August 25, 2009

WEATHERING THE STORM

Recent Court Decision Exposes the Reach of a Corporate Family's Financial Distress to its Bankruptcy-Remote Special Purpose Entities and Their Lenders

In the recent heyday of real estate and structured finance, the use of "bankruptcy–remote" special purpose entities (SPEs) as borrowers was a fundamental underwriting requirement by lenders in many loans, and a critical factor considered by ratings agencies, to shield lenders and their collateral from the potentially adverse impact of bankruptcy filings by their borrowers' parents and siblings.

On April 16 and 22, 2009, General Growth Properties, Inc. ("GGP") – a publicly-traded real estate investment trust operating a nationwide network of approximately 200 shopping malls in 44 states filed for Chapter 11. GGP had financed its acquisitions and operations, in part, through conventional property-specific mortgages and conventional mortgage and commercial mortgage-backed securities (CMBS) financing. Ultimately, GGP believed that the Chapter 11 filings for it and almost half of its affiliates were necessary to address an overall capital structure GGP believed had become unmanageable due to the collapse of the credit markets.

On August 11, 2009, the Bankruptcy Court for the Southern District of New York overseeing the GGP Chapter 11 cases denied motions by several property lenders and special servicers to dismiss the Chapter 11 cases of certain SPE subsidiaries of GGP as bad faith filings, or, in one instance, on the ground that the SPE was ineligible to be a Chapter 11 debtor. The Court ruled that the interests of the entire GGP group must be taken into account in determining whether an individual SPE's Chapter 11 filing should be dismissed as a bad faith filing.

On May 14, 2009, the Court entered a final DIP order approving a $400 million DIP financing embodying negotiated terms, including adequate protection, which, from the perspective of the property lenders, substantially improved on the terms initially proposed by the debtors. The DIP financing order was viewed generally by commentators and the real estate financing community as maintaining the integrity of the pre-petition SPE structures, while addressing in a satisfactory manner the practical considerations resulting from the debtors' immediate financing needs. However, several commentators noted that the SPE structures would be tested next through the motions to dismiss.

The motions to dismiss framed their argument on the parties' intention to structure the SPEs in question as "bankruptcy remote" entities to make them more attractive to potential investors, as well as to insulate property-specific borrowers from the obligations of their parents and affiliates. As a result, the movants argued that that they were now being forced to assume the credit risk of the entire GGP group – a risk that they had not bargained for when investing in specific SPEs – and that their borrowers had no present or impending need for Chapter 11 protection, since they still produced sufficient cash flow to service their individual debts.

The *General Growth* August 11 decision did not reach surprising conclusions, especially in the context of the Bankruptcy Court's initial orders on DIP financing, use of cash collateral and consolidated cash management. The Court stressed that its decision focused narrowly on whether or not to dismiss the Chapter 11 cases of certain GGP SPEs as bad faith filings, and did not foreshadow how the Court would rule on other important issues that might yet be raised in the GGP cases, including substantive consolidation and the classification and treatment of the secured, mezzanine and unsecured debt asserted against GGP debtors. Still, lenders to companies structured similarly to GGP – holding companies with intermediate holding companies for property-level SPE subsidiaries – must now consider whether or not the *GGP* decisions represent a developing body of law which may be used as precedent in other cases. Moreover, as the real estate financing markets bottom out and lenders consider re-introducing

This alert is for informational purposes only and is not intended to be legal advice. Transmission is not intended to create and receipt does not establish an attorney-client relationship. Legal advice of any nature should be sought from the legal counsel. For more information about Haynes and Boone and our practice, please visit www.haynesboone.com
©2009 Haynes and Boone, LLP

liquidity, prospective lenders, borrowers and rating agencies will have to consider whether the results of the GGP case raise implications for the future of securitizations premised on the bankruptcy-remote SPE structure.

Perhaps the most significant finding by the *General Growth Properties* court is its analysis of the fiduciary duties owed by the independent directors, officers and managers of solvent SPEs to the SPE lenders, special servicers and equity holders. The Court noted that, in 2007, the Delaware Supreme Court had rejected the notion that directors of a nearly insolvent company, operating in the "zone of insolvency," owed fiduciary duties to creditors, [1] and mandated that directors of a solvent corporation consider only the interests of the shareholders in exercising their fiduciary duties. Noting that the movants did not argue that the SPE debtors in question were insolvent at any time, the Court determined that the fiduciaries of the SPE borrowers properly exercised their duty in considering the interests of the SPEs' equity holders over the property-level creditors. This result flew in the face of lender expectations that the "independent" fiduciaries of the SPE would, in fact, focus on the lenders' interests in determining whether to approve the SPE's bankruptcy filing. As a result, the consideration of the interests of the GGP entities as a whole by the SPE fiduciaries was deemed proper, and their bankruptcy filings were found to be not premature even where the loan maturities for a SPE's debt was years away.

In addition, lenders must now consider whether the *General Growth Properties* decision is evidence of a broader predilection by bankruptcy courts against dismissing as bad faith filings the Chapter 11 case of an SPE in circumstances similar to the GGP cases. The perception that bankruptcy courts will be loathe to dismiss SPE bankruptcy cases filed for the benefit of an entire corporate group may invite companies structured similarly to GGP to pursue their financial restructuring in Chapter 11, regardless of whether their SPE subsidiaries are insolvent.

Accordingly, property-level and CMBS lenders, REMIC securities holders and their master and special servicers must now be alert to the prospects that their borrowers and collateral can be the subject of bankruptcy cases regardless of their individual financial condition. Moreover, the historic and accepted use of SPEs and securitizations for property-specific and CMBS financing has not always succeeded in isolating and protecting the collateral, cash and debt of GGP property-level lenders from the claims of creditors of affiliated entities controlled under the larger GGP corporate umbrella. Lenders should expect that their financing structures will be viewed by courts in the context of a dormant 2009 financing market, rather than the lenders' expectations borne out of the boom years of real estate financing.

For more information concerning this issue, please contact:

Lenard Parkins
212.659.4966
lenard.parkins@haynesboone.com

Michael Foreman
212.659.4976
michael.foreman@haynesboone.com

Trevor Hoffmann
212.659.4993
trevor.hoffmann@haynesboone.com

Stephen Pezanosky
817.347.6601
stephen.pezanosky@haynesboone.com

John Penn
817.347.6610
john.penn@haynesboone.com

Sue Murphy
214.651.5602
sue.murphy@haynesboone.com

Kenric Kattner
713.547.2518
kenric.kattner@haynesboone.com

Sarah Foster
512.867.8412
sarah.foster@haynesboone.com

Eric Terry
210.978.7424
eric.terry@haynesboone.com

[1] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

This alert is for informational purposes only and is not intended to be legal advice. Transmission is not intended to create and receipt does not establish an attorney-client relationship. Legal advice of any nature should be sought from the legal counsel. For more information about Haynes and Boone and our practice, please visit www.haynesboone.com

©2009 Haynes and Boone, LLP