Perception or Reality: What Shall We Make of *General Growth*?

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Recent court decisions coming out of the Chapter 11 bankruptcy case of General Growth Properties, Inc. have shaken up the world of structured finance. As the lending community anticipates a new round of commercial real estate bankruptcies, certain decisions by the bankruptcy court in that case appear to have imperiled the sanctity of the "single purpose entity" ("**SPE**") structures upon which the markets for commercial mortgage-based securities ("**CMBS**") and asset securitization rely. As a result, those who deliver (and rely on) "non-consolidation" and "true sale" opinions must consider and assess the significance of *General Growth* in structuring future transactions.

The *General Growth* Case

General Growth filed on April 16, 2009 in the United States Bankruptcy Court for the Southern District of New York.[2] The case has been the source of particular scrutiny because certain members of the debtor group were single purpose, so-called "bankruptcy remote" entities whose charters contained "separateness" covenants (the "**SPE Debtors**").[3] Perhaps the greatest source of concern lies in the fact that the SPE Debtors' cases were permitted to be filed at all; but two orders entered in the case have also raised significant concern in the commercial lending community.

As described by the bankruptcy court, the Debtors' corporate structure is "extraordinarily

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[2] Case No. 09-11977 (ALG) (Bankr. S.D.N.Y.) (jointly administered).

[3] As the court explained:

> Sometimes referred to as a "single-purpose entity" or "bankruptcy remote entity", an SPE has been described by one commentator as "an entity, formed concurrently with, or immediately prior to, the closing of a financing transaction, one purpose of which is to isolate the financial assets from the potential bankruptcy estate of the original entity, the borrower or originator." David B. Stratton, *Special-Purpose Entities and Authority to File Bankruptcy,* 23-2 Am. Bankr. Inst. J. 36 (March 2004). "Bankruptcy-remote structures are devices that reduce the risk that a borrower will file bankruptcy or, if bankruptcy is filed, ensure the creditor procedural advantages in the proceedings." Michael T. Madison, *et. al.,* The Law of Real Estate Financing, § 13:38 (2008).

In re Gen. Growth Props., Inc., 09-11977 (ALG), 409 B.R. 43, 49 n.16 (Bankr. S.D.N.Y. 2009).

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complex".[4] The parent company directly or indirectly owned and controlled hundreds of project-level subsidiary entities, including SPEs established to hold title to individual properties. The SPEs were Delaware limited liability companies designed to be bankruptcy-remote.[5] Thus, the SPE operating agreements required unanimous written consent of an SPE's managers for the entity to file or consent to the filing of a bankruptcy proceeding, including two "Independent Managers" who were to be appointed by a "nationally recognized company that provides professional independent directors, managers and trustees." [6]

In performing their duties, the Independent Managers were (as is typical in these arrangements) "[t]o the extent permitted by law" to consider only the interests of the SPE, "including its respective creditors" – presumably a reference to the SPEs' secured creditors, as it has been alleged that some SPEs have no other creditors. Moreover, each Independent Manager was to have "a fiduciary duty of loyalty and care similar to that of a director of a business corporation organized under the General Corporation Law of the State of Delaware."[7]

On the eve of the bankruptcy filing, the Independent Managers were terminated from the boards of those of the Subject Debtors that maintained the independent-manager requirement. Their replacements, two "seasoned individuals" selected by the Debtors, joined the other managers in voting to commence bankruptcy proceedings. [8] The filings took both the terminated Independent Managers and the lenders by surprise. Noting that the lenders apparently believed that the Independent Managers had an inviolate duty to protect only the lenders' interests, the bankruptcy court commented that "if [the lenders] believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, ***they were mistaken***." [9]

The Contested Motions

On the petition date, the Debtors filed a motion for the use of cash collateral in connection with the approval of debtor-in-possession ("**DIP**") financing. The court entered a cash collateral order that authorized the use of the cash surplus of the SPE Debtors so that it could be made available to the entire debtor group. Certain lenders, who had extended pre-petition financing to the SPE Debtors, had argued that this was impermissible because the SPE Debtors' organizational and loan documents included separateness and single purpose entity provisions. While permitting the cash surplus to be upstreamed, the court did grant a replacement lien on the cash and required a second lien on certain other properties. In connection with the DIP financing, the court denied the debtors' request to pledge the SPE Debtors' assets as collateral subject to a second lien to secure debtor-in-possession financing.

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[4] Id. at 49.

[5] See id. at 63.

[6] Id. at 63, 67.

[7] Id. at 63.

[8] Id. at 67-68.

[9] Id. at 64 (emphasis added).

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Another round of controversy ensued when certain lenders petitioned the court to dismiss the SPE Debtors' bankruptcy cases as "bad faith" filings. The SPE Debtors' formation documents required that each entity maintain an "independent" director or manager. The lenders apparently anticipated that these persons would not serve the interests of the parent company and would oppose the filing of any voluntary bankruptcy petition. Here, however, as noted the independent directors and managers of the SPE Debtors were replaced on the eve of bankruptcy, without prior notice to the lenders, and the entities promptly voted to file bankruptcy petitions.

The lenders argued that financially sound single purpose subsidiaries with no present need for bankruptcy relief (and which might never have such a need) should not be permitted to use the financial problems of their parent as leverage to file a Chapter 11 case, thereby circumventing the SPEs' contractual commitments to the lender. One lender ominously warned that allowing the SPEs to remain in bankruptcy "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."[10]

The court denied the motions to dismiss. As a threshold matter, the court found that the SPE Debtors "were in varying degrees of financial distress" at the time of filing, in some cases because they "were either guarantors on maturing loans of other entities or their property was collateral for a loan that was maturing, or there existed other considerations that in the Debtors' view placed the loan[s] in distress, such as a high loan-to-value ratio".[11] Furthermore, the court concluded that, under applicable law, the independent managers of the solvent SPEs appropriately considered the interests of the SPE shareholders in determining to seek bankruptcy protection, reasoning as follows:

> [Under the SPE operating agreements] the Independent Managers can act only to the extent permitted by applicable law, which is deemed to be the corporate law of Delaware. Delaware law in turn provides that the directors of a solvent corporation are authorized – indeed, required – to consider the interests of the shareholders in exercising their fiduciary duties. … [T]here is no contention in these cases that the Subject Debtors were insolvent at any time – indeed, [the lenders'] contention is that they were and are solvent. [The lenders] therefore get no assistance from Delaware law in the contention that the Independent Managers should have considered only the interests of the secured creditor when they made their decisions to file Chapter 11 petitions, or that there was a breach of fiduciary duty on the part of any of the managers by voting to file based on the interests of the Group.[12]

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[10] 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.).

[11] Gen. Growth Props., 409 B.R. at 58.

[12] Id. at 64, citing North Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (directors of a corporation approaching insolvency "must exercise their business judgment *in the best interests of the corporation for the benefit of its shareholder owners*") (Emphasis supplied by the bankruptcy court).

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In denying the motions to dismiss, the court stressed that it was not ruling on the issue of substantive consolidation, which was not before the court. "[T]he question of substantive consolidation is entirely different from the issue whether the Board of a debtor that is part of a corporate group can consider the interests of the group along with the interests of the individual debtor when making a decision to file a bankruptcy case. Nothing in this Opinion implies that the assets and liabilities of any of the [SPE debtors] could properly be substantively consolidated with those of any other entity."[13]

A prominent international trade organization saw the issues differently. In an *amicus curiae* brief filed in support of the lenders' motions to dismiss, the Commercial Mortgage Securities Association stated:

> From a bankruptcy perspective, it would not be inaccurate to say that the approach taken by CMBS lenders with respect to isolation of assets is designed to mitigate the risk of substantive consolidation. In most CMBS transactions above a given monetary threshold, one condition precedent to closing was the delivery of an opinion by counsel for the borrower with respect to substantive non-consolidation. Even though these opinions were invariably delivered on a reasoned basis with significant qualifications, they provide comfort to the lender that, based on the then current case law, compliance with the Separateness Covenants would greatly mitigate the risk that a creditor of a parent company could prevail in making a consolidation claim that the assets of the subsidiary should be available to satisfy the debts of the parent or affiliates. One of the express Separateness Covenants provides that the borrower will not violate any assumptions taken by counsel in the opinion. In a CMBS loan, this agreement as to how the borrower will conduct its affairs in compliance with the Separateness Covenants is as critical as the agreement to pay debt service and an essential part of the benefit of the bargain for the lender. In this sense, these opinions further supported the basic CMBS structure and the isolation of assets and cash flows.[14]

Lenders and borrowers alike, and their counsel, have expressed concern that the *General Growth* opinions may indeed make it difficult, if not impossible, to finance real estate assets, especially in a time of economic uncertainty (at best) in the nation as a whole and the real estate industry in particular.

A Brief History of Asset Securitization in the Bankruptcy Courts

Bankruptcy court challenges to structured finance are not unprecedented. Perhaps the first reported bankruptcy court decision involving the legitimacy of a Chapter 11 case involving

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[13] Gen. Growth Props., 409 B.R. at 69.

[14] Brief of *amicus curiae* Commercial Mortgage Securities Association ("**CMSA Brief**"), at 15-16.

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single purpose, "bankruptcy remote" entities was *Kingston Square Associates*, decided in 1997.[15] The case commenced with the filing of involuntary petitions against a group of debtors, including numerous SPEs. The SPE charter documents required the unanimous board consent by each entity for a bankruptcy filing, including the consent of a so-called "independent" director. While ostensibly independent, evidence adduced in the case made clear that this director was paid by, and beholden to, the lenders who had provided securitized financing to the entities. Facing imminent foreclosure, the debtors' principal essentially arranged for the filing of an involuntary petition against the SPEs by a handful of its creditors.

Presaging *General Growth*, the lenders moved to dismiss the SPE cases as bad faith filings. They alleged, among other things, that the SPEs acted in bad faith by orchestrating involuntary bankruptcy filings against them by assisting the efforts of petitioning creditors' counsel. The court agreed that the debtors had orchestrated the commencement of the cases but refused to dismiss them as bad faith filings absent evidence as to whether a successful reorganization was possible.[16]

Another important court challenge to asset securitization is an unpublished interim order entered by a bankruptcy court in the case of *LTV Steel* on February 5, 2001.[17] As in *General Growth*, the dispute revolved around the debtors' motion to use certain 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. After the court entered a "first day" order approving the debtors' financing motion, certain lenders moved (belatedly, in the court's view) for modification of the financing order. The lenders argued, among other things, that proceeds of the accounts receivable had been sold to the debtors' SPE affiliates and thus were not property of the bankruptcy estate.

The bankruptcy court denied the lenders' motion. In a memorandum opinion, the court directed a threatening salvo at the asset securitization industry, essentially questioning whether the transfer of accounts receivable in which the debtor retained at least an equitable interest was in fact a "true sale." The court also found that the lenders' interest in its collateral was adequately protected by replacement liens in postpetition accounts receivable. The structured finance community collectively sighed its relief when the lender agreed to provide debtor-in-possession financing to the bankruptcy estate, and the alarming interim order was subsumed in a

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

[16] Id. at 714-15. Mortgage backed securitization was a relatively new phenomenon at the time of the filing of the involuntary petitions against the *Kingston Square* SPEs. The bankruptcy court observed:

> Fashion has a role not only in the garment industry but in the legal one as well. One of the newest fashions in commercial real estate financing is so-called "mortgage backed securitization" coupled with the presence of corporate governance provisions known as "bankruptcy remote provisions" designed to make bankruptcy unavailable to a defaulting borrower without the affirmative consent of the mortgagee's designee on the borrower's board of directors.

Id. at 714. Unwilling to dismiss the cases, but distrustful of the existing directors, the court instead granted the alternative relief requested by the lenders, appointing a Chapter 11 trustee to manage the debtors. See id. at 738.

[17] In re LTV Steel Co., Case No. 00-43866 (Bankr. N.D. Ohio) (unpublished op.).

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consensual final financing order.

With the proliferation of securitized transactions over the ensuing decade, SPE structures remained largely untested by the bankruptcy courts. From time to time the courts substantively consolidated the estates of debtor and non-debtor affiliates, but published decisions did not involve "single purpose" entities. Moreover, a decision issued in 2005 by the federal Third Circuit Court of Appeals, *In re Owens Corning*, appeared to signal a decreased willingness on the part of the courts to employ substantive consolidation absent a showing that its use will lead to an equitable result for all creditors.[18] The *Owens Corning* court refused to uphold a "deemed consolidation" of a debtor and its non-debtor subsidiaries, corporations and limited liability companies comprising a multinational corporate group, where subsidiaries were borrowers and guarantors of debt used to benefit the corporate parent.[19]

With the advent of the recent financial crisis came several high profile bankruptcy court decisions worrisome to many in the lending community. Such cases included, among others, the bankruptcy sales of substantially all the assets of Chrysler Corporation and General Motors Corporation. Like *General Growth*, these decisions appeared to be unconventional – in that they facilitated a seeming reordering of bankruptcy priorities and implemented a thoroughgoing corporate reorganization through a bankruptcy sale rather than under a Chapter 11 plan – but in fact were predicated upon practices that have become commonplace in bankruptcy courts over the past two decades.[20]

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[18] 419 F.3d 195, 215-216 (3d Cir. 2005).

[19] Id. at 210. Describing substantive consolidation as imprecise and "extreme", since "it may affect profoundly creditors' rights and recoveries", the court concluded:

> [T]his "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies … what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

Id. at 211.

[20] See generally, e.g., Douglas G. Baird, "The New Face of Chapter 11", *American Bankruptcy Institute Law Review*, Vol. 12:No. 1, 69, 73 (Spring 2004) (noting that, "[o]f the 10 largest chapter 11s of 2002, eight used the bankruptcy court as a way of selling their assets to the largest bidder, whether piecemeal or as a going concern."). As Professor Baird commented in 2004:

> Some practices … are hard to square with conventional doctrine. A debtor seeks to sell a subsidiary free and clear of claims even when the subsidiary itself has not filed for bankruptcy. In theory, the only asset of the estate is the debtor's equity interest in the subsidiary. Only this equity can be sold free and clear. Any sale should leave the rights of the creditors of the subsidiary unaffected. But the legal separation between corporate groups is not always respected. But even if such transactions could not withstand appellate scrutiny, they may go forward nevertheless, excepting only the liabilities of those that filed objections. Such practices continue until someone appears who is intransigent and refuses to compromise. In a world in which negotiations and side-deals dominate, such a person may never appear.

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General Growth is not the only bankruptcy case to arise out of the current economic crisis in which a court has authorized Chapter 11 debtors to sell or use property of an affiliate without making findings as to whether debtor and affiliate were operated as separate entities and without ruling that the entities' assets and liabilities should be substantively consolidated. In the case of *Lehman Brothers Holdings Inc.*, filed on September 15, 2008,[21] another New York bankruptcy court authorized a bankruptcy sale of assets owned by of non-debtor affiliates of affiliated debtors that were used in connection with the affiliated debtors' brokerage business. With one exception, the non-debtors were not parties to the sale, and the record does not indicate whether or not they were individually solvent. Unlike *General Growth*, the legal implications of *Lehman Brothers* have garnered scant attention, even in the bankruptcy trade press.[22]

The law after *General Growth*

Notwithstanding the attention *General Growth* has received, the authors believe that the court orders discussed in this commentary have not changed the law in any significant respect. The bankruptcy court permitted the debtors to use the assets of the SPE Debtors, but the court's final financing order provided the lenders with adequate protection. Likewise, while denying the lenders' motion to dismiss the SPE Debtors' cases, the court took pains to point out that in doing so, it was not substantively consolidating the debtors' estates (an issue not before the court).

The *General Growth* court delayed the lenders from foreclosing on their collateral by authorizing the SPE Debtors to remain in bankruptcy with the continuing protection of the automatic stay, a statutory injunction that (among other things) bars lien foreclosure during the pendency of a bankruptcy case.[23] That, however, is unremarkable. "Bankruptcy remote" cannot mean "bankruptcy proof" because federal law does not permit lenders and borrowers to contract around the operation of the Bankruptcy Code. For example, it is well known among bankruptcy lawyers and sophisticated commercial lenders that including so-called "ipso facto" clauses in loan agreements will not prevent a borrower from filing a bankruptcy petition.[24] Likewise, while

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Id. at 97 ; compare In re Trans World Airlines, Inc., 322 F.3d 283 (3d Cir. 2003) (authorizing bankruptcy sale free and clear of employment discrimination claims and voucher plan awarded to flight attendants in settlement of class action).

[21] Case No. 08-13555 (Bankr. S.D.N.Y.).

[22] But see Stephen Lubben, "The Sale of the Century and Its Impact on Asset Securitization: *Lehman Brothers*", *American Bankruptcy Institute Journal* Vol. 27 (December/January 2009) (discussing the implications of the Lehman Brothers sale order to issuers of nonconsolidation opinions) (hereinafter "**Lubben**").

[23] The automatic stay derives from Section 362 of the United States Bankruptcy Code (the "**Bankruptcy Code**"), as follows:

> 11 U.S.C. § 362 Automatic stay
>
> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title … operates as a stay, applicable to all entities, of –
>
> (4) any act to create, perfect, or enforce any lien against property of the estate … .

[24] An "ipso facto" clause is a contract provision stating that insolvency, the filing of a voluntary bankruptcy petition or consent to the filing of an involuntary bankruptcy petition constitute events of default under the contract. Such

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the General Growth court permitted the debtor group to utilize, as cash collateral, the proceeds of accounts receivable and inventory of the SPE Debtors, such use was made subject to provisions designed to provide the lenders with adequate protection of their interests in the SPE Debtors' collateral.[25]

The lending community has been on notice for at least a dozen years that the requirement of an independent director does not mean that a bankruptcy petition can never be filed on behalf of a "bankruptcy-remote" entity.[26] In refusing to dismiss the bankruptcy cases of the SPE Debtors, the *General Growth* court relied on Delaware law regarding the fiduciary duties of independent directors and managers of solvent entities to consider shareholder interests. The court recognized the replacement of directors who had been appointed pursuant to the loan documents. In the court's view, even independent managers appointed at the behest of the secured lenders could not vote against the best interests of shareholders in connection with a contemplated bankruptcy filing by the SPE Debtors. The court's conclusions, however, were grounded on *Gheewalla*, a decision issued by the Delaware Supreme Court two years earlier.[27]

As a matter of law, whether or not the SPE Debtors remain in bankruptcy is irrelevant to the issue of substantive consolidation. Substantive consolidation of a debtor with a non-debtor affiliate (an "informal involuntary") is rare.[28] Nonetheless, it has been ordered – generally where the behavior of the debtor and its non-debtor affiliate was such that the entities were deemed alter egos of one another under applicable state law or had substantially commingled their assets.[29] If the SPE Debtors carried out their businesses in conformity with the separateness

provisions are routinely included in contracts and agreements, including loan agreements, and are not without value; but their value lies in the fact that they may be invoked against non-debtors, such as third party guarantors, and (perhaps) in whatever *in terrorem* effect they may have upon the uninitiated.

[25] See 11 U.S.C. § 361 ("When adequate protection is required under section 362, 262 or 364 of this title of an interest of an entity in property, such adequate protection may be provided by … providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property…").

[26] See Kingston Square Assocs., 214 B.R. 713.

[27] See Gen. Growth Props., 409 B.R. at 64, citing North Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).

[28] See, e.g., In re Fas Mart Convenience Stores, Inc., 320 B.R. 587, 595 (Bankr. E.D. Va. 2004) (substantive consolidation of debtor and non-debtor would require "most unusual and compelling circumstances" not present here, where creditors relied on separateness of entities, and affairs of debtors and non-debtor were not so entangled that consolidation would benefit all creditors); In re Smith Corona Corp., 95-788 (Bankr. D. Del. October 18, 1996) (motion by debtor member and three debtor subsidiaries to substantively consolidate granted but motion by same entities to substantively consolidate three related non-debtor corporations denied); Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.), 141 B.R. 869, 869 (Bankr. E.D. Pa. 1992) (in denying substantive consolidation, the court stated "the involuntary substantive consolidation of the case of a debtor with the non-case of a non-debtor is ... fraught with conceptual problems ... [and] should be granted in only extraordinary situations, notably when the debtor and the non-debtor are alter egos of one another and/or have totally commingled their assets.").

[29] In re Bonham, 229 F.3d 750, 766-67 (9th Cir. 2000); 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 affiliate was alter ego of the debtor and "clear and manifest injustice" had been worked on the creditors).

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requirements included in their charter documents, the risk of substantive consolidation is remote, regardless of whether or not the entities retain the protection of the bankruptcy court.[30]

More troubling, perhaps, is *Lehman Brothers*, the case in which the court authorized a bankruptcy sale of the assets – not the stock – of non-debtor affiliates who were not parties to the sale, without substantively consolidating the entities. Whatever precedential value (if any) the court's order approving the sale may have is lessened by the fact that the order is unpublished, and contains no reasoning to justify a bankruptcy court's exercise of jurisdiction or power to authorize the sale of assets that are not "property of the estate" within the meaning of the Bankruptcy Code.[31]

Nonetheless, the willingness of a bankruptcy court to take such a step is disturbing. Attorneys who deliver non-consolidation opinions may be well-advised to consider whether, and how, to address the possibility that a court presiding over the bankruptcy case of a borrower or originator may authorize a sale, use or lease of assets of an SPE affiliate without first, or contemporaneously, making appropriate findings and effecting a substantive consolidation of the entities.[32]

What will the market make of *General Growth*?

What effect – if any – will *General Growth* have in the marketplace? Arguably none – if the market for securitized loans were essentially efficient. In an efficient market, loan pricing (i.e., interest rates) should embody all publicly available information relevant to the lender's risk of nonpayment and loss or impairment of the value of the collateral, including insolvency, bankruptcy and substantive consolidation risk.[33] Publicly available information certainly includes the state of decisional law at any given time.

If *General Growth* has not changed the law, in an efficient market the pricing and availability of loans to SPEs should be unaffected. It is not clear, however, that the state of the law as enunciated in General Growth was truly understood by the lending community. If that is

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[30] The issue of substantive consolidation may be joined in early 2010, when the debtors are required to file a Chapter 11 plan or lose the exclusive right to do so.

[31] "Property of the estate" is explained in Section 541 of the Bankruptcy Code as follows:

> 11 U.S.C. § 541 Property of the estate
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> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> > (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case. …

[32] See Lubben, *supra* note 22.

[33] The Efficient Market Hypothesis has been described as a cornerstone of modern financial theory. Semi-Strong Form Efficiency is a class of the Efficient Market Hypothesis that suggests that all information that is publicly available is accounted for in the market prices of investments, so that it absent non-public information, it is not possible to obtain above normal returns over long periods of time. See Investopedia®, http://www.investopedia.com/terms/s/semistrongform.asp.

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so, the cost and availability of capital in new financings may be significantly affected. Markets are not always efficient. Commentators worry that the relief granted to the debtors in *General Growth* enhances the risk of substantive consolidation of corporate groups involving SPEs and threatens to destroy the real estate finance industry and asset securitization markets. As one party argued:

> The risk that a borrower that agreed to operate within [a] structure [formed by separateness covenants and limited recourse provisions] in return for non-recourse financing could then disavow the structure without risk of enforcement is a risk that cannot be underwritten. If this perception takes hold in the marketplace, investors will falter [and] the market will stall … In summary, the entire architecture of securitization for CMBS and all other asset classes in the capital markets which constitute such a significant and critical part of the economy and its eventual recovery is built upon the foundation of asset isolation and the consequent non-interruption of cash flow. Without that dual groundwork, the trumpeted engine of recovery will falter at best or collapse at worst.[34]

Implications for Reasoned Opinions

While the authors take the view that the law of substantive consolidation has not materially changed, counsel should be attuned to the implications of recent case law in structuring new transactions and in issuing and reviewing reasoned opinions that deal with substantive consolidation issues. For example, after *General Growth* there can be no doubt that SPE structures are not "bankruptcy proof" simply because transaction documents call for one or more members or directors who are "independent" to the fullest extent permitted by law.

By contrast, *General Growth* does not preclude the possibility that meaningful protection may be obtained by taking advantage of recent changes in Delaware law, which now contemplates that the charter of a Delaware limited liability company may exclude, rather than simply limit, a member's fiduciary duties.[35] Counsel may wish to consider forming a Delaware limited liability company to serve as SPE, stating in the entity's charter that independent members owe fiduciary duties only to *creditors* of the SPE, and not to the SPE itself (or, by extension, to holders of interests in the entity). Such provisions are largely untested, however, and counsel are cautioned that the exclusion of traditional common law duties may create new and unanticipated problems and risks.[36] The use of an SPE organized and located in a foreign jurisdiction where the law permits a member or director to be responsible only to creditors of the

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[34] CMSA Brief at 15, 21-22.

[35] See generally Mark M. Maloney and Michelle L. Carter, "Asserting Breach-of-Fiduciary-Duty Claims in the Context of Delaware LLCs", *American Bankruptcy Institute Journal,* Vol. 36 (September 2009). *Because sound legal advice must necessarily take into account all relevant facts and developments in the law, including Delaware law, the information contained in this article is not intended to constitute legal advice as to any particular matter. Readers should contact Delaware counsel when entering into transactions predicated upon principles of Delaware law.*

[36] See id.

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SPE may also provide a path around the problems which *General Growth* has, at the very least, raised in the minds of many lawyers.

In crafting reasoned opinions dealing with substantive consolidation issues, the authors deem it advisable to deal explicitly with the implications of *General Growth* and *Lehman Brothers*. We particularly encourage counsel to consider disclaiming any opinion as to whether a court would authorize a debtor-in-possession to sell, use or lease assets of a "bankruptcy-remote" debtor or non-debtor affiliate without making findings as to whether or not the debtor-in-possession and affiliate were operated as separate entities and without ruling that the entities' assets and liabilities should be substantively consolidated.

Conclusion

Bankruptcy courts sit as courts of equity. Depending on the facts, from time to time such courts permit debtors to use and sell the assets of their SPE affiliates, even without reaching substantive consolidation and true sale issues. It is the authors' opinion, however, that the bankruptcy court's decisions to date in *General Growth* are consistent with precedent, and have not appreciably increased the bankruptcy or substantive consolidation risk associated with SPE borrowers.

Concerns voiced regarding *General Growth* suggest that market participants may not have appreciated the state of the law as it existed before the cases were filed. Lenders surprised by the court's decisions may have assumed that – by creating compartmentalized structures that segregated classes of assets in single purpose entities – they could be reasonably assured that the entities would remain solvent and the assets out of reach of the originator, other creditors and the courts. *General Growth* and *Lehman Brothers* should dispel any such assumptions. The reaction to these decisions suggests that asset securitization markets may not be efficient.

Prudence dictates that counsel and market participants closely monitor *General Growth* as it continues to unfold in the courts. Counsel would also do well to consider improved ways to structure securitized transactions to ensure that single purpose entities are as "bankruptcy remote" as the developing law allows. Counsel should also ensure that their legal opinions are consistent with the law as it has evolved to date.

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