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KIRKLAND ALERT

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Recent Bankruptcy Court Decision Reconciles Central Tenets of Commercial Real Estate Financing and Bankruptcy Law

Introduction

The past two decades witnessed an evolution in commercial real estate financing. During the 1980s, banks, thrifts, and specialty finance companies lent funds to real estate companies primarily on a recourse basis. That practice gradually gave way to the origination and warehousing of non-recourse loans in anticipation of their subsequent inclusion in commercial mortgage-backed securities or "CMBS" transactions. In a CMBS transaction, funding is provided by the capital markets. A typical CMBS structure involves the issuance of securities backed by the cash flows of multiple underlying mortgage loans made in favor of unrelated—and usually single-asset—real estate entities (each, an "Underlying Borrower"). The Underlying Borrowers use the funding for, among other things, the acquisition or development of particular properties, refinancing existing debt, or general corporate purposes. The CMBS market grew rapidly, accounting for $229 billion in issuances during 2007, versus approximately $52 billion in issuances in 2002.

Once a pool of loans is originated and earmarked for a CMBS transaction, the lenders sell those loans to a trust (the "CMBS Issuer") that sells securities to investors in the CMBS offering. The Underlying Borrowers' debt service payments to the CMBS Issuer are, in turn, distributed by the CMBS Issuer to the CMBS investors. The CMBS Issuers generally qualify for tax purposes as real estate mortgage investment conduits or REMICs to take advantage of favorable tax treatments.

The CMBS Issuer and the Underlying Borrowers in a CMBS transaction are typically structured as special purpose entities or "SPEs" that are designed to be "bankruptcy remote." The governing documents of the SPEs incorporate certain structuring attributes intended to minimize the likelihood that the SPE will become a debtor in bankruptcy. For example, organizational documents or operating agreements generally prohibit the SPE from incurring additional indebtedness or liens and place limitations on non-ordinary course transactions. The organizational documents and operating agreements also require that each SPE have one or more independent directors (or managers in the case of a limited liability company) who must unanimously approve a bankruptcy filing. Generally, these documents contain provisions to the effect that "to the extent permitted by law, the independent directors [or managers] shall consider only the interests of the company, including its respective creditors, in acting or otherwise voting on whether to approve a bankruptcy filing."

Until now, the "bankruptcy remote" attributes of CMBS borrowers have remained largely untested. However, the bankruptcy court overseeing the chapter 11 cases of General Growth Properties, Inc. and certain affiliated entities last week issued a 47-page opinion squarely addressing the ability of nominally "bankruptcy remote" CMBS borrowers and other SPEs to obtain bankruptcy relief.

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General Growth Properties, Inc.

On April 16, 2009, General Growth Properties, Inc., one of the nation's largest real estate investment companies, and nearly 400 affiliated entities (as applicable, "GGP") filed chapter 11 cases in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). GGP's primary business is the ownership and management of over 200 shopping centers (including shopping malls, strip malls, and festival marketplaces) in 44 states, including joint venture interests in approximately 50 properties, and non-controlling interests in a handful of other joint ventures.

One of the primary drivers resulting in GGP's bankruptcy filing was the looming maturity of approximately $9.9 billion in CMBS-related debt by 2012. The CMBS market suffered a serious contraction during 2008, with issuances plummeting by nearly 97% from approximately $229 billion in 2007 to approximately $7 billion in 2008.

When investor confidence in the debt markets waned, underwriters stopped issuing and lenders stopped financing commercial real estate—even loans backed by stable, income producing properties such as those owned by GGP. The collapse of the real estate financing market prevented GGP from refinancing its maturing debt in the marketplace.

Structural aspects unique to CMBS also impeded GGP's extensive efforts to renegotiate the terms of CMBS-related debt outside of bankruptcy. In a CMBS transaction, the REMIC is managed by a variety of professionals, including a "master servicer" and a "special servicer." The master servicer handles most day-to-day loan administration functions and has the duty to service loans that are not in default or distress. The special servicer holds authority to modify significant loan terms (such as maturity or interest), but only after responsibility for the loan is transferred from the master servicer to the special servicer. Transfer of this authority, however, occurs only in limited circumstances, such as the borrower's failure to make a balloon payment upon maturity. Hence, the special servicer will have authority to modify significant loan provisions only where an event of default has already occurred or is likely to occur within the very near term.

The Motions to Dismiss

Notwithstanding the evaporation of the credit markets, GGP's bankruptcy filings were reported to be unexpected.[1] Many of GGP's project-level secured lenders believed that filing an SPE for bankruptcy was impossible.[2] Indeed, about one month into GGP's chapter 11 cases, several of GGP's project lenders and servicers moved to dismiss the chapter 11 cases of certain GGP subsidiaries. In particular, the movants argued that: (1) the Bankruptcy Court should adopt a doctrine of "prematurity" and dismiss the SPE cases for bad faith because the SPEs had sufficient cash flow to service their debt obligations and their only debts did not mature for one to three years from the date of the bankruptcy filing and (2) the SPEs' managers did not have authority to file the chapter 11 cases in the first instance.[3] CMBS servicers characterized the matter as "the most important decision on the doctrine of good faith since the 1978 [C]ode."[4]

GGP objected to these motions to dismiss. GGP argued that, among other things, the relevant bankruptcy filings were reasonable, prudent, and advisable decisions undertaken to safeguard and preserve the long-term value of each relevant entity, including with respect to GGP as an equityholder in the relevant entities. The parties took discovery, and the Bankruptcy Court conducted a two-day trial on the merits of the parties' arguments.

The Bankruptcy Court's Opinion

On August 11, 2009, the Bankruptcy Court denied each of the motions to dismiss.[5] The Bankruptcy Court rejected the position that the SPE filings were premature. Specifically, the Bankruptcy Court found that, although the SPEs were able to meet their current debt service obligations, the "disarray in the financial market made it uncertain whether they would be able to refinance debt years in the future" given that the CMBS market "was 'dead' as of the Petition Date, and that no one knows when or if that market will revive."[6] Moreover, the Bankruptcy Court highlighted that the independent managers only reached the decision to file the SPEs for bankruptcy after participating in a detailed board process that included obtaining an overview of the SPEs' financial situation and the advice and recommendations of the SPEs' financial and legal advisors. Thus, the Bankruptcy Court declined to impose an "arbitrary rule … that a debtor is not in financial distress and cannot file a Chapter 11 petition if its principal debt is not due within one, two or three years."[7]

Very importantly, the Bankruptcy Court rejected the argument that the SPEs' independent managers should not have considered the interests of the GGP group, taken as a whole, when determining whether to approve a bankruptcy filing. Each of the SPEs' operating agreements contained language providing that: "to the extent permitted by law, the Independent Managers shall consider only the interests of the Company, including its respective creditors" when acting or otherwise voting on a bankruptcy proceeding.[8] However, it was undisputed that the SPEs were solvent when they filed for bankruptcy.[9] Thus, the operating agreements did not alter the general rule under well-settled Delaware law that independent managers were entitled (if not required) to consider the interests of equityholders when electing to file for bankruptcy.[10] The Bankruptcy Court noted that "a judgment on an issue as sensitive and fact-specific as whether to file a Chapter 11 petition can be based in good faith on consideration of the interests of the group as well as the interests of the individual debtor."[11] Moreover, the Bankruptcy Court observed that "if the [lenders] believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing . . . they were mistaken."[12]

The Bankruptcy Court also denied contentions that GGP acted in bad faith by (1) failing to negotiate with the relevant lenders prior to filing for bankruptcy and (2) replacing previously-appointed independent managers with two new managers who ultimately approved the bankruptcy filings. First, the Bankruptcy Court determined that GGP was under no obligation to engage in any such prepetition negotiations and that the structural limitations unique to CMBS debt (discussed above) would have rendered such negotiations futile in any event.[13] Second, the Bankruptcy Court found that GGP had demonstrated that the process of removing and replacing incumbent managers was entirely consistent with its operating agreements and that the new independent managers were in fact independent.[14]

Potential Impact on SPE-Structured Companies and Their Lenders

The Bankruptcy Court's decision will have implications for SPE-structured companies and lenders to such companies. Importantly, the Bankruptcy Court's decision affirms that the SPE structure, on its own, will not prevent a nominally "bankruptcy remote" entity from obtaining bankruptcy relief. While the SPE structure is designed to make a bankruptcy filing less likely, it does not and, as a matter of public policy, cannot prevent a bankruptcy filing altogether.

Moreover, the Bankruptcy Court's decision provides guidance as to whose interests the directors or managers of solvent SPEs may consider in determining whether to approve a bankruptcy filing. Not only are the directors or managers of SPEs permitted to consider the financial health of the borrowing group as a whole, but, under certain circumstances, may be duty-bound to consider the interests of the SPEs' equityholders as well.

Finally, the Bankruptcy Court's decision highlights the importance of the board process for directors and managers of SPEs—indeed, all companies—when determining whether to file a company for bankruptcy. Simply put, directors and managers should follow the most thorough process that is appropriate under the circumstances. Directors' and managers' actions will be viewed with the benefit of 20/20 hindsight and, quite possibly, in the context of litigation.

Kirkland & Ellis LLP represents certain of the GGP entities in their chapter 11 cases and served as trial counsel for the SPEs in the motions to dismiss.

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1 Kris Hudson and Linglin Wei, WALL ST. J., *Move by General Growth Rattles Malls' Investors*, May 8, 2009, at B1.

2 *Id.*

3 After conducting discovery on the SPEs' process for obtaining authority to file bankruptcy, one of the lenders withdrew its motion to dismiss with prejudice.

4 Hrg. Tr. June 17, 2009, at 17:1–6, *In re Gen. Growth Props., Inc.*, 09-11977 (ALG).

5 *See In re Gen. Growth Props., Inc.*, 09-11977 (ALG), —B.R.—, 2009 WL 2448423 (Bankr. S.D.N.Y. Aug. 11, 2009). Copies of the Bankruptcy Court's opinion, the motions to dismiss, and related papers may be obtained for a fee via PACER, available at http://www.nysb.uscourts.gov, and free of charge at www.kccllc.net/generalgrowth.

6 *Id.* at *12.

7 *Id.*

8 *Id.* at *15.

9 *See id.*

10 *See id.* (citing *N. Am. Catholic Educational Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)).

11 *Id.* at *14.

12 *Id.* at *16.

13 *See id.* at *17–*18.

14 *See id.* at *18–*20.

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