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Bankruptcy Law

Bankruptcy Remote Entities: What About the Rents?

Lenders will seek to exercise greater control

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After the savings & loan crisis of the early 1990s, and for much of the ensuing 15 years, the commercial mortgage industry experienced a proliferation of securitized mortgage lending, culminating in 2007 with the domestic issuance of nearly $230 billion of commercial mortgage backed securities ("CMBS"). Securitized mortgage loans were typically structured as nonrecourse loans to single purpose, single asset, bankruptcy remote entities ("SPEs"). In addition to being non-recourse, the CMBS mortgage loan structure offered borrowers favorable economic terms and held out to lenders the promise of minimizing the risks associated with borrower bankruptcy.

The CMBS party ended in 2008 with the onset of the global credit crisis. CMBS domestic issuance in 2008 was a little more than $12 billion, just over 5 percent of what it was in 2007. The frozen credit markets, and the nearly complete shutdown of the CMBS lending market, have put billions of dollars of CMBS mortgage loans at risk of maturity default because of the limited availability of take-out financing. One victim of the crisis is General Growth Properties ("GGP"), one of the largest shopping center owners in the country and one of the largest CMBS borrowers. In April of 2009, GGP and a number of its affiliated SPEs filed voluntary petitions under Chapter 11 of the Bankruptcy Code in the Southern District of New York, jointly administered under Docket No. 09-11977. The GGP case is one of the first to test the continuing efficacy of the SPE structure in the context of the new credit market conditions. The GGP court's decisions permitting the use of cash collateral and denying certain lenders' motions to dismiss the bankruptcy cases of their SPE borrowers have triggered alarm bells for CMBS lenders.

This article provides an overview of the CMBS loan structure and the GGP case and examines at least one question left unresolved by the GGP decisions.

A core component of the CMBS loan structure is the requirement that a borrower be an SPE. The reason is two-fold: (1) to isolate the entity and its assets from credit problems of its parent and affiliates; and (2) to limit risks of insolvency and the risk of other creditors pursuing involuntary bankruptcy or other remedies against the SPE. To achieve these goals, lenders impose restrictions that limit SPE borrowers to owning and operating the mortgaged property and prohibit them from incurring liabilities other than the mortgage debt (with exceptions for trade payables incurred in the ordinary course). Pursuant to a series of "separateness" covenants, SPEs agree to maintain separate accounts, to maintain separate financial statements, not to commingle assets with those of other entities, and not to pledge assets for the benefit of any other entity.

Another component of the CMBS loan structure is the naming of independent directors to the board of the SPE or to the board of the entity that manages the SPE. The directorship provisions are intended to protect against a voluntary bankruptcy filing by an SPE by conditioning authorization for such action on the consent of the independent directors. CMBS lenders typically require that the SPE's organizational documents require that the directors consider the interests of the creditors in connection with any bankruptcy or insolvency decision to the extent permitted by law. While directors owe fiduciary duties to the entity and its owners, in some jurisdictions, directors may be permitted, or even required, to consider the interests of creditors when the entity approaches the "zone of insolvency."

Despite a loan structure based on bankruptcy remote entities, including the usual SPE restrictions and separateness covenants, the GGP court considered the interests of the entire GGP corporate group, rather than the interests of each

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subsidiary independently. The GGP court permitted the continuing use of the SPE rents as part of the overall cash management of the group and denied the motions to dismiss the bankruptcy cases of solvent subsidiary SPE borrowers.

The GGP court considered significant that the lenders apparently had not enforced prepetition prohibitions on the commingling of funds and had allowed GGP to use a cash management system into which the rent revenues of the subsidiary SPEs were swept. Although the bookkeeping permitted accurate accounting for each SPE's revenues and expenses, the cash flow from all of the properties was deposited into a collective cash management account. Since the lenders had allowed this arrangement prepetition, the court viewed them as no worse off with the arrangement continuing post-petition. The court reasoned further that the cash flows from the subsidiary SPE properties were needed for the restructuring of the parent entity's debt and for the benefit of the entire group.

One of the questions left open by the GGP decisions is the post-petition impact of termination provisions in an assignment of rents given by an SPE borrower to a mortgage lender. The answer likely depends upon whether the assignment of rents is determined to be collateral (limited to a pledge of the rents) or absolute (conveying title to the rents with a license permitting the borrower's use until default) and the effectiveness in bankruptcy of any provisions limiting the borrower's use of the rents.

An assignment of rents is an instrument enhancing a mortgagee's security by providing resort to the rents from the property to satisfy the mortgage debt. The determination of whether an assignment of rents is collateral or absolute is governed by state law. *Butner v. United States*, 440 U.S. 48 at 55 (1979). In New Jersey, an instrument that, by its language, evidences an unambiguous intent immediately to transfer title to the rents to the mortgagor is considered absolute, regardless of whether it includes conditions. *In re Jason Realty, L.P.,* 59 F.3d 423 (3d Cir. 1995); *In re Joseph F. Carretta*, 220 B.R. 203 at 211 (D.N.J. 1998) ("The 'precise wording' of the assignment determines its effect").

If an assignment of rents is collateral, the rents become property of the bankruptcy estate and may be used by the debtor as cash collateral or to help fund a plan of reorganization. 11 U.S.C. Section 541(a) (1) (commencement of bankruptcy case creates estate including "all legal or equitable interests of the debtor in property"). On the other hand, if an assignment of rents is absolute, the use of the rents will be governed by the provisions in the assignment that limit the debtor's license to collect and use the rents, except to the extent that the effectiveness of those provisions is limited by the Bankruptcy Code. If the license has been terminated by a prepetition default, then the rents do not become property of the estate.*In re Jason Realty*, supra. If there has been no prepetition default, then the rents become property of the estate upon the filing of the petition. 11 U.S.C. Section 541(a) (1). This is so regardless of any clause in the assignment deeming the debtor's bankruptcy filing a termination event. See 11 U.S.C. Section 541(c)(1)(B).

The question arises whether provisions in an assignment of rents can divest the estate of the rents based upon a post-petition event.

For example, a lender might rely on a self-executing provision terminating the debtor's license if there is a bankruptcy filing by a separate entity, such as a parent guarantor, to argue that the rents are no longer property of the estate and no longer available for the debtor's use. The lender could take the position that, because the relevant automatic stay provisions of 11 U.S.C. Section 362 apply only to "acts," a self-executing contract provision terminating the debtor's right to use the rents is not stayed. The debtor might counter that a bankruptcy filing by or against a related entity *concerns* the debtor within the meaning of 11 U.S.C. Section 363(l), which permits the debtor to use property of the bankruptcy estate notwithstanding any provision based on the "insolvency or financial condition of the debtor" or the commencement of a bankruptcy case "concerning the debtor." If 11 U.S.C. Section 363(l) were interpreted this way, the debtor would continue to have use of the rents. In addition, the debtor might argue that 11 U.S.C. Section 362(a) (3) precludes the lender from actually collecting the rents, because to do so arguably would require an "act" to "obtain…property from the estate." The resolution of these issues remains uncertain.

As the credit markets slowly thaw, lenders and borrowers, especially those who utilize the capital markets, will face new commercial mortgage finance challenges. Lenders and their counsel will seek ways to address the issues raised by the GGP decisions and those in other cases involving the SPE structure. A central focus of lenders will be efforts to exercise greater control over the rents, whether through more restrictive cash management arrangements or provisions in assignments of rents. How successful lenders will be in these efforts remains to be seen. ■