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BANKRUPTCY

A recent ruling in the General Growth Properties bankruptcy case has reverberated throughout the real estate industry, forcing legal and financial experts to question whether practices considered acceptable in the past will remain effective in the future. Here the authors deconstruct the August decision by the United States Bankruptcy Court for the Southern District of New York that the Chapter 11 filings of several GGP special-purpose entities were not made in bad faith. They note that the ruling could have untold long-term implications for the way borrowers and lenders structure the financing of large, complex real estate enterprises.

Implications of the 'Bad Faith Filing' Decision in GGP's Bankruptcy Proceeding

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The bankruptcy proceeding of General Growth Properties Inc. (GGP) and various of its subsidiaries and affiliates has been closely watched thus far because of its far-reaching implications for the commercial real estate industry and for the sources of capital that have sustained it. In one of the most significant decisions in that case to date, Judge Allan L. Gropper of the United States Bankruptcy Court for the Southern District of New York ruled Aug. 11 that the voluntary filings by various solvent GGP subsidiaries (the SPE Debtors) were not made in bad faith, and as a result the moving creditors' motion to dismiss the SPE Debtors' Chapter 11 cases was denied. The decision thus calls into question the structural integrity of prevalent forms of real estate and other asset-based finance.

The moving creditors' argument was based on the fact that the specific SPE Debtors were single-purpose,

bankruptcy-remote entities, each of whose financial viability was subject to ''no imminent threat,'' and that therefore the filing of bankruptcy petitions by those entities was motivated by bad faith and an interest in harvesting the excess cash flow from the solvent SPE Debtors' relatively well-positioned properties to support the broader GGP restructuring effort.

In reaching his conclusion, Gropper focused on a number of factors. Given that a finding of a ''bad faith filing'' necessitates an examination of ''the facts and circumstances of each case'' and of the ''totality of circumstances,'' Gropper set out a detailed recitation of the developments that led to GGP's and the SPE Debtors' filings. Among the factual highlights he relied upon were:

- the unprecedented collapse of the credit markets, and specifically the commercial mortgage-backed securities (CMBS) market, which GGP (along with so many other real estate owners and developers) had relied upon as an essential element of its capital structure;
- the fact that GGP and its various affiliates take a nationwide, integrated approach to the ownership and management of properties, offering centralized leasing, marketing, management, and cash management functions;
- GGP's diligent efforts in attempting to engage with existing lenders to renegotiate the troublesome terms of its debt, and to tap into other capital sources to refinance maturing obligations; and
- that ''the CMBS structure''—which typically grants day-to-day loan servicing and administration authority to a master servicer absent some specific triggering event, and which prohibits these master servicers from modifying underlying loan terms—''caused additional roadblocks to the Company's attempts to refinance its debt or even talk to its lenders.''

Gropper's factual exploration was holistic. He found that the applicable debtor board members, managers, and their advisers could consider the interests of the GGP enterprise as a whole in deciding whether to file the SPE Debtors for bankruptcy. This is in conflict with the understanding, or at least the seemingly faulty underwriting assumptions, of securitization lenders, who, Gropper concluded, wrongly viewed ''bankruptcy-remote'' entities as being ''bankruptcy-proof.'' Although the single-purpose entity (SPE) construct on which the CMBS and other securitized financing structures rely was ''intended to insulate the financial position of each of the [SPE] Debtors from the problems of its affiliates,'' the court found that the creditors in question were no doubt aware of, and in part benefited from the resources made available by, the broader ''corporate family'' of which these SPE Debtors were a part.

As a practical matter, some element of financial distress is presented in most circumstances leading to a bankruptcy filing. In this latest GGP decision, Gropper determined that the SPE Debtors are in fact currently in distress to varying degrees, including due to the risk of a cross-default provision subjecting the SPE Debtors to acceleration of debt upon the occurrence of other GGP entity filings, the existence of hyper-amortization periods, and recent interest rate increases. In what many will view as a ''low bar,'' he also found financial distress in the form of a ''high'' loan-to-value ratio of 70 percent or more, and/or mortgage debt maturity dates that will arise within the next three or four years (especially under the circumstances at hand, where the timing and prospects of a revival of the currently ''dead'' CMBS market are in serious doubt).

Process-Based Review. Apparently just as important as the substantive underpinnings of the decision to file the SPE Debtors, the Court went to great lengths to describe favorably the process undertaken by the directors and management of, and advisers to, GGP in reaching the decisions they did. The court's decision, thus, provides a procedural blueprint for flagging real estate enterprises made up of SPEs who may seek to deleverage and get a fresh start with a more manageable capital structure via the Bankruptcy Code. Particularly helpful for real estate owners and operators under financial stress is footnote 26 of Gropper's opinion, which lays out a 1-factor test applied by GGP in deciding whether to file an entity for bankruptcy.[1]

Gropper also applied a procedure-based analysis in reaching his conclusion that the equities disfavored the moving creditors' position. In contrast to the thoughtful and methodical internal review undertaken by the debtors' directors, management, and advisers, the court portrayed the moving creditors as being excessively unresponsive and paralyzed by ''form over substance'' considerations presented by the existing CMBS servicing and pooling arrangements governing the loans in question.

Independent Managers. Another noteworthy finding of the court in the recent decision relates to one of the fundamental safeguards against bankruptcy risk created by the architects of CMBS financing: the insertion of independent managers, whose consent would be required as a condition to a bankruptcy filing, into CMBS borrower entities' organizational structure. In the case of the SPE Debtors, their independent managers, who were undoubtedly installed at the direction of lenders' counsel to ''create impediments to a bankruptcy filing,'' were replaced in the period leading up to the entities' filings to facilitate reorganization. The court found, however, that this action was not evidence of bad faith, and in fact was the result of a justified desire to have ''seasoned individuals'' with ''known experience in restructuring environments and complex decisions'' replace the prior independent managers. Importantly, the applicable organizational documents did not prohibit or impede any such replacement.

The court also found that these actions were not indicative of a bad faith filing because Delaware corporate law, which was expressly made applicable to the managers by the terms of the entities' operating agreements, provides that ''directors and managers owe their duties to the corporation [or limited liability company] and, *ordinarily*, to the shareholders'' (italics added). Further, the SPE Debtors' Operating Agreements, in describing the role of the independent managers, provided that: ''To the extent *permitted by law*. . .the Inde-

[1] Among the factors included in this test are (1) whether the entity in question is a borrower or guarantor under a loan that is in default and for which there is no forbearance protection, or for which forbearance may be freely revoked by the lender; (2) whether such entity is subject to a cross-default associated with other affiliates' filings; (3) whether a cash trap has been implemented with respect to that entity; (4) whether the entity's debt matures in the ensuing four years; (5) whether the entity's loan-to-value ratio exceeds 70 percent; and (6) whether the entity's assets are necessary for a corporate restructuring.

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pendent Managers shall consider only the interests of the Company, *including its respective creditors*, in acting or otherwise voting on [bankruptcy-related matters]'' (italics added). Ironically, in this case the very fact that the SPE Debtors were clearly solvent at the time that the decision to file for bankruptcy was made seems to have undermined one of the purposes of the independent managers—i.e., to prevent the filing of a solvent entity simply because affiliated entities are suffering financial distress. On this point, the court found that ''Delaware law. . .provides that the directors of a solvent corporation are authorized—indeed, required—to consider the interests of the shareholders in exercising their duties,'' whereas in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court found that directors of an *insolvent* corporation have duties to the corporation's creditors.

Potential Reaction and CMBS Market Impact. While the decision stopped short of ordering the substantive consolidation of the assets and liabilities of the SPE Debtors with the remainder of the GGP enterprise (and in fact the opinion was careful in expressly stating no such result was intended), and emphasized that the creditors are entitled to adequate protection including post-petition interest and fees if they are oversecured, the decision has surely given CMBS lenders, investors, and servicers reason to fear what Gropper described as the ''inconvenience'' of Chapter 11 filings (including partial cash flow interruption), and to wonder what other protections that they previously assumed existed (e.g., non-consolidation protection, and the servicing and governance structures created by standard pooling and servicing arrangements) will be dismantled in this case and other commercial real estate bankruptcies that are sure to follow.

The ramifications of this decision in the marketplace are likely to be widespread and profound. It would not be surprising to see the increased risks associated with CMBS borrowers becoming subject to affiliate-driven bankruptcy proceedings result in material increases in CMBS spreads in the secondary market, as well as in the pricing for any new loans intended for future securitizations—at least in the near term as additional lender protections are devised and tested.

Lenders and their counsel will no doubt seek to craft additional safeguards that will either impair their borrowers' ability to file for bankruptcy, and/or at least give sufficient advance warning of impending filings so as to provide lenders with an opportunity to take protective action. To address the risk of excess cash flow being ''upstreamed'' to parent entities from a thriving SPE borrower, lenders may seek to impose strict cash controls (e.g., cash traps and/or hard lockboxes) throughout the entire term of their loans, rather than relying (as they have until recently) on springing lockboxes that only become effective following a loan default or violation of a debt service coverage or similar test.[2] Along the same lines, lenders may require that excess cash flow be applied to amortize principal and/or be used to fill up various property-specific reserve accounts with higher caps, in an attempt to prevent the leakage of value away from their collateral to service affiliates' needs.

Whether sufficient political will exists to support any action that could be perceived as supportive of sophisticated financial engineering, especially in light of the various crises and reactions thereto over the last year, also remains to be seen.

Lenders may now more frequently require non-recourse carve-out guarantees from parent entities and/or principals with significant net worth. These documents typically provide that the full amount of the indebtedness becomes a full recourse obligation of the guarantor(s) upon a voluntary filing, or collusive involuntary filing, with respect to an SPE borrower. Where these guarantees exist, reason and anecdotal evidence suggest that they may chill a decision to file a borrower. But these guarantees may have little deterrent effect in a situation where, like GGP, a real estate ownership enterprise as a whole, including the parent entity, is facing a crisis. Consequently, lenders may seek to (1) expand the scope of their underwriting process to include a more detailed review of the sponsor/parent entity's financial condition, (2) include ongoing financial reporting obligations with respect to that sponsor/parent entity (in addition to the SPE borrower), and (3) possibly even include financial covenants and tests applicable to the sponsor/parent entity akin to those that have been more typically associated with parent-level corporate credit facility documentation.

Additionally, lenders' counsel may seek to test the scope of Gropper's findings with respect to the independent manager replacement strategy employed by GGP. For instance, lenders may seek to require, by contract, that independent managers consider *only* the interests of creditors. There may be a limit to the effectiveness of the contractual approach in the context of state law regimes that may provide that certain fiduciary duties (e.g., those of a director or manager of a business organization to the organization's equityholders) be imposed as a matter of law and/or be deemed non-waivable.[3] Further, to address some of the specific lan-

[2] Note, however, the fact that an entity is subject to a ''cash trap'' mechanism is one of the factors under the GGP 10-point test (which was tacitly endorsed by the court) that indicates a distressed scenario that may justify a bankruptcy filing.

[3] Note, however, that in 2005, modifications were made to Section 18-1101(c) of the Delaware Limited Liability Company Act which state: ''[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager. . .the member's or manager's or other person's duties may be expanded or restricted *or eliminated* by provisions in the limited liability company agreement. . . .'' (italics added). The extent to which outright elimination of any ''default'' fiduciary duties of an independent manager to equityholders may be an effective market response for future CMBS loan transactions is yet to be seen. Although this change in the law provides little help in those situations where the limited liability company agreement does not expressly eliminate independent managers' fiduciary duties, it theoretically could serve as an important element of future attempts by CMBS

guage on which the SPE Debtors and Gropper relied, lenders may insist that independent managers (either in organizational documents or within the loan documents) only be permitted to be removed with the lender's consent, though many lenders may fear that such a significant intrusion into the internal workings of their borrower entity will open up a Pandora's box of potential lender-liability claims. A more subtle and possibly less risky approach might be to require that independent managers be removed only following the delivery of advance written notice; this would at least provide lenders with fair warning and give them sufficient time to prepare for a filing and/or to redouble workout negotiation efforts. An alternative mechanism might allow the appointment of new independent managers immediately, but provide for some ''overlap'' period where the prior independent managers, who would still retain theoretical veto rights over bankruptcy-related actions, would remain in place. Regardless of what new solutions are concocted by lenders and their counsel to address this issue, courts of equity and, specifically, bankruptcy judges who tend to be sympathetic to the problems facing debtors, may continue to find that these mechanisms cannot be used to thwart efficient reorganizations. For this reason, if there is to be any real assurance with respect to the efficacy of any independent manager structure for asset-based lenders seeking to ring-fence their borrowers from external risk, it may need to come from legislative action taken either by Congress or by state legislatures overriding common law-based fiduciary duty principles.

One lesson that lenders, investors, and servicers may glean from this decision is that courts are likely not to look kindly upon those who are unresponsive in the face of repeated, good faith requests by borrowers to engage in workout discussions. In addition to the normal institutional inertia that can plague lenders and hamper borrowers' workout efforts in a non-CMBS context, the ''roadblocks'' Gropper referred to that are inherent in CMBS structures legally impede servicers' ability to negotiate mutually-beneficial alternatives to bankruptcy, even where all parties see a filing as the least favorable outcome. While the court in this case seemed to speak critically of servicers who hide behind the formalistic arrangements circumscribing their authority to modify loans, servicers understandably have been loathe to take action that flies in the face of their contractual obligations, even in light of exigent circumstances. For these reasons, it is unlikely that, absent governmental intervention,[4] servicers will follow the tacit instructions of Gropper and elevate substance over form, because in doing so they would expose themselves to potential lawsuits brought by CMBS investors under the pooling and servicing documentation. The extent to which governmental intervention is emboldened by this decision, and whether any such intervention will primarily take the form of additional debtor-friendly decisions by judges and/or legislative or regulatory action at the federal or state level, remain to be seen. Whether sufficient political will exists to support any action that could be perceived as supportive of sophisticated financial engineering, especially in light of the various crises and reactions thereto over the last year, also remains to be seen.

One other potential outcome of this decision may be that future debtors may seek to leverage this decision, which sanctions the treatment of a collection of numerous SPE property owners as part of a larger enterprise, to blunt the effectiveness of the single-asset real estate (SARE) rules. The goal of the SARE rules was to prevent debtors' abuse of bankruptcy law simply to frustrate mortgage lenders' ability to recover their collateral in situations where it was quite clear that no equity cushion remained. We expect that real estate owners and operators that file for bankruptcy will rely on the collectivistic approach employed by Gropper in this decision in an attempt to erode SARE creditor protections.

As a result, going forward, lenders may respond by insisting on the inclusion of advance waivers of the automatic stay in their loan documents, though such provisions are likely to be brushed aside by bankruptcy judges when enforcement of that may raise the prospect of overwhelming the debtor before it has had any meaningful opportunity to reorganize. One other possible reaction of lenders may be to impose ''exploding'' interest rates on their borrowers—i.e., an automatic interest rate increase of, for example, 200 to 300 basis points that springs into effect upon a borrower's passage of a resolution authorizing a bankruptcy filing. Any such provisions may be viewed warily by judges, however, and would be vulnerable to attack by debtors' counsel as unenforceable *ipso facto* clauses.

Conclusion. The most lasting significance of Gropper's recent decision may be to focus the real estate finance industry, the real estate, bankruptcy, and securitization bars, elected officials, and regulators on the inherent tension between, on the one hand, the principle of giving debtors, especially those facing unprecedented asset and credit market illiquidity, the benefit of sufficient time, breathing space, and protections to make effective reorganization possible, and on the other hand, the fact that debtor-friendly decisions that override SPE bankruptcy-remoteness protections may become counterproductive by making CMBS lenders, investors, and servicers more skittish, which in turn may make the financing that debtors will need to support their reorganization efforts even more expensive and scarce. Application by the courts of equitable principles and statutory bankruptcy protections, absent some overriding legislative and/or regulatory intervention, may turn out to produce an unintended consequence: the undermining of other efforts the Obama administration, the Federal Reserve Board, Federal Deposit Insurance Corporation, and other governmental actors have initiated—including expanding the Term Asset-Backed Securities Loan Facility (TALF) program

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lenders and investors to deprive the managers of solvent SPE borrowers of the legal basis for initiating a bankruptcy proceeding, especially where the only justification for doing so is the struggles of the borrower's corporate family. Those who put too much faith in such an approach, however, may do so at their own peril, since the ramifications and tenability of the ''duty vacuum'' that would be created by a complete elimination of managers' fiduciary obligations to equity interest holders have not been fully explored. One can only wonder whether excessive tinkering with well-settled fiduciary duties will serve to erode, rather than strengthen, the entities' immunity from enterprise bankruptcy risk.

[4] It is worth noting that any legislative or regulatory action that seeks to sacrifice the sanctity of the contractual protections that investors in existing CMBS bargained for in their pooling and servicing documentation may face serious constitutional challenges under takings or other theories.

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to cover CMBS acquisitions, and creating the Public-Private Investment Program (PPIP)—to address the looming commercial real estate finance crisis. As a result, bankruptcy judges issuing decisions like the one discussed above may soon find their dockets crowded with the Chapter 11 filings of other commercial real estate enterprises. Market observers and participants will no doubt be watching anxiously to see if decisions like Gropper's result in an acceleration of bankruptcy filings by other real estate companies, and/or generate momentum for a broader legislative or regulatory solution for the commercial real estate and CMBS industries' growing problems.