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General Growth Properties Bankruptcy: SPE Structure Survives, but Consideration of Corporate Group Permitted,

Patrick C. Sargent, Charles T. Marshall and Peter K. McKee, Jr.

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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 cash collateral ruling respected and retained the integrity of the structure. In addition, the court ruled that in examining whether a debtor filed in good faith, the interest of the corporate group should be considered.

The filing presented three significant questions for those involved in structured finance. First, 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, such relief would have substantially the same effect, thus jeopardizing a structure that has been relied upon by lenders, rating agencies and investors for years. Second, since the GGP SPE Subs were structured as bankruptcy remote finance subsidiaries and since most were quite solvent and had no apparent inability to pay their obligations as they became due, would lender motions for dismissal be granted? Third, since these entities all had independent directors, how and why did they vote in favor of voluntary bankruptcy and what lessons should lenders take away from this experience?

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, which is customary for limited liability companies) 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 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

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a director to consider the interest of the company which, as that company approaches the zone of insolvency, in some jurisdictions may include its creditors; or (ii) perhaps that such director will simply consider the basis upon which the lender made the loan and not approve a frivolous or evasive bankruptcy filing.

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.¹ 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.

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.²

This modification of the typical prohibition on commingling was not fatal to counsel 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.³ 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, the court granted a first priority security interest to each GGP SPE Sub lender in the cash management account for obligations of the related subsidiary, which ironically gave those lenders a better secured position than they had pre-petition.

FIRST RULING—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.⁴ While the judge expressed annoyance at their claims of systemic risk, his order addressed the concerns raised by these industry associations.

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Fortunately, several proposals for DIP financing emerged, and a group led by Farallon Capital secured court approval on May 14, 2009 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 percent 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.⁵ 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.

SECOND RULING—MOTIONS TO DISMISS

The DIP financing described above 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 that motions by lenders for dismissal of the GGP SPE Subs from bankruptcy would succeed in Round 2. On August 11th, the bankruptcy court fulfilled those expectations with its ruling against motions for dismissal. Significantly, the court said it was not required to examine the issue of good faith in filing as if each GGP SPE Sub were wholly independent, rather the interest of the corporate group should be considered.

Two special servicers on behalf of securitization trusts and two other lenders filed motions to dismiss the bankruptcy Cases for 20 GGP SPE Subs.⁶ 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 1 to 3 years off (in some cases, 20 years).⁷ Also, the lenders claimed that the borrowers' failure to negotiate and the surreptitious dismissal of the independent managers without notice indicated bad faith.

On August 11th, in a disappointing but not unexpected result, the bankruptcy court released a lengthy 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. According to the court, 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 re-negotiate 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 found a level of financial distress that satisfied 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.

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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.⁸ 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."⁹ 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." This seems to invite lender claims for adequate protection and post-petition interest.

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.

CONSEQUENCES

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Although 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 one percent 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 one percent based on a Fitch study; and
- 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 exceed three percent and many expect them to rise to five percent or six percent 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 bankruptcy filing may be the first example.

SOME LESSONS LEARNED

A number of lessons were learned from the first two rounds of the GGP case (in what likely will be a long bout):

- The SPE structure survived and is a useful tool for lending.
- Lenders to 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 their perceived duty to consider the lenders' interests in voting on voluntary bankruptcy. As Judge Gropper noted in the GGP case, Delaware courts have rejected creditor claims they are owed such duty by directors while the borrower is in the zone of insolvency. In any event, since the GGP SPE Subs were not approaching insolvency, such argument was not applicable in this case.
- Independent directors may still be 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.

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- 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.¹⁰ 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.
- 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.
- Despite the fact that the GGP borrowers bargained for and received higher proceeds, lower rates, and non-recourse financing in return for the lenders' expectation of ready access on default directly to the property collateral without interference from credit problems of affiliates, the court perceived the CMBS structure as a roadblock. In the context of the worst economic environment since the Depression, the court overlooked these traditional lender/borrower bargains and expectations. Going forward, those lender expectations should be tempered a bit.

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.

NOTES

1. See *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).
2. See generally, Debtors' Motion for Interim and Final Orders Pursuant to Sections 105(a), 345(b), 363(b), 363(c) and 364(a) of the Bankruptcy Code and Bankruptcy Rules 6003 and 6004 (A) For Authorization to (I) Continue Using Existing Centralized Cash Management System (II) Honor Certain Prepetition Obligations Related to the Use of the Cash Management System, and (III) Maintain Existing Bank Accounts and Business, Forms; (B) For an Extension of Time to Comply with Section 345(b) of the Bankruptcy Code; and (C) Scheduling a Final Hearing (April 16, 2009). *Note*; All references herein to GGP Filings may be found and accessed at www.kccllc.net/GeneralGrowth.
3. See *In re Owens Corning*, 419 F.3d 195, 214 (3d Cir. 2005), cert. denied 547 U.S. 1123 (2006). For a discussion of the Owens Corning decision, see Sargent, Third Circuit Reverses Owens Corning; Substantive Consolidation as a Shield, Not a Sword, *Real Estate Finance*, Vol. 22, No. 4 (Dec. 2005).
4. Amended Brief of Amici Curiae with Respect to the Filing of Voluntary Petitions in Bankruptcy by the Individual Property Owner Subsidiaries in the General Growth Properties, Inc. Bankruptcy (May 1, 2009).
5. Final Order Authorizing Debtors to (A) Obtain Postpetition Secured Financing Pursuant to Bankruptcy Code Sections 105(a), 362, and 364, (B) Use Cash Collateral and Grant Adequate Protection Pursuant to Bankruptcy Code Sections 361 and 363 and (C) Repay in Full Amounts Owed Under Certain Prepetition Secured Loan Agreement. (May 14, 2009).
6. See, e.g., Motion of INC 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).
7. Many of the loans that have maturity dates 20 or more years off 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

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extend the loan past its short-term anticipated repayment date (usually 3 to 7 years) without being in default, but incentivize the borrower to seek a re-financing from another lender.

8. 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.

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

10. See *111 Debt Acquisition LLC v. Six Ventures, Ltd.*, 2009 WL 414181 (S.D. Ohio).