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General Growth Bankruptcy Ruling Has Potential Far Reaching Implications

If you have purchased or are considering purchasing distressed loans, please take note. The recent ruling in General Growth Properties' bankruptcy may directly impact you.

On August 11, 2009 the bankruptcy court rendered what may be one of the most significant decisions to affect lenders in recent history. The decision, involving the April 2009 bankruptcy filing of General Growth Properties, could forever change the way lenders look at special purpose entities (SPEs) and the way they look at independent directors.

The GGP bankruptcy represents the biggest commercial real estate collapse in American history. It involved approximately 390 GGP subsidiaries which also filed for bankruptcy. These SPE subsidiaries were the property level ownership entities in the GGP corporate structure which directly owned and operated separate retail shopping centers. As such, they were encumbered by first priority mortgage loans given by both CMBS lenders and traditional institutional lenders. Many of the SPE subsidiaries were solvent, single purpose entities at the time. One of the significant issues in the case has challenged many previously held assumptions regarding special purpose, bankruptcy remote entities and independent directors because they were thought to provide protections to lenders.

Lenders have operated under the notion that the SPE structure would mitigate the bankruptcy risk of its subject borrower. The requirement that borrowers be structured as an SPE has been fundamental to a lender's decision to extend financing, and to the decision of an investor buying commercial mortgage backed securities ("CMBS") issued by the trust holding these types of loans. The lender's expectations regarding the protections afforded them as a result of the SPE structure will need to change as a result of the court's decision. The question is how and what type of precedent value will the decisions in the GGP bankruptcy have in the future.

The fundamental goal of an SPE bankruptcy-remote structure is to isolate the subject borrower's assets and cash flow from unrelated liabilities and the bankruptcy of its parent and other subsidiaries. Because an SPE consists of an entity which has agreed to restrictions limiting its activities to its current trade and business, it is able to incur no further debt beyond its first priority mortgage loan and ordinary trade payables. The structure was intended to segregate assets and liabilities thereby minimizing the risk of the subject borrower's need to file for voluntary bankruptcy. The SPE structure often involves the requirement that the borrower appoint an independent manager or director whose affirmative vote is required prior to an SPE filing for bankruptcy protection; with the intent that this hurdle will eliminate a spurious bankruptcy filing by such borrower.

While most lenders did not consider the SPE protections to render an entity "bankruptcy proof" they did fully expect that the segregation of an SPE's assets and cash flow would mitigate the likelihood that the borrower would be rendered insolvent. Lenders understood that, despite the SPE restrictions imposed, a borrower could vote to file for voluntary bankruptcy if doing so served its best interests. However, lenders believed the risk that its subject borrower would become embroiled in the bankruptcy of its parent or affiliates to be greatly reduced or eliminated. The Court's rulings thus far have largely ignored the lender's intent behind the SPE structure.

The Court used a "corporate family" rationale to allow the use of the commingled cash flow from the 390 subsidiaries in a restructure of GGP based on a rationale that, although many of the subsidiaries were solvent, they would have trouble refinancing their debt in today's market conditions and, as such, while

not insolvent, were in financial distress. Lenders objected, feeling that these bankruptcy filings were made in bad faith.

Although the result of these motions was anticipated given the high bar required for the dismissal of a bankruptcy petition, it is the applied rationale which is the most noteworthy. The Courtqs ruling avoided the specter of consolidation but nonetheless treated cash flow from the separate entities as available to service the debtor-in-possession financing requested by GGP, thus disrupting long-held assumptions about SPE structures.

Many loan documents do not prohibit the replacement of the independent director but require that one be appointed by the closing of the loan and maintained throughout the term. The Courtqs ruling upsets one of the popular misconceptions that the independent director is appointed to protect the Lender from a bankruptcy filing of the borrower. Typically, the unanimous vote of the board, including the independent director, prior to a filing in bankruptcy is required by a lender. On this point the Court was clear that independent managers and directors hold the same fiduciary duties as any other manager or director of the company to act in the best interests of the corporation and its shareholders and not to protect the lender. Only when the subject debtor is within the %zone of insolvency+ may the interests of creditors be considered.

Observers of the GGP bankruptcy initially focused on the "midnight" dismissal of these independent directors and their replacement, but in many cases the independent directors were replaced, which was not prohibited in the lender's documents. Further, GGP presented evidence that the individuals who replaced the previously appointed independent directors and mangers had extensive real estate and restructuring experience. Regardless of these individuals' unique skills, the courtqs universal application of the same fiduciary duties upon independent and non-independent directors raises the question as to whether independent directors hold a benefit to the lender. We believe they still thwart an attempt by a borrower to game play by filing a bankruptcy rooted in other than the best interests of the company.

Whether a bankruptcy petition has been filed in good faith is a wholly fact-dependent analysis, and the Court elected to view the GGP bankruptcy through the prism of the currently stagnant capital markets. Accordingly, the weight of the precedent set by the rulings in the GGP bankruptcy remains unclear. If the markets improve, will this ruling be applicable in future attempts by parent companies to use the assets and cash flow of their SPE subsidiaries in a corporate reorganization? The Court is clear that use of the SPE structure alone will not isolate a borrower from the risk of its parent company or other subsidiaries' insolvency; rather the SPE structure will guide the Court in determining the extent of a lenderqs adequate protection.

As the GGP bankruptcy case progresses, for lenders who rely upon the SPE structure to mitigate bankruptcy risk and aid in the underwriting of the risks associated with making a loan, the ruling illustrates the weaknesses of this structure. While the borrower and its assets remained separate and unconsolidated, the entity itself was involved in a bankruptcy filing and a corporate reorganization which will impact the lender's loan even if its borrower and asset were performing.

Since the precedent value of this case remains unclear, expect lenders to retain their SPE requirements. There will be hope that as the capital markets thaw, this case may seem an anomaly reliant greatly on current market conditions. You may expect new loans to modify the covenants regarding the control of the independent director and its replacement. Potentially, lenders may impose new hard cash management structures as a means of avoiding the commingling of cash at the parent level to thwart the impact of the Court's ruling. Lenders and servicers may also seek to implement post-closing audit procedures to ensure that borrowers continue compliance with SPE requirements.

We will continue to monitor the GGP bankruptcy closely. The precedent set by the case may depend largely on the success of the GGP reorganization itself. A successful reorganization may further empower the Courts to liberally apply the precedent of this case in other bankruptcy filings involving complex borrower structures in the future.

This document is intended to provide you with general information about recent decisions in the bankruptcy proceedings of General Growth Properties. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed below or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

Ana Lazo Tenzer
altenzer@bhfs.com
T 303.223.1156

Michael J. Pankow
mpankow@bhfs.com
T 303.223.1106

Denver Office
410 Seventeenth Street
Suite 2200
Denver, CO 80202-4432
T 303.223.1100

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