

Commercial Mortgage Insight

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Bankruptcy-Remote Loan Pools Hold Great Benefits In CRE Deals

By opting to legally secure commercial real estate loans, single-purpose entities ultimately help both lenders and borrowers.

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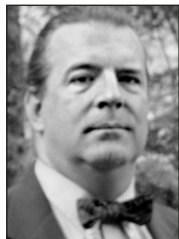
For financial institutions that make loans secured by commercial real estate, the worst possible outcome is that a borrower should default on a loan and file for bankruptcy protection. This causes the collateral to be consolidated with the borrower's other assets for resolution purposes, thus delaying or impairing the lender's ability to collect on the outstanding loan.

To lessen this threat, many lenders are insisting that such commercial property be legally separated from the borrower's other assets. The goal is to create a single purpose entity (SPE) that is bankruptcy-proof, or what current jargon defines as "bankruptcy-remote." This means that the entity cannot easily be placed into bankruptcy by virtue of consolidation with the bankruptcy of its parent company or legal owner.

In recent years, the use of SPEs as a proven and reliable financing tool for securitized lending, structured finance and off-balance-sheet financing of

high-quality assets has continued to grow in popularity.

One of the emerging economic factors pressing lenders to make greater use of SPEs has been the growth of the commercial mortgage-backed securities (CMBS) marketplace. Just as lenders bundle residential loans into large pools that are then sold to private investors, in a similar way, the owners of commercial mortgage loans transfer portfolios of such



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loans to trusts, which then issue securities secured by the loans. These securities are then sold in the CMBS market.

Monitoring

Independent rating agencies, such as Moody's Investors Service, Standard & Poor's and Fitch Ratings, rate such securities by performing a credit analysis of the underlying commercial mortgage loans that make up the pool. The key concern of these rating agencies is the continued economic performance of the real estate itself, since that is critical to ensuring the investor's return. This concern has made SPEs particularly attractive as a way to protect the earnings of securitized commercial real estate and, in that way, to gain a higher rating for the securities.

There are clear guidelines that were established and generally accepted by

the rating agencies as to what an SPE must do to maintain bankruptcy-remote status. Failure to follow these criteria can jeopardize the underlying purpose of the SPE, setting the stage for a bankruptcy court to disallow the SPE and consolidate its assets into those of a bankrupt parent company or owner.

One of the key criteria is that at least one director or manager of the SPE be "independent," with no current or prior relationship with the lender or the borrower. Typically, unanimous consent of the directors or managers is required for the entity to file for bankruptcy protection. So, the single vote of the independent director can prevent such a filing.

In addition to requiring that an SPE maintain an independent director, lenders and credit rating agencies impose further restrictions on the SPE to prevent the borrower from commingling income or transferring income from the mortgaged asset to another underperforming asset.

Such requirements commonly include:

- Prohibition against engaging in any business not related to the property;
- Prohibition against liquidation, consolidation or merger without the unanimous consent of the directors, members or partners of the SPE;
- Prohibition against incurring any debt, except for ordinary trade debt;

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- Maintenance of separate books, records and accounts;
- Use of the SPE's own name in conducting business, with separate stationery, invoices and checks;
- Prohibition against commingling of assets with affiliates or transacting business with them, except at arm's length;
- Prohibition against guaranteeing the debt of an affiliate; and
- A "lockbox" arrangement to monitor cash disbursements.

Independent director

Selecting the wrong independent director or manager can put the SPE in jeopardy and have disastrous consequences for the lender. Independent directors must be truly independent. They are required to act in their own fiduciary capacity on behalf of all equity investors, shareholders, members and, in the case of impending bankruptcy, all creditors. This effectively eliminates from consideration anyone who has previously been a direct or indirect owner of the SPE or an employee, officer, manager, family member, supplier or contractor, including anyone affiliated with or connected to a lender or creditor of the SPE.

The independent director must also be someone who is regularly available for both signing of documents for loan closings as well as continuing corporate governance functions.

To ensure that the independent director is truly independent, many SPEs acquire independent directors by direct contracts with service organizations like the National Registered Agents Inc. Typically, such organizations employ qualified, professional directors who have a thorough understanding of the law regarding single purpose entities and, more importantly, have no interest in the SPE other than the service they are providing.

Since the independent director or member must be truly independent - acting in good faith on behalf of all interested parties - it would be wrong to simply assume that the independent director or member will, in every instance, promote only the interests of the lender and vote against any attempt by the SPE to file for voluntary

bankruptcy protection.

There is an established case law to demonstrate that choosing an independent director or member based upon such an assumption may result in

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dramatically negative consequences for the lender. In one case - re Kingston Square Associates et al, 214 BR 713 (1997) - the court held that as an entity approaches insolvency, directors owe a fiduciary responsibility to all creditors of the company.

In another case, re Cumberland Farms Inc., 249 BR 341 (2000), the court held that directors "cannot be permitted to serve two masters whose interests are antagonistic."

Such court decisions underscore the importance of having an experienced independent director who can protect the SPE and its assets, without giving the appearance of acting as an agent for the lender. If the bankruptcy court deems an independent director to be an agent of the lender, the court can choose to consolidate the assets of the SPE with those of the parent company in a bankruptcy, thus defeating the underlying purpose of the SPE.

LLCs

An increasingly popular trend is to establish new SPEs as limited liability companies (LLCs). What makes the LLC attractive is its flexibility. Such entities combine many of the advantageous features of the corporation

and the limited partnership.

For example, unlike a limited partnership, where participation in the management of the partnership by a limited partner brings unlimited liability with it, a member of an LLC is, in principle, free to participate in the management of the LLC. Similarly, in a corporation, the shareholder's role is restricted to voting for the board of directors and to other limited matters. In an LLC, a member can help manage the entity.

A particularly attractive entity choice for the purposes of an SPE is the single-member LLC. Having just a single member cuts management costs and vastly simplifies the fiduciary responsibilities of the independent member. It also gives the lender greater assurance that its interests will be protected.

Because LLCs are still relatively new and are treated differently by the courts in different states, it is important to establish an LLC, especially a single-member LLC, in a state that treats LLCs as corporations rather than as partnerships, and recognizes the validity of a single-member LLC. For this reason, Delaware has become a favorite location for SPEs.

Delaware Code Title 6, §18-101(7) specifically states that: A limited liability company agreement of a limited liability company having only one member shall not be unenforceable by reason of there being only one person who is a party to the limited liability company agreement.

The advantage of having the LLC recognized as a corporation is that, unlike a partnership, a corporation will not dissolve upon the death, departure or bankruptcy of its last member. To protect the interests of the lender, it is critical that the SPE outlast the duration of the loan.

Mezzanine financing

Lenders are not the only ones favoring SPEs. Borrowers see them as tools to enable them to raise more money on



their commercial property, often through mezzanine financing and at better rates than the borrower might receive were the assets commingled with the borrower's other assets.

The typical mezzanine borrower has a piece of commercial property that is already mortgaged but is producing more than enough income to meet the requirements of the senior loan and to finance additional borrowing. To make the loan attractive, the borrower establishes an SPE to isolate that property from other property in the company's portfolio that might not be performing as well.

The newly formed, bankruptcy-remote SPE, which becomes owner of the property, takes the loan and distributes the proceeds to the principal entity. With the property now owned by the SPE, the lender has assurances

that the income stream will not be diverted to the borrower's other operations and will be used to service the loans.

SPEs are enormously advantageous. By providing lenders with an extra layer of protection, they enable lenders to make loans to commercial borrowers - often at a more attractive rate of interest than might be otherwise possible if the loan were secured by collateral that was commingled with other assets.

For guidance in drafting the documents for an SPE, there are sample contracts available that have been thoroughly vetted. However, it is still critical to double check that the SPE will not run afoul of the bankruptcy laws in the state in which it is established, especially if the SPE is an LLC or single-member LLC.

Since different states treat LLCs

differently, and since some states are hostile to single-member LLCs, prudence would dictate that the choice of forum in which to form the SPE be thoroughly researched before proceeding.

As the goal of the independent director is to prevent the SPE from becoming insolvent and to insulate it from the consequences of anyone else's insolvency, it makes sense to appoint an independent director who is knowledgeable and experienced, and who fully understands the fiduciary powers and responsibilities of this role.

Choosing the right independent director or member is essential. And for lenders seeking assurances, the right choice may mean the difference between having a valid SPE and risking consolidation of the secured asset in a bankruptcy proceeding. ●