

By Neil O'Hara

# Securitization Comes in for a *General Mauling*

*Is General Growth Properties' bankruptcy the story of the downfall of a company that had overreached? Or is it the story of the beginning of the end of securitization? Its Chapter 11 filing put special purpose entities under attack. It may turn out to be a one-off. But structured finance investors should be concerned.*

Corporate bankruptcies are not supposed to be of much concern to investors in secured debt. But General Growth Properties' (GGP) lurch into the restructuring process changed that. When the real estate investment trust, and the largest issuer of commercial mortgage-backed securities (CMBS), filed for bankruptcy in April, it dragged the special purpose entities (SPEs) that own 166 of its malls into Chapter 11 along with it. As the story unfolded, CMBS holders, who had helped finance GGP's sprawling empire, discovered to their horror that a structure intended to insulate them from the bankruptcy of the parent might yet fail to achieve its purpose.



*Bankruptcies shouldn't leave asset-backed investors in harm's way*

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The dismay wasn't limited to GGP's bondholders, either. Investors market-wide interpreted this as an attack on the cornerstone on which structured finance is built. Every structured debt financing — whether for commercial or residential mortgages, auto loans, credit cards or student loans — depends on SPEs to give asset-backed securities (ABS) investors a direct interest in a pool of assets that will continue to service the debt even if the sponsor goes belly-up. If SPEs, which are supposed to be bankruptcy-remote, can be caught up in a parent company reorganization, the whole premise on which securitized debt rests starts to unravel. It's not hard to understand why investors are so alarmed.

The organization documents that govern SPEs typically provide for an independent director, who must approve certain actions in which the interests of investors and the sponsor conflict like a voluntary bankruptcy filing. In the case of GGP, its SPEs have by and large continued to service their debt and throw off surplus cash, just not enough for GGP to stay current on its own obligations. Yet the independent directors of all the SPEs gave

their consent to bankruptcy filings even though the individual malls in GGP's portfolio remain solvent. GGP also replaced the directors of almost all the SPEs shortly before the bankruptcy filing, which has raised suspicions among some CMBS investors that the replacements were straw men for GGP rather than truly independent. Representatives for GGP declined to comment.

"They found a way to pervert the purpose of having independent directors, who are supposed to represent the SPE and not be conflicted by considerations affecting the sponsor," says Ralph Dalosio, a managing director in the New York-based structured finance group at Natixis. He points out that a sponsor's incentive to attack SPEs in a bankruptcy proceeding increases the more the value of the collateral assets in an SPE exceeds its outstanding securitized debt. If a challenge is successful, the surplus collateral can be used to satisfy other creditors and improve the sponsor's position in a reorganization.

Investors may be up in arms, but that doesn't mean GGP did anything wrong. Mark Ellenberg, a real estate workout and insolvency lawyer at New York-based Cadwalader, Wickersham & Taft, points out that the independent director owes a fiduciary duty to the SPE, not the CMBS holders. With substantial mortgage repayments on many of the underlying mall properties coming due — a majority in the next three years — and no prospect of refinancing while the CMBS market remains closed to new issuance, Ellenberg says the independent directors probably felt the filings were justified. "If an independent director thinks there is a bona fide reason for the SPE bankruptcy then he or she has a fiduciary obligation to vote for it," he says.

It's too soon to play Taps for the securitization market, however. In many respects, GGP was unique. Its financial woes were largely self-inflicted: its \$12.6 billion acquisition of Rouse Company in late 2004 created a debt burden at the parent level that GGP struggled to service even before the recession hit. GGP relied on CMBS more than other REITs, too, and its outsized market presence gave it unusual clout in negotiating favorable terms for each transaction.

The market certainly has not reacted to GGP's bankruptcy as if it were the end of the world. Spreads on CMBS have nar-

rowed sharply since the April filing, although Natixis' Dalosio cautions that the Fed's extension of the Term Asset-backed Securities Loan Facility to cover legacy CMBS has disguised the real effect. "Under normal circumstances, GGP would have sent chills through the market and spreads would have backed up," he says. "But spreads continue to tighten and hold as a result of

programs that demonstrate the government is committed to removing the CMBS refinancing risk from the system."

### No panic

The ratings agencies haven't hit the panic button, either. While Fitch Ratings designated all GGP loans in securitizations it had rated as "loans of concern" that "no longer have investment grade characteristics," it did not immediately downgrade the rated securities because

GGP loans represent only 1% to 12.6% of the collateral pools. Fitch did place a negative outlook on 99 classes in 21 GGP-related transactions and expressed particular concern about junior bonds, which bear the brunt of the higher expenses bankruptcy inevitably entails. Nevertheless, the agency noted that the 56 GGP loans in Fitch-rated deals have debt service coverage ratios ranging from 1.12x to 2.97x and "are generally considered to have stable performance."

GGP's attempt to sweep the SPEs into bankruptcy may not succeed in any case. Creditors have the right to challenge a bankruptcy filing that is made in bad faith, and ING Clarion Capital Loan Services, a GGP CMBS servicer, has already submitted a petition to have eight malls that back the loans it services removed from the bankruptcy proceedings. Metropolitan Life Insurance, KBC Bank and other lenders to specific SPEs followed suit; as *American Securitization* went to press, expectations were that the bankruptcy court would rule on all these petitions by the end of June. While the statute does not define bad faith, Ellenberg says restructuring and extending debt maturities normally qualifies as a legitimate attempt at rehabilitation. "The farther out the maturity date is the more that concept gets stretched," he concedes. "I think the court will do a careful case by case analysis of each of these SPE debtors."

If ING Clarion succeeds in its petition, Allen Dickey, an insolvency and restructuring lawyer at Munsch Hardt Kopf & Harr in Dallas, expects other servicers will follow suit. "If the



Like SPEs, open for business, for now

***"[GGP] found a way to pervert the purpose of having independent directors, who are supposed to represent the SPE and not be conflicted by considerations affecting the sponsor,"***  
***Ralph Dalosio, Natixis managing director***

judge kicks those borrowers out of the bankruptcy it will be a big victory for all these securitized lenders and servicers," he says. It won't necessarily spell disaster for securitization if the judge denies the petition, either. The court could accept the SPE bankruptcy filings but still maintain their separate existence through the reorganization.

### Silver lining

Indeed, the orders handed down by the court so far do exactly that, to the immense relief of the Commercial Mortgage Securities Association (CMSA), a trade association dedicated to promoting real estate capital market financing. CMSA noted that the court did not grant the debtor-in-possession (DIP) lenders the second lien on GGP's SPE properties they asked for — the request was withdrawn after a bidding war erupted among lenders competing to provide DIP financing — but did give the SPEs an administrative claim on any cash passed upstream, which entitles them to priority repayment before the reorganized entity emerges from bankruptcy. The rulings respect the intent of SPEs and protect the position of CMBS investors better than the original DIP loan proposal.

Dickey says that although he and other workout attorneys have long thought securitization structures were vulnerable to attack, he isn't convinced the GGP case will set a precedent permitting the debtor to consolidate the SPEs substantively into a single bankruptcy estate. GGP would have to argue that the SPEs were so entangled that lenders dealt with them as if they were an undivided entity. "For example, did the lender to one of

the malls in California look to a mall in Ohio when it extended credit?" he asks. "I haven't seen any facts like that in this case."

So far, GGP has only applied for "procedural consolidation" of the SPEs to permit all the bankruptcy cases to be handled together for administrative convenience, according to John Kim, a real estate lawyer at Sonnenschein Nath & Rosenthal in New York. GGP excluded from the bankruptcy filing certain entities with which it had already agreed to refinance outstanding debt, which at least puts those entities in a different category. "I think GGP is trying to gain leverage to refinance the SPEs' debt," says Kim.

Although the bankruptcy courts have generally upheld separateness covenants and bankruptcy-remote structures in the past, a bankruptcy proceeding that respects the separate existence of the SPEs doesn't let the CMBS holders off the hook altogether. Kim says the servicing obligation switches from a regular servicer to a special servicer, which charges higher fees — typically 25 basis points versus 10 bp or less for regular servicing. The SPEs will also incur a workout or liquidation fee, usually 1% of the outstanding loan balance, as well as legal expenses related to the bankruptcy. Fitch Ratings estimates that legal costs on resolved loans averaged about 1% of principal in 2008.

In addition, although GGP has agreed to pay interest on outstanding CMBS at the contracted rates, it has not committed to make principal payments as due. Provided that the servicer has complete confidence it will eventually receive the money, it has an obligation to advance principal payments to



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CMBS investors — and will charge interest on those amounts, typically at the prime rate. The incremental expenses related to bankruptcy give investors a strong incentive to challenge the SPE filings. The extra costs come off the top and reduce the cash flow otherwise available to investors, so the junior CMBS tranches take the hit first.

It's a safe bet that investors will re-examine the qualifications for independent directors and the circumstances under which they can be replaced in future securitization deals. Linda Striefsky, a real estate lawyer at Thompson Hine in Cleveland, says CMBS transactions typically prevent the sponsor from amending SPE organizational documents, switching managers or changing the independent director without giving lenders notice. "I'm a little surprised the GGP documents didn't require notice," she says. "But either these deals did not have that or GGP changed the independent directors without the lenders knowing it was going to happen." Discovery relating to the petitions to remove certain malls from the bankruptcy proceeding is likely to explore the circumstances surrounding the change of SPE directors, which may affect whether the SPE filings were made in "bad faith."

Striefsky notes that however investors try to tighten up SPE governance they can't go too far without jeopardizing their own position. "There is a line you don't want to cross as a lender," she says. "You don't want to have too much control over the borrower or you will be deemed an equity owner."

### Unique strengths

Greg Cross, a partner in the Baltimore office of law firm Venable, which is representing four special servicers in the GGP bankruptcy, agrees that future deals will tighten up the provisions governing the replacement of independent directors. One possibility: independent directors could be selected jointly by CMBS investors and the SPE sponsor rather than by the sponsor alone. "Just as there will be increased scrutiny on CMBS underwriting standards when the market reopens, there will be increased scrutiny of legal structures," he says.

It's possible that CMBS deals may withstand debtors' efforts to crack open SPEs in a bankruptcy case better than other securitized transactions. "Each piece of real estate is deemed to be unique," says Cross. "That strengthens the argument against substantive consolidation in a commercial real estate securitization." As Fitch Ratings notes, however, consumer asset-backed deals that involve diversified pools of credit card receivables or residential mortgages are more robust because they are

less susceptible to the bankruptcy of a single borrower in the first place.

Investors may take another look at the non-recourse carve-out provisions in CMBS deals, too. The sponsor doesn't guarantee CMBS in the normal course; that would defeat the purpose of keeping the debt off its balance sheet. Lenders are supposed to look to the assets alone for repayment and in the event of sponsor bankruptcy, they take the collateral but make no cash claim against the borrower unless it has misbehaved in some way: for example, by diverting rent.

Munsch Hardt's Dickey says CMBS deals typically include a springing guarantee that takes effect only when the SPE files for bankruptcy. In smaller deals, the guarantors are individuals who assume personal liability if the guarantee is triggered. Larger transactions often substitute a corporate entity in lieu of a warm body, which renders the guarantee less effective as a deterrent to SPE bankruptcy, especially when, as in this case, the sole guarantor was a corporate entity already headed for Chapter 11. "If the GGP

loans had limited guarantees signed by the president, chief executive or chairman of GGP I don't think you would have seen these SPEs thrown into bankruptcy," says Dickey.

GGP's financings were so large that a personal guarantee would have had little credibility, however. The aggregate principal outstanding on its securitized debt when it filed for bankruptcy was about \$9.5 billion. Venable's Cross points out that corporate guarantees and personal guarantees that swamp the guarantors' means feature in all commercial real estate transactions, not just those financed by CMBS. "It's not a securitization issue," he says. "It's true in every deal."

Personal guarantees still have a deterrent effect that may prevent other CMBS issuers from following GGP's lead. Cadwalader's Ellenberg attributes GGP's ability to insist on a corporate guarantor to its powerful position as the largest issuer of CMBS. In his view, the GGP bankruptcy has made waves due to its size and scope rather than because it thrusts a stake in the heart of securitization. That doesn't mean CMBS holders shouldn't be concerned, however. "Bad things can happen to secured creditors in bankruptcy," says Ellenberg. "But nothing that has happened yet is fundamentally inconsistent with the basic principles of structured finance." ▼

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Could the fate of securitization be decided here?

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