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Real Estate Workout Advisory

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On August 11, 2009, Judge Allan Gropper, of the Bankruptcy Court for the Southern District of New York in the jointly administered proceedings of *In re General Growth Properties, Inc.*,[1] issued a Memorandum of Opinion denying the motions of various secured lenders[2] to dismiss the cases of one or more debtors owned directly or indirectly by General Growth Properties, Inc. (the "Debtors"). The movants had contended that the Debtors filed their cases in bad faith, and that one Debtor, a trust, was ineligible to file for bankruptcy. The Court denied the motions, holding that the bankruptcy filings were made in good faith because they were not premature, and that it could not be shown that confirmation of a plan of reorganization was objectively futile. The Court further held that the trust Debtor was indeed eligible to file for bankruptcy because it was a business trust.

The Court analyzed the general principle that a Chapter 11 reorganization case can be dismissed as a bad-faith filing under the rule set forth in *In re C-TC 9th Avenue Partnership v. Norton Co. (In re C-TC 9th Avenue Partnership*) and that grounds for dismissal exist if it is clear that, as of the filing date, there is no "reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings," noting that the rule required a showing of objective futility of the reorganization process and subjective bad-faith filing.

The movants argued that, objectively, the Debtors' cases were filed prematurely, asserting that the individual Debtors were not in financial distress at the time of filing, as the maturity date was in some cases years away, and that the prospect of liability was too remote. The Court disagreed — both as to the Debtors as a group and individually. The Court reasoned that, while the Bankruptcy Code had no requirement that a Debtor be insolvent at the time of filing, the Debtors nevertheless carry an enormous amount of fixed debt that is not contingent. The Court noted a number of factors demonstrating current distress, including that some or all of the Debtors were subject to cross-defaults of affiliates, that they were subject to hyper-amortization, that they guaranteed maturing loans of other entities, that their property secured maturing loans, or that other considerations demonstrated distress such as high loan-to-value ratios. The Court also noted that the overall debt structure had been premised upon future refinancing that was demonstrably uncertain due to the collapse of the credit markets.

The movants further argued that the bankruptcy-remote structure of the project-level Debtors required that each Debtor's financial distress be analyzed in isolation (rather than as part of the larger group), and that under such analysis the Debtors individually were not sufficiently distressed. While the Court agreed that the structure of the entities was designed to insulate each of the Debtors from the financial problems of its affiliates, it was clear that structure was designed as an integrated whole: the balloon payments at maturity meant that the bankruptcy-remote entities would default without their parents' assistance if financing could not be obtained, that the lenders clearly were aware that they were extending credit to a larger group, and that if the ability of the group to obtain refinancing was impaired, that the financial situation of the subsidiary would be impaired as well. The Court rejected arguments that the presence of independent managers of the bankruptcy-remote entities required examination of the Debtors only individually, since the independent managers owed fiduciary duties both to creditors and, under Delaware law, shareholders (i.e., the parents).

The Court also rejected arguments that a plan was objectively futile since it could not be confirmed over certain creditors' opposition, noting that the Bankruptcy Code did not require that a debtor prove that a plan is confirmable in order to file a petition, and that litigation posturing about plan opposition did not mean that a consensus could not be reached later in a case.

The movants asserted that the Debtors failed to exercise subjective good faith because the Debtors failed to negotiate prior to filing, and that the Debtors' bad faith was evidenced by their firing the independent managers of several of the bankruptcy-remote entities and replacing them shortly before the petition date. The Court rejected both arguments. The Court reasoned that the Bankruptcy Code does not require a borrower to negotiate with its lender before filing a Chapter 11 petition, and noted further that there was much evidence in the record that the Debtors had been unable to get certain lenders (most notably the CMBS lenders) to talk with them at all. The Court also noted that the termination of the independent managers had been reasonable under the circumstances because the Debtors required sophisticated, experienced managers to address the complex issues confronting them and that the original managers appointed by the corporate services company lacked the expertise necessary to fulfill their fiduciary obligations. The replacement managers subsequently acted in accordance with Delaware law in approving the bankruptcy filings, and the lenders' expectation that the managers were intended to prevent the Debtors from filing bankruptcy was inconsistent with the managers' fiduciary obligations.

Finally, the Court rejected the arguments of one lender that one of the Debtors, a trust, was ineligible to file because it was an Illinois land trust whose primary function was simply to hold title to real estate and not to conduct business. The Court reasoned that the trust was clearly a business trust (which is deemed a "corporation" under the Bankruptcy Code and therefore eligible to file for Chapter 11), distinguishing it from a land trust or other kinds of trusts, because it was a profit-making enterprise, it was an active participant in various business activities, it was the named lessor in leases with its tenants, it was the borrower under a loan agreement, and it was authorized to conduct business in Pennsylvania.

OBSERVATIONS

For those professionals watching the GGP case closely, Judge Gropper's decision not to dismiss any of the GGP SPE subsidiaries comes as no surprise. The decision is wholly consistent with the judge's statements and demeanor since the outset of the case. Judge Gropper's observations about the CMBS structure, the "roadblocks" to GGP's attempts to refinance its CMBS debt, the practical difficulties of negotiating with CMBS servicers in advance of an imminent default and the "unprecedented collapse" of the real estate finance market and the "disarray" in the financial markets make for interesting reading. The judge's detailed discussion of the steps taken by GGP in analyzing whether and which entities to file, and how to go about it, also makes for interesting reading. But the result is clear. The court found that the filing of an SPE subsidiary can be made in the context of, and not in isolation from, the entire "group" of GGP entities, and that the "independent" directors and managers could/should take that into account. And the judge sent a reminder to lenders that "independent" directors and managers are not there solely to protect the interests of secured creditors (e.g., "solely for the purpose of voting 'no' to a bankruptcy filing") but have fiduciary duties in their decision making process. Interestingly, this judge was convinced that the last minute "replacement" of these SPE directors was not an event demonstrating "bad faith," but a good thing, because the new directors were an upgrade over the original directors, with much more background and experience in the real estate industry.

The judge in various places in his decision—and consistent with his prior statements in the case—goes out of his way to throw a bone to the SPE structure (and the CMBS industry) by pointing out that "fundamental protections...that the SPE structure represents are still in place and will remain in place during" a Chapter 11 case. The judge views those protections to include an insulation from substantive consolidation of the assets and liabilities of the various SPE entities (at this early date in the case, no substantive consolidation motions have been filed) as well as rights to adequate protection and post-petition interest and fees for oversecured creditors. ("Secured creditors' access to their collateral may be delayed by a filing, but secured creditors have a panoply of rights" and while the secured creditors "have been inconvenienced" by the filings—such as by having cash flows interrupted and special servicers appointed—they still have typical bankruptcy protections.) The court pointed out that earlier in the case during the cash collateral fight, where cash was upstreamed from the SPE's to the parent GGP entity, that the bankruptcy protection of adequate protection resulted in the secured SPE creditors receiving, among other things, payment of interest at the non-default rate during the case, continued maintenance of the properties, a replacement lien on the cash being upstreamed and a second priority lien on other properties. Further, as a result of the DIP bidding process, there were no second liens placed on the SPE properties to secure the DIP loan approved by the court. From Judge Gropper's perspective, this is evidence that the bankruptcy process and secured creditor protections are working.

No doubt this case will be widely commented upon and analyzed, and it's unclear whether any of the secured creditors who lost their motions will appeal. But on a going forward basis, the decision will need to be taken into account in connection with future financings—CMBS, ABS and others—both in terms of underwriting, deal structuring and legal documentation. Stay tuned.

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[1] Case no. 09-11977 (Bankr. S.D.N.Y., August 11, 2009) (jointly administered) (the "Opinion").

[2] The movants were ING Clarion Capital Loan Services, LLC as special servicer to certain secured lenders; Helios AMC, LLC, as special servicer to other secured lenders; and Metropolitan Life Insurance Company and KBC Bank, N.V.

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