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General Growth Properties Challenges Secured Creditors' Rights

The Chapter 11 cases of General Growth Properties, Inc. (GGP) and its subsidiaries present a double-pronged attack on secured creditors' rights. The first surprise was that GGP's subsidiaries managed to file at all—many of the 166 entities owning shopping centers were structured as "bankruptcy remote" special purpose entities whose organizational documents and loan agreements were designed to make their entry into bankruptcy difficult, if not impossible. The second, and much worse, surprise was that the Bankruptcy Court permitted GGP to transfer excess cash flow from successful properties to support the operations of the parent company and cash flow negative debtors.

The SPE Problem

To obtain mortgage financing for its properties, GGP set up 166 special purpose entities (SPEs) whose sole purpose was to borrow money. SPEs typically own only one property, which is encumbered by a lender's mortgage. Further, SPEs have relatively few creditors, so their lenders hold strong or controlling positions should the SPE end up in bankruptcy. The organizational documents of SPEs usually require them to adhere to "separateness covenants" requiring them to maintain their assets and records separate from those of all others. This is designed to prevent SPE assets from being dragged into the bankruptcy estate of any related company that might file for bankruptcy. SPEs are attractive to lenders because they are usually "bankruptcy remote," meaning their filing for bankruptcy is less likely because their organizational documents require the affirmative vote of one or two independent directors for them to file a bankruptcy case.

To circumvent the bankruptcy-remote obstacle, shortly before the bankruptcy filings, GGP replaced the directors on roughly 90% of its SPE boards. All 166 boards subsequently authorized bankruptcy filings for their entities. GGP was able to pull this off because most of the GGP entities' bylaws or similar agreements permitted the borrower to replace the independent directors, and the documents governing the others did not prohibit it.

What Lenders Can Do to Mitigate This Risk

There is no magic bullet that can prevent a borrower from filing for bankruptcy protection. But there are steps a lender can take to minimize the risk:

- When negotiating forbearance, extension and modification agreements, take the opportunity to revisit covenants relating to the replacement of independent directors.
- Tighten eligibility requirements for independent directors (such as prior board experience, not having served on the board of a company that filed for bankruptcy, and limiting the independent directors' number of simultaneous SPE

New York Office
2 Park Avenue
New York, New York 10016
Phone: (212) 592-1400
Fax: (212) 592-1500

Princeton Office
210 Carnegie Center
Princeton, New Jersey 08540
Phone: (609) 452-3800
Fax: (609) 520-9095

Newark Office
One Gateway Center
Newark, New Jersey 07102
Phone: (973) 274-2000
Fax: (973) 274-2500

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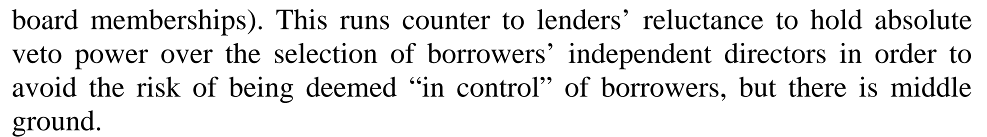

board memberships). This runs counter to lenders' reluctance to hold absolute veto power over the selection of borrowers' independent directors in order to avoid the risk of being deemed "in control" of borrowers, but there is middle ground.

- Consider negotiating the right to suggest a pool of candidates from which borrowers may select independent directors, much the same way that a lender may suggest potential restructuring advisors to a borrower without making any particular appointment for the borrower. In this regard, do not allow borrowers to amend the bankruptcy-remote provisions in their organizational documents without the lender's prior approval.

- Require the SPE to have at least two independent directors.

- Require that borrowers provide advance notice before removing independent directors, and do not allow them to do so arbitrarily.

The Cash Flow Problem

In the typical Chapter 11 real estate case, the borrower uses the property's cash collateral to pay the operating expenses of the property, taxes and insurance, and pays the balance paid to the secured lender as adequate protection. But in the GGP Chapter 11, the Bankruptcy Court issued an order authorizing GGP to sweep the "excess" cash flow of profitable subsidiary debtors to the parent entity, for use in GGP's operations and to support the operations of subsidiaries that are cash flow negative. In this case, "excess" cash flow means all cash flow beyond the amounts required to pay operating expenses, taxes, insurance and interest to first priority mortgage lenders at the non-default contract rate.

In our experience, it is highly unusual for a bankruptcy judge to allow cash flow from one real estate debtor to be used to fund operations of a different debtor. Virtually every secured lender to GGP's separate subsidiaries that own shopping centers objected to this provision. But the Bankruptcy Court overruled the objections, finding that the mortgage lenders were adequately protected because: (1) they are to receive interest payments post-petition at the non-default rate, (2) GGP promised to continue to maintain the properties in accordance with its pre-bankruptcy practice, (3) in most cases, there is an "equity cushion," meaning that the properties had values in excess of the debt encumbering them, and (4) the mortgage lenders were granted a second lien on a portfolio known as the "Goldman properties," which was valued at nearly $220 million.

How Lenders Can Avoid This

This case sets a dangerous precedent because GGP was able to convince the Bankruptcy Court to disregard well-established practice that protects secured creditors' rights. They did it by convincing the court that there was a low risk of loss for the lenders if their cash were swept and used to benefit of other lenders. These battles will be fact-specific, and here are some tips on fighting them:

- Challenge the factual assumptions underpinning the borrower's requests.

- Highlight the factual differences between your case and the GGP case, and argue that the extraordinary relief awarded in the GGP case should not be granted because the facts do not show the same low level of risk to the lender.

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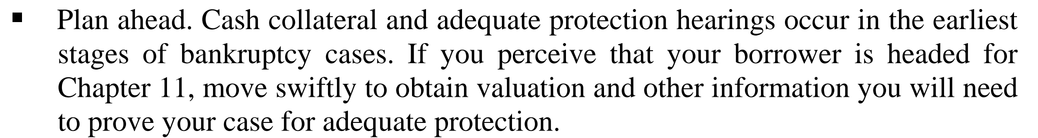

- Plan ahead. Cash collateral and adequate protection hearings occur in the earliest stages of bankruptcy cases. If you perceive that your borrower is headed for Chapter 11, move swiftly to obtain valuation and other information you will need to prove your case for adequate protection.

For more information please contact: **Stephen Selbst** at **(212) 592-1405** or **sselbst@herrick.com** or **Paul A. Rubin** at **(212) 592-1448** or **prubin@herrick.com**.

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