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Something Special

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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.

Don’t Be Cruel: Appellate Division Upholds Waiver of Fiduciary Duties But Denies Motion to Dismiss Claim for Breach of Good Faith and Fair Dealing

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Can contracting parties waive all common law fiduciary duties? That was one of the questions presented to the New York Supreme Court, Appellate Division, First Department (the “Court”) in *111 West 57th Investment LLC, on Behalf of Itself and Derivatively on Behalf of 111 West 57th Partners LLC, et al. v. 111 W57 Mezz Investor LLC, 111 West 57th Partners LLC, et al.* On March 30, 2021, the Court answered in the affirmative and modified the trial court’s decision to, among other things, uphold that a waiver of fiduciary duties is enforceable under Delaware law. At the same time, the Court allowed a claim of the Plaintiff (as defined herein) to proceed based on the Defendant’s (as defined herein) alleged breach of the duty of good faith and fair dealing as required by the New York Uniform Commercial Code (N.Y.U.C.C. § 1-304).

The case arose from a loan to finance the construction of a luxury condominium project located at 105-111 West 57th Street, New York, New York (the “Property”). The financing consisted of a mortgage and two mezzanine loans totaling an amount up to $725 million. The defendant, 111 W57 Mezz Investor LLC (“Defendant”) acquired the $25 million junior mezzanine loan (the “Loan”) on June 28, 2017. At the time, the Loan was subject to a forbearance agreement. The forbearance period ended on June 29, 2017 and, a week later, the Defendant issued a notice of “strict foreclosure” to 111 West 57th Sponsor LLC (the “Sponsor”), the managing member of the 111 West 57th Mezz LLC (“Borrower”). After the Sponsor failed to timely object to the strict foreclosure, 111 West 57th Investment LLC (the “Plaintiff”) filed an action for a preliminary injunction and temporary restraining order to prevent the Defendant from consummating the foreclosure. The trial court denied the injunction, the Court affirmed the decision and the foreclosure proceeded. On May 14, 2019, the Defendant filed an amended complaint asserting a claim for monetary damages.

Background

The Sponsor and the Plaintiff entered into a joint venture (the “Joint Venture”) in June 2013 to acquire and develop the Property. At the time of the strict foreclosure notice, the Joint Venture owned 100% of the equity in the Borrower, which owned 100% of the equity in 111 West 57th Holdings LLC (the “Senior Mezz Borrower”), which in turn owned 100% of the equity in 111 West 57th Property Owner LLC, the owner of the Property (the “Property Owner”). Initially, the Property Owner and the Senior Mezz Borrower obtained loans in the amounts of $400 million and $325 million, respectively. The $325 million loan to the Senior Mezz Borrower was ultimately split into (a) a $300 million loan to the Senior Mezz Borrower, which was

secured by the membership interests in the Property Owner (the “Senior Mezz Loan”) and (b) a $25 million loan to the Borrower, which was secured by the Borrower’s membership interests in the Senior Mezz Borrower (the “Loan”).

In January 2017, the lender of the Senior Mezz Loan notified the Senior Mezz Borrower that the Senior Mezz Loan was “out of balance” by $57 million – that is, the costs of completing the construction exceeded the amounts available from the financing. Shortly thereafter, the Senior Mezz Lender made a demand for payment to cure the “out of balance.” The Senior Mezz Borrower failed to make the required payment and the parties entered into a forbearance agreement to provide for time to find a new lender or equity partner. The forbearance period ultimately ended on June 29, 2017 without an infusion of additional capital. As the subordinate lender, the Defendant moved quickly to protect its collateral and issued a default notice on the same day that the forbearance period ended.

Strict Foreclosure

After the Borrower did not cure the default, the Defendant issued a notice of a strict foreclosure to the Borrower and the Sponsor in accordance with the applicable loan documents and the Uniform Commercial Code. A strict foreclosure under the UCC permits a lender to accept collateral in full or partial satisfaction of the underlying obligations without the need for judicial action, subject to certain requirements, including the consent of the debtor. In the case of a proposal under which the collateral is transferred in full satisfaction of the debt, the debtor’s consent may be deemed to be granted if they do not object within 20 days. In this case, neither the Borrower nor Sponsor objected to the Lender’s strict foreclosure proposal, notwithstanding the Plaintiff’s insistence that the Sponsor do so. Before the expiration of the 20-day time period, the Plaintiff filed a lawsuit to enjoin the foreclosure. As noted above, the trial court denied the injunction and the Court affirmed the decision of the trial court, and the strict foreclosure was consummated.

Amended Complaint

On May 14, 2019, the Plaintiff filed an amended complaint to asset a claim for monetary damages and alleging a breach of the UCC, a breach of the implied covenant of good faith and fair dealing, conversion, and aiding and abetting a breach of fiduciary duty. The basis of their claims, as noted by the Court, was an allegation that the Defendant had effectively bribed the Sponsor’s principals into not objecting to the foreclosure by agreeing that they would be permitted to continue to serve as the construction manager of the project and to have an opportunity to reinvest in the Property post-foreclosure. The Court dismissed all of the Plaintiff’s claims other than their breach of good faith and fair dealing claim.

With respect to the Plaintiff’s claim for aiding and abetting a breach of fiduciary duty, the Court noted that the limited liability company for the Joint Venture, which governed the relationship between the Sponsor and the Plaintiff, contained a waiver of all fiduciary duties. In dismissing the Plaintiff’s claim, the Court implicitly rejected the Plaintiff’s contention that the fact that the waiver provision contained an exception for “fraud, intentional misconduct or a knowing and culpable violation of law” meant that there was not a full waiver of all fiduciary duties.

While the Court was persuaded by clear waiver language in the limited liability company agreement for the Joint Venture and the principle under Delaware law that parties can freely waive fiduciary duties by contract, significantly, the Court refused to dismiss the Plaintiff's claim that the Defendant breached its covenant of good faith and fair dealing. The Plaintiff's claim for a breach of the covenant of good faith was rooted in its allegation that the Sponsor's failure to object to the strict foreclosure was the result of a scheme to enrich the principals of the Sponsor at the expense of other members of the Joint Venture. The Court reasoned that because the alleged acts were intentional, bad faith acts, such acts are not subject to the waiver of fiduciary duties and could be a breach of the covenant of good faith and fair dealing.

Conclusion

While the Court's decision provides an affirmation that parties to a limited liability company agreement can effectively waive certain duties (including all fiduciary duties) under Delaware law, it is important for parties to recognize that the covenant of good faith and fair dealing may be breached by intentional acts, notwithstanding express waivers of fiduciary duties. As a lender, actual or alleged breaches of the covenant of good faith and fair dealing can significantly increase enforcement costs.

Insurance Broker Letters in Commercial Real Estate Financings: Why Do We Need Them?

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Insurance is a key and critical element to any commercial real estate financing. After all, such financings are usually limited recourse, such that the properties will be owned by a special purpose vehicle with no other equally valuable assets. In that regard, the lenders will be intent on knowing that the fundamental collateral that supports their debt is protected from destruction, damage, or any other events that could affect the value and income stream generated from such asset.

It has therefore become market standard practice for lenders to ensure that certain protections are provided with regards to insurance, one of which is a condition precedent ("CP") that is required from the borrower: an insurance broker letter. Whilst it is not a finance document, the insurance broker letter can still in some transactions have the potential to elicit significant resources and time in order to negotiate and finalise its terms.

This article looks to explain why broker letters are needed in commercial real estate financings and what we can do to reduce the strain they can cause.

Lender protections

There are a number of key protections that lenders seek with regards to insurance. These include:

- naming the lender as composite insured or co-insured on the insurance policy in order to provide it with the same legal rights as the borrower;
- naming the lender as first loss payee to ensure that the insurer would be required to make the payment to the lenders directly, or in accordance with their authorisation and direction (though, this is often subject to a negotiated *de minimus* amount so that "nominal" payments can be excluded);
- including non-vitiation clauses to prevent the insurer from attributing non-disclosure or misrepresentation or breach of policy by the insured to the lenders;
- building in waiver of subrogation clauses to protect the lenders from the insurer "stepping into its shoes" once the claim has been settled; and
- providing obligations to notify the lender of any matters that could invalidate the policy, such as non-payment of premium.

Lender protections under the facility agreement

The Loan Market Association ("LMA") form of real estate finance facility agreements do contain model clauses for the insurance covenants to deal with the

issues addressed above, and these are now well-established clauses that are rarely negotiated at any material level, other than to conform and adapt it to the factual positions relevant to the circumstances of a particular transaction. It is through such covenants that the lenders can ensure that the borrower is contractually obliged to protect the lenders' interests in respect of insurance.

The lenders will want to go further and seek actual evidentiary confirmation that the insurance policy currently in place (or that will be in place as at the date of utilisation of the loan) does indeed comply with the insurance covenants under the facility agreement. The lenders will conduct their own due diligence on the insurance, and in some instances, a third-party insurance auditor will be instructed at the cost of the borrower to do this (particularly for Pfandbriefe-compliant financings where such loan will form part of the collateral to Pfandbriefe-covered bonds issued by German mortgage banks).

In addition to these, the lenders will seek as a CP to drawdown of the loan a letter from the borrower's insurance broker as evidentiary confirmation that the lenders' requests for protection in respect of the insurance have been met.

Insurance broker letter

It has become a market standard CP in European real estate financings for the borrower's insurance broker to issue a letter addressed to the lenders confirming that the insurance policy complies with the terms of the insurance covenants of the facility agreement. To achieve this, the letter will usually outline the policy in place, confirm that the policy does provide the lenders with the relevant and requested protections, and that the premium has been paid.

In 2016, the LMA published a form of insurance broker letter that was intended for use in real estate finance property investment transactions. The purpose of this form of broker letter was to try to standardise the form of this deliverable across the market due to the prevailing difficulties that the real estate sector was experiencing in negotiating broker letters.

Whilst to date law firms and lenders have generally embraced the LMA form, some insurance brokers do equally have a preference toward their own "house" form of broker letter. It is for this reason that negotiations as to the exact wording and terms of the broker letter do ensue, and in practice, can take some time, and in some cases, even being the cause for holding up a transaction.

The argument that we often hear against having any meaningful negotiation on the letter is that, in principle, it is supposed to simply be a representation of fact, not opinion, so that it should be a low-risk letter that presents objective and factual positions. However, where contention often arises is:

- when the lender seeks to request positive confirmations on certain details of the policy, such as cover, limitations and exclusions, all of which would require due diligence from the broker, as well as some degree of judgment, in order to confirm;
- if the broker is insistent on using its own house form, or requires changes to the LMA form to conform it to such house form (for instance, some brokers' standard house forms will expressly state that no duty of care is owed to the

lenders, whereas for the lenders they would argue that the insurer should take responsibility for giving such statement); and

- issues around liability and caps on liability, and reliance (for instance, some lenders will insist on the letter benefiting their successors, but some brokers may resist this for the reason that they believe this would extend their scope of liability too widely).

Are insurance broker letters needed?

Broker letters are a market standard CP. For now, borrowers cannot avoid this, and there are no signs of appetite from lenders of waiving this CP or allowing it to be a condition subsequent. Whilst in some cases the time and resources spent on negotiating its terms may seem disproportionate to the value it provides, the approach to negotiating and agreeing it, like most other aspects of any real estate financing transaction, will ultimately depend on risk allocation, time management and resources.

For instance, the LMA form of broker letter is undoubtedly a good starting point. However, it must be appreciated from all sides of the table the dynamics between the parties and what is being requested, such that some tailoring and negotiation of its terms will be inevitable, not least to deal with transaction-specific matters and internal positions and concerns of the individual brokers. Ultimately, the insurance broker is being asked by a third-party lender, which is not its client, to provide a letter of confirmation to be relied upon and be liable for its contents.

Needless to say, it is worth acknowledging that the confirmations given under a broker letter are a “one-off,” in that they are given on the date of issuance (usually on or around the date of utilisation of the first loan) and does not get repeated during the life of the loan. As such, the benefits that a broker letter provides is ultimately limited.

Conclusion

The key point for consideration when it comes to insurance and insurance broker letters is to ensure that such work stream is actioned as early as possible in a transaction and to manage the parties appropriately in order that the right people are communicating to one another at the earliest instance. This would mean getting the insurance broker in touch with the lender, or vice versa, as soon as possible. If not, you may be unwittingly surprised by how long the process of agreeing a broker letter can take.

Recent Transactions

Here is a rundown of some of Cadwalader's recent work on behalf of our clients.

Recent transactions include:

- Represented the lender in advances totaling $271.6 million under various revolving credit facilities to finance multifamily and manufactured housing community properties.
- Represented the co-lenders in an $845 million mortgage loan secured by 48 industrial properties and certain land and ancillary assets in California, Georgia, Maryland and Minnesota for a major U.S. industrial property portfolio owner.
- Represented the lenders in a $1.1 billion financing secured by two midtown Manhattan office buildings.