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Fox Rothschild Podcast

Featuring Partner David Jaffe in Pittsburgh

We are talking today with David Jaffe on Fox Rothschild Podcast. David is a partner with Fox Rothschild in Pittsburgh. He advises clients on corporate finance, mergers and acquisitions, restructuring and corporate governance. David recently authored an article about the decision of the Michigan Court of Appeals in Wells Fargo, N.A. v. Cherryland Mall Limited Partnership*, and the case's impact on loan markets and single purpose entity borrowers.*

***Question**: David, welcome to the podcast.*

David Jaffe: Thank you. Glad to be here.

***Question**: David, if the* Cherryland *decision is widely followed, do you envision any unanticipated adverse consequences on the limited recourse loan market*?

David Jaffe: The *Cherryland* case threatens major changes to limited recourse financings and to the availability of capital through loan securitizations. It could have profound effects on the debt capital markets generally and on single purpose entity borrowers in particular.

***Question:** David, for the benefit of listeners who may not know, what is "limited recourse financing"?*

David Jaffe: The fundamental tenets of limited recourse financing are asset isolation and borrower separateness. The basic bargain between a lender and a borrower includes limitations on the lender's ability to pursue recourse against the loan parties in exchange for covenants that prohibit the borrower from commingling assets, cash flows and operations with any other entity. These loans are prevalent in real estate development and in the construction industry and in other industries where project-specific financing is needed.

***Question:** David, how do these loans work?*

David Jaffe: In the classic limited recourse financing structure, a new legal entity is formed as the borrower for a financing. The organizational documents of the new entity and the loan documents contain extensive separateness covenants and limitations on the purpose and scope of permissible activities of the borrower entity, the latter being the so- called "SPE" covenants. The separateness and the SPE provisions are intended to insulate the lender's collateral and to reinforce the independent legal integrity of the borrower in such a manner that the assets and the entity remain "bankruptcy remote" beyond the reach of creditors other than the lender.

***Question:** David, are the loans guaranteed? Or do they stand on their own?*

Answer: The loans typically are guaranteed by the borrower's parent or a corporate affiliate in a position of control over the borrower that owns, directly or through affiliates, net assets in addition to the borrower's assets. But, and this is the key, because the lender has agreed to look solely to the assets financed for its source of repayment, its recourse against the guarantor is limited to a very narrow set of occurrences. These so called "bad boy" recourse triggers include things like voluntary bankruptcy filings by the borrower, asset transfers, encumbrances and, importantly in the *Cherryland* case, failure to maintain "single purpose entity" status. Any of these actions will trigger recourse against the guarantor for the total amount of the debt.

Question: *David, why are these types of structures important?*

David Jaffe: As a financing mechanism, commercial enterprises rely on limited recourse loans as a means of containing and mitigating risk. Unlike traditional bank loans, limited recourse loans generally don't contain extensive cross-default or cross-collateral provisions. So the impact of project failure is contained within the project itself. Moreover, because the loans are uniform, asset specific and bankruptcy remote, they are saleable to investors in the form of securitized loan pools. So a large, liquid and important capital market has evolved for issuers of non-recourse debt.

Question: *David, how did these issues come into play in the* Cherryland *case?*

David Jaffe: Cherryland Mall Limited Partnership obtained a mortgage loan that was guaranteed by one of its principals. Under the loan covenants, the borrower's failure to maintain its status as a single purpose entity would trigger recourse against the guarantor.

The borrower defaulted on its loan when it failed to make a mortgage payment. To recover the deficiency following a foreclosure action, the lender sued the borrower and the guarantor, arguing that the borrower's failure to make its payment constituted a breach of its covenant to remain solvent and pay its debts and liabilities. The lender argued that this solvency violation was a breach of the special purpose entity covenants triggering full recourse against the guarantor. The dispute in the case focused on the definition, or lack thereof, of the term "single purpose entity" and what was required of the borrower to maintain that status under the loan documents.

Question: *So David, what were the court's findings?*

David Jaffe: The court rejected the borrower's arguments that the loan documents failed to clearly define the term "single purpose entity." It reasoned that SPE status and separateness, while distinct concepts, are closely intertwined. It found that although the loan documents did not explicitly define the term "single purpose entity," all of the separateness covenants were commonly considered single purpose entity covenants based on the court's review of cases analyzing and interpreting similar loans. The court held that a violation of any separateness covenant was sufficient to negate SPE status.

Question: *Sounds like basic contract interpretation to me. What makes this case so important?*

David Jaffe: Specifically, with respect to the solvency covenant the court drew two conclusions that have far-reaching implications. First, that the solvency covenant was in fact an SPE

covenant the breach of which triggered guarantor recourse. Second, that the manner in which the covenant was breached had no bearing on lender's recourse rights. On the latter point, the court found no difference between solvency violations that were the result of volitional acts by the borrower – such as an unauthorized dividend payment, for example – and insolvency resulting solely from market conditions, which was the case in *Cherryland*.

Although the court recognized that the decision would have implications far beyond the case it was deciding, it was unwilling to "legislate from the bench" as they say, leaving the public policy implications of the case to the legislatures to sort out.

Question: *Do you think the case was wrongly decided or were the documents just bad?*

David Jaffe: *Cherryland* may very well be a classic case of "bad documents making bad law" but it's more than just a cautionary tale of bad draftsmanship. The court's conflation of the principles of separateness and single "purpose-ness," for lack of a better term, coupled with its conclusion that a mere decline in market value triggers a covenant breach, leads me to question whether these litigants (and the market participants generally) truly intended such a result. The court's reasoning renders the "bad boy act" recourse triggers superfluous and appears to contradict and undermine the fundamental premise of the non-recourse lending industry – which is, that some affirmative and conscious conduct by a loan party is required to trigger recourse.

Question: *David, what do you foresee as consequences on the limited- recourse loan market?*

David Jaffe: Many borrowers rely on a common guarantor to guarantee the obligations of multiple SPE borrowing entities. So the nightmare scenario that could occur is recourse against the common guarantor triggered by a default of a single immaterial covenant of a single SPE subsidiary could result in a cascading series of related entity defaults across the entire corporate enterprise. So if borrowers begin to feel threatened by this possibility, a wave of preemptive bankruptcy filings by limited recourse borrowers could occur.

Question: *David, in the "nightmare" scenario you describe, what are some of the challenges borrowers might encounter?*

David Jaffe: The resulting restructuring transactions are likely to have very significant federal income tax implications. To the extent that loans are modified or written down, borrowers are apt to incur material amounts of cancellation of indebtedness income on which tax will be owed. Furthermore, many borrowers are disregarded entities for tax purposes. So to the extent that loan covenants prohibit them from upstreaming funds, the debt cancellation income tax problem will be compounded by a phantom income issue where the parent corporation, as the ultimate taxpayer, has no cash to pay the tax bill.

There is one other noteworthy tax issue of particular significance to real estate developers. For assets accumulated through tax deferred exchanges, including the popular section 1031 like-kind exchanges, gains that have long been deferred could be accelerated and realized as loans are discharged and the underlying properties are conveyed or transferred in corporate restructuring or reorganization transactions.

Question: *So, David, what do you view as the industry fallout?*

David Jaffe: Use of common organizational structures by borrowers, combined with the virtually universal adoption of industry standard loan documentation of the type at issue in the *Cherryland* case, have conspired to make resolution of these issues critical to the continued viability of the limited-recourse lending market.

Question: *David, with all of this in mind, what are you advising clients?*

David Jaffe: In the interim, while the market sorts out the impact of this case, there are steps every issuer should take on a so-called "clear day" before loan defaults occur. First, commence an internal review of your loan portfolio and all related transaction documents to identify areas of possible default risk. Second, be proactive in engaging your lenders to seek concessions where necessary. Finally, be sure to retain competent and experienced counsel to guide you through these complexities.

Narrator*: Well, thank you David. Listeners, to receive a copy of David's article about the* Cherryland *case, please contact him at 412-391-6410 or at djaffe – that's D-J-A-F-F-E – at foxrothschild.com.*

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