

## **GGP: Single Purpose Entity or All in the Corporate Family?**

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On August 11, 2009, in a long-awaited ruling in the chapter 11 case of General Growth Properties, Inc. (“GGP”), the Court denied the motions to dismiss that had been brought on behalf of several of the property-level lenders.<sup>1</sup> Few if any observers anticipated that the Court would grant these motions and actually dismiss some of the individual SPE borrowers from the larger GGP bankruptcy. But while the result itself may not be surprising, the Court delivered a lengthy (nearly fifty page) detailed opinion supporting its ruling. This opinion provides a sobering insight into how a long-tenured and well-respected bankruptcy judge views the role of single purpose entities (“SPEs”). And, given that the primary function of single purpose entities in structured finance is to mitigate bankruptcy risk, one could argue that the only perspective that really matters on this topic is that of the bankruptcy judge.

Among secured lenders, the concern at the outset of the case focused on the likelihood of substantive consolidation.<sup>2</sup> As the case has unfolded, the risk of substantive consolidation has receded, but it appears that the Court has found an alternative path in the direction, but stopping short, of substantive consolidation. Loosely formulated as the

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<sup>1</sup> Memorandum of Opinion, In re: General Growth Properties, Inc., No. 09-11977 (Bank. S.D.N.Y. Aug. 11, 2009) (hereinafter, the “Opinion”). The motions to dismiss were filed after the Court issued its final order with regard to debtor-in-possession (“DIP”) financing and the use of cash collateral. As the Court summarizes, its final cash collateral order “had various forms of adequate protection for the project-level lenders, such as the payment of interest at the non-default rate, continued maintenance of the properties, a replacement lien on the cash being upstreamed from the project-level Debtors and a second priority lien on certain other properties. DIP financing was arranged, but the DIP lender did not obtain liens on the properties of the project-level Debtors that could arguably adversely affect the lien interests of the existing mortgage lenders.” Opinion at 17.

<sup>2</sup> See Daniel B. Rubock, *GGP Warns of Possible Substantive Consolidation Motions for the First Time in Its Bankruptcy Case*, Moody’s Structured Finance, August, 2009.

“corporate family” view, this path is less draconian (from the standpoint of secured lenders) than substantive consolidation, but it still unsettles certain assumptions upon which lenders, especially in the commercial mortgage-backed securities (“CMBS”) market, have relied. While the end is not “nigh,” adjustments in terms of lender expectations, as well as modifications to structuring and underwriting criteria, tailored in response to the case, will be a part of the landscape going forward.

### **The Corporate Family vs The SPE**

At its most general, the issue is: how should an SPE borrower that is part of a larger corporate-level bankruptcy be viewed in bankruptcy? Is there a basis for treating the SPE in bankruptcy the same way it is viewed in structuring a transaction, namely on a stand-alone basis, or, alternatively, does the SPE structure merely provide a guideline for a bankruptcy court to decide the appropriate adequate protection for a secured lender, while treating the SPE as part of the parent company’s bankruptcy case? The Court’s response to this question may be guessed from its view of the good faith filing issue (discussed below): “[t]he Court is not required in these cases to examine the issue of good faith as if each Debtor were wholly independent. We turn to the interests of the Group as a whole.”<sup>3</sup>

One of the overarching themes to which the Court returns several times in the Opinion is the near impossibility of raising capital in the frozen credit markets. There is no ground to dispute this contention, but the critical point is that the Court looks at this obstacle from the perspective of the GGP group as a whole—the parent and the SPE subs—rather than at the individual entity level. In describing the capital structure of the GGP debtors, the Court speaks of the “consolidated outstanding indebtedness” of GGP

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<sup>3</sup> Opinion at 27. The “Group” refers to the GGP parent-level debtors together with the SPEs.

and its SPE subsidiaries.<sup>4</sup> The court does not collapse the interests of parent and subsidiary, as would be the case in a substantive consolidation, but does view the problems facing the various GGP entities through the same lens. A key factor for the Court is GGP's perceived inability to successfully reorganize at the parent company level without the certainty of cash flow from the SPE assets beyond the amounts required to be paid to the secured lenders as adequate protection.<sup>5</sup>

The response of a secured creditor (of an SPE) might be to wonder why it suddenly must bear the burden of the parent's financial difficulties. The Court, however, sees an alignment of interests between the parent and the SPEs, asserting, wrongly perhaps, that the inability of the parent to restructure would inevitably impair the financial situation of the SPEs.<sup>6</sup>

The Court's reasoning suggests that it is applying a "corporate family" doctrine to the GGP entities, an approach that treats affiliated companies as a collective whole engaged in a common enterprise. While it stops short of substantive consolidation, this approach stands well adrift from, if not antithetical to, viewing an SPE as a stand-alone entity.

To support its position, the Court first takes note of the lack of direct precedent and then looks to a handful of cases following In re: U.I.P.,<sup>7</sup> a 1987 decision involving

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<sup>4</sup> Opinion at 6.

<sup>5</sup> See Final Order Authorizing Debtors to (A) Obtain Postpetition Secured Financing Pursuant to Bankruptcy Code Sections 105(a), 362, and 364, (B) Use Cash Collateral and Grant Adequate Protection Pursuant to Bankruptcy Code Sections 361 and 363 and (C) Repay in Full Amounts Owed Under Certain Prepetition Secured Loan Agreement, In re: General Growth Properties, Inc., No. 09-11977 (Bank. S.D.N.Y. May 14, 2009).

<sup>6</sup> Opinion at 28. The Court declines to consider the contrary and hardly unreasonable position that a solvent SPE borrower with a moderately leveraged loan on a cash flowing property would have access to refinancing capital regardless of the difficulties facing the parent.

<sup>7</sup> Heisley v. U.I.P. Engineered Prods. Corp. (In re: U.I.P. Engineered Prods. Corp.) 831 F.2d 54 (4th Cir. 1987).

the bankruptcy of a steel company with multiple operating company subsidiaries. The Court takes these cases together to stand for the principle as stated in In re: U.I.P. that “the nature of a corporate family created an “identity of interest”...that justified the protection of the subsidiaries as well as the parent corporation.”<sup>8</sup> In reaching this conclusion, the Court stops short of the full discussion one would expect in applying, and arguably expanding, the “corporate family” doctrine to the GGP case. On their facts, In re: U.I.P. and its related cases appear to stand for the principle that the corporate family doctrine should apply when the parts are worth far less than the whole, or, put another way, when the unity of interest protects not just the entities, but more importantly the underlying asset value.

It is not clear that this logic is sound as applied by GGP. The GGP SPEs, while part of a large, complicated corporate structure in one sense, were operationally (or at least could be) distinct, in that the malls could have been operated or managed independently from one another and the parent, either by GGP or another shopping center company or a sophisticated institutional investor.<sup>9</sup> As such, the parts were not worth less than the whole—many healthy performing shopping centers could continue to operate successfully without the corporate parent.

While citing the cases on the “corporate family” doctrine as legal support for its conclusion, the Court is clearly focused on what it perceives to be the equities of the case in front of it. An example of this perspective is the Court’s implicit approval of GGP’s attempt early in 2009 to convene a “special servicer summit” to discuss loan

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<sup>8</sup> Opinion at 29 (quoting *In re: U.I.P. Engineered Prods. Corp.* at 56).

<sup>9</sup> See Brief of Commercial Mortgage Securities Association and Mortgage Bankers Association as Amici Curiae, *In re: General Growth Properties, Inc.*, No. 09-11977 (Bank. S.D.N.Y. Aug. 11, 2009) (distinguishing the relationship between the GGP parent and SPE subsidiaries from a parent corporation with more operationally interconnected, less free-standing subsidiaries).

modifications *en masse* for the securitized loans to the SPEs. Missing, however, from the Court’s analysis is an acknowledgement that the CMBS structure is itself a whole. The distinction in roles between master servicer and special servicer, the limitations on modifying loans not in default,<sup>10</sup> and the separate treatment of separate loans<sup>11</sup>—these are part of the basic architecture of CMBS, not contrivances to prejudice a borrower or honest debtor. In the Court’s words, quoting the debtors’ brief, “the CMBS structure caused additional roadblocks to the Company’s attempts to refinance its debt or even talk with its lenders.”<sup>12</sup> While the emphasis on preserving value for the collective enterprise is clearly the Court’s focus, it seems unduly dismissive not even to discuss the contrary position, namely that separate loans to separate entities by separate lenders on separate properties should be treated separately.

### **Bad Faith**

One of the contentions raised in the motions to dismiss is that the bankruptcy petitions were filed in bad faith. The Court’s analysis and rejection of this argument is detailed and grounded in case law and looks at the concept of bad faith against both objective and subjective tests, all of which can be distilled into three elements.<sup>13</sup> First, insolvency is not a requirement to a voluntary bankruptcy. The appropriate test is whether the entity is in some measure of financial distress. Second, as a condition to

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<sup>10</sup> In GGP, most of the project-level loans were not in default and regardless of whether the loans were a CMBS loan or a traditional portfolio loan, lenders usually do not discuss, or entertain requests for, extensions or modification if a loan is performing. Moreover, the US Tax Code limits the ability of master and/or special servicers to agree to “significant modifications” to a CMBS loan until it (not its current family group) is in imminent default.

<sup>11</sup> GGP interpreted hyper-amortization (with its Anticipated Repayment Dates) in certain loans, which imposed steep interest rate increases, cash traps at the property level and application of excess cash to principal, “as equivalent to maturity and the consequences of a loan becoming hyper-amortized as equivalent to default.” Opinion at 9.

<sup>12</sup> Opinion at 15.

<sup>13</sup> Opinion at 18–42.

bankruptcy, financial distress appears to be a fluid enough concept to fit almost any fact pattern. In the Court's reasoning, a solvent SPE borrower with a moderately leveraged mortgage loan and no other debt could find itself to be in financial distress based solely on the prospect of having difficulty refinancing its mortgage in two or three years. Third, even though a borrower has no obligation to negotiate with its lender prior to filing for bankruptcy, the difficulty perceived by GGP in attempting to negotiate with the master servicers and special servicers of the individual CMBS loans seems to have informed the Court's view that the filings, while inconvenient for the secured lenders, were not in bad faith.<sup>14</sup>

The Court's overall handling of the bad faith analysis points to a settled precept: the standard for dismissal on such grounds is and shall remain a very high bar to clear. This is not inconsistent with the favored *raison d'etre* of Chapter 11, to facilitate the rehabilitation of the honest debtor.

### **Independent Directors**

"Where were the independent directors" has been one of the persistent questions in the GGP bankruptcy. Unfortunately, the answer may be that "they don't appear to matter."

Admittedly, this may overstate things, but this case will at least lead to a thorough reexamination on the role, utility and value of independent directors in CMBS transactions. While few in the marketplace believed that bankruptcy-remote meant bankruptcy-proof, most did not think it was quite so proximate. One reason for this

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<sup>14</sup> It is interesting to note that in another high profile case being heard down the hall from GGP, In re Extended Stay Inc., the Court appears to be less troubled with the role of loan servicers. No. 09-13764 (Bank. S.D.N.Y.). Rejecting a proposed deal between the debtors in that case and several certificate holders, the Court makes clear that it is the special servicer that acts as the voice of the CMBS lender in default scenarios and that this aspect is part of the CMBS structure. *Id.*

belief was the requirement typically contained in both the loan documents and the organizational documents of the SPE Property Owners that any voluntary bankruptcy filing needed the affirmative vote of the independent directors.

Whatever the ultimate outcome of the GGP case, one positive result will definitely be a better understanding of how the independent director concept works (or doesn't work) in CMBS finance.<sup>15</sup> In particular, what duty does an independent director have to consider the interests of creditors of the borrower and shareholders (and perhaps creditors) of the borrower's parent company? And what if independent directors in place at the closing of a loan are dismissed—possibly in contravention of the organizational documents, an *ultra vires* act—and replaced with compliant directors who could be counted on to vote in favor of the bankruptcy?<sup>16</sup>

At one of the hearings on the motions to dismiss, GGP offered testimony that (i) the initial independent directors put in place at the closing of the mortgage loans were really just place-holders pursuant to the requirements of the secured lenders<sup>17</sup> and (ii) the SPEs had undertaken a lengthy, deliberative process in deciding to replace the initial independent directors.<sup>18</sup> The replacement independent directors were described as “seasoned individuals” who both satisfied the standard of “independence” required by the

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<sup>15</sup> Even some of the special servicers, in testimony at the hearing, seemed to have inflated views of the role of independent directors, a position that drew rebuke from the Court. Opinion at 33.

<sup>16</sup> If in fact the independent directors were inappropriately fired and replaced, this could and support a motion to dismiss the bankruptcy case. Generally speaking, on the facts in GGP, there is no basis for sustaining a motion to dismiss on these grounds. *But see* In re Kingston Square Associates, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) (noting that “when a corporation approaches insolvency or actually becomes insolvent, directors’ fiduciary duties expand to include general creditors.”).

<sup>17</sup> In describing these place-holder directors, the Court noted that “[i]t does not appear that these managers had any expertise in the real estate business and as mentioned above, some of the lenders thought the independent managers were obligated to protect their interests alone.” Opinion at 38-39.

<sup>18</sup> The Court seemed impressed with the extent of GGP’s pre-filing deliberation, noting that the extensive discussions lasted for six weeks and included a “total of seven Board meetings and three informational sessions” in the months before its filing. Opinion at 22.

organizational and loan documents and, in contrast to the directors being replaced, had significant restructuring experience and qualifications to assist the SPE debtors in their analysis and decision.<sup>19</sup> The problem with the *ultra vires* argument is that the loan documents and the organizational documents governing the role of independent directors did not expressly prohibit their replacement. In most instances, the relevant loan document and organizational document provisions required that the borrower maintain two (2) independent directors at all times and that any decision to file bankruptcy required the unanimous consent of all directors, including the independent directors. With respect to the termination or removal of independent directors, the documents only provided that termination would not be effective until a successor had been appointed. There is no provision for notice to or consent by the secured lender for the removal or replacement of the independent directors, so long as the SPE Property Owner appoints a replacement that satisfies the standard of independence set forth in the organizational documents. With regard to removal or replacement of independent directors, the organizational documents governing the GGP loans mirrored the comparable provisions in typical capital-market compliant organizational documents.

In terms of the scope of duty for an independent director, the Court states the position clearly, that the independent managers had the same duties as the non-independent directors of a Delaware corporation, specifically a “prima facie duty to act in the interests of the corporation *and its shareholders*.”<sup>20</sup> The Court cites Gheewalla, the

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<sup>19</sup> The prior independent directors had been provided by Corporation Service Company, which “supplie[d] these directors in the same fashion as it provides filing and other ministerial services for corporations.” Opinion at 38.

<sup>20</sup> Opinion at 40 (emphasis added). As the Court noted, “beyond the unsecured debt of the parent companies were thousands of equity holders who depended, in large part, on the net cash flow of and the equity in the project-level Debtors as a principal source of protection for their investment.” *Id.* at 30.

controlling Delaware Supreme Court case that states the proposition that directors have duties to the corporation and its shareholders when operating in a “zone of insolvency.”<sup>21</sup> This is an accurate statement as to present Delaware law, but not necessarily one that has been accepted by the CMBS market with respect to its assumptions about the mitigating role independent directors should play in the decision to file for bankruptcy. Most CMBS lenders did not expect an independent director to act as a shield for the lender,<sup>22</sup> but they probably did not underwrite the probability that the independent director would also be focused on the interests of the parent entity.<sup>23</sup> Commenting on the confusion about the role of the independent directors, the Court states, “the record at bar does not explain exactly what the Independent Managers were supposed to do.”<sup>24</sup> At the outset of the case, concern seemed to focus on the termination of the independent directors that were in place and their replacement with individuals hand-picked by GGP. The real question is whether this even mattered, given the standard of duty to all independent directors are held under Delaware law.<sup>25</sup>

As the GGP case moves forward, CMBS lenders will focus on ways to “fix” the independent director issue, namely whether there are structural or documentary changes that will result in a legally sound basis for continuing to rely on this mechanism as a

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<sup>21</sup> North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007). Gheewalla does acknowledge that creditors may bring a derivative action against directors on behalf of the corporation, a useless remedy in the context of an independent director whose sole function is to vote on insolvency matters.

<sup>22</sup> As the Court noted, “if [Secured Lenders] believed 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 a secured creditor, they were mistaken.” Opinion at 33.

<sup>23</sup> As one commentator noted, “the brand new law the judge made was this: in determining whether SPEs may file for Chapter 11 bankruptcy, independent directors perhaps must take into account the interests of the parent corporation.” Daniel Rubock, *GGP Judge: Bankruptcy-Remote Entities Remain in Bankruptcy, but Don’t Worry About Substantive Consolidation*, Moody’s Structured Finance, August, 2009.

<sup>24</sup> Opinion at 33.

<sup>25</sup> Notwithstanding the expectations of the secured lenders, at least two of the place-holder directors voted in favor of the Chapter 11 filings of those debtors on whose boards they still served. Opinion at 40.

bankruptcy mitigant in future transactions.<sup>26</sup> In formulating any such proposals, one of the key questions is the linkage between the “corporate family” doctrine and the expanded scope of duty for independent directors under the *Gheewalla* case.

### **Substantive Consolidation**

The initial concern over substantive consolidation has abated, thankfully. On multiple occasions, in writing and from the bench, the Court has swatted away the possibility, most recently stating, “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.”<sup>27</sup> Some commenting on the case remain focused on substantive consolidation, but as discussed above, the real concern may be the slow creep via judicial expansion of the “corporate family” doctrine.<sup>28</sup>

With all the anticipation surrounding GGP, there may be a tendency, of which we are no doubt at least guilty in part, of reading too much into the various interlocutory statements by the Court as the case grinds forward. In the Opinion before us now, the narrow issue is really just to decide the grounds for sustaining or denying a motion to dismiss. In dealing with this issue, the Court expressly favors a case-by-case approach, but one that takes into account “the interests of the group as well as the interests of the individual debtor.”<sup>29</sup> This does not mean the end for CMBS lending or for the use of

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<sup>26</sup> One of the structural “fixes” under discussion in the CMBS industry is the prospect of requiring SPE borrowers to hold their assets in a business trust, with Delaware being the oft-spoken venue of choice. However, given the Court’s treatment of an Illinois business trust in the GGP case, a similar use of Delaware business trusts would likely be ineffective. Focusing on the actions of the business trust rather than organizational formalities, the Court dismisses the idea that a business trust is not a bankruptcy eligible debtor. Opinion at 43.

<sup>27</sup> Opinion at 42.

<sup>28</sup> See Rubock *supra* note 2.

<sup>29</sup> Opinion at 30.

single purpose entity structures. It does mean that lenders need to adjust their expectations to fit this – to some degree, new – reality.

### **Conclusion**

In assessing the ramifications of the Court’s treatment of GGP and its SPEs under the “corporate family” doctrine, the unanswerable question is the extent to which the Court’s decision is a reaction to the collapse in the markets for real estate credit. From a secured lender’s perspective, the real test of the SPE structure is whether it can withstand the pressure of bankruptcy. Given the market conditions of the last 18 months, the Court appears to be saying that the state of the markets is a crucial fact by itself in the case, and that these market conditions merit a balancing of the genuine expectations of the secured creditors as to the durability of the SPE structure against the reasonable expectation of GGP and the SPE borrowers that a refinancing market would exist.<sup>30</sup> Put another way, the dire market conditions that provide the context for this case may act to limit its precedential impact, at least in market climates more hospitable to raising capital.

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<sup>30</sup> As the Court noted, “[f]aced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to refinance the project-level debt, the Debtors’ management had to reorganize the Group’s capital structure. [Secured Lenders] do not explain how the billions of dollars of unsecured debt at the parent levels could be restructured responsibly if the cash flow of the parent companies continued to be based on the earnings of subsidiaries that had debt coming due in a period of years without any known means of providing for repayment or refinance.” Opinion at 30.