# Bankruptcy Remote Structures: Recent Nonconsolidation Opinion Concerns

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The hallmark of structured finance is the isolation of the assets being underwritten and relied upon for repayment of the securities backed by those assets. In commercial real estate (CRE) financing, that isolation occurs both at the property level and the issuer level. Here, we focus on the borrowers in CRE securitizations.

Each commercial property financed through securitization should be owned by a bankruptcy remote, single (or special) purpose entity (SPE), usually a Delaware limited liability company. The SPE organization documents should include three critical provisions: (1) limitation of purpose to owning, operating, and financing the specific property to be financed; (2) limitation on the debt that may be incurred for the mortgage loan that will be included in the securitization and trade payables not exceeding 2% to 4% of the mortgage loan principal balance; and (3) separateness covenants designed to require the SPE to operate and hold itself out as separate and distinct from its affiliates.

To provide additional comfort regarding isolation and bankruptcy remoteness for large loans, typically $20 million and above, including single-asset, single-borrower deals, the SPE structure should also include: (1) an independent director whose vote is required for certain major actions, principally a voluntary bankruptcy proceeding; and (2) a reasoned legal opinion of counsel, which evaluates all relevant factors concerning the loan and SPE borrower structure under current bankruptcy case law and concludes that if the SPE parent, guarantor, or other specified affiliates (affiliate debtor parties) were involved in a bankruptcy proceeding, the assets and liabilities of the SPE borrower would not be substantively consolidated with the assets and liabilities of one or more of the affiliate debtor parties ( the "nonconsolidation opinion").

Substantive consolidation is an equitable remedy utilized by bankruptcy courts in resolving complex bankruptcies in pursuit of the congressional goal of promoting reorganizations. It is not a statutorily prescribed remedy; it arises out of the equitable powers of the court under section 105 of the U.S. Bankruptcy Code (11 U.S.C. Sec. 101 et seq.) and thus involves broad discretion that may be exercised based on all relevant facts and circumstances before the court.

The nonconsolidation opinion differs from customary opinions, such as enforceability and authority opinions, in that the considerable uncertainties of bankruptcy require that the legal conclusion not be viewed apart from the underlying reasoning and assumptions as to the relevant facts. Accordingly, the facts of the transaction are crucial to the analysis and bear significantly on the legal conclusion. This is clear in the framing of the opinion request, which typically reads substantially as follows:

> whether, in connection with a bankruptcy proceeding instituted by or against any one or more of the Affiliate Debtor Parties under the United States Bankruptcy Code, a federal court exercising bankruptcy jurisdiction and reasonable judgment *after full consideration of all relevant factors*, in a properly briefed, argued and presented case, and properly applying applicable, currently-reported decisional law, would order the substantive consolidation of the assets and liabilities of the SPE with those of any one or more of the Affiliate Debtor Parties. [emphasis added]

The factual assumptions must be based upon written provisions in the transaction documents or other credible evidence for counsel to reasonably rely on them in the legal analysis. This view and expectation of nonconsolidation opinions has been widely recognized and described in legal publications concerning structured financings for over 30 years. See, for

example, “Special Report by the Tribar Opinion Committee: Opinions in the Bankruptcy Context: Rating Agency, Structured Financing, and Chapter 11 Transactions,” 46 Business Lawyer 718 (1991); and “Special Report on the Preparation of Substantive Consolidation Opinions,” 64 Business Lawyer 411 (2009).

The CRE structured finance industry recognizes and relies on the benefits of a nonconsolidation opinion, as evidenced by customary loan seller representations and warranties in a CRE securitization, which include a “Single Purpose Entity” that states, in part, “and each Mortgage Loan with a principal balance of $20 million or more has a counsel’s opinion regarding non-consolidation of the borrower.”

Two key benefits of the opinion are: (1) counsel familiar with bankruptcy proceedings, substantive consolidation, and bankruptcy remote structures is involved to facilitate the structure and implementation of the SPE criteria and to advise the borrower on those matters; and (2) providing additional evidence for the lender to present to a bankruptcy court that it reasonably relied on separateness in extending credit to the SPE borrower. Creditor reliance is an important factor bankruptcy courts consider in determining whether consolidation is appropriate.

Guaranties of the SPE borrower obligations by a parent or other affiliate are an important consideration in the substantive consolidation analysis. For example, a parent entity that provides a full credit guaranty of the SPE borrower loan would weigh against the lender’s claim that it relied on the separateness of the SPE and its assets and thus would weigh in favor of consolidation.

The analysis of other types of guaranties and indemnities demands a closer look. Since the CRE loan is nonrecourse, the lender usually requires a nonrecourse carveout guaranty (also referred to as a “bad acts” guaranty) from the parent or other affiliate (the “affiliate guarantor”) providing that the SPE borrower and the affiliate guarantor will both be liable:

- For losses and damages resulting from certain acts of the borrower, which generally include (1) fraud or intentional misrepresentation; (2) misappropriation of rents, insurance proceeds, or condemnation awards; (3) intentional material physical waste of the mortgaged property; and (4) breach of the environmental covenants contained in the related loan documents.
- For the full amount of the mortgage loan (the springing guaranty) in any of the following events: (1) a petition for bankruptcy, insolvency, dissolution or liquidation pursuant to federal bankruptcy law, or any similar federal or state law, is filed by, consented to, or acquiesced to by the SPE borrower; (2) the SPE borrower or affiliate guarantor have colluded with or solicited petitioning creditors to cause an involuntary bankruptcy filing; or (3) voluntary transfers of either the mortgaged property or controlling equity interests in the SPE borrower made in violation of the loan documents.

Because the nonrecourse carveout guaranty requires active and intentional breach of specific undertakings by the SPE or its affiliates and is not triggered by a credit default due to insufficient operating revenues, it does not generally rise to the level of concern presented by other credit guaranties; rather it is a deterrent to specific bad acts. Similarly, an environmental indemnity by a parent/sponsor provides additional support and incentive for compliance with environmental laws and is triggered only by their violation, but it is not a credit guaranty.

On the other hand, a completion or performance guaranty could have a credit component, depending upon the terms. If funds have been escrowed or reserved in amounts estimated to cover all or substantially all of the costs, the credit component is significantly less, and should not prevent counsel from rendering the opinion. If funds have not been escrowed or reserved, or if the amount escrowed or reserved is significantly less than estimated costs, the analysis becomes more acute.

Each case is different and requires counsel to evaluate the facts and circumstances in light of current bankruptcy case law. Current case law does not specify a clear level or amount of credit guaranty that merits consolidation, and counsel must make an informed judgment. See, e.g., *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), *cert. denied*, 126 S.Ct. 1910 (U.S. 2006); and *In re Food Fair Inc.* 10 B.R. 123 (Bankr. S.D.N.Y. 1981).

Nonconsolidation opinion precedent and practice includes instances when counsel has provided the opinion if the transaction documents specify credit limits on guaranties of 10%, 15%, and even 20% of the loan principal balance. However, for some transactions the scope and extent of guaranties may exceed counsel's comfort level in rendering the opinion. In such circumstances, the lender may have to weigh the benefit of receiving the nonconsolidation opinion against receipt of the guaranty. Each has its own benefits and limitations.

In a few recent transactions involving loans on properties in transition or undergoing restoration or construction that incorporate credit guaranties or performance and completion guaranties, counsel has either excluded the guaranties from the scope of the opinion or assumed a particular limit on the credit exposure that is not included in the transaction documents. The essence of the nonconsolidation opinion requires counsel to evaluate *all* factors in the transaction and assess whether those factors would lead a court to substantively consolidate the assets of the SPE with those of an affiliate guarantor in a bankruptcy proceeding under current law. To exclude a specific, acknowledged fact or agreement from the scope of the opinion or make an assumption that is not based on transaction documents or credible evidence eviscerates the very purpose of the opinion and renders its use questionable. More concerning, it provides a roadmap for a court to hold in favor of consolidation and jeopardizes the creditor reliance factor that is essential to a favorable ruling for the lender in most courts.

This problem has been identified in some cases in the exceptions to the loan seller representations regarding the SPEs we referred to. In other cases, it has been identified only through follow-up questions on whether the exclusions, qualifications, or assumptions were included in the opinions. The issue's importance also has been recognized in the risk factor section of certain offering circulars containing loans with problematic exclusions, qualifications, or assumptions, which reads substantially as follows:

> At origination, each of the borrowers delivered to the lender a counsel's opinion regarding non-consolidation of the related borrowers; however, such opinion did not express an opinion regarding the substantive consolidation of the assets and liabilities of the related borrowers with those of the related guarantors or the related pledgors due to the existence of the potential obligations of the guarantors under the related full recourse guaranties or the pledgors under the related pledge agreements. We cannot assure you that such guaranties or pledges would not be considered by a bankruptcy court as a significant factor in determining whether to substantively consolidate the assets and liabilities of any of the borrowers with those of the related guarantors or the related pledgors.

Nonconsolidation opinions containing these exclusions, qualifications, and assumptions conflict with recognized opinion practice, do not accurately evaluate the risk of substantive consolidation in bankruptcy, and are viewed as credit negative. A recipient of the SPE representation should reasonably expect that the nonconsolidation opinion is consistent with the TriBar Report, Substantive Consolidation Opinion Report, and other publications about the scope, content, and requirements for factual assumptions therein. Securitization participants and counsel should make these expectations clear when requesting the opinion and should carefully review the opinion to avoid accepting a misleading and potentially damaging opinion.




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