AMERICAN BANKRUPTCY INSTITUTE

2019 Bankruptcy Battleground West

Looking for the Remote: Structuring Enforceable Bankruptcy-Remote, Special-Purpose Entities in Commercial Real Estate Finance

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CONCURRENT SESSION

2019

Looking for the Remote?

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MARCH 2019

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Non-Recourse Theory of Lending

Current commercial real estate lending based on fundamental bargain between borrower and lender:

- Real estate investors leverage their returns on a project with debt in order to:
  - Limit downside risk by recourse only to the collateral, 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, and
  - Limit the risk assumed to a decline in the value of the particular collateral.

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Non-Recourse Theory of Lending (cont.)

Protections for lender to rely on diligence and prompt access to its collateral include:

- Circumscribe borrower's ability to file bankruptcy;
- Limit borrower's commercial activity; and
- Trigger full recourse liability for violations of this fundamental bargain, i.e., the recourse guaranty.

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Controlling The Decision to File Bankruptcy

General Rule

A Debtor's pre-petition waiver of the right to file a bankruptcy case is unenforceable because it is a violation of public policy.

Includes limitations placed by lender in corporate organizational documents.

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What can a lender do?

- Blocking Director/Golden Shares
- Independent Manager
- Take Equity

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Blocking Directors & Golden Shares

- Blocking director with no fiduciary duties to the debtor.
  - *In re Lake Michigan Beach Pottawattamie Resort, LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016).
- Creditor minority equity interest for the purpose of controlling bankruptcy filing.
  - *In re Intervention Energy Holdings, LLC*, 2016 WL 3185576 (Bankr. D. Del. 2016).

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Blocking Directors & Golden Shares

Generally, Void As Against Public Policy

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Independent Managers

"[T]he director must be subject to the normal fiduciary duties and in some circumstances must vote in favor of a bankruptcy filing, even if not in the best interests of the creditor that they were chosen by."

In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899, 913 (2016).

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Equity

- *In re Global Ship Systems*, LLC, 391 B.R. 193 (Bankr. S.D. Ga. 2007).
- *Squire Court Partners, LP v. Centerline Credit Enhanced Partners LP (In re Squire Court Partners LP)*, 574 B.R. 701 (E.D. Ark. 2017).
- *Franchise Services of North Am., Inc. v. U.S. Trustee (In re Franchise Services of North Am., Inc.)*, 891 F.3d 198 (5th Cir. 2018).

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Equity

Federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing bankruptcy petition.

Things to Think (Litigate) About

- How much equity does a lender need to invest in order to be able to block bankruptcy filing?
- When was equity given?
- Can a lender unilaterally remove the independent manager?
- How independent is independent?

Separateness Covenants and the Recourse Guaranty

Why Separateness Covenants?

- Structural underpinning for commercial real estate lending on basis that recourse is principally against the collateral. The property owner is "separate" from its equity owner.
- Separateness covenants minimize the opportunity and risk for bankruptcy to interfere with lender's recourse against the real property.

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Separateness Covenants

- To maintain books and records separate from any other person or entity;
- To maintain its accounts separate from those of any other person or entity;
- Not to commingle assets with those of any other entity;
- To conduct its own business in its own name;
- To maintain separate financial statements;
- To pay its own liabilities out of its own funds;
- To observe all corporate, partnership, or LLC formalities and other formalities required by the organic documents;
- To maintain an arm's-length relationship with its affiliates;
- To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
- Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
- Not to acquire obligations or securities of its partners, members, or shareholders;
- To allocate fairly and reasonably any overhead for shared office space;
- To use separate stationery, invoices, and checks;
- Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity (except as provided in the transaction documents);
- To hold itself out as a separate entity;
- To correct any known misunderstanding regarding its separate identity; and
- To maintain adequate capital in light of its contemplated business operations.

Standard & Poor's *Legal Criteria for U.S. Structured Finance Transactions*, October 2006.

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The Hammer: Springing Recourse Guaranty

- 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, especially 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 actor" behaviors, but this is only as good as the creditworthiness of the guarantor.

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Enforceability of Springing Recourse Guaranties

- Usually enforceable in state court, generally the more favorable forum for a lender.
- Generally not against public policy, despite arguably incentivizing managers to delay an appropriate or necessary bankruptcy filing. *See Bank of America v. Lightstone Holdings, LLC (In re Extended Stay Inc.)*, 418 B.R. 49 (Bankr. S.D.N.Y. 2009).
- That the liability of a springing recourse guaranty may substantially exceed the damages is usually of no moment. Sophisticated financial parties can agree to full-recourse liability.

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Multiple Lender Structures

Multiple Lender Structures

- First/Second Lien Structures, or so-called "contractual subordination."
  - First and Second Lien Lenders share lien in common collateral, but Second Lien Lender agrees to subordination of lien, including standstill of enforcement remedies and "silent" rights regarding release of collateral, bankruptcy financings, and bankruptcy sales.
  - Generally disfavored in real estate lending, but still see this legacy structure on occasion.
- Senior/Mezzanine Structures, or so-called "structural subordination."
  - Senior-Mortgage Lender makes a loan secured by the real property of the mortgage borrower.
  - Junior-Mezzanine Lender makes a loan to mezzanine borrower secured by a pledge of the membership interests in the mortgage borrower.

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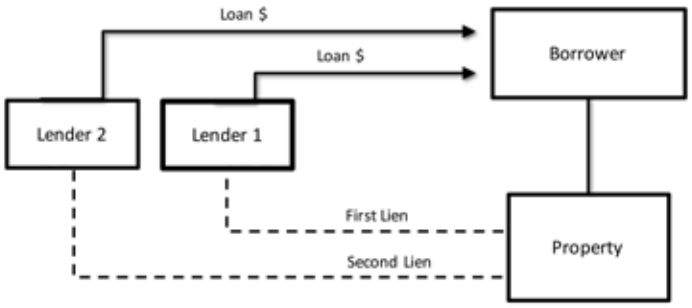
First Lien / Second Lien Loan Structure



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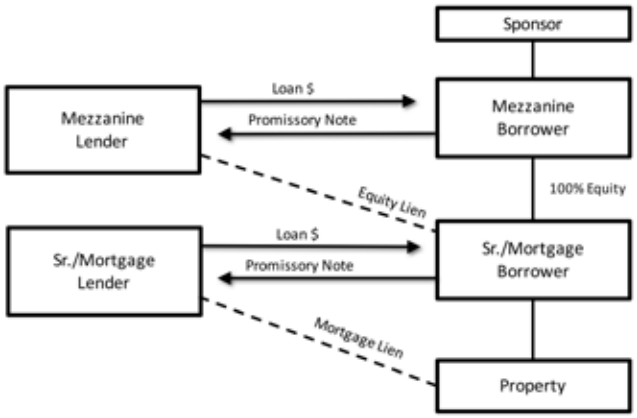
Senior / Mezzanine Loan Structure



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Common Collateral Risks

- "Common collateral" risks to senior lender in a first-second lien "contractual subordination" structure:
  - Modification of debt may result in loss of priority.
  - Junior lender foreclosure may result in termination of leases.
  - Bankruptcy of junior lender stays senior lender remedies.
  - Appointment of receiver by junior lender vs. senior lender.
  - Interference with deed-in-lieu transaction.
  - The rights the junior lien creditor has as an unsecured creditor are preserved following foreclosure of the senior lien.
  - Enforceable in a bankruptcy pursuant to §§ 510(a) and 1129(a)(1).
- Structural subordination creates two *separate* pools of collateral.

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That's a Nice SPE You've Got There… It'd Be a Shame If Someone Consolidated It

Substantive Consolidation

- Substantive Consolidation is a judicially created doctrine derived from Section 105(a)
- Substantive Consolidation is an equitable doctrine unique to Bankruptcy
  - It is different than the doctrine of Piercing the Corporate Veil, which does not sound solely in equity
- Multiple tests have been created – Tests generally divided between Debtor Driven Tests and Creditor Driven Tests
  - Debtor Driven Tests - Typically mirror the standard for Alter Ego Liability / Piercing the Corporate Veil
    - *FDIC v. Hogan (In re Gulfco Inv. Corp.)*, 593 F.2d 921, 928 (10th Cir. 1979)
    - *In re Tureaud*, 45 B.R. 658, 662 (Bankr. N.D. OK 1985)
  - Creditor Driven Tests - Focus on balancing the interests of Creditors
    - *In re Bonham*, 229 F.3d 750 (9th Cir. 2000)
    - *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp)*, 810 F.2d 270, 276 (DC Cir. 1987)
    - *Eastgroup Properties v. Southern Motel Assoc. Ltd.*, 935 F.2d 245, 248-249 (11th Cir. 1991)
    - *FDIC v. Colonial Realty Co.*, 966 F.2d 57, 61 (2nd Cir. 1992) (aim is "fairness to all creditors")
- Both Debtor Driven Tests and Creditor Driven Tests end up being very fact intensive

Alter Ego / Corporate Veil Test

Under these Debtor Driven Tests courts look primarily to the debtor and debtor-related entities and the relationships with each other

Common Factors Considered When Applying Debtor Driven Tests

- Commingling of Funds
- One Entity Holding Out that it is Liable for the Debts of the Other
- Identical Equitable Ownership of the Entities
- Use of Same Offices and Employees
- Use of Entity as A Mere Shell or Conduit for the Affairs of the Other
- Inadequate Capitalization
- Disregard of Corporate Formalities
- Lack of Segregation of Corporate Records
- Identical Officers and Directors

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Balancing Tests

When applying Creditor Driven Tests courts look to balance the interests of creditors and focus primarily on how substantive consolidation will affect creditors

Common Factors Considered When Applying Balancing Tests

- Whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit
- Whether the affairs of the debtors are so entangled that consolidation will benefit all creditors

Note: *Either of these Factors are Typically Held to be Sufficient to Warrant Substantive Consolidation*

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Substantive Consolidation in the Ninth Circuit

- Ninth Circuit takes a balancing, creditor-driven approach
- *In re Bonham*, 229 F.3d 750 (9th Cir. 2000)
  - In *Bonham* the Ninth Circuit adopted the Second Circuit's two-part creditor driven test:
    - "(1) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit" ***or***
    - "(2) whether the affairs of the debtor are so entangled that consolidation will benefit all creditors"

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Nonconsolidation Opinions

- When Required / Requested
  - Rated Securities Market
  - Loans Exceeding a Specified Percentage of the Pool or a Specified Dollar Amount
- Who Prepares
  - Generally Prepared by Borrower's Counsel and Addressed to the Lender and any Rating Agency
  - Often Addressed to Each of the Big Three Rating Agencies - Moody's Investors Service, Standard & Poor's, and Fitch Ratings

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Non-Consolidation Opinions

Why are They Required?

- Shows Lender that Someone Has Thought Seriously About the Structure of the Transaction
  - While ultimate opinion is important, the detailed analysis provided in the opinion also gives the recipient of the opinion comfort that the opinion preparer understands the relevant law and has at least thought about the issues
- Industry Practice

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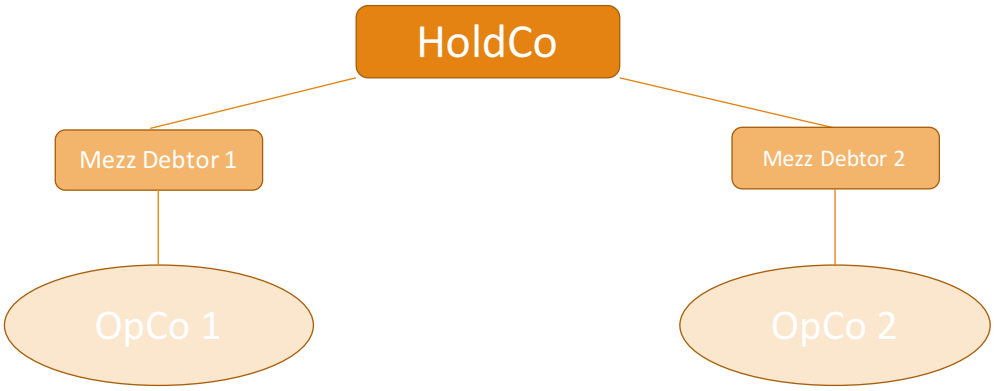
In re Transwest Resort Properties 881 F.3d 724 (9th Cir. 2018)



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In re Transwest Resort Properties 881 F.3d 724 (9th Cir. 2018)

- Five Debtors
- Cases Jointly Administered **but not** Substantively Consolidated
- Mezzanine Debtors Only Had One Creditor
- Joint Plan Proposed By All Five Debtors
- Under the Plan a Third Party Agreed to Contribute $30 Million and Take Over Ownership of the OpCos
- Sole Creditor of the Mezzanine Debtors Sought to Block Plan by Voting Against Plan
  - Argued, *inter alia,* that Section 1129(a)(10) was not satisfied because no impaired class of creditors voted in favor of the plan because the sole creditor of each mezzanine debtor voted against the plan
- Issue Presented to the Ninth Circuit was One of First Impression – Does Section 1129(a)(10) Apply on a "Per Debtor" Basis or a "Per Plan" basis?
- Panel Held Plain Language of Statute Mandates 1129(a)(10) is "Per Plan"

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"[T]o the extent the Lender argues that the 'per plan' approach would result in a parade of horribles for mezzanine lenders, such hypothetical concerns are policy considerations best left for Congress to resolve."
--*Transwest Resort Properties* at 730.

THE PARADE OF HORRIBLES

- Essentially eliminates 11 U.S.C. 1129(a)(10) as an easy backstop for mezzanine lenders who had in the past relied on their blocking position as the sole creditor of the mezzanine entity
- Shifts burden from the debtor or debtors (who must show that 1129(a)(10) is satisfied) to the objecting creditor (who will now have to show the plan is a *de facto* substantive consolidation and that such substantive consolidation is not warranted)
  - Potentially forces mezzanine lenders to perform a deeply factual substantive consolidation analysis in potentially every instance a group of related debtors can now easily manufacture an impaired consenting class to get around Section 1129(a)(10)
  - Factual analysis will – at least in the Ninth Circuit – be creditor-driven and will look to all creditors; not just the interest of the mezzanine creditors

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Does it All Just Come Back To Substantive Consolidation?

Judge Frieland Wrote a Separate Concurring Opinion in *Transwest*

- Agrees Section 1129(a)(10) is "Per Plan"
- However, He Is Sympathetic to the Mezzanine Lender's Argument that the "Per Plan" Approach Resulted in *De Facto* Substantive Consolidation
- Agreed that Effect of Joint Plan in *Transwest* Was Substantive Consolidation of the Debtors
- Problem Is that the Lenders Waived Their Right to Challenge Substantive Consolidation By Not Raising It
- Lender Should Have Challenged the Plan as an Improper Substantive Consolidation and Asked the Bankruptcy Court to Perform a Substantive Consolidation Inquiry
  - "It is possible that, if there had been an objection raising the question, Debtor's single-purpose entity structure would have defeated any request for substantive consolidation. The original loan documents required maintaining the Operating Debtors and the Mezzanine Debtors as separate entities. As a result, the bankruptcy court might have concluded that creditors treated Debtors as separate entities, and further that the special-purpose entity structure prevented their assets from becoming entangled- thus rendering substantive consolidation unavailable under this circuit's test." *Transwest Resort Properties* at 733

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Fallout From *Transwest*

Debtor Side

- Consider Filing in the Ninth Circuit
- Include a Separate *Transwest* Section in Any Non-Consolidation Opinion

Creditor Side

- Object to Any Offensive Joint Plan on the Basis that it Results in a *De Facto* Substantive Consolidation
- Creditor's Focus Will Shift to Limiting the Ability of SPEs to file for Bankruptcy Protection in the First Place Rather than Relying on a Blocking Position in Chapter 11

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Please feel free to reach out…

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