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Bankruptcy-Remote Special Purpose Entities and a Business's Right to Waive Its Ability to File for Bankruptcy

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BANKRUPTCY-REMOTE SPECIAL PURPOSE ENTITIES AND A BUSINESS'S RIGHT TO WAIVE ITS ABILITY TO FILE FOR BANKRUPTCY

INTRODUCTION

In 2009, General Growth Properties, Inc. (General Growth), a real estate investment trust that managed hundreds of shopping centers throughout the United States, filed for chapter 11 bankruptcy.[1] General Growth did not directly own or manage any of its individual properties.[2] Rather, it created hundreds of subsidiaries (special purpose entities) to own and manage each individual piece of real estate.[3]

General Growth was structured this way because of the manner in which it financed its operations. Each special purpose entity (SPE) received a mortgage loan secured by a piece of property owned by that SPE.[4] Many of the banks lending to the individual SPEs were active in the commercial mortgage-backed securities (CMBS) market.[5] These banks pooled the mortgages that they received from General Growth with similar commercial mortgages and sold securities to investors that represented the collective rights to payment on those mortgages.[6] A crucial aspect of CMBS financing is that the individual mortgagors have a low risk of default.[7] Lenders based their decision to invest in General Growth on whether the activity of any particular SPE was likely to cause it to become insolvent. Thus, the SPE was an attempt by these banks,

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[1] *In re* Gen. Growth Props., Inc., 409 B.R. 43, 54 (Bankr. S.D.N.Y. 2009).

[2] *Id.* at 47–48.

[3] *Id.* at 49.

[4] *Id.* at 50.

[5] *Id.*

[6] *See* Patrick D. Dolan, *Lender's Guide to the Securitization of Commercial Mortgage Loans*, 115 BANKING L.J. 597, 597 (1998). Note that a similar structure to the type of SPE discussed in this Comment, sometimes called a special purpose vehicle (SPV), is used during the securitization process. To securitize a pool of mortgages, the loan originator must transfer the pooled mortgages to a separate entity, which then issues the securities. When using the term SPE, this Comment is not discussing that entity. For discussion of the impact of substantive consolidation on that type of SPV, see generally Peter J. Lahny IV, LL.M Thesis, *Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, 9 AM. BANKR. INST. L. REV. 815 (2001); Michael J. Cohn, Note, *Asset Securitization: How Remote Is Bankruptcy Remote?*, 26 HOFSTRA L. REV. 929 (1998).

[7] *See generally* Georgette C. Poindexter, *Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization*, 50 EMORY L.J. 519, 543–47 (2001).

along with General Growth, to minimize the risk that any individual SPE would find itself in bankruptcy.[8]

To make General Growth's SPEs more attractive to CMBS lenders, the SPEs were designed to be "bankruptcy-remote."[9] There were various provisions included in the loan documents of the SPEs that were meant to ensure that each SPE would only engage in business related to one property, not incur additional indebtedness, and to file for bankruptcy must acquire the approval of an independent director that represented the lender's interest.[10] When General Growth filed for bankruptcy, however, it pulled all of its subsidiaries into bankruptcy with it, including many SPEs that were not in financial distress and had not defaulted on their loans.[11] General Growth's intent was to use the cash flow from some of these healthy SPEs to help pay for its reorganization, which would "preserve value for the [d]ebtors' estates and creditors."[12] The Bankruptcy Court for the Southern District of New York denied motions by these SPEs' debtors to dismiss those cases from bankruptcy for filing in bad faith.[13]

The General Growth bankruptcy raises two serious issues about the theory of bankruptcy law. First, where does the right to file for bankruptcy come from? It is clear that not every firm is given the right to the protections offered by the Bankruptcy Code whenever it pleases. For example, there are requirements that a petition be filed in good faith[14] and that a firm have a

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8 William McInerney, *From Bankruptcy-Remote to Risk-Remote; Reframing the Single-Purpose Entity in CMBS Finance*, N.Y. L.J., Aug. 23, 2010, at 9, *available at* http://www.cadwalader.com/assets/article/082310McInerneyNYLJ.pdf.

9 *Gen. Growth*, 409 B.R. at 49 n.15.

10 *Id.* at 49.

11 The Prudential Insurance Co. of America's & Prudential Retirement Insurance & Annuity Co., a Connecticut corp. f/k/a CIGNA Life Insurance Co.'s: (I) Objection to Debtors' Motion Requesting (A) Entry of (i) Interim & Final Orders (a) Authorizing the Debtors' Use of Cash Collateral & Granting Adequate Protection Therefore Pursuant to Sections 361 & 363 of the Bankruptcy Code & Bankruptcy Rule 4001, & (b) Modifying the Automatic Stay, & (ii) a Final Order Authorizing Borrowing With Priority Over Administrative Expenses & Secured by Liens on Property of the Estates Pursuant to Section 364(c) of the Bankruptcy Code, & (B) Scheduling a Final Hearing on Each Requested Final Order & (II) Request for (A) Determination that Certain Debtors are Single Asset Real Estate Debtors, (B) Adequate Protection, (C) Segregation & Accounting for Its Cash Collateral, (D) Entry of an Order Recognizing the Establishment of All Prerequisites for a Section 507(b) Claim, & (E) Granting Relief from the Automatic Stay or Dismissing Cases of Certain Debtors for Cause at 3, *In re* Gen. Growth Props., Inc., 412 B.R. 122 (Bankr. S.D.N.Y. 2009) (No. 09-11977 (ALG)) [hereinafter *Prudential Insurance Company's Objection*].

12 *Gen. Growth*, 409 B.R. at 69 (internal quotation marks omitted).

13 *Id.* at 56–70.

14 *See* Robert J. Keach, *Solvent Debtors and Myths of Good Faith and Fiduciary Duty*, AM. BANKR. INST. J., Dec./Jan. 2005, at 36, 36.

legitimate chance at reorganization.[15] The SPEs in *In re General Growth Properties, Inc.* were allowed to enter bankruptcy even though some were not in financial distress and were not in default on any obligations.[16]

Second, why is a firm not allowed to waive the right to file for bankruptcy? There is a clear rule in bankruptcy law that a waiver of bankruptcy eligibility is not enforceable.[17] However, most courts that discuss the issue do not give a clear reason why such a waiver is not enforceable.

This Comment will argue, in four parts, that the SPE presents a limited situation in which bankruptcy courts should enforce a waiver of bankruptcy eligibility. Specifically, it will argue that a firm's promise not to file for bankruptcy should be enforceable if that firm is not insolvent. Part I will review the three doctrines that led the *In re General Growth* court to deny the motions to dismiss the SPEs' cases from chapter 11.[18] Part II will analyze the

[15] *In re* Landing Assocs., Ltd., 157 B.R. 791, 812 (Bankr. W.D. Tex. 1993).

[16] *Gen. Growth*, 409 B.R at 64 ("There is no contention in these cases that the Subject Debtors were insolvent at any time.").

[17] Klingman v. Levinson, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy."); Nw. Bank & Trust Co. v. Edwards (*In re* Edwards), 439 B.R. 870, 874 (Bankr. C.D. Ill. 2010) ("For public policy reasons, the right to a discharge in bankruptcy may not be contracted away."); Double v. Cole (*In re* Cole), 428 B.R. 747, 752 (Bankr. N.D. Ohio 2009) ("[I]t is not unusual for parties to insert language into contracts whereby one party agrees to waive their right to discharge through bankruptcy . . . . [W]hatever one party's reliance on the efficacy of such an agreement, they are not, as a matter of public policy, enforceable."); Simmons Capital Advisors, Ltd. v. Bachinski (*In re* Bachinski), 393 B.R. 522, 533 (Bankr. S.D. Ohio 2008) ("[A] prepetition waiver of discharge entered into in a nonbankruptcy case is unenforceable."); Marra, Gerstein & Richman v. Kroen (*In re* Kroen), 280 B.R. 347, 351 (Bankr. D.N.J. 2002) ("[T]he court is impelled to evaluate the mixed fact/law question of the attorney's purported justifiable reliance on an oral representation, pre-petition, waiving discharge in bankruptcy. The fundamental point here is that such waivers are void, offending the policy of promoting a fresh start for individual debtors."); *In re* Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) ("[A]n agreement not to file bankruptcy is unenforceable because it violates public policy."); Freeman v. Freeman (*In re* Freeman), 165 B.R. 307, 312 (Bankr. S.D. Fla. 1994) ("An agreement to waive the benefit of a discharge in bankruptcy is void, as against public policy."); Alsan Corp. v. DiPierro (*In re* DiPierro), 69 B.R. 279, 282 (Bankr. W.D. Pa. 1987) ("[T]he court gives no significance to the portion of the [j]udgment [e]ntry determining that said [j]udgment shall not be dischargeable in bankruptcy. A debtor cannot contract away the right to a bankruptcy discharge in advance of the bankruptcy filing."); Markizer v. Economopoulos (*In re* Markizer), 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1986) ("An agreement to waive the benefit of a discharge in bankruptcy is wholly void, as against public policy."); Artinian v. Peli (*In re* Peli), 31 B.R. 952, 956 (Bankr. E.D.N.Y. 1983) ("Agreements waiving the right to file a petition in bankruptcy violate public policy and will not be given effect."); *In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) ("It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."); Johnson v. Kriger (*In re* Kriger), 2 B.R. 19, 23 (Bankr. D. Or. 1979) ("It is a well settled principle that an advance agreement to waive the benefit of a discharge in bankruptcy is wholly void, as against public policy.").

[18] *Gen. Growth*, 409 B.R 43.

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SPE structure and the *In re General Growth* decision in detail. Part III will review the scholarly literature on contracting around bankruptcy, giving particular attention to two arguments commonly advanced as reasons that a firm should not be able to waive its right to bankruptcy or significantly alter its bankruptcy rights. This Comment will then argue that the SPEs in *In re General Growth* present an example of cases where bankruptcy courts should relax the rule that waivers of bankruptcy eligibility are generally non-enforceable.

PART I

Three doctrines are relevant to the decision in *In re General Growth*: substantive consolidation, the requirement that a petition by filed in good faith, and the nonenforceability of the promise not to file bankruptcy. This Comment contends that these three doctrines overlap to produce a questionable result. Specifically, the hesitance of bankruptcy courts to dismiss a petition for "bad faith," combined with their refusal to enforce a waiver of the right to file, presents a situation where solvent firms that have contracted with lenders to avoid bankruptcy have been allowed to file regardless. This is exactly what happened in *In re General Growth*.[19]

A. *Substantive Consolidation*

Substantive consolidation is an equitable doctrine by which courts treat separate entities as if they were one for the purpose of bankruptcy proceedings.[20] There is no statutory authority for the doctrine; rather, it is "a product of judicial gloss" fashioned by courts "to ensure the equitable treatment of all creditors."[21] The early history of substantive consolidation shows three types of cases in which courts applied the doctrine.

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[19] *See id.* at 55–70.

[20] *See generally* Dennis J. Connolly, John C. Weitnauer & Jonathan T. Edwards, *Current Approaches to Substantive Consolidation:* Owens Corning *Revisited*, 2009 NORTON ANN. SURV. BANKR. L. 27 (2009); William H. Widen, *The Reality of Substantive Consolidation*, AM. BANKR. INST. J., July/Aug. 2007, at 14; Lahny, *supra* note 6; William C. Blasses, Comment, *Redefining into Reality: Substantive Consolidation of Parent Corporations and Subsidiaries*, 24 EMORY BANKR. DEV. J. 469 (2008).

[21] Ryan E. Scharar, Comment, *The Limits of Securitization: Why Bankruptcy Courts Should Substantively Consolidate Predatory Sub-Prime Mortgage Originators and Their Special Purpose Entities*, 2008 MICH. ST. L. REV. 913, 930 (2009) (quoting Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988)) (internal quotation marks omitted).

First, there were cases in which one corporation was a "mere instrumentality" of another and in which it was "logical and convenient" to treat the corporation and the subsidiary as the same entity.[22]

Second, there were cases in which bankruptcy courts applied substantive consolidation to prevent debtors from making fraudulent transfers intended to protect their wealth from the bankruptcy estate. For example, in *Sampsell v. Imperial Paper & Color Corp.*,[23] the debtor was doing business as an individual and incurred over $100,000 in debt.[24] Shortly after incurring this debt, the debtor transferred his stock of goods to a corporation of which only he, his wife, and their children were directors, officers, or stockholders.[25] Since the corporation was not formed until the debtor was hopelessly insolvent, the Court found that it was "a sham and a cloak" designed merely to shield the debtor's assets from his creditors in bankruptcy.[26]

Third, courts have applied substantive consolidation in cases in which the assets of several debtors are so "hopelessly obscured" that the accounting costs of sorting out the assets would be high enough to reduce the amount available for creditors to recover.[27]

Sampsell represents the early history of substantive consolidation, but the tests that courts use in applying the doctrine have changed since that decision was rendered almost seventy years ago. There is no single test that courts apply to determine whether substantive consolidation is appropriate in any given set of circumstances.[28] Different courts have fashioned different tests, and each case is decided by looking at the totality of the circumstances.[29] However, the two tests most often applied[30] are the two-factor test, used in *Union S Savings*

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[22] Christopher J. Predko, *Substantive Consolidation Involving Non-Debtors: Conceptual and Jurisdictional Difficulties in Bankruptcy*, 41 WAYNE L. REV. 1741, 1745–46 (1995) (quoting Stone v. Eacho (*In re* Tip Top Tailors, Inc.), 127 F.2d 284, 288–89 (4th Cir. 1942)) (internal quotation marks omitted). For a more detailed history of substantive consolidation, see Lahny, *supra* note 6.

[23] Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941). Some scholars have argued that *Sampsell* is the "seminal case" in the area of substantive consolidation. Lahny, *supra* note 6, at 866.

[24] *Sampsell*, 313 U.S. at 215.

[25] *Id.*

[26] *Id.* at 217 (internal quotation marks omitted).

[27] *See In re* Bonham, 226 B.R. 56, 79–80 (Bankr. D. Alaska 1998) (quoting Chem. Bank N.Y. Trust Co. v. Kheel (*In re* Seatrade Corp.), 369 F.2d 845, 847 (2d Cir. 1966)) (internal quotation marks omitted).

[28] Predko, *supra* note 22, at 1750.

[29] *Id.*

[30] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 765–66 (9th Cir. 2000) ("Two 'similar but not identical' tests have been applied to assess whether substantive consolidation is proper, neither of which

Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)[31] and the three-part, burden-shifting test, followed in *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*.[32]

In *In re Augie/Restivo Baking*, the court noted that although different courts had pointed to "[n]umerous considerations" to determine whether applying substantive consolidation would be equitable to all creditors, most of these considerations are simply variants on two important factors.[33] The first factor is "whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit.'"[34] The second factor is whether "the affairs of the debtors are so entangled that consolidation will benefit all creditors."[35]

In *In re Auto-Train*, the court applied a three-part test.[36] First, the proponent of consolidation must show "a substantial identity between the entities to be consolidated," and "that consolidation is necessary to avoid some harm or to realize some benefit."[37] Next, if the proponent demonstrates these two elements, then the creditor may rebut "on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."[38] Finally, if the creditor demonstrates this, then the court should consolidate only if the benefits of consolidation "heavily outweigh the harm."[39]

In *In re General Growth*, the parent corporation, General Growth, indirectly owned and managed properties throughout the United States via hundreds of subsidiaries.[40] General Growth was structured this way because it

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we have had occasion to apply or adopt." (quoting Reider v. Fed. Deposit Ins. Corp. (*In re* Reider), 31 F.3d 1102, 1107 (11th Cir. 1994)).

[31] Union Sav. Bank v. Augie/Restivo Baking Co. (*In re* Augie/Restivo Baking Co.), 860 F.2d 515, 518 (2d Cir. 1988); *see also Reider*, 31 F.3d at 1108; *In re* 599 Consumer Elecs., Inc., 195 B.R. 244, 248 (S.D.N.Y. 1996); *In re* Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993).

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

[33] *Augie/Restivo Baking Co.*, 860 F.2d at 518.

[34] *Id.* (quoting 5 COLLIER ON BANKRUPTCY ¶ 1100.06[1] (Lawrence P. King ed., 15th ed. 1996)).

[35] *Id.*

[36] *Auto-Train*, 810 F.2d at 276. For additional discussion regarding the three-part test, see also Simon v. ASIMCO Techs., Inc. (*In re* American Camshaft Specialties, Inc.), 410 B.R. 765, 780 (Bankr. E.D. Mich. 2009); Saccurato v. Shawmut Bank, N.A. (*In re* Mars Stores, Inc.), 150 B.R. 869, 879 (Bankr. D. Mass. 1993).

[37] *Auto-Train*, 810 F.2d at 276.

[38] *Id.*

[39] *Id.* (quoting James Talcott, Inc. v. Wharton (In re Cont'l Vending Mach. Corp.), 517 F.2d 997, 1001 (2d Cir. 1975)) (internal quotation marks omitted).

[40] *In re* Gen. Growth Props., Inc., 409 B.R. 43, 47–48 (Bankr. S.D.N.Y. 2009).

financed its operations by organizing the subsidiaries as bankruptcy-remote SPEs.[41] Thus, the subsidiaries could more easily obtain credit because lenders felt secure that their finances would not become intertwined with the larger parent company.[42]

The General Growth bankruptcy was not a good candidate for substantive consolidation. An SPE's status as an independent economic unit is the entire basis on which the lender chooses to extend credit. Moreover, treating General Growth as a single entity was certainly not beneficial to all creditors, as many of them vehemently protested the inclusion of the SPEs in General Growth's filing.[43] Once the SPEs were allowed to file, the court entered cash collateral orders that allowed the SPEs to "upstream cash from the individual properties for use at the parent-level entity."[44] Thus, some creditors extended credit to individual SPEs in exchange for the promise that those SPEs would not commingle assets with any other entity or engage in any business besides managing collateral for the loan, only to see a bankruptcy court allow the SPEs essentially to make intercompany loans to their parent entity in bankruptcy.

The court expressly rejected the idea that it was applying the doctrine of substantive consolidation and claimed that it was merely consolidating the proceedings for administrative convenience, stating:

> The salient point for purposes of these [m]otions is that the fundamental protections that the [m]ovants negotiated and that the SPE structure represents are still in place and will remain in place during the [c]hapter 11 cases. This includes protection against the substantive consolidation of the project-level [d]ebtors with any other entities. There is no question that a principal goal of the SPE structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the [b]oard of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case.[45]

The court accurately pointed out that the estates of the SPEs were still technically separate from the estate of General Growth and that this decision

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[41] *Id.* at 51.

[42] David B. Stratton, *Special-Purpose Entities and Authority To File Bankruptcy*, AM. BANKR. INST. J. Mar. 2004, at 36, 36.

[43] *Prudential Insurance Company's Objection*, *supra* note 11, at 5.

[44] *Gen. Growth*, 409 B.R. at 55.

[45] *Id.* at 69.

merely allowed the SPEs to enter bankruptcy and form their own estates.[46] While the court's point may be correct as a technical matter, it seems hard to square the assertion that the court was not applying substantive consolidation with its statement that it would allow separate entities to consider the interests of each other for the purpose of deciding whether to file a bankruptcy proceeding.[47] At least one creditor in its filings accused the court of applying a form of "*de facto* substantive consolidation."[48]

De facto substantive consolidation is a fair characterization of the court's decision to allow the project-level debtors to consider the interests of General Growth as a whole when filing for bankruptcy.[49] One of the reasons that General Growth wanted its SPEs to enter bankruptcy was so that it could use their cash collateral to help fund its reorganization.[50] Thus, the lenders' purpose in requiring that the SPEs promise not to incur other financial obligations or debt unrelated to managing the collateral for the loan was frustrated, even if the bankruptcy estates of the SPEs technically remained separate from the estate of General Growth. It is not clear how the court could deny the lenders' motions to dismiss the SPEs' bankruptcy cases and still make the assertion that "the fundamental protections that the [m]ovants negotiated and that the SPE structure represents are still in place," when keeping those SPEs out of bankruptcy was the exact protection for which the lenders thought they were negotiating.[51]

B. A Corporation May Not Waive Its Right to Enter Bankruptcy

There is a longstanding tradition in bankruptcy law that one cannot waive the right to file for bankruptcy.[52] One of the earliest cases espousing this

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46 *Id.*

47 *Id.*

48 *Prudential Insurance Company's Objection*, *supra* note 11, at 3.

49 *See Gen. Growth*, 409 B.R. 43.

50 *See id.* at 55; *see also In re* Gen. Growth Props., Inc., 412 B.R. 122, 125–26 (Bankr. S.D.N.Y. 2009).

51 *Gen. Growth*, 409 B.R. at 69.

52 Klingman v. Levinson, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987); Fallick v. Kehr (*In re* Fallick), 369 F.2d 899, 904 (2d Cir. 1966); *In re* Weitzen, 3 F. Supp. 698, 698 (S.D.N.Y. 1933); Nw. Bank & Trust Co. v. Edwards (*In re* Edwards), 439 B.R. 870, 874 (Bankr. C.D. Ill. 2010); Double v. Cole (*In re* Cole), 428 B.R. 747, 752 (Bankr. N.D. Ohio 2009); Simmons Capital Advisors, Ltd. v. Bachinski (*In re* Bachinski), 393 B.R. 522, 533–34 (Bankr. S.D. Ohio 2008); Marra, Gerstein & Richman v. Kroen (*In re* Kroen), 280 B.R. 347, 351–52 (Bankr. D.N.J. 2002); *In re* Madison, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995); Freeman v. Freeman (*In re* Freeman), 165 B.R. 307, 312 (Bankr. S.D. Fla. 1994); Alsan Corp. v. DiPierro (*In re* DiPierro), 69 B.R. 279, 282 (Bankr. W.D. Pa. 1987); Markizer v. Economopoulos (*In re* Markizer), 66 B.R. 1014, 1018 (Bankr. S.D. Fla. 1986); Artinian v. Peli (*In re* Peli), 31 B.R. 952, 956 (Bankr. E.D.N.Y. 1983); *In re* Tru Block

principle is *In re Weitzen*, which was decided in 1933.[53] In that decision, a court laid out the rationale for the rule:

> The agreement to waive the benefit of bankruptcy is unenforceable. To sustain a contractual obligation of this character would frustrate the object of the Bankruptcy Act, particularly of section 17. This was held by the Supreme Judicial Court of Massachusetts, where it was said: "It would be repugnant to the purpose of the Bankruptcy Act to permit the circumvention of its object by the simple device of a clause in the agreement, out of which the provable debt springs, stipulating that a discharge in bankruptcy will not be pleaded by the debtor. The Bankruptcy Act would in the natural course of business be nullified in the vast majority of debts arising out of contracts, if this were permissible. It would be vain to enact a bankruptcy law with all its elaborate machinery for settlement of the estates of bankrupt debtors, which could so easily be rendered of no effect. The bar of the discharge under the terms of the Bankruptcy Act is not restricted to those instances where the debtor has not waived his right to plead it. It is universal and unqualified in terms. It affects all debts within the scope of its words. It would be contrary to the letter of section 17 of the Bankruptcy Act as we interpret it to uphold the waiver embodied in this note. So to do would be incompatible with the spirit of that section. Its aim would largely be defeated."[54]

This reasoning is consistent with most decisions that discuss the issue. Courts routinely refuse to enforce waivers of the right to file bankruptcy on the grounds that such waivers frustrate the purpose of the Bankruptcy Code (or former Act), or that they are void against "public policy."[55] Some courts have gone so far as to find that such waivers are unenforceable because there is a constitutional right to file for bankruptcy.[56] However, this argument has been rejected for multiple reasons: the Constitution does not require Congress to

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Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983); Johnson v. Kriger (*In re* Kriger), 2 B.R. 19, 23 (Bankr. D. Or. 1979).

[53] *Weitzen*, 3 F. Supp. at 698–99.

[54] *Id.* (citation omitted) (quoting Federal Nat'l Bank v. Koppel, 148 N.E. 379, 380 (Mass. 1925)).

[55] *See supra* note 17.

[56] Thomas G. Kelch & Michael K. Slattery, *The Mythology of Waivers of Bankruptcy Privileges*, 31 IND. L. REV. 897, 900 (1998) (citing Merritt v. Mt. Forest Fur Farms of Am., Inc. (*In re* Mt. Forest Fur Farms of Am., Inc.), 103 F.2d 69, 71 (6th Cir. 1939); *In re* Pine Tree Feed Co., 112 F. Supp. 124, 126 (D. Me. 1953); *In re* Citadel Props., Inc., 86 B.R. 275, 276 (Bankr. M.D. Fla. 1988); *In re* Adana Mortg. Bankers, Inc., 12 B.R. 989, 1009 (Bankr. N.D. Ga. 1980), *vacated sub nom.* Gov't Nat'l Mortg. Ass'n v. Adana Mortg. Bankers, Inc. (*In re* Adana Mortg. Bankers, Inc.), 687 F.2d 344 (11th Cir. 1982)).

make bankruptcy laws at all, and individuals are allowed to waive other constitutional rights, such as those governed by the Fifth Amendment.[57]

In the case of individuals, the public policy goals in refusing to enforce bankruptcy waivers are clear. The justification that an individual is entitled to be free from the burdens of debt and have a chance to wipe the slate clean is often referred to as the "fresh start" policy.[58] The purpose behind the fresh start policy is to "relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes."[59] Courts have refused to enforce a waiver of the right to file bankruptcy because of the social consequences of being a debtor with no hope of returning to solvency.[60] There are humanitarian reasons for allowing an individual to file for bankruptcy.[61] At least one scholar has even gone so far as to say that the reasons for allowing discharge to individual debtors are purely moral.[62] Being hopelessly insolvent can impair a person's ability to buy a house, lease a car, maintain a job, and generally advance in society. One of the purposes of bankruptcy law is to limit negative social consequences of being a debtor,[63] and allowing an individual to alter or waive the ability to file bankruptcy would frustrate that purpose.

To the extent that humanitarian reasons for the fresh start policy are unconvincing, there is also the concern that an individual saddled with debt will have no reason to actively participate in the economy.[64] If one knows that

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57 *Id.* at 900; Steven L. Schwarcz, *Rethinking Freedom of Contract: A Bankruptcy Paradigm*, 77 TEX. L. REV. 515, 539 (1999).

58 Irby v. Preferred Credit (*In re* Irby), 359 B.R. 859, 861 (Bankr. N.D. Ohio 2007); Kelch & Slattery, *supra* note 56, at 905; Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 307–08 (1997). *See generally* Charles G. Hallinan, *The "Fresh Start" Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49 (1986). Not all scholars accept the fresh start policy as grounds for the right to declare bankruptcy. For a critique of the policy, see generally F.H. Buckley, *The American Fresh Start*, 4 S. CAL. INTERDISC. L.J. 67 (1995).

59 Robert C. Yan, Note, *The Sign Says "Help Wanted, Inquire Within"—But It May Not Matter if You Have Ever Filed (or Plan To File) for Bankruptcy*, 10 AM. BANKR. INST. L. REV. 429, 433 (2002) (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244–45 (1934)) (internal quotation marks omitted).

60 Tracht, *supra* note 58, at 307–08.

61 See Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor*, 48 WASH. & LEE L. REV. 515, 517–21 (1991); Tracht, supra note 58, at 307–08.

62 Flint, *supra* note 61, at 519–21.

63 See Otis B. Grant, *Are the Indigent Too Poor for Bankruptcy? A Critical Legal Interpretation of the Theory of a Fresh Start Within a Law and Economics Paradigm*, 33 U. TOL. L. REV. 773, 778 (2002).

64 *See* Tracht, *supra* note 58, at 307–08.

creditors will immediately seize the fruits of one's labor, then one will shut down economically, having lost the incentive to produce income.[65]

These seem to be valid reasons for preventing the waiver of an individual's right to file, but the "fresh start" policy that applies to individual debtors does not apply to businesses.[66] There are no humanitarian concerns when it comes to the debt of a business, as businesses can be sold off or shut down if they are no longer economically viable. However, courts will not enforce bankruptcy waivers by businesses.[67]

The decision in *In re General Growth* raises the issue of the right of a business to waive or alter its ability to file bankruptcy through contract. Presumably, if the parties believed that such a waiver would be enforceable, the lenders would simply have insisted that the debtors organize as a separate entity that did not have the ability to enter bankruptcy instead of coming up with an elaborate scheme of separateness covenants and independent directors to achieve bankruptcy-remote status. If such a mechanism were available, then the SPEs' lenders would have been even more sure that the SPEs would not end up in bankruptcy. Moreover, the court dismissed the argument that the creditors' rights were impaired by allowing the SPEs to enter bankruptcy.[68] The court held that the independent managers' fiduciary duty to the creditors was superseded by their promise to consider the interests of the company as a whole.[69] Moreover, the court made it clear that it was appropriate for the SPEs, which were organized specifically to be separate from General Growth, to consider themselves part of the larger "corporate group" when making a decision to file.[70] This court is not alone in refusing to allow entities to use the SPE structure to limit their ability to enter bankruptcy.[71]

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65 *Id.*

66 *Id.*

67 United States v. Royal Bus. Funds Corp., 24 F.2d 12, 15 (2d Cir. 1983) ("We by no means intend to disturb the general rules that a debtor may not agree to waive the right to file a bankruptcy petition . . . ."); *In re* Tru Block Concrete Prods., Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) ("It is a well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy."); Tracht, *supra* note 58, at 307 (citing *Tru Block Concrete*, 27 B.R. at 492).

68 *In re* Gen. Growth Props., Inc., 409 B.R. 43, 69 (Bankr. S.D.N.Y. 2009).

69 *Id.* at 63–64.

70 *Id.* at 69.

71 Sheri P. Chromow & K.C. McDaniel, *Surviving a CMBS Bankruptcy*, *in* MODERN REAL EST. TRANSACTIONS 747, 754 (ALI-ABA Continuing Legal Education, Course of Study No. SJ004, 2003) ("Case law has rejected the idea of limiting the power of directors or requiring them to refuse a vote in favor of bankruptcy.").

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C. The Good Faith Filing Requirement

Not every business that files for bankruptcy is insolvent. There are many instances where solvent businesses enter bankruptcy because they believe that they are on the brink of financial distress, or that some impending event will cause them to become insolvent.[72] One of the reasons for this is the Code's policy of keeping the barriers to bankruptcy low.[73]

A showing of insolvency is not required for a business to enter bankruptcy.[74] There is a concern that if businesses were forced to demonstrate insolvency before being allowed access to the bankruptcy system, then many firms would have to wait to file until they were hopelessly insolvent, precluding a realistic chance that they could be reorganized successfully.[75] In the case of large corporations, it can be difficult and expensive to value the assets and liabilities to get a clear determination of whether the corporation is insolvent, and courts feel that such a determination is better left to the corporation's directors than to judges.[76] Additionally, solvent firms may wish to take advantage of some of the provisions of the Code that are not available

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[72] Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 423 (1972) ("Chapter X proceedings are not limited to insolvent corporations . . . ."); United States v. Huebner, 48 F.3d 376, 379 (9th Cir. 1994) ("The Bankruptcy Act does not require any particular degree of financial distress as a condition precedent to a petition seeking relief."); *In re* James Wilson Assocs., 965 F.2d 160, 170 (7th Cir. 1992) ("[T]he Bankruptcy Code permits an individual or firm that has debts to declare bankruptcy even though he (or it) is not insolvent."); Connell v. Coastal Cable T.V., Inc. (*In re* Coastal Cable T.V., Inc.), 709 F.2d 762, 764 (1st Cir. 1983) (noting that a debtor need not necessarily be insolvent). *But see* Lynch v. Johns-Mansville Sales Corp., 23 B.R. 750, 752 (S.D. Ohio 1982).

[73] *See* Susan Block-Lieb, *Fishing in Muddy Waters: Clarifying the Common Pool Analogy as Applied to the Standard for Commencement of a Bankruptcy Case*, 42 AM. U. L. REV. 337, 418–27 (1993); Ali M.M. Mojdehi & Janet Dean Gertz, *The Implicit "Good Faith" Requirement in Chapter 11 Liquidations: A Rule in Search of a Rationale?*, 14 AM. BANKR. INST. L. REV. 143, 145–46 (2006).

[74] *See* Carlos J. Cuevas, *Good Faith and Chapter 11: Standard that Should Be Employed To Dismiss Bad Faith Chapter 11 Cases*, 60 TENN. L. REV. 525, 581–82 & n.340 (1993); Mojdehi & Gertz, *supra* note 73, *at* 158; Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 488 (1996); Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919, 921 n.7 (1991) ("Conspicuous by its absence from the Bankruptcy Code is any requirement that the debtor be insolvent in either an equity or balance sheet sense."); Alan N. Resnick, *Bankruptcy as a Vehicle for Resolving Enterprise-Threatening Mass Tort Liability*, 148 U. PA. L. REV. 2045, 2055 (2000); Howard Seife, *Solvent Debtors May Be Unable To Enter Bankruptcy in Absence of "Financial Distress,"* 122 BANKING L.J. 52, 52 (2005) (arguing also that this trend may be reversing); Keach, *supra* note 14, at 36 (suggesting that the trend of open access to the bankruptcy system may be reversing).

[75] Resnick, *supra* note 74, at 2055.

[76] *See* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXTS, CASES, AND PROBLEMS 422 (6th ed. 2009).

to firms outside of bankruptcy, like the ability to void or assign executory contracts.[77]

A firm's access to the bankruptcy system depends, not as much on its solvency, as on whether it filed a petition in good faith.[78] The essential requirement for a showing of good faith is that the petition has some "valid reorganizational purpose."[79] This means that the business must enter chapter 11 for one of the purposes that the chapter was intended to serve,[80] and not some other reason, such as gaining a tactical advantage in litigation.[81]

One case on this issue is *In re SGL Carbon Corp*.[82] In that case, a corporation filed for chapter 11, claiming that an impending antitrust suit threatened to make the corporation insolvent.[83] Simultaneously, the CEO of the corporation had a conference call with securities analysts in which he stated

> that SGL Carbon was experiencing healthy and growing success and denied that the class action antitrust litigation was materially interfering with SGL Carbon's operations or its customer relationships. [The CEO] added that unlike most [c]hapter 11 cases, SGL Carbon's petition did not involve serious insolvency or credit problems. SGL Carbon Vice President Theodore Breyer acknowledged in his deposition that SGL Carbon had no defaults nor any financial distress when it filed for [c]hapter 11.[84]

Thus, the petition was dismissed for a lack of good faith.[85] Even the court in *In re SGL Carbon* noted that that case is the exception to the general rule that the Code is intended to encourage early filing.[86]

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[77] Plank, *supra* note 74, at 548–51.

[78] *See* Keach, *supra* note 14, at 36.

[79] *See In re* SGL Carbon Corp., 200 F.3d 154, 163 (3d Cir. 1999); Keach, *supra* note 14, at 36 (quoting *SGL Carbon*, 200 F.3d at 165) (internal quotation marks omitted).

[80] *See SGL Carbon*, 200 F.3d at 165 (citing Marsch v. Marsch (*In re* Marsch), 36 F.3d 825, 828 (9th Cir. 1994)).

[81] *Id.* at 165 (citing Furness v. Lilienfield, 35 B.R. 1006, 1013 (Bankr. D. Md. 1983)).

[82] *Id.* at 154.

[83] *See id.* at 157.

[84] *Id.* at 166 (internal quotation marks omitted)

[85] *Id.* at 156.

[86] *See id.* at 163 ("It is well established that a debtor need not be insolvent before filing for bankruptcy protection. It also is clear that the drafters of the Bankruptcy Code understood the need for early access to bankruptcy relief to allow a debtor to rehabilitate its business before it is faced with a hopeless situation." (citations omitted)).

PART II

Three doctrines have been discussed so far. Substantive consolidation allows bankruptcy courts to pull a debtor's related entities into bankruptcy to ensure a more equitable distribution to creditors.[87] There is also a general trend in bankruptcy that courts will not enforce either a promise not to file for bankruptcy or a waiver of specific rights in bankruptcy by an individual or a business.[88] Finally, courts recognize a policy of encouraging businesses to file early because of the concern that, if they wait too long to enter bankruptcy, they will be so hopelessly insolvent that there will not be a realistic chance for them to reorganize or even to pay a meaningful amount to creditors.[89] Courts will not make an in-depth inquiry into a business's reasons for entering bankruptcy unless it is clear that the filing is really just an attempt to defraud creditors.[90] Thus, there will be cases where solvent debtors file bankruptcy merely to take advantage of some provision of the Code.

The next step is to look at a case in which these three doctrines overlap with each other to produce questionable results. In *In re General Growth*, several subsidiaries of a Real Estate Investment Trust were effectively substantively consolidated with the bankruptcy of their parent corporation.[91] The subsidiaries promised not to file for bankruptcy, and they had attempted to organize themselves as bankruptcy-proof SPEs.[92] Moreover, many of these

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[87] *See supra* note 20 and accompanying text.

[88] *See supra* note 17 and accompanying text.

[89] *See supra* note 75 and accompanying text.

[90] *See, e.g.*, *SGL Carbon*, 200 F.3d at 166.

[91] Note that the court in *In re Gen. Growth* denied that it was substantively consolidating the SPEs with General Growth. *In re* Gen. Growth Props., Inc., 409 B.R. 43, 69 (Bankr. S.D.N.Y. 2009). This is true as a technical point because the SPEs still had individual bankruptcy cases. *Id.* at 54. However, several commentators have noted that what the court did was close to substantive consolidation or at least signaled a move toward substantive consolidation in similar cases in the future. James Bryce Clark & Maura B. O'Connor, *Judicial Responses to SPE Structures: Less than Meets the Eye, But More to Come*, *in* 1 COMMERCIAL REAL ESTATE FINANCING 2010: HOW TO HANDLE DEFAULTS, DISTRESS, MATURITIES, AND STACKS OF DEBT 197, 207 (Peter S. Muñoz, Peter A. Sarasek & Joshua Stein eds., 2010); Jason Lynch, *Reevaluating Bankruptcy Remoteness: Transfers of Risk, Implications of the GGP Reorganization*, AM. BANKR. INST. J., July/Aug. 2010, at 58, 58; George R. Pitts, *More than Was Dreamt of in Your Philosophy: Recent Developments and Familiar Principles in Chapter 11 Cases*, *in* CREDITORS' RIGHTS IN CHAPTER 11 CASES: LEADING LAWYERS ON IDENTIFYING AND PROTECTING THE RIGHTS OF SECURED AND UNSECURED CREDITORS DURING CHAPTER 11 BANKRUPTCY CASES 23, 31 (2010); *see also supra* discussion accompanying notes 28–31.

[92] *Gen. Growth*, 409 B.R. at 61; *see also* Lynch, *supra* note 91, at 60; McInerney, *supra* note 8, at 9; Stratton, *supra* note 42, at 36; *General Growth: Bankruptcy and the Downfall of Securitization as We Know It?*, WESTLAW LEGAL CURRENTS (May 5, 2009), http://www3.gsionline.com/Legalcurrents/Article_20090505_E1.asp (last visited Jan. 19, 2012).

subsidiaries were not in financial distress; they had not defaulted on payment of their loans, and they had complied with all the provisions of their lending documents.[93] Despite these circumstances, the SPEs were allowed to file along with their parent corporation.[94] This Comment will attempt to demonstrate that, in cases like *In re General Growth*, there is reason to give effect to an attempt by a debtor and its creditor to contract around the bankruptcy system. First, it is necessary to fully understand the transaction at issue in *In re General Growth*.

A. The Special Purpose Entity

A special purpose entity, or SPE, is an entity (a corporation in the instance of General Growth) that is organized so that a lender can "reduce the risk that the borrower will file bankruptcy."[95] An SPE can also take the form of a limited partnership or a limited liability company.[96] It is also sometimes called a single purpose entity[97] or a special purpose vehicle.[98] The general idea is that, instead of lending to a large company that already has obligations to other creditors, a lender can extend credit to a subsidiary of that company that has been organized only to manage the specific project for which the loan is required.[99] The subsidiary is less likely to file for bankruptcy because it is insulated from the financial obligations of the parent corporation and only manages one piece of property, and even if the subsidiary does file for bankruptcy, the lender is still at a reduced risk because it will not have to compete with every creditor of the parent for the subsidiary's assets.[100]

B. Structure of SPEs

The first step in creating an SPE is for the parent company to transfer assets to the SPE.[101] For example, if the SPE is to own and manage a piece of real estate and needs a loan to acquire or improve that real estate, then the parent company transfers to the SPE the property to be used as collateral for the

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93 *Prudential Insurance Company's Objection*, *supra* note 11, at 3.
94 *Gen. Growth*, 409 B.R. at 46–47.
95 MICHAEL T. MADISON ET AL., THE LAW OF REAL ESTATE FINANCING § 13:38, at 13-70 (2009).
96 *See* Stratton, *supra* note 42, at 36.
97 *Id.*
98 Lynch, *supra* note 91, at 58.
99 *See, e.g.*, Stratton, *supra* note 42, at 36.
100 *Id.*
101 *Id.*; *see* McInerney, *supra* note 8, at 9.

loan.[102] Then, when the SPE is ready to borrow, the lender insists on certain provisions in the loan documentation that assure the bankruptcy-remote status of the SPE. The two types of provisions put in the loan documents are: (1) covenants designed to ensure that the borrower continues to operate as a single purpose entity; and (2) the appointment of an independent director to the SPE's board who takes the lender's interest into account in any decision to file bankruptcy.[103]

These covenants are designed to ensure that the actions of the SPE remain independent from those of the parent company or its affiliates.[104] The creditor of the SPE is trying to avoid two things: First, it does not want the SPE to incur any other debt or to guarantee the debt of any affiliate or otherwise-related entity.[105] Second, it does not want the SPE to engage in any other business transaction because it does not want cash that should be used to develop the subject property, or other collateral for the loan, to be diverted to some other venture.[106] Covenants often prohibit the borrower from:

> (1) engaging in business other than to operate the collateral; (2) owning property other than the collateral; (3) merging with another entity or acquiring any subsidiary; (4) incurring other debt (with exceptions of ordinary course trade payables and equipment financing); (5) co-mingling assets with affiliates; and (6) guaranteeing the debt of an affiliate or pledging its assets to secure the debt of another. . . . [The covenants may also] (7) require with regard to any affiliates that the borrower maintain separate books and records, bank accounts, and maintain a separate office.[107]

These restrictions are often included in the organizational documents of the SPE as well as the loan documentation.[108] The covenants are designed to ensure that the SPE does not find itself in a position where it would need to file bankruptcy, i.e., it does not incur any debt besides the debt it owes to the one lender.[109]

The appointment of the independent director is meant to ensure that the SPE's management does not make decisions without taking into account the

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[102] McInnerney, *supra* note 8; Stratton, *supra* note 42, at 36.
[103] Stratton, *supra* note 42, at 36.
[104] *See* McInerney, *supra* note 8, at 9; Stratton, *supra* note 42, at 36.
[105] *See* MADISON ET AL., *supra* note 95, § 13:38, at 13-70 (2009); Stratton, *supra* note 42, at 36.
[106] *See* Stratton, *supra* note 42, at 36.
[107] MADISON ET AL., *supra* note 95, § 13:38, at 13-70 (2009) (footnote omitted).
[108] *Id.*
[109] *See id.*

interests of the creditor.[110] Because the parent company owns the SPE, the individuals appointed to the management structure of the SPE often have some relationship with the parent company.[111] In some cases, an individual on the parent company's board of directors can also be on the SPE's board of directors.[112] In that case, the lender is concerned that, if the parent company is in financial distress, the interests of the SPE will take a backseat to the interests of the parent, and the SPE's management will choose to voluntarily file for bankruptcy or to make some other business decision that may be detrimental to the creditor.[113]

To alleviate this concern, the lender insists on the appointment of an independent director to the SPE's management that has no relationship to the parent.[114] The SPE is required to obtain the consent[115] of the independent director to: (1) file for bankruptcy; or (2) make any amendment to the SPE's organizational documents.[116] The independent director is also required to take into account the interests of the creditor when voting on any action by the SPE.[117]

One question concerning independent directors that arises with some frequency is to whom do these directors owe a fiduciary duty?[118] In *In re General Growth*, the SPEs have included provisions in their loan documentation that prompted the independent directors to consider only the interests of the secured creditors when voting as a board member.[119] However, the court held that the independent directors were constrained by their original operating agreements, which required board members to consider the interests of the parent companies—including perhaps the parent's creditors—when making a decision about the corporation's business operations.[120] Independent

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[110] *See* Stratton, *supra* note 42, at 36.

[111] *See id.*

[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] In practice, the independent director does not officially have veto power over a decision to file, but there are circumstances where the independent manager is, in effect, given veto power when the unanimous consent of the board is required. *See, e.g.*, *In re* Gen. Growth Props., Inc., 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009).

[116] Stratton, *supra* note 42, at 36.

[117] *Id.*

[118] *See, e.g.*, *Gen. Growth*, 409 B.R. at 63; *In re* Kingston Square Assocs., 214 B.R. 713, 721 (Bankr. S.D.N.Y. 1997).

[119] *See Gen. Growth*, 409 B.R. at 64.

[120] *See id.* at 63.

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directors are also constrained by their obligation to consider the interests of investors when making decisions about whether to file bankruptcy.[121] Independent directors can thus be put in a position where they have seemingly conflicting fiduciary duties: one to the creditors of the SPE, and a second to the shareholders of the corporation on whose board they sit.[122] In the case of corporations, courts will look to the law of the state of incorporation to determine questions of who has the authority to file a voluntary bankruptcy petition.[123]

C. Benefits of SPEs

Some benefits of the SPE structure to the lender are straightforward: if the SPE follows the covenants described above, the lender is less exposed to the risk that the borrower would incur other financial obligations and have the lender's collateral end up in the bankruptcy estate of the parent company. Because of the reduced risk, the lender can offer credit on more favorable terms, and so for the borrower, the SPE structure offers an opportunity to borrow at a lower interest rate than might be available for the parent company.[124] The credit rating of an SPE is generally higher than its parent because the SPE holds only one isolated asset and does not have any debt, whereas the parent may already have various obligations to different lenders.[125] Thus, it is easier for the SPE to attract investors and borrow at lower rates than the parent.[126]

Another advantage to an SPE transaction from the lender's perspective comes from § 362(d)(3),[127] which authorizes lifting the automatic stay in single asset real estate (SARE) chapter 11 cases.[128] Under § 362(d)(3), a court must grant relief from the stay "with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate . . . ."[129] Section 101 defines "single asset real estate" as follows:

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121 *See id.* at 64–65; Stratton, *supra* note 42, at 36.
122 *See* Stratton, *supra* note 42, at 36.
123 *Id.* at 37; *see, e.g.*, *Gen. Growth*, 409 B.R. at 63–64.
124 Stratton, *supra* note 42, at 36.
125 *See id.*
126 *See id.*
127 11 U.S.C. § 362(d)(3) (2006).
128 *See id.*
129 *Id.*

> The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.[130]

In theory, § 362 would apply to SPEs that exist solely to manage or own a single piece of real estate.[131]

D. Commercial Mortgage-Backed Securities

Perhaps the most attractive aspect of the SPE in the real estate context is that the loan an SPE obtains can be pooled together with other loans and sold as commercial mortgage-backed securities (CMBS).[132] In a CMBS transaction, a lender makes several mortgage loans to separate entities.[133] It then pools those mortgages together and sells them to a securitization trust.[134] The trust then sells securities to investors.[135] These securities constitute the right to payment on the original mortgages.[136]

Every month the interest payments made on a pool of loans are paid to investors in order based on the rating of the bonds they hold.[137] Each class of investor must be paid completely before any lower class gets paid, and thus the highest bondholders have a minimal risk of not receiving payment.[138] Indeed, before the recent financial crisis, some higher-rated mortgage-backed securities were given the same credit rating as U.S. Treasury bonds.[139] From the originating lender's perspective, the CMBS transaction is desirable because it can sell a mortgage off to be securitized and receive money from investors

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[130] *Id.* § 101(51B).

[131] *See Prudential Insurance Company's Objection*, *supra* note 11, at 26.

[132] Dolan, *supra* note 6, at 597–98; *Bankruptcy and the Downfall of Securitization*, *supra* note 92.

[133] Dolan, *supra* note 6, at 597–98.

[134] *Id*. at 598.

[135] *Id.*; Anna T. Pinedo, *Easing into a New Model for Housing Finance: A Postmortem on Securitization and the Financial Crisis*, 41 UCC L.J. 157, 162 (2009).

[136] Pinedo, *supra* note 135, at 162.

[137] COMMERCIAL MORTG. SEC. ASS'N & MORTG. BANKERS ASS'N, BORROWER GUIDE TO CMBS 2 (2004), *available at* http://www.crefc.org/industryresources.aspx?id=3348

[138] *Id.*

[139] Randolph C. Thompson, *Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis*, BUS. L. BRIER, Fall 2008, at 51, 52.

right away instead of waiting for payment from each individual mortgagor.[140] Thus, the lender can offer better terms to each borrower.

Moreover, CMBS bring a new source of capital to the commercial real estate market because investors who purchase securities would "otherwise not be active real estate lenders."[141] In 2007 alone, the amount of credit created for property owners because of the CMBS structure was valued at approximately $230 billion.[142]

The SPE is crucial to the success of a CMBS transaction. Some commentators have suggested that if bankruptcy-remote SPEs did not exist, the entire CMBS market would collapse.[143] For rating purposes, CMBS are made up of mortgages that have similar terms.[144] Rating agencies base the rating of security on how likely it is that the pool of borrowers will pay off the debt. Thus, the original lender in a CMBS transaction must be certain that the borrower will not end up in financial distress, and more specifically, that the asset being financed will not become subject to other debt.[145] This is because the value of securities is directly tied to the credit rating they receive, which in turn is directly tied to the likelihood that the original mortgagers will default. The income generated by CMBS is made up of payments made by the original mortgagors. If those mortgagors end up in bankruptcy, or if their property becomes encumbered by other debt, then they are much more likely to default on payments.

E. The General Growth Properties Bankruptcy

In 2009, General Growth filed a voluntary petition under chapter 11 of the Bankruptcy Code.[146] General Growth's bankruptcy is interesting because it calls into question the effectiveness of the bankruptcy-remote SPE.[147] Aside

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[140] Pinedo, *supra* note 135, at 162.

[141] Amended Brief of Amici Curiae with Respect to the Filing of Voluntary Petitions in Bankruptcy by the Individual Property Owner Subsidiaries in the General Growth Properties, Inc. Bankruptcy at 5, *In re* Gen. Growth Props., Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009) (No. 09-11977 (ALG)) [hereinafter *Amended Amici Brief*].

[142] *Id.*

[143] *Bankruptcy and the Downfall of Securitization*, *supra* note 92.

[144] Pinedo, *supra* note 135, at 163.

[145] *Amended Amici Brief*, *supra* note 141 at 6–7, 11.

[146] *In re* Gen. Growth Props., Inc., 409 B.R. 43, 54 (Bankr. S.D.N.Y. 2009).

[147] *See, e.g.*, Lynch, *supra* note 91, at 58; McInerney, *supra* note 8, at 9; Arthur J. Steinberg & Scott I. Davidson, *Bankruptcy Remote Entities: Not as Remote as You May Think*, N.Y. L.J., Nov. 18, 2009, at 4,

from its effect on the commercial real estate finance market, this bankruptcy also highlights a potential problem—that the Code does not allow businesses to contract away their right to file for bankruptcy.

General Growth was the parent corporation of hundreds of SPEs.[148] When General Growth filed for bankruptcy, it brought those entities into its bankruptcy estate, surprising creditors who had made loans to those entities on the assumption that they would remain bankruptcy-remote.[149] Even more troubling to these creditors was the fact that many of the SPEs were allowed to enter bankruptcy, despite the fact that they had positive cash flows and no imminent risk of mortgage default.[150] This Comment addresses why businesses like the SPEs in General Growth are allowed to file for bankruptcy.

General Growth was organized as a Real Estate Investment Trust (REIT).[151] A REIT is "a tax-favored vehicle through which the average person" can invest in real estate.[152] The purpose of the REIT is to allow individuals who otherwise would not have the financial means to invest in real estate to do so through a trust.[153] Investors receive shares in the trust, which holds real estate and is managed by professionals.[154] The income to the REIT is not subject to the federal income tax.[155] To qualify as an REIT, an entity must meet the following eight requirements:

(1) be organized as a corporation, trust, or association;
(2) be managed by one or more trustee or directors;
(3) have transferable shares or certificates;
(4) be taxable as a domestic corporation . . . ;
(5) not be a financial institution or insurance company;
(6) be owned by 100 or more persons;
(7) not be closely held; and

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available at http://www.kslaw.com/imageserver/KSPublic/Library/publication/11-09%20NYLJ%20Steinberg,%20Davidson.pdf.

148 *Gen. Growth*, 409 B.R. at 48.

149 Kris Hudson & Lingling Wei, *Move by General Growth Rattles Malls' Investors*, WALL ST. J., May 8, 2009, http://online.wsj.com/article/SB124163910180492861.html.

150 Steinberg & Davidson, *supra* note 147, at 4.

151 *Gen. Growth*, 409 B.R. at 47.

152 Michael K. Carnevale et al., *Real Estate Investment Trusts*, 742-3d Tax Mgmt. (BNA), U.S. Income, at Introduction (2008).

153 *Id.*

154 *Id.*

155 *Id.*

> (8) elect to be taxed as a REIT or have in effect such an election made for a previous taxable year.[156]

General Growth owned or operated over 200 shopping centers in 44 different states.[157] It owned and managed these properties indirectly through hundreds of small subsidiaries, many of which were organized as SPEs.[158]

General Growth financed its operations three ways. Some of the properties were funded by conventional mortgage debt.[159] Other properties were funded by commercial mortgages that were bundled and sold into the CMBS market.[160] And some of the properties were funded by "mezzanine loans."[161]

Mezzanine loans are a form of financing available to owners of property that has already been mortgaged.[162] The key to mezzanine financing is a process called "structural subordination."[163] In a mezzanine loan transaction, the property owner forms a new entity to which it transfers all of the property's equity.[164] The owner pledges the ownership of the new entity to the lender as security for the loan. Thus, the lender has no claim against either the holder of the first mortgage on the property or against the property itself.[165] The benefit of mezzanine financing is that it allows a borrower to receive more financing on an individual piece of property without having to take a second mortgage, which poses increased risks for the lenders in the first mortgage.[166]

Much of General Growth's debt was financed in the CMBS market.[167] General Growth formed SPEs to own or manage shopping centers, and each SPE mortgaged the subject property. These mortgages matured after only seven years and had balloon payments due at maturity. When the CMBS market was healthy, General Growth would refinance mortgages that were

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156 *Id.*

157 *In re* Gen. Growth Props., Inc., 409 B.R. 43, 47 (Bankr. S.D.N.Y. 2009).

158 *Id*. at 49.

159 *Id.*

160 The court found that as time went on this became the primary source of capital for General Growth. *Id.* at 50; *Bankruptcy and the Downfall of Securitization*, *supra* note 92.

161 *Gen. Growth*, 409 B.R. at 51.

162 Steve Horowitz & Lisa Morrow, *Mezzanine Financing*, *in* REAL ESTATE FINANCING DOCUMENTATION 649, 651–52 (ALI-ABA Continuing Legal Education, Course of Study No. SL007, 2006).

163 *Id*. at 652.

164 *See* Andrew R. Berman, *Risks and Realities of Mezzanine Loans*, 72 MO. L. REV. 993, 995 (2007).

165 *Id*. at 1015.

166 Horowitz & Morrow, *supra* note 162, at 652.

167 *Bankruptcy and the Downfall of Securitization*, *supra* note 92.

close to maturing.[168] Unfortunately for General Growth, the CMBS market collapsed during the financial crisis of 2008.[169] Thus, General Growth was unable to refinance its mortgage debt and was at risk of going into default on billions of dollars of debt that would come due within a few years. General Growth filed for bankruptcy when it determined that it would not be able to refinance this debt.[170]

Though General Growth as a whole was struggling, many of its SPEs were in perfect financial health.[171] Nevertheless, General Growth caused its SPEs to file for bankruptcy, and the bankruptcies of General Growth and its SPEs were administratively consolidated into a single proceeding.[172]

There are two primary reasons that the SPEs were compelled to join General Growth in bankruptcy. First, the court rejected the creditors' argument that the SPEs' petitions should be dismissed as premature, bad-faith filings.[173] The court deferred to General Growth's finding that its capital structure had become unmanageable and any financially healthy SPEs would not be so once their mortgages matured. This approach is consistent with the Code's early filing allowance.[174] In this case, General Growth hired financial analysts to evaluate each SPE debtor. It then held a series of meetings with financial analysts and restructuring advisors in which the Vice Chairman of General Growth "provided an overview of [each subject debtor's] financial and operational considerations, including the property's performance, outlook, and projected capital needs."[175] The board then separated the SPEs into different classes based on these factors and voted on whether to put each debtor into bankruptcy. The court noted that, although some of the debtors were financially healthy, many others had mortgage debt that was hyperamortizing or maturing before 2012, and some were guarantors on maturing loans taken

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168 *In re* Gen. Growth Props., Inc., 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009).

169 Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1038 (2009).

170 *Gen. Growth*, 409 B.R. at 55.

171 Steinberg & Davidson, *supra* note 147, at 4.

172 Brian M. Resnick & Steven C. Krause, *Not So Bankruptcy-Remote SPEs and* In re General Growth Properties Inc., AM. BANKR. INST. J., Oct. 2009, at 1, 1.

173 *Gen. Growth*, 409 B.R. at 56.

174 *See, e.g.*, *In re* SGL Carbon Corp., 200 F.3d 154, 163 (3d Cir. 1999) ("The District Court was correct in noting that the Bankruptcy Code encourages early filing. It is well established that a debtor need not be insolvent before filing for bankruptcy protection." (citation omitted)); *see also* Resnick, *supra* note 74, at 2055.

175 *Gen. Growth*, 409 B.R. at 58 (internal quotation marks omitted).

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out by other entities, which would be a clear violation of the covenants made to make the SPEs bankruptcy-remote.[176]

In denying the motions to dismiss, the court applied a form of de facto substantive consolidation, despite the court's insistence that the SPE structure was safe and that it would not apply substantive consolidation to the facts in this case.[177] The court deemed this a fair result because the SPEs' lenders, the movants in this case, did not deny that they knew that they were lending to a larger corporate structure.[178] Moreover, the court found that some of the SPEs were commingling assets and making intercompany loans.[179]

F. *An Example of the Transaction at Issue in General Growth: The Harborplace Loan*

The Harborplace loan is representative of how transactions between lenders and SPEs were structured under General Growth and will give the reader a concrete idea of what those transactions looked like. On September 11, 2007, Prudential Insurance delivered a note for $50 million (Note) to an SPE of General Growth to secure real property in Baltimore known as Harborplace.[180] Section 14 of the Note stated:

> Borrower hereby covenants . . . during the term of the Loan, Borrower shall not (i) engage in any business other than entering into and performing its obligations under the Documents; (ii) acquire or own a material asset; (iii) maintain assets in a way difficult to segregate and identify, or commingle its assets with the assets of any other person or entity; (iv) fail to hold itself out to the public as a legal entity separate from any other or fail to maintain capital sufficient therefore; (v) fail to conduct business in its own name or fail to maintain record, accounts or bank accounts separate from any other person or entity; (vi) file or consent to a petition pursuant to applicable bankruptcy, insolvency, liquidation or reorganization statues[sic], or make an assignment for the benefit of creditors with[out] the unanimous consent of its members; (vii) incur additional indebtedness except for trade payables in the ordinary course of business, provided that such indebtedness is paid sixty (60) days after incurred; (viii) dissolve, liquidate, consolidate, merge or

176 *Id.*
177 *Id.* at 69.
178 *Id.* at 61.
179 Resnick & Krause, *supra* note 172, at 60.
180 *Prudential Insurance Company's Objection*, *supra* note 11, at 6.

> sell all or substantially all of its assets; or (ix) modify, amend or revise its organization documents in any material respect which adversely affects its existence as a single purpose entity or its performance of obligations with respect to the Loan.[181]

Section 2.10 of the Note contained the following warranties: "(i) Grantor's only asset is the Property and (ii) the Property generates substantially all of the gross income of the Grantor and (iii) there is no substantial business being conducted by the Grantor other than the business of operating the Property and the activities incidental thereto."[182] The Note also contained these covenants:

> Grantor hereby covenants and agrees that (i) during the term of the Loan, Grantor shall not own any assets in addition to the Property, (ii) the Property shall remain as a single property or project, and (iii) during the term of the Loan, the Property shall generate substantially all of the gross income of the grantor and there is no substantial business being conducted by the Grantor other than the business of operating the Property and the activities incidental thereto.[183]

The Harborplace borrower was not in default on the loan.[184] However, over Prudential's objection, the court entered an order on May 14, 2009, authorizing other debtors' use of Prudential's cash collateral in the Harborplace loan.[185] Thus, when the court speaks of the "varying financial distress" of individual debtors that justified General Growth placing those debtors into bankruptcy, it is including at least some SPEs that were in fact not in financial distress at all.[186]

PART III

There has been an academic debate for some time over the mandatory nature of chapter 11 proceedings.[187] In Robert Rasmussen's 1992 article, *Debtor's Choice: A Menu Approach to Bankruptcy*, he argued that there was "increasing uneasiness . . . over the normative desirability" of the chapter 11 process in the academic community.[188] The debate, however, was solely

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[181] *Id*. at 8.
[182] *Id.*
[183] *Id.*
[184] *Id*. at 5.
[185] *In re* Gen. Growth Props., Inc., 412 B.R. 122, 134 (Bankr. S.D.N.Y. 2009).
[186] *In re* Gen. Growth Props., Inc., 409 B.R. 43, 57 (Bankr. S.D.N.Y. 2009).
[187] Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 52–53, 60–61 (1993).
[188] *Id.* at 52.

focused on whether Congress or the courts could fashion a better remedy.[189] Rasmussen suggested that a firm's investors control the firm's access to bankruptcy reorganization instead of allowing legislators to address the issue.[190]

This article instigated a debate between contractualists, [191]who argued that businesses should be given more control over what happens in the case of insolvency, and traditionalists,[192] who argued that the bankruptcy system attempts to address certain concerns for which privatized insolvency proceedings would fail to adequately account.[193] Many different perspectives have been offered as part of the debate, but the two sides essentially break down in the following way.

Contractualists argued that the Bankruptcy Code is an inefficient model for some firms and that those firms should be able to alter their rights in bankruptcy and find a model that works for them.[194] Traditionalists essentially responded that parties contracting around bankruptcy do not have the appropriate incentives to internalize all the effects of a debtor's insolvency and that the legislature better takes into account the interests of some third party.[195]

The rest of this Comment will argue that the SPE structure at issue in *In re General Growth* is an example of a case where bankruptcy courts should re-evaluate their refusal to enforce a waiver of the right to file bankruptcy. The argument is that, at the lending stage, General Growth's subsidiaries should

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[189] *Id.*

[190] *Id*. at 53 ("[A] firm's ability to file for bankruptcy reorganization should be determined by the firm's investors rather than by the government.").

[191] See Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1 (1996); David Gray Carlson, *Bankruptcy Theory and the Creditors' Bargain*, 61 U. CIN. L. REV. 453, 457 (1992); Rafael Efrat, *The Case for Limited Enforceability of a Pre-Petition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133 (1995); Kelch & Slattery, *supra* note 56; Rasmussen, *supra* note 187, at 53; Schwarcz, *supra* note 57, at 532; Alan Schwartz, *Bankruptcy Contracting Reviewed*, 109 YALE L.J. 343 (1999); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998) [hereinafter Schwartz, *A Contract Theory Approach*]; Tracht, *supra* note 58, at 307.

[192] *See, e.g.*, Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. ILL. L. REV. 503, 505 (2001); Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999) [hereinafter LoPucki, *Contract Bankruptcy*]; Lynn M. LoPucki, *Bankruptcy Contracting Revised: A Reply to Alan Schwartz's New Model*, 109 YALE L.J. 365 (1999); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

[193] Block-Lieb, *supra* note 192, at 505.

[194] Ziad Raymond Azar, *Bankruptcy Policy, Legal Heritage, and Financial Development: An Agenda for Further Research*, 24 EMORY BANKR. DEV. J. 379, 383 (2008).

[195] *Id*. at 386.

have been able to explicitly promise not to enter bankruptcy in addition to "bankruptcy-proofing" themselves through the use of independent manager provisions and separateness covenants. Such promises should be enforced in cases where, like in *In re General Growth*, those subsidiaries are not insolvent.

This Comment contends that scholarship on contractual waivers of bankruptcy has not adequately addressed the SPE issue and that the decision in *In re General Growth.* reflects this shortcoming.[196] The bankruptcy-remote SPEs at issue in *In re General Growth*[197] provide an example of a case where bankruptcy courts should reevaluate their unwillingness to enforce waivers of the right to file bankruptcy. If an entity has promised not to file, is not insolvent, and has only one creditor, there is no reason to allow it access to the bankruptcy system. In any bankruptcy case, there must be some origin of the right to file; no one would argue that bankruptcy should be a system completely open to any firm or individual regardless of financial condition. In the case of SPEs, the normal arguments as to why firms should be allowed to file early and should not be able to contract around bankruptcy do not seem to carry as much weight. The SPE is unique from normal firms in several respects. Most importantly, it has only one major creditor.[198] And it is organized for a narrow and more defined purpose and can only make transactions that are specifically related to that purpose.[199]

The articles discussing contractual waivers of bankruptcy all deal with the same basic fact pattern: a lender and a borrower want to enter a financing arrangement, but they want to somehow alter their bankruptcy rights because they believe that entering chapter 11 will be detrimental to their interests. The borrower then becomes insolvent. The disagreement is over whether courts should enforce the system that the parties negotiated for themselves or allow either the debtor or creditor to enforce its bankruptcy rights, i.e., enforce a voluntary filing by the debtor or an involuntary filing by a group of creditors. An important premise on which the conclusion in this Comment is based is that most, if not all, of the scholarship on the issue of contracting around bankruptcy focuses solely on the situation where a firm contracts for a certain bankruptcy and ends up insolvent, and not the situation in *In re General*

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[196] *In re* Gen. Growth Props., Inc., 409 B.R. 43, 47 (Bankr. S.D.N.Y. 2009).

[197] *Gen. Growth*., 409 B.R. 43.

[198] Stratton, *supra* note 42, at 36 ("One of the limitations included is restrictions on the ability of an SPE to incur additional indebtedness, other than the indebtedness associated with the current transaction.").

[199] *Id.*

Growth, where a firm contracts around bankruptcy, is not insolvent, but files for bankruptcy regardless.[200]

In re General Growth adds a new wrinkle to the discussion because many of the debtors in that case were solvent.[201] The court justified allowing those debtors to enter chapter 11 because, generally, courts will defer to a debtor's determination of whether it is in imminent financial distress; they do not want to force debtors to wait until they are hopelessly insolvent to file. However, it is not clear that the two theories—one that says businesses cannot waive their rights to enter bankruptcy, one that says businesses should be allowed to file early—can operate concurrently.

The rest of this section will discuss two arguments that are commonly advanced against allowing firms to contract around bankruptcy—the creditors' bargain theory and the interests of third parties in a large business bankruptcy—and argues that they should not apply in the case of SPEs.

A. *The Creditors' Bargain Theory*

The creditors' bargain theory is often put forth as a reason that courts should not enforce a debtor's attempt to waive or otherwise alter its ability to

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[200] Adams & Baillie, *supra* note 191, at 2 ("The factual scenario described above is not an uncommon one. When a corporate debtor defaults on an obligation to a lender, the two parties will often attempt to renegotiate the loan agreement to give the debtor a chance to cure the default."); Block-Lieb, *supra* note 192, at 509 ("[P]art IV compares the implementation of three types of bankruptcy rules that could define rights in the event of a debtor's financial distress."); LoPucki, *Contract Bankruptcy*, *supra* note 192, at 336 (discussing bankruptcy-proofing structures: "[w]hen employed successfully, the result is usually that the debtor remains outside bankruptcy; no court has occasion to write an opinion; and the existence of the contract remains known only to the parties. Only the 'clumsiest' and 'most egregious' are challenged in court and risk exposure in published opinions."); Rasmussen, *supra* note 187, at 57 ("A creditor's treatment in a bankruptcy proceeding thus affects the creditor's initial lending decision. This is because the bankruptcy regime specifies a creditor's payoff when certain contingencies occur. The contingencies that determine the creditor's 'bankruptcy payoff' are the firm encountering financial distress and filing a bankruptcy petition."); Schwartz, *A Contract Theory Approach*, *supra* note 191, at 1807 ("Business bankruptcy systems attempt to solve a coordination problem for the creditors of insolvent firms."); Tracht, *supra* note 58, at 302 ("During the past decade, bankruptcy theory has been dominated by a debate between proponents of economic models that emphasize bankruptcy as a wealth-maximizing solution to the collective action problem facing creditors of insolvent firms, and critics who see broader social goals for the bankruptcy system."); Warren & Westbrook, *supra* note 192, at 1202 ("With our data, we explore these issues. We draw on information we have collected from thousands of failed businesses that initially filed for bankruptcy . . . .").

[201] *Bankruptcy and the Downfall of Securitization*, *supra* note 92; *see* Robert A. Brown, *Financial Reform and the Subsidization of Sophisticated Investors' Ignorance in Securitization Markets*, 7 N.Y.U. J.L. & BUS. 105, 107 n.3, 132 (2010).

file for bankruptcy.[202] The theory begins with the premise that the bankruptcy system was organized as a response to a collective action problem. Before the Bankruptcy Act, state collection laws emphasized a "first in time" approach.[203] Under this approach, when a debtor becomes insolvent, creditors essentially race to the courthouse to collect on the debtor's estate. The first creditor who is able to perfect its interest and begin seizing the debtor's assets is entitled to do so.

The collective action problem arises because the acts of each individual creditor in asserting its interest are detrimental to the creditors as a whole if those acts decrease the value of the debtor's estate.[204] There are two ways in which individual creditor actions can hurt creditors as a whole. First, creditors may face high transactional costs in perfecting their interests in the debtor's assets.[205] Second, the debtor's assets may not be managed efficiently. For example, if a debtor is forced to stop doing business and pay debts immediately, then the value to creditors that could have been produced by keeping the debtor afloat is lost.[206] The result is that the creditors as a group are worse off than they would have been if they had cooperated to maximize the value of the debtor's assets.[207] Thus, the first in time approach to bankruptcy is undesirable from both the creditor's perspective, because any one creditor faces higher costs and is less likely to reclaim its debt, and the debtor's perspective, because the system incentivizes behavior by creditors that quickly depletes the debtor's estate.[208]

Under the creditors' bargain theory, the bankruptcy system can be described as a hypothetical contract into which each creditor has entered to avoid the collective action problem described above.[209] Although the creditors have not in fact entered into an agreement with each other, a system binding the creditors can be justified theoretically on the basis that each creditor would have agreed to it if the creditor were designing a bankruptcy system without

202 *See* Carlson, *supra* note 191, at 457; Rasmussen, *supra* note 187, at 53; Schwarcz, *supra* note 57, at 532; Tracht, *supra* note 58, at 307.

203 Schwarcz, *supra* note 57, at 527.

204 Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127, 128 (1997).

205 Tracht, *supra* note 58, at 315–16.

206 *Id.*

207 *Id.* at 316.

208 *See id.*

209 Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 744–45 (2004).

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any knowledge of what its position would be in relation to other creditors.[210] If the bankruptcy system can be viewed as a hypothetical contract to which each creditor would agree, then system should maximize the wealth of the creditors as a group because otherwise there would be no justification for binding each creditor to the hypothetical contract. To do this, the system must achieve two fundamental goals. First, it must place each creditor in as equal a position as possible relative to other creditors.[211] If the system does not treat creditors equally, then it does not solve the collective action problem because the preferred creditors still have an incentive to act to the detriment of other creditors. Second, the system must put an emphasis on preserving value in the debtor's estate.[212]

The creditors' bargain theory rejects contractual waivers of bankruptcy rights on the grounds that such waivers allow one creditor to waive other creditors' rights under the hypothetical bankruptcy contract.[213] Some proponents of this theory argue that the issue is not whether waiving out of bankruptcy is right or wrong but rather that it is impossible because bankruptcy itself represents a contract that already binds creditors and debtors.[214] Sometimes the problem is put in terms of "waiving the rights of others."[215] Under the creditors' bargain theory, the debtor's right to file bankruptcy is only one of the rights at issue in a contractual waiver. In addition, each creditor has a right to have the debtor file.[216] Thus, if a debtor and a single creditor agree that the debtor waives its right to file for bankruptcy, then they have in effect waived the rights of other creditors. Presumably, this argument would not apply to a case in which there is a single creditor and a single debtor, which is exactly the case presented by General Growth's SPEs.[217]

One major response to the creditors' bargain theory starts by asking: "What about the group of debtors and creditors for whom bankruptcy is not the most efficient system?" Why shouldn't a creditor and debtor be able to opt out of the

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210 Carlson, *supra* note 191, at 458.

211 *Id.* at 462 (noting that there is an argument that the current bankruptcy system does not do this at all, because it divides creditors into different classes and gives them different rights based on, to give an example, whether they are secured or unsecured).

212 *Id.* at 464.

213 *See* Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 728 (1984).

214 LoPucki, *Contract Bankruptcy*, *supra* note 192, at 317–18.

215 Tracht, *supra* note 58, at 335.

216 *See, e.g.*, *In re* Sky Grp. Int'l, Inc. 108 B.R. 86, 88 (Bankr. W.D. Pa. 1989) ("The legislative history makes it clear that the automatic stay has a dual purpose of protecting the *debtor and all creditors* alike . . . .").

217 *See In re* Gen. Growth Props., Inc., 409 B.R. 43, 49 (Bankr. S.D.N.Y. 2009).

bankruptcy system if they determine that bankruptcy would not be the most profit-maximizing way to respond to the debtor becoming insolvent? The proponent of the creditors' bargain theory would make the response above and note that even if one creditor is willing to allow the debtor to opt out, that creditor cannot waive the rights of other creditors. However, assuming a world of rational and sophisticated bargainers, the creditors and debtors for whom bankruptcy does not maximize profit will "sort" themselves out of the pool of creditors and debtors that benefit from bankruptcy if the waiver option is available to them.[218] To see why, consider the following. Imagine that a borrower, X, has determined that the legal and administrative costs of chapter 11 are too burdensome, and it would prefer to waive its right to file. If bankruptcy is truly an efficient system for some lenders, then the cost of borrowing from those lenders for X will be increased as they will increase the cost of capital in exchange for allowing X to opt out of the bankruptcy system.[219] However, creditors expecting to do well if the borrower's bankruptcy rights were waived would lend to X on terms that are more favorable.[220] Thus, if lenders and borrowers can reasonably predict whether a bankruptcy will be beneficial to their interests and can opt out of the bankruptcy system if they so choose, then it is unlikely that a borrower will simultaneously be in debt to one creditor that prefers the bankruptcy system and one creditor that prefers some other remedy.[221] If such a situation can be avoided, then the creditors' bargain theory loses much of its force.

This response assumes a high level of sophistication on the part of borrowers and lenders. Both parties must be able to accurately predict whether a bankruptcy would be beneficial or detrimental to them. One obstacle to this position is evidence that managers put in the position to make such promises tend to underestimate the likelihood and the negative consequences of insolvency.[222] However, there is empirical evidence that parties can accurately predict whether opting out of bankruptcy would be beneficial.[223]

The creditors' bargain theory questions the ability of a firm to contract around the bankruptcy system because of the idea that the bankruptcy system itself is a contract between all of the firm's potential creditors and that any one

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[218] Tracht, *supra* note 58, at 317–18.
[219] *Id.*
[220] *See id.* at 335.
[221] *See id.* at 317–18.
[222] Schwarcz, *supra* note 57, at 589.
[223] Tracht, *supra* note 58, at 328–29.

creditor should not have the ability to waive the other creditors' rights to have the debtor in bankruptcy.[224] This argument holds significantly less weight in the case of an SPE. This is because SPEs, by design, have only one major creditor and are contractually restricted from acquiring any more.[225] The covenants that the borrower-SPE made to acquire the Harborplace Loan described previously illustrate this point. That SPE promised not to "(i) engage in any business other than entering into and performing its obligations under the Documents; (ii) acquire or own a material asset; (iii) maintain assets in a way difficult to segregate and identify, or commingle its assets with the assets of any other person or entity."[226] The SPE also promised not to "incur additional indebtedness except for trade payables in the ordinary course of business, provided that such indebtedness is paid sixty (60) days after incurred."[227] Assuming that the SPE does not violate these covenants, there is no risk that it will incur any significant debt aside from that owed to the lender and some short-term debt owed to vendors and suppliers for sixty-day periods at a time. Thus, the bankruptcy system does not represent a creditors' bargain to find a remedy to the SPE's financial distress because the SPE in fact has only one creditor and that creditor has contracted for its own remedy.

Separateness covenants do not, however, address the issue of "involuntary creditors," such as tort claimants, unsophisticated creditors, and creditors whose claims are so small as not to justify the costs that accompany a transactional solution.[228] There is a risk that, even having entered into an agreement with the lender to only engage in a single and defined business venture, the SPE will commit a tort against some third party that will result in a large judgment against this SPE. A traditionalist would argue that giving effect to the SPE's promise not to file bankruptcy would subvert the rights of the involuntary creditor, which did not have a chance to come to the table when the SPE and the lender were negotiating.[229] However, enforcing a promise not to file only in the case that the SPE remains solvent would not affect the rights of these creditors. Say that one involuntary creditor won a tort judgment against an SPE. If the SPE were able to pay the judgment without becoming insolvent, then it would be forced to do so since the alternative of filing for chapter 11 would not be available. If the judgment were so large that the SPE

[224] *See* Jackson, *supra* note 213, at 728.
[225] Stratton, *supra* note 42, at 36.
[226] *Prudential Insurance Company's Objection*, *supra* note 11, at 8.
[227] *Id.*
[228] Block-Lieb, *supra* note 192, at 516.
[229] Warren & Westbrook, *supra* note 192, at 1221.

did not have sufficient assets to pay it, then the SPE would have liabilities in excess of its assets and thus be insolvent. The SPE could enter chapter 11,[230] and the involuntary creditor would not be in the same position as if the promise not to file had not been given any effect. Additionally, the original lender, assuming that it is a sophisticated party, should be able to account for the risk that the SPE will receive such a judgment against it since it can be sure that the SPE has not contracted with any other third party in a way that affects its bankruptcy rights.[231]

The creditors' bargain theory should not be considered a reason not to enforce waivers of bankruptcy privileges by SPEs because the theory does not adequately describe the relationship between an SPE and its creditors. The theory assumes that a debtor can have multiple creditors: voluntary or involuntary, sophisticated or unsophisticated, with or without security interests. However, because of the nature of the SPE, the number of creditors is narrowed to one original lender and a class of possible involuntary creditors whose rights would not be affected by allowing the SPE to contract around the bankruptcy system.

B. The Interests of the Community

A second reason why courts may not want to enforce a contractual waiver of the right to file for bankruptcy is the impact of a debtor's insolvency on the community.[232] A bankruptcy, especially in the case of larger businesses, can impact third parties, such as employees, customers, and suppliers.[233] There is debate on the extent to which the Bankruptcy Code itself adequately protects the interests of these third parties.[234] A creditor and debtor who fashion their own remedy for the insolvency of the debtor are unlikely to give much, if any, weight to the interests of third parties, potentially forcing those parties to bear some of the cost of the debtor's insolvency.[235] Some argue that the statute and

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[230] This Comment does not address the issue of whether a court should enforce an insolvent firm's promise that it will not file for bankruptcy.

[231] *See* Warren & Westbrook, *supra* note 192, at 1221.

[232] Schwartz, *A Contract Theory Approach*, *supra* note 191, at 1815.

[233] *See* S. Todd Brown, *Non-Pecuniary Interests and the Injudicious Limits of Appellate Standing in Bankruptcy*, 59 BAYLOR L. REV. 569 (2007); Nathalie D. Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L.J. 429 (1998); Matthew L. Seror, Note, *Analyzing the Inadequacies of Employee Protections in Bankruptcy*, 13 S. CAL. INTERDISC. L.J. 141 (2003); Travis J. Ketterman, *The Impact of an Employer's Bankruptcy on Employees*, ILL. B.J., June 2006, at 304.

[234] *See* Brown, *supra* note 233; Martin, *supra* note 233; Seror, *supra* note 233; Ketterman, *supra* note 233.

[235] Schwartz, *A Contract Theory Approach*, *supra* note 191, at 1815.

the courts do an equally poor job of considering the interests of third parties, such as employees and involuntary tort claimants.[236]

The argument for the interests of the community asserts that the contractualist position focuses too much on creating an efficient market for lenders and borrowers before insolvency and not enough on the effects of insolvency when it happens.[237] According to this view, contractualists wrongly favor looking to the ex ante effects of bankruptcy, like minimizing the cost of credit, over the ex post effects, like discharge of debt owed to involuntary creditors, such as tort claimants.[238] This objection encompasses the interests of the community because involuntary creditors such as employees and mass-tort claimants would not be taken into account since they would never have the opportunity to contract with a debtor over what to do in the case of the debtor's insolvency.[239]

The objection also applies to the voluntary creditor who contracts with a debtor to avoid bankruptcy. Pointing to empirical evidence that borrowers and lenders do not always act rationally and do not have access to all relevant information on the impact of a default, critics argue that creditors—especially small, nonbank lenders—would not be able to make contracts that adequately address the effects of the debtor's insolvency.[240] In other words, unsophisticated creditors and debtors would not be able to protect their interests because they are unlikely to have access to all relevant information concerning the debtor's insolvency, and research in the field of behavioral economics indicates that they would not act rationally even if they did have access to all such information.[241] Thus, legislation is the preferable solution to a debtor's insolvency because it is the best way to take into account the effects of insolvency on all affected parties.[242]

Even if enforcing an SPE's promise not to file for bankruptcy would not affect the rights of other creditors, there is still the issue of the interests of other third parties that may be affected by not allowing the result from *In re General Growth*. By most accounts, the General Growth reorganization was a

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236 *See* Brown, *supra* note 233; Martin, *supra* note 233; Seror, *supra* note 233; Ketterman, *supra* note 233.
237 Block-Lieb, supra note 192, at 532–33.
238 *See id.*
239 *Id.*
240 *Id.*
241 *Id.* at 533.
242 Warren & Westbrook, *supra* note 192, at 1199.

success, and many of the properties that General Growth owns and operates throughout the country were able to remain in business.[243]

In the long run, however, it would be preferable to ensure that the SPE structure remains a viable option for lenders in the commercial real estate market. The bankruptcy-remoteness of any commercial real estate borrower is crucial to the success of CMBS lending.[244] The value of each security is related to the risk that an individual mortgager will default on its mortgage.[245] The ratings agencies that value CMBS require that a CMBS borrower own only the mortgaged property and have no debt except for the mortgage.[246] This is because a "central goal" of the securitization process is to ensure that a bankruptcy court does not interfere with the debtor's obligation to repay the loan.[247] The result in *In re General Growth* is the worst case scenario for lenders that wish to participate in the CMBS market because a court order to use one SPE's cash collateral to finance the obligations of the parent or of other subsidiaries essentially nullifies the separateness covenants on which the lender first based its decision to lend to the SPE. For the lender, these separateness covenants are really just a roundabout way of ensuring that the SPE will not end up in bankruptcy. In a world where the SPE could make an enforceable promise to stay out of bankruptcy, lenders would have more certainty that an SPE would not default on its loan, which would in turn make it easier to market securities made up of the SPEs' mortgages and would enable borrowers to get more favorable terms from CMBS lenders, who could be more confident in repayment.[248]

There is evidence that preserving and improving the CMBS market would bring great benefit to the third parties and to the community at large by strengthening the real estate market.[249] The CMBS market allows new investors to contribute capital to the real estate market by investing in securities that otherwise would not want to take the risk of financing individual mortgages.[250] Additionally, it allows lenders, by selling off commercial

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[243] *General Growth Properties' Reorganization Plan Is Approved*, L.A. TIMES, Oct. 21, 2010, http://articles.latimes.com/2010/oct/21/business/la-fi-general-growth-20101021.

[244] *See* Brown, *supra* note 201, at 132; *Bankruptcy and the Downfall of Securitization*, *supra* note 92.

[245] *Amended Amici Brief*, supra note 141, at 5.

[246] Brown, *supra* note 201, at 132.

[247] *Id.*

[248] *Amended Amici Brief*, *supra* note 141, at 5.

[249] *See* Georgette Chapman Phillips, *The Paradox of Commercial Real Estate Debt*, 42 CORNELL INT'L L.J. 335, 335 (2009).

[250] *Amended Amici Brief*, *supra* note 141, at 5.

mortgages, to convert their long-term assets into short-term ones, thus making the lending a more attractive source of income for them.[251] The total value of the CMBS market is $800 billion, or approximately one-half of all commercial real estate acquisitions.[252] In 2007, the amount of credit created for individual property owners by the CMBS market was valued at $230 billion, which was 40% of the debt capital that was given to commercial and multifamily real estate owners that year.[253] Some have argued that CMBS played a key role in pulling the real estate market out of the savings and loan crisis of the 1980s.[254]

Finally, while the argument from the interests of the community may be compelling in some circumstances, it carries little weight in the specific case of SPEs like those at issue in *In re General Growth*.[255] At least some of the SPEs were not in financial distress and had not defaulted on their loans.[256] Thus, the customers, employees, and suppliers of General Growth's shopping centers had nothing to fear from business going on as usual. In fact, allowing financially healthy SPEs into bankruptcy would be worse for those third parties because it would divert some of the SPEs' cash flow to the parent's reorganization.

There may be reason to worry that allowing SPEs to waive their right to bankruptcy eligibility could have adverse effects on some third parties that might benefit from having those SPEs in bankruptcy. On the other hand, the failure of the CMBS market is a "potentially catastrophic event" for the economy.[257] The SPE structure is an important aspect of the CMBS market, and the adverse effects of keeping SPEs out of bankruptcy should be weighed against the substantial positive impacts that CMBS have on the national real estate market.[258]

One can imagine the following objection to the enforcement of a promise by a solvent SPE not to file bankruptcy. Those entities, in order to circumvent that rule, might violate the separateness covenants they have made with their

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[251] Brown, *supra* note 201, at 135.

[252] *Id.* at 108; Ken Miller, *Using Letters of Credit, Credit Default Swaps and Other Forms of Credit Enhancements in Net Lease Transactions*, 4 VA. L. & BUS. REV. 45, 46 (2009).

[253] *Amended Amici Brief*, *supra* note 141, at 5.

[254] Yevgeniya Drobitskaya, *TALF and Revenue Procedure 2009-45: New Hope for the Commercial Mortgage-Backed Securities Market?*, 29 REV. BANKING & FIN. L. 41, 41–42 (2009); *see also Amended Amici Brief*, *supra* note 141, at 5.

[255] *In re* Gen. Growth Props., Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[256] *See id.* at 58; *Prudential Insurance Company's Objection*, *supra* note 11, at 5.

[257] Brown, *supra* note 201, at 108; *see also* Phillips, *supra* note 249, at 335.

[258] *See Amended Amici Brief*, *supra* note 141, at 5.

lender and incur other debt just so that they can get the protections offered by the Code. Indeed, the *In re General Growth* opinion indicates that some of General Growth's SPEs had been guaranteeing the debt of other entities and making intercompany loans.[259] Once an SPE has multiple creditors, the force of the argument that they should be denied the protections of the Code begins to dissipate.

For this rule to be successful, courts would have to refuse to give effect to an SPE's attempt to violate its separateness covenants. An analogy can be made to the treatment given to enforceable stock transfer restrictions. A lender that has negotiated for separateness covenants is in a similar position to a corporation that has placed restrictions on the transferability of its shares in that it is unlikely to be satisfied by enforcement of its rights through an action for damages.[260] Such a corporation wants to be financially compensated for the transfer of its shares; it also wants to keep its shares in the hands of a small group of defined shareholders.[261] Similarly, an SPE's lender has no use for damages as a remedy for an SPE's violation of its covenants because it is really negotiating for the assurance that the SPE will not end up in bankruptcy.[262] These parties do not need "liability rules," which allow their rights to be infringed upon if the SPE is willing to pay sufficient value for it. Rather, they need a restriction on alienability where the transaction they are trying to prevent will not be recognized even between two willing parties.[263]

In corporate law, when a valid share transfer restriction has been violated, courts have been willing to set aside such transactions and treat them as if they had not occurred.[264] Nonbankruptcy courts would have to be willing to give

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[259] *Gen. Growth*, 409 B.R. at 58.

[260] *See* Carrie A. Platt, Comment, *The Right of First Refusal in Involuntary Sales and Transfers by Operation of Law*, 48 BAYLOR L. REV. 1197, 1207–08 (1996) ("[S]hare transfer restrictions, specifically the right of first refusal, are extremely important to businesses, particularly closely-held corporations that are generally characterized by the following attributes: (1) the shareholders are few in number, often only two or three; (2) they usually live in the same geographical area, know each other, and are well acquainted with each other's business skills; (3) all or most of the shareholders are active in the business, usually serving as directors or officers or as key participants in some managerial capacity; and (4) there is no established market for the corporate stock, the shares not being listed on a stock exchange or actively dealt in by brokers." (quoting F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.08, at 31 (3d. ed. 1994)) (internal quotation marks omitted)).

[261] *See id.*

[262] *See* McInerney, *supra* note 8, at 9; *supra* note 104 and accompanying text.

[263] Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972).

[264] George J. Siedel, *Close Corporation Law: Michigan, Delaware, and the Model Act*, 11 DEL. J. CORP. L. 383, 412 (1986).

similar treatment to attempts by SPEs to incur other debt or guarantee the debt of related entities if the rule proposed by this Comment is to be successful.

CONCLUSION

The General Growth bankruptcy raises a host of issues about the nature and purpose of bankruptcy law. All the parties in the case of General Growth—the lenders, the borrowers, and the bankruptcy judge—were operating under an assumption that an entity is prohibited from waiving its right to file bankruptcy and that any attempt to do so should be subject to close scrutiny. This assumption has been present in the case law and in scholarly literature for decades, but many argue that it is not clear where it came from or whether or it makes sense. Why should a firm not be able to waive its right to file bankruptcy? Where does the right to file for bankruptcy come from in the first place? These questions have inspired a lively scholarly debate, especially over the last twenty years.

This Comment argues that the SPEs at issue in *In re General Growth* present a unique case that has not been fully addressed in the literature on the enforceability of waivers of bankruptcy privileges.[265] Most of this literature focuses on the typical bankruptcy case, where an insolvent firm enters bankruptcy because its liabilities have so far exceeded its assets that it needs the protection of the Code in order to continue operating. However, this is not the only situation in which a firm might file for bankruptcy. The case law is clear: a firm need not be insolvent in order to file,[266] and indeed many of the SPEs in *In re General Growth* were not insolvent when they filed their own petitions.[267] Moreover, the Court gave no effect to the SPEs' attempts prefiling to organize themselves as "bankruptcy-remote."

There does not seem to be a clear reason why the conventional wisdom on the nonenforceability of bankruptcy waivers should apply to firms operating as SPEs. SPEs have only one creditor, and thus there is little risk of prejudice to other parties from enforcement of such a waiver. Moreover, allowing the SPE to enter bankruptcy deprives the creditor of the rights that it bargained for during the lending process. Finally, the SPE structure is crucial to the securitization process, which allows capital to flow into the commercial real

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[265] *In re* Gen. Growth Props., Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[266] *See, e.g.*, Caplin v. Marine-Midland Grace Trust Co., 406 U.S. 416, 423 (1972) ("Chapter X proceedings are not limited to insolvent corporations . . . .").

[267] *Gen. Growth*, 409 B.R. 43.

estate market. In the future, courts should enforce bankruptcy waivers by solvent SPEs.

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