AN OVERVIEW OF BANKRUPTCY REMOTE STRUCTURES

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Bankruptcy remote structures have been employed in the United States to lessen the risk of non-payment under a credit facility for the past 25 years. Although these structures are used extensively in aircraft and real estate lending in the United States, they are not a part of the traditional shipping loan structure. With increased use of Chapter 11 by shipping companies with little or no presence in the United States, higher value assets and the wish to securitize shipping loans, bankruptcy remote structures are increasingly used in the origination and restructuring of shipping debt.

The remote structure must consist of a single purpose company (“SPC”) borrower that owns a single asset generating a stream of income used to pay the credit facility. The SPC is “remote” in two ways. First, it is separated from the other entities of the borrowing group, which may own numerous assets and have significant other debt. Second, the provisions of the facility and the constitutional documents of the SPC make it difficult for the SPC to enter into bankruptcy.

REMOTENESS FROM GROUP

The SPC borrower must be separate from other companies in the borrowing group. This requirement is imposed by the various ratings agencies, which publish criteria for a borrower to be seen as bankruptcy remote (1). The separateness requirement is designed to prevent substantive consolidation, an equitable doctrine in bankruptcy where the assets and debts of legally separate entities that are members of the same corporate or affiliated group are combined into a single bankruptcy estate. Substantive consolidation can significantly alter the rights of the various debtors’ creditors.

Comfort that there will not be substantive consolidation is accomplished by using restrictions that have been commonplace in ship finance structures for many years, such as prohibiting the SPC borrower from engaging in business other than operating the collateral, from owning property other than the collateral and from incurring additional debt (except ordinary course trade payables). In addition, observing corporate formalities, maintaining separate decision making and operations, bank accounts, offices and financial statements, among other things, all favor the recognition of an SPC as bankruptcy remote. Intercompany guarantees and cross-default provisions are disfavored by ratings agencies and decrease the bankruptcy remoteness of the structure. This is more problematic for traditional ship lending, where support from the parent guarantor is usually a prerequisite with standalone, limited recourse financing traditionally being used more in the offshore and LNG sectors.

INABILITY TO FILE FOR BANKRUPTCY

There are certain features of the bankruptcy remote SPC and the facility documentation that make it difficult or costly for the SPC to file for bankruptcy. The SPC constitutional documents will generally require unanimous shareholder and board approval to file for bankruptcy. To give fuller effect to this requirement shares of the SPC may be held in a trust controlled by a third party. Alternatively, lenders can accept a so-called “golden share” or, with respect to LLC, a non-economic membership unity that, in essence, gives lenders a veto right over any decision to file. Lenders may also choose to install independent board members to monitor the company and prevent an improvident bankruptcy filing. This may give rise to compliance and approval issues within a bank but third-party independent non- economic members can be obtained through various service companies. These members generally agree not to vote in favor of a bankruptcy petition unless required by law or other specific requirements are satisfied by the SPC.

Lenders must consider the laws under which an SPC is formed and the type of entity employed as borrower. For example, if a trust is formed to hold the shares of the bankruptcy remote SPC borrower, the trustee will have certain obligations to the lender, such as only declaring bankruptcy under the specific conditions set forth in the trust deed. Only certain jurisdictions allow the duties of the trustee or directors of the company to be varied. In most jurisdictions, the trustee has a fiduciary duty to the beneficiary of the trust. Under the bankruptcy remote structure, the trustee’s obligations to the lenders may conflict with such a duty. Unless permitted by the statute under which the borrowing entity or trust is formed, provisions in the constitutional documents varying the directors’ or trustees’ fiduciary duties could be held void as against public policy, unenforceable and subject the director or trustee to damages.

Because of the increased risk of substantive consolidation when intra-group guarantees are provided to secure a debt, “ring-fenced” or bankruptcy remote structures are generally “non-recourse” to other members of the group. Guarantees from persons or entities outside the group remain valuable and do not increase the risk of substantive consolidation. These often take the form of contingent personal guarantees from the beneficial owner. These “bad boy” or “warm body” guarantees may be enforced only if the borrower SPC takes certain actions prohibited in the guarantee, such as filing for bankruptcy. These types of guarantees are often the most effective deterrent to the improper commencement of an insolvency proceeding given their significant punitive effect on the guarantor.

Several recent decisions have called into question the enforceability of certain elements of the bankruptcy remote structures traditionally employed, holding that an absolute prohibition on the borrower seeking bankruptcy protection is void as against public policy (2). In light of these decisions, care must be used in drafting the trust and constitutional documents.

As the regulators are paying increased attention to capital adequacy requirements, traditional ship finance lending is becoming harder for a number of traditional lenders and new ways should be considered to enable lending to the shipping industry to continue. Consideration is therefore rightly being given to alternative financing structures that decrease the risk of non-payment due to bankruptcy and permit the securitization of loan portfolios. Bankruptcy remote elements are a required feature of almost all loans that will be converted to bonds, so the issues and techniques outlined above will take on increasing significance.

1 See for example “Bankruptcy Remoteness Criteria for Special Purpose Entities in Global Structured Finance Transactions”, Moody’s, October 2014.

2 See In re Intervention Energy Holdings, 2016 WL 3185576, at *4. (voiding an LLC's operating agreement provision that effectively afforded lenders veto power of the LLC's authority to file for bankruptcy, and allowing allegedly improperly authorized bankruptcy petition to proceed); In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899, 911-15 (Bankr. N.D. Ill. 2016) (same).

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