In the 1990s, commercial mortgage backed securities emerged as a means of enhancing funding of real estate loans by tapping into the capital markets. Commercial mortgage backed securities (CMBS) are loans originated or facilitated by traditional real estate lenders, but ultimately sold to individual investors as rated securities of a pool. CMBS now are the second largest source of commercial and multifamily real estate financing, exceeded only by commercial banks. In 2004, CMBS issuance in the United States alone exceeded $90 billion, and from all accounts it continues to grow. In theory and frequently in practice, the capital markets allow borrowers to obtain more competitive rates than in other forms of debt financing, so there is good cause for this trend to continue.

A strong secondary market is necessary to provide the liquidity and market efficiency that supports mortgage backed securities and enables adequate credit ratings, which in turn requires regulation as well as adherence to non-regulatory but highly structured procedures for the underlying loan transactions, including due diligence and documentation. Lenders and the marketplace expect standardized documentation and consistent adoption of best practices. The securities are rated by specific investment grade according to a variety of factors, including their conformity to standard structures as well as credit. Standardization is especially critical because the loans are reviewed and administered by multiple parties, including originators, underwriting firms, trustees for ultimate noteholders or bondholders, master loan servicers, subservicers, and special servicers. Consequently, there is little room for alteration of rules and process based on relationship or other subjective factors.

Traditionally, much commercial real estate held for investment purposes has been owned in a partnership or limited liability company ownership structure, with real estate being the entity’s only significant asset and mortgage debt its only significant liability. Initially, general partnerships consisting of a single institution and a single developer, or limited partnerships for syndication with multiple limited partners were formed for the purpose of owning only one or a small number of assets and each had a unique investor base. Limited liability companies became the entity of choice in the mid to late 1990’s, but employed essentially similar structures. Notwithstanding the fact that these entities frequently owned a single asset, a significant number of reported Chapter 11 bankruptcy cases have involved these real estate owner entities, in which the owner was attempting to avoid foreclosure when the mortgage loan went into default. The automatic stay arising in the bankruptcy proceeding enabled the debtor to at least delay, perhaps for an extended period of time, realization on the property, placing significant risk on the mortgage lender and providing excellent bargaining position for the borrower in a loan restructuring. Bankruptcy sometimes encouraged the creditor to let the property remain in the debtor’s hands indefinitely.
Goals of CMBS Loans
The primary goal of loans generated for structured finance transactions and sale in the CMBS markets is to maintain constant cash flow, by assuring that the property income payable to the ultimate bondholders is not interrupted for reasons unrelated to the operation of the property. The rating of the security depends on the likelihood of continuing cash flow. To enhance this rating, the lender needs to avoid not only payment defaults but payment delays as well as substantive claims of competing creditors. Thus, one of the most important goals in the structuring of mortgages intended for the CMBS market is reduction of the risk that the borrower will avoid or delay realization on the security through a bankruptcy proceeding.

Bankruptcy Risks
Although some protections have been added to the Bankruptcy Code for purposes of reducing abuse of bankruptcy proceedings and consequent delays on realization on security for single asset real estate cases, the best protections are limited to cases where the secured debt does not exceed $4 million (in which cases debtor cannot obtain a stay on foreclosure unless a plan is filed or post-petition payments made). For loans of greater size there remain significant cost and delay risks to the lender in a bankruptcy through the automatic stay, even though the actual potential benefit of a “reorganization” through bankruptcy is limited. Adding significantly to lenders’ concerns with the bankruptcy of entities owning real estate is the so-called “new value” concept. Some courts have interpreted the Bankruptcy Code to allow the debtor-owner to retain mortgaged property indefinitely under a plan of reorganization even though creditors object and the mortgage debt is not repaid in full if “new value” is injected into the business. This “new value” concept creates an exception to the absolute priority rule that would otherwise protect the mortgage holder. Bank of America Nat’l Trust and Savigs Assoc. v. 203 N. LaSalle Street Partnership, 626 U.S. 434 (1999). The standards applicable to the ‘new value’ concept at this point, including the amount of new value required to satisfy the exception, are neither objective nor well-defined by the courts.

Agreements Restricting Bankruptcy Action
As in all loan transactions, in the CMBS transaction the borrower agrees not to file a petition in bankruptcy or take advantage of the automatic stay, not only in the loan documents but in its LLC operating agreement or other internal organization documents. Because the so-called “ipso facto rule” in bankruptcy and its variations appears to make such covenants not to file generally non-binding on the courts (see Federal National Bank v. Koppel, 253 Mass. 157, 148 N.E. 379 (1925), In re Tru Block Concrete Products Inc., 27 B.R. 486 (Bankr. S.D. Cal. 1983) and Chapters 541, 365 and 349 of the Bankruptcy Code), restrictions in the loan documents would not provide the intended benefit to the lender. And given the fact that the SPE borrower frequently is also a single member entity, the member’s commitment in the organizational documents literally runs to itself. In practice, this “internal” commitment is intended to enhance the enforceability of the restriction and to benefit the lender as a third party beneficiary, and may expressly so state. Delaware law recently has confirmed the rights of persons that are not members of the entity, providing that the governing agreement of the limited liability company or partnership may grant rights to a person who is not a party to that agreement, e.g., DLLCA § 18-101(7); DRULPA § 17-101(12). Thus, the lender is given an avenue of enforcement through entity restrictions as well as loan covenants. Also, because the bankruptcy rules do not expressly permit a filing by less than all managers or members of the LLC, authority for
filing may instead be found in the organizational documents, which by lender’s restrictions are tailored to preclude a voluntary filing. Thus, notwithstanding the judicial and statutory limitations on anti-bankruptcy covenants, they are retained because of possible internal authority issues and because breach of the covenants at least triggers recourse liabilities or may have other negative consequences that borrower wishes to avoid.

SPEs: Bankruptcy Remoteness
Due to the uncertainties with enforceability of bankruptcy-related covenants, CMBS lenders have taken steps to cause the transaction to be structured to minimize, to the maximum extent possible, the likelihood that the borrower could become insolvent or file or be subject to an involuntary petition. Fundamentally, the structure requires that a special purpose vehicle (SPV) or single/special purpose entity (SPE) be formed to act as the borrower and sole owner of the property. The purposes of the SPE structure are restricting the borrower from incurring additional liabilities, insulating the borrower from unrelated liabilities, reducing the risks of termination or dissolution and inhibiting the borrower from using bankruptcy proceedings to avoid foreclosure. Due to its primary purpose, the required form of SPV or SPE has become known as a “bankruptcy remote entity,” and all of these terms have essentially the same meaning. For purposes of this paper, the SPE generally will refer to a special purpose bankruptcy remote entity.

The Standard & Poor’s guidelines define an SPE as “an entity which is unlikely to become insolvent as a result of its own activities and which is adequately insulated from the consequences of any related party’s insolvency.” First and foremost, in order to reduce the practical possibility of bankruptcy filings, the single purpose of the borrower entity must be strictly the ownership and operation of the particular property that secures the mortgage. In addition to this limitation on purpose, to be considered “bankruptcy remote,” the debt of the entity must be limited to mortgage debt and other limited debt incurred in the ordinary course of ownership and operation of the mortgaged property. Basically, outside credit risks are to be eliminated. (For a full description of Standard & Poor’s SPE requirements, see Standard & Poor’s, Structured Finance, Legal Criteria for U.S. Structured Finance Transactions, Ch. 3, at standardpoor’s.com, hereafter “S&P”). In some cases the rating of the security may permit other debt, in which case full subordination and other intercreditor protections are required. Again, both the organic documents and the loan documents will contain the debt and other restrictions. (For an example of lenders’ general bankruptcy remoteness requirements, see Exhibit A).

Separateness Covenants
The entity must not only be unlikely to become insolvent as a result of its own activities, it also must be adequately insulated from the consequences of a related party’s insolvency. Lenders seek to control the operation of the SPE by requiring a host of separateness covenants that understandably reiterate the borrower’s status as a purpose and power-constrained, separate and sole purpose entity, and are intended to avoid “piercing the corporate veil,” alter-ego claims and real third party liabilities of both the SPE and its owners. Structurally, the SPE in most significant transactions must be an SPE on two levels, that is, both the owner and at least one member must be special purpose entities, although if the borrower is a single member Delaware LLC which maintains a member that would be admitted if necessary (see below), it may not be required to have a SPE component entity. These covenants include fundamental restrictions on activities and powers outside the planned scope
of owning and managing the asset, prohibitions on additional debt, the need to maintain separate books and records, prohibitions on commingling assets, mandates to keep a separate entity structure without merger or reorganization, and other requirements to display to the outside world that the entity is an SPE, include separate stationery, accounts, document signature formalities and the like. Even the SPE’s indemnity to its members or managers must be subordinated or capped in amount.

The separateness covenants are certainly required in both the loan documents and the SPE’s operating agreement, and frequently in its Certificate of Formation or other state-required filing as well. Lenders believe that the organic documents may provide an element of public or internal notice that the loan documents do not, particularly in the case of a filed certificate, and therefore may be less susceptible to change without the lender’s approval, more likely to be seen by other debtors and also more likely to be duly observed by the borrower itself. Since the provisions of the agreement and the certificate may be required to parallel each other, it is wise not to file (or amend) the certificate until all details of lender’s requirements have been determined.

As the Merrill Lynch restrictions on Exhibit B indicate, the lender may well require strict language conformity for the separateness covenants in the organizational documents. (For other examples see Exhibit C and Exhibit D). The ramification of breaching these covenants can seem draconian; the entire loan transitions from non-recourse to recourse liability. Now that CMBS lenders require significant credit support, these covenants have true force.

Due to the separateness mandate, most CMBS lenders are not comfortable with the series LLC permitted by Delaware law. Although in theory the assets and liabilities of each series can be considered independent, the appearance creates discomfort and the theory has not been tested (see DLLCA Sec. 18-215). If permitted, special requirements are imposed. (See S&P.)

Pre-existing Entities
If the owning entity pre-existed the loan, the lender requires additional assurance that any prior liabilities have been satisfied and that its past behavior did not create circumstances that could cause future liabilities. For simplicity and added comfort, some lenders will not permit the use of an entity that ever held other property. Thus, especially if the borrowing entity owned more assets than the property that will serve as security, but sometimes even if a non-complying form of SPE is the current owner, the lender may require transfer to a new SPE. The transfer to the new SPE must then be carefully structured as a true sale to avoid characterization of the asset as part of the transferor’s estate under Section 541 of the Bankruptcy Code, requiring consideration of factors such as retention of any rights in the asset, the fair value of the asset and price paid, and any recourse to the transferor. Even if it is not necessary to establish a new SPE to hold the property, the borrower will almost certainly need to modify its organizational documents if the SPE was formed prior to determining the identity of the lender. As noted above, each lender’s SPE requirements are somewhat different so anticipating these formation requirements prior to a lender’s commitment is risky.

SPEs & Other Unintended Consequences
While avoidance of negative bankruptcy consequences is the primary focus in formation and operation of the SPE, lenders also seek to assure that the structure of the entity otherwise does not result in unintended consequences that could harm income production of the property or realization on