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BANKRUPTCY REMOTE

The Chapter 11 bankruptcy filing by General Growth Properties demonstrates some of the weaknesses of the bankruptcy remote structure commonly used in CMBS lending. Here the authors from Goodwin Procter LLP *review the application of bankruptcy and Delaware law to the bankruptcy remote structure and summarize how the GGP bankruptcy filing has affected CMBS lenders and investors. They also suggest possible changes to the structure.*

CMBS Bankruptcy Remote Structuring and the Recession: Revisiting the Benefits

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Introduction

The eyes of the real estate industry are firmly focused on the United States Bankruptcy Court for the Southern District of New York as it addresses the bankruptcy of General Growth Properties, Inc. (GGP) and 166 of its subsidiaries. GGP is the second largest owner of shopping malls in the United States. Its recent struggle with high leverage, falling property values, and frozen credit markets is emblematic of the commercial real estate industry in the current financial crisis. The current crisis has led to the GGP bankruptcy highlighting the integrity of the sophisticated (although largely untested) bankruptcy remote structure used by numerous sponsors, lenders, and holders of commercial mortgage-backed securities (CMBS). Indeed, the

entire CMBS industry will keep a watchful eye on the GGP proceedings[1] as interested parties debate the original benefits of the bankruptcy remote structure.

The CMBS market was one of the primary drivers of the availability of credit in commercial real estate lending over the past decade. The bankruptcy remote structure was a critical feature of this market.[2] CMBS loans are generally secured only by the subject real property and eliminate the need for significant credit enhancement guarantees from parent companies, which were a commonplace feature of real estate lending prior to the CMBS boom.[3] The CMBS lending market offered borrowers lower interest rates than those available from more traditional lending sources by removing the risk of a loan default from the single lender's balance sheet and spreading it across numerous investors in a securitization pool. From the lender's perspective, the CMBS market replenished liquidity by replacing loan assets with proceeds from the securitization of loan pools. Lenders could then make new loans and generate additional fees from new borrowers. It is not surprising, therefore, that the CMBS structure was one of many catalysts for a rise in property values as willing lenders and investors continued to pour capital into the CMBS market.

At the beginning of the recent financial crisis, defaults in the residential sub-prime market dominated the media's attention. Today, with the global economy well into a ''great recession,'' the focus has shifted to the potential for significant defaults in commercial real estate loans. In this regard, analysts estimate that between 2009 and 2018 approximately $685 billion of commercial loans securitized in CMBS structures will be maturing, a large percentage of which will not qualify for refinancing in similar amounts based on the drop in property values and the high loan-to-value ratios of the original loans.[4] Certainly, the failure of the bankruptcy remote structure to function as intended would further damage the commercial real estate finance industry just when the U.S. Government has extended the Term Asset-Backed Securities Loan Facility (TALF) to newly-issued and legacy CMBS subscriptions by offering either five-year or three-year loans designed to assist in restarting the moribund market.

For years, commercial lenders and CMBS issuers, with the blessing of ratings agencies, accepted the premise (as they do today) that the bankruptcy remote structure provides significant protection against any (a) voluntary bankruptcy filing by the mortgage borrower, (b) involuntary bankruptcy of the mortgage borrower, and (c) substantive consolidation of the mortgage borrower with its parent or affiliates. Depending upon the outcome of the GGP case and any future cases that implicate the integrity of the bankruptcy remote structure, there is a risk that one of the value propositions underlying the CMBS structure to investors will be adversely affected by an actual or perceived failure of its intended purpose. If the perceived benefits of the CMBS single purpose bankruptcy remote structure prove illusory, attempts by the U.S. Government to provide liquidity to the CMBS credit markets may be compromised and investors may be unwilling to participate in refinancing commercial loans even if economic terms are more favorable for lenders and investors than in the recent past.

In this article, we examine the legal foundations of the bankruptcy remote structure and the potential challenges to the structure's integrity, including those making their way before the bankruptcy court in the GGP case. Given the reliance of the CMBS market on the bankruptcy remote structure, it is important to understand its potential weaknesses, especially now that the commercial real estate industry has encountered financial distress. In this article, we also make suggestions, in light of the GGP proceedings, for improvements to the structure that could provide the CMBS market greater comfort with respect to the structure's effectiveness from the lenders' perspective.

Overview of the CMBS Single Purpose Bankruptcy Remote Structure

A typical CMBS financing begins with the transfer of a real estate asset, such as an office building, from the fee simple owner to a newly-created[5] special purpose entity[6] (the SPE) controlled by or affiliated with the property owner.

The SPE borrower obtains a commercial mortgage loan from a lender, usually a financial institution with the subject property serving as collateral, and uses the proceeds from the loan either to finance the acquisition of the property or, in the case of a refinancing, repay the prior indebtedness. Any excess proceeds from the loan are used to establish reserves, fund ongoing expenses of the SPE, or are distributed to the SPE's owner.

The lender/CMBS sponsor then transfers the mortgage loan into a securitization vehicle (usually an entity qualifying as a Real Estate Mortgage Investment Conduit (REMIC) under Sections 860A—G of the U.S. Internal Revenue Code of 1986, as amended[7]) that pools the loan with other mortgage indebtedness and ''securitizes'' the loans by issuing securities that are backed by the revenue stream from the mortgage loan payments. One or more classes of fixed-rate securities of the entity are then sold to third-party investors, thereby generating liquidity for the original lender. The original lender

[1] General Growth Properties, Inc., et al., Chapter 11 Case No. 09-11977 (ALG), United States Bankruptcy Court, Southern District of New York.

[2] As discussed below, the bankruptcy remote structure was designed to minimize the risks that a borrower would become a debtor in bankruptcy and that its assets and liabilities would be consolidated with those of its parent or affiliates in bankruptcy. It was not designed to completely eliminate the risk of a borrower entering bankruptcy.

[3] The CMBS market grew rapidly between 2000 and 2007, with new issuances of CMBS jumping from $19.4 billion in 2000 to a high of $190 billion in 2007 and an aggregate of $672 billion of CMBS issued from 2000 to 2008. However, by 2008 the CMBS issuance market dropped to $10.7 billion, the lowest amount in a decade. See Deutsche Bank Report, ''Potential Refinancing Crisis in Commercial Real Estate,'' dated April 22, 2009 (Figure 18, page 17).

[4] See *id.* at 3-5.

[5] In certain circumstances, in part to avoid significant transfer taxes, borrowers are allowed to reuse existing or ''recycled'' entities in CMBS financings.

[6] Special purpose entity is sometimes referred to as a single purpose entity.

[7] The REMIC provisions of the Internal Revenue Code were first introduced into the Internal Revenue Code in the Tax Reform Act of 1986.

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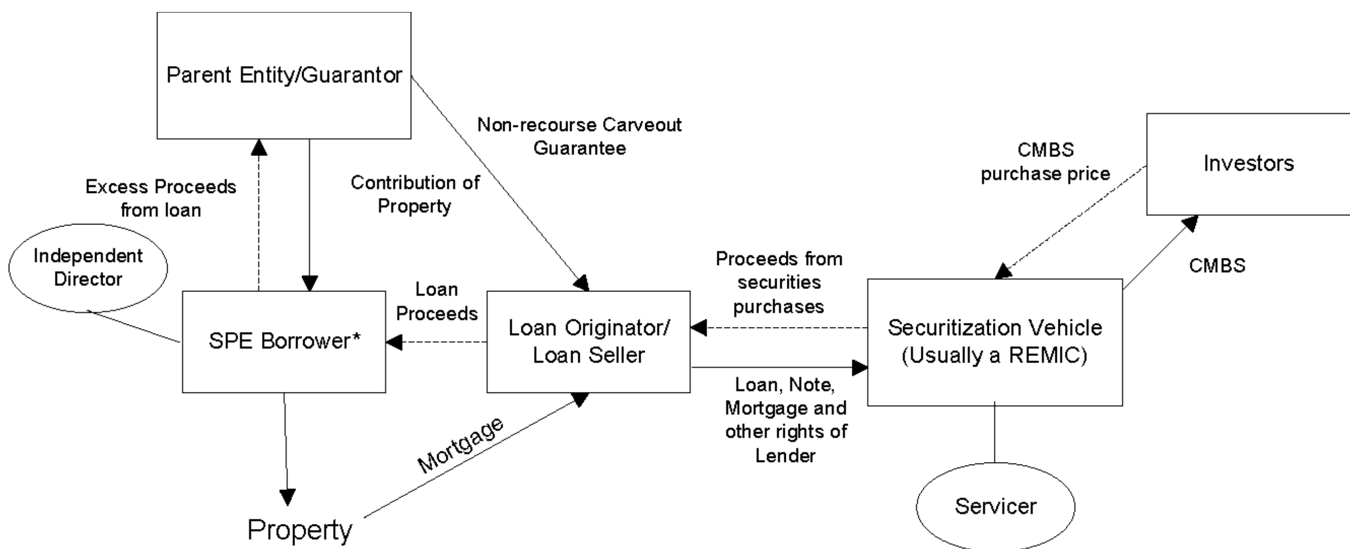

* The organizational documents of an SPE borrower, typically a Delaware limited liability company, contain a standard set of "separateness covenants" that require the SPE borrower to conduct its business in such a way as to minimize the risk it could be consolidated with its parent or an affiliate. During the term of the loan, the SPE borrower's cash flow is distributed in accordance with a cash management system set forth in the loan documents. In the event of a default, all cash flow is usually trapped in a lock-box controlled by the lender.

will also receive fees for originating and securitizing the loans. One or more servicers are engaged, for a fee, to monitor the loans of the securitization vehicle, collect payments, and make distributions to the CMBS investors.

The inherent benefits of the CMBS structure made it popular with both borrowers and lenders. With the risk of default on a loan spread among a large group of assets and investors in a securitization vehicle, lenders were able to offer interest rates to borrowers that were more favorable than those available from other traditional lending sources. Furthermore, because these were loans secured by only the subject real property, they were non-recourse to the owners of the borrower and did not require significant credit enhancement guarantees, although, as discussed below, creditworthy owners of the borrower typically entered into non-recourse carve-out guarantees. On the other hand, lenders enjoyed the benefits of increased liquidity that allowed receipt of additional fees from both the new loans and the securitization, removal of the mortgage loans from the balance sheet of the lender, and the transfer of default risk to the investors in the securitization vehicle.

As a condition to making any commercial real estate loan that will be securitized, the lender requires that the entity holding the collateral asset be a bankruptcy remote special purpose entity. The terms ''special purpose entity'' and ''bankruptcy remote'' refer to two distinct, but overlapping, concepts that work in tandem to minimize the risk of a borrower, either voluntarily or involuntarily, being subject to a bankruptcy proceeding. A special purpose entity, in the real estate context, is an independent legal entity formed solely to own and manage the single real estate asset that serves as collateral for a commercial real estate loan.[8] Typically, the SPE's organizational documents restrict the purpose of the SPE to owning the real estate asset and contain additional provisions intended to ensure that the SPE conducts no business other than owning, operating and mortgaging the subject property. A bankruptcy remote structure refers to (a) the governance and other restrictions and requirements in the organizational documents of an SPE that are designed to reduce the possibility that the entity will either file a bankruptcy petition or be the subject of an involuntary bankruptcy proceeding and (b) the ''separateness covenants'' designed to ensure that the borrower will not be consolidated with its parent or an affiliate, if a bankruptcy of the parent or an affiliate occurs.

Purpose of Bankruptcy Remote Structure

The bankruptcy remote structure is employed by commercial real estate lenders in an attempt to protect their loan collateral from becoming subject to the risks of bankruptcy. There are three main ways in which the structure theoretically mitigates these risks. First, the risk of a voluntary bankruptcy is limited by the requirement that an independent director(s) or independent manager(s) vote to approve the commencement of any bankruptcy proceeding.[9] Independent directors are individuals that are not otherwise associated with the borrower or its affiliates and who will presumably weigh the merits of any bankruptcy filing objectively without motivation to use a bankruptcy proceeding offensively to benefit the equity holders of the SPE (for example, to

[8] Adam B. Weissburg & John Matthew Trott, *Special Purpose Bankruptcy Remote Entities*, Los Angeles Lawyer, Jan. 2004 at 12.

[9] CMBS lenders usually obtain opinions of counsel that the required vote of the independent director for a bankruptcy filing is enforceable under applicable state law. Most SPE borrowers are organized as Delaware limited liability companies.

restructure the mortgage loan in a manner adverse to the lender).[10] Second, bankruptcy remote structures minimize exposure to an involuntary bankruptcy petition by creditors of the SPE by specifically limiting the debt, both secured and unsecured, that an entity can incur. This limits both the amount of the liabilities of the SPE borrower and the number of parties with standing to force an involuntary bankruptcy. A requirement that a creditworthy guarantor provide a full springing recourse guarantee of the debt in the event there is a voluntary or collusive involuntary bankruptcy filing typically serves as an added deterrent to those types of filings.[11] Third, bankruptcy remote structures are intended to require the SPE to conduct its operations in a manner intended to ensure that the assets and liabilities of the SPE would not be consolidated with the assets and liabilities of a parent or affiliate that is involved in a bankruptcy.[12] The organizational documents of the SPE typically contain ''separateness covenants'' to govern such conduct.[13]

CMBS sponsors and lenders, supported by many of the credit rating agencies, relied heavily on the assumption that the remote bankruptcy provisions, specifically the independent director provisions, in the SPE's governing documents would provide protection against an SPE borrower filing for voluntary bankruptcy.[14] As noted, the value proposition of the CMBS structure was partially based on the presumption that it was highly unlikely that an SPE would be subject to a bankruptcy proceeding and that the mortgage collateral would be available to the lender in case of a default without the risk that the lender's rights would be compromised or that the economics associated with the loan would be affected in a bankruptcy, including by delaying the payment of interest or principal. By isolating the underlying value of the subject property from bankruptcy and from the credit risks of the borrower and its parent company, CMBS sponsors underwrote only the value of the property, which at least theoretically increased the value of the CMBS securities from that of a simple debt instrument and lowered the interest rate to the borrower.[15]

As noted, the value proposition of the CMBS structure was partially based on the presumption that it was highly unlikely that an SPE would be subject to a bankruptcy proceeding and that the mortgage collateral would be available to the lender in case of a default without the risk that the lender's rights would be compromised or that the economics associated with the loan would be affected in a bankruptcy, including by delaying the payment of interest or principal.

What might happen if an SPE finds itself in bankruptcy, notwithstanding its bankruptcy remote structure, is determined by the Bankruptcy Code[16] and is unfolding in the context of the GGP proceedings. The Bankruptcy Code is divided into several chapters, with Chapter 7 governing liquidation cases, Chapter 11 governing most reorganization cases, and Chapters 1, 3, and 5 containing general provisions that apply to the other chapters.[17]

Upon the filing of a bankruptcy petition under Chapter 11 (voluntary or involuntary), a stay automatically takes effect that enjoins creditors from any acts against the debtor or its property.[18] The debtor becomes a ''debtor in possession'' with many of the powers of a trustee, including the power to use, sell, or lease property in the ordinary course of its business. The automatic stay prevents a lender from foreclosing and from applying any of the debtor's cash over which it has control. Conversely, the debtor's right to use property does not include ''cash collateral'' such as rental income or a bank account subject to the lender's control unless (a) the lender consents or (b) the debtor convinces the bankruptcy court that the lender's interest in the cash collateral is ''adequately protected.''[19] Although ''adequate protection'' can be a complicated concept, it essentially means with respect to cash collateral that the collateral is not being dissipated to the ultimate detri-

[10] Independent directors are typically engaged through third-party service companies that specialize in providing independent directors (and often, other ministerial services) to SPE borrowers.

[11] A springing recourse guaranty is a contingent guaranty that becomes effective on the occurrence of the contingency, including the voluntary or collusive involuntary bankruptcy of a borrower. The deterrent effect of a springing recourse guarantee may be limited where the guarantor also is subject to a bankruptcy proceeding or is otherwise insolvent. In bankruptcy, the guarantee obligation will become a general unsecured claim against a bankrupt guarantor.

[12] A bankruptcy court's determination to substantively consolidate the assets and liabilities of a borrower with those of its parent or affiliates is driven by factual questions based on issues that implicate the borrower's compliance with certain ''separateness covenants.'' CMBS lenders also usually obtain an opinion of counsel that, subject to compliance by the borrower with the ''separateness covenants,'' the assets of the borrower will not be consolidated with the assets of its parent or affiliates in the event of a bankruptcy of such parent or affiliate.

[13] For a list of the typical ''separateness covenants'' required in a CMBS transaction, *see* Standard & Poor's, *Legal Criteria for U.S. Structure Finance Transactions*, May 1, 2003 at 95.

[14] Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 Cardozo L. Rev. 1553, 1672-73 (2008).

[15] *Id.*

[16] 11 U.S.C. §§ 101, et seq. (the ''Bankruptcy Code'').

[17] Except for certain regulated entities such as banks and insurance companies, most business entities are eligible to be debtors under the Bankruptcy Code. Any eligible debtor can commence a voluntary case under Chapter 7 or 11 while three creditors holding liquidated, non-contingent, undisputed, unsecured claims aggregating $13,475 can file an involuntary petition against a debtor. This discussion will focus on Chapter 11 cases because that is the more likely destination for an SPE bankruptcy.

[18] 11 U.S.C. § 362(a).

[19] 11 U.S.C. § 363.

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ment of the lender.[20] Typically, this condition is satisfied if the property continues to generate cash flow and the lender is given a lien on post-petition income to replace the cash collateral that is expended. [21] In an ordinary Chapter 11 case, the lender can be denied access to cash for an indefinite period of time; however, in an SPE bankruptcy, the ''single asset real estate rules'' (''SARE,'' which are discussed further below) will generally require that some debt service payments begin within 90 days. If the SPE borrower can be kept out of bankruptcy, then the lender can immediately access, retain and apply cash flow to necessary expenses and to debt service, no doubt a more appealing scenario than the automatic stay/cash collateral alternative.[22]

The rules concerning the stay against foreclosure are somewhat different but also invoke the concept of ''adequate protection.'' A secured lender can obtain relief from the automatic stay to proceed with a foreclosure if either (a) the debtor has no equity in the property and reorganization does not seem probable in a reasonable time or (b) the secured creditor's interest in the property is not ''adequately protected.'' [23]

In this context, ''adequate protection'' means that the debt exceeds the value of the collateral and the deficiency is not increasing.[24] Note that a request by the lender for relief from the automatic stay will likely require the court to hear evidence on valuation, making the process even more onerous. In addition, and beyond the scope of this article, the debtor and the secured lender will be conflicted about whether a higher or lower value serves their interests. This is because the value that drives a strategy for relief from stay may be contrary to the value that drives a strategy for a reorganization plan.[25]

Assuming that the debtor can obtain authority to use its cash collateral and avert foreclosure, it must then propose a plan of reorganization. If the debtor can satisfy certain threshold criteria, the most important of which is that the plan be approved by at least one class of creditors that is impaired by the plan, then the debtor may impose a plan on any secured creditor who rejects the plan. Colloquially, this is known as a ''cram down'' and allows the debtor to modify the terms of the debt so long as the lender (a) retains its lien and (b) receives deferred cash payments that total at least the value of the collateral (as determined by the court) and that preserve the court-determined value by bearing interest at a court-determined rate.

[20] 11 U.S.C. § 361.

[21] See the discussion below for the application of this condition in the GGP proceedings.

[22] The ability of a CMBS securitization vehicle to issue AAA-rated securities requires some certainty as to the timing of payments. Any potential delay or disruption in the anticipated timing can greatly hinder the ability of the securitization vehicle to acquire this rating and thus maximize revenue from the sale of its securities.

[23] 11 U.S.C. § 362(d)(1) and (2).

[24] *United Savings Ass'n v. Timbers of Inwood Forest,* 484 U.S. 365, 370 (1988).

[25] The secured lender would likely prefer a lower value in the stay context since it enhances its prospects for relief from the stay. Conversely, in the context of a reorganization plan, the secured lender would prefer a higher value to avoid the detrimental economic effects of the so-called ''cram-down'' rules of § 1129(b) of the Bankruptcy Code.

The final potential affront for the *bona fide* lender is the possible substantive consolidation of the borrower with a parent or affiliate. Substantive consolidation is an equitable doctrine pursuant to which bankruptcy courts merge the assets and liabilities of the borrower with those of a parent (or affiliated entity) and the combined creditors of the borrower and the parent (or affiliated entity) are required to look to the combined estate, including the mortgage loan collateral, for repayment. Substantive consolidation is rare and generally results when the assets and affairs of the related debtors have been commingled to such an extent that the bankruptcy court cannot separate them.[26] Even in a substantive consolidation situation, a lender would likely retain its mortgage on specific real estate, but its exposure to cram down would be heightened by the addition of creditors beyond those of the SPE who could vote in favor of a reorganization plan.

Effects of Single Asset Real Estate Bankruptcy Rules

The SARE rules[27] are likely to govern the treatment of SPE borrowers in bankruptcy (assuming no substantive consolidation) and level the playing field somewhat for the lender. These rules were promulgated to correct perceived bankruptcy abuses by debtors following the real estate boom and bust of the late 1980s and early 1990s. During the resulting real estate collapse many borrowers who owned single asset real estate, either individually or through limited partnerships, could not pay their mortgages and lenders began foreclosure proceedings. Borrowers responded to the foreclosures by filing Chapter 11 petitions to invoke the automatic stay to prevent the loss of their investment and the coincident negative tax consequences triggered by a foreclosure sale.[28] In some cases, borrowers were able to use the bankruptcy to renegotiate their mortgages to reflect the lesser current market value of the property. These Chapter 11 filings by single asset entities were perceived as an abuse of the bankruptcy system because the policy justification for holding secured lenders at bay while a business reorganizes did not apply to single asset real estate entities that had no prospects of reorganization in the traditional sense of solving their operating problems and realigning their capital structure. Instead, single asset entities generally had few employees, vendors, and counterparties that depended on the business continuing as a going concern and generally involved only two parties, the debtor and the secured creditor. Single asset reorganization was wholly dependent on an increase in entity value caused by a recovery in the real estate market and generally was not used to improve operations or modify a complex capital structure.[29]

As a result, in the 1994 Bankruptcy Reform Act, Section 362(d)(3) of the Bankruptcy Code was added (and then further modified in the 2005 Bankruptcy Abuse

[26] Seth D. Amera and Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 15 Am. Bankr. Inst. L. Rev. 1 (2006).

[27] 11 U.S.C. § 362(d)(3).

[28] *National Bankruptcy Commission: Proposals for Single Asset Real Estate*, 5 Am. Bankr. Inst. L. Rev. 531, 534-38 (1997).

[29] *Id.* at 536.

Prevention and Consumer Protection Act) to require debtors in single asset real estate cases to file a plan of reorganization or begin paying debt service within 90 days of commencing the case or lose the protection of the automatic stay.[30] The bankruptcy remote single purpose entity employed in the CMBS structure, which limits the purpose of the borrower to owning and managing a single real estate asset, will typically cause the SPE borrower to fall within the single asset bankruptcy rules.[31]

The debtor can retain the protection of the automatic stay beyond the 90 days by either (a) filing a plan of reorganization that has ''a reasonable possibility of being confirmed within a reasonable period of time'' or (b) making monthly payments to all secured creditors at the non-default rate of interest on the lower of the face amount of the debt or the *value* of the collateral.[32]

Prohibition on 'Bankruptcy Proofing'

As the term implies, the bankruptcy remote structure does not prevent an entity from entering bankruptcy. In other words, it does not make the entity bankruptcy proof. The bankruptcy remote structure only makes the possibility that an entity will voluntarily file for bankruptcy or be brought into a bankruptcy proceeding more remote as a result of the safeguards described in this article. The intricacies of the bankruptcy remote structure would be unnecessary if lenders could simply require that a borrower be bankruptcy-proof by conditioning the loan on an enforceable absolute waiver of the right to file bankruptcy for the term of the loan. However, courts have consistently found that agreements in which the borrower waives the protection of the bankruptcy laws are unenforceable and void as against public policy.[33] The bankruptcy remote structure was artificially constructed by the CMBS market and the rating agencies to limit the potential for the bankruptcy of an SPE without violating the well-settled prohibition against bankruptcy proofing.

Judicial refusal to enforce bankruptcy-proofing provisions is grounded in a line of cases stretching back to the 1925 Massachusetts Supreme Judicial Court case *Federal National Bank v. Koppel*.[34] The court reasoned that if advance waivers of bankruptcy protection were enforceable, lenders would always insist on a waiver and borrowers would invariably agree because of the borrowers' overriding interest in securing the loan without regard to the future consequences of the waiver. This result would undermine Congress's goals in creating the Bankruptcy Code, which was to promote equality of distribution among similarly situated creditors, permit debtors a fresh start by discharging the debt, and promote the idea that the rehabilitation of a business is preferable to liquidation—justifications that remain as relevant today as in 1925.[35]

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The bankruptcy remote structure stands on an unsteady foundation as it tries to balance its goal of preventing borrower access to the bankruptcy courts with the long line of cases holding that the intent of Congress in passing the Bankruptcy Code would be undermined if access to bankruptcy protection is limited. Since 1925, lenders have worked to develop mechanisms to prevent borrowers from accessing the protection of the Bankruptcy Code that do not run afoul of the public policy prohibition on bankruptcy proofing. Although largely unchallenged in the courts, the bankruptcy remote structure is not an absolute prohibition on bankruptcy and therefore has not been viewed as a *per se* legal violation of the prohibition against bankruptcy proofing.

Vulnerability of Protections Afforded by Independent Directors

As noted, a key feature of the bankruptcy remote structure is the introduction of one or more independent directors into the borrower's governance structure. The management directors, or inside directors, are given the authority to direct and oversee the entity's day-to-day operations. The sole function of independent directors is to vote on certain material corporate actions, including with respect to the potential bankruptcy of the entity. The governing documents provide that a borrower's equity owner must appoint one or more independent directors, which may not be, among other things, employees, major customers, and immediate family members of the borrower entity, its principals, and affiliates. By excluding people with a clear basis for allegiance to the borrower and its parent, the possibility that an independent director could be controlled by the borrower's parent company is reduced and it is more likely that the independent director will evaluate the

[30] ''Single asset real estate'' is defined as ''real property constituting a single property or project, other than residential real property with fewer than 4 residential units, that generates substantially all of the gross income of the debtor . . . on which no substantial business is being conducted by a debtor other than the business of operating the real property and incidental activities.'' 11 U.S.C. § 101(51B).

[31] Bankruptcy courts have interpreted the ''no substantial business'' provision to exclude hospitals, hotels, casinos, manufacturing facilities, ranches, and marinas from the definition of single asset real estate.

[32] As discussed below, GGP has agreed to continue making monthly interest payments to its CMBS lenders on the principal amount of the debt at the non-default rate.

[33] *Federal National Bank v. Koppel*, 253 Mass. 157, 159 (1925); *In re Patricia Wells Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995); *In re Tru Block Concrete Products,* 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983). For an excellent discussion of the history of bankruptcy law in the United States, see David A. Skeel, *Debt's Dominion: A History of Bankruptcy Law in America*, Princeton University Press, 2001.

[34] *Koppel* at 159.

[35] *See Koppel* at 159; *In re Madison* at 690.

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bankruptcy filing objectively.[36] Finally, the organizational documents in most circumstances require that, in acting or otherwise voting on the corporate actions, the independent directors shall consider only the interests of the SPE, including its respective creditors, to the fullest extent permitted by law.

Under state law, directors generally owe fiduciary duties to the entity that they serve. Equity owners of an entity are usually the ultimate beneficiaries of those duties as the residual interest holders of the entity. If the entity fails to act to enforce a breach of duty, equity owners can bring legal action for breaches of duty as derivative actions on behalf of the entity. If the entity becomes insolvent, directors must be careful to act in a way that attempts to maximize the value of the entity for the benefit of all interested parties, including the creditors. Creditors become the residual interest holders of an insolvent entity and they inherit the right to bring derivative actions for breach of duty on behalf of the entity. Since a director's duty, absent provisions to the contrary in an SPE borrower's organizational documents, is to maximize the value of the SPE borrower, real estate lenders have accepted the fact that in some cases, an independent director's fiduciary duties in the zone of insolvency may require the independent director to consent to a bankruptcy filing.[37]

As discussed elsewhere in this article, the bankruptcy remote structure includes limitations on additional debt and narrowly defines the purpose of the SPE to try and limit the risk that the SPE will reach the zone of insolvency. However, no court has directly faced the question of independent director's duties in the context of an SPE. Indeed, only the bankruptcy court in *In re Kingston Square Associates* (''*Kingston Square*'') discussed independent directors of a bankruptcy remote SPE at length.[38]

In *Kingston Square*, the governance documents of a number of SPE borrowers contained standard independent director provisions. The board of directors of each borrower entity was composed of three members, one of which was an ''independent'' director.[39] The governance documents required that the independent director approve any bankruptcy filing. To circumvent this constraint, management contrived to have creditors file an involuntary bankruptcy. The holding of the case related to whether the collusive involuntary bankruptcy filing involved fraudulent intent. The judge in *Kingston Square* endorsed the proposition that ''corporate action taken by an insider without board or shareholder authority may later be found to have been appropriate in circumstances where the existence of the corporation is very much at risk.'' The court did not specifically address the question of whether the independent director provision was void as against public policy, although the argument was raised by the debtor. Although not directly part of the finding in *Kingston Square*, the court indicated that there was an important role for the independent director to play in the borrower's fundamental corporate decisions and that the independent director has fiduciary duties that must be upheld.

Weaknesses in CMBS Bankruptcy Remote Structure Exposed by the GGP Case

As discussed above, the independent director approval requirement contained in the organizational documents of a typical SPE provides lenders and investors in the CMBS structure with comfort that an SPE borrower will not file a voluntary bankruptcy petition, other than in extraordinary circumstances. That comfort was derived from the fact that a bankruptcy court presumably will not permit an *ultra vires* bankruptcy filing made in violation of the express requirement for the consent of an independent director contained in a borrower's organizational documents. Therefore, a bankruptcy filing can only be made with the approval of an independent director. However, in most cases, SPE organizational documents require only that the SPE borrower maintain one or more independent directors at all times whose approval is required for any bankruptcy-related actions. The organizational documents generally do not prohibit the removal and replacement of an independent director by the SPE borrower's equity holder in accordance with the laws of the jurisdiction of organization of the borrower, so long as the new director meets the independence criteria. This ability to ''remove and replace'' an independent director provides the parent of an SPE borrower with the tools to replace an independent director who may object to a voluntary bankruptcy filing with a new director who is more sympathetic to the filing. In effect, the unfettered ability to remove and replace an independent director allows parent companies to ''director shop'' for individuals willing to consent to a bankruptcy filing.

This appears to be the tactic that GGP used to obtain the consent of independent directors to the filing of the voluntary bankruptcy petitions for its SPE borrowers. In the weeks preceding GGP's bankruptcy filings in April 2009, GGP supposedly removed the independent directors of most of its SPE borrowers and replaced

[36] The following summarizes the independent director provisions of the typical governing documents of an SPE. The SPE borrower will be required to maintain at least one, and many times two, independent director(s) that meets the definition of independence in the governing documents. The governing documents will further require the consent of all directors, including the independent director(s), before the borrower SPE: (a) changes the definitional requirements for an independent director or any of the provisions related to the independent director in the organizational document, (b) merges, consolidates, or sells substantially all of the assets of the SPE, (c) institutes proceedings to have the SPE be adjudicated bankrupt, (d) consents to the institution of bankruptcy proceedings against the SPE, (e) files a petition seeking, or consent to, reorganization or relief with respect to the SPE under any applicable law relating to bankruptcy, (f) consents to the appointment of a receiver, liquidator, assignee, trustee of the SPE, or a substantial part of its property, (g) makes any assignment for the benefit of the SPE's creditors, or (h) takes any action in furtherance of the foregoing.

[37] Of course the exposure of the independent director for a breach of his or her fiduciary duties will be limited if the independent director (a) is exculpated for a breach of the duty of care (as is permitted by Delaware law) and (b) has no interest in the transaction and thus no exposure to a claim for a breach of the duty of loyalty.

[38] *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

[39] The *Kingston Square* court noted that the independent director may not have been truly ''independent'' since he was a former employee and consultant to the lender who looked to the lender for payment of his director's fees and therefore effectively was the designee of the lender. *Kingston Square* at 716-17.

these directors with new directors, in accordance with state law, that met the independence criteria in the borrowers' organizational documents. These new independent directors then approved the voluntary bankruptcy filings. Despite the fact that the removal and replacement of the independent directors may have violated the spirit of the original agreement with the lenders, GGP's actions were permitted under state law and do not appear to have been prohibited by the organizational documents of the SPE borrowers. Thus, by removing and replacing the independent directors, GGP was able to obtain the consent necessary for the voluntary bankruptcy filings.

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In addition to the independent director requirement, a CMBS loan also typically contains cash management provisions that govern the distribution of cash by a borrower. In the event of a default under the mortgage loan, all cash flow from the subject property is sent to a lock-box controlled by the lender and applied at the lender's discretion, including to pay down the mortgage loan. As a result, after an event of default, according to the cash management provisions of the loan document, the parent company of an SPE borrower should be left without the benefit of any excess cash flow from properties that are generating an amount of cash greater than the applicable borrower's debt service payments. In bankruptcy, the court should theoretically respect the separate debtor entities and not invade the assets of one debtor for the benefit of a parent or affiliate. Consideration of a secured lender's right to ''adequate protection'' of its cash collateral, as discussed above, is typically analyzed in the context of the specific SPE and only the particular SPE (and not its parent) is generally entitled to use its cash collateral if the bankruptcy court finds that the secured lender is ''adequately protected.'' In GGP, however, the court considered whether to permit excess cash to be distributed by an SPE borrower to the parent company's bankruptcy estate, which can then be used by the estate to operate the parent's and affiliates' business.

The GGP bankruptcy court recently ruled, against the objections of secured lenders, that each of the SPE borrowers may loan any remaining amounts to the parent's bankruptcy estate subject to payment to the CMBS lenders of current interest at the non-default contract rates and the payment of ordinary course operating and maintenance expenses and taxes for the subject property.[40] The individual SPE borrowers will receive a first priority administrative claim on the bankruptcy estate's cash account in the amount of the loan by the particular SPE and, to ensure ''adequate protection,'' the CMBS lenders will receive corresponding replacement liens on the administrative claims arising from the loans by the SPE borrowers to the bankruptcy estate. Nevertheless, to the detriment of the CMBS lenders, the excess cash will not be trapped at the borrower level to pay down the applicable mortgage loan even though the filing of the bankruptcy was a default under the mortgage loan.

In effect, the bankruptcy court has made available to the GGP bankruptcy estate cash that would otherwise have served as collateral for the individual mortgage loans presumably because the court concluded that mortgage lenders were ''adequately protected.'' While the decrease in the secured CMBS lender's collateral is somewhat mitigated by the fact that each SPE borrower will receive a first priority administrative claim on the bankruptcy estate's cash account in the amount lent by the SPE, and the CMBS lender will receive a corresponding replacement lien, the secured lenders are certainly in a worse position than if all excess cash flow from a property was being used to pay down their mortgage loan. However, the result is consistent with the pre-bankruptcy practice of GGP, which was to operate a consolidated cash management system that swept cash from subsidiaries to a parent account and then re-advanced it as needed, presumably keeping accurate intercompany account records.[41]

By continuing to pay interest on each of the CMBS loans at the contract rate, GGP has also thus far been able to avoid the effects from the relief from the stay under the SARE rules and retain control of the reorganization process of its SPE borrowers on its own timeline. With the GGP bankruptcy in its early stages, the issue of whether the required interest payments will continue to be based on the outstanding principal balance of the loans, or be reduced to reflect decreases in the market value of the properties, has not yet been addressed and may not be addressed if GGP continues to pay interest on the outstanding principal loan amount without objection. As the GGP bankruptcy progresses, given the uncertainties in the valuation of commercial real estate in the current markets, it will be interesting to see whether GGP attempts to reduce required interest payments based on the current market value of its properties and, if it does, how the bankruptcy court will determine the valuations of these properties and how reduced values will affect the commingled use of cash collateral.

Ways to Improve Independent Director Requirement in Light of GGP Bankruptcy

Although the limitations of the bankruptcy remote structure are fresh in the minds of the CMBS industry, the most likely immediate response from lenders and

[40] Final Order Authorizing Debtors to Use Cash Collateral and Grant Adequate Protection at 21-23, *In re General Growth Properties, Inc.*, No. 527 (Bankr. S.D.N.Y. May 14, 2009).

[41] Final Order Authorizing the Debtors to Continue Using Existing Centralized Cash Management System at 3, *In re General Growth Properties, Inc.*, No. 518 (Bankr. S.D.N.Y. May 14, 2009).

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CMBS investors will be to (a) conservatively underwrite cash flows and value and (b) price the added bankruptcy risk into the underwriting of new loans. When combined with other significant external market factors, it will not be surprising if the uncertainties relating to the bankruptcy remote structure highlighted by the GGP bankruptcy filing lead to CMBS mortgage loans with significantly higher interest rates than prior to the start of the current financial crisis.

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Additionally, the current environment provides an opportunity to address a number of changes to the independent director requirement that could provide lenders with added protections against voluntary bankruptcy filings by SPE borrowers. In light of the impact of the GGP filing on the integrity (or at least the perception of the integrity) of the bankruptcy remote structure, alternatives that may have previously been dismissed because of the fear that they would result in bankruptcy proofing or lead to lender liability concerns will need to be revisited to reassess their effectiveness in deterring bankruptcy filings.[42] These are not necessarily novel ideas and in fact may have been included in the organizational documents of some SPEs previously. However, in light of the GGP proceedings, they may become uniform in future organizational documents of SPE borrowers.

First, given the flexibility allowed by the law governing Delaware limited liability companies, the duties of the independent directors under the organizational documents of a Delaware SPE could be fixed to provide that in the event of the conflict between the interests of the SPE and a secured creditor,[43] when considering bankruptcy issues, the paramount duties of the independent directors should be to the secured creditor.[44] This gloss on the duty of care would not lead to an absolute prohibition on a bankruptcy filing, but it would certainly make it easier for an independent director to vote against a bankruptcy filing and provide a framework for an independent director to address potential conflicts while attempting to maximize the value of the entity to all stakeholders. Second, the appointment of an independent director following the removal of the director's predecessor may be made subject to the consent of the CMBS lender, not to be unreasonably withheld or delayed. This ''reasonable consent'' right would of course mitigate the effect of potential ''director shopping'' by an SPE borrower's parent company, and it would also prevent potential abuse by CMBS lenders that fail to approve new independent directors in an effort to stall or to prevent a bankruptcy filing. Finally, a CMBS lender may consider acquiring a sliver equity interest in an SPE borrower at the time the CMBS loan is made. Although an absolute waiver of the right to file a bankruptcy is in violation of public policy, in cases where a lender holds both a debt and equity position in a borrower, courts have found that the lender retains a separate right to act in its capacity as an equity holder, and as such, can refuse to consent to a voluntary bankruptcy filing.[45]

Conclusion

As the GGP case illustrates, the benefits of the bankruptcy remote structure are being revisited as interested parties focus their attention on the original objectives of the structure. Lenders to the GGP bankruptcy remote SPEs do not believe they received what they bargained for because the independent director safeguard has not proven effective in preventing the SPEs in the GGP case from voluntarily filing for bankruptcy protection. In fact, the remove and replace strategy of GGP appears to counteract the benefit of the structure from the perspective of the CMBS market.

The fundamental question is how can the bankruptcy remote structure, and, in particular, the governance provisions relating to the independent directors, be improved for the benefit of the CMBS market as a whole without bankruptcy proofing the structure or imposing

[42] To the extent that a lender effectively has a consent right over the ability of a borrower to file for bankruptcy, there is the potential that litigation over the decision-making process of the lender with respect to the granting of consent could lead to liability for the lender in the event that it is later determined by a court that bankruptcy was in the best interests of the borrower. This liability, which could arise under various theories of applicable state law, may extend to actions taken to prevent the appointment of an independent director where the organizational documents of a borrower require that the approval of the independent director is required for a bankruptcy filing. Similarly, if an independent director is found to be under the control or influence of a lender, as opposed to a scenario where the organizational documents of a borrower merely require that paramount duties are owed to the lender in considering bankruptcy-related issues, there is also the potential for liability for the lender in the event that the independent director fails to approve a bankruptcy that is alleged to have been in the best interests of the borrower.

[43] The organizational documents of a typical SPE require that an independent director only consider the interests of the borrower and its creditors (and not the borrower's equity owners) when considering bankruptcy issues.

[44] As discussed above, it is well-settled in almost all jurisdictions, including Delaware, that the directors of an entity approaching insolvency owe fiduciary duties to general creditors. *Kingston Square* at 735. Nevertheless, Delaware courts have made it clear that the principles of contract preempt fiduciary duties where the parties have made their intentions to do so plain. *Brickell Partners* v. *Wise*, 794 A.2d 1, 3 (Del. Ch. 2001); Del. Code Ann. Tit. 6, § 18-1101(b) (2008).

[45] *In the matter of Global Ship Systems, LLC*, 391 BAR. 193 (Bankr. S.D. Ga. 2007). CMBS lenders, however, will need to be especially careful in evaluating this final alternative as it carries the additional risk of equitable subordination, meaning that the loan by the CMBS lender may risk being reclassified as equity and thus subordinated to the other liabilities of the SPE borrower if the lender/sliver equity holder is found to have acted improperly and thereby harmed other parties.

lender liability concerns along the way. All can agree that in the current economic climate with the CMBS market in a state of government-sponsored rehabilitation, clarity around these issues would be welcomed. The bankruptcy court in the GGP proceedings has the opportunity, directly or indirectly, to provide more clarity with respect to the bankruptcy remote structure and to assist the CMBS market as it attempts to find a comfortable place between protecting the interests of lenders who participate in the CMBS market, on the one hand, and remaining true to the underlying policy objectives of the Bankruptcy Code articulated in *Koppel* and its progeny, on the other hand. Perhaps GGP and other similar cases that unfold in the near future will shed much-needed light on these issues. In the meantime, participants in newly-issued CMBS bankruptcy remote structures, and any existing lenders who have the opportunity to revisit the governance terms of borrower SPEs, would be well advised to consider modifying the ''remove and replace'' provisions relating to the independent directors so that the lenders have a stronger voice in the destiny of these SPEs. Lenders cannot eliminate the risk of a borrower bankruptcy, but they can reduce those risks by tightening the safeguards in the bankruptcy remote structure while focusing on improved risk underwriting.

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