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Not So Bankruptcy-Remote SPEs and *In re General Growth Properties Inc.*

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Special purpose entities (SPEs) have been used for years by various types of borrowers in financing transactions to isolate financial or other assets supporting a loan from the creditworthiness and default risk of the SPE's parent and affiliates. SPEs have been structured to be "bankruptcy-remote" in an attempt to protect lenders from becoming entangled in a bankruptcy case caused by financial difficulties of other members of the corporate family. SPEs typically incorporate carefully-crafted impediments to a bankruptcy filing in their organizational documents and loan agreements.


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Market participants have long assumed that these structures are effective mechanisms for protecting lenders from being frustrated or delayed by a bankruptcy case due to the financial condition of its parent or affiliates, and therefore have permitted borrowers to obtain less-expensive financing than might otherwise be available. This assumption has been cast in some doubt by *In re General Growth Properties Inc.*,[1] the largest-ever real estate bankruptcy case, in which more than 160 of General Growth's bankruptcy-remote SPE subsidiaries were, to the surprise of many market participants, included in the chapter 11 filings.

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In two recent rulings, Judge **Allan L. Gropper** of the U.S. Bankruptcy Court for the Southern District of New York first approved the company's debtor-in-possession (DIP) financing facility, supported by excess rents from the SPEs, and then denied several motions to dismiss the SPEs' bankruptcy cases as improper and filed in "bad faith." Significantly, however, Judge Gropper did not question the legal separateness of the SPEs or substantively consolidate their bankruptcy estates with those of other SPEs or General Growth. Nonetheless, in blessing the bankruptcy filings of well-capitalized solvent SPEs, the court has caused great concern for commercial mortgage-backed securities (CMBS) market participants that have relied on these constructs as the foundation for minimizing some of the risks inherent in complex financing transactions.[2]

Background

Typically, an SPE's organizational and/or loan documents require the SPE to have at least one "independent"[3] director (or a manager for an LLC) obligated, to the extent permitted by law, to consider only the interests of the SPE, "including its respective creditors," in deciding whether to approve the SPE's filing for bankruptcy protection.[4] In fact, an officer of one of General Growth's SPE lenders testified that his understanding was that the independent board member's role was to "prevent a bankruptcy filing."[5]


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General Growth is a publicly-held shopping mall owner, operator and manager headquartered in Chicago. By the time of its bankruptcy filing on April 16, 2009, the company was the second-largest shopping mall operator and one of the largest real estate investment trusts (REITs) in the United States, owning more than 200 malls in 44 states, as well as several commercial office buildings and five master-planned communities.

Most of General Growth's real estate properties are held by SPEs, and the corresponding financing obligations are owed directly by those SPEs. General Growth established these SPEs to "ring fence" each of its real estate assets and the resulting cash flows (and its lenders' interests in those assets and cash flows) from its own and every other subsidiaries' credit risk. SPEs generally are formed in accordance with standards promulgated by rating agencies, which require that theses entities adhere to "separateness covenants" that restrict the types of assets they can own and indebtedness they can incur.

Historically, General Growth had satisfied its capital needs through mortgage

1 *In re General Growth Properties Inc.,* Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009).

2 The Commercial Mortgage Securities Association and the Mortgage Bankers Association filed an amici curiae brief to, among other things, express their "grave concern" regarding "the catastrophic impact [that the filing of General Growth's SPEs,] if it stands, could have on the CMBS market, as well as on structured finance and the broader capital markets that rely on the same underlying principles of asset isolation in the architecture of securitization." *In re General Growth Properties Inc.,* Case No. 09-11977 (ALG), 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 [Dkt. No. 289] (the *amici* brief) at 3 (Bankr. S.D.N.Y. May 1, 2009).

3 To qualify as an "independent" director or manager, a person must ordinarily "have no affiliation with nor derive any meaningful income from the borrower." *Amici* brief at 10, n. 11.

4 An SPE's organizational documents typically require that any bankruptcy filing be authorized by a unanimous vote of the directors.

5 *In re General Growth Properties Inc.,* Case No. 09-11977 (ALG), memorandum of opinion [Dkt. No. 1284] (the opinion) at 33 (Bankr. S.D.N.Y. Aug. 11, 2009).

loans obtained from banks and insurance companies, increasingly through CMBS transactions. So much so that approximately $15 billion of the company's $27.3 billion in consolidated outstanding prepetition debt is in the form of CMBS, making the company the largest borrower in the CMBS market.[6] The free-flowing credit markets of recent years, especially the CMBS market, had reliably provided General Growth with ready access to capital to finance its growth, and its business plan necessarily was premised on the ability to refinance its debt obligations prior to or upon maturity. By early 2009, however, the constriction in the credit markets had taken its toll on the CMBS market, which in turn created insurmountable liquidity problems for General Growth. Nonetheless, most of the debtors' CMBS loans (even those owed by SPEs that filed for bankruptcy) were not in default, continued to be adequately collateralized and even had excess cash flows.

DIP Facility and Use of Cash Collateral

At the outset of its chapter 11 case, General Growth sought court approval of a $375 million DIP facility to be provided by one of the company's significant shareholders. The DIP facility was to be secured by a postpetition lien on substantially all of the company's assets, including a junior lien on the properties of the SPE debtors. Prior to its bankruptcy filing, General Growth's subsidiaries (including the SPEs) would typically upstream rents into a commingled main operating account, from which General Growth would pay its subsidiaries' operating expenses and make intercompany loans. In connection with the proposed DIP facility, General Growth sought authority to continue to use the cash collateral held in its main operating account and to provide the DIP lenders with a junior lien on such cash.

As adequate protection for the use of cash collateral generated by SPEs, General Growth proposed granting the SPE lenders, among other things, a first-priority lien on the cash in its main operating account, a first-priority lien on such respective lender's SPE's intercompany claims resulting from the consolidation of cash collateral in the main operating account, and a junior lien on certain other assets. General Growth also proposed to continue to pay interest at the applicable non-default rates, maintain the properties, pay taxes vigorously and other operating expenses in accordance with their prepetition agreements.

The lessons of General Growth *are likely to cause market participants and rating agencies to review market practices relating to SPE structures. Market participants will surely revisit and revise the organizational documents used by SPEs to further constrain their ability to file for bankruptcy.*

The proposed DIP facility was contested by several of the SPE debtors' secured lenders and their agents, who argued, among other things, that their interests in the various properties and the rents therefrom were not adequately protected, and that the approval of the DIP facility would constitute a *de facto* substantive consolidation of the estates.

Following a competitive bidding process, General Growth obtained a $400 million DIP facility from various other lenders (led by several holders of General Growth's unsecured debt) on more favorable terms than the initial proposal. Importantly, these lenders were willing to provide a DIP facility without receiving guarantees by the SPEs or a pledge of their assets (other than those assets that were unencumbered or that secured loans that were to be satisfied with the proceeds of the DIP facility), which appeased many of the lenders' concerns.

In approving the DIP facility, Judge Gropper found that the debtors' proposal adequately protected the SPE lenders' interests, even given the risks inherent in cash flows from shopping mall rents. Judge Gropper also distinguished the use of cash collateral from "substantive consolidation," explicitly stating that "we are not substantively consolidating any estates [and are] only deciding the matters before the Court today."[7] Since the SPEs ultimately were not required to guaranty the DIP facility and the court respected the separateness of the entities, this outcome regarding the DIP facility may have been somewhat comforting to CMBS market participants.

Motions to Dismiss the SPE Debtors' Cases for "Cause"

Several special servicers, agents and lenders under the SPEs' prepetition facilities (collectively, the movants) moved to dismiss the SPEs' chapter 11 cases for "cause" pursuant to §1112(b) of the Bankruptcy Code, generally arguing that the filings were improper and not filed in "good faith" because the SPEs were not insolvent or in danger of becoming so, were not facing the imminent maturity of their facilities and did not directly benefit from chapter 11 bankruptcy protection.

The principle that a chapter 11 case can be dismissed as a bad-faith filing is founded in precedents rather than statutes. The leading case within the Second Circuit regarding dismissal of a petition filed in bad faith is *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship),* in which the Second Circuit held that dismissal is warranted if "there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings."[8] Judge Tina Brozman of the U.S. Bankruptcy Court for the Southern District of New York subsequently restated this principle as follows: "[T]he standard in this Circuit is that a bankruptcy petition will be dismissed if *both* objective futility of the reorganization process *and* subjective bad faith in filing the petition are found."[9]

Objective Bad Faith

In support of their contention that the SPEs' chapter 11 filings were premature, the movants relied on several precedents in which courts dismissed the bankruptcy cases of debtors that were not in financial distress at the time of filing, but rather premised their filings on speculative liability arising from a litigation (presumably in an attempt to obtain an advantage over the opposing litigants).[10] Judge Gropper held that the record did not support a determination of bad-faith filings by any of General Growth's subsidiaries, and distinguished *SGL Carbon* and *In re Schur Management* by noting that in those cases, those debtors were not in financial distress and instead faced wholly speculative litigation claims

6 Generally, lenders in the CMBS markets hold certificates from a real estate mortgage conduit (REMIC) backed by a large pool of mortgages. These lenders rely on diversification within the mortgage pool to reduce their risk of default by any individual borrower, and further reduce their risk (at the enterprise level) by lending to bankruptcy-remote SPEs.

7 *In re General Growth Properties Inc.,* Case No. 09-11977 (ALG), transcript of hearing, held on May 13, 2009, [Dkt. No. 574] at 153 (Bankr. S.D.N.Y. May 20, 2009).

8 113 F.3d 1304, 1309-10 (2d Cir. 1997).

9 *In re Kingston Square Assocs.,* 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).

10 *See, e.g., In re SGL Carbon Corp.,* 200 F.3d 154 (3d Cir. 1999). In *SGL Carbon,* the debtors filed for bankruptcy solely to protect against antitrust litigation while at the same time denying any liability and publicly touting their financial health. The Third Circuit held that "the mere possibility of a future need to file, without more, does not establish that a petition was filed in 'good faith.'" *Id.* at 164. *See also In re Schur Mgmt. Co. Ltd.,* 323 B.R. 123 (Bankr. S.D.N.Y. 2005).

for which they had denied any liability. The court reasoned that, although the SPEs would face varying degrees of financial difficulty due to maturing mortgage debt over the next several years, their debts were not contingent and would necessarily mature at some not-too-distant time. Judge Gropper refused to create an arbitrary rule barring a debtor from filing an anticipatory chapter 11 petition based on when its principal debt is due, and found that the SPEs were not unreasonable in concluding that they would not be able to refinance the billions of dollars of their maturing real estate debt in the coming years as a result of the moribund state of the CMBS market.[11]

The movants further argued that the bankruptcy-remote structure of the project-level SPE debtors required that the financial distress of each SPE be analyzed solely from such SPE's perspective. Judge Gropper rejected this argument, and held that each SPE was justified in considering not only its independent need for restructuring, but also the financial distress of the company as a whole in deciding whether to file for chapter 11 protection. He reasoned that while the SPE structure was intended to insulate the financial position of each SPE from its affiliates, the movants should have known that, given the larger and somewhat integrated corporate structure of the company, the financial situation of the parent company would impact its subsidiaries, which included the SPEs.

Judge Gropper further stated that the boards of the SPEs were in fact *required* to consider the interests of their parent companies and that the movants were mistaken in their view that independent managers can satisfy their fiduciary duties by voting, to the creditors' benefit, against any bankruptcy filing. Although the operating agreements of many of the SPEs provided that their independent directors must consider the interests of both the SPE and its creditors in deciding whether to consent to a bankruptcy filing, the directors are also required to adhere to applicable law—namely Delaware corporate law. Judge Gropper observed that Delaware law provides that directors and managers owe their duties to the corporation and, ordinarily, its shareholders. Judge Gropper cited *North American Catholic Educational Programming Foundation Inc. v. Gheewalla,* in which the Delaware Supreme Court stated that although directors of an insolvent corporation had a duty to creditors, "[w]hen a *solvent* corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment *in the best interests of the corporation for the benefit of its shareholder owners.*"[12] Judge Gropper concluded that the SPEs' directors or managers (including the independent directors or managers) had a duty to the SPEs' *shareholders,* rather than to their creditors, because there was no contention that the SPEs were insolvent (in fact, the movants argued to the contrary). Thus, assessed in light of the financial troubles of General Growth as a whole, the filings by the SPE debtors were "unquestionably not premature."[13]

Subjective Bad Faith

In addition, the movants asserted that the SPEs acted in subjective bad faith because they failed to negotiate with the lenders prior to the filing, and the initial independent directors of several of the SPEs were fired and replaced shortly before the chapter 11 filings. In response to the first argument, the court noted that nothing in the Bankruptcy Code requires a borrower to negotiate with its lenders before filing for bankruptcy, and there is no evidence on record that pre-filing talks would have resulted in any agreement to refinance the obligations. While Judge Gropper acknowledged that the movants have been inconvenienced by the bankruptcy filings (for example, by the partial interruption of the cash flows and the appointment of special servicers for the CMBS obligations), he noted that "inconvenience to a secured creditor is not a reason to dismiss a Chapter 11 case."[14]

Despite the movant's intention to the contrary, Judge Gropper was not convinced that the firing and replacing of several independent directors—in some instances, even the directors themselves were not aware that they had been fired until after the filings—was sufficient to support a finding of bad faith. The *amici* brief had cited "rumors in the market" that the chapter 11 filings took place because the SPEs' independent directors were replaced in possible contravention of their organizational documents,[15] and the movants alleged that the firing and replacement of independent directors on the eve of filing was improper. Instead, Judge Gropper noted that the relevant SPEs' organizational documents did not prohibit the dismissals.[16] Furthermore, the court found that the replacement independent directors had the appropriate experience to determine whether a bankruptcy filing was necessary and "satisfied the requirements of that position."[17]

Future Implications

Judge Gropper's denial of the motions to dismiss was viewed by many market participants as inconsistent with the protections thought to be provided to lenders in structured finance transactions involving bankruptcy-remote vehicles in the event of a bankruptcy of their corporate parent. Yet, the court has in some ways respected the separateness of the corporate entities and perhaps, strengthened the expectation that the SPEs' estates will not be substantively consolidated with their affiliates.

The lessons of *General Growth* are likely to cause market participants and rating agencies to review market practices relating to SPE structures. Market participants will surely revisit and revise the organizational documents used by SPEs to further constrain their ability to file for bankruptcy. However, the court's ruling that the directors of SPE entities must consider the interests of their shareholders when deciding whether to file for bankruptcy will likely make it far more challenging to create an SPE structure that fully isolates assets from the financial difficulties of corporate parents.

Other similarly-structured commercial real estate companies, which tend to be overleveraged and likely face significant challenges to refinancing or consensually restructuring their obligations out of court, may be encouraged by the *General Growth* case to file for bankruptcy as well. It remains to be seen how other courts will treat such filings, and whether such courts may be more reluctant to invade an SPE's cash collateral generated solely by securities or other more traditional financial assets (rather than operating assets as in General Growth) for the benefit of affiliated entities in furtherance of the goal of reorganizing the sponsoring enterprise. ■

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11 The company's financial advisor testified that CMBS issuances dropped by at least 97 percent in 2008 when compared to the corresponding time periods in 2007. Opinion at 26, n. 32.

12 *Id.* at 32 (quoting *North American Catholic Educ. Programming Found. Inc. v. Gheewalla,* 930 A.2d 92, 101 (Del. 2007) (emphasis added)).

13 *Id.* at 33.

14 *Id.* at 42.

15 *Amici* brief at 10, n. 11.

16 Opinion at 39.

17 *Id.* at 39-40.