

Canadian Structured Finance Newsletter

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A CANADIAN PERSPECTIVE ON THE GENERAL GROWTH PROPERTIES CASE

General Growth Properties, Inc. (GGP) has been in the news this week after the announcement that Toronto-based Brookfield Asset Management Inc. intends to acquire a stake in the bankrupt U.S. property manager. GGP, which filed for creditor protection in April 2009, was the second biggest shopping mall owner in the United States and its insolvency ranks as one of the largest commercial real estate bankruptcies of all times. Structured finance transactions are carefully designed so that bankruptcies, such as that of GGP, will not affect asset-backed securities (ABS). However, the unfolding story of GGP illustrates once more that previous consensus understandings as to potential legal outcomes may not rule the day when a matter comes before a bankruptcy court.

In a typical securitization structure, an originator of assets (the Seller) transfers a pool of assets to a special-purpose entity (SPE) that issues securities backed by the cash flows generated by the assets. The SPE is carefully designed to have a separate identity from the Seller. If structured properly, the SPE will be bankruptcy remote from the Seller, meaning that the bankruptcy of the Seller will have no impact on the SPE or the ABS that it has issued. Bankruptcy remoteness allows a rating agency to rate the ABS on the basis of the credit characteristics of the underlying assets without having to worry about the possibility that the Seller will go bankrupt.

When GGP made its voluntary bankruptcy filing, 166 SPEs that had been created to finance GGP properties filed for bankruptcy at the same time. The inclusion of the SPEs allowed cash from these entities to be channeled upward to support GGP. The SPEs had voluntarily become parties to a proceeding that they had been carefully crafted to avoid. The filing caused great concern in the securitization community as the bankruptcy remoteness of SPEs is an absolute necessity in a securitization transaction.

Certain creditors of 20 of the SPEs brought a motion to dismiss their bankruptcy filings. They argued that the SPEs were solvent, had positive cash flow and were in no danger of being unable to meet their liabilities as they came due. The fact that independent directors of each of the SPEs had been replaced shortly before the filing was also an issue. Independent directors are a common feature of SPEs and they are intended to lessen the likelihood that the SPE will make a voluntary assignment into bankruptcy. The replacement of the independent directors with new directors more favourable to a bankruptcy filing was pointed to as an indication of bad faith.

In dismissing the motion and allowing the SPEs to file for bankruptcy protection along with GGP, the court held that the depressed state of the ABS market and the difficulty the SPEs would have refinancing their debt were indicative of financial stress being experienced by the SPEs. Furthermore, the court noted that the U.S. Bankruptcy Code does not require that a debtor be insolvent in order to make a voluntary filing. As for the replacement of the independent directors, while finding that the action was surreptitious, the court held that it was not indicative of bad faith as all the formalities under the transaction documentation for the dismissal and appointment of independent directors had been properly followed.

As the GGP bankruptcy proceeding has evolved, the outcome for creditors of the SPEs has not been as dire as initially feared. The court went to some lengths to protect the creditors of the SPEs by granting them a first-priority security interest in the GGP-level account to which SPE cash flow is being diverted. In addition, the debts of many of the SPEs, which could have potentially faced default upon maturity, have been reworked to the benefit of creditors. However, with this decision, the court has cast doubts on the bankruptcy remoteness of numerous U.S. securitization structures by allowing the SPEs to make a voluntary bankruptcy filing in these circumstances. The full consequences of this decision are not yet clear, but it is likely that the role of independent directors and the relationship between SPEs and Sellers in U.S. securitization transactions will have to be reconsidered.

This decision does not directly affect Canadian securitizations; however, Canadian bankruptcy courts often review the practice of their U.S. counterparts when considering issues similar to those that have arisen in the United States. It should be more difficult for an SPE to make a voluntary bankruptcy filing in Canada as both of Canada's major insolvency regimes, the *Bankruptcy and Insolvency Act* and the *Companies Creditors' Arrangement Act*, require that insolvency be demonstrated before a debtor can proceed with a filing. However, DBRS will be watching Canadian developments closely for any sign that the GGP precedent may be followed.

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