

General Growth Properties

Casting a Cloud over Traditional Perceptions of Bankruptcy Remote Financing Structures

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To the surprise of many, when General Growth Properties Inc. (“GGP”) commenced a Chapter 11 proceeding in April 2009, it caused 166 solvent bankruptcy remote entities that were current on all their indebtedness (the “General Growth SPEs”) that each owned a single mall property to also file Chapter 11 petitions. In August, in a highly anticipated test of the legal structures underpinning securitized financing, the United States Bankruptcy Court for the Southern District of New York denied a motion to dismiss bankruptcy cases filed by General Growth SPEs. *In re: General Growth Properties, Inc.*, 2009 WL 2448423, No. 09-411977 (Bankr. S.D.N.Y. Aug. 11, 2009). The GGP case is significant as it is the first decision to analyze comprehensively a bankruptcy risk.

In the past 20 years or so, real estate finance has evolved from mortgage loans made by a bank or institution that held the loans until maturity and maintained its relationship with the borrowers, to non recourse loans utilizing so called “bankruptcy remote” structures, which loans were then securitized and sold to investors as commercial mortgage backed securities (“CMBS”). The economics of CMBS loans were favorable to borrowers because, among other things, the bankruptcy remote structure was implemented to isolate the assets from other parts of a borrower’s business, ensuring that cash flows would be dedicated solely to the specific CMBS debt. Perhaps more importantly, CMBS loans were designed to minimize the risk that a borrower would utilize bankruptcy to delay a lender from foreclosing a defaulted mortgage, or from taking advantage of the cramdown provisions of the Bankruptcy Code.

The term “bankruptcy remote” is used frequently in the GGP decision, but can mean different things to different people. Typical components of a bankruptcy remote structure include an independent manager or director (who often is an employee of a corporate service company) whose affirmative vote is needed to commence a bankruptcy case; separateness covenants that require a borrower to segregate its assets and operations from its affiliates and limit a borrower’s ability to incur debt or engage in activities unrelated to ownership of real estate or other specific assets (creating a “single purpose entity” or “SPE”); and a non-recourse care-our or “bad boy” guaranty, which triggers liability on an equity owner in the event of voluntary bankruptcy filing. The GGP case challenges the assumptions underlying the first two components of these bankruptcy remote structures.

The independent manager or director was the focus of much of the GGP decision. The existence of an independent manager was thought by some as making an SPE bankruptcy proof. Indeed, an officer of a GGP lender testified that an independent manager was meant to prevent a bankruptcy filing and such filings were not intended to happen. Although this seems to be an overstatement of the role of the independent manager, an independent manager or director that owed fiduciary duties to creditors was generally considered to be effective against preventing tactical bankruptcy filings by property owners. Common practice during the last

down cycle in commercial real estate, was when an entity owning a single asset would file for Chapter 11 protection in order to delay foreclosure with the hope that the market could revive and the debt could be refinanced, or to impose enough delay and expense on a lender to compel the lender to allow the borrower to maintain control of the property.

Because the Bankruptcy Code's cramdown requirements include an impaired class of creditors voting to accept the plan, the secured lenders of an SPE should be able to defeat any effort at cramdown, as in most cases such lenders will be the only impaired creditor or hold the sufficient unsecured claims to control the vote of any unsecured creditor class. However, if the SPEs are substantively consolidated with entities with other creditors, the vote of those other creditors could be used to cram down the debt held by the SPE secured lender. For this reason, an SPE's ability to incur other indebtedness is restricted, and the SPE is required to maintain separate operations from its affiliates.

Finally, a bankruptcy remote structure can include a non-recourse carve-out guaranty, which provides that a loan will become recourse or to the equity owner if a borrower commences a voluntary bankruptcy case provides a disincentive for a bankruptcy filing. These types of guarantees have been held to be enforceable. *See First Nationwide Bank v. Brookhaven Associates, et al.*, 637 NYS 2d 418 (1996).

THE GGP CASE

The first test of the SPE structure in the GGP case arose immediately after the filing. The initial proposed debt-or-in-possession financing provided for, among other things, granting the DIP lenders second liens on properties owned by the General Growth SPEs and providing that excess cash flow be made available to the parent company. Numerous General Growth SPEs lenders opposed the financing. The court allowed General Growth SPEs to upstream their excess cash to GGP's centralized cash management system, however, the final negotiated financing orders did not include General Growth SPEs as obligors and mortgagors, thus preserving the position of the lenders to the General Growth SPEs as the sole secured creditors of those entities. Also, the General Growth SPE lenders were granted replacement liens on GGP's centralized cash management account, which were senior to the liens of GGP's DIP lenders.

With DIP financing in place, the court turned to motions to dismiss the General Growth SPE petitions filed by several General Growth SPE lenders because the General Growth SPEs were not filed in good faith; in other words, the filings were not an appropriate use of the Bankruptcy Code. Although it is not an explicit provision of the Bankruptcy Code, courts have required that a bankruptcy case be filed in good faith so that the powerful provisions of the Bankruptcy Code are used to promote the policies of the bankruptcy law's three-fourths preservation of going concern values in a manner that equitably deals with the rights of all affected parties. The good faith principle ensures that the delay and costs imposed upon a bankruptcy case are not utilized with an improper notice of delaying creditors without a concomitant benefit.

The movants made several arguments in support of their motions to dismiss the cases as "bad faith" filings. First, there was no imminent threat to the financial viability of the General Growth SPEs, the General Growth SPEs were not in financial distress, were current on all their obligations as the loans were not on the verge of maturity, and thus the filings were filed prematurely. Accordingly, it was claimed that the SPE cases were not filed for a legitimate reorganizational purpose, but to gain a tactical advantage and additional leverage in future

efforts to extend the maturity of the loans. Also, because the General Growth SPE lenders were the only creditors, the General Growth SPEs would not be able to impose a cramdown on the lenders over their objection.

It was also argued that the purpose of the General Growth SPE filings was to benefit their affiliates and a filing to benefit a non-debtor was an impermissible use of the provisions of Chapter 11. The replacement of independent managers plan to filing, and the fact that no effort was to renegotiate the loans prior to filing were argued to be indications of bad faith.

THE COURT'S ANALYSIS

The court noted that both objective and subjective bad faith are required to dismiss a petition. The court enunciated a high standard for a creditor to dismiss a bankruptcy case as a bad faith filing, noting that the good faith doctrine should be used sparingly and with great caution. It utilized a holistic approach, noting that no one factor is determinative and the court should examine the debtors' financial condition (the objective factors) and motives (subjective factors). The court distinguished precedents that dismissed cases as premature because they presented distinct factual scenarios – in the other cases cited by the movants the debtors filed bankruptcy while litigation was still pending, and the debtors denied all liability such that any adverse effects from such litigation was wholly speculative. In contrast, the General Growth SPEs carried an enormous debt burden, although most maturities extended almost two years from the filing. Notwithstanding the absence of a looming maturity, the court noted that many General Growth SPEs would have incurred cross defaults to the defaults or bankruptcy filings by affiliates. The court refused to establish a principle that a pending maturity was needed to sustain a bankruptcy filing. The court relied on the unrebutted evidence that the CMBS market was “dead” as of the filing date, and it was uncertain if or when the market could revive to buttress its conclusion that GGP's decision to restructure in the bankruptcy context was made in good faith.

Also, the court rejected the argument that it was required to examine each SPE as an independent entity. Because the lenders were aware that the General Growth SPEs were part of a larger corporate group, the court did not consider itself to be acting contrary to any legitimate expectations that the financial situation of a General Growth SPEs would be impaired if the ability of the group to refinance its indebtedness was eroded. The court also relied on the fact that the General Growth SPEs benefitted from being part of the GGP group through economies of sale, shared expenses, and increased purchasing power.

The court noted that the interest of the parent companies needed to be taken into account in determining whether the General Growth SPEs' filings should be sustained because many of General Growth SPEs' operating agreements required the independent managers to consider the interest of the company, including its creditors, “to the extent permitted by applicable law.” Because the SPEs were solvent, Delaware law requires the managers to consider the interests of shareholders. The court flatly rejected any notion that an independent manager should veto a bankruptcy filing because of the desires of a secured lender.

The court was also unconvinced by the secured lenders' argument that the cases should be dismissed because a plan could not be confirmed over their objection. The court would not consider this argument before a plan was proposed and noted that parties often find it in their interest to reach an agreement on a

plan, and that debt can always be rendered unimpaired under a plan and that there is no requirement that a plan be confirmable to file a Chapter 11 petition.

After finding no objective bad faith, the court turned to a subjective analysis. The lenders argued that there was subjective bad faith because the debtors failed to negotiate with the lenders prior to filing for Chapter 11 protection, and because the independent managers of the General Growth SPEs were replaced shortly before the bankruptcy filings.

SUBJECTIVE ANALYSIS

The court noted that there were often good reasons not to engage in pre-filing discussion and relied on evidence that the debtors were unable to initiate a constructive dialogue with the CMBS lenders because only special servicers were empowered to negotiate an extension or refinancing, and special servicers could only be appointed if a loan were prepared to extend or refinance their loans out of court, which supported the conclusion that the decision not to initiate discussions pre-filing was reasonable and in good faith.

Finally, the court rejected the argument that it was bad faith to engineer the 11th-hour removal of independent managers who were experienced real estate executives. The court was persuaded that these actions did not constitute subjective bad faith because no action was taken that violated any provisions of the corporate documentation. The debtors had no contractual obligations to inform the lenders or independent managers of the removal and replacement. The court relied on the decision *In re Kingston Square Associates*, 214 B.R. 713 (Bankr.S.D.N.Y.1997), and suggested that as long as the action was not rooted in a fraudulent or deceitful purpose and that was designed to preserve value for the debtors estate and creditors, it did not support a finding of subjective bad faith.

The court in denying the motions emphasized that the basic SPE protections bargained for by the secured lenders remain in place, that the principal goal of the SPE was to avoid substantive consolidation and that nothing in the decision implied that substantive consolidation was an appropriate remedy. This may be an indication that any substantive consolidation motion will face an uphill battle.

CONCLUSION

The GGP bankruptcy filing made many realize that a bankruptcy remote structure did not make an entity bankruptcy “proof,” and that in situations where a loan is made to an entity that is part of a real estate company with many properties or affiliates, the SPE structure may not provide protections from all bankruptcy risks.

There are a number of lessons lenders should take away from the GGP cases that should help protect future bankruptcy structures. First, the court was persuaded by the fact that the “secret” replacement of independent managers did not violate the terms of the operating agreements. Accordingly, in future transactions borrowers’ organizational documents should limit the borrowers’ ability to replace independent managers; for example, there could be a requirement for “cause” that can be defined. Also, to prevent the appointment of an independent manager biased to the debtor, and replacement could be limited to a preapproved list or could be subject to lender approval (although lenders may be hesitant about using this right out of concern for a lender liability claim). Clearly, prior notice of the removal or replacement of independent directors should also be required. In addition, because Delaware limited liability company law permits the parties to establish fiduciary

duties by contract, the borrowers' organizational documents should explicitly provide that all managers have fiduciary duties to creditors even if the debtor is solvent. More aggressive lenders should consider a provision that provides for fiduciary duties solely to creditors which also may be enforceable, but is untested. Other techniques to ameliorate bankruptcy risks include strict cash controls such as hard lockboxes, rather than a lockbox that springs into effect upon a default, and the requirement that excess cash flow be used to fund reserves.

Thus far the bankruptcy remote structures remain substantially intact. However, the real test for the CMBS structures will occur if a motion to substantively consolidate the General Growth SPEs is filed. Participant and investors in CMBS will continue to monitor the situation as such motion, if successful, could seriously undermine the market assumptions, and potentially the pricing of CMBS in new transactions or in the secondary market.