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Lessons From General Growth Properties

Law360, New York (August 28, 2009) -- The bankruptcy of real estate investment trust General Growth Properties Inc. (GGP) warrants attention not only because it is the largest real estate bankruptcy case ever filed, but because of the shadow it cast on the commercial real estate financing world, and in particular the already besieged market for commercial mortgage backed securities (CMBS).

In an Aug. 11, 2009, decision, the bankruptcy court denied several motions to dismiss certain of the debtors' cases, essentially determining that the "bankruptcy remote" nature of their structures does not render them "bankruptcy proof."

Lenders and investors would be wise to monitor the progress of the case, which could fundamentally alter real estate finance in both the short and long term.

GGP and the CMBS Market

Beginning on April 16, 2009, GGP and nearly 400 of its affiliates (together with GGP, the debtors) filed petitions under Chapter 11 of the Bankruptcy Code.

Notably, many of the debtors are single purpose entities (SPEs) that exist only for the purpose of owning and operating the individual properties that comprise GGP's real estate portfolio.

Like most SPEs, each of the GGP entities owns just a single property or project and conducts no business other than that of operating (and in some cases managing) the property that it owns.

Lenders extend financing to SPEs on a nonrecourse basis in reliance on the property serving as collateral being beyond the claims of other creditors and "bankruptcy remote" in relation to an SPE's affiliates, with which the SPE has no connection but for common ownership.

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In other words, SPEs are designed to ensure “asset isolation,” i.e., to insulate lenders and other parties transacting business with the SPE from the risk that their collateral might be subject to the obligations of the SPE’s affiliates.

The significance of the SPE to the growth of the commercial real estate financing market in the U.S. over the last three decades has been enormous.

Its evolution as a financing vehicle facilitated the creation of the CMBS market, which greatly expanded the amount of capital available for real estate investment by making it easier for smaller investors to participate in the market.

SPEs were attractive to property owners and acquirers because they made it easier for lenders to extend financing without requiring the owners/borrowers to pledge their personal assets as collateral.

Lenders, in turn, could diffuse their risk by bundling loans and selling them as securities in public or private markets, where investors were more willing to allocate capital to the securitized loans because, in significant part, of the “asset isolation” features of the SPE.

In 2007, approximately 40 percent of the commercial and multifamily real estate lending market in the U.S. — roughly $230 billion — was attributable to CMBS issuance. To many observers, the “asset isolation” provided by the SPE structure is a primary foundation for the entire CMBS market.

The Bankruptcy Case

The commercial real estate and CMBS markets have closely watched the GGP bankruptcy filing. The specific manner in which GGP used the SPEs to its advantage in the case generated a firestorm of opposition, primarily from lenders to the SPEs.

In the early days of the case, the debtors sought authority to use the cash collateral encumbered by their pre-existing lenders and to obtain $375 million in debtor-in-possession financing (the DIP financing) from a new set of lenders (the DIP lenders).

Approximately $215 million of the proposed new money would be used to refinance a credit facility the debtors had obtained from Goldman Sachs in 2008, with the remainder of the funds supporting ongoing operations.

The inclusion of so many SPE’s in GGP’s bankruptcy filing generally undermines the “asset isolation” that the SPEs are counted on to supply, as the bankruptcy links the SPEs’ assets and liabilities to those of GGP and the other non-SPE debtors, even if only for procedural purposes.

Prior to the bankruptcy case, most, if not all of the SPEs were current on their credit facilities and, allegedly, were financially and operationally sound. It might seem to some

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that many of the SPEs have no need to reorganize and therefore no business being in Chapter 11.

With that in mind, three parties — ING Clarion Capital Loan Services LLC (ING), Helios AMC LLC (Helios) and Metropolitan Insurance Company and KBC Bank NV (together, MetLife), each a lender to one or more SPEs or servicer to lenders to SPEs — filed motions to dismiss the cases of certain SPE borrowers, arguing that the bankruptcy case benefits only the parent entities, at the expense of the property-owning SPEs and their lenders.

The DIP Financing

The DIP financing included a request to use the properties owned by the SPE debtors as collateral for the loans being made to their ultimate parent, even though the SPE Debtors were in compliance with their respective loan documents and would not be borrowers under the new credit facility.

The terms of the DIP financing also would require SPEs to guarantee the new debt under certain circumstances, also apparently in violation of their own prepetition loan documents.

The DIP Financing drew more than 20 objections, as well as the attention of many industry groups that filed a “friend of the court” brief that explained the harmful (in their view) implications of including the SPEs in the bankruptcy.

The overriding theme of the objections was that GGP was treating the SPEs as if they (and their assets) were part of one consolidated entity, in direct contravention not only of bankruptcy law and the specific financing agreements to which the SPEs are party, but also of the bedrock principle on which the CMBS market (and by extension the commercial real estate finance market) is based — asset isolation.

Prolonged negotiations between the debtors, the DIP lenders and objecting parties produced not only amended DIP financing documents, but an entirely new group of DIP lenders willing to provide more favorable terms and an additional $25 million in availability to the

debtors.

In addition to better pricing and the elimination of certain warrants that were to be given to the DIP lenders, the properties owned by the debtor SPEs were no longer being pledged as collateral to secure the new debt.

Prepetition secured lenders also were granted a first lien on GGP’s primary bank account as adequate protection of their security interests in their SPEs’ cash collateral, addressing, at least in part, lenders’ concerns that cash belonging to SPEs was being diverted to their ultimate parent GGP in violation of the SPEs’ loan documents.

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Notwithstanding those material concessions, however, the principal tenet of the lenders' objections — that the DIP financing and the inclusion of the SPEs in the bankruptcy filing impermissibly deprived the lenders of the benefits for which they had bargained (i.e., exclusive rights to the SPE properties as security for their loans) — remained in dispute.

On May 14, 2009, the bankruptcy court sided with GGP and approved the DIP financing over all remaining objections.

The Motions to Dismiss

Within the first few weeks of the case, various parties indicated their intention to seek the dismissal of one or more of the SPE debtors.

Accordingly, the bankruptcy court set May 29, 2009, as the deadline to file motions to dismiss. ING and Helios, which hold CMBS debt, and MetLife, which holds traditional mortgage debt, filed motions seeking the dismissal of certain of the SPEs.

On Aug. 11, 2009, the bankruptcy court denied the motions to dismiss. In a detailed 47-page opinion, Judge Gropper considered and then rejected each of the arguments advanced by ING, Helios and MetLife (collectively, the movants).

Among other things, the bankruptcy court rejected the argument that the SPEs had filed in bad faith, which (according to the movants) was shown because the SPEs had filed prematurely when they were not yet in financial distress; the SPEs had failed to negotiate with the Movants prior to commencing their bankruptcy cases; and, in the case of those SPEs to which MetLife had loaned money, they would not be able to confirm a plan of reorganization over MetLife's objection.

Of particular importance to those who lend to or invest in SPEs, however, is the bankruptcy court's finding that it was appropriate for the SPEs to consider not just their own respective balance sheets, but also the financial situation of the corporate group when considering bankruptcy.

While recognizing that there was "no question that the SPE structure was intended to insulate the financial position of each of the [SPEs] from the problems of its affiliates, and ... to make each [SPE] 'bankruptcy remote,'" the court also noted that the Movants "do not contend that they were unaware that they were extending credit to a company that was part of a much larger group."

Indeed, in a pleading filed by the debtors in connection with their [successful] efforts to extend exclusivity, the debtors accused certain of their lenders of ignoring, among other things, the "overwhelming evidence of the integrated nature of the debtors' operations" and asserted that "the debtors' properties are interrelated and integrated."

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Indeed, the bankruptcy court suggested that it was not only reasonable for the SPEs to consider the needs of their corporate parent in determining to file, but it may even have been required under Delaware corporate law.

While the operating agreements of the SPEs apparently were drafted in a manner so as to limit their managers' duties in considering a bankruptcy filing and to make a filing less likely, the managers' duties nonetheless are controlled by the corporate law of Delaware.

It is well-settled that the directors of a solvent corporate entity — and the movants certainly emphasized in their pleadings the solvency of the SPEs — owe their fiduciary duties to shareholders.

Therefore, in considering the needs of the corporate group rather than focusing solely on the interests of the SPEs' secured creditors, the SPEs' managers acted appropriately and in accordance with Delaware law.

The movants found little sympathy for their positions from the bankruptcy court, which noted, somewhat dismissively, that "movants have been inconvenienced by the Chapter 11 filings."

That the movants did not expect the SPEs to file for bankruptcy was not deemed to be sufficient grounds for dismissing the cases.

Noting that "secured creditors' access to their collateral may be delayed by a filing, but secured creditors have a panoply of rights," the court concluded that "the fundamental protections that the movants negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases." Lenders to individual SPEs may beg to differ.

Conclusion

Although they have not yet been at issue in the GGP bankruptcy, lenders to SPEs often include "bad boy carve-outs" in their loan documents and should consider whether such provisions will mitigate some of the risks brought to light in the GGP case.

A bad boy guaranty is a loan agreement provision that allows the lender to pursue a guarantor or provides that the loan becomes recourse to the borrower upon the occurrence of certain "bad" acts by the borrower, such as failure to make a scheduled payment or filing for bankruptcy.

Bad boy carve-outs, which have been upheld by courts in the non-bankruptcy context, perhaps can alleviate some of the risk faced by nonrecourse lenders to SPEs that elect to file for bankruptcy with their corporate parent and affiliates.

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Is the GGP bankruptcy an isolated case driven by a historically depressed economy and the unique needs of a sprawling real estate enterprise such as GGP?

Or does the case represent a crack in the foundations of the SPEs that underlie much of the commercial real estate financing market?

If other courts are as ready to endorse similar strategies as the GGP court was, the viability of the SPE as a vehicle for financing real estate is likely to diminish significantly.

Whether that results in or contributes to a material long-term contraction of the real estate financing market, or simply leads to the evolution of alternate structures to fill the void, it is clear that lenders and investors should watch closely and adapt their behavior to any heightened risk.

--By Douglas R. Gooding (pictured) and John F. Ventola, Choate Hall & Stewart LLP

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