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Protecting Lenders In Structured Financing Transactions: The Utility of "Bankruptcy-Remote" Entities Following In re GGP Properties, Inc.

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November 20, 2013 - In 2009, Judge Allan L. Gropper of the U.S. Bankruptcy Court for the Southern District of New York issued several remarkable rulings in the bankruptcy *In re GGP Properties, Inc.*[1]("GGP"). Participants in structured credit markets initially expressed their "grave concern" regarding the potential "catastrophic impact" of the GGP rulings.[2] While the ultimate effects of the rulings remain unsettled, they do demand that lenders reconsider the limits of protection manufactured through the use of "bankruptcy-remote" special purpose entities in structured-financing transactions.

Background

Borrowers regularly use special purpose entities ("SPEs") to increase access to structured credit markets. The advantages of financing through an SPE are built into the operating documents, which typically include separateness covenants and limited recourse provisions that seek to make the SPE "bankruptcy-remote" to protect lenders from becoming entangled in insolvency proceedings in separate areas of an SPE's Company.

GGP was a publicly-held shopping mall owner, and the second-largest mall operator in the United States. Most of its real estate properties were held by individual SPE subsidiaries, who directly owed the debt for financing agreements on the properties but in a structure that kept the assets separate from credit risk elsewhere in the Company. This enabled lenders to have their loans secured by the relatively predictable cash flows from specific real estate assets.

GGP had historically satisfied its capital funding needs through commercial mortgages, relying on the market for commercial mortgage-backed securities ("CMBS"). GGP's debt was typically secured by SPE-owned shopping center properties. GGP's CMBS funding model impelled it to regularly refinance SPE-held debt before exploding repayments scheduled near maturity became due.

Notable Rulings

Judge Gropper made two critical rulings that immediately reverberated across the credit markets: first, that the well-capitalized, solvent SPEs were included in GGP's voluntary bankruptcy filing, and second, that GGP's debtor-in-possession ("DIP") financing facility could be secured by excess rents generated by the SPE subsidiaries. Collectively, these rulings undermined the previously assumed effectiveness of SPEs' structure to isolate its assets from affiliated entities.[3]

Although the GGP rulings addressed credit in the CMBS market, the implications of the rulings cast doubt on what were thought to be sacrosanct arrangements in structured financing markets more generally. A more recent decision by the Seventh Circuit demonstrates that GGP is not an isolated instance of judicial skepticism of SPEs. In *Paloian v. LaSalle Bank, N.A.*, ("*Paloian*"), the Seventh Circuit reminded lenders that an SPE cannot be insulated from other creditors unless the SPE conducts *bona fide* business transactions with the debtor (such as a "true sale"), manages the assets it holds in its own interest rather than the debtor's, and observes proper corporate formalities such as maintaining offices, phone numbers, e-mails, and bank accounts, preparing financial statements, and filing tax returns.[4] Following these rulings, the extent of SPEs' ability to isolate assets and limit risk for lenders remains uncertain. The GGP rulings indicate that enhanced structures and other mechanisms may be needed to protect lenders from the risk posed by insolvency in an SPE's affiliated Company.

Practical Implications for Lenders

Despite the GGP and Seventh Circuit rulings that call into question bankruptcy-remote entities' separateness, an SPE's organizational and financing documents remain the most effective tools for isolating assets from an affiliated company's bankruptcy.

Lenders should seek provisions in a special purpose borrower's operating agreement that:

1. Require independent directors, mandated to consider only the interests of the borrower and its creditors when considering bankruptcy filings, to the extent permitted under applicable law;
2. Demand notice prior to a borrower's dismissal or replacement of independent directors. Notice would potentially allow lenders to seek further protections prior to an SPE's bankruptcy filing and encourage consensual refinancing or restructuring of a borrower's debt out of court; and
3. Ensure adherence to corporate formalities.[5]

Further, the creditworthiness and default risk of an SPE's sponsoring and affiliated Company is a factor that needs to be carefully scrutinized. For example, a group that may face maturing debt concomitantly or who operates through a highly-leveraged capital structure should signal a potential need for additional guarantees or credit facilities. Risky group-level debt structures indicate susceptibility to liquidity crunches and a group's potential to upstream and pool SPEs' cash flows when troubled. Last, the operating agreement or loan documents should declare the governing law, both for establishing the SPE-transferee's independence and for determining the presence of a "true sale."

Footnotes

[1]. *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[2]. Amended Brief of *Amici Curiae* With Respect to the Filing of Voluntary Petitions in Bankruptcy by the Individual Property Owner Subsidiaries in the GGP Properties, Inc. Bankruptcy, Brief for Commercial Mortgage Securities Association and Mortgage Bankers Association, ("CMSA *Amici* Brief"), *In re Gen. Growth Props, Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. May 1, 2009), ECF No. 289, at 3.

[3]. Key determinations included:

1. The bankruptcy court approved GGP's DIP financing facility, secured by excess rents from SPE subsidiaries. The court held that the SPE structure did not preclude up-streaming excess cash for the benefit of the GGP group.
2. The court denied several motions to dismiss SPE-debtors' voluntary bankruptcy filings for cause pursuant to § 1112(b) of the Bankruptcy Code. Judge Gropper denied movants' arguments that the SPEs' filings were improper and in bad faith. He predicated approval of the SPEs' filings on aspects of (i) GGP's course of funding and market conditions, (ii) boards' duties under applicable law and (iii) provisions of the SPEs' operating agreements, themselves.
3. The court did not question the legal separateness of the SPEs and refused to substantively consolidate the SPEs' bankruptcy estates with those of other affiliates or GGP. In re GGP, 409 B.R. at 69 ("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.").

[4] 619 F.3d 688 (7th Cir. 2010).

[5]. The Seventh Circuit's remand opinion in *Paloian* provides guidance regarding which corporate formalities lenders should include in formal documents. See *Paloian*, 619 F.3d at 696 (listing attributes of separateness the court found lacking in the SPE's operations); see also Samantha Rothman, L*essons from General Growth Properties: The Future of the Special Purpose Entity*, 17 Fordham J. Corp. & Fin. L. 227, 257 (2012) (listing several corporate governance provisions to ensure an SPE abides by corporate formalities).

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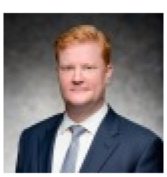

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