C A D W A L A D E R

What’s So Special about Special Purpose Entities?

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Lenders often require their borrowers to be “special purpose entities” in real estate transactions. This is a way that lenders can mitigate their bankruptcy risk in the event that the borrower or any of its parent entities file for bankruptcy. In addition, since most real estate financing is non-recourse, lenders require that the borrower is a separate, special purpose entity so that no other property or business will impact the property which is the subject of the underlying loan. But what it means to structure a borrower as a “special purpose entity” can mean different things, depending on the underlying loan circumstances. This article examines the different elements typically required when structuring a borrower as a “special purpose entity.”

First, and perhaps most importantly, a special purpose borrower’s purpose should be limited to owning the underlying collateral for the loan. For a mortgage borrower, this means that they should only be permitted to own the real property plus any incidental personal property used in the operation of the real property. For a mezzanine borrower, their purpose should be limited to owning the equity interest being pledged as collateral for the loan. By limiting the purpose of the borrower, a lender curtails the number of other creditors that may be involved in any bankruptcy proceeding by the borrower.

Second, the borrower should be structured in a manner to protect against dissolution. This is the reason that lenders often require a borrower either to be a Delaware limited liability company with springing members or to have a “special purpose” Delaware limited liability company with springing members as an equity owner. These springing members “spring” into place as special members upon the occurrence of any event that causes the last remaining member of the borrower (or the special purpose member) to cease to be a member of the borrower or the special purpose member. This allows the borrower (or special purpose member) to continue without dissolution until a new member can be appointed pursuant to the terms of the controlling operating agreement.

Third, the borrower should be prohibited from incurring additional indebtedness in the underlying documents. Both the loan agreement and the borrower’s operating agreement typically limit the borrower’s ability to incur indebtedness to only the underlying loan plus unsecured trade payables and/or equipment leases. This permitted debt is then subject to a cap with further requirements that the borrower repay such indebtedness within sixty days of the date that the debt is incurred and not be secured or evidenced by a note. There are typically also covenants in the loan agreement and the borrower’s operating agreement that prohibit the borrower from guaranteeing the debts of any other entity or pledging its assets as collateral for the debts of any other entity. These covenants provide a further limit to the number of creditors that may be involved in a bankruptcy proceeding by the borrower.

Fourth, the borrower should be required to keep its assets separate from those of its parent and other entities. These covenants are found in both the loan agreement and the borrower’s operating agreement and require, among other things, that the borrower maintain separate books and records from any other person or entity and prohibit the borrower from commingling its assets with those of any other person or entity. Such covenants are intended to prevent an outside third party from confusing the identity of the borrower with that of a parent entity and are intended to prevent the substantive consolidation of the borrower with a parent entity should the parent entity file for bankruptcy.

Fifth, for loans over $20 million, the loan documents and organizational documents should include covenants that require the borrower to obtain the consent of an “independent director” prior to taking any bankruptcy actions. The independent directors are required to be engaged from a specified list of third-party providers and to satisfy certain other conditions that ensure they are independent from the borrower and its equity holders. Generally, one independent director is required for loans over $20 million and two independent directors are required for loans over $40 million. That said, some borrowers (especially in a balance sheet deal) may negotiate to have only one independent director regardless of the size of the deal. Once independent directors are in place, a borrower cannot take a bankruptcy action without an independent third party confirming that such action is in the best interest of the borrower.

Finally, for loans over $20 million, lenders typically obtain further bankruptcy protection by requiring the borrower to deliver a nonconsolidation opinion. The nonconsolidation opinion essentially backstops the bankruptcy protections set forth above by having an attorney examine the “special purpose entity” provisions to confirm that, assuming the borrower complies with the bankruptcy protections listed above, in the event that one or more equity holders of borrower were to file a bankruptcy petition, the bankruptcy court would *not* consolidate the assets of the borrower with those of its parent entity and, as a result, the assets of the borrower will not be available to pay its parent’s creditors.

Despite all of the foregoing protections, it is important to note that a bankruptcy court is a court of equity and, as a result, no matter what “special purpose entity” provisions are built into the structure of a loan, there will always be an element of risk to a lender in a bankruptcy proceeding. However, with the proper structure, the risk to the lender’s collateral can be minimized.