Round 2 of General Growth Properties Bankruptcy: Motions to Dismiss SPE Bankruptcies Denied, No Bad Faith, Corporate Group Considered

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The structured finance industry heaved a sigh of relief after the court in Round 1 of the General Growth Properties (GGP) bankruptcy approved a cash collateral order and Debtor in Possession (DIP) financing that respected the integrity of the 166 special-purpose finance subsidiaries (GGP SPE Subs) as separate entities.[1] Nonetheless, the financing, which provided for upstream loans by the GGP SPE Subs to GGP but granted their respective secured lenders a first-priority security interest in the central account, made it highly unlikely that those GGP SPE Subs would be completely isolated from the financial troubles of their parent. Nervous market participants did not expect motions by lenders for dismissal of the GGP SPE Subs from bankruptcy to succeed in Round 2.

On August 11th, the bankruptcy court confirmed those expectations with its ruling against motions for dismissal. Significantly, the court said that the determination of whether a filing of a subsidiary that is part of a larger corporate group was made in good faith should be based not only on the interests of the subsidiary, but also on the interests of the corporate group.

The Motions to Dismiss

Two special servicers on behalf of securitization trusts and two other lenders filed motions to dismiss the bankruptcy cases for 20 GGP SPE Subs.[2] At the heart of these motions were allegations of bad faith because the GGP SPE Subs were not financially distressed and had filed for bankruptcy solely to benefit GGP in a manner detrimental to the lenders of the GGP SPE Subs. The lenders argued that the filings were premature since many of the GGP SPE Subs had monthly cash flows that exceeded the amounts required to pay debt service, fund escrows and reserves and pay operating expenses, with maturity dates at least one to three years off (in some cases, 20 years).[3] Also, the lenders claimed that the borrowers' failure to negotiate and the surreptitious dismissal of the independent managers without notice indicated bad faith.

The Ruling

On August 11th, in a disappointing but not unexpected result, the bankruptcy court released a 47-page ruling rejecting all of the motions to dismiss, thus ensuring the continued participation of the GGP SPE Subs in the bankruptcy of their parent.

Standard for Dismissal for Bad Faith

The Bankruptcy Code does not provide for dismissal of a Chapter 11 bankruptcy filing for bad faith, but the court recited that the Second Circuit permits dismissal if, as of the filing date, the court finds both (i) objective futility of the reorganization process and (ii) subjective bad faith in filing. Such determination is based on the totality of the circumstances and dismissal for "lack of good faith should be used only sparingly and with great caution." While there was no indication that the reorganization process would be futile, the court nonetheless began an examination of bad faith by assessing whether the debtors were in actual financial distress.

Financial Distress. The court found that the record demonstrated that the GGP SPE's Subs were in varying degrees of financial distress evidenced by certain cross-defaults with affiliates, hyper-amortization and increased interest provisions, and maturities occurring in the next three years. Moreover, after several meetings with financial and legal advisors, the respective boards determined there was no reasonable expectation that the debts could be refinanced (due to the lack of a CMBS market) or modified (due to the lack of willingness of the lenders and servicers to renegotiate or extend loans).

Based on the steps taken by the debtors and their ultimate decision to pursue restructuring through bankruptcy and the lenders' failure to show that the conclusions reached by the GGP SPE Subs were not reasonable, the court held that GGP SPE Subs demonstrated a level of financial distress that was adequate for purposes of satisfying the requirements for good faith. The court also reiterated the well-established rule that the Bankruptcy Code does not require a debtor be insolvent in order to file and stated that there is no particular degree of financial distress required prior to seeking relief.

Consideration of Corporate Group. Rejecting the lenders' contention that the issue of good-faith filing should be viewed only from each individual debtor's perspective, the court considered the interests of the corporate group and cited bankruptcy cases that support including subsidiaries in the bankruptcy proceeding of their parent regardless of whether on a stand-alone basis a subsidiary is otherwise flourishing.[4] The court questioned how the parent entity debt can be effectively restructured without the cash flows from property level subsidiaries. In fact, under Delaware law, the directors of a solvent company must consider interests of the shareholders (in this case the parent, GGP) when deciding whether to file for bankruptcy. Because the organizational documents required the directors to consider the interests of the shareholders, including the creditors to the extent allowed by applicable law, the court discussed a recent Delaware case that rejected the proposition that directors have a fiduciary duty to creditors when the company is operating in the "zone of insolvency."[5] However, since the GGP SPE Subs were not insolvent, the duty to creditor issue was not applicable. When considering the financial distress of the GGP group, the court found that the filings by the GGP SPE Subs were unquestionably neither premature nor in bad faith.

The court next addressed the lenders' bad-faith claims based on borrowers' failure to negotiate and the pre-filing dismissal of the independent managers.

Failure to Negotiate. The court noted that the Bankruptcy Code does not require that a debtor must negotiate with its creditors prior to filing a bankruptcy petition. Moreover, the court found that the record gave no evidence that pre-filing discussions would have yielded any meaningful results. Rather, the record indicated that the debtors' efforts to negotiate were frustrated by the structure of CMBS transactions and that the lenders and servicers were not even willing to meet or negotiate with the debtors prior to filing.

Dismissal of Independent Managers. Testimony indicated that the original independent managers of the GGP SPE Subs were dismissed in the weeks prior to the filings because they did not have the real estate or restructuring experience necessary to make an informed decision regarding the need for a bankruptcy filing. They were replaced by GGP with two "seasoned individuals" that also met the requirements of the loan documents and organizational agreements of the GGP SPE Subs. Despite recognition that the dismissals were surreptitious in nature, the independent managers were replaced and appointed in accordance with the loan documents and organizational agreements and were bound by the same fiduciary duty to their company as their predecessors. The court rejected the lenders' contention that their rights were materially impaired by the filings, noting that the secured creditors have a "panoply of rights, including adequate protection and post-petition interest and fees if they are oversecured."

It's Not Consolidation

While unwilling to dismiss the GGP SPE Sub bankruptcy cases, the court reiterated its respect for the rights of the secured creditors of the GGP SPE Subs as separate entities.

> "The salient point for purposes of these Motions is that the fundamental protections that the Movants negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases. This includes protection against the substantive consolidation on the project-level Debtors with any other entities. There is no question that a principal goal of the SPE structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity."

Some Lessons Learned:

- The court still respects the separateness of each GGP SPE Sub; substantive consolidation is not an issue.

Articles

- Lenders to members of corporate groups—even where an SPE is used—must consider the potential impact of those corporate groups in assessing the likelihood of bankruptcy. SPEs are bankruptcy remote, not bankruptcy proof. In fact, voluntary bankruptcy of an SPE borrower is not as "remote" as it was perceived to be prior to this ruling.
- Lenders have relied too heavily on independent directors and an expected duty to lenders' interests in considering a vote for voluntary bankruptcy. The duty of a director to the corporation's creditors while in the zone of insolvency under Delaware law has been rejected and in any event was not applicable in this case. Lenders are on notice that SPEs may be more likely to enter bankruptcy when the parent is distressed even if the sub is not.
- The court harshly criticized the responsiveness of the servicers, which weighed in favor of the debtor in determining good faith in filing. An important lesson for servicers: more informative communication is better, and providing guidelines to requirements for successful extension and modifications will both make the job easier and reduce criticism.
- The court perceived the CMBS structure as a roadblock which, together with the unprecedented economic environment, allowed it to overlook the fact that borrowers bargained for and received higher proceeds, lower rates, and non-recourse financing in return for the lender's expectation of ready access on default directly to the property collateral without interference from credit problems of affiliates. Going forward, those lender expectations should be tempered a bit.

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1. For a discussion of the background and results of the May 14 ruling, *see*, "Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives."

2*. See*, *e.g.*, Motion of ING Clarion Capital Loan Services LLC, Pursuant to 11 U.S.C. § 1112(b), to Dismiss the Cases of Bakersfield Mall, LLC; RASCCAP Realty, Ltd.; Visalia Mall, L.P.; GGP-Tucson Mall L.L.C.; Lancaster Trust; HO Retail Properties II Limited Partnership; RS Properties Inc.; Stonestown Shopping Center L.P.; and Fashion Place, LLC (May 4, 2009).

3. Many of the loans that have maturity dates in the 2030s have ARD ("anticipated repayment date") features that result in "hyper-amortization" or "turbo" of the loans. Upon the occurrence of an anticipated repayment date, (i) the interest rate on the loan will increase, (ii) all excess cash flow will be applied to pay down principal on the loan and (iii) certain expenditures must be submitted to the lender for approval. The purpose of the ARD feature is to allow the borrower to extend the loan past its short-term anticipated repayment date (usually three to seven years) without being in default, but incentivize the borrower to seek refinancing from another lender.

4. The court cited *Heisley v. U.I.P. Engineered Prods. Corp. (In re U.I.P. Engineered Prods. Corp.),* 831 F.2d 54 (4th Cir. 1987), including a finding that if the parent's filing was made in good faith it was irrelevant whether subsidiaries could independently demonstrate good faith filings.

5*. See, North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).