COURT DENIES MOTIONS TO DISMISS BANKRUPTCIES OF GENERAL GROWTH SPECIAL PURPOSE ENTITIES: ARE BANKRUPTCY-REMOTE ENTITIES IN FACT BANKRUPTCY-REMOTE?

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To Our Clients and Friends:

Bankruptcy-remote entities are widely used in securitizations and other types of transactions in an attempt to isolate an asset—often loan collateral—from the risks and disruption of a bankruptcy proceeding. Bankruptcy lawyers have long warned that bankruptcy-remote entities are not bankruptcy-proof and, when legitimately in financial distress, may become debtors. But a recent decision of the United States Bankruptcy Court for the Southern District of New York in the Chapter 11 proceedings of General Growth Properties, Inc. and its affiliated debtors raises the question whether these entities should even be considered bankruptcy-remote.

General Growth Properties, Inc.

General Growth is a publicly held real estate investment trust that owns or manages more than 200 shopping centers across the country. General Growth is highly leveraged and its business model requires the regular refinancing of indebtedness, a task that became increasingly difficult in the second half of 2008. On April 16, 2009, General Growth and most of its domestic subsidiaries, including 166 bankruptcy-remote special purpose entities (SPEs), filed voluntary bankruptcy petitions. While the bankruptcy of General Growth itself came as no surprise, the bankruptcy of the SPEs, many of which were solvent and liquid, was unexpected and immediately raised questions concerning the effectiveness of the bankruptcy-remote structures on which these and many other financings are based. These concerns were heightened when it later emerged that the independent directors and managers of most of the SPEs had been replaced prior to the bankruptcy filings by new directors and managers selected by General Growth without the knowledge of the SPEs' lenders.

Bankruptcy-Remote Structures

An SPE may be drawn into a bankruptcy proceeding in any of three ways, and bankruptcy-remote structures seek to minimize the risk of all three. First and most important, the danger of a voluntary bankruptcy filing is reduced by the requirement in the SPE's organizational documents that an independent director or manager vote to approve the commencement of any insolvency proceeding. Independent directors and managers are otherwise unaffiliated with the SPE and its affiliates and, consequently, more likely to weigh the merits of a bankruptcy filing impartially. In particular, an

independent director or manager should be less inclined to approve the use of a bankruptcy filing offensively to benefit the SPE's equity holders to the detriment of its creditors. Second, bankruptcy-remote structures attempt to minimize the risk of an involuntary bankruptcy filing by restricting the ability of the SPE to incur indebtedness and engage in other activities that might give rise to unanticipated liabilities. If the number of creditors is minimized, the possibility that three disgruntled unsecured creditors holding unpaid claims might file an involuntary bankruptcy petition is reduced. Finally, bankruptcy-remote structures seek to limit the possibility that the SPE is substantively consolidated with a bankrupt affiliate through insertion of "separateness covenants" in the SPE's organizational documents. The separateness covenants require that the SPE conduct itself in a manner that is designed to avoid behavior that might result in substantive consolidation.

Motions to Dismiss

Following the bankruptcy filings of General Growth and its subsidiaries and some initial skirmishing over cash management, cash collateral and debtor-in-possession financing motions,[1] lenders to approximately 20 SPEs filed motions seeking dismissal of their borrower's bankruptcy cases on the grounds that the bankruptcy filings were in "bad faith." The primary argument made by the moving lenders was that the cases had been filed prematurely because the SPEs were not in any immediate financial distress and did not require relief under the Bankruptcy Code. In addition, the lenders argued that the filings were the result of a flawed process as the SPEs failed to negotiate with the lenders prior to filing for bankruptcy, and General Growth replaced the independent directors and managers of the SPEs with new directors and managers on the eve of bankruptcy.

Bankruptcy Court Decision

On August 11, 2009, the bankruptcy judge presiding over the case, Judge Allan L. Gropper, issued a decision denying the motions to dismiss. Judge Gropper held that the lenders had failed to establish either objective or subjective bad faith on the part of the SPEs.

Notwithstanding that, in many cases, the SPEs' loans did not mature for several years, Judge Gropper found that the SPEs were in varying degrees of financial distress due to the unprecedented collapse of the real estate markets and the resulting uncertainty as to the prospects for refinancing. Judge Gropper declined to establish an "arbitrary rule" that a debtor is not in financial distress and cannot file a Chapter 11 petition if the debt it is seeking to restructure is not due within one, two or three years. On the contrary, the Judge noted that the Bankruptcy Code "'does not require any particular degree of financial distress as a condition precedent to a petition seeking relief.'"

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1 *For more background concerning the General Growth Properties bankruptcy, please see our Client Update of June 1, 2009, entitled Bankruptcies of General Growth Properties' "Bankruptcy-Remote" Affiliates Test CMBS Structure.*

Significantly, Judge Gropper went on to hold that the SPEs need not evaluate their financial condition in isolation. Relying on a "family filing" standard enunciated in two previously little-noticed decisions, the Judge held that the decision "whether to file a Chapter 11 petition can be based in good faith on considerations of the [corporate] group as well as the interests of the individual debtor." While recognizing that the bankruptcy-remote structure was intended to insulate the SPEs from the problems of their affiliates, Judge Gropper found that this intent was trumped by the inclusion of the SPEs in a large, integrated corporate family. "Movants do not contend," the Judge stated, "they were unaware that they were extending credit to a company that was part of a much larger group, and that there were benefits as well as possible detriments from this structure. If the ability of the Group to obtain refinancing became impaired, the financial situation of the subsidiary would inevitably be impaired." It is worth noting that, in reaching this conclusion, the Bankruptcy Court—which makes frequent reference to the reliance of General Growth on cash flow from the SPEs—placed greater emphasis on the importance of the subsidiaries to the health of the bankrupt parent rather than the benefits flowing to the subsidiaries from the relationship.

In fact, Judge Gropper argued that the directors and managers of the SPEs were obligated to consider the interests of General Growth in determining whether to authorize a bankruptcy filing. Citing Delaware corporate law providing that the directors of a solvent corporation have fiduciary duties to the corporation's shareholders, the Judge held that directors and managers were "authorized—indeed required—to consider the interests of [their] shareholders." In reaching this conclusion, Judge Gropper was little impressed by language in the SPEs' operating agreements stating that the independent directors and managers were to consider only the interests of the SPE, including its creditors, in determining whether to authorize a bankruptcy filing. The decision also makes no mention of Section 18-1101 of the Delaware Limited Liability Company Act which states that the fiduciary duties of a director or manager may be "expanded or restricted or eliminated by provisions in the limited liability company agreement."

Judge Gropper also rejected the lenders' argument that the SPEs' failure to negotiate with their lenders established subjective bad faith on the part of the SPEs. The Judge stated that the Bankruptcy Code does not require that a borrower negotiate with its lenders before filing a Chapter 11 petition. The Judge also found that the SPEs had complied with their organizational documents in connection with the replacement of the independent directors and managers.

In conclusion, the Judge suggested—in language that has been repeated by a number of commentators—that he had done no real violence to the bankruptcy-remote structure of the SPEs and that "the fundamental protections that the Movants negotiated and that the SPE structure represents are still in place." In making this claim, the Judge stressed that he had not substantively consolidated the SPEs with other entities. This contention, however, is debatable. As already noted, in a bankruptcy-remote structure, non-consolidation is a means to an end rather than an end in itself. It is part of a complex web of arrangements designed to avoid a bankruptcy filing. When

another element of this web—the protections against a voluntary bankruptcy filing—fails and the SPE enters bankruptcy, the fact that other elements of the structure survive is of limited consolation to the creditors of the SPE.

Implications

Judge Gropper's decision in the General Growth bankruptcy could have a significant impact on the securitization market.

At a minimum, the decision should lead lawyers to reread and, in many cases, rewrite key provisions of limited liability company agreements. The provisions that govern the ability of the member to replace independent directors or managers should be revised to prevent the type of director shopping that appears to have taken place here. Further, the provisions that define the scope of the independent directors' or managers' fiduciary duties may merit further clarification.

In addition, the decision is a useful reminder that no matter how carefully an SPE is structured and its organizational documents are drafted, it will not be bankruptcy-proof and its independent directors or managers may, when confronted by real financial distress, authorize the filing of a bankruptcy petition. The more integrated the assets and operations of the SPE with those of its affiliates, the more significant this risk may be.

The real issue, however, is whether—given the Bankruptcy Court's application of the "family filing" standard and Delaware fiduciary duty law—bankruptcy-remote structures continue to provide lenders and others that rely on them with any meaningful protection from the financial distress of related entities. The resolution of this issue will only become clear as other courts determine whether and how to apply the holdings in General Growth.

Please feel free to contact us with any questions.

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