



NRAI WHITEPAPER

# Choosing An Independent Director



**NATIONAL  
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An NRAI Solutions Company

## Choosing an Independent Director

With the adoption of Sarbanes-Oxley in 2002 and now the financial meltdown of 2009, how rating agencies, lenders, creditors, trustees and borrowers involved in financial transactions carry out their responsibilities has become even more critical. If you work with clients involved in today's complex world of structured finance and securitization, it is important to protect your clients' interests by choosing a company who has qualified, skilled and experienced personnel to handle the activities of independent director, independent manager, independent trustee and/or springing member roles.

### Special Purpose Entities

The Special Purpose Entity ("SPE") or Special Purpose Vehicle ("SPV") structure has been in use for decades. However, with the Enron scandal and subsequent enactment of Sarbanes-Oxley, the deployment of these entity types has mushroomed and become more prominent.

A simple definition for an SPE is an entity formed for a single purpose and concurrently with or immediately prior to a specific commercial transaction, one that is unlikely to become insolvent as a result of its own activities. It is also designed to be insulated from the consequences of any related party's insolvency.

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A Special Purpose Entity ("SPE") is an entity formed for a single purpose, concurrently with or immediately prior to a specific commercial transaction, one that is unlikely to become insolvent as a result of its own activities.

The SPE is typically employed in one of three types of transactions – a property specific or large loan transaction, a pool transaction (e.g. a securitization), and/or a credit lease transaction. Also known as "bankruptcy remote" entities, these entities have covenants and restrictions to protect the underlying SPE assets from bankruptcy, including the appointment of independent directors, managers or trustees. The hallmark of an SPE structure has been its bankruptcy remoteness — restrictions of its activities, including its ability to incur debt, dissolve or file for bankruptcy. To maintain the bankruptcy remoteness, secured creditors look to the independent director, manager or trustee as the objective or independent vote to prevent otherwise solvent SPE's from seeking bankruptcy protection, particularly in instances when related or parent entities become insolvent.

### Role of the Independent Director, Manager or Trustee

In general terms, the independent director, manager or trustee cannot have any vested interest in the business transaction and must be independent to all other parties involved. This allows them to review any proposed bankruptcy proposal independently and serves to protect all creditors and shareholders from borrowers (the SPE owners) who may seek to escape financial responsibility through bankruptcy. Anyone who acts as an independent director must take the job seriously and understand his or her fiduciary duties pursuant to applicable law. See *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

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Independent directors are not just beholden to a secured creditor's desire that an SPE stays out of bankruptcy. They must look at and understand all of the circumstances surrounding the request for bankruptcy protection.

Historically, the independent director just looked at the financial circumstances of the SPE situation itself to determine if bankruptcy was necessary and not to the corporate shareholders or parent company structure. However, in the ruling of *In re: General Growth Properties, Inc.* (Bankr. S.D.N.Y. 2009) applying Delaware law, the court ruled that the SPE's independent directors' owed a duty to the SPE's parent corporation and its shareholders and not just to the SPE itself or its secured creditors when making a decision regarding whether to file for Chapter 11 protection.

The court based its decision, among other things, on the fact that the General Growth Properties and the subsidiary SPE's had co-mingled funds and used a cash management system that integrated all revenues together rather than maintaining separateness covenants as outlined in the original loan documents.

The conclusion thus rendered in the General Growth Properties case provides that independent directors, managers and trustees are not just beholden to a secured creditor's desire that an SPE stay out of bankruptcy but mandates they must look at and understand all of the circumstances surrounding the request for bankruptcy protection.

The General Growth Properties court decision has been the subject of numerous articles which discuss the viability of SPE's as a vehicle for bankruptcy remote protections and how the independent director role may change or be defined in the future. As concluded in "When Bankruptcy Remote is not Bankruptcy Proof", Real Estate Alert, August 2009, Schiff Hardin, LLP, the author noted,

It is likely that in future financing transactions, lenders that use "bankruptcy remote" or "special purpose entities" will (i) modify the independent director provisions to implement prior notice requirements for the removal or replacement of independent directors; [and will] (ii) require borrower's confirmation and acknowledgement that the initially appointed independent directors possess the necessary qualifications and understand the business and operational needs of the borrower and its parent entities . . . .

With the independent director, manager and trustee duties expanding and becoming a more integrated part of your clients' asset protection, selecting a national company who can provide knowledgeable, skilled and experienced professionals becomes paramount. For more information about independent directors, managers and trustees and the services provided, please visit [www.independentdirector.com](http://www.independentdirector.com).

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