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LEGAL OPINION NEWSLETTER

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General Growth Properties

[Editor's Note: We include here Pam Holleman's summary of her presentation at the fall WGLO seminar on developments in the Chapter 11 bankruptcy of General Growth Properties involving special purpose entities. As she notes in her summary, these developments are of particular interest to counsel in structured financings who give (or receive) substantive consolidation opinions. See generally TriBar Opinion Committee, Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions, 46 Bus. Law. 717 (1991); Committee on Structured Finance and Committee on Bankruptcy and Corporate Reorganization, Association of the Bar of the City of New York, Special Report on the Preparation of Substantive Consolidation Opinions, 64 Bus. Law. 411 (2009).]

Recent court decisions in the Chapter 11 bankruptcy case of shopping center owner General Growth Properties, Inc. have shaken the world of structured finance, particularly as it relates to the use of "special purpose entities" ("SPEs").¹ After General Growth and more than

¹ Case No. 09-11977 (ALG) (Bankr. S.D.N.Y.) (jointly administered), filed April 16, 2009.

one hundred of its SPE subsidiaries filed for bankruptcy protection on April 16, 2009, the court authorized the debtors – over the objection of certain pre-petition lenders – to “upstream” the SPEs’ cash surplus to finance the operations of the entire debtor group. Later, the court denied the lenders’ motions to dismiss the SPEs’ cases as “bad faith” filings.² The SPEs were Delaware limited liability companies formed to hold title to individual properties and were designed to be “bankruptcy remote”: their charters required unanimous consent of all their managers, including so-called “independent” managers, in order to file or consent to a bankruptcy filing. The charters also contained “separateness” provisions designed to reduce the risk of “substantive consolidation” – a doctrine whereby a court can determine that the assets of one entity should be made available to satisfy the debts of a parent or affiliated company. One lender warned that permitting the solvent SPEs to remain in bankruptcy, circumventing contractual commitments to the lenders, “may well signal the demise of a form of non-recourse, commercial real estate financing that has been efficacious, less expensive and in other ways beneficial to borrowers and their equity holders.”³ In denying the motions to dismiss, however, the court emphasized that it was not ruling on the issue of whether or not the assets and liabilities of the SPEs could appropriately be substantively consolidated with the assets and liabilities of any other entity – an issue that was not before the court.

Contrary to widespread perception, the bankruptcy court’s decisions to date in *General Growth* are consistent with precedent and have not appreciably increased the bankruptcy risk associated with SPE borrowers.⁴ The court allowed the debtor group to utilize the proceeds of accounts receivable and inventory of the SPEs as cash collateral, but granted the lenders replacement liens and other adequate protection of their interests. The court’s refusal to dismiss the SPEs’ cases was grounded in the established principle that a filing is not made in bad faith where there is a possibility of a successful reorganization,⁵ whether or not the debtor is insolvent.⁶ The court found that all of the SPEs “were in varying degrees of financial distress,” particularly as it was uncertain that the collateralized mortgage backed securities market would revive within the next several years when the SPEs’ debt must be refinanced.⁷ While the SPEs had terminated their “independent” managers shortly before the filing, without advance notice to the managers or to the lenders, the court found (citing Delaware law) that the entities had not violated their charters and held that the replacement managers acted properly in taking into consideration the needs of the entire debtor group in approving the bankruptcy filings.⁸ As the court observed: “[I]f [the lenders] believed that an ‘independent’ manager can serve on a board

² *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 72 (Bankr. S.D.N.Y. 2009).

³ Post-Trial Memorandum in Support of ING Clarion Capital Loan Services LLC’s Motion to Dismiss the Clarion Debtors’ Bankruptcy Cases filed July 2, 2009, Chapter 11 Case No. 09-11977 (ALG) (Bankr. S.D.N.Y.).

⁴ *See, e.g., In re Kingston Square Assocs.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) (denying a motion to dismiss the involuntary bankruptcy cases of special purpose entities); *compare In re LTV Steel Co.*, Case No. 00-43866 (Bankr. N.D. Ohio) (unpublished op.) (granting, on an interim basis, debtors’ motion to use cash collateral to finance their bankruptcy cases, including the proceeds of accounts receivable and inventory that had been sold, pre-bankruptcy, to wholly-owned, bankruptcy-remote affiliates of the debtors).

⁵ *See, e.g., Kingston Square Assocs.*, 214 B.R. at 725.

⁶ *See, e.g., In re The Bible Speaks*, 65 B.R. 415, 424 (Bankr. D. Mass. 1986).

⁷ *Gen. Growth Props.*, 409 B.R. at 58.

⁸ *Id.* at 63-64, *citing North Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

solely for the purpose of voting ‘no’ to a bankruptcy filing because of the desires of a secured creditor, *they were mistaken*.”⁹ Whether or not an SPE is “bankruptcy remote” is in any event largely irrelevant to the issue of substantive consolidation (on which the court did not rule): if an entity conducts its business in conformity with the separateness requirements included in the typical SPE charter, the risk of substantive consolidation is remote, regardless of whether or not the entity files for bankruptcy protection.¹⁰

While recent case law (such as the U.S. Court of Appeals for the Third Circuit’s decision in *In re Owens Corning*) suggests that substantive consolidation orders may become increasingly rare,¹¹ *General Growth* may signify an ironic new paradigm: a case in which the court makes no findings as to whether a parent and its SPE affiliate were operated as separate entities, and does not substantively consolidate the entities’ assets and liabilities, but nonetheless authorizes the parent’s sale or use of the SPE’s assets without lender consent. Those who deliver (and rely on) “non-consolidation” and “true sale” opinions must consider and assess the significance of this new paradigm in structuring future transactions and in crafting reasoned opinions. From a structural perspective, suggested responses have focused on enhancing an SPE’s “bankruptcy remoteness,” as by forming the SPE in a jurisdiction where the law permits a member or director to be accountable only to creditors. Given the courts’ focus upon the possibility of a successful reorganization, however, such approaches may be unsuccessful, and efforts to exclude traditional common law duties may create new and unanticipated problems and risks. From an opinion giver’s perspective, counsel should consider disclaiming any opinion as to whether a court, in the bankruptcy case of an SPE’s parent or affiliate, would authorize the sale, use or lease of the SPE’s assets without making appropriate findings and effecting a substantive consolidation of the entities.

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⁹ *Id.* at 64 (emphasis added).

¹⁰ Compare *In re Bonham*, 229 F.3d 750, 766-67 (9th Cir. 2000) (substantively consolidating the assets of a debtor and its non-debtor affiliate); accord *In re 1438 Meridian Place*, 15 B.R. 89, 96 (Bankr. D.D.C. 1981) (holding that non-debtor affiliate could be subject to jurisdiction of the bankruptcy court where the affiliate was an alter ego of the debtor and “clear and manifest injustice” had been worked on the creditors).

¹¹ See *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005) (describing substantive consolidation as “extreme”, since “it may affect profoundly creditors’ rights and recoveries”, and concluding that “this ‘rough justice’ remedy should be rare ...”).