



Mall giant's bankruptcy case continues to reverberate in mortgage lending world

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Debate continues over the legal significance and anticipated industry implications of the Chapter 11 bankruptcy proceedings of General Growth Properties Inc. (GGP), the second-largest U.S. real estate investment trust, or REIT.

The case, *In re: General Growth Properties, Inc., et al.*, is likely the largest real estate bankruptcy of all time and already has raised a number of novel legal concerns.

On Aug. 11, in what by then was a closely watched and long-anticipated ruling, the U.S. Bankruptcy Court for the Southern District of New York denied the motions of several commercial mortgage holders to dismiss the bankruptcy cases of their GGP property-level borrowers and confirmed that those borrowers could remain in bankruptcy despite their so-called "bankruptcy remote" structures and strong positive cash flows.

In so doing, the court dealt a major setback to these secured lenders, who had challenged the validity of the GGP subsidiaries' Chapter 11 filings as having been filed in bad faith and in violation of the subsidiaries' special-purpose entity (SPE) structures.

The decision on these motions to dismiss has generated wide interest among legal and industry commentators, both as it relates to other large distressed real estate companies as well as to the future of commercial real estate finance.

Background

In April, GGP and 387 of its subsidiaries filed for Chapter 11 protection with an aggregate of \$18.27 billion of property-level mortgage debt, nearly \$10 billion of which was securitized in the commercial mortgage-backed securities (CMBS) market (the latter figure making GGP the largest single CMBS sponsor in the world).

This debt is secured by mortgages on more than 100 properties, the majority of which are large, regional shopping malls. Challenges to the filings of the property-level SPE subsidiaries quickly followed but were not decided until the Aug. 11 ruling.

The mortgage lenders' primary arguments in their motions to dismiss were that the SPE subsidiaries' filings were made in bad faith and that the filings were beyond the corporate authority of the individual SPEs. The essence of these contentions was that GGP had inappropriately caused the bankruptcy filings of its solvent subsidiaries merely to benefit its insolvent parent companies.

The court - in a well-reasoned, 47-page decision - denied each of the mortgage lenders' motions to dismiss. It found that the filings were not made in bad faith because the subject SPE debtors were in financial distress; they had attempted to negotiate with their lenders; had carefully considered, on an entity-by-entity basis, the prospects of emerging from financial distress (particularly the dubious prospects of refinancing); and they had at least a reasonable likelihood of being able to reorganize.

Importantly, in making these findings, the court also determined that the interests of a group of affiliated entities as a whole may be considered in determining whether any member of the group properly filed for bankruptcy protection, and that the court was not required to examine the issue of good faith as if each debtor entity were a stand-alone entity.

Also, while many of the SPE debtors were clearly solvent on a balance sheet or cash flow basis, and while some would not be facing debt maturities for more than three years after the petition date, the court found that other indicia of distress, including the distress of the parent companies and other affiliated entities, were valid considerations in the good-faith analysis.

The court also determined that GGP's replacement, on the eve of filing, of its SPE subsidiaries' independent directors with new independent directors who may have been more disposed to approve the bankruptcy filings, did not itself compel a finding of bad faith.

Thus, calling the motions to dismiss the subsidiaries' filings a "diversion," the court denied each of the motions to dismiss and directed the parties to commence in earnest their negotiations over a plan of reorganization. No appeals of the court's decision were timely filed.

Fact-intensive analysis

As the GGP proceedings developed, the court's decision came as no surprise to many parties who were keenly aware of the power of bankruptcy courts to look to substance over form to overcome potential structural barricades to an entity's ability to seek bankruptcy protection.

While many observers, including the Mortgage Bankers Association and the Commercial Mortgage Securities Association, initially decried the inclusion of the GGP SPEs in the bankruptcy proceedings as potentially "disastrous" to the securitization industry, and while most observers continue to consider the decision to have "widespread and profound" ramifications, especially on the CMBS marketplace, several facts should be noted regarding the impacts of the court's decision.

The first is that at the outset of the GGP cases, in connection with the approval of GGP's \$400 million debtor-in-possession financing and use of cash collateral, each of the mortgage lenders were granted "adequate protection" rights that include:

(i) the current payment, during the pendency of the bankruptcy cases, of all pre-petition, non-default rate interest on their loans (many of which are interest-only loans);

(ii) first priority liens on both GGP's main operating accounts and on funds that are "upstreamed" from the SPEs to their parent entities; and

(iii) second liens on other real property that secure the debtor-in-possession (DIP) loan. This level of adequate protection was available only because GGP entered bankruptcy with strong positive cash flows and available DIP financing and, therefore, could afford to provide meaningful protection to its mortgage lenders during the pendency of its Chapter 11 proceedings.

The court also readily recognized that its decision was based on a fact-intensive analysis that included a determination that unprecedented circumstances had rendered the commercial refinancing market ostensibly unavailable to GGP, which had suffered massive aggregate mortgage debt maturities of approximately \$1.1 billion between January and April 2009 alone and would be facing more than \$18 billion in total debt maturities by the end of 2012.

Future 'fixes' for lenders

It is important to note that the SPE structures and loan documentation deployed by most of GGP's mortgage lenders were, for the most part, sophisticated, thorough and otherwise "market."

Accordingly, Judge Gropper's disallowance of the motions to dismiss was not the product of any shortcomings or the lack of what were thought to be customary "best practices" that allowed the SPE filings to survive the challenges brought by secured lenders.

Now, in light of the GGP decision, commentators have begun suggesting new structural and legal mechanisms, as well as revised business practices, that might be employed in commercial mortgage lending (whether securitized or not) in an attempt to help protect against GGP-like filings by SPE borrowers that are part of a larger corporate family.

The first category of new legal protections is aimed at limiting the ability of a sponsor, or parent entity, to remove an SPE's independent managers and replace them with ones who may be more disposed to approve a bankruptcy filing.

These include adding a requirement in the entity documents that notice of removal be delivered to the lender and that the effectiveness of removal be delayed for a period of time to allow a lender to prepare for a potential filing.

Another suggestion is to require that replacement independent directors must be chosen from a pre-approved list of individuals or providers, such as those available through selected providers of independent manager services.

Still others have raised the notion of permitting independent managers to be replaced only for cause, or only with the consent of the lender.

These modifications have their limitations, since the notice and delay provisions would provide little other than fair warning, and the more aggressive tactics, such as requiring lender consent, raise justifiable fears of lender liability.

Furthermore, any efforts to use independent manager provisions to universally block a bankruptcy filing will be met with stiff legal challenges, as suggested in the following excerpt from the court's decision:

"... if Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken."

In other words, it seems likely that these types of "protections" would have fared no better in Judge Gropper's courtroom.

The second category of legal "fixes" would tinker with the fiduciary duties of SPE managers in a further attempt to stop or forestall a manager's vote to approve a bankruptcy filing.

The Delaware Limited Liability Company Act, for example, permits parties to modify contractually the fiduciary duties of the managers of an LLC.

Thus, going forward, lenders might seek either to insert into the SPE entity documents contractual duties to creditors (i.e., the lender), or to eliminate or limit the managers' statutory duties to shareholders.

The contractually modified duties might be designed to arise or be eliminated only under specified circumstances that might lead to a bankruptcy filing. Certain of the SPE documents in the GGP cases did in fact contain contractual modifications of managers' duties in favor of creditors; however, those documents also contained language that generally deferred to Delaware corporate law.

Since applicable Delaware corporate law currently provides that a solvent corporation's directors' fiduciary duties run to shareholders and not to creditors, even in what was previously considered the "zone of insolvency," the references to Delaware corporate law effectively trumped the contractual modifications.

In any event, these new approaches have not been tested and, again, if the contractually modified duties amounted to an absolute impediment to a Chapter 11 filing, reviewing courts would likely determine them to be invalid and against the public policy behind permitting commercial entities the right to seek bankruptcy protection.

Whether or not they add new legal maneuvers, commercial mortgage lenders are likely to significantly modify their business practices in light of the GGP decision in an attempt to further protect against the risk that the bankruptcy of a parent or affiliate will drag the borrowing entity into Chapter 11.

In addition to generally more conservative pricing and underwriting criteria, these changes will likely include increased recourse guarantee obligations, earlier cross-default triggers, additional reporting requirements, and covenants for sponsors and other affiliated entities, as well as tightened cash reserve requirements and cash trap mechanisms.

Conclusion

Whether and to what extent these or other adjustments would be effective going forward remains to be seen, and if one believes that we are still in the early innings of a crisis in commercial real estate, it is likely that the industry's existing transaction structures will be tested further before a new paradigm emerges.

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