

Commercial Lenders Under Attack: SPEs Are Not Bankruptcy Proof

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Recently courts have rendered decisions demonstrating how bankruptcy statutes and jurisprudence can override the words and intent of loan documents and lenders' remedies notwithstanding the widespread concern about the fiscal health of our lending institutions and the need for them to recover to unfreeze the credit markets and permit economic growth to resume. So far, the public policy of debtor rehabilitation has trumped creditors' rights. Although one might assume that these decisions involve only residential transactions protecting middle income home owners caught up in the tsunami of the global economic recession, they do not. Some of these decisions involve hundred million dollar commercial loans.

The most notable decision was rendered on August 11, 2009, in *In re General Growth Properties, Inc., et al.* where the United States Bankruptcy Court for the Southern District of New York squarely ruled that bankruptcies of Special Purpose Entities (SPE) orchestrated by replacing their independent members without advising them (or their lenders) of the replacement for seven weeks, were not "bad faith filings," even in the instances of solvent Special Purpose Entities with positive cash flows and no substantial maturities in the near term. And, in part based on recent Delaware jurisprudence that directors owe no direct fiduciary duties to creditors even when the corporation is insolvent, it interpreted the role of Special Purpose Entities and the duties of their independent directors/managers contrary to the intentions and expectations of the borrowers and lenders in forming them. The decision requires lenders to overhaul the loan and security agreements and governance of the SPEs used in structuring these loans.

In *GGP* the language of the loan documents could not have been any clearer supporting the lenders' position and yet, the Bankruptcy Court was still able to render a decision against the creditors because bankruptcy law fundamentally overrides many creditors' contractual remedies and substitutes "adequate protection" for the creditors' security interests. *GGP* involved five motions to dismiss certain of the Chapter 11 cases filed by one or more debtors that were owned directly or indirectly by General Growth Properties. *GGP* is a publicly traded REIT and the parent of approximately 750 subsidiaries, joint ventures and affiliates that own or manage 200 shopping centers in 44 states. *GGP* had approximately \$18.27 billion in mortgage and mezzanine debt secured by properties,

\$1.83 billion of which was the subject of these motions, and \$6.58 billion of unsecured debt.

The issue in the case was the control of the Special Purpose Entities that were established with the intention of preventing a bankruptcy filing without the approval of the independent directors or managers of the SPE. In fact, the very purpose of the SPE was to isolate the business affairs of the borrower's affiliates and parent so that each loan stood on its own merits, creditworthiness, and collateral value. SPEs' organizational documents usually contain prohibitions on consolidation and liquidation, restrictions on mergers and asset sales, prohibitions on amendments to the organizational and transaction documents and separateness covenants. The typical SPE also contains an obligation to retain one or more independent directors or managers. As the bankruptcy court's decision shows, however, the holding company's right to change the independent directors or managers can by itself unravel the creditor's rights.

In the case of GGP, the typical mortgage loan had a three to seven year term, with low amortization and a large balloon payment on maturity although some of the loans also had what the court described as anticipated repayment dates (ARD) at which point the loan became "hyper-amortized" even if the actual maturity date was significantly in the future. Those deals were structured in such a way that, if the loan were not prepaid on the ARD, then absent bankruptcy intervention, there would be a steep increase in the interest rate, a requirement that cash be retained at the project level with excess cash applied to principal, and a requirement that certain expenditures had to be submitted to the lender for approval.

Many of these mortgage loans were financed in the commercial mortgaged-backed securities (CMBS) market with a debt stack that also included mezzanine debt. The court took judicial notice of the fact that GGP's capital structure required that GGP be continuously able to refinance and that, in the latter half of 2008, the crisis in the credit markets precluded GGP from refinancing both its maturing debt and its debt that reached ARD. The court recognized that in terms of distress, the ARD was virtually tantamount to the actual maturity date. The court noted that, prior to the Chapter 11 filings, the lenders refused to allow further forbearance and the credit markets precluded GGP from selling any of its assets to pay down debt. The debtors claimed that the CMBS structure caused roadblocks to its ability to refinance its debt or speak with its lenders. The court also expressed the belief that GGP required relief because GGP contacted the master servicers to obtain permission to speak to the

special servicers to discuss changes in the loan terms, but the master servicers refused and the special servicers would not speak to GGP. In other words, GGP's complaint about this aspect of the CMBS structure that enabled it to raise huge amounts of funding was that the structure that was intended to insulate the lenders and investors from changing the deal actually operated as intended. But, it was all predicated on the belief that bankruptcy was not an option!

In April, 2009, GGP and 360 of its affiliates filed for protection under Chapter 11 of the Bankruptcy Code and moved for permission to use cash collateral, including the cash produced by the SPE's, and to obtain debtor in possession financing. Many of GGP's creditors objected to GGP upstreaming the cash from the individual SPE's for use at the parent level and GGP's ignoring the SPE documents. In addition, several creditors moved to dismiss the case as to several of the debtors alleging that they were filed in bad faith in that there was no imminent threat to the financial viability of the subject debtors. The court allowed upstreaming of cash, subject to the provision of adequate protection, largely in the form of first priority replacement liens on the cash accounts.

In his August 11, 2009 decision, Judge Gropper held the filings were not made in bad faith and allowed the cash flow from the successful properties to be used to support all of GGP notwithstanding that the properties were owned by separate SPE's. Judge Gropper also noted that just because an SPE is bankruptcy-remote does not mean that it is bankruptcy-proof. In his decision, Judge Gropper found that GGP operated as an integrated whole company with many services, including the sourcing of new leases, provided by senior management of the holding companies. Implicitly, this took precedence over the structures established by cautious lenders wanting to avoid being embroiled in a borrower's bankruptcy filing and brought them all into the bankruptcy cases.

One result of the *GGP* decision is that the cautious lender, who made certain that its borrowers were solvent and its collateral safe, can be drawn into the borrower's owner's financial problems. The end result of the *GGP* decision is that, in the future, lenders will not make loans without carefully examining every level of the ownership structure and either increasing the cost of credit to account for the potential credit impairments created by higher ownership levels, or demanding new means of insulation from the owners of SPE's. The entire SPE structure will have to be altered (together, no doubt, with the CMBS system) because, on its first attack, it failed to achieve the desired goal.

Judge Gropper also expressed the belief that "as to certain of the debtors, the filing was not premature because the 1978 Bankruptcy Code incentivizes a debtor to file earlier rather than later in order to preserve the value of the estate." Judge Gropper also took judicial notice of the fact "that the CMBS market, in which they historically had financed and refinanced most of their properties, was 'dead' as of the Petition Date, and that no one knows when or if the market will revive." The court noted that the Bankruptcy Code does not require that the debtor be insolvent prior to filing.

Judge Gropper then raised an issue that has to send a chill throughout the lending community by noting that

there is no question that the SPE structure was intended to insulate the financial position of the Subject Debtors from the problems of its affiliates, and to make the prospect of a default less likely. There is also no question that this structure was designed to make each Subject Debtor 'bankruptcy remote'. Nevertheless, the record also establishes that the Movants each extended a loan to the respective Subject Debtor with a balloon payment that would require refinancing in a period of years and that would default if financing could not be obtained by the SPE or by the SPE's parent company coming to the rescue. [Emphasis added.]

Accordingly, the fact that the parent entity might have to rescue the affiliate at some point in the future, was a sufficient nexus for the Bankruptcy Court to rule that the SPE could file a chapter 11 petition in good faith. Judge Gropper also pointed out that GGP depended on the cash flow from the subsidiaries, a fact the lenders understood.

The Judge then examined the role of the Independent Managers of the SPE in voting for the Chapter 11 filing and points out that because the Subject Debtors were formed under Delaware law, the directors/managers were obligated to consider the interests of the shareholders (the holding companies) in exercising their fiduciary duties. Therefore, notwithstanding the purpose of the SPE's, the Independent Managers did not (and, in fact, should not) consider the needs of the secured lenders in making the decision to file for Chapter 11.

Judge Gropper also found support for the SPE's filing chapter 11 cases in good faith in the fact that the special servicers refused to speak to the borrowers. He reasoned that GGP had no choice but to file under Chapter 11 when it recognized the likelihood that GGP would not be able to refinance the debt when it came due in 2010 and later. Ironically, the

refusal of the special servicers to negotiate due to the risk to the servicers of negotiating with the borrowers in contravention of their Pooling and Servicing Agreements and the Intercreditor Agreements ultimately supported the SPE's resorting to chapter 11. The Pooling and Servicing Agreements had been drafted on the assumption there would be no chapter 11 cases and the remedies in the documents would be carried out as written. Once it turned out that GGP could orchestrate chapter 11 filings by the SPE's, the inability of the servicers to negotiate may have prevented an out of court solution from being developed.

One of the surprising elements of the decision is GGP's firing of the Independent Managers prior to the Chapter 11 filings and GGP's failure to notify not only the lenders and servicers, but waiting seven weeks before informing the fired Independent Managers that they had been replaced. The judge did not believe that such an action demonstrated bad faith ostensibly due to the fact that there was no specific requirement that notice be given together with GGP's concern that a disclosure of the firing would give the public notice of its intended filings.

Regardless of how one defines bad faith, one might question whether the firings and lack of notice could expose the directors and officers of GGP to the risk of subsequent civil and criminal charges on the ground that management and directors of a public company took secret actions designed to lead to chapter 11 filings while simultaneously incurring new debt every day which they knew would not be repaid, at least according to its terms. Put differently, the validity of the bankruptcy filings for purposes of restructuring GGP and its SPEs, does not shield its officers and directors from their secret acts that likely injured numerous creditors who would not have been injured had the acts not been secret.

GGP demonstrates the bankruptcy remote structures and related agreements were ineffective, at least against officers and directors willing to undertake secret acts and the potential liability they may entail.

Prior to the decision, there was a concern that Judge Gropper would use the concept of a substantive consolidation to tie GGP and all of its affiliates together. As a practical matter, however, given that real estate titles are publically recorded, there could hardly be a case that the different SPE's' assets were hopelessly commingled. Thus, substantive consolidation is an extremely remote risk in GGP. The ability of an SPE's cash to be loaned to its holding company is another issue. There, the jury is still out as to whether the adequate protection granted to each SPE for its cash is sufficient to assure the repayment of its money. This uncertainty can only increase the cost of debt in the CMBS market unless new ways

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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are found to make SPEs bankruptcy-proof and make the markets believe in them.

The most significant aspect of the GGP filing and the decisions in *GGP* is that the existing CMBS structure did not achieve the desired goals of protecting the lender. If the CMBS structure is to be available as a tool for real estate financing in the future, it will have to be revamped to avoid any possibility that the GGP situation can reoccur. After considering what has happened, we have the following suggestions for safeguarding lenders' expectations:

1. The SPE transactions should be recast using security contracts and/or other contracts the Bankruptcy Court is powerless to enjoin under sections 555, 556, 559, 560, and 561 of the Bankruptcy Code so that on a default such as the bankruptcy of the SPE or its holding company, the lender may terminate the contract and liquidate the collateral security such as the deed to the real property. Even if the efficacy of these types of derivatives is questioned by the SPE or its holding company, the risk these statutes will be enforced according to their terms should deter the use of bankruptcy or lead to a negotiation favorable to the lender.
2. Although the most obvious modification is to require notice to the servicers prior to the independent directors/managers being replaced, we do not think that would be adequate. A safer approach would be to require the servicers' prior written consents to replace an independent director/manager and to the identity of each replacement.
3. The cash flow from the property should be assigned to the servicer and paid into a lock box. This alone does not prevent a chapter 11 debtor from obtaining use of the cash, but diminishes the debtor's ability to deploy it for unapproved purposes prior to bankruptcy.
4. The SPE's certificate of incorporation or operating agreement should provide that a) a bankruptcy filing cannot occur without the approval all the directors/managers, and b) the directors/managers shall owe duties to protect creditors in the enforcement of their contractual rights including remedies.

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