Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives

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June 24, 2009

Despite fears that the bankruptcy filing by General Growth Properties (GGP), accompanied by voluntary bankruptcy filings for 166 special-purpose finance subsidiaries (GGP SPE Subs) that own and operate individual malls subject to mortgages in dozens of commercial mortgage-backed securities (CMBS) securitizations, would spell the death knell for structured finance, the bankruptcy court's May 14 cash collateral ruling respected and retained the integrity of the structure.

The filing presented two significant questions for those involved in structured finance. First, since the GGP SPE Subs were structured as bankruptcy remote finance subsidiaries with at least one independent director and since most were quite solvent and had no apparent inability to pay their obligations as they became due, how could the entities file for bankruptcy? Second, would the court permit GGP to grant a second lien on the individual properties of each GGP SPE Sub to secure Debtor in Possession (DIP) financing? While the motion for DIP financing did not specifically request substantive consolidation of the GGP SPE Subs into GGP, the result would have been substantially the same, thus jeopardizing a structure that has been relied upon by lenders, rating agencies and investors for years.

Background: SPEs

The premise underlying a bankruptcy remote single-purpose entity (SPE) in structured finance is to isolate the collateral relied upon as the source of repayment of the related obligation from the credit problems of its parent and affiliates. This structure has been particularly useful for providing non-recourse financing on commercial real estate. The hallmarks of an SPE, which should be contained in the entity's organizational documents, are (i) limited purpose, only owning and operating the property that secures the debt, (ii) prohibition on the incurrence of indebtedness other than the first lien mortgage, acceptable trade accounts payable, and, within parameters prescribed in the loan documents, certain other limited debt (typically subject to subordination and other customary intercreditor agreements), in order to minimize the risk of insolvency and the risk of other creditors that might pursue remedies such as bankruptcy, and (iii) separateness covenants governing operation of the SPE which have been gleaned from bankruptcy court cases that instructed which factors and behavior weighed more favorably for and against substantive consolidation.

Background: Independent Directors

In addition, the GGP SPE Subs—as is typical for large loan borrowers—were required to have at least one "independent" director or manager whose vote is necessary in order for the SPE to file voluntary bankruptcy. The independent director is usually defined in the organizational documents to be a person that is not, except in his or her capacity as independent director, an officer, director or equity owner of the SPE or its affiliates, a creditor, customer or supplier of the SPE or its affiliates, controlling or under common control with the SPE or its affiliates, or a family member of the foregoing. While this definition would preclude a person with clear ties to the SPE borrower, it would not necessarily avoid a friendly individual more inclined to vote in accordance with the SPE borrower's owners. Some definitions expanded to include—or even require—that the independent director be experienced in acting as independent director for SPE finance subsidiaries and an employee of one of the several independent companies that sprang up in response to heavy demand for this service.

It is important to note, as the GGP case highlights, that having an independent director does not assure that an SPE borrower will not voluntarily file for bankruptcy; it only assures that a director who is presumably independent from the SPE and its parent and affiliates will weigh his or her obligation as a director under applicable state law in deciding whether to vote in favor or against a voluntary bankruptcy filing. At best, a lender to an SPE may be comforted by (i) the typical duty of a director to consider the interest of the company which, as that company approaches the zone of insolvency, includes its creditors; or (ii) perhaps that such director will simply consider the basis upon which the lender made the loan and not join in filing a frivolous or evasionary bankruptcy.

Bankruptcy courts in at least one case have criticized the board of directors in an SPE finance subsidiary, including the independent director, for abdication of their fiduciary duty to the entity. [See *In re Kingston Square Associates, 214 B.R. 713 (Bankr. S.D.N.Y. 1997.]* In *Kingston Square*, the borrower allegedly colluded with other creditors to secure an involuntary bankruptcy filing after the non-independent directors determined that they would not involve the independent director. The independent director previously had been an employee of the lender and it was feared that he would not approve any action that would interfere with the lender. The court did not find that the debtor acted collusively with creditors in orchestrating a filing, but stated in *dicta* (and thus without legal precedential effect) that action taken by a corporate insider without required board or shareholder authority may later be found to have been appropriate in circumstances where the existence of the entity is very much at risk. The upshot: independent directors provide a level of review and objectivity that may avoid an overly hasty bankruptcy filing, but even their fiduciary duty may ultimately allow them to vote in favor of filing.

Motions to Dismiss Filing: Ultra Vires and Bad Faith

In the GGP case, motions have been filed by several lenders challenging the bankruptcy filings as ultra vires, or outside the authority of the GGP SPE Sub as required by the organizational documents, and as being done in bad faith. If the entities did not have independent directors, as defined in and required by the organizational documents, who properly authorized the filings, the challenge may be successful. Consequently, lenders are seeking to determine the scope and degree to which the independent director requirement was met. The bankruptcy code also allows a filing to be dismissed for cause, which courts have held includes bad faith or lack of good faith. There is no bankruptcy code requirement that a debtor be insolvent in order to file, but creditors in filings have maintained that the entities were solvent, had the ability to pay their obligations as they became due, and were in no financial stress or duress that would justify reorganization. Most of the entities had loan maturities at least 12 months away. Moreover, lenders have alleged that the GGP SPE Subs filings had no legitimate rehabilitation or reorganization purpose but were filed due to unrelated financial problems of the GGP parent.

Inasmuch as the cash collateral order was granted on May 14 and set in motion a reasonably logical and rational basis for moving forward on the jointly administered (as opposed to substantively consolidated) bankruptcy cases, some view the challenge to the GGP SPE Subs filings as unlikely to bear fruit. The court may be disinclined to effectively unwind that order, whether or not there is a demonstrable basis for *ultra vires* or bad faith findings. Similarly, if the independent directors in fact met the definitional requirements and voted for the voluntary filings, there may not be much appetite to pursue cases against those directors for breach of duty. According to the Debtor's Motion in Opposition of the Motions to Dismiss, GGP determined that the existing independent directors of its GGP SPE Subs (some of whom were from professional companies that provide independent director services) were not sufficiently knowledgeable about restructurings and capital markets, and GGP therefore replaced them with individuals they determined had such experience and met the independence requirement. The Debtor's Motion further stated that the boards held several meetings and reviewed financials and market information before voting for relief in bankruptcy.

On June 17, the bankruptcy court held its first hearing on lender motions to dismiss several of the GGP SPE Sub bankruptcy filings. After lengthy proceedings, one lender withdrew its motion with prejudice, signaling it was not confident it would ultimately prevail. The remaining hearings were deferred until later in the month, leaving the challenges unresolved.

Servicers for securitization trusts, of course, will need to balance the desire to avoid a bad precedent with the use of trust resources for an outcome that may be uncertain and might not justify the time or expense in result.

The Cash Management System

The separateness covenants that govern a typical SPE include not commingling the funds or other assets of the SPE with those of the parent or any other affiliate. This covenant stems from bankruptcy cases where commingling resulted in the inability to identify each entity's separate revenues and expenses and effectively treating the corporate group as a single enterprise. In the case of GGP and its GGP SPE Subs, lenders essentially gave a pass or qualified exception to this requirement, presumably due to the negotiating position of such a large and financially stout company. GGP was allowed to maintain a cash management system that swept each GGP SPE Sub account on a daily basis in order to maximize the efficiency and cash management of the entire group of entities. GGP and the GGP SPE Subs stated that the cash management system would accurately identify each GGP SPE Sub's own revenues and expenses in a way that made accounting and recordkeeping clear and manageable. The tradeoff was that the funds on a daily basis were swept from property level accounts and went directly to the parent. Accounting entries allocated revenues and expenses, but the parent had immediate access to the funds and was entitled to keep amounts in excess of required debt service, escrows and reserves as a distribution by the subsidiaries. This modification of the typical prohibition on commingling was not fatal to rendering a non-substantive consolidation opinion because bankruptcy courts have recognized that large corporations commonly employ cash management systems, and imperfections and inaccuracies in those systems do not justify consolidation. *See In re Owens Corning, 419 F. 3d 195, 214 (3d Cir. 2005), cert. denied 126 S. Ct. 1910 (U.S. 2006).* The GGP form of cash management system set the stage for the court to continue that arrangement post-petition without concern that the integrity of the separate entities was being jeopardized or made worse than prior to bankruptcy. In fact, granting a first priority security interest to each GGP SPE Sub lender in the cash management account for obligations of the related subsidiary ironically gave the lender a better secured position than it had pre-petition.

DIP Financing

In the bankruptcy filing, the original proposal by the GGP debtor for DIP financing at the parent level included the guaranty by each GGP SPE Sub of the financing and included a second lien on each of the mall properties owned by the GGP SPE Subs. The negative impact on the broader structured finance industry of a successful motion for this financing plan is hard to overstate, and industry participants mustered. The Commercial Mortgage Securities Association (CMSA) and the Mortgage Bankers Association (MBA) joined in an *amicus curiae* (friend of the court) filing that outlined the industry's concerns over eviscerating a legal structure that had been relied upon by the capital markets for over 20 years. While the judge expressed annoyance at their claims of systemic risk, his order addressed the concerns raised by these industry associations. Fortunately, several proposals for DIP financing emerged, and a group led by Farallon Capital secured court approval for a plan that omitted the egregiously offensive terms of the initial proposal and provides in pertinent part: (i) $400 million to GGP, which will allow payoff of the parent-level Goldman financing and free up approximately $600 million of properties held at the parent level, at a rate of LIBOR plus 12 points, with a 1.50 floor, a two-year term and 3.75% exit fee, and (ii) a second lien in favor of the DIP lender on the cash management account into which all funds from the GGP SPE Subs are swept, such funds being treated as upstream loans by the GGP SPE Subs to GGP rather than distributions on equity. Significantly, the GGP SPE Subs are not guarantors of, nor do their respective properties secure, the DIP financing. The judge specifically stated that his order did not constitute a substantive consolidation of GGP and its subsidiaries. Consequently, the fears of the finance industry that the integrity of the SPE structure would not be respected did not materialize—the structure survived.

Consequences

While the cash collateral order respected the integrity of each GGP SPE Sub and therefore alleviated most of the concerns of lenders to the GGP SPE Subs and, more broadly, of the structured finance industry at large, there remain a number of negative consequences to the bondholders of the affected securitization trusts, as would be expected in any bankruptcy involving securitized mortgage loans:

- Each loan is now in special servicing, which requires special servicer time and resources, even though most entities were solvent and paying debt service in accordance with the loan documents [only about eight of the loans had maturity defaults at filing].
- Each trust will bear additional fees and expenses, including a 25 basis-point special servicing fee during the pendency of bankruptcy, and up to a 1% workout or liquidation fee once the loan is either resolved out of bankruptcy or liquidated. In addition, the legal fees and expenses associated with the workout will likely be borne by the trust, typically averaging about 1% based on a Fitch study.

- While the court has authorized ongoing non-default interest payments by the GGP SPE Subs, the principal amortization portion of the payment is currently not being made. Under most pooling and servicing agreements, the master servicer is required to advance the principal amortization portion—so long as it is deemed recoverable—and will receive interest on such advance, which is an additional expense of the trust.

There are also consequences to the broader market. Investors are a bit more apprehensive about the structure and its ability to withstand the current market downturn at a time when industry participants are trying feverishly to restart the capital markets. Delinquencies on CMBS have risen to 2.8% and many expect them to rise to 5% or 6% by year-end. The contribution of $13.8 billion by GGP to the specially-serviced rolls, most of which had no reason to be in bankruptcy, does not help. In addition, GGP is viewed as a harbinger of future copycat filings. The recent Extended Stay Hotel filing may be the first example.

Some Lessons Learned

A number of takeaways from this first act (in what likely will be a long drama) of the GGP case:

- The SPE structure survived and is a useful tool for lending.
- Independent directors are also a useful tool, but they are not a guarantee that a bankruptcy filing by an SPE will not occur. Lenders may not legally prohibit a borrower from filing a voluntary bankruptcy—such a provision would be void as against public policy—and thus it would be advisable not to require lender involvement that might be viewed as having the same substantive effect, such as appointment rights or perhaps even approval rights. The best bet in future transactions is to require that such a director come from one of the professional independent director companies.
- Lockboxes likely will need to be “hard,” (set in place at the outset of the loan and diligently maintained throughout) rather than “springing” upon some trigger event.
- Exceptions to traditional SPE separateness covenants—such as the GGP waiver on commingling funds into a single cash management structure—will be to a lender’s peril.
- Expect non-recourse carve outs in loan documents to trigger full recourse to the parent or significant individual sponsor/affiliate in the event of a voluntary or collusive filing. Such full recourse triggers became market for conduit loan transactions and have been upheld by courts as a disincentive to bankruptcy filing. GGP loan documents, as was typical for loans to affiliates of the larger REITs, provided only for an indemnity by the parent of loss suffered by the lender in the event of a voluntary or collective filing, not full recourse. In GGP’s case, however, it was of course the parent that filed for bankruptcy, so lenders would be wise to consider requiring a financially stout individual.

Some questions will be answered following the hearings on bad faith claims by lenders in the GGP case. However, the case will likely continue for some time and the court is free to render additional orders that may modify current orders. Market participants are hopeful that the court will continue to recognize and respect the integrity of the SPE and related tenets of structured finance so that investors will not be reluctant to restart the stalled engine of the capital markets.

Stay tuned.

Should you have any questions about these matters, please contact Pat Sargent, Charlie Marshall or Peter McKee.

Note: Click here to find GGP Filings.