General Growth Properties, Inc. Decision Notes Weaknesses of Securitization Special Purpose Entities

August 13, 2009

Securitizations are based in part on the design or hope that special purpose entities ("SPEs") holding securitized assets are unlikely to file for bankruptcy. If an SPE does eventually file for bankruptcy, a second expectation is that the bankruptcy will be fairly straightforward due to the SPE's limited amount of assets and debts.

The first half of the design may not work. A recent decision from the U.S. Bankruptcy Court for the Southern District of New York demonstrates that the SPE structure will not always shield these entities from becoming entangled in bankruptcy with a troubled parent company, particularly with the current state of the credit markets. On August 11, 2009, Judge Gropper issued a decision in In re General Growth Properties, Inc., et al. (Bankr. S.D.N.Y., Case No. 09-11977) denying five separate motions to dismiss the bankruptcy cases of certain special purpose entity ("SPE") debtors. The parties moving to dismiss were either lenders of the SPE entities or special servicers to certain secured lenders under a commercial mortgage-backed securities ("CMBS") structure. In total, these motions sought to dismiss twenty of the approximately 390 jointly-administered cases making up the General Growth Properties, Inc. ("GGP") bankruptcy.

While the bankruptcies of these twenty GGP SPEs were caused in part by holes present in the governing documents[1] that allowed GGP to appoint new “independent” directors or managers who would vote in favor of bankruptcy, Judge Gropper’s decision demonstrates that any directors or managers of SPEs may, in good faith, support a decision to file bankruptcy based upon the inability to refinance CMBS debt maturing in the future. This decision should serve as a cautionary tale for those involved in structuring SPE and CMBS transactions.

a. The GGP Business Model and Resulting Bankruptcy

GGP is the ultimate parent of 750 wholly-owned debtor and non-debtor subsidiaries through which it owns and manages approximately 200 shopping centers in 44 states. The GGP business model relied on a significant amount of financing. As of the end of 2008, GGP had $18.27 billion in project-level debt secured by mortgages on the respective individual properties, some of which was conventional mortgage debt, but a significant portion of which was debt securitized in the CMBS market. Most loans had three to seven-year terms with low amortization and balloon payments due upon maturity. Failure to repay or refinance upon maturity would trigger a steep increase in the interest rate, a requirement that cash be kept at each project-level, and required lender approval of certain expenditures. Many project-level entities were cash-flow positive at the time GGP filed for bankruptcy but held debt with maturity dates over the next several years.

GGP’s business model was entirely dependent on the ability to refinance its various property-level mortgage loans. In the latter half of 2008, the credit crisis spread to commercial real estate finance, including the CMBS market. GGP’s attempts to refinance were complicated by the fact that master servicers and special servicers restricted communications and declined to negotiate modifications to the loan terms of certain loans until the loans came closer to maturity. Without the ability to refinance, the company experienced increasing liquidity problems and ultimately defaulted on two large project-level loans at the end of 2008. As a result, GGP decided upon a bankruptcy filing and sought to cause many of the project-level SPEs to file bankruptcy as well.

b. Special Purpose Entities

All twenty of the debtors subject to the motions to dismiss were structured to be SPEs so that project-level entities would be bankruptcy-remote. In furtherance of this goal, organizational documents prohibited consolidation of GGP’s various SPEs, restricted mergers and asset sales, and required that one or more “independent” directors or managers be retained by each SPE. However, many of the mortgage loans were guaranteed by other GGP entities, and certain loans were advanced by one lender to multiple Debtors. Moreover, corporate documents did not interfere with the rights of a shareholder to appoint new independent directors to the board.

The SPE structures failed to keep the project-level entities out of bankruptcy. On the eve of GGP’s bankruptcy filing in April, certain independent directors and managers of individual SPEs were terminated and replaced by other independent directors and managers.[2] The moving lenders took issue with the votes to send the SPEs into bankruptcy, noting the irregularities surrounding the director and manager terminations, and further noting that these SPEs were cash-flow positive at the time bankruptcy was filed and that certain entities did not have debt maturing for several years.

c. The Ruling

In the Second Circuit, grounds to dismiss a bankruptcy exist only if it was clear on the filing date that "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, 1309-10. Dismissal is generally ordered only where there is both objective futility in pursuing a bankruptcy filing and subjective bad-faith in actually following through with a filing. In re Kingston Square Assoc., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).

Judge Gropper held that there was no evidence of bad-faith filings by the individual debtors for the following reasons:

1. Well-established case law does not require that a debtor be insolvent when a bankruptcy case is filed, and while certain project-level loans were not due for several years, the collapse of the CMBS market, difficulties in negotiating with the CMBS servicers to modify loans, and projections that the market would continue to be dormant for the foreseeable future demonstrated that severe financial distress was likely for each individual debtor.

2. Testimony at the hearing by lender representatives revealed that future negotiations on refinancing would have been futile.

3. The debtors properly considered the interests of the entire GGP group of companies when deciding to place approximately 390 separate entities in bankruptcy. In spite of the SPE status at each project level, each SPE lender was aware that they were funding loans for the benefit of the entire GGP group, and a meaningful restructuring of GGP's entire capital structure could only be accomplished by providing a means of refinancing any maturing project-level debt.

4. The debtors held no obligation to present a confirmable plan in the early stages of the bankruptcy.

5. Each independent manager or director held fiduciary duties under the documents akin to the duties of a director of a Delaware corporation. Citing North American Catholic Educational Programming Foundation v. Gheewalla, 930 A.2d 92 (Del. 2007), Judge Gropper concluded that in the "zone of insolvency," each independent manager or director held duties to the corporation itself and not simply to the body of creditors. While calling termination of the independent directors on the eve of the bankruptcy filing "admittedly surreptitious," corporate

documents did not interfere with the rights of a shareholder to appoint new independent directors to the board.

As a result of this decision, those dealing with SPEs and CMBS structures should be aware of the following:

1. Even “independent” directors and managers of an SPE may conclude that problems within the corporate family support filing bankruptcy for the SPE.

2. Directors and managers may properly support a bankruptcy filing based on problems arising in the future, so long as there is more than a “mere possibility” that problems will arise.

3. Termination of “independent” directors in an SPE, even on the eve of a bankruptcy filing, may not be a sign of bad faith so long as termination complies with applicable organizational documents. Here, equity holders of each individual debtor held the right to terminate and replace the independent directors. It is critical that governing documents for SPEs limit the unilateral rights of various constituencies.

4. Beware of a borrower’s attempts to negotiate with lenders before the bankruptcy. If lenders or CMBS servicers give a borrower the “run-around,” this may weigh against finding objective bad faith if the borrower concludes that a pre-bankruptcy work-out is not possible.

---

[1] Most of the twenty debtor SPEs subject to the motions to dismiss were organized as LLCs. For these entities, the LLC Operating Agreements allowed shareholders to terminate the independent managers of the LLCs and to replace them with new managers.

[2] The parties disputed whether either the new or the old directors and managers were truly “independent.” Judge Gropper noted there was evidence that certain lenders believed the old independent directors and managers were appointed to protect the interests of the lenders, and all of the new directors and managers were hand-picked by GGP. However, the Debtors stated that they terminated the old directors and managers and replaced them with independent directors and managers with more business and restructuring experience.