

SPECIAL-PURPOSE BANKRUPTCY-REMOTE ENTITIES

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FREQUENTLY ASKED QUESTIONS

Introduction

Requiring that a borrower be a special-purpose bankruptcy-remote entity is a prominent requirement for loans which are being made as part of portfolios for commercial mortgage-backed securities (CMBS). As stated by Standard & Poor's:

The terms "single-purpose," "special purpose," and "bankruptcy-remote" are used in a variety of context 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.

In the CMBS industry, the underwriting of loans often times result in requirements that borrowers be SPEs. This article answers many of the most frequently asked questions about SPEs.

What is an SPE?

Standard & Poor's defines 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.

How may an SPE be "unlikely to become insolvent as a result of its own activities"?

An SPE is unlikely to become insolvent as result of its own activities if it (i) maintains its assets in a way which segregates and identifies such assets separate and apart from the assets of any other person or entity, (ii) holds itself out to the public as a separate legal entity distinct from any other person or entity, (iii) conducts business solely in its own name, and (iv) has no indebtedness other than a loan being made secured by a particular parcel property, and indebtedness for trade payables incurred in the ordinary course of business. The foregoing is an abbreviated version of an extensive list of "limited purpose and separateness covenants made by a borrower in loan documents and/or its organizational documents (e.g., bylaws of corporation, partnership agreement of limited partnership, or operating agreement of limited liability company). For purposes of this article, the aforementioned requirement will be referred to as the "single purpose/special purpose requirement."

How is an SPE adequately "insulated from the consequences of any related party's insolvency"?

An SPE which not only meets the single purpose/special purpose requirement, also meets bankruptcy-remote requirements when it is adequately insulated from the consequences of any related party's insolvency. Accordingly, such an SPE in addition to complying with single purpose/special purpose requirements, should also (i) have at least one director, general partner, managing member, principal shareholder or other similar controlling person (an "independent controlling person") which is not associated with the borrower other than as such independent controlling person, and (ii) be subject to organizational documents requiring a unanimous vote or consent for the borrower to file a petition in bankruptcy, to dissolve, liquidate, consolidate, merge or sell all or substantially all of the assets of borrower. These requirements are sometimes referred to below as bankruptcy-remote requirements.

Do SPEs need to meet single purpose/special purpose and bankruptcy-remote requirements on all loans?

Typically, on loans of \$15,000,000 or less, a borrower must only meet the single purpose/special purpose requirement. Based upon certain issues relating to a particular borrower, however, on some occasions for underwriting purposes a lender may also want to impose bankruptcy-remote requirements on a borrower. Almost without exception, for loans which exceed \$15,000,000, a borrower must meet both single purpose/special purpose and bankruptcy-remote requirements.

What type of legal entities make the SPEs?

The type of entities most frequently utilized as SPEs are corporations, limited partnerships and limited liability companies.

Are there any other requirements for a loan of less than \$15,000,000?

Generally not. Most often for a loan of less than \$15,000,000 it is simply necessary that single purpose/special purpose requirements be set forth in the organizational documents. Well drafted loan documents may also have the borrower providing "negative covenants" providing that a borrower will not violate any single purpose/special purpose requirements as lender's counsel outlines such requirements in the loan documents to satisfy rating agencies. A more detailed description is set forth below.

Are there any other requirements for a loan of more than \$15,000,000?

Yes. In addition to meeting all single purpose/special purpose and bankruptcy-remote requirements, the SPE in order to be further protected from dissolution risks shall not only require in its organizational documents a unanimous vote or consent of the borrower as set forth above, but shall also have an "Independent Director". An

Independent Director of a corporation is unrelated and unaffiliated from any other person or entity who owns or controls an ownership interest in a borrower.

Why is there a requirement of an Independent Director on loans of more than \$15,000,000?

If the unanimous consent of all directors in a borrower corporation is required to file a bankruptcy petition with respect to the SPE, then the Independent Director's vote protects against the situation where an otherwise solvent SPE might be voluntarily filed by directors if the borrower's other directors believe it advantageous for it to file a bankruptcy petition (irrespective of whether the bankruptcy was for a proper purpose or despite the effect on the SPE's creditors). The requirement of an Independent Director protects the owner of a loan against the risk that an otherwise solvent SPE would file a bankruptcy.

Why are non-consolidation opinions also required on loans of more than \$15,000,000?

One of the fundamentals of a loan of more than \$15,000,000 is not only that it meet single purpose/special purpose and bankruptcy-remote requirements, but that the lender also receive a non-consolidation opinion at the time of closing the loan. Lenders are concerned on loans of more than \$15,000,000 that not only are SPE requirements met, but that borrower's counsel also provide a non-consolidation opinion letter. A non-consolidation opinion letter generally states that (i) a borrower's assets shall not be consolidated with the assets of any party controlling borrower ("Controlling Party") or any other person or entities owning directly or indirectly more than a 49 percent (49%) interest in the borrower in the event of a bankruptcy or insolvency of any Controlling Party or such other person or entities, and (ii) the assets of each Controlling Party shall not be consolidated with the assets of any person or entities owning directly or indirectly more than 49 percent (49%) of such Controlling Party in the event of a bankruptcy or insolvency of such person or entities. A Controlling Party is deemed any person or entity who has the ability to control the borrower's activities.

If an SPE meets single purpose/special purpose bankruptcy-remote requirements and a non-consolidation opinion is obtained, is the lender one hundred percent (100%) protected?

There is ample precedent that a creditor who shows that (i) it has relied on separate credit of one entity not to be consolidated with any other entity; and (ii) that it will be prejudiced by consolidation, that a bankruptcy court should not consolidate entities. Although at least one bankruptcy court decision in 1999 may indicate that courts could ultimately head in a different direction, the doctrine of non-consolidation appears likely to be upheld.

Do the rating agencies address these issues in any other way?

Duff and Phelps Credit Rating Co. has an SPE classification system that some lenders may be employing with increasing frequency in 2000:

Level One SPE — Single purpose/special purpose covenants contained in the loan documents only.

Level Two SPE — Level One plus limited purpose and separateness covenants in the organizational documents of the borrower.

Level Three SPE — Level Two plus limited purpose and separateness covenants in the organizational documents of the general partner or managing member of the borrower, as applicable.

Level Four SPE — Level Three plus a non-consolidation opinion.

Level Five SPE — Level Four plus an Independent Director.

For loans of less than \$15,000,000, correspondents and brokers should expect lenders to almost always impose the requirement of a Level Two SPE, and for loans of more than \$15,000,000, a Level Five may be expected unless otherwise specifically negotiated.

Conclusion

The correspondent or loan broker should coordinate with lender during the loan application process as to what SPE requirements will be imposed upon the borrower and the borrower should be made certain to understand the extent and nature of such requirements in order to facilitate efficiently closing the loan.