MORTGAGE OBSERVER

SEPTEMBER 2013 ISSUE - **JOSHUA STEIN** IN THE NEWS - STEIN'S LAW - Page 12

Stein's Law

Single Purpose Entities Out of Control

Suppose a commercial mortgage borrower entity also operates a hot dog stand, sells flowers and borrows from a loan shark—all using the name of its ultimate owner—and also keeps chaotic accounting records indistinguishable from those of its ultimate owner. Then suppose the ultimate owner decides to file bankruptcy.

If all that happens, then the bankruptcy court might decide that, as a financial matter, it's impossible to distinguish the commercial real estate borrower from its owner. The court might then extend the owner's bankruptcy proceeding to include the assets and liabilities of the commercial real estate borrower—a "substantive consolidation" of the two companies.

Joshua Stein

Substantive consolidation could lead to delays if the real estate lender tried to foreclose on the borrower. The bankruptcy might cause the lender some incremental losses. On the other hand, bankruptcy might also give the lender more information and involvement in the borrower's affairs, and a mechanism to enforce its rights without the delays of state-court foreclosures.

Over the last few decades, in a small handful of reported bankruptcy cases involving complicated operating companies, substantive consolidation has actually happened. It doesn't happen very much. The courts don't favor it. Thus far, it has never or almost never happened in commercial real estate bankruptcies. Even in the infamous recent meltdown of General Growth Properties, it didn't happen.

The fear of substantive consolidation has, however, led to the development of several significant layers of complexity—and risk for borrowers—in many commercial mortgage loan closings. Those mechanisms are also supposed to reduce the risk of bankruptcy in the first place.

First, real estate borrowers often must comply with pages of "single-purpose entity" covenants, to try to reduce (a) the likelihood of a bankruptcy and (b) the already low risk that a commercial real estate borrower will be dragged into its parent company's bankruptcy proceeding. Those SPE covenants tend to grow over time. That happened recently in response to the General Growth bankruptcy proceedings, which perhaps represented a "close call" for substantive consolidation in real estate finance. Recent loan documents contain more than 50 numbered paragraphs, each with a separate SPE covenant. Some seem obvious. Others go into tedious detail that may not be realistic.

Second, because of lenders' overwrought and exaggerated fear of substantive consolidation, for commercial loans above a threshold amount, some lenders will require the borrower to obtain a special opinion of counsel to give comfort that a court probably would not substantively consolidate the borrower with its ultimate owner, if the latter filed bankruptcy. Those opinions cost money, cause delay and ultimately give the lender little incremental assurance against a risk that is already very small. They consist largely of a tedious discussion of the few cases where the bankruptcy courts addressed substantive consolidation.

Third, lenders often ask the ultimate owners of a borrower to backstop the borrower's obligation to comply with the SPE covenants by signing conditional guaranties of the entire loan that activate if the borrower doesn't comply. That's where the real problems can begin. The SPE covenants can, in some cases, be violated by relatively trivial events that create no serious incremental risk of bankruptcy or substantive consolidation but, in the hands of an aggressive lender, can become a way to try to assert large claims under guaranties.

Thus a solution that was already far out of proportion to the problem being solved ends up creating huge and entirely unjustified problems for guarantors, undercutting the fundamental structure, logic and assumptions of traditional nonrecourse commercial real estate financing.

The entire overblown SPE exercise seems particularly pointless in the very common case where a commercial real estate borrower actually consists of (or is owned by) a joint venture between an investor and a developer or sponsor. Those parties have their own strong incentives to assure that the borrower maintains financial independence from its owners. The ordinary exercise of those incentives should as a practical matter reduce to near zero any risk of financial sloppiness that could lead to substantive consolidation.

Even when a single investor owns 100 percent of a borrower, a simple and ordinary requirement for the borrower to maintain its own books and records and provide its own separate financial statements should go a long way toward eliminating any risk of financial sloppiness. And if the borrower's principal has already guaranteed the loan if the borrower files a voluntary bankruptcy, it would be reasonable to have that guaranty activate if, in a bankruptcy proceeding of the borrower's owner, that bankruptcy were actually extended (via substantive consolidation) to include the borrower.

A limited guaranty of that type would give the lender reasonable protection against the very small risk of substantive consolidation, while preventing expensive and unexpected claims against the guarantor. MO

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