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The Future Of SPEs In Light Of General Growth

Law360, New York (February 09, 2010) -- On Dec. 15, 2009, Dec. 23, 2009, and Jan. 20, 2010, the Bankruptcy Court for the Southern District of New York confirmed 216 bankruptcy plans (the "Plan") for several affiliated special purpose entity ("SPE") project-level debtors of General Growth Properties ("GGP")[1].

Significant in the Plan were certain provisions addressing the flaws in the structure of the SPEs that filed for bankruptcy provisions that may serve to help the lenders whose bargained-for expectations were badly dashed when the bankruptcy court denied their motions to dismiss the SPEs' bankruptcy petitions.

The SPE-related provisions in the confirmed Plan may serve as a road map to lenders to strengthen the "bankruptcy remoteness" of SPEs and minimize (but not entirely eliminate) the risk to lenders when an SPE files bankruptcy.

An SPE is a legal entity used to isolate lenders from financial risk by requiring specific provisions in the organizational documents to reduce the possibility of a bankruptcy filing by the SPE and is often considered to be "bankruptcy remote."

The SPE usually holds specific groups of assets secured by lenders and must operate as a distinct legal entity. The SPE organizational documents usually require that the SPE maintain a separate existence from the parent and other affiliates in an attempt to protect its assets from a future bankruptcy.

Generally, a prohibition on a particular debtor's right to file bankruptcy is considered to be an "ipso facto" clause which is void as against public policy.[2]

However, the SPE is a tool that has been used to indirectly reduce the risk of a "voluntary" bankruptcy filing by requiring appointment of an independent director that will vote against a proposal to file bankruptcy. Over the past decade, there has been a trend toward increased use of SPEs to protect lenders.[3]

However, the sanctity of these SPEs and the protections they afford to lenders was recently called into question when the United States Bankruptcy Court for the Southern District of New York dropped a bombshell in the General Growth Properties ("GGP") bankruptcy case,[4] holding that SPEs could in fact seek bankruptcy protection, finding that an SPE's fiduciary duties ran to its shareholders and not its creditors.

The court held that even though the SPEs had replaced their independent directors on the eve of bankruptcy, this did not amount to bad faith because the collective interests of all of the debtors should be considered, not simply the interest of each individual SPE.

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Therefore, the bankruptcy court declined to dismiss the SPEs' respective bankruptcy petitions. However, the court noted that the fundamental protections afforded by the structures of the SPEs were still in place, including protection against substantive consolidation.

Because there have not yet been any reported decisions interpreting General Growth,[5] the effect of the decision on the future of SPEs, and how courts will use it to fashion future remedies in cases involving SPEs, is still unknown.

The bankruptcy court, in confirming the GGP Plan, attempted to provide some protection to the lenders to fix the inadequacies contained in the SPEs' pre-bankruptcy organizational documents.

With regard to appointment of independent directors, the Plan requires that the SPEs have at least two independent directors unaffiliated with the SPEs and approved by the lenders and that the lenders have the right to consent to any new or replacement independent director.[6]

In addition, the Plan provides that the SPEs were governed by Delaware law, which recognizes the right to waive a director's fiduciary obligations.[7]

Finally, the Plan provides that when determining whether to file a future bankruptcy for the SPEs, (a) the independent directors must consider only the interest of the SPE as a stand-alone business entity, (b) shall not require or permit the independent directors to consider the interest of the member or any direct or indirect beneficial owner of the member, (c) require the independent directors to consider the exclusive interest of the lenders who shall be a third-party beneficiary to such provision.[8]

The Plan affords additional protection to the lenders in the event of a future bankruptcy by the SPEs by providing that the lenders have automatic relief from the automatic stay set forth in section 362 of the Bankruptcy Code to pursue relief against the SPEs' parent company. Additionally, in the event of a future filing by the SPEs, the extended maturity date of the lenders' loan will automatically terminate.

Although the provisions in the Plan seemingly protect each of the lenders' respective security interests in their respective SPEs, the provisions do not prohibit a future bankruptcy filing.

Additionally, it is unclear whether provisions that purport to give lenders automatic relief from the automatic stay in the event of a future bankruptcy filing are enforceable.[10]

Also, the Plan cannot undue the harm that has been done to the lenders by the filing in the first place. The centralized cash management system is still being utilized by all debtors to the detriment of the SPE lenders to each of their respective debtors.

The bankruptcy court previously ruled that each of the lenders were adequately protected because they would receive payment of interest at the nondefault rate, continued maintenance of the properties, a replacement lien, and a second priority lien on other properties.

The bottom line is that the SPE lenders were still forced to restructure their loans as a result of the bankruptcy[10] — a risk that they negotiated to avoid.

The bankruptcy court's decision not to dismiss the SPEs' bankruptcy is not likely to eliminate the use of SPEs given the court's implicit recognition that properly-formed SPEs will not be subjected to substantive consolidation.

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However, lenders will undoubtedly take a closer look at the SPE structure when documenting their loans. The General Growth Plan provides lenders with a guidepost to help fill in the gaps to minimize the risk of future bankruptcy filings and the harm caused by such filings.

For example, lenders will likely require their SPE borrowers to revise their organizational documents by including provisions that require two independent directors (friendly to the lenders, of course), consent of the lenders for removal or appointment of those directors, a provision that automatically lifts the automatic stay under section 362 of the Bankruptcy Code if a bankruptcy is filed, a waiver of fiduciary duties if state law permits such waiver, and consideration of the lender's interest if bankruptcy is contemplated.

However, the legality of such provisions will undoubtedly be challenged in the future. Lenders will continue to develop creative new ways to make it harder for SPEs to file bankruptcy (or at least minimize the risk to lenders in the event of an SPE bankruptcy).

Ultimately, the "big picture" effect of General Growth on the viability of SPEs is likely to be a tightening of credit lending and availability. However, even if courts follow General Growth to permit SPE bankruptcies, lenders may consider certain prophylactic provisions and concepts approved as part of GGP's confirmed Plan as a road map to mitigate the risks to lenders in future SPE bankruptcies.[11]

--By Keith C. Owens (pictured) and Katherine R. Catanese, Foley & Lardner LLP

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[1] The Plan covered 96 loans and approximately $21.6 billion in debt. As of Jan. 29, 2010, certain of the remaining debtors that were not subject to the confirmed Plan filed a motion to extend the exclusivity period to file a plan of reorganization to April 26, 2010.

[2] See, generally, In re Tru Block Concrete Prods. Inc., 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983).

[3] See David B. Stratton, Special-Purpose Entities and Authority to File Bankruptcy, 23 ABI Journal 36 (March 2004).

[4] See In re General Growth Properties Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[5] See In re Squires Motel LLC, 416 B.R. 45 (Bankr. N.D. N.Y. 2009) (citing In re General Growth Properties for the proposition that there is an implicit requirement of good faith when a bankruptcy is filed).

[6] The prepetition organizational documents did not contain a provision requiring lender consent to replacement or appointment of a new director; rather, they only required the "unanimous written consent of the Managers of the Company, including both of the Independent Managers" to authorize a bankruptcy filing. The prepetition organizational documents did not prohibit ouster of the independent directors on the eve of bankruptcy and replacement with directors that would vote in favor of the bankruptcy.

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[7] See Del. Code, tit. 6, §§ 15-103, 17-1101 (West 2010). The prepetition organizational documents provided that the independent managers have a fiduciary duty of loyalty and care “similar to that of a director of a business corporation organized under General Corporation Law of the State of Delaware.”

[8] The prepetition organizational documents provided 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 ...”

[9] Compare In re Rowe, 239 B.R. 44, 54 (Bankr.D.N.J.1999) (permitting prospective relief from the automatic stay in certain circumstances); In re Felberman, 196 B.R. 678, 683 (Bankr. S.D.N.Y. 1995) (same); In re Abdul-Hasan, 104 B.R. 263, 266-67 (Bankr.C.D.Cal. 1989) (same); In re Greenberg, 200 B.R. 763, 770 (Bankr. S.D.N.Y. 1996) (same), with In re Hamer, No. Civ. A 00-1180, 2000 WL 1230496 at *7 (E.D. Pa. Aug.18, 2000) (holding that as a matter of law, prospective lifts of the automatic stay are prohibited and should be “attached to new cases during their pendency, rather then tacked onto orders in prior cases”); In re Taylor, 77 B.R. 237, 240 (B.A.P. 9th Cir. 1987) (holding that prospective relief from the automatic stay is not within the bankruptcy court’s jurisdiction because the court cannot prospectively issue an order prohibiting the stay from applying in a future bankruptcy); In re Taras, 136 B.R. 941 (Bankr. E.D. Pa. 1992) (same); In re Norris, 39 B.R. 85 (E.D. Pa. 1984) (same).

[10] Through the Plan, the lenders were considered “impaired” and received an amended and restated note with a new maturity date, secured by a continuing lien with the same priority existing prepetition and a loan modification agreement amending and restating the prepetition note.

[11] Foley & Lardner LLP represents Wilmington Trust Company as the indenture trustee with respect to certain securities issued by certain debtors in the GGP bankruptcy.

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