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Real Estate/Bankruptcy and Creditors' Rights

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The GGP Case—What It Means for Lenders

On April 16, General Growth Properties, Inc. and certain of its affiliates ("GGP") filed for Chapter 11 bankruptcy in the United States Bankruptcy Court for the Southern District of New York. GGP operates a national network of approximately 200 shopping centers. To the surprise of many, most of GGP's property-specific SPE subsidiaries ("SPE Debtors") also filed for bankruptcy.

On April 17, Judge Allen Gropper consolidated the Chapter 11 cases for procedural purposes only. Subsequently, GGP filed motions seeking authorization to continue using an existing centralized cash management system to use cash flow from its shopping centers, including those owned by the SPE Debtors, and to obtain debtor-in-possession ("DIP") financing.

Several of the SPE Debtors' mortgage lenders ("SPE Lenders") filed objections to GGP's motions and filed motions to dismiss the bankruptcies of their SPE Debtors on the grounds that such entities are solvent, adequately capitalized and have sufficient cash flow to pay their current obligations, including debt service. Some SPE Lenders also raised concerns about the legal separateness of the SPE Debtors, and the impact that their inclusion in GGP's bankruptcy case might have on the future of structured finance transactions.

On May 14, Judge Gropper entered an order granting GGP's motions to use net cash flow generated from properties encumbered by secured debt, and approved a $400 million DIP loan from a group of lenders. In granting the motions, Judge Gropper stated that those measures were "necessary to prevent substantial harm to the Debtors' estates that would otherwise result if the Debtors fail to obtain the [DIP] financing contemplated herein to preserve the Debtors' assets and continue their operations." However, Judge Gropper also ordered that the SPE Lenders were entitled to adequate protection of their interests in their respective prepetition collateral. Judge Gropper specifically ordered, among other things, that to the extent of the diminution in value of their prepetition collateral (as determined by the court), the SPE Lenders are entitled to postpetition perfected first priority liens on funds in GGP's main operating account and intercompany claims among the Debtors based upon the property-specific net cash that flows into the Debtors' centralized cash management system.

Judge Gropper's ruling has been positively received by the CMBS community, and has been viewed as affirming the sanctity of single purpose entities. The GGP case is not over, and several questions remain unanswered, but following are some thoughts and observations to keep in mind:

The issue of whether the SPE Debtors could or should be substantively consolidated was not before the court. The various filings were procedurally consolidated only. The value of

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the non-consolidation opinions that populate the loan closing binders in countless real estate finance transactions has not been called into question.

All of the "bells and whistles" that real estate lenders and their counsel have been requiring to ensure bankruptcy remoteness remain effective deterrents against the risks that they were designed to mitigate. That is, those bells and whistles are intended to prevent a solvent parent entity from causing its insolvent SPE to file for bankruptcy protection as a defensive maneuver to stave off a foreclosure. Specifically, the threat of personal recourse to a solvent parent entity being triggered by the voluntary or collusive bankruptcy filing at the SPE level should continue to be an effective deterrent. And the independent directors of an insolvent SPE owe a fiduciary duty to the creditors of the SPE, chiefly its mortgage lender, and the downside of breaching those fiduciary duties is significant. The GGP case turned the assumed fact pattern on its head—here a financially troubled parent dragged many solvent SPEs into bankruptcy. The recourse trigger against a parent that already is a debtor in a bankruptcy proceeding has absolutely no deterrent value, and the independent directors of the solvent SPE have a fiduciary duty to the equity holders, which in this case would be an insolvent GGP entity that would benefit from the inclusion of the SPEs in the bankruptcy case.

The reality is that real estate lenders, while relying in the abstract on the separateness and bankruptcy remoteness of property-level SPEs, did not use—and likely could not have used—structure to mitigate the risks that have been highlighted in the GGP case. In short, proper structuring can make the borrower entities bankruptcy "remote," but not bankruptcy "proof." While the risks highlighted in the GGP case are more pronounced when the borrower is an SPE subsidiary of a REIT or other large, corporate owner of real estate, lenders undoubtedly will continue to make loans to such SPEs, but with some additional mitigating measures.

Clearly, the creditworthiness of the ultimate parent will be much more relevant and will require more underwriting due diligence. Excessive leverage at the parent level, especially when the parent level income is tied almost exclusively to the performance of a narrow sector of the real estate market, might render the parent susceptible in the event of a significant economic downturn. Increased focus on this risk eventually may impact the pricing of the subsidiary's debt.

In the case of a REIT or large corporate sponsor, a related factor to consider will be the timing of mortgage debt maturities in its portfolio of property specific SPEs. GGP often utilized five-year debt, and its portfolio had maturity concentrations. One way to mitigate that risk is to employ the "hyper-amortization" loan structure, in which the loan has an anticipated repayment date of five to 10 years after the initial closing, but does not technically mature for some greatly extended period. This structure allows the borrower to avoid a maturity default, but provides that excess cash flow after the anticipated repayment date be swept to the lender and used to repay outstanding principal. The hyper-amortization structure is not perfect (and the cash sweep feature after the anticipated repayment date presents other potential issues), but may become more common in the wake of the GGP case.

Property-level cash management, which often was waived or structured as "springing" in the case of institutional sponsors, will likely become more prevalent. One of the issues in the GGP case was the fact that property-level cash flows were commingled in a parent-level operating account, which facilitated the argument that the DIP lenders should be granted a first priority lien on those cash flows. Segregation of property-level cash flow through the use of lender controlled accounts, with only excess cash flowing to the commingled operating account, likely will become common.

Many of the SPE Lenders were REMIC trusts ("CMBS Lenders"). One criticism that GGP had of the CMBS Lenders was that they could not get any response to their request for relief with respect to looming maturities for which refinancing was not available. Whether or not those suggestions were accurate, they highlight a difficult issue that CMBS Lenders will face when dealing with parent-level financial stress. When a particular SPE owns a property that is performing well, under a Pooling and Servicing Agreement, a master servicer will have no authority to modify the loan, or to transfer the asset to the special servicer. Since the loan must be in default (or imminent default) for the special servicer to have any significant latitude in modifying the loan or otherwise addressing the parent-level stress, the current CMBS structure will be an impediment even if the servicer is sympathetic. One possible patch might be to include parent-level financial covenants so that parent-level financial stress can be an express event of default, which would allow the special servicer to engage the borrower prior to a parent bankruptcy filing.

In the next chapter in this evolving story, on June 17, 2009, Judge Gropper will hear the motions of the various SPE Lenders to dismiss the bankruptcy cases of the SPE Debtors for cause as bad faith filings. The arguments in support of those motions fall into two general categories. The first category of arguments suggest that there was no financial justification for the bankruptcy filings, and that the filings result in no benefit and only burdens to the SPE Debtors. The second category turns on the authority for the bankruptcy filings under the organizational documents of the SPE Debtors and applicable state law, the propriety of actions taken on the eve of bankruptcy to replace independent managers of the SPE Debtors, and the failure to adhere to the other governance and contractual documents of the SPE Debtors. There is case law addressing motions to dismiss related to both categories, and it is clear that the courts have required rather egregious conduct to support a bad faith filing determination. Here, if Judge Gropper were to find that the bankruptcy filings of the SPE Debtors were made without requisite authority under the organizational and governance documents and applicable state law, the court could determine the motions to dismiss without addressing the allegations of bad faith.

The shockwaves have subsided, but the GGP case is providing a formidable test to many things the lenders, especially lenders involved in the securitization market, hold sacrosanct. The damage so far has been minimal, but the case has exposed some chinks in the armor that will need to be considered when real estate lending resumes.