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Structured Finance Fact Sheet

Special Purpose Entities

The Basics

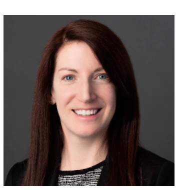
- Lenders often require the Borrowers in structured finance transactions to be Special Purpose Entities (or "SPEs") in order to reduce the risk of a Borrower bankruptcy filing.
- An SPE is an entity that is unlikely to become insolvent as a result of its own activities and is adequately insulated from the consequences of any parent entity or other affiliate's insolvency.
- SPE requirements help isolate the assets that are being financed and limit the risk that the Borrower's financial condition will be affected by outside factors, such as the performance of other assets or the financial condition of the Borrower's parent entities or other affiliates. SPE covenants also limit the Borrower's exposure to creditors other than the Lender.

How it Works

- SPE covenants should be included in both the deal documents and the Borrower's organizational documents and should apply from the closing date forward. A few of the key requirements include:
    - Limiting the Borrower's assets and activities to the ownership and operation of the financed assets;
    - Limiting the Borrower's ability to incur other debt, except for a limited amount of unsecured trade debt in the event that the Borrower is an operating entity;
    - Requiring the Borrower to maintain its own books, records, bank accounts and financial statements separate from those of any parent entity or other affiliate;
    - Requiring any transactions between the Borrower and its affiliates to be on arm's length terms; and
    - Prohibiting guarantees of the Borrower's obligations by its affiliates, other than Bad Acts Guarantees* or guarantees that are de minimis (typically 10% or less of the principal amount of the loan).
- The SPE covenants should be included in the Borrower's organizational documents so that any action in violation of the SPE covenants would be ultra vires (void) under applicable local law.
- In the deal documents, a breach of the SPE covenants should be an event of default and an indemnity recourse trigger for the Bad Acts Guaranty, if applicable.

See "Structured Finance Fact Sheet: The Bad Acts Guaranty" (March 2021).

For more information on these issues, contact:



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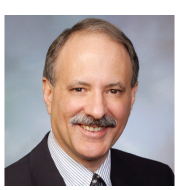

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Practice Tips

- An SPE that has been in existence and conducted business prior to the current transaction is known as a "recycled" SPE.
- A recycled SPE carries additional bankruptcy and underwriting risk because it may not have complied with SPE requirements since its formation and it may have trailing liabilities from a prior business, especially if it has owned or operated other assets in the past.
- To reduce these additional risks, a Lender can require the Borrower to make "backwards" SPE representations and underwriting representations in the deal documents.
- The backwards SPE representations apply from the date of the Borrower's formation to the closing date, and allow the parties to uncover and address any separateness issues that might arise due to the Borrower's prior existence and activities.
- The underwriting representations are given by the Borrower as of the closing date, and are designed to uncover and address any trailing liability issues and, in the case of any misrepresentation, shift the risk of the Borrower's prior existence and activities away from the Lender.
- In the deal documents, a breach of the backwards SPE representations and the underwriting representations should also be an event of default and, if applicable, an indemnity recourse trigger for the Bad Acts Guaranty.