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## **Non-Recourse Carve-Outs, “Bad-Boy” Guaranties, and Personal Liability After Cherryland**

Strategies to Resolve Lender and Guarantor Disputes in and Outside of Bankruptcy

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THURSDAY, JANUARY 30, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

Daniel K. Wright, II, Member, Tucker Ellis, Cleveland

Thomas W. Coffey, Senior Counsel, Tucker Ellis, Cleveland

James H. Schwarz, Partner, Benesch Friedlander Coplan & Arnoff, Indianapolis

Paul S. Magy, Member, Clark Hill, Birmingham, Mich.

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**NON-RECOURSE CARVE-OUTS, "BAD BOY"  
GUARANTIES, AND PERSONAL LIABILITY AFTER  
CHERRYLAND**

Strafford live webinars  
Thursday, January 30, 2014  
1:00 p.m. to 2:30 p.m. EST

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By

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## General Outline

- I. **Introductions and overview of presentation**
- II. **Case Study**
- III. **Non-Recourse Carve-Outs – James H. Schwarz, Esq.**
  - A. Laundry List of Carveouts from A to Z
    1. Erosion of Collateral
    2. Destruction of Collateral
    3. Allocation of External Risks
    4. Preventing Additional Investment by the Lender
    5. Behavior Control
  - B. Environmental Indemnities
    1. Violations of Environmental Laws
    2. Who Gets the Benefit of the Indemnity
    3. Indemnification
    4. Carveout from Indemnity
    5. Termination of Indemnity
  - C. Recent Case Law Concerning Non-Recourse Loans
    1. Heller Financial
    2. Penn Mutual
    3. Travelers Insurance
    4. Blue Hills
  - D. Other Protective Devices
    1. Bankruptcy Remote Entity
    2. Cash Management Agreement
  - E. Tax Implications and Non-Recourse Debt
  - F. Conclusion
  - G. Sample Provisions
    1. Borrowers Broad Exculpation
    2. Lenders Narrow Exculpation
- IV. **“Springing Recourse” and “Bad-Boy” Guaranties – *Wells Fargo Bank, N.A. v. Cherryland Mall Limited Partnership, et al.* – Paul S. Magy, Esq.**
  - A. Basic Facts and Procedural History
    1. Separateness covenants
    2. Limited Recourse Provisions
  - B. Analysis
    1. Suit on the Mortgage
    2. Suit for Deficiency under the Promissory Note
    3. Guaranty
  - C. Single-Purpose Entity/Separateness – Requirements and Violations
    1. Limitations on the purpose of the SPE
    2. Restrictions on additional indebtedness

3. Prohibitions on consolidation and liquidation; restrictions on mergers and asset sales
4. Prohibitions on amendments to organizational documentation
5. Separateness covenants
6. Impediments to filing a bankruptcy petition (independent director)
- D. Definition of "Single Purpose Entity"
  1. Integration Clause
  2. Headings/Captions to be Given No Effect
  3. No definition of "SPE"/Need for Extrinsic Evidence
  4. Standard and Poor's U.S. CMBS Legal and Structured Finance Criteria – October, 2002
- E. Substantive Consolidation in Bankruptcy
- F. Cases Relied Upon
  1. LaSalle Bank, N.A. v. Mobile Hotel Props, LLC
  2. Blue Hills Office Park LLC v. J.P. Morgan Chase Bank
  3. Wells Fargo Bank Minnesota, N.A. v. Leisure Village Assoc.
- G. Michigan Legislation
- H. Conclusion
  1. Issues Raised by this Decision
    - (a) Interpretation
    - (b) Why would a borrower or guarantor agree to full recourse upon insolvency? Isn't that a recourse loan?
    - (c) Chilling effect of the Lenders, CMSA's and MBA's course of action
    - (d) Alternatives to CMBS?

**V. Bankruptcy Perspective – Thomas W. Coffey, Esq.**

- A. Best Case – Conclude a successful plan of reorganization whereby the remaining first mortgage debt is amortized over an extended period, but at a (lower) market interest rate
- B. Worst Case – Provide for an orderly liquidation in bankruptcy, thus avoiding a distress sale at foreclosure. A liquidation in bankruptcy will (in theory) provide for better market exposure and a disposition under better conditions, yielding a higher sales price (and a lower deficiency claim against the guarantors)
- C. Immediate Benefits
  1. Stops a foreclosure sale – the borrower gains time to re-tenant and refinance the property
  2. Gives the borrower more control over the future of the property
  3. Postpones the establishment of a deficiency against the guarantors
- D. Impediments to Reorganization
  1. The "bankruptcy remote" provisions in the borrower's organizational documents
  2. Relatively few creditors/lack of an "impaired accepting class" of creditors who are not insiders
- E. Possible Actions

1. Standing: Determine if the REMIC Trustee "holds" the original promissory note and guaranty. The borrower does not want to pay twice!
  2. Amend organizational documents
  3. Obtain a loan to:
    - (a) Create a small but independent "impaired accepting class"
    - (b) Fund shortfall in cash flow to pay interest due the mortgagee during the Chapter 11 proceeding
- F. Future Benefits
1. Obtain control of escrows held by the servicer
  2. Court intervention in leasing process to obtain approval of leases and/or improve procedure for leasing and funding of tenant work
  3. "Term out" existing indebtedness (at least three years)
  4. Reduce the interest rate to a (lower) market rate
    - (a) Resulting reduction in debt service/increase in cash flow.
  5. Right to prepay at any time without penalty or premium
  6. Negotiated resolution of guaranty issues
  7. Negotiated resolution of default interest, late fees, attorneys' fees, and other amounts
  8. Reinstatement of the loan
  9. Mutual covenant not to sue – a fresh start
  10. No adverse tax consequences
  11. Preservation of the borrower's ability to file a second bankruptcy
- G. Bring the Mortgagee to the Table
1. "Cram down" will be objectionable to the mortgagee

**VI. Conclusion – What have we learned?**

## CASE STUDY

### Borrower

New Market Center, LLC, a Delaware limited liability company (the "Borrower"), developed a strip center known as New Market Center in Hometown, Ohio in 2001 (the "Center"). Borrower is structured as a single purpose "bankruptcy remote" entity. Its sole managing member is New Market Center, Inc., a Delaware corporation ("Manager"), the sole shareholders of which are John Doe (50%) and Richard Roe (50%). Doe and Roe are also the sole directors; the lender did not require a third independent director. The other members are as depicted on the attached structure chart.

### Governing Documents

The governing documents of Borrower and Manager permit Borrower to commence a case under Chapter 11 of the U.S. Bankruptcy Code with the unanimous consent of all members of Borrower and all directors of Manager, respectively.<sup>1</sup>

Material amendments to these governing documents are prohibited without (a) the approval of the first mortgage holder, and (b) a "no downgrade letter" from the applicable rating agencies.<sup>2</sup>

The governing documents also prohibit the Borrower from incurring any indebtedness except for (a) the first mortgage, and (b) trade payables incurred in the ordinary course of business of operating the Center in amounts that are "normal and reasonable under the circumstances".<sup>3</sup>

### Shopping Center

New Market Center consists of approximately 62,821 square feet of gross leasable area and includes the tenants indicated on the attached site/leasing plan.

### Financing

Borrower obtained a commitment for a permanent loan from BundesBank Mortgage Capital, LLC dated October 11, 2001, amended November 3, 2001, and extended November 27 and December 15, 2001. The loan was in the original principal amount of \$5.5 million with interest at the rate of 7.0% per annum for a period of 10 years and matured on December 31, 2011. The amortization period is 30 years, and the current principal balance is approximately \$4.8 million. The loan is non-recourse except for certain "bad boy carve-outs".

Borrower's principals, John Doe and Richard Roe, ("Guarantors") executed a joint and several personal guaranty relative to the loan. The guaranty was intended to be limited to the

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<sup>1</sup> How would things be different if there was an outright prohibition on filing a petition in bankruptcy?

<sup>2</sup> How would things be different if the loan documents prohibited "any amendments" to the governing documents?

<sup>3</sup> How would things be different if the loan documents prohibited "any and all debt other than the first mortgage loan"?

“bad boy carve-outs” in the non-recourse provisions contained in the loan documents (see below).

The loan was sold to a REMIC trust (i.e. “securitized”) in early 2002. The trustee of the trust (“Mortgagee”) is J.P. Moneybags Bank, N.A. (“Trustee”). The servicer of this loan is Buffadia (“Servicer”) and the special servicer is ABC Capital Asset Management LLC (“Special Servicer”).

### Tenants

Short Circuit was an anchor tenant of the Center, occupying approximately 17,209 square feet of the 62,821 gross leasable square feet of the Center (or 27.3% thereof) until December, 2009, when they ceased paying rent, filed for protection under the Bankruptcy Code, ceased operating, and vacated their store premises. This allowed the other anchor tenant of the Center, Old Army, to pay vastly reduced rent, all of which created a serious financial hardship for Borrower.

Guarantors have contributed substantial amounts of cash to Borrower throughout 2010 and into 2011 to enable Borrower to pay all debt service payments to Servicer during this difficult period.

In October, 2010 the Borrower concluded a lease extension with an existing tenant of the Center, Shoe Circus, LLC (“Shoe Circus”), for 12,150 square feet of GLA (19.27% of the Center). This document included a co-tenancy provision requiring Old Army to occupy at least 16,500 square feet in the Center. The existing Old Army lease expires in early 2012. Servicer approved this document on behalf of Mortgagee. This is a key fact, as we shall see below.

In late 2011, Borrower negotiated a new 5-year business deal with Old Army for approximately 17,000 square feet (or 27% of the total leaseable area) in the Center and presented the documentation to Mortgagee (in care of the Servicer) for approval, but Servicer has never approved or disapproved the new Old Army lease deal, despite repeated requests from Borrower, and despite the co-tenancy provision in the Shoe Circus, LLC lease, which Servicer approved just months before, thus causing a failure under the co-tenancy provision in the Shoe Circus lease.

In early 2011, Borrower also negotiated a letter of intent for a new 10-year lease with Betty Ann’s Fabric Warehouse for the entire 17,209 square feet of space that was previously occupied by Short Circuit and presented said documentation to Mortgagee (in care of Servicer) for approval, but Servicer has never approved or disapproved the Betty Ann Fabrics transaction despite repeated requests from Borrower.

The Old Army and Betty Ann lease deals would provide a positive cash flow from the Center for the foreseeable future, and would allow the Center to be refinanced by a life insurance company.



## **Mortgage Provisions/Lease Approvals**

The mortgage contains the following provision regarding approval of leases by Mortgagee:

### **62. Leases.**

(a) Mortgagor shall not enter into any Lease ("Major Lease") (i) greater than ten percent (10%) of the gross leaseable area of the Improvements or 10,000 square feet of the Mortgaged Property or (ii) with a term of ten (10) years or more without the prior written approval of Mortgagee[, not to be unreasonably withheld, conditioned or delayed.]<sup>4</sup> Mortgagor shall specifically request approval in writing and furnish such information as Mortgagee shall reasonably require. Mortgagee shall approve or disapprove any such Major Lease within fifteen (15) business days after receipt of such written request and all requested information.

Consequently, Mortgagee and/or Servicer has effectively brought the leasing of approximately 73.27% of the Center's GLA to a halt, destroying the cash flow and value of the Center, and increasing the likelihood of a deficiency judgment in foreclosure and a claim under the guaranty for damages.

## **Re-tenanting Costs**

Borrower expects to have substantial re-tenanting costs on this project that could be upwards of \$500,000. Servicer currently holds a "Leasing Reserve Escrow" of \$480,000, but has no obligation to (and will not) release any portion of the reserve to Borrower, even if the current default is cured.

## **Trade Area Activity**

Nippon Motor Company has recently broken ground on a major production facility in Market Center's trade area. This will likely increase the value of New Market Center dramatically, so there is substantial "upside" at the end of the rainbow . . . if Borrower can hang on to the Center. Otherwise, Mortgagee (or the purchaser at a foreclosure sale) may reap a windfall.

## **Sale of Adjacent Parcel**

Borrower owned an adjacent 2 acre parcel of undeveloped land that is not included in the legal description that is attached to the Market Center mortgage. Borrower sold this parcel to an unrelated third party in May, 2011 for \$500,000 and immediately distributed all proceeds to its members. On the date of sale, Borrower was not in default under the Market Center mortgage.

Special Servicer has asserted that although the adjacent 2 acre parcel was not included in the legal description attached to the mortgage, the granting clause of the mortgage includes "appurtenances" and "proceeds" in the definition of "Mortgaged Property", and argued that the 2

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<sup>4</sup> What if the bracketed language was not present? What if this provision contained a "deemed approval" clause?

acre parcel was an "appurtenance", the \$500,000.00 received by Borrower upon sale constituted "proceeds", and that same constitute "Mortgaged Property" that are subject to the lien and security interest created under the loan documents.

Special Servicer has further asserted that since the loan documents prohibit a transfer of "the Mortgaged Property or any part thereof or interest therein", the distribution of the proceeds of sale to the members of Borrower was a violation of the loan documents, that such distribution constitutes "waste", and that the \$500,000.00 must be returned to Borrower.

Finally, Special Servicer has claimed that Guarantors are liable for the amount of said distribution under paragraph 1(f) of their Guaranty (see below).<sup>5</sup>

### Promissory Note

The promissory note contains the following rider (part (b) applies after maturity on December 31, 2011):

#### **"HYPER AMORTIZATION RIDER**

Notwithstanding any other provision to the contrary contained in this Note:

(a) Maker shall have the right to prepay the entire principal balance and all other amounts due ("Payoff"), without premium, on any Payment Date within three months prior to the Maturity Date.

(b) From and after the Maturity Date, interest shall accrue on the unpaid principal balance at a rate per annum equal to the Interest Rate plus two (2%) percentage points ("Revised Interest Rate"). Interest accrued at the Revised Interest Rate and not paid pursuant to Section 4(a)(ii) of that certain Cash Management and Security Agreement, dated the date hereof, between Borrower and Lender (the "Lockbox Agreement"), shall be deferred and added to the principal balance of this Note and, if permitted by applicable law, shall earn interest at the Revised Interest Rate (such accrued interest is hereinafter referred to as "Accrued Interest"). All of the unpaid principal balance of the Note, including any Account Interest, shall be due and payable on the date (the "Extended Maturity Date") which is the earlier to occur of (x) **the twentieth (20th) anniversary of the Maturity Date** or (y) the date on which the indebtedness including all interest and Accrued Interest is repaid to Payee from funds available in the Deposit Account pursuant to the Lockbox Agreement." (emphasis added)<sup>6</sup>

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<sup>5</sup> Compare this situation with the facts of *Travelers Ins. Co. and Blue Hills*.

<sup>6</sup> How would things be different if the loan documents did not include this additional 20 year period following the maturity date?

## **Loan Default**

In light of the substantial and unsustainable financial burden imposed upon Borrower in this situation (which was voluntarily absorbed by Borrower's principals during 2010 and into early 2011), and because of the failure and/or refusal by Mortgagee and Servicer to approve the new Old Army and Betty Ann lease transactions, Borrower's principals were forced to re-evaluate the situation, and in late 2011 determined that it no longer made sense to continue their contributions of capital to Borrower. Consequently, Borrower is unable to continue to pay the full debt service to Mortgagee, but has remitted all net cash *from the operation of the property* to Servicer in a timely manner.

Borrower has in good faith continued to manage the Center (without fee or charge), has directed the tenants to pay all rent and other charges directly to Special Servicer (which the tenants have done), and has otherwise fully cooperated with Mortgagee and Special Servicer. Borrower has asked whether its members must return the \$500,000 distributed to them in May, 2011.<sup>7</sup>

Because the full debt service due for the final months of 2011 has not been paid, the Special Servicer has become involved. Special Servicer is a "B Piece buyer" and owns some of the lower-rated tranches of debt in the subject REMIC trust (see the attached diagram illustrating a typical CMBS transaction).

In February, 2012, Special Servicer instructed its counsel to send a "Notice of Default and Acceleration" to Borrower and the Guarantors. Thereafter, Special Servicer's counsel threatened to file a Verified Complaint Requesting Appointment of Receiver, Injunctive Relief, and Other Equitable and Legal Relief in state court. However, because of the relatively small size of the loan, the cost of the receiver, the fact that all tenants had been instructed by Borrower to pay their rent directly to the Special Servicer and are doing so, and that there are no real expenses to be paid other than real estate taxes, insurance and electricity for the parking lot lights, this complaint has not yet been filed.<sup>8</sup>

Special Servicer has recently obtained an appraisal of Market Center that sets the value at \$2.8 Million. Special Servicer has indicated that this will be Mortgagee's bid in foreclosure, and that Mortgagee will pursue a claim for a deficiency in the amount of \$2.0 Million against Guarantors.<sup>9</sup>

## **Deficiency Claim**

The original loan commitment dated October 12, 2001 was for a "market rate, non-recourse" mortgage loan, and provides in pertinent part:

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<sup>7</sup> What factors affect how this question is answered? See *Travelers Ins. Co.*

<sup>8</sup> How would things be different if Borrower had not cooperated (to a point) with Servicer and Mortgagee? See *Travelers Ins. Co.*

<sup>9</sup> What bearing does the mortgagee's bid in foreclosure have on this situation? See *Whitestone* and *Penn Mutual*. Does it make a difference whether state law permits judicial or non-judicial foreclosure sales?

14. Non-recourse: The loan shall be non-recourse except that the Borrower and its Key Principals shall be required to provide guarantees against (a) misapplication of funds, (b) Borrower's obligations for environmental representations, indemnities and covenants, (c) fraud and misrepresentation, and (d) the filing of a bankruptcy proceeding within nine (9) months after closing the Loan.

The loan commitment was revised (and extended) three times, but this provision was never changed.

The Guaranty provides in pertinent part as follows:

1. Indemnity and Guaranty. Guarantor (i) assumes liability for, (ii) guarantees payment to Lender of, (iii) agrees to pay, protect, defend, save harmless and indemnify Lender from and against any and all liens, damages (including, without limitation, punitive or exemplary damages), losses, liabilities (including, without limitation, strict liability), obligations, settlement payments, penalties, fines, assessments, citations, claims, litigation, demands, defenses, judgments, suits, proceedings, costs and expenses of any kind whatsoever (including reasonable attorneys', consultants' and experts' fees and disbursements actually incurred in investigating, defending, settling or prosecuting any claim or proceedings or enforcing any term of this Guaranty) (collectively "Costs") which may at any time be imposed upon, incurred by or asserted against Lender as a result of the following "Indemnified Matters":
- (a) Rent or other payments received from Tenants paid more than one (1) month in advance;
  - (b) Proceeds of insurance policies, condemnation or other taking not applied in accordance with the Loan Documents;
  - (c) Rents, issues, profits, revenues of the Center and tenant security deposits relating to the Center received and applicable to a period after the occurrence of an Event of Default or Default, which are not applied to the ordinary and necessary expenses of owning and operating the Center or paid to Lender;
  - (d) All obligations, requirements and indemnities of Borrower under the Loan Documents relating to Hazardous Substances or compliance with Environmental Laws;
  - (e) Physical waste<sup>10</sup>;

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<sup>10</sup> See *Travelers Ins. Co.*

(f) Transfer of the Mortgaged Property or any part thereof or interest therein in violation of the Loan Documents; and

(g) Fraud, material misrepresentation or failure to disclose a material fact by Borrower or any of its principals, officers, general partners or members, any guarantor, any indemnitor. In addition, Guarantor hereby unconditionally and irrevocably guarantees payment of the entire Debt if any of the following occurs [within nine (9) months of the date hereof]:<sup>11</sup> (i) a voluntary bankruptcy filing by, or an involuntary bankruptcy filing against, Borrower or any general partner or managing member or majority shareholder of Borrower; or (ii) the Center becomes an asset in any bankruptcy proceeding.

(h) This is a guaranty of payment and performance and not of collection. The liability of Guarantor under this Guaranty shall be direct and immediate and not conditional or contingent upon the pursuit of any remedies against Borrower or any other person (including, without limitation, other guarantors, if any), nor against the collateral for the Loan. In the event of a Default, Lender shall have the right to enforce any and all rights, powers and remedies available to Lender which shall be non-exclusive and cumulative. If the indebtedness and obligations guaranteed hereby are partially paid or discharged by reason of the exercise of any of the remedies available to Lender, this Guaranty shall nevertheless remain in full force and effect, and Guarantor shall remain liable for all remaining indebtedness and obligations guaranteed hereby. **Guarantor shall be liable for any deficiencies in the event the full amount of the Indebtedness owing under the Loan Documents is not received by Lender after the receipt of any payments or after foreclosure of the Mortgage.**

Special Servicer now claims that the text set forth in bold above obligates the Guarantors to pay any deficiency judgment that the Mortgagee may obtain.

Borrower and Guarantors initially thought that a mutual mistake occurred as to the terms of the Guaranty that are set forth in bold above, as these provisions of the Guaranty are at variance with the provisions of the Loan Commitment.

Borrower and Guarantors now recall that (a) Guarantors demanded that the language highlighted in bold above be deleted from the Guaranty prior to their execution to make the Guaranty consistent with the loan commitment provision quoted above, and (b) BundesBank agreed, but they suspect that in the closing process, BundesBank or its counsel may have mistakenly attached the Guarantor's signature pages to the prior draft (containing the text set forth in bold above) of the Guaranty at the closing.

### **Borrower's Reaction**

After an evening of drinking with his old friend from Tennessee, Jack Daniels, one of the Guarantors fired off a hasty e-mail to Special Servicer stating in part "any attempt to enforce any

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<sup>11</sup> What if the bracketed language was not present?

claims against me beyond those discreet obligations set forth in paragraphs 1(a) through (g) of my Guaranty **will be met with a counterclaim for fraud!**"<sup>12</sup>

Borrower and Guarantors are also livid that Special Servicer has blocked their ability to re-tenant and refinance the Center through its inaction on the requests for consent to the Old Army and Betty Ann lease transactions (both of whom are AAA credits), particularly since Old Army is an existing tenant of the Center, and is *required* as a tenant under the co-tenancy provisions of the Shoe Circus lease, which Servicer expressly approved in October, 2010. **Borrower and the Guarantors (a) claim that Special Servicer, as a "B Piece Buyer", has a conflict of interest, and (b) propose to sue Mortgagee, Servicer, and Special Servicer for bad faith and damages based on various tort theories.**

### Issues

1. What should Borrower do?
2. What should Guarantors do?
3. Is a single asset bankruptcy helpful to Borrower or the Guarantors?
4. How would the results change if certain key provisions in the loan documents were different?

Attached: Table of Authorities  
CMBS Structure Chart  
Ownership Structure Chart  
Site/Lease Plan  
Pro-Forma

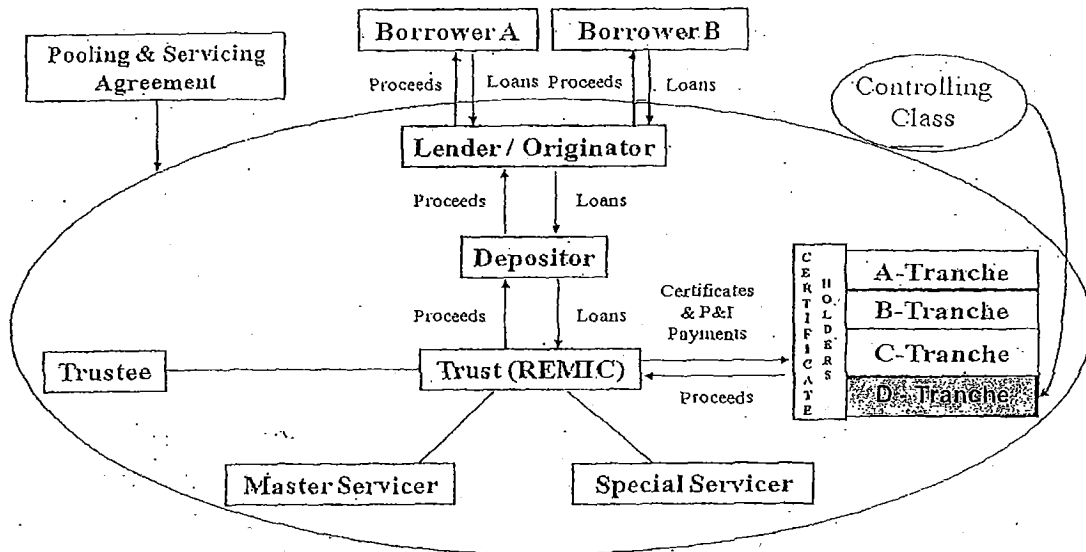
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<sup>12</sup> What if the loan documents contained a contractual limitation on damage claims against the lender? Is such a provision unconscionable?

### Table of Authorities

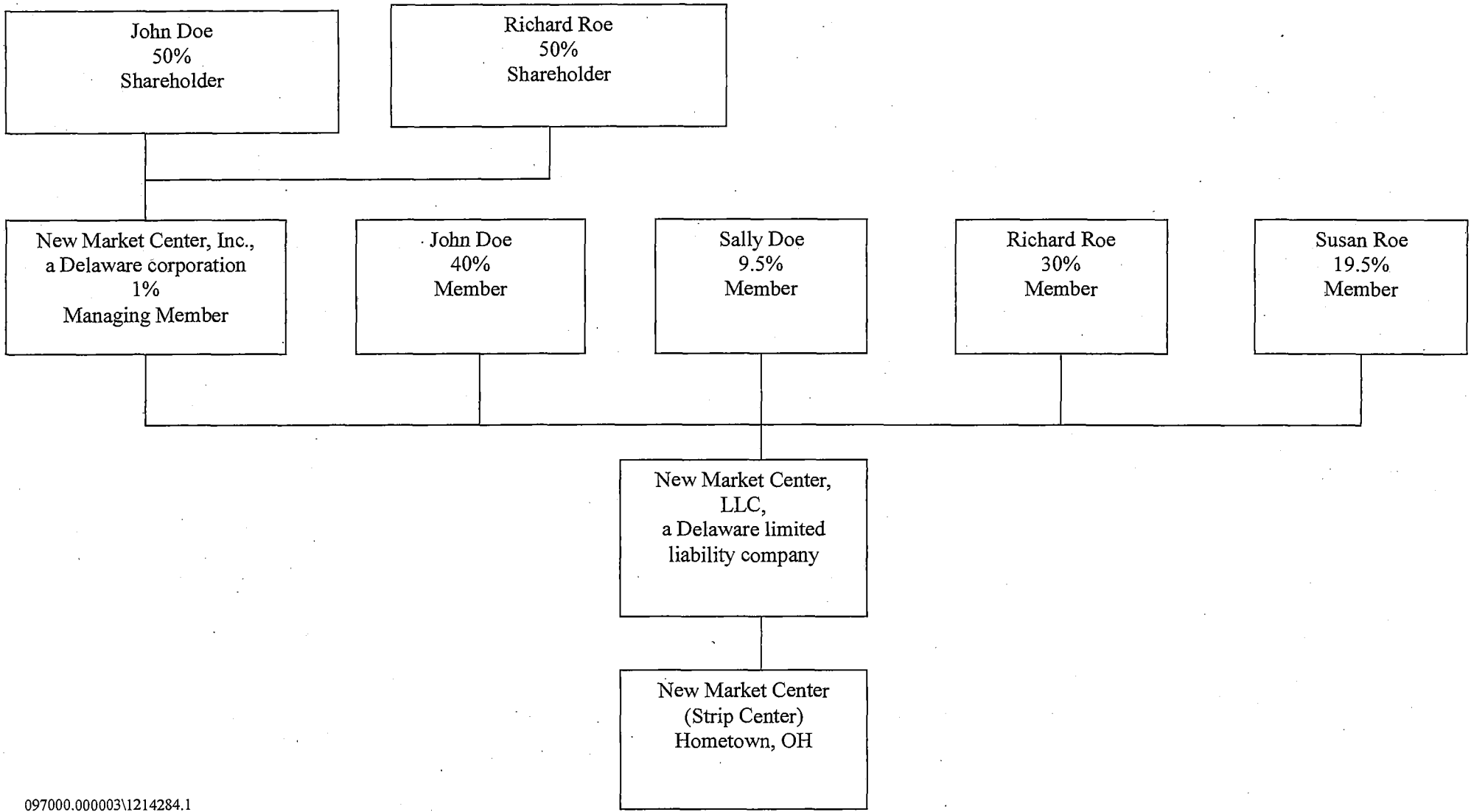
1. *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership et al.*,
  - (a) 295 Mich. App. 99, 812 N.W.2d 799 (2011)
  - (b) 493 Mich. 859, 820 N.W.2d 901 (2012)
  - (c) *(On Remand)* 300 Mich. App. 361, 835 N.W.2d 593 (2013)
  
2. *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., LLC*,
  - (a) 2011 WL 4695820 (E.D.Mich.) (Oct. 5, 2011)
  - (b) 835 F.Supp.2d 384 (E.D.Mich 2011)
  - (c) 2012 WL 205843 (E.D.Mich Jan. 24, 2012)
  
3. *Heller Financial, Inc. v. Lee*, 2002 WL 1888591 (N.D.Ill.)
  
4. *Penn Mutual Life Insurance Company v. Cleveland Mall Associates*, 916 F.Supp.715 (E.D. Tenn., 1996)
  
5. *Whitestone Savings and Loan Association v. Allstate Insurance Company*, 28 N.Y.2d 332, 270 N.E.2d 694, 321 N.Y.S2d 862 (1971)
  
6. *Travelers Ins. Co. v. 633 Third Assocs.*, 14 F.3d 114 (2<sup>nd</sup> Cir. 1994)
  
7. *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank, et al.*, 477 F.Supp.2d 366 (USDC, D. Mass., 2007)
  
8. *LaSalle Bank N.A. v. Mobile Hotel Properties, LLC, et al*, 367 F.Supp.2d 1022 (E.D. Louisiana, 2004)
  
9. *In re: General Growth Properties, Inc. et al., Debtors*, 409 B.R. 43, 62 Collier Bankr.Cas.2d 279, 51 Bankr.Ct.Dec. 280 (Aug. 11, 2009)
  
10. Ohio Non-Recourse Mortgage Loan Act, Ohio Revised Code Section 1319.07-09, effective March 27, 2013.

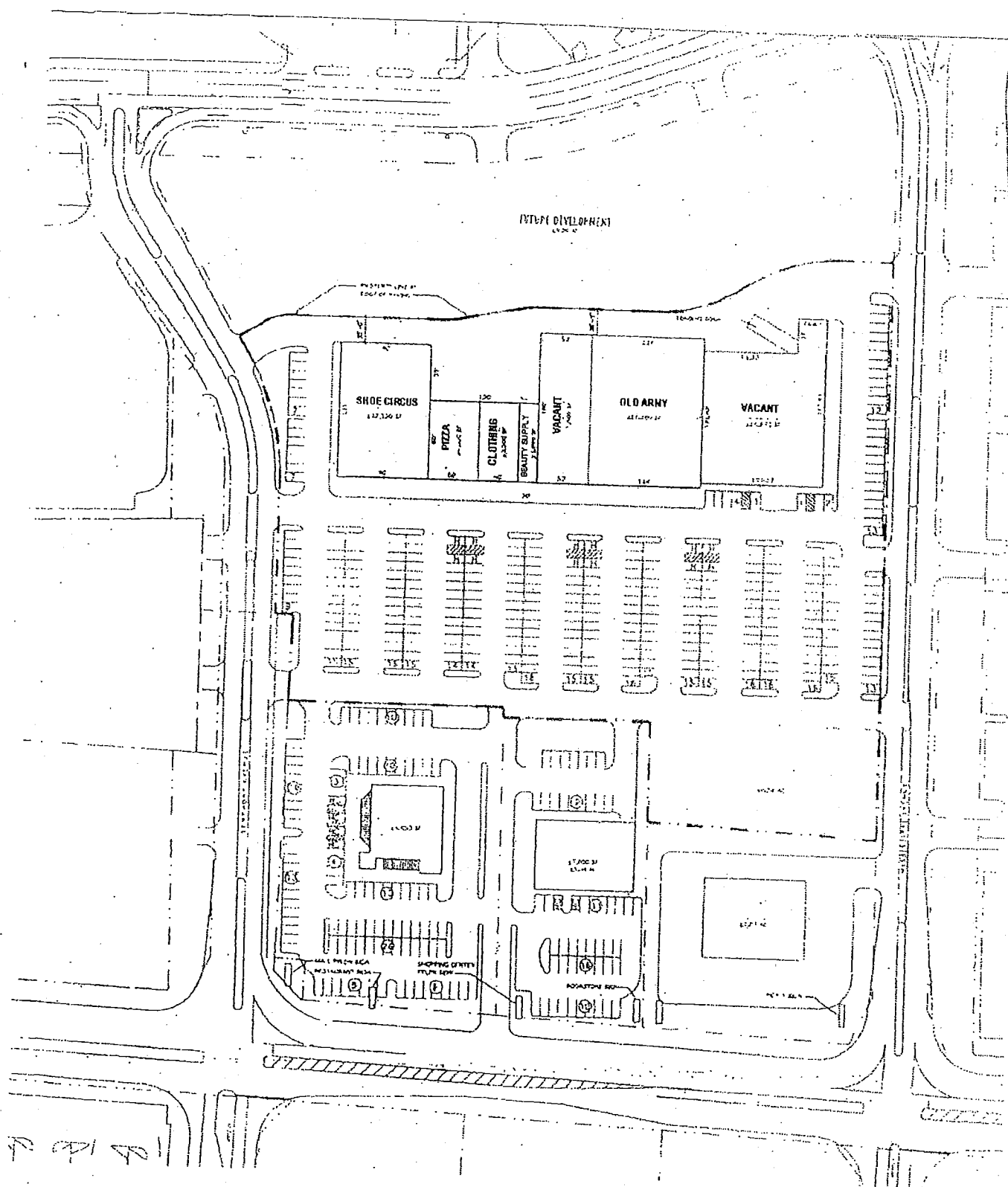
The diagram below provides a summary of the events in a typical CMBS transaction.




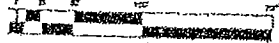


STRUCTURE CHART  
OF  
NEW MARKET CENTER, LLC






**SITE/LEASE PLAN**



# Market Center

August 28, 2009

**Pro-Forma  
Market Center**

	<u>Pre-Bankruptcy</u>	<u>Post-Bankruptcy</u>	<u>Difference</u>
Income	\$ 280,476.00 <sup>1</sup>	\$ 580,000.00 <sup>2</sup>	\$ 299,524.00
Expenses	\$ (161,644.00)	\$ (161,644.00)	\$ -0-
NOI	\$ 118,832.00	\$ 418,356.00	\$ 299,524.00
Interest	\$ (350,000.00) (@7%)	\$ (294,788.00) (@5.9%)	\$ (55,212.00)
Principal	\$ (121,965.00)	\$ (61,784.00)	\$ (60,181.00)
Repair and TI Escrows	\$ (51,180.00)	\$ (61,784.00)	\$ 10,604.00
Net	\$ (404,313.00)	\$ -0-	\$ 404,313.00

<sup>1</sup> Includes Shoe Circus at reduced rent due to failure of co-tenency. Excludes Old Army (expired).

<sup>2</sup> Includes Shoe Circus at full rent, new Old Army lease, and new Betty Ann lease.

**NON-RECOURSE CARVE-OUTS  
AND HOW TO DEAL WITH THEM**

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**NONRECOURSE CARVEOUTS AND HOW TO DEAL WITH THEM**

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**I. INTRODUCTION**

A non-recourse loan is a "secured loan that allows the lender to attach only the collateral, not the borrower's personal assets, if the loan is not repaid." Black's Law Dictionary 947 (7<sup>th</sup> ed. 199). Once upon a time nonrecourse loans might have been nonrecourse in a "real" sense. If a borrower was unable or unwilling to pay the debt on a property, the borrower had the option to walk away from the deal without having to put up any more money to exercise this exit strategy. The borrower had all of the upside if market values went up and none of the down side. The lender took all of the market risks if property values plummeted below the amount outstanding under the loan. Lenders and their counsel realized that this left borrowers in the enviable position of being able to make all the decisions with respect to the property without having to worry about the lender and its interests. In response to these experiences, the list of "carve-outs" to the basic exculpation section in the loan document has grown by leaps and bounds. Borrowers have always taken the broad view that in nonrecourse financing they always have the right to "walk from the deal" at any time when it no longer makes any economic sense without having to come up with additional cash. On the other hand, lenders have had a hard time coming to terms with the concept that borrowers should not be required to pay back funds advanced and which they promised to repay. As a result, at the end of the day, a borrower is left with an economic choice either to (a) pay off the loan in full and keep the property or (b) give up the property to the lender, in good condition, quickly and peacefully.

In a typical single-asset real estate transaction with a limited liability company with no other assets as the borrower, nonrecourse provisions really make no sense at all. The way the transaction is set up makes the loan "nonrecourse" to the principals of the owning entity. In that situation, the entity cannot be pierced, it has no other assets and the lender's sole practical remedy is to foreclose against the property. The lender generally will seek to protect itself in such instance by obtaining a guaranty from a party with substantial assets, and the same issues as to exculpation will arise in the negotiation of such guaranty. There may be reductions in such guaranteed amounts based upon satisfaction of debt service coverage tests, lease-up provisions or completion of construction.

This article attempts to describe how the documentation in commercial real estate financing deals with the competing interests of borrowers and lenders over nonrecourse provisions. In a perfect world, a borrower would always pay off the loan at the end of the day and never engage in any "bad" acts that would endanger the lender's collateral prior to a default situation. However, once a loan goes bad, the borrower and the lender will have different interpretations as to what actions should be permitted. Because of these dynamics, parties should take great care in reviewing the nonrecourse sections in the loan documentation.

**II. LAUNDRY LIST OF CARVE OUTS FROM A TO Z**

As anyone who has negotiated a nonrecourse loan can attest, the list of possible nonrecourse carve outs is seemingly endless. In the draconian nonrecourse carve out provision, the only thing the borrower may have nonrecourse against is for the payment of principal and interest on the loan itself. It is interesting to note that nothing forces a lender to foreclose on a property and "take back the keys," so that a borrower in a nonrecourse deal could still be stuck with paying operating expenses even after an event of default in a

nonrecourse deal. Joshua Stein in his article, *Nonrecourse Carve outs: How Far is Far Enough?*,<sup>1</sup> breaks down nonrecourse carve outs into five (5) categories:

- (1) Erosion of collateral;
- (2) Destruction of collateral;
- (3) Allocation of external risks;
- (4) Preventing additional investment by the lender; and
- (5) Behavior control.

Each category may be thought of as a policy underlying various carve outs, and any one carve out may further one or more of these policies. These policies should be kept in mind when nonrecourse carve outs are being negotiated as they will help the attorney understand both his client's and the other side's positions. The lender understands in any nonrecourse transaction that the lender has agreed to bear the risk of any market decline in the property. What the lender has not bargained for is that the borrower will strip cash out of the deal or make any deals which will negatively impact the income stream of the property, or that the borrower will no longer be interested in prudently managing the property after the borrower realizes that this property cannot be "turned around."

A. Environmental Obligations. This carveout is intended to allocate the risk of all environmental problems to the borrower. It attempts to protect the lender from any loss incurred as a result of any environmental obligation undertaken by the borrower in the loan documents. The amount of such loss is not subject to any cap whatsoever. These obligations are discussed below in the section dealing with environmental indemnity provisions.

B. Misapplication of Casualty and Condemnation Proceeds. A behavior central device, this carveout covers the situation where the borrower receives casualty or insurance proceeds and fails to apply such funds in accordance with the terms of the loan documents. The liability under this carve-out should be limited to the amount of the misapplied funds.

C. Misapplication of Security Deposits. This carveout covers security deposits put up by lessees under their leases. There should not be recourse against the borrower for any security deposits properly applied in substantial compliance with the leases or which are promptly delivered to the lender within a predetermined time limit after a request by the lender.

D. Misapplication of Property Income. The lender's concern here is that property income is not used for the benefit of the collateral property, but rather distributed to the principals of the borrower. Again, the borrower wants to make sure that only cash received is included in the determination of property income. Also, the borrower will want to limit this provision to apply only after receipt of notice from the lender of an event of default. In such a situation, it will be extremely difficult to determine if prior to such distribution there were not enough funds to pay for property expenses and debt service that was due in the near future. In addition, a limited partner or member who has no obligation to repay such loan surely will not

be willing to give back such funds. The lender will want to make sure that any operating payment covenants are first satisfied from such property income prior to any distributions to the principals.

E. Failure to Pay Impositions. Impositions will include real estate and personal property taxes and insurance premiums. The lender will want all impositions to be paid whether or not an event of default has occurred so that it knows it will not have to go out of pocket to cover required property expenses. The borrower will want a limitation providing that this obligation only arises to the extent that there is sufficient property income to satisfy such impositions and that property income must first be applied to impositions before it is applied to any other property expenses. The lender can cover this situation by requiring imposition escrows or by using a lockbox account with cash management provisions.

F. Removal of Improvements. This provision is meant to protect the lender from the removal or disposal by borrower in violation of the loan documents, of any fixtures, personal property, or improvements at the property. The borrower will want to limit this to any intentional and wrongful removal. Many lenders try to include a diminution of value concept. The borrower should attempt to limit such value loss to situations where a foreclosure sale has occurred, and as a result of such diminution of value, the lender has failed to recover the full amount of the loan obligations from the sale as determined by a court of law of competent jurisdiction beyond the right of further appeal.

G. Collection Costs. These provisions are normally picked up as advances which are treated as principal under the loan. The borrower should always require the lender to go out of pocket before these are carved out from the exculpation provisions.

H. Cash on Hand. This provision is intended to pick up cash or cash equivalents held by the borrower when an event of default has occurred or cash payments made to principals of the borrower within a certain time period prior to an event of default. As a general rule, the lender will not have a security interest in the cash of the borrower. The borrower should try to limit this carveout to cash payments made at a time when operating expenses or debt service payments were due at such time but not paid.

I. Cash Distributions. If there is a violation of a loan provision which limited the amount of cash which could be distributed to principals, the lender will want to be able to reach such funds improperly paid. These are normally tied to some debt service coverage ratio test.

J. Fraudulent Transfers. To the extent that a payment made is treated as a fraudulent transfer in a bankruptcy proceeding, the lender will want to be made whole. This provision should be limited only to the actual loss suffered by the lender.

K. Lease Impairments. The purpose of this provision is to make sure that the cash stream of the property is not impaired by the borrower. The lender is concerned about any amendment, modification, cancellation, termination, or waiver of any lease, or the obligations of any lessee agreed to by borrower or any default by borrower under a lease which allows the lessee to either terminate the lease or set off against lease payments. The borrower

<sup>1</sup> Joshua Stein, *Nonrecourse Carve outs: How Far is Far Enough? A Tool To Reduce Lenders' Risk Can Reduce Their Competitiveness*, Real Estate Rev. (Summer 1997).

would like to limit any such acts to material acts on the part of borrower that materially impair the lender's security and any intentional and substantial defaults caused by the borrower.

L. Prohibited Leases. Many pension fund lenders must make sure that certain leases are not entered into or such acts may impact their tax exempt status. In order to control the borrower, the lender may wish to establish a formula or procedure to calculate such loss, or perhaps to convert the whole loan into a full recourse deal.

M. Transaction Costs of any Lien Enforcement Action. The lender does not want the property to bear the costs of any transfer taxes and recording charges required to be paid in order to record any deed or other conveyance document that has to be recorded in a lien enforcement action. This may include costs associated with the appointment of a receiver, an action to prevent waste, foreclosure costs, bankruptcy action costs and specific performance actions.

N. Violations of Law. This provision attempts to make the borrower personally liable for the failure to comply with legal requirements so that the lender does not have to cure such problems with its funds. Such provision attempts to pick up violations of the American with Disabilities Act and ERISA violations. The borrower wants to limit this only to violations that occurred while the borrower owned the property and for which the borrower received prior written notice from a governmental entity.

O. Operating Costs. This provision attempts to recover from the borrower utility charges, insurance premiums and other operating costs required to be paid by the borrower under the loan documents. Again, the borrower will want to limit this carveout to property income that was available to pay such costs and charges.

P. Uninsured Casualty. This provision protects the lender against any casualty not covered by insurance, including deductible amounts. The borrower may argue that it should only be responsible for such amounts to the extent it failed to maintain the insurance required under the loan documents.

Q. Criminal Acts. The lender does not want to bear the costs of any criminal penalties incurred as a result of the acts of the borrower. The borrower should attempt to limit such carveout to any penalty actually imposed by a court of law of competent jurisdiction beyond right of further appeal.

R. Closing Costs. These provisions carveout from the exculpation provisions any commitment fee, loan fee, mortgage recording tax, brokerage commission, title insurance premium or other closing costs that the borrower was required, but failed, to pay, with respect to the loan. Most of these costs are paid from loan proceeds at the time of the closing, so these should not be big items of concern.

S. Yield Maintenance Premiums. This provision imposes liability on the borrower if any yield maintenance premium is payable as a result of a prepayment of the loan.

T. Interference with Lien Enforcement Actions. Lenders want to get back the property as quickly as possible in the event they have to bring an enforcement action.

Lenders will want to enforce full liability against the borrower if the borrower takes any action to contest, delay, oppose, impede or otherwise interfere with a lien enforcement action. The borrower should have the right to contest whether an event of default occurred that gave rise to the enforcement action, and if borrower prevails, the lender should pay borrower's costs and attorney fees in defending such action.

U. Bankruptcy. Lenders do not want to be subject to the provisions of the Bankruptcy Code and its automatic stay. Accordingly, lenders draft full recourse clauses to prevent the borrower from ever filing by imposing full recourse liability if such an action occurs. These provisions should only relate to voluntary actions commenced by the borrower.

V. Prohibited Transfers. In approving a nonrecourse deal, lenders take into account in their underwriting that the principals of the borrower know how to manage and operate the property. Accordingly, lenders insert springing full recourse clauses to prevent transfers of the ownership interest in the borrower to other parties. The borrower should try to limit this provision to intentional and voluntary transfers of interests which take management out of the control of the original principals.

W. Fraud. A normal carve out provision is for fraud committed by the borrower in connection with the loan. The better question is what constitutes "fraud" because the term is rarely defined in the loan documentation. The amount of the recourse liability should be limited to any actual damage suffered by the lender; the entire loan should not become recourse. Fraud should be defined as the actual, material, intentional and proven fraud or intentional misrepresentation (and not include any constructive or negligent fraud or misrepresentation), upon which the lender actually and reasonably relied upon in making such loan, which fraud or intentional misrepresentation is not cured within a set period of time after receipt of written notice from the lender.

X. Non-Delivery of Financial Information or Documents. Not only does the lender want to get its collateral back quickly, but it also needs to obtain the financial and other property documents in order to effectively manage the property. The lender may impose a requirement for the delivery of documents and information from the borrower or the loan will become fully recourse. If such a provision is agreed to by the borrower, any such document must be a material document, and the lender must be required to give detailed notice to the borrower of such documents allowing a reasonable time period for the borrower to provide the same.

Y. Additional Financing. In order to get the property quickly, the lender does not want to deal with any subordinate lenders who may have a security interest in the property. Most loan documents include a prohibition against any additional financing placed against the property, and many include a carveout that makes the loan entirely recourse for a violation of such covenant. The borrower should have the right to pay routine trade payables and to obtain unsecured loans for improvements, replacements or repairs to the property.

Z. SPE Covenants. In securitized real estate transactions, lenders require that the borrower comply with special purpose entity provisions which make them bankruptcy remote. The failure to meet such provisions normally requires the loan to become recourse in full. This protective device is discussed in Article V below.

### III. ENVIRONMENTAL INDEMNITIES

A nonrecourse carveout that appears in almost every commercial real estate loan is an environmental indemnity. In fact, an environmental indemnity generally goes further than a loan with full recourse, as the indemnifying parties generally include not only the borrower, but also the guarantors and/or any other parties affiliated with the borrower.

A. Violations of Environmental Laws. Environmental indemnities protect the lender against any losses incurred as a result of any violations of applicable environmental laws. The borrower should be required to remedy a violation of environmental laws only to the extent that a governmental agency provides written notice to the borrower that an environmental problem exists. The mere fact that the lender may want the borrower to deal with a problem should not be the catalyst for environmental remediation. The fact that hazardous materials are present on the property should not cause any action to be undertaken. It is only when there is a violation of environmental laws that the borrower must take action. If any action is required by a notice from a governmental agency, the borrower needs the right to contest any such alleged violation prior to the time that the lender can undertake any such actions and look to the borrower for repayment under an indemnity.

B. Who Gets Benefit of the Indemnity. Most lenders want the indemnity to run not only to them but also to any third party who acquires the loan by foreclosure or deed in lieu of foreclosure. A borrower does not have a problem with the indemnity running in favor of the lender, or any purchaser or assignee of all or any part of the loan, including participants or affiliates of the lender, such purchaser, assignee or participant. However, a borrower does not want its indemnity to survive once the party with which it has negotiated the loan is no longer in the picture. Accordingly, a borrower does not want the indemnity to run in favor of a party who acquires the property by foreclosure, power of sale, or by deed in lieu of foreclosure.

C. Indemnification. Lenders want to be indemnified for any environmental risks, whether the problem occurred as a result of the mortgaged property or from any other property, with no limitations whatsoever. The borrower does not want to be on the hook for any consequential damages as a result of such indemnification. The borrower wants to be responsible for releases of hazardous substances on or from its property and not from adjoining properties where it has no control of such situation. The lender will argue that any environmental risk is to be allocated solely to the borrower.

D. Carve Out from Indemnity. The borrower should not have any liability under such indemnity for the acts attributable to the lender or its agents or employees during the period of time that the borrower owns the property. The lender will want to reduce such limitation to its gross negligence or willful misconduct. In addition, the borrower should not have any liability to the lender to the extent that it can establish that any environmental violation occurred after the property is conveyed to a third party as a result of a foreclosure, power of sale or deed in lieu of foreclosure.

E. Termination of Indemnity. The lender will want the indemnity to survive the repayment of the loan. The borrower will want the indemnity to terminate when the loan is repaid in full. Most lenders will agree to a termination of the indemnity within a certain period of time either after the loan has been repaid or the date that the lender, or its affiliate, acquires the property. If the loan has been repaid, there is little chance that the lender will ever

be considered an "operator" of the property. Some lenders will require that an environmental assessment be undertaken at the time of the indemnity termination in order to have evidence that the property was "clean" at the time of the loan payoff.

### IV. RECENT CASE LAW CONCERNING NONRECOURSE LOANS

In *Heller Financial, Inc. v. Lee*,<sup>2</sup> the borrower was found liable for the nonrecourse debt for a hotel in Orlando, Florida. The note contained a nonrecourse clause provided that "[s]ubject to the provisions set forth below, no Maker shall be personally liable to pay the Loan . . . ." However, the note also included a carveout, which stated:

[N]otwithstanding the foregoing, each Maker (excluding Robert Ahnert), jointly and severally, shall be personally liable for . . . (b) repayment of the Loan and all other obligation[s] of Maker under the Loan Documents in the event of (i) any breach of any of the covenants in Section 6.3 or 6.4 of the Loan Agreement pertaining to transfers, assignments and pledges of interests and additional encumbrances in the Property and the Corporation . . . .<sup>3</sup>

Section 6.4 of the loan agreement prohibited the borrower from permitting the filing of any lien or other encumbrance on the Property. Ultimately though, six liens were filed on the property, to which the lender did not consent. Based on the terms of the note, the court, applying Illinois law, found that there was a default and the entire indebtedness was due and payable.<sup>4</sup> The borrower attempted to avoid this result by arguing that the carve outs were actually liquidated damages provisions that were unenforceable as penalties. The court however, concluded that that the carve out was not a liquidated damages provision because it only provided for actual damages; the amount outstanding under the loan.<sup>5</sup> However, assuming that the outstanding debt exceeded the aggregate amount of the impermissible liens, the carve out provided for a remedy greater than the actual damages from the default. From the opinion, it does not appear that this argument was raised, as the court did not address it.

In *Penn Mutual Life Insurance Company v. Cleveland Mall Associates*,<sup>6</sup> the lender bid on a mall renovation project at the foreclosure sale, but paid less for it than the amount of the debt. The lender then wanted to recover the difference. The court granted the defendants' motion in limine and held that the value of the mall is the amount at which the lender had successfully bid for it at the foreclosure sale.

In reaching its conclusion, the court relied on the rule in *Whitestone Savings and Loan Association v. Allstate Insurance Company*,<sup>7</sup> which deems the price bid at a foreclosure sale to be the value of the property. Allowing the mortgagee to sue later on grounds that the property is actually worth less than the bid price would undermine the integrity of a foreclosure

<sup>2</sup> No. 01 C 6798, 2002 WL 1888591 (N.D. Ill. Aug. 16, 2002).

<sup>3</sup> *Id.* at \*1.

<sup>4</sup> See *Id.* at \*5.

<sup>5</sup> See *Id.*

<sup>6</sup> 916 F. Supp. 715 (E.D. Tenn., 1996).

<sup>7</sup> 270 N.E.2d 694 (1971)

sale and create the possibility of fraud or of a double recovery when the mortgagee seeks the proceeds of any insurance on the property. The lender in *Penn* argued that there should be a tort/fraud exception to the *Whitestone* rule under the circumstances of a nonrecourse loan because when the loan is nonrecourse, the lender has no motivation to bid less than the amount of the debt, as a deficiency will not be available. The court rejected this argument, stating that there is no reason for the lender to bid any less than the value of the property.

The lesson from *Penn* is to always pursue a deficiency if possible. This case did not discuss any negotiated carveout for fraud. Presumably, that is because either no such carveout appeared in the documentation or more likely, because the question never became ripe: in the court's eyes, the lender recovered the entire debt when it bid the full amount at the foreclosure sale. In fact, the court even stated that one reason to bid less than the full amount of the debt in the nonrecourse context could be that the lender may have other reasons to pursue the borrower.<sup>8</sup> These reasons could include a remedy based on a nonrecourse carve out.

The case of *Travelers Ins. Co. v. 633 Third Assocs.*<sup>9</sup> shows how the acts of the borrower can cause a court to "override" a nonrecourse provision. The lender loaned the borrower \$145 million on a nonrecourse basis. The borrower learned that it would be losing some important tenants. Faced with a depressed real estate market and mounting vacancies, the borrower distributed \$4 million to its partners and was prepared to distribute another \$17 million. The lender brought suit to set aside the first distribution and to enjoin the proposed distribution as a fraudulent conveyance. The district court dismissed the complaint because it determined that the lender had no property interest in the accumulated cash assets of the borrower due to the non-recourse provisions. Because it had no interest it could not claim to be injured by actual or threatened distributions. Later, the borrower failed to pay its real estate taxes and its loan payments. After such default, the borrower distributed the \$17 million to its partners. The next day the lender filed for foreclosure and had a receiver appointed. The lender amended its complaint alleging that the distributions rendered the borrower incapable of performing its obligations under the loan, including the payment of property taxes. The lender claimed that the failure to pay property taxes would constitute waste remediable in equity, as would failure to maintain the property in good condition and repair. The district court dismissed the lender's equitable action for waste because it would lie only against a mortgagor in possession and because at the time of the complaint a receiver was in place.

The court recognized that the intentional failure to pay property taxes where there is an obligation to do so or where the failure is fraudulent constitutes waste. The court further held that the mere failure to pay principal and interest will not constitute waste. The court allowed the claim of waste relating solely to the period of time before the appointment of a receiver. The court also found that the distribution injured the lender because the borrower might have been enjoined from distributing cash reserves to its partners on the grounds that such a distribution would have prevented it from paying property taxes. Accordingly, the lender had standing to challenge the distributions under the fraudulent conveyance statute insofar as the lender's claims related to the portion of the distributions against which an equitable action for waste could be brought.

<sup>8</sup> *Penn*, 916 F.Supp. at 718.

<sup>9</sup> 14 F.3d 114 (2d Cir. 1994), reversing 816 F.Supp. 197 (S.D.N.Y. 1993).

The most recent case is *Blue Hills Office Park LLC v. J.P. Mortgage Chase Bank*.<sup>10</sup> This case demonstrates that sometimes it is best to deliver back the property as soon as possible and that prior actions can come back to haunt a borrower if the non-recourse carve-outs are not drafted well. In *Blue Hills*, the borrower brought an action against the lender for breach of the covenant of good faith and fair dealing. The basis for the claim was that the lender failed to make available to the borrower certain sums held in a leasing reserve to pay real estate taxes and debt service on the loan. This reserve account was established for the payment of loan principal and interest if the primary tenant vacated the property.

The biggest problem for the borrower and the guarantors of the loan was that the borrower had entered into a settlement agreement with the owner of the adjacent property and waived its right to object to the issuance of a special permit to construct a parking garage. Without notifying or seeking the consent of the lender, the borrower entered into such settlement agreement with the adjacent property owner and an affiliate of the property's primary tenant. The borrower received \$2,000,000 in settlement proceeds and never notified the lender of such settlement. The primary tenant gave notification to the borrower that it was not renewing its lease. As a result the borrower did not have sufficient funds to pay the real estate taxes that were due. The borrower requested the lender to make funds available from the leasing reserve to pay debt service and the real estate tax payment. The lender did not respond to such request but did pay the real estate taxes. However, the lender told the borrower that the loan was accelerated as of August 2, 2004, the date the real estate taxes were due. Thereafter, the lender notified the guarantors of its intention to foreclose on the property and of their potential liability under the guaranty in case of a deficiency in the proceeds of the foreclosure sale. The foreclosure sale occurred and the property was sold for less than the outstanding debt. The lender then requested the guarantors to pay the deficiency.

The lender contended that the borrower transferred part of the mortgaged property without the prior written consent of the lender as a result of entering into the settlement agreement and not providing such funds to the lender. As a result, such event triggered full recourse liability under the loan. The court agreed with such analysis and the failure to pay the \$2,000,000.00 to the lender caused the guarantors to become liable for the full deficiency, which was greater than the \$2,000,000 not paid over to the lender. It should also be noted that the court found that the borrower failed to maintain its status as a single purpose entity. Such a violation also caused full recourse liability under the loan.

## V. OTHER PROTECTIVE DEVICES

In addition to nonrecourse carve outs, lenders often employ other mechanisms to protect against the risk presented by nonrecourse loans. The two most common that appear in almost all such loans are the requirement that the borrower be "bankruptcy remote" and that some sort of cash management arrangement be put in place.

A. Bankruptcy Remote Entity. Under a bankruptcy remote structure, the borrower is formed as a special purpose entity whose single purpose is own and operate the property secured by the loan. While it is becoming more common for these entities to be organized as limited liability companies, the corporate and partnership forms of organization

<sup>10</sup> 477 F. Supp. 366 (Mass. 2007)



can also be used. Pursuant to the special purpose entities' organizational documents, the entity is prohibited from filing for bankruptcy without the unanimous consent of its governing body. This governing body can be a board of directors, its general partners, or a board of managers. One or more of these parties is typically an independent party designated by the lender or by some third party. The loan documents will likely also include covenants that insure that the borrower is treated as a separate and distinct entity from its parent. Borrower's counsel frequently will be required to issue an opinion that consolidation of the borrower with its affiliates is not likely.

B. Cash Management Agreement. Cash management agreements are also often used to protect against the risk of misapplication of funds in nonrecourse loans. The cash management arrangement is intended to insure that either on an ongoing basis or upon a loan default, all income produced by the property will automatically flow into a separate account to which the borrower does not have free access. If sufficient income is generated by the project, the use of a cash management agreement shall insure that operating expenses, taxes and other impositions will be paid and also make it unlikely that the borrower will be able to drain money out of the project. In addition to the cash management arrangement, lenders may also require that certain reserve accounts be maintained or other credit enhancements such as letters of credit be used to decrease some of the risk.

## VI. TAX IMPLICATIONS OF NONRECOURSE DEBT

A borrower under a nonrecourse loan who chooses to give up the collateral and walk away from a project essentially sells the property to its lender. This analogy becomes even more apropos when the tax aspects of the transaction are considered.

Generally, nonrecourse purchase money mortgages are included in the borrower's basis for the property. This general rule is limited in three situations: (1) when the nonrecourse debt exceeds the fair market value of the property; (2) when the seller retains significant control over the property transferred; and (3) when the term of the nonrecourse debt exceeds the useful economic life of the encumbered property.<sup>11</sup>

When contemplating exiting a project with nonrecourse debt, concerns regarding tax implications will move higher on the priority list. The leading case regarding mortgage rules for tax implications is *Crane v. Commissioner of Internal Revenue*<sup>12</sup> in which the Supreme Court held that the amount realized on the disposition of encumbered property includes the amount of any liability in which the taxpayer-debtor is relieved.

However, the Court in *Crane* indicated that if nonrecourse liability exceeded the value of the property, the amount realized would be limited to the property's value.<sup>13</sup> The concept behind this economic benefit theory was that when nonrecourse debt exceeds the value of the property, the debtor cannot be held personally liable for the debt and will treat the debt as being limited to the value of the property. However, in a later case, the Supreme Court rejected this reasoning and held that the amount realized for tax purposes included the entire

nonrecourse liability even if it exceeded the fair market value of the encumbered property.<sup>14</sup> In *Commissioner of Internal Revenue v. Tufts*, the taxpayer had a basis in the property, after depreciation, deductions and other capital contributions of \$1,455,740.00, and the fair market value of the property was \$1,400,000.00. The nonrecourse debt on the property exceeded both of these amounts and the taxpayer, following the reasoning from *Crane*, claimed a loss of \$55,740.00. While acknowledging the validity of *Crane* rationale, the Court departed from its logic and found that there was a gain of approximately \$400,000.00 after including the entire nonrecourse mortgage that was assumed.

## VII. CONCLUSION

When one thinks of an exculpated real estate loan, one normally assumes that the lender has agreed to waive its right to seek recovery from any asset of the borrower other than the collateral securing such loan in the event of either a payment or a performance default under the loan documents. The lender has agreed to look solely to such security for repayment and waives its right to obtain a deficiency judgment against the borrower. The borrower has a viable exit strategy if the deal goes "south" with a financial exposure limited to its equity in such real estate.

The lender has concerns in any exculpated deal that the borrower may do "bad things" such as misapplication of funds or the commission of fraud or misrepresentation at the time of the loan application or loan closing, inducing the lender to make a nonrecourse loan based on such underwriting considerations. The lender also is concerned with economic risks dealing with the operation of the property, such as payment of impositions, the maintenance of the property, the filing of mechanics' liens and environmental contamination. The lender is also concerned about the time and expense involved in foreclosing on a property when it is the only source of recovery for the loan and the borrower is no longer interested in managing and operating the same.

The lesson to be learned in arriving at a balance of these concerns is that the carve outs should be addressed at the loan commitment stage and not negotiated during the closing process. Both parties are entitled to get the benefit of their intended bargain, but "nonrecourse" certainly can mean different things to different people depending on which side of the borrower/lender table you are sitting on. It should be noted that a violation of a non-recourse carve-out can cause a non-recourse guarantor to be liable for the entire loan amount even if the violation causes actual damages less than the amount of the outstanding loan. Notwithstanding the parties' intentions at the closing of the loan, that nonrecourse loan may not be as nonrecourse as the borrower and the guarantors originally thought.

## VIII. SAMPLE PROVISIONS

- A. Borrower's Broad Exculpation.
- B. Lender's Narrow Exculpation.

<sup>11</sup> GUERIN, SANFORD M., TAXATION OF REAL ESTATE TRANSACTIONS 17 (2001).

<sup>12</sup> 331 U.S. 1 (1947).

<sup>13</sup> *Id.* at 14 n. 37.

<sup>14</sup> *Commissioner of Internal Revenue v. Tufts*, 461 U.S. 300, 307 (1983)

## ATTACHMENT A

Notwithstanding anything to the contrary contained herein or in any other Loan Documents, except as expressly provided for in the Guaranty of Completion or the Guaranty of Payment, no past, present or future partner of the Borrower shall have any personal liability for the repayment of principal or interest on the Loan or for the payment or performance of any of the agreements or obligations whatsoever, monetary or otherwise, of the Borrower pursuant to the Loan Documents, all such liability being expressly waived by the Banks and the Agent, and the Agent and the Banks shall look solely to the assets of the Borrower for the repayment of such principal and interest and for the performance of such agreements or obligations and shall not seek any deficiency or personal judgment against any past, present or future partner of the Borrower; provided, however that the foregoing provisions of this paragraph shall not limit the liability of either the Guarantor or the General Partner for fraud.

## ATTACHMENT B

### Section X. Exculpation.

(a) Except as otherwise provided in this Section X, neither Borrower nor any constituent partner of Borrower shall be personally liable for the payment of any principal, interest or other sum evidenced by the Note or for any deficiency judgment that Lender may obtain following the foreclosure of the Mortgage; and Lender's sole recourse against Borrower for any default under the Note, the Mortgage or any other Loan Document shall be limited to the property encumbered by the Mortgage and any other collateral given to secure the Loan (collectively, the "Property").

(b) The foregoing limitation of liability set forth in subsection (a) above shall not apply, affect, impair or prejudice Lender's rights to:

(1) name Borrower or any constituent partner of Borrower as a partner defendant in any action, proceeding, reference or arbitration, subject to the limitations of this Section X;

(2) assert any unpaid amount due under the Loan as a defense or offset against any claim or cause of action against Lender by Borrower, any of its constituent partners, or any guarantor or indemnitor in connection with the Loan;

(3) exercise self-help remedies (such as setoff) against any real or personal property of Borrower or any other person or entity;

(4) enforce against any person or entity whatsoever, including Borrower and its constituent partners, and recover under any leases, master leases, guarantees of payment, guarantees of completion, environmental or other indemnities, surety bonds, letters of credit, insurance policies and other similar rights to payment or performance which may be executed in connection with the Loan or the Property;

(5) recover against Borrower compensatory, consequential and punitive damages as well as any other costs and expenses incurred by Lender (including, without limitation, attorneys', experts' and consultants' fees and expenses) as a result of Borrower's fraud, breach of trust, breach of warranty, misrepresentation, waste, failure to maintain the insurance required under the Loan Documents, failure to pay taxes or assessments which are a lien against the Property, breach of the due-on-sale clause of the Mortgage, breach of the restriction against further encumbrance contained in the Mortgage, entry into or modification of leases in violation of the provisions of the Loan Documents, or receipt of rentals for periods of more than \_\_\_\_\_ month(s) in advance under leases of the Property;

(6) recover any insurance proceeds, condemnation, awards, tenant security deposits, utility deposits, prepaid rents or other similar funds or payments attributable to the Property which were not paid to Lender or were not otherwise applied as required in the Loan Documents;

(7) recover any rents, income, revenues, issues and profits of the Property that were received at any time after the occurrence of an Event of Default or at any time within the 12 month period preceding such occurrence that were not applied as required under the Loan Documents, or if the Loan Documents contain no such requirements, that were not applied to pay amounts due under the Loan Documents, operating and maintenance expenses (including taxes and insurance premiums) of the Property, and any deposits to a reserve or escrow account as required under the Loan Documents;

(8) recover any Loan proceeds not applied as required under the Loan Documents;

(9) enforce against Borrower all of Borrower's obligations to complete construction on the Property as contemplated by the Loan Documents;

(10) enforce any indemnity or other obligation of Borrower which may arise from or in connection with Lender's issuance of or performance under any set aside letter, or the enforcement of any set aside letter against Lender;

(11) recover from Borrower and its constituent partners the entire indebtedness evidenced or secured by the Loan Documents in the event of the exercise of any right or remedy under any federal, state or local forfeiture law resulting in the loss of the lien of the Mortgage (or the priority thereof) against the Property, less any proceeds Lender may receive under its title insurance policy therefor;

(12) recover from Borrower and its constituent partners (A) any fees, expenses, costs and charges (including attorneys', experts' and consultants' fees and expenses) which Lender incurs as a party (by intervention or otherwise) to any action or proceeding directly or indirectly affecting Borrower, the Property or Lender's interests, rights or remedies under any of the Loan Documents or (B) any payments or funds expended or advanced by Lender pursuant to the provisions of any Loan Document to perfect, protect or maintain the priority of any Loan Document or to protect, repair or maintain the Property;

(13) recover from Borrower and its constituent partners any loss, liability or expense (including attorneys', experts' and consultants' fees and expenses) incurred by Lender in connection with any claim or allegation made by Borrower or any of its constituent partners, or any successor, assign or creditor of Borrower or any of its constituent partners, that the Loan is, or any Loan Document establishes, a joint venture or partnership arrangement between Lender and Borrower;

(14) recover from Borrower and its constituent partners any amount withdrawn from any account in which Lender has a security interest unless such withdrawal was made in accordance with the document creating such security interest or was otherwise authorized by Lender in writing; or

(15) recover any costs, expenses of liabilities (including attorneys', experts' and consultants' fees and expenses) incurred by Lender and arising from a breach of any judgment, verdict, order, consent decree or settlement relating to the deposit, storage, disposal, burial, dumping, spilling, leaking, cleanup, characterization, remediation or

abatement of toxic or hazardous waste, hazardous materials, hazardous substances or waste products (as defined in any applicable federal or state law) or arising from any environmental provision in any Loan Document relating to the Property or any portion thereof (including, without limitation, any such environmental provision contained in the Mortgage or in any environmental indemnity given to Lender in connection with the Loan).

(c) Borrower and its constituent partners shall be personally liable for the payment of all amounts and performance of all obligations described in the foregoing subsection (b), clauses (1) through (15).

(d) Notwithstanding the limitation of liability in subsection (a) above, Borrower shall be fully personally liable for all of Borrower's obligations under the Loan Documents, and Lender's recourse to the personal assets of Borrower and its constituent partners shall not be limited in any way by this Section X, if Borrower (A) attempts to prevent or delay the foreclosure of the Mortgage or any other collateral for the Loan or the exercise of any of Lender's other remedies under any Loan Document, or (B) claims that any Loan Document is invalid or unenforceable and such a claim will have the effect of preventing or delaying such foreclosure or any other exercise of remedies. Without limitation, Borrower shall be deemed to have attempted to prevent or delay such foreclosure or other exercise of remedies if (i) borrower files a petition under the Bankruptcy Reform Act of 1978, 11 U.S.C. §101 et seq. (the "Bankruptcy Code"), as amended, (ii) Borrower opposes a motion by Lender to lift an automatic stay imposed pursuant to 11 U.S.C. §362 and for leave to foreclose the Mortgage and any other collateral for the Loan, or (iii) Borrower files a proposed plan of reorganization under the Bankruptcy Code under which Lender would receive (x) less than all of the Property or (y) a lien encumbering less than all of the Property or (z) a lien having a lower priority or terms less favorable to Lender than the Mortgage as it existed immediately prior to the filing of a petition under the Bankruptcy Code. Nothing in this Section X shall be deemed to be a waiver of any right which Lender may have under Sections 506(a), 506(b), 1111(b) or any other provision of the Bankruptcy Code to file a claim that all of the Property shall continue to secure all of the indebtedness owed to Lender under the Loan Documents.

(e) Nothing in this Section X shall release, impair or otherwise affect the validity or enforceability of the Note, the Mortgage and the other Loan Documents or the perfection or priority of the lien of the Mortgage upon the Property. Nothing herein shall be construed to prohibit Lender from exercising any remedies available to Lender provided that, except as provided in subsections (b) and (d) above, Lender shall not attempt to execute against or recover out of any property of Borrower other than the Property. Nothing herein shall modify, diminish or discharge the personal obligations under the Loan Documents as set forth in a separate written guaranty thereof, or the personal liability of Borrower or any other person or entity under any indemnification provisions of the Loan Documents.

## Michigan's Legislature Declares Post Closing Solvency Covenants Unenforceable as Nonrecourse Carveouts

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Michigan borrowers in general and nonrecourse carve out guarantors in particular, have had great cause for concern in the aftermath of two court decisions that parsed the intricacies of the specific contract language while ignoring the basic purpose of CMBS lending and the rationale behind SPE ("single or special purpose entity") status. *Wells Fargo Bank, NA v. Cherryland Mall*, \_\_\_ N.W. 2d \_\_\_, 2011 WL678593 (Mich. App. 2011) and *51382 Gratiot Avenue Holdings Inc. v. Chesterfield Development Company*, 2011 U.S. Dist. LEXIS (E.D. Mich. 2011) have turned the CMBS industry on its ear by transforming nonrecourse guarantees into full recourse guarantees merely on the basis of insolvencies caused by the economic downturn. The mere insolvency of a borrower in a CMBS loan had never before been understood to trigger recourse to the carveout guarantor unless, perhaps, if the insolvency was caused by other bad acts of the borrower. Otherwise, since virtually every defaulting borrower entity is arguably insolvent, every so-called nonrecourse loan would, actually be the opposite. This would lead to the absurd result that a carveout guarantor's liability would be limited to actual damages caused by "bad boy" acts, but have full liability if the value of the property falls below the amount of the debt merely because of market conditions.

In the past several years, numerous CMBS properties have been foreclosed upon, while numerous others have been given back to the lender by deed in lieu of foreclosure. Where there have been deficiencies in foreclosure sales or there have not been releases obtained for the benefit of the guarantor, these two cases have sent a chill up the spine of many who had tried to put the past behind them. Special servicers, on the other hand, may feel that they have been handed a recoupment tool on a silver platter. Special Servicers are asking attorneys whether they can, should or have a fiduciary duty to examine all past deficiencies to make a determination regarding probable liability and potential collectability from carve out guarantors. In Michigan there is a six year statute of limitations to bring these "new" claims that had not previously been on anyone's radar screen. Each state has its own statute covering enforcement of guarantees. Obviously tens, if not hundreds of billions of dollars of guarantor exposure is implicated if suddenly nonrecourse carve out guarantors are liable for deficiency judgments based solely on the borrower's insolvency. How about the question of whether a carveout guarantor needs to include this potential liability on their financial statement as a contingent liability that is no longer as remote as it previously seemed?

Numerous CRE trade associations and others submitted amicus briefs in the Michigan Court of Appeals supporting reversal of the lower court ruling in the *Cherryland* case. The CMBS world held its breath waiting and watching. Disappointingly, the court exalted form over substance, gave short shrift to the fundamental purpose of the particular covenants involved, ignored direct evidence of the actual intent of the parties that insolvency was not a recourse triggering event, but wrote that if its decision appeared "*incongruent with the nature of nonrecourse debt*" and could result "*in economic disaster for the business community in Michigan*" it was a matter of public policy best addressed by the legislature. *Cherryland* at 16.

## Michigan's Legislature Acts Swiftly to Enforce the Original Intent of Nonrecourse CMBS Loans Page 2

In light of the court's invitation on December 27, 2011, the actual existence of two deficiency judgments totaling over twelve million dollars, more lawsuits being filed by the law firm representing the different special servicers hoping to seize these new opportunities, Michigan's commercial real estate interests took action. Led by the Building Owners and Managers Association of Metro Detroit (BOMA) and with the support and backing of the entire CRE community, legislation was proposed and quickly passed to end the threat of these cases for guarantors in Michigan. On March 29, 2012, Michigan's Governor signed the Michigan Nonrecourse Mortgage Loan Act into law. <http://www.legislature.mi.gov/documents/2011-2012/publicact/pdf/2012-PA-0067.pdf>. The Act passed with overwhelming, bi-partisan support in the Michigan Senate 37-5 and the Michigan House 97-12. It expressly declares a borrower's "insolvency" unavailable as a triggering event for a non-recourse carveout in a commercial mortgage loan on Michigan property, characterizing such springing recourse as a deceptive trade practice and, as such, unenforceable. The enabling language of the new law states:

The legislature recognizes that it is inherent in a nonrecourse loan that the lender takes the risk of a borrower's insolvency, inability to pay or lack of adequate capital after the loan is made and that the parties do not intend that the borrower is personally liable for payment of a nonrecourse loan if the borrower is insolvent, unable to pay, or lacks adequate capital after the loan is made. The legislature recognizes that the use of a post closing solvency covenant as a nonrecourse carveout, or an interpretation of any provision in a loan document that results in a determination that a post closing solvency covenant is a nonrecourse carveout, is inconsistent with this act and the nature of a nonrecourse loan; is an unfair and deceptive business practice and against public policy; and should not be enforced.

It states in §3(1) that: "A post closing solvency covenant shall not be used, directly or indirectly, as nonrecourse carveout or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan." The Act was given immediate and retroactive effect and expressly applies to the "enforcement and interpretation of all nonrecourse loan documents in existence on, or entered into on or after the effective date of this act. §5. The enabling language of the new law goes on to state:

It is the intent of the legislature that this act applies to any claim made or action taken to enforce a post closing solvency covenant on or after the effective date of this act, to any claim made to enforce a post closing solvency covenant that is pending on the effective date of this act; and to any action to enforce a post closing solvency covenant that is pending on the effective date of the act, unless a judgment or final order has been entered in that action and all rights to appeal that judgment or final order have been exhausted or have expired.

While Michigan's Nonrecourse Mortgage Loan Act ostensibly solves the problem of the *Cherryland* and *Chesterfield* cases for CMBS loans on Michigan properties or governed by Michigan law, it remains to be seen what the impact of those cases as "persuasive authority" will be in other states if lenders attempt to pursue carve out guarantors on this basis. It can certainly be said that Michigan's legislature acted with such speed and virtual unanimity that there is no doubt regarding its views about those cases. Yet, the final chapter on the cases and the new

**Michigan's Legislature Acts Swiftly to Enforce  
the Original Intent of Nonrecourse CMBS Loans**  
Page 3

law is still in the drafting stage. The *Cherryland* case is pending on application for review by the Michigan Supreme Court. The *Chesterfield* case is on appeal to the United States 6<sup>th</sup> Circuit. While each case could be decided on the merits, either court may dispose of the appeal before it as moot. This would be a mistake, especially since the lender has announced its plan to challenge the legislation—at least its retroactivity—on constitutional grounds. It would be ironic if the guarantors were first victimized by springing recourse and then victimized a second time by a springing judgment if the legislation is later invalidated in whole or in part. It would also be unfortunate if the *Cherryland* and *Chesterfield* cases actually remained uncriticized by higher courts when they have been criticized in virtually every other corner and by every other scholar that has written on the subject.

The constitutional challenge should be interesting and may not be an all or nothing proposition. The Michigan legislature identified three classes of claims for immediate and retroactive effect: 1) those that may be brought in the future based upon provisions in existing loan documents and 2) those that are currently pending or being litigated through the courts, including 3) those that may have already resulted in a judgment, so long as the cases are under appeal. Not surprisingly, the lender's attorney wants to protect the judgments he has fought hard to secure. He will argue that his client's contract rights have been impaired and constitutional rights have been violated. The obvious counter argument is that the legislation did not take away any right that the contracts provided. Those rights never existed. The legislation only took away an interpretation by the courts that was incorrect under every fundamental understanding of CMBS and the original intent of the parties. The Contract Clause prohibition (both federal and Michigan) on impairment of contract is not absolute and is subject to the inherent police power of the State to safeguard the interests of its people. Thus, litigation over the constitutionality of the statute will involve an examination of whether 1) there actually is an impairment (is there such a thing as a carveout for insolvency in a CMBS loan); 2) the law is necessary to the public good in that State (such as avoiding the freeze of CMBS investment in a state and the draining of its resources); and 3) the manner in which the Legislature to addressed the problem was reasonable. A court may differentiate between the classes of claims being given retroactive effect as part of that constitutionality analysis or sustain the broad retroactivity as reasonable under all of the circumstances.

The question of whether a post closing solvency covenant should ever trigger nonrecourse carve out guarantor liability is one with billions of dollars of implications around the country. How the Michigan courts have dealt with this, how the CRE community has responded to it, how the Michigan legislature resolved it and the attendant litigation will be instructive for practitioners, judges, investors, lenders and legislators.

Act No. 67  
Public Acts of 2012  
Approved by the Governor  
March 29, 2012  
Filed with the Secretary of State  
March 29, 2012  
EFFECTIVE DATE: March 29, 2012

STATE OF MICHIGAN  
96TH LEGISLATURE  
REGULAR SESSION OF 2012

Introduced by Senators Meekhof and Richardville

## ENROLLED SENATE BILL No. 992

AN ACT to regulate the use and enforceability of certain loan covenants in nonrecourse commercial loan transactions in this state.

*The People of the State of Michigan enact:*

Sec. 1. This act shall be known and may be cited as the "nonrecourse mortgage loan act".

Sec. 2. As used in this act:

(a) "Nonrecourse carveout" means a specific exception, if any, to the nonrecourse provisions set forth in the loan documents for a nonrecourse loan that has the effect of creating, if specified events occur, personal liability of the borrower or a guarantor or other surety of the loan for all or some amounts owed to the lender.

(b) "Nonrecourse loan" means a commercial loan secured by a mortgage on real property located in this state and evidenced by loan documents that meet any of the following:

(i) Provide that the lender will not enforce the liability or obligation of the borrower by an action or proceeding in which a money judgment is sought against the borrower.

(ii) Provide that any judgment in any action or proceeding on the loan is enforceable against the borrower only to the extent of the borrower's interest in the mortgaged property and other collateral security given for the loan.

(iii) Provide that the lender will not seek a deficiency judgment against the borrower.

(iv) Provide that there is no recourse against the borrower personally for the loan.

(v) Include any combination of subparagraphs (i) to (iv) or any other provisions to the effect that the loan is without personal liability to the borrower beyond the borrower's interest in the mortgaged property and other collateral security given for the loan.

(c) "Nonrecourse provisions" means 1 or more of the provisions described in subdivision (b)(i) to (v), whether or not the loan is subject to a nonrecourse carveout or carveouts.

(d) "Post closing solvency covenant" means any provision of the loan documents for a nonrecourse loan, whether expressed as a covenant, representation, warranty, or default, that relates solely to the solvency of the borrower, including, without limitation, a provision requiring that the borrower maintain adequate capital or have the ability to pay its debts, with respect to any period of time after the date the loan is initially funded. The term does not include a covenant not to file a voluntary bankruptcy or other voluntary insolvency proceeding or not to collude in an involuntary proceeding.

Sec. 3. (1) A post closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carveout or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan.

(2) A provision in the documents for a nonrecourse loan that does not comply with subsection (1) is invalid and unenforceable.

(14)

Sec. 4. This act does not prohibit a loan secured by a mortgage on real property located in this state from being fully recourse to the borrower or the guarantor, including, but not limited to, as a result of a post closing solvency covenant, if the loan documents for that loan do not contain nonrecourse loan provisions.

Sec. 5. This act applies to the enforcement and interpretation of all nonrecourse loan documents in existence on, or entered into on or after, the effective date of this act.

Enacting section 1. The legislature recognizes that it is inherent in a nonrecourse loan that the lender takes the risk of a borrower's insolvency, inability to pay, or lack of adequate capital after the loan is made and that the parties do not intend that the borrower is personally liable for payment of a nonrecourse loan if the borrower is insolvent, unable to pay, or lacks adequate capital after the loan is made. The legislature recognizes that the use of a post closing solvency covenant as a nonrecourse carveout, or an interpretation of any provision in a loan document that results in a determination that a post closing solvency covenant is a nonrecourse carveout, is inconsistent with this act and the nature of a nonrecourse loan; is an unfair and deceptive business practice and against public policy; and should not be enforced. It is the intent of the legislature that this act applies to any claim made or action taken to enforce a post closing solvency covenant on or after the effective date of this act; to any claim made to enforce a post closing solvency covenant that is pending on the effective date of this act; and to any action to enforce a post closing solvency covenant that is pending on the effective date of this act, unless a judgment or final order has been entered in that action and all rights to appeal that judgment or final order have been exhausted or have expired.

This act is ordered to take immediate effect.

*Carol Morey Viventi*  
Secretary of the Senate

*Gay E. Randall*  
Clerk of the House of Representatives

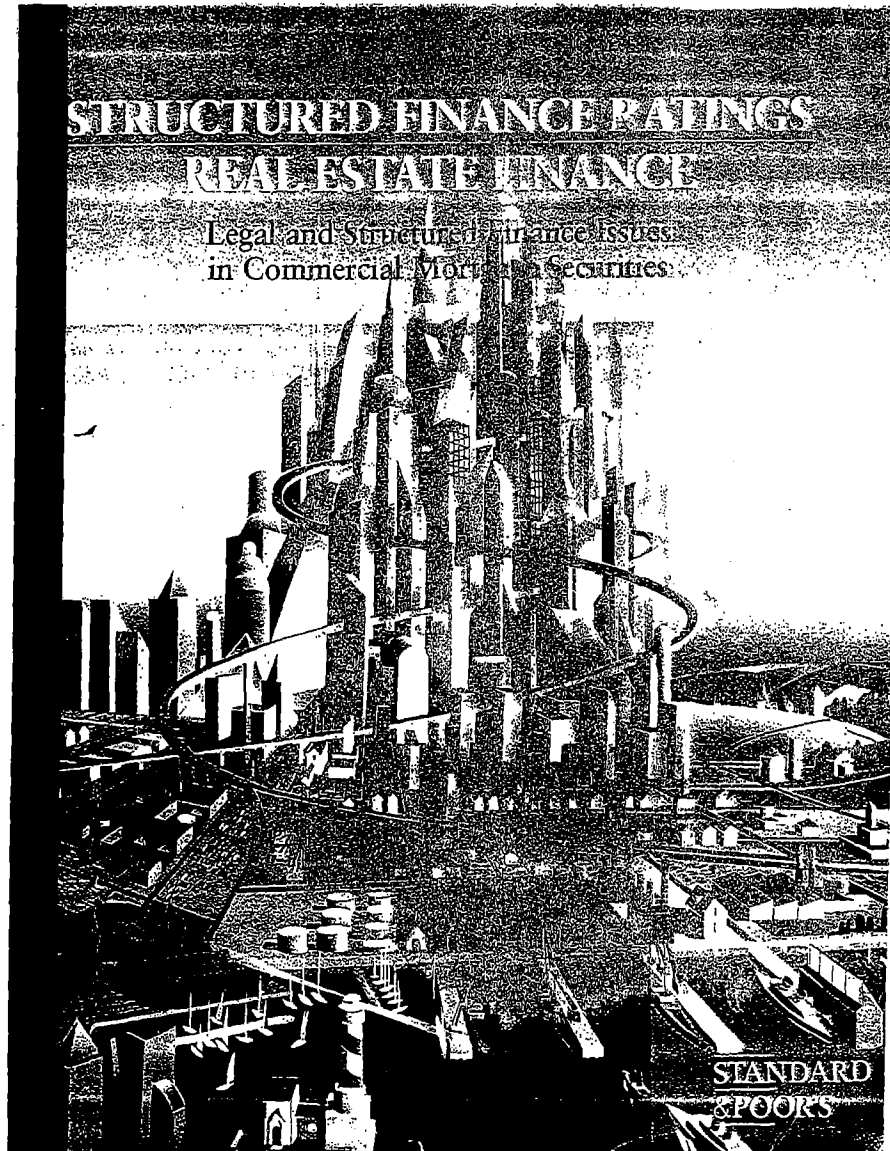
Approved .....

.....  
Governor

# STRUCTURED FINANCE RATINGS

## REAL ESTATE FINANCE

Legal and Structured Finance Issues  
in Commercial Mortgage Securities



## CHAPTER FOUR SPECIAL-PURPOSE BANKRUPTCY-REMOTE ENTITIES

### OVERVIEW

The terms "single purpose," "special purpose," and "bankruptcy remote" are used in a variety of contexts throughout structured finance and securitization. Although the terms have generally recognized meanings, those meanings may vary greatly depending on the role of the entity and the type of transaction. Special-purpose bankruptcy-remote entities ("SPEs") are used in a wide variety of commercial mortgage securitizations. Furthermore, the role of the SPE may be that of borrower, depositor, general partner, member, lessor, issuer or some other role.

As the commercial mortgage securitization market has evolved, so has the special-purpose bankruptcy-remote real estate vehicle. In early pool transactions only the depositor was required to be an SPE (see Chapter Two, Pool Transactions). The depositor would perform only one function in its "corporate" life, i.e., depositing commercial mortgage loans into the trust which would issue the rated securities. Creating the depositor as an SPE was relatively straightforward—once the depositor deposited the loans, it was prohibited from engaging in any other activities which would expose it to liabilities. The prohibition rarely presented any business problems because once the deposit was complete, there was little need for the continued existence of the depositor in the first place. This is still generally true with respect to pool deals. However, in the last few years, Standard & Poor's has seen an increasing number of property-specific transactions where the underlying borrower, who owns and operates real estate as a business, must also be an SPE. Because the borrower is very much an operating entity, criteria had to be developed to meld the historical SPE depositor criteria with the realities of owning and operating real estate.

In January 1993, Standard & Poor's published its Real Estate Finance SPE criteria to address the increasing changes in the commercial mortgage market. Since that time, Standard & Poor's has seen a number of commercial mortgage "conduit" transactions where pools of newly originated loans are being securitized. Standard & Poor's has received dozens of requests with respect to the need for SPEs in those conduit transactions. In addition to the newly formed commercial mortgage conduits, Standard & Poor's has begun to see real estate developers who want to use limited liability companies as borrowers in conduit, credit lease and other property-specific transactions.

As a result of the continuing changes in the real estate market and as the types of deals and vehicles change, Standard & Poor's has decided to publish below its criteria relating to SPEs in the context of commercial mortgage securitization transactions.

## RATIONALE FOR THE SPE IN A COMMERCIAL MORTGAGE TRANSACTION

To understand the rationale for Standard & Poor's criteria, it is necessary to first define an SPE in the most basic terms:

*An SPE is an entity which is unlikely to become insolvent as a result of its own activities and which is adequately insulated from the consequences of any related party's insolvency.*

The SPE is generally utilized in one of three different types of transactions:

1. The property-specific transaction;
2. The pool transaction; and
3. The credit lease transaction.

The most basic forms of these transactions, which are subject to a variety of structural permutations, are discussed in detail in Chapters One, Two and Three of this publication and are briefly summarized below.

### Property-Specific Transactions

The property-specific transaction is driven by owners and operators of real estate who are looking to borrow funds at a lower overall cost than what might be available from traditional lending sources.

In the property-specific transaction, Standard & Poor's credit analysis focuses on the property mortgaged by the borrower as collateral for the loan. It is critical to Standard & Poor's analysis that the borrower not be subject to economic problems unrelated to the borrower's real estate collateral. It is for this reason that the borrower in the property-specific transaction must be an SPE.

As noted above, many property-specific transactions include, as part of their structure, a deposit of one or more mortgage loans into a trust. As a result, a property-specific transaction may require multiple SPEs. In addition to the borrower being an SPE, the depositor may be required to be an SPE if the transfer of the loan by the depositor to a trust could not be characterized properly as a true sale.

## RATIONALE FOR THE SPE IN A COMMERCIAL MORTGAGE TRANSACTION (continued)

### Pool Transactions

As discussed in Chapter Two, in a traditional pool transaction, an owner of mortgage loans (the "Depositor") will transfer a portfolio of mortgage loans (together with any reserve funds, security deposits, insurance policies, LOCs, guarantees or other forms of credit enhancement for the mortgage loans) to a trust which will issue the rated securities in exchange for the proceeds from the sale of the securities which are issued by the trust and secured by the mortgage loans. Generally speaking, Standard & Poor's credit analysis in a pool transaction focuses on a combination of asset-specific and actuarial analysis of the economic characteristics of the mortgage pool, with limited analysis of the underlying pool borrowers.

One of the concerns that Standard & Poor's has in connection with the transfer of the loans from the Depositor to the trust is whether the transfer constitutes a "true sale" under applicable law. Even though the transfer may be accomplished by means of a "purchase and sale" agreement, circumstances surrounding the transfer could lead a court to conclude that the transfer of loans was not a sale but a financing transaction whereby the trust made a secured loan to the Depositor. If such a recharacterization were to occur, the transfer of the loans would be viewed as a pledge of collateral by the Depositor, and, if the Depositor were to become subject to a bankruptcy proceeding, the loans would be deemed to be part of the Depositor's estate under Section 541 of the U.S. Bankruptcy Code (the "Bankruptcy Code"). Consequently, the automatic stay and other Bankruptcy Code provisions could apply to the mortgage loans and their proceeds, creating the likely interference with payments on the rated securities.

In order to ameliorate the risk that the transfer is not a "true sale," the Depositor is frequently established as an SPE. The purpose of creating an SPE Depositor is to create an entity which should not become subject to a bankruptcy proceeding, thus alleviating the risk that the Depositor will become insolvent, file a bankruptcy petition and then (it or its creditors) claim that the transfer was not a true sale. If the Depositor does not become subject to a bankruptcy proceeding, there is a lower likelihood that the Depositor or its creditors will have any incentive to recharacterize the transaction as a secured financing.



### Credit Lease Transactions

As discussed in Chapter Three, in a credit lease transaction the borrower obtains a loan which is secured by a "triple net" lease to a rated tenant. The borrower executes a note and mortgage in favor of the lender and assigns its right to collect the rents to the lender. This lender will then deposit the note, mortgage and assignment of rents into a trust which will issue rated securities. (Again, as in property-specific transactions, the trust structure is not always utilized and the borrower may issue its notes directly).

The key difference between the structured credit lease transaction and traditional real estate financing is that in the structured credit lease transaction, if the tenant carries a credit rating (or its lease payments are guaranteed by a creditworthy entity), the borrower will be able to obtain a rating on its debt obligation, even though the borrower is not rated. Generally speaking, this rating will change only if the rating on the tenant improves or declines.

Because the rating on the transaction is tied to the tenant's rating (and not that of the landlord/borrower), it is critical that the landlord/borrower be an SPE. If the landlord/borrower were not bankruptcy remote, its insolvency could interfere with the flow of income paying the rated securities.

As with the property-specific transaction, a credit lease transaction may require multiple SPEs. If a depositor deposits the loan into a trust, in addition to the landlord/borrower being an SPE, the depositor may be required to be an SPE if the transfer of the loan by the depositor to the trust could not be characterized properly as a true sale.

### OVERVIEW OF SPE CRITERIA

Standard & Poor's SPE criteria can be divided up into four fundamental categories:

1. Items intended to prohibit the SPE from incurring liabilities:
  - Limitation on Purpose
  - Limitation on Indebtedness
  - Prohibition on liquidation, consolidation, merger, etc.
2. Items intended to insulate the SPE from liabilities of third parties:
  - Separateness covenants
  - Nonconsolidation opinions
3. Items intended to protect the SPE from dissolution risk:
  - Prohibition on dissolution
  - Special-purpose bankruptcy-remote equity owner (e.g., SPE general partners and SPE members)
4. Items intended to protect the solvent SPE from filing a bankruptcy petition:
  - Independent director

The three most frequently misunderstood aspects of the SPE are the independent director, the special-purpose equity owner and the nonconsolidation opinion.

#### Independent Directors

Generally speaking, Standard & Poor's requires that an SPE have an independent director among its board of directors. The independent director's vote is required to undertake certain actions, most importantly, to file a bankruptcy petition with respect to the SPE. The independent director is intended to protect against the situation where an otherwise solvent SPE might be voluntarily filed by directors who are also directors of the SPE's parent. For example, if there were no independent director, the board of directors of the SPE may be the exact same directors for the SPE's parent. If the parent were to become insolvent and deem it advantageous for the SPE to file a bankruptcy petition (irrespective of the effect on the SPE's creditors), the board of directors may simply vote to file a bankruptcy petition with respect to the solvent SPE. The independent director is intended in part to help insulate against the risk that the parent's board of directors will be able to control the SPE and vote to file the otherwise solvent SPE.

OVERVIEW OF SPE CRITERIA (continued)

Special-Purpose Equity Owner

The most frequently used SPEs in commercial mortgage transactions are corporations and limited partnerships. Although this is not the case with corporations, with limited partnerships there are circumstances under which the insolvency of an equity owner could cause a dissolution of the limited partnership.

Limited partnership SPEs are most frequently used as borrowers in credit lease and property-specific transactions. Generally speaking, they consist of one general partner and multiple limited partners. Under the Revised Uniform Limited Partnership Act, if a general partner of a limited partnership were to become subject to a bankruptcy proceeding, the partnership would dissolve unless it was otherwise continued or reconstituted by the remaining partners. Because Standard & Poor's cannot predict whether or not the remaining partners would continue or reconstitute, Standard & Poor's attempts to protect against the dissolution risk by requiring that the general partner of the limited partnership be an SPE. If the general partner is an SPE, this should greatly reduce the chances that the general partner will become insolvent and the partnership will dissolve.

The SPE general partner also protects against the possibility that the partnership would be involuntarily filed or that a bankruptcy court's approval might be required for the limited partnership to undertake certain acts which could be critical to the limited partnership's ability to repay the rated indebtedness. For example, if the sole general partner of an SPE limited partnership were to become insolvent and the partnership wanted to refinance the rated securities, it is possible that bankruptcy court approval might be required in order to refinance the rated securities. If, however, the general partner were an SPE, the general partner should not become the subject of a bankruptcy proceeding and no court approval would be required.

OVERVIEW OF SPE CRITERIA (continued)

Nonconsolidation Opinions

One of the fundamental components of an SPE is that the insolvency of an affiliate of an SPE should not impact the SPE. Under the equitable provisions of Section 105 of the Bankruptcy Code, a court has the power to "substantively consolidate" ostensibly separate but related entities. Substantive consolidation treats the assets and liabilities of the entities as if they belonged to one, enabling the creditors of each formerly separate estate to reach the assets of the consolidated estate.

In a commercial mortgage transaction, if an affiliate of the SPE were to become insolvent, it is possible that the affiliate or the affiliate's creditors would attempt to substantively consolidate the insolvent affiliate with the SPE, effectively placing the SPE under bankruptcy court protection and subjecting its assets to the claims of the affiliate's creditors.

When courts decide whether to substantively consolidate two entities, a great deal of their focus is on the degree to which the affairs of the entities are intertwined. The separateness requirements (see *Chapter Four, SPE Limited Partnerships*) are intended to separate the affairs of the affiliate with those of the SPE, and help protect against the consolidation risk. However, substantive consolidation is a complex subject and the separateness covenants alone will not adequately protect against the risk. For this reason, counsel to the SPE must properly structure the transaction and the relationship between the affiliate and the SPE to avoid the substantive consolidation risk. In order to confirm this structure, Standard & Poor's requires the counsel for the SPE to deliver an opinion to that effect.

SPECIFIC SPE CRITERIA

Although a wide range of entities such as general partnerships, limited partnerships, corporations, municipalities, not-for-profit institutions, eleemosynary institutions, public purpose corporations and business trusts are utilized in commercial mortgage transactions, the type of entities most frequently utilized in recently rated commercial mortgage transactions are corporations, limited partnerships and limited liability companies. Where possible, the following criteria should be incorporated into both the entity's organizational documents and, as applicable, the transaction documents (see *Chapter One, Representations and Warranties in Property-Specific Transactions*).

SPECIFIC SPE CRITERIA (continued)

SPE Limited Partnerships

In Standard & Poor's analysis of a limited partnership, Standard & Poor's will evaluate whether the limited partnership conforms to the following:

1. The limited partnership's purpose should be limited. The nature of the limitation will depend on the limited partnership's role in the transaction. For example, a borrower's purpose generally should be limited to owning and operating the mortgaged property. A depositor's purpose generally should be limited to depositing the mortgage loans.
2. The limited partnership's ability to incur indebtedness should be limited. Again, the nature of this limitation will depend on the limited partnership's role in the transaction. For example, a borrower generally will be limited to incurring (1) the indebtedness which secures the rated securities and (2) liabilities in the ordinary course of business relating to the ownership and operation of the mortgaged property.
3. The limited partnership (and, as applicable, its partners and affiliates) should be prohibited from engaging in any dissolution, liquidation, consolidation, merger or asset sale, or amendment of its limited partnership agreement as long as the rated securities are outstanding.
4. At least one general partner of the limited partnership should be an SPE (see Chapter Four, *SPE Corporate General Partners and SPE Corporations*). Among other things, this requirement is intended to protect against dissolution of the limited partnership during the course of the rated transaction.
5. The consent of the general partner of the limited partnership (including the vote of the independent director of the SPE general partner) should be required in order to:
  - File, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings;
  - Dissolve, liquidate, consolidate, merge, or sell all or substantially all of the assets of the partnership;
  - Engage in any other business activity; and
  - Amend the limited partnership agreement.

SPECIFIC SPE CRITERIA (continued)

6. The limited partnership (and, as applicable, its partners and affiliates) should agree to abide by certain "Separateness Covenants" whereby the limited partnership covenants:
  - To maintain books and records separate from any other person or entity;
  - To maintain its accounts separate from any other person or entity;
  - Not to commingle assets with those of any other entity;
  - To conduct its own business in its own name;
  - To maintain separate financial statements;
  - To pay its own liabilities out of its own funds;
  - To observe all partnership formalities;
  - To maintain an arm's-length relationship with its affiliates;
  - To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
  - Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
  - Not to acquire obligations or securities of its partners, members or shareholders;
  - To allocate fairly and reasonably any overhead for shared office space;
  - To use separate stationery, invoices, and checks;
  - Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity;
  - To hold itself out as a separate entity;
  - To correct any known misunderstanding regarding its separate identity; and
  - To maintain adequate capital in light of its contemplated business operations.
7. If there is more than one general partner, the limited partnership agreement should provide that the partnership shall continue (and not dissolve) for so long as another solvent general partner exists.
8. If the limited partnership is an out-of-state or foreign entity, the limited partnership must be qualified under applicable law in the state in which the collateral is located.
9. Standard & Poor's requests an opinion of counsel that upon the insolvency of (1) a limited partner having greater than a 49% interest in the limited partnership or (2) any general partner that is not an SPE, the limited partnership or its assets and liabilities would not be substantively consolidated with that insolvent partner. Depending on the circumstances, additional nonconsolidation opinions may be required.

SPECIFIC SPE CRITERIA (continued)

SPE Corporate General Partners

Typically, the SPE General Partner is a corporation. In Standard & Poor's analysis of a corporation, Standard & Poor's will evaluate whether the certificate or articles of incorporation conforms to the following:

1. The corporation's purpose should be limited to acting as general partner of the limited partnership.
2. The corporation's ability to incur indebtedness should be limited.
3. The corporation should be prohibited from engaging in any dissolution, liquidation, consolidation, merger or asset sale, or amendment of its articles of incorporation as long as the rated securities are outstanding.
4. The corporation should have at least one independent director.
5. The unanimous consent of the directors should be required to:
  - File, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings or cause the partnership to do so;
  - To dissolve, liquidate, consolidate, merge, or sell all or substantially all of the assets of the corporation;
  - Engage in any other business activity; and
  - Amend the articles of incorporation of the corporation or vote to amend the limited partnership's limited partnership agreement.
6. The directors of the corporation should be required to consider the interests of the creditors of the corporation in connection with all corporate actions.
7. The corporation should agree to observe the "Separateness Covenants" referred to above.
8. Standard & Poor's requests an opinion of counsel that upon the insolvency of any shareholder holding more than a 49% of the stock of the corporation, the corporation or its assets and liabilities would not be substantively consolidated with that insolvent shareholder. Depending on circumstances, additional nonconsolidation opinions may be required.

SPECIFIC SPE CRITERIA (continued)

SPE Corporations

In Standard & Poor's analysis of a corporation, Standard & Poor's will evaluate whether the certificate or articles of incorporation conforms to the following:

1. The corporation's purpose should be limited. The nature of the limitation will depend on the corporation's role in the transaction. For example, a borrower's purpose generally should be limited to owning and operating the mortgaged property. A depositor's purpose generally should be limited to depositing the mortgage loans.
2. The corporation's ability to incur indebtedness should be limited. Again, the nature of this limitation will depend on the corporation's role in the transaction. For example, a borrower generally will be limited to incurring (1) the indebtedness which secures the rated securities and (2) liabilities in the ordinary course of business relating to the ownership and operation of the mortgaged property.
3. The corporation should be prohibited from engaging in any dissolution, liquidation, consolidation, merger or asset sale, or amendment of its articles of incorporation as long as the rated securities are outstanding.
4. The corporation should have at least one independent director.
5. The unanimous consent of the directors should be required to:
  - File, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings;
  - To dissolve, liquidate, consolidate, merge, or sell all or substantially all of the assets of the corporation;
  - Engage in any other business activity; and
  - Amend the articles of incorporation of the corporation.
6. The directors of the corporation should be required to consider the interests of the creditors of the corporation in connection with all corporate actions.
7. The corporation should agree to observe the "Separateness Covenants" referred to above.
8. If the corporation is an out-of-state or foreign entity, the corporation should be qualified under applicable law in the state in which the collateral is located.
9. Standard & Poor's requests an opinion of counsel that upon the insolvency of any shareholder holding more than a 49% of the stock of the corporation, the corporation or its assets would not be consolidated with that insolvent shareholder. Depending on circumstances, additional nonconsolidation opinions may be required.

SPECIFIC SPE CRITERIA (continued)

SPE Limited Liability Companies

In Standard & Poor's analysis of a limited liability company, Standard & Poor's will evaluate whether the articles of organization of the company conforms to the following:

1. The limited liability company's purpose should be limited. For example, a borrower's purpose generally should be limited to owning and operating the mortgaged property. A depositor's purpose generally should be limited to depositing the mortgage loans.
2. The limited liability company's ability to incur indebtedness should be limited. The nature of the limitation will depend on the limited liability company's role in the transaction. For example, a borrower generally will be limited to (1) incurring the indebtedness which secures the rated securities and (2) liabilities in the ordinary course of business relating to the ownership and operation of the mortgaged property.
3. The limited liability company should be prohibited from engaging in any dissolution, liquidation, consolidation, merger or asset sale and amendment of its articles of organization as long as the rated securities are outstanding.
4. The limited liability company must have at least one member which is an SPE, such as an SPE corporation, described above. Generally, only the bankruptcy-remote special-purpose member should be designated as the "manager" under the law under which the limited liability company is organized, and the limited liability company's articles of organization should provide that it will dissolve only on the bankruptcy of a managing member.
5. The unanimous consent of the members (including the vote of the independent director of the SPE member) should be required to:
  - File, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings;
  - Dissolve, liquidate, consolidate, merge, or sell all or substantially all of the assets of the limited liability company;
  - Engage in any other business activity; and
  - Amend the limited liability company's organizational documents.

SPECIFIC SPE CRITERIA (continued)

6. The limited liability company should agree to observe the "Separateness Covenants" referred to above.
7. To the extent permitted by tax law, the articles of organization should provide that the vote of a majority of the remaining members is sufficient to continue the life of the limited liability company, in the event of a termination event. If the required consent of the remaining members to continue the limited liability company is not obtained, the articles of organization must provide that the limited liability company not liquidate collateral (except as permitted under the transaction documents) without the consent of holders of the rated securities. Such holders of the rated securities may continue to exercise all of their rights under the existing security agreements or mortgages, and must be able to retain the collateral until the debt has been paid in full or otherwise completely discharged.
8. If the limited liability company is an out-of-state or foreign entity, the limited liability company should be qualified under applicable law in the state in which the collateral is located.
9. Standard & Poor's requests an opinion of counsel that upon the insolvency of any member holding more than 49% of the membership interests in the limited liability company, the limited liability company or its assets and liabilities would not be substantively consolidated with that insolvent member. Depending on the circumstances, additional nonconsolidation opinions may be required. Also, Standard & Poor's requires an opinion of counsel that the limited liability company will be taxed as a partnership and not as a corporation.

## U.S. CMBS Legal and Structured Finance Criteria

### Introduction

The commercial mortgage securitization market has steadily evolved since the publication in 1994 of Standard & Poor's criteria governing commercial mortgage securitization transactions. One result has been that Standard & Poor's has received numerous requests for an update of Structured Finance Ratings, Real Estate Finance—Legal and Structured Finance Issues in Commercial Mortgage Securities. As the commercial mortgage securitization market has seasoned and grown significantly over the last several years, Standard & Poor's felt it was appropriate to re-evaluate the existing criteria and to add further topics that are pertinent to these issues, the evolution of which, in each case, is due to Standard & Poor's addressing novel features or changes that have arisen over the last several years. This guide compiles and updates Standard & Poor's legal criteria for commercial mortgage securitization.

It should be noted that, as the marketplace evolves, the criteria discussed in this publication are subject to revision. Standard & Poor's regularly reviews its criteria to keep current with both changes in the law and market developments in the area of structured finance. As a result, these criteria are not stagnant, but evolve over time. Standard & Poor's welcomes contact and communication with potential as well as current market participants to consult with it for clarification regarding any of the criteria described in this publication, or with any questions regarding future structured transactions and developments as they arise. The goal is to enable easy access and to provide the reasoning behind the rating criteria. To this end, Standard & Poor's will continue to publish its criteria to keep market participants informed of any new approaches to rating structured transactions. As a practical necessity, this publication cannot and does not purport to address every issue that comes up in a loan origination or commercial mortgage securitization transaction. In the absence of clear guidelines, market participants are urged to use a prudent lender standard.

This publication is divided into five sections and 16 appendixes. The first three sections deal with the three basic types of commercial mortgage securitization transactions:

- The property-specific or "stand-alone" transaction (i.e., a loan transaction involving a single property with one borrower, multiple properties with one borrower, cross-collateralized multiple properties with multiple borrowers, a small number of non-cross-collateralized properties with unrelated borrowers that does not constitute a pool) and the large loan transaction (i.e., a large loan included within a conduit or pool transaction or a group of large loans to unrelated borrowers that are pooled together) (see section one);
- The pool transaction (i.e., pools of performing loans, pools of nonperforming loans and conduits) (see section two); and
- The credit lease transaction (see section three).

Each of these types of transactions has a number of variations and may involve any one of several property types, including retail, multifamily, office, industrial, mobile home parks, health care, warehouse and mixed use.

The last two sections address issues that are applicable to each of the three types of commercial mortgage transactions. Specifically, section four deals with Standard & Poor's criteria relating to special-purpose bankruptcy-remote entities (SPEs). Section five describes Standard & Poor's criteria relating to legal opinions. The appendixes deal with certain specific topics in greater detail, as well as providing some of the

standard forms for CMBS transactions.

We would like to express our appreciation to the authors of some of the attached appendices, including Tom Gillis, Tom Murray, Dina Moskowitz, Roy Chun, Shawn Harrington, Nancy Olson, and James Penrose.

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## Section Four Special-Purpose Bankruptcy-Remote Entities

### Overview

The terms "single purpose," "special purpose," and "bankruptcy remote" are used in a variety of contexts throughout the structured finance and securitization markets. Although the terms have generally recognized meanings, those meanings may vary greatly depending on the role of the entity and the type of transaction. Special-purpose, bankruptcy-remote entities "SPEs" are used in a wide variety of commercial mortgage securitizations. Roles that may call for an SPE entity in a securitization include those of borrower, depositor, trust, general partner, member, lessor, and issuer.

Since the original publication of *Standard & Poor's Legal and Structured Finance Issues in Commercial Mortgage Securities*, Standard & Poor's has received ongoing inquiries regarding criteria relating to SPEs. These inquiries grow out of various market factors, including the increased desire by issuers to use limited liability companies and the inclusion of large loans in pool transactions. This section updates the criteria regarding SPEs in light of these market factors and inquiries.

### Rationale for the SPE in a Commercial Mortgage-Backed Transaction

To understand the rationale for Standard & Poor's criteria, it is necessary to describe an SPE in the most basic terms. An SPE is an entity, formed concurrently with or immediately prior to the subject transaction, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party's insolvency. The SPE is generally utilized in one of three different types of transactions:

- The property-specific or large loan transaction;
- The pool transaction; and
- The credit lease transaction.

The most basic forms of these transactions, which are subject to a variety of structural permutations, are discussed in detail in sections one, two, and three of this publication and are briefly summarized below.

#### Property-Specific and Large Loan Transactions

In the property-specific or large loan transaction, Standard & Poor's credit analysis focuses on the property mortgaged by the borrower as collateral for the loan. It is critical to Standard & Poor's analysis that the borrower be insulated from economic issues that are unrelated to the borrower's real estate collateral. It is for this reason that the borrower in the property-specific or large loan transaction must be an SPE.

As discussed in section one, many property-specific transactions include, as part of their structure, a deposit of one or more mortgage loans into a trust. As a result, in a property-specific transaction, multiple SPEs may be appropriate. In addition to each borrower being an SPE, the depositor and/or the holder of any securities or interests in mortgage loan received or retained in connection with a transfer of a loan or loans should be an SPE if the transfer of the loan or loans by the originator to the depositor, or by the depositor to a trust, could not otherwise be characterized properly as a "true sale".

#### Pool Transactions

As discussed in section two, in a traditional pool transaction, one or more mortgage loan sellers will transfer a portfolio of mortgage loans (together with any loan documentation, reserve funds, security deposits, insurance policies, letters of credit, guarantees, or other forms of credit enhancement for the mortgage loans) to the depositor which, in turn, will transfer a such mortgage loans to a trust. The trust will issue the rated securities, which are backed by the mortgage loans, to investors in exchange for the proceeds from the sale of the securities.

One of the concerns that Standard & Poor's has in connection with the transfer of the loans from the originators to the depositor, or from the depositor to the trust, is whether the transfer constitutes a true sale under applicable law. Even though the transfer may be accomplished by means of an agreement between the transferor and the transferee for the purchase and sale of the mortgage loans, circumstances

surrounding the transfer could lead a court to conclude that the transfer of loans was not a sale, but rather a financing transaction whereby the transferee has made a loan to the transferor secured by the transferor's interest in the mortgage loans.

If such a recharacterization were to occur, the putative transfer of the mortgage loans would instead be construed as a pledge of mortgage loans by the transferor as collateral for the financing and, if the transferor were to become subject to a bankruptcy proceeding, a bankruptcy court could include the loans in the transferor's estate pursuant to Section 541 of the "Bankruptcy Code". Consequently, the automatic stay and other Bankruptcy Code provisions could apply to the mortgage loans, any related collateral, and proceeds of the foregoing, which would likely interfere with timely payments of interest or the ultimate payment of principal on the rated securities.

In situations where a transfer cannot be characterized properly as a true sale, the transferor generally should be an SPE. In addition, any securities or interests in the transferred mortgage loans received or retained by a loan originator in connection with such transfer generally should be held in an SPE.

The purpose of creating an SPE in these situations is to create an entity that should not become subject to a bankruptcy proceeding. The use of an SPE entity is designed to reduce the risk of the transferor becoming insolvent (or being substantively consolidated with an insolvent affiliate), filing a bankruptcy petition, and claiming (or having other creditors of the transferor claim) that the transfer of the mortgage loans and other collateral to the depositor or the securitization trust was not a true sale. If the depositor or holder of securities or retained interests do not become subject to a bankruptcy proceeding (or substantively consolidated with an insolvent affiliate), the likelihood that the depositor or holder of securities or retained interests or their creditors will have any incentive to recharacterize the transaction as a secured financing is consequently reduced. (See Section Five, *Legal Opinions*, for a more detailed discussion of true sale issues).

#### Credit Lease Transactions

As discussed in Section Three, in a credit lease transaction, the borrower, as landlord and owner of the fee interest in an income-producing real property, obtains a loan that is secured by a "triple net" bondable lease to a rated tenant. Typically, the landlord/borrower will execute a note and mortgage in favor of the lender and will assign its right to collect the rents under the lease to the lender. The lender will then deposit, either directly or indirectly through a depositor, the note, mortgage, assignment of rents, and related collateral into a trust that will issue rated securities.

As in property-specific transactions, the trust structure (i.e., where the trust issues the rated securities) is not always employed. The lender or its affiliate may instead directly issue the rated securities (through an indenture or otherwise) and deposit the notes, the mortgages, the assignments of leases and rents, and the related collateral with a collateral administrator to hold in trust and as collateral for the rated securities.

A key difference between the structured credit lease transaction and traditional real estate financing is that in the former case, if the tenant has been assigned a credit rating by Standard and Poor's (or the tenant's lease payments are guaranteed by an entity who has been assigned a credit rating), it will be possible, under most circumstances, to assign a rating to the credit lease debt obligation of the landlord/borrower based on the credit rating of the tenant (or its guarantor). Generally, the rating ascribed to the credit lease debt obligation of a landlord/borrower will be adjusted only if the rating on the tenant (or the guarantor of the tenant's lease obligations) improves or declines.

Because the rating on the transaction is tied to the rating of the tenant (or its creditworthy guarantor), it is critical that the landlord/borrower be an SPE. If the landlord/borrower were not an SPE, a landlord/borrower insolvency could interfere with timely payments of interest or the ultimate payment of principal on the rated securities.

As with property-specific transactions and pool transactions, in a credit lease transaction, multiple SPEs may be appropriate. For example, if a depositor conveys the credit tenant loans into a trust, in addition to the landlord/borrower being an SPE, the depositor also should be an SPE if the transfer of the credit tenant loan by the depositor to the trust could not be characterized properly as a true sale.

## Overview of SPE Criteria

The following general categories are the framework for Standard & Poor's SPE criteria:

- Restrictions intended to limit or eliminate the ability of an SPE from incurring liabilities other than the debt to be included as part of the rated transaction, including (i) restrictions and/or limitations on indebtedness, and (ii) limitations on purpose of the SPE and the activities in which it may engage.
- Restrictions intended to insulate the SPE from liabilities of affiliates and third parties, including (i) the requirement that the organizational documentation of the SPE and the transaction documents contain separateness covenants described in this section and (ii) the requirement that a nonconsolidation opinion be delivered with respect to the SPE meeting the guidelines described in Section Five of this publication.
- Restrictions intended to protect the SPE from dissolution risk, including (i) absolute prohibitions on liquidation and consolidation for so long as the rated securities are outstanding, (ii) restrictions on merger of the SPE, and sale of all or substantially all of the assets of the SPE, in each case, without the prior written consent of the lender and, following the securitization of the indebtedness, receipt of a ratings confirmation, and (iii) the requirement that, except for a property structured single member limited liability company as discussed below, (a Single Member LLC\*), the SPE have appropriate single-purpose, bankruptcy-remote equity owners (e.g., SPE general partners with respect to an SPE limited partnership, or an SPE member holding a meaningful economic interest with respect to an SPE limited liability company that is not a Single Member LLC).
- Restrictions intended to limit a solvent SPE from filing a bankruptcy petition (or taking any other insolvency action), including the requirement that the SPE (and/or any SPE constituent entity) have an independent director or independent manager whose vote is required prior to the filing of any bankruptcy (or taking any other insolvency actions) in accordance with the guidelines of this section.

\*Although a single-member LLC typically contains only one member, it may contain multiple members. The term "single-member LLC" is used in this section for ease of discussion. (See Appendix XIII for a discussion of Standard & Poor's SPE criteria for single-member LLCs).

The foregoing categories of restrictions for SPEs are discussed in detail in this Section.

### Specific SPE Criteria

Although a wide range of entities such as general partnerships, limited partnerships, limited liability companies, corporations, municipalities, not-for-profit institutions, charitable institutions, public purpose corporations, and business trusts are utilized in commercial mortgage transactions, the type of entities most frequently used in recently rated commercial mortgage transactions are corporations, limited partnerships, and limited liability companies. The following criteria should be incorporated into both the transaction documents in addition to the following:

- If the SPE is a corporation, the filed articles of incorporation;
- If the SPE is a limited liability company, the limited liability company operating agreement;
- If the SPE is a limited partnership, the limited partnership agreement; and
- If the SPE is another type of entity, its corresponding organizational documents.

### Restrictions on Additional Indebtedness

The ability of an SPE to incur indebtedness, other than the indebtedness that is supporting the rated securities, should be limited. The nature of this limitation will depend on the SPE's role in the transaction.

For example, the SPE mortgage borrower's organizational documentation and the transaction documentation that evidences the indebtedness backing the rated securities should generally restrict the SPE mortgage borrower from incurring indebtedness other than (i) the indebtedness that backs the rated securities and (ii) unsecured trade payables that are as follows:

- Subject to a cap on the aggregate amount of trade indebtedness that may be incurred, which maximum amount, in the case of an SPE mortgage borrower in property specific or large loan

transactions, is generally less than 2% of the principal amount indebtedness supporting the rated securities, and is generally less than a *de minimis* amount in the case of an SPE equity owner of an SPE mortgage borrower);

- Incurred in the ordinary course of business;
- Related to the ownership and operation of the mortgaged property;
- Required to be paid within 60 days from the date such trade payables are first incurred by the SPE mortgage borrower (and not merely 60 days from the date on which the trade payables are due); and
- Not evidenced by a promissory note (see Section One, Permitted Indebtedness, for a further discussion of additional debt).

Standard & Poor's will generally review, on a case-by-case basis, the documentation and information with respect to any additional debt that an SPE is permitted to incur.

### Limitations on the Purpose of an SPE

The purpose for which the SPE is formed and the activities that the SPE may be engaged in should be expressly limited in both the transaction documents and the organizational documentation of the SPE. The nature of the limitation will depend on the SPE's role in the transaction. For example, an SPE mortgage borrower's purpose should be limited to owning and operating the mortgaged property that is collateral for the debt supporting the rated securities and activities necessary and incidental to such purpose. The purpose of any equity owner of an SPE mortgage borrower that itself is a SPE constituent entity should be limited to owning the equity interests in the SPE mortgage borrower, while an SPE depositor's purpose should be limited to depositing the mortgage loans into the trust that will issue the rated securities.

### Prohibition on Consolidation and Liquidation; Restrictions on Mergers and Asset Sales

Both the organizational documentation of an SPE and the transaction documentation related to the indebtedness that supports the rated securities should, for so long as the rated securities are outstanding, prohibit the SPE from doing the following:

- Consolidating or combining with another entity;
- Liquidating or winding-up; and
- Merging or selling all or substantially all of its assets, in each case, without the prior written consent of the lender and, in the case of property-specific or large loan transactions, receipt of a ratings confirmation.

### Prohibition on Amendments to Documentation

Both the organizational documentation of an SPE and the transaction documentation related to the indebtedness that supports the rated securities should prohibit the SPE from amending the provisions of the organizational documentation of the SPE that pertain to SPE criteria (including any defined terms pertaining to such criteria) as long as the rated securities are outstanding.

### SPE Equity Owners of SPE Limited Partnerships, SPE Limited Liability Companies, and Multitiered SPE Structures

The discussion that follows addresses the proper structuring for SPE equity owners in limited partnerships and limited liability companies, which are two of the most common types of entities used in commercial mortgage transactions. SPE equity owners for other types of entities, such as general partnerships and trusts, are examined by Standard & Poor's on a case-by-case basis.

#### SPE Equity Owners in SPE Limited Partnerships

SPE limited partnerships are frequently used as borrowers in mortgage loan transactions. Typically, SPE limited partnerships consist of one general partner and one or more limited partners. Under the Revised Uniform Limited Partnership Act, if a general partner of a limited partnership were to become subject to a bankruptcy proceeding, the partnership would dissolve unless it was otherwise continued or reconstituted by the remaining partners. Because Standard & Poor's cannot predict whether or not the remaining partners would continue or reconstitute an SPE limited partnership, Standard & Poor's seeks to protect against this dissolution risk by requiring that all general partners of the SPE limited partnership be structured as SPEs themselves. Requiring the SPE limited partnership to have each of its general partners be an SPE should reduce the risk of a general partner becoming insolvent, which might otherwise cause the SPE limited partnership to dissolve.



Providing that all general partners of an SPE limited partnership will be SPEs should also protect against the possibility that, in the case where a general partner becomes insolvent but the limited partnership is not, a bankruptcy court's approval in connection with the general partner's insolvency might be required for the SPE limited partnership to undertake certain acts. For example, if the sole general partner of an SPE limited partnership were to become insolvent and the SPE limited partnership desired to refinance the related mortgage loan, it is possible that the approval of the bankruptcy court would be required with respect to such proposed financing.

Where an SPE general partner of the SPE limited partnership is not an SPE corporation or a properly structured single-member LLC, but instead is an SPE limited partnership or SPE limited liability company that is not a properly structured Single Member LLC, the SPE general partner should itself have SPE general partners that are SPE corporations or properly structured single-member LLCs in the manner described in this Section. This guideline applies with equal force to each SPE limited partnership or limited liability company included in the chain of general partnership ownership in the borrower structure.

**SPE Equity Owner In SPE Limited Liability Company**  
In general (except in the case of a properly structured single-member LLC), with respect to transactions involving an SPE limited liability company, at least one member of the SPE limited liability company holding a meaningful economic interest in such SPE (generally at least 0.5%) should itself be an SPE. Standard & Poor's chief concern is that the bankruptcy or insolvency of non-SPE members may precipitate the bankruptcy or insolvency of the SPE limited liability company or a dissolution of the SPE limited liability company. Having at least one member of the SPE limited liability company that is itself an SPE mitigates such risk. However, as described in Appendix XIII, Standard & Poor's will rate a transaction involving a properly structured single-member LLC (which has no SPE economic members).

Where the SPE equity owner of the SPE limited liability company is not an SPE corporation or a properly structured single-member LLC, but instead is structured as an SPE limited liability company that is not a single-member LLC, such SPE equity owner must itself have an SPE equity owner that is an SPE corporation or a properly structured single-member LLC in the manner described in this Section. This guideline applies with equal force to each SPE limited liability company or SPE limited partnership included in the borrower structure.

#### The "Independent Director"

The following discussion concerns Standard & Poor's recommendations for "independent directors" for SPE organizational structures. These recommendations are commonly followed in transactions reviewed by Standard & Poor's and are currently viewed by Standard & Poor's as prevalent in the market. The discussion that follows does not, however, attempt to address each possible permutation and combination of entities that may comprise the SPE's organizational structure. Independent director provisions for general partnership borrowers, trust borrowers, and other borrowing structures that differ from the structures described below are examined by Standard & Poor's on a case-by-case basis.

As noted above, the vote of the independent director is required to undertake certain actions, most importantly, to file a bankruptcy petition or take other insolvency action with respect to the SPE. The provisions regarding the independent director are intended to protect against a voluntary bankruptcy petition being filed by the shareholders, members, partners, directors, or managers (as applicable) of an otherwise solvent SPE. This situation could arise, for example, where all of the directors on the board of an SPE corporation were also members of the board of directors of the operating company parent of that SPE corporation.

If there were no independent director on the board of the SPE corporation, and the parent of the SPE corporation were to become insolvent and, as a consequence, deem it advantageous for the SPE corporation to file a bankruptcy petition (without regard to the impact on the SPE corporation's creditors), the directors of the SPE corporation could simply vote to file a bankruptcy petition with respect to the otherwise solvent SPE corporation. The independent director is, therefore, intended (in part) to help insulate against the risk that the shareholders, members, partners, directors, or managers (as applicable) of the parent of the SPE will be able to control the SPE and vote to file a bankruptcy petition with respect to an otherwise solvent SPE.

The following is a generally acceptable definition of "independent director".

A duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time while serving as a director or manager of the relevant entity and may not have been at any time in the preceding five years, any of the following:

- A direct or indirect legal or beneficial owner in such entity or any of its affiliates;
- A creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates; or
- A person who controls (whether directly, indirectly, or otherwise) such entity or any of its affiliates, or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.

#### Independent Directors for SPE Corporations

An SPE corporation should have, at all times while the indebtedness supporting the rated securities is outstanding, at least one independent director duly appointed to, and serving on, its board of directors. In addition, the unanimous consent of the board of directors of the SPE (including the independent director(s)) should be required to file, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings with respect to the SPE corporation. The board of directors of the SPE corporation (including the independent director(s)) should be required to consider the interests of the creditors of the SPE corporation in connection with all such bankruptcy and insolvency actions.

#### Independent Directors for SPE Limited Liability Companies

An SPE limited liability company should have, at all times while the indebtedness supporting the rated securities is outstanding:

- An independent manager or independent director who is a duly appointed member of, and serving on, the board of managers or board of directors of the SPE limited liability company borrower, if the SPE limited liability company borrower is structured such that it includes a board of managers or board of directors whose vote is required with respect to taking any bankruptcy or insolvency action; or
- An SPE independent member that is a member of the SPE limited liability company borrower having (x) if such independent member of the SPE limited liability company borrower is a corporation, an independent director, (y) if such independent member of the SPE limited liability company borrower is a limited liability company, an independent manager or independent manager, or (z) if such independent member of the SPE limited liability company borrower is a limited partnership, an SPE general partner that itself has an independent director; if such general partner is a corporation, or an independent manager or independent member if such SPE general partner is a limited liability company; or
- As to any single-member LLC, an independent member that is a "non-economic member", which may be a corporation having an independent director, a limited liability company having an independent member, or independent manager or a limited partnership having a general partner that has an independent director, independent manager, or independent member, as applicable. For any properly structured single-member LLC, the independence feature provided by an independent director may also be provided by an individual who serves as the "non-economic member" of the limited liability company borrower, provided the individual would otherwise qualify as an independent director if the SPE limited liability company borrower were structured with a board of managers.

#### Independent Directors for SPE Limited Partnerships

Each general partner of an SPE limited partnership borrower should have, at all times while the indebtedness supporting the rated securities is outstanding, the following:

- An independent director among its board of directors, if such general partner is a corporation, in the manner described under the Section entitled "Independent Directors for SPE Corporations," above; or
- An independent manager or independent member (as applicable) if such general partner is a properly structured single-member LLC, in the manner described under the Section entitled "Independent Directors for SPE Limited Liability Companies" above.

#### Separateness Covenants

As discussed above, in order to increase the likelihood that an SPE will be insulated from the liabilities and obligations of its affiliates and third parties, the SPE should agree to abide and, as applicable, its shareholders, members, partners, and affiliates should agree to cause the SPE to abide by the following separateness covenants with respect to the SPE (the "Separateness Covenants") whereby the SPE covenants, among other things:

- To maintain books and records separate from any other person or entity;
- To maintain its accounts separate from any other person or entity;
- Not to commingle assets with those of any other entity;
- To conduct its own business in its own name;
- To maintain separate financial statements;
- To pay its own liabilities out of its own funds;
- To observe all partnership formalities;
- To maintain an arm's-length relationship with its affiliates;
- To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
- Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
- Not to acquire obligations or securities of its partners, members, or shareholders;
- To allocate fairly and reasonably any overhead for shared office space;
- To use separate stationery, invoices, and checks;
- Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity;
- To hold itself out as a separate entity;
- To correct any known misunderstanding regarding its separate identity; and
- To maintain adequate capital in light of its contemplated business operations.

#### Nonconsolidation Opinions

In order for an entity to be considered an SPE, the insolvency of an affiliate of that SPE should not impact the SPE. Under the equitable provisions of Section 105 of the Bankruptcy Code, a court has the power to "substantively consolidate" ostensibly separate but related entities. Substantive consolidation treats the assets and liabilities of the entities as if they belonged to one, enabling the creditors of each formerly separate estate to reach the assets of the consolidated estate.

In a commercial mortgage transaction, if an affiliate of the SPE were to become insolvent, it is possible that the affiliate or the affiliate's creditors would attempt to substantively consolidate the insolvent affiliate with the SPE, effectively placing the SPE under bankruptcy court protection and subjecting its assets to the claims of the affiliate's creditors.

In determining whether to substantively consolidate two entities, courts generally focus on the degree to which the affairs of the entities are intertwined. The separateness covenants (and the other SPE criteria) described in this Section are intended to separate the affairs of the affiliate with those of the SPE, and to mitigate consolidation risk. The law pertaining to substantive consolidation is, however, a complex subject and the separateness covenants alone will not adequately protect against the risk. For this reason, counsel to the SPE must properly structure the transaction and the relationship between the SPE and its affiliates (including affiliated property managers) to avoid the risk of substantive consolidation. In order to confirm whether a given SPE structure is appropriately insulated from consolidation risk, Standard & Poor's relies on an opinion of counsel for the SPE to that effect. Standard & Poor's specific guidelines with respect to nonconsolidation opinions are discussed in detail in Section Five of this publication.

#### Pre-Existing Entities as SPEs

Generally, an SPE entity should be formed immediately prior to the subject transaction in order to limit the risk that any prior activity involving the entity (i.e., activity occurring before the incurring of the indebtedness securing the rated securities) could be a basis for consolidating such the proposed SPE with any other

entity. Standard & Poor's has frequently been asked whether a pre-existing entity may qualify for treatment as an SPE, and has, on a case-by-case basis, reviewed transactions involving mortgage loan borrowers that are pre-existing entities. (See Appendix XIV for a further discussion of "pre-existing" or "recycled" SPEs.)

#### Entity-Specific SPE Criteria

As noted above, the types of entities most frequently used in recently rated commercial mortgage transactions are corporations, limited partnerships, and limited liability companies. Set forth below are specific criteria that should be incorporated into both the transaction documents:

- If the SPE is a corporation, the filed articles of incorporation;
- If the SPE is a limited liability company, the limited liability company operating agreement;
- If the SPE is a limited partnership, the limited partnership agreement; and
- The SPE criteria apply with equal force to an SPE that is itself serving as a SPE equity owner of another SPE. Standard & Poor's guidelines for each of these types of entity are set forth described here.

#### SPE Corporations

In Standard & Poor's analysis of an SPE corporation (including where the SPE corporation is acting as an SPE equity owner of an SPE limited partnership or SPE limited liability company as described above), Standard & Poor's will evaluate whether both the certificate or articles of incorporation of the SPE corporation and the transaction documents relating to the indebtedness that support the rated securities generally conform to the following:

- **Limited purpose.** The SPE corporation's purpose should be limited as described under the heading "Limitation on the Purpose of an SPE" above.
- **Restriction on additional debt.** The SPE corporation's ability to incur indebtedness should be limited as described under the heading "Restrictions on Additional Indebtedness" above.
- **Prohibition on other activities, merger, consolidation, and asset sales.** The SPE corporation (and its equity owners and affiliates) should, so long as the rated securities are outstanding, be (i) prohibited from engaging in any business activity other than owning the mortgaged property that secures the related indebtedness if such SPE corporation is the borrower, or, if such SPE corporation is an SPE equity owner, from engaging in any business activity other than owning equity interests in the SPE borrower; (ii) prohibited from consolidating or combining with another entity; (iii) prohibited from liquidating or winding-up; and (iv) prohibited from merging or selling all or substantially all of its assets, in each case, without the prior written consent of the lender, and, in the case of a property-specific or large loan transaction, receipt of a ratings confirmation.
- **Prohibition on amendments to documentation.** The SPE corporation should be prohibited from amending the SPE provisions of its organizational documentation as described under the heading "Prohibition on Amendments to Documentation" above.
- **Independent director.** The SPE corporation should have at least one independent director, and the unanimous consent of the board of directors (including the independent director) should be required to file, or consent to the filing of, a bankruptcy or insolvency petition, or otherwise institute insolvency proceedings as described under the heading "The Independent Director" above.
- **Separateness covenants.** The SPE corporation should agree to observe the separateness covenants described under the heading "Separateness Covenants" above, and the separateness covenants should be contained in the filed articles or certificate of incorporation of such SPE corporation (as well as in the transaction documents).
- **Foreign qualification.** If the SPE corporation is formed in a jurisdiction different from where the mortgaged property is located, the SPE corporation should be qualified under applicable law in the state in which the mortgaged property is located.
- **Nonconsolidation opinion.** Standard & Poor's will typically expect a non-consolidation opinion to be delivered in the circumstances described in Section Five of this publication.

#### SPE Limited Partnerships

In Standard & Poor's analysis of an SPE limited partnership (including where the SPE limited partnership is acting as an SPE equity owner of another SPE limited partnership or SPE limited liability company as

described above), Standard & Poor's will evaluate whether both the limited partnership agreement of the SPE limited partnership and the transaction documents relating to the indebtedness that supports the rated securities conform to the following:

- **Limited purpose.** The SPE limited partnership's purpose should be limited as described under the heading "Limitation on Purpose of an SPE" above.
- **Restriction on additional debt.** The SPE limited partnership's ability to incur indebtedness should be limited as described under the heading "Restrictions on Additional Indebtedness" above.
- **Prohibition on other activities, merger, consolidation, and asset sales.** The SPE limited partnership (and its equity owners and affiliates) should, so long as the rated securities are outstanding, be (i) prohibited from engaging in any business activity other than owning the mortgaged property that secures the related indebtedness if such SPE limited partnership is the borrower, or, if such SPE limited partnership is an SPE equity owner, from engaging in any business activity other than owning equity interests in the SPE borrower; (ii) prohibited from consolidating or combining with another entity; (iii) prohibited from liquidating or winding-up; and (iv) prohibited from merging or selling all or substantially all of its assets, in each case, without the prior written consent of the lender and, in the case of a property-specific or large loan transaction, receipt of a ratings confirmation.
- **Prohibition on amendments to documentation.** The SPE limited partnership should be prohibited from amending the SPE provisions of its organizational documentation as described under the heading "Prohibition on Amendments to Documentation" above.
- **SPE general partner.** All of the general partners of the SPE limited partnership should be SPEs as described under the heading "SPE Equity Owner of Limited Partnerships and Limited Liability Companies" above.
- **Independent director.** The consent of the SPE general partner of the SPE limited partnership (including the vote of the independent Director of the SPE general partner) should be required in order to file, or consent to the filing of, a bankruptcy or insolvency petition or otherwise institute insolvency proceedings as described under the heading "The Independent Director" above.
- **Separateness covenants.** The SPE limited partnership should agree to observe the separateness covenants with respect to the SPE described under the heading "Separateness Covenants" above, and the separateness covenants should be contained in both the transaction documents and the limited partnership agreement of such SPE limited partnership. Additionally, the limited partnership agreement of the SPE limited partnership should specifically require that for so long as the indebtedness supporting the rated securities is outstanding, each of the equity owners of the SPE limited partnership will cause the SPE limited partnership to observe the Separateness Covenants.
- **Continuity provisions.** If there is more than one general partner, the limited partnership agreement of the SPE limited partnership should provide that the SPE limited partnership shall continue (and not dissolve) for so long as another solvent general partner of the SPE limited partnership exists.
- **Foreign qualification.** If the SPE limited partnership is formed in a jurisdiction different from where the mortgaged property is located, the SPE limited partnership should be qualified under applicable law in the state in which the collateral securing the indebtedness that secures the rated securities is located.
- **Nonconsolidation opinion.** Standard & Poor's will typically expect a non-consolidation opinion to be delivered in the circumstances described under the heading "NonConsolidation Opinions" above.

SPE Limited Liability Companies  
In April of 2002, Standard & Poor's published its third edition of "Legal Criteria for Structured Finance Transactions," which is Standard & Poor's legal criteria for residential mortgage-backed and asset-backed structured finance transactions. The publication included "Appendix IV: Legal Criteria for LLCs," which significantly revised the criteria for SPE limited liability companies and incorporated Standard & Poor's criteria on single-member LLCs. That appendix is attached to this publication as Appendix XIII, Revised Legal Criteria for Multi- and Single-Member LLCs.

Standard & Poor's has now adopted these criteria for use in commercial mortgage-backed securitizations. Therefore, in Standard & Poor's analysis of an SPE limited liability company (including where the SPE limited liability company is acting as an SPE equity owner of an SPE limited partnership or another SPE limited liability company as described above), Standard & Poor's will evaluate whether the SPE limited liability company's limited liability company operating agreement, the transaction documents relating to the

indebtedness supporting the rated securities and the opinions delivered in connection therewith conform to Appendix XIII.

#### Conduit SPE Criteria

In typical conduit transactions, lenders make mortgage loans (usually under \$20 million in original principal balance) to borrowers with the specific intent to convey the mortgage loans into a securitization within a relatively short time following the closing of the loan. Generally, all of the conduit mortgage loans conveyed into the securitization trust are expected to meet standard underwriting criteria established by the originating conduit lender.

Standard & Poor's is frequently asked whether borrowers in conduit transactions must comply with Standard & Poor's SPE criteria described in this section, if the pool of conduit mortgage loans included in the securitization is large enough and diverse enough to be treated as a pool-wide or aggregate basis by Standard & Poor's, strict compliance with Standard & Poor's SPE criteria would not be necessary.

If, however, mortgage loans to any borrower or group of affiliated borrowers comprise in the aggregate more than 5% of the mortgage loan pool, or if any mortgage loan is \$20 million or more, the SPE criteria should be complied with. Standard & Poor's general guidelines are set forth below. These assume that the loan documents contain a prohibition on subordinate indebtedness secured by the mortgaged property that serves as collateral for the loans.

#### Loans with Less than 5% Borrower Concentration or Less than \$20 Million

With respect to mortgage loans made to a borrower or affiliated groups of borrowers, where (i) the principal balances of such mortgage loans (as of the closing date of the securitization) comprise (in the aggregate) less than 5% of the aggregate outstanding principal balance of all of the mortgage loans comprising the securitized pool of mortgage loans, and (ii) the outstanding principal balance of any single mortgage loan is less than \$20 million, borrowers should comply with Standard & Poor's SPE criteria, except that such borrowers need not comply with the following:

- Recommendations for an independent Director as discussed under the heading "The Independent Director" above;
- Delivery of a nonconsolidation opinion regarding the borrower as discussed under the heading "Nonconsolidation Opinions" above; and
- If the borrower is a limited partnership or a limited liability company, the recommendation that an equity owner be an SPE as discussed under the heading "SPE Equity Owner of SPE Limited Partnerships and SPE Limited Liability Companies and Multitiered SPE Structures," above.

However, loans that only meet these standards will not be viewed by Standard & Poor's as full bankruptcy-remote SPEs.

#### Loans with 5% or Greater Borrower Concentration or \$20 Million or Greater Principal Balance

For mortgage loans made to a borrower or affiliated groups of borrowers, where (i) the principal balances of such mortgage loans (as of the closing date of the securitization) comprise (in the aggregate) 5% or more of the aggregate outstanding principal balance of all of the mortgage loans comprising the securitized pool of mortgage loans or (ii) the outstanding principal balance of any single mortgage loan is \$20 million or more, the borrower should be structured in compliance with all of Standard & Poor's SPE criteria.

In any event, Standard & Poor's may request that additional borrowers be SPEs or waive its SPE guidelines depending upon Standard & Poor's evaluation of economic and other incentives for filing a bankruptcy petition.

For ease of reference, we refer to the independent directors, independent managers, and independent members in this discussion as "Independent Directors."

## Substantive Consolidation in Bankruptcy: A Primer for Real Estate Lawyers

by

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Over the last two decades, the issue of substantive consolidation in bankruptcy has become a major concern in real estate mortgage financing, such that this concept has assumed a preeminent place in the structuring and documentation of mortgage loans. This has resulted in all sorts of legal gymnastics aimed at avoiding not only substantive consolidation in bankruptcy, but the very filing of bankruptcy by a borrower altogether, as well as some unintended consequences for lenders and borrowers alike. Yet few lawyers outside the bankruptcy bar fully understand this mysterious concept.

Related concepts involving "single purpose entities" and "separateness covenants" in loan documentation have received much attention in the last year with the advent of Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership et al., --- N.W.2d ---, 2011 WL 6785393 (Mich.App.) and 51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co., LLC, 2011 WL 4695820 (E.D.Mich.) (Oct. 5, 2011); ---F.Supp.2d---, 2011 WL 6153023 (E.D.Mich.) (Dec. 12, 2011); and 2012 WL 205843 (E.D.Mich.) (Jan. 24, 2012), wherein insolvency was found as a matter of law to be a violation of the "separateness covenants" contained in the loan documents at issue, in each case triggering a "springing recourse" guaranty, a result that might have been avoided with a better understanding of the concepts and principles surrounding substantive consolidation.

The purpose of this article is to review, explain, and hopefully demystify the concept of substantive consolidation in bankruptcy, and to promote a better understanding of what it is, and is not, so that lender's and borrower's future negotiations (and loan documentation) may accurately reflect the existing legal jurisprudence on this subject.

### I. Background

"Substantive consolidation is the merger of separate entities into one action so that the assets and liabilities of both parties may be aggregated in order to effect a more equitable distribution of property among creditors." Matter of Baker & Getty Financial Services, Inc., 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987); See also, In re Owens Corning, 419 F.3d 195, 205 (3rd Cir. 2005).

The application of substantive consolidation is not expressly authorized under the Bankruptcy Code. Rule 1015 of the Rules of Bankruptcy Procedure provides for joint administration of cases; however, the Advisory Committee Notes thereunder state that "consolidation, as distinguished from joint administration, is neither authorized nor prohibited by this rule since the propriety of consolidation depends on substantive considerations and affects the substantive rights of creditors of the different estates." Advisory Committee Note, Bankr. Rule 1015. Accordingly, the power to substantively consolidate derives from the general equity jurisdiction of a court of bankruptcy under Section 105(a) of the Bankruptcy Code. In re Richton International, 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981). Nonetheless, courts recognize that as a general rule "the power to consolidate should be used sparingly because of the possibility of unfair treatment of creditors of a corporate debtor who have dealt solely with that debtor without knowledge of its interrelationship with others." Chemical Bank New York Trust Company v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966). See also, In re Owens Corning, 419 F.3d 195 (3rd Cir. 2005)(reversing substantive consolidation in view of prejudice to creditors).

Certainty is elusive with respect to substantive consolidation in bankruptcy because of the application of the general equity powers of the bankruptcy courts to these issues and the evolving nature of the substantive consolidation doctrine. The application of the doctrine is extremely fact intensive and relates to the business and creditor relationships leading up to bankruptcy as well as other factors. One court stated the matter more bluntly: "as to substantive consolidation, precedents are of little value, thereby making each analysis on a case-by-case basis." In re Crown Machine & Welding, 100 B.R. 25 (Bankr. D. Mont. 1989). Furthermore, the case law has not evolved in an entirely consistent manner. Accordingly, case law is only a general guide in attempting to anticipate what circumstances merit its application.

Early cases involving substantive consolidation applied a test that resembled the test for piercing the corporate veil or determining whether one corporation was the alter ego of another. A leading case in this regard is Fish v. East, 114 F.2d 177 (10th Cir. 1940), in which the court set forth the "instrumentality" rule. The court held that the assets of a subsidiary organized by its parent corporation to raise money from the public for the parent should be consolidated with the parent because, based on an analysis of the facts, the two corporations were actually one enterprise with the subsidiary operating as a mere instrumentality of the parent. In so holding, the court identified ten factors as supporting a decision to consolidate:

- (1) The parent corporation owns all or a majority of the capital stock of the subsidiary.
- (2) The parent and subsidiary corporation have common directors or officers.
- (3) The parent corporation finances the subsidiary.
- (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
- (5) The subsidiary has grossly inadequate capital.
- (6) The parent corporation pays the salaries or expenses or losses of the subsidiary.

(7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.

(8) In the papers of the parent corporation and in the statements of its officers "the subsidiary" is referred to as such or as a department or division.

(9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation.

(10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.

Courts frequently cited and relied on the Fish case in analyzing facts and determining whether a subsidiary and its parent should be consolidated. See, e.g., In re Gulfco Investment Corp., 593 F.2d 921, 928-29 (10th Cir. 1979); Anaconda Building Materials Co. v. Newland, 336 F.2d 625, 629 (9th Cir. 1964); Fisser v. International Bank, 282 F.2d 231, 238 (2d Cir. 1960); Maule Industries v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956).

Under this approach, courts did not generally permit consolidation without a showing that organization of the subsidiary resulted in some blatant abuse, even in cases where one or more of the above factors was present. As noted by one court:

Few questions of law are better settled than that a corporation is ordinarily a wholly separate entity from its stockholders, whether they be one or more. . . . But notwithstanding such situation and such intimacy of relation, the corporation will be regarded as a legal entity, as a general rule, and the courts will ignore the fiction of corporate entity only with caution, and when the circumstances justify it, as when it is used as a subterfuge to defeat public convenience, justify wrong, or perpetuate a fraud.

Commerce Trust Co. v. Woodbury, 77 F.2d 478, 487 (8th Cir. 1935). Thus, it was observed that "The reported cases have generally been easily decided because the courts could point to blatant abuses of the separate corporate entities in the enterprise structure." Landers, A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy, 42 U. Chi. L. Rev. 589, 635 (1975). It has been noted that "[i]n the older cases, the application of substantive consolidation was limited to extreme cases involving fraud or neglect of corporate formalities and accounting procedures." In re Standard Brands Paint Co., 154 B.R. 563, 568 (Bankr. C.D. Cal. 1993).

While earlier decisions frequently cited the ten factors enunciated by the Fish v. East and Gulfco courts, subsequent decisions have produced a list of seven elements relevant to determining the appropriateness of consolidation:

1. The presence or absence of consolidated financial statements;
2. The unity of interests and ownership between the various corporate entities;

3. The existence of parent and inter-corporate guarantees on loans;
4. The degree of difficulty in segregating and ascertaining individual assets and liabilities;
5. The transfer of assets without formal observance of corporate formalities;
6. The commingling of assets and business functions; and
7. The profitability of consolidation at a single physical location.

See, Matter of Baker & Getty Financial Services, Inc., 78 B.R. 139, 142 (Bankr. N.D. Ohio 1987), In re Vecco Construction Industries, Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980), In re Richton, 12 B.R. at 558 (Bankr. S.D.N.Y. 1981) and In re Stop & Go of America, Inc., 49 B.R. 743, 747 (Bankr. D. Mass. 1985).

There are a few reported opinions involving substantive consolidation in which at least one of the legal entities was a statutory limited liability company. See In re Edwards Theatres Circuit, Inc., 281 B.R. 675, 677 & n.1, 678 (Bankr. C.D. Cal. 2002) (noting that bankruptcy estates of five California corporations and two Delaware limited liability companies, and their affiliates, were substantively consolidated in confirmed Chapter 11 plan). "Based on the development of the case law with respect to both corporations and partnerships, however, there does not appear to be any reason why materially different standards or principles should apply to an analysis of these [substantive consolidation] issues as they relate to a limited liability company." 2 Collier on Bankruptcy ¶ 105.09[1][c], at 105-87 (15th ed. rev., 1998) (footnote omitted). See, also, In re Owens Corning, 419 F.3d 195 (3rd Cir. 2005) and In re Brentwood Golf Club, 329 B.R. 802 (Bankr. E.D. Michigan 2005).

Although the presence of some or all of the foregoing elements may be instrumental in determining whether the parent and subsidiary should be treated as a single entity, their existence alone does not necessarily mandate substantive consolidation. The courts recognize that these factors should not be mechanically applied and are not dispositive, but they must be evaluated in the overall "balancing of equities" favoring consolidation versus those favoring separation. See In re DRW Property Co. 82, 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985); In re Doughnut Queen Ltd., 41 B.R. 706, 709 (Bankr. E.D.N.Y. 1984). The Third Circuit Court of Appeals in In re Owens Corning, 419 F.3d 195 (3rd Cir. 2005) warned against the dangers of merely using a checklist of factors, saying that "too often the factors in a checklist fail to separate the unimportant from the important, or even to set out a standard to make the attempt. . . . Running down factors as a check list can lead a court to lose sight of why we have substantive consolidation in the first instance. . . ." In re Owens Corning, 419 F.3d 195, 210-11 (3rd Cir. 2005) The party proposing consolidation bears the burden of demonstrating that a prejudice resulting therefrom is outweighed by the benefit to be obtained. Id. Moreover, this burden is a "substantial" one. In re N.S. Garrott & Sons, 48 B.R. 13, 18 (Bankr. E.D. Ark. 1984). The balancing test also has been stated:

1. There must be a necessity for substantive consolidation or a harm to be avoided by the use of substantive consolidation; and

2. The benefits of substantive consolidation must outweigh the harm to be caused to objecting creditors.

In re F.A. Potts & Co., Inc., 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982).

This approach is clarified by the court in In re Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982):

While several courts have recently attempted to delineate what, might be called the 'elements of consolidation,' [citations omitted] we find that the only real criterion is that which we have referred to, namely the economic prejudice of continued debtor separateness versus the economic prejudice of consolidation. There is no one set of elements which, if established, will mandate consolidation in every instance. Moreover, the fact that corporate formalities may have been ignored, or that different debtors are associated in business in some way, does not by itself lead inevitably to the conclusion that it would be equitable to merge otherwise separate estates.

Therefore, even in cases where a significant number of the foregoing factors and elements were present, the courts considered them in the context of specific circumstances that weigh in favor of consolidation. Even in cases where substantive consolidation is ordered, some courts limit the scope of its effect and expressly find that substantive consolidation is not retroactive and does not operate to destroy certain defenses and rights that existed prior to substantive consolidation. See, In re Garden Ridge Corporation, et al., 338 B.R. 627 (Bankr. D. Del. 2006).

## II. Analysis

Current case law indicates that the circumstances in which substantive consolidation has been held appropriate are as follows:

### A. Fraud Upon, or Injustice to, Creditors

Where affiliates of the debtor were organized to hinder and delay judgment creditors and property transfers were for the sole purpose of placing property beyond the reach of creditors, consolidation is appropriate. In re Tureaud, 45 B.R. 658 (Bankr. N.D. Okla. 1985). Accord, In re Stop & Go of America, Inc., 49 B.R. at 743 (shell corporation formed to hold franchise was a "deliberate scheme" to protect franchise seller's interest in a manner likely to result in fraud on creditors; corporation had no telephone, office, bank account, expenses or income).

The court in Gulfco, supra, stated: "It is, of course, proper to disregard a separate legal entity when such action is necessary to avoid fraud or injustice." 593 F.2d at 928. Although the ten factors in Fish v. East were present to a "considerable degree," the court held that consolidation was not appropriate because of the absence of a purpose to organize the corporate subsidiaries to hinder and delay creditors fraudulently. Id.

Thus, the mere identity of corporate names, stockholders and officers or the fact of ownership of capital stock in one corporation by another alone are not sufficient to justify disregarding the corporate fiction. The corporation must have been "organized or used to hinder, delay or defraud the creditors of the bankrupt, and constitutes mere legal paraphernalia observing

form only and not existing in substance or reality as a separate entity." Maule Industries, Inc. v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956).

Additionally, courts will review the circumstances to determine whether the effect of substantive consolidation will work an injustice on one creditor to the benefit of another. For example, consolidation has been denied where it would unjustly benefit creditors of a parent corporation over creditors of the subsidiary proposed to be consolidated. In re Flora Mir Candy Corporation, 432 F.2d 1060 (2d Cir. 1970) (subsidiary's debenture holders would be unfairly disadvantaged).

### B. Creditor Reliance on Enterprise as a Group

Courts also have allowed substantive consolidation in cases where the creditors have relied justifiably on the assets and credit of a group of entities, or the credit of a parent when dealing with its subsidiary. See Stone v. Eacho, 127 F.2d 284 (4th Cir. 1942). In In Soviero v. Franklin National Bank of Long Island, 328 F.2d 446 (2d Cir. 1964), there were clear findings of commingling of assets and functions of the affiliated entities and flagrant disregard of corporate forms. Moreover, creditors were advised that the bankrupt was a "consolidated enterprise" and were delivered consolidated financial statements listing assets of the affiliated companies as those of the bankrupt without separation. Id. at 447. See also In re Richton International Corporation, 12 B.R. 555 (Bankr. S.D.N.Y. 1981); In re Food Fair, Inc., 10 B.R. 123 (Bankr. S.D.N.Y. 1981); and In re Murray Industries, Inc., 119 B.R. 820 (Bankr. MD. Fla. 1990). Likewise, the U.S. Court of Appeals for the Third Circuit has upheld consolidation of the estates of three debtors, all having the same officers, directors, and shareholders, operating identical businesses under very similar names, that did not heed corporate formalities in the course of borrowing funds and using credit. In re Lisanti Foods Inc., 241 Fed. Appx. 1, 2-3 (3d Cir. 2007). In granting consolidation where creditors relied on the consolidated enterprise, the Second Circuit in the Soviero case also made it clear that consolidation should not be limited to cases where the subsidiary was organized for the purpose of hindering or defrauding creditors. Soviero v. Franklin National Bank, 328 F.2d at 448.

On the other hand, where creditors rely solely on the representations and credit of a parent corporation and additional security from subsidiary corporations is not required, substantive consolidation of a subsidiary into its parent will not be imposed. Anaconda Building Materials Co. v. Newland, 336 F.2d 625 (9th Cir. 1964) (so holding, notwithstanding that the parent held all the outstanding stock of each subsidiary, there were some common officers and directors, and some evidence that the subsidiaries were minimally capitalized). See also In re Flora Mir Candy Corporation, 432 F.2d 1060, 1062-63 (2d Cir. 1970).

Similarly, where a creditor extended credit to a debtor based on that debtor's finances alone, without knowledge of the debtor's negotiations to merge with another entity, the Second Circuit in In re Augie/Restivo Baking Company, Ltd., 860 F.2d 515 (2d Cir. 1988) held that consolidation would impair the rights of that creditor and unfairly benefit later creditors of the merged entities. The court went on to hold that the various considerations enumerated in prior decisions "are merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and 'did not rely on their separate identity in extending credit' . . . or

(ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.” Id. at 518 (citations omitted).

#### C. Interrelationships of Entities and Accounts

“Where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.” Chemical Bank v. Kheel, 369 F.2d at 847 (2nd Cir. 1966). The situation must be extremely egregious, however, and amount to an impossibility of reconstructing financial records to determine intercorporate claims, liabilities and ownership of assets. See also In re Reserve Capital Corp., 2007 WL 880600, \*5 (Bankr. N.D.N.Y. 2007) (refusing to order substantive consolidation upon request of a trustee who “acknowledge[d] . . . that untangling the affairs of the Debtors, while it may require extensive legal and forensic accounting work, is not impossible”); In re 1438 Meridian Place, N.W., Inc., 15 B.R. 89 (Bankr. D.D.C. 1981) (neither the court nor the creditors could intelligently sort out or separate the financial affairs of the corporations).

Although inequities may be involved in the consolidation, they may be outweighed by practical considerations such as accounting difficulties and expense, which may occur where interrelationships of corporate groups are highly complex or untraceable. See, In re Continental Vending Machine Corp., 517 F.2d 997, 1001 (2d Cir. 1975), cert. denied sub nom. James Talcott Inc. v Wharton, 424 U.S. 913 (1976).

#### D. Impact on Estates and Plans of Reorganization

Though a provision for merger or consolidation of the debtor with one or more persons may be a permissible means for the mandatory adequate implementation of a Chapter 11 plan, 11 U.S.C. § 1123(a)(5)(C), the mere inclusion of a substantive consolidation provision in a Chapter 11 plan does not mean that such a provision will be or can be automatically confirmed over proper objection. See, In re Stone & Webster, Inc., 286 B.R. 532, 542, 545 n.8, 546 (Bankr. D. Del. 2002) (reserving examination of facts of Chapter 11 case bearing upon numerous substantive consolidation factors and concomitant determination whether substantive consolidation warranted). Where consolidation will facilitate or expedite reorganizational proceedings for a number of related debtors, consolidation may be imposed, particularly if separate plans of reorganization would not be feasible. In Interstate Stores, Inc., 15 Collier Bankr. Case 634, 640-41 (Bankr. S.D.N.Y. 1978); In re F.A. Potts & Co., Inc., 23 B.R. 569 (Bankr. E.D. Pa. 1982). The ability to consummate a plan quickly alone, however, may not justify consolidation, particularly if the rights of creditors of the proposed consolidated entity would thereby be diminished. In re Flora Mir Candy Corp., 432 F.2d 1060, 1063 (2d Cir. 1970).

Traditionally, substantive consolidation has been granted by the courts “sparingly” due to the extreme impact on substantive rights of creditors. However, the Eleventh Circuit Court of Appeals, in adopting for the first time a standard by which to evaluate motions for substantive consolidation, has noted what it termed “a ‘modern’ or ‘liberal’ trend toward allowing substantive consolidation, which has its genesis in the increased judicial recognition of the widespread use of interrelated corporate structures by subsidiary corporations operating under a

parent entity’s corporate umbrella for tax and business purposes.” Eastgroup Properties v. Southern Motel Association, Ltd., 935 F.2d 245 (11th Cir. 1991). See also, In re Affiliated Foods, Inc., 249 B.R. 770 (Bankr. W. D. Mo. 2000) and In re Brentwood Golf Club, 329 B.R. 802, 811 (Bankr.E.D. Michigan 2005); contra Owens Corning, 419 F.3d at 209 n.15 (“we disagree with the assertion of a ‘liberal trend’ toward increased use of substantive consolidation”).

The Eleventh Circuit requires that the proponent of substantive consolidation show that (i) there is substantial identity between the entities to be consolidated; and (ii) consolidation is necessary to avoid some harm or to realize some benefit. Upon making these two showings, the court held that a presumption arises that creditors have not relied solely upon the credit of one of the entities involved in the consolidation. The burden then shifts to the objecting creditor to show that it (a) has relied on the separate credit of one of the entities being consolidated, and (b) will be prejudiced by substantive consolidation. Finally, if the objecting creditor successfully demonstrates the foregoing, then the court nonetheless may order consolidation, but only if it determines that the benefits of consolidation “heavily” outweigh the harm. Eastgroup Properties v. Southern Motel Assn., supra, citing In re Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987). The decision falls within the “creditor reliance” fact situations discussed above, except that it creates a presumption of creditor nonreliance merely upon a showing of substantial identity and the avoidance of harm or realization of benefit from consolidation. While such a presumption may not necessarily follow from the required showing, creditors of a limited purpose entity formed in connection with a structured finance transaction could, in many cases, show both reliance on a single entity and substantial harm from consolidation.

The Eleventh Circuit’s decision in the Eastgroup Properties case also demonstrates that consolidation may be granted not only with respect to a parent and its subsidiary, but also to members of a consolidated group, and entities that merely have “common ownership.” In the Eastgroup Properties case, one debtor was a limited partnership that had three corporate equity owners, which were also the ultimate owners of the other debtor, a corporation. None of the owners was involved in the bankruptcy proceeding as debtor. See also, F.D.I.C. v. Colonial Realty Co., 966 F.2d 57 (2d Cir. 1992) (bankruptcy court has authority to permit substantive consolidation of general partnership with two of its individual general partners).

The Eighth Circuit follows a similar but not identical approach. “Factors to consider when deciding whether substantive consolidation is appropriate include (i) the necessity of consolidation due to the interrelationship among debtors; (ii) whether the benefits of consolidation outweigh the harm to creditors; and (iii) prejudice resulting from not consolidating the debtors.” In re Giller, 962 F.2d 796, 799 (8th Cir. 1992) (granting consolidation by finding that the benefits outweigh the harm).

The Second and Third Circuits (encompassing New York and Delaware, among other jurisdictions) follow the traditional set of factors but have reduced them to two alternative standards. “[A] proponent of substantive consolidation must demonstrate one of two rationales for its application: that (i) prepetition the entities for whom substantive consolidation is sought disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.” In re Lisanti Foods, 241

Fed. Appx. at 2 (marks and citations omitted); See, In re Augie/Restivo Baking Co., 860 F.2d at 518 (same).

Limited case law specifically addresses the legality of substantive consolidation of a bankrupt debtor and a solvent non-debtor affiliate. Although a split of authority exists, it has been held that creditors (who did not have a claim against the non-debtor affiliates directly) could bring before the court parties alleged to be the "alter ego" of the debtor. In re 1948 Meridian Place, 15 B.R. at 95-96. See In re Crabtree, 39 B.R. 718, 722-26 (Bankr. E.D. Tenn. 1984) (the right to bring additional parties before the court who are the alter ego of the debtor is independent of the right of creditors to force a person into bankruptcy under Section 303 of the Bankruptcy Code); Matter of Munford, 115 B.R. 390 (Bankr. N.D. Ga. 1990).

On the other hand, the court in In re Alpha & Omega Realty Inc., 36 B.R. 416 (Bankr. D. Idaho 1984), held that a solvent affiliate of the debtor would not be consolidated with the debtor's estate because the affiliate was not itself a debtor. In support of the position against consolidation of non-debtor parties, the court in In re DRW Property Co., 82, supra, stated that it was "unaware of any statutory or common law authority to substantively consolidate debtor and non-debtor partnerships. The non-debtor partnerships are certainly well outside of the scope of this Court's jurisdiction." 54 B.R. at 497 (emphasis in original). See also In re The Julien Company, 120 B.R. 930 (Bankr. W.D. Tenn. 1990) (motion to consolidate debtor corporation with nondebtor shareholder violates due process rights of non-debtor and its separate creditors); In re Lease-A-Fleet, Inc., 141 B.R. 869, 872 (Bankr. E.D. Pa. 1992) ("caution must be multiplied exponentially in a situation where a consolidation of a debtor's case with a non-debtor is attempted, by a single party which . . . is a creditor of the debtor only and whose efforts are not joined by any other interested parties").

In a prominent decision by the United States Supreme Court considering substantive consolidation, the court held in Sampsel v. Imperial Paper & Color Corporation, 313 U.S. 215 (1941), that substantive consolidation of a non-debtor corporation into an individual bankrupt's estate was proper where the transfer of property by the individual to the corporation was not in good faith, was made for the purpose of placing it beyond the reach of the individual's creditors, and where the effect of the transfers was to hinder, delay or defraud the individual's creditors. Id. at 217-18 (so holding despite the Court of Appeals finding that the non-debtor corporation could not be deemed the alter ego of the individual bankrupt under applicable state laws). Thus, the decisions in favor of consolidation of a debtor's solvent affiliate usually require some sort of harm or fraud on creditors and typically include a determination that the solvent entity was merely the "alter ego" of the debtor.

#### **E. General Growth Properties and the Effect of Bankruptcy Filings for Special Purpose Entities.**

The bankruptcy case of General Growth Properties, Inc. and its affiliates in 2009 provided some unique insights into the effect of bankruptcy filings for affiliated entities including special purpose entities. The General Growth Properties case involved 388 separate entities, including a large number of special purpose entities. A number of motions to dismiss these cases were filed by secured creditors. The motions were denied in a consolidated opinion

by the bankruptcy court. See, In re General Growth Properties, Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009) (the "GGP Decision").

In the GGP Decision, the bankruptcy court found that independent managers acted correctly when they voted to commence bankruptcy proceedings for the special purpose entities, noting that under applicable Delaware law, the managers were obligated to protect the interests of owners, notwithstanding the impending insolvency of the entities. The bankruptcy court also rejected contentions that the filings for the special purpose entities were made in bad faith. The court found that the creditors knew when they extended credit to the debtor entities that they were accepting security from special purpose entities that were part of a large group of affiliated companies and that it was therefore proper to evaluate the good faith and reasonableness of the bankruptcy filings from the perspective of the consolidated group, and not from the perspective of the individual special purpose entities.

However, the most significant aspect of the GGP Decision may be relative to substantive consolidation. The bankruptcy court noted that the secured lenders, who were inconvenienced by the filings, still enjoyed the fundamental protections of the special purpose entity structure, including "protection against the substantive consolidation of the project-level Debtors with any other entities." In re General Growth Properties, Inc., 409 B.R. at 69 (Bankr. S.D.N.Y. 2009). As if to emphasize its point, the bankruptcy court added that "Nothing in this Opinion implies that the assets and liabilities of any of the Subject Debtors could properly be substantively consolidated with those of any other entity." Id.

As the holding of the GGP Decision makes clear, even if a special purpose entity does become a debtor in a bankruptcy case, and even if the case involves affiliated entities, substantive consolidation is not necessarily in the offing. In fact, the GGP Decision recognized protection against substantive consolidation as a fundamental protection provided by the special purpose entity structure, for which the creditors negotiated. The GGP Decision's recognition of a creditor's right not to have a special purpose entity debtor substantively consolidated in jointly administered affiliate bankruptcy cases bolsters the traditional notion that substantive consolidation, far from being automatic in bankruptcy, is merited only rarely and when the circumstances warrant it.

### **III. Conclusion**

As the case law demonstrates, while skillful efforts to avoid a borrower's filing for protection in bankruptcy have not been entirely fruitful, efforts to avoid substantive consolidation in bankruptcy have generally been effective absent egregious circumstances warranting the application of this doctrine.

Under the current state of the law in this area, in cases involving a typical single purpose entity structure and separateness covenants such as those incorporated into the major rating agencies' structured finance criteria from the applicable case law referred to above, it would be difficult for a creditor, the SPE debtor, or its trustee in bankruptcy to claim that recognition of the debtor as separate from any other person would be inequitable, or result in a fraud or injustice on creditors. Similarly, it would be difficult for such an SPE debtor or its trustee in bankruptcy to argue that such a structure mislead creditors by creating the appearance that the debtor and its



affiliates were one unit, or that the affairs of the debtor and any other person were so entangled that it would be too costly or time consuming to deal with or consider them separately, that it appeared that the assets of the debtor were available to meet claims of any other person, or that assets were transferred to the debtor without fair consideration or with intent to hinder, delay, or defraud creditors. Finally, creditors of such an SPE debtor should be able to show reliance on the separate credit and assets of such an SPE debtor (i.e., that they were "ring fenced"), and that creditors of such debtor would be unable to show that any of them did in fact rely on the credit and assets of any other person, absent perhaps a "springing recourse" guaranty or similar device, which could actually militate *against* the lender's goal of avoiding substantive consolidation.

In this regard, it is important to note that one may not be able to have it both ways, particularly before a court of equity such as a U.S. Bankruptcy Court, and argue that (a) an SPE debtor's assets should be "ring fenced" for one creditor such that substantive consolidation should not apply, but (b) that the ring fencing, even though observed by the debtor, does not apply to the creditor, and that that same creditor may look to other persons for satisfaction of the debt but still avoid substantive consolidation. Until this discrete issue is authoritatively decided, this will very much remain a work in progress.