

## THE GENERAL GROWTH COURT REFUSES TO GRANT MOTIONS TO DISMISS 21 "BANKRUPTCY REMOTE" SUBSIDIARIES FROM BANKRUPTCY

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**O**n August 11, 2009, the Bankruptcy Court for the Southern District of New York denied five motions to dismiss a total of 21 property-level subsidiaries of General Growth Properties, Inc. ("GGP") from what has become the largest real estate bankruptcy in U.S. history. The much-anticipated ruling reinforces the concern of many that single purpose, "bankruptcy remote" borrowers are far from "bankruptcy proof".

### BACKGROUND

GGP, a publicly traded real estate investment trust and the second largest shopping mall owner in the country, along with more than 300 of its subsidiaries (together with GGP, the "GGP Group"), filed for Chapter 11 bankruptcy protection on April 16, 2009. The GGP Group's corporate structure was generally organized so that each shopping mall property is owned by a single purpose entity (each an "SPE"), an entity that is restricted from owning any assets other than an individual shopping center or incurring any debt except as secured by such center. At the time of the filing, many of the mall-owning SPEs were not in default under their respective mortgage loans – the shopping malls at issue were performing well, with upwards of 90% occupancy rates, and many of their mortgage loans would not mature for several years.

Two significant reasons for causing the property-level SPEs to file were to protect their excess cash flow in order to pay existing upstream indebtedness and to obtain additional debtor-in-possession financing. To this end, and over the strenuous objections of the mortgage lenders, the GGP Group was successful in obtaining an order from the Court on May 13, 2009 (the "May 13 Order"), allowing the GGP Group to sweep all cash generated by the properties into a central account to be used to pay expenses throughout the family of companies, and the order approved \$400 million in debtor-in-possession financing. As adequate protection, the mortgage lenders were allowed to maintain their liens against the properties and were given a first priority lien on the cash held in the central account.

### "BANKRUPTCY REMOTE" STRUCTURES AND SEPARATENESS

Mortgage lenders have been attempting for decades to avoid the scenario of a seemingly healthy borrower being pulled into bankruptcy because of the debts of its parent. Thus, commercial mortgage

lenders routinely require their borrowers to be structured as "bankruptcy remote" entities. To render a borrower "bankruptcy remote", the organizational documents for the borrower must restrict the borrower from owning any asset other than the mortgaged property, and also require that specific steps be taken to insure the "separateness" of the borrower's operations from the operations of its parent or affiliates. The borrower is also restricted from incurring any indebtedness other than the relevant mortgage loan (subject to de minimis trade payables necessary to operate the property). Depending on the size of the loan, the borrower might also be required to maintain one or more independent directors, whose consent is required in connection with the borrower's ability to transfer assets, amend the organizational documents, or file for bankruptcy. These measures are intended to isolate or "ring fence" the assets of the borrower from claims by other creditors. The SPEs at issue in the GGP Group bankruptcy contain all of these bankruptcy remote and separateness provisions.

### THE COURT'S RULING

Amid this backdrop, two special servicers and two lenders moved to dismiss the bankruptcy filings in connection with twenty of the GGP Group's SPEs. The primary argument for dismissal was that the bankruptcy filings were made in bad faith, citing various technical grounds for such a claim. While the rejection of each of these technical grounds by the Court is significant, the language of the Court's decision relating to "bankruptcy remote" structures may have the most significant impact on the commercial mortgage market.

In several of the lenders' moving papers, the lenders argued that they relied on the separateness and credit worthiness of the individual SPEs and the underlying real property when underwriting and pricing the various loans, implying that they might not have made the loans at those prices had they been forced to evaluate the overall financial health of hundreds of parent and affiliated entities. During hearings on the motion, counsel for the lenders argued that, by allowing these bankruptcies to continue, the Court could affect pricing and underwriting standards across the industry.

The Court, however, was not persuaded by this argument and suggested that, because of the short-term, balloon payment nature of the loans, the lenders were, in fact, not making loans to individual

SPE borrowers in a vacuum. Rather, they were benefitting from the ability of the GGP Group of companies to effectively pay off or refinance these loans as they came due. If the lenders benefitted from the intangible value of having a large nationally-recognized company such as GGP affiliated with the borrower, the Court appeared to suggest, the lenders had to bear the risk of this structure as well.

The lenders also argued that the independent managers of the SPEs who consented to filing for bankruptcy, who were all replacement managers designated by the GGP Group, did not follow the requirements of the organizational documents of the SPEs, which, in many cases, required the independent managers to “consider only the interests of the [SPE], including its respective creditors” in determining whether bankruptcy was appropriate. The Court, by contrast, turned the lenders’ argument on its head, holding that not only are independent managers allowed to consider the interests of parent companies when determining whether bankruptcy is appropriate, “the interests of the parent companies *must* be taken into account.” The Court pointed out that state law (in the case at bar, Delaware) imposes a fiduciary duty on independent managers, and such managers are required to consider the interests of shareholders in exercising those duties. In this case, the Court suggested that it was appropriate to consider the interests of the broader GGP Group in ensuring access to property-level cash flow and obtaining debtor-in-possession financing to pay off debts incurred by parent companies.

The Court also seemed impressed by the pre-petition diligence performed by the GGP Group in connection with their decision to file, both with regard to the internal evaluations performed by the GGP Group and its experts and with regard to the attempts by the GGP Group to discuss work-out issues with its lenders.

During hearings on the motions to dismiss, the Court repeatedly asked how the lenders were harmed by the bankruptcy. The May 13th

Order allowing the debtor’s use of cash collateral and approving debtor-in-possession financing preserved the lenders’ real property liens and granted certain additional liens on newly established accounts. The Court stated that if the lenders thought this was insufficient protection, they should have raised it then.

The lenders also suggested that allowing the bankruptcies to continue was tantamount to a substantive consolidation of the assets of the GGP Group for purposes of the bankruptcy. Substantive consolidation is a means by which a bankruptcy court sitting in equity may disregard the corporate formalities of a subsidiary to “consolidate” its assets with the assets of its parent into one bankruptcy estate. The Court went out of its way to state that substantive consolidation is not at issue, as no one had yet moved the Court to substantively consolidate any of the assets. In fact, much of the Court’s holding relied upon the corporate formalities of the individual SPEs (i.e., such as analyzing the role of independent managers), rather than disregarding them.

The lenders’ concerns with the Court’s holding are broader than the nuanced facts of one case. When the lenders originated these loans, as have many lenders over the last decade, they placed as many obstacles as possible in the way of filing for bankruptcy, from springing guarantees to cross defaults to elaborate organizational structures buttressed by opinions of counsel. They did this to avoid the sticky, expensive and complex risk spectrum that arises when one crosses the threshold into Bankruptcy Court. However, as the GGP Court has held, no matter how many creative obstacles may be placed in front of the door to the courthouse, bankruptcy remote borrowers are still not bankruptcy proof.

*The August 11th ruling in the GGP bankruptcy case will be discussed and analyzed in greater detail in a White Paper that will be distributed in the next day or two. For more information concerning this case, please contact any of the Cozen O’Connor real estate attorneys listed below.*

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