true sale and true contribution determinations is similar to the point that it can be accurately stated that there are generally recognised true sale and true contribution principles. However, the ultimate determination will be governed by the law of a particular state. While the parties generally expressly choose a particular state’s law to govern the issue, whether such a choice itself will be respected will depend on a court’s application of governing choice of law principles.

The substantive consolidation doctrine is a bankruptcy doctrine. Notwithstanding the general rule that each legal entity (including its assets and liabilities) is separate and distinct from other (even related) legal entities and must be treated as such in bankruptcy, the doctrine permits a bankruptcy judge to combine or consolidate the assets and liabilities of two or more related entities so that there will be a common pool of assets from which the liabilities against all such entities are to be satisfied. The doctrine is equitable in nature and case law consistently states that it is to be used sparingly. There is no express statutory provision in the code setting forth the doctrine or its applicable standards; it is a creature of case law. The Supreme Court has not articulated the governing legal standard for the application of the doctrine, but one of the best-known federal appellate court decisions summarises the considerations underlying the application of the substantive consolidation doctrine as “merely being variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and ‘did not rely on their separate identity in extending credit’...; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors ...[in the sense that] untying is either impossible or so

costly as to consume all assets” (*Union Sav Bank v Augie/Restivo Baking Co (In re Augie/Restivo Baking Co)*, 860 F 2d 515, 518-519 (2d Cir 1988)).

Thus, the true sale or contribution and substantive consolidation concepts are concerned with the same thing – isolating the transferred assets from the credit (including bankruptcy) risk of the originator – but from different perspectives. The true sale or contribution inquiry is concerned with the efficacy of the transfer of the assets itself: did the transfer by the originator to the SPV satisfy the governing legal standards such that the originator can be said to have parted with its ownership of the assets? The substantive consolidation inquiry is concerned with the viability of the SPV itself and its relationship to (including any continuing business relationships with) the originator: will the SPV be created, maintained and operated, particularly in relation to the originator, in a manner that ensures that its assets and liabilities will be recognised in any subsequent bankruptcy as being separate and distinct from those of the originator, or instead is the manner of the creation, maintenance or operation of the SPV likely to result in a bankruptcy judge being entitled, upon the request of a trustee, creditor or other party in interest, to exercise his or her discretion in any subsequent bankruptcy of the originator to consolidate the assets and liabilities of both the originator and the SPV and treat them as if they were a combined entity, vitiating the utility of any true sale characterisation of the original transfer of the securitised assets?

Thus, a US securitisation transaction is structured against the backdrop of this legal framework as the parties seek to obtain an acceptable level of bankruptcy remoteness. The transfer documents address true sale and contribution issues, such as the level of recourse by the SPV against the originator relating to the assets to be securitised. With a view towards both underscoring the reasonableness of the reliance by the securitisation creditors of the SPV on the separate legal existence of the SPV and avoiding an impermissible entangling of the affairs of the originator and the SPV, the transfer and organic documents address and impose limitations and other requirements on the creation and maintenance of the separate legal existence of the SPV, as well as on its future operation, including its relationship with the originator, such as requiring the SPV to:

- comply with all corporate formalities;
- maintain and account for its assets and

liabilities separately (including imposing limitations regarding the extent to which its assets may be commingled with those of the originator); and

- maintain any business dealings with the originator on arm's-length terms.

It is standard practice in US securitisation transactions that a reasoned legal opinion addressing these legal issues be delivered, usually by counsel for the originator, as a condition to the closing of the transaction.

Of course, these issues do not constitute the universe of legal and business issues addressed in any typical US securitisation transaction. For example, subsidiary issues relating to true sale and non-consolidation concepts are routinely considered, such as the sufficiency of consideration involved in the transfer (or whether the transfer instead can be attacked as having constituted a fraudulent conveyance against the originator's creditors). In addition, the state law doctrines of 'piercing the corporate veil', 'alter ego' and 'corporate instrumentality' are similar to, but conceptually distinct from, the substantive consolidation doctrine (although a consideration of these doctrines is generally subsumed as a practical matter in the treatment of the substantive consolidation issues in US securitisation transactions). There are also federal statutes (eg, tax and pension statutes) that purport to impose corporate group liability in certain circumstances and whose possible application is routinely considered when structuring US securitisation transactions. In addition, a myriad of independent tax, accounting, regulatory and other issues are routinely considered in such transactions.

Moreover, even with respect to the question of bankruptcy remoteness, the concern is not limited to the legal framework alone. Parties to US securitisation transactions are also concerned with creating a transaction that makes the bankruptcy of the SPV remote as a practical matter as well as a legal matter, and certain standard bankruptcy remoteness provisions, such as the limitations on the scope and nature of the SPV's business, are concerned more with these practical considerations than with legal principles.

The major ratings agencies have published criteria relating to their own requirements regarding bankruptcy remoteness as they consider ratings for proposed transactions (eg, see Standard & Poor's *Legal Criteria for US Structured Finance Transactions* (October 2006)).

Securitisations in US bankruptcy cases

Where transactions have been structured and maintained in a manner that is free from fraud and otherwise consistent with generally recognised true sale and non-consolidation principles, securitisation structures have been respected and treated in the US bankruptcy cases of originators according to the general expectations underlying the design of the structures (see *Securitization of Financial Assets*, Jason HP Kravitt ed, 2d ed 1996 & Supp 2007), Section 5.05[M], pp 5-248 to 5-260). For example, where the securitisation structure has been the source of ongoing funding for the originator and the securitised assets have continued to function in a manner consistent with original underwriting assumptions, it has been a common experience for the securitisation transaction either to be continued with the consent of the SPV securitisation parties as a form of court-approved debtor-in-possession financing in the originator's Chapter 11 case (see *Imperial Sugar*, discussed in *id*, Section 5.05[M][12]) or to be unwound and paid off in full shortly after the commencement of the originator's bankruptcy with the proceeds of a new post-bankruptcy securitisation transaction (see *Carter Hawley Hales Stores*, discussed in *id*, Section 5.05 [M][3]) or a traditional debtor-in-possession financing facility (see *National Gypsum Co.*, discussed in *id*, Section 5.05 [M][4]).

Following cases such as *Days Inn* and *LTV Steel Company*, there was some market reluctance over transactions that involve the securitisation of both non-financial assets (eg, inventory) and financial assets or that otherwise involve the core assets of the originators, even though such cases have resulted in either a consensual resolution or the payment in full of the securitisation transactions relatively shortly after the commencement of the originators' bankruptcy cases (see *id*, Sections 5.05[M][6] and 5.05[11] for a discussion of *Days Inn* and *LTV Steel Company*, respectively). One might raise analogous issues for whole business securitisations, but most such transactions, if well structured, will be designed to have the securitised business function independently from the remaining operations of the originator. While this area continues to evolve, US securitisation transactions involving such assets are likely to continue to be viewed and considered by market participants on a transaction-by-transaction basis (eg, see Standard & Poor's, *Corporate Securitization Ratings: Reaching New Frontiers* (February 2007)).

In re Owens Corning – an important non-consolidation decision

Designing a US securitisation transaction to minimise the risks that the assets and liabilities of the SPV will be substantively consolidated (or combined and treated as a single pool) with those of the originator in any subsequent bankruptcy is one of the twin pillars of the isolation principle underlying US securitisation transactions. Substantive consolidation is a judge-made doctrine with no definitive standard for its application, having yet to be articulated by the Supreme Court.

One of the better-known federal appellate court decisions articulating a substantive consolidation standard is the *Augie/Restivo* decision. *Augie/Restivo* is significant not only because it articulates a rigorous standard doctrine that must be met before consolidation can be ordered, but also because, as a Second Circuit decision, it is binding authority on New York bankruptcy courts, where many large Chapter 11 cases are filed.

However, other federal court decisions have been depicted as representing a more liberal trend in substantive consolidation case law. The best known of these is *Drabkin v Midland-Ross Corp (In re Auto-Train Corp, Inc)* (810 F 2d 270 (DC Cir 1987)), which articulated a “balancing test” requiring a bankruptcy court to determine first whether there exists a “substantial identity between the entities to be consolidated”, and only after making such a determination to determine whether the proponent of the substantive consolidation has carried its burden to demonstrate “that consolidation is necessary to avoid some harm or realize some benefit”. If an opponent of the requested consolidation after such a showing can demonstrate “that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation”, the court may still order consolidation, but “only if it determines that the demonstrated benefits of consolidation ‘heavily’ outweigh the harm” (810 F 2d at 276).

Counsel delivering reasoned opinion letters in US securitisation transactions routinely opine that the *Auto-Train* balancing test would not warrant, based on the factual assumptions and subject to the limitations set forth in such opinion, the substantive consolidation of the assets and liabilities of the originator with those of the SPV in any subsequent bankruptcy. However, it is a less rigorous standard than the *Augie/Restivo* test.

In Re Owens Corning involved not a securitisation transaction, but another common

transaction structure: a syndicate of lenders making loans to a parent corporation that were then guaranteed by the parent corporation’s subsidiaries (419 F 3d 195, 199 (3d Circuit 2005)). In the ensuing bankruptcy cases of the parent corporation and the subsidiary guarantors, the debtors moved for substantive consolidation of the assets and liabilities of the debtors in anticipation of proposing a plan of reorganisation for the debtors (*id*). The net effect of the requested substantive consolidation was the elimination of the lenders’ subsidiary guarantees (*id*). Over the lenders’ objection, the lower court granted the motion (*id* at 202). The lenders then appealed the decision to the Third Circuit.

In reversing the lower court’s decision, the Third Circuit essentially adopted a more robust version of *Augie/Restivo*’s two-prong test, holding that substantive consolidation is appropriate, in a contested setting, only where either pre-bankruptcy, the subject entities “disregarded separateness so significantly [that] their creditors relied on the breakdown of entity borders and treated them as one legal entity, or [post-bankruptcy,] their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors” (*id* at 211 (footnotes omitted)). Specifically, with respect to the first (reliance) prong, the Third Circuit went beyond *Augie/Restivo* and held that even if the proponents of substantive consolidation could prove that creditors “actually and reasonably relied” on the entities as if they were a combined entity, substantive consolidation still had to be denied as to the opponents of the consolidation if such opponents could prove that they relied on the separate existence of one or more of such entities and would be “adversely affected” by the requested consolidation (*id* at 212).

Significantly, the Third Circuit flatly rejected the more relaxed standard of *Auto-Train*: “The *Auto-Train* approach... adopts, we presume, one of the *Augie/Restivo* touchstones for substantive consolidation while adding the low bar of avoiding some harm or discerning some benefit by consolidation. To us this fails to capture completely the few times substantive consolidation may be considered and then, when it does hit one chord, it allows a threshold not sufficiently egregious and too imprecise for easy measure. For example, we disagree that ‘[i]f a creditor makes [a showing of reliance on separateness], the court may order consolidation ... if it determines that the demonstrated benefits of consolidation ‘heavily’ outweigh the harm.’ [*Auto-Train*], at 276 (citation

omitted); ... If an objecting creditor relied on the separateness of the entities, consolidation cannot be justified vis-à-vis the claims of that creditor.” (419 F 3d at 210.)

Owens Corning is significant for parties to US securitisation transactions for several reasons. It represents a recent federal appellate decision that flatly rejects the more relaxed *Auto-Train* standard. It also embraces a more rigorous test for the application of the doctrine. In particular, it underscores that creditor reliance on the separateness of the entities – which is a touchstone of US securitisation structure where the SPV’s creditors are in fact relying on the separateness of the SPV – should bar consolidation as to the claims of those creditors. It was also decided by the federal appellate court whose decisions are binding precedent on the US Bankruptcy Court for the District of Delaware which – like the US Bankruptcy Court for the Southern District of New York – is the court in which many large Chapter 11 cases are filed.

The decision is also interesting for the Third Circuit’s sensitivity to the widespread use of a particular transaction structure in the marketplace: “To begin, the Banks did the ‘deal world’ equivalent of ‘Lending 101.’ They loaned \$2 billion to [the parent corporation] and enhanced the credit of that unsecured loan indirectly by subsidiary guarantees covering less than half the initial debt. What the Banks got in lending lingo was ‘structural seniority’ – a direct claim against the guarantors (and thus against their assets levied on once a judgment is obtained) that other creditors of [the parent corporation] did not have. This kind of lending occurs every business day. To undo this bargain is a demanding task.” (419 F 3d at 212.)

The same can easily be said of participants in US securitisation transactions.

Bankruptcy and servicing

In US securitisation transactions the SPV usually does not operate its own business, which through the limitations imposed by the transaction documents and its organic documents is to be limited solely to the ownership and operation of the transferred assets. Instead, the SPV contracts such servicing out to another party, usually the originator itself in the first instance. When the servicing agreement has not been properly terminated (or expired by its terms) prior to the commencement of the originator’s bankruptcy, the originator’s rights and interests under the servicing

agreement do constitute property of the originator’s bankruptcy estate. Indeed, as has been the recent experience for the mortgage lending companies that have become debtors in US bankruptcy cases, the originator’s servicing rights may be the only ongoing property right of any value that the originator still owns in such cases.

Servicing as a valuable asset in an originator’s bankruptcy

When the servicing agreement has not been terminated prior to the commencement of the originator’s bankruptcy case, it is likely to be viewed as an executory contract. The Bankruptcy Code has several different provisions intended to permit bankruptcy debtors to continue to obtain the benefits of profitable contracts, through the assumption or assumption and assignment of profitable executory contracts, and to relieve themselves of the burdens of unprofitable contracts through the repudiation of such agreements (see 11 USC Section 365).

A debtor’s ability to continue to obtain the benefits of a profitable executory contract is a fundamental part of the Bankruptcy Code. Indeed, as a general rule the statute expressly nullifies and renders ineffective contractual provisions prohibiting the assignment of a debtor’s rights under an executory contract, as well as provisions (commonly referred to as *ipso facto* clauses) permitting the non-debtor party to terminate the servicing agreement based on the bankruptcy (or financial condition) of the debtor (11 USC Section 365(e), (f)). While there are certain types of executory contract that the debtor is statutorily prohibited from being able to assume, such as executory contracts to make loans to the debtor (11 USC Section 365(c)(2)), bankruptcy courts have treated servicing agreements as executory contracts and have permitted the assumption and assignment of servicing agreements in bankruptcy cases of originators/servicers.

However, the Bankruptcy Code nonetheless imposes statutory requirements that must be satisfied before a servicing agreement may be assumed or assumed and assigned in an originator’s bankruptcy case. These include curing (or providing a mechanism for curing) all non-*ipso facto* defaults (if any) under the servicing agreement, compensating (or providing a mechanism to compensate) the non-debtor party for any damages relating to any such defaults and providing “adequate assurance” of the debtor’s (or,

where the servicing agreement is to be assigned, the assignee's) ability to render future performance under the agreement (11 USC Section 365(b), (f)).

The Bankruptcy Code is likely to accord an originator in a Chapter 11 case a significant length of time (up to the confirmation of a plan of reorganisation) to decide whether to assume or reject a servicing agreement (11 USC Section 365(d)). It is possible for a non-debtor party to obtain an order from the bankruptcy courts compelling the originator to make such a decision promptly or even permitting the non-debtor party to terminate the servicing agreement based on performance-based defaults. However, conventional wisdom among US bankruptcy practitioners is that it will be difficult to do so without first proving that the originator is unable to continue to service the securitised assets at an acceptable performance level (as determined by the bankruptcy court).

Modifying servicing agreement for the benefit of the originator or servicer

The Bankruptcy Code renders unenforceable any 'anti-assignment' and *ipso facto* clauses contained in servicing agreements. However, the statutory nullification of those provisions generally constitutes the extent of the bankruptcy court's ability to rewrite the material provisions of the contract. Where the bankrupt servicer is unhappy with material provisions such as the amount of the servicing fee or where such servicing fee is paid in the securitisation waterfall, the bankruptcy court is generally powerless to rewrite those provisions at the originator's unilateral urging (see *In re Fleming Cos*, 499 F 3d 300, 306 (3d Cir 2007) – a bankruptcy court may not modify a contract term if the term is integral to the bargain struck between the parties and non-performance of that term would deny the party the full benefit of its bargain). However, the bankruptcy court can approve a consensual modification of the material provisions of a servicing agreement, and in one very well-known originator/servicer bankruptcy that is exactly what happened.

At the time of its bankruptcy filing in 2002 Consec Finance Corp was the largest originator and servicer of manufactured housing loans in the United States. However, at the time of the bankruptcy filing the compensation terms under the standard servicing agreement for Consec securitisations were unprofitable, in terms of both the amount of the fee and its payment priority in the securitisation waterfalls. In addition, the

consensus among the key securitisation parties was that if the securitisation trusts were forced under exigent circumstances to transfer servicing to another servicing platform, the pertinent securitisation trusts would suffer significant losses. To avoid such losses, the parties effectively reached a consensual resolution whereby the servicing compensation provisions were modified, in both amount and payment position in the securitisation waterfalls, and as a result of such modification Consec's modified servicing rights and its servicing platform could be sold as a going concern on a more orderly basis (see *In re Consec, Inc*, Case No 02-B-49672 (Bankr, ND Ill Mar 14 2003).

Rejection of servicing agreement by originator

As a general rule, where it is not in the originator's business interest to continue to service the assets, the bankruptcy judge will permit the originator to reject the servicing agreement, although the non-debtor parties can seek to prevent or at least delay such a rejection for a definite time period while they try to make replacement servicer arrangements.

Where the originator cannot satisfy the statutory requirements for assumption or assignment (and the non-debtor parties will not waive or modify those requirements), such a rejection eventually will be mandated. In either situation, the ability of the non-debtor parties to find and arrange an orderly transition to an acceptable replacement servicer is likely to become a paramount concern to the other securitisation parties.

Bankruptcy of the SPV: key issues

The bankruptcy remoteness of the SPV is an intended feature of a US securitisation transaction. However, there is a difference between bankruptcy remote and bankruptcy proof. Parties to US securitisations do not expect that SPVs will not become bankruptcy debtors under any set of circumstances, and the legal opinions delivered in connection with US securitisation transactions usually opine as to the true sale and non-consolidation issues based on the assumption that both the originator and the SPV will have become debtors in a US bankruptcy case.

A general overview of the other possible bankruptcy issues that may rise in connection with a SPV bankruptcy filing is outside the scope of this chapter. However, this part briefly discusses two

such issues in the context where, notwithstanding the assumption and underwriting regarding the strength of those assets at the inception of the transaction, the securitised assets do not perform as expected or, for whatever reason, the SPV itself otherwise becomes financially distressed.

Commencement of a US bankruptcy case for the SPV

In US securitisation transactions, it is common to mandate, as part of the SPV's governing organic documents, that the SPV have an independent fiduciary (eg, an independent director where the SPV is a corporation), and that the vote of that independent fiduciary be required for significant SPV decisions, including before the SPV can be properly authorised to commence a voluntary bankruptcy case. One of the notions underlying these independent director provisions is the intended benefit to the SPV and its creditors of having an independent fiduciary consider major decisions from the SPV's perspective and thus be in a position to prevent the SPV from taking actions at the direction of the originator that may harm the SPV and its creditors.

However, where the SPV is itself in financial distress, the independent fiduciary may well believe that the commencement of a bankruptcy of the SPV is in the best interests of the SPV and its constituencies, including its creditors (eg, see *In re Kingston Square Associates*, 214 BR 713, 734, 736 (Bankr SDNY 1997), observing that an independent director of the general partner of each SPV, who refused to vote for the voluntary bankruptcy of 11 financially distressed securitisation SPVs, "abdicated his fiduciary role to the Debtors, creditors, and limited partners in favor of the interests of [the secured creditors]"). In addition, even where such an independent fiduciary refuses to cast such an affirmative vote, the SPV and its creditors may challenge the enforceability of the affirmative vote requirement on estoppel or other grounds (eg, see *In re American Globus Corp*, 195 BR 263, 265-266 (Bankr SDNY 1996), refusing to dismiss a bankruptcy case for failure to obtain required 100 per cent shareholder vote because dismissal would frustrate Bankruptcy Code objectives, as well as based on estoppel principles). Finally, any such requirement for the proper corporate law authorisation of a voluntary filing would not prevent an involuntary bankruptcy petition from being filed against a financially distressed SPV (see 11 USC Section 303; *In re Kingston Square Associates*, 214 BR at 734, 736, refusing to

dismiss involuntary bankruptcy petitions against SPVs even though such filings had been orchestrated by the SPVs themselves in order to circumvent the independent director provisions).

Non-US SPV and ancillary proceeding under Chapter 15 of the Bankruptcy Code

It is not uncommon for an SPV in a securitisation transaction to be a non-US entity (eg, a Cayman Islands limited liability company), but to nonetheless issue securities and have assets in the United States. If such an SPV were to become financially distressed, it could in theory be eligible to be a debtor in an insolvency proceeding in its home jurisdiction or in a US bankruptcy case. It could also become subject to insolvency proceedings in both jurisdictions. In such a situation, the Bankruptcy Code contains provisions, set forth in Chapter 15 (the US-enacted version of the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency), that permit the non-US proceeding to be considered the main proceeding and the US proceeding the ancillary proceeding. In such a situation, the non-US proceeding would be the dominant proceeding, with the expectation that actions taken in the US ancillary proceeding would be limited to and focused on facilitating and furthering the objectives of and results in the non-US proceeding, subject to certain substantive limits imposed by Chapter 15 on the bankruptcy judge's power (see 11 USC Sections 1519, 1521).

However, explicit statutory standards in Chapter 15 govern the recognition of non-US proceedings as the foreign main proceeding, or as a foreign non-main proceeding. If such statutory requirements cannot be satisfied, the non-US proceeding cannot be recognised. Two recent decisions involving Cayman Island hedge funds have refused to grant recognition to non-US proceedings, even in the absence of any objection to such recognition by any interested parties (see *In re Bear Stearns High-Grade Structural Credit Strategies Master Fund, Ltd*, 374 BR 122 (Bankr SDNY 2007), Cayman Islands proceedings of 'letterbox' company that did not conduct any business in the Cayman Islands, but whose business was conducted (and whose liquid assets were located principally) in New York could not be recognised as a foreign main or foreign non-main proceeding under Chapter 15, and the only US bankruptcy relief open to it was a voluntary or involuntary proceeding under Chapter 7 or 11 of the

Bankruptcy Code; *In re Basis Yield Alpha Fund (Master)*, 381 BR 37 (Bankr SDNY 2008), refusing to grant summary judgment on similar set of facts).

Where a financially distressed non-US securitisation SPV similarly has the centre of its business operations, particularly the bulk of its assets, in the United States, these two decisions

indicate that there may be some question as to whether any non-US insolvency proceedings for such SPV will be able to be recognised under Chapter 15 of the Bankruptcy Code and that instead, the only US bankruptcy avenue available to such a non-US SPV may be its own proceeding under Chapter 11 or Chapter 7 of the Bankruptcy Code.