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Single-Purpose Entities and Independent Directors: Does the General Growth Ruling Change Structured Finance?

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A recent Delaware bankruptcy court decision[1] on the ability of "bankruptcy remote" single-purpose entities emphasizes the complicated nature of the bankruptcy process and the issues that need to be considered when using "bankruptcy remote" entities in funding structures. Given the prevalence of such entities, this is an important decision for all participants in the structured finance industry.

Executive Summary

General Growth Properties, Inc. ("**General Growth**"), the owner of shopping center properties across the United States, filed a voluntary bankruptcy petition, as did its subsidiaries, many of which were structured as bankruptcy remote single-purpose entities ("**SPEs**"). Certain creditors of the SPEs filed motions to dismiss arguing, among other things, that the SPE bankruptcies were filed in bad faith. The General Growth court denied such motions, allowing the SPE voluntary bankruptcies to stand. The General Growth ruling with respect to the bad faith filing motions has attracted a lot of attention in the structured finance industry but, as the ruling relates to the special-purpose structure, it confirms what was already known – bankruptcy remote is not bankruptcy proof. Despite attempts to isolate the assets of an SPE from a bankruptcy filing of the parent (sponsor) of the SPE (the "**Paren**t"), a bankruptcy filing of the Parent may result in the bankruptcy of the SPE. However, if structured appropriately, a parent bankruptcy filing should not impair the fundamental protections of the SPE structure, which include avoiding substantive consolidation.

Typical Use of SPE and Independent Director in Equipment Finance

In a typical[2] structured finance transaction of equipment that involves a bankruptcy remote entity, the Parent creates a subsidiary whose purpose is limited to acquiring equipment (and related leases) to be financed and undertaking ancillary obligations. The SPE acquires the equipment and enters into a financing arrangement that is nonrecourse to the Parent, pledging the equipment and the leases as collateral. Some of the customary features of a bankruptcy remote entity are (i) organizational documents that limit the entity's business to a single, specific and narrow purpose (generally speaking, acquiring, leasing, financing, refinancing and eventually liquidating the equipment), (ii) organizational documents and financing documents that contain "separateness" covenants that require the subsidiary to be managed and operated in a manner that is distinct from the assets and business of the Parent (among other entities), and (iii) the appointment of one or more independent managers or independent directors of the SPE ("**Independent Directors**") who meet certain requirements that provide some comfort to financing parties that the Independent Director is not overly sympathetic to the interests of the Parent. The Independent Director's favorable vote or consent is typically necessary for the SPE to approve a voluntary bankruptcy filing, to consent to an involuntary bankruptcy or to conduct other specified organic changes that may be detrimental to the SPE's lenders. Due to the proliferation of single-purpose financings in recent years, companies now provide "professional" Independent Directors ("**Professional Independent Directors**") for a fee.

In connection with your typical financing transaction, counsel to the Parent and SPE provides a reasoned legal opinion related to the "true sale" of the assets to the SPE, the "non-consolidation" of the SPE into the bankruptcy estate of the Parent and "non-rejection" by the Parent of the leases assigned to the SPE by the Parent in a Parent bankruptcy.

In re General Growth Properties, Inc. – Motion to Dismiss and Ruling

On April 16, 2009, General Growth together with its SPE subsidiaries filed voluntary petitions under chapter 11 of the U.S. Bankruptcy Code. General Growth owns shopping center properties, many of which (if not most) are financed through the use of bankruptcy remote SPEs. Despite their bankruptcy remoteness, the General Growth SPEs were among the subsidiaries that filed voluntary bankruptcy petitions.[3]

Motions to dismiss the bankruptcy filings of certain SPEs as "bad faith" filings were presented by certain creditors of the SPEs. The motions argued, among other things, that the filings were ultra vires and unauthorized because General Growth caused the termination of many of the Independent Directors, who were Professional Independent Directors, prior to the bankruptcy filings.[4] The Independent Directors were replaced with Independent Directors who were experienced in corporate restructuring, who reviewed General Growth's restructuring outlook and who voted in favor of the SPE bankruptcies.

The organizational documents of the General Growth SPEs attempted to alter the fiduciary duty of the Independent Directors and require that the Independent Directors, to the extent permitted by law, consider the interests of the SPEs, including their respective creditors, when voting on matters related to bankruptcy filings. The bankruptcy court concluded that the Independent Directors are required to take the interests of the shareholders into account when exercising their fiduciary duties. The court also stated that:

> ... if Movants believed that an "independent" manager can serve on a board solely for the

purpose of voting "no" to a bankruptcy filing because of the desires of a secured creditor, they were mistaken. As the Delaware cases stress, directors and managers owe their duties to the corporation and, ordinarily, to the shareholders.[5]

There are two important parts of the court's decision. First, in allowing the SPEs to file for bankruptcy, the court noted that all cash generated by the SPEs was automatically swept out of lockbox accounts on a daily basis and then used to fund General Growth's day-to-day operations. If the SPEs were not allowed to file for bankruptcy protection, the SPEs' creditors would be able to cut off this cash flow. Cutting off the cash flow in turn would cut off General Growth's funding (and consequently its ability to operate) and essentially prevent an effective restructuring. The financiers were aware that their financing structure and cash flow model funded the SPEs and General Growth as an integrated enterprise and the court was unwilling to allow the financiers to disregard the essential nature of the General Growth business model in the bankruptcy.

Second, even given the essential nature of allowing the SPEs' cash flow to fund General Growth's ongoing operations in order to allow an effective restructuring, the court only allowed General Growth's continued use of such cash flow after the financiers were given "adequate protection" for their collateral position. It appears that there were extensive negotiations with the financiers with respect to the collateral provided to satisfy the adequate protection requirement and the financiers were able to negotiate reasonable terms.

While the ruling on the fiduciary duty of the Independent Director may cause some concern in the structured finance industry (the court having acknowledged that the creditors of the SPEs have been "inconvenienced"[6] by the SPE filings), the court also concluded that:

[t]he salient point for purposes of these Motions is that the fundamental protections that the Movants 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 entities.[7]

Conclusions

The denial of the motions to dismiss the SPE bankruptcies in the General Growth case was an important development for lenders in SPE structures, but the ruling as it relates to Independent Directors and their fiduciary duties should not be considered a change from existing law. It reminds us that bankruptcy remote is not bankruptcy proof. While structured finance transactions properly utilizing SPEs can reduce the risk of substantive consolidation in the event of a Parent bankruptcy, this risk cannot be entirely eliminated. If the SPEs are not substantively consolidated into a Parent's bankruptcy estate, as is the case in with General Growth (at least so far), a first-priority fully secured creditor of a properly structured SPE that files under Chapter 11 should not suffer significant adverse consequences, other than those attendant to delays in realizing on collateral.

Finally, it is worth noting that “best practice” in Delaware already has developed to address the issues raised by General Growth. In the most recent LLC Operating Agreements, the parties have minimized the provision regarding the managers’ fiduciary duties to any persons other than as explicitly agreed amongst the transaction parties. Although not yet tested in court, such changes will strengthen the creditors’ ability to keep SPEs out of their Parents’ bankruptcies.

If you have any questions regarding this ruling, please contact John T. Bycraft (312-609-7580).

[1] Memorandum of Opinion, In re General Growth Properties, Inc., No. 09-11977 (Bankr. S.D.N.Y. August 11, 2009).

[2] Describing “typical,” “standard” or “customary” terms and provisions in structured finance is a dangerous endeavor because custom and practice vary depending on the type of structure and the asset class, among other things. This summary describes what we have seen in parent-sponsored SPE transactions (as was the case with General Growth) of “big ticket” equipment finance (railcar and aircraft primarily), as opposed to other asset classes and “orphan” trust structures, among other structures.

[3] Importantly, the SPEs did not file as part of a “consolidation.”

[4] Creditors also argued that certain SPEs’ bankruptcy filings were premature because the SPEs were not (yet?) in financial distress and filed bankruptcy to benefit General Growth and not the applicable SPE. All motions to dismiss failed.

[5] Memorandum of Opinion, In re General Growth Properties, Inc., No. 09-11977 (Bankr. S.D.N.Y. August 11, 2009), at 33.

[6] Id. at 42.

[7] Id.

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