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BANKRUPTCY COURT ALLOWS GENERAL GROWTH'S "BANKRUPTCY-REMOTE"

In a decision made on August 11, 2009, the U.S. Bankruptcy Court for the Southern District of New York allowed solvent, special purpose entity subsidiaries of a bankrupt parent company, General Growth Properties, Inc., to maintain their Chapter 11 bankruptcy cases, raising several important issues related to the use of special purpose entities structured to be "bankruptcy-remote."

GGP Business Model and 2009 Bankruptcy Filings

General Growth Properties, Inc. (GGP) is the ultimate parent company of approximately 750 wholly-owned subsidiaries, joint venture subsidiaries and affiliates, including various Special Purpose Entities or SPEs. The GGP Group owns and manages over 200 shopping centers in 44 states in the United States. As of December 31, 2008, the GGP Group's capital structure included approximately $18.27 billion in debt, partly secured by mortgages on the individual properties of the company. The secured debt consisted of both conventional mortgage debt as well as debt that was securitized in the Commercial Mortgaged-Backed Securities (CMBS) market. The typical mortgage loan for the GGP Group had a three to seven-year term, with low amortization and a large balloon payment at maturity. Penalties for failure to repay or refinance upon maturity included a steep increase in interest rate, a cash requirement, and a requirement that certain expenditures be submitted to the lender for approval. The GGP Group sought to avoid these penalties by refinancing its loans prior to the maturity date.

As the credit crisis spread to the CMBS market in the latter half of 2008, prompting a change in commercially acceptable loan terms, the GGP Group was unable to refinance its maturing debt or to obtain new financing. After experiencing liquidity problems and defaulting on various loans, approximately 390 debtors within the GGP Group filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code in April 2009. Thereafter, certain Lenders, as well as the servicers to certain CMBS lenders, of the GGP Group debtors filed motions to dismiss the bankruptcy cases of twenty of the GGP Group's SPE Debtors. The Lenders argued that the bankruptcy cases of these SPE Debtors were filed prematurely in that there was no imminent threat to the financial viability of the SPE Debtors, which were cash-flow positive. The Lenders further argued that the filings were in bad faith since there was no possibility of confirming a plan over the objection of the Lenders and, therefore, no real chance of reorganization, and because the SPE Debtors replaced their independent managers just prior to the bankruptcy filings.

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The SPEs of the GGP Group were bankruptcy-remote entities, as evidenced by various provisions in their organizational documents including *(i)* prohibiting consolidation of GGP's various SPEs, *(ii)* restricting mergers and asset sales, and *(iii)* requiring that one or more "independent" directors or managers be retained by each SPE. Such features are consistent with common practice in the securitization market. The bankruptcy-remote structure of the SPE is an important consideration for commercial real estate lenders in protecting loan collateral from becoming subject to the risks of bankruptcy. Specifically, independent directors or managers not associated with an SPE, its parent or affiliates would be more likely to consider a bankruptcy filing objectively without the motivation to use such a filing to benefit the equity holders of the SPE. Conventional wisdom was that the existence of independent directors or managers eliminated the risk of a bankruptcy filing.

However, in the case of the GGP Group, these features of the SPE structure failed to prevent the SPE Debtors from filing for bankruptcy. On August 11, 2009, the U.S. Bankruptcy Court for the Southern District of New York issued a decision in *In re General Growth Properties, Inc., et al.* (Bankr. S.D.N.Y., Case No. 09-11977) that denied the motions to dismiss the bankruptcy cases of the SPE Debtors holding, as a general matter, that there was no evidence of prematurity or bad faith in the filings by the SPE Debtors.

The Bankruptcy Court Ruling

In denying dismissal, the U.S. Bankruptcy Court for the Southern District of New York applied the standard for the dismissal of a bankruptcy as outlined in the case of *C-TC 9th Ave. P'ship v. Norton Co. (In re C-TC 9th Ave. P'ship)*, 113 F.3d 1304 (2d Cir. 1997), stating that grounds for dismissal exist if it is clear 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." The court analyzed both the objective futility of the SPE Debtors' bankruptcy filings and whether the debtors exercised subjective good faith.

In determining that the bankruptcy filings of the SPE Debtors were not premature, the Court found:

- ***Insolvency is not a requirement***: Although the SPE Debtors were cash-flow positive at the time bankruptcy was filed and certain of the SPE Debtors did not have debt maturing for several years, the Bankruptcy Code does not require that a debtor be insolvent when a bankruptcy case is filed under Chapter 11. The state of the CMBS market and the difficulties of the GGP Group in refinancing and obtaining new loans demonstrated that each of the SPE Debtors was in severe financial distress and had ample justification for filing the Chapter 11 petitions.

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- ***SPE may consider the interests of the group***: The SPE Debtors were justified in considering the interests of the entire GGP Group in deciding to file for bankruptcy. Although each SPE was a separate entity, many of the mortgage loans were guaranteed by other GGP entities, and certain loans were advanced by one lender to multiple debtors. The Court noted that the Lenders to the SPEs were aware that they were extending credit to an entity that was part of a much larger group, and that there were benefits as well as possible detriments from this structure.

- ***Ability to confirm a plan not a requirement to a bankruptcy filing***: The Court found that the debtors were not required to prove that a plan for reorganization is confirmable in order to file a petition under the Bankruptcy Code.

In addition, the Court determined that the Lenders failed to demonstrate that the SPE Debtors exercised bad faith in filing petitions for bankruptcy based on the following:

- ***No requirement for negotiation with Lenders prior to a bankruptcy filing***: Although the Court acknowledged that there are often good reasons for such negotiations to take place, the Bankruptcy Code does not require that a borrower negotiate with its lender prior to filing a petition. The Court found that there was no evidence that pre-filing negotiations would have been adequate to deal with the problem and, further, that there was no evidence that the Lenders would have been willing to work with the SPE Debtors.

- ***The discharge and replacement of Independent Managers by the SPE Debtors did not constitute bad faith***: The Court found that while the SPE Debtors terminated their independent managers on the eve of the bankruptcy filings and replaced them with select individuals to serve as successor managers in order to facilitate the SPE Debtors' bankruptcy filings, these actions did not constitute subjective bad faith sufficient to require the dismissal of the bankruptcy cases. The SPE Debtors did not violate any provisions of their corporate documents. In addition, the Court noted that the successor independent managers exercised their rights to support the bankruptcy filings of the SPE Debtors in a manner consistent with their fiduciary duties, as the independent managers do not have a duty to keep the SPE Debtors from filing for bankruptcy, but rather a duty to act in the interests of a company and its shareholders or equity owners.

Ultimately, in denying the motions of the Lenders to dismiss the cases, the Court noted that although the bankruptcy filings pose an inconvenience to the Lenders by partially interrupting the cash flows of the SPE Debtors and requiring the appointment of special servicers for the CMBS obligations, the fundamental creditor protections that the Lenders negotiated and that the SPE structure represents were in place and

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would remain in place during the bankruptcy cases. These include protections against the substantive consolidation of the SPE Debtors with any other entities.

Conclusion

The Court's decision in the GGP case highlights significant points and considerations relating to the use of SPEs in securitization market, including that:

- The financial difficulties of a corporate group could result in the bankruptcy filing of a solvent, bankruptcy-remote SPE.
- The termination and replacement of independent managers or directors of an SPE may not be evidence of bad faith of an SPE if such termination and replacement complies with the organizational documents of the SPE. This may prompt Lenders to require in the loan documents that they be notified prior to changes in the managers or directors of SPEs.

Undoubtedly, the full impact of the GGP case will become evident as the lending industry adjusts its expectations and practices in dealing with bankruptcy-remote SPE entities in light of this decision.

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