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General Growth Properties Rulings Raise Concerns with Bankruptcy-Remote Structures

The General Growth Properties, Inc. ("GGP") bankruptcy has produced two rulings to date that have important implications for the structured finance and CMBS markets. The first ruling related to the channeling of cash collateral from bankruptcy-remote entities into a common cash management system used by a group of affiliated companies in bankruptcy, and the second ruling, issued August 11, 2009, allowed a parent company to cause the bankruptcy filing of its solvent, special purpose real estate subsidiaries. This Alert summarizes the dynamics of those rulings and discusses their consequences for those involved in securitization transactions that depend upon the core principle of separating assets from the credit risk of a parent company through the use of bankruptcy-remote special purpose entities ("SPEs").

Anyone familiar with the GGP bankruptcy knows that, much to the surprise and consternation of the affected mortgage lenders, when GGP (the corporate parent) filed for bankruptcy, it also filed voluntary petitions for 166 property-level SPEs. Nearly $10 billion of the $18.27 billion of GGP's property-level debt was securitized in the CMBS market.

As a rule, GGP's property-level borrowers' loans had three- to seven-year terms with low amortization rates and balloon payments at maturity. Although virtually all of GGP's SPE borrowers for which it filed bankruptcy petitions were cash-flow positive as of their filings, GGP nonetheless justified these filings on the grounds that the SPE borrowers were part of a larger corporate family and that, notwithstanding their current financial status, the difficulties of refinancing their debt in a CMBS market that was "dead" justified their effort to restructure that debt in bankruptcy.

Very early in the case (and before any decision on whether the SPE borrowers belonged in bankruptcy), the court held that as long as the property-level lenders were adequately protected, the debtor could upstream cash from those SPEs (*i.e.*, cash collateral) into the GGP group's common cash management account. That adequate protection took the form of interest payments at the non-default contract rate, timely payment of property-level expenses and replacement liens on the cash that was upstreamed and on the common cash management account. In response to arguments that allowing the cash to move from the SPEs to the common account amounted to *de facto* substantive consolidation of the special purpose borrowing entities into the corporate parent, the court did not allow the lien of the DIP lender to prime the replacement liens given to the property-level lenders.

Questions about DIP financing and cash collateral are always raised on the first days of a bankruptcy filing, while motions testing whether a case was filed in bad faith and should be dismissed require motion practice, discovery and trial. Several lenders and special servicers filed motions seeking to dismiss approximately 20 of the project-level filings.

The motions to dismiss were based on assertions that the filings were made in bad faith, because (i) each applicable SPE was financially solvent and the maturity date of its debt was several years away, (ii) each applicable SPE's financial situation should have been analyzed independently without consideration of the interests of the GGP corporate family as a whole, (iii) each applicable SPE should have negotiated (but did not) with its lenders prior to filing and (iv) the independent manager[1] of each applicable SPE was fired and replaced shortly before the filing, all without notice to the terminated independent manager.

Despite the policy implications of the ruling, the bankruptcy court looked at these motions only through the lens of what the Bankruptcy Code and developed precedent allow, brushing aside each of the arguments and denying the motions to dismiss. The ruling was based upon testimony that allowed the court to find that:

1. refinancing of the property-level debt in a market that might remain dormant for some time was problematic;
2. future negotiations on refinancing that debt would have been futile;
3. notwithstanding the separateness of each individual property loan, the lenders were aware that they were dealing with a larger group;
4. each independent manager held fiduciary duties to the SPE and its equity owner and not to the SPE's creditors; and
5. while the firing of the independent managers on the eve of bankruptcy was "admittedly surreptitious," that firing did not violate the SPE's governing documents, because the governing documents did not require that notice of termination be given to the fired independent manager and the replacement independent manager satisfied the requirements of an independent manager.

The court emphasized that it was not substantively consolidating the SPEs into the GGP corporate family. GGP counsel represented to the court that it might move for consolidation of "groups" of SPEs, but no motion to that effect has yet been filed. Avoiding substantive consolidation is, of course, an absolute requirement for bankruptcy remoteness and for securitization structures.

While much of the GGP story remains to be written, these two rulings clearly show that the bankruptcy remote structures that have supported massive amounts of financing in a large array of asset classes may not be able to withstand the challenges to those structures in a bankruptcy. Indeed, the rulings (i) open the door for subsequent court decisions to follow in cases almost certain to arise in the future, given the current state of the markets and the reliance upon SPEs in various structured financings over the past several years, (ii) enhance the threat of substantive

[1] Certain SPEs had independent managers and others had independent directors. For convenience, the term "independent manager" is used in this Alert to cover both categories.

consolidation of bankruptcy cases of corporate families involving SPEs in the future and (iii) threaten to severely weaken any prospects for recovery of the real estate finance industry and asset securitization markets.

Investors justifiably relied upon and took comfort in the SPE structure and invested billions of dollars with the expectation that SPEs were created to be bankruptcy-remote and legally isolated from external events at the parent level. The GGP rulings seriously undermine the benefits of using securitization as a financing tool and, as a result, both lenders and investors in real estate finance and asset-backed securitizations may not accept the now higher risk of SPEs being swept into bankruptcy, along with affiliates whose business model employs the use of SPEs.

In the wake of these rulings, rating agencies now will need to take into account the enhanced bankruptcy risk associated with SPE borrowers in commercial mortgage securitizations, thereby likely resulting in greater subordination levels. Such enhanced bankruptcy risk will increase the importance of parties that advance delinquent payments of principal and/or interest, or otherwise provide liquidity to such securitizations. Furthermore, investors will likely look less favorably on commercial mortgage securitizations that include material concentrations of borrowers affiliated with major real estate sponsors, a characteristic that was once viewed as a marketing plus. Undoubtedly, the GGP rulings will be reflected in disclosure documents relating to securitizations of commercial mortgages as well as other financial assets.

The rulings also may affect the willingness of lenders to extend non-recourse financing to real-estate borrowers, and may cause lenders to demand higher interest rates and fees on these transactions. Non-recourse lending is, to a significant extent, based on the isolation of the real estate collateral securing the subject mortgage loan. The trend of the GGP decisions clearly impacts the value of SPEs in providing that isolation.

If the securitization and real estate finance markets are to survive, let alone thrive, once more, action must be taken to address the risks exposed in the GGP cases associated with bankruptcy-remoteness and an SPE being swept into bankruptcy by related entities. One place to start would be for lenders and investors to perform a careful review of the transaction documents and SPE organizational documents for existing structured finance deals.

In denying the motions to dismiss, the court determined that (i) the replacement of the independent managers did not violate the terms of either the SPE's organizational documents or the independent managers' terms of engagement and (ii) the conduct by the independent managers leading to the decision to file the bankruptcies of the SPEs did not violate their fiduciary duties. Greater control over the termination of independent managers seems appropriate, although control that in effect makes a bankruptcy filing impossible could be challenged as violating the public policy that allows a bankruptcy filing in the first place. The term "bankruptcy-remote" acknowledges that an SPE is not bankruptcy-proof, but the parties to a securitization should be able to assure themselves at the outset of a transaction that the independent manager will be impartial and not biased in favor of the parent company, and will consider the interests of creditors when making key decisions.

The organizational documents of SPEs typically require the unanimous vote of all managers, including the independent managers, in order for the SPE to commence a voluntary bankruptcy proceeding. The judge in the GGP case determined that the SPE organizational documents did not require that notice of termination of the independent manager be given to the terminated manager or anyone else, and he refused to read such a provision into the documentation. It is our experience that SPE organizational documents generally permit the equity owner to replace the independent manager at will, and do not specifically provide for notice thereof. Clearly, it is a simple matter to add a notice provision, and the provision could be written so that notice must be given to both the terminated manager and the lender (in which case the SPE organizational documents should make the lender an express third-party beneficiary), and the appointment of the replacement manager would not be effective until a certain time period had elapsed following the notice. Similarly, it might be useful to include covenants in the transaction documents requiring the SPE to give notice to the lenders of any change of managers and requiring periodic delivery to the lenders of a list of managers' names.

A notice provision, however, while imposing an additional procedural requirement and avoiding the surprise element that was present in the GGP situation, would not ultimately prevent a bankruptcy filing in a situation where the sponsor had lined up a replacement independent manager who was known to favor bankruptcy. As noted earlier, a mechanism cannot be put in place that would make a bankruptcy filing impossible, but certain other governance procedures may be worth considering. One possibility would be to provide that an independent manager may only be removed for cause. A second possibility would be to provide that replacement independent directors must be appointed from a list of candidates agreed upon in advance, or from employees of a list of designated SPE service companies.

Provisions in the SPE organizational documents relating to fiduciary duties of the managers should also be reviewed. Under Delaware law, corporate directors have a fiduciary duty to the corporation and its equity owners, but do not owe any duty to creditors until actual insolvency (and then such duties are only enforceable in a derivative action, not directly).[2] For this reason, it is preferable not to use a Delaware corporation as an SPE. On the other hand, under Section 18-1101 of the Delaware Limited Liability Company Act, which allows a limited liability company agreement to restrict or eliminate fiduciary duties of a manager to a member of the limited liability company, fiduciary duties may be established in favor of creditors of a limited liability company, whether or not the limited liability company is insolvent.

The SPE limited liability company agreements in GGP contained such a provision, which stated that the independent managers "shall consider only the interests of the Company, including its respective creditors." However, such limited liability company agreements also separately stated that the independent manager had a fiduciary duty similar to that of a director of a Delaware corporation. The latter provision appears frequently in SPE documents, but care must be taken, because Delaware corporate law no longer provides for a fiduciary duty to creditors when a

[2] Prior to 2007, Delaware case law had held that corporate directors had a duty to both creditors and shareholders when the corporation was in the vicinity of insolvency.

corporation is in the vicinity of insolvency. Therefore, the latter provision should be made specifically subject to the requirement that independent managers must consider the interests of the SPE and its creditors. It appears that the GGP documents did not contain such an ordering of provisions, because the court disregarded the provision to consider the interests of creditors. Such a provision should be enforceable, and would also reduce the risks associated with the appointment of replacement independent managers with a predisposition in favor of filing the SPE for bankruptcy protection.

The GGP case is a forceful reminder that SPEs using standard bankruptcy-remote technology can end up in bankruptcy. Nonetheless, there are some steps lenders can take to shore up bankruptcy-remoteness provisions and to distinguish their transactions from the precedent of the GGP bankruptcy. The suggestions made in this Alert should not be regarded as a cure-all, and we expect that the GGP rulings will cause securitization lenders to be more cautious as the implications of the rulings continue to be analyzed.

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