INSIDE THE MINDS

Financial Services Enforcement and Compliance

Leading Lawyers on Outlining Recent Regulatory Changes and Developing Effective Review Processes

ASPATORE

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Establishing Effective Compliance Programs for Real Estate Borrowers and SPE Covenants

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Introduction

The last twenty-five years have brought sea changes to the relationship between real estate owners and the capital markets. The industry has moved from a model dominated by the private developer-owner who, operating in a partnership (or tiers of related partnerships), borrowed against the security of each project, sometimes backed by a personal guaranty, from a lender who carefully underwrote the particular security and the borrower and then kept the loan on the lender's own balance sheet. Today, developers' access to capital markets looks very different: developers frequently seek equity by operating in the form of publicly traded real estate investment trusts, and debt is often originated by a lender who anticipates selling it, through one or more steps, to the trustee of a real estate mortgage investment conduit (REMIC), which sells interests in the debt (or "securitizes" it) to investors.

The New Compliance Landscape

The reason for the new models, from the developer's perspective, is enhanced access to less expensive capital. The price to the developer is, in large part, a compliance regime that seems very demanding to those who remember the old days of minimal reporting and few constraints. The most obvious costs are on the equity side, in the form of the reporting requirements for a public company. Whether because of the involvement of underwriting investment banks, regulatory oversight from the Securities Exchange Commission (SEC), or a healthy fear of the liability that goes with flawed disclosures, these concerns are readily apparent and typically the subject of great attention for the newly public company.

Much less appreciated, and therefore frequently troublesome, are the compliance problems in the new borrowing regime. These concerns deserve much greater attention, both at the time the loan is extended and during the life of the loan. Developers can build a compliance system to protect themselves both by careful examination of the obligations they undertake in each loan and by ensuring that they administer the loan in a way that protects them from unanticipated liability and defense expenses.

The New Debt Regime—The Need for a Systematic Compliance Approach

The developer typically seeks, and obtains, non-recourse debt on income-producing properties.[1] The lender underwrites the loan terms based on the real property alone and relies on the value of the real property to protect it against the borrower's possible default. However, two major concerns lead lenders to insert characteristic protections in the loan documents. In the last several years, the meaning of these provisions has led to a significant amount of litigation, with often surprising results. Putting aside whether these results were right, even the risk of falling into such a dispute is highly undesirable for a developer, and this risk can be dramatically mitigated with an appropriate compliance system. The design of the system requires a full understanding of the two areas of concern for lenders.

The Bad Boy Carve-Outs

In general, a lender who accepts a non-recourse loan is relying on the real property as the source of recovery of the loan amount. The lender is willing to take the risk that the property falls in value, but that is the main risk it intends to take. If the borrower defaults by not repaying the loan, the lender intends to foreclose on the property. However, if the borrower prevents the lender's access to the security—for example, if the borrower successfully restructures the loan in bankruptcy—the real property itself will not give the lender the protection it sought. The lender therefore demands that the principals of the borrower, or a creditworthy affiliate of the borrower, guarantee that the principals will not act in ways that prevent the lender's access to the security. In industry jargon, these steps are known as "bad-boy acts." The requirement of the "bad-boy" guaranty is imposed not as a way of seeking recovery from the principals for the borrower. Instead, it serves to create a strong disincentive for certain actions that would impede the lender's access to the security. Thus, the lender sees a guaranty from a creditworthy entity as a way of protecting the loan structure. The bad-boy guaranty is

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[1] On this score, the phenomenon of securitization of debt secured by real estate has probably helped the developer. The certificates issued by a REMIC in a securitization are sold to investors based on a rating agency determination and of the real estate that serves as collateral. Consequently, an individualized underwriting of the creditworthiness of the sponsor does not add enough to the marketability of the certificates to give much value to full recourse for the debt.

triggered—or, in other words, there is springing recourse—only if the borrower violates one of a list of covenants, or commits a "bad-boy act." Certain other threshold issues create similar risks that the lender does not intend to take, such as the risk that the collateral is not really as it appears. These similar risks are typically the subject of additional "bad-boy" carve-outs; they include what the industry calls "lie, cheat, and steal" acts, such as significant misrepresentations in obtaining the loan and, frequently, environmental issues. If violated, they too trigger liability under the guaranty.

A Special Carve-Out: The Special Purpose Entity

A borrower bankruptcy is of special concern to a lender. The bankruptcy would immediately stop enforcement of remedies, at least on a temporary basis, delaying the lender in taking possession of the real property.[2] Moreover, a confirmed plan of reorganization, even over the objection of the lender, can, in some circumstances, fundamentally change the value of the lender's recovery.[3]

To deal with this concern, virtually all real estate lenders now require the borrower to create a special purpose entity (SPE) to own and operate the real estate that will serve as security for the loan. Rating agencies demand the structure if the debt will become part of a rated securitization.[4] For the reasons discussed below, the rating agencies see the structure as protection against a cram-down of the loan in a borrower bankruptcy or even against an extended delay in the lender's ability to realize on the security. Portfolio lenders also typically demand the structure, motivated by the same perceived protection it offers against bankruptcy of the borrower.

The basic ideas behind the SPE structure are (1) to maximize the possibility that the single-asset real estate rules[5] apply if there is a bankruptcy, because

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[2] 11 U.S.C. § 362 (2010).
[3] 11 U.S.C. § 1129(b).
[4] While originators for securitization trusts popularized the structure and brought some uniformity to documentation, the ideas came out of the experience of portfolio lenders in the last downturn, where borrower bankruptcies slowed enforcement and occasionally resulted in dramatic losses for lenders. *See Bank of America v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999); *In re Greystone III Joint Venture*, 948 F.2d 134 (5th Cir. 1992), cert. den., 506 U.S. 821 (1992).
[5] 11 U.S.C. § 362(d)(3).

these rules shorten the bankruptcy-related delay, (2) to minimize the possibility that there will be other creditors in a bankruptcy who might provide the consenting class required for a cram-down over the secured lender's objection,[6] and (3) to minimize the risk of a substantive consolidation of the borrower with some other entity that is a debtor in a bankruptcy. The last problem arises if a bankruptcy court collapses the borrower with a group of SPEs, or with the developer's management entity, to treat the assets of the whole group as available for the debts of the debtor. The substantive consolidation would undo all the careful planning of bankruptcy protections. As a result, the lender requires both a separate entity and that the developer maintain that separate entity in a way designed to avoid substantive consolidation with any other entity.

Acts inconsistent with the SPE structure fall naturally into the list of bad boy acts: if the developer destroys the SPE structure, the lender may not be able to reach the security on which it relied in agreeing to the non-recourse provision. Consequently, the lender routinely requires that the covenants related to the SPE structure be backed by the bad-boy guaranty.

The Developer's Expectation; Potential Surprises

Until recently, the usual understanding of a developer with a loan structured in this way—with personal liability triggered for "bad-boy acts" and a required SPE—was to view the loan as non-recourse. The typical honest developer has no intention of violating the "lie, cheat, and steal" terms. In his or her view, then, the bad boy guaranty would bring no significant incremental exposure.[7] Perhaps as important, the typical developer expects that he or she will have complete control: by simply avoiding the "bad boy acts," he or she avoids liability on the guaranty.

However, a series of cases in recent years reached startling results, results that indicated that judges often do not understand the concept of non-recourse or bad-boy guaranties. In each of these surprising cases, though, the judge relied on a violation—hyper-technical perhaps, but a violation—

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[6] *See supra* n. 3.

[7] One might view the guaranty with respect to environmental problems as adding exposure. However, the exposure is likely limited, based on the developer's own environmental due diligence.

of a covenant as the basis of disproportionate liability that the borrower never anticipated.[8] Perhaps the most troubling example was *Wells Fargo Bank v. Cherryland Mall L.P.*[9] There, the failure of the borrower to pay the guaranteed debt "violated" the SPE covenant to pay debts as they came due, triggering the guaranty and full personal liability for the principals of the borrower. In other words, the inability of the borrowing subsidiary to pay back the loan—the only situation where non-recourse is important—was treated by the court as a trigger for full recourse on the loan.

While *Cherryland* may be the most troubling, it is certainly not the only troubling result from the borrower's perspective. Guarantors have likewise been held to have full personal recourse on loans because of a technical breach cured without harm to the lender.[10] Putting to one side the question whether any of these surprising results were correct, the developer can design a compliance system that minimizes the possibility of having to defend against an aggressive theory or of suffering a surprising result.

Designing the Compliance System

A good compliance system is critical to ensuring that, in possible litigation with a lender, the borrowers' expectations of non-recourse are met. The system requires careful attention at two stages. First, the system starts at

[8] *E.g., Wells Fargo Bank v. Mitchell's Park, LLC*, 1:10-CV-3820-TWT, 2012 WL4989888 (N.D. Ga. Oct. 11, 2012); *51382 Gratiot Avenue Holdings, LLC v. Chesterfield Development Co.*, 835 F. Supp. 2d 384 (E.D. Mich. 2011), recon. den., 2:11-CV-12047, 2012 WL 205843 (E.D. Mich. Jan 24, 2012); *Blue Hills Office Park LLC v, J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007); *Wells Fargo Bank v. Cherryland Mall L.P.*, 295 Mich. App. 99 (2011); *CSFB 2001-CP-4 Princeton Park Corporate Center, LLC v. SB Rental I, LLC*, 410 N.J. Super. 114 (App. Div. 2009). A refreshing change in direction, at least from the borrower's point of view, came in a recent case where the California Court of Appeal reversed a summary judgment entered on a bad boy guaranty and directed summary judgment for the borrower. *GECCMC 2005–C1 Plummer Street Office Limited Partnership v. NRFC NNN Holding, LLC*, 204 Cal.App.4th 998, 1002 (2012) review denied (July 11, 2012) ("As [the borrower] points out, this interpretation of the guaranty is consistent with the parties' intent, expressed in the deed of trust and other loan documents, to carve out exceptions to the loan's non-recourse provision only in the event that Borrower commits certain 'bad boy acts' that pose particular risks to Plummer's interests and collateral."); *see also JLM Financial Investments 4, LLC v. Aktipis*, 11 C 2561, 2013 WL 2434607(N.D. Ill. June 3, 2013); *ING Real Estate Fin. (USA) LLC v. Park Ave. Hotel Acquisition LLC*, 26 Misc.3d 1226(A), 907 N.Y.S.2d 437 (Sup. Ct. 2010).

[9] *See Cherryland Mall L.P.*, *supra* n. 8. *See Gratiot Avenue Holdings, LLC.*, *supra* n. 8.

[10] *Princeton Park Corporate Center, LLC*, *supra* n. 8.

the beginning: during the negotiation of the loan. While the acts that trigger springing recourse may in many instances be dictated by the lender, there are still important steps that borrower's counsel should take in documenting the loan.

Certainly in light of these judicial warnings, real estate borrowers should protect themselves as they negotiate a loan. Moreover, they should continue to protect themselves as they live with the loan. Additional measures are prudent if the project that secures the loan begins to experience financial distress.

The key features of this compliance system, as with any internal control system,[11] should be, first, to identify the risks; second, to take steps to eliminate those risks that can be eliminated; third, to take steps to minimize the likelihood that remaining risks materialize; and, fourth, to monitor performance. After reviewing the overall elements of system design (immediately below), it is worth examining a series of easily identifiable problem areas. These problem areas, discussed in the next section, should be a part of each stage of the compliance system.

1. Identify the risks in the loan documents: look for liability triggers, including well-hidden triggers. This step is often more difficult than expected: the obligations that can trigger liability under the guaranty are not always where they seem to belong, in the covenants. Although the guaranty (and, to a lesser extent, the loan agreement) are the sources of personal liability, the extensive use of cross-references and definitions across the full set of closing documents make it important to review all the loan documents (the loan agreement, the security instrument, the cash management agreement, closing opinions, any modification agreements, and the like) with this question in mind, to ensure that all sources of potential personal liability are included in the compliance system. The index to the closing binder or a closing memo would be a good starting point to ensure that the appropriate documents are included in the review. In each of these documents, it is important

[11] *See generally* S. Lorne, K. Smalley & J. Schultz, *Internal Controls: Sarbanes-Oxley Act §404 and Beyond*, BLOOMBERG BNA, http://www.bna.com/Internal-Controls-Section404-p3682/.

to look beyond the covenants labeled as such. Sometimes, there are covenants buried in surprising elements of the definition of "special purpose entity," if the failure to maintain SPE status is, as is usually the case, a default. Likewise, some agreements incorporate by reference the assumptions contained in the legal opinions, making it a default if those assumptions become untrue.

2. Determine the scope of the risks: classify full recourse triggers and loss triggers. For each covenant (or covenant in disguise), it is important to identify the results of a breach: is the covenant a "loss trigger" or a "full recourse trigger"? Briefly, a "loss trigger" is a covenant the breach of which results in recourse only for the amount of loss caused by the particular breach. For instance, a failure to pay property taxes might result in recourse for the amount of the unpaid property taxes that become a lien on the property, along with any interest or penalties. A "full recourse trigger," on the other hand, is a covenant the breach of which makes the full amount of the loan—typically increased by costs of collection, late fees, and the like—a recourse liability.[12]
3. Confirm the identification of the risks: be sure that the relevant members of the developer's team have reviewed the triggers. Often, the person responsible for obtaining the financing is the project developer, whose responsibilities extend to site selection and assemblage, marketing, entitlements, and financing—a consummate dealmaker who has, at best, a limited acquaintance with the back office. His or her goal is non-recourse debt with "standard" carve-outs, but that alone is not enough to ensure that the carve-outs mesh with the developer's system. The general counsel, controller, the treasurer, and the risk manager/insurance officer all need to review the full list of triggers. Again, it is critically important not to limit their review to those provisions

[12] There are very persuasive arguments against the enforcement of full recourse triggers, including that they are unenforceable penalties and, in some cases, an attempt to circumvent the unenforceability of an advance waiver of the protection of the bankruptcy laws. The law on these arguments is likely to develop further, but to date has not favored borrowers. *See, e.g., U.S. Bank, Nat. Ass'n v. Kobernick*, 454 F. App'x 307 (5th Cir. 2011); *UBS Commercial Mortg. Trust 2007-FL1 v. Garrison Special Opportunities Fund L.P.*, 33 Misc. 3d 1204(A), 938 N.Y.S.2d 230 (Sup. Ct. 2011). In any event, it is often difficult for a lawyer to recommend that his or her client test the enforceability of the clauses: the price of being wrong is frequently too high to risk even a small probability of losing.

that are denominated as "covenants"; the review must extend to covenants that masquerade as definitions or legal opinions, as well as events of default.

4. Take steps in negotiating the loan to eliminate risks where possible: clarify that the triggers require bad acts rather than just a bad change in circumstances. The basic trade between borrowers and lenders in these bad-boy guaranties is that the lender will rely only on the security, and the developer will not do certain things that prevent the lender from realizing on the security. Every trigger should be defined as an action within the control of the guarantor. "Insolvency" is not an action but a condition, and should not be a covenant with full recourse as the price of breach. That kind of problem presents the risk of the infamous *Cherryland*[13] result: when the borrower cannot pay the debt, it becomes full recourse, as the court ignores the conflict between the result and the now-meaningless non-recourse provision.
5. Take steps in negotiating the loan to minimize remaining risks: consider where loss recourse is the appropriate result and build in safety valves. Many lawyers would argue that imposition of full recourse for a breach that does not cause material harm to the lender would violate the principle of contract law that such a result would be an unenforceable penalty. Nonetheless, one of the most notorious judicial results is that of CSFB 2001-CP-4 *Princeton Park Corporate Center, LLC v. SB Rental I, LLC*,[14] in which liens were prohibited; the developer allowed a lien but then paid it off; and later, the lender, undamaged by the lien in any way, was permitted to rely on it as a trigger for full personal recourse. The courts are not always so harsh[15]—but the lesson for transactional counsel is to limit full recourse triggers to those that truly threaten the lender's access to the security and limit their application to

[13] *See Cherryland Mall L.P.*, *supra* n. 8.

[14] *See Princeton Park Corporate Center, LLC*, *supra* n. 8. A number of cases agree that the trigger is not an unenforceable penalty. *See e.g*., *Weinreb v. Fannie Mae*,49A04-1211-PL-587, 2013 WL 3670741 (Ind. Ct. App. July 16, 2013); *See Mitchell's Park, LLC*, *supra* n. 8; *Bank of Am., N.A. v. Freed*, 983 N.E. 2d 509 (Ill. App. 2012) appeal pending (May 2013); *G-3 Purves Street, LLC v. Thomson Purves, LLC*, 953 N.Y.S. 2d 109 (Sup. Ct. 2012); *see UBS Commercial Mortgage Trust 2007*-FL1, *supra* n. 12; *Heller Financial v. Lee*, 01 C 6798,2002 WL 1888591 (N.D. Ill. Aug. 16, 2002).

[15] *See ING Real Estate Fin. (USA) LLC*, *supra* n. 8 (no recourse because of cure).

situations of material damage in that access with an express requirement of notice and an opportunity to cure.

6. Plan for administration of the loan: provide a roadmap for compliance. It is good practice both for the in-house lawyer and outside counsel to collaborate on a post-closing memo alerting the client to the likely issues in complying with the covenants (and covenants in disguise) that, if breached, will trigger partial or full liability.
7. Monitor: revisit the compliance plan. Once any potential conflicts between the developer's system and the triggers have been identified and a plan identified for ensuring compliance, it is prudent to build in a regular periodic review. Personnel often leave or are promoted, and newcomers do not know the unusual constraints placed on the administration of the loan; the press of other issues in operating the project comes to the fore and covenants fade in the institutional memory; changes in the property, market, or business present situations that were not anticipated at the time of drafting. It is helpful to audit the performance of the potentially troublesome covenants at least annually, as described further below.
8. When problems loom, conduct a covenant audit. When the financial performance of a project lags projections, the possibility of approaching a lender for relief should always involve consideration of the results if relief is not forthcoming: Will there be a foreclosure or a deed in lieu of foreclosure?[16] What are the implications under the bad boy guaranty? This latter question should involve a careful update of the most recent covenant audit, if there is one, and, if there is not, the immediate design and conduct of a covenant audit.

Many, if not most, borrowers take the majority of the steps above. Few, however, conduct the regular covenant audit, and likely even fewer conduct the covenant audit at the critical point of financial distress, when its results provide a key piece of information in negotiating for relief with a lender. The covenant audit is also the best way to recover if the borrower failed in other steps in the compliance program; it gives the borrower a second

[16] Another critical inquiry, beyond the scope of this chapter, will be the tax consequences of any relief, foreclosure, or deed in lieu.

chance to design a compliance program and possibly to cure or minimize any problems. It warrants extensive attention.

Key to the Compliance System: The Covenant Audit

A key element of the compliance program is auditing performance against covenants. To minimize the risk of surprise recourse liability, transactional counsel should meet at least annually with the borrower's representative who has primary responsibility for administering the loan, often the chief financial officer or controller. A useful format for such a review is attached as Appendix A, based on the common concerns discussed in the section below. But there are a number of general questions about the purpose, rationale, and approach to a covenant audit to explore first.

- *Why should management dedicate resources to the review?*
  A review of administrative compliance will rarely be a priority for a developer. The focus is always on closing the next loan rather than administering the last. However, the almost-incredible recent judicial results may create a climate where the work appears worthwhile.[17] A developer who knows, for example, that one court imposed full personal liability because of a lien that was paid off[18] (even if others do not[19]) may be more interested in ensuring that no liens are ever incurred and in taking steps to protect against inadvertent exposure.
- *Who should conduct the covenant audit?*
  The party best positioned to conduct the covenant audit is usually in-house counsel. With in-depth knowledge of the developer's administrative practices, in-house counsel has the best insight into likely areas of concern, knows the questions to ask, and the right people to ask. Outside counsel is a second-best choice. In any event, the participation of a lawyer is critical to make judgments as to how a court might assess various practices in light of the precise language of the guaranty.

[17] If in-house counsel leads the effort, as recommended below for other reasons, avoiding out-of-pocket expense may make the whole process more palatable.
[18] *See Princeton Park*, *supra* n. 14.
[19] *See ING Real Estate*, *supra* n. 15.

- *What obligations should the audit cover?*
  The audit should cover each of the risks identified in the review of the loan documents, possibly already included by thoughtful transactional counsel as part of the work-product of the original financing. If not, the list should be developed now, as described above.

Once the covenants are identified, counsel familiar with the organization or with real estate developers' practices generally should be able to identify likely trouble areas for special focus. The most likely problems are common covenants that may not match the particular developer's administrative practices. Examples include everything from the use of stationery that does not match the detailed criteria of the SPE definition to a portfolio-wide insurance program that does not match the exact co-insurance limitations imposed by the loan on an individual property. Some areas of frequent concern are discussed in the next section, below. Counsel should develop a list for special focus for the particular property-owner and the particular loan. The businessperson responsible for the loan should double-check that the selection of the focus subset has picked up all the covenants of concern.

Identify the Right Personnel

Next, for each covenant, the audit team should identify the person who should be responsible for monitoring compliance with the covenant and specific questions that person should address. For instance, the controller should review covenants concerning reporting. A specific question to address, in an industry notoriously late in gathering accounting data, would be whether reports have been timely furnished.

It is important too at this stage to identify future compliance steps: while today's practice may be completely consistent with the terms of the guaranty, planned changes in administration, like a systems conversion, a new insurance program, or a new vendor relationship across a family of SPEs, can threaten compliance in the future.

Address Problems

If the audit uncovers situations where the borrower's practice is questionably compliant with the terms of the loan documents, the first step

is to determine the consequences of breach, specifically whether the covenant is a loss trigger or a full recourse trigger.[20] Next, it is important to consider whether the questionable compliance truly is a breach: perhaps the lender has expressly, or by long practice, accepted performance that is not exactly what was contemplated in the document. Or perhaps the performance, while not what counsel expected, is exactly what the business people understood the terms to require and in fact is a reasonable reading of the agreement.

Finally, it is worth considering what curative measures are possible and which of those are advisable. Sometimes the curative measure means coming into compliance for the future; sometimes it means correcting the past; sometimes it means seeking express or implied approval from the lender for the past practice. The nature of the relationship with the lender and the current performance of the loan will be part of the delicate balance driving the decision. No single set of rules can dictate the appropriate next steps.

Areas to Consider in the Covenant Audit

While the administrative systems of different developers will each pose its own unique set of concerns, some areas are always worth flagging.

SPE Covenants

The SPE covenants are often the most counterintuitive to the developer, who is likely to assume that the formation of a separate entity is enough to satisfy the covenants. Consequently, the detail and specificity of these covenants often come as a surprise, and it is important to compare the covenants to the developer's administrative systems. [21]

Bankruptcy Protections

The bankruptcy protections typically prohibit steps such as acquiescing in an application for the appointment of a receiver or similar officer for the

[20] *See* Part IV (2), *supra*.
[21] Failures to maintain separate telephone lines and office supplies have even been listed (along with other asserted breaches) as a basis for liability. *See Mitchell's Park, LLC*, *supra* n. 8.

property. These provisions are aimed at preventing the borrower from placing itself in a situation where the lender on this loan cannot proceed against the security by agreeing to these measures in favor of other creditors. However, the lender on this loan may itself wish for the borrower to cooperate in these kinds of remedies for the benefit of this lender; it may wish to appoint a receiver, for instance. A cooperative borrower may acquiesce in the appointment of a receiver in accommodating (or at least not obstructing) the lender's attempt to gain control or ownership of the real property—and then find that the cooperation arguably triggers the bad boy guaranty.[22]

Insurance

Many developers use portfolio-wide programs for insurance, with pooled deductibles and co-insurance features. Many loan documents, on the other hand, have specific requirements for the property that secures the loan. The two can be reconciled, but the risk manager and/or insurance agent should be alerted to the issue. Often, the application of the proceeds to repairs on the property prevents the lender from suffering any real harm. Also, operational reporting to the lender may have already put the lender on notice of the precise coverage in place.

Reporting

Particularly for acquisition financing, the reporting practices and timing may evolve as the new owner operates the property. Frequently, however, the loan documents attempt to specify the practices or timing of reports with great precision, unencumbered by an understanding of how the property operates. The actual circumstances of the property may result in practices and timing that are, for all practical purposes, substantively equivalent to what is required but technically non-compliant. For example, a property may present legitimate operational issues that cause monthly results to become available later than contemplated in the loan documents, but the required information is consistently provided on the same, slightly later, monthly cycle. The

[22] The author is not aware of any court that has taken such a counterintuitive step. Nonetheless, borrowers and their principals should proceed with caution and, before cooperating, obtain the agreement of the lender that such a step will not be a trigger for any recourse.

problem should ideally be addressed in drafting the loan documents. Frequently, however, it does not surface until some time into the life of the loan. A practice of accepting technically non-compliant or late reports may be binding on a lender in any event—but obtaining express approval early in the life of the loan, before anyone's financial expectations are likely to have been disappointed, is a much more secure position for the borrower.

Tax Returns

The SPE documents frequently require a separate tax return for each entity in the structure. However, for a single-member limited liability company (LLC), the entity may be disregarded for federal tax purposes and not require a return. It may be a good idea to put the lender on notice of the decision, and it may be worth filing back returns.

Environmental Issues

This covenant is unusual in our list in that it typically does not surprise the guarantor to have personal liability for environmental issues, an exposure that may survive beyond the enforcement of the obligation against the security. The guaranty on environmental problems has a unique impact on the covenant audit in that it may create options for the borrower on a troubled loan. It is worth determining the environmental status of a property before resolving other actions to be taken to remedy possible covenant problems. If the guarantor will have full personal liability triggered by environmental issues anyway, the developer may well be less concerned about other actions that would be otherwise forbidden or about remedying other possible problems.

Conclusion

The tasks described above admittedly can be administratively burdensome if first implemented in the middle of the life of a loan. However, if designed in the negotiation process and maintained routinely going forward, they do not need to add a significant cost or interference with ongoing operations. Also, as insurance against the defending against lenders' theories like *Cherryland* and *Princeton Park*, the costs are small indeed.

Key Takeaways

- Flag all potential recourse triggers for careful analysis not only by deal counsel but also by the relevant personnel at the client's operation, including accounting, marketing, and risk management.
- Inform clients that a good compliance system is critical to ensuring that, in possible litigation with a lender, the borrowers' expectations of non-recourse are met. Careful attention is required during the negotiation of the loan and through the life of the loan, with special attention if the project begins to experience financial distress.
- Include in the compliance system all sources of potential personal liability in the loan documents, and be sure that the relevant members of the developer's team have reviewed the liability triggers.
- Ensure that in-house and outside counsel collaborate on a post-closing memo alerting the client to the likely issues in complying with the covenants (and covenants in disguise) that, if breached, will trigger partial or full liability. Build in a regular periodic review process.
- Keep in mind that in-house counsel who has in-depth knowledge of the developer's administrative practices is best positioned to conduct the covenant audit. Identify the covenants (other than payment) in the loan documents; and then identify likely trouble areas for special focus. Also identify who should be responsible for monitoring compliance with the covenant and specific questions that person should address.
- Undertake an annual review of performance.
- At the first sign of financial distress, update the review to develop a strategy for any case of questionable compliance.
- Consider whether an instance of questionable compliance truly is a breach, what curative measures are possible, and which of those are advisable.

Kathleen Smalley is a partner at Boies Schiller & Flexner LLP. Her practice includes sophisticated real estate transactions and disputes, complex corporate transactions, corporate and family business governance, acting as outside general counsel on high-stakes litigation with a particular emphasis on litigation concerning complex transactions, and on matters relating to family wealth. Her experience in debt workouts and bankruptcy is

deep, including the primary executive responsibility for the successful reorganization in bankruptcy and recapitalization of a national portfolio of properties with differing equity structures and cross-collateralized mortgages. In the development arena, she led an initiative to remediate and develop brownfields and advised clients on entitlements strategies to bring blighted or poorly zoned properties to their highest and best use. In addition, Ms. Smalley has been heavily involved in the placement of new financing. She has led teams on the negotiation of complex structured finance, again backed by multistate portfolios of real property, and on negotiating equity investments with financial investors.

With twelve years in the Trammell Crow organization, including service as the general counsel of Trammell Crow Company and as general counsel of Crow Holdings (representing holdings of members of the Trammell Crow family), and five years as the senior vice president, corporate operations and general counsel of Catellus Development Corporation (NYSE: CDX), and twelve years in private practice, Ms. Smalley has extensive experience in representing public, private, and family-held businesses. Ms. Smalley's expertise includes corporate governance matters ranging from internal investigations to design of internal governance systems. As a trustee of the California State Teachers' Retirement System (CalSTRS), she chaired the board governance committee and served on the Investment Committee (with jurisdiction over governance issues in portfolio companies) and on the Audit Committee.

Ms. Smalley has taught semester-long courses on real estate transactions at Harvard, Yale, Stanford, and UCLA law schools and a seminar at Harvard Law School on the problems of corporate counsel. She is a former law clerk to Justice Sandra Day O'Connor and a graduate of Harvard Law School.

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APPENDIX

FORMAT FOR COVENANT AUDIT

[Identify loan]

Lender: ______________

Security: ______________

Loan Amount: ______________ Loan Date: ______________ Maturity: ________________

Guarantor: ______________ Counsel: ______________ Prepared by: ________________

Documents reviewed: [Should include Loan Agreement, Mortgage/Deed of Trust, Note, Guaranty, any Modification Agreement, ancillary closing documents, possibly including legal opinions]

Covenant	**Doc. Ref.**	**Brief explanation of terms**	**Loss trigger or full recourse trigger?**	**Potential problem**	**Proposed action**	**Priority**	**Resp. party**	**Status**

Courtesy of Kathleen Smalley, Boies Schiller & Flexner LLP

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