STRUCTURING COMMERCIAL MORTGAGE SECURITIZATION SPECIAL PURPOSE ENTITIES AFTER GENERAL GROWTH PROPERTIES

Committee on Structured Finance

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Introduction

The filing by General Growth Properties, Inc ("GGP") and its subsidiaries (collectively, the "GGP Group") of chapter 11 petitions and the decisions permitting the use of cash collateral and denying motions to dismiss the cases of GGP's special purpose entity ("SPE") subsidiaries have raised substantial concern among active participants in the commercial mortgage-backed securitization ("CMBS") market. This article summarizes the events in the GGP case and describes possible modifications to the organizational documents for SPEs and credit documents for loans to SPEs to mitigate the risk that future secured lenders may suffer the same fate as did the secured lenders in the GGP case. Of course, the GGP case was decided based on its own particular facts, and steps designed to address the circumstances upon which the GGP Court relied may not achieve their purpose in a future case.

The commercial real estate sector has long relied on organizational structures involving SPEs to isolate and control financial risk. The SPE structure is intended to limit the scope of risks that a secured lender must consider and underwrite by isolating an individual real estate project in a distinct legal entity. If this structure works as planned, a lender to an SPE can focus on project risks while being isolated from risks related to the financial health of such SPE's parent and the financial health of the parent's other projects.[1]

In order to achieve this risk management objective, SPE organizational documents typically have three fundamental characteristics: (1) such documents limit the SPE's objects and powers, (2) such documents create structural obstacles to the SPE's filing for bankruptcy for reasons not related to the financial condition of the project,[2] typically requiring the consent of directors or managers of the SPE who are independent of the originator, and (3) reinforced by the credit documents, such organizational documents impose separateness covenants that limit

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[1] Steven L. Schwarcz, *Structured Finance – A Guide to the Principles of Asset Securitization*, at §§ 1:1, 1:3 (3d ed. 2007) [hereinafter "Securitization Principles"]; Steven L. Schwarcz, Bruce A. Markell, and Lissa Lamkin Broome, *Securitization, Structured Finance, and Capital Markets*, at 6–8 (1st Ed. 2004); *Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., Structured Financing Techniques*, 50 Bus. Law. 527, 533, 595–606 (1995) [hereinafter "Structured Finance Techniques"]; *Comm. on Structured Fin. and Comm. on Bankr. & Corporate Reorganization of the Ass'n of the Bar of the City of N.Y., Special Report on the Preparation of Substantive Consolidation Opinions*, 64 Bus. Law. 411, 424–431 (2009) [hereinafter "Non-Consolidation Opinions"]; *see* Brian M. Resnick and Steven C. Krause, *Not So Bankruptcy-Remote SPEs and In re General Growth Properties Inc.*, 28 Am. Bankr. Inst. J. 8, at cover (October 2009).

[2] It is expected or should be expected that, if the project owned by the SPE is failing and the lenders begin to foreclose, the parent will cause the SPE to file for bankruptcy.

bankruptcy risk by generally requiring the SPE to operate as a stand-alone entity and limiting the SPE's ability to incur obligations unrelated to the securitized financing.[3]

General Growth Properties

GGP was and is[4] a publicly-traded real estate investment trust, among the largest operators of regional shopping centers in the United States, with additional holdings in commercial office properties and master-planned communities. GGP and its affiliates owned or managed over 200 shopping centers in 44 states.[5] At the end of 2008, the GGP Group had $29.6 billion in assets and $27.3 billion in liabilities, with $2.45 billion of those liabilities attributable to joint ventures.[6] As is typical in the commercial real estate industry, GGP holds the bulk of its operating assets through SPE subsidiaries, with each SPE typically holding one asset.

The GGP Group obtained the bulk of its financing, $18.27 billion as of the end of 2008, from secured borrowing by its SPEs. The SPEs' mortgages included both traditional loans funded by financial institutions and loans funded by the sale of commercial mortgage-backed securities. The mortgages typically had terms of three to seven years, with little amortization and a large "balloon" payment due at maturity. Some of the loans included a "hyper-amortization" feature triggered by failure to refinance before an earlier anticipated repayment date, under which (1) the interest rate of the loan would increase substantially, (2) the SPE would have to allocate all of its excess cash flow to amortization of the loan, and (3) the lender would gain the right to approve certain expenses.[7]

GGP also carried $6.58 billion of generally short-term unsecured debt at the parent level. In order to continue in business, the GGP Group needed to refinance a significant proportion of its project-level and parent-level debt each year. The GGP Group's debt structure became unsustainable as the credit markets tightened in the second half of 2008.[8] By early 2009, while GGP's balance sheet showed that GGP's assets exceeded its liabilities,[9] GGP had failed to refinance various parent-level and project-level debt as it matured and therefore depended on short-term forbearance agreements with creditors to operate.[10] Several mortgage loans to GGP Group SPEs had matured, several had entered hyper-amortization, and $18.4 billion in debt

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[3] Securitization Principles, at §§ 1:1, 1:3, 3.1–3.4; Structured Finance Techniques, 50 Bus. Law. at 554–58; *Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities* (October 1, 2006); *Standard & Poor's Structured Finance Ratings, Real Estate Finance, Legal and Structured Finance Issues in Commercial Mortgage Securities*, at 115 (undated); *see In re General Growth Properties, Inc.*, 409 B.R. 43, 49 (Bankr. S.D.N.Y. 2009) [Docket No. 1284] [hereinafter the "Bad Faith Filing Decision"].

[4] GGP successfully proposed and confirmed a chapter 11 plan for certain of its affiliates that became effective on December 30, 2009 and January 8, 2010.

[5] Bad Faith Filing Decision, 409 B.R. at 47; Disclosure Statement for Plan Debtors' Joint Plan of Reorganization, at 14, *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. December 1, 2009) [Docket No. 3659] [hereinafter the "Disclosure Statement"].

[6] Bad Faith Filing Decision, 409 B.R. at 48.

[7] *Id.* at 48–53.

[8] *Id.* at 51–54.

[9] General Growth Properties, Inc. Form 10-K, at F-7 (February 27, 2009, for the year ended December 31, 2008).

[10] *Id.* at 1, 7, 34–35.

would mature by the end of 2012.[11] The GGP Group had little prospect of resolving its liquidity problems, because institutions were generally unwilling to make large loans secured by commercial real estate and the CMBS market was essentially closed.[12] In contrast, on an operational level, at the time of the filing the shopping centers were stable and generating positive cash flow. The malls were 92.5% rented for an average term of more than nine years.[13] Most of the GGP Group's SPE subsidiaries were current on their debt service obligations, and the GGP Group as a whole had positive net income in 2008.[14]

The GGP Bankruptcy Cases

GGP filed a voluntary chapter 11 bankruptcy petition on April 16, 2009.[15] GGP also caused 388 GGP Group SPEs to file voluntary chapter 11 petitions[16] and, through motions to use cash collateral and to continue cash management practices, sought authority to use the cash generated by the GGP Group SPEs to fund the reorganization.[17] The filings by the SPEs and the efforts to use the SPEs' cash conflicted with two key premises of the SPE structure: (1) that an SPE would not be subject to a bankruptcy case at the instance of its parent except where the SPE was itself insolvent; and (2) that an SPE's assets, in particular its cash flow, would not be

[11] Bad Faith Filing Decision, 409 B.R. at 50–54.

[12] *See id.* at 54, 57. The First Day Declaration reported that the commercial mortgage-backed securitization market that had expanded from $52 billion in issuance in 2002 to $229 billion in 2007 had shrunk 97% to $6.4 billion in the first three quarters of 2008 and that issuance in the fourth quarter was off 98% from the year earlier quarter. Declaration of James A. Mesterharm Pursuant to Local Bankruptcy Rule 1007-2 in Support of First Day Motions, at ¶ 41, *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0013] [hereinafter the "Mesterharm Decl."].

[13] Mesterharm Decl. ¶ 8.

[14] Bad Faith Filing Decision, 409 B.R. at 55; *see* General Growth Properties, Inc. Form 10-K (February 27, 2009, for the year ended December 31, 2008); Jesse Cook-Dubin, New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11: Part I, 28 Am. Bankr. Inst. J. 9, at 28–29 (November 2009); Brian M. Resnick and Steven C. Krause, *Not So Bankruptcy-Remote SPEs and In re General Growth Properties Inc.*, 28 Am. Bankr. Inst. J. 8, at 60 (October 2009).

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

[16] Bad Faith Filing Decision, 409 B.R. at 54. GGP had approximately 750 affiliates. *Id.* at 47; Mesterharm Decl. ¶ 1.

[17] *See* 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 and Extension of Time to Comply With Section 345(b) of the Bankruptcy Code; and (C) Scheduling a Final Hearing, *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0008] [hereinafter the "Cash Management Motion"]; Debtors' Motion Requesting (I) Entry of (A) Interim and Final Order (1) Authorizing the Debtors' Use of Cash Collateral and Granting Adequate Protection Therefor Pursuant to Sections 361 and 363 of the Bankruptcy Code and Bankruptcy Rule 4001, and (2) Modifying the Automatic Stay, and (B) A Final Order Authorizing Borrowing With Priority Over Administrative Expenses and Secured by Liens on Property of the Estates Pursuant to Section 364(c) of the Bankruptcy Code, and (II) Scheduling of a Final Hearing on Each Requested Final Order, *In re Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0009] [hereinafter the "Cash Collateral Motion"].

affected or interrupted by the parent's financial condition or bankruptcy.[18] Therefore, the GGP Group SPEs' bankruptcy filings were perceived by lenders as a practical test of the efficacy of SPE structures.

The pleadings filed by GGP emphasized that GGP ran its business and that of its affiliates as an integrated enterprise managed at GGP's Chicago headquarters. GGP purchased utilities, supplies, and insurance centrally and utilized a central leasing program.[19] Most significantly, GGP managed its cash through a centralized cash management system. Individual properties and subsidiaries did not have check-writing capabilities; GGP functioned as paying and collecting agent and made payments for debt service, taxes and operating expenses for the properties. In the ordinary course of business, the GGP Group used this centralized cash management system to collect and transfer funds generated by debtor and non-debtor subsidiaries.[20] Funds were swept from lockbox receipts to lenders' depository accounts and upstreamed to the main operating account. Disbursements were made from the main operating account to various disbursement accounts for debt service, operating expenses, accounts payable and payroll. If an SPE subsidiary failed to generate enough income during a particular period to meet its obligations, GGP would nonetheless pay those obligations, effectively loaning money from healthier SPEs to the unhealthy SPE, and account for the transfer as an intercompany payable.[21] GGP's centralized cash management system did have one significant limitation: certain mortgage lenders to GGP Group SPEs had deposit account control agreements under which such lenders would assume control of an SPE's deposit account upon default or cross-default, preventing that SPE from upstreaming cash to GGP. These "springing cash traps" would ensure that all of an SPE's income would be available for payment of the SPE's debt service obligations if the SPE or GGP encountered financial distress.[22]

GGP sought (1) to continue the GGP Group's centralized cash management system, under which GGP would collect and disburse the cash generated by the GGP Group SPEs (including cash collateral securing the SPEs' obligations under their mortgage loans),[23] (2) to use

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[18] Non-Consolidation Opinions, 64 Bus. Law. at 424–431; Structured Finance Techniques, 50 Bus. Law. at 595–606; Securitization Principles, at §§ 1:1, 3:1–3:4; Brian M. Resnick and Steven C. Krause, *Not So Bankruptcy-Remote SPEs and In re General Growth Properties Inc.*, 28 Am. Bankr. Inst. J. 8, at 60 (October 2009).

[19] Mesterharm Decl. ¶¶ 16–22.

[20] Cash Management Motion ¶¶ 13, 17, 20.

[21] *See In re General Growth Properties, Inc.*, 412 B.R. 609, 610–11 (Bankr. S.D.N.Y. 2009) [Docket No. 0518] [hereinafter the "Cash Management Order"]; Cash Management Motion ¶ 54; Patrick C. Sargent, Charles T. Marshall, and Peter K. McKee, Jr., *Andrews Kurth LLP Client Alert – Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives* (June 24, 2009); Mark Ellenberg, Peter Dodson, and Michelle Raftery, *Cadwalader Clients & Friends Memo – General Growth Properties Bankruptcy Court Defers Final Ruling on Cash Collateral, Cash Management and DIP Financing Issues* (May 11, 2009).

[22] *See* Cash Management Order, 412 B.R. 609, 612–13 (Bankr. S.D.N.Y. 2009); Request for Clarification and Reservation of Rights of U.S. Bank National Association With Respect to Debtors' Motion for Interim and Final Orders Pursuant to Sections 105(a), 345(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, ¶¶ 1–3, *In re General Growth Properties*, Chapter 11 Case No. 09–11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0024].

[23] Cash Management Motion.

the "cash collateral" of the GGP Group SPE debtors' secured lenders, and (3) to incur $375 million in "Debtor in Possession" or "DIP" financing.[24] The Court issued an interim order permitting GGP to collect and use the cash generated by its SPEs pending a final hearing on the cash management system and DIP financing package scheduled for May 8, 2009 and directing GGP to continue paying interest on the GGP Group SPEs' loans at the pre-petition non-default rate while suspending payments for amortization of principal.[25]

In many transactions involving a parent/SPE structure, the transaction documents require the SPE to collect its income in its own separate bank account and pay its expenses from that account, only then upstreaming excess cash to its parent.[26] As described above, the GGP Group did not follow that practice – prior to its bankruptcy filing, GGP swept income from its SPE subsidiaries into a common operating account and then paid its SPE subsidiaries' obligations from that common account.[27] This was inconsistent with typical separateness covenants and the assumptions underlying most "non-consolidation" legal opinions;[28] GGP had nonetheless been able to obtain such opinions in light of case law acknowledging that it is common for large corporate groups to use consolidated cash management systems.[29]

GGP proposed to borrow $375 million in DIP financing. The DIP lender was to have a first-priority administrative expense claim on the central account GGP used to collect cash pursuant to GGP's cash management system. The GGP Group SPEs were to guarantee GGP's obligations under the DIP loan and secure those guarantees with second-priority liens on substantially all of their assets. The SPEs' mortgage lenders viewed the guarantees, which were prohibited by their loan covenants, as seriously impairing the SPEs' independence and objected because the SPEs would receive almost no benefit from the DIP financing, the proceeds of which were to go to GGP and certain of its administrative-level subsidiaries.[30]

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[24] Cash Collateral Motion.

[25] Interim Order Pursuant to Sections 361, 363, 503, and 507 of the Bankruptcy Code and Bankruptcy Rule 4001 (I) Authorizing Use of Cash Collateral, (II) Granting Adequate Protection, (III) Modifying the Automatic Stay, and (IV) Scheduling a Final Hearing on Use of Cash Collateral, *In re Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0044] [hereinafter the "Interim Cash Management Order"].

[26] Non-Consolidation Opinions, 64 Bus. Law. at 420–21; Structured Finance Techniques, 50 Bus. Law. at 552; Securitization Principles at §3:4; Patrick C. Sargent, Charles T. Marshall, and Peter K. McKee, Jr., *Andrews Kurth LLP Client Alert – Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives* (June 24, 2009).

[27] Notes 20–22 *supra* and accompanying text; *see* Cash Management Order, 412 B.R. 609, 610–11 (Bankr. S.D.N.Y. 2009); Cash Management Motion ¶¶ 14–20.

[28] *See* Non-Consolidation Opinions, 64 Bus. Law. at 412–13 (2009).

[29] Patrick C. Sargent, Charles T. Marshall, and Peter K. McKee, Jr., *Andrews Kurth LLP Client Alert – Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives* (June 24, 2009) (citing *In re Owens Corning*, 419 F.3d 195, 214–15 (3d Cir. 2005)). Note, however, that some commentators had suggested that centralized cash management systems and non-cash settlement of intercompany obligations increases bankruptcy risk. *See* Non-Consolidation Opinions, 64 Bus. Law. at 421–22. Centralized cash management was inconsistent with Standard & Poor's legal criteria for SPEs, *see Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities* (October 1, 2006).

[30] Cash Collateral Motion ¶ 2; s*ee* Mark Ellenberg, Peter Dodson, and Michelle Raftery, *Cadwalader Clients & Friends Memo – General Growth Properties Bankruptcy Court Defers Final Ruling on Cash Collateral, Cash Management and DIP Financing Issues* (May 11, 2009).

The Court's May 14, 2009 orders granting GGP's motions included substantial additional protection for the GGP Group SPEs' secured creditors as a whole.[31] The Court permitted GGP to continue using its centralized cash management system but gave the GGP Group SPEs' secured creditors a first-priority administrative expense claim on GGP's centralized cash account.[32] Under the DIP financing package that the Court ultimately approved, GGP borrowed $400 million. In the approved financing, the GGP Group SPEs did not guarantee GGP's obligations or grant liens on their respective assets and the DIP lender's administrative expense claim on GGP's central cash account was junior to the GGP Group SPEs' secured creditors' claims.[33]

Motions to Dismiss for Bad-Faith Filing

Two conventional mortgage lenders to GGP Group SPEs and two special servicers acting on behalf of securitization trusts backed by mortgage loans to GGP Group SPEs filed motions to dismiss the bankruptcy cases of their respective GGP Group SPE debtors on the grounds that the SPEs had filed those petitions in "bad faith." The essence of the creditors' arguments was that those GGP Group SPEs were not the proper subject of chapter 11 reorganization cases because the SPEs were not in sufficient financial distress: most of them were paying their obligations as they came due, and their mortgages typically would not mature for another one to three years.[34]

The moving creditors and the Commercial Mortgage Backed Securities Association, acting as *amicus curiae*, strenuously argued that the purpose of the SPE structure was to insulate secured creditors of individual SPEs from credit risk related to the financial health of the larger corporate group.[35] GGP likely benefited from lower interest rates as a result of lenders' expectation that the SPE structure would limit their risk exposure.[36] GGP, by contrast,

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[31] *See generally In re General Growth Properties, Inc.*, 412 B.R. 122 (Bankr. S.D.N.Y. 2009) [hereinafter the "Cash Collateral and DIP Financing Order"]; Cash Management System Order, 412 B.R. 609.

[32] Cash Management Order, 412 B.R. at 610–11; Cash Collateral and DIP Financing Order, 412 B.R. at 134–35; *see* Douglas R. Gooding and John F. Ventola, *Lessons from General Growth Properties*, Law360 (August 28, 2009); Mark Ellenberg, Peter Dodson, and Michelle Raftery, *Cadwalader Clients & Friends Memo – General Growth Properties Bankruptcy Court Enters Final Order on Cash Collateral, Cash Management, and DIP Financing Issues* (May 18, 2009).

[33] Cash Collateral and DIP Financing Order, 412 B.R. at 123, 127, 134–35; Patrick C. Sargent, Charles T. Marshall, and Peter K. McKee, Jr., *Andrews Kurth LLP Client Alert – Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives* (June 24, 2009); Mark Ellenberg, Peter Dodson, and Michelle Raftery, *Cadwalader Clients & Friends Memo – General Growth Properties Bankruptcy Court Enters Final Order on Cash Collateral, Cash Management, and DIP Financing Issues* (May 18, 2009).

[34] *See generally*, Motion of ING 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, *In re General Growth Properties*, Chapter 11 Case No. 09–11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009) [Docket No. 0334] [hereinafter the "Motion to Dismiss"]; Patrick C. Sargent, Charles T. Marshall, and Peter K. McKee, Jr., *Andrews Kurth LLP Client Alert – Round 2 of General Growth Properties Bankruptcy: Motions to Dismiss SPE Bankruptcies Denied, No Bad Faith, Corporate Group Considered* (August 27, 2009).

[35] *See* Bad Faith Filing Decision, 409 B.R. at 61; Brief of Amicus Curiae, at 20–22, *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. May 1, 2009) [Docket No. 0233].

[36] Securitization Principles at § 1:3; *see* Brian M. Resnick and Steven C. Krause, *Not So Bankruptcy-Remote SPEs and In re General Growth Properties Inc.*, 28 Am. Bankr. Inst. J. 8, at cover (October 2009).

emphasized the high level of functional integration within the GGP Group and the benefits of that integration to creditors. GGP argued that its centralized management and leasing operations promoted efficiency and increased its SPEs' income by attracting national chain tenants and that its centralized cash management system permitted GGP to pay the obligations of its less healthy SPEs. Both of these integrated features, GGP argued, furthered creditors' interests.[37]

The Court agreed with GGP, finding that the moving creditors had benefited from the GGP Group's integrated structure.[38] The Court also placed significant weight on the fact that almost all of parent GGP's income came from its SPE subsidiaries. The Court found that this income would dry up over the next several years as one SPE after another failed to refinance its mortgage loan and defaulted. Therefore, according to the Court, it would be impractical to reorganize GGP meaningfully without simultaneously addressing the capital structure of its SPE subsidiaries.

In the absence of a showing of "*both* objective futility of the reorganization process *and* subjective bad faith in filing the petition,"[39] the Court denied the creditors' motions.

Subjective Bad Faith

The principal bases of the creditors' assertion of subjective bad faith were that (1) GGP fired and replaced the independent managers of many of the SPEs shortly before filing for bankruptcy, without notifying the creditors or the dismissed managers that GGP had done so until after the filings, and (2) GGP failed to negotiate with the SPEs' lenders before causing the SPEs to file for bankruptcy.[40]

Prior to GGP's bankruptcy filing, the SPEs' independent managers had typically been individuals supplied by Corporation Services Company ("CSC"), a national provider of ministerial corporate services. When considering whether to cause the SPEs to file for bankruptcy, GGP replaced those CSC-supplied independent managers with managers having real-estate restructuring experience. GGP characterized this as a well-intentioned effort to ensure that the SPEs' independent managers were individuals capable of making a meaningful contribution to the restructuring process.[41] The Court acknowledged that GGP had not notified the SPEs' creditors that it was dismissing the incumbent independent managers and appointing replacements, but the Court held that the SPEs' governing documents did not require such notice.[42]

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[37] *See* Debtors' Memorandum of Law in Opposition to the Motions of ING Clarion Capital Loan Services LLC and Wells Fargo Bank, N.A., as Trustee, et al., to Dismiss the Cases of Certain Debtors and Debtors in Possession, at 4–8, *In re General Growth Properties, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. June 8, 2009). [Docket No. 0711]; Mesterharm Decl. ¶¶ 16–22.

[38] Bad Faith Filing Decision, 409 B.R. at 61–63.

[39] *In re Kingston Square Assocs.*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997) (emphasis in original).

[40] Bad Faith Filing Decision, 409 B.R. at 65–66.

[41] *Id.* at 67–69.

[42] *Id.*

The Court found that the independent managers that GGP appointed met the test for independence set forth in the SPEs' organizational documents, that GGP was therefore within its rights to appoint them and that any expectation on the moving creditors' part that the independent managers would act as their representatives on the board or otherwise serve as an impenetrable roadblock to bankruptcy was illegitimate.[43]

Lenders had expected that the SPEs' governing documents would make it difficult for GGP to induce its SPEs to file for bankruptcy. The SPEs were Delaware LLCs with typical SPE provisions in their governing documents requiring them to have two independent managers satisfying specified criteria for independence from GGP. Under the LLC agreements, an SPE could not file a bankruptcy petition unless both of its independent managers consented, and the governing documents required the independent managers, to the extent permitted by applicable law, to consider only the interests of the SPE, including its creditors, when deciding whether to give that consent. The purpose of this provision was to force the independent managers to ignore parent GGP's interests when making their decision. However, the governing documents also provided that the independent managers would have "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."[44]

The Court held that, under Delaware law, the directors of a solvent Delaware corporation have a fiduciary duty to manage the corporation in the best interests of its shareholders, not its creditors, even if the corporation is approaching insolvency.[45] There was no question that the GGP Group SPEs at issue were solvent when they filed their petitions. Therefore, according to the Court, not only was it proper for the SPEs' independent managers to consider parent GGP's interests when deciding whether to file a chapter 11 petition but in fact the independent managers had a fiduciary duty to do so.[46] CSC's counsel had reached that same conclusion.[47]

The Court also rejected the moving creditors' argument that GGP's failure to negotiate with the moving creditors prior to causing the GGP Group SPEs to file bankruptcy petitions

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[43] Interestingly, GGP may have been able to cause the SPEs to file chapter 11 petitions even without removing the incumbent CSC-supplied independent managers. In the immediate aftermath of GGP's chapter 11 filing, CSC sought advice of counsel regarding (1) whether GGP's termination of the CSC-supplied independent managers at many GGP Group SPEs was proper and (2) whether the fiduciary duties of the CSC-supplied independent managers who remained at a few GGP Group SPEs required them to consider parent GGP's interests when considering whether to authorize a bankruptcy filing. CSC's counsel advised that GGP had properly terminated CSC-supplied independent managers where GGP had done so and that the remaining CSC-supplied independent managers' fiduciary duties required them to consider parent GGP's interests. Accordingly, the CSC-supplied independent managers at GGP Group SPEs authorized those SPEs to file Chapter 11 petitions. Sandra E. Mayerson, *Squire Sanders Assists Corporation Service Company in Addressing Novel Issues in General Growth Properties*, Squire Sanders Bankruptcy & Restructuring Update, Summer 2009, at 5–6.

[44] Bad Faith Filing Decision, 409 B.R. at 63–65.

[45] *Id.* at 63–64 (*citing North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)). The *Gheewalla* court rejected earlier Delaware Court of Chancery cases suggesting that the directors of solvent corporations operating in the "zone of insolvency" had fiduciary duties running directly to creditors.

[46] Bad Faith Filing Decision, 409 B.R. at 63–65.

[47] Sandra E. Mayerson, *Squire Sanders Assists Corporation Service Company in Addressing Novel Issues in General Growth Properties*, Squire Sanders Bankruptcy & Restructuring Update, Summer 2009, at 5–6.

showed subjective bad faith, holding that the Bankruptcy Code does not require commercial debtors to negotiate with their creditors before filing for bankruptcy.[48]

Objective Bad Faith

The Court further held that the reorganization cases were not objectively futile.[49] The Court's analysis of the propriety of the SPEs' bankruptcy filings when considered in isolation was not decisive, because the Court held that it was appropriate to consider the circumstances of the GGP Group as a whole when assessing whether the individual SPEs filed their petitions in bad faith.[50] The Court noted approvingly that GGP had applied a thorough analytical process to each SPE before deciding whether to cause that SPE to file a chapter 11 petition, consulting with restructuring experts and considering a number of criteria related to each SPE's financial situation, including whether such SPE was in default or cross-default or subject to a forbearance agreement on its mortgage loan, whether the loan-to-value ratio was excessive, whether the SPE's mortgage loan would mature within three to four years, and whether the SPE had unencumbered assets. While GGP caused the overwhelming majority of the GGP Group SPEs to file chapter 11 petitions, it did not cause all of them to do so.[51] Based on the distressed financial condition of the GGP Group as a whole, the Court held that the subject SPEs had filed their petitions in objective good faith.[52]

The Court further concluded that GGP had established that it included its SPE subsidiaries in its bankruptcy case as part of an overall plan to preserve the overall value of the GGP Group estate for the benefit of its creditors. The Court noted that a core purpose of bankruptcy law is to protect creditors' rights. Although the Court acknowledged that including the GGP Group SPEs in GGP's bankruptcy case would inconvenience the moving creditors, the Court noted that they retained the right to adequate protection and post-petition interest and fees to the extent that such creditors were oversecured. In the Court's view, the key purpose of the SPE structure was to protect creditors from substantive consolidation. The Court emphasized that it was not substantively consolidating the SPEs with GGP and denied the moving creditors' motions.[53]

Possible changes to SPE governing documents

Lawyers analyzing the GGP decision have suggested several changes that lenders may seek in SPE organizational documents for future transactions in an effect to reduce the risk that a parent/originator could cause a repeat of the GGP situation.[54] The Committee advances the following suggestions for consideration.

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[48] Bad Faith Filing Decision, 409 B.R. at 65–67.

[49] *Id.* at 55–65.

[50] *Id.* at 61–65.

[51] *Id.* at 59–60, 59 n.26.

[52] *Id.*

[53] *Id.* at 69–70, 72.

[54] There are various degrees of uncertainty with respect to the efficacy of adopting each of these changes. Even if the parent/originator agrees to include any one of the provisions in the SPE organizational documents a court may

Section 18-1101(c) of the Delaware Limited Liability Company Act provides that an LLC agreement may waive the fiduciary duties that a manager of the LLC would otherwise owe to the LLC or the LLC's members or managers at law or equity, provided that the LLC agreement may not eliminate the implied contractual covenant of good faith and fair dealing.[55] Therefore, lenders may prefer that SPEs be organized as Delaware LLCs and that an SPE's LLC agreement include provisions explicitly overriding the otherwise applicable fiduciary duties of the managers and specifying and limiting the fiduciary duties of the independent managers.[56] The SPE's LLC agreement might provide that, when the SPE's independent managers are voting on matters for which the LLC agreement requires their consent, including potential bankruptcy filings, the independent managers (1) must consider the interests of the SPE as a stand-alone entity, (2) need not and shall not consider the interests of the SPE's parent, and (3) shall consider the interests of the lender and other creditors while providing the independent managers the broadest possible exculpation from potential liability. The agreement might also provide that the lender is an intended third party beneficiary of this provision. If these provisions are included in an SPE's LLC agreement, the SPE's lenders will be able to argue to a court analyzing the duties of the SPE's independent managers that the independent managers are neither required nor permitted to consider the SPE's parent's interests when deciding whether to authorize a bankruptcy filing.[57]

The risk of a parent unilaterally replacing an SPE's independent managers can be reduced by provisions (1) requiring that the managers be employed by an independent corporate services company unless that requirement is waived pursuant to the terms of the LLC agreement, which waiver requires the lender's consent, (2) requiring advance notice of the resignation or removal of an independent manager (unless the independent service provider who employs the independent manager causes the independent manager to resign), and (3) permitting the removal of the independent manager only for cause.[58] It could also be useful to include a provision prohibiting the managers from authorizing a bankruptcy filing in the absence of a report by a financial professional that the SPE is insolvent or unable to pay its current debts as they become due.

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determine that the provision is not enforceable or, even if enforceable, does not change the court's determination in the case.

[55] *See also*, James G. Leyden, Jr. and Laura Dietrich, *Delaware Limited Liability Companies and Limited Partnerships*, Practising Law Institute, Corporate Law and Practice Course Handbook Series, PLI Order No. 23298, at 57–60 (January 27, 2010).

[56] *Kaye Scholer LLP Client Advisory – General Growth Properties Rulings Raise Concerns with Bankruptcy-Remote Structures* (August 26, 2009); *see Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities* (October 1, 2006).

[57] *See Kaye Scholer LLP Client Advisory – General Growth Properties Project-Level Lenders Fare Well in GGP Bankruptcy Plan* (January 4, 2010) (discussing changes to the GGP Group SPEs' governing documents under the GGP Group's Joint Plan of Reorganization); *Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities* (October 1, 2006).

[58] *See Gibson Dunn Update – In re: General Growth Properties, Inc. -- Court's Denial of Motion to Dismiss Will Affect Single Purpose Borrowers* (September 4, 2009). Other provisions that have been suggested but that are considered to be less likely of being determined to be enforceable or effective and may expose the lender to liability risks are (1) requiring advance notice to the lender of a bankruptcy filing and (2) granting the lender a veto over the nomination of an independent manager.

Lenders may consider bargaining for "springing guarantees" (commonly known as "bad boy" guarantees) requiring the SPE's parent to guarantee the loan if the parent causes the SPE to file a bankruptcy petition while the SPE is solvent and paying its debts as they come due, in order to make it less attractive for an SPE's parent to cause the SPE to file for bankruptcy.[59] In addition, lenders might also seek to require individual officers, directors, or owners of the parent personally to guarantee (the "warm body guarantee") the SPE's obligations if the SPE files a bankruptcy petition.[60]

Lenders may seek stricter separateness covenants in the credit agreements and organizational documents for SPEs.[61] The covenants might require each SPE to pay its obligations out of its own income before upstreaming any excess cash to its parent. Lenders may also seek non-contingent cash traps that prevent SPEs from upstreaming any cash at all to their parents during the term of the loan. Doing so would undermine any reasonable reliance by the parent on the SPE's excess cash, making it harder for a bankruptcy court to justify making that cash available to the parent to further the parent's reorganization.[62] As countervailing considerations, lenders should recognize that the parent will expect an economic return and may require upstreaming the cash flow currently to meet its obligations. In addition, the lenders to a weaker property will benefit when a parent has the ability to use excess cash from its stronger SPEs to pay operating expenses and debt service on under-performing properties.[63] No lender can be certain that it will not be the lender benefited rather than harmed by support from other properties.

Some commentators have suggested that lenders draft provisions into their transaction documents by which an SPE waives the automatic stay if the SPE files for bankruptcy, thereby giving the lenders the right to commence or continue a foreclosure action after a bankruptcy filing. This waiver was included in the revised documents for the GGP SPE lenders upon confirmation of their chapter 11 plans. Even those who suggest seeking such a waiver recognize

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[59] *See* Douglas R. Gooding and John F. Ventola, *Lessons from General Growth Properties*, Law360 (August 28, 2009); *Kaye Scholer LLP Client Advisory – General Growth Properties Project-Level Lenders Fare Well in GGP Bankruptcy Plan* (January 4, 2010); Arthur J. Steinberg and Scott I. Davidson, *Bankruptcy Remote Entities: Not as Remote as You May Think*, New York Law Journal (November 18, 2009).

[60] *See* Douglas R. Gooding and John F. Ventola, *Lessons from General Growth Properties*, Law360 (August 28, 2009); Arthur J. Steinberg and Scott I. Davidson, *Bankruptcy Remote Entities: Not as Remote as You May Think*, New York Law Journal (November 18, 2009). The argument has been made that the effect of such a personal guarantee is arguably to induce the guarantor to breach his or her fiduciary duties to the parent and the parent's stakeholders. Therefore, while such a personal guarantee likely would be highly effective at preventing a parent from causing its SPE subsidiaries to file bankruptcy petitions, it is not clear whether courts will be willing to enforce it.

[61] In some commentators' view, this was a prudent practice even before the GGP bankruptcy case. *See* Non-Consolidation Opinions, 64 Bus. Law. at 420–21; *Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Special-Purpose Entities* (October 1, 2006).

[62] *Gibson Dunn Update – In re: General Growth Properties, Inc. -- Court's Denial of Motion to Dismiss Will Affect Single Purpose Borrowers* (September 4, 2009); *Gibson Dunn Update – Bankruptcy Judge Approves General Growth Properties' Reorganization Plan* (January 4, 2010).

[63] *See* Bad Faith Filing Decision, 409 B.R. at 61.

that the enforceability of such waivers is questionable, especially where, unlike GGP, the waiver was not part of the resolution of a prior bankruptcy.[64]

Lenders should recognize that none of these changes will make it impossible for an SPE to file a bankruptcy petition – if they did, they might be found to be void as against the public policy favoring reorganization.[65] Lenders must also consider the risk that the incorporation of all of the suggestions discussed here might undermine the separateness of the SPE.[66] On the other hand, if these suggestions are taken and are held to be effective then it would be substantially more difficult and less attractive for an SPE's parent to cause the SPE, for strategic reasons, to file for bankruptcy at a time when the SPE itself is not in serious distress. In that case, these suggestions would reduce the risks faced by the GGP lenders and increase the likelihood that the SPE structure is effective.[67]

Conclusion

The GGP Court's decision was largely a product of the choices made by the parties involved in structuring the GGP Group SPEs and negotiating the terms of the credit agreements, particularly the cash management practices and the absence of limits on GGP's ability to replace the managers of the SPEs.[68] In an effort to mitigate the risks highlighted by the GGP case, transactional planners should evaluate the changes to SPE organizational and credit documents discussed above in terms of both effectiveness and appropriateness with respect to the relevant transaction. To the extent that these modifications prove to be effective to insulate SPEs from their parents' financial problems, such modifications will help to preserve the SPE structure as a valuable risk management tool for asset-backed lenders.

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[64] *See, e.g. In re Frye*, 320 B.R. 786 (Bankr. D. Vt. 2005) (summarizing cases reaching a variety of conclusions regarding the enforceability of pre-petition waivers of the automatic stay, applying a ten-factor balancing test, and scheduling an evidentiary hearing to develop additional facts relevant to those ten factors); s*ee* Matthew W. Kavanaugh, Donald Lee Rome, and Randye B. Soref, *Business Workouts Manual*, §§ 21:1, 21:4–5 (2d Ed. 2008); *Bankruptcy Remote Entities: Not as Remote as You May Think*, New York Law Journal (November 18, 2009); *Kaye Scholer LLP Client Advisory – General Growth Properties Project-Level Lenders Fare Well in GGP Bankruptcy Plan* (January 4, 2010).

[65] Securitization Principles, § 3:2 n.3; *see Andrews Kurth LLP Client Alert – Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives* (June 24, 2009).

[66] If the parent gives a full recourse guarantee of the SPE's mortgage loan, risk of loss of the SPE's real estate asset remains with the parent. This is inconsistent with a true sale of the asset from the parent to the SPE and therefore undermines the SPE's separateness. *See* Structured Finance Techniques, 50 Bus. Law. at 544–45; Standard & Poor's Legal Criteria For U.S. Structured Finance Transactions: Appendix I: Typical Factors Considered By Courts In Determining Existence Of A True Sale (October 1, 2006). A narrowly-tailored springing guarantee that only becomes effective if the parent causes the SPE to file a bankruptcy petition while the SPE is solvent and paying its debts as it comes due does remove the parent from liability unless and until it takes the step inconsistent with separateness of causing the solvent SPE to file. However, any guarantee establishes a connection between the SPE and the parent that transactional planners should consider when evaluating the SPE's separateness.

[67] *See Kaye Scholer LLP Client Advisory – General Growth Properties Rulings Raise Concerns with Bankruptcy-Remote Structures* (August 26, 2009); *Gibson Dunn Update – Bankruptcy Judge Approves General Growth Properties' Reorganization Plan* (January 4, 2010).

[68] *See* Eric Berman, *Trends in Securitization*, 1 Practical Law the Journal 2, at 59, 63–64 (December 2009/January 2010).

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* Recused from this report.