Bankruptcy Remote Clauses Are Not Ironclad

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Issuers of mortgage-backed securities often insist that borrowers be or become "bankruptcy remote" as a condition of lending. Bankruptcy remote clauses are designed to block a borrower's access to the bankruptcy courts. Bankruptcy remote clauses can take several forms. One of the most popular types requires the borrower to amend its bylaws: (i) to permit the lender to appoint an independent director to sit on the borrower's board of directors, and (ii) to prohibit the borrower from voluntarily seeking bankruptcy protection without the affirmative consent of every member of its board of directors. Thus, under the provisions of bankruptcy remote or "bankruptcy-proof" bylaws, the borrower would not be authorized to file a voluntary petition for relief under the Bankruptcy Code without the affirmative consent of the "independent" director selected by the lender.

Many thought that bankruptcy remote provisions effectively closed the doors of the bankruptcy courts to borrowers who agreed to such corporate governance provisions. However, in *In re Kingston Square Associates*,[1] Chief Judge Tina L. Brozman of the United States Bankruptcy Court for the Southern District of New York declined to dismiss, as bad faith filings, involuntary bankruptcy cases commenced against borrowers who had consented to bankruptcy remote provisions even though the borrowers' principal openly orchestrated the filing of the involuntary petitions together with the petitioning creditors. Judge Brozman's decision indicates that a borrower can circumvent the bankruptcy remote provisions with some simple maneuvering where: (a) the borrower is not barred by statute or court order from commencing a bankruptcy case; and (b) it appears that the borrower may have equity in its property, so bankruptcy could prevent a foreclosure sale that would wipe out the claims of unsecured creditors and the interests of the borrower's limited partners or equity holders.

The facts in *Kingston Square* are straightforward. As a result of refinancings made in 1991 and 1993 (the "Refinancings"), affiliates of Donaldson, Lufkin and Jenrette Securities Corporation (DLJ) held over $277 million in mortgages on 41 different apartment complexes controlled by Morton Ginsberg. Integral to each of these transactions was the inclusion, in the charters of each corporate borrower or the corporate general partner of each limited partnership borrower, of a bankruptcy remote provision that prohibited each borrower from seeking voluntary bankruptcy protection without the unanimous consent either of its board of directors or that of its corporate general partner. DLJ was permitted to appoint its consultant, Laurence Richardson, to serve as an "independent" director on the boards either of each borrower or the corporate general partner of each borrower. Mr. Richardson was an attorney who had previously served as a vice president of DLJ. At least a portion of his director's fee was paid by a subsidiary of DLJ.

After the borrowers defaulted in 1994, DLJ commenced foreclosure actions. By mid-1996, judgments totaling approximately $370 million had been obtained against the borrowers. To frustrate DLJ's foreclosure efforts, in the fall of 1996, Mr. Ginsberg orchestrated the filing of involuntary bankruptcy petitions against eleven of the borrowers. An entity controlled by Mr. Ginsberg advanced $75,000 to pay the fees and expenses of the counsel for the petitioning creditors. In addition, Mr. Ginsberg helped the petitioning creditors' counsel locate creditors eligible to join in the filing of the petitions, and he provided the attorneys with the information necessary to prepare the involuntary petitions.

DLJ moved to dismiss the involuntary bankruptcy petitions pursuant to section 1112(b) of the Bankruptcy Code, claiming that the debtor-induced involuntary filings were devised to "perform an end run" around bankruptcy remote clauses and required a finding that the cases were filed in bad faith. DLJ argued that the debtors' coordination of their efforts with the petitioning creditors to obtain bankruptcy protection constituted improper collusion for a fraudulent or deceitful purpose. DLJ also contended that the filing of each involuntary petition was timed either to stay a scheduled foreclosure sale or to coincide with a particular borrower's deadline in which to file an appellate pleading, thereby frustrating its attempts to enforce its rights as to each involuntary debtor's property.

Judge Brozman rejected DLJ's arguments. Initially, she noted that collusion contains two components: (i) the secret acts of at least two people; and (ii) a wrongful purpose. Accordingly, involuntary petitions should be dismissed as collusive if: (i) there is concerted action between the debtor and the petitioning creditors; *and* (ii) the parties fraudulently invoke the jurisdiction of the bankruptcy court.

Based upon Ginsberg's conduct, Judge Brozman found that the debtors did orchestrate the filing of the involuntary cases together with the petitioning creditors and their counsel. However, she observed that nothing in the bankruptcy remote provisions barred any party connected with the borrowers from acting on its own to file involuntary petitions. Furthermore, Judge Brozman relied on another recent New

York case[2] for the proposition that corporate action taken by an insider without board or shareholder authority may later be found to have been appropriate where the very existence of the corporation was seriously imperiled.

Next, Judge Brozman examined whether the jurisdiction of the court had been fraudulently invoked. The Bankruptcy Court rejected the notion that all debtor-induced involuntary filings require a finding of bad faith which, in turn, constitutes cause to dismiss the bankruptcy cases. In reviewing modern collusion cases that were dismissed as bad faith filings,[3] the Bankruptcy Court found that each case involved an attempt by a debtor to reinvoke bankruptcy jurisdiction under the guise of having an involuntary petition filed against it by friendly creditors, despite the existence of a prior court order or statute barring the debtor from gaining access to the bankruptcy courts for a second time. In contrast, the filings orchestrated by Mr. Ginsberg were not used as a method to circumvent a court order or other statutory bar against bankruptcy filings. Instead, the actions taken were merely to prevent the DLJ foreclosures, which threatened to wipe out the claims of unsecured creditors and the interests of the borrower's limited partners. Accordingly, these borrowers had not fraudulently invoked the jurisdiction of the Bankruptcy Court.

An important factor in this case was the debtors' argument that they had a reasonable belief that they could reorganize (rather than liquidate). The debtors' proof included an appraisal showing that the debtors had equity in the properties. Judge Brozman stated that this suggested that the debtors had not been acting in bad faith. Additionally, the debtors produced third parties interested in purchasing the properties (for unspecified sums)

Equally important was Judge Brozman's criticism of DLJ's "independent" director, Mr. Richardson. At a hearing on December 5, 1996, Judge Brozman had urged the borrowers' directors to meet. In fact, no meetings of the directors of the involuntary debtors had been held after the closing of the Refinancings three years earlier. The directors finally met on December 16 and 17, 1996. The Bankruptcy Court characterized Mr. Richardson's conduct at these meetings as "peculiar." He abstained on the vote concerning whether the involuntary debtors should ratify the filing of the involuntary petitions, which served as a pocket veto given the unanimity requirement for a bankruptcy filing. Thereafter, he advised the other board members that he would require additional information before deciding how to vote. Mr. Richardson then took five weeks to write an eleven-page letter to the respective counsel for the petitioning creditors, the borrowers and DLJ's agent asking extensive questions concerning issues raised in documents he was provided at the board meetings. The Bankruptcy Court saw this as a transparent stalling tactic designed to prevent ratification of the filings.

The Bankruptcy Court also criticized Mr. Richardson for other reasons. He appeared to be unaware that, when a corporation approaches insolvency, directors' fiduciary duties expand to include general creditors. The court found it "inconceivable" that he did not understand that the corporate general partners, of which he was a director, bore fiduciary obligations to the limited partners. Mr. Richardson also ignored the plight of these limited partners whose interests would be eliminated by the foreclosure actions. The court declared that his failure to ratify the involuntary filings exemplified his failure to carry out the duties he owed to creditors and limited partners. Indeed, the Bankruptcy Court found that Richardson was independent in name only, and had abdicated his fiduciary role in favor of the interests of DLJ.

In sum, the Bankruptcy Court never ruled on the enforceability of the bankruptcy remote provisions. Instead it ruled that, though a borrower's orchestration of the filing of an involuntary petition against it is suggestive of bad faith, standing alone it is not sufficient grounds for dismissal under section 1112(b) of the Bankruptcy Code. Accordingly, in Judge Brozman's view, a borrower's orchestration of the filing of an involuntary petition against it despite its consent to a bankruptcy remote provision will not be grounds for dismissal as a bad faith filing where: (a) the debtor is not barred by court order or statute from seeking to refile a bankruptcy case; and (b) there is credible evidence that the debtor has equity in its real property, and a bankruptcy case is necessary to preserve that value and prevent a mortgagee from proceeding with a foreclosure that would wipe out the claims of unsecured holders and the interests of the borrower's partners or shareholders. Moreover, an "independent" director appointed by a lender pursuant to a bankruptcy remote clause may not forsake his fiduciary obligations to the borrower, its shareholders and creditors in favor of the interests of the mortgagee, especially where the borrower's existence is threatened by the lender's foreclosure action.

Kingston Square has not sounded the death knell for bankruptcy remote clauses. Lenders continue to insist on their use in connection with loan refinancings that are to be included in a pool of loans for mortgage-backed securitizations. Furthermore, whether other courts will adopt the reasoning of the *Kingston Square* court remains to be seen. Nevertheless, lenders and borrowers should be aware that bankruptcy remote provisions do not guarantee that a borrower cannot gain access to the bankruptcy courts.

Endnotes

1. 214 B.R. 713 (Bankr. S.D.N.Y. 1997).
2. Management Technologies, Inc. v. Morris, 961 F. Supp. 640 (S.D.N.Y. 1997).
3. Federal Deposit Ins. Corp. v. Cortez, 96 F.3d 50 (2d Cir. 1996); In re Winn, 49 B.R. 237 (Bankr. M.D. Fla. 1985); In re Corto, 1995 WL 643372 (W.D.N.Y. Oct. 18, 1995), *aff'd*, 112 F.2d 503 (1997).

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