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Substantive Non-Consolidation Opinion Letters

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Substantive non-consolidation opinion letters have long been a regular “check-the-box” item in large commercial real estate transactions. While substantive consolidation jurisprudence has not changed materially over the past decade, these opinion letters should not be treated lightly by borrowers or their counsel.

Each loan transaction is unique, and each non-consolidation opinion letter should be given the same care and individualized due diligence to ensure that the opinion letter will serve its purpose. There are common issues and considerations arising in the substantive non-consolidation context that borrowers and borrowers’ counsel would be well advised to anticipate. Failing to do so could delay the closing of the transaction, as lenders who require a non-consolidation opinion typically will not fund their loans without delivery of a satisfactory opinion.

The Role of Substantive Non-Consolidation Opinions

Commercial real estate borrowers can often obtain less expensive loans that will be pooled with other loans, contributed to a trust, and securitized through the commercial mortgage-backed securities (CMBS) market. Rating agencies that rate such securities, and even lenders who do not necessarily intend to “securitize the loan,” want to ensure that the underlying mortgaged properties, and the revenues they generate, are sufficiently isolated from the reach of other creditors.

Requiring the borrower to be structured as a bankruptcy-remote, single-purpose entity (SPE), which cannot file a bankruptcy case without consent of a board including authorization from at least one party independent of the borrower, is an important first step toward achieving isolation of the asset. Substantive consolidation is a judicially created doctrine that can be applied by bankruptcy courts as a matter of equity to consolidate the assets and liabilities of affiliated entities.

Due to the risk of substantive consolidation, lenders in the CMBS market request, and rating agencies require, the delivery of an opinion of counsel that if a non-borrower affiliate that has the ability to control the borrower or its operations were to become a debtor under the Bankruptcy Code, substantive consolidation will not occur between the former and the borrower. The relationships covered by the opinion letter are commonly referred to as “pairings.” Thus, borrowers retain counsel to provide the non-consolidation opinion letter, and counsel have devised certain separateness covenants that are inserted into the governing documents and loan documents of the borrower to make it less likely that substantive consolidation might be ordered.

There is no foolproof mechanism to avoid substantive consolidation, but requiring the opinion letter is generally seen as an effective tool to reduce the risk.

Steps for the Opinion-Giver to Take

Ensure that a substantive non-consolidation opinion is necessary in the first instance. Given the proclivity of lenders to request a non-consolidation opinion in commercial real estate transactions, the borrower should first determine that an opinion letter truly is necessary before it incurs the expense of obtaining one. If the lender does not intend to securitize the loan in the CMBS market, and if the issuance of a non-consolidation opinion letter is not required under the loan commitment, an opinion letter may not be needed.

Even where the loan is intended to be pooled in a securitization, rating agencies only require a non-consolidation opinion for loans exceeding certain threshold amounts. Last, if the entities in the borrower's chain of control are themselves SPEs (or the non-SPE owners do not own 49% or more of an SPE), an opinion may not be necessary. Unfortunately, notwithstanding an actual need for an opinion, there is little that can be done if an obstinate lender insists on it as a condition to closing, or where an institutional lender has little flexibility to waive prescribed policies.

Review all transactional and organizational documents. Borrower's counsel cannot simply rely on the borrower or the borrower's transactional counsel to review the documents for a loan transaction. Indeed, a benefit to the lender in obtaining a non-consolidation opinion letter is that the process itself (requiring counsel to independently review the transaction and to opine on the risk of substantive consolidation) provides an additional layer of due diligence and comfort that the transaction is structured to mitigate against the risk of substantive consolidation.

Identify all the proper pairings and confirm with lender's counsel that the pairings are acceptable. Submitting a draft opinion letter to lender's counsel without first agreeing on the appropriate pairings invites trouble and needless work. Pairings that were excluded in an early draft of an opinion, and which must then be included, may require changing the structure of a deal late in the process. Submitting an opinion that omits pairings that the lender views as necessary also sends red flags to lender's counsel, and may result in an overly critical review of the opinion. It is generally a good practice for the opinion-giver to discuss pairings with lender's counsel immediately after understanding the structure of the transaction and before beginning to draft the opinion.

Confirm that the structure of the transaction is acceptable to the lender, and independently analyze whether the structure is proper for the type of transaction involved. The parties should agree on the structure of the transaction, and borrower's counsel should independently confirm that the structure is proper for the type of transaction involved. For example, one national purchaser of multifamily loans exceeding $5 million requires the borrower, if it is an LLC, to be a Delaware LLC and to have a springing member, *i.e.*, a new member that will be automatically appointed to replace a dissolving member. Borrower's counsel should be aware of any specific structure requirements, and bring any concerns to the attention of the parties as early as possible.

Ensure that the separateness covenants and independent director provisions contained in the loan agreement and the organizational documents are consistent. In cases where new SPE borrower entities are being created just prior to the transaction, the parties often will negotiate separateness covenants and independent director provisions in tandem, so that those provisions can be "cut and pasted" from the loan agreement into the organizational documents. Where the borrower is a pre-existing entity with separateness covenants and independent director provisions already in place in its organizational documents, the parties must be careful to duplicate the negotiated provisions from the loan agreement, or to modify them as may be appropriate.

In either case, it is incumbent upon the opinion issuer to ensure consistency of the provisions, because the non-consolidation opinion will rely heavily on the assumption that the separateness covenants will be complied with. Inconsistency or confusion as to which version of the covenants should apply could detract from the effectiveness of the opinion.

Determine whether the use of a recycled entity is permitted and whether the conditions for such use can be satisfied. If any SPE entity relevant to the opinion is a pre-existing entity, borrower's counsel should confirm immediately with the lender that such a recycled entity is permitted to be used, and should ascertain what representations of prior conduct the lender requires. In most cases, the opinion-giver will need to obtain and rely upon the certification of one or more individuals with authority at the parent entity who have personal knowledge of the pre-existing borrower's prior conduct. Counsel should confirm early in the process that such an individual will be available and agree to give such a certification.

Practice Pointers

Engaging counsel to prepare the non-consolidation opinion. Engage counsel early, once it has been determined that a non-consolidation opinion will be necessary. Borrower's non-consolidation opinion counsel should work in tandem with borrower's real-estate counsel, receiving drafts of transactional and organizational documents, discussing the structure of the deal, and identifying any peculiar aspect of the transaction that might deviate from market terms and impact on the substantive consolidation analysis.

Opinion counsel's role in the loan transaction. Borrower's coun– sel should be engaged in the process, reviewing draft documents as they are being prepared. The delivery of a satisfactory non-consolidation opinion should not impede or delay the transaction from closing. Counsel should avoid needless disputes over wordsmithing, and should use practical solutions to keep costs down.

Counsel should use as a template the version of an opinion that has already been accepted by sophisticated lender's counsel in other transactions. For example, the authors use the form that they used in delivering opinions for the construction and refinancing of stadiums and practice facilities for affiliates of Major League Baseball and National Football League teams. The opinion's description of the subject transaction should be consistent with the enforceability opinion that is issued by borrower's counsel.

Which law to address? The opinion letter must recognize the disparity in the case law across jurisdictions in applying the doctrine of substantive consolidation. Most courts look to some form of the doctrine enunciated by the U.S. Court of Appeals for the Third Circuit (*Owens Corning*, 419 F.3d 195, 205-09 (3d Cir. 2005)), and by the U.S. Court of Appeals for the Second Circuit (*In re Augie/Restivo Baking Co., Ltd.*, 860 F.2d 515, 518 (2d Cir. 1988)), but some look to the decision of the U.S Court of Appeals for the District of Columbia in *In re Auto-Train Corp., Inc.*, 810 F.2d 270, 276 (D.C. Cir. 1987). It is helpful for the opinion letter to discuss the standard for substantive consolidation in each of those cases and address whether and how the legal principles articulated in those cases would apply to the facts of the transaction at issue.

Dealing with non-recourse carve-out guaranties. Non-recourse carve-out guaranties (a/k/a "Bad Boy" guaranties) are common in commercial real estate transactions, and the existence of such guaranties might be a cause of concern for an opinion-giver. After all, the fact that a guarantor could become subject to full recourse on the debt upon the occurrence of certain triggering bad acts, including specifically bankruptcy acts, could blur the separate identity of the subject entities and suggest that in making the loan, the lender relied on the combined assets of the borrower and the guarantor.

However, the substantive consolidation analysis requires the opinion-giver to weigh all the pertinent facts and circumstances of the particular transaction, and the guaranty can be viewed in that context and as-but-one element that factors into the analysis. Thus, the opinion-giver could conclude that, if the lender dealt separately with the guarantor in obtaining the guaranty, as is typically assumed, the existence of the guaranty would actually reinforce the separateness of such entities. *See, e.g., In re Augie/Restivo Baking Co.*, 860 F.2d at 519 (fact that secured creditor required separate guaranty from affiliate was factor favoring non-consolidation). Moreover, the fact that the guarantor does not incur recourse liability on the entire debt, except under certain triggering events that the guarantor has the ability to avoid triggering, tends to mitigate the risk of a finding of substantive consolidation.

Recycled entities. Lenders generally prefer a borrower to be a newly formed SPE immediately prior to the transaction. If a pre-existing entity is used (whether or not it is an SPE already), and the lender permits the use of such “recycled entity,” the lender will typically require representations and warranties concerning the past conduct of the entity.

The opinion-giver should obtain a certification of the member of the recycled borrower, affirming that the entity has maintained its separate existence at all times prior to the new loan transaction. In addition, borrower’s counsel should undertake an independent review of documents, public reports and record searches to confirm, as much as possible, that the recycled entity certification is accurate. For example, counsel should review Uniform Commercial Code, (UCC) federal and state tax liens and judgment liens search reports; litigation search reports; and bankruptcy search reports for the borrower; and the borrower’s prior organizational documents and amendments thereto.

Assumptions made in opinion letter. The recipient of the opinion letter must recognize that each situation is *sui generis*, and that a bankruptcy court, acting as a court of equity, has the discretion to deviate from existing case law analyses to reach a divergent result. Counsel may rely on the truth, in all respects material to the opinion, of the matters set forth in the transaction documents, the organizational documents, and the borrower’s certificates. Counsel should assume that facts are as represented in the loan documents and certificates. Counsel may assume that the borrower has complied and will continue to comply with the separateness covenants in all material respects.

Tax issues with LLCs. Where the borrower is structured as an LLC, an issue could arise because LLCs are disregarded for federal income tax purposes under applicable Internal Revenue Service regulations. Such treatment in commercial real estate development and operations is common and well-known, and counsel will assume that the borrower maintains separate books and records so that such tax treatment will not result in significant difficulty or expense in separating the borrower’s finances from those of a paired entity. Given those circumstances, the tax treatment of an LLC (if it is disregarded for tax purposes) should not change counsel’s opinion as to substantive consolidation.

Conclusion

This discussion is intended to highlight certain potential issues that might arise in the course of providing a substantive non-consolidation opinion letter. All parties must bear in mind that, no matter how the transaction is structured, how faithfully an SPE complies with its separateness covenants or how many safeguards are instituted to mitigate the risk of substantive consolidation, the opinion letter is and can only be a reasoned opinion that analyzes and assesses these risks. The opinion-giver does not function as a guarantor or insurance company.

The power to invoke substantive consolidation is an equitable one, and bankruptcy courts have the right to invoke equity as they deem appropriate. Even the most airtight opinion letter cannot predict with certainty how a court of equity will apply various factors or principles in its discretion to a current transaction at some unknown future date.

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