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

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Editor's Note: *Part I appeared in the November 2009 issue. 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.*

As discussed in Part I, General Growth Properties Inc. (GGP), along with 387 of its affiliates and subsidiaries, filed the largest real estate bankruptcy case in history in April 2009.[1] Among the debtors were numerous single-purpose entities (SPEs), which held single real estate assets. Some of the SPEs were designed to be bankruptcy-remote, as evidenced in some instances by provisions in their organizational documents that required the unanimous consent of one or more independent directors before the SPEs could file for bankruptcy.

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Three lenders moved to dismiss the cases filed by 21 of the SPEs (the subject debtors) on the grounds that they were filed in bad faith. Among other grounds, the lenders asserted that the subject debtors were not insolvent or about to be insolvent at the time of the filings, and that the filings were therefore premature. The lenders also expressed concern about the replacement of the subject debtors' independent directors, arguing that doing so circumvented the bankruptcy-remote provisions in their organizational documents.

About the Author

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Part I explained that on Aug. 11, 2009, the U.S. Bankruptcy Court for the Southern District of New York denied the lenders' motions, finding that the SPEs' chapter 11 filings were not premature and therefore not objectively filed in bad faith. Part II examines the court's finding that there was no subjective evidence of bad faith, as well as the potential consequences of the *GGP* decision.

Feature

Corporate Group Filing and Subjective Evidence of Bad Faith

Perhaps the most contentious and consequential aspect of the *GGP* decision is that the subject debtors' boards, including their independent managers, were justified in considering, and even *required to* consider the parent company's interests in deciding whether to file chapter 11 petitions. The court followed case law from the Fourth and Fifth Circuits, holding that the standard for determining whether a subsidiary of a parent company in chapter 11 filed its own petition in good faith is whether the subsidiary "should have been included in the parent company's bankruptcy estate," *not* whether the subsidiary standing alone needed to file.[2] Where *GGP* broke new ground was in finding good faith notwithstanding the subject debtors' alleged disregard of the SPE and bankruptcy-remote elements in their organizational documents.

Under state law, specifically Delaware law, even an independent manager has duties to the company's shareholders. Many of the subject debtors' operating agreements acknowledged this requirement. On the one hand, the operating agreements seemed to provide otherwise by stating that "[t]o the extent permitted by law... the Independent Managers shall consider only the interests of the Company, including its respective creditors, in acting or otherwise voting on the matters referred to Article XIII(p)" (Article XIII(p) requires unanimous consent of the applicable subject debtors' managers prior to filing for bankruptcy). On the other hand, the operating agreements provided that "in exercising their rights and performing their duties under this Agreement, any Independent Manager shall have a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware." The court described it as appropriate to expressly provide that the independent managers' duties were similar to those of directors of corporations, suggesting that independent managers have such duties irrespective of whether the LLC's operating agreement so provides.

1 *In re General Growth Properties Inc., et al.*, Case No. 09-11977 (Bankr. S.D.N.Y.).

2 *See, e.g., In re U.I.P. Engineered Prods. Corp.*, 831 F.2d 54, 56 (4th Cir. 1987); In re Mirant Corp., 2005 WL 2148362 (Bankr. N.D. Tex. 2005).

The court interpreted Delaware law as requiring directors, including independent directors, to consider the interests of shareholders as long as a corporation is solvent. In 2007, the Delaware Supreme Court rejected a controversial line of Chancery Court holdings that held that had expanded directors' fiduciary obligations expand to include the company's creditors not just when the company is clearly insolvent, but any time the company is operating in the "zone of insolvency."[3] Ostensibly following this case, the *GGP* court held that an independent manager of a solvent subsidiary must consider the interests of the parent company ahead of the company's creditors in deciding whether to authorize a bankruptcy filing. The logical extension of this reasoning is that, even in its operating agreement, a subsidiary cannot contract around independent managers' or directors' duties to the parent company while the subsidiary is solvent.

While acknowledging that the subject debtors' replacement of their independent managers was "surreptitious," the court found that the replacement was probably consistent with the subject debtors' operating agreements, and in any event was intended to preserve value rather than to defraud the subject debtors' creditors. As is customary in the structured-finance world, the lenders and GGP agreed to obtain independent managers from a placement agency, Corporation Service Co. (CSC). GGP replaced the subject debtors' independent managers approximately one month before filing, but did not notify CSC of the replacement until the case was filed. However, upon reviewing documents provided by the debtors, the two independent managers who had been replaced testified that they had been properly removed.[4] In the end, the lenders were unable, or possibly unwilling, to present credible evidence that the replacement was wrongful. In fact, one lender not discussed in the opinion withdrew its motion to dismiss, according to GGP's counsel, "[a]fter conducting discovery on the SPEs' process for obtaining authority to file bankruptcy."[5]

The court also implied that even if suspicious, the replacement of the independent managers in order to facilitate a bankruptcy filing might not have been a sufficient display of bad faith to warrant dismissal of the subject debtors' cases. In *In re Kingston Square Associates,* 214 B.R. 713 (Bankr. S.D.N.Y. 1997), a case with strikingly similar facts, Chief Judge Tina Brozman denied the motions to dismiss, alleging that an SPE debtor, in an effort to circumvent an independent manager's refusal to authorize a bankruptcy filing, had recruited creditors to file an involuntary petition against itself. That court agreed that the debtor's collusion with petitioning creditors was "suggestive of bad faith," but found that the debtor's primary motive for collusion was to preserve the value of the debtors for their creditors, rather than for fraudulent purposes. Following *Kingston Square Associates,* the *GGP* court held that the subject debtors had borne their burden of proving that the filings were intended to preserve value for their estates and creditors. This reasoning suggests that even *improper* replacement of independent managers might not be cause for dismissal.

Equitable concerns, too, favored denial of the motions to dismiss. It is clear from its opinion that part of the reason the court was unswayed by the lenders' arguments was that the reason they had originally lent money to the subject debtors was because the subject debtors were part of the GGP group, stating that "the record also establishes that the Movants each extended a loan to the respective Subject Debtor with a balloon payment that would require refinancing in a period of years and that would default if financing could not be obtained by the SPE or by the SPE's parent coming to its rescue. Movants do not contend that they were unaware that they were extending credit to a company that was part of a much larger group, and that there were benefits as well as possible detriments from this structure. If the ability of the Group to obtain refinancing became impaired, the financial situation of the subsidiary would inevitably be impaired."[6]

While it is probably true that the subject debtors were so reliant on services from others in the GGP group that their properties would be significantly less valuable if not part of that group, this reasoning arguably ignores the conditions that GGP agreed to when it solicited loans to its SPEs. As the lenders repeatedly pointed out in their motions and briefs, without agreeing to the SPE structure, GGP would not have had access to mortgages that would be resold in the commercial mortgage-backed securities (CMBS) market. The direct consequence of not agreeing to the SPE structure would likely have been higher borrowing costs, and possibly reduced borrowing ability even at the higher costs.

Possible Implications

Several practitioners in the commercial real estate field have questioned why bankruptcy courts do not hold hearings at the outset of a case to determine whether a petition was filed in good faith (or at least authorized). At a minimum, *GGP* slams the door on that idea. Judge **Allan L. Gropper** noted that debtors routinely avoided such hearings under former Chapter X by filing under Chapter XI instead, and that Congress "rejected" a requirement to hold such hearings when it passed chapter 11. Most bankruptcy practitioners would probably sympathize with the court's concern that holding a first-day hearing on the petition itself "would doubtless invite significant litigation at the start of every Chapter 11 case."[7]

Although some structured-finance professionals are already predicting that the decision will destroy the CMBS market—concerns that Judge Gropper has called "hyperbole"[8]—it is not yet clear whether that is the case. As an initial matter, a decision by a bankruptcy court is not binding on other judges in the same jurisdiction, let alone elsewhere nationwide. Regarding the substance of the decision, obviously, few secured creditors want to see a borrower file for bankruptcy, but the separateness of the borrower from its parent is far more essential to the marketability of CMBS than the degree to which the borrower is bankruptcy remote.

Certainly, the *GGP* opinion knocks the wind out of bankruptcy remoteness. In SPE provisions other than the bankruptcy-remote clauses, the subject debtors' lenders went to great lengths to prevent the subject debtors from incurring debt other than debt to their respective lender(s). Except when due to diminution in the value of the collateral, a GGP SPE should never be insolvent if it complies with the covenants in the loan documents prohibiting it from incurring other debt. Yet, somewhat perversely, the only time an independent director (appointed at the lender's behest)

3 *North Am. Catholic Educ'l Programming Found. Inc., v. Gheewalla,* 930 A.2d 92 (Del. 2007).

4 *Mem. Op.* at 40 n. 41.

5 Kirkland & Ellis LLP, "Recent Bankruptcy Court Decision Reconciles Central Tenets of Commercial Real Estate Financing and Bankruptcy Law," available at www.kirkland.com/siteFiles/Publications/6A960CB0803B94778F872F6ED5DF91EB.pdf (last visited Aug. 23, 2009).

6 *Mem. Op.* at 28.

7 *Mem. Op.* at 25.

8 Transcr., May 8, 2009, hrg., at 160 (Dkt. No. 499).

can consider the lender's interests is in the rare case where the SPE is insolvent. Under these circumstances, it will not be surprising if some lenders abandon the independent-director requirement altogether and replace it with novel attempts to keep borrowers out of bankruptcy.

The SPE structure may well survive without effective bankruptcy-remote provisions. As discussed, bankruptcy remoteness is just one tool to accomplish the objectives of protecting the lender's position in the collateral, reducing the likelihood of substantive consolidation and eliminating obstacles to collection and foreclosure. As long as a borrower's assets and liabilities remain strictly separate from those of the borrower's affiliates, those goals will still be served fairly well. Even permitting a parent company to use cash collateral of its SPE subsidiaries' lenders, while likely to make lenders less secure, does not inevitably lead to substantive consolidation.

It is true that making it easier for bankruptcy-remote entities to file for bankruptcy, and increase pressure on lenders to agree to use of their cash collateral, could be the first steps down the path of substantively consolidating such entities with their affiliates. However, it is not clear that anything else in the *GGP* case makes substantive consolidation more probable. To the contrary, the agreement on cash collateral unambiguously preserved the SPEs' separateness from their affiliates.[9] The opinion denying the motions to dismiss, too, emphasized that "the question of substantive consolidation is entirely different" and "[n]othing 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."[10] If future courts interpret *GGP* narrowly, it may not prove to be a watershed decision after all. ■

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9 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 §§361 And 363 And (C) Repay In Full Amounts Owed Under Certain Prepetition Secured Loan Agreement (Dkt. No. 527) (May 14, 2009).

10 *Mem. Op.* at 42.