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GGP Opinion Leaves Unanswered Questions

On August 11, the Honorable Allan L. Gropper issued an opinion of the U.S. Bankruptcy Court for the Southern District of New York denying five motions to dismiss certain Chapter 11 bankruptcy cases of several property-specific special purpose subsidiaries (SPE Debtors), including a number of issuers of commercial mortgage-backed securities (CMBS), that are owned by mall operator General Growth Properties, Inc. (GGP).¹

Multiple lenders (SPE Lenders), each holding a first mortgage loan secured by property of one of the SPE Debtors, filed the motions shortly after the commencement of the GGP bankruptcy on April 16. On May 14, Judge Gropper had previously entered an order granting GGP's motions to use net cash flow generated from properties encumbered by secured debt, and approved a \$400 million DIP loan from a group of lenders.²

GGP, a publicly traded real estate investment trust (REIT), operates approximately 200 malls and shopping centers and is the ultimate parent of approximately 750 wholly owned debtors and affiliates, including the SPE Debtors. In denying the Motions, Judge Gropper examined in detail the complex corporate and capital structure of GGP before specifically addressing the merits of the Motions. One aspect of the GGP structure is the creation of a separate special purpose entity (SPE) to own each project in order to isolate the assets, liabilities and operations of that project from those of affiliated entities. The use of an SPE creates a "bankruptcy remote" structure that lenders often require for certain loans, including those originated for the CMBS market. The loans of the SPE Lenders include CMBS loans, and the GGP case has been closely followed by the securitization community since the April 16 filing.

The SPE Lenders sought dismissal of the bankruptcy cases of the SPE Debtors on two key grounds: (i) that the cases were filed in bad faith, and (ii) that the cases were filed without requisite authority. Noting that the dismissal of a Chapter 11 case on the grounds that it was filed in bad faith is "judge-made" doctrine, Judge Gropper embraced precedent set by earlier cases that found that a bankruptcy will be dismissed for bad faith only if both "objective futility of the reorganization process" and "subjective bad faith in filing the petition" are found. In determining whether good faith exists, the court stressed that no single factor is determinative and that it must examine "the totality of the circumstances."

In seeking a dismissal of the SPE Debtors' bankruptcy cases, the SPE Lenders argued that the SPE Debtors filed their bankruptcy cases prematurely. Specifically, the SPE Lenders argued that none of the SPE Debtors had a mortgage with a maturity date earlier than

¹ Click [here](#) for the opinion. The August 14 issue of Katten's *Corporate Financial Weekly Digest* first reporting that decision can be found [here](#).

² The June 3 Katten Client Advisory "The GGP Case—What It Means for Lenders," which more fully describes the earlier decision, can be found [here](#).

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March 2010, and consequently, the SPE Debtors should have waited until much closer to the maturity dates on their respective loans to file for bankruptcy. The SPE Lenders further argued that the issue of financial distress and prematurity of filing should not be addressed from the perspective of the GGP debtors as a group, but separately on an individual entity basis.

The court found that the issues should be evaluated from the perspective of the group. The court noted that the Bankruptcy Code does not require a debtor to be insolvent as a condition to filing, but also found that the SPE Debtors were in varying degrees of financial distress at the time of filing. The court cited multiple factors, including a large amount of fixed debt that is not contingent, cross-default provisions of loans that caused defaults under loans of affiliates, and hyper-amortization provisions of the loans. When triggered, the hyper-amortization provision of the loans causes substantial increases in the interest rate and requires excess cash generated by the mortgaged property to be used to pay down the principal balance of the loan.

The court acknowledged that the intent of the structure of the SPE Debtors was to insulate the financial position of each from the problems of its affiliates and to make the prospect of a bankruptcy less likely. However, Judge Gropper noted that when the SPE Lenders made their loans, they were aware that they were extending credit to an entity that was part of a much larger group and that GGP, the ultimate parent of the SPE Debtors, clearly depends on the cash flow of its subsidiaries. Accordingly, adding that the SPE Lenders did not question GGP's good faith in filing its own Chapter 11 petition, the court ruled that the filings by the SPE Debtors were not premature from the group perspective.

The SPE Lenders also asserted that the SPE Debtors acted in "subjective bad faith" because the independent managers of the SPE Debtors were replaced on the eve of filing. Judge Gropper found that the organizational documents of the SPE Debtors did not prohibit such action and that the new independent managers were qualified to serve. Therefore, the removal of the independent managers did not constitute subjective bad faith on the part of either GGP or the SPE Debtors sufficient to require dismissal.

In denying the Motions, Judge Gropper also concluded that the rights of the SPE Lenders were not materially impaired by the bankruptcy filings of the SPE Debtors. The court pointed out that the SPE Lenders were given various forms of adequate protection, such as payment of interest on their loans at the non-default rate, continued maintenance of the properties encumbered by their liens, a replacement lien on the cash from the properties of the SPE Debtors that is paid upstream to the GGP parent, and a second priority lien on other properties. While acknowledging that the SPE Lenders had been "inconvenienced" by the filings, Judge Gropper found that the fundamental protections that the SPE Lenders negotiated in their loan transactions and the SPE structure remain in place and will remain in place during the Chapter 11 cases, which he specifically stated "includes protection against the substantive consolidation of the project-level Debtors with any other entities."

The opinion also raises the question of the extent to which other courts will follow Judge Gropper's reasoning and allow SPE entities to reorganize in Chapter 11 if they are affiliated with a larger group. The opinion appears to be influenced by the specific facts before the court, especially the awareness of the SPE Lenders that they were extending credit to an SPE that was part of a much larger group. It remains to be seen whether this reasoning will be extended in other cases to an SPE entity that is part of a smaller affiliated group. Certainly, parties to other troubled commercial real estate ventures are following the strategies of GGP and may try to use them if their own filing is necessary. It is not known at this time whether the SPE Lenders will appeal, and if they do, whether the appellate courts will affirm or overturn. At the time of the publication of this advisory, the court is receiving proposed forms of orders from the parties. The time for appeal will run from the date the court enters the order denying the Motions.

The opinion ends with a closing suggestion to the parties: "These Motions are a diversion from the parties' real task, which is to get each of the Subject Debtors out of bankruptcy as soon as feasible. The Movants assert talks with them should have begun earlier. It is time that negotiations begin in earnest."

There are still many questions left unanswered in the GGP cases that raise specific issues for real estate lenders, including securitization market participants, and broader general issues. One question that remains is whether the bankruptcy cases of GGP and its affiliated debtors will be substantively consolidated. Although Judge Gropper states that nothing in his opinion implies that the assets and liabilities of any of the SPE Debtors could properly be substantively consolidated with those of

any other entity, substantive consolidation was not before the court. There is currently no pending motion for substantive consolidation, and GGP may not disclose its intentions until it files its plan or plans of reorganization. Absent substantive consolidation, how will GGP confirm the plans of reorganization of the SPE Debtors over the objections of the SPE Lenders? Will GGP try to use the “cramdown” provisions of the Bankruptcy Code to force the SPE Lenders to accept the terms of their plans? Alternatively, will GGP and the SPE Lenders follow Judge Gropper’s suggestion and reach a negotiated resolution? The court has extended until February 26, 2010, the exclusive period during which only the GGP debtors may file their plan or plans of reorganization, with a status conference on plan formulation and progress to be scheduled in November or December, and the real estate lending and securitization community undoubtedly will continue to follow the case with interest.

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