

# Strategic Entity Formation Issues & Recourse Beyond The Collateral

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## Overview of Entity Types

- Review of Borrower Entity Issues
  - Key Entity Issues
  - Overview of Different Entity Types
- Lender Concerns Regarding Borrower Entity Types
  - Lender's Role in Reviewing Entity Structures
- The Role of Entity Types in Loan Workouts
  - Borrower Issues vs. Lender Ownership Issues
- Purposes for Single Asset or Single Purpose Entities
  - The pluses and minuses of using an SPE

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## Borrower Entity Structures

- Allocation of Recourse Liability Depending on Entity Type
- Use of Entities to Address Tax Considerations
  - Active vs. Passive Roles
- Role of Entities in Estate Planning
  - Boundaries of Lender Cooperation
- Relationships Between Co-Investors
  - Management Issues
  - Capital Investment Issues

- Role and Extent of Management
  - Stability and Continuity of Management
  - Flexible Use of Due on Sale Restrictions
- Sources of Capital Funding
  - Timing of Equity Contributions – Lender Concerns
  - Future Equity Contributions – Lender Controls
  - Role of Investments vs. Loans – Lender Restrictions
  - Permissibility of Investor Distributions – Lender Controls

- Corporations and Limited Liability Companies
  - Owner Managed vs. Third Party Managers – Lender Restrictions
  - Authorization to Sign – Lender Controls
  - Changes in Management – Lender Beware of Pre-Arranged Workout
  - Relationship of Subsidiary or Affiliated Entities

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## Unique Issues for Partnerships

- **General Partnerships/Joint Ventures**
  - Effect of Bringing in New Partner – Management and Liability Issues
  - Replacing Partners – Lender Concerns
- **Limited Partnerships**
  - Differences in Changing or Adding General Partners vs. Limited Partners
  - Areas of Focus for Lenders with Multi-Tiered Structure

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## Reaching Beyond Liability Shield

- **Inter-Company Debt Issues**
  - Why Subordination Agreements are Important
  - Priority In A Bankruptcy Proceeding
- **Claw-Back of Owner Distributions:**
  - Role of Insolvency due to Distributions
  - Improper Dissolution under Organizational Documents
  - Must Pay All Creditors As Part of or Prior to Orderly Dissolution
- **Bankruptcy Concepts**
  - Preferential Transfer Rules
  - New Debt for New Collateral
  - Cooperative Bankruptcy

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### Summary; Final Thoughts

- Creativity Within Each Variation of Entity Type Need Not Be Unduly Limited By Lenders
- Each Entity Structure Includes Limitations and Opportunities For Lender
- Bankruptcy Risks Change Substantially Based on Entity Types



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## Overview of Guarantor Recourse Issues

- Recourse -- Statutory, Contractual and Practical Concerns
  - Statutory Limitations on Recourse Under State Law
  - De Facto Limitations on Recourse Resulting From the Structure of the Deal and/or The Parties
  - Contractual Limitations on Recourse
- Recourse Against Third Parties – i.e., Guarantors, Investors, Title Companies and Others
- Alternatives to Recourse Only Against The Property and The Borrower

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## Statutory Recourse Limitations

- **Anti-Deficiency Rules (CCP Section 580)**
  - Restricts Recourse to the Collateral
  - Protections for Borrowers Usually Extended to Guarantors
- **One-Action Rules (CCP Section 726)**
  - Establishes Method of Pursuing Recourse When a Debt is Secured by Real Property
  - May Obtain Waivers of 580 and 726 Protections to Pursue Other Remedies or Other Collateral
  - Exceptions – Environmentally Impaired Property, Letters of Credit and Other Collateral

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## Practical Recourse Limitations

- De Facto Recourse limitations
  - Single Asset Borrower
  - Third Party Pledgor of Real Property Collateral
  - Damage, Destruction and Condemnation – Application of Proceeds

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## Contractual Recourse Limitations

- Construction Loans
  - Rarely Include Recourse Limitations, Other Than De Facto Limits With an SPE Borrower
- Term Loans With Limited Recourse Provisions
  - Standard “Bad-Boy Carve-Outs”
  - Springing Recourse
  - Recourse Burn-Offs
  - Recourse Allocation Among Several Guarantors

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## Lender Issues

- **Guaranties**
  - Payment Guaranty – Full, Limited, Springing or Burn-Off
  - Completion Guaranty
  - LTV Maintenance Guaranty – Continuing Obligation or Springing
  - Debt Service Guaranty – Pre and Post Default
- **Waivers of the Anti-Deficiency/One-Action Rules**
  - Language Must be Clear and Precise
  - Must Be Up To Date

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## Enforcing Guaranties

- Enforcing Guaranties
  - Actions On Guaranties Can Be Included In a Foreclosure Action, Pursued Separately Or Pursued After a Foreclosure Sale
    - Beware of Fair Value Limitations on Recovery
    - Beware of “True Guarantor” Issues
  - Completion Guaranty – Cannot Compel Construction, so May Have to Settle For Money Judgment
    - Liquidated Recovery Approach
  - Inclusion of Bad Boy Carve-Outs In Completion or payment Guaranties

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## Lender Issues (Part 2)

- Funding or Equity Agreements
  - Used with Equity Investors and Similar Parties
  - Direct Obligation Vs. Surety Obligations
  - Used With or Without a Separate Note
- Third Party Accommodator
  - Usually Subject to Recourse Limitations
  - Guarantor Waivers
  - Consideration is always an Issue

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## Alternative Protections

- **Cash Management; Reserves**
  - Springing Lockbox or Soft Lockbox
  - Changes In Waterfall Provisions
  - Application of Reserve or Other Excess Funds
- **Financial Covenants**
  - Usually Triggers Defaults, Not Recourse
  - Can Use Specific Enforcement if Specified in Loan Documents
- **Monetary Penalties**
  - Convert Non-Monetary Defaults to Monetary Defaults



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### Summary; Final Thoughts

- Plenty of Room For Creativity Within Each Variation of Recourse Limitations
- If Limiting Recourse, Understand the Options and Overlap Between Involuntary and Voluntary Recourse Issues
- Look Beyond the Borrower and the Collateral to Improve Recovery

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