

New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11: Part I

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Editor's Note: Please refer to the cover article by Brian M. Resnick and Steven C. Krause in the October 2009 issue that also discusses the recent General Growth Properties ruling. The article in this issue (Part I of a two-part series) discusses the ruling and its potential ramifications in additional detail.

In enacting chapter 11 in 1978, Congress deleted the requirement of former chapter X that the bankruptcy court hold a hearing to determine whether the petition was filed in good faith. Under the Bankruptcy Act of 1898, courts had to be satisfied that a chapter X case was filed in good faith—and otherwise complied with chapter X requirements—or the petition would be dismissed.

Since this change, courts have resisted efforts to dismiss chapter 11 cases for lack of good faith in filing the petition, except upon evidence of the most egregious forms of bad faith. Courts have typically only found bad faith in filing where the debtor owned a single parcel of real estate and filed for chapter 11 on the eve of a foreclosure sale, or where a clearly solvent debtor filed for chapter 11 in an effort to discharge liability, which a plaintiff in nonbankruptcy court litigation was attempting to reduce to judgment.

Nevertheless, in *In re General Growth Properties Inc., et al.*, Case No. 09-11977 (Bankr. S.D.N.Y.), three secured lenders were so concerned about chapter 11 filings by 21 so-called property-level entities (the subject debtors) of the lead debtor that those lenders filed motions to dismiss the subject debtors' cases. Many of these subject debtors were organized as special-purpose entities (SPEs). They had provisions in their organizational documents that the lenders had required as a condition for lending, intending to isolate the SPEs from the potential bankruptcy filings of the rest of their corporate family. Several of the subject debtors also had clauses in their operating agreements designed to

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make them “bankruptcy remote.” The lenders argued that the subject debtors' bad faith was manifested in their admitted solvency and lack of imminent financial distress, as well as their dead-of-night replacement of independent directors (the appointment of which was a condition of many of the lenders' loan documents) with ones who would approve bankruptcy filings that were not in the lenders' best interests.

After a two-day trial and weeks of deliberation, Bankruptcy Judge **Allan L. Gropper** denied the motions to dismiss.

Feature

While not *per se* excluding bad-faith filing as cause for dismissing a chapter 11 case, the court confirmed that insolvency is not a requirement for a debtor to file for chapter 11, and that a subsidiary that files as part of its corporate family's chapter 11 case may not itself need to be in any financial jeopardy. In so holding, the court's decision arguably may have eviscerated the reliability of certain bankruptcy-remote provisions, including requiring the unanimous vote of independent directors to file for bankruptcy. This holding is also leading many in the structured-finance industry to question the effectiveness of the SPE structure as a means of ensuring a subsidiary will be isolated from its parent's bankruptcy filing.¹

Why Did 21 Solvent Companies Need to File for Bankruptcy?

General Growth Properties Inc. (GGP), a publicly-traded real estate investment trust (REIT), is the second-largest owner and operator of malls in the United States. It owns or manages more than 200 shopping centers, plus a number

¹ To be clear, the GGP court did not address the issue of the possible substantive consolidation of any of the subject debtors' estates with that of the parent company. The issue before the court was whether the filing of bankruptcy by the subject debtors was in good faith. The issue of substantive consolidation may, or may not, be raised in the future.

of office buildings, master-planned communities and other properties and ventures. Its signature properties include Water Tower Place in Chicago, Faneuil Hall Marketplace in Boston, South Street Seaport in New York and the Grand Canal Shoppes at the Venetian Hotel in Las Vegas.

On April 16, 2009, GGP and hundreds of its affiliates—eventually totaling 388 debtors—filed the biggest real estate bankruptcy case in U.S. history. The stated principal reason for GGP's filing was that billions of dollars' worth of its loans had matured or soon would mature. Due to the credit crunch and the breakdown of the commercial mortgage-backed securities (CMBS) market, GGP was unable to extend or refinance its maturing debt, even at prices that would have been painfully high.

Why so many of GGP's affiliates filed, and how GGP determined which ones should file, is more complicated. A majority of the debtors are SPEs that own just a single real estate asset and have no employees. This structure is a product of the way GGP financed its acquisitions and operations: The bulk of GGP's financing is in the form of mortgage loans that amortizes very little principal during their intended term, which leaves a substantial balloon payment at maturity. Many of these loans have terms of just three to seven years, while others technically mature at a later date but have an “anticipated repayment date” partially into the term, at which point they begin to “hyperamortize” and accrue interest at high rates, thereby forcing GGP to extend or refinance them long before maturity.

As a condition of extending this type of financing, GGP's lenders imposed a variety of requirements on how GGP holds its properties. The most common requirements are that each property be owned by an SPE and that its organizational documents contain bankruptcy-remote provisions. In the real estate industry, an SPE is

often a single-member LLC, which has no assets other than a single real estate asset and no debt other than a single loan secured by that real estate. The SPE is typically prohibited from incurring or guaranteeing additional indebtedness, selling its single asset, merging or amending its organizational documents without lender consent.

To those ends, and significantly for the GGP case, many of the subject SPEs were designed to be “bankruptcy remote.” Bankruptcy-remote provisions are a subset of SPE provisions, usually found in both the loan documents and the SPE’s organizational documents, which provide for independent directors (for a corporation) or managers (for an LLC) whose affirmative votes are required before the SPE can file for bankruptcy. These provisions: (1) reduce the likelihood that an SPE will be swept up in a bankruptcy filing by other members of its corporate family, (2) protect the lender’s position in collateral by preventing the SPE’s excess cash from being used to fund the bankruptcy case (it greatly reduces the risk that the SPE would be consolidated with related entities) and (3) limits access to a borrower’s foremost foreclosure prevention tool: bankruptcy.

Not all of the SPEs that are part of the GGP bankruptcy filing had loans that were about to mature or were experiencing other financial distress as stand-alone entities. To the contrary, while some of the subject debtors had loans due or hyperamortizing as of the petition date, others’ loans will not mature or hyperamortize until 2011, 2012 and possibly later. Further, all but one of GGP’s lenders professed to be over-secured. It is unclear whether that was universally true, but it generally appeared that each subject debtor was solvent on the date of filing.

GGP presented evidence that the subject debtors’ Boards of Directors considered a number of factors in deciding whether to file petitions for each subject debtor, including whether its loan documents contained cross-default clauses that would be triggered by other affiliates’ bankruptcy filings, whether it was already in default or had loans maturing or hyperamortizing within three years of the petition date, whether its mortgage loan had a loan-to-value ratio above 70 percent, whether GGP contemplated selling the subject

debtor’s assets through a §363 sale, and (more candidly) whether it had unencumbered assets that could be used to fund the bankruptcy case and obtain postpetition financing.

GGP succeeded in using the SPEs’ unencumbered assets to fund the bankruptcy case. Early in the case, the court held that GGP could continue to sweep excess cash from the SPEs’ accounts, as it had done prepetition. The final order authorizing GGP to obtain debtor-in-possession financing and use cash collateral provided significant protection for any such cash that was collateral for loans to the SPE debtors.²

Prematurity/Objective Evidence of Bad Faith

Section 1112(b) of the Bankruptcy Code requires bankruptcy courts to dismiss a bankruptcy case, or convert it to a chapter 7, if a party-in-interest establishes cause for doing so. The statute provides an inclusive list of examples of cause, none of which involves bad faith in filing the case. However, in the Second Circuit (and elsewhere), courts have treated bad faith in filing as an additional cause for dismissal. Elaborating on these cases, the *GGP* court examined objective and subjective evidence of the subject debtors’ alleged bad faith, and whether their attempted reorganization was objectively futile. The court did find that the lenders had not proved objective futility, but its finding that the subject debtors had acted in good faith is the aspect of the decision that will likely have far-reaching consequences.

Judge Gropper found that most of the subject debtors were in some degree of financial distress on the petition date, and that when considering the interests of the GGP group as a whole, the subject debtors’ petitions were not filed so prematurely as to demonstrate objective bad faith in filing. The lenders argued that the lack of financial distress or imminent loan defaults by the subject debtors made their bankruptcy filings premature.

The court found that one subject debtor’s loan was already hyperamortizing; the loans of five others would mature or begin to

hyperamortize in 2010, with three others doing so in 2011 or 2012. Several others were either guarantors of, or had posted collateral for, loans that were maturing soon; others’ loans contained cross-default clauses that would have been triggered by GGP’s bankruptcy filing had the subject debtors not also filed; and the few remaining subject debtors had other considerations, which made their boards reasonably believe they were in financial distress. The court did not specify what these other considerations were, other than to give one example: namely, that a loan had a loan-to-value ratio above 70 percent. Nor is it clear from GGP’s memoranda in opposition to the motions to dismiss what such other considerations included; in one instance, GGP alleged that the only factors that one subject debtor’s management considered were “[o]ther financial considerations.”³

Another important consideration was the uncertainty in the CMBS market, upon which the debtors had relied heavily to refinance loans as they came due. CMBS issuances during the first three quarters of 2008 were down a staggering 97 percent from the same period the year before. Even one of the lenders’ representatives testified that based on current circumstances, the CMBS market would be unlikely to issue enough debt to refinance the subject debtors’ debt coming due in 2009 through 2012.⁴ The court was persuaded that given the potential difficulty in refinancing their loans—even those that would not need to be refinanced for three years—it was reasonable for the subject debtors to file for bankruptcy along with the rest of the corporate group.

In holding that the subject debtors’ petitions were not filed prematurely, the court distinguished *In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999), among other cases. In *SGL Carbon*, the U.S. Court of Appeals for the Third Circuit held that a case was filed in bad faith where the debtor was financially healthy other than having a significant antitrust case pending against it. The GGP court distinguished *SGL Carbon*, on the grounds that unlike

³ Debtors’ Memorandum of Law in Opposition to the Motions of ING Clarion Capital Loan Services LLC and Wells Fargo Bank NA, as trustee, et al., to Dismiss the Cases of Certain Debtors and Debtors in Possession, at 25 (Dkt. No. 711) (referring to HO Retail Properties II Limited Partnership).

⁴ *Mem. Op.* at 26.

² Final Order Authorizing Debtors To (A) Obtain Postpetition Secured Financing Pursuant To Bankruptcy Code §§105(A), 362 and 364; (B) Use Cash Collateral And Grant Adequate Protection Pursuant To Bankruptcy Code §§361 And 363; and (C) Repay In Full Amounts Owed Under Certain Prepetition Secured Loan Agreement, at 20-24 (Dkt. No. 527) (May 14, 2009).

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SGL Carbon’s disputed and contingent debts, the GGP family “carr[ies] an enormous amount of fixed debt that is not contingent.”⁵

Preview of Part II

Predictably, lenders and other structured-finance participants are

concerned about any decision that makes it easier for a solvent borrower to file for bankruptcy, especially a solvent borrower that they have gone to lengths to isolate from its less credit-worthy affiliates. The aspect of *GGP* that may prove to be its biggest bombshell—the court’s interpretation

of independent directors’ duty to their company’s shareholder—will be discussed in Part II of this article. Part II will also examine the potential consequences of the *GGP* decision, including questioning whether some of the fears about the decision are being exaggerated. ■

⁵ *Mem. Op.*, at 21.

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