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Lessons From General Growth Properties: The Future Of The Special Purpose Entity

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ABSTRACT

With the crash of the financial market, the effectiveness of "bankruptcy remote" provisions has been tested and examined. In the recent case of *In re General Growth Properties*, the court allowed a bankruptcy remote special purpose entity to voluntarily file for relief under Chapter 11 of the Bankruptcy Code along with its related corporate entities, despite the fact that bankruptcy remote provisions are designed to avoid precisely this result. This Note analyzes the *General Growth* decision and explores its potential future implications for the special purpose entity as a securitization tool. While *General Growth* casts doubt on the viability of special purpose entities, a careful examination of the facts and circumstances surrounding the opinion sheds light on how bankruptcy remote provisions can remain effective by following proper procedural precautions.

TABLE OF CONTENTS

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[*] Associate, Togut, Segal & Segal LLP; J.D., Fordham University School of Law, 2011; A.B., Freeman School of Business at Tulane University, 2006. Special thanks to Professor Susan Block-Lieb and my colleagues at Togut, Segal & Segal LLP for their guidance, assistance, insight, and continued support.

INTRODUCTION

The creation of a bankruptcy remote "special purpose entity" or "special purpose vehicle," (hereinafter "SPE") has been a longstanding valuable securitization tool, protecting lenders from the financial risks of large commercial borrowers. Corporations generally set up a subsidiary in the form of a SPE to separate the ownership of an asset from the risk associated with its financing. A SPE is generally designed to be "bankruptcy remote" so that it is difficult for a majority of board members or managing members of a business to put it into bankruptcy.[1] Recent case law casts doubt as to whether the SPE securitization model is still effective. This doubt arises from the recent Chapter 11 case of *In*

1. In describing a bankruptcy remote entity, the Financial Accounting Standards Board has explained: "the special-purpose corporation is designed to make remote the possibility that it would enter bankruptcy, either by itself or by substantive consolidation into a bankruptcy of its parent should that occur. For example, its charter forbids it from undertaking any other business or incurring any liabilities, so that there can be no creditors to petition to place it in bankruptcy. Furthermore, its dedication to a single purpose is intended to make it extremely unlikely, even if it somehow entered bankruptcy, that a receiver under the U.S. Bankruptcy Code could reclaim the transferred assets because it has no other assets to substitute for the transferred assets." Statement of Financial Accounting Standards 140, App. A, ¶83(c).

re General Growth Properties ("GGP"), in which a voluntary bankruptcy petition was filed by a bankruptcy remote SPE.[2]

This Note discusses securitization through SPEs and the effectiveness of bankruptcy remote provisions. Part I discusses the effect of the SPE structure, a SPE's characteristics, and standard bankruptcy remote provisions. Part I also explains why SPEs are valuable securitization methods and describes the risks they intend to mitigate. Part II discusses the potential legal challenges that may be brought against a SPE and the risks lenders face by participating in such a transaction. Part III addresses the effectiveness of Bankruptcy Remote Provisions against voluntary and involuntary bankruptcy filings, focusing on the recent *GGP* opinion. Part IV examines the consequences of the *GGP* decision and its predicted effect on future SPE financing. Finally, Part V concludes by outlining the proper protective measures a transferor should take in creating a SPE to ensure that the securitization survives potential challenges.

I. SPEs GENERALLY

A. WHAT IS A SPE?

A SPE is an independent legal entity that can be used to mitigate the disruption caused by a bankruptcy filing by all or some of the members of a corporate group.[3] It is therefore an essential element of securitization.[4] SPEs are structured so that investors are protected from the credit risk of the loan originator or servicer, also known as the "sponsor" or "transferor."[5] Essentially, a lender may be more inclined to provide a secured loan to an independent entity rather than to a complex corporate group with several creditors. Generally, a SPE is created when the transferor transfers ownership of some income producing assets, such as equity generating income or mortgages generating payments, to

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2. 409 B.R. 43 (Bankr. S.D.N.Y. 2009)

3. *See* Stuart M. Saft, *Refinancing a Discounted Indebtedness: Special Purpose Entities*, COMMERCIAL REAL ESTATE WORKOUTS § 7:33 (3d ed.) (2010).

4. CHARLES R. GIBBS ET AL., MORTGAGE AND ASSET BACKED SECURITIES LITIGATION HANDBOOK § 7:3 (2010).

5. Marcia L. Goldstein et. al., *General Growth Properties: Are Bankruptcy-Remote Entities in Fact Bankruptcy-Remote?*, 2010 AM. BANKR. INST. 187; *see generally* Sheryl A. Gussett, *Bankruptcy Remote Entities in Structured Financings*, 15 MAR. AM. BANKR. INST. J. 15 (1996) (discussing means of creating the SPE and whether an entity can truly be bankruptcy remote).

a SPE.[6] An SPE achieves bankruptcy remote status through governance provisions and restrictive covenants. Ideally, the SPE will be a newly created corporation, limited liability company, partnership, nonprofit, business trust, or limited liability partnership.[7] While tax considerations largely determine which type of entity will be ideal, most commonly, SPEs are either limited partnerships or limited liability companies.[8]

The effect of this structure is to separate the credit quality of the assets being securitized from the credit risk of any other entity involved in the financing.[9] Isolating the assets makes the financing more attractive to a lender by lessening potential risk.[10] This separation is achieved by structuring the sale of assets between the transferor and the SPE as a "true sale" between the parties rather than as a transfer of a security interest in the assets.[11] After a true sale of the assets, the transferor is left with no legal or equitable interest in the assets.[12] If the transferor later files for bankruptcy, the transferred assets will not be included as part of the transferor's estate; and investors who are secured by the SPE's assets are not at risk of losing any part of their security interest.

Corporate governance provisions and restrictive covenants generally ensure that the SPE will be bankruptcy remote. This structure prevents the SPE from becoming a debtor in bankruptcy and also protects the SPE's assets from the bankruptcy of a related corporate entity.[13] Bankruptcy remote provisions are often found in the SPE's charter or bylaws.[14] The SPE's corporate documents will generally contain restrictive provisions requiring that the SPE be limited to its

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6. Baxter Dunaway, *Law of Distressed Real Estate, Special Purpose Entity (SPE/SPV) and Bankruptcy Remoteness*, 4 LAW OF DISTRESSED REAL ESTATE § 56:4 (2010).

7. "In some states this will result in the payment of a substantial transfer tax and an alternative will be to use an existing entity which is restructured to meet the bankruptcy remoteness requirements." *Id.* at § 56:29.

8. *Id.* at § 56:55.

9. *Id.* at § 56:27.

10. Saft, *supra* note 3.

11. Dunaway, *supra* note 6, § 56:4, :27.

12. *See id*.

13. *Id*. § 56:27.

14. *See, e.g.*, Katherine D. Kale, *Securitizing the Enterprise: Enterprise Liability and Transferred Receivables in Bankruptcy*, 20 BANKR. DEV. J. 311, 319 (2003).

stated purpose of holding the collateral assets, therefore restricting it from engaging in outside activities.[15]

Additionally, restrictive covenants ensure the borrower's status as a SPE. These covenants often prohibit the borrower from (1) engaging in business other than to operate the collateral; (2) owning property other than the collateral; (3) merging with another entity or acquiring any subsidiary; (4) incurring other debt (with exceptions of ordinary course trade payables and equipment financing); (5) co-mingling assets with affiliates; and (6) guaranteeing the debt of an affiliate or pledging its assets to secure the debt of another.[16] These covenants limit the SPE's powers to activities necessary to operate the structured transaction.[17] Additional activities may include things such as permitting the SPE to incur debt for future real estate taxes and/or additional covenants contained in easements and other matters of public record.[18] If one lender wishes to secure loans on multiple properties, the SPE may be designed to operate all the relevant properties. However, if the borrower wishes to change management or sell any of the relevant properties, lender approval will be required.[19] These limits preclude the SPE from engaging in operations outside the asset securitization, thus reducing the risk of the SPE becoming insolvent.[20]

In addition, a SPE's bankruptcy remote provisions will also generally require that in order to file for bankruptcy voluntarily, there must be unanimous consent of the SPE's directors or partners with an "independent" director, partner, or managing member of the SPE (the "independent director requirement").[21] The independent director requirement prevents common directors of the SPE and the SPE's parent entity from submitting a solvent SPE to bankruptcy solely for the parent entity's advantage.[22] The independent director is often designated by the lender and can presumably veto any suggestion of the SPE filing a

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15. Dunaway, *supra* note 6, § 56:52.

16. Michael T. Madison et. al., *Impact of Bankruptcy on Real Estate Transactions*, 2 LAW OF REAL ESTATE FINANCING § 13:38 (2009).

17. Dunaway, *supra* note 6, § 56:31.

18. *Id.*

19. *Id*. ("More than one property may be operated if the lender is securitizing loans on all of the properties. If the borrower wishes to sell or change management of one of the properties this would be a 'defeasance,' which requires the approval of the lender or may be provided for in the agreement.").

20. *Id*.

21. GIBBS ET AL., *supra* note 4, § 7:4.

22. Saft, *supra* note 3.

voluntary bankruptcy petition.[23] Therefore, the independent director requirement protects the lenders' interests by shielding the SPE from complete control of the parent company's board of directors.

Rating agencies assign credit ratings for issuers of certain types of debt obligations and for the debt instruments themselves. These agencies set the requirements as to who can be considered an independent director. Typically, an independent director must not:

> (1) [H]ave a direct or indirect legal or beneficial interest in the borrower or any of its related entities; (2) be a substantial creditor, customer, supplier, employee, or other person that derives any of its purchases or revenues from the borrower or its related entities; (3) be a member of the immediate family of any member, manager, creditor, customer, supplier, employee or other person that derives any of its purchases or revenues from the borrower or its related entities; or (4) be a person or entity controlling or under common control of anyone referred to in items one through three.[24]

B. WHY HAVE A SPE?

SPEs are intended to address two primary issues. First, through their separate structure and bankruptcy remote provisions, SPEs aim to minimize the risk of the commercial borrower of a securitized loan becoming the subject of a bankruptcy case ("Borrower Bankruptcy Risk").[25] This includes the risk of a corporate parent or affiliate's financial problems spreading to the borrower and the risk of the borrower itself enduring financial difficulty.[26] The effectiveness of a SPE's ability to reduce Borrower Bankruptcy Risk was tested by the court in *General Growth Properties*, discussed *infra* in Part III of this Note.

Second, SPEs are intended to minimize the risk that the assets of a borrower will become substantively consolidated with those of a related

23. STANDARD & POOR'S LEGAL CRITERIA FOR STRUCTURED FINANCE TRANSACTIONS (Apr. 2004), *available at* www.mbaa.org%2Ffiles%2FresourceCenter %2FRegAB%2FRegABLegalCriteriaforStructuredFinance%28S%26P%29.pdf&ei=9f UnT5PfEKfq0gHbxZDsAg&usg=AFQjCNGbIICKrE1Gk3Cu__pfzxHffOq8Pw&sig2= nMqHZ6NVkRBBrlZvgjkNgA.

24. Dunaway, *supra* note 6, § 56:33.

25. GIBBS ET AL., *supra* note 4, § 7:3.

26. *Id.*

corporate entity ("Substantive Consolidation Risk").[27] Loan issuers and rating agencies often insist that single borrowers or property specific groups set up a SPE in order to securitize a loan to protect the creditors from the risk of the SPE being substantively consolidated.[28] If the bankruptcy filings of a SPE and related entity are substantively consolidated by the bankruptcy court, the assets and liabilities of the different entities will be consolidated and dealt with as if they were a single entity that held all the assets and incurred all the liabilities.[29] The process of substantively consolidating the assets and liabilities of the SPE with the related entity will delay any quick resolution to the bankruptcy case, and may also prevent the lender from realizing on its collateral.[30] This is because even if the SPE is not itself the subject of a bankruptcy filing, the bankruptcy court has jurisdiction to authorize a temporary restraining order or injunction that will prevent any creditor from exercising its collection or enforcement efforts.[31] Further, section 362 of the Bankruptcy Code provides for an automatic stay to prevent the SPE and its creditors from foreclosing on assets of the debtor.[32] Substantive Consolidation Risk is discussed *infra* in Part II of this Note.

Bankruptcy remote structures also protect creditors if the SPE does, in fact, file for bankruptcy through certain procedural advantages. Section 362(d)(3) of the Bankruptcy Code, added as part of the Bankruptcy Reform Act of 1994, provides for lifting of the automatic stay in a "single asset real estate" case unless within 90 days of the filing of bankruptcy the debtor has either filed a reorganization plan that has a reasonable possibility of being confirmed within a reasonable time, or has commenced monthly payments of post-petition interest to the mortgagee at a current fair market rate on the value of the creditor's interest in the real estate.[33] However, if the SPE has included covenants

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27. *Id.*

28. Dunaway, *supra* note 6, § 56:35.

29. *Id.*

30. GIBBS ET AL., *supra* note 4, § 7:3.

31. *Id.*

32. 11 U.S.C. § 362(d)(3) (2006).

33. In the 1994 amendments, Congress limited the applicability of expedited relief from a stay by defining four components of "single asset real estate": (1) a single property or project; (2) that generates substantially all of the debtor's gross income; (3) on which the debtor conducts no substantial business aside from operating the real property; and (4) having aggregate non-contingent, liquidated secured debts of less than \$4 million. Steven H. Felderstein & Joan S. Huh, *Single Asset Real Estate Cases*, *30th Annual Current Developments in Bankruptcy Reorganization*, 905 PLI/COMM 37 (citing 11 U.S.C. § 101(51B) (1994)).

to preserve the SPE as a single asset, single purpose borrower, the SPE may be subject to accelerated procedures for purposes of lifting the stay, giving an advantage to the secured lender.[34] Courts may also be more willing to enforce stay waivers in pre-petition workout agreements involving single asset debtors.[35]

II. CHALLENGES TO THE SPE STRUCTURE AND LENDER RISKS

A. CHALLENGES TO THE SPE STRUCTURE

1. Recharacterization: What is a "True Sale" Versus a Secured Loan?

Although the structure of a SPE is designed to isolate assets, the legal separateness of an SPE can be challenged in bankruptcy court by the trustee or debtor in possession ("DIP"). Challenges to the separateness of the SPE's structure are often based on the notion that the SPE is not in fact separate from the transferor.[36] Depending on the precautions taken by the transferor in setting up the sale transaction (discussed in detail below), the court may find that instead of a true sale of assets, the sale transaction was a step transaction, or simply a loan, and therefore the assets are still part of the transferor's estate under section 541 of the Bankruptcy Code.[37] If the assets are deemed to be part of the transferor's estate, their value will be disbursed to creditors of the transferor, rather than the SPE's lenders.[38]

Case law reveals a significant number of factors that bear on the question of whether a transaction is legally a loan or a "true sale," and usually no single factor is determinative.[39] State law determines whether a transaction is a true sale or a secured loan; and courts look to the parties' intentions and the facts and circumstances of the transaction including the practices, objectives, and relationship between parties.[40] In

34. Madison et al., *supra* note 16.

35. *Id.* § 13:10.

36. Dunaway, *supra* note 6, § 56:38.

37. 11 U.S.C. § 541.

38. *See id.* § 541(a).

39. Dunaway, *supra* note 6, § 56:38 (discussing risk of recharacterization of transaction as not a true sale).

40. Dunaway, *supra* note 6, § 56:38 (citing *In re* Golden Plan of Cal., Inc., 829 F.2d 705, 708-09 (9th Cir. 1986)); *see* Redic v. Gary H. Watts Realty Co., 762 F.2d

addition to the parties' intent, courts have focused on the extent to which the risks and benefits associated with ownership have been retained or transferred.[41] Courts look to the level of recourse that the SPE has against the seller for repayment of the purchase price of the assets. In a "true sale" the buyer is taking full credit risk on the payment.[42] Where the buyer has direct recourse to the transferor (the seller), the buyer has the right to collect from the seller any amount that is not paid, indicating the transaction is intended to be a loan rather than a true sale.[43] The more recourse the SPE has available, the more likely it is that the transaction will be viewed as a loan.

In determining whether a challenged sale transaction is a "true sale" or a loan, courts may also consider whether there are disproportionate reserves, which party controls collection on accounts, which party controls the sale proceeds, whether parties abided by formal accounting procedures, whether the buyer purchased specific assets as opposed to an undivided interest in a blind pool of assets, whether excise and ad valorem taxes have been paid by the buyer, whether the buyer has the right to resell the assets, and the reasonableness of the purchase price.[44]

If the sale transaction is re-characterized from a true sale to a loan from the transferor to the SPE, or a security interest, and the transfer of assets was not perfected under Article 9 of the U.C.C., then the SPE holds the assets as an unperfected security interest, avoidable under section 544(a) of the Bankruptcy Code and section 9-317 of the U.C.C., and the SPE becomes an unsecured creditor in the transferor's pool of creditors.[45] If the transfer was perfected, as most rating agencies require, the SPE's investors would be secured creditors with a higher priority, meaning they are more likely to get repaid in the cascade of distribution.[46]

In a bankruptcy of the transferor, courts have great latitude in determining whether the transferred assets were truly sold to the SPE, or if instead they are part of the transferor's estate. Bankruptcy courts have

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1181, 1185-86 (4th Cir. 1985); Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); *In re* Carolina Utils. Supply Co., 118 B.R. 412 (Bankr. D.S.C. 1990).

41. *Id.*

42. John F. Hilson, *Asset-Based Lending: A Practical Guide to Secured Financing*, 2010 PRACTISING LAW INST. § 2:5.3.

43. *Id.*

44. *Id.*

45. *See* 11 U.S.C. § 544(a) (2006); U.C.C. § 9-317 (2000).

46. Dunaway, *supra* note 6, § 56:40.

broad powers under section 105 of the Bankruptcy Code and have the ability to broadly interpret the definition of the "estate" of a debtor under section 541 of the Bankruptcy Code. In *In re LTV Steel Co.*, the court held that the debtor was entitled to use cash collateral that had been transferred to two SPEs of the debtor, which had been formed to purchase the accounts and inventory of the debtor.[47] The case involved a loan originator that had filed for bankruptcy and challenged its own securitization by asserting that it had not "truly" sold all of its assets to a bankruptcy remote SPE.[48] This assertion was made even though the debtor, LTV, had agreed to and benefited from the securitization.[49]

Prior to filing for bankruptcy, LTV and its creditor, Abbey National, entered into a securitization transaction.[50] LTV created a wholly-owned subsidiary SPE known as LTV Sales Finance Co. LTV then entered into an agreement with the SPE, which purported to sell all of LTV's rights and interests in its accounts receivables on a continuing basis.[51] Abbey National agreed to loan $270 million to the SPE in exchange for the SPE granting Abbey National a security interest in the receivables.[52] Subsequently, LTV filed a petition in Chapter 11. The SPE was not in bankruptcy. Nevertheless, LTV filed a motion seeking an interim order permitting it to use cash collateral.[53] This cash collateral consisted of the receivables and inventory that were owned by the SPE.[54] LTV stated to the court that it would be forced to shut its doors and cease operations if it did not receive authorization to use the cash collateral.[55]

LTV argued that despite the intent and the language of the securitization documents, it still owned the securitized assets.[56] However, the entire premise of a securitization facility is that the securitized assets have been transferred to the SPE and the assets are no longer LTV's "collateral."[57] In fact, a debtor's request to "use" that

47. *In re* LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001).
48. *See id.* at 279-82.
49. *See id.* at 285.
50. *Id.* at 280.
51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.*
56. Dunaway, *supra* note 6, § 56:39.
57. *Id.*

collateral presupposes that the debtor still owns such assets.[58] After an emergency hearing, the bankruptcy court permitted LTV to use the securitized assets on an interim basis, and granted the SPE a senior lien in inventory and receivables generated post-petition by LTV.[59]

The court explained that the "Debtor has at least some equitable interest in the inventory and accounts that were a product of its labor, and that this interest is property of the Debtor's estate . . . sufficient to support the entry of the interim cash collateral order."[60] The court was satisfied that without entry of the interim order, LTV would have been immediately forced to cease its business operations.[61] Such an occurrence would have eliminated LTV's chance to reorganize its business and would have had dire consequences for LTV's employees, customers, and creditors. Considering the potential effect of ending the debtor's business, the court held that the general equities of the situation "highly favored the debtor."[62] This decision has been heavily criticized as an insufficient basis for the court's determination that the debtor retained any interest in the transferred property, as the court failed to consider the relevant facts or legal principles applicable to such a determination.[63] Ironically, in a later Stipulation and Order by the court which resolved the parties' dispute, the court ordered that the transfers at issue constituted "true sales."[64]

LTV Steel Co. was factually unusual in that the transferor challenged its own securitization, which is generally inconsistent with a transferor's interests.[65] Nonetheless, the court's approach to the true sale issue is significant. In *LTV Steel Co.,* the court was influenced by the fact that use of the cash collateral was essential to the survival of the business and jobs of its thousands of employees.[66] This shows the importance of DIP financing as an exit strategy in securitization.[67]

58. *Id*.
59. *In re* LTV Steel Co., 274 B.R. at 281.
60. *Id.* at 285.
61. *Id.* at 284.
62. *Id.* at 286.
63. Hilson, *supra* note 42, § 2:5.3 n.31.
64. *Id.*
65. *See generally* Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1698 (2004).
66. *In re* LTV Steel Co., 274 B.R. at 284.
67. Dunaway, *supra* note 6, § 56:39.

Further, where a debtor retains substantial risk in asset securitization, the court may recharacterize the transaction as a secured loan.[68]

2. *Substantive Consolidation*

Substantive consolidation is the pooling of the assets and liabilities of technically distinct corporate entities.[69] For purposes of distribution in bankruptcy, substantive consolidation treats multiple entities as if they were one.[70] If the transferor files for bankruptcy, the transferor's creditors may argue for substantive consolidation. The transferor's creditors want the estate to be as valuable as possible to maximize their recovery.[71] Substantive consolidation of the SPE and transferor increases the amount of assets to be divided up among the transferor's creditors.[72] Substantive consolidation is likely to occur where the debtor makes payments out of the ordinary course of business, pledges additional or substitute collateral (with value in excess of the released collateral) or if the borrower transfers collections to the SPE.[73]

In *In re Augie/Restivo Baking Company, Ltd.*, the Second Circuit set out what has become the widely followed standard for when substantive consolidation is appropriate.[74] The court identified two critical concerns that should be addressed: (1) "whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit'"[75] and (2) "whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[76] The Second Circuit has since further developed this

68. T. Randall Wright, *Bankruptcy Issues in Partnership and Limited Liability Company Cases*, SR056 ALI-ABA 1201 (2010).

69. *See generally* 5 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 3D § 21:3 (2008).

70. William L. Norton, Jr., *Joint Administration, Procedural Consolidation, and Substantive Consolidation of Cases (Code § 302(b))*, 2 NORTON, *supra* note 69, § 21:3.

71. *See generally* 2 NORTON, *supra* note 69, § 21:3 (discussing substantive consolidation).

72. *Id*.

73. Dunaway, *supra* note 6, § 56:37.

74. Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (*In re* Augie/Restivo Baking Co., Ltd.), 860 F.2d 515 (2d Cir. 1988); *see also In re* Raymond Professional Group, Inc., 438 B.R. 130, 138 (Bankr. N.D. Ill. 2010); *In re* The Lodge at Big Sky, LLC, 454 B.R. 138, 142 (Bankr. D. Mont. 2011); *In re* Murray Indus., Inc., 119 B.R. 820, 829 (Bankr. M.D. Fla. 1990).

75. *Id.* at 518 (citing *5 Collier on Bankruptcy* 1100-33).

76. *Id.* at 518.

standard to include consideration of (1) whether the related entities have assumed each other's contractual obligation; (2) whether there is a sharing of overhead, management, accounting, and other related expenses between the entities; (3) the existence of intercompany loan guarantees; (4) a failure to respect corporate formalities when shifting funds between entities; (5) inadequate capitalization of a subsidiary; (6) a parent corporation owning all or a majority of the subsidiary's capital stock; and (7) whether the related entities have common directors, officers, and business locations.[77] These factors illustrate the importance of separateness in a SPE asset securitization in order to ensure that the court will honor the independence of the SPE.

3. Fraudulent Conveyance/Avoidable Preference

Other potential challenges to the sale transaction include: (1) that the transfer was a fraudulent conveyance avoidable under section 548 of the Bankruptcy Code or (2) that the SPE was a creditor and the transfer was an avoidable preference under section 547.[78] Avoidance suits can be detrimental to a SPE securitization because if a transfer of assets is avoided as a fraudulent transfer or preference, the assets will not be available to make timely payments to the investors.[79]

A fraudulent conveyance, which is avoidable under the Bankruptcy Code or applicable state law, is a viable attack against a SPE when the purchase price paid by the borrower is less than the reasonably equivalent value of the assets, and when the transferor is insolvent or financially distressed at the time of the transfer.[80] If the rating agency determines that there is a risk of a fraudulent conveyance, it will generally require a "fraudulent conveyance opinion" to the effect that the transfer and the related payments to the holders of the rated securities would not be recoverable as a fraudulent transfer under section 548 or applicable state law.[81] In defending against a fraudulent conveyance action, Bankruptcy Code section 550(b) provides protection

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77. Dunaway, *supra* note 6, § 56:35 (citing *In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 723, 764 (Bankr. S.D.N.Y. 1992); Committee on Bankruptcy and Corp. Reorganizations of the Bar of City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 558 (1995); Malcolm S. Dorris, *Problem Cases in Bankruptcy*, 747 PLI/Comm 395, 418–419 (1996)).

78. *Id.* § 56:27.

79. *Id.*

80. *Id.*

81. *Id.*

for a good faith transferee to the extent of the value given and is applicable whether or not the transferee is a creditor.[82] In determining whether the transferee acted in good faith, courts generally apply an objective test, which asks whether the transferee knew or reasonably should have known of the debtor's insolvency or of his fraudulent intent.[83]

A preferential transfer may also be avoided by a trustee in bankruptcy when a debtor made a transfer within 90 days, or for an insider, one year on account of antecedent debt while the debtor was insolvent.[84] A payment is "on account of an antecedent debt" if the debt owed the creditor was incurred before the transfer of the debtor's property was made.[85] This could be a problem if the SPE's transferor becomes a debtor and has made transfers to the SPE within the prescribed period prior to the transferor's bankruptcy.[86] Preference attacks are likely to occur when debt payments were made outside the ordinary course of business or when there was a pledge of additional collateral or substitute collateral having a value in excess of released collateral.[87] If the rating agency determines that there is a preference risk in connection with a transfer of assets, it will generally request a "preference opinion" from an independent attorney to the effect that the payments to the holders of the rated securities would not be recoverable as a preference.[88]

In defending against a preference action, available defenses under section 547(c) of the Bankruptcy Code include the contemporaneous new value exception, the ordinary course of business exception and the subsequent new value exception.[89] Under the "contemporaneous

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82. 11 U.S.C. § 550(b) (2006).

83. W. Homer Drake, Jr., *Property Recovered by the Trustee*, BANKR. PRAC. FOR GEN. PRACTITIONER § 5:15 (2010).

84. 11 U.S.C. § 547(b).

85. *See, e.g.*, *In re* Tanner Family, LLC, 556 F.3d 1194, 1196 (11th Cir. 2009) (noting that a payment made to terminate a lease is a payment made on account of antecedent debt because the obligation to pay future rent under the lease arose at the time the lease was signed).

86. Dunaway, *supra* note 6, § 56:37.

87. *Id.*

88. *Id.*

89. Other defenses to a preference action include: Enabling Loan Exception; Floating Lien Exception; Statutory Lien Exception; Domestic Support Exception; Small Preference Exception; and Consumer Debt Repayment Plan Exception. 11 U.S.C. § 547(c) (2006).

exchange for new value exception," the trustee may not avoid a transfer if: "(1) the transferee . . . extended new value to the debtor in exchange for the payment or transfer; (2) the exchange of payment for new value [was] intended by the debtor and transferee to be contemporaneous; and (3) the exchange [was] in fact substantially contemporaneous."[90] The rationale for this exception is that because new value is given, a contemporaneous exchange does not diminish the debtor's estate.[91] In determining whether the transfer was made in the ordinary course of business between the parties, the court applies a subjective test, considering factors such as the timing, amount, and manner of payment.[92]

In order to benefit from the "new value" defense, the creditor must establish that it provided new value to the debtor after the preferential transfer, which was (1) not secured by an otherwise unavoidable security interest; and (2) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.[93] The theory behind this exception is that, when the creditor who received the preferential payment subsequently extends new value, the creditor has essentially returned the preference to the estate, so long as the debtor does not pay the creditor for that new value and does not give the creditor a security interest in exchange for it.[94]

B. Lender Risks in Bankruptcy Remote Structuring

A lender's involvement in bankruptcy remote structuring can entail several risks for the lender. First, the lender's involvement in the sale transaction may cause it to be considered an "insider" which would extend the look-back period in which a DIP or trustee can avoid the transaction as a preference.[95] Further, the bankruptcy court may invoke its equitable power to subordinate the lien of the secured creditor who interfered with the debtor's business to the detriment of other creditors.[96] Equitable subordination is a doctrine which provides that for purposes of

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90. *See id.* § 547(c)(1).

91. *In re* JWJ Contracting Co., Inc., 371 F.3d 1079, 1081 (9th Cir. 2004).

92. Drake, Jr., *supra* note 83, § 5:13 (citing *In re* First Jersey Secs., Inc., 180 F.3d 504 (3d Cir. 1999)); *In re* Pillowtex Corp., 427 B.R. 301 (Bankr. D. Del. 2010)).

93. 11 U.S.C. § 547(c)(4) (2006).

94. Drake, Jr., *supra* note 83, § 5:13 (2010) (citing *In re* Furr's Supermarkets, Inc., 317 B.R. 423 (B.A.P. 10th Cir. 2004)).

95. 11 U.S.C. § 101(31)(C)(v).

96. Madison et al., *supra* note 16, §§ 13:38, 12:17.

distribution, the bankruptcy court may, after notice and a hearing, subordinate all or part of an allowed claim to all or part of another allowed claim, or all or part of an allowed interest to all or part of another allowed interest.[97]

A claim is likely to be equitably subordinated where the lender becomes too intimately involved in the affairs of the debtor or seeks otherwise to take unfair advantage of other creditors. Under these circumstances the court will order the lender's claims to be subordinated to the claims of other creditors.[98]

In other words, equitable subordination may be applied by the court where the lender engages in some inequitable conduct that results in injury to other creditors or an unfair advantage to the lender. If the lender designates an independent director to serve on the SPE's board, the lender's involvement might trigger lender liability consequences for excessive control.[99] Further, if the lender is considered an insider, the risk of equitable subordination is more likely.[100] This is because for inside creditors, the court uses a somewhat lower standard to establish inequitable conduct warranting subordination.[101]

Another risk to the lender stems from the possibility of the lender's designated director breaching his or her fiduciary duties to the SPE when the independent director acts in the best interest of the lender, but contrary to the best interests of the SPE. This risk was addressed by the court in *Kingston Square*, discussed *infra* in Part III of this Note.

III. EFFECTIVENESS OF BANKRUPTCY REMOTE PROVISIONS

As discussed earlier, bankruptcy remote provisions are generally part of the SPE structure to protect investors by ensuring that they get paid on time.[102] If the transferor, or the SPE itself were to file for

97. 11 U.S.C. § 510(c)(1) (2006).

98. Hilson, *supra* note 42, § 12:6.6.

99. Madison et al., *supra* note 16, § 13:38.

100. *See, e.g.*, Bayer Corp. v. MascoTech, Inc., 269 F.3d 726, 744 (6th Cir. 2001) ("[W]hen reviewing equitable subordination claims, courts impose a higher standard of conduct upon insiders."); *In re* Herby's Foods, Inc., 2 F.3d 128, 131 (5th Cir. 1993) ("[I]f the claimant is an insider, less egregious conduct may support equitable subordination"); *In re* Interstate Cigar Co., 182 B.R. 675, 679 (Bankr. E.D.N.Y. 1995) ("[C]ourt gives 'special scrutiny' to [an insider's] transactions with the Debtor").

101. *See id.*

102. *See infra* Part I.B.

bankruptcy, the investors would likely be at risk of not getting paid on time or in the full amount.[103] This risk is more significant where the transferor has control over the SPE or its downstream affiliated entities.[104] The SPE cannot be prohibited from voluntarily filing for bankruptcy, however, the independent director requirement limits this risk. Even if the SPE does not voluntarily file a bankruptcy petition, the SPE can be forced into bankruptcy by creditors forcing it to file an involuntary petition.[105] However, rating agencies minimize the risk of involuntary filings by limiting the debt the SPE can incur and requiring prompt payment.[106]

A. BANKRUPTCY REMOTE PROVISIONS FAILURE TO PROTECT AGAINST AN INVOLUNTARY PETITION

Despite rating agencies' preventative measures, bankruptcy remote SPEs can still be involuntarily forced into bankruptcy by creditors. This was illustrated in *Kingston Square,* where a SPE's creditors forced the bankruptcy remote SPE into bankruptcy by filing an involuntary petition against it.[107] In *Kingston Square,* the bankruptcy court appointed a trustee to administer the estates of various limited partnership and corporate debtors in connection with two failed commercial real estate securitization transactions.[108] In each instance, the debtors used bankruptcy remote provisions coupled with mortgage-backed securitization.[109] When implemented together, bankruptcy became unavailable to the defaulting borrower without the affirmative consent of the mortgagee's designee on the borrower's board of directors.[110] The appointed director for each debtor corporation or corporate general partner was a former attorney who had worked for an affiliate of the lender and whose director compensation after default was paid by the lender.[111]

Upon default of the mortgages underlying the securitization interest, the trustee, on behalf of the investors, began to foreclose on the

103. *Id.*
104. *See supra* Parts I.A, I.B.
105. 11 U.S.C. § 303 (2006); Dunaway, *supra* note 6, § 56:52.
106. *Id.*
107. *In re* Kingston Square Assocs., 214 B.R. 713 (Bankr. S.D.N.Y. 1997).
108. *Id*. at 738.
109. *Id*. at 716.
110. *Id*.
111. *Id*. at 716-17.

mortgages.[112] In response to the foreclosures on the debtors' underlying assets, the SPE, in an effort to circumvent an independent manager's refusal to authorize a bankruptcy filing, allegedly recruited creditors to file an involuntary petition against itself.[113] Although the bylaws for each debtor required the unanimous consent of the board of directors in order to file a voluntary bankruptcy petition, this structure was evaded by solicitation of the debtors' creditors who invoked the involuntary petition.[114]

The debtors' lenders moved to dismiss the case pursuant to section 1112(b) of the Bankruptcy Code, which, among other things, requires that insolvency petitions not be filed in bad faith.[115] Even though the Bankruptcy Code does not explicitly require that a Chapter 11 petition be filed in good faith, many courts have developed a "bad faith" standard where the bankruptcy court may dismiss a petition at the inception of the case.[116] The lenders argued that the SPE's alleged recruitment of and collusion with the petitioning creditors constituted bad faith warranting dismissal of the petition. Observing that the Second Circuit requires an additional finding of "objective futility" in using the reorganization process, the court denied the motion to dismiss.[117] Judge Brozmon concluded that the unsecured creditors' "reasonable belief that they could reorganize" suggested "they were not acting in bad faith" in filing the petition.[118] The court agreed that the debtors' collusion with petitioning creditors was "suggestive of bad faith" but found that the debtors' primary motive was to preserve the value of the debtors' estate for their creditors.[119]

As an additional matter, while the involuntary petition was orchestrated in contravention of the spirit of agreement between the secured investors and the general partner, the court concluded that the filing was justified by gross malfeasance by the board in fulfilling its fiduciary obligations to the company's stakeholders.[120] Specifically, the court addressed the lender's designated director's lack of independence

112. *Id*. at 717.
113. *Id*. at 719-23.
114. *Id*. at 737.
115. *Id*. at 724-25.
116. *Id*. at 724.
117. *Id*. at 725.
118. *Id*. at 734.
119. *Id*. at 734-36.
120. *Id*. at 737.

as one of the mitigating factors against dismissal. The court noted that the director failed to take any action or to inform himself about what was happening after he learned of the commencement of foreclosure.[121] This inaction was characterized by the court as a breach of fiduciary duty to the stakeholders, as well as to general creditors of the insolvent debtor.[122] Further, a breach of fiduciary duty, if attributed to the lender, could give rise to an affirmative claim for damages.

Kingston Square can be read narrowly to conclude that an independent director must be truly independent or read broadly to hold that corporate formalities can be overlooked if there is a reasonable opportunity to reorganize.[123] The case raises issues of whether directors owe a fiduciary duty to shareholders of a SPE, unsecured trade creditors and professionals, or bondholders/investors, but it does not decide how these conflicts should be addressed.[124] Nonetheless, it is arguable that the bankruptcy remote provisions of a SPE should be enforced to prevent voluntary or involuntary bankruptcy orchestrated by a transferor as the transferor has obtained the benefit of the securitization with full knowledge of the bankruptcy remote provisions.[125]

B. BANKRUPTCY REMOTE PROVISIONS FAILURE TO PROTECT AGAINST A VOLUNTARY PETITION

As seen in *Kingston Square,* while bankruptcy remote provisions in the SPE structure may reduce Borrower Bankruptcy Risk, they do not eliminate such risk entirely. A subsequent case, *General Growth Properties, Inc.,* ("GGP"), illustrates how bankruptcy remote provisions can fail to protect an SPE from a voluntary bankruptcy filing.[126] In *GGP*, the Southern District of New York held that the Chapter 11 filings of certain SPEs were not bad faith and that the SPEs were eligible for

121. *Id*. at 736.

122. Madison et al., *supra* note 16, § 13:38 (citing *In re* Kingston Square Assocs., 214 B.R. at 736).

123. Sheryl A. Gussett, *A Not-So-Independent Director in a Bankruptcy Remote Structure*, 1998 AM. BANKR. INST. J. 24.

124. Dunaway, *supra* note 6, § 56:52 (citing Robert Dean Ellis, *Securitization Vehicles, Fiduciary Duties, and Bondholders' Rights*, 24 J. CORP. L. 295, 324 (1999)) (seeming to uphold the general principle of providing fiduciary protections to creditors in times of financial distress, but condemning the board's failure to uphold its duties to all stakeholders).

125. *Id*.

126. *In re* Gen. Growth Props., Inc. (*GGP*), 409 B.R. 43 (S.D.N.Y. 2009).

bankruptcy despite being set up as bankruptcy remote. In *GGP*, secured lenders (the "Lenders") filed motions to dismiss against five subsidiaries of GGP that were included in GGP's Chapter 11 filing.[127] GGP was a publically traded real estate investment trust and the ultimate parent of 750 wholly owned debtor and non-debtor subsidiaries, joint ventures and affiliates.[128] GGP's group portfolio primarily consists of more than 200 shopping centers in 44 states across the country.[129] GGP had $18.27 billion in mortgage and debt secured by properties of which $1.83 billion was the subject of the motions to dismiss.[130] GGP had typically satisfied its capital needs through mortgage loans from banks and insurance companies, and from the commercial mortgage backed securities ("CMBS") market.[131] The typical mortgage loan had a three to seven year term with a low amortization and a large balloon payment at maturity.[132] Failure to repay or refinance the debt by the repayment date would result in hyper-amortization, meaning a steep interest rate increase, a requirement for approval of expenditures by the lender, and/or a requirement that the cash be kept at the project level with any excess applied to the principal of the mortgage.[133] GGP generally refinanced debts before the repayment date to avoid the possibility of hyper-amortization.[134]

By the end of 2008, as the credit crisis hit and the CMBS market became increasingly volatile, GGP was unable to refinance its maturing debt.[135] Nor could GGP sell any of its assets in an attempt to pay down the debt, largely because potential purchasers were also having trouble finding the necessary financing.[136] Due to this financial hardship, GGP began using its operating cash flow to pay its regular expenses, leaving GGP unable to meet prior financial obligations.[137] Many of GGP's loans

127. *Id*. at 46-47.
128. *Id*. at 47.
129. *Id*.
130. *Id*. at 48.
131. *Id*. at 49-51.
132. *Id*. at 50.
133. *Id*.
134. *Id*.
135. *Id*. at 53-54.
136. *Id*.
137. *Id*. at 54.

went into default, and foreclosure proceedings were commenced relating to some of the defaulting loans.[138]

GGP filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on April 16, 2009.[139] GGP had set up several SPEs as part of its corporate structure, and these entities, (the "Subject Debtors") were included in its bankruptcy filing. Each of the Subject Debtors was structured with operating agreements that required the consent of the SPE's independent managers before the filing of a bankruptcy petition.[140] Immediately prior to the bankruptcy filings, GGP had replaced two of the independent managers from one SPE.[141] The new independent managers voted in favor of the bankruptcy filing.[142] Despite GGP and the Subject Debtors having positive cash flow and positive performance as of the date of filing, GGP believed that its capital structure had become unmanageable to service the $18.4 billion debt due to mature in 2012 because of the collapsing CMBS market.[143]

1. Development of the Bad Faith Standard

The Lenders filed a motion to dismiss, arguing that the Subject Debtors' petitions should be dismissed as having been filed in bad faith.[144] Under the equitable doctrine of "bad faith," a court is authorized to dismiss a bankruptcy petition where there is no reasonable likelihood that the debtor intends to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings.[145] The *GGP* court relied on the standard set forth in *Kingston Square* which had held that a bankruptcy petition will be dismissed for bad faith if both objective futility of the reorganization process and subjective bad faith in filing the petition are found.[146] Under *Kingston Square,* no one factor

138. *Id*.

139. The case was procedurally consolidated, pursuant to Federal Rule of Bankruptcy Procedure 1015(a), meaning that two or more petitions in the same bankruptcy court against the same debtor are merged to allow the administration of a unitary estate.

140. *GGP*, 409 B.R. at 62.

141. *Id*. at 67.

142. *Id*.

143. *Id*. at 54-55.

144. *Id*. at 47.

145. *Id.* at 56 (citing C-TC 9th Ave. P'ship v. Norton Co. (*In re* C-TC 9th Ave. P'ship), 113 F.3d 1304, 1309-10 (2d Cir. 1997)).

146. *Id.* at 56 (citing *In re* Kingston Square Assocs., 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997)).

is determinative of bad faith and the court must base its decision on the totality of circumstances of the debtor's financial condition and motives.[147]

The *GGP* court further discussed the evolution of the "bad faith" doctrine. It noted that when Congress adopted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), it strengthened provisions of 11 U.S.C. § 1112 to dismiss or convert a Chapter 11 case, but did not expressly provide a bad faith provision.[148] Congress also amended Bankruptcy Code § 1121(d) to shorten bankruptcy cases, omitting a requirement that the court hold a hearing on the debtor's good faith.[149] The court reasoned that Congress' omission in requiring a good faith hearing is consistent with the Code's provisions to leave the debtor in possession, and incentivizing the debtor to file early in order to preserve the debtor's estate.[150]

The Lenders argued that the Subject Debtors' bankruptcy cases should be dismissed because they prematurely sought bankruptcy protection and because the prospect of liability on their debt was speculative.[151] The prematurity argument was based on the fact that the petitions were filed before the balloon payments on many of the SPEs' three to seven year loans had become due, and before the loans were in default.[152] The Lenders also argued bad faith based on the Subject Debtors' decision to file for relief without attempting to negotiate with the Lenders.[153] The Lenders claimed that they could veto any plan the Subject Debtors proposed, so that no reorganization would be possible.[154]

The court disagreed with these arguments, explaining that the Subject Debtors carry enormous fixed debt that was neither contingent nor speculative as it was set to mature at a fixed date.[155] Further, the Subject Debtors and GGP were in financial distress at the time of the filing.[156] Four of the Subject Debtors had either cross defaulted to the

147. *Id*. at 56.
148. *Id*. at 60.
149. *Id*. at 60 & n.30.
150. *Id*. at 60.
151. *Id*. at 57.
152. *Id*. at 57-58.
153. *Id*. at 66.
154. *Id*. at 65.
155. *Id*. at 57.
156. *Id*.

defaults of other GGP affiliates or would soon be in default.[157] Additionally, one of the loans had gone into hyper-amortization in 2008 so that interest had increased by 4.26%, with additional mortgage debts maturing in 2010, 2011, and 2012 that likely faced the same problem.[158] Further, the Subject Debtors were either guarantors on maturing loans of other GGP parties, had property that was collateral for a maturing loan, or some loans had a high loan-to-value ratio indicating financial distress.[159]

The court therefore concluded that it was unnecessary to require the Subject Debtors to wait for the principal debt payments to become due before filing for Chapter 11 protection.[160] Further, the Bankruptcy Code does not require that a debtor be insolvent prior to filing bankruptcy, and therefore a solvency analysis was not required in determining whether GGP acted in good faith.[161]

2. Failure to Negotiate/Replacing Independent Directors Not Bad Faith

The Lenders further argued that the Subject Debtors had acted in bad faith because they failed to negotiate prior to filing the petition, and because the independent directors had been fired and replaced weeks before the bankruptcy petition without notice to the Lenders.[162] The court dismissed this argument on two grounds. First, the Bankruptcy Code does not require borrowers to negotiate with their lenders before filing a bankruptcy petition.[163] Second, there was no indication that the Lenders would have been able or willing to refinance or modify the Subject Debtors' loans.[164] Further, the Subject Debtors presented evidence establishing that they could not even get the CMBS lenders to speak with them regarding loan modification or refinancing.[165]

The court ultimately accepted the Subject Debtors' decision to discharge the original independent directors and replace them prior to bankruptcy. Based on *Kingston Square*, the *GGP* Court held that the

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157. *Id*. at 57-58.
158. *Id*. at 58.
159. *Id*.
160. *Id*. at 60.
161. *Id*. at 61.
162. *Id*. at 66.
163. *Id*.
164. *Id*.
165. *Id*.

managers' replacement was insufficient to warrant dismissal based on bad faith.[166] The *GGP* Court held that the new independent directors had expertise and experience in assessing bankruptcy and restructuring issues that might arise.[167] GGP offered testimony that the company did not disclose the replacement of the independent managers because it wanted to avoid unwanted publicity about a potential bankruptcy filing.[168] Further, the operating agreements did not require them to disclose the replacements,.[169] As long as the SPE property owner appointed a replacement that satisfied the standard of independence set forth in the organizational documents, no notice or consent was required regarding the secured lenders.[170]

The court also identified other ways in which the Lenders were protected. Specifically, it pointed to such mechanisms as adequate protection, fees and interests if their claims are oversecured, and protection against substantive consolidation.[171] The Lenders' inconvenience would not justify dismissing a Chapter 11 petition.[172] Therefore, the court concluded that the Subject Debtors did not act in bad faith by filing Chapter 11 petitions without negotiating or by replacing the independent directors without disclosure.[173] This reasoning suggests that even *improper* replacement of independent managers might not be cause for dismissal on grounds of bad faith.[174]

3. Corporate Family Doctrine

The Lenders also argued that the bankruptcy remote SPE structure required that each Subject Debtor's financial distress be analyzed exclusively, and that the court should only consider the financial condition of each Subject Debtor independently rather than the entire

166. *Id.* at 69.
167. *Id.* at 68.
168. *Id*.
169. *Id*.
170. Joseph Philip Forte, *GGP: Single Purpose Entity or All in the Corporate Family?*, SR048 A.L.I.-A.B.A. 1497, 1503 (2010).
171. *GGP*, 409 B.R. at 69.
172. *Id*.
173. *Id*. at 66-68.
174. Jesse Cook-Dubin, *New York Bankruptcy Court Topples Contractual Barriers to Filing Chapter 11: Part II*, 28-JAN AM. BANKR. INST. J. 16, 90 (2010).

condition of the GGP entity.[175] The court acknowledged that the SPE structure was unquestionably intended to insulate the financial position of each Subject Debtor and to make the prospect of default less likely.[176] However, the Subject Debtors had balloon payments due to the Lenders that would require refinancing in the near future. If the Subject Debtors were not able to obtain financing and if GGP, the parent entity, did not come to the SPEs' rescue, the loans would soon be in default.[177] The court explained that the Lenders had to be aware they were lending to a company that was part of a larger corporate group, as this was admittedly part of the reason they chose to extend the loans to the Subject Debtors.[178] Further, lending to a part of a corporate group entailed both the benefits and detriments of this structure.[179] If the ability of the group to obtain financing became impaired, the financial situation of the subsidiary would inevitably be impaired.

The few cases on point supported GGP's position that the interest of the entire group or company should be considered rather than only that of the individual debtors.[180] The court applied *Heisley v. U.I.P. Engineered Product Corp. (In re U.I.P.)*, a case involving the bankruptcy of a steel company with multiple subsidiaries. In *Heisley,* the court addressed several debtors' cases together because "the nature of a corporate family create[s] an 'identity of interest' . . . that justifies the protection of the subsidiaries as well as the parent corporation."[181] *Heisley* supports the principle that the corporate family doctrine should apply when the parts are worth far less than the whole, or when the unity of interest protects not just the entities, but the underlying asset value.[182] Adopting the reasoning set forth in *Heisley, GGP* held that "financial distress" for each GGP entity did not have to be determined separately. The court found that GGP functioned as an integrated operation and that

175. *In re* Gen. Growth Props., Inc. (*GGP*), 409 B.R. 43, 61 (S.D.N.Y. 2009).

176. *Id*.

177. *Id*.

178. *Id*. at 61-62.

179. *Id.* at 61.

180. *Id*. at 61-62 (discussing Heisley v. U.I.P. Engineered Prods. Corp. (*In re* U.I.P. Engineered Prods. Corp.), 831 F.2d 54 (4th Cir. 1987); *In re* Mirant Corp., No. 03-46590, 2005 WL 2148362 (Bankr. N.D. Tex. Jan. 26, 2005). These cases stand for the proposition that it is sound business practice for a parent to seek Chapter 11 bankruptcy protection for its wholly owned subsidiaries when such subsidiaries are crucial to the reorganization plan.

181. *GGP*, 409 B.R. at 62*; In re* U.I.P. Engineered Prods., 831 F.2d at 56.

182. Forte, *supra* note 170, at 1501.

the nature of its corporate structure created an identity of interest that justified the protection of the subsidiaries, as well as the parent corporation.[183]

The court accepted GGP's argument that it had to reorganize its capital structure due to the collapsed CMBS market and its inability to refinance.[184] The Lenders did not explain how billions of dollars in unsecured debt at the parent levels could be restructured if the cash flow of the parent continued to be based on the earnings of the subsidiaries that had debt due in the coming year that they would be unable to repay or refinance.[185] The court would not adopt the Lenders' argument that the interests of the subsidiaries and their creditors should be secondary to those of the parent and its creditors.[186] The court was required to take account of the interests of both the parent company and subsidiaries.[187] Further, the GGP board considered each subsidiary individually in determining whether it should file its own Chapter 11 petition.[188] Therefore, because GGP's filing was found to be proper, the filings of the Subject Debtors were also justified and necessary to the reorganization of GGP.

4. *The Fiduciary Duties of the Independent Directors*

In examining the relative operating agreements, the court noted the duties expressly enumerated to the independent managers. The operating agreements provided that the managers (i) were only to consider the interests of the company, including the company creditors; (ii) that the unanimous written consent of the managers was required before filling a bankruptcy petition; and (iii) that the managers had a fiduciary duty of loyalty and care similar to those of the General Corporation Law of the State of Delaware.[189] Delaware corporate law provides that directors must consider the interests of shareholders as long as the debtor is solvent.[190] The court found that the provision requiring the independent director to consider the interests of the company and its creditors

183. *GGP*, 409 B.R. at 62.
184. *Id*. at 62.
185. *Id*. at 62-63.
186. *Id*. at 63.
187. *Id*.
188. *Id*. at 58-59.
189. *Id*. at 63.
190. *Id*. at 64.

conflicted with the provision stating the independent director could only act in accordance with Delaware corporate law.[191]

The court held that pursuant to Delaware law and the relative operating agreements, the duty of the independent directors was not to prevent the SPEs from filing a bankruptcy petition.[192] Instead, the independent directors had the same duties as non-independent directors of a Delaware corporation, which is a prima facie duty to act in the interests of the corporation and its shareholders, not just the secured lender.[193]

The court relied on *North American Catholic Educational Programming Foundation Inc. v. Gheewalla,* which rejected the proposition that directors of a Delaware corporation owed a duty to creditors when operating in the zone of insolvency.[194] In *Gheewalla,* the Delaware Supreme Court rejected a controversial line of Chancery Court holdings that had expanded directors' fiduciary obligations to include the company's creditors, not just when the company is insolvent but any time the company is operating in the "zone of insolvency."

Based on *Gheewalla,* the *GGP* court concluded that an independent manager of a *solvent* subsidiary must consider the interests of the parent company above the creditors in deciding whether to authorize a bankruptcy filing.[195] The court explained that the Lenders were simply mistaken if they believed the SPEs' independent managers were obligated only to protect the secured lenders' interests.[196]

IV. GGP AFTERMATH

A. DOES *GGP* MEAN MORE SUBSTANTIVE CONSOLIDATION?

As discussed earlier, SPEs are primarily intended to mitigate the risk of substantive consolidation.[197] Commentators have expressed growing concern that the *GGP* decision will make it easier for bankruptcy remote entities to file for bankruptcy and increase pressure

191. *Id*.
192. *Id*. at 68.
193. *Id*. (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007)).
194. *GGP*, 409 B.R. at 64 (citing *Gheewalla*, 930 A.2d at 101).
195. *Id*.
196. *Id*. at 64-65.
197. *See infra* Part I.B.

on lenders to agree to the use of their cash collateral.[198] The concern is that permitting a parent company to use cash collateral of its SPE's lenders will make the lenders less secure and substantive consolidation more probable.[199] However, a narrow interpretation of *GGP* will be unlikely to promote substantive consolidation. The *GGP* court explained that "the question of substantive consolidation is entirely different" and "[n]othing . . . implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity."[200] This reasoning suggests that the court applied a "corporate family" doctrine treating affiliated companies as a collective whole engaged in a common enterprise.[201] The court did not collapse the interests of the parent and the subsidiary, as would be the case in substantive consolidation, but did view the corporate problems as affecting the entity as a whole.[202]

Rather than promoting substantive consolidation, *GGP*'s application of the corporate family doctrine illustrates how SPE borrowers, as part of a larger corporate bankruptcy, should be viewed as part of the corporate family in the bankruptcy process. This is particularly instructive in the "bad faith" context. In *GGP*, the court explained how the credit crisis and current economy have affected lending practices among SPEs.[203] This economic climate created a need for the court to consider the interests of the corporate family as a whole.[204] The court explained that:

> Faced with the unprecedented collapse of the real estate markets, and serious uncertainty as to when or if they would be able to refinance the . . . debt, the Debtors' management had to reorganize the Group's capital structure. [Secured lenders] do not explain how the billions of dollars of unsecured debt at the parent levels could be restructured responsibly if the cash flow of the parent companies continued to be based on the earnings of subsidiaries that had debt coming due in a

198. Dubin, *supra* note 174, at 91.
199. *Id*.
200. *GGP*, 409 B.R. at 69.
201. Forte, *supra* note 170, at 1500.
202. *GGP*, 409 B.R. at 61-62.
203. *GGP*, 409 B.R. at 53-55.
204. *GGP*, 409 B.R. at 62-63.

> period of years without any known means of providing for repayment or refinance.[205]

Thus, the state of the market is itself a crucial factor warranting a balancing of the secured creditors' expectation of the SPE's durability, versus the parent and SPE borrowers' expectations that a refinancing market would exist.[206]

B. If Independent Directors Can Be Replaced on the Eve of Bankruptcy, Are These Provisions Still Effective?

GGP has also led many market participants to question the effectiveness of independent director provisions, based on the fact that in *GGP*, independent directors were replaced on the eve of the SPEs' bankruptcy filing.[207] However, the court pointed out that the replacement directors satisfied the Lender's explicit requirements for independence.[208] While the independent directors have a duty to the creditors when the SPE is insolvent, the vast majority of SPE debtors are solvent, meaning this duty runs in favor of equity.[209] Going forward, lenders will be likely to enhance independent director requirements by ensuring that they receive notice and the opportunity to verify compliance prior to any director's removal or replacement.[210] However, too much lender control can lead to additional unwanted lender liability, as a lender's excessive control over a borrower's business can lead to the lender being liable for the borrower's debt.[211]

According to the reasoning set forth in *GGP*, a subsidiary cannot contract around the independent directors' duties to the parent company while the subsidiary is solvent. Therefore, creditors of a solvent

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205. *Id*. at 62-63.

206. Forte, *supra* note 170, at 1505.

207. *GGP*, 409 B.R. at 67-68.

208. *Id*. at 68.

209. Daniel S. Huffenus & Deborah L. Fletcher, *The GGP Bankruptcy Cases – What They Mean for Lenders* in COMMERCIAL REAL ESTATE FIN. 2010: HOW TO HANDLE DEFAULTS, DISTRESS, MATURITIES, AND STACKS OF DEBT 2010, at 217, 223 (Real Estate Law and Practice Course Handbook Series, PLI Order No. 23198, 2010).

210. *Id*. at 223-24.

211. *Id*. Under traditional principles of lender liability, "a creditor that has not assumed the formal indicia of ownership may become liable for the debts of its borrower if the lender's conduct is such as to cause it to become the debtor's agent, partner, or alter ego." Coppola v. Bear Stearns & Co., Inc., 499 F.3d 144, 148 (2d Cir. 2007).

subsidiary cannot avoid limited fiduciary protection. In *GGP*, the Lenders had gone to great lengths to attempt to prevent the Subject Debtors from incurring debt other than to their respective lenders.[212] According to the debt-restricting provisions, except when due to diminution in the value of collateral, a GGP SPE should never be insolvent if it were to comply with the provisions that prohibit it from incurring other debt.[213] By contrast, independent directors of an *insolvent* SPE owe a fiduciary duty to the SPE's creditors, but directors of a *solvent* SPE only owe fiduciary duties to the corporation and its shareholders.[214] Therefore, the only time an independent director can consider the lender's interests is in the rare case where the SPE is insolvent.[215]

In *GGP*, fiduciary requirements proved to be an ineffective source of lender protection when the independent directors of a solvent SPE owed a fiduciary duty to the equity holders. These equity holders were the insolvent GGP parent entity who benefitted from the SPEs' inclusion in the bankruptcy process. Because lenders only receive fiduciary protection when the SPE itself is insolvent, and because application of the corporate family doctrine in bankruptcy focuses on the interests of the corporate group as a whole, the parent entity's interests will almost always be considered before those of the lender. This fiduciary limitation may cause lenders to refrain from using the independent director requirement because its application can seriously negate its advantages to lenders.

CONCLUSION

Despite recent attacks, SPEs remain a valuable method of securitization. SPEs can still effectively be bankruptcy remote as long as proper procedural precautions are followed. Based on *GGP*, a borrower's operating agreement should require independent directors to consider *only* the interests of the borrower and its creditors when considering bankruptcy filings.[216] While this kind of limitation may only be effective while the SPE is insolvent, it will preserve separateness, as

212. *GGP*, 409 B.R. at 49-50.
213. Dubin, *supra* note 174, at 91.
214. *Id*.
215. *Id*. at 91.
216. Steven G. Horowitz, *Current Issues for Commercial Real Estate Lenders*, SR048 ALI-ABA 1497 (2010).

well as increase lenders' fiduciary protection in the zone of insolvency. The operating agreement should eliminate any fiduciary duty to members and other affiliates, as permitted under applicable corporate law.[217]

Further, the SPE should have corporate governance provisions which ensure that the SPE is abiding by corporate formalities, such as (1) maintaining books and records separate from any other related corporate entities; (2) maintaining separate accounts; (3) making sure there is no commingling of assets between related corporate entities; (4) conducting business under the SPE's name as opposed to that of any other related entity; (5) maintaining separate financial statements; (6) paying liabilities out of the SPE's own funds; (7) maintaining an arm's length relationship with affiliates; (8) paying its salaries for its own employees; (9) not guaranteeing debt of any other entity; (10) not pledging assets for the benefit of any other entity; (11) not acquiring obligations or securities of any of its partners; (12) maintaining adequate capital; and (13) reasonably allocating and sharing overhead costs for shared office space.[218] Even small measures such as using independent stationary, invoices, and checks can help ensure that the entity's separateness will be upheld.[219] The transferor and lender should monitor these provisions in order to help preserve the SPE's legal structure for both parties' advantage.

The creditworthiness of the parent will also play a critical role in obtaining SPE financing. Despite its separateness, the financial state of the parent entity inherently affects the financial state of the SPE. Because of this, lenders are likely to require more underwriting due diligence.[220] Excessive leverage at the parent level or maturity concentrations among affiliated borrowers might render the parent susceptible to a failing economy where refinancing is not available.[221] The *GGP* opinion is likely to draw focus to this risk, which could impact the pricing of subsidiary debt. The more the SPE relies on and is intertwined with the parent entity and its affiliates, the more likely it is that financial distress at the parent level will trickle down.

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217. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(c) (2010); Horowitz, *supra* note 216.
218. Saft, *supra* note 3.
219. *Id.*
220. Huffenus & Fletcher, *supra* note 208, at 223.
221. *Id*. at 224 (explaining that increased focus on this risk from *GGP* may eventually impact the price of subsidiary debt).

Lenders can also take action to protect themselves in bankruptcy remote structuring. To ensure the effectiveness of the independent director requirement, lenders may require notice prior to the replacement of the borrower's independent managers.[222] This would increase scrutiny on any independent director replacements, and may prevent replacement from occurring solely to the lender's disadvantage. If possible, the independent managers should have experience in real estate finance and insolvency.

Lenders should also consider the advantage of structuring independent director provisions to ensure that the directors are truly independent of both the lender and the borrower's existing principals.[223] A director that has been designated by the lender, who acts as a mere puppet of the lender, runs the risk of breaching fiduciary duties to the corporation and to third party creditors, and a truly independent director would mitigate this risk.[224] A truly independent director could strictly abide by his or her corporate fiduciary duties and prevent against the risk of lender liability due to excessive control. While in the short run this may appear less favorable to the lender as the lender may not be able to rely on the director to favor its interests; independence will lessen the risk that the SPE will make a bad faith decision regarding a distressed loan.[225]

Even if the independent director requirements prove to be ineffective, there are other protective mechanisms available to lenders that can help protect their interest in the collateral. As long as the borrower's assets and liabilities remain strictly separate from those of the borrower's affiliates, the goals of bankruptcy remote provisions can still be served. The transfer of assets should be carefully structured as a true sale, giving the SPE limited recourse against the transferor for the asset purchase price.[226] Structuring the transfer as a true sale will ensure that the SPE has maximum protection against any financial distress of the transferor, and therefore incentivize lending.

Additionally, newly enacted legislation will improve the quality of lending practices, which will ultimately further protect lenders. Section

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222. *Id*. at 223-24.
223. Madison et al., *supra* note 16.
224. *Dealing with a Debtor Approaching Bankruptcy*, Corporate Practice Series (BNA) No. 80-2 § XIII, *available at* 2010 WL 3726453.
225. Madison et al., *supra* note 16.
226. *See infra* Part II.A.1.

941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), signed into law on July 21, 2010, requires that lenders now retain a small ownership percentage in the loans they originate.[227] In the past, lenders could sell an entire loan almost immediately after issuing it, which created a lack of accountability in issuing the loan and its quality.[228] By requiring partial-ownership, the Dodd-Frank Act gives lenders a business incentive to check the quality of the asset and make sure it is capable of supporting the loan.[229]

The immediate effect of this legislation may be to slow recovery of the CMBS market because of uncertainty as to the requirements, increased compliance costs, and because money will not be freed up as quickly.[230] However, in the long run, this added incentive will improve investor confidence and ultimately provide a more efficient lending market.[231]

Despite *GGP,* precautionary structuring and new restrictive legislation, such as the Dodd-Frank Act, will encourage commercial lending through bankruptcy remote SPEs. *GGP* illustrates the effect of a credit crisis on lending practices and bankruptcy law. The risk of a SPE being negatively affected by the financial trouble of related corporate entities cannot be completely avoided.[232]

The surprising result in *GGP* was necessary given the undeniable financial distress of the parent entity and the court appropriately focused on recovery of the corporate group as a whole. It would be unrealistic to argue that a corporate parent's financial distress would not affect its subsidiary, no matter how separate or remote. Further, recovery of the corporate group may require a restructuring of all its parts.

Additionally, legislative reform will promote accountability in lending practices and deter the type of irresponsible lending that largely contributed to the credit crisis. Therefore, modern concerns need not diminish the effectiveness of bankruptcy remote provisions. Instead, *GGP* emphasizes practical reorganizational challenges that large corporate entities may face when trying to restructure in a damaged economy, and how SPE securitization is not immune from these

227. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

228. Ass'n of Corporate Counsel, *Facing Today's Real Estate Issues with Elizabeth A. Whitman*, ACC Docket, 28 No. 9 ACCDKT 94, 96 (2010).

229. *Id*.

230. *Id*. at 96.

231. *Id*. at 97.

232. *See infra* Part III.B.3.

challenges. *GGP* serves as a valuable tool for understanding how to carefully construct restrictive corporate governance provisions in order to provide greater lender protection when faced with an uncertain economy.