

A Guide to Commercial Mortgage-Backed Securities: What You Should Know about the “New” Environment

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ABOUT THIS WHITE PAPER:

Commercial real estate investors need to make smart choices on where they get funds. Commercial mortgage-backed securities (CMBS) are becoming popular again, because they offer an easy way to access capital.

However, the rules changed after 2008. Many terms are no longer negotiable. And some lenders try to protect themselves by asking for onerous conditions—which *should* be renegotiated. How will you know which is which?

This paper will help. It shares useful background on the market—focusing on traditional CMBS and Fannie/Freddie programs. Then it examines examples of troublesome text in loan documents and couples these with suggestions on when it makes sense to renegotiate versus what you can't change. A table compares terms for traditional CMBS and Fannie/Freddie programs, so you may easily see the difference.

There is a growing requirement for investors to become a single-purpose entity (SPE). The end of this paper includes an appendix with specific requirements for SPEs, written in plain English.

Commercial mortgage-backed securities (CMBS)—once a major force in the market—are returning as a growing source of funding for commercial real estate (CRE) investors. This is due in part because they offer an easy way to access capital. For example, the end lender on a shopping center in Illinois could be a pension fund in Sweden, whose manager has never been to the United States. However, because of the 2008 residential real estate crash—and the larger financial crisis it spawned—the next phase of the CMBS story looks quite different from the last one.



You need to know if the CMBS approach makes sense for you. This paper offers a good start, with 1) some useful background on the market, 2) the legal hot spots you should understand when negotiating these loans, 3) new provisions in the “CMBS 2.0” world—where negotiating will benefit borrowers most, and 4) rationales for explaining requests for changes in contracts.

Two Main Types of CMBS and How They Work

CMBS finance commercial real estate loans by 1) bundling (or pooling) a large amount of mortgages into a single security, and 2) selling interests in that security. While you may remember CMBS being intricately involved in the recent financial crisis, it was actually born out of another crisis: for the savings and loans. In the aftermath of this situation, a government agency (the Resolution Trust Corporation) created pools of mortgages as a way to

efficiently move the huge volume of loans on the balance sheets of failed thrifts.¹

Let's focus on two major types of CMBS, starting with the traditional version.

This works much like a conventional loan. An originating lender—usually an investment bank or national institution—and a borrower negotiate and enter into a mortgage loan. The originator then sells or assigns the loan into a trust vehicle—which has a number of other mortgage loans. The CMBS is born.



Then it is sliced into tranches—or bonds—according to the amount of risk involved. Next, national agencies such as S&P or Moody's rate the bonds. As you would expect, the higher the risk, the lower the price. The bonds are priced accordingly, so institutional investors can buy them. As with any bond, the price moves in the opposite direction of its yield.

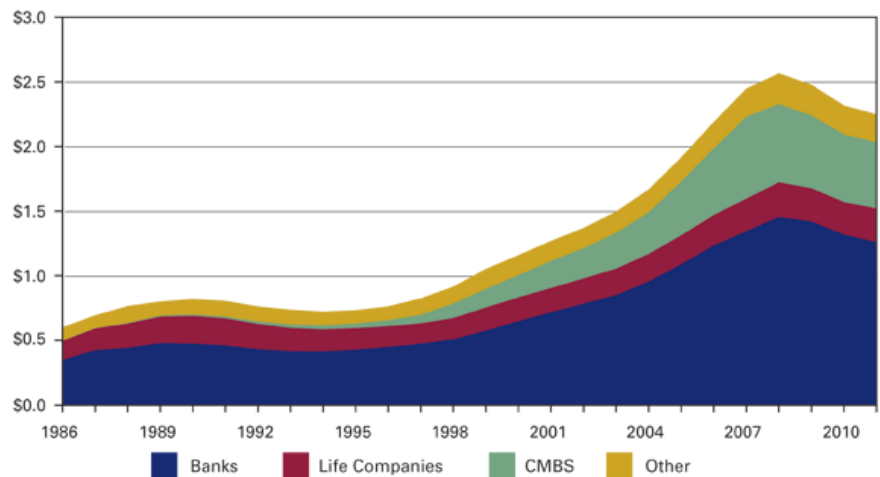
A pooling and servicing agreement governs the disposition of the loans in the pool. A servicer is hired to administer the loans: collecting payments, disbursing reserves, etc. When a loan encounters difficulty and/or default, it is handed over to a special servicer to work with the borrower on rectifying any problems.

The second type of CMBS is a “delegated program.” That means there is one buyer, usually Fannie Mae or Freddie Mac. The terms are demanded prior to a borrower's loan application, and usually are originated by a financial institution, such as an insurance company.

We will discuss both here.

¹ “The Past, Present and Future of CMBS,” by Sam Chandan, Wharton Real Estate Review, Spring 2012.

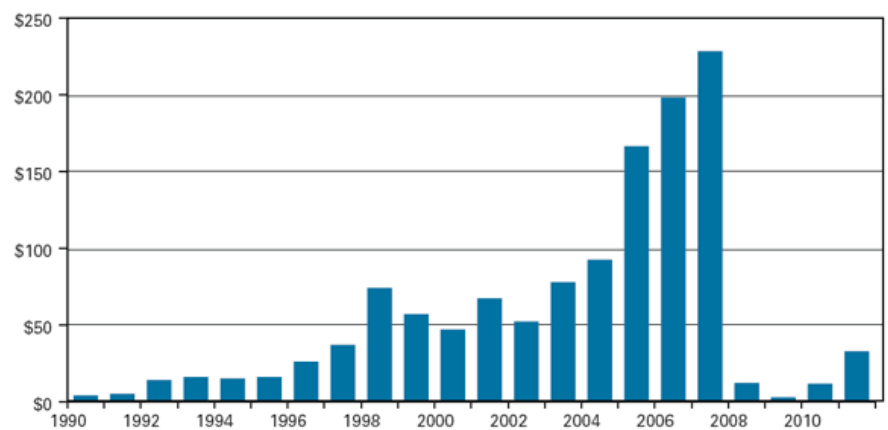
The Growing Importance of CMBS Loans U.S. Commercial Real Estate Loan Originations



Since their introduction in the 1990s, CMBS significantly increased their share of commercial real estate loans originated in the U.S.²

CMBS Returning from a Trough

Total Amount of CMBS per Year in the U.S.



The amount of CMBS grew most dramatically in the early 2000s, peaking at over \$200 billion in 2007. While that number collapsed to under \$3 billion in 2009, it still represents a significant opportunity for CRE investors.

² Chandran and Federal Reserve

Key Terms

Single-purpose entity (SPE) – CMBS lenders require a borrower to be an SPE. This means the only thing the borrower—or the entity that is receiving the loan—owns is the property. The operation can't have any other debt or do any other deals. This can give smaller borrowers some pause, because they're not used to this approach—and the filings involved can cost in the \$1,000 range. But to qualify for a CMBS, you need to be an SPE. (See the appendix at the end of this paper for SPE requirements.)

Non-consolidation opinion – This is issued by a law firm or lawyer most often licensed in Delaware—because of that state's well-developed corporate laws. The opinion states two basic points. One: if the borrower goes bankrupt, it won't pull in any other organizations—such as the lender—to gain access to their assets. Two: the borrower has no “sister companies”—or close relationships with other operations—that could attach its cash or assets if they go broke. In technical terms, the operation isn't consolidated with any other.

Non-dissolution opinion – This opinion states that the SPE has one or more directors on its board who are not related (by business or personal relationships) to those who own the business. When determining if a company should declare bankruptcy, a majority of the board must vote to take this action. The idea is that independent directors are less likely to approve a bankruptcy because their personal interests aren't tied to the SPE. That makes it harder to file for bankruptcy—and get out of repaying the lender.

Why CMBS Terms Changed

The *beauty* of CMBS loans was that they “allocated risk.” Each loan became part of a larger bond that was sliced and distributed globally. Unlike a single loan in a portfolio, no one lender suffered the full brunt of a failing loan. But this allocation of risk also turned out to be the *problem* with CMBS loans. When commercial real estate followed the residential market into a downturn, many “lenders” suffered losses.

This led to stricter underwriting for CMBS loans. Items that were negotiable in 2007 are likely to be off limits now. Today's CMBS pools have much lower loan balances and numbers of loans, fewer interest-only components, and significantly higher debt service coverage ratio requirements.

This is partially due to changes in regulations for the companies that create the loans. Originators now are required to retain an interest in their CMBS. That means they often own a slice of the tranches. In addition, should something “go wrong” with the underlying loans, it now is easier for CRE investors to sell their CMBS bonds back to the originator.

Gone are the “wild west” days of an originator just wanting to package and sell a CMBS, get its money, and not caring how the loans performs after that. As a result, pool sizes are smaller—so each loan matters more. Debt service coverage is stricter, since the originator must bear some of the risk. In addition, originators are less likely to be flexible on legal or business terms that will potentially harm the loans' resale values.

Hot Spots in Traditional CMBS Loans

As a CRE investor, you should pay particular attention to these areas in traditional CMBS loan contracts. Each section offers language to include or avoid—and the reasons why.

SINGLE-PURPOSE ENTITY REQUIREMENTS AND INDEPENDENT DIRECTORS

Single-purpose entity (SPE) requirements in loan documents are probably the most common and most controversial aspects of CMBS loans. Most commercial mortgage loans require borrowers to be SPEs. However, SPE requirements for CMBS tend to be particularly strict because of the standardized nature of the loans that go into them. Many require non-consolidation and non-dissolution legal opinions.

Much of this was thrown into disarray by the General Growth (GG) bankruptcy.⁴ In that case, the holding company and many financially healthy SPE borrowers under CMBS loans *all* filed for bankruptcy protection. The borrower brought the healthy SPEs into the case to use their cash flow to help pay for the parent company's reorganization.

This filing violated the SPE provisions of many of the GG entities' CMBS loan documents—because you had one related entity assisting another. It also weakened the Independent Director Doctrine idea. This means the lender requires the borrower LLC to have a member with no relationship or

⁴ *In re: General Growth Properties, Inc., et al., Debtors*, 400 B.R. 43 (2009)

economic interest in borrower. The purpose of this is to have a roadblock to a bankruptcy filing.

The court in the GG case rejected the GG lenders' motions to dismiss the bankruptcy filings. This happened because the independent directors voted in favor of them, saying, "If Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken."⁵

Naturally, CMBS 2.0 loan documents now reflect a response to the GG case. Although not an entirely settled law, this case threw the enforceability of standard CMBS SPE covenants into doubt. SPE requirements (you may find them all in the appendix) now commonly include the following new provisions, each from 2013 originations. *The text in red is important, and the words that are crossed out are unfavorable to you and should be removed from any agreement:*

- (a) **to the extent the Property produces sufficient revenue, becomes insolvent and fails to pay its debts and liabilities** (including, as applicable, shared personnel and overhead expenses) from its assets as the same shall become due;
- ~~(b) share any common logo with or hold itself out as or be considered as a department or division of (i) any general partner, principal, member or Affiliate of Borrower or of Principal, as the case may be, (ii) any Affiliate of a general partner, principal or member of Borrower or of Principal, as the case may be, or (iii) any other Person;~~
- ~~(c) fail to allocate fairly and reasonably any overhead expenses that are shared with an Affiliate, including paying for office space and services performed by any employee of an Affiliate;~~

The point made under (a) is clearly a reaction to the GG case. However, the first clause is highlighted because it gained importance in a case called *Cherryland Mall*. In *Cherryland*,⁶ the equivalent SPE provision to (a) read:

Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities ... from its assets as the same shall become due.

Notice the difference from (a), with its "to the extent the Property produces sufficient revenue ..." In the *Cherryland* foreclosure case, the property was sold at a \$2.1 million deficiency. The court ruled that because the property lost value—which caused the deficiency—it was insolvent. This triggered recourse against the guarantor.⁷

The Michigan legislature quickly passed a law to reverse the court's decision. However, the *Cherryland* lender is suing the state, challenging the constitutionality of the new law.⁸ Here's what this means to you. When negotiating this provision, be sure to include the highlighted portion, which seems to be a fix.

⁵ *Id.* at 64.

⁶ *Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership and David Schostak*, 2011 Mich. App. LEXIS 2360 (2011).

⁷ *Id.* at 42.

⁸ <http://www.mckennaloug.com/publications-advisories-2946.html>

Items (b) and (c) are also challenging. (b) is just unreasonable. I have had it removed from loan documents because an SPE may be part of a greater “brand.” For example, AMLI has many apartment buildings that are called “AMLI (building name).” (c) is also problematic. It seems to deny the existence of an SPE in the first place, since sharing resources with an affiliate clearly entails a closer relationship than the GG “unrelated” entities had. This also should be removed.

One other development is the application of the Independent Director Doctrine to loans of *all* sizes. Previously, I encountered this on loans starting at \$15 million or \$20 million, depending on the lender. Now it is appearing at significantly lower amounts. I recently encountered two loans—at \$7 million and \$12 million—that required independent directors.

However, there is wiggle room within the Independent Director Doctrine. Here is a common requirement for independent directors:

~~Provided by a nationally recognized company that provides professional independent directors, managers and trustees~~

I have successfully stricken the “professional” independent director requirement for some smaller loans. The rationale is that it’s an unfair cost in a low-pain situation to require the borrower to hire, for example, CSC as an independent director. In one 2013 loan, I convinced the lender to allow the principal’s son to be the independent director.

FINANCIAL REPORTING REQUIREMENTS

Financial reporting requirements before securitization have changed with the market, too. For example, in a vintage 2007 CMBS, these were the loan requirements:

Until the earlier to occur of (A) **eighteen (18) months** following the date hereof, or (B) a Secondary Market Transaction, Mortgagor shall furnish monthly each of the items listed in subsections 17(b)(ii)(A), (B) and (C) below, but dated as of the last day of each such month (collectively, the “Pre-Securitization Financials”) within twenty (20) days after the end of such month.

Here is the language in a loan from 2013:

Prior to any Secondary Market Transaction, Borrower shall furnish to Lender, within twenty (20) days after the close of each calendar month, (i) a current Rent Roll (on a trailing twelve [12] month basis) together with an Officer’s Certificate certifying that such Rent Roll is true, correct and complete and (ii) operating statements (including Capital Expenditures) prepared for such calendar month, noting Net Operating Income, Gross Income from Operations, and Operating Expenses, and other information necessary and sufficient to fairly represent the financial position and results of operation of the Property during such calendar month.

The extra financial disclosures (which often make borrowers bristle) *burn off after 18 months in the “old” CMBS*. In the new CMBS, the extra requirements

What You Should Know about Defeasance



Repaying your CMBS loan early—because you have the cash or sold the properties on which it was based—doesn't mean you are "off the hook." You need to replace that revenue to your lender, which is called defeasance.

When CMBS loans are sold, buyers are promised a regular revenue stream for a number of years. If you repay yours in advance, they are deprived of this income. Replacing it requires two actions: 1) purchasing US Treasuries (or similar approved securities) that will provide a comparable cash flow stream, and 2) creating a straw man corporate entity to become the "substitute borrower" and make the remaining monthly payments.

are in effect until securitization. I believe the rationale is that in the prior version, after 18 months, the originator believes it will never sell the loan. That means the loan is "stale," so it does not need the extra disclosures to market the loan.

In CMBS 2.0, market disruptions are on originators' minds. They believe it could take more than 18 months to package a loan. I have not been successful in getting these extra requirements waived—but you as a CRE investor need to be aware of them.

ASSUMPTIONS AND TRANSFERS BY THE BORROWER

Assumptions have always been a good way for a borrower to get out from under a CMBS loan when it wants to sell the property but does not want to go through the defeasance process. In prior versions of documents, assumption provisions generally looked like bank loan assumption provisions, with the exception of needing to placate ratings agencies. One new provision I have seen in some recent loans requires a non-consolidation opinion. For example:

Transferee shall deliver to Lender an opinion of counsel from an independent law firm with respect to the **substantive non-consolidation [non-dissolution]** of Transferee and its constituent entities (partners, members or shareholders), which law firm and which opinion shall be satisfactory to (i) Lender, if a Securitization has not occurred, or (ii) Lender and the Rating Agencies, if a Securitization has occurred.

The non-consolidation requirement is problematic. After GG, non-consolidation opinions have gone from a range of \$5,000 to \$10,000 and now reach \$20,000 to \$30,000. This is an extraordinary cost for a new borrower! I have proposed to provide *non-dissolution* opinions. These opinions say it is difficult or unlikely that the borrower will be able to dissolve itself—something made even less likely with the independent director requirement. Non-dissolution opinions cost less than non-consolidation opinions.

Another problem is the perceived limit on assumptions:

Notwithstanding anything to the contrary contained in Section 5.2.10 hereof, Lender shall not unreasonably withhold its consent to a **one-time** sale of the Property provided that (i) Lender receives at least sixty (60) days prior written notice of such transfer, (ii) no Event of Default has occurred and is continuing both at the time such notice is given and as of the closing date of such transaction and (c) upon the satisfaction of the following conditions precedent ...

While this provision has generally remained intact from CMBS 1.0 to CMBS 2.0, it is a bigger problem now. With de novo loans still harder to secure since 2009, and interest rates now rising, I am becoming involved in more loan assumptions for both buyers and sellers. This provision has traditionally been interpreted by lenders to mean a limit of one transfer during the life of the loan. That makes it important to try to eliminate the reference to the "one-time" transfer, because it will make the property harder to sell.

BECOMING LESS FLEXIBLE: DEFEASANCE DEPOSITS

In the past, when borrowers defeased a loan, they could have the following language (in italics) changed:

Maker shall pay to Payee an amount equal to the full principal amount of this Note together with an additional amount such that the aggregate amount (the “Defeasance Deposit”) is at least sufficient to purchase direct, non-callable obligations of the United States of America, *including obligations of agencies of the United States* (the “Defeasance Collateral”)

Traditionally, there has been no difference between 10-year Treasury securities and obligations of U.S. agencies, such as Fannie/Freddie, etc. In the past, I’ve seen AAA-rated agency obligations approved, but I have not gotten that change in the CMBS 2.0 environment. This appears to be related to the downgrade of U.S. debt.

SECURITIZATION/SECONDARY MARKET TRANSACTION COOPERATION

A disturbing trend has developed that could cost you money and create heartache when it comes to securitization. All sides agree that the securitization process is stricter now. One question is who should bear the risk of having to jump through hoops. Compare the following sections on the borrower’s cooperation with the lender in connection with a secondary market transaction:

Old:

Mortgagor shall cooperate with Mortgagee in effecting any such Secondary Market Transaction and shall cooperate to implement all requirements imposed by any Rating Agency involved in any Secondary Market Transaction, including but not limited to ...

New (example based on analysis of many forms):

If requested by Lender, Borrower and Guarantor shall assist Lender **in satisfying the market standards to which Lender customarily adheres or which may be reasonably required in the marketplace** or by the Rating Agencies in connection with any Secondary Market Transaction, including, without limitation, to ...

This is an issue. I have been on the lender and borrower sides when the lender has gone back to the borrower—after the close—to clarify or amend a loan document because of the “ratings agencies” or “securitization.” Even an error by the lender’s counsel can lead down this path.

Ratings agency and securitization criteria have always been explicit. It should be unnecessary to go back to the borrower and ask for modifications: some of which could be material, and all of which will cost the borrower legal fees. To open this up to market standards in an environment that still has not fully corrected itself should be a non-starter. This comment should be stricken from any secondary market transaction discussion.

Fannie and Freddie Loans

The CMBS discussion would not be complete without mention of the “government agencies” Fannie Mae and Freddie Mac (the GSEs), which have a large portion of the multifamily lending market. Here are some important facts:

- Fannie and Freddie funded over 70 percent of the multifamily market in 2009. By 2011, their share was down to 50 percent.⁹
- In 2012 alone, Freddie funded \$28.8 billion in loans.¹⁰
- 95 percent of Freddie’s second quarter 2013 loans were earmarked for securitization (up from 29 percent in 2009).¹¹

If you own multifamily properties, one avenue you can take is doing a deal with a GSE—or more accurately, with a financial institution that packages loans for a GSE to receive. Only choose this path if the following terms are acceptable to you—because they are non-negotiable:

- An SPE is required for almost all loans greater than or equal to \$5 million.
- A non-consolidation opinion is required for almost all loans greater than or equal to \$25 million.
- Nearly all loans greater than \$50 million require a hard cash management agreement. This means your tenants make their payments to a lender lockbox—not to you. The lender also holds taxes and insurance in escrow. Any funds beyond your loan payments and escrow are forwarded to you.
- An independent director may be required for large loans on a case-by-case basis.

I have successfully revised Fannie’s loan documents in the transfers and assumptions arena. This, however, only happens with relatively large “institutional” borrowers.

Traditional CMBS versus Fannie Mae Loans

The primary drawback of GSE loans is that they generally are non-negotiable. But Fannie’s latest loan documents compare favorably against more traditional CMBS lenders on some terms:

	TRADITIONAL	FANNIE
Voluntary Prepayment	Defeasance or yield maintenance required	Full prepayment (after lockout period) with prepayment premium
SPE Requirements	Frequent independent director	Rare independent director
Pre/Post-Securitization Financials	Different disclosures and frequencies	No difference
Non-Consolidation Opinions	May be required, and form often requires in connection with assumption	Not required
Loan Assumption	“One time” provision	No limit

⁹ https://www.fanniemae.com/content/fact_sheet/multifamilyoverview.pdf

¹⁰ http://www.freddiemac.com/multifamily/pdf/mf_securitization_investor-presentation.pdf

¹¹ *Id.*

Borrower Be Aware

As the commercial real estate market continues to rebound, you may feel the relief of finally being able to do deals. However, when it comes to CMBS loans, some of the rules have changed. Areas that once were negotiable no longer offer that flexibility. And lenders—in an effort to protect themselves and hedge their bets—may ask CRE investors to take on more risk and costs.

It's important to know the accepted practices in the CMBS 2.0 environment. You also need to understand what constitutes an unreasonable request, and how to negotiate more balanced provisions in a contract. This paper offers areas I have frequently encountered and makes suggestions on what to do.

My best recommendation is to work with an attorney who has recent experience with CMBS. Someone who knows the ins and outs of traditional and GSE loans—and which is the best match for your needs—can save you a great deal of time, money and frustration. This will free you to focus on what you do best: creating and operating a successful property portfolio.

Appendix: Single-Purpose Entity Requirements

Here are the legal requirements for a single-purpose entity (SPE), in relatively plain English.

1. While the loan is outstanding, your company will *not* do any of these things:
 - a. Engage in any business or activity other than owning, operating and maintaining the property (because that's truly the "single-purpose" of this business).
 - b. Acquire or own any assets other than 1) the property and 2) any incidental personal property that's necessary for conducting the business of owning and running the property.
 - c. Merge into or consolidate with any person.
 - d. Dissolve, terminate or liquidate—in whole or in part—or transfer or dispose of most of or all of its assets.
 - e. Change its legal structure.
 - f. Fail to observe all of the organizational formalities; fail to preserve its continuing operation as a company in good standing under the legal requirements of the state in which it's incorporated; or amend, modify, terminate or fail to comply with the provisions of its organizational documents.
 - g. Own any subsidiary, or make an investment in any person.
 - h. Combine its assets with the funds or assets of any other person.
 - i. Get into any debt—secured or unsecured, direct or contingent (including guaranteeing any obligation)—other than 1) the debt involved in this loan, and 2) trade and operational debt that's related to the ordinary course of business with trade creditors. It's fine for your company to have the following kinds of debt with trade creditors:
 - a) unsecured, b) not related to a note, c) on commercially reasonable terms and conditions, and d) due not more than 60 days past the date incurred and paid by that time. Leases on equipment to run the business also are permitted. However, the aggregate amount

- of the indebtedness on leases described in points 1) and 2) can't exceed 2 percent of the outstanding principal amount of the debt. No indebtedness on any other debt may be secured (whether that's subordinate or parri passu—on equal footing) by the property.
- j. Fail to maintain all of its books, records, financial statements and bank accounts separate from any affiliates and related parties. Your company's assets have not and will not be listed as assets on the financial statement of any other person. However, your company's assets may be included in a consolidated financial statement of its affiliates. This is fine if these two provisions are met. One: the notes to the consolidated financial statements for the affiliate indicate that your company is separate from the affiliate, and that your assets and credit are not available to satisfy the debts and other obligations of that affiliate or any other person. Two: your assets are listed on your own separate balance sheet. Your company has maintained and will maintain its books, records, resolutions and agreements as official records.
 - k. Enter into any contract or agreement with any general partner, member, shareholder, principal or affiliate—unless the terms and conditions are fair and similar to those that would be available on an arm's-length basis with unaffiliated third parties.
 - l. Maintain its assets in a way that makes them costly or difficult to segregate, find or identify from those of any other person.
 - m. Assume or guaranty the debts of any other person, hold itself out to be responsible for the debts of any other person, or otherwise pledge its assets for the benefit of any other person. Your company also can't hold out its credit as being available to satisfy the obligations of any other person.
 - n. Make loans or advances to anyone.
 - o. Fail to file its own tax returns, unless it's prevented from doing this by legal requirements.
 - p. Fail to 1) hold itself out to the public as a legal entity—separate and distinct from any other person, 2) conduct its business solely in its own name, or 3) correct any known misunderstanding about its separate identity.
 - q. Fail to maintain adequate capital to meet normal business expenses that are reasonably foreseeable in a company of its size and character, and in light of the business it expects to do (to the extent there's enough cash flow from the property to do this).
 - r. Without the unanimous written consent of all of its partners or members 1) file or consent to the filing of any petition—either voluntary or involuntary—to take advantage of any Creditors Rights Laws; 2) seek or consent to the appointment of a receiver, liquidator or any similar official; 3) take any action that might cause the company to become insolvent; or 4) make an assignment for the benefit of creditors. In some cases, “partners or members” will include an independent director, who can be engaged at the company or at the SPE Component Entity level.
 - s. Fail to allocate shared expenses (including shared office space) or fail to use separate stationery, invoices and checks.
 - t. Fail to pay its liabilities (including salaries of its own employees) from its own funds, or fail to have enough employees to handle its expected

- business operations (in each case, to the extent there's enough cash flow from the property to do this).
- u. Change your company's name or its principal place of business.
 - v. Acquire the obligations or securities of its partners, members, shareholders or other affiliates.
 - w. Violate the assumptions about the company and its principals included in any Non-Consolidation Opinion or New Non-Consolidation Opinion.

If a two-tiered SPE is required, you will need to use #2 and perhaps #3.

2. **If your company is a partnership** – each general partner must be a corporation or an acceptable LLC. **If your company is a limited liability company that is not an acceptable LLC** – at least one member of company must be a corporation or an acceptable LLC. In either case, each must be an “SPE Component Entity,” whose sole asset is its interest in the company. The SPE Component Entity will at all times comply with each of the terms in Subsections a. through f., as well as h. mentioned above. In addition, it has to comply with Subsections v. or w. if the SPE Component Entity owns its respective interests in your company.

If SPE Component Entity is an acceptable LLC, it must comply with Sections #3 and #4 below, as if any representation, warranty or covenant was made directly by the SPE Component Entity. The SPE Component Entity can't have any business or activity other than owning an interest in your company. It will not acquire or own any assets other than its partnership, membership, or other equity interest in your company. It must continue to have no less than a 0.5 percent direct equity ownership interest in your company. It will not incur any debt: secured or unsecured, direct or contingent (including guaranteeing any obligation). And it will make sure your company complies with the provisions of this Section.

If your company is a Delaware or Maryland Single Member Limited Liability Company, then #3 and #4 will apply.

3. There may be times when the last remaining member of the company must stop being a member. This could happen for two reasons. First, the member has assigned all of its limited liability company interest to someone else, in accordance with the loan documents. Second, the member resigned, and another member was admitted, in accordance with the terms of the loan. In any other situation, the company has two options to appoint a new member. One: any natural person who is designated under the company's organizational documents. Two: any person acting as an independent director of the company (if one is required). This person shall become a member of the company with a zero percent economic interest (called a “special member”) and shall continue the company without dissolving it.

The special member may not resign or transfer its rights unless a) a successor special member has been admitted to the company, in accordance with the requirements of Delaware law; and b) there is still at least one independent director after the resignation or transfer.



Here are five other important points about special members. One: a special member will automatically stop being a member of your company as soon as the first substitute member joins. Two: the special member must have no interest in the company's profits, losses and capital, and has no right to receive any distributions of the company's assets. Three: under Delaware's limited liability company act, the special member can't be required to make any capital contributions to the company and can't receive a limited liability company interest. Four: the special member may not bind the company. Except as required by the Act, the special member has no right to vote on, approve or otherwise consent to any action by—or matter relating to—the company. This includes mergers, consolidations or conversions, as long as this doesn't limit the special member's capacity as an independent director to vote on the matters required by the loan. Five: before becoming a special member, this person can't be a member of the company, but could have served as an independent director.

4. Sometimes a person can't be a member to the fullest extent permitted by law. When this happens, within 90 days the member's personal representative must agree in writing to a) continue the company, and b) admit the personal representative or someone it nominates as a substitute member of your company. Any action initiated by or brought against a member or special member (under Creditors Rights Laws) can't stop members or special members from being a member of your company. Should this happen, the company will continue without being dissolved. Each member and special member waives any right it has to dissolve the company if any action taken against the member or special member under any Creditors Rights Laws, or if something else happens that prevents them from being a member of your company.
5. As long as the loan remains outstanding, your company can't allow direct or indirect transfers of ownership interests that would violate the provisions of the loan agreement.
6. While the loan is in place, any obligation your company has to indemnify its directors and officers, partners, members or managers is subordinate to the loan. No indemnity payment from company funds (versus funds from other sources, such as insurance) can be paid from money that was allocated to any other person under the loan documents.
7. As long as the loan is outstanding, your company can't amend, end or otherwise alter the provisions of the loan without your lender's prior written consent.
8. There must always be at least one duly appointed independent director. Independent directors must meet these criteria. At the time when they are appointed—for the five years before this, and while they are serving as independent directors—they can't have been a shareholder (or other equity owner) of, or an officer, director (other than an independent director), partner, member or employee of your company.

This also applies to any of your company's shareholders, partners, members, subsidiaries or affiliates. They can't be a customer of, or

supplier to, or other person who derives any of its purchases or revenues from its activities with your company or any of its shareholders, partners, members, subsidiaries or affiliates. They can't control or be under the control of any shareholder, officer, director, partner, member, employee supplier, or customer. And they can't be a member of the immediate family of any shareholder, officer, director, partner, member, employee, supplier, or customer. When appointed, they must have at least three years of experience in serving as an independent director, and be employed by, in good standing with, and engaged by your company in connection with an approved independent director provider.

9. This is another requirement for SPEs that must have independent directors. The board of directors or managers of your company and its constituent members can't take any action that requires a unanimous vote of these two groups unless at least one independent director is involved.

The resignation, removal or replacement of any independent director won't be effective unless the lender and the rating agencies receive written notice at least two business days before the change happens. This must be accompanied by evidence that the replacement independent director satisfies the terms and conditions of the loan and your company's organizational documents.

Independent directors will only consider the interests of the constituent members and your company (including its creditors) in acting or otherwise voting on matters that are related to your loan and your company's organizational documents. In each case, independent directors will base their decisions only on the extent of their economic interests in your company. That means they can't make decisions based on a) all other interests (including those of the constituent members), b) the interests of affiliates of the constituent members and company, and c) the interests of any group of affiliates of which the constituent members or company is a part.

Other than those already mentioned, independent directors can't have any fiduciary duties to constituent members, any directors of your company, or any other person. Independent directors will operate in good faith and fair dealing under the applicable laws. An independent director won't be liable to your company, any constituent member, or any other person for breach of contract or breach of duties (including fiduciary duties), unless the independent director acted in bad faith or engaged in willful misconduct.

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Sam Lichtenfeld is a Partner in the Corporate and Real Estate Practice Groups. Sam represents clients in a wide range of areas, including commercial real estate, asset-backed and mezzanine loans; real estate acquisitions, dispositions and financings; and fund formation and joint ventures. In addition, Sam has extensive experience nationwide in representing multi-family investment companies in acquisitions, disposition and the financing of apartment buildings.

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