

## Cover Your Assets

Single-purpose entities protect real estate investments in bankruptcy.

by Robert K. Rowell, JD

Lenders holding commercial real estate-secured loans want to ensure that, if a borrower goes bankrupt, the collateral property will not be consolidated with the borrower's other assets. To ease such fears, borrowers use "bankruptcy-remote" single-purpose entities, or SPEs, to separate such collateral from their other assets.

However, SPEs offer advantages to borrowers as well, allowing them to leverage their financing through mezzanine loans. Commercial real estate professionals can serve their clients more efficiently by increasing their knowledge of SPEs.

### Independent Status

In recent years, the growth of the commercial mortgage backed securities market has pressed lenders to make greater use of SPEs. Very simply put, in CMBS transactions, commercial real estate loans are bundled together and transferred to a trust, which issues securities based on the strength of the mortgages. Agencies such as Moody's Investors Service, Standard & Poor's, and Fitch Ratings rate the CMBS securities by performing credit analyses of the underlying loans. Their key concern is the continued economic performance of the real estate itself. This concern has made SPEs an attractive way to protect securitized commercial real

estate earnings, which leads to a higher agency rating.

Standard & Poor's has established accepted guidelines stating what an SPE must do to maintain bankruptcy-remote status. A key criterion is at least one independent SPE director or manager who has no current or prior relationship with either the lender or the borrower. Typically unanimous consent of all directors is required for the entity to file for bankruptcy. Thus, the single vote of the independent director can prevent such a filing.

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Selecting the wrong director can jeopardize the SPE and have disastrous consequences for the lender. To be truly independent, directors must act in their own fiduciary capacity on behalf of all equity investors, shareholders, and members and, in the case of impending bankruptcy, all creditors. This effectively eliminates anyone who previously has been a

direct or indirect owner of the SPE or an employee, officer, manager, family member, supplier, contractor, or anyone affiliated with or connected to the SPE's lenders or creditors. Other independent requirements include

- prohibition against engaging in any business not related to the property;
- prohibition against liquidation, consolidation, or merger without the unanimous consent of the SPE's directors, members, or partners;
- prohibition against incurring any debt, except ordinary trade debt;
- maintenance of separate books, records, and accounts;
- use of the SPE's own name in conducting business with separate stationery, invoices, and checks;
- prohibition against commingling of assets with affiliates or transacting business with them, except at arm's length;
- prohibition against guaranteeing an affiliate's debt; and
- a lockbox arrangement to monitor cash disbursements.

It is wrong to assume that an independent director always will promote just the lender's interests and vote against any SPE attempt to file for voluntary bankruptcy. Established case law demonstrates that choosing an independent director based upon such an assumption may result in negative consequences for the lender. For example, in the case of *Kingston Square Associates et al*, the court held that as an entity approaches insolvency, directors owe a fiduciary responsibility to all the company's creditors. In another case, *Cumberland Farms Inc.*, the court held that directors "cannot be permitted to serve two masters whose interests are antagonistic."

Such court decisions underscore the importance of having an experienced independent director who can protect the SPE and its assets without giving the appearance of acting as the lender's agent.

## Mezzanine Financing

Borrowers can use SPEs to raise more money on their commercial real estate, often through mezzanine financing, and generally at better rates than they might receive if the collateral were commingled with their other assets.

Typically mezzanine borrowers have a piece of commercial property that already is mortgaged but is producing more than enough income to meet the senior loan requirements and finance additional borrowing. To make the loan attractive, the borrower establishes an SPE to isolate that property from other property in the company's portfolio that might not be performing as well. This assures lenders that the income stream will not be diverted to the borrower's other operations but will be used to service the loan.

For example, a small adhesives manufacturer with revenues of \$20 million used a combination of mezzanine and equity financing to initially raise \$25 million for acquisitions. In a second mezzanine deal, the company raised an additional \$55 million — \$45 million in debt and the rest in equity. As a result of a series of successful acquisitions, the company quickly increased its revenues to \$100 million. In this real-life example, the borrower raised more money than is typical of mezzanine financing. However, this situation demonstrates the ability of mezzanine financing to leverage assets and fuel rapid growth. For the lender, the key to such financing was isolating the securitized property from the company's other assets.

## Single-Member LLCs

Another growing trend is to establish new SPEs as limited

liability companies, which offer greater flexibility. Such entities combine many of the advantageous features of corporations and limited partnerships.

A particularly attractive choice for an SPE is the single-member LLC. Having just a single member cuts management costs and vastly simplifies the fiduciary responsibilities of the independent member who is also the manager. In addition, this structure gives lenders greater assurance that their interests will be protected.

Because LLCs still are relatively new and are subject to state regulations, it's important to establish an LLC, especially a single-member LLC, in a state that treats them as corporations rather than as partnerships and recognizes the validity of a single-member LLC.

The advantage of having the LLC recognized as a corporation is that, unlike a partnership, a corporation will not dissolve upon the death, departure, or bankruptcy of its last member. To protect lenders' interests, it's critical that SPEs outlast the duration of the loans.

SPEs give lenders an extra layer of protection but also enable borrowers to leverage their borrowing capacity. For help in drafting the documents to form an SPE, there are sample contracts that have been thoroughly vetted. However, it still is critical to double check that the SPE will not run afoul of the bankruptcy laws in the state in which it is established, especially if the SPE is an LLC or single-member LLC.



Robert K. Rowell, JD, is vice president and general counsel of National Registered Agents in Princeton, N.J. Contact him at (802) 365-4118 or rkrowell@nrai.com.

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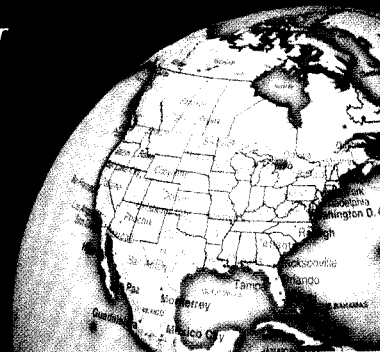
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