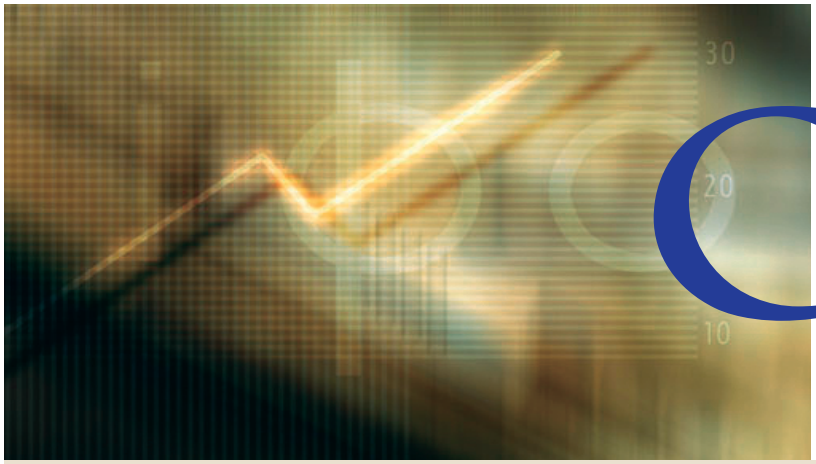

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SPEs - Bankruptcy Remote? Not So Much

By Don Hanmer

As a result of the experiences of the 80s and 90s, lenders became sensitive to delays and problems incurred in connection with bankruptcy of commercial real estate entities and attempted to eliminate or minimize such problems in the future by requiring creation of special purpose entities ("SPEs") to own real estate assets collateralizing a loan. In addition, with respect to a variety of collateralized financial transactions, SPEs were required by investors and rating agencies for the same reasons.

An SPE is created by inserting certain provisions in the borrower's governing documents to insure that the borrower is a single asset entity, to prevent activities that are likely to cause it to be substantively consolidated with other entities in the event of a bankruptcy, to prevent, to the extent possible, the borrower from filing bankruptcy and, if the borrower does file bankruptcy, to try to ensure that the lender will be able to lift the stay in an expeditious manner and proceed against its collateral. Generally, the provisions the special purpose entity must meet were provided by the lender, required by the rating agencies, and often were not negotiable.

However, some of the anticipated benefits to lenders of SPEs have been called into question by the recent case *In re General Growth Properties, Inc., et al*. 409 B.R. 43 (Bankr., S.D.N.Y. 2009). In this case various lenders sought to have the court dismiss chapter 11 cases filed by one or more debtors owned directly or indirectly by General Growth Properties, Inc. The lenders argued that the bankruptcies of certain SPEs should be dismissed on the grounds they were filed in bad faith. General Growth Properties, Inc. was a publicly-traded real estate investment trust and the ultimate parent of approximately 750 wholly-owned debtor and non-debtor subsidiaries and affiliates. Some of the entities were SPEs.

One argument made by the lenders was that the filings with respect to some of the SPEs were bad faith filings because on a standalone basis the SPE had ample cash flow and the debt encumbering its assets would not mature for some period of time. The court said, in analyzing this question, "However, contrary to the movant's contentions, the court is not required in these cases to examine the issue of good faith as if each debtor were wholly independent." It then analyzed the interests of the group of related entities as a whole in determining whether or not the bankruptcy filing by individual SPEs was in bad faith.

The court recognized that the SPE structure was intended to insulate the financial position of each of the subject debtors from the problems of its affiliates, to make the prospect of a default less likely, and to make the SPE debtor "bankruptcy remote." The court said, however, that the lenders knew that they were extending credit to a company that was part of a much larger group, that there were benefits as well as possible detriments to the structure, and if the ability of the group to obtain financing became impaired the financial situation of a subsidiary SPE would be impaired. The court held there is authority that where the parent was dependent on cash flow from the subsidiaries and had significant debt itself, the interests of the parent companies must be taken into account.

The typical SPE documents contained an obligation to retain one or more independent directors or managers, and provided that a decision to file bankruptcy had to be approved by the independent director or manager. The independent directors or managers were meant to be unaffiliated with the parent of the SPE or any entity related to the SPE and the lenders expected and believed that the independent director or manager would protect the interests of the lenders.

The court recognized that the drafter had attempted to create impediments to a bankruptcy filing. An officer of one of the loan servicers even testified that the real reason he was disturbed by the chapter 11 filings was the inability of the independent managers to prevent the filing: "Well, my understanding of the bankruptcy as it pertains to these borrowers is that there was an independent board member who was meant to, at least from the lender's point of view, meant to prevent a bankruptcy filing to make them bankruptcy remote, and that such filings were not anticipated to happen." The court, however, said that managers and directors owe their duties to the corporation or entity and ordinarily to the shareholders or owners notwithstanding any such provisions in the documents.

The court said although it is clear that the movants have been inconvenienced by the chapter 11 filings, inconvenience to a secured creditor is not a reason to dismiss a chapter 11 case. The salient point for purposes of these motions is that the fundamental protections the movant negotiated and that the SPE structure represents are still in place and will remain in place during the chapter 11 cases. This includes protection against the substantive consolidation of the project level debtors with any other. The court said a principal goal of the SPE structure is to guard against substantive consolidation but the question of substantive consolidation is entirely different from the issue of whether the board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor in making the decision to file a bankruptcy case.

So the court found that the provisions of the SPEs did not prevent the SPEs from being put into bankruptcy along with affiliates and related entities and that the independent directors and managers could not ignore their fiduciary duty to the entity and its owners or shareholders notwithstanding provisions in the documents. However, the court specifically said that this decision does not override another goal of the SPE structure which is to prevent substantive consolidation. That issue is preserved for another day. It is important for borrowers, lenders, servicers, and lawyers to be aware of both the limitations and benefits of the SPE structure in light of this decision. ■