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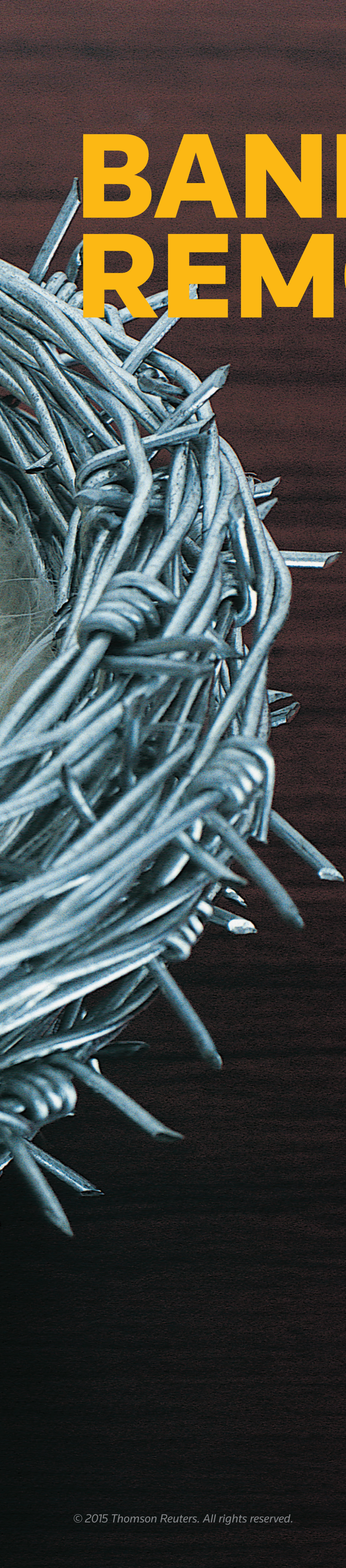

BANKRUPTCY REMOTE ENTITIES in Commercial Real Estate Transactions

In commercial real estate transactions, lenders commonly require borrowers to organize as bankruptcy remote entities to limit certain risks associated with a borrower's bankruptcy filing. This article discusses the fundamentals of using a bankruptcy remote entity to purchase and finance commercial real estate and the key considerations for both lenders and borrowers.

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Bankruptcy remote entities (BREs) are often used in commercial real estate financing transactions for loans exceeding a certain threshold amount, typically $10 million to $20 million (depending on the lender). To limit certain risks associated with a borrower's bankruptcy filing, lenders often require borrowers to be BREs, which are separate legal entities that take title to the real property (and related personal property) securing the loan extended to the BRE.

Lenders typically prefer BRE borrowers to be Delaware limited liability companies (LLCs), and in some cases Delaware limited partnerships (LPs) or corporations, because Delaware entities may provide protections unavailable under the organizational laws of other states.

A properly structured BRE isolates a lender's collateral from the insolvency and bankruptcy risks associated with other types of financing. Recourse to equity owners is generally limited and the costs of financing to the BRE may also be lower. Counsel, however, should be aware of the limitations of BREs, including:

- BREs are only bankruptcy remote, not bankruptcy proof.
- Particular provisions must be incorporated into the BRE's organizational documents and loan documents.
- BREs must be economically viable with respect to the debt they incur.
- Equity owners must be able to comply with the single purpose entity (SPE) (also called special purpose entity) organizational requirements throughout the term of the loan or face consequences, including recourse to the equity owners.

This article examines:

- The differences between SPEs and BREs.
- The primary characteristics of BREs.
- The reasons why lenders require BREs.
- Borrowers' concerns with bankruptcy remote compliance.
- Independent directors and the protections they provide against insolvency.
- The purpose of separateness provisions.
- The risks of substantive consolidation.

DIFFERENCES BETWEEN SPEs AND BREs

In commercial real estate transactions, the terms single purpose, special purpose and bankruptcy remote are often used interchangeably in the context of a structured or securitized commercial real estate loan transaction. However, there are important differences between an SPE and a BRE.

SPEs

An SPE generally refers to an LLC, LP or a corporation formed under the laws of a particular state (often Delaware in real estate transactions) and organized for the express purpose of holding a single real estate asset (or single portfolio of assets). All the major, nationally recognized rating agencies further define an SPE as an entity that is unlikely to become insolvent as a result of its own activities and is adequately insulated from the consequences of any related party's insolvency.

BREs

Not all SPEs are BREs. A BRE is always an SPE, but it has additional characteristics that an SPE does not necessarily have. For example, for an SPE to be a BRE, it must include as part of its organizational structure at least one director, general partner, managing member or controlling person who is not otherwise affiliated or associated with the borrower (referred to as independent directors or independent managers).

The independent director's primary purpose is to approve or disapprove a borrower's bankruptcy filing. The borrower must have the approval of one or more independent directors to have sufficient authority to file for bankruptcy.

CHARACTERISTICS OF BREs

There are a number of key characteristics that are associated with BREs.

BANKRUPTCY PROOF VERSUS BANKRUPTCY REMOTE

A BRE is not a bankruptcy proof entity. It would offend public policy to prohibit a person or an entity from availing itself of the protections available to debtors under the Bankruptcy Code (Code). A BRE cannot be prohibited from seeking Code protection, and any provisions creating that prohibition are likely unenforceable. When structuring a BRE, the goal is to reduce the likelihood that the BRE will:

- File a voluntary bankruptcy action.
- Become insolvent.
- Have an involuntary bankruptcy action filed against it.

To achieve this goal, a BRE's organizational documents should allow it to file a voluntary bankruptcy petition with the required approvals, including that of the independent directors or managers. These provisions are intended to create a hurdle to filing a voluntary petition but also be respected by a bankruptcy court. Lenders achieve bankruptcy remoteness by requiring several operational provisions in the BRE's organizational documents and the related loan documents.

ORGANIZATIONAL STRUCTURE

While most BREs are typically Delaware LLCs, there may be reasons to use another type of entity, such as the requirements of the jurisdiction in which the mortgaged property is located. LPs, corporations and statutory trusts (though they are used infrequently), may be set up as BREs.

When an LP is the borrower, it is not uncommon for the borrower to create a Delaware LP with a Delaware LLC as its general partner. In this situation, both the Delaware LP borrower and the Delaware LLC general partner are typically structured as BREs.

The required BRE provisions generally apply no matter which entity form is used. While there may be some variations from one entity to the next, this article primarily discusses a single member Delaware LLC BRE. If properly structured, a Delaware LLC may have a single member, which may:

- Simplify the borrower's organizational structure.
- Be required if the borrower is obtaining mezzanine financing (see below *Mezzanine Financing*).

While a corporation may be set up as a BRE, corporations are rarely used as an ownership vehicle (and therefore a borrower) in commercial real estate loan financings. Corporations present issues not generally seen with the use of an LP, LLC or a trust. Corporate laws generally require the officers and directors of a corporation to act as fiduciaries for the shareholders and to consider the best interests of the shareholders of the corporation above all else, particularly the corporation's creditors.

Laws governing LLCs and other forms of alternative entities are typically far more flexible. For example, when a Delaware LLC is the BRE or the general partner of an LP BRE, the factors considered can be altered or varied in a manner that is advantageous to a lender and increases bankruptcy remoteness. This includes requiring the directors, managers or officers of the Delaware LLC to additionally consider the interests of a creditor of a BRE (in other words, the lender).

BRE REQUIREMENTS

A BRE is less likely to become insolvent as a result of its own activities if it:

- Is formed for the limited purpose of owning and operating specific real property.
- Holds itself out to the public as a separate legal entity distinct from any other person or entity.
- Maintains its assets in a way that segregates and identifies them separately and apart from the assets of any other person or entity.
- Conducts business solely in its own name.
- Has no indebtedness other than a loan that is secured by a particular parcel of property and indebtedness for trade payables incurred in the ordinary course of business.

These requirements seek to ensure that the borrower remains a BRE and does not file for bankruptcy, or in the event of its parent's or affiliate's bankruptcy, will not be substantively consolidated into that bankruptcy.

Limited Purpose

The purpose of a BRE set out in its organizational documents must be limited. The organizational documents typically state that the BRE's purpose is:

> "to [acquire,] own, maintain, operate, lease, etc. the real property and engage in any lawful act or activity and exercise any powers permitted to the BRE organized under the laws of the state of formation that are related or incidental to and necessary, convenient or advisable for the accomplishment of owning the real property, including entering into the loan documents and the extension of the loan."

The BRE cannot own assets other than the real and personal property specified in its organizational documents. By requiring a limited purpose, lenders limit the potential pool of creditors and other operational risks that could arise if the BRE borrower had a broader purpose or owned other assets.

Isolated Assets and Liabilities

The separate legal entity principle is the key to the successful implementation of a BRE structure. The real and personal property and cash flow generated from the property are owned by the BRE, which is a separate legal entity from its equity owners. As a separate legal entity, a BRE should enjoy all the attributes and benefits associated with legal separateness. If properly structured, the BRE's lender should incur less risk associated with creditors of the equity owners or of an insolvency or bankruptcy of an equity owner.

Limitation on Debt and Liens

Other than the loan extended by the BRE's lender, the BRE is generally prohibited from:

- Incurring any other debt, except a limited amount of trade debt associated with the operation of the property.
- Granting any liens on its assets.

These prohibitions are intended to limit the number of potential creditors that could possibly force the BRE into an involuntary bankruptcy or obtain a lien on the BRE's assets. They restrict the BRE from incurring any major debt other than the loan.

CONTROL BY LENDERS

Given the organizational flexibility of LLCs and LPs, particularly in Delaware, the lender will have certain rights under the BRE's organizational documents, such as:

- The right to consent to:
  - amendments to the BRE's organizational documents as they relate to its bankruptcy remoteness; and
  - equity transfers in the BRE.
- Third-party beneficiary rights to enforce the bankruptcy remote provisions.

The lender should have no right to vote for or otherwise trump a voluntary bankruptcy proceeding. This type of provision would likely be unenforceable as against public policy. It is not, however, unusual for the lender to have substantial input regarding the removal and appointment of the BRE's independent directors or managers and the criteria that they must meet. Additionally, changes to the criteria and the provisions on which the independent directors or managers vote are often subject to lender consent or approval.

REASONS LENDERS REQUIRE BREs

There are several different types of bankruptcy risks that motivate lenders to require their borrowers to be BREs, such as:

- **The borrower's own acts.** These acts may involve risks related to:
  - the ownership and operation of the property, which is important so that the lender's collateral generates sufficient cash flow to cover debt service, reserves and expenses (such as property management fees);
  - actions affecting the borrower entity (such as consolidation, liquidation or a merger); and
  - the borrower seeking voluntary bankruptcy protection.

- **A related party's bankruptcy or insolvency.** While an equity owner's solvency may not seem as crucial as the solvency of the underlying borrower, commercial lenders often evaluate lending risk based on the equity owners' creditworthiness, experience operating similar commercial property and general financial well-being.

Regardless of the risks and implications, lenders often require their borrowers to be BREs simply because of rating agency requirements. Market participants and investors in the commercial mortgage-backed securities (CMBS) market have expectations for the operational requirements of a BRE.

While not all lenders have the same standards, commercial real estate loans over a certain monetary threshold amount are generally subject to BRE lending strictures. The specific requirements for when a borrower must be a BRE vary among lenders and may be dependent on other factors, such as whether the loan will be securitized, participated or sold.

CMBS FINANCING

If the loan is destined for pooling with other commercial real estate loans for a CMBS issuance, certain rating agency criteria may apply, and the organizational documents of the BRE and the underlying loan documents need to contain many (if not all) of the standard separateness provisions (see below *Separateness Provisions*).

Even for loans not subject to rating agency criteria, borrower's counsel may find that lenders still require the borrower to meet these standards. For smaller loans, however, some lenders may not require a BRE or may require a BRE that meets only some BRE requirements. For example, for smaller loans, lenders often:

- Waive the requirement that a borrower appoint an independent director or manager, or allow the borrower to have only one independent director or manager, rather than two.
- Limit (but almost never waive) separateness covenants, which are generally required in the borrower's organizational documents and the loan documents.

Search Commercial Mortgaged-backed Securities (CMBS) Finance: Overview for more on both the legal and business aspects of CMBS financing.

MEZZANINE FINANCING

BRE structures are often used in commercial real estate financings when the borrower is obtaining mezzanine financing. The mortgage borrower is a single member BRE that owns the mortgaged real property and grants the mortgage lender a lien on the real property as collateral for the mortgage loan.

The mezzanine borrower is a separate BRE that owns 100% of the issued and outstanding ownership interests of the mortgage borrower BRE. The mezzanine borrower obtains a mezzanine loan from the mezzanine lender and in return pledges its interest in the mortgage borrower as collateral for the mezzanine loan. Having the mezzanine loan secured by the equity interest in the mortgage borrower, rather than the property itself, avoids junior mortgages on the real property. This allows the mortgage borrower to comply with the BRE provisions.

Mezzanine financing provides the borrower with an additional source of financing without requiring a junior mortgage on the real property. This structure prevents a junior lender from placing a second mortgage or junior lien on the real property, which protects the senior lender against the risk of a junior mortgagee forcing a foreclosure under its loan documents.

Search Mezzanine Loans in Commercial Real Estate Finance for more on the purpose and structure of mezzanine loans in commercial real estate finance.

BORROWERS' CONCERNS WITH BANKRUPTCY REMOTE COMPLIANCE

Commercial real estate investors understand that complying with a lender's BRE requirements is part of the cost of doing business. However, compliance with a lender's requirements often causes concern for commercial real estate borrowers.

BRE compliance guidelines frequently require a borrower to form more than one new entity in connection with a financing. This can result in additional costs, including:

- Upfront transactional fees.
- Annual franchise taxes.
- Entity filings.

Borrowers are also concerned with the minutiae of compliance, particularly because a breach of the separateness provisions in the borrower's organizational documents or the loan documents is often included as a nonrecourse carveout in the loan documents, making an otherwise nonrecourse loan fully recourse to the borrower and guarantors. To avoid this, borrower's counsel should review and negotiate the language in the separateness provisions.

Search Negotiating Nonrecourse Carveout Guaranties in Commercial Real Estate Loans for more on nonrecourse carveouts.

The most persuasive argument a borrower has against requiring strict compliance with the separateness provisions is that the requirements limit a borrower's ability to structure a transaction in a way that minimizes the economic impact of state and local real property transfer taxes. Many states and municipalities impose transfer taxes on the purchase and sale of real property.

In some states, it may be possible to avoid the transfer tax by purchasing the stock, partnership interests or membership interests of the entity that holds title to the property, rather than purchasing the property itself. However, the separateness requirements in a loan transaction often preclude a borrower from structuring the transaction with these considerations in mind.

Search State Transfer Tax Comparison Chart for a 50-state overview of the taxes levied on the transfer of real property, including both direct and indirect transfers.

INDEPENDENT DIRECTORS AND PROTECTIONS AGAINST INSOLVENCY

Lenders typically require their borrowers to use independent directors or independent managers (also sometimes called independent persons) as another safeguard to ensure an SPE borrower is bankruptcy remote. Appointing an independent director limits a borrower's ability to take certain actions associated with bankruptcy, insolvency and dissolution (and certain other material actions) without the independent director's vote. A major or material action typically means:

- Filing any voluntary bankruptcy petition, instituting proceedings to have the BRE be adjudicated bankrupt or insolvent, or consenting to the institution of bankruptcy or insolvency proceedings against the BRE or filing a petition seeking, or consenting to, reorganization or relief with respect to the BRE under any applicable federal or state law relating to bankruptcy.
- Consenting to the appointment of a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the BRE or a substantial part of its property.
- Making any assignment for the benefit of creditors of the BRE.
- Admitting in writing the BRE's inability to pay its debts generally as they become due, or take action in furtherance of any such action.

Material actions may also include sales of assets, mergers or consolidations, and liquidations and dissolutions. Any other actions included in the list of material actions should be carefully considered and counsel should determine the appropriateness of having to obtain the independent director's consent for these actions.

The independent director helps insulate against the risk that the shareholders, members, partners, directors or managers (as applicable) of the borrower's parent will be able to control the borrower and vote to file a bankruptcy petition to help other related entities when the borrower may be otherwise solvent. This mechanism requires that any decision affecting the solvency of the borrower has the approval of both:

- The borrower's member or manager (if the borrower is an LLC) or general partner (if the borrower is an LP).
- One or more of the appointed independent directors or managers.

There may also be additional consent requirements in the member or general partner's respective organizational documents before that entity's consent is obtained.

These provisions generally require the independent director or manager to affirmatively vote or provide its written consent before a voluntary bankruptcy petition is authorized. Consent may also be required in certain other circumstances, such as for amendments to the company's organizational documents.

Properly structured, these types of provisions are enforceable under Delaware law for a Delaware LLC and respected in a proceeding under the Code. Many lenders require BREs to have two independent directors, both of whom must consent to the action being considered. Requiring the consent of two separate, independent individuals exercising their fiduciary or contractual duties under the organizational documents offers the lender additional protection.

In determining what is in the BRE's best interests, independent directors or managers may consider the economic interests of the lender before consenting to a voluntary bankruptcy proceeding. If a Delaware LLC is used, the lender may require the LLC agreement to include language stating that:

> "to the fullest extent permitted by law, and notwithstanding any duty otherwise existing at law or in equity, the independent directors only need to consider the interests of the BRE when voting on major or material actions."

While the fiduciary duties of the independent directors can be eliminated for a Delaware LLC, the organizational documents of the Delaware LLC cannot eliminate the implied contractual covenant of good faith and fair dealing implicit in contracts.

Independent directors also help to protect the lender from a borrower amending its organizational documents to circumvent the separateness requirements. Lenders generally prohibit the BRE from amending any of the provisions in its organizational documents that are associated with being a BRE until the loan is repaid in full:

- Without obtaining lender consent.
- After securitization, without a rating agency confirmation that the amendment will not result in a reduction, withdrawal, downgrade or qualification of the then current rating by a

The independent director helps insulate against the risk that the shareholders, members, partners, directors or managers (as applicable) of the borrower's parent will be able to control the borrower and vote to file a bankruptcy petition to help other related entities when the borrower may be otherwise solvent.

rating agency of the loan or any pool of loans of which the loan forms a part, or of any of the securities issued by a securitization trust of which the loan forms a part.

SEPARATENESS PROVISIONS

As an SPE, the borrower's organizational documents contain certain provisions, called separateness provisions, that are intended to ensure that its managers, members, directors and other controlling persons operate the BRE as a separate legal entity. The loan documents also contain:

- Representations from the BRE that it is in compliance with the separateness provisions.
- Covenants of compliance with the separateness provisions throughout the term of the loan.

Separateness provisions are intended to protect against a substantive consolidation in the event an equity owner or affiliate of the BRE becomes a debtor in bankruptcy (see below *Substantive Consolidation*). Under the Code, the equitable principle of substantive consolidation provides that if the activities of two entities are so entwined that it would be unjust to their creditors to treat them as separate entities, the court may combine the assets and liabilities of two or more entities and eliminate any intercompany debt among the consolidated entities. Creditors of the consolidated entities would share in the pooled assets as if there was only one debtor.

Despite taking precautions to minimize the possibility of the BRE becoming subject to a bankruptcy, a lender could still have a properly structured BRE that ends up consolidated in a bankruptcy case if the BRE does not comply with the separateness provisions and otherwise respect its separate legal existence from other persons.

The separateness provisions vary across lenders but are not significantly different and are often grouped together with other BRE-related provisions.

Search Bankruptcy Remote Entities in Commercial Real Estate Transactions for a comprehensive set of separateness provisions a lender may require in a borrower's organizational documents and loan documents.

A lender generally requires the BRE borrower to be a new entity formed immediately before the transaction. This requirement limits the risk that any prior activity undertaken by the borrower before the loan is closed could be a basis for consolidating the borrower with any other entity or allow for a bankruptcy filing. If a pre-existing entity is used, and it was not a BRE, it is referred to as a "recycled entity." If the lender allows the borrower to be a recycled entity, the lender typically:

- Reviews all past iterations of the borrower's organizational documents.
- Requires backward-looking representations and warranties in both the amended organizational documents and the loan documents and a legal opinion or accountant's certificate. These items attest to the past activities of the borrower so that the lender can confirm the borrower has always acted in compliance with the separateness provisions, even though it may have had no obligation to do so.
- Requires search reports to confirm the borrower's representations and warranties.

If a pre-existing SPE or BRE is used (as is often the case in a stock purchase or merger), it is not technically a recycled entity. In practice, however, lenders' counsel typically undertakes the same type of entity-level due diligence review and requires the same deliverables in these scenarios as it would if the entity were a true recycled entity. In these cases, a lender may require the borrower to provide additional negative covenants and representations and warranties in the loan documents relating to actions that the borrower has not done in the past or will not do in the future.

SUBSTANTIVE CONSOLIDATION

A lender may require a borrower to be a BRE to avoid a substantive consolidation of the borrower with its parent or other affiliate entity. If an entity is truly an SPE, it should not be affected by the insolvency of an affiliate.

Under the general equitable powers provided in section 105 of the Code, however, a bankruptcy court may disregard the separate legal existence of an entity and substantively consolidate the assets and liabilities of that entity with those of any one or more of the entity's equity owners or affiliates. Substantive consolidation treats the assets and liabilities of the entities as if they belonged to one entity, enabling the creditors of each formerly separate entity to reach the assets of the consolidated estate.

The creditors of an insolvent upper-tier debtor would seek to look to the assets of that debtor's wholly owned subsidiary if the subsidiary has substantial equity value above its secured debt. Creditors look for sources of repayment anywhere they can find them. However, a secured creditor's right to its collateral is still respected even if a borrower is substantively consolidated with another entity. Though the lender's lien will be respected, there are potential harms the lender wants to avoid, including:

- **The automatic stay of section 362 of the Code.** The automatic stay prevents the lender from exercising any rights over its collateral or against the BRE without first obtaining relief from the court. Seeking relief from the automatic stay would likely result in delay of payment to the lender. Also, the lender will incur the cost of retaining counsel to protect its interests in the bankruptcy case.
- **Restructuring of the lender's secured debt.** The lender's secured debt could be subject to restructuring in the bankruptcy case it now finds itself a part of as a result of the substantive consolidation. A bankruptcy court may alter the terms of the loan in a way that helps the consolidated debtors if the bankruptcy court finds that there will be no harm to the lender. Examples include lengthening the term of the loan or lowering the borrower's monthly payments.

A bankruptcy court is a court of equity and there may be a compelling equitable argument for substantive consolidation under the right facts. For example, the court might favor small "mom and pop" creditors that may lose their family business because they were left with no recovery, rather than favor another lender that has its secured claim respected and is paid in full with interest even if the court allows substantive consolidation. This is a sympathetic dynamic for the creditors seeking substantive consolidation and the court may be looking for a reason to justify this relief.

A deemed consolidation should be distinguished in a Chapter 11 plan for distribution purposes. In a deemed consolidation, assets and liabilities of the debtor are treated as if there were a true substantive consolidation. Merger of the separate affiliated entities and intercompany liabilities and guarantees would be eliminated, but solely for purposes of the Chapter 11 plan confirmation and claims distribution process. Creditors of each separate entity would therefore be lumped together by class to vote on the plan and for distributions under the plan. There would not be an actual consolidation or merger of the entities.

While there are many precedents and standards a bankruptcy court might use to determine if substantive consolidation is warranted, depending on the jurisdiction in which the court is located, as a general matter they are all fairness tests. It is often stated in judicial opinions that substantive consolidation should be used sparingly and as a last resort. Stated tests for substantive consolidations on their face appear difficult to meet.

For example, in *In re Owens Corning*, the test used by the court for consolidation sets a high hurdle to clear (*419 F.3d 195 (3d Cir. 2005)*). The test established that:

> "[W]hat must be proven (absent consent) concerning the entities for whom a substantive consolidation is sought is that (i) prepetition they 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."