

message from partner in charge

In this issue, we focus on a wide variety of topics relating to business in this new economy:

First, Brad Boericke, Mike Reed, David Stratton and Nina Varughese note that a recent bankruptcy court decision holds that so-called “independent manager” provisions are ineffective in precluding bankruptcy filings by supposedly ‘bankruptcy-remote’ entities.

Our latest Peppercast features Roger A. Lane and Courtney Worcester, members of our Commercial Litigation Practice Group, as they discuss an interesting issue in these trying economic times: how to prevent litigation before entering a major transaction.

Leon Barson reports on a Ninth Circuit case that holds that managers of a bankrupt company can be sued by employees for unpaid wages under the Federal Labor Standards Act.

And Carol Degener, Greg Nowak and Jeremy Frey note an ongoing comment period for an SEC proposal aimed to curb so-called ‘pay-to-play’ practices by companies having dealings with public pension funds.

David B. Stratton
302.777.6566 / strattond@pepperlaw.com

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Court: Independent Manager Provisions Ineffective to Preclude Bankruptcy Filing by Supposedly ‘Bankruptcy-Remote’ Entities

Over many years it has become common practice for parties in securitizations and other structured financings to employ organizational structures designed to be “bankruptcy remote.” A common feature of these structures is a requirement in the organizational documents of the special (or single) purpose entity (or vehicle) (SPE) intended to be bankruptcy remote that the SPE have one or more “independent managers” whose consent is required for the SPE to file a voluntary bankruptcy petition. The objective of these independent manager requirements is to reduce the possibility that creditors or investors who have extended credit to the SPE will be caught up in a bankruptcy, which would preclude the enforcement of their remedies against the SPE or its assets, and to insulate the SPE from the risk of having its assets “substantively consolidated” with those of an insolvent affiliate. The efficacy of such independent manager requirements has been called into question by a recent decision of the U.S. Bankruptcy Court for the Southern District of New York in the Chapter 11 bankruptcy case of *General Growth Properties, Inc.*

General Growth Properties Business Structure and Events Leading to Bankruptcy

GGP is a parent company for a publicly traded real estate investment trust with approximately 750 subsidiaries (collectively, the GGP Group). The GGP Group’s portfolio primarily consists of more than 200 shopping centers in 44 states across the country.

The capital needs of the GGP Group were satisfied through mortgage loans obtained from banks, insurance companies and, increasingly, the commercial mortgage backed securi-

ties (CMBS) market. Each mortgage was the obligation of a separate GGP Group subsidiary, which was organized as an SPE (the SPE Debtors), an entity “one purpose of which is to isolate the financial assets from the potential bankruptcy estate of the original entity, the borrower or the originator.”¹

The typical mortgage loan for an SPE Debtor had a three-to seven-year term with a low amortization and a large balloon payment at maturity. There was an anticipated repayment date, at which point the loan became “hyper-amortized,” even if the maturity date was as far as 30 years in the future. Failure to refinance or pay the debt by the repayment date would result in a steep interest rate increase, a requirement of approval of expenditures by the lender, or a requirement that cash be kept at the project level with any excess applied to the principal of the mortgage. GGP Group’s practice was to refinance the debt before the repayment date to avoid hyper-amortization.

By the end of 2008, GGP Group’s ability to refinance its debt as it became due was adversely affected by the credit crisis and the related volatility of the CMBS market. Unable to obtain refinancing, renegotiate terms, or pay off the loans, GGP Group filed voluntary petitions under Chapter 11 of the Bankruptcy Code. Various SPE Debtors were included in the filings even though their loans were not in default or near maturity. While GGP Group had remained stable and maintained generally positive cash flow, the company believed its capital structure had become unmanageable due to the collapse of the credit markets.

The operating agreements of the SPE Debtors provided for “independent managers” whose consent was required for the filing of a bankruptcy petition. Immediately prior to the bankruptcy filings, GGP Group replaced the individuals who had been serving as the independent managers with new managers in order to facilitate the bankruptcy filings.

However, several lenders to the SPE Debtors filed motions with the court to dismiss their borrowers’ cases as “bad faith” filings because, they argued, the SPE Debtors (i) filed for bankruptcy prematurely, (ii) were not in financial distress at the time of the filings, (iii) would be unable to confirm a plan of reorganization, and (iv) showed bad faith in failing to negotiate with lenders and replacing independent managers prior to filing.

On August 11, 2009, the Bankruptcy Court for the Southern District of New York denied motions by certain lenders to dismiss the Chapter 11 cases of certain SPE subsidiaries of General Growth Properties, Inc. (GGP) as bad-faith filings.

The Court’s Decision and Analysis in Denying the Motions to Dismiss

Judge Allan Gropper denied the lenders’ motions to dismiss the bankruptcy filings of the GGP Group subsidiaries as bad-faith filings. The court noted that in the Second Circuit, grounds for dismissal exist if it is clear on the filing date that “there was no reasonable likelihood that the debtor intended to reorganize and no reasonable probability that it would eventually emerge from bankruptcy proceedings.”² The Second Circuit’s bad-faith filing standard includes a two-pronged test: “a bankruptcy petition will be dismissed if *both* the objective futility of the reorganization process *and* the subjective bad faith filing the petition are found.”³

The Lenders Failed to Make the Showing of the Objective Futility of the Reorganization Process.

- ***The Bankruptcy Filings Were Not Premature.***

The court determined that the SPE Debtors’ Chapter 11 filings were not premature even though those specific borrowers were not yet in default or facing loan maturity. The court reasoned that the disarray in the real estate financing market created sufficient uncertainty as to whether these borrowers would be able to refinance debt maturing years in the future. Despite the lenders’ arguments to the contrary, the SPE Debtors’ debts were neither speculative or contingent, but, rather, set to mature at a fixed date. The court further reasoned that there is no requirement that an entity postpone filing until it is actually insolvent. Because the various SPE Debtors were all in varying degrees of financial distress by April 2009, the SPE Debtors’ filings were not premature. GGP Group showed that there was an extensive financial evaluation of which entities would be placed into bankruptcy with consideration given to (i) an entity’s defaults or cross-defaults with other loans, (ii) the maturity date of its loans, and (iii) other restructuring factors including a loan-to-value ratio above 70 percent. In fact, the court stated that the Bankruptcy Code gives a debtor an incentive to file for bankruptcy earlier rather than later, in order to preserve the value of the estate.

- ***The Collective Interest of GGP and the GGP Group.***

Furthermore, the court held that “financial distress” for each GGP Group entity did not have to be determined separately. GGP Group functions as an integrated operation and the nature of its corporate structure creates an “identity of interest” that justifies the protection of the subsidiaries as well as the parent corporation.⁴ Since the filing of the parent company, GGP, was found to be proper, the filings by the subsidiaries of the GGP Group, including the SPE Debtors, were also justified and necessary to the reorganization of GGP.

- ***The Duty of the Independent Managers.***

The court held that, absent insolvency, the independent managers had a duty to the entity and its owners under Delaware state law. Contrary to what the lenders argued, the duty of the independent managers under the organizational documents was not necessarily to prevent a bankruptcy filing. Therefore, the independent managers’ decision to authorize the bankruptcy filings was not premature.

- ***Inability to Confirm a Plan Is Not Grounds for Dismissal.***

The court rejected one lender’s argument that the SPE Debtors’ alleged inability to confirm a plan over its objection is grounds for dismissal. In making this argument, the court found this lenders’ argument to be premature, and perhaps ironically suggestive of the lender’s bad faith. The court stated that there is no requirement under the Bankruptcy Code that a debtor must prove that a plan is confirmable in order to file a petition.

The Lenders Failed to Make a Showing of a Subjective Bad Faith Filing

The court rejected the lenders’ argument that SPE Debtors acted in bad faith by (i) failing to negotiate with the lenders prior to filing and (ii) replacing the original independent managers with new ones who would approve and facilitate the filings.

- ***Negotiation with the Lenders Was Not a Condition Precedent to Filing for Bankruptcy.***

The court held that a business borrower is not required to negotiate with its lenders before filing a Chapter 11 petition. The court noted, moreover, that the record was replete with evidence of the lenders’ unwillingness to negotiate refinancing or modification of the terms with the Debtors; in fact, as its practice, one CMBS lender would not even talk with the Debtors until the CMBS debt was in or nearing default. Therefore, the SPE Debtors’ bankruptcy filings were not in bad faith.

- ***Replacement of the Independent Managers Did Not Constitute Bad Faith.***

Perhaps the most noteworthy aspect of the court’s decision was the holding regarding the replacement of the SPE Debtors’ independent managers in order to facilitate the bankruptcy filings. The court found that this action did not constitute subjective bad faith. The court found that the SPE Debtors’ organizational documents did not prohibit this action or interfere with the rights of a shareholder to appoint an independent manager. The court rejected the lenders’ argument that the filings materially impaired their



Peppercast: Prevent Litigation Before Entering A Major Transaction

Transactions that are affected in down markets tend to attract litigation – either by stockholders or competing bidders at the outset, or when one party seeks to get out, or after market conditions have improved and second-guessing sets in.

In this podcast, Pepper attorneys Roger A. Lane and Courtney Worcester, members of the firm’s Commercial Litigation Practice Group and residents of Pepper’s Boston office, discuss an interesting issue in these trying economic times: how to prevent litigation before entering a major transaction.

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rights as misguided because “the principal purpose of bankruptcy law is to protect the creditors’ rights ... [T]he [lenders] have been inconvenienced by the Chapter 11 filings ... However, inconvenience to a secured creditor is not a reason to dismiss a Chapter 11 case. The salient point ... is that the fundamental protections that the [lenders] negotiated and that the SPE structure represents are still in place and will remain in place during the Chapter 11 cases.”

- ***Inconvenience to a Secured Creditor Is Not a Reason to Dismiss a Chapter 11 Case.***

In perhaps an equally controversial aspect of the opinion, the court held that the limitations on the lenders’ rights resulting from the bankruptcy filings, while causing “inconvenience,” did not impair the “fundamental protections” they had negotiated. However, the court emphasized that “[n]othing 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.”

Conclusion

This decision could have enormous implications to the securitization markets. While there can be little doubt that this is not the last word on the subject of bankruptcy filings by SPEs, absent reversal or modification on appeal, practitioners should closely examine the bankruptcy court’s opinion in *General Growth Properties* for its implications in transactions involving special purpose entities designed

to be “bankruptcy remote.” Particular attention should be given to any changes that might be made in the organizational documentation of the special purpose entity to avoid the result that occurred in *General Growth Properties*.

Authors:

J. Bradley Boericke
215.981.4790 / boerickej@pepperlaw.com

Michael H. Reed
215.981.4416 / reedm@pepperlaw.com

David B. Stratton
302.777.6566 / strattond@pepperlaw.com

Nina M. Varughese
215.981.4407 / varughesen@pepperlaw.com

Endnotes

- 1 David B. Stratton, *Special-Purpose Entities and Authority to File Bankruptcy*, 23-2 Am. Bankr. Inst. J. 36 (March 2004).
- 2 *C-TC 9th Ave. P’ship v. Norton Co. (In re C-TC 9th Ave. P’ship)*, 113 F.3d 1304, 1309-10 (2nd Cir. 1997).
- 3 *In re Kingston Square Assocs.*, 214 B.R. 713, 725 (Bankr. S.D.N.Y. 1997).
- 4 *Heisley v. U.I.P. Engineered Prods. Corp. (In re U.I.P. Engineered Prods. Corp.)*, 831 F.2d 54 (4th Cir. 1987); citing *A.H. Robins v. Piccinin*, 788 F.2d 994 (4th Cir. 1986).

Managers of Bankrupt Company Can be Sued for Unpaid Wages Under FLSA

Late last month, in *Boucher v. Shaw* (<http://www.ca9.uscourts.gov/datastore/opinions/2009/07/27/05-15454.pdf>), the Ninth Circuit held that employee/managers could be sued under the Fair Labor Standards Act (FLSA) for unpaid wages, despite the fact that the corporation had filed for bankruptcy protection.

In *Boucher*, former employees and their union filed a class action against three employee/managers after The Castaways Hotel, Casino and Bowling Center sought bankruptcy protection and subsequently discharged its employees. The employees sought unpaid wages under both Nevada law and the FLSA. The district court determined that

the managers were not “employers” under Nevada’s wage payment law, that the union lacked standing to sue under Nevada law, and that the employees could not maintain a cause of action under the FLSA.

On appeal, the Ninth Circuit observed that under the FLSA, the term “employer” is to be construed broadly to include individuals who have “control over the nature and structure of the employment relationship,” or “economic control.” The Circuit Court concluded that the three managers, two of whom also were co-owners of the casino, fit within the definition of “employer.” (The court also found that because the three managers were not parties to

the bankruptcy proceeding, they were not entitled to any bankruptcy protections.) Accordingly, the plaintiffs had adequately stated a claim for relief under the FLSA as against the employee/managers for unpaid wages.

The appellate court considered scenarios in which the wage claims may have impacted property of the bankruptcy estate such that the plaintiff employees may have been forced to proceed in the bankruptcy forum - for example, if there was a requirement that the debtor indemnify the managers or if they sought payment of the obligation under a D&O policy - but neither side raised that argument.

In addition to existing concerns over potential liability under state wage payment and collection laws, there is now the possibility that unpaid former employees will look to hold directors, officers and other senior-level employees liable as employers for unpaid wages under the FLSA. The decision serves as a fairly important reminder that such individuals have genuine exposure for employee wage obligations when a corporate employer seeks bankruptcy protection.

Author:

*Leon R. Barson
215.981.4424 / barsonl@pepperlaw.com*

SEC Approves Proposal Aimed to Curb ‘Pay to Play’ Practices

At the July 22 SEC Open Meeting, the commissioners voted unanimously to propose measures aimed at restraining investment advisers from making political contributions to state or local government officials in exchange for contracts to manage public pension plans and similar government investment accounts. Public pension funds hold \$2.2 trillion in assets representing one third of all U.S. pension assets.

In this crackdown on so-called “pay to play” practices, the proposal would restrict investment advisers from making political contributions to elected officials who are in a position to hire investment advisers, soliciting contributions for such officials or paying a placement agent to solicit a government client on behalf of the investment adviser. If the adviser makes a political contribution to an elected official involved in awarding contracts, the proposed rules would bar an investment adviser from managing public pension programs for compensation for a period of two years; it is unclear whether contributions made before the proposal date would be disqualifying. Executives or employees would be permitted to make contributions up to \$250 per election per candidate *if* the contributor is entitled to vote for the candidate in question. The rules would apply to the adviser itself, as well as to certain executives and employees of the adviser, and the restrictions would apply to contributions made to incumbents as well as candidates. In addition, the restrictions would apply to advisers of pooled investment vehicles, such as mutual funds, that are used as investment vehicles in certain government plans such as 529 plans.

Pepper Point: *Hedge funds, funds of funds and private equity funds are all potentially affected, especially where such funds are tapped as part of a governmental plan asset allocation. It is unclear (though to be expected) that the prohibition will apply to employees of general partner entities (who control the investment adviser’s appointment under state law), as well as to employees of the investment manager to the pooled investment vehicle.*

Investment advisers also would be prohibited from asking “other people” or political action committees to make a donation to an elected official or candidate who is in a position to hire the adviser or to make a payment to a political party of the state or locality where the adviser is seeking to provide advisory services to the government. Also, an adviser and certain of its executives and employees are prohibited from violating the rules indirectly by funding contributions through third parties such as spouses, companies affiliated with the adviser or attorneys.

Pepper Point: *The proposal is unclear as to who these “other people” may be, but it is anticipated that the proposal will incorporate the traditional “direct and indirect concepts” contained in the federal securities laws, in addition to the third party rule.*

Additionally, the rules, while not banning a state or local government from hiring a third party to assist in the selection of investment advisers, would prohibit investment advisers from paying placement agents to solicit government officials on the advisers’ behalf.

Pepper Point: *In a marked departure from Advisers Act Rule 206(4)-3, not even disclosure and consent apparently would allow for the use of paid solicitors.*

The SEC action comes after an avalanche of other remedial efforts by various states in recent months.

CalPers, the nation's largest pension fund, adopted a new policy, effective May 11, 2009 and applicable to new agreements with managers signed after that date and to existing contracts for investment vehicles in which CalPers is the majority investor. This new policy requires disclosure and registration of placement agents used by CalPers external investment managers.

Earlier this year, New York attorney general Andrew Cuomo created a code of conduct for investment firms doing business with public pension funds. The code, which has been adopted by The Carlyle Group among others, bans investment firms from using placement agents, lobbyists or other third parties to influence the investment decision-making process at public pension funds.

In an attempt to curb pay-to-play practices, the code also prohibits an investment firm, its principals, agents, employees and their immediate family members from making campaign contributions of more than \$300 to officials of public pension funds that the investment firm is soliciting for business or which have an investment in a fund sponsored by the investment firm. The code also seeks to increase transparency by requiring disclosure of conflicts of interest and information relating to campaign contributions, investment fund personnel and payments to third parties.

The code was created in the wake of Cuomo's ongoing probe of the state pension fund, which has resulted in indictments of Hank Morris and David Loglisci; charges against Raymond Harding, the former chairman of the state Liberal Party; the guilty plea of hedge-fund manager Barrett Wissman; and charges against Saul Meyer, a partner in Aldus Equity.

Pepper Point: *The proposed rules implicate First Amendment issues. Regardless of whether the proposed rules are ultimately promulgated, advisers as a matter of "best practices" should review and consider making changes to their internal compliance practices consistent with the proposed rules' provisions. As always, all advisers*

having any dealings with public officials affecting their business should consult with qualified counsel.

There is a 60-day comment period, expiring on October 6, 2009, for the pay-to-play proposal. Pepper Hamilton LLP will submit comments, as it has in the past on other SEC regulatory proposals (*see e.g.* Comments on the SEC's "Super Accredited Investor" Proposal, dated 3/9/07 - <http://www.sec.gov/comments/s7-25-06/s72506-572.pdf>) If you have any thoughts you would like us to consider for inclusion in our comments, please e-mail them to Gregory J. Nowak.

Authors:

Carol M. Degener
212.808.2705 / degenerc@pepperlaw.com

Gregory J. Nowak
215.981.4893 / nowakg@pepperlaw.com

Jeremy D. Frey
215.981.4445 / 609.452.0808 / frej@pepperlaw.com

Pepper Hamilton LLP

Attorneys at Law

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