

# Client Alert

Current Issues Relevant to Our Clients

October 23, 2013

## Recent Noteworthy Securitization Case

*In re Doctors Hospital of Hyde Park, Inc.* 2013 WL 5524696 (Bankr. N.D. Ill. 2013)

### Introduction

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On October 4, 2013, a Chicago bankruptcy court judge decided a case which establishes favorable precedent for the securitization market. In *In re Doctors Hospital of Hyde Park, Inc.*, 2013 WL 5524696 (Bankr. N.D. Ill. 2013), Judge Jack B. Schmetterer upheld the structure of a healthcare receivables securitization against a challenge by the originator/debtor, validating the separate existence of the special purpose entity and the true sale of receivables to the special purpose entity. Chapman and Cutler LLP represented the defendant and successfully opposed the challenge to the securitization structure.

The case involved a fraudulent transfer claim by the bankruptcy trustee of a Chicago hospital. The bankruptcy trustee claimed that from August 1997 to April 2000 the hospital was insolvent and made lease payments as debt service on a separate real estate loan which were not exchanged for reasonably equivalent value.

After a trial in 2006 Judge Schmetterer found that the hospital was insolvent as of August 1997 and that the hospital did not receive reasonably equivalent value (in excess of market value) for the lease payments. However, he also concluded that certain of the challenged payments could not be recovered as fraudulent transfers because they were made with funds owned by a securitization special purpose entity, not the debtor hospital. *In re Doctors Hospital of Hyde Park, Inc.*, 360 B.R. 787 (Bankr. N.D. Ill. 2007). On appeal, the district court affirmed. *Paloian v. LaSalle*, 406 F.Supp.2d 299 (N.D. Ill. 2007).

On further appeal, the Court of Appeals for the Seventh Circuit reversed and remanded, finding that the bankruptcy court had erroneously analyzed the hospital's solvency and that the hospital was "comfortably solvent" in August 1997. *Paloian v. LaSalle*, 619 F.3d 688 (2010). In its opinion, the Seventh Circuit also raised questions for remand about whether the securitization special purpose entity was legitimate, including whether the transfer of receivables by the hospital to the entity were true sales.

Following a re-trial of the fraudulent transfer case after remand by the Seventh Circuit, Judge Schmetterer has now concluded that the challenged payments were made with funds owned by a legitimate bankruptcy remote entity, not the hospital, and were therefore not recoverable as fraudulent transfers.

In his ruling, Judge Schmetterer validated the bedrock securitization principles of "true sale" transfers and separate special purpose entities. The pertinent facts and legal conclusions reflected in Judge Schmetterer's October 4, 2013 decision are summarized below.

### Background Facts

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In April 1997, Doctors Hospital of Hyde Park, Inc. ("*Doctors Hospital*") closed a healthcare receivables securitization transaction. Pursuant to the securitization transaction, Doctors Hospital transferred all its healthcare receivables to MMA Funding, LLC, a newly formed special purpose, bankruptcy remote entity ("*SPE*"). The SPE, in turn, used the receivables as collateral for a \$25 million line of credit from Daiwa. The initial proceeds of the Daiwa line of credit were used to retire a loan outstanding from Doctors Hospital to First National Bank of Northbrook which was secured by the receivables. Thereafter, the loan proceeds were used by Doctors Hospital in its hospital operations. Chart 1 schematically represents the basic structure of the healthcare securitization transaction.

In August 1997, Doctors Hospital closed a separate \$50 million real estate loan with Nomura. The Nomura loan was secured by the hospital property, which was owned by an affiliate of Doctors Hospital, HPCH, LLC. The Nomura loan proceeds were

paid to Dr. James Desnick, who owned both HPCH and Doctors Hospital. HPCH was the borrower on the Nomura loan and leased the hospital property to Doctors Hospital. Doctors Hospital guaranteed the loan and its rent payments serviced the monthly debt payments on the loan. Chart 2 schematically represents the basic structure of the Nomura loan.

The Nomura loan was designed to be integrated with the pre-existing Daiwa healthcare securitization structure so that monthly debt service to Nomura would be paid directly by the SPE's borrowings from Daiwa, not by Doctors Hospital. Chart 3 schematically represents the agreed upon flow of funds.

However, for the first ten months of the Nomura loan (between August 1997 and July 1998) the monthly debt service on the Nomura loan was not paid in the agreed upon manner. Instead, during this period Doctors Hospital received the securitization loan proceeds, via the SPE, and then made the monthly payments itself on the Nomura loan. Chart 4 schematically represents the incorrect flow of funds during this period.

Beginning in July, 1998, the agreed upon cash flow structure (Chart 3) was followed and the Nomura monthly debt service was paid directly with funds loaned by Daiwa to the SPE.

The fraudulent transfer case challenged the payments made on the Nomura loan to Chapman's client, as successor-in-interest to Nomura, between August 1997 and Doctors Hospital's bankruptcy filing on April 17, 2000.

In the re-trial of the fraudulent transfer case on remand, Judge Schmetterer applied the Seventh Circuit's ruling and re-evaluated Doctors Hospital's solvency between August 1997 and April 2000. In addition, Judge Schmetterer closely evaluated the healthcare securitization structure to determine whether the SPE was a valid bankruptcy remote entity, separate from Doctors Hospital.

In a lengthy opinion, Judge Schmetterer ruled that Doctors Hospital did not become insolvent until October 1, 1999—two years later than his determination after the first trial. Judge Schmetterer also concluded that payments made on the Nomura loan after this date could not be recovered by the bankruptcy trustee because they were made with funds owned by the SPE, not Doctors Hospital. Based on these conclusions, the Court found that Chapman's client had no fraudulent transfer liability.

### **The Court Finds that the SPE was a separate Bankruptcy Remote Entity which received a transfer of receivables in a True Sale**

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At issue in the remand trial, in addition to solvency, was whether the SPE was a legitimate and separate bankruptcy remote entity beginning in July 1998, when the payments on the Nomura loan followed the agreed upon cash flow structure.<sup>1</sup> The Seventh Circuit had cast some doubt on this question based on the record before it. However, the Seventh Circuit stated that if on remand the bankruptcy court found that the SPE was truly a legitimate and separate bankruptcy remote entity, then payments made on the Nomura loan from its funds could not be recovered as fraudulent transfers.

In his remand decision, Judge Schmetterer thoroughly reviewed the structure of securitization transactions generally as well as the evidence admitted at the remand trial concerning the SPE. In the process he reaffirmed fundamental premises of securitization law, observing that:

- securitization “has several economic benefits including stimulating loan supply, increasing liquidity, allowing a broader range of investors to access a class of assets usually limited to banks and, and increasing risk diversification.”
- “SPEs are able to receive financing at a lower interest rate than the originator of the receivables.”
- “It cannot be assumed that transaction participants seek bankruptcy remoteness for nefarious purposes. Nor does it circumvent public policy permitting persons and entities to avail themselves of the protection of the Bankruptcy Code when necessary. Rather bankruptcy remoteness is sought because ‘the bankruptcy process can involve risks to a secured lender, even when its liens and security interest in the assets of its borrower are properly perfected and non-avoidable... By minimizing these risks through a ‘bankruptcy remote’ structure, the lender can provide lower-cost loans to the SPE.’”

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<sup>1</sup> The bankruptcy trustee did not seek substantive consolidation of Doctors Hospital and the SPE. Likewise, principles of “alter ego” were not at issue in the remand trial because after the first trial Judge Schmetterer had determined that the SPE was not the alter ego of Doctors Hospital, and this decision was affirmed by the district court and remained undisturbed by the Seventh Circuit's ruling. Nevertheless, Judge Schmetterer referred by analogy to alter ego and substantive consolidation principles in his October 4, 2013 ruling.

In a wide ranging opinion, Judge Schmetterer ruled that central to whether the SPE was a legitimate bankruptcy remote entity was the SPE's "operational distinctness" from Doctors Hospital and the legal characterization of the transfer of receivables to the SPE. He declared that the answer to both questions depended on state law, not federal law, and on an analysis under state law of the economic substance and function of the transaction, not the "form" of the transaction chosen by the parties.

## The SPE was Operationally Distinct

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The SPE, Judge Schmetterer found, was "operationally distinct" from Doctors Hospital because its sole function was to buy and hold Doctors Hospital's receivables and be the borrower on the Daiwa loan, and the bankruptcy trustee failed to show that the SPE did not function as designed. In reaching this conclusion, Judge Schmetterer examined both the facts existing on the closing date of the securitization as well as the functioning of the SPE after the closing.<sup>2</sup> He focused on the following factors which supported his conclusion that the SPE was a special purpose bankruptcy remote entity, separate and distinct from Doctors Hospital:

- On the securitization closing date, the evidence documented the SPE's creation and governance as a special purpose bankruptcy remote entity, separate and distinct from Doctors Hospital.
- On the securitization closing date, legal opinions were delivered regarding the SPE's creation and separateness, and such opinions were relied upon by Daiwa.
- On the securitization closing date, the loan agreement and related documents demonstrated that the SPE was separate from Doctors Hospital.
- UCC financing statements filed in connection with the closing provided "notice to the world" that the SPE was separate from Doctors Hospital.
- Daiwa required that the SPE be structured as a special purpose bankruptcy remote entity, separate and distinct from Doctors Hospital, and would not have made the loan without this structure.
- After the securitization closing date, the SPE and Doctors Hospital observed separate corporate formalities, kept separate records and had separate offices and operations.
- After the securitization closing date, the SPE had a separate bank account.
- After the securitization closing date, the SPE submitted advance requests, more than 500 borrowing base certificates and other documents demonstrating that it was an entity separate and distinct from Doctors Hospital.
- After the securitization closing date, the SPE never exceeded its limited, special purpose function (the SPE "was not organized to function in a traditional business sense, i.e., it was not 'making widgets'") and did not engage in activities that it was never designed to conduct.

Judge Schmetterer rejected the bankruptcy trustee's arguments that a few "minor errors" warranted disregarding the SPE.

For example, the Daiwa loan was reflected as a liability on Doctors Hospital's audited financial statements even though Doctors Hospital's accountants had reviewed the Daiwa loan documents and Daiwa had made clear in responses to auditor requests that the SPE was the borrower. Relying on case law interpreting substantive consolidation, Judge Schmetterer observed that while Daiwa had a contractual agreement with the SPE that required separate financial statements, it was Daiwa's choice, based on the information it needed in extending credit, whether to enforce that agreement. Judge Schmetterer found that the SPE's failure to prepare separate financial statements may have given rise to a breach of contract claim but should not, by itself, destroy the separateness of a validly composed corporate entity.

In addition, certain of the advance requests presented to Daiwa were made on Doctors Hospital's letterhead, and certain of the borrowing base certificates were signed by Doctors Hospital. Judge Schmetterer found that the vast majority of advance

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<sup>2</sup> A risk in any securitization transaction, from a bankruptcy perspective, is that the conduct of the transaction parties after the closing date will not conform to the governing documents. While the bankruptcy risks may have been minimized and managed as of the closing date, those risks must continue to be managed for the entire life of the transaction in order for investors or lenders to receive the benefit of their bargain. Otherwise, what appears to be a low bankruptcy risk on the closing date may grow over time into an unacceptable risk.

requests and borrowing base certificates were delivered without these errors. Furthermore, he relied on Daiwa's testimony that these sorts of mistakes were common at the beginning of a lending relationship.

The bankruptcy trustee's argument that the SPE should be disregarded because it failed to maintain its own office (instead sharing office space with an affiliate) was also rejected. Again, Judge Schmetterer relied on Daiwa's testimony that special purpose entities typically share office space with a parent corporation, and he found that sharing office space was consistent with the SPE's limited purpose.

"The weight of the evidence [from the remand trial]," Judge Schmetterer concluded, "was heavily in favor of the conclusion here that the entity involved in this case was real and should be recognized as valid."

### The Receivables were sold to the SPE in a "True Sale"

Judge Schmetterer observed that a 'true sale' is a crucial step in the formation of a valid [bankruptcy remote entity]." After examining the evidence from the remand trial, Judge Schmetterer determined that the initial and ongoing transfers of healthcare receivables from Doctors Hospital to the SPE represented a "true sale." Again, he relied both on the facts as they existed on the closing date of the securitization as well as how the transaction functioned after the closing date. He focused on the following factors which supported his "true sale" conclusion:

- On the securitization closing date, the transaction documents demonstrated that the structure was a true sale.
- On the securitization closing date, Doctors Hospital received proceeds of the Daiwa line of credit in an amount sufficient to retire a pre-existing loan secured by the receivables.
- On the securitization closing date, the corporate governance actions and resolutions demonstrated that it was a true sale.
- On or shortly after the securitization closing date, UCC financing statements were filed providing "notice to the world" that the receivables had been sold in a "true sale."
- Shortly after the closing date, Doctors Hospital gave notice to the obligors that the receivables had been transferred to the SPE and provided new payment information to the obligors.
- After the securitization closing date, Doctors Hospital parted with access to and control over the receivables and their proceeds, all of which were paid into a segregated account as prescribed by transaction documents, without commingling of Doctors Hospital's funds.
- After the securitization closing date, the borrowing base certificates delivered to Daiwa evidenced the SPE's receipt of ongoing transfers of receivables.
- The transfer of the receivables was an arms length transaction, negotiated between Doctors Hospital and the SPE through separate counsel and approved by both entities (including the SPE's independent director).
- The SPE possessed no recourse to Doctors Hospital if the obligors failed to pay the receivables, and the SPE's recourse to Doctors Hospital for breaches of representations and warranties did not constitute impermissible recourse.
- Doctors Hospital's role as contractual servicer of the receivables in exchange for a separate fee, where Doctors Hospital had no authority to negotiate a change in the terms of the receivables in its own name and did not commingle the proceeds of the receivables with its own funds, was not inconsistent with a "true sale."

Judge Schmetterer rejected the bankruptcy trustee's argument that no true sale had occurred because Doctors Hospital's audited financial statements continued to reflect the receivables as its own. He pointed out that the UCC financing statements "indicated to the outside world the true control of the interests in those receivables."

Relying on the Seventh Circuit's decision, the bankruptcy trustee also argued that a true sale could not have occurred because Doctors Hospital, the seller, owned 99% of the SPE, the buyer, and Dr. James Desnick owned 100% of both Doctors Hospital and Medical Management of America, Inc., the other 1% owner of the SPE. Relying on Illinois law interpreting the "alter ego" doctrine, Judge Schmetterer concluded that these ownership interests were not enough to invalidate the sale where the interests of both the buyer and seller were separately represented and the actions of both were separately ratified by their boards of directors (including the SPE's independent director).

## Conclusion

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The Doctors Hospital decision represents an important victory for the securitization market. It validates bedrock principles—“true sale” transfers as well as the separateness of originators and special purpose entities—on which parties to securitization transactions rely.

## For More Information

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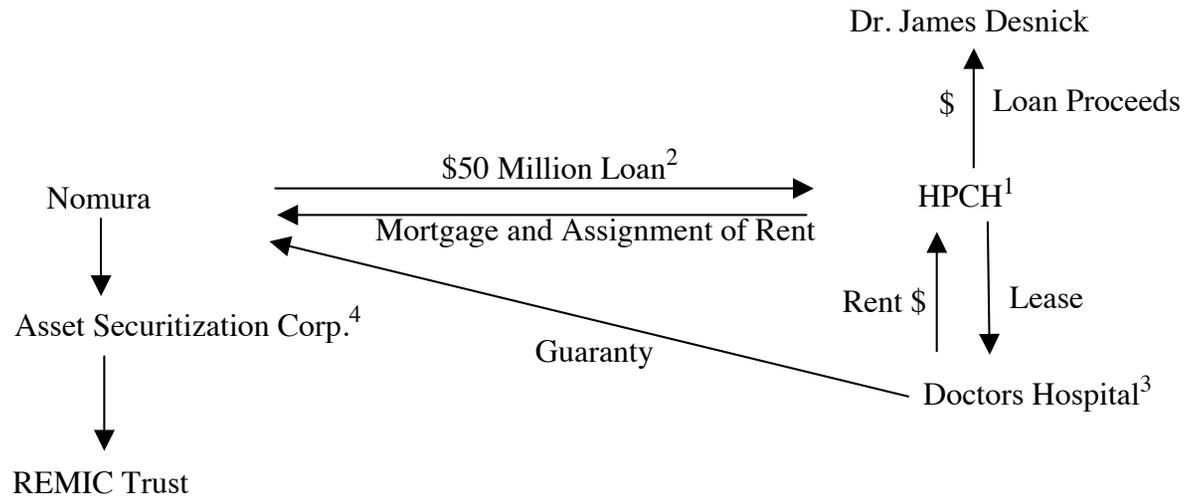
**DOCTORS HOSPITAL  
HEALTHCARE SECURITIZATION STRUCTURE  
APRIL 1997**



- 1 Doctors Hospital transferred healthcare receivables to its wholly owned, special purpose subsidiary, MMA Funding, LLC, in a true sale pursuant to a contribution agreement. MMA Funding, as a bankruptcy remote entity, never filed for bankruptcy protection.
- 2 MMA Funding entered into an asset-based revolving loan agreement with Daiwa providing for a credit line in the maximum amount of \$25,000,000. Doctors Hospital was not a party to the loan agreement. Daiwa made loans to MMA Funding pursuant to the loan agreement. The loan proceeds were made available to MMA Funding's parent, Doctors Hospital, including initial loan proceeds which were used to retire a loan outstanding from Doctors Hospital to First National Bank of Northbrook which was secured by the receivables.
- 3 Doctors Hospital filed a chapter 11 bankruptcy petition on April 17, 2000.

Chart 1

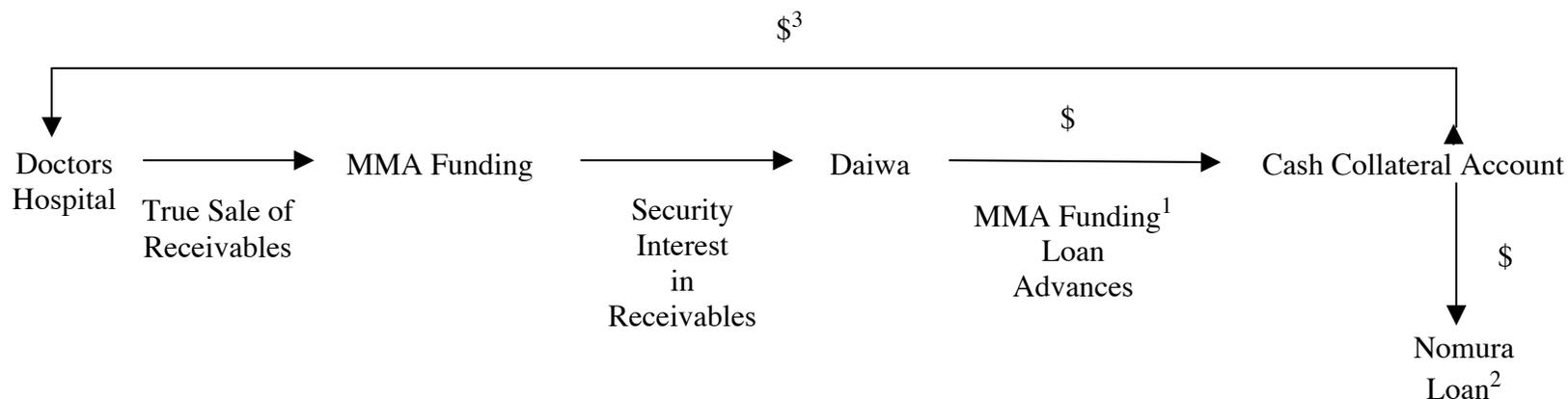
**DOCTORS HOSPITAL  
NOMURA LOAN STRUCTURE  
AUGUST 1997**



- 1 HPCH owned the hospital property.
- 2 HPCH obtained a \$50 million loan from Nomura. The loan was secured by a mortgage on the hospital property.
- 3 Doctors Hospital, leased the hospital property and guaranteed the loan. The loan was also secured by an assignment of the Doctors Hospital lease. The Doctors Hospital lease payment equaled the monthly debt service payment to Nomura.
- 4 Nomura sold the loan into a REMIC. The REMIC was the defendant in the fraudulent transfer case.

Chart 2

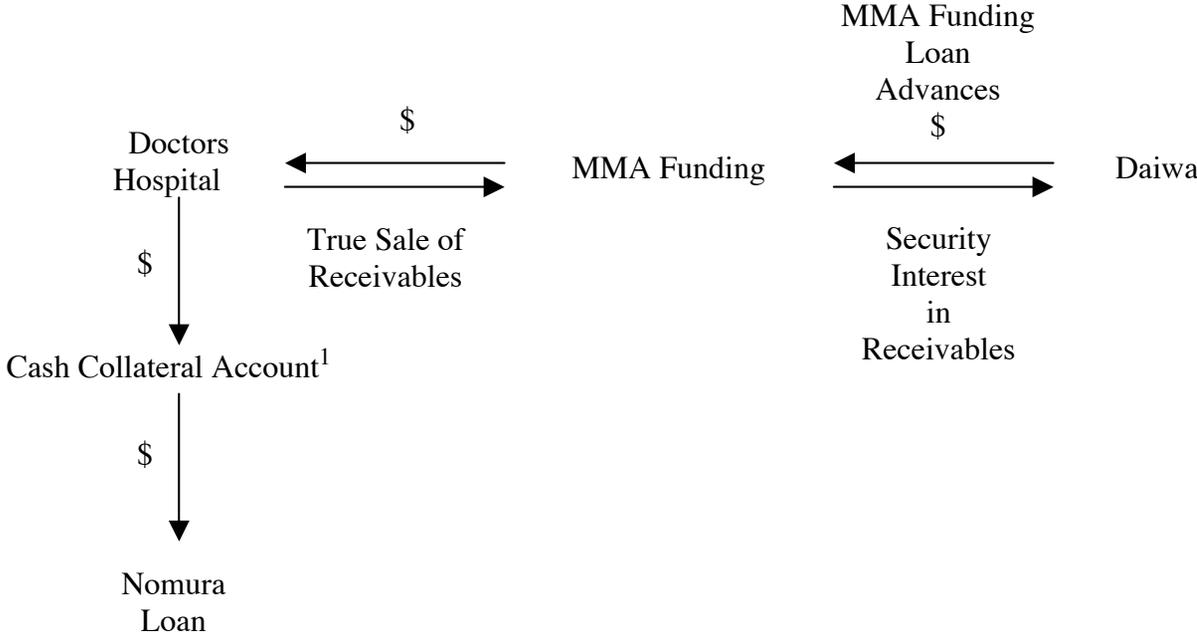
**DOCTORS HOSPITAL  
HEALTHCARE SECURITIZATION AND NOMURA LOAN  
INTEGRATED STRUCTURE & FLOW OF FUNDS**



1. The Nomura loan documents required that debt service on the Nomura loan flow through the healthcare securitization. Instead of Doctors Hospital receiving the securitization cash flow (as it had before the Nomura loan—*see* Chart 1) and then making rent payments to fund debt service, the Nomura loan documents required that the healthcare securitization proceeds be paid directly into a cash collateral account. These were the transfers challenged as fraudulent transfers in the litigation.
2. Debt service on the Nomura loan was paid from the cash collateral account.
3. Excess funds were paid to Doctors Hospital from the cash collateral account, but Doctors Hospital did not touch the funds until the Nomura loan payments were made. For the period during which the cash flowed in this manner, Judge Schmetterer concluded that the funds were owned by MMA Funding, a legitimate and separate bankruptcy remote entity, not Doctors Hospital, and therefore the advances into the cash collateral account were not subject to avoidance.

Chart 3

**DOCTORS HOSPITAL  
HEALTHCARE SECURITIZATION AND NOMURA LOAN  
INCORRECT FLOW OF FUNDS**



1 Until July, 1998, the required cash flow (see Chart 3) was not followed. Doctors Hospital improperly received the cash flow and made payments directly into the cash collateral account. For the period during which the cash flowed in this manner, the funds used to make the Nomura debt service payments were owned by Doctors Hospital and therefore the payments were potentially subject to avoidance.

Chart 4