General Growth
Special Purpose Entities (Barely) Survive First Bankruptcy Test

By W. Rodney Clement Jr. and H. Scott Miller

W. Rodney Clement Jr. is partner in the Jackson, Mississippi, office of Bradley Arant Boult Cummings LLP. H. Scott Miller is counsel in the Hartford, Connecticut, office of Bingham McCutchen LLP.

Lenders have used bankruptcy-remote, special purpose entities (SPEs) since the early 1990s to attempt to isolate their collateral from the claims of affiliates of their borrower, especially in loans secured by commercial mortgage-backed securities. The value of the SPE structure was put to the test in the General Growth Properties (GGP) bankruptcy in 2009. *In re General Growth Properties, Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009). At the end of the day, bankruptcy principles prevailed over most but not all of the separateness and bankruptcy remoteness protections intended to protect the lenders' collateral.

SPEs Generally

Most lenders require that an SPE will be the sole owner of the assets securing the loan, although the borrower may be the SPE's parent or other affiliate. There are two distinct aspects to an SPE: separateness of identity and the role of an independent director.

Lenders require covenants in both the organizational and loan documents obligating the borrower to maintain the SPE's separate identity. Typical separateness covenants in loan documents provide that the SPE has a limited purpose, will maintain all corporate formalities, will pay its own debts and liabilities, will maintain separate books and records, will conduct its business in its own name, will not commingle its assets with the assets of any other person, and will not be responsible for the debts of any other person. Also, an SPE's ability to merge with another company or sell its assets is limited.

One reason that the lender wants an SPE to own the collateral is to attempt to prevent the collateral for the loan from being subject to substantive consolidation in bankruptcy. Substantive consolidation is a federal common law doctrine that permits a bankruptcy court to consolidate separate entities into a single bankruptcy. See *In re Owens Corning,* 419 F.3d 195, 205 (3d Cir. 2005) (extensive discussion of doctrine of substantive consolidation, including history). Substantive consolidation can permit a lender's collateral to be used to pay debts of unsecured and other creditors. The test for substantive consolidation is whether the creditors dealt with the different entities as a single economic unit and did not rely on their separate identities in extending credit, or whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. The separateness covenants attempt to track the analysis a bankruptcy court would perform, with the goal of ensuring that substantive consolidation would be found to be inappropriate.

Another feature of an SPE is that the debtor's organizational documents require one or more independent directors and require that the vote of the independent directors is necessary for the borrower to file bankruptcy. An independent director is one that is not affiliated, organizationally or economically, with the borrower or its officers or directors. Because of the demand for independent directors, companies exist whose business is to supply experienced independent directors. From a lender's perspective, the purpose of an independent director is to prevent a borrower from filing for bankruptcy in a mere attempt to gain leverage; the independent director is supposed to provide for a rational, independent review.

The GGP bankruptcy was the first large-scale test of both aspects of the SPE structure. The court's decision dealt a severe blow to lenders and has led some to conclude that SPEs were not quite the bankruptcy shield that lenders had envisioned them to be.

SPEs and the GGP Bankruptcy

GGP, a publicly traded real estate investment trust, primarily engages in the ownership and management of large-scale shopping centers. Before the bankruptcy, GGP was the ultimate parent of over 200 shopping centers in 44 states (in addition to other real estate interests), with each shopping center being owned by a direct or indirect subsidiary of GGP. This article will refer to such owners and their financial performance as being at the "property level."

The owner of each shopping center was treated as an SPE for lending purposes, and the loan documents con-

Published in *Probate & Property*, Volume 25, Number 1, January/February 2011. © 2011 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

tained typical separateness covenants. Most of the SPE borrowers also were required to have two independent managers. The operating agreements required the unanimous consent of the managers to file for bankruptcy protection and required the managers to consider only the interests of the company and its respective creditors in determining whether to file bankruptcy. The operating agreements also provided, as is customary, that the managers had a fiduciary duty of loyalty and care similar to that of directors of a Delaware corporation.

In 2008, GGP had widely publicized problems with unsecured indebtedness maintained at the corporate levels of the enterprise, and this indebtedness needed restructuring. Property performance, however, was generally strong and almost all mortgage loans were paying debt service on time with healthy ratios.

The nature of GGP—whose property level cash flow was critical to the survival of the corporate enterprise—put GGP in a bind. GGP could not risk any action at the corporate level that would put its mortgage loans into default, because several loans contained provisions that, on default, cash would be kept at the property level, with excess cash applied to principal. This would have made GGP's reorganization impossible, and the decision was made that a bankruptcy of the entire enterprise was necessary.

The Independent Director and the GGP Bankruptcy

The first hurdle to GGP's bankruptcy was determining a way for the property-level entities to make a voluntary bankruptcy filing, when independent director review was required.

In conformance with the industry standard independent director provisions, GGP was able to replace or supplement the existing independent managers of all of the SPE borrowers with two individuals selected by GGP, in each case without notice to the lenders (or, for that matter, the removed independent managers). These new individuals had a process by which they evaluated the financial health of each SPE, and ultimately these new independent managers, together with the existing boards of directors or managers, approved the filing of bankruptcy petitions for the SPE borrowers.

The lenders were upset about this process, primarily for two reasons. First, the lenders saw healthy, performing properties that did not need to be in bankruptcy and questioned whether the SPE bankruptcies were filed in bad faith. Second, the lenders believed that the independent managers failed to take into sole consideration the needs of the property-level borrower and its creditors and thus violated their fiduciary duties.

On the bad faith claim, the lenders argued that the filings were premature because the SPE borrowers were not in default on their loans at the time of the bankruptcy filings, and the maturity dates of the loans for some of the SPE borrowers were several years out. The court, however, noted that the Bankruptcy Code does not require that a debtor be insolvent before filing. The court further stated that it was appropriate for the managers of the SPE debtors to consider the interests of the entire General Growth group in determining whether to file a bankruptcy petition.

> Faced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to the refinance the project-level debt, the Debtors' management had to reorganize the Group's capital structure. Movants do not explain how the billions of dollars of unsecured debt at the parent levels could be restructured responsibly if the cash flow of the parent companies continued to be based on the earnings of subsidiaries that had debt coming due in a period of years without any known means of providing for repayment or refinance.

General Growth Props., Inc., 409 B.R. 43 at 62–63. The court noted that the lenders were aware that they were extending credit to an entity that was part of a 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." Id. at 61.

The lenders also argued that the failure of the debtors to negotiate with the lenders showed bad faith. The bankruptcy court stated that the Bankruptcy Code does not require that a borrower negotiate with its lender before filing a Chapter 11 petition. The court also noted that there was no evidence in the record to indicate that pre-filing talks would have been fruitful. The court particularly noted that GGP tried but could not get the commercial mortgage-backed securities servicers to talk with it before the bankruptcy filing.

Finally, the lenders argued that the discharge of the independent managers showed bad faith. The replacement independent managers were two persons that the court characterized as "seasoned individuals." GGP asserted that, once bankruptcy became an option, it was important to have independent managers with experience in restructuring and capital markets. GGP also asserted that the appointments of the replacement managers were not disclosed before the bankruptcy because disclosure could "subject the company to publicity about potential restructuring strategies" and because the debtors had no contractual duty to do so. Id. at 68. The court found that the removals were not inconsistent with the organizational documents. Although "admittedly surreptitious," according to the court, the re-

Published in *Probate & Property*, Volume 25, Number 1, January/February 2011. © 2011 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

placement of the independent managers was not evidence of bad faith and was consistent with the Bankruptcy Code's purpose of preserving value for the debtors' estates and creditors.

The court acknowledged that the drafters of the independent manager provisions might have intended to create an impediment to bankruptcy by requiring the independent managers to consider the interests of creditors. Indeed, an officer of one of the servicers stated in a deposition: "Well, my understanding of bankruptcy as it pertains to these borrowers is that there was an independent board member who was meant to, at least from the lender's point of view, meant to prevent a bankruptcy filing to make them a bankruptcy-remote, and that such filings were not anticipated to happen." The court emphasized, however, that the creditors' interests were not the *sole* consideration; to the contrary, Delaware law requires the directors of a solvent corporation to consider the interests of the company's shareholders when the directors are exercising their fiduciary duties.

The court acknowledged that directors of a corporation have duties to creditors when the corporation is insolvent. Id. at 64 (citing *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92 (Del. 2007)). But the SPE borrowers were not insolvent at the time of filing. Moreover, although some courts had held that directors have a duty to creditors when the corporation is operating in the "zone of insolvency," the Delaware Supreme Court had rejected that rule. Even when a corporation "is navigating in the zone of insolvency . . . directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment *in the best interests of the corporation for the benefit of its shareholder owners." General Growth Props.,* 409 B.R. at 64 (citing *North Am. Catholic Educ. Programming Found.,* 930 A.2d at 101). Thus, if the lenders "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. . . . Seen from the perspective of the Group, the filings were unquestionably not premature." *General Growth Props.,* 409 B.R at 64–65.

Separateness and the GGP Bankruptcy

The second issue relating to SPEs that arose in the GGP bankruptcy related to separateness and the ability of the GGP enterprise to send rents—each mortgage lender's cash collateral—upstream to a centralized concentration account maintained at the corporate level, with the rents to be used for the benefit of the entire enterprise (and not just the specific property from which they were derived).

After GGP and the SPE borrowers filed their bankruptcy petitions, the SPE borrowers continued to "upstream" cash to GGP under the centralized cash management system that was in place before the bankruptcy. Lenders to the SPE borrowers objected that this practice violated the separateness covenants and asserted that their rights to this cash collateral were inviolate. The bankruptcy court held that the SPE structure and the loan documents did not preclude the SPE borrowers from continuing to upstream their cash surplus to GGP. The lenders to the SPE borrowers received adequate protection in the form of continued payments of interest, a first-priority security interest in the centralized cash account, and a second lien on other properties. 409 B.R. at 55. The judge specifically took exception to arguments made by the Commercial Mortgage Securities Association and the Mortgage Bankers Association that allowing cash collateral of the SPE to be used by GGP would cause a systemic risk in the commercial mortgage-backed securities market. The court expressly stated that the bankruptcy estates were not being substantively consolidated:

> There is no question that a principal goal of the SPE structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity.

Id. at 69.

Analysis of the *General Growth Properties* Decisions

The decisions of the court, as they pertain to SPE issues, need to be looked at separately.

The court's decision regarding the duties of the independent directors seems sound. There was no suggestion in the case that the SPE borrowers did not follow all of the corporate formalities. Under the relevant Delaware law, the independent directors were permitted to consider only the interests of the shareholders and not the interest of the secured creditor. Thus, in the end, the real question was whether the industry standard language failed the lenders by allowing the borrower to place its own chosen independent directors.

The court's analysis of separateness and GGP's ability to upstream its rents into a centralized account caused

Published in *Probate & Property*, Volume 25, Number 1, January/February 2011. © 2011 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

much consternation as being tantamount to a de facto substantive consolidation, with rents—a lender's collateral—being used for the benefit of the enterprise. From a purely legal perspective, there was no substantive consolidation, just administrative consolidation. And with excellent record-keeping and creditor-specific liens on the concentration account in the amount of the cash collateral used, each creditor's specific liens, at least on paper, were acknowledged and preserved.

But, although the SPE debtors were not substantively consolidated in this case, the rights of the lenders to the SPE borrowers were substantially limited. An arguably thin line exists between substantive consolidation and a case in which the bankruptcy estates of the parent and subsidiaries are jointly administered and the cash from the subsidiaries is used to pay the unsecured creditors of the parent.

Each mortgage loan was reorganized—consensually—by extending the loan at the contract rate. At this time, these rates, based on the fair market value of the properties, were below market interest rates. This reorganization effectively transferred value from the lenders to the equity, which benefitted GGP's equityholders. That transfer, combined with the lender's inability to apply the cash from the SPE borrowers' debt (which was instead used for the benefit of the enterprise), does have all the hallmarks of a de facto substantive consolidation, at least from a lender's business perspective. This consolidation is anathema to the concept of separateness.

Issues for Lenders Going Forward

One could argue that the *General Growth* decision upholds the integrity of the SPE structure. Substantive consolidation did not occur. Each creditor's liens were preserved and records were kept to ensure the same. Arguably, the first priority security interest that the lenders to the SPE borrowers received in the centralized cash management account as adequate protection for allowing the debtor to continue to use the surplus cash from the separate properties was more valuable than the cash flows from a single property.

For separateness, the real issue was whether the centralized cash management scheme was merely a continuation of the status quo that existed before the filings. This scheme was likely a violation of the separateness covenants existing in the loan documentation. Therefore, the court was essentially asked to enforce the separateness covenants for the first time after the lenders failed to do so themselves since loan inception. The court was not willing to start enforcing these provisions when a massive forfeiture was at stake.

For lenders that really care about separateness, it becomes paramount to exercise diligence to ensure that the borrower's actual practices conform to the separateness covenants. Lenders cannot rely on the blackletter text of the covenants when they ignore the borrower's actual ongoing practices. The irony is that many lenders may find strict adherence to the separateness covenants to be economically burdensome or impractical to impose on their borrowers. Expect to see more lenders requiring structural changes to effect a more lender-friendly result, such as by requiring their borrowers to deposit cash in hard lockboxes rather than directly into centralized cash management systems.

For the independent director provisions, the real challenge is going to be whether lenders can sufficiently draft around *General Growth* so that the SPE provisions continue to have value. Lenders already have started making changes to SPE corporate documents to address the court's decision regarding independent directors. Expect to see more governing documents that require the borrower to use only independent directors from corporate services providers, require notice to lenders before substituting independent directors, and require cause for removal of independent directors. The issue for negotiation between lenders and borrowers will be how closely lenders can control the independent directors without the control being deemed by a court to be an unenforceable attempt to prevent the borrower from filing bankruptcy. Although a lender may not be able to prevent a borrower from replacing an independent director, the fact that the borrower is attempting to replace an independent director is a red flag that the borrower is contemplating bankruptcy.

The court's holding that the managers of the SPE borrowers were permitted to and may have had a duty to consider the interests of the entire GGP group in considering whether to file bankruptcy is a setback for the separateness principle. Some commentators have expressed their opinion that the *General Growth* court misinterpreted the relevant provisions of the operating agreements. E.g., Elisa Erlenbach Maas, Director, Richards Layton & Finger, Remarks from Erosion of Bankruptcy Remote Structuring by the Courts: What Do the Sunwest and General Growth Decisions Mean for Your Practice, at ABA Bus. Law Section 2010 Spring Meeting (Apr. 24, 2010). Lenders will maintain that the most effective way to prevent a bankruptcy filing is not via independent director provisions, but via a requirement to maintain a solvent guarantor or provide other credit enhancement.

The *General Growth* court described in detail the steps that GGP and its SPE borrowers took to substitute the independent managers and obtain their approval for the bankruptcy of the entire group. This decision in effect lays out a road map for bankruptcy attorneys to use to attack the SPE structure in other loans. Expect to see more SPE bankruptcies using this road map.

Finally, do lawyers need to make changes to their enforceability and nonconsolidation opinions to reflect *Gen-*

Published in *Probate & Property*, Volume 25, Number 1, January/February 2011. © 2011 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

eral Growth? Although some lawyers have modified their opinions to address specifically the issues in *General Growth,* and it all depends on the opinions requested, the authors believe that the general bankruptcy exceptions that are typically in mortgage enforceability and nonconsolidation opinions should insulate opinion givers from the issues raised in *General Growth.*

Conclusion

Three lawyers are sitting at a bar—a lending lawyer, a corporate lawyer, and a bankruptcy lawyer. The bartender asks: "So, what do you think of the *General Growth* decision?" The lending lawyer drops his head to the bar and sobs: "What part of 'separate' couldn't the court understand? This is the end of securitized mortgage lending and Western civilization." The corporate lawyer replies pensively: "Thank goodness that I made an exception for bankruptcy in my enforceability and nonconsolidation opinions. Assuming that the commercial mortgage-backed securities market ever comes back to life, I might have to look at tightening up my independent director provisions." The bankruptcy lawyer says: "What's the big deal about the separateness covenants? Just one more broken promise on the Boulevard of Broken Dreams that is bankruptcy. This decision is going to be great for my practice. Round for the house!"

The point is that what one thinks of *General Growth* likely depends on one's perspective. For bankruptcy lawyers, *General Growth* provides new ideas and authority for challenging separateness covenants and bankruptcy remoteness devices. For corporate lawyers who prepare and review the organizational documents of borrowers, it provides a valuable lesson about "independent" directors. For lending lawyers, the result could have been (and almost was) much worse and provides some tough lessons from which to learn. For any lawyer who is interested in real estate lending, securitization of real estate loans, or bankruptcy, *General Growth* provides valuable lessons about the distinction between "bankruptcy-proof" (the SPE ideal) and "bankruptcy remote" (the *General Growth* reality).

Published in *Probate & Property*, Volume 25, Number 1, January/February 2011. © 2011 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.