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BANKRUPTCY RISKS IN STRUCTURING PORTFOLIO LOANS

JOSHUA STEIN

When real estate lenders take a portfolio of properties as collateral, they know they might face "bankruptcy problems" if different partnerships or limited liability companies own each property. Although this sounds like a dire deal-killer, just what is the risk? How serious is it? How can lenders mitigate it?

This article tries to answer those questions, at least in the abstract. Any specific transaction requires competent professional advice, because the details of that transaction and of state law may change the analysis. The reader is, of course, cautioned not to rely on this article for any particular transaction.

For convenience, in this article each "Property Owner" owns a single "Property" and delivers a "Property-Specific Mortgage" to the "Lender." The aggregate financing is the "Portfolio Loan"—typically one loan, cross-collateralized and cross-defaulted. Each Property Owner agrees to pay the entire Portfolio Loan, but only on a nonrecourse basis.

Each Property Owner will often have different partners, with the general partners controlled by the same ultimate parent. (For "general partner," one can substitute "managing member." For "limited partner," one can substitute "passive member.")

If just one Property Owner suffers financial distress, the use of multiple Property Owners can create problems for Lender, because an unsecured creditor or a bankruptcy trustee may scrutinize Property Owner's secured debt and try to convince a court to convert a secured loan into an unsecured one or invalidate it entirely. Property Owner's own management—the principals of the borrowing group—could make the same threat.

While this hypothetical may seem unlikely, it does describe one risk that can actually hit. One reason a Lender takes security is to gain the benefits of being a secured creditor. If under any circumstance a "secured" loan ultimately might not stay

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OUR VIEWPOINT

THE EFFECT OF THE INTERNET ON THE FUTURE GEOGRAPHY OF REAL ESTATE INVESTING

ALLEN CYMROT AND HOWARD A. ZUCKERMAN

Will the Internet become the catalyst for the emerging commercial importance of America's hamlets, villages, towns, and small cities? During the past 25 years, I have identified and created some important trends within the real estate industry. My focus has always been to improve investor information and to increase the investment return from real estate. Some of these ideas have included:

- Designing a national real estate company with a decentralized operating system.
- Creating an evaluation system that weighs and rates a specific property's area, location, structure, amenities, capitalization ratio, debt, leverage, and property management.
- Detailing the future demise of the regional shopping mall as we know it.
- Analyzing the mistakes of dot-com companies whose poor use and abusive costs are their ultimate Achilles's heel.

Some of these ideas are now commonplace operating methodologies, some are evolving, and some are yet to happen. They are all important and will make a meaningful contribution toward improving an investor's return on their real estate investment. Yet the ultimate extinction of regional shopping malls and the collapse of numerous dot-com companies, are but a few of the effects that the Internet will have on the real estate industry. The Internet will redirect the geography of real estate investing in America.

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Populous Cities

To date most real estate investing in America has been focused on the 50 most populous cities. As of July 1, 1998 these cities, ranked in order, are: 1. New York, 2. Los Angeles, 3. Chicago, 4. Houston, 5. Philadelphia, 6. San Diego, 7. Phoenix, 8. San Antonio, 9. Dallas, 10. Detroit, 11. San Jose, 12. San Francisco, 13. Indianapolis, 14.Jacksonville, 15. Columbus, 16. Baltimore, 17, El Paso, 18. Memphis, 19. Milwaukee, 20. Boston, 21. Austin, 22. Seattle, 23. Washington, 24. Nashville, 25. Charlotte, 26. Portland, 27. Denver, 28. Cleveland, 29. Fort Worth, 30. Oklahoma City, 31. New Orleans, 32. Tucson, 33. Kansas City, 34. Virginia Beach, 35. Long Beach, 36. Albuquerque, 37. Las Vegas, 38. Sacramento, 39. Atlanta, 40. Fresno, 41. Honolulu, 42. Tulsa, Omaha, 43. Miami, 44. Oakland, 45. Mesa, 46. Minneapolis, 47. Colorado Springs, 48. Pittsburgh, 49. Saint Louis, 50. Cincinnati.

These cities have the best funded business associations and the best funded chambers of commerce, each staffed with talented professionals. The job of these professionals is to produce propaganda proving that their city is at the center of the universe for all business and living needs. To that end, and to date, the top 50 cities have received the most recognition and have been the driving forces and geographical magnets for our economy. Everyone knows their names. They're referred to as the economic centers. They've successfully promoted themselves as business hubs, the places you have to be to succeed, the places you have to be to carry on business, and the centers of the universe for culture and entertainment.

Other Side of the Coin

But how important to the rest of the country are the 50 most populous cities? As of July 1998 the country's population was 270,295,240. At the same time, the total population for the 50 most populous cities was 42,302,313, which represents 15.7% of the population. In other words, 227,992,927 people don't live in the 50 most populous cities. In 1994 the U.S. Census Bureau identified 11,047 other places with 2,500 or more inhabitants (in addition to the 50 most populous cities). The Internet is about to introduce a wake-up call for those 11,047 other places. Because of the Internet, many of those communities will be able to compete more successfully against their larger counterparts for goods, services, jobs, and investment. One result of the success of small communities will be that their real estate investment opportunities will become more attractive.

Laptops, PCs, digital cameras, RAM, DVDs, hard disks, scanners, printers, electronic organizers, e-mail, the Internet, etc. We are watching a technological revolution. Its imprint on the way we live and work and where we live and work will prove to be bigger than any other revolution, invention, or innovation in our country's history. The technological revolution is changing the way we shop, use healthcare, communicate, get entertainment, travel, work, and manage businesses. These

secured, then the exercise fails. The mere threat may cost Lender leverage.

Whoever raised the issue would argue that when Property Owner signed the Portfolio Loan, it incurred debt that far exceeded both the value of its assets (the Property) and the benefits Property Owner received. In other words, Property Owner "got ripped off"—in legal parlance, a "fraudulent transfer."

Fraudulent Transfer Issues

Although as a real-world credit matter, Lender makes any Portfolio Loan to the entire borrowing group, a court might well decide to conduct a sepa-

changes are transforming the geographical configuration of our country.

Businesses are discovering a dramatic increase in their geographical flexibility. Businesses with a modem and a laptop or a PC need less space, and in many cases are discovering that they don't have to be near the central business district of a major city. While businesses are beginning to change their geographical configurations, consumers are discovering more and more reasons to use the Internet for their goods, services, information, and entertainment. Those purveyors who continue to depend on interactive contact in a brick-and-mortar facility will use disinformation, alternative attractions, the government, and whatever else they can find to slow down or stop the Internet juggernaut.

Internet Perspectives

Let's put this Internet juggernaut into perspective. The first Industrial Revolution (which most of us studied in school) lasted from 1712 to the 1830s. It included Thomas Newcomen's steam engine, Samuel Slater's cotton mill, Eli Whitney's cotton gin, Robert Fulton's steamboat, and Francis Cabot's cotton manufacturing plant. The first Industrial Revolution took place over more than 100 years.

The World Wide Web and Internet commerce are approximately six years old. For all practical purposes, they have just been conceived and are just getting started. The ultimate benefits, uses and effect on our society will occur over many years. Although still in its formative stage, the Internet already rivals in size the automobile, energy, and communication industries. The Internet economy grew at an estimated compound average growth rate of 174.5% from 1995 to 1998, compared with the overall worldwide average economic growth rate (which includes the U.S. Internet economy) of 3.8% in the same period. The Internet economy generated an estimated $301.4 billion in U.S. revenue and was responsible for 1.2 million jobs in 1998, according to a study by the University of Texas' Center for Research in Electronic Commerce.

The Internet may be slowed, it may run into some bad publicity, and it may be subject to some government regulation, but it can't be stopped. The explosive growth of home computers, commerce-to-consumer business, commerce-to-commerce business, and Intranet use has ensured the long-term, continuing growth of the technology revolution. Activity to date clearly illustrates the ability of the Internet to translate many of the advantages of working and living in a large city to a small community. The door has been opened, and it will not be shut again.

Small-Town Advantages

After identifying and examining some of these smaller communities, business executives are discovering that they generally have:

- Less violent crime.
- Fewer teenage gangs and drugs.
- Less graffiti.
- Better primary and secondary schools.
- Convenient access to libraries and exercise facilities.
- Convenient access to hiking, biking and other outdoor enjoyments.
- Lower residential rents
- Less population density.
- More open spaces.
- Lower home prices and real estate taxes.
- More house per dollar.
- More land per house.
- Cleaner air and water.
- Less noise and highway congestion and fewer commuting problems.
- Smaller lines and less waiting for local restaurants, shopping, banking, entertainment, etc.
- Less cumbersome–and more responsive—local government.

The big-city advantage of many stores and products is all negated by the Internet. The combination of the Internet and the quality-of-life advantages just enumerated will cause a sociological geographical revolution that will result into the emerging commercial importance of America's small cities, towns, villages, and hamlets. This emerging of commercial importance will offer real estate investors extraordinary returns on their real estate investments. Not every small community will offer attractive real estate investment returns. Therein begins the need to gather information, analysis, and comparisons, and to make the decisions.

Conclusion

When it comes to above average investment returns, you are what you know. In a business climate, information is king—the key to making better decisions. All the information available points to the emergence of small communities in America, and with it superlative real estate investment opportunities. Those real estate investors who recognize this emergence of smaller communities will be the beneficiaries of a once-in-a-lifetime investment opportunity. Those real estate investors who don't recognize this opportunity will become the second-rate guys.

rate "fraudulent transfer" analysis if only one Property Owner were in financial trouble. (This assumes multiple Property Owners are not "substantively consolidated" in bankruptcy, a possibility discussed below.)

A court will typically evaluate Property Owner's solvency based on a "balance sheet" analysis—a comparison of assets against liabilities. Or a court could find a "fraudulent transfer" if it decides Property Owner did not receive fair consideration or reasonably equivalent value and at the time of the

closing could not pay its debts or had "unreasonably small capital" for its anticipated business. The court would make this analysis with 20/20 hindsight when (presumably) Property Owner is in financial distress. If the court finds "insolvency" but no "fair consideration" or "reasonably equivalent value" to Property Owner, the court might set aside the Site-Specific Mortgage or some or all of Property Owner's liability for the Portfolio Loan. This would not be a good outcome for Lender.

Possibility of Contribution

That outcome is, however, by no means inevitable. A court sympathetic to Lender might say that if Lender were to force one Property Owner to pay the entire Portfolio Loan, then that Property Owner could legally force the other Property Owners to contribute to this loss. The court could attach a value to this "contribution right" of any one Property Owner, treating it as an asset that balances out Property Owner's possible liability for the entire Portfolio Loan. On that basis, the Portfolio Loan did not make Property Owner insolvent and the Portfolio Loan was not a fraudulent transfer at all.

A court might also recognize that in the real world, Lender will almost certainly enforce the Portfolio Loan against all Property Owners at once, not just one hapless Property Owner. Based on that practicality, the court might discount the prospective liability of any one Property Owner.

Although suggested by some of the decided cases, neither a discount for contribution rights nor a discount for improbability is uniformly accepted. A court trying to rescue only a single distressed Property Owner from its financial plight might instead compare the assets and liabilities of that particular Property Owner, decide its new liabilities (the Portfolio Loan) overwhelmed its assets, and conclude that it became insolvent as a result. While this outcome is possible, Lender could certainly call it improper.

The definition of a "fraudulent transfer" leaves plenty of discretion to the judge. Courts are skeptical of indirect or secondary benefits that allegedly accrued to an insolvent borrower. If the other "fraudulent transfer" tests were met, the court might set aside a Property-Specific Mortgage. At best, Lender would become an unsecured creditor and, at worst, it might lose its claim against that Property Owner.

Mitigating the Risks

A Lender can structure and document a Portfolio Loan to mitigate these risks. How far to go depends on Lender's concern about the borrower group, the state of the market, whether the next lender down the street would care, and Lender's exit strategy. Here are some steps Lender might take.

Liability Limitation

The loan documents can limit each Property Owner's liability for the Portfolio Loan to whatever liability each Property Owner can bear without becoming "insolvent." If correctly written, such provisions would reduce, but might not eliminate, the "fraudulent transfer" risk. A court might say they are self-serving and formalistic and do not change the underlying substance.

Effect of Nonrecourse Clause

Because the Portfolio Loan is nonrecourse for each Property Owner, its liability for the Portfolio Loan cannot exceed the value of its Property, even if the face amount of the Portfolio Loan is much higher. A Lender can therefore say that the Portfolio Loan could not possibly make any Property Owner "insolvent." A court might have the same response as above to this argument.

Bankruptcy would add new issues, because in Chapter 11 a "nonrecourse" loan often becomes "recourse." But Property Owner is a single-purpose entity with only one asset, the Property, totally encumbered by the Property-Specific Mortgage. How can one say any Property Owner has meaningful exposure beyond the value of its Property? The answer may depend on Property Owner's other creditors.

Formal Contribution Agreement

All Property Owners can enter into a formal contribution agreement, either under the loan documents or separately. It would amount to a mutual aid pact. If any one Property Owner ever paid more than its share of the Portfolio Loan, it could look to the others for help on an equitable basis. This would give each Property Owner an identifiable and formal "contingent asset" to balance out the "contingent liability" of the Portfolio Loan, thus perhaps preventing insolvency. The value of this approach depends, in part, on the value of the reimbursement claims among Property Owners.

A mutual-aid agreement probably further diminishes the "fraudulent transfer" risk, but probably does not eliminate it. It may create single-purpose entity issues and priority issues, and it doesn't help at all if all the Property Owners suffer financial distress.

Structuring and Disbursement

In closing the Portfolio Loan, Lender can try to show why a court should allocate it among the Property Owners and not treat it as a huge liability that overwhelms any individual Property Owner. For example, Lender can:

- Fund to the various Property Owners, because courts have invalidated loans where the lender could not show the actual borrower received the loan proceeds.
- Require Property Owners to execute separate notes evidencing their shares of the Portfolio Loan and separate first mortgages for

each note. Each Property Owner would grant a second mortgage to secure only the entire Portfolio Loan except the part represented by that Property Owner's note.

- Try to show the parties intended to allocate the Portfolio Loan among Property Owners in a way that preserved each one's solvency.

Indemnity to Lender

All Property Owners and their partners (and perhaps their affiliates) can indemnify Lender against fraudulent transfer risks of any one Property Owner. The Property-Specific Mortgages, and perhaps new equity pledges, could secure these indemnities. This would make it much harder for any borrower affiliate to try to play the "fraudulent transfer" card.

Equity pledges raise their own issues and concerns, primarily about the reliability of the security package and what a lender can do to realize on its collateral. And they might raise more fraudulent transfer issues, depending on who owns what.

Global Bankruptcy

If the "fraudulent transfer" issue arose for any one Property Owner, other circumstances would almost certainly exist to allow Lender to default the entire Portfolio Loan. Lender could make sure of it by crafting appropriate defaults in the Portfolio Loan. If Lender did accelerate the Portfolio Loan, this would probably force all Property Owners into bankruptcy.

Lender might prefer a single global bankruptcy for all Property Owners. A court might treat the assets and liabilities of all Property Owners as if they were assets and liabilities of one entity—a substantive consolidation. Although lenders normally dread substantive consolidation, in a Portfolio Loan they would probably favor it, at least for the multiple Property Owners, and assuming the Property Owners as a group were not insolvent.

When and how to substantively consolidate multiple parties depends, however, on the discretion of the particular judge. While a court might accept Lender's position, it might also conclude that Lender cannot assert it after having dealt with Property Owners as separate entities.

Common General Partner

Property Owners can restructure their internal ownership so they all have the same general partner, making that general partner personally liable for the Portfolio Loan. Lender could proceed against the common general partner, directly, without having to consider issues that arose because the general partner had somehow assumed liability for some other entity's indebtedness. If Lender obtained a judgment against the general partner, Lender could enforce it against all assets of the general partner, including its interests in all Property Owners.

Guaranty

An upper-tier deep-pocket entity might execute a narrow and limited guaranty, to protect Lender only against the risk that any part of the transaction might be deemed a "fraudulent transfer." Such a guaranty might be even narrower, applying only if Property Owner's management, by manipulating the bankruptcy process, ever tried to invalidate any Property-Specific Mortgage as a "fraudulent transfer." Such a guaranty would create the right incentives.

As long as ownership used its control in a way that did not hurt Lender, the guaranty would never trigger. Thus, Lender would continue to bear whatever risks might arise from any actions that other creditors (e.g., trade creditors, slip-and-fall plaintiffs, and environmental claimants) might take to set aside the Property-Specific Mortgages. An upper-tier guaranty would, however, protect Lender against bad faith by the very parties most likely to exercise it–Property Owner's management.

A "guaranty" of this type should raise few legal issues or problems of its own, such as questions about its validity. And if the borrowing group is proceeding in good faith, it is hard to see how the borrowing group can make any good arguments for not giving such a guaranty, other than general aversion to contingent obligations and any personal liability of any kind.

Purchase Agreement

As a variation on the theme, Lender might ask that some higher-level entity agree to purchase the Portfolio Loan at par (plus a prepayment fee) from Lender if anyone tries to invalidate any Property-Specific Mortgage. An obligation to purchase the Portfolio Loan would eliminate potential issues about measuring Lender's damages and hence about the amount of Lender's claim under a limited guaranty—but perhaps raise issues about whether the arrangement is really a guaranty after all.

Borrower's Reactions

If Lender adopts some or all of these deal structures, Lender should significantly diminish the likelihood that Property Owner's management could use the bankruptcy and "fraudulent

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transfer" process as a creative technique to leverage Lender. A borrower's reaction to any of these structures might include the following arguments:

- This is a nonrecourse loan without any credit enhancement, period, paragraph.
- No upper-tier entity in any branch of ownership wants to be exposed on any of these risks.
- Assuming a multi-branch ownership structure, no branch can control another. (Lender would, of course, suggest internal indemnities or allocations of liability. If the branches of ownership are not comfortable enough with one another to stand shoulder to shoulder, the Lender might ask larger questions about the group.)
- No one upper-level entity indirectly holds all the equity and thus is an appropriate guarantor.
- The rest of the world closes multi-property multi-borrower secured loans without worrying about these problems, or by adopting only some of the measures suggested above—and, in particular, no guaranties. (True?)

The strength of these arguments depends on how badly Lender wants to make the Portfolio Loan, Property Owners' other alternatives, and how Lender thinks Property Owners would behave under stress. Also, some measures suggested here (such as double mortgages) might incur significant extra cost, perhaps excessive in comparison to the risk. As a middle ground, Lender might accept: (a) liability limitations for each Property Owner; (b) a simple contribution agreement; and maybe (c) equity pledges. Though these measures would not eliminate the issue, they would substantially diminish it.

Conclusion

Finally, given how much needs to go wrong for Lender to suffer any loss from the risks described above, Lender might treat them as background noise—like the risk of being run over by a bus if one crosses the street—depending perhaps on such things as whether the loan-to-value ratio is 45% or 90%. The issue might, however, not be the size of the risk but who should bear it. Even it's very small, why should it be Lender's risk at all?

HOW MEASURING SMART GROWTH WILL HELP AMERICA'S COMMUNITIES GROW SMARTER

STAN ROSS

Smart Growth means many things to many people. While it's fine that this issue is viewed differently by those on various sides of the debate, there is a need for general agreement on what Smart Growth is, if only because once it is defined, it can be measured. And if it can be measured, then cities and regions can be evaluated as to their progress in creating, implementing, and adapting Smart Growth initiatives.

For example, they might receive points for creating growth corridors of concentrated commercial development and high-density housing adjacent to existing freeways, major highways, and mass transit and other infrastructure–or for creating regional growth plans. This would be analogous to the "Best Cities" ratings developed by some publications and organizations, but it would be based on criteria specifically designed to measure smart growth in a community or region.

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Reasons

But why measure? First, communities themselves could learn from such a performance standard: what progress they have made, how they could improve, and how they can achieve balance. Second, residents would know how their communities compare with others on important issues like quality of life. Third, and equally important, such a performance standard would provide corporations with important information on which to base decisions about where to locate and how to attract and retain managers and employees.

Ten or 20 years ago, companies might have been automatically drawn to pro-growth cities and regions—those with the lowest taxes, lowest wages, cheapest land, and so on. While these are still important, companies today are struggling with the tightest labor market in 30 years, and they are deeply concerned with meeting hiring needs.

Quality of Life

Companies also need to operate in regions that have a high quality of life: affordable housing, good schools and a high level of public services. In other words, they need to be in smart-growth cities and regions: those that have struck the right balance between growth and quality of life. These are places that employees want to live.

Smart growth companies come at a price. States and cities must pay for infrastructure and services to support growth. This revenue comes from taxes or fees, bond financing, and other sources. But in addition to this, special incentives, and the money to pay for them, may be required to promote smart growth. For example: incentives for developers to build close to infra-