



## Restructuring and Insolvency Practice

August 2009

### Bankruptcy Court Allows General Growth's SPEs to Continue Their Bankruptcy Cases

The Chapter 11 case of General Growth Properties, Inc. ("GGP") and its affiliates pending in the U.S. Bankruptcy Court for the Southern District of New York has been closely watched by mortgage lenders and investors in commercial-mortgage backed securities ("CMBS"). GGP filed bankruptcy petitions for itself and numerous entities, including 166 individual special purpose entities ("SPE") intended upon formation to be "bankruptcy remote" – *i.e.*, insulated from the risk of a potential bankruptcy filing of their corporate parents and affiliates.

Five secured lenders ("Lenders") to certain of the SPEs filed motions to dismiss their respective Chapter 11 cases in May 2009. On August 11, 2009, in an eagerly anticipated ruling, the Bankruptcy Court denied each motion to dismiss, a victory for GGP and its reorganization efforts and a blow to the Lenders, who argued that the SPEs they financed should not be included in GGP's broad corporate restructuring.

The Lenders asserted that the SPEs' bankruptcy filings should be dismissed as bad faith filings, a doctrine under which a Chapter 11 case may be dismissed where, as articulated in the Second Circuit, there is no reasonable likelihood of an intent to reorganize the filing entity and no reasonable probability that the debtor will emerge from bankruptcy. The Court noted that in order to succeed, the Lenders were required to show both the objective futility of the reorganization process and subjective bad faith of the debtors in filing the petition.

Recognizing the difficulty of arguing that reorganization was unlikely, certain of the Lenders disavowed the established Second Circuit standards and instead asserted that the SPEs' bankruptcy cases, viewed individually, were premature and on that basis alone should be viewed as bad faith filings. The Lenders' "premature filing" argument took two forms. First, the Lenders argued the SPEs filed prematurely because many were solvent and did not have to refinance for at least one, two or three years. Second, they argued that because GGP used a bankruptcy remote corporate structure, the individual SPEs and the Court should take into account only each individual SPE's financial circumstances and ignore the financial condition of the corporate whole.

The Court rejected these arguments, finding that the Lenders failed to establish the SPEs and GGP acted unreasonably when deciding to file their cases. The Court noted that the Bankruptcy Code does not require a debtor to be insolvent prior to filing, and the Court declined to accept a rule that Chapter 11 is not available to a debtor whose principal debt is not due for a year or more. The Court noted that, in a collapsing real estate market, the health of each SPE would inevitably impact the group, particularly in the case of GGP, where pre-petition cash flow from the SPEs serviced unsecured debt of the parent, none of which was easily refinanced in the present credit market. Further, the Court suggested that the SPEs were required to take the interests of GGP into account.

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Many of the SPEs were organized under Delaware law and their charters required their managers to act in accordance with the fiduciary duties of Delaware corporate law, relying on recent Delaware case law requiring a board to consider the interests of shareholders of a solvent debtor – in this case, GGP or another parent level affiliate – in exercising its fiduciary duties, even if the relevant entities were in the “zone of insolvency.”<sup>1</sup>

One of the Lenders attempted to establish objective futility by asserting that GGP could not confirm a plan in each relevant SPE bankruptcy case over its objection (implying that the Lender would oppose any such plan). The Court summarily rejected this argument, holding that the Bankruptcy Code does not require proof that a plan is confirmable at filing. The Court noted that parties which disagree, and litigate, at the outset of a case regularly reach settlement later.

The Court proceeded to analyze whether GGP exercised subjective bad faith in each SPE’s bankruptcy filing. The Court found the Lender’s first argument in this regard – that GGP failed to negotiate with the Lenders prior to filing bankruptcy petitions – was without merit, noting that GGP made many attempts to negotiate but was rebuffed at every stage. Many CMBS loans are managed by a “master servicer” until default, when they are transferred to a “special servicer.” Crucially, master servicers lack the authority to alter any material mortgage terms. Special servicers can restructure loans but only in accordance with the CMBS documents, which often require the consent of holders of CMBS securities. GGP, anticipating future defaults, reached out to its master servicers early in 2009, hoping to restructure its debt. GGP was told it could communicate with the special servicers only after service was transferred, and transfer could occur only at a time much closer to maturity or after default. When GGP attempted to contact its special servicers directly, it was referred back to its master servicers. Mired in this “catch 22,” GGP tried to get everyone in a room by inviting the master and special servicers to a “servicers’ summit” in February 2009 but cancelled it when only one servicer agreed to attend.

The Lenders also claimed that bad faith was evidenced by the discharge of the original independent managers of several of the SPEs. The SPEs’ charter documents permitted the independent managers to be supplied by a “nationally recognized company that provides independent directors, managers and trustees.” The original independent managers were employees of Corporation Service Company, but lacked relevant business experience and apparently served as managers in a ministerial capacity. GGP replaced them with experienced restructuring professionals as it prepared for bankruptcy, and no evidence was offered that these replacements did not qualify as independent managers under the relevant charter documents. Citing the legal duty under Delaware law to act in the best interests of each SPE’s shareholders if the debtor is solvent and with no legal bar to a change in the independent managers, the Court found no subjective bad faith in GGP’s replacement of the managers.

In denying the motions to dismiss, the court expressly confirmed that its decision did not call into question the integrity of the GGP entity structure or implicate substantive consolidation concerns, the avoidance of which is a primary goal of SPE structures. The Court viewed the Lenders’ motions as a diversion from the parties’ true task: to ensure that the SPEs emerge from bankruptcy as soon as possible. The Bankruptcy Court decreed that “[t]he [Lenders] assert talks with them should have begun earlier. It is time that negotiations commence in earnest.”

In summary, the Court concluded that the SPEs’ bankruptcy filings were a good faith effort to preserve value for GGP’s creditors and estates as a whole, and found, among other things, that (i) insolvency is not a prerequisite to filing a case, (ii) the independent managers were replaced in accordance with each SPE’s governing documents, (iii) the managers of solvent SPEs had a fiduciary duty under Delaware law to their corporate parents and shareholders, notwithstanding the SPEs may have been in the zone of insolvency, (iv) a Chapter 11 filing is not objectively futile because at the outset of the case a key constituent says it will oppose any plan of reorganization, and (v) under the circumstances of these cases, each of the SPE debtors could take into account the financial condition of related entities in determining to file their cases.

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<sup>1</sup> See *North American Catholic Education Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 at 101 (Del. 2007)

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