PRESENTED AT

35th Annual Jay L. Westbrook Bankruptcy Conference

November 17-18, 2016
Austin, TX

Bankruptcy Remoteness

Hon. Craig A. Gargotta
U.S. Bankruptcy Court, Western District of Texas
San Antonio, TX

Ashley L. Gargour
Andrews Kurth Kenyon LLP
Houston, TX

Sarah A. Nickodam
U.S. Bankruptcy Court, Western District of Texas
San Antonio, TX

Bankruptcy Remoteness

I. Overview

Bankruptcy remoteness, also referred to as securitization or structured finance, is common in commercial settings and the creation of a special purpose entity ("SPE") is not a novel concept. An overly simplistic example of an SPE structure is as follows:

> New Holdco is formed. Sponsor is the sole owner of New Holdco. New Holdco is structured as a "bankruptcy remote" entity or SPE. The provisions in the formation documents and loan documents (i) restrict New Holdco's operations and ability to acquire assets or incur liabilities, (ii) protect against consolidation of New Holdco with Sponsor, and (iii) prohibit a bankruptcy filing by New Holdco without unanimous consent.

Structured finance transactions such as the one outlined above are often designed to insulate the SPE's assets from the sponsor's bankruptcy. Further, the transactions can be a strategic tool to restrict an SPE's ability to file bankruptcy or ability to decide to file bankruptcy, typically through anti-bankruptcy provisions in the formation documents or contracts of business entities. These provisions raise certain ethical considerations: May debtors abrogate their fiduciary duty to seek bankruptcy relief, and if so, does it violate public policy by restraining the right to file bankruptcy?

This paper will attempt to address these potential ethical issues by first explaining the structure and use of a bankruptcy remote and then analyzing its effect through the use of recent case law. A discussion of bankruptcy remotes allows practitioners to revisit the importance of fully explaining legal issues to clients and putting this understanding in writing in the form of an engagement letter. Given the seeming uncertainty over how courts may rule on bankruptcy remotes, any practitioner looking to use this type of structure would be wise to fully understand how and why these provisions are sometimes being invalidated, and attempt to negate an ethics violation or malpractice allegation by making sure that clients understand the advantages and disadvantages of this type of securitization.

The Typical Bankruptcy Remote

In a structured finance transaction, financial assets of an income producing nature are pooled. Generally, the lender will be able to look only to transferred assets in the pool to pay the securities or debt obligations. This type of structured financing vehicle enables companies to raise capital when they might otherwise have difficulty. The popularity of the structured finance transaction is understandable. This vehicle allows a company to leverage a pool of assets rather than having to rely on the company's overall credit for creditworthiness. This approach results in lower cost borrowing for most companies seeking leverage. At the same time, this structure provides risk management to the investors and a substantial cost reduction as well as providing a source of financing to a company from an illiquid investment. The common key feature of most of these transactions is the creation of a "bankruptcy remote" SPE. This practice is also referred to as "ring fencing."

Though the term "bankruptcy remote" may suggest some nefarious purpose, such corporate structures will not typically be disregarded. This type of investment has, however, raised issues concerning "substantive consolidation" of the SPE into the

Title search: Bankruptcy Remoteness

Also available as part of the eCourse
2016 Bankruptcy eConference

First appeared as part of the conference materials for the
35th Annual Jay L. Westbrook Bankruptcy Conference session
"Bankruptcy Remoteness"