

Another Take On SPEs: The Sky Isn't Falling

Law360, New York (March 24, 2010) -- Law360 recently published "The Future of SPEs In Light of General Growth." The authors of that article were correct to note the significance of the U.S. Bankruptcy Court for the Southern District of New York's decision (the "General Growth Decision") in General Growth Properties Inc., bankruptcy case no. 09-11977, (the "General Growth Case").

This article offers an alternative perspective on the relationship between special purpose entities ("SPEs") and the U.S. Bankruptcy Code, and the overall impact of the General Growth Decision.

SPEs are not created to make bankruptcy impossible. Instead, SPEs are only intended to make bankruptcy more remote. Therefore, the General Growth Decision, which confirmed the General Growth SPEs' plans of reorganization, was not, or at least should not have been, the "bombshell" that many commentators have described it as.

Perhaps the mischaracterization of the decision in the General Growth Decision is the result of a common misconception regarding the structure of SPEs. In particular, many wrongly believe that the governing documents for SPEs require the appointment of an independent director that will vote against a proposal to file bankruptcy.

However, the governing documents for SPEs do not require their independent directors to vote against a proposal to file bankruptcy. Instead, these independent directors have the right to vote for or against any proposal to file for bankruptcy.

The idea behind requiring independent directors is to have them vote based upon their fiduciary duties and not merely yield to an SPEs' management. In the context of a bankruptcy, this means that the independent directors are less likely to vote for a bankruptcy than directors controlled by an SPEs' management.

Independent directors might not vote for a proposal to file bankruptcy for a number of reasons, one of the most significant being the restrictions placed on single-asset bankruptcy cases by the bankruptcy code. Nevertheless, the independent directors make an SPE's chance of filing for bankruptcy more remote but certainly not impossible.

Just as important as the concept that SPEs are designed to increase the "remoteness of bankruptcy" is one of the main reasons why lenders to SPEs may want to avoid bankruptcy — to protect cash flow.

As many lenders who have lent money to a party that later files for bankruptcy know, the protections of the Bankruptcy Code can often disrupt the cash flow from debtors to their lenders. However, the filing of a bankruptcy petition does not need to create this disruption if the lenders have carefully planned their loan structure to protect the cash flow.

For example, the General Growth Case was in many ways a success for lenders because the prepetition cash management regimes stayed in effect during the course of the bankruptcy, specifically, the cash continued to flow to the lenders to cover their debt service.

Some lenders were upset that “their” cash was funding the reorganization or servicing of other assets, but in the end those lenders aren’t entitled to be oversecured. In fact, it could have been worse if the debtors in the General Growth Case had sought and been permitted to direct use of all the cash.

The cash management structure approved in the General Growth Case can and should influence how lenders and SPEs deal with cash flow issues in future bankruptcy cases.

In certain circumstances it may even be advantageous for lenders if an SPE debtor files for bankruptcy. It is conventional wisdom that there are currently a great deal of commercial mortgage-backed security (“CMBS”) loans that need to be renegotiated. However, unless or until loan servicers are willing and able to renegotiate loans, bankruptcy may be the only practical way to work out these loans.

Loan servicers are rarely willing and able to renegotiate because the tax code, the loan documents and the trust indentures with the bondholders limit when and under what terms the servicers can renegotiate.

For their part, it would be wrong to suggest that lenders are eager to renegotiate loans to SPEs on less favorable terms. Nevertheless, given their options in the current market, lenders may be less reluctant to renegotiate a loan by way of a bankruptcy since this option may be preferable to initiating a foreclosure proceeding.

It is important to rebut the misconception that a primary effect of the General Growth Decision will be a tightening of the credit market. As most of the readers of this publication are all too aware, the CMBS market was essentially dead long before the General Growth Decision. In fact, the inability to refinance its property level debt through this market appears to have been one of the main reasons for General Growth’s bankruptcy filing.

Therefore, although the filing of many of General Growth’s SPEs in the General Growth Decision may have been a surprise to lenders, it is impossible to say how or if the General Growth Decision will further tighten a market.

Instead, the short-term effect of the General Growth Decision may be an increase in bankruptcy filings by SPEs which could actually accrue to the benefit of lenders seeking to renegotiate the terms of their loans (see above). More long term, the General Growth Decision is likely to result in lenders taking a more deliberate and thoughtful approach to the structure of the cash flow regimes.

Finally, while the cash flow regimes held up in the General Growth Case, the case clearly points to a need to restructure CMBS deals generally. While bankruptcy may make sense as a viable option under the current CMBS structure, it is far from optimal considering the risk of springing liability, the costs and the uncertainty involved in any bankruptcy case.

What is more, the General Growth Case is a reminder to many that there are limits to the ability of contract parties, despite good faith and fair-dealing, to preempt statutory rights and structures, particularly bankruptcy. With that said, there is a long-term need for policymakers, underwriters, mortgage brokers and lawyers need to work together to determine a new CMBS structure that will be flexible enough to work in a downturn without having to resort to bankruptcy.

--By William A. Rudnick (pictured) and James R. Irving, DLA Piper LLP

William Rudnick is managing partner of DLA Piper's Chicago office, and a member of the firm's real estate and corporate groups. James Irving is an associate in the firm's Chicago office, and a member of the firm's bankruptcy and restructuring subgroup.

General Growth Properties Inc. is a client of DLA Piper LLP.

The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.