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Special Purpose Entities in Real Estate Transactions: Structuring and Documentation

Mastering Separateness Provisions, Single Member LLCs, Recycled Entities, Independent Directors, and Non-Consolidation Opinions

TUESDAY, NOVEMBER 26, 2019

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Today's faculty features:

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Special Purpose Entities in Real Estate Transactions: Structuring and Documentation

Matthew Kelsey, Allison Kidd, Eric Wise,
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November 26, 2019

Introduction to Real Estate Financing Structures

- Bankruptcy has driven the evolution and form of the real estate finance structures that predominate in the market.
- The choice among various real estate finance structures and provisions will affect the results in a future workout or bankruptcy proceeding.
- Bankruptcy dynamics drives the structuring of special purpose entities.
- Here we discuss taming the bankruptcy bogeyman.

Theory of Non-Recourse Real Estate Lending

- Real estate investors leverage their returns on a project with debt in order to:
  - Limit downside risk by recourse only to the collateral;
  - Increase return on equity by reducing equity; and
  - Shield personal wealth and other sources of recovery.
- Real estate lenders underwrite loans on the basis of recourse being only to the collateral in order to:
  - Limit the underwriting to the risks of diligence and those associated with the particular collateral only (i.e., by utilizing a special purpose entity as borrower); and
  - Limit the risk assumed to a decline in the value of the particular collateral.

Theory of Non-Recourse Real Estate Lending (cont'd)

- Lender's willingness to lend on a non-recourse, collateral-only basis is predicated on Lender having unimpeded access to, and true and complete information about, the collateral.
  - Don't lie;
  - Don't cheat;
  - Don't steal; and
  - Don't obstruct efforts to recover against the collateral.
- These principles form the basis of "non-recourse carveout" or "bad boy" guaranties.
  - Lenders may seek to expand the non-recourse carveouts to cover underwriting or performance issues unrelated to bankruptcy risks.

Bankruptcy's Impact on Non-Recourse Real Estate Lending

- Before discussing the structure of borrower as a special purpose entity, we discuss how to and why avoid bankruptcy.
- Getting into bankruptcy:
  - Blanket prohibitions against filing for bankruptcy protection are against public policy.
  - There are three ways an entity can be put into bankruptcy: (1) voluntarily, by the entity's management; (2) involuntarily, by the entity's unsecured creditors; or (3) involuntarily, by application of the equitable doctrine of "substantive consolidation."

Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- General Principles of Bankruptcy Policy:
  - Debtor's property becomes part of an "estate" that is administered through a court-supervised process.
  - Maximize the value of the estate's assets for the benefit of *all stakeholders*, not just secured creditors.
  - Absent an agreement post-filing, similarly situated creditors are treated similarly (equality of treatment of creditors within each creditor class).
  - Watch dog appointed for unsecured creditors to ensure bankruptcy process is not run solely for the benefit of secured creditors.
  - Prohibition on enforcement actions (aka the "automatic stay") to provide the debtor time to develop a reorganization or liquidation strategy.
  - *These bankruptcy policies are antithetical to the goals of senior secured lenders, who want quick access to the real estate if there is an event of default*.

Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- Three Biggest Consequences to Secured Creditors in Bankruptcy:
    - The Automatic Stay. The automatic stay is triggered automatically upon filing, which enjoins remedial actions of all creditors.
    - Cramdown. A key bankruptcy power is to bind classes of creditors to a plan to restructure a debtor's balance sheet, even if the creditor class votes to reject the treatment proposed in the plan.
    - Priming Financing/Cash Collateral. A debtor can obtain access to liquidity post-bankruptcy to operate, either through financing on a priming basis or cash generated by the property.

Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- The automatic stay enjoins:
  - enforcement of any lien against property of the estate (e.g., foreclosure actions);
  - any act to obtain possession of or exercise control over property of the estate; and
  - recovery of a claim against a debtor.
- It is possible to lift the automatic stay for "cause" (e.g., the debtor lacks any equity in the property).
- If the property is essential to an effective reorganization, courts will not lift the automatic stay to allow a secured lender to foreclose.
- If the debtor qualifies as a single asset real estate debtor, secured creditors receive enhanced rights.

Plan of Reorganization: "Cramdown" Treatment

- Cramdown. Section 1129(b) of the Bankruptcy Code allows the confirmation of a plan over the "no" vote of a class of creditors, even if the creditor class is senior and secured (known colloquially as "cramdown").
- Cramdown is a powerful tool because it binds an entire class of creditors to a plan they have voted to reject.
- Two key components to confirm a "cramdown" plan:
  - The plan must not discriminate unfairly; and
  - The plan must be "fair and equitable."
- Cramdown requires the acceptance of an impaired consenting class of creditors.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- For secured creditors, a plan is "fair and equitable" if it satisfies one of three criteria:
  - <u>Sale</u>. The collateral securing the debt is sold free and clear, and the liens attach to the sale proceeds.
  - <u>Return of the Collateral</u>. The secured creditor is provided with the "indubitable equivalent" of its claims.
  - <u>New Loan</u>. The secured creditor retains liens on the property and receives deferred payments: (1) totaling the amount of the allowed secured claim, and (2) equal to the value, as of the plan effective date, of the creditor's interest in the estate's interest in property.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- New Loan. This cramdown treatment presents the greatest risk that secured creditors will not receive a full recovery.
- Paid over time. As the new loan will be paid over time, a rate of interest on the loan must be determined to ensure the creditor receives present value of claim.
- Two Approaches:
  - Prime Plus/Formula Approach. Interest rate on the new loan set at the prime rate (as of the plan effective date) plus a nominal increase to account for credit risk of loan to reorganized debtor.
  - Market Approach. Where a market exists for the type of loan being offered to the secured creditor, the interest rate should be set at the market rate.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- Impaired Consenting Class: The "Per Debtor" vs. "Per Plan" Approach
  - "Per Debtor" approach for cramdown requires that section 1129(a)(10) of the Bankruptcy Code must be satisfied by each debtor to a joint plan. Thus, each debtor must have at least one impaired accepting class to confirm the plan.
  - "Per Plan" approach for cramdown requires that section 1129(a)(10) must be satisfied by a plan. Thus, a joint plan only needs a single impaired accepting class even though the debtors under a joint plan may not be substantively consolidated.
- Even though a mezzanine borrower is structured to have one creditor, the mezzanine lender, the "per plan" approach to cramdown can undermine the purpose of this commercial real estate structure. *See, e.g.*, *In re Transwest Partners*, 881 F.3d 724 (9th Cir. 2018).

Other Bankruptcy Risks: Priming Loans, Adequate Protection

- The last significant bankruptcy risk that can affect secured lenders is the debtor's ability to use cash post-filing to operate its business.
- There are two ways for a debtor to obtain access to liquidity:
  - Priming Financing. The Bankruptcy Code authorizes a debtor to obtain a loan that primes senior secured lenders.
  - Cash Collateral. The Bankruptcy Code authorizes a debtor to use cash generated by the property.
- Adequate Protection. To obtain priming financing or right to use cash collateral, senior lenders must receive adequate protection.
- Adequate protection burden is usually met by the debtor in a bankruptcy case, and the form of adequate protection may not seem adequate to the senior lenders.

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote Special Purpose Entity

- Structuring a bankruptcy remote SPE generally involves attention to at least two areas:
  - Authority to File: Attention to an SPE's ability to file bankruptcy.
  - Liabilities and Creditors: Attention to forces that may lead to a voluntary filing, involuntary filing or interfere with the lender's exercise of remedies or recovery in a bankruptcy.

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote SPE – Authority to File

- Restrictions on a borrower's ability to file bankruptcy may be enforceable under state law but held void as against federal public policy.
- Applicable non-bankruptcy law governs who has the authority to make an entity's decision to commence bankruptcy proceedings.
- Mechanisms designed to avoid an entity's voluntary bankruptcy include:
    - Appointment of independent directors.
    - Agreements among various stakeholders.

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote SPE – Authority to File (cont.)

- Appointment of one or more Independent Directors:
  - From a nationally recognized company that provides professional independent directors.
  - Resignation, removal or replacement requires advance notice to Lender.
- The duties of an Independent Director:
  - Why not prohibit a bankruptcy filing and only consider the interests of the Lender?

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote SPE – Authority to File (cont.)

- Agreements between borrower and lender to interfere with a borrower’s right to commence bankruptcy may not be enforceable:
  - The “Blocking Director” (*Lake Michigan Beach Pottwattamie Resort*).
  - The “Golden Share” (*Intervention Energy*).
- Agreements between “bona fide” equity holders regarding a borrower’s authority to file bankruptcy are generally enforceable:
  - Majority or unanimous vote among equity holders required. (*DB Capital; Squire Court; Franchise Services*).

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote SPE – Authority to File (cont.)

- An SPE is intended to be bankruptcy remote, but not bankruptcy proof.
- Notwithstanding the appointment of an independent director, the SPE can still commence a bankruptcy voluntarily:
    - Exercise of fiduciary duty of independent board member of SPE to file bankruptcy will be respected.
    - Fiduciary duty runs to SPE entity and, derivatively, its stakeholders under Delaware law.
    - Insolvency not required—an SPE can be solvent and still avail itself of bankruptcy protection.
    - Imminent risk of default is not required to commence a chapter 11 case.
    - Limiting/eliminating fiduciary duties of board members may trigger lender liability risks to other stakeholders.

Minimizing the Bankruptcy Risk: Structuring a Bankruptcy Remote SPE – Liabilities and Creditors

- An SPE is a newly created entity with no prior business activities that could have given rise to preexisting creditors, or other claims (tort, environmental, etc.).
- SPE activities are restricted to those necessary or incidental to the financing which is accomplished by:
  - restrictions being placed in the organizational documents of the SPE;
  - restrictions placed in the transactional documents; and
  - drafting protection against amendments into the foregoing documents.
- Permitted encumbrances should be narrowly tailored. There should be no other mortgage liens and protections against other liens.

Minimizing the Bankruptcy Risk: The Challenge of Recycled SPE Entities

- There may be transactional reasons such as tax advice or prior precedent to lend to an entity with a prior history, but these “recycled” entities pose challenges to the bankruptcy-remote structure.
  - Additional creditors that may present bankruptcy risks.
  - Additional liabilities hat may impede access to collateral.
- Lenders typically require certification from borrower reflecting an adequate investigation into matters that mitigate the risks related to bankruptcy.
  - No prior litigation or disputes with taxing authorities.
  - A clean Phase One on all prior and currently owned properties.
  - Material compliance with SPE covenants since formation.

Minimizing the Bankruptcy Risk: Full Springing Recourse Liability

- Full recourse liability if borrower commences a bankruptcy:
  - Borrower commences a voluntary bankruptcy; or
  - Borrower engages in collusive behavior leading to an involuntary bankruptcy.
- Full recourse liability if borrower violates separateness covenants. However, post-*Cherryland* the consequences for these violations are often heavily negotiated between:
  - “Above the line” liability for losses, and
  - “Below the line” liability for the outstanding indebtedness.
- Full recourse liability if borrower encumbers or otherwise “transfers” the collateral property.
- A guarantor is on the hook for these “bad boy” behaviors, but this is only as good as the creditworthiness of the guarantor.

Minimizing the Bankruptcy Risk: Full Springing Recourse Liability (cont.)

- "Bad boy" guaranties are generally enforceable.
  - Can be enforced in state court (favorable forum), not necessarily in bankruptcy court.
  - Not against public policy, despite incentivizing managers to delay an appropriate or necessary bankruptcy filing.
  - That the liability of a "bad boy" guaranty may substantially exceed the damages is usually of no moment. Sophisticated financial parties can agree to full-recourse liability.

Minimizing the Bankruptcy Risk: Minimizing the Risk of Substantive Consolidation

- Efforts to structure a bankruptcy remote SPE are not only designed to:
    - minimize the opportunity for a legitimate voluntary bankruptcy, and
    - avoid the circumstances that might support an involuntary bankruptcy commenced by creditors,
- But also to avoid the involuntary bankruptcy of substantive consolidation….

Substantive Consolidation

- Substantive consolidation: an equitable doctrine where the assets and liabilities of two separate companies are combined.
  - Substantive consolidation is an extraordinary remedy vitally affecting substantive rights because every entity is likely to have a different debt-to-asset ratio, thus consolidation almost invariably redistributes wealth among creditors of the various entities.
  - This problem is compounded by the fact that liabilities between the consolidated entities are also extinguished.

Substantive Consolidation (cont'd)

- When does a court order substantive consolidation?
  - Creditors dealt with the to-be-consolidated entities as a single unit and did not rely on their separate identities when extending credit; or
  - The affairs of the debtor are so entangled that consolidation will benefit all creditors because disentangling is either impossible or so costly as to consume the assets of the to-be-consolidated entities.
- If corporate formalities (e.g., separateness covenants) are not observed, an entity can be pulled into a bankruptcy case if it is consolidated with one of its bankrupt affiliates.

Substantive Consolidation & Non-Con Opinions

- Non-Consolidation Opinions
  - A Non-Con Opinion is a letter from an independent attorney to a lender that its prospective borrower would not (or should not) be consolidated into a third-party's bankruptcy.
  - A Non-Con Opinion may be required by a rating agency in connection with a loan transferred to a Real Estate Mortgage Investment Conduit (REMIC). A REMIC is used to pool together similar loans and issue mortgage-backed securities, which are priced according to risk assessments performed by rating agencies.

Substantive Consolidation & Non-Con Opinions (cont'd)

- Limitations of a Non-Con Opinion:
  - It is not a guaranty.
  - Certain assumptions can neuter the opinion.
- Utility of a Non-Con Opinion:
  - Reliance on the opinion can provide protection. At least attention is paid to separateness issues that may impact consolidation and credit risks (e.g., SPE covenants and recycled entities).
  - Institutional policy may require a Non-Con Opinion.
  - Maximize exit strategies—a transferee may require a Non-Con Opinion.

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Allison Kidd is a partner in the San Francisco office of Gibson, Dunn & Crutcher. She is a member of the firm's Real Estate and Land Use Groups where she is regularly called upon to represent developers and investors in complex real estate transactions and development matters.

Ms. Kidd's practice includes a wide variety of commercial real estate financing transactions. She represents institutional and private investors in acquisitions and dispositions, mortgage and mezzanine financings, and joint ventures, working with a variety of asset classes including office, residential, senior housing, industrial and mixed-use. Drawing on her land use expertise, Ms. Kidd has particular experience in development stage projects and construction financing.

Ms. Kidd also represents developers in land use matters including structuring and implementing public-private partnerships, negotiating development and community benefit agreements, obtaining entitlements from municipal agencies and subdivision mapping.

Ms. Kidd was recognized as a "Rising Star" by Law360 for her work on high profile development matters, including the Golden State Warriors' new basketball arena (the Chase Center) in San Francisco and Brookfield's 28-acre, mixed-use waterfront development known as "Pier 70" in San Francisco.

Ms. Kidd is a member of Lambda Alpha International and the Urban Land Institute. She received a law degree and master of public policy, with an emphasis on urban development policy, in 2008 from the University of California, Los Angeles. She received her B.A., *magna cum laude*, from Columbia in 2001.

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Matthew K. Kelsey is a partner in the New York office of Gibson, Dunn & Crutcher and a member of Gibson Dunn's Business Restructuring and Reorganization Practice Group. Mr. Kelsey's practice focuses on representing companies, financial institutions and creditor groups inside and outside of Chapter 11 in numerous industries, including the real estate, retail, pharmaceutical, infrastructure, finance, shipping, and construction sectors.

Mr. Kelsey is recognized as a leading restructuring lawyer by the *International Financial Law Review* and, in 2011, was recognized as one of 12 "Outstanding Young Restructuring Lawyers" in the nation by *Turnaround & Workouts Magazine*. The *Brookstone Holdings* Chapter 11 case, which was led by Mr. Kelsey, was recognized as "Restructuring Deal of the Year" by *The Deal* on March 26, 2019.

Mr. Kelsey received his Juris Doctor, with honors, from Rutgers University School of Law — Newark. He obtained his Bachelor of Arts degree from Thomas Aquinas College. He is a member of the Order of the Coif and the recipient of the American Bankruptcy Institute's Medal of Excellence. He is admitted to practice law in New York and admitted in the U.S. District Court, Southern District of New York.

Mr. Kelsey has authored numerous articles, including Make-Whole Provisions Still Enforceable After Momentive; Delaware Bankruptcy Court Reclaims Control of Article III Suits; The Melting Ice Cube: Diminution in Value Collateral Problems in Multi-Lien Capital Structures; A Tale of Two Cases on 3rd-Party Releases; The Battle Over 3rd-Party Releases Continues; Minimizing the Risk of Borrower Bankruptcy; Restructuring Issues Concerning Real Estate Projects; Obtaining Adequate Protection: An Analysis Pertaining to Real Estate Projects; and Debt Recharacterization Under Lothian Oil.

Mr. Kelsey's speaking engagements include Enforcing Security Interests Outside of Bankruptcy: Remedies Under the Uniform Commercial Code, Webcast; Real Estate Lending Structures and Their Bankruptcy Drivers: Understanding How We Got Here, Webcast; The Fulcrum Playbook: How Has the Last Cycle Changed Things, Turnaround Management Association (TMA) Distressed Investing Conference; The Sun Sets on Solyndra, West Coast Turnaround Management Association; and Corporate Duties in Distressed M&A Transactions: From LOI to Closing, American Law Institute. Mr. Kelsey also leads seminars for distressed investing and workout professionals at investment firms, financial institutions and hedge funds on a variety of restructuring topics.

Mr. Kelsey is a member of the Sponsorship Committee of Catholic Renewal, a charitable organization consisting of leaders of the restructuring community that fundraises for Catholic Charities of New York.

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Eric Wise is a partner in the New York office of Gibson, Dunn & Crutcher. He is a member of Gibson Dunn's Global Finance and Business Restructuring, and Reorganization Practice Groups. Mr. Wise advises debtors and creditors in complex financing and restructuring transactions, including agent banks in complex leveraged financings, cross-border and multi-currency transactions, real estate financings, asset-based financings, and bank and bond/bridge financings and creditors and debtors in out-of-court and in-court restructurings.

Mr. Wise has advised corporate debtors and individual debtors, as well as lender and bondholder groups, commercial banks, hedge funds, and private equity funds. Mr. Wise has substantial experience in debt covenant analysis and junior capital structures, including second lien and subordinated financings and mezzanine structures. Mr. Wise also has extensive experience in Chapter 11 cases, and has been involved in numerous work-outs, rights offerings, recapitalizations, restructurings, and post-petition and exit financings, and distressed debt purchases and sales.

Mr. Wise's experience extends across a wide range of industries, such as shipping, telecommunications, healthcare, hospitality, real estate, steel, automotive, chemical, energy, transportation, financial institutions, and paper and forest products sectors. Mr. Wise is frequently asked to advise on intercreditor relationships and complex debt structuring issues.

Mr. Wise is the author of "'All Assets' First-Lien/Second-Lien Intercreditor Agreements," published in the March 7, 2018 issue of *Bloomberg Law*; "The Melting Ice Cube: Diminution in Value Collateral Problems in Multi-Lien Capital Structures," published in the November 2017 (Vol. 26, No. 6) issue of the *Norton Journal of Bankruptcy Law and Practice*; "Obtaining Adequate Protection: An Analysis Pertaining to Real Estate Projects," published in the April 2013 (Vol. 22, No. 2) issue of the *Norton Journal of Bankruptcy Law and Practice*; "Restructuring Issues Concerning Real Estate Projects," published in the March 10, 2011 issue of BNA's *Bankruptcy Law Reporter*; "Reorganization Securities And Second-Lien Structures," published by Law360 at www.law360.com on November 9, 2010; "X Clauses: Meaning and Mutations," published on November 8, 2010 by *Bloomberg Law Reports—Bankruptcy Law*; "Tanking Bond Prices Spell Opportunity for Issuers," *The National Law Journal*, Bankruptcy Law Section, February 16, 2009; "Second Lien Loans: A Market Matures;" The Metropolitan Corporate Counsel, April 2007; "Covenants: A Brief Guide to Survival" *The Banking Law Journal*, June 2007; and "Crises in Auto Industry Raises Finance Issues" *The National Law Journal*, Bankruptcy Law Section, July 11, 2005. Mr. Wise is also the author of "Is Detroit Dead?," *City Journal*, August 9, 2013, and contributes from time to time to general interest publications.

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Mr. Yearwood represents various portfolio lenders (including specialty finance companies, life insurance companies, hedge funds, and banks), debt fund managers, private equity firms, CMBS lenders, and loan servicers in transactions involving loan origination, loan purchases and sales, subordinate debt financing and acquisition, post-closing modifications, and work-outs.

Mr. Yearwood has been ranked as a leading lawyer for Real Estate in California by legal directory *Chambers USA 2018*, where he is recognized as having a "celebrated lender-side practice, advising on high-value transactions involving properties across the US," and noted by clients as being "great at coming up with flexible and creative solutions in situations that require something outside the box."

In addition, he has been listed as a recommended lawyer for Real Estate and Structured Finance by *The Legal 500* (U.S.).

Mr. Yearwood is a fellow in the American College of Mortgage Attorneys and a frequent speaker on commercial real estate lending and subordinate debt structures.

Prior to joining the firm, Mr. Yearwood practiced with Dechert LLP since 2005. He received his Juris Doctor in 2005 from the University of California, Berkeley. He received his undergraduate degree in 2001 from the University of California, Berkeley.