

Articles

"In Re Kingston Square Associates: Questioning Independent Director Provisions"

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November 30, 1997

A decision in the United States Bankruptcy Court for the Southern District of New York raised questions regarding the operation of charter and bylaw provisions in single purpose entities (SPEs) that required an "independent director". The multiple bankruptcy cases involved two commercial mortgage-backed securitization (CMBS) transactions backed by mortgages on various multi-family properties controlled by Morton Ginsberg. Each of the properties was owned by an SPE that was either a corporation or a limited partnership that also had an SPE corporate general partner. In each case, the charter or bylaws required that there be an independent director whose consent was necessary in order to file a voluntary bankruptcy proceeding. Each board of directors consisted of Ginsberg and two others, one of whom was designated by Ginsberg, and the other was Laurence Richardson, as the independent director.

Shortly after the securities were issued, the mortgages fell into default. Donaldson, Lufkin & Jenrette Securities Corporation (DLJ), the original underwriter of the securities, repurchased all of the securities and proceeded to foreclose on the properties. The foreclosure proceedings prompted Ginsberg to attempt to thwart this action in order to preserve some value for the equity owners. Both Ginsberg and the other non-independent director testified that they had not involved Richardson, who had worked for DLJ for three years prior to being appointed as independent director and thereafter served as consultant to DLJ, because of their belief that Richardson would not approve any course of action that would interfere with DLJ's plans. Consequently, Ginsberg took a series of actions to orchestrate the filing of involuntary bankruptcy proceedings against several of the borrowers by an assembled group of creditors. The only issue for the court was whether this action by Ginsberg constituted collusion, thereby warranting a dismissal of the involuntary filings.

In a sternly worded opinion, the court held that although the debtors and petitioning creditors clearly had orchestrated the filing of the involuntary petitions, their behavior was not consonant with what is required by case law to show collusion and, therefore, did not warrant dismissal of the cases without evidence that the debtors had no chance at rehabilitation. Under the circumstances of these cases, the court determined that appointment of a chapter 11 trustee was the only reasonable alternative to insure that the limited partners and creditors were protected, that the properties were not allowed to deteriorate, and that Ginsberg and the "friendly" creditors would not impede what was best for the debtor estates.

The decision to appoint a chapter 11 trustee was made in part because there was a strong suggestion in the record that the debtors' boards of directors abdicated their fiduciary responsibilities, in particular the independent director. No board meetings were held after the initial loan closings until December 16, 1996; the directors had minimal communication with each other; no financial reports or updates on legal proceedings were circulated; the boards took no action in the face of commencement of foreclosure proceedings or installation of receivers; further, Richardson took no action and did not seek any information after learning in 1995 that the properties were being foreclosed, and he failed to ratify the involuntary bankruptcy filings at the December 1996 board meeting, which was called only after the strong suggestion of the court. As the court noted, the directors have fiduciary obligations to the corporation and its shareholders, to the borrower's limited partners (with respect to limited partnership borrowers with an SPE corporate general partner) and, as the entity approaches insolvency, the duties expand to include consideration of the general creditors.

This decision is also notable for what was not directly addressed. The judge stated that because the court did not find that the debtors and petitioning creditors acted collusively in their filings, she need not reach the merits of whether the bylaw provision containing the "bankruptcy proof provision" should be nullified as void against public policy; the validity of this provision was not properly before the court. Nonetheless, the judge cited case law that supported the debtors' and petitioning creditors' position that "corporate action taken by an insider without board or shareholder authority may later be found to have been appropriate in circumstances where the existence of the corporation is very much at risk." Thus, the court apparently may be willing to entertain a voluntary bankruptcy filing without required board approval under sufficiently egregious circumstances. The decision also did not involve substantive consolidation of the borrowers with any affiliate, rather only a determination of whether involuntary filings should be dismissed as collusive.

Articles

What are the lessons from this decision regarding SPEs and securitization transactions?

First and foremost, the decision clearly demonstrates that the commonly accepted SPE provisions in structured finance transactions facilitate creation of a "bankruptcy remote" entity and do not establish a "bankruptcy proof" entity. A borrower cannot legally be prohibited from voluntarily filing bankruptcy, and an involuntary proceeding may be filed by three creditors meeting the requirements of the Bankruptcy Code. The bankruptcy remoteness is effected in part by obligating the SPE to operate in such a manner that it is not difficult to discern it as separate and distinct from its parent/partners, and by limiting the debt that it may incur.

Second, the definition of "independent director" should not include an approval or appointment right by the lender or any one acting on behalf of the lender. This creates numerous potentials for conflict of interest, lender liability and other pitfalls as described by Judge Brozman. "Independent" should be defined in specific and objective terms that achieve independence.

Third, no matter what efforts are made in structuring a transaction and providing covenants and operational guidelines, there is no guaranty that the parties will carry on their business in the manner they have agreed. The Kingston record was replete with instances of the failure to adhere to corporate formalities. Fulfillment of SPE covenants and requirements depends on the responsibility and integrity of the borrower, its officers and directors.

Fourth, the decision may be read as obligating a director, including an independent director, to vote in favor of voluntary bankruptcy in the face of foreclosure proceedings where there is some evidence of equity in the properties securing a mortgage loan that could benefit general unsecured creditors and equity owners. That duty is a matter of state corporate law, with which all directors should be familiar. All participants in securitization transactions should understand that the possibility of voluntary or involuntary bankruptcy exists, even for an SPE borrower.

In conclusion, the Kingston decision is a strong reminder of the limitations of the SPE structure as well as the inappropriateness of defining "independent director" to mean one who is appointed or approved by the lender or its designee. The requirement of an independent director fulfills two purposes: first, as a factor enabling counsel to render a non-consolidation opinion (i.e., there is not a complete overlap of directors at the parent and subsidiary), and second to provide an element of independent judgment from a person who by definition does not have an economic interest in the transaction or any affiliate of the SPE, and is not related by family to a person with an economic interest or control over the SPE. As made clear by the judge in the Kingston decision, anyone who acts as independent director must take the job seriously and understand his or her fiduciary duties pursuant to applicable law.