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General Growth Update II: Bankruptcy Court Issues Significant Ruling Allowing SPE Debtors to Remain in Bankruptcy

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In a significant ruling addressing the issue of when a company may file a bankruptcy petition, the United States Bankruptcy Court for the Southern District of New York on August 11, 2009 denied the motions to dismiss the bankruptcies of certain financially solvent subsidiaries of General Growth Properties, Inc. ("GGP" and, together with all of its subsidiaries and affiliates, the "GGP Group"). GGP, one of the largest shopping mall owners and managers in the country, filed a voluntary bankruptcy petition on April 16, 2009. The bankruptcy petition included approximately half of GGP's subsidiaries, many of which were financially healthy special purpose entities ("SPEs"). Like so many other companies that relied heavily on secured lending, including debt issued in the commercial mortgage-backed securities ("CMBS") market, GGP became unable to refinance its heavy debt-load. The court's memorandum of opinion was in response to five motions to dismiss that challenged the propriety of the bankruptcy filings as to several subsidiaries of GGP (the "SPE Debtors"). One motion was filed by ING Clarion Capital Loan Services LLC ("ING Clarion"), as special servicer to certain secured lenders, another was filed by Helios AMC, LLC ("Helios"), as special servicer to other secured lenders, and three other motions to dismiss were filed by Metropolitan Life Insurance Company ("Metlife" and, together with ING Clarion and Helios, the "Lenders"). All five Lenders advanced a substantially similar argument that the bankruptcy petitions of the SPE Debtors were filed in bad faith.

In issuing his opinion, Judge Allan L. Gropper, the judge overseeing the bankruptcy of GGP, applied existing case law on the issue of when a petition in bankruptcy is filed in bad faith. According to Judge Gropper, the test to determine whether a bankruptcy petition has been filed in bad faith is (i) whether the petition was subjectively filed in bad faith and (ii) whether the reorganization of the debtor is objectively futile. In advancing this test, Judge Gropper reaffirmed relevant Second Circuit case law on this issue.[2] According to Judge Gropper, such a standard is enormously difficult to meet as the court stated that "a bankruptcy petition should be dismissed for lack of good faith only sparingly and with great caution."

Subjective Bad Faith

The first prong of the test required the court to determine whether GGP subjectively filed the SPE Debtors' bankruptcy petitions in bad faith. With regard to this prong of the test, the Lenders argued that GGP had: (i) prematurely filed the SPE Debtors' bankruptcy petitions; (ii) failed to negotiate with

the Lenders prior to the filing of the bankruptcy petition; and (iii) fired and replaced the independent managers of the SPE Debtors on the eve of bankruptcy. The judge rejected each of these arguments.

The Lenders first argued that the premature filing of the bankruptcy petitions on behalf of the SPE Debtors was an example of GGP's subjective bad faith. In support of this argument, the Lenders asserted that each of the SPE Debtors was not in financial distress at the time of filing as evidenced by the fact that there were no defaults under the loans, the loans had not yet matured, and the properties were maintaining adequate cash flow. Despite these arguments, the court found that, in GGP's view, the SPE Debtors were in varying degrees of financial distress on the petition date. The court noted that loans to four of the SPE Debtors had cross-defaults as a result of the defaults of affiliates or would have been in default as a result of other bankruptcy petitions. The court also found that the loans to the remaining SPE Debtors had gone into hyper-amortization in 2008 and that interest had increased by 4.26%. The court further noted that five of the SPE Debtors had mortgage debt maturing or hyper-amortizing in 2010, two in 2011, and one in 2012. Finally, the court found it significant that certain of the SPE Debtors were guarantors on maturing loans of other entities, had property that was collateral for a loan that was maturing, or were subject to other considerations that, in GGP's view, placed their loans in distress, such as a high loan-to-value ratio.

The court showed great deference to the method by which GGP determined whether the SPE Debtors were in financial distress. For example, in late 2008, GGP assembled a team to assist in the evaluation of restructuring options, including restructuring advisors, financial advisors, and legal advisors. The process of evaluating GGP's restructuring options took approximately six weeks and encompassed a total of seven board meetings and three informational sessions. During these meetings, the boards discussed general considerations applicable to the project-level companies, as well as specific facts relating to the individual properties, with both GGP personnel and the financial, restructuring, and legal advisors available. The boards specifically focused on the collapse of the commercial real estate financing market, the challenges facing the CMBS market, and the practical difficulties of negotiating with CMBS servicers to meaningfully modify loan terms. The boards also focused on the integration of the SPE Debtors with GGP, the requirements for securing DIP financing, and the consequences of filing an entity for bankruptcy individually, outside of a coordinated restructuring with other GGP entities. In these meetings, GGP evaluated whether to file each individual entity. On the eve of the petition date, after reviewing these considerations, the boards separately voted to put GGP and most of the GGP Group into bankruptcy.

The court declined to establish an arbitrary rule, of the type desired by the Lenders, 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. In declining to establish such a rule, the court determined that the Lenders did not establish that GGP's procedures to determine which SPE Debtors to file for bankruptcy were unreasonable or that GGP was unreasonable in concluding that the disarray in the financial markets made it uncertain that it would be able to refinance debt years into the future. In particular, the court noted that GGP had demonstrated that the CMBS market was "dead" in early 2009 and that it was uncertain as to when or if the CMBS market would ever revive. The court asserted that not every stand-alone company with ample cash flow would necessarily act in good faith by filing a Chapter 11 petition years before its debt became due. However, the court deferred to GGP's methodology and determinations, including the consideration of whether the decision to file the SPE Debtors was in the best interests of the GGP Group as a whole.

The Lenders argued that the bankruptcy-remote structure of the SPE Debtors required that the analysis of GGP's financial distress be determined separately, and that consideration of the financial

problems of the GGP Group as a whole would violate the very purpose of the SPE structure. The court noted that the SPE structure was intended to isolate the financial position of each of the SPE Debtors from the problems of their affiliates, and to make the prospect of a default less likely. The court also noted that the SPE structure was designed to make each of the SPE Debtors "bankruptcy remote." However, the court held that the secured lenders knew that they were extending credit to SPE Debtors that were part of a much larger group, and that there were benefits as well as possible detriments from this structure. The court noted that GGP's management had to reorganize GGP's capital structure in a time of unprecedented collapse in the real estate markets. The court further noted that the Lenders could not explain how billions of dollars of unsecured debt at the parent level could be restructured responsibly without the support of the GGP Group as a whole. Thus, the court held that the interests of the entire GGP Group must be taken into account when determining whether a Chapter 11 petition was filed in bad faith.

The Lenders further argued that the independent managers of the SPE Debtors should have considered only the interests of the Lenders when they made their decision to file a Chapter 11 petition. Alternatively, the Lenders argued that the independent managers breached their fiduciary duties by voting to file for bankruptcy based on the interests of the GGP Group as a whole. In response, the court noted that the organizational documents of the SPE Debtors were governed by Delaware law, which requires an independent manager to consider the interests of the owners of the SPE Debtor when entering the "zone of insolvency." Thus, the court found that the independent managers of each SPE Debtor did not breach their fiduciary duties when considering the interests of the GGP Group in determining whether to file bankruptcy. The court rejected the Lenders' argument that an "independent" manager can serve on a board solely for the purpose of voting "no" to a bankruptcy filing because of the desires of the secured creditor. According to the court, when seen from the perspective of the GGP Group as a whole, the filings were unquestionably not premature.

An additional argument of the Lenders under the rubric of subjective bad faith was that GGP failed to negotiate with the Lenders prior to the bankruptcy filing. In rejecting this argument, the court ruled that, although there "are often good reasons for a commercial borrower and its lender to talk before a bankruptcy case is filed," such logic does not imply "that a Chapter 11 case should be deemed filed in bad faith if there is no prepetition negotiation." Significantly, the court took into consideration that the Lenders provided no evidence that they would have readily agreed to refinancing had GGP commenced negotiations prior to the bankruptcy filing. The court did not indicate whether it would have reached a similar outcome had the Lenders provided such evidence.

Finally, the Lenders argued that GGP's discharge of the independent managers on the eve of the bankruptcy filings was an example of GGP's subjective bad faith. The operating agreements of most of the SPE Debtors required two independent managers or directors. GGP relied upon Corporation Service Company ("CSC") to supply managers to most of its SPEs. The day prior to the filing date, GGP sent a letter to CSC that terminated each of the independent directors and replaced them with two "seasoned individuals" selected by GGP. Because the terminations complied with the operating agreements of the SPE Debtors, and because the two individuals satisfied the requirements of the position, the court held that these terminations did not constitute subjective bad faith on the part of GGP.

The court acknowledged that the Lenders clearly had been inconvenienced by the Chapter 11 filings. According to the court, however, inconvenience to a secured creditor is not a reason to dismiss a Chapter 11 case. Significantly, the court held that the fundamental protections that the Lenders had negotiated and that the SPE structure represents are still in place and will remain in place during the

Chapter 11 cases. According to the court, the principal goal of the SPE structure – to guard against substantive consolidation – was not addressed by this opinion. Rather, the court merely held that GGP did not subjectively act in bad faith when making its decision to file bankruptcy for itself and for certain members of the GGP Group.

Objective Futility

The second prong of the test to determine whether a bankruptcy petition was filed in bad faith is to determine the objective futility of the reorganization process. The court noted that this prong of the test was largely conceded by both ING Clarion and Helios since "there was a reasonable likelihood that the Debtors intended to reorganize and could successfully emerge from bankruptcy." Metlife, however, argued that the objective futility of the reorganization process could be established due to the fact that GGP could never confirm a plan over MetLife's objection. As such, MetLife claimed that there was no chance of reorganization for GGP. The court dismissed this argument by simply noting that there is no requirement in the bankruptcy code that a debtor must prove that a plan is confirmable in order to file a bankruptcy petition. In the end, the court held that the Lenders had failed to establish either the subjective bad faith or the objective futility of the SPE Debtors' bankruptcy petitions.

The court labeled these motions to dismiss as a mere "diversion" from the real task at hand. In doing so, the judge effectively chided the Lenders for draining judicial resources in slowing down the bankruptcy of the GGP Group. While the market-wide impact of the court's decision will not be known for some time, the court has effectively laid down a roadmap for a corporate parent to determine whether a financially healthy and solvent SPE may file a bankruptcy petition in support of the restructuring of the corporate group as a whole.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[2] *See, e.g.*, *C-TC 9th Ave. P'ship v. Norton Co.*, 113 F.3d 1304 (2d Cir. 1997); *In re Kingston Square Assocs.*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).