SHULMAN HODGES & BASTIAN LLP
Redefining Full Service.

Special Purpose Entities NOT So Bankruptcy Remote

by Leonard M. Shulman, Managing Partner and Michael J. Petersen, Partner

I. Special Purpose Entities required by lenders

For many years commercial real estate lenders have required borrowers over a certain size to own the commercial real estate being pledged as collateral in a Special Purpose Entity (commonly called an "SPE"). The SPE is a corporation or more often a limited liability company with its sole asset the commercial real property collateral. Often the SPE imposes restrictions upon additional debt and requires "independent" members or directors, whose approval is required for the SPE to file for bankruptcy.

Among the lender's purposes in requiring SPEs is to prevent the owners of the commercial property from seeking bankruptcy protection in the event of foreclosure. This purpose is arguably achieved by: (1) setting up the SPE as a separate entity so that (a) its debts and obligations will not be consolidated with the parent/owner of the SPE and (b) the financial problems of the parent/owner will not give rise to a cause for the SPE to file for bankruptcy; (2) making bankruptcy filing by the SPE unlikely because its only debt is the commercial real estate loan; (3) making the ability to file a bankruptcy difficult to obtain by requiring "independent" members' or directors' approval; and (4) setting up a situation where, if the SPE did file, the lender would likely receive prompt relief from stay, as the only asset is the commercial property subject to the lender's lien as the only creditor.

II. General Growth Properties files bankruptcy and establishes a new paradigm when 388 SPEs also file bankruptcy

General Growth Properties, Inc. ("GGP") is a publicly traded real estate investment trust (commonly referred to as a "REIT") and ultimate parent of 750 subsidiaries, joint ventures and affiliate entities through which it owns or manages 200 shopping centers and a variety of other real estate investments.

On April 16, 2009, GGP filed for bankruptcy in the Southern District of New York. At the same time, 388 of its affiliated entities, primarily SPEs, also filed for bankruptcy. That day, GGP moved for and obtained an order for joint administration of its bankruptcy and those of its SPE entities. Metropolitan Life Insurance Company, KBC Bank N.V., ING Clarion Capital Loan Services LLC and Helios AMC, LLC, as special services to certain secured lenders, moved to dismiss the bankruptcies of the SPEs on the grounds of bad faith. Judge Allan L. Gropper denied the motions and issued a Memorandum of Opinion dated August 11, 2009. *In re General Growth Properties, Inc.,* 409 B.R. 43 (Bankr. S.D.N.Y. Aug. 11, 2009). The judge examined four essential factors in determining there was not a basis to dismiss the SPE filings on the grounds of bad faith.

A. The financing/refinancing business model was no longer operative

GGP's basic business plan, common to most real estate companies, was to finance its properties by borrowing with loans generally maturing in three to seven years with low rates of amortization. Upon maturity GGP would refinance the existing loans. GGP contended that as of the filing, refinancing simply was not available, noting among other facts that the CMBS (Commercial Mortgage Back Securities) market upon which GGP had relied was "dead." Not surprising to anyone who has followed the commercial real estate credit markets, the judge noted that there was no evidence to suggest GGP could refinance the billions of dollars in loans coming due.

B. SPE's determination to file bankruptcy must consider parent/owner needs

The lenders argued that any bankruptcy filing by an SPE had to be based solely upon the situation of that SPE. The court rejected this position, noting (a) the lenders were aware of the relationship, (b) Delaware law requires the interest of the parent as owner be considered by the SPE decision makers, who owe the owners a fiduciary duty, and (c) independent managers/board members can NOT serve solely for the purpose of voting "no" on bankruptcy filings.

C. The bankruptcy filings of the SPEs met the subjective good faith standard

The lenders raised two issues in their attempt to demonstrate a lack of subjective good faith. First, the lenders cited the failure of GGP to negotiate with them prior to filing. The court found there was no duty to negotiate prior to filing.

Second, the lenders raised the issue that immediately before filing, GGP had fired the existing independent managers, without notice to the lenders or independent managers, and replaced them with two "seasoned hands," who approved the bankruptcy filings. The court noted (i) that the replacements conformed to the requirements of the documents, and (ii) earlier discussions regarding the duties of the new managers concluded there was no showing of a lack of subjective good faith.

D. Bankruptcy filings by the SPEs were NOT too early

The lenders argued that the filings were premature and the SPEs should have waited until default or imminent default. The court noted there was no requirement of insolvency to file bankruptcy. Furthermore, the court noted a policy of encouraging early filing to preserve assets. Under the circumstances, with refinancing no longer viable, the court declined to find the filings premature.

III. What does GGP mean for other lenders and borrowers

A. Borrowers

Real estate companies that are in a similar predicament to GGP have to consider a similar parent/SPE filing. It should be noted that the GGP bankruptcy restructuring appears to have been successful, with GGP planning to exit bankruptcy. One note of caution, the GGP case is in the Southern District of New York, and thus far appears relatively unique. There can be no assurance that local courts will look at matters similarly and each case is likely to turn on its own unique facts.

B. Lenders

Lenders should seek to strengthen their SPE requirements to provide for notice and consent for the replacement of independent managers or board members. Lenders also need to be aware of the risk that a consolidated filing will be permitted.

Leonard Shulman

Leonard M. Shulman is the Managing Partner of Shulman Hodges & Bastian LLP. He concentrates his practice in Commercial Law and Bankruptcy and handles all aspects of litigation, creditors' rights, mergers and acquisitions, trustee, creditor's committee and the representation of debtor's in the insolvency context and can be reached at lshulman@shbllp.com.

Michael Petersen

Michael J. Petersen is a Partner in the Corporate and Transactional Department at Shulman Hodges & Bastian LLP. Mr. Petersen handles a full range of business activities including lender and creditor representation and can be reached at mpetersen@shbllp.com.