BANKRUPTCIES OF GENERAL GROWTH PROPERTIES' "BANKRUPTCY-REMOTE" AFFILIATES TEST CMBS STRUCTURE

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To Our Clients and Friends:

The recent Chapter 11 filings by General Growth Properties, Inc. and 387 of its affiliates (collectively, one of the largest owners and operators of shopping malls located in the United States) have attracted widespread attention within the real estate community. While the bankruptcy of General Growth itself came as no surprise after months of negotiations failed to yield agreement on a long-term restructuring of several billion dollars of distressed loans, the bankruptcy filings of 166 "bankruptcy-remote" special purpose entities (SPEs), each of which was formed solely to own and operate a single shopping mall, were unexpected and have raised questions regarding the effectiveness of the SPE structure on which commercial mortgage-backed securities (CMBS) financings are based.

SPEs IN CMBS FINANCINGS

CMBS lenders make loans based on the value of a specific asset or portfolio of assets (and the cash flow it generates). In so doing, they rely on the belief – central to all structured financings – that a defined group of assets can be structurally isolated from the bankruptcy risks associated with an affiliated company or business.

This isolation is achieved through a variety of structuring techniques, including the creation of a "bankruptcy-remote" SPE to own the real estate assets in question. The SPE is referred to as "bankruptcy-remote" because it is structured in such a way that it is unlikely to commence, or have commenced against it, a bankruptcy case. First, the activities of the SPE (including, in particular, the incurrence of debt) are restricted to those necessary or incidental to the ownership and operation of the property. By so doing, the risk of an involuntary bankruptcy filing is reduced because the CMBS lenders should be the only material creditors of the SPE. Second, provisions are inserted in the organizational documents of the SPE requiring that its board of directors include one or more independent directors and that initiation of a bankruptcy must be authorized by a unanimous vote of the board. Such provisions are designed to ensure that a voluntary bankruptcy filing is approved by at least one director independent of any association with the SPE's parent or other affiliated entities.

In addition, a bankruptcy-remote SPE is typically precluded from engaging in a variety of actions that might result in its "substantive consolidation" with an affiliated entity. A bankruptcy court's equitable powers include the power to consolidate two nominally separate legal entities, pooling the assets of the two and treating claims of creditors as claims against a common fund. Typically, in determining whether to exercise this power,

bankruptcy courts focus on two issues: the relationships of the two entities with each other and with their creditors and the impact of consolidation on these creditors. As a result, a bankruptcy-remote SPE generally agrees not to engage in a variety of suspect activities, including: (i) entering into any contract or agreement with any affiliate except on an arms-length basis; (ii) commingling assets with those of any other person; (iii) guaranteeing indebtedness of another person; (iv) pledging assets to secure the obligations of another person; and (v) conducting business in the name of another person.

It is believed that each of the General Growth SPEs were structured in this manner, which is why the bankruptcy filings of these entities came as a surprise to many real estate professionals.

GENERAL GROWTH BANKRUPCTY FILINGS

Bankruptcy lawyers have long stressed that SPEs are "bankruptcy-remote," not "bankruptcy-proof," and in the past, bankruptcy proceedings have been commenced by, or with respect to, bankruptcy remote SPEs. See, e.g., In re Kingston Square Associates, 214 B.R. 713 (Bankr. S.D.N.Y. 1997). But the filing on April 16, 2009, of numerous General Growth SPEs that were in no apparent financial distress was unprecedented. A key issue is whether the voluntary petitions were properly authorized and whether the independent directors' votes were properly obtained. Counsel for General Growth has stated that the bankruptcies were properly approved, but specific details have not been made public.

"FIRST DAY" RELIEF REQUESTED BY GENERAL GROWTH

At the commencement of its bankruptcy proceeding, General Growth filed a motion seeking approval of debtor-in-possession (DIP) financing. As originally proposed, the General Growth SPEs were to guarantee the DIP loans and the DIP lenders would receive (i) a junior lien on all real and personal property of the SPEs; (ii) a first-priority security interest in all unencumbered real and personal property of the SPEs; and (iii) a first-priority security interest in General Growth's central operating account and all funds therein (including funds generated by the SPEs). General Growth also requested the ability to use the cash collateral of pre-petition secured lenders (including lenders to the SPEs) in exchange for payment of current interest at the non-default contract rate and certain other "adequate protection."

Contemporaneously, General Growth also filed a motion seeking authority to continue its pre-petition centralized cash management system. This system provides for the upstreaming of cash from the SPEs to upper-tier entities and the central operating account which was to be subject to the security interest in favor of the DIP lenders. In exchange, each SPE would receive an intercompany claim with an "administrative priority," which would give the claim priority over unsecured creditors but not over secured creditors such as the DIP lenders.

Numerous pre-petition lenders to the SPEs and CMBS servicers objected to the proposed DIP financing and cash management relief on the grounds that they disregarded the required separateness of the SPEs. The Commercial Mortgage Securities Association and Mortgage Bankers Association also filed an *amicus* brief arguing that the requested relief amounted to a *de facto* substantive consolidation of the SPEs. During the lengthy hearings devoted to the consideration of these motions, Judge Allan Gropper, the bankruptcy judge presiding over the General Growth cases, made a number of comments suggesting that he found these objections unpersuasive. Ultimately, however, he was not required to rule on the objections. A competition for the DIP financing developed, resulting in a material improvement in the terms of the financing, including the elimination of the SPE-level guarantees and security interests. However, the Bankruptcy Court did authorize General Growth to use the proposed centralized cash management system (although on terms more favorable to SPE lenders than those originally proposed).

MOTIONS TO DISMISS THE SPE BANKRUPTCY CASES

Thus far, motions to dismiss have been filed with respect to the bankruptcy cases of 22 of the SPEs and more are anticipated. The motions filed to date allege that the bankruptcy cases of the SPEs should be dismissed because they are without a legitimate reorganizational purpose and, therefore, were commenced in bad faith. The SPE lenders assert that the SPEs are solvent and have sufficient liquidity to operate.

The motions also challenge or reserve the right to challenge the bankruptcy petitions filed by the SPEs on the grounds that they were not authorized in accordance with the organizational documents of the SPEs, as discussed above. Many of the SPE lenders have requested, formally and informally, information relating to the authority of the SPEs to file bankruptcy petitions. The hearing on the pending motions is scheduled for June 17.

The General Growth bankruptcy is far from over and its full impact on General Growth's CMBS financings remains unclear. However, the bankruptcy is likely to result in a review of existing CMBS financings and whether this financing structure will be utilized in the future.

Please feel free to contact us with any questions.

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