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Bankruptcy Remoteness

Charles J. Altman and James P. Carroll

Rating agency "bankruptcy remoteness" requirements are an important aspect of commercial mortgages originated for the CMBS market. Bankruptcy remoteness refers to various provisions in the organizational documents of the borrower and the loan documents that are designed to insulate the lender's collateral from the risk of bankruptcy. In this article we present the applicable legal principles in a straightforward, non-technical manner and explore their real world implications.

Bankruptcy and Real Estate

While it is obvious that a borrower's bankruptcy is something to be avoided, it is worthwhile to take a brief look at the mechanisms of bankruptcy to see how they would impact a commercial mortgage. Bankruptcy law provides a spectrum of options for insolvent organizations ranging from continued operations by a debtor in possession of its assets to liquidation supervised by a court appointed trustee. Chapter 11 of the Bankruptcy Code affords the debtor the opportunity to continue its operations while restructuring ongoing obligations. The basic public policy behind Chapter 11 is the desire to give the debtor an opportunity to reorganize and thus preserve jobs and the going concern value, without unduly restricting the ability of creditors to realize the benefit of their negotiated contractual rights.

The filing of a Chapter 11 bankruptcy petition is an option that is often considered by real estate borrowers in monetary default whose property is worth less than the current balance of the mortgage loan. Bankruptcy can provide such borrowers with both timing and substantive benefits.

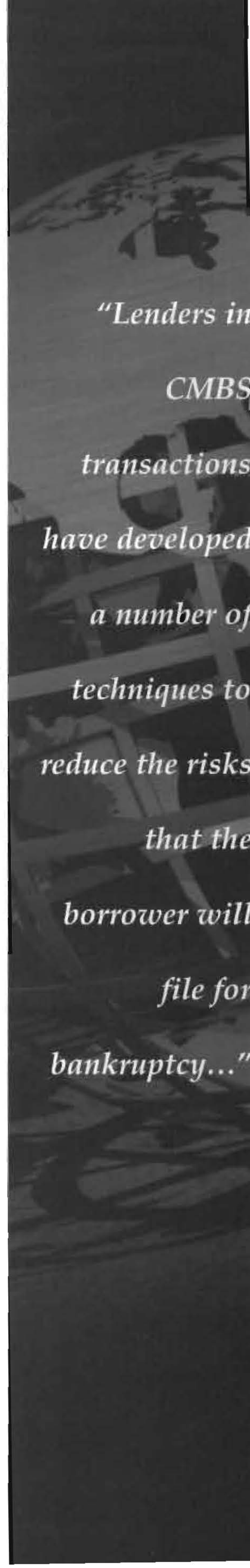
One benefit available to every debtor is the "automatic stay." The filing of the bankruptcy petition automatically stays or suspends all pending legal actions against the debtor or its assets. A lender that is in the process of foreclosing on its collateral must put the foreclosure on hold until the stay is lifted. A relatively quick state foreclosure action can be made subject to a federal matter entailing both increased time and legal fees before the lender can obtain title to the collateral. Thus, the stay can dramatically change the negotiating power between a lender and borrower. Borrowers are motivated to delay because it increases their bargaining power and because they may hope that due to improving local or national economic conditions, the property's current difficulties may be resolved during the course of a protracted bankruptcy.

In addition to the automatic stay, a bankruptcy filing gives the debtor an opportunity to resolve its obligations under a plan of reorganization. The plan can, in some cases, dramatically harm the lender. By cleverly establishing creditor classes, a debtor may be able to obtain approval of a plan which leaves it in possession of the property and gives the lender a restructured loan with a reduced principal amount, longer repayment terms or a reduced interest rate. The owners of the borrower may also be able to retain their ownership interests by contributing new value to the borrower, even though the lender's claim is not paid in full.

Lenders in CMBS transactions have developed a number of techniques to reduce the risks that the borrower will file for bankruptcy or will become involved in a bankruptcy of one or more of its affiliates.

Bankruptcy Remote Structures

A "bankruptcy remote" entity is one structured to reduce the risk of dissolution and whose organizational documents prohibit the entity from becoming involved with activities other than the ownership of the mortgaged property that might precipitate a bankruptcy filing or draw it into a bankruptcy of one of its affiliates. These remoteness objectives are accomplished



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by requiring that the borrowing entity be a "Single Purpose Entity" (SPE). In theory, bankruptcy remoteness reduces the likelihood that a borrower with a poorly performing property will file for bankruptcy protection. Unfortunately, this is not the case.

Separateness Covenants

The SPE borrower has limitations in its organizational documents and covenants in the loan documents which prohibit it, without the lender's consent, from, among other things:

- Engaging in any business other than ownership and operation of the mortgaged property.
- Incurring any indebtedness other than the mortgage loan and other indebtedness incurred in the ordinary course of its business.
- Consolidating with or merging into or with any other entity.
- Dissolving, liquidating or selling substantially all of its assets.
- Commingling its assets with the assets of any other entity.
- Failing to maintain separate books, records and bank accounts.
- Entering into any contract with any affiliate of the borrower that is not commercially reasonable and similar to an arms-length contract.
- Holding itself out as responsible for the debts of another entity.
- Failing to conduct its business in its own name.
- Amending any of the foregoing provisions while any amounts remain outstanding under the loan.

These SPE restrictions in the borrower's organizational documents and the loan documents are sometimes referred to as "Separateness Covenants." The Separateness Covenants are designed to reduce the risk that the borrower will file for bankruptcy due to reasons unrelated to the mortgage or that the borrower will be drawn into a bankruptcy case filed by one of its affiliates.

SPE Corporations

Many lenders require that borrowers of larger loans have to be an SPE corporation or have an SPE corporation as one of its constituent parties. In the case of an SPE limited partnership or limited liability company borrower, the general partner or managing member is required to be an SPE corporation. Having a special purpose corporation as a constituent party serves several purposes. It stabilizes the structure because a corporation's existence is not dependent on the continued existence of its shareholders. Thus, the borrower would always have at least one constituent party. In addition, it provides a means of appointing an independent director whose affirmative vote is required before the borrower can file a voluntary bankruptcy petition. The independent director requirement is discussed in greater detail below.

Substantive Consolidation

Substantive consolidation is an equitable doctrine that permits the bankruptcy court to pool the assets and liabilities of the borrower with those of its controlling equity owners or an affiliated property manager. It is not based upon any explicit provision in the Bankruptcy Code. The doctrine can be applied when an owner has held out its assets to creditors as being available to pay the borrower's debts. For example, if a real estate developer owns several borrowing entities and has held them out to creditors and vendors as all being under common ownership and all standing behind each other's obligations, it might be appropriate to consolidate all of the borrower's assets and liabilities and structure a plan of reorganization that encompasses the whole. A lender whose loan is performing would not want that property combined or consolidated with troubled loans of affiliates of the borrower. A lender whose loan is not performing might not want its voting power in a bankruptcy case to be diluted.

The case law strongly suggests that no single factor is determinative. There appears to be a substantial correlation between a finding that it would be difficult to ascertain the debtor's separate assets and liabilities and a decision to consolidate the assets and liabilities of affiliated debtors. Other than financial entanglement, the most significant factor in determining whether to order substantive consolidation is a balancing of the benefits and prejudices to creditors that would be caused by consolidation, taking into account creditors' reliance on the separate credit of the entities, when the court has already found financial entanglement.

In larger CMBS loans, borrowers are often required to obtain a "Non-Consolidation Opinion." This is a legal opinion in which a reputable law firm analyzes the factual circumstances of the borrower's organization and, based on the assumption that the borrower complies with its Separateness Covenants, opines that a court which correctly applied existing law would not order substantive consolidation of the assets and liabilities of the borrower with those of its controlling affiliates.

Some attorneys who once were heavily involved with workouts and bankruptcies are puzzled by the requirement of a Non-Consolidation Opinion. In the late 1980s and early 1990s, numerous borrowers took advantage of the bankruptcy laws to prevent a foreclosure. However, the number of cases that involved substantive consolidation was very small. A consolidated case with many assets would certainly have taken longer to resolve than a single asset case and might have provided the borrower with a greater chance at confirming a plan. Yet, most defaulting borrowers were pleased enough if they could successfully maintain the automatic stay and then take months or years to develop a plan. Very few fact patterns existed or were created that posed issues of substantive consolidation.

Since history does not suggest that substantive consolidation is a major risk, why do rating agencies require Non-Consolidation Opinions? The answer is that the rating agencies want to ensure that a reputable law firm has done sufficient due diligence to verify that the transaction has been structured to reduce bankruptcy risks unrelated to the mortgage loan. Reputable law firms take Non-Consolidation Opinions seriously because they create potential liability for the firm rendering the opinion. Once the rating agency is satisfied that the proper structure is in place, it rates the transaction based on the ability of the borrower to repay the loan out of its own assets.

Of course, if a borrower cannot repay its mortgage loan, Separateness Covenants may have limited utility. The borrower will likely file for bankruptcy in an attempt to preserve value for its equity holders or avoid adverse tax consequences.

The Separateness Covenants that form the basis for the Non-Consolidation Opinion are within the control of the borrower. A borrower that sees problems down the road which will likely lead to a monetary default could take certain "preventive actions." If it chooses, it could create facts, which would lend credence to arguments for consolidation. For example, the borrower could transfer other assets into the borrowing entity, commingle assets with borrower affiliates, or enter into contracts and agreements with affiliates that entangle and complicate business relationships. By doing this, the borrower will increase the likelihood of substantive consolidation. Each of these actions is likely to be a default under the loan terms. However, they might be attractive for a desperate borrower seeking time or bargaining power.

The lender does not benefit from having a Non-Consolidation Opinion in such circumstances. The opinion is based upon the facts that existed at the time of the opinion, i.e. the time of loan origination. The opinion is not a guaranty of a judicial outcome; it is a reasoned statement that, based upon the existing law and continued observance of the Separateness Covenants, substantive consolidation would not be granted by a bankruptcy court that correctly applied the law. The opinion has no applicability to an unscrupulous borrower who violates its Separateness Covenants.

Independent Director

Another approach to reduce the risk of the borrower filing a bankruptcy case and the risk of substantive consolidation is to require that the borrower's board of directors or the borrower's general partner or managing member, as applicable, have a director that is not affiliated with the borrower. The relevant organizational documents are drafted to provide that any bankruptcy filing by the borrower requires the unanimous consent of all directors of the borrower or the special purpose corporation that is a constituent of the borrower. Since the independent director will presumably not consent to a frivolous bankruptcy filing, no such filing should be possible.

The relevant organizational document provisions generally preclude an individual from serving as independent director if such person is, becomes, or was during the preceding five years: (1) a stockholder, director, officer, partner, attorney, customer, or supplier of the borrower or any of its affiliates, (2) a person controlling or under common control with any such person, or (3) a member of the immediate family of such person.

Unfortunately, experience over the past few years has indicated that the benefits of an independent director may be inflated. Many single asset real estate borrowers are less than scrupulous in observing the corporate proprieties of meetings, minutes, etc. While some independent directors are diligent, some are not. Moreover, the principals of the borrower may take actions that attempt to circumvent the independent director's role even with respect to approving a bankruptcy filing, such as replacing a troublesome independent director with someone more friendly.

Perhaps the greatest difficulty with the independent director is that under the laws governing corporate directors, the independent director owes a fiduciary duty to other parties in addition to the lender. Thus, at the crucial moment when called upon to vote for the filing of a voluntary bankruptcy petition, the independent director faces potential personal liability if he disregards these other interests including those of equity holders.

Springing Bankruptcy Recourse

Many lenders have taken another approach to reducing the risk of a bankruptcy filing. Perhaps one might call it the motivational approach. Instead of, or in addition to, Separateness Covenants and independent directors, they have focused upon the motivations of the people who control a voluntary bankruptcy filing.

CMBS loans are generally non-recourse. If the borrower defaults, the lender's only remedy is to proceed against the property. However, the key principals of the borrower are generally required to sign a guaranty of certain exceptions to the non-recourse provisions. Such a guaranty generally provides, for example, that if a key principal were to steal insurance proceeds from the borrower, the principal would be personally liable to the lender for those amounts. In a related approach, lenders can have a controlling principal agree that in the event the borrower files a voluntary Chapter 11 petition, the principal will become personally liable for the full amount of the loan. This is also generally extended to include a situation where creditors file an involuntary petition and the principal objects to the lender's efforts to lift the automatic stay. The process by which the principal becomes fully liable for the loan is generally called "Springing Bankruptcy Recourse" since it "springs" into place only in these circumstances.

Of course, many principals object to the lender's request for such a guaranty. The objections raised include the argument that if things go badly, they have a right to file for bankruptcy protection and that their partners and investors expect them to use every available means to fight the lender's foreclosure. In such negotiations the lender will point out that they are getting a non-recourse loan. If the property cannot support the debt service then they have to hand over the keys. Their capital at risk is limited to their equity, perhaps 20% to 30% of the initial property value, while the lender's capital at risk is three to four times as great.

Some CMBS analysts assign limited value to Springing Bankruptcy Recourse. They argue that if a controlling principal's properties start to encounter difficulties, there are likely to be problems across the board, which will affect many of that individual's assets. If faced with losing several properties at once, the principal may file a personal Chapter 11 rather than trigger individual asset filings. This would obviate any benefit from Springing Bankruptcy Recourse.

However, many real estate bankruptcy attorneys feel otherwise. They argue that Springing Bankruptcy Recourse is the single greatest deterrent to a borrower filing Chapter 11. A key belief of real estate entrepreneurs is the use of other people's money and the sheltering of one's own assets. Given a choice between walking away from a money-losing property or putting all of one's personal assets at risk, they will clearly choose the former. These attorneys argue that this is true for almost all entrepreneurs and the proof is in their reactions to the choice of bankruptcy remoteness options. Most controlling principals would rather create a SPE, obtain an expensive Non-Consolidation Opinion and install an independent director, before they would choose Springing Bankruptcy Recourse.

The Way Bankruptcy Law Should Work

Until now we have reviewed the theory and reality of bankruptcy of single asset borrowers. It is worthwhile to examine the larger picture of whether this makes any sense.

The availability of Chapter 11 bankruptcy for CMBS and other real estate borrowers results in expenditures of millions of dollars in legal fees and related costs. But should this be the case?

The United States legal system sometimes places too much importance on form and not enough on substance. Until now, we have assumed that because single asset real estate borrowers can avail themselves of bankruptcy protection that it is right for them to do so. Although Chapter 11 is an appropriate solution for many debtors, there are compelling policy reasons why it should not be available to most single asset real estate debtors.

Unlike a true operating company, most real estate borrowers have few if any direct employees and their customers (tenants), managing agents, suppliers, and vendors would not be materially harmed by having a lender take title to the property and then, in all likelihood, sell it to a new solvent owner. In fact, most of the entities that deal with an insolvent borrower/owner would be very pleased to have a solvent owner. It is only in the hospitality and senior housing sector that there is likely to be a true constituency whose fate is tied to the current owner.

During the late 1980s and early 1990s, there were many proposals for amending the Bankruptcy Code to restrict single asset real estate bankruptcies. In 1994, Congress took a first feeble step when it created a streamlined process that is more creditor friendly. However, this process is only applicable for a narrow class of real estate with secured debt less than $4 million. It does not apply to residential property with fewer than four units. In such cases, the bankruptcy court must lift the automatic stay if the debtor has not, within 90 days, filed a plan of reorganization that has a reasonable chance of acceptance or unless the debtor has started to make interest payments to the secured creditor. Congress gave no reason for choosing the totally arbitrary $4 million limit.

In view of the positive economic fundamentals in most real estate markets over the past five years, it is too early to tell whether this new Bankruptcy Code provision will have any meaningful results.

In 1994, Congress also settled an important issue relating to the perfection of a security interest in the rental income of a mortgaged property. Such security interests are now perfected to the extent provided in the applicable security agreement, without regard to whether the lender has taken action to enforce the assignment of rents. Thus, borrowers are no longer able to get control over rental income by simply filing a bankruptcy petition.

In conclusion, we see that a Chapter 11 filing is available to most real estate borrowers. Lenders have devised various defenses and the CMBS industry has particularly focused on the creation of bankruptcy remote entities. Only time will tell how successful we have been.

Charles J. Altman is a Senior Attorney with Lehman Brothers Inc. and is responsible for the legal and closing function in the conduit-lending program.

James P. Carroll is Managing Partner of the Charlotte, North Carolina office of Cadwalader, Wickersham & Taft and a member of the firm's Real Estate Department. Mr. Carroll currently serves as Vice Chairman of the American Bar Association's Committee on Real Estate Securitization.