Bankruptcy Court Denies Lenders' Motions to Dismiss SPE Bankruptcies But Says Fundamental Protections of SPE Structure Continue

When General Growth Properties, Inc. (GGP) filed for bankruptcy in April 2009, special purpose subsidiaries (SPEs) holding title to approximately 160 of GGP's mall assets also filed.

Three lenders—Metropolitan Life Insurance Company, a conventional lender, and ING Clarion Capital Loan Services LLC and Helios AMC, LLC, both in their capacity as special servicers for pools of commercial mortgage backed securities—moved to dismiss the bankruptcy cases of certain of the SPE debtors, arguing that the SPEs in question had filed for bankruptcy prematurely, in bad faith, and in violation of their organizational documents.

The bankruptcy court recently denied the lenders' motions, concluding that the bankruptcy filings were properly made. However, the court indicated that the fundamental lender protections of the SPE structure remain in place during the bankruptcy proceedings.

Filings Not Made in Bad Faith

Premature Filing

After reviewing the procedures used by GGP, which included assessment of specific entity-level factors (such as loan maturity date, cross-defaults, and loan-to-value ratios), the current moribund state of the CMBS market, and the expectation that the market will worsen, the court determined that the SPEs were not premature or acting in bad faith in deciding to file for bankruptcy. The court placed significant weight on the detailed and deliberative process undertaken by the managers of the SPEs, including the use of outside experts, and the fact that the entities' obligations to repay the mortgage debt were fixed and not contingent.

Scope of Inquiry

When determining the issue of good faith, the court concluded it was proper for the managers of each SPE to take into account the interests of the GGP group as a whole, rather than focusing solely on the circumstances of each individual SPE.

The court looked to the SPEs' organizational documents, many of which state that the managers of each SPE have fiduciary duties equivalent to the duties of a director of a Delaware corporation. Given that the SPEs (most of which are LLCs) were solvent at the time of their filing, the court concluded that the managers, including the independent managers, had a duty under Delaware law to operate the SPEs in the interests of the equity holders and not just in the interests of the creditors.

The court sided with the GGP debtors in concluding that reorganization of the parent entities would not be appropriate without a contemporaneous reorganization of the SPEs because it would be unclear "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."

Replacement of Independent Managers

While the court acknowledged that the replacement of the independent managers of certain of the SPEs prior to the bankruptcy filing was "surreptitious," the organizational documents of the SPEs only set forth the required number and qualifications for independent managers and did not place any restrictions on GGP's ability to replace the independent managers at any time or from time to time. Since none of the lenders had bargained to receive notice of any change in the identity of the independent managers, they could not complain.

Substantive Consolidation Implications

The court again took pains to state that its decision does not result in substantive consolidation. In the words of the court, "the fundamental protections that the [lenders] negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases. This includes protection against the substantive consolidation of the project-level debtors with any other entities."

Lessons Learned

While caution is needed when extrapolating from rulings made in this extraordinary case, the following four developments seem likely:

- Lenders will be less inclined to lend to subsidiaries of centrally-managed real estate companies and funds on an individual rather than pooled basis without significantly more lender protections, such as hard lock boxes, required amortization, principal guarantees, lower loan-to-value ratios, and financial covenants governing the amount of debt that may be incurred by the entire enterprise.
- Lenders and rating agencies will require that they receive advance notice of changes in the managers of their SPE borrowers and that SPE organizational documents require managers to consider the circumstances of the SPE as a standalone entity and to give preferential weight to the interests of creditors in connection with any decision to file for bankruptcy.
- Bankruptcy filings of bankruptcy-remote special purpose entities may increase as others use GGP as a roadmap to protect equity.
- The Treasury Department will feel increased pressure to revise the tax rules governing REMIC and investment trusts to allow investors, trustees, servicers, and special servicers to work proactively with borrowers without adverse tax consequences.

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