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May 2009

General Growth Update

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Introduction

On April 16, 2009, General Growth Properties, Inc. ("GGP"), and nearly 400 related entities (together, the "Debtors"), filed for bankruptcy protection under chapter 11 of the United States Code (the "Bankruptcy Code") in the U.S. Bankruptcy Court for the Southern District of New York, Judge Allen Gropper presiding, commencing the largest real estate bankruptcy in U.S. history.

Over the past several years, GGP had acquired The Rouse Company, assumed roughly $18.4 billion in debt, and became the second-largest owner of shopping malls in the U.S. The GGP business is run as an integrated enterprise with management centralized in its Chicago headquarters. Aside from basic operational needs — which are handled at the property level — the centralized system provides national support for substantially all aspects of business operations, including accounting, business development, construction, contracts, human resources, and the like. GGP's cash needs are mostly met by collection of rents from its shopping centers and other properties.

When GGP filed for bankruptcy on April 16, 2009, it submitted numerous "first day motions," including one related to debtor-in possession ("DIP") financing (the "DIP Motion") and requesting the use of the secured lenders' cash collateral (the "Cash Collateral Motion"),[1] and another to approve its pre-petition cash management procedures (the "Cash Management Motion", and collectively with the DIP Motion and the Cash Collateral Motion, the "First Day Motions").

DIP Motion

Since the petition date, GGP engaged in a continuous effort to improve the terms of the initial DIP loan offered by Pershing Square Capital Management, L.P. ("Pershing"). On May 13, 2009, Judge Gropper entered an order approving a DIP loan from an investor group led by Farallon Capital Management, L.L.C. ("Farallon"). The approved DIP loan is in the amount of $400 million (as opposed to $375 million in the Pershing proposal), eliminates the warrants required by Pershing, and gives GGP the ability to convert all or a portion of the outstanding DIP loan into post-emergence equity or debt. The DIP loan carries an interest rate equal to the London Interbank Offered Rate (LIBOR) plus 12%, and requires an exit fee of 3.75%. GGP intends to use the bulk of the DIP loan proceeds to pay off the 2008 Goldman Sachs revolving credit facility in the amount of $215 million (the "Goldman Sachs Facility").

Cash Collateral Motion

In the Cash Collateral Motion, the Debtors argued, *inter alia*, that they require additional funds, in the form of cash collateral, to fund their operations and provide funding to non-Debtor affiliates consistent with pre-petition practices.

The result would be that the Debtors could use the cash flow from all of their properties to fund all of their operations, irrespective of any interest or claim thereto from any secured lender. Because section 363 of the Bankruptcy Code conditions the ability of a debtor to use cash collateral on providing adequate protection ("Adequate Protection") to those third-party entities with an interest in that cash (the "Adequate Protection Parties"), the Debtors offered their secured lenders, *inter alia,* (i) a lien on other collateral, (ii) an assurance to use the cash collateral to maintain the properties, and (iii) payment of interest on the secured loans at the non-default contract rate set under the respective loan documents.

Cash Management Motion

In the Cash Management Motion, the Debtors requested to continue their pre-petition centralized cash management system whereby funds generated by all Debtor entities flow into a main operating account (the "Main Operating Account"). According to the Debtors, prior to bankruptcy, the funds with respect to most properties which were generated at the property level were upstreamed to the Main Operating Account. From there, the funds were paid directly to the secured lenders in satisfaction of all debt and maintenance payments on the properties. The Debtors requested to continue this practice post-petition, which was met with fear and skepticism by the secured lenders.

The Objecting Motions

Subsequent to the Debtors' Motions, numerous objections (the "Objections") were filed by commercial mortgage backed securities ("CMBS") lenders or the special servicers, including ING Clarion Capital Loan Services LLC, Wells Fargo Bank, New York Life Insurance Company, and others (together, the "Objecting Parties"). The Objecting Parties argued that granting the First Day Motions would destroy CMBS lending. The primary arguments found in the Objections fell within four categories.

First and foremost, the Objecting Parties were concerned that the First Day Motions would effectively result in a substantive consolidation of GGP. According to the Objections, by allowing cash derived at the property level to be upstreamed directly into the Main Operating Account, the Debtors would effectively be collapsed into one super-entity. With respect to the Cash Management Motion, some of the Objecting Parties argued that this practice violated the terms of certain loan documents. Second, the Objecting Parties claimed that the individual single purpose entities ("SPEs") were set up as "bankruptcy proof" entities which were entirely isolated from the parent company and its many other subsidiaries. A third concern was that the Adequate Protection which was being offered was insufficient. Certain Objecting Parties were concerned that the replacement liens on the cash contained in the Main Operating Account would be junior to the liens provided to the DIP lender. Lastly, and more generally, the Objecting Parties argued that the First Day Motions requested a "sea change" in the CMBS lending universe. This final argument was more thoroughly described in the Brief of Amicus Curiae by the Commercial Mortgage Securities Association (the "CMSA").

The Amicus Brief

The CMSA, a trade organization whose members represent a broad cross-section of firms and individuals that are actively engaged in commercial real estate capital market finance activities, including large banks, insurance companies, money managers, and credit-rating agencies, argued that the substantive consolidation of the various Debtors would have a chilling effect on the CMBS market. CMBS securities are issued in the public or private markets backed by the cash flow and collateral from a pool of disparate mortgage loans of unrelated entities. One of the fundamental elements of CMBS financing is the isolation of the asset being financed. To accomplish this, CMBS lenders require their borrowers to be structured as SPEs. The SPE structure is intended to distance the properties from the parent company, to ensure a constant and bankruptcy-remote source of cash by which to issue bonds to various investors who would otherwise not normally invest in real estate. According to the CMSA, if a CMBS lender cannot guarantee the isolation of the property being financed (including the cash being generated therefrom), no financing will occur.

To isolate the asset, a CMBS borrower typically must agree to certain separateness covenants. These separateness covenants generally require the CMBS borrower to own no assets other than the asset being financed, to engage in no activities unrelated to the ownership of that asset, and to take appropriate steps to maintain the separateness of the borrower entity. CMBS lenders also typically require borrowers to agree to certain recourse provisions. These recourse provisions are triggered upon the occurrence of, inter alia, certain events that could impair the isolation of the financed asset. Applying these arguments to the GGP bankruptcy filing, the CMSA argued that the Court's granting of the First Day Motions would result in the violation of the separateness covenants. In the original filing, GGP argued each of the property owning entities and their affiliates are a part of one larger enterprise (as opposed to isolated entities). The CMSA responded to this point by asserting that, if granted, the effect of the First Day Motions would be to shatter the bedrock of structured finance of commercial real estate. Given the importance of CMBS financing to commercial real estate investment, such a decision could hinder – if not halt altogether – the systemic recovery of the commercial real estate markets.

Granting Of The Orders

When Judge Gropper laid out his final orders on May 14, 2009, several of the concerns of the Objecting Parties and of the CMSA were realized. The orders first approved the Farallon DIP loan in the amount of $400 million, noting that the Debtors had made reasonable efforts to secure financing on terms better than the original DIP loan offered by Pershing, and that those terms were negotiated in good faith. Upon approval, the proceeds of the DIP loan were used to payoff the Goldman Sachs Facility, with the Debtors pledging as collateral the unencumbered equity of its subsidiaries' shopping centers. The DIP loan also granted to Farallon a perfected lien in the Main Operating Account, junior only to the Adequate Protection liens granted to the Adequate Protection Parties. By allowing the secured lenders, rather than the DIP lender, to be granted the first priority lien on the Main Operating Account, the court addressed some of the concerns found in the Objections and, in so doing, eased a primary fear amongst the secured lenders.

However, not all concerns of the Objecting Parties and of the CMSA were alleviated. In the order granting the Cash Collateral Motion, the court authorized each Debtor "to use all Cash Collateral, wherever it may be located and regardless of whether it is in an account controlled by any Adequate Protection Party." Furthermore, the court ordered "[a]ll Adequate Protection Parties . . . to relinquish control over all Cash Collateral to the Debtors and [to] not interfere with any effort by the Debtors or their banks to redirect Cash Collateral to the Main Operating Account." Thus, the court obstructed the ability of the secured lenders to direct property-level rents and income to satisfy the property-level debt. The court agreed with the Debtors insofar that this would not constitute a substantive consolidation, noting that bankruptcy courts routinely allow debtors to sweep cash from multiple affiliates into one main account. In return for providing access to the cash collateral, the court granted to the secured lenders as Adequate Protection (A) first priority liens on (i) amounts owed between affiliates, and (ii) the Main Operating Account, and (B) second priority liens on the properties securing the Goldman Sachs Facility.

In addition, the court granted the Debtors' Cash Management Motion, essentially giving broad discretion to the Debtors to control all money in the Main Operating Account consistent with their pre-petition practices, subject only to the liens granted to both the Adequate Protection Parties and the DIP lender. This post-petition ability by the Debtors to control funds generated at the property-level — before and independent of the satisfaction of the property-level debt — is significant, notwithstanding that GGP may have utilized a similar practice pre-petition. Although the court granted to the CMBS lenders a first priority lien on the cash flowing through the Main Operating Accounts, as well as on intercompany amounts owed, this decision was widely denounced by the secured lenders.

To be sure, by avoiding a substantive consolidation at the expense of the secured lenders, the bedrock of structured finance in the real estate market was not uprooted — at least for the time being. Yet, the court made clear that secured lenders will not always be insulated from the effects of "bankruptcy remote" entities entering bankruptcy. While the significance of this decision is yet to be determined, it is clear that the CMBS market remains focused on this and other decisions in the GGP bankruptcy, which may ultimately reshape the future landscape of commercial lending.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] Although both the DIP financing and the cash collateral issues were raised in one consolidated motion, for ease of reference we will refer to them separately as the DIP Motion and the Cash Collateral Motion.