

CLIENT ALERT

Caution: Bankruptcy-Remote Entities Are Not Necessarily Bankruptcy Proof

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"Bankruptcy-remote entities" have been utilized for years in commercial transactions as a means to protect a defined group of assets from being administered as property of a bankruptcy estate in the event of a bankruptcy filing by an affiliated entity. There is no statute or authoritative legal precedent establishing the characteristics of bankruptcy-remote entities. Instead, the business world and literature have focused on the legal structure of such entities. The ongoing saga of litigation over the issue arising from the Doctors Hospital bankruptcy demonstrates that there is no guarantee that a bankruptcy-remote entity is bankruptcy proof.

Doctors Hospital of Hyde Park, Inc. filed a chapter 11 bankruptcy petition in April 2000. In 2004, a chapter 11 trustee was appointed and took over certain litigation against the hospital's lender, LaSalle Bank, which was the trustee for a CMBS trust. Part of the litigation related to the pre-bankruptcy capital structure of the hospital and its affiliates. A non-debtor affiliate, MMA Funding, LLC, had been created to finance purchases of the hospital's receivables. It was intended that MMA would be a bankruptcy-remote special purpose vehicle ("SPV"). Purchases of the receivables were funded by advances on a loan from Diawa HealthCo-2 to MMA. In turn, Diawa's loan was secured by an assignment of the purchased receivables from MMA. As a result of this financing structure, a portion of the Diawa loan proceeds were used to pay creditors of the hospital, including LaSalle.

Notwithstanding the apparent commonplace nature of MMA's SPV structure and attributes, the chapter 11 bankruptcy trustee argued that MMA was nothing more than a department of the hospital. If the argument succeeds, then the trustee may be able to recover as fraudulent transfers the payments made from the Diawa loan proceeds to the hospital's creditors. At the conclusion of the first trial in March 2007, the bankruptcy court upheld MMA's SPV structure. That conclusion was upheld by the district court on appeal in 2009.

In 2010, however, the Seventh Circuit vacated the lower courts' decisions and remanded the case. The Seventh Circuit observed that MMA lacked "the usual attributes of a bankruptcy-remote vehicle" and that there was "scarcely any evidence in [the] record that MMA Funding even existed, except as a name that ... lawyers put in some documents." *Paloian v. LaSalle Bank, N.A., as Trustee*, 619 F.3d 688, 695-96 (7th Cir. 2010). The Seventh Circuit's remand guidance on the SPV issue was that there needed to be evidence that MMA was operationally distinct from the hospital. *Id.* at 595 ("To make the idea work, the separate entity must be, well, separate. It must buy assets (here, accounts receivable). It must manage these assets in its own interest rather than the debtor's.").

On remand, the trustee moved for summary judgment based on the trial record. He did not offer any new affidavits or evidence. LaSalle offered three affidavits and additional documents in opposition to the motion. The bankruptcy court denied the motion for summary judgment, finding that "[d]etailed evidence as to indicia of entity operations is yet to be produced." *In re Doctors Hospital of Hyde Park, Inc.*, 463 B.R. 93, 109-12 (Bankr. N.D. Ill. 2011). It remains to be seen whether the parties will be able to produce any evidence to support or refute the operational separateness required under the Seventh Circuit's new standard. A

status conference is scheduled for April 30, 2012, when the bankruptcy court will hear the parties on the issue of the right to a trial by jury.

Even if this is a case of bad facts creating bad law, this case is a cautionary tale. Parties seeking to create bankruptcy-remote SPVs should consult with their attorneys about how to do more than merely establishing a separate legal structure. Entity formation is the time to consider creating favorable circumstances that can be used, if necessary, to demonstrate independent operational activities of the intended SPV.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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