

Separateness Covenants

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These Standard Clauses are a representative set of separateness requirements that a lender may require in a borrower's organizational documents and loan documents. These Standard Clauses contain integrated drafting notes with important explanations and drafting and negotiating tips.

DRAFTING NOTE: READ THIS BEFORE USING DOCUMENT

SPECIAL PURPOSE ENTITIES

In commercial real estate securitized lending transactions, the terms single (or special) purpose entity (SPE) and bankruptcy-remote entity (BRE) are often used to describe borrowing entities interchangeably. However, the difference between these characterizations is that:

- An SPE is one that is formed for a narrow or specific purpose (often to hold one property).
- A BRE is an SPE that has additional characteristics to reduce the likelihood that the entity will:
 - file a voluntary petition in bankruptcy;
 - become insolvent;
 - have any significant creditors other than the lender; or
 - suffer an involuntary bankruptcy action against it.

For a more detailed discussion of SPEs and BREs, see Practice Note, Bankruptcy Remote Entities in Commercial Real Estate Transactions: Differences Between Single

Purpose Entities and Bankruptcy Remote Entities ([8-606-5185](#)) and What Is a Bankruptcy Remote Entity? ([8-606-5185](#))

SEPARATENESS COVENANTS

One characteristic of a BRE is the inclusion of separateness provisions (or separateness covenants) in its organizational documents. These covenants are intended to ensure that a borrower's managers, members, directors, or other controlling persons operate the BRE as an entity legally separate from any other entity. These provisions are intended to increase the likelihood that a court will view the borrower as a separate legal entity and protect against a substantive consolidation if an equity owner or affiliate of the BRE becomes a debtor in a bankruptcy action (see Practice Note, Bankruptcy Remote Entities in Commercial Real Estate Transactions: Bankruptcy, Insolvency, and Substantive Consolidation Cases ([8-606-5185](#))).

Some of these requirements are arguably unrelated to separateness and are

instead related to a lender's underwriting considerations or to being a BRE, but they are often grouped together under one heading, typically entitled "Single-Purpose Entity" or "Separateness Covenants."

In practice, the loan documents contain corresponding covenants requiring the BRE borrower's compliance.

Although separateness provisions vary from lender to lender, they are typically similar and are often grouped together with other BRE-type provisions. These provisions typically fall into the following general categories:

- Restrictions intended to limit or eliminate the borrower's ability to incur liabilities other than the loan advanced under the loan documents, including:
 - restrictions or limitations on indebtedness; and
 - limitations on the borrower's allowed purpose and the activities in which it may engage.
- Restrictions intended to insulate the borrower from the liabilities of its affiliates or third parties, including requiring that:
 - both the loan documents and the borrower's organizational documents contain separateness covenants; and
 - the borrower deliver a nonconsolidation opinion (see Practice Note, Legal Opinions: Commercial Real Estate Finance ([3-590-8127](#))).
- Restrictions preventing the borrower from liquidating, consolidating, merging, or selling substantially all of its assets while the loan is outstanding without the prior consent of the lender.
- Requirements that the borrower have appropriate single-purpose, bankruptcy-remote owners and managers, if applicable.
- Restrictions limiting an otherwise solvent borrower from filing a bankruptcy petition (or taking other insolvency action), including requiring the borrower to have an independent director or manager who must vote to approve any insolvency action before it is taken (see Drafting Note, Independent Directors).

Counsel for the borrower should pay close attention to the list, as a breach of the separateness covenants often causes the nonrecourse nature of the loan to become recourse to the guarantors (see Practice Note, Trends in Nonrecourse Carveout Guaranties in Commercial Real Estate Loans ([9-520-7581](#)) and Negotiating Nonrecourse Carveout Guaranties in Commercial Real Estate Loans ([2-521-0515](#))).

For a discussion of the use of BREs in commercial real estate transactions, including a discussion of the separateness provisions often required by lenders, see Practice Note, Bankruptcy Remote Entities in Commercial Real Estate Transactions: Differences Between Single Purpose Entities and Bankruptcy Remote Entities ([8-606-5185](#)).

WHERE TO USE THESE STANDARD CLAUSES

In many commercial real estate finance transactions, lenders typically require separateness covenants in both:

- The loan documents.
- The borrower entity's organizational documents.

ASSUMPTIONS

These Standard Clauses assume that the BRE is:

- The mortgage borrower with title to the real property.
- An LLC, a limited partnership, or a corporation.
- Newly formed specifically for the transaction into which it is entering.

Certain terms are capitalized but not defined in these Standard Clauses because they are defined elsewhere in the agreement (for example, Lender, Loan Documents, and BRE).

BRACKETED ITEMS

Bracketed items in ALL CAPS should be completed with the facts of the transaction. Bracketed items in sentence case are either optional provisions or include alternative language choices to be selected, added, or deleted at the discretion of the drafting party.

ARTICLE I

SEPARATENESS COVENANTS

Section 1.01 Separateness Covenants. Since the date of its formation, and at all times on and after the [Closing Date/date hereof], [COMPANY NAME] has complied with and shall at all times comply with the following requirements:

- (a) is and shall be organized solely for the purpose of acquiring, developing, owning, holding, selling, leasing, transferring, exchanging, managing and operating the [REAL PROPERTY NAME] (the “**Property**”), entering into and performing its obligations under the Loan Documents with Lender, refinancing the Property in connection with a permitted repayment of the loan, and transacting lawful business that is incidental, necessary and appropriate to accomplish the foregoing;
- (b) has not engaged and shall not engage in any business unrelated to the activities set forth in clause (a) above;
- (c) has not owned and shall not own any real property other than the Property;
- (d) does not have, shall not have and at no time had any assets, other than the Property and personal property necessary or incidental to its ownership and operation of the Property;

DRAFTING NOTE: LIMITATIONS ON PURPOSE

Section 1.01(a), (b), (c), and (d) are covenants meant to limit the purpose for which the borrower is formed and the activities in which it can engage.

Lenders typically require an SPE to:

- Protect the value of the collateral they are receiving in return for making the loan.
- Minimize the likelihood that the SPE will be put into bankruptcy by its creditors because of activities unrelated to the mortgaged asset.
- Make it easier for a lender to foreclose if the borrower defaults.

In this instance, the SPE mortgage borrower covenants that it:

- Was formed for the sole purpose of owning the property and engaging in all ancillary business associated with its ownership of the property (see Section 1.01(a)).

- Has not engaged in any business unrelated to owning the property (see Section 1.01(b)).
- Has not and will not own any other property other than the mortgaged property (see Section 1.01(c)).
- Does not have nor has had at any time any assets other than the property (see Section 1.01(d)).

The nature of these limitations depends on the SPE’s role in the transaction. This section applies to an SPE mortgage borrower but should be conformed depending on the entity to which these clauses pertain. For example, the purpose of an SPE equity owner in an SPE borrower is to own the equity interests in the borrower, rather than to own and manage real property.

- (e) has not engaged in, sought, consented or permitted to and, to the fullest extent permitted by law, shall not engage in, seek, consent to or permit: (i) any dissolution, winding up, liquidation, consolidation or merger; or (ii) any sale or other transfer of all or substantially all of its assets or any sale of assets outside the ordinary course of its business, except as permitted by the Loan Documents;

(f) has not caused (other than with respect to the operating agreement of [COMPANY NAME] entered into on the closing date) and shall not cause, consent to or permit any amendment of its limited partnership agreement, articles of incorporation, articles of organization, certificate of formation, operating agreement or other formation document or organizational document (as applicable) with respect to the matters set forth in these separateness provisions;

DRAFTING NOTE: NO DISSOLUTION, MERGER, REORGANIZATION, OR AMENDMENT

Lenders typically require the covenants in Section 1.01(e) and (f) to be in both the loan transaction documents and the borrower's organizational documents.

These covenants prohibit (to the fullest extent permitted by law) the SPE entity from:

- Liquidating its assets or winding up its business.
- Merging or selling substantially all of its assets.
- Consolidating or combining with another entity.

- Amending the provisions of its organizational documents.

The lender typically also has certain additional rights under the SPE's organizational documents, such as:

- Consent rights to any amendment of the SPE's organizational documents regarding bankruptcy remoteness.
- The right to approve or disapprove transfers of ownership interests in the SPE.
- Third-party beneficiary rights to enforce the bankruptcy remote provisions.

(g) if such entity is a limited partnership, has and shall have at least one general partner and has and shall have, as its only general partners, bankruptcy remote entities, each of which: (i) is a corporation or single-member Delaware limited liability company; (ii) has at least one (1) independent director; and (iii) holds a direct interest as general partner in the limited partnership of not less than a certain percentage amount (1% or less);

DRAFTING NOTE: LIMITED PARTNERSHIP ENTITY

Section 1.01(g) requires that, if the borrower is a limited partnership, all of its general partners:

- Be bankruptcy remote entities.
- Be a corporation or single-member, Delaware LLC.

- Have at least one independent director.
- Hold at least a certain percentage interest in the limited partnership.

(h) if such entity is a corporation, has and shall have at least one (1) independent director;

(i) if such entity is a limited liability company (other than a limited liability company meeting all of the requirements applicable to a single-member limited liability company), has and shall have at least one member that is a bankruptcy remote entity, that is a corporation or a single-member limited liability company, that has at least one (1) independent director and that directly owns at least some minimum percentage of the equity of the limited liability company;

DRAFTING NOTE: LLC ENTITY

Section 1.01(i) provides that if the entity is an LLC, it must have at least one member that is a BRE corporation or single-member LLC that:

- Has at least one independent director.
- Owns an equity interest in the borrower.

Requiring that at least one member of the borrower entity holding a meaningful economic interest in the entity be an SPE reduces the risk that the bankruptcy or insolvency of a non-SPE member would throw the borrower itself into bankruptcy.

(j) if such entity is a single-member limited liability company: (i) is and shall be a Delaware limited liability company; (ii) has and shall have at least one (1) independent director serving as manager of such company; (iii) shall not take any bankruptcy related action and shall not cause or permit the members or managers of such entity to take any bankruptcy related action, unless all independent directors then serving as managers of the company shall have consented in writing to such action; and (iv) has and shall have a natural person or one entity that is not a member of the company, that has signed its limited liability company agreement and that, under the terms of such limited liability company agreement becomes a member of the company immediately prior to the withdrawal or dissolution of the last remaining member of the company;

DRAFTING NOTE: SINGLE-MEMBER LLC ENTITY

Section 1.01(j) provides that if the entity is a single-member LLC, it must:

- Be a Delaware LLC.
- Have at least one independent director serving as a manager of the company.
- Not take any bankruptcy-related action, nor permit the members or managers to take any bankruptcy-related action, unless all independent directors consent in writing to that action.
- Have one or more springing members (typically the independent directors) (see Springing Members).

This section requires any single-member LLC to be a Delaware company. Delaware is often the preferred state for formation since the rating agencies typically have a favorable view of Delaware LLC law. Therefore, in structured finance and securitized transactions, lenders often prefer that the borrower be a Delaware LLC.

If the borrower entity is a single-member SPE formed in Delaware, lenders do not typically require its sole member to be an SPE.

INDEPENDENT DIRECTORS

Lenders typically require their borrowers to use independent directors (also sometimes called independent managers or independent persons) as another safeguard to ensure that 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. 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 otherwise be solvent.

This mechanism requires that any decision affecting the solvency of the borrower have the approval of both:

- The borrower's member or manager (if the borrower is an LLC) or general partner (if the borrower is a limited partnership).

- One or more of the appointed independent directors or managers.

SPRINGING MEMBERS

A springing member is a person who becomes a special member of the LLC when certain events occur. Before becoming a special member of the LLC, the springing member does not have any interest (ownership or economic interest) in the LLC and is not a member. The springing member does not:

- Participate in the decision-making process of the LLC.
- Receive distributions from the LLC.
- Make capital contributions to the LLC.
- Have the power or authority to bind the LLC.

Lenders require springing members to prevent the borrower SPE entity from terminating for lack of members.

(k) has not and shall not (and, if such entity is: (i) a limited liability company, has and shall have a limited liability agreement or an operating agreement, as applicable; (ii) a limited partnership, has and shall have a limited partnership agreement; or (iii) a corporation, has and shall have a certificate of incorporation or articles that, in each case, provide that such entity shall not): (A) to the fullest extent permitted by law, dissolve, merge, liquidate or consolidate; (B) sell all or substantially all of its assets; (C) amend its organizational documents with respect to the matters set forth in this definition without the consent of Lender; or (D) without the affirmative vote of the independent directors of itself or the consent of the person that is a member or general partner in it, take any bankruptcy related action;

(l) has at all times remained solvent and paid its debts and liabilities from its assets as the same became due and has maintained adequate capital and, to the extent there exists sufficient cash flow from the operations of the Property to do so, will at all times remain solvent and will pay its debts and liabilities (including a fairly allocated portion of any personnel and overhead expenses that it shares with any affiliate) from its assets as the same become due, and will maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations (in each case, to the extent there exists sufficient cash flow from the operations of the Property to do so); provided, that the foregoing shall not require any member, partner or shareholder of [COMPANY NAME] to make any additional capital contributions to [COMPANY NAME];

(m) has not failed and shall not fail to correct any known misunderstanding regarding the separate identity of such entity and has not identified and shall not identify itself as a division of any other person;

(n) has maintained and shall maintain its bank accounts, books of account, books and records separate from those of any other person and, to the extent that it is required to file income tax returns under applicable law, has filed and shall file its own income tax returns, except to the extent that it is required by law to file consolidated tax returns and, if it is a corporation, has not filed and shall not file a consolidated income tax return with any other corporation, except to the extent that it is required by law to file consolidated tax returns;

(o) has maintained and shall maintain its own records, books, resolutions and agreements;

(p) has not commingled and shall not commingle its funds or assets with those of any other person and except as contemplated by any property management agreement (where the property manager is acting as an agent of [COMPANY NAME]), has not participated and shall not participate in any cash management system with any other person except each co-borrower under the loan;

(q) has held and shall hold its assets in its own name;

(r) has conducted and shall conduct its business in its name or in a name franchised or licensed to it, except for business conducted on behalf of itself by another person under a business management services agreement that is on commercially reasonable terms, so long as the

manager, or equivalent thereof, under such business management services agreement holds itself out as an agent of [COMPANY NAME];

(s) has: (i) maintained and shall maintain its financial statements, accounting records and other entity documents separate from those of any other person; (ii) shown and shall show, in its financial statements, its asset and liabilities separate and apart from those of any other person; and (iii) not permitted and shall not permit its assets to be listed as assets on the financial statement of any of its affiliates except as required by GAAP; provided, however, that: (A) any such consolidated financial statement contains a note indicating that [COMPANY NAME]'s separate assets and credit are not available to pay the debts of such affiliate and that [COMPANY NAME]'s liabilities do not constitute obligations of the consolidated entity; and (B) such assets shall also be listed on [COMPANY NAME]'s balance sheet, as applicable;

(t) has paid and shall pay its own liabilities and expenses, including the salaries of its own employees, out of its own funds and assets, and has maintained and shall maintain a sufficient number of employees, if any, in light of its contemplated business operations;

(u) has observed and shall observe all partnership, corporate or limited liability company formalities, as applicable;

(v) shall have no Indebtedness other than: (i) the loan; (ii) permitted debt under the Loan Documents; and (iii) such other liabilities as [COMPANY NAME] is expressly permitted to incur pursuant to the loan agreement or as otherwise imposed by law;

(w) has not assumed, guaranteed or become obligated and shall not assume, guarantee or become obligated for the debts of any other person, has not held out and shall not hold out its credit as being available to satisfy the obligations of any other person, in each case except as permitted pursuant to the loan agreement and the other Loan Documents;

(x) has not acquired and shall not acquire obligations or securities of its partners, members or shareholders or any other owner or affiliate;

DRAFTING NOTE: NO ADDITIONAL INDEBTEDNESS

Section 1.01(v), (w), and (x) restrict the SPE borrower's ability to incur indebtedness other than the loan. The borrower's ability to incur debt is typically limited to the mortgaged debt and other debt incurred in the ordinary course of owning and operating the property. By limiting the borrower's ability to incur additional debt, and therefore limiting the number of the borrower's creditors (other than the lender), these covenants are meant to minimize the likelihood that the SPE

borrower will be put into bankruptcy by these creditors.

However, lenders may allow the borrower to incur additional debt if the debt:

- Is fully subordinated to the lender's debt.
- Is nonrecourse to the SPE or any of its assets.
- Does not constitute a claim against the SPE.
- Is on arms-length terms, including any additional debt with affiliates.

(y) has allocated and shall allocate fairly and reasonably any overhead expenses that are shared with any of its affiliates, constituents, or owners, or any guarantors of any of their respective obligations, or any affiliate of any of the foregoing, including, but not limited to, paying for shared office space and for services performed by any employee of an affiliate;

(z) has maintained and used and shall maintain and use separate stationery, invoices and checks bearing its name and not bearing the name of any other entity unless such entity is clearly designated as being [COMPANY NAME]'s agent;

- (aa) has not pledged and shall not pledge its assets to secure the obligations of any other person;
- (bb) has held itself out and identified itself and shall hold itself out and identify itself as a separate and distinct entity under its own name or in a name franchised or licensed to it and not as a division or part of any other person;
- (cc) has maintained and shall maintain its assets in such a manner that it shall not be costly or difficult to segregate, ascertain or identify its individual assets from those of any other person;
- (dd) has not made and shall not make loans to any person and has not held and shall not hold evidence of indebtedness issued by any other person or entity (other than cash and investment-grade securities issued by an entity that is not an affiliate of or subject to common ownership with such entity or permitted debt under the Loan Documents);
- (ee) has not identified and shall not identify its partners, members or shareholders, or any affiliate of any of them, as a division or part of it, and has not identified itself and shall not identify itself as a division of any other person;
- (ff) other than capital contributions and distributions permitted under the terms of its organizational documents, has not entered into or been a party to, and shall not enter into or be a party to, any transaction with any of its partners, members, shareholders or affiliates except in the ordinary course of its business and on commercially reasonable terms comparable to those of an arm's-length transaction with an unrelated third party;
- (gg) has not had and shall not have any obligation to, and has not indemnified and shall not indemnify its partners, officers, directors or members, as the case may be, in each case unless such an obligation or indemnification is fully subordinated to the loan and shall not constitute a claim against it in the event that its cash flow is insufficient to pay the loan;
- (hh) has not had and shall not have any of its obligations guaranteed by any affiliate except as provided by the Loan Documents with respect to the guaranty and environmental indemnity;
- (ii) has not formed, acquired or held and shall not form, acquire or hold any subsidiary; and
- (jj) has not permitted and shall not permit any affiliate or constituent party (other than the property manager, solely in its capacity as an agent of [COMPANY NAME]) independent access to its bank accounts.

DRAFTING NOTE: SEPARATENESS PROVISIONS

Section 1.01(l) through (jj) contain representative separateness covenants. However, a particular lender may demand additional covenants.

These provisions are meant to:

- Ensure that the SPE is operated as a separate legal entity from its affiliates, members, managers, directors, and other controlling persons or entities.
- Protect against substantive consolidation in bankruptcy.

Lenders typically require that these representative separateness covenants be

included in both the loan documents (which will also include representations relating to separateness) and the SPE's organizational documents.

Although the language of these covenants may vary depending on the lender, the covenants generally require that the SPE:

- Maintain adequate capital to support its contemplated business.
- Correct any known misunderstanding regarding its separateness.
- Maintain separate books and records.
- Maintain separate accounts.

- Not commingle assets with those of another entity.
- Hold assets in its own name.
- Conduct business in its own name.
- Maintain separate financial statements.
- Pay its own liabilities out of its own funds.
- Observe all corporate, partnership, or LLC formalities.
- Not guarantee the debts of any other entity.
- Not hold out its credit as being available to satisfy the obligations of others.
- Not acquire obligations or securities of its partners, members, or shareholders.
- Allocate overhead expenses that are shared with any affiliates fairly and reasonably.
- Maintain separate stationery, invoices, and checks.
- Not pledge any of its assets for the benefit of any other entity.
- Hold itself out and identify itself as a separate and distinct entity under its own name or in a name franchised or licensed to it and not as a division or part of any other person.
- Maintain its assets in a manner that does not make it difficult to segregate or distinguish the SPE's assets from another's assets.
- Not make loans to another person or entity.
- Not identify its partners, members, or shareholders (or affiliates of any of them) as a division of the SPE.
- Maintain an arm's-length relationship with its partners, members, shareholders, affiliates, and unrelated third parties.
- Not provide indemnities unless they are fully subordinate to the loan.
- Not form any subsidiary.
- Not permit any affiliate access to its bank accounts.

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