The Impact of COVID-19 on Distressed Real Estate in the U.S. Both In and Out of Bankruptcy

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COVID-19 Suspensions of Deadlines to Comply with Lease Obligations in Bankruptcy

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Overview

1. Background on Debtor's Timely Rent Obligations and Court's Equitable Powers Under Bankruptcy Code
2. Impact of COVID-19 on Court's Exercise of Equitable Powers
3. COVID-19 Suspension Relief Granted Under Sections 105 and 305
4. Denial of COVID-19 Suspension Relief Under Strict Interpretation of Section 365
5. Key Takeaways

Background on Debtor's Timely Rent Obligations & Equities of the Case Exception

Debtor's Timely Rent Obligations Under U.S. Bankruptcy Code:

- Section 365(d)(3). Trustee must timely perform all the debtor's obligations under an unexpired lease of nonresidential real property starting on day 1 until such lease is assumed or rejected; court may, for cause, grant an extension of no greater than 60 days. 11 U.S.C. § 365(d)(3)
- Section 365(d)(5). Trustee must timely perform all the debtor's obligations under an unexpired lease of personal property starting on day 60 until such lease is assumed or rejected, unless the court orders otherwise "based on the equities of the case" (the "EOTC" exception). 11 U.S.C. § 365(d)(5)

Equities of the Case Exception:

- Allows court to grant debtors relief from performing timely lease obligations "based on the equities of the case"; only from personal property lease obligations
  - Purpose of EOTC exception is to give debtors breathing room to make informed decision on whether to assume or reject lease
  - EOTC exception is rarely invoked; traditionally used modestly to adjust amount and timing of payments, not to materially alter contract
- There is no EOTC exception for section 365(d)(3). Pre-COVID, no court had ever extended the fixed 60-day relief period for unexpired leases of nonresidential real property

COVID-19's Impact on Court's Exercise of Equitable Powers

- Relying on either section 105 or section 305 of the Bankruptcy Code or both, courts during 2020 overrode the clear statutory obligation for debtors to timely perform under real property leases after 60 days
  - Section 105 allows the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. 11 U.S.C. § 105(a)
  - Section 305 allows the court to "suspend all proceedings" in a bankruptcy case "at any time if . . . the interests of creditors and the debtor would be better served by such [] suspension." 11 U.S.C. § 305(a)(1)
- They have also supported much more generous relief for personal property leases under the EOTC exception

COVID-19 Suspension Relief Granted under Sections 105 and 305 – *Pier 1 Imports*

***In re Pier 1 Imports, LLC*, No. 20-30805 (KRH) (Bankr. E.D. Va. Feb. 17, 2020)**

- March 31, 2020. Relying on § 105 of the Code, Pier 1 sought approval from the court with respect to various payment obligations, including its Section 365(d)(3) lease obligations, to (1) "temporarily cease making or delaying all . . . payments . . . including rent payments;" and (2) "automatically adjourn" motions to lift the stay or to compel the debtors to assume or reject leases for the pendency of the "Limited Operation Period" (LOP). *See* Debtor's Mar. 31, 2020 Emergency Mot. at 3, 5
- April 6, 2020. Court extended the LOP beyond the maximum 60-day extension
- May 5, 2020. Court further extended the LOP through May 31, 2020
  - "There is no feasible alternative to the relief sought," because the Debtors "have been ordered to close their business" and therefore "cannot operate as a going concern and produce the revenue necessary to pay rent." May 10, 2020 Mem. Op. at 10
  - Court did not reach the substantive arguments on whether lease obligations could be altered—rather than merely delayed—and whether any contractual doctrines excused Pier 1's performance. Pier 1 sought—and the court granted—"only to delay the payment of certain accrued but unpaid rent obligations during the Limited Operations Period." Id. at 6
  - "[T]o the extent adequate protection is required, the continued payment of the related non-rent payments and assurance of cure payment in July is sufficient to protect the Lessors against any perceived diminution in value." Id. at 17
- May 22, 2020 Status Update. Pier 1 partially terminated LOP, reopened a number of stores, and did not expect to request a further extension of LOP. Pier 1 also indicated intent to pay rent for the period of the LOP, subject to certain conditions favorable to Pier 1 regarding store wind-downs.
- Since then, Pier 1 has not sought to extend the LOP

COVID-19 Suspension Relief Granted under Sections 105 and 305 – *Modell's Sporting Goods*

***In re Modell's Sporting Goods, Inc.*, No. 20-14179 (VFP) (Bankr. D. N.J. March 11, 2020)**

- Unlike Pier 1, Modell's sought to delay its entire case under section 305
- Initially sought 60-day "bankruptcy suspension"; later shortened request to extend "[a]ll deadlines that would otherwise occur" for a 21-day period, and also bar parties from seeking relief during this period. *See* Mar. 28, 2020 Emergency Application, at 2; Apr. 30 Hr'g Tr. at 96
- March 27, 2020. Court entered order temporarily suspending case to April 30, 2020
- April 30, 2020. Court granted further extension of suspension through May 31, 2020
  - Twenty-two landlords objected to the request, arguing that section 305 does not contemplate a stay of a case, but rather a suspension of specific proceedings or obligations within the larger case. The US Trustee did not object, but noted this is "an unusual use of section 305," and that "suspension should not become a commonplace remedy." Mar. 25 Hr'g Tr. at 20:5-8; Apr. 30 Hr'g Tr. at 29:17-20
  - Court held section 305 "is not limited to situations cited by the landlords, but instead…relief under that section is available to any bankruptcy case in which the interests of creditors and the debtors would be better served by…suspension." April 30, 2020 Hr'g Tr. at 102:2-7
  - Court noted form of adequate protection was unclear given lack of liquidity to pay rent, that there are genuine questions regarding enforceability of lease obligations in light of COVID-19, and suggested mediation to address these issues
- June 5, 2020. Court granted further suspension through June 15, 2020
- June 11, 2020. Court approved parties' stipulation, providing that the parties have engaged in numerous mediation sessions, and debtors agree to a go-forward budget, which includes paying rent due to the landlords. Debtors have not sought further suspension

COVID-19 Suspension Relief Granted under Sections 105 and 305 – *CraftWorks*

***In re Craftworks Parent, LLC*, No. 20-10475 (BLS) (Bankr. D. Del. Mar. 3, 2020)**

- April 2, 2020. Court approved supplemental DIP proposal, conditioned on the debtors agreeing to budget, even though the budget did not include timely rental payments to landlords required under Section 365(d)(3)
- March 27, 2020. Pursuant to section 105(a), debtors requested additional $4 million in DIP financing, attaching a proposed six-week budget through May 10, 2020 (i.e. Day 68) which was silent on the rental payments required under section 365(d)(3)
  - Landlords objected, arguing that debtors sought an indefinite, de facto extension of lease obligations until some point in time beyond May 10, 2020—at least 68 days after the bankruptcy filing
- April 2, 2020. Court approved requested funding over landlord objections on the basis that the DIP satisfied the requirements for obtaining postpetition financing under section 364
  - To comply with government-imposed store closure mandates as a result of COVID-19, "Debtors ceased operating all of their 261 restaurants and have laid off nearly all of their approximately 18,000 employees" and required immediate access to postpetition financing to preserve their assets, pay critical expenses, and administer the Chapter 11 cases. Apr. 2 Order at 2
  - Debtors' plan proposed only to pay "their most critical business-related expenses," which made no mention of lease payments. *Id.* at 7

***See also* "For Cause" Extensions:**

- Debtors in less dire conditions that have filed later during COVID-19 and after the shelter-in-place orders have been relaxed have still been granted extensions *up to* the statutory 60-day maximum on the basis that COVID's impact on their business constituted the "cause" necessary under 365(d)(3) for the court to grant the 60-day extension (e.g., *J.C. Penney, J.Crew)*

Denial of COVID-19 Suspension Relief under Strict Interpretation of § 365 – *CEC Entertainment*

***In re CEC Entertainment, Inc.*, No. 20-33163 (Bankr. S.D. Tex. June 24, 2020)**

- Debtors sought relief to extend the rent suspension period beyond section 365(d)(3)'s 60-day maximum, advancing three arguments: (1) sections 365(d)(3) and 105 give the court equitable power to alter CEC's rent obligations; (2) global pandemic and related government regulations are *force majeure* events that allow delayed performance under the leases; and (3) frustration of purpose doctrine relieves CEC's obligation to timely pay rent
- Dec. 14, 2020. Court rejected all three arguments and denied relief
  - Court not empowered to relieve obligations beyond section 365(d)(3)'s 60-day postpetition period: "Section 365(d)(3) unambiguously requires that debtors timely perform obligations under commercial leases" and "[t]he Court cannot override that statutory mandate." *Id.* at 9. "Both the text and the intent of § 365(d)(3) are clear: commercial real property lessees must continue to perform after filing for bankruptcy. Section 365(d)(3) requires that the debtor timely perform its lease obligations." *Id*
  - Also rejected debtors' force majeure and frustration of purpose arguments through a strict interpretation of state law applicable to each holdout lease
- Admin vs. Superpriority Claim. The court disagreed with *Pier 1,* which held that section 365(d)(3) grants landlords an administrative, not a "superpriority" claim. *Id.* at 8-9
  - Intent behind 365(d)(3) was "to prevent commercial lessors from unwillingly extending credit to debtor-lessees during the pendency of a chapter 11 case." *Id.* at 9
  - "[T]he remedy for a violation of § 365(d)(3) is beyond the scope of this opinion." *Id*
- Did not discuss the court's authority to extend other deadlines in light of COVID-19
- Decision remains unchallenged

***See also In re Forever 21, Inc.*, No. 19-12122 (Bankr. D. Del. Sept. 29, 2019)**

Key Takeaways

- COVID-19 has led some U.S. courts to grant rent suspensions beyond section 365(d)(3)'s 60-day maximum period pursuant to sections 105 or 305, which was previously unthinkable
  - These cases were all filed at the start of the COVID-19 pandemic and involved debtors severely impacted from having to close their stores to comply with government-imposed "shelter-in-place" orders
  - These suspensions applied only to deferral of payment; they did not eliminate the rental obligation or amount in any way, and these debtors ultimately agreed to make the delinquent payments
  - These suspensions were also temporary rather than indefinite, and are no longer in effect today
- Other courts have disagreed and held a debtor to its obligations based on the clear language of section 365(d)(3)

Key Takeaways (cont.)

It is also worth noting that the U.S. Congress recently extended the time for debtor-tenants to assume leases in bankruptcy

- In general, a debtor has until confirmation of the chapter 11 plan to decide whether to assume or reject executory contracts
- However, section 365(d)(4) of the Bankruptcy Code provides that, when the debtor is a lessee of nonresidential real property, it must decide whether to assume or reject no later than 120 days after the petition date
  - Such period may be extended by an additional 90 days for cause
  - If the debtor does not assume the lease and make the necessary cure payments within the requisite time frame, the lease is deemed rejected
- In the Consolidated Appropriations Act enacted in December 2020, and in response to the COVID-19 pandemic, Congress extended the 120-day period to 210 days, giving debtor-tenants additional time to assume the lease and make necessary cure payments
  - Such period can still be extended by an additional 90 days for cause

Additional Opportunities and Limitations in Distressed Real Estate

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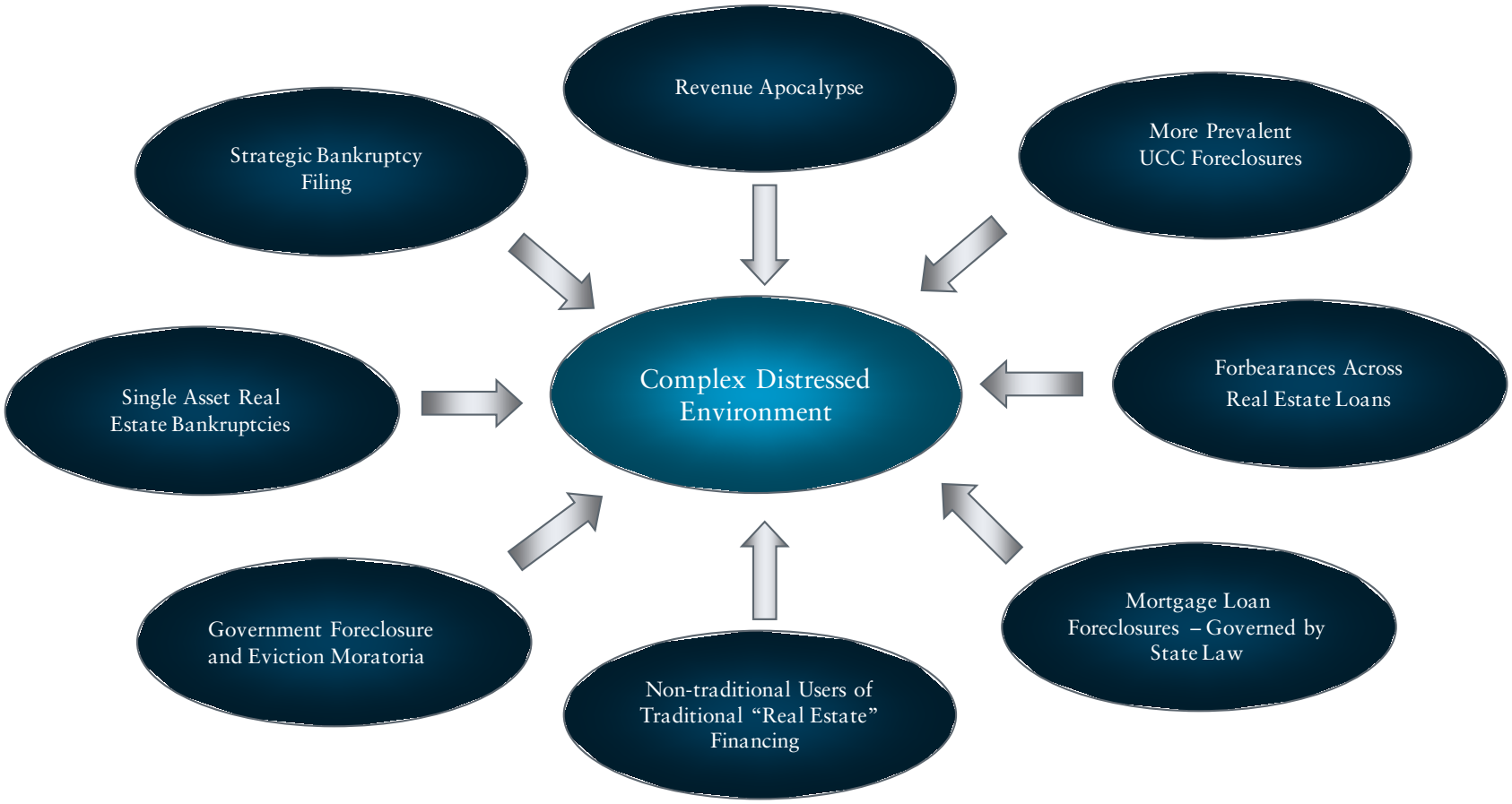
The Current Dynamic



Overview

The COVID-19 pandemic has resulted in a challenged real estate market that also creates significant opportunities for distressed investors both in and out of bankruptcy

- Outside of bankruptcy, mortgagors face moratoria on foreclosure actions at both the federal and state level, causing lenders to pursue alternative enforcement measures
  - UCC foreclosures on mezzanine loans (i.e., loans secured by equity interests in the property owner) have been scrutinized by state courts
- On the other hand, distressed investors may take advantage of opportunities to buy distressed real estate assets and mortgage or mezzanine loans both in and out of bankruptcy
  - Investors may acquire real estate assets outside of bankruptcy by purchasing real property or controlling equity interests outright from owner
    - Investors may also purchase debt secured by the real property asset or the equity interests in the borrower and foreclose on the collateral (foreclosure on real property assets, however, is subject to expiration of the moratoria)
  - Similarly, investors can acquire real estate assets in a bankruptcy by purchasing (i) assets pursuant to section 363 of the Bankruptcy Code or a chapter 11 plan or (ii) distressed debt or debt claims to convert to equity under a chapter 11 plan
    - J.C.Penney recently sold its real estate assets in a sale under section 363 of the Bankruptcy Code

Moratoria on Foreclosure Actions

U.S. federal and state moratoria on mortgage foreclosure actions limit secured creditors' abilities to exercise remedies on defaulting loans

- The Federal Housing Finance Authority (FHFA) and Department of Housing and Urban Development (HUD) extended their foreclosure and eviction moratoriums for the benefit of homeowners with FHA-insured single family mortgages through June 30, 2021
- New York state's moratorium on residential evictions and foreclosures for those experiencing hardship from lost income or increased costs because of the COVID-19 pandemic has been extended through May 1, 2021 pursuant to the COVID-19 Emergency Eviction and Foreclosure Prevention Act of 2020
  - The Act also prevents local governments from engaging in a tax lien sale or a tax foreclosure (including in connection with any unpaid tax, special ad valorem levy, special assessment, or other similar charge) until at least May 1, 2021
    - Tax payments and assessments due to the local government remain due and payable
- On March 9, 2021, Governor Cuomo extended the moratorium on commercial evictions and foreclosures for nonpayment through May 1, 2021, which was recently extended through August 31, 2021

Moratoria on Foreclosure Actions (cont.)

- The current moratorium for commercial evictions and foreclosures is tied to nonpayment. At least one lender sought to foreclose on a property based on nonfinancial defaults, and if that case is not dismissed outright and the parties are not sanctioned, other lenders will likely seek to foreclose based on material nonfinancial defaults
- The current moratorium for commercial evictions and foreclosures extends through May 1, 2021, and it appears legislative action will codify such result
  - Current focus of legislature is small businesses
  - Legislation could require affirmation that nonpayment is due to COVID-19 (similar to residential requirements)
  - It is unclear if anyone is focused on treatment of Special Purpose Entities
- Multiple courts have held that the moratoria are applicable only to mortgage foreclosures, and therefore do not prevent mezzanine lenders from foreclosing on equity interests through a UCC foreclosure (discussed further below)
  - However, in *Shelbourne BRF LLC et al. v. SR 677 Bway LLC*, a New York supreme court held that the "logic" of the moratorium is applicable to UCC foreclosure because valuation of the equity interest is based on the value of the real estate itself. The *Shelbourne* decision was subsequently overturned on appeal, but on separate grounds that did not address whether the moratorium should extend to UCC foreclosures

Alternatives to Foreclosing on Real Property Assets

OVERVIEW

UCC Foreclosure

- If available to foreclose on equity, this option is cheaper and quicker than foreclosure on real property

Deed in Lieu

- Take property subject to all existing liens and encumbrances, but can be a quick process
- Title insurance implications

Involuntary Bankruptcy

- Potential liability for petitioning creditors in event the case is dismissed
- Long and expensive process
- Risk of cram-up

Voluntary Bankruptcy

- Long and expensive process
- Risk of cram-up

Alternatives to Foreclosing on Real Property Assets

UCC FORECLOSURE

- Section 9-610(a) of the Uniform Commercial Code provides that a secured creditor may sell or otherwise dispose of its collateral, but requires that that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable." U.C.C. § 9-610(b)
- Is it possible to conduct a "commercially reasonable" sale during a worldwide pandemic?
  - In *D2 Mark LLC v. Orei VI Investments LLC*, a New York state supreme court found that certain conditions of a proposed sale were problematic including, among other things: a virtual or in-person sale, without specifying which it would be; a 36-day notice period, during the majority of which the governor's stay-at-home order prevented an in-person inspection of the collateral; a prohibition of communication with the mezzanine borrower or its affiliates regarding the sale, without lender's consent. The *D2 Mark LLC* court enjoined the UCC sale for 30 days because of some of the unique characteristics of that sale process, but the opinion may nevertheless help future UCC foreclosures avoid a similar fate
  - In *1258 ASSOC MEZZ II LLC v. 12E48 MEZZ II LLC*, a separate New York state supreme court allowed a UCC foreclosure sale to proceed notwithstanding the moratorium. After initially postponing the sale to permit additional notice and advertising of the sale, the court denied the borrower's request for a preliminary injunction noting that any damages from the proposed sale were speculative and therefore would not support a preliminary injunction. The court did not opine on whether the sale itself was commercially reasonable, reserving the borrower's rights to argue the sale was commercially unreasonable after the sale concludes

Acquisitions in Chapter 11

- Two ways to purchase assets in chapter 11:
  - Option 1: "Section 363 sale" – asset sale pursuant to section 363 of the Bankruptcy Code through an asset purchase agreement during the chapter 11 case, before consummation of a chapter 11 plan
  - Option 2: Acquisition through a chapter 11 plan
- A "loan to own" creditor can use outstanding claims to purchase the company through either approach:
  - If the claims are secured, the creditor can use those claims as consideration to "credit bid" in an asset sale under section 363 or a chapter 11 plan
  - The debt claims can convert to equity through a plan of reorganization

Acquisitions in Chapter 11 (cont.)

Select Advantages of Acquisitions in Chapter 11

1. Free and Clear of Interests. The bankruptcy court has the power to approve the sale of assets free and clear of liens and many historical liabilities (e.g., tort, pension, environmental)
2. Transfer of Executory Contracts. Buyers have the ability to choose to assume certain favorable executory contracts and leases despite anti-assignment clauses; can maximize value and "fit" of target assets for the acquirer
3. Good Faith Purchaser Protection/Assurance of Finality. The sale order must explicitly state that the buyer is a good faith purchaser to obtain this protection
4. No Fraudulent Transfer Liability. The auction process ensures that the debtor receives the best possible offer for the assets sold, so there can be no claim that reasonably equivalent value was not received
5. Price. Bankruptcy sales present an opportunity to buy valuable assets at below-market prices because there are generally fewer prospective buyers competing for the assets
6. Ability to bind non-consenting stockholders. Chapter 11 allows restructuring of the target's debt without unanimous creditor consent; provisions in corporate charters requiring the approval of a majority of stockholders to sell substantially all of the assets of a company are not enforced in bankruptcy

Acquisitions in Chapter 11 (cont.)

Select Legal Risks for Loan to Own Strategies

- Equitable subordination
  - Risk that acquired claims may be equitably subordinated based on conduct of claim seller or buyer
  - Subordination of debt to other debt claims if lender acted unfairly toward other creditors
- Breach of fiduciary duty
  - If seller or acquirer of claims is a member of the creditors' committee, access to inside information may limit the ability to trade
- Vote of claim holder on plan approval may be disqualified if not cast in "good faith"
  - If buying claims for purpose of proposing plan, may need to disclose or risk being deprived of vote
- A portion of claim may not be entitled to recovery due to prepetition transfers made to claim seller
  - May be fraudulent transfers or preferences
  - Require indemnification from claim seller

SARE and SPE Cases: Overview

Real estate bankruptcies present unique issues for borrowers and creditors alike

- Certain borrowers may be eligible for a single asset real estate (SARE) case, which provides for an expedited process in chapter 11
  - However, such status may be lost as a result of the debtor's (or its affiliates') prepetition conduct, even when such actions violate the debtor's loan documents
    - In *Sutton 58 Associates LLC v. Pilevsky*, discussed below, the New York Court of Appeals recently held that when affiliates of the debtors cause the debtors to violate their loan documents and lose status as a SARE entity, such affiliates may be liable for a claim of tortious interference of contract because the Bankruptcy Code would not preempt such state law claims
- A special purpose entity (SPE), which is often considered a bankruptcy remote entity, may file for bankruptcy protection along with its parent even when the SPE has sufficient liquidity and is not subject to default under its loan documents
  - This was a prominent issue in the wave of real estate bankruptcies that filed amid the 2009 financial crisis, including in *In re General Growth Properties*, and may resurface as the COVID-19 pandemic continues to impact real estate markets

Single Asset Real Estate (SARE) Cases

The Borrower's bankruptcy may be considered a single asset real estate case, which provides for an expedited process

- Special provisions apply to "single asset real estate" (SARE) cases, defined in section 101(51B) of the Bankruptcy Code to include a company in chapter 11:
  - that conducts no business other than operating real estate that constitutes a single property or single project (and incidental activities);
    - Courts have found multiple parcels of land to constitute a single project where several apartment buildings on adjacent parcels have a common plan or purpose (see In re Vargas Realty Enter. Inc., 2009 WL 2929258, at *4-5 (Bankr. S.D.N.Y. July 23, 2009)) or where adjacent undeveloped parcels were to be developed as one large resort even though the debtor planned to construct a hotel, golf courses, convention center, spa, and related services on the various properties (see In re Webb MTN, LLC, 2008 WL 656271, at *1 (Bankr. E.D. Tenn. Mar. 6, 2008))
  - where a single real property or project generates substantially all of the company's income; and
  - that is not involved in any substantial business other than the operation of the real property
- A secured creditor may file a motion with the bankruptcy court to designate the debtor as a SARE debtor if the debtor does not designate itself as such
  - The filing of such a motion starts the clock for the expedited SARE process

Single Asset Real Estate (SARE) Cases (cont.)

- SARE debtors often file for chapter 11 protection to avoid imminent foreclosure on their property
  - Filing for bankruptcy gives the debtor the benefit of the automatic stay and runway to raise new capital and/or refinance debt
- Unlike in typical chapter 11 cases, a creditor in a SARE case with a claim secured by an interest in the real property can obtain relief from the automatic stay to foreclose on the property 90 days after commencement of the chapter 11 case unless:
  - the company has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
  - the company is making monthly payments of interest on the value of the creditor's secured claim, calculated at the nondefault contract rate

SARE Case Study: *Sutton 58*

***Sutton 58 Assoc. LLC v. Pilevsky*, 2020 N.Y. Slip Op. 06939 (N.Y. 2020)**

- In this case, recently decided by the New York Court of Appeals, a lender (the "Lender") lent money to a mortgage borrower ("Mortgage Borrower") and the sole owner of the Mortgage Borrower's membership interests ("Mezz Borrower" and, together with the Mortgage Borrower, the "Borrowers") for the development of certain real estate assets
  - The loan documents contained provisions that obligated the Borrowers to become, and remain, SARE entities as defined in the Bankruptcy Code
  - After the Borrowers defaulted on the loans, certain persons and entities affiliated with the Borrowers (collectively, the "Defendants") allegedly caused the Borrowers to breach these covenants by, among other things, obtaining interests in more than three residential properties
  - The Lender initiated a UCC foreclosure sale of the Mezz Borrower's membership interest in the Mortgage Borrower and, shortly thereafter, the Mezz Borrower filed for bankruptcy
- The Lender filed a motion to dismiss the Mezz Borrower's bankruptcy petition, arguing that the filing was made in bad faith because there were no assets to reorganize other than a dispute over the Lender's right to foreclose on the membership interest. The Lender also asked the court to modify the automatic stay to allow the UCC foreclosure

SARE Case Study: Sutton 58 (cont.)

- In response to the Lender's motion to dismiss, the Mortgage Borrower also filed for bankruptcy, giving credence to the argument that the case was more than just an attempt to stave off the UCC foreclosure
  - The Lender eventually withdrew the motion to dismiss after the bankruptcy court noted that such motion was premature, especially after the Mortgage Borrower filed for bankruptcy protection
  - The assets were sold in a 363 sale and distributed to the creditors in a liquidating plan
- Separate from the bankruptcy litigation, the Lender filed a claim against the Defendants for tortious interference with contract
  - Specifically, the Lender alleged that the Defendants engaged in a scheme to breach the loan documents by causing the Borrowers to take actions that rendered the entities no longer SARE companies
- The parties arguments were largely focused on whether the Bankruptcy Code preempted the Lenders' state law contract claims, and a New York appellate court agreed with the Borrowers that the Lender's claims were preempted
- Consequently, in a split decision, the New York Court of Appeals reversed the lower court's decision, finding no risk of conflict between state and federal law when an action is brought by a non-debtor against another non-debtor on the basis of alleged wrongdoing that happened prior to the bankruptcy filing. The New York Court of Appeals found that the Lender's claims against the Defendants would not affect the debtor's estate, even though the damages were the result of the bankruptcy filing

SPE Case Study: *General Growth Properties*

***In re General Growth Properties Inc.*, Case No. 09-11977 (ALG), Dkt. No. 1284 (Bankr. S.D.N.Y. Aug. 11, 2009)**

- Although an older case, *GGP* instructs that special purpose entities ("SPEs") can file for bankruptcy protection notwithstanding solvency and lack of default
- In this case, General Growth Properties, Inc. ("*GGP*"), a REIT with subsidiary SPEs set up as direct owners of its properties, filed for chapter 11 protection in April 2009 along with over 160 of its SPEs, reporting $29.6 billion in assets and $27.3 billion in liabilities in the aggregate at the time of filing
- Following the filing, a number of lenders under the SPEs' prepetition loans argued that the SPEs' chapter 11 cases should be dismissed for "cause"
  - The lenders generally argued that the filings were improper and not filed in "good faith" because the SPEs were not insolvent or in danger of becoming so, were not facing the imminent maturity of their facilities, and did not directly benefit from chapter 11 bankruptcy protection
  - Lenders also argued that the independent managers or directors of the SPEs were obligated to consider only the interests of the SPE, including its respective creditors, in deciding whether to approve the SPE's filing for bankruptcy protection

SPE Case Study: *General Growth Properties* (cont.)

- In ultimately ruling that the filings were not in bad faith, the bankruptcy court held that each SPE and its directors were justified in considering not only its independent need for restructuring, but also the financial distress of the company as a whole in deciding whether to file for chapter 11 protection
  - The bankruptcy court reasoned that while the SPE structure was intended to insulate the financial position of each SPE from its affiliates, the lenders should have known that, given the larger and somewhat integrated corporate structure of the company, the financial situation of the parent company would impact the individual SPEs
- The bankruptcy court also noted that GGP's cash management system made the SPEs look more like an integrated structure with GGP as the parent because the SPEs would typically upstream rents into a commingled main operating account, from which GGP would pay its subsidiaries' operating expenses and make intercompany loans
- Notwithstanding the court's ruling on bad faith filings, the court was clear that the secured lenders still enjoyed a fundamental protection of the SPE structure – that the individual SPEs maintained "protection against substantive consolidation of the project-level debtors with any other entities"