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Effective Use of Special Purpose Entities**David J. Sewell**

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EFFECTIVE USE OF SPECIAL PURPOSE ENTITIES

This paper provides an overview of the uses and characteristics of special purpose entities in Texas. The first section of the paper discusses the general aspects of a special purpose entity and describes the contexts in which special purposes entities are used. The remaining sections of the paper focus on the various characteristics of special purpose entities and analyze sample provisions for a special purpose entity's governing documents.¹ These sections also contain discussions concerning which aspects of a lender's standard special purpose language may be negotiated by the entity's counsel.

1. An Overview of Special Purpose Entities

Special purpose entities are a tool used mostly by real estate developers and owners of operating commercial real estate properties to make their projects attractive to commercial lenders. The use of a single purpose entity enhances the "financability" of a real estate project because it gives the lender greater comfort that the primary asset—the real estate project itself—will be shielded from many events that might prevent the lender from foreclosing its loan. This paper will analyze the various provisions that help create a special purpose entity.

For securitized loans, also known as "conduit loans," single purpose entities are required by the rules governing the securities market. In order for many real estate securities to receive an investment-grade rating, the borrower must be a special purpose entity. Conduit loans are often attractive to real estate owners because interest rates for such loans are generally lower than interest rates for non-conduit loans. But, borrowers should be aware that conduit loans often require them to prepare and submit voluminous detailed written materials concerning various aspects of the real estate project and the borrowing entity, the payment of loan transaction fees that might be greater than equivalent fees in non-conduit loans, and the use of a special purpose entity.

A special purpose entity is created by inserting certain special purpose provisions into the borrower's governing documents. Standard special purpose provisions will typically be provided to the borrower and the borrower's counsel by the lender, and very few of the provisions will be negotiable. Depending on the type of borrowing entity, the lender may require special purpose provisions be inserted into a limited partnership's ("LP") partnership agreement, a limited liability company's ("LLC") company agreement or certificate of formation, or a corporation's certificate of formation. A lender may also prefer that its borrower be a newly formed entity so that there is no risk posed by past events.

In the case of an LLC, borrowers should resist amending the certificate of formation to add special purpose language and attempt to convince the lender that inclusion in the company agreement, along with a prohibition against amending the agreement without lender consent, will sufficiently protect the lender. Another helpful technique for the borrower is to place all of the special purpose provisions in an addendum or an amendment to the LP's partnership agreement or LLC's company agreement with a general provision that the terms of the addendum or amendment control over inconsistent provisions in the body of the document. If practitioners

¹ For purposes of this paper, "governing documents" has the meaning given such terms in the Texas Business Organizations Code, § 1.002(36).

will utilize this model when forming a special purpose entity with lender-specific language, then the special purpose language may be easily deleted if the relationship with the lender terminates or amended if a new lender has different special purpose language.

In drafting and negotiating special purpose language, lenders and borrowers should aim to maintain a balance between restricting changes that might affect the value of the collateral and allowing enough flexibility to permit future actions that might be desired by both the lender and the borrower, such as refinancings, sale-leasebacks, securitizations, loan modifications, and foreclosures.

2. Single Asset Covenant

Special purpose entities generally own only one asset—the primary asset that the lender will foreclose if the borrower defaults on its loan. In the real estate context, the single asset is the real estate project. Lenders require a single asset covenant to prevent events involving other assets or projects from affecting the value of its collateral. For example, if ABC Limited Partnership owned two office buildings, but XYZ Bank had a lien against only one of the buildings, a casualty event or major lawsuit involving the other building could deplete the resources of ABC Limited Partnership and affect its ability to comply with its loan covenants for the XYZ Bank loan. In this scenario, XYZ Bank’s loan to ABC Limited Partnership might potentially be impacted by events that do not relate to its collateral. In order to minimize this possibility, lenders will require borrowers to own only a single asset—the asset that acts as the collateral for the loan.

The single asset covenant is usually contained in the purpose clause of an LP’s partnership agreement or an LLC’s company agreement. A lender may also require the single asset covenant to be added to the LLC’s certificate of formation (the promulgated form of certificate of formation for an LP does not include a purpose statement). For a corporation, the single asset covenant will be added to the certificate of formation.

One issue an LP should resist is a requirement that the general partner of the LP also be a single asset entity. During the early years of conduit loans, lenders routinely insisted that the general partner of an LP borrower be a single asset entity—that is, that it own no assets other than the general partner interest in the LP borrower. In recent years, some lenders have relaxed this requirement so that an LLC or corporation may be the general partner of a number of different LPs, including the borrower, without violating a single asset covenant. Some lenders, however, continue to insist that general partners be single asset entities.

Some sample single asset provisions are set forth below:

SAMPLE 1: The sole purpose of the Company is to acquire, own, hold, maintain, and operate _____ (the “Property”), together with such other activities as may be necessary or advisable in connection with the ownership of the Property. The Company shall not engage in any business, and it shall have no purpose, unrelated to the Property and shall not acquire any real property or own assets other than those related to the Property and/or otherwise in furtherance of the limited purposes of the Company.

SAMPLE 2: The nature of the business and of the purposes to be conducted and promoted by the [corporation] [limited partnership] [limited liability company] (the “Company”), is to engage solely in the following activities:

1. [If applicable] To acquire from [seller], certain parcels of real property, together with all improvements located thereon, in the City of _____, State of _____ (the “Property”).
2. To own, hold, sell, assign, transfer, operate, lease, mortgage, pledge and otherwise deal with the Property as permitted under the loan documents executed and delivered by the Company in connection with that certain mortgage loan from _____ in the principal amount of \$ _____ (the “Loan”).
3. To exercise all powers enumerated in the [Applicable Law] of [State of Organization] necessary or convenient to the conduct, promotion or attainment of the business or purposes otherwise set forth herein.

SAMPLE 3: (Relating to a corporation that will be the general partner of an LP borrower)
The nature of the business and of the purposes to be conducted and promoted by the Corporation is to engage solely in the following activities:

1. To acquire, manage, own, and hold the general partnership interest in _____, LP (the “Partnership”), which Partnership shall acquire and own certain parcels of real property, together with all improvements located thereon, in the City of _____, State of _____ (the “Property”), and to act as General Partner of the Partnership with all rights, powers, obligations, and liabilities of a general partner under the limited partnership agreement of the Partnership; and
2. To exercise all powers enumerated in the Texas Business Organizations Code of the State of Texas necessary or convenient to the conduct, promotion or attainment of the business or purposes otherwise set forth herein.

3. Restriction on Certain Entity Changes and Transactions

Special purpose entities’ governing documents should also have restrictions on making certain significant structural changes. Once again, the rationale from the lender’s perspective is to maintain the status quo with regard to its collateral. The types of transactions that will be restricted include dissolution, mergers, sales of the principal asset, transfers of ownership interests in the entity itself, incurring additional indebtedness in a significant amount, and the amendment of the entity’s governing documents. Typically, these restrictions prohibits such actions without the prior consent of the lender and the consent of all directors (of a corporation) or members (of an LLC), including disinterested directors or members, if required by the lender.²

² For a discussion of the requirement of disinterested directors and members, see Section 4 of this paper.

Single-member LLCs pose a unique situation with regard to prohibitions against dissolving the borrowing entity. With regard to single-member LLCs, lenders want to protect against the dissolution or bankruptcy of the LLC's single member and the effect such event would have on the entity. The Texas Business Organizations Code gives the lender some comfort in this area. Under Texas Business Organizations Code § 11.056, an LLC is not required to dissolve if, within 90 days after the termination of the LLC's last remaining member, the member's legal representative either agrees to become a member or designates another member.³ Lenders will often insist on a special purpose provision in the LLC's company agreement that requires such a designation be made after the dissolution of the sole member of a single-member LLC.

The borrower's counsel should attempt to negotiate for the borrower's ability to transfer a non-controlling amount of ownership interests without the lender's consent. Some lenders will agree to this concept. But, some lenders will insist that the class of permitted transferees be limited to family members or estate planning vehicles of the current owners.

With regard to restrictions on additional indebtedness, the borrower's counsel may also want to negotiate to allow the borrower to borrow limited amounts for working capital or other uses (but which are not secured by the principal asset).

Some sample provisions follow:

SAMPLE 1: The Company shall only incur indebtedness in an amount necessary to acquire, operate and maintain the Property. For so long as any mortgage lien in favor of _____, its successors or assigns (the "First Mortgage") exists on any portion of the Property, the Company shall not incur, assume, or guaranty any other indebtedness. For so long as the First Mortgage exists on any portion of the Property, the Company shall not dissolve, liquidate, merge or sell substantially all of its assets. Subject to applicable law, dissolution of the Company shall not occur so long as the Company remains owner of the Property subject to the First Mortgage. For so long as the First Mortgage exists on any portion of the Property, no material amendment, including, without limitation, Sections _____ [RELATING TO SPECIAL PURPOSE PROVISIONS], to this [certificate of incorporation or to the corporation's by-laws] [limited partnership certificate and/or limited partnership agreement] [certificate of formation and/or company agreement] may be made without first obtaining approval of the mortgagee holding the First Mortgage on any portion of the Property, or, after the securitization of the Loan, only if the Company receives (i) confirmation from each of the applicable rating agencies that such amendment would not result in the qualification, withdrawal or downgrade of any securities rating and (ii) approval of such amendment by the mortgagee holding the First Mortgage.

No transfer of any direct or indirect ownership interest in the Company may be made such that the transferee owns, in the aggregate with the ownership interests of its affiliates and family members in the Company, more than a 49% interest in the Company, unless such transfer is conditioned upon the delivery of an

³ Tex. Bus. Org. Code § 11.056.

acceptable non-consolidation opinion to the holder of the First Mortgage and to any applicable rating agency concerning, as applicable, the Company, the new transferee and/or their respective owners.

SAMPLE 2: The Company shall not:

(a) make any loans to any member of the Company (individually, a "Member" and collectively, the "Members"), [if Manager-managed, insert: to any Manager,] or to any Affiliate (as defined below) of the Company, the Managing Member or any of the Members;

(b) except as permitted by the Lender in writing, sell, encumber (except with respect to the Lender) or otherwise transfer or dispose of all or substantially all of the properties of the Company (a sale or disposition will be deemed to be "all or substantially all of the properties of the Company" if the sale or disposition includes the Property or if the total value of the properties sold or disposed of in such transaction and during the twelve months preceding such transaction is sixty six and two thirds percent (66-2/3%) or more in value of the Company's total assets as of the end of the most recently completed Company fiscal year);

(c) to the fullest extent permitted by law, dissolve, wind-up, or liquidate the Company;

(d) merge, consolidate or acquire all or substantially all of the assets of an Affiliate of same or other person or entity;

(e) change the nature of the business conducted by the Company; or except as permitted by the Lender in writing, amend, modify or otherwise change this Agreement (or, after securitization of the Loan, only if the Company receives (i) confirmation from each of the applicable rating agencies that such amendment, modification or change would not result in the qualification, withdrawal or downgrade of any securities rating and (ii) permission of the Lender in writing).

The Company shall have no indebtedness or incur any liability other than (a) unsecured debts and liabilities for trade payables and accrued expenses incurred in the ordinary course of its business of operating the Property, provided, however, that such unsecured indebtedness or liabilities (i) are in amounts that are normal and reasonable under the circumstances, but in no event to exceed three percent (3%) of the original principal amount of the Loan and (ii) are not evidenced by a note and are paid when due, but in no event for more than sixty (60) days from the date that such indebtedness or liabilities are incurred and (b) the Loan. No indebtedness other than the Loan shall be secured (senior, subordinated or pari passu) by the Property.

4. Bankruptcy Remoteness

One of the most significant aspects of special purpose entities is that they are "bankruptcy remote." Bankruptcy remoteness means that the entity is prohibited from filing bankruptcy

without obtaining permission from the lender and/or disinterested owners, directors, or managers. Lenders require bankruptcy remote special purpose entities in order to prohibit their collateral from becoming involved in a bankruptcy proceeding. Despite the requirement of their inclusion, bankruptcy covenants have proven to not be a fool-proof way to prevent borrowers from filing for bankruptcy.⁴

In order to bolster the bankruptcy remoteness of an entity, some lenders require that at least one disinterested person be a director (of a corporate borrower) or manager (of an LLC borrower). Whether or not this is required often depends on the amount of the loan. Borrowers' counsel will want to resist this requirement as much as possible, but lenders' hands may be tied on this issue because of the requirements of various rating agencies.

See some sample bankruptcy remoteness provisions below:

SAMPLE 1: For so long as the First Mortgage exists on any portion of the Property, the Company will not voluntarily commence a case with respect to itself, as debtor, under the Federal Bankruptcy Code or any similar federal or state statute without the unanimous consent of [the board of directors[, including at least _____ Independent Directors,] of the] [all of the partners of the] [all of the members of the] Company.

SAMPLE 2: The Company shall not, and no Member or other person or entity on behalf of the Company shall, without the prior written affirmative vote of one hundred percent (100%) of the Members: (a) institute proceedings to be adjudicated bankrupt or insolvent; (b) consent to the institution of bankruptcy or insolvency proceedings against it; (c) file a petition seeking, or consenting to, reorganization or relief under any applicable federal or state law relating to bankruptcy; (d) consent to the appointment of a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the Company or a substantial part of its property; (e) make any assignment for the benefit of creditors; (f) admit in writing its inability to pay its debts generally as they become due or declare or effect a moratorium on its debts; or (g) take any action in furtherance of any such action ((a) through (g) above, with respect to any individual or entity, collectively, a "Bankruptcy Action").

A Bankruptcy Action by or against any Member shall not cause such Member to cease to be a member of the Company and upon the occurrence of such an event, the Company shall continue without dissolution. Additionally, to the fullest extent permitted by law, if any Member ceases to be a member of the Company such event shall not terminate the Company and the Company shall continue without dissolution.

SAMPLE 3: (Requiring a disinterested director/manager)
[With Corporate Borrower: The Board of Directors shall include at least one individual who is an Independent Director.] [With Limited Partnership Borrower: It shall at all times have a special purpose corporate general partner with an

⁴ See, e.g., *In re Kingston Square Associates*, 214 Bankr. 713 (Bankr. S.D.N.Y. 1997). In this case, a principal of a bankruptcy remote borrower was able to trigger an involuntary bankruptcy filing against the entity.

Independent Director.] [With Limited Liability Company Borrower: It shall at all times have a special purpose corporate member with an Independent Director.] An “Independent Director” shall mean a director of the Corporation who is not at the time of initial appointment, or at any time while serving as a director of the Company [Company’s corporate general partner] [Company’s corporate member], and has not been at any time during the preceding five (5) years: (i) a stockholder, director (with the exception of serving as the Independent Director of the Corporation), officer, employee, partner, member, attorney or counsel of the Company [Company’s corporate general partner] [Company’s corporate member] or any affiliate [of any of them]; (ii) a customer, creditor, supplier or other person who derives any of its purchases or revenues from its activities with the Company [Company’s corporate general partner] [Company’s corporate member] or any affiliate [of any of them]; (iii) a person or other entity controlling or under common control with any such stockholder, partner, member, customer, creditor, supplier or other person; or (iv) a member of the immediate family of any such stockholder, director, officer, employee, partner, member, customer, creditor, supplier or other person. (As used herein, the term “control” means the possession, directly or indirectly, of the power to direct or cause the direction of management, policies or activities of a person or entity, whether through ownership of voting securities, by contract or otherwise.)

5. Entity Separateness

Lenders require borrowers to employ broad, general language in their governing documents that ensures the entity “separateness” of the borrower. The separateness provisions pertain to operational matters as well as legal matters and seek to prevent the borrower from having its assets substantively consolidated with those of another affiliated entity. The provisions are also aimed, in part, to insulate the entity from a piercing-the-corporate-veil argument that might endanger the collateral.

A sample provision follows:

SAMPLE: For so long as the First Mortgage exists on any portion of the Property, in order to preserve and ensure its separate and distinct [corporate] [limited partnership] [limited liability company] identity, in addition to the other provisions set forth in this [certificate of incorporation] [partnership certificate and/or partnership agreement] [certificate of formation and/or company agreement], the Company shall conduct its affairs in accordance with the following provisions:

1. It shall establish and maintain an office through which its business shall be conducted separate and apart from those of [its parent and] any affiliate(s) or, if it shares office space with [its parent or] any affiliate(s), it shall allocate fairly and reasonably any overhead and expense for shared office space.
2. It shall not own and will not own any asset or property other than (i) the Property and (ii) incidental personal property necessary for the ownership or operation of the Property.

3. It will not engage, directly or indirectly, in any business other than the ownership, management and operation of the Property and it will conduct and operate its business as presently conducted and operated.
4. [For Corporate Borrower: Its Board of Directors shall hold appropriate meetings or act by unanimous consent) to authorize all appropriate corporate actions, and in authorizing such actions, shall observe all corporate formalities.]
5. It will not enter into any contract or agreement with [its parent,] any affiliate of the Company or any constituent party of the Company except upon terms and conditions that are commercially reasonable and substantially similar to those that would be available on an arms-length basis with unrelated third parties.
6. It has not incurred and will not incur any indebtedness, secured or unsecured, direct or indirect, absolute or contingent (including guaranteeing any obligation), other than (i) the indebtedness secured by the First Mortgage and (ii) trade payables or accrued expenses incurred in the ordinary course of the business of operating the property with trade creditors and in amounts as are normal and reasonable under the circumstances. No indebtedness other than the indebtedness secured by the First Mortgage may be secured (subordinate or pari passu) by the Property.
7. It has not made and will not make any loans or advances to any third party, including [its parent,] any affiliate of the Company or constituent party of the Company and shall not acquire obligations or securities of its affiliate(s).
8. It is and will remain solvent and will pay its debts and liabilities (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due.
9. It has done or caused to be done and will do all things necessary to observe organizational formalities and preserve its existence, and it will not amend, modify or otherwise change the [certificate of incorporation or the corporation's by-laws] [limited partnership certificate and/or limited partnership agreement] [certificate of formation and/or company agreement] without the prior written consent of the First Mortgage holder or, after the securitization of the Loan, only if the Company receives (i) confirmation from each of the applicable rating agencies that such amendment would not result in the qualification, withdrawal, or downgrade of any securities rating and (ii) approval of such amendment by the mortgagee holding the First Mortgage.
10. It will maintain all of its books, records, financial statements and bank accounts separate from those of [its parent,] its affiliate(s) and any constituent party and the Company will file its own separate tax returns. It shall maintain its books, records, resolutions and agreements as official records.
11. It will be, and at all times will hold itself out to the public as, a legal entity separate and distinct from any other entity (including [its parent,] any affiliate or

any constituent party of the Company), shall correct any known misunderstanding regarding its status as a separate entity, shall conduct and operate its business in its own name, shall not identify itself or any of its affiliates as a division or part of the other and shall maintain and utilize a separate telephone number and separate stationery, invoices and checks.

12. It will maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations.

13. Neither the Company nor any constituent party will seek or permit the dissolution, winding up, liquidation, consolidation or merger in whole or in part, of the Company, or acquire by purchase or otherwise all or substantially all the business or assets of, or any stock or other evidence of beneficial ownership of any other person or entity.

14. It will not commingle the funds and other assets of the Company with those of [its parent,] any affiliate or constituent party, or any affiliate of any constituent party, or any other person.

15. It has and will maintain its assets in such a manner that it will not be costly or difficult to segregate, ascertain or identify its individual asset or assets, as the case may be, from those of any affiliate or constituent party, or any affiliate of any constituent party, or any other person.

16. It shall not pledge its assets and does not and will not hold itself out to be responsible for the debts or obligations of any other person.

17. It shall pay any liabilities out of its own funds, including salaries of any employees.

18. The Company shall maintain a sufficient number of employees in light of its contemplated business operations.

19. The Company shall not guarantee or become obligated for the debts of any other entity or person.

20. [For Limited Partnership and Limited Liability Company Borrowers] It shall have a corporate [general partner] [managing member] which shall be organized to be a single purpose, "bankruptcy remote" entity with organizational documents substantially similar to the organizational documents of the current corporate [general partner] [managing member] of the Company.

21. The Company shall not form, acquire or hold any subsidiary.

For purpose of this Article ____, the following terms shall have the following meanings:

“affiliate” means any person controlling or controlled by or under common control with the Company, including, without limitation (i) any person who has a familial relationship, by blood, marriage or otherwise with any [director, officer or employee] [partner or employee] [member or employee] of the Company, [its parent,] or any affiliate thereof and (ii) any person which receives compensation for administrative, legal or accounting services from the Company [, its parent] or any affiliate. For purposes of this definition, “control” when used with respect to any specified person, means the power to direct the management and policies of such person, directly or indirectly, whether through the ownership of voting securities, by contract or otherwise; and the terms “controlling” and “controlled” have meanings correlative to the foregoing.

“parent” means, with respect to a corporation, any other corporation owning or controlling, directly or indirectly, fifty percent (50%) or more of the voting stock of the corporation.

“person” means any individual, corporation, partnership, limited liability company, joint venture, association, joint stock company, trust (including any beneficiary thereof), unincorporated organization, or government or any agency or political subdivision thereof.

6. Subordination of Certain Owner Rights

Special purpose language also forces the entity owners to subordinate their rights to indemnification by the entity to the lender’s loan. This subordination protects the lender by placing its loan at a superior position to a claim for indemnification by an owner of the entity. The Texas Business Organizations Code allows entities to place limitations on indemnification obligations in their certificate of formation or, for an LP, in the partnership agreement.⁵

See the following sample provisions:

SAMPLE 1: Any indemnification of the Company’s [directors and officers] [partners] [members] shall be fully subordinated to any obligations respecting the Property (including, without limitation, the First Mortgage) and such indemnification shall not constitute a claim against the Company in the event that cash flow necessary to pay holders of such obligations is insufficient to pay such obligations.

SAMPLE 2: [If the company agreement provides for a Company indemnity obligation, the following applies:] Any indemnification obligation of the Company shall (a) be fully subordinated to the Loan and (b) not constitute a claim against the Company or its assets until such time as the Loan has been indefeasibly paid in accordance with its terms and otherwise has been fully discharged.

⁵ Tex. Bus. Org. Code § 8.003 (Vernon 2006).

7. Conclusion

Special purpose entities are effective vehicles for real estate projects or other single-enterprise entities. Lenders require special purpose entities in order to protect their valuable collateral, and with proper negotiation, borrowers should be able to retain enough control and flexibility to profitably and effectively operate their businesses.