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GGP Bankruptcy: Bankruptcy Remote Does Not Mean Bankruptcy Proof

Joseph V. Gatti
joseph.gatti@akerman.com

In an opinion dated August 11, 2009, Judge Allan Gropper rejected the motions of various creditors to dismiss as bad faith filings several properties from the consolidated bankruptcy case of General Growth Properties, Inc. Judge Gropper stated that the fundamental protections that the creditors previously negotiated, including adequate protection of the lenders' interest in the collateral and the non-consolidation of the special purpose property level debtors with any other entities will remain in place. As a result of the decision and other recent developments in the GGP bankruptcy case, it now appears that the second largest mall owner in the country and its lenders will be able to begin to work out the debt refinancing issues underlying the bankruptcy filing.

Summary of the Case

On April 16, 2009, General Growth Properties, Inc. ("GGP") and many of its affiliates filed for bankruptcy under Chapter 11 in the United States Bankruptcy Court for the Southern District of New York. GGP operates a nationwide network of shopping centers and sought bankruptcy protection after the credit crunch closed off its ability to obtain financing for the hundreds of millions of dollars of loans that have reached or are soon to be reaching maturity. The bankruptcy included the filing of 166 "bankruptcy-remote" special purpose entities, which were each formed to own and operate a single shopping mall. The inclusion of these bankruptcy remote entities, many of which were in no apparent financial difficulty as of the date of the bankruptcy filing, has roiled the commercial mortgage credit markets and is being closely watched by real estate investors and borrowers.

Commercial real estate loans that are intended to be securitized are made based on the value of a specific property or group of properties and the cash flows that they

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generate. As a result, lenders rely on the notion that these special purpose entity borrowers will remain isolated from the credit condition and potential bankruptcy of their parent and affiliated entities. This bankruptcy remoteness is achieved by structuring several safeguards into the special purpose entity that make it unlikely to file or have filed against it a bankruptcy petition. These safeguards include (i) strict limits on the activities of the special purpose entity, including its ability to incur any debt other than the mortgage debt, which precludes an involuntary bankruptcy petition and (ii) the requirement that the board of directors or board of managers of the entity include one or more directors or managers who are independent of the parent company. This coupled with the further requirement that any bankruptcy of the entity be approved by a unanimous vote of all directors or managers including the independent directors or managers, limits the likelihood of the filing of a voluntary bankruptcy petition.

GGP replaced the original independent managers of some of the bankruptcy remote entities prior to the commencement of the bankruptcy filing without notice to such discharged managers or the creditors of these entities. The new independent managers voted in support of the bankruptcy filing of the special purpose entities and Judge Gropper consolidated each of those filings into one bankruptcy case.

On June 17, Judge Gropper heard arguments from several lenders, requesting the bankruptcy court dismiss as bad faith filings the bankruptcy cases of twenty-one property level special purpose entity subsidiaries of GGP. The lenders' motions argued that the loans to these entities were each performing at the time of the bankruptcy filing and the various lenders faced no immediate risk of insolvency or financial crisis. In fact, according to the opinion, each of the properties was generating sufficient cash flow at the time of the bankruptcy filing in excess of the debt service requirement of its loan and none of the subject loans has a maturity date earlier than one year after the commencement of the bankruptcy case—with several of the loans not maturing for up to three or more years.

The Decision

The Court stated the general rule that bankruptcy remote is not bankruptcy proof. A bankruptcy petition will not normally be dismissed as a bad faith filing as long as the debtor has a legitimate rehabilitative objective. In order to dismiss the bankruptcy petition the lenders would need to show both the objective bad faith evidenced by the futility of the reorganization process and the subjective bad faith of the debtors in filing the petition.

The lenders alleged objective bad faith as each of the special purpose debtors was generating sufficient cash flow in excess of its individual debt service requirement

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and none of the debtors had a loan maturing within a year of the filing date. As a result, the lenders argued that GGP should have waited until much closer to the respective maturity dates on the loans to file these entities in bankruptcy. The lenders made this argument based on looking at each debtor individually and not on a group wide basis.

In reviewing this claim, Judge Gropper found that the various debtors were all in some amount of financial distress, including cross defaults, high loan-to-value ratios and the occurrence of loan maturity or hyper-amortization dates on the loans within one to four years. As a result of this analysis, Judge Gropper held that despite the bankruptcy remote nature of these debtors, the court is not required to examine the issue of good faith as if each debtor was wholly independent of its corporate group. Analyzing the GGP entities as a whole, the Court held that the filings were unquestionably not premature and that there was no bad faith in the filing.

With respect to the subjective bad faith element, the lenders claimed that the debtors acted in bad faith because they failed to negotiate the refinancing of their debt prior to the bankruptcy filing and that the debtors fired and replaced the independent managers shortly before the managers needed to vote on the potential bankruptcy filing. The Court, however, found that many of the subject debtors' loans were included in commercial mortgage backed securities deals, and since the loans were not in default the special servicers were not yet servicing the loans and so no negotiations could have occurred. With respect to those debtors that had loans that were not in securitization vehicles, testimony showed that because of the change in market conditions and the high loan-to-value ratios of the loans, the lender would not have considered refinancing any of the loans unless and until millions of dollars of debt was repaid. As a result, the evidence did not support a bad faith claim.

As for the discharge of the independent managers, evidence showed that there was nothing in the special purpose entities' charter documents that prevented such a firing and replacement with other independent managers. Further, evidence showed that the newly appointed independent managers were “seasoned” real estate professionals who understood the matters before them and had the time to address them whereas the previous managers were not necessarily so qualified.

Judge Gropper found that the lenders “have been inconvenienced by the Chapter 11 filing . . . However, inconvenience to a secured creditor is not a reason to dismiss a Chapter 11 case.” The Court noted that the current proceedings “are a diversion from the parties' real task, which is to get each of the Subject Debtors out of bankruptcy as soon as possible. The Movants assert talks with them should have begun earlier. It is time that negotiations commence in earnest.”

“Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity.”

Substantive Consolidation

Despite the rejection of the motions to dismiss, the outcome for the commercial mortgage securitization market is not expected to be significant. Judge Gropper noted that the lenders continue to have in place the “fundamental protections” that they negotiated for including protection against substantive consolidation of the project level debtors with any other entity. Further, the Court noted:

There is no question that a principal goal of the SPE structure is to guard against substantive consolidation, but the question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity.

As a result, it appears that Judge Gropper is not considering disregarding the corporate separateness of the various special purpose entity debtors. Such a move, which GGP hinted that it was considering pursuing during a hearing in late July, would likely throw the already fragile commercial mortgage lending industry into disarray. Judge Gropper’s ruling should provide comfort to participants in that market that the special purpose entity structure that underlines the commercial mortgage market remains sound.

Joseph V. Gatti is Of Counsel in the firm’s Tysons Corner office. His practice focuses on structured finance with an emphasis on the securitization of financial assets.

For further information please contact your principal lawyer at the firm or one of the Akerman attorneys listed below:

James D. Barnett	954.759.8967	jim.barnett@akerman.com
Joseph V. Gatti	703.761.2748	joseph.gatti@akerman.com
David E. Otero	904.598.8604	david.otero@akerman.com
Janice L. Russell	305.982.5611	janice.russell@akerman.com

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Plaza of The Americas
600 North Pearl Street, Suite 51900
Dallas, TX 75201
214.720.4300

Denver

511 Sixteenth Street, Suite 420
Denver, CO 80202
303.260.7712

Ft. Lauderdale

Las Olas Centre II
350 East Las Olas Boulevard
Suite 1600
Ft. Lauderdale, FL 33301-2229
954.463.2700

Jacksonville

50 North Laura Street, Suite 2500
Jacksonville, FL 32202-3646
904.798.3700

Los Angeles

725 South Figueroa Street, 38th Floor
Los Angeles, CA 90017-5438
213.688.9500

Madison

222 West Washington Avenue, Suite 380
Madison, WI 53703
608.257.5335

Miami

One Southeast Third Avenue
25th Floor
Miami, FL 33131-1714
305.374.5600

New York

335 Madison Avenue, Suite 2600
New York, NY 10017-4636
212.880.3800

Orlando

CNL Center II at City Commons
420 South Orange Avenue, Suite 1200
Orlando, FL 32801-3336
407.423.4000

Tallahassee

Highpoint Center, 12th Floor
106 East College Avenue
Tallahassee, FL 32301
850.224.9634

Tampa

SunTrust Financial Centre
401 East Jackson Street, Suite 1700
Tampa, FL 33602-5250
813.223.7333

Tysons Corner

8100 Boone Boulevard, Suite 700
Vienna, VA 22182-2683
703.790.8750

Washington, D.C.

801 Pennsylvania Avenue N.W., Suite 600
Washington, DC 20004
202.393.6222

West Palm Beach

Esperante Building
222 Lakeview Avenue, Suite 400
West Palm Beach, FL 33401-6183
561.653.5000

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