New York Law Journal

Real Estate Law&Practice

WWW.NYLJ.COM

An ALM Publication

©2010 ALM

MONDAY, AUGUST 23, 2010

From **Bankruptcy**-Remote to **Risk**-Remote

Reframing the single-purpose entity in CMBS finance.

BY WILLIAM McINERNEY

IN RE General Growth Properties Inc.[1] and *In re Extended Stay Inc.*[2] both challenged how effectively the single purpose entity (SPE) prevents real estate Chapter 11 filings. The findings of these reorganizations indicated that SPE structure alone will not preclude a bankruptcy filing.

© BIGSTOCK

Familiar to most real estate professionals, these two cases initially appeared to threaten the viability of the SPE structure in real estate finance. But the damage was not lethal, and the SPE does not have to die.

To preserve the utility and intended purpose of the structured single purpose entity, practitioners will have to adjust their current practices. This article scrutinizes the SPE-specific facts before the courts in *General Growth* and *Extended Stay*,[3] with a focus on how practitioners can respond effectively to issues raised by these filings.

Historically, the hallmark of an SPE has been its bankruptcy-remoteness. Its activities, including its ability to incur debt, dissolve or file for bankruptcy, are generally restricted, and it usually has a single purpose (which, in the case of real estate finance, involves holding and managing a single property or group of related properties).[4]

Covenants require that an SPE's actions remain separate from that of its parent company and affiliates. This prevents the unrelated liabilities of the parent or affiliates from impacting the SPE borrower. Thus, when lending to a real estate SPE, the risk of non-payment is based only on the creditworthiness of the real property that serves as collateral for the loan.[5]

Collectively, these features make lending to an SPE highly attractive. Creditors can easily underwrite their investment while the SPE benefits from transactional terms that reflect the reduced risk presented by its organizational structure.[6]

GGP Enters Chapter 11

The Chapter 11 petition of General Growth Properties (GGP) was the largest real estate bankruptcy filing in U.S. history.[7]

WILLIAM McINERNEY *is co-chair of the finance practice at Cadwalader, Wickersham & Taft.* JANICELYNN ASAMOTO, *a summer associate with the firm, assisted in the preparation of this article.*

The ultimate parent to a large corporate family, GGP (as well as its SPE subsidiaries) had incurred significant debt, including secured debt with variable maturities, low rates of amortization, and balloon payments due at maturity.[8]

GGP's capital structure depended on its ability to refinance this substantial debt. However, when the credit markets dried up, the threat of its outstanding debt loomed too large.[9] As a result, GGP compelled many of its solvent SPEs to file voluntary Chapter 11 petitions.[10]

Creditors predictably objected to including the assets of these SPEs in the larger bankruptcy estate and urged the court, among other things, to eliminate GGP's integrated cash management structure, a process that commingled the income of multiple SPEs.[11] They also moved to dismiss the filing on the grounds that the cases were prematurely filed and, since most of the SPEs were financially viable, filed in bad faith.[12]

The creditors perceived that the Chapter 11 petitions had been filed in bad faith because of the quiet dismissal of the independent directors who sat on the SPE boards.[13] On both counts the court sided with GGP. The challenge going forward is for practitioners to avoid a similar result.

The interactions between GGP and its subsidiaries often implicated the autonomy of the SPEs. GGP's centralized cash management procedures were one source of contention.

GGP commingled SPE funds in its own account, then used this account to pay all expenses of the SPEs, including those of cash-flow negative ones. Essentially it regularly made unsecured intercompany loans. No entity guaranteed the intercompany loans, and recipients could benefit from the liquidity without providing any collateral.[14]

Although the court found this arrangement was a reasonable business practice for such a large real estate conglomerate,[15] the cash management structure also indicated that GGP and its SPEs were a single, large corporate group whose assets and activities were decidedly intertwined.

Noting that GGP's income depended primarily on the earnings of its SPEs and a reorganization that ignored the realities of GGP's capital structure would be futile, the court decided that GGP could consider "the interests of the group" when making "a judgment on an issue as sensitive and fact-specific as whether to file a Chapter 11 petition…."[16]

Practice Tips

In light of the conclusion reached by the *General Growth* court, SPEs and their affiliates should carefully look at activities that might lead a court to disregard an SPE's separateness covenants.

Practitioners can rebut the appearance of corporate consortium by drafting loan documents with specific procedures for managing SPE income. Creditors should mandate that all SPE income pass through a creditor-controlled hard lockbox.

Debt service and other SPE expenditures would be satisfied by disbursements from this account according to a predetermined priority structure. Assuming the SPE continues to generate income, the hard lockbox ensures that, even if the parent becomes insolvent, the cash available from the lockbox will be applied first toward SPE loan obligations.

The SPE entity itself should have final priority, allowing income to be upstreamed to the parent, but only after satisfying all SPE expenses.

Another assault on the appearance of corporate separation occurs when, as with GGP, the loan documents dictate that the parent's bankruptcy or insolvency automatically triggers an event of default for an SPE.[17] When GGP deliberated about which of its SPEs should enter bankruptcy, these cross-default provisions helped justify the Chapter 11 filings of the solvent SPEs.[18]

Practitioners should revise future cross-default provisions in a way that safeguards entity separation. Future provisions should describe a parent's bankruptcy or insolvency as a possible event of default, to be decided at the sole discretion of the creditor. Such a provision protects creditors against an affiliate's insolvency but allows them to judge if and when an affiliate's insolvency would negatively impact its investment in an SPE.

One of the major lessons to be drawn from *General Growth* is the importance of maintaining a barrier between SPE activities and those of its parents or affiliates. Given GGP's cash management structure and the cross-default provisions, the facts before the court unfortunately did suggest a measure of corporate interdependence.

As the court itself noted, deciding whether to file for bankruptcy is a fact-specific determination.[19] The modifications suggested above will help distinguish future parent-SPE relationships from the nominal separation that existed between GGP and its SPEs.

Independent Directors' Role

Another line of defense against acts of corporate interdependence and in particular bankruptcy filings lies with an SPE's independent directors.

Generally, an SPE's organizational documents mandate that certain SPE actions, including the decision to file for bankruptcy, require the assent of the independent director.[20] From a creditor's perspective, these directors should withstand pressure to file for bankruptcy if the SPE was solvent and would not benefit from reorganization. Directors would thus protect a creditor's expectation that the solvent SPE would rarely enter bankruptcy and, if it did, only to address concerns about the cash flow from the specific real estate owned.

In *General Growth*, without providing any advance notice, GGP replaced the independent directors of many SPEs just before filing for Chapter 11 relief.[21] The loan documents, however, supported the validity of the directors' surreptitious termination.

None of the loan documents (1) prohibited the replacement of directors, (2) prohibited termination without notice, or (3) impeded GGP's right to appoint an independent director.[22]

> Creditors should negotiate for third-party **guaranties** that impose **significant liability** on the guarantor when an SPE files for bankruptcy. Without it, the **favorable terms** received by SPE borrowers on the basis of their bankruptcy-remote structure might not be **justified**.

Citing the lack of provisions intended to curtail such behavior, the court held that the directors' replacement was not undertaken in subjective bad faith.[23] The court further disagreed with the creditors' assertion that the role of these directors was to rebuff actions disadvantageous to creditors.[24]

The operating agreement was clear; independent directors could consider creditor interests, but only "to the extent permitted by law."[25] The Delaware Supreme Court, however, has unequivocally ruled that directors of solvent corporations, even when in the zone of insolvency, must act "in the best interests of the corporation for the benefit of its shareholder owners."[26]

Because the SPEs here were never insolvent and GGP was the ultimate shareholder of the entities, the operating agreement bound the directors to consider the interests of GGP as shareholder.

In retrospect, the documents in *General Growth* failed to adequately protect the interests of creditors and their expectations that a particular SPE would remain bankruptcy-remote. Although little can be done about how courts currently interpret Delaware law, independent director provisions can and should be refined.

At the very least, creditors should receive advance notice when an independent director is replaced. Moreover, to avoid relationships that might suggest a conflict of interest, independent directors should come from nationally recognized companies that provide such individuals to similar corporations.

Finally, the court noted with approval that GGP's replacement directors were "seasoned" in a restructuring setting.[27] Thus, by ensuring that the initial independent directors have relevant experience and exposure to a restructuring environment, a parent may be unable to justify removing an already well-qualified independent director.

The 'Bad Boy' Guaranty

As GGP entered bankruptcy, *Extended Stay* challenged the validity of another mainstay of the single purpose entity structure: the "bad boy" or "non-recourse" guaranty.

Although most CMBS loans are non-recourse, parties commonly carve out indemnification and guaranty provisions for losses resulting from the particularly egregious acts of the SPE and its sponsors.[28] The commission of such acts, including a voluntary bankruptcy filing or a failure to maintain SPE status, triggers the guaranty.[29]

From the creditor's perspective, the guaranty provides additional security for a mortgage loan by ensuring that a lender's expectations when making a loan are met or, if the expectation is broken, that the lender will have a remedy and be adequately compensated. In addition, and particularly with a creditworthy guarantor that is itself unwilling to enter bankruptcy, the "bad boy" guaranty deters the Chapter 11 filing of an SPE and prevents actions that could generate significant liabilities for the guarantor.[30]

Such guaranties were at issue when Extended Stay Hotels (ESH) went to court.[31]

In 2007, a group of investors acquired ESH in an acquisition financed with mortgage and mezzanine debt exceeding $7 billion. The mortgage loan was securitized and some of the mezzanine loans were sold to investors.

The loans were generally non-recourse but as part of the acquisition some of the investors signed a non-recourse guaranty, which imposed joint and several liability up to $100 million if the SPE voluntarily filed for bankruptcy. The guaranty agreement specifically stated that the guarantors had no right of offset or indemnity against ESH.[32]

When ESH filed for Chapter 11, triggering the non-recourse carveout, purchasers of the mezzanine debt sought to enforce the guaranty. The guarantors argued that because the state court contract action derived from the ESH bankruptcy, it was a "core" proceeding that should be addressed by the bankruptcy court.

The court disagreed, finding that "a claim by a non-debtor against a non-debtor involving guarantees…is external to the bankruptcy

process."[33] The mere fact that bankruptcy was the contingent triggering event did not convert the claim into one "arising under" federal law.[34]

Because the plain language of the guaranty agreement allowed no right of offset or indemnity against the borrower, ESH as debtor was isolated from any financial harm relating to the guarantors' liability. As a result, the court concluded that the bankruptcy estate would be unaffected by the state court action.[35]

When it confirmed the validity of third-party guaranties despite a Chapter 11 filing, the *Extended Stay* court corroborated the expectations of most practitioners. Past legal precedent had established that courts were willing to uphold recourse language for bad-boy acts generally[36] and with regard to bankruptcy filings in particular.[37]

Practice Tips

Armed with the precedent that these contracts will be enforced, creditors should negotiate for third-party guaranties that impose significant liability on the guarantor when an SPE files for bankruptcy. Without it, the favorable terms received by SPE borrowers on the basis of their bankruptcy-remote structure might not be justified.

In addition, the deterrence and remunerative effect of these guaranties is tied to the creditworthiness of the guarantor. Thus, practitioners should diligently ensure that guarantors are well-capitalized and consider imposing covenants that place reasonable limits on a guarantor's financial activity.[38]

Conclusions

In the wake of these two cases, creditors must adjust their expectations.

General Growth demonstrated that certain traits of corporate interdependence in a large real estate conglomerate will lead a court to disregard an SPE's separateness provisions. Moreover, independent directors are not beholden to a creditor's desire that an SPE stay out of bankruptcy.

Despite these developments, the *General Growth* court emphasized that the "fundamental protections…that the SPE structure represents are still in place and will remain in place."[39] Meanwhile, the *Extended Stay* decision illustrated that third-party guaranties could successfully limit the risk of an investment, even if the SPE ultimately files for bankruptcy.

Moving forward, practitioners must reframe the criteria used to distinguish future SPEs for their clients. GGP brings into high relief the risks of cross-lending, cross-defaults, and economic interdependence.[40] To secure the benefit of their bargain, creditors should ensure that future loan documents avoid the separation concerns apparent in the *General Growth* facts.

Additionally, by refining loan and guaranty provisions, creditors will have further recourse against an SPE's collusive or voluntary bankruptcy filing. By negotiating for these additional protections, creditors can ensure that the single purpose entity remains, if not a bankruptcy-remote vehicle, at least a risk-remote vehicle for future CMBS transactions.

1. *In re Gen. Growth Props. Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009) [hereinafter Gen. Growth Bad Faith Filing]; *In re Gen. Growth Props. Inc.*, 412 B.R. 122 (Bankr. S.D.N.Y. 2009) [hereinafter Gen. Growth DIP Fin.]; *In re Gen. Growth Props. Inc.*, 412 B.R. 609 (Bankr. S.D.N.Y. 2009) [hereinafter Gen. Growth Cash Mgmt. Order]. For the sake of simplicity, each case is referred to as *General Growth* in the text.
2. *In re Extended Stay Inc.*, 418 B.R. 49 (Bankr. S.D.N.Y. 2009).
3. For further commentary regarding the bankruptcy-specific issues in these cases, see, e.g., Jonathan Canfield, "Bankruptcy Court Addresses SPEs' Rights to Chapter 11 in General Growth Properties," CADWALADER RESTRUCTURING REV., Sept. 2009, at 7; Patrick C. Sargent et al., "Round 1 of General Growth Properties Bankruptcy: SPE Structure Survives," ANDREWS KURTH LLP ARTICLES, June 24, 2009; Patrick C. Sargent et al., "Round 2 of General Growth Properties Bankruptcy: Motion to Dismiss SPE Bankruptcies Denied, No Bad Faith, Corporate Group Considered," ANDREWS KURTH LLP ARTICLES, Aug. 29, 2009.
4. STANDARD & POOR'S, U.S. CMBS LEGAL AND STRUCTURED CRITERIA 89, 91 (2003).
5. See Thomas J. Gordon, Comment, "Securitization of Executory Future Flows as Bankruptcy-Remote True Sales," 67 U. CHI. L. REV. 1317, 1322-27 (Fall 2000).
6. Kenneth N. Klee and Brendt C. Butler, "Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues," in CHAPTER 11 BUSINESS REORGANIZATIONS, at 55 (ALI-ABA Course of Study 2004); Harold S. Novikoff and Barbara Kohl Gerschwer, "Bankruptcy Remote Special Purpose Entities," in CHAPTER 11 BUSINESS REORGANIZATIONS, at 79 (ALI-ABA Course of Study 2003).
7. See generally Corinne Ball, "The Credit Crisis' Legacy in a Truly Remarkable Year," 242 NYLJ, 5 (2009); Canfield, supra note 3.
8. Gen. Growth Bad Faith Filing, 409 B.R. 43, 53 (Bankr. S.D.N.Y. 2009).
9. Id. at 59.
10. Id. at 53, 55 n.23.
11. Id. at 55.
12. Id.
13. Id. at 67.
14. Gen. Growth Cash Mgmt. Order, 412 B.R. 609, 610-11 (Bankr. S.D.N.Y. 2009).
15. Id. The court allowed GGP to continue its prepetition cash management practices. Id. at 613. In exchange, Lenders received interest on CMBS loans at the non-default contract rate outlined in the original agreement and a replacement lien (secured by a first lien on the commingled main operating account) on any claims relating to the intercompany loans. Id. at 611; see also Gen. Growth DIP Fin., 412 B.R. 122, 126-27, 130-132 (Bankr. S.D.N.Y. 2009).
16. Gen. Growth Bad Faith Filing, 409 B.R. at 63.
17. Id. at 58, 59 n.26.
18. See id. at 58-59.
19. See supra note 16 and accompanying text.
20. STANDARD & POOR'S, supra note 4, at 93.
21. Gen. Growth Bad Faith Filing, 409 B.R. at 68-69.
22. Id. at 68.
23. Id. at 68.
24. Id. at 64-65.
25. Id. at 63.
26. *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).
27. Gen. Growth Bad Faith Filing, 409 B.R. at 63.
28. Anthony J. Colletta and Daniel M. Kasell, "Nuances of Non-Recourse Carve-Out Guarantees," in REIT AND REAL ESTATE M&A RESTRUCTURINGS AND RECAPITALIZATIONS 2010, at 125, 127 (PLI Real Estate Law & Practice, Course Handbook Series No. 22990, 2010)
29. Id. at 131-32.
30. Id. at 127-28.
31. *In re Extended Stay Inc.*, 418 B.R. 49, 54 (Bankr. S.D.N.Y. 2009).
32. Id. at 58.
33. Id. at 60.
34. Id. at 59.
35. Id. However, the court did note that if ESH could show that the guarantors played a critical role in the company, the state court action might be stayed as an impediment to the reorganization process. Id. at 58-59.
36. *Blue Hills Office Park LLC v. JPMorgan Chase Bank*, 477 F. Supp. 2d 366, 380-83, 388 (D. Mass. 2007) (finding guarantors owed lenders the balance of debt remaining after foreclosure sale, in accordance with plain language of guaranty agreement, after SPE violated terms of guaranty); *CSFB 2001-CP-4 Princeton Park Corporate Ctr., LLC v. SB Rental I, LLC*, 980 A.2d 1 (N.J. Super. A.D. 2009) (upholding full recourse guaranty that imposed liability for borrower's failure to secure lender's consent before further encumbering the mortgaged property).
37. *First Nationwide Bank v. Brookhaven Realty Assocs.*, 223 A.D.2d 618, 621 (N.Y. App. Div. 2d Dept. 1996) (holding that even after borrower's bankruptcy petition had been dismissed, lender could enforce the full recourse liability because "a bankruptcy default clause is enforceable under the laws of this State, [and] the one at issue here should be enforced"); see also *FDIC v. Prince George Corp.*, 58 F.3d 1041 (4th Cir. 1995) (holding that carve-out language in a promissory note did not waive or compromise borrower's right to file bankruptcy).
38. See *Colletta & Kasell*, supra note 28, at 133.
39. Gen. Growth Bad Faith Filing, 409 B.R. 43, 69 (Bankr. S.D.N.Y. 2009).
40. Id. at 61.

Reprinted with permission from the August 23, 2010 edition of the NEW YORK LAW JOURNAL. © 2010 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints@alm.com. # 070-08-10-20