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Bankruptcy Court Denies Motions to Dismiss Cases of SPE Subsidiaries of General Growth Properties, Inc.

Role of Independent Managers Addressed; Section 18-1101(c) of Delaware LLC Act Ignored

On August 11, a United States bankruptcy judge denied motions to dismiss the Chapter 11 cases of 21 special purpose entity ("SPE") subsidiaries (the "Subject Debtors") of General Growth Properties, Inc. ("GGP"). A final order denying the motions was entered on August 28. The decision raises a number of issues, primarily with respect to the role of independent managers, that are of particular interest to the commercial mortgage-backed securities ("CMBS") industry.

Lessons from the GGP Cases

To date, the GGP bankruptcy cases have highlighted the need for review of and potential changes to existing practices, including the following:

1. If a borrower (or the general partner of a borrower that is a limited partnership) in a CMBS financing transaction is a Delaware limited liability company, its operating agreement should require that, to the fullest extent permitted by law, including Section 18-1101(c) of the Delaware Limited Liability Company Act (the "LLC Act"), its independent managers consider only the interests of the borrower and its creditors when voting on whether to file a bankruptcy proceeding. Operating agreements should expressly eliminate any corporate law fiduciary duties to members and any other affiliates of the borrower, as permitted by Section 18-1101(c).
2. Some lenders have begun to include in loan agreements a requirement that (except in the case of the death or resignation of an independent manager) a borrower provide the lender with prior notice of the replacement of its independent managers. Borrowers and lenders should also consider the background and expertise of independent managers. Preferably, the independent managers should have experience in real estate finance and insolvency. Additionally, in situations involving both mortgage and mezzanine financings, lenders and borrowers should consider having different individuals serve as independent managers of the mortgage borrower and of the mezzanine borrower.
3. Cash management has been an important issue in the GGP cases. Prepetition, the GGP subsidiaries upstreamed their income to a commingled account maintained by the parent from which the expenses of all subsidiaries were paid and intercompany loans were made and tracked. The secured lenders to the SPE debtors received a senior lien on the commingled account as adequate protection for the debtors' use of their cash collateral. Notwithstanding this protection, the postpetition continuation of the prepetition upstreaming of cash, together with other facts of the case, raise concerns about a *de facto* substantive consolidation (as opposed to a legal substantive consolidation) of the debtors' estates. We anticipate that cash management practices will be even more heavily scrutinized by CMBS lenders in the wake of the GGP cases.
4. Many of the Subject Debtors (and presumably some of the other debtors) were unable to enter into workout negotiations prepetition because the master servicers of the loans had no authority to modify the loans. The debtors were not permitted to communicate with the special servicers because the loans were not close enough to default. Changes to the rules governing pre-default communications among borrowers, master servicers and special servicers should be explored by the industry.

Background

On April 16, 2009, GGP and 166 of its SPE shopping center subsidiaries filed Chapter 11 petitions in the United States Bankruptcy Court for the Southern District of New York. Hundreds of other GGP subsidiaries, including joint venture entities, wholly-owned SPEs and the manager of the properties owned by the SPE subsidiaries, did not file bankruptcy petitions. Although the filings by the SPEs raised concerns for the CMBS industry, Judge Allan L. Gropper's early rulings on the use of cash collateral and DIP financing maintained in important respects the separateness of the SPEs. Nevertheless, a few lenders and special servicers moved to dismiss the cases of the Subject Debtors on the ground that they were filed in bad faith because the Subject Debtors were not in financial distress, the properties were generating cash flow that was more than sufficient to cover debt service, property taxes and operating expenses, and the various loans would not mature for at least a year.

Dismissal for Bad Faith

In the Second Circuit, a Chapter 11 petition will be dismissed as a bad faith filing if "it is clear that on the filing date there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings." *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304, 1309-1310 (2d Cir. 1997)(citations omitted). The test has objective and subjective components. Dismissal for bad faith is warranted only "if both objective futility of the reorganization process and subjective bad faith in filing the petition are found." *In re Kingston Square Associates*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997)(citations omitted and emphasis deleted).

Objective Bad Faith

The lenders and the special servicers argued that the bankruptcy filings by the Subject Debtors, when considered from the perspective of a Subject Debtor individually and not from that of the GGP corporate group, were premature. In their view, the Subject Debtors should have waited until dates that are closer to their respective loan maturity dates before filing bankruptcy petitions.

Individual Debtor's Financial Distress

The court found that the Subject Debtors were in "varying degrees of financial distress" when they filed their Chapter 11 petitions. One had a loan that began to hyper-amortize prepetition and others had loans that would either mature or hyper-amortize within the next three years. Some had loans that defaulted upon the bankruptcy of a parent entity. Still others had loans with high loan-to-value ratios. The court also found that the Subject Debtors had taken reasonable steps to assess their financial situation and decide whether to file bankruptcy petitions. In light of the collapse of the CMBS and other credit markets in 2008, Judge Gropper found that it was reasonable for each Subject Debtor to conclude that it may not be able to refinance its debt within the coming years. Moreover, the Bankruptcy Code does not require that a debtor be insolvent in order to file a bankruptcy petition. To the contrary, Judge Gropper noted that by filing a Chapter 11 petition earlier rather than later, a debtor will maximize the value of its bankruptcy estate for its creditors. For these reasons, he concluded that, when viewed solely from the perspective of the Subject Debtors, the filings were not premature.

Independent Managers Must Consider Equityholder's Interest

Of particular significance to the CMBS industry is the court's ruling that the independent managers of each Subject Debtor were not only permitted to consider the interests of the GGP corporate group (i.e., the handful of direct and indirect parent entities together with all of their debtor and non-debtor subsidiaries) in deciding whether to file a bankruptcy petition, but, under Delaware law, were required to do so. Many of the Subject Debtors (and the other SPE debtors) are Delaware limited liability companies. Their operating agreements require them to have two independent managers who must consider only the interests of the Subject Debtor and its creditors when taking any action in connection with a bankruptcy filing. However, the operating agreements also imposed on the independent managers fiduciary duties of loyalty and care "similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware." Judge Gropper looked to *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007), in which the Delaware Supreme Court held that the directors of a solvent corporation that is operating in the zone of insolvency "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." Relying on *Gheewalla*, Judge Gropper stated that the lenders and the special servicers erroneously believed that the independent managers had duties to act in their interests. The judge reasoned that, because the Subject Debtors were solvent, their independent managers had properly considered whether Chapter 11 filings by the Subject Debtors would be in the interests of GGP and the other parent entities, all of which had substantial debt and relied on cash upstreamed by the Subject Debtors and the other SPE debtors to finance their operations. Viewed from the group's perspective, the court concluded that the Subject Debtors' bankruptcy filings were not premature and, therefore, did not demonstrate bad faith.

Confirmable Plan of Reorganization Not a Consideration

One lender argued that reorganization of some of the Subject Debtors would be futile because the lender intended to oppose confirmation of any plan of reorganization that may be proposed. The lender claimed to be the sole creditor of its Subject Debtors. If true, its opposition to any plan of reorganization would make it impossible for the Subject Debtors to satisfy the Bankruptcy Code's requirement that a plan be accepted by one impaired class of claims. The court quickly disposed of this argument, noting that the Bankruptcy Code does not require that a debtor prove that it has a confirmable plan of reorganization as a condition precedent to filing a Chapter 11 petition. Additionally, it is possible that the plans of reorganization would leave the debts unimpaired or that the lender might eventually decide that settlement is in its best interest.

Subjective Bad Faith

The lenders and special servicers based their subjective bad faith claims in part on the Subject Debtors' failure to negotiate with them before filing bankruptcy petitions. However, the Bankruptcy Code does not require prepetition negotiation between a Chapter 11 debtor and its creditors. The court found no evidence that the lenders were willing to work with the Subject Debtors before the bankruptcy filings. To the contrary, the court found that the CMBS structure impeded any possibility of pre-bankruptcy negotiations because only special servicers, not master servicers, have authority to negotiate a refinancing or an extension of the term of a loan. Special servicers are appointed only when a loan is in default or close to default. The Subject Debtors were not in default prepetition and, therefore, were prohibited from engaging in refinancing or restructuring discussions with the special servicers.

The lenders and the special servicers also argued that the Subject Debtors' firing and replacement of their independent managers before they filed their bankruptcy petitions demonstrated the Subject Debtor's subjective bad faith. Two employees of Corporation Service Company ("CSC") had served as independent managers of more than 150 of the Subject Debtors. The court found that these individuals did not have expertise in the real estate business. Prior to the bankruptcy filings, but unbeknownst to the CSC-supplied independent managers until after the bankruptcy filings, the Subject Debtors terminated their CSC-supplied independent managers and replaced them with two individuals whom the court described as "seasoned." The new independent managers satisfied the requirements of the Subject Debtors' organizational documents. The Subject Debtors had no contractual obligation to notify the CSC employees of their terminations. According to testimony given at the hearing on the motions, the Subject Debtors did not notify the CSC employees of their terminations earlier because they wanted to avoid generating publicity about their restructuring efforts. For these reasons, the court concluded that the lenders and the special servicers did not present sufficient evidence of the Subject Debtors' subjective bad faith to warrant dismissal of the cases.

Substantive Consolidation Distinguished

The issue of substantive consolidation of the Subject Debtors' bankruptcy estates with GGP and/or other members of the corporate group was not before the court. Nevertheless, in ruling on the motions to dismiss, Judge Gropper observed that "a principal goal of the SPE structure is to guard against substantive consolidation." He distinguished the issue of substantive consolidation from the issue of whether the board of directors of a debtor may consider the interests of the corporate group of which the debtor is a member when deciding whether to file a Chapter 11 petition. Judge Gropper explicitly stated that his decision to deny the motions to dismiss does not imply "that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity." Instead, the judge emphasized that the protections negotiated by the lenders and created by the SPE structure remain in place.

Implications for CMBS Transactions: Duties of Independent Managers

The judge's statements distinguishing substantive consolidation and asserting that the SPE structure of the Subject Debtors (and the other SPE debtors) has been maintained, together with similar comments that he made in ruling on the debtors' DIP financing, cash collateral and cash management motions, are encouraging to CMBS lenders. However, as discussed below, the ruling creates confusion as to the duties of independent managers.

Judge Gropper's ruling that the independent managers were required to consider the interests of the GGP corporate group when deciding whether to file bankruptcy petitions for the Subject Debtors rests on an incomplete reading of Delaware law. The judge relied on the Delaware Supreme Court's *Gheewalla* decision, which held that directors of a solvent corporation that is in the zone of insolvency have fiduciary duties to shareholders, not creditors. Yet most of the Subject Debtors are not corporations but, rather, limited liability companies or limited partnerships. Although the operating agreements of many of the limited liability companies impose on independent managers "a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware," they also state that "[t]o the fullest extent permitted by law, including Section 18-1101(c) of the [Delaware Limited Liability Company] Act," when acting on bankruptcy matters, the independent managers "shall consider only the interests of the [Subject Debtor], including its respective creditors." These provisions are standard for CMBS financings.

Section 18-1101(c) of the LLC Act permits a manager's fiduciary duties to be "expanded or restricted or eliminated by provisions in the limited liability company agreement." The only duties that an operating agreement cannot eliminate are implied contractual covenants of good faith and fair dealing. Section 18-1101(b) of the LLC Act makes clear that the policy of the LLC Act is to "give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." Thus, notwithstanding that the operating agreements impose general fiduciary duties upon the independent managers of a Subject Debtor, those duties are limited to acting in the interests of the Subject Debtor and its creditors when the independent managers are voting upon bankruptcy matters. This partial elimination and expansion of the fiduciary duties of the Subject Debtors' independent managers, which was negotiated by most of the Subject Debtors and their respective lenders, is permissible under Delaware law. *See generally Flight Options International, Inc. v. Flight Options, LLC*, 2005 WL 5756537 *7-8 (Del. Ch. 2005)(LLC agreement imposed general fiduciary duties on managers of LLC but limited those duties, in the context of a transaction between the LLC and its affiliates, to requiring that the transaction be arms'-length). *See also Douzinas v. American Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149-1150 (Del. Ch. 2006)(noting that alternative entity statutes, including the LLC Act, permit contracting parties to expand or restrict fiduciary duties, such that "it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship"). Specific contractual provisions trump more general contractual provisions. *Flight Options*, 2005 WL 5756537 at *8 (citation omitted).

Judge Gropper's decision does not mention Section 18-1101(c) of the LLC Act, let alone address its limiting effect on the fiduciary duties of managers of a limited liability company. Indeed, it does not appear that either the effect of Section 18-1101(c) or the relevance of *Gheewalla* to most of the Subject Debtors was fully fleshed out in the pleadings or at oral argument. These issues may be explored if any of the lenders and special servicers pursue an appeal. Until then, the bankruptcy court's failure to consider the limiting effect of Section 18-1101(c), coupled with the unambiguous language of that statute and the interpretations of the Delaware courts that have addressed it, lessen the precedential value of Judge Gropper's opinion as to the fiduciary duties of independent managers of limited liability companies.

In CMBS financings, it is far more common for an SPE borrower to be organized as either a limited liability company or a limited partnership than as a corporation. The Delaware Revised Uniform Limited Partnership Act contains a provision that is substantially similar to Section 18-1101(c) of the LLC Act. *See* 6 Del. C. § 17-1101(d). Moreover, if a CMBS borrower is a limited partnership, then its general partner is usually a Delaware limited liability company that has independent managers and observes SPE requirements. Therefore, at the present time, it appears that the requirement in the operating agreements of CMBS borrowers (or, if applicable, their general partners) that independent managers acting on bankruptcy matters consider only the interests of the borrower and its creditors will continue to afford some protection to lenders, notwithstanding the court's opinion to the contrary in the GGP cases.

As the GGP bankruptcy cases progress, more issues that are of interest to the CMBS market will likely emerge. We will continue to monitor developments in the GGP cases and provide further Advisories.

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