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Best practices in commercial real estate financing: The borrower's agenda in negotiating loan documents

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ABSTRACT

How should a borrower respond to a draft set of commercial mortgage loan documents? This paper, consisting of four quarterly instalments appearing in the 2003/2004 volume of this publication, seeks to answer that question. The author discusses business and legal issues that mortgage loan documents typically raise for a borrower; some structural variations and the special concerns they might create; the closing process; and some issues that a borrower may want to raise on its own initiative.

PART I

INTRODUCTION

In a real estate owner's perfect fantasy world, if the owner needed money, it would simply: (1) borrow a lender's money; (2) give that lender a valid mortgage lien, so the lender could foreclose and take the borrower's property if the borrower did not repay; and (3) go on with the borrower's life just the same as before. In the real world, however, when a real estate owner decides to borrow against its real estate, it must sacrifice freedom that it otherwise would have had, and it must assume burdens and responsibilities that it did not otherwise need to bear.

From a lender's perspective, as soon as any mortgage loan has closed, the borrower has the lender's money. The lender has only its loan documents and whatever promises, obligations, security, assurances and credit they contain. The lender must rely on those loan documents as the mechanism, in many cases the only mechanism, to preserve its collateral and collect its loan.

Because loan documents matter so much to a lender, any lender's counsel writes them primarily to protect the lender and its collateral and to give the lender as much control, information and leverage, and as many rights and remedies, as possible. (This seems to be especially necessary for lenders in the USA, given the legal environment in which American commercial mortgage loans are closed and enforced.) To accomplish these goals, American

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Borrower obligations and restrictions

commercial mortgage loan documents generally cover a broad set of issues, imposing on the borrower a range of obligations and restrictions.

Although the wording, scope and details always vary and sometimes change over time, generic mortgage loan documents represent a familiar starting point for any commercial real estate finance transaction. That starting point has accreted over many decades based on a combination of real estate finance law, changes in the business world, trends in commercial real estate, lenders' lessons learned the hard way and the requirements of the secondary market. Exactly how mortgage loan documents became the way they are is beyond the present discussion.

In many cases, the restrictions that loan documents impose are more theoretical than real, the real estate equivalent of laws against suicide. That is because many of these restrictions merely compel the borrower to do what any competent real estate owner would already do anyway.

Flexibility and surprises

In a significant number of other cases, though, the interests of borrowers and lenders are not aligned. These areas relate primarily to certain decisions about the collateral and the loan and how to deal with a range of possible unexpected events that might affect either of them. In each case, the lender wants the ability to control these decisions and the consequences of unexpected events. The borrower knows that each such control mechanism may limit future flexibility.

Changing leverage

This discussion starts from the perspective of a borrower (or its counsel) that has received and must respond to a draft of either a commitment letter¹ or a set of generic loan documents. For a borrower, the commitment letter represents the stage when the borrower has the most leverage. The borrower may not yet be under great time pressure, other lenders may still be available and competing for the borrower's business and this particular lender is still trying to 'get the deal'. As a result, the lender may be willing to stretch and flex a bit. In contrast, once a borrower has paid its commitment fee and the lender has issued the commitment letter, the borrower's leverage drops substantially. If a particular concession is not in the commitment letter, then the lender has no reason to agree to it in the loan documents. Conversely, if the borrower insists on covering a concession in the commitment letter, the borrower should avoid spending much time ever again negotiating that issue. Whether or not a commitment letter imposes any legal obligations, both sides often regard its terms as being 'the deal' and (for better or worse) not subject to further discussion.

The commitment letter therefore represents a particularly appropriate time for the borrower to try to define the basic terms of the loan and its structure, documentation and security. This is the best point in the process for a borrower to try to control the paper, cut back complexity and foresee and prevent unnecessarily burdensome closing requirements.

Depending on the lender's approach to the commitment letter and

Commitment letter issues

the borrower's tastes, the commitment letter may or may not represent the right stage to negotiate and resolve smaller issues relating to the loan. In some loan transactions, the parties may want the commitment letter to 'spell out' virtually every detail, to avoid problems and save time later. In other cases, the parties may prefer to use a more limited commitment letter, and rely on the loan documents and closing process as the mechanism to put flesh on the bones of the deal.

The borrower's approach will often depend on just how much leverage it retains after signing the commitment letter. For example, the following circumstances may lead a borrower to worry less about the level of detail in the commitment letter: (a) low commitment fee; (b) no time or financial pressure to close; (c) 'plain vanilla' property without issues; (d) loan pricing at or about market levels; and (e) previous good experience with the same lender. To the extent that these circumstances do not exist, the borrower may care more about how much the commitment letter covers.

As the preceding paragraphs show, issuance of a commitment letter represents a crucially important point in the commercial lending process. A borrower will usually serve its interests best by bringing counsel into the discussions before the commitment letter is issued, rather than after. (The same recommendation also applies to a lender's use of counsel.) All too often, a borrower will bring counsel into the transaction only after the commitment letter has been issued and it is time to 'close the loan', usually as quickly and cheaply as possible. A borrower taking that approach misses its best opportunity to define the rules of the game in a way that will save time, trouble, effort and money later in the loan closing process, and over the much longer life of the loan itself.

Single commercial mortgage loan

This paper, consisting of four parts, seeks to present a fairly complete summary of the issues that a borrower and its counsel will often consider raising in response to a commitment letter or a full set of loan documents. The discussion generally assumes a single mortgage loan without additional forms of financing. The use of mezzanine loans, preferred equity, split mortgage notes and so on raises a whole new set of structuring and other issues, all mostly beyond the scope of this paper.

Although the discussion here emphasises a borrower's view of real estate finance, it targets secondarily lenders and their counsel, because it collects in one place almost everything they may encounter when negotiating a typical commercial real estate loan. The author represents both borrowers and lenders. Though this paper views the world from a borrower's perspective, the author does not intend to imply that lenders should accept the borrower's position on any issue covered in this paper.

In this discussion, certain themes arise again and again, including these:

- *Extra obligations.* Do the loan documents require the borrower to

do anything more — or spend more money — than it would otherwise?

- *Extra burdens.* Do the loan documents impose any other incremental burdens or restrictions on the borrower? What will these cost?
- *Flexibility.* How much flexibility will the loan documents give the borrower?
- *Third parties.* To what degree do the loan documents require the borrower to obtain from third parties any documents or cooperation that those third parties may have no legal obligation to provide?

Zero-sum game?

Loan documents are in substantial part a ‘zero-sum game’. To the extent that they give the lender control, flexibility and leverage, they potentially give the borrower a loss of control, flexibility and leverage. They potentially create a need for the borrower to go back to the lender after the closing to obtain consents and cooperation if the borrower ever wants to do anything for which the loan documents require the lender’s consent.²

If the borrower knows the lender well, the borrower may be willing to live with the risks of imperfect loan documents. The borrower may believe that as long as it pays its obligations and makes reasonable requests, the lender will probably accommodate.

A cautious (or nervous) borrower will remember, though, that lenders merge, staff members leave and lenders sell loans. When a lender sells a loan, that loan may well end up in a securitisation, part of a large pool, serviced by an underpaid servicer in a distant city and without any particular individual with whom the borrower can ever establish a good working relationship. The servicer may regard its role in dealing with the borrower as nothing more than an opportunity to collect fees for future consents.

Fees for future consents

Therefore, a modern borrower may be less likely than in the past to rely on the lender’s future cooperation, good faith, accommodation and practicality. If the borrower wants cooperation, good faith, accommodation and practicality from the lender, the borrower may need to build it into the loan documents from the beginning, or assume that the borrower will never see it.

Lender’s agenda

The borrower’s overall approach will depend largely on the borrower’s understanding of the lender’s agenda. If a lender is motivated entirely by the need to securitise the loan, that lender may be particularly inflexible on some issues but more flexible on others. A lender that intends to maintain the loan in its portfolio, or syndicate it to a small group of other banks, will have a different agenda. A borrower should understand the variations in lender motivations at the outset, as they will drive the borrower’s negotiating strategy.

The borrower must also consider its own agenda and appetite. A borrower can, if it wishes, figure out some way to negotiate every sentence in every loan document. There is almost nothing in any

Perfect documents?

loan document that cannot somehow be made more borrower-friendly or qualified or watered down or limited in some way. A borrower with infinite time and a high tolerance for legal fees could try to achieve perfect loan documents by instructing its counsel to spot and improve the treatment of every single possible issue and then some. Borrowers rarely adopt that extreme approach, or at least rarely do so twice.

At the other end of the spectrum, a borrower might decide that rather than go through painstaking and costly negotiations at the outset to try to achieve perfection in the loan documents, they would prefer to deal with any imperfection later, if and when it becomes evident. Such a borrower may decide to aim its ammunition at only a short list of key issues, probably the following:

Minimalist negotiations

- *Business deal.* Do the loan documents properly reflect the business deal?
- *No immediate default.* Do the loan documents impose obligations that are significantly inconsistent with the way the borrower does its business, and will the loan documents therefore place the borrower in default immediately?
- *Personal liability.* Has the borrower limited the personal liability of its principals to the maximum extent reasonably possible under the circumstances?
- *Easy exit.* Is the loan as pre-payable as possible under the circumstances?

Technical defaults

If a borrower and its counsel limit themselves to those four issues, the loan document negotiation process becomes much simpler and, in most cases, the loan documents will (as a practical matter) be no worse for the borrower than if the borrower had negotiated every line of every paragraph. This ‘minimalist’ approach to loan document negotiations is not, however, very prevalent, because of a concern that it will come back to bite the borrower during the life of the loan. Moreover, this approach creates a greater risk that the borrower will be in technical default under the loan documents as the facts of the loan and the property unfold over time. If the borrower or its parent company has other credit facilities that attach consequences (or reporting obligations) to any default under any loan, the borrower may need to approach each particular loan with greater emphasis on preventing defaults of any kind, even minor and technical ones.

On the lender side, although a lender will typically start out by wanting the loan documents to give it as much control and protection as possible, a lender may also realise that the more control and protection the loan documents give the lender, the more time and effort it will need to spend in responding to inquiries and administering the loan (assuming the borrower complies with whatever reporting and consent requirements the loan documents impose).

Many of the borrower's requests for approvals or deliveries of information may be utterly routine and far more than a lender really needs in order to monitor the loan effectively and prevent problems. The lender may lose sight of important issues in a barrage of paper. A lender may therefore prefer a more limited approach, in which the loan documents establish fewer but more important and worthwhile restrictions and requirements.

Securitisation and syndication

On the other hand, almost any lender negotiating loan documents does so in the shadow of a possible future securitisation or loan syndication or sale, and may hesitate to accommodate the borrower if doing so may make the loan non-securitisable, securitisable on less favourable terms or less saleable.

Regardless of a borrower's appetite for loan document negotiations, this paper gives the borrower and its counsel a menu from which to choose which issues, if any, to raise with the lender. The author in no way recommends that a borrower raise all the issues suggested here, or even most of them. That is particularly true if the borrower knows the process will be futile or prefers an extremely limited approach to loan document negotiations. By having the menu available, though, the borrower and its counsel can more easily choose which appetisers and main dishes they want to order.

This paper cannot, however, describe every possible issue that could ever be relevant to every possible loan, and does not substitute for competent legal representation. A borrower's counsel can, for example, identify additional issues to raise based on the specific terms of specific documents — and also identify what issues not to raise because governing law in the particular state already dictates a particular outcome, sometimes more favourable than whatever the borrower is likely to achieve through negotiations.

Commitment letter issues

The first instalment of this paper begins by considering some issues that a borrower and its counsel will often want to consider raising at the commitment letter stage. (If a borrower does not involve counsel at the commitment letter stage, the borrower may want to try to raise these issues at the loan document stage. At that point, though, it will be an uphill battle.)

Structural elements

The second part turns to certain structural elements, such as lockboxes, that often appear in loans and how a borrower might respond to them.

Hybrid legal/business issues

The third part of the paper covers more extensively some issues introduced in the first and second parts, and also highlights other issues that a borrower might raise in response to provisions that commonly appear in lenders' standard loan documents. That discussion focuses first on hybrid legal/business issues — provisions that a borrower's business people will probably understand instantly and care about. It then turns to more legalistic provisions — provisions for which business people have little patience but that they could live to regret in the future if ignored.

Finally, the fourth part of this paper suggests some proactive

Proactive issues

issues that borrowers and their counsel should consider raising — issues not suggested by standard loan document provisions themselves, but instead arise from the likely needs, concerns or agenda of a particular borrower. To identify these concerns and to assess how important they are to a particular borrower, a borrower should ask itself some questions about the property and the transaction. Some of those questions will be covered towards the end of the fourth part of this paper. This four-part discussion considers loan negotiations almost entirely from the borrower's point of view. The author does not intend to imply that any particular outcome on any issue is 'right' or 'wrong'. The author actually represents lenders more often than borrowers, and this paper does not reflect the author's practices or expectations when representing the lender.

Moreover, this paper does not try to describe how a lender — whether a portfolio lender or a securitisation lender — might respond to any issues suggested here. A proposal that one lender may regard as 'absurd' in one transaction may seem perfectly reasonable to that same lender when dealing with some other borrower or on some other property. In some cases, however, where borrowers and lenders often negotiate a 'compromise' position on an issue, that typical compromise is summarised here.

The discussion disregards issues that would appear on any borrower's short list of obvious economic issues — loan amount, maturity, interest rate, amortisation and the like — issues that often seem like afterthoughts or footnotes in a morass of details and hypothetical possibilities of the type explored here. This discussion does, however, cover some non-obvious issues that arise in defining and calculating the monetary terms of the loan, because these issues can cost a borrower money that the borrower did not expect to pay. The entire discussion excludes construction loans.

FUNDAMENTAL ISSUES FOR THE COMMITMENT LETTER

Basic issues

When a borrower reviews a commitment letter or structures a loan transaction, the borrower and its counsel should consider, at a minimum, the short list of fundamental issues set forth below. If counsel first becomes involved at the loan document stage, the same issues will require immediate attention, but as described above, they may already be set in stone.

Of course, every transaction raises a range of issues and has its own dynamics. A borrower's leverage — including above all whether the borrower has already paid a commitment fee or, in the alternative, can negotiate with other lenders simultaneously — will determine whether a borrower or its counsel can successfully score on these or any other points. A lender's flexibility will often drop dramatically if the lender intends to securitise the loan and must worry about complying with 'the rating agency requirements'. But these requirements are sometimes in flux and not absolutely clear. The consequences of non-compliance may or may not be grievous

for the lender. If a securitised lender wants to make a deal badly enough, a borrower may perhaps still find some flexibility. (The lender, of course, may later regret that flexibility if it finds that the securitisation market penalises the lender because of what the loan documents say.)

Against that backdrop, any borrower should consider the following fundamental issues and strategies at the commitment letter stage.

Lender's due diligence issues

Handle problems in advance

If the mortgaged property suffers from a problem that the lender's due diligence will inevitably reveal — a zoning problem, a pending condemnation, a very tenant-oriented lease, a looming lease termination — the borrower should put that information on the table when negotiating the loan. Lenders are far more accommodating and flexible before a borrower has paid a commitment fee.

If the property soon will need a new roof or building system, spell out in the commitment letter any actions the borrower will take, such as establishing a reserve fund or making monthly reserve deposits. If the borrower waits until the lender's engineering consultant makes recommendations, the borrower will probably not like those recommendations as much as whatever the borrower would have proposed.

Ground leases

Whenever a 'problem characteristic' of any property is of a legal nature (such as the fact that the property is ground leased), the borrower should often ask the lender to 'sign off' on it early in the process. The lender may in return ask the borrower to pay the lender's legal and other fees incurred in considering whatever issue causes the problem. Such an investment by the borrower often may make sense, particularly if capped.

Lender's costs

Refund of fees

A borrower should beware of non-refundable fees, particularly if the transaction dies because the lender disapproves something about the property or the loan. The borrower should try to have the lender agree to refund as much of the fee as possible, even though the lender will typically insist on covering its third-party costs first.

The treatment of this issue may vary depending on why the deal did not close. For example, a lender will be less likely to agree to refund fees if the borrower simply decides not to borrow the loan (or borrows it elsewhere) than if, for example, an acquisition does not close or the lender decides not to make the loan because the lender identifies problems with the property or wants to change the business deal.

Furthermore, if the lender agrees to 'lock in' a particular interest rate for a particular period, the borrower's case for obtaining a refund of the commitment fee is substantially weakened, as the fee can represent compensation for the lender taking the risk of a change in interest rates.

Legal obligation to borrow

Sometimes, the lender will want the borrower to agree to try to correct any problems that arise, as a condition of the borrower's being entitled to a refund of (some portion of) the commitment fee. In any such case, the borrower will want to limit its 'cure' obligations so that they are not open-ended.

More generally, a borrower usually expects a commitment letter to be a one-way obligation, in which the borrower pays a commitment fee in exchange for the right — but not the obligation — to close a loan. To the extent that a commitment letter obligates the borrower to borrow, the borrower will often argue that such a requirement varies from industry expectations and may create exposure and liability that the borrower did not expect to incur.

Controlling due diligence and closing costs

Any commitment letter will require the borrower to pay for the lender's legal, consulting and due diligence costs. A borrower and its counsel should therefore try to define and limit those costs as much as possible.

Third party reports

The borrower can assume that any lender will want environmental and engineering reports and an appraisal. The borrower should try to persuade the lender to use the same reports or at least the same professionals as the borrower has used in the past. (Lenders may worry about objectivity and reliability. Borrowers can mitigate that fear by using 'brand name', nationally or regionally recognised professionals — the same professionals the lenders would engage themselves.)

Legal fees

A borrower may also want to try to cap the fees of the lender's consultants and even, ideally, the lender's counsel. Lenders often hesitate to agree to the latter caps, for at least three reasons. First, caps on legal fees may produce less vigorous representation, which may be exactly what the borrower had in mind. Secondly, lenders know that borrowers have far greater control than lenders over what a lender's legal fees will be. Thirdly, unless the exact scope of the job can be predicted in advance, lender's counsel (or at least lender's preferred counsel) may hesitate to agree to a cap. Therefore, practically speaking, if a borrower truly wants to control the lender's legal fees, one of the best techniques is to cover as many issues as possible in the commitment letter (as already suggested in this paper), as this creates much less work for lender's counsel in drafting, negotiating and redrafting the loan documents later — a process that typically takes more time and money than negotiating the same issue in a commitment letter.

Prenegotiated documents

Another good technique to control costs might be to ask the lender to use 'negotiated' loan documents from another transaction — either one with the same parties or conceivably a similar transaction with another borrower. (A borrower may want to add such a requirement to the commitment letter.) To the extent that the earlier transaction varies from the current transaction, though, any

savings will be partly, or even completely, offset by the need for lender's counsel to comb through all the documents to squeeze out any deal-specific anomalies or concessions that do not apply to the current transaction.

Finally, if the borrower has had particularly bad experiences in the past with a particular law firm, the borrower might be able to ask the lender to use someone else.

Opinions of counsel

Matters of opinion

Driven partly by the rating agencies, lenders have learned to love opinions of counsel more and more over the years. These opinions can be quite expensive. Some of the more exotic new opinion requirements may flunk any rational cost-benefit test. A borrower should watch out for open-ended opinion requirements in a commitment letter, such as a requirement for the borrower to deliver 'such opinions of counsel as lender or its counsel shall require'. A requirement of that type may turn out to be very expensive. If a borrower can cut back or at least clearly delineate the opinion requirements in the commitment letter, the borrower may reduce costs, complexity and the potential for delays.

The following represents a typical menu of opinions that a lender may require and how a borrower might react to each of them.

- *Entity issues.* Borrower's counsel will opine that the borrower was validly formed, the right people signed the documents, the documents were validly delivered and the transaction complies with whatever requirements govern the borrower. Opinions of this type are fairly routine and rarely cause problems.³
- *Enforceability.* A lender will also ask borrower's counsel to opine that the documents are 'enforceable'. That word raises a hornet's nest of additional issues, most of which have no practical business significance except for the potential cost and delay they might cause if someone decides to be creative or non-standard in thinking about them. The issue of 'enforceability' is, however, quite routine. In most cases it causes little trouble, if any. In states where usury and choice of law are difficult issues, they may cause special problems with the 'enforceability' opinion. These problems can (and generally should) be considered and resolved at the outset, in structuring the loan, and not merely dealt with in the opinion.
- *Substantive consolidation.* If the lender intends to securitise the loan, the lender may require an opinion stating that borrower's affairs would not be 'consolidated' into some other bankruptcy proceeding affecting, for example, the majority owner of the borrower (or vice versa). Such an opinion requires borrower's counsel to assess whether the borrower's ownership structure and internal procedures and related covenants in the loan documents are strong enough (assuming the borrower complies with all of them) to prevent a 'consolidation'. The borrower's first line of

Standardisation

defence against such opinions is to ‘just say no’. If that fails, the borrower can try to limit the exact scope of the opinion — for example, that in a bankruptcy of a specific identified entity, a bankruptcy court ‘should’ not consolidate the assets and liabilities of the borrower.

- *Structure-specific opinions.* Occasionally, the entity structure of the borrower may lead the lender to require additional opinions to confirm that the entity structure works and does not create special bankruptcy risks or problems.
- *Personal property security interests.* If the collateral for the loan will include substantial amounts of personal property (movables), and sometimes even if it does not, a lender may request opinions telling the lender it has good liens (‘security interests’) in that personal property. A borrower may feel these opinions incur expense and effort on an issue that lender’s counsel can handle without the help of an opinion, or for which the lender does not really need whatever comfort an opinion can provide. Moreover, because there is no generally accepted standard as to when and whether a lender should obtain such opinions, a lender will not usually (except perhaps in the case of a hotel loan) suffer any great loss by going without.
- *State law.* If the loan is being closed in a state where lender’s counsel does not practice, the lender may ask the borrower’s counsel (or the lender’s own special counsel) in that particular state to issue an opinion giving the lender assurances about the loan documents and the loan. These ‘local counsel opinions’ are not as standardised as some of the other opinions described above. They can cause a great deal of excitement if the lender insists that the opinion cover a wide scope of issues. It may be more efficient for the lender simply to engage its own counsel and obtain informal advice from that counsel, rather than require a full opinion of counsel. A borrower might also take the position that if a lender chooses to make loans in a particular state, that lender should go to the trouble of learning any special legal requirements in that state, without imposing on the borrower the extra burden of dealing with an extra set of counsel — particularly for issues that are unique to the particular lender rather than the loan, such as requirements to qualify to do business.

State law

Zoning

- *Zoning and code compliance.* A lender will want to know that the mortgaged property complies with zoning and other laws. One way to obtain that comfort is through an opinion of counsel, but that solution is usually more expensive and less meaningful than other ways to cover these issues, such as a certificate from a qualified engineer or consultant.
- *General compliance with law.* Occasionally a lender will request an opinion that a borrower complies with law, generally. Such opinions are of limitless scope and most borrowers’ counsel will refuse to provide them.

A borrower should try to delineate in the commitment letter exactly what opinions the lender will require, in an attempt to minimise the requirements as much as possible. Also, if the borrower foresees any possible issue regarding the borrower's choice of counsel to issue the various opinions, the borrower should try to resolve it in the commitment letter. The borrower may want to attach a form of the required opinion to the commitment letter, although this is relatively unusual.

Space leases

Importance of rental income

Today's lenders look primarily to rental income and hence to existing tenants and leases — both of which are, for the most part, usually beyond the borrower's control at the time of any particular loan closing, because they have already been negotiated and signed. If any major leases are highly tenant-oriented or otherwise potentially objectionable, the borrower might want to have the lender sign off on them as part of the commitment letter. (The last thing a borrower wants to hear about is the 'lease amendment' that lender's counsel thinks the borrower should go out and get for the closing.)

Rental stream preapproval

If the commitment letter contemplates that the lender will review, approve and validate the borrower's rental stream at the time of the closing, then the borrower and its counsel should give some thought to any elements of that rental stream that may create trouble. For example, a tenant in bankruptcy (or heading that way) will probably create a problem, as may seasonal income from the company that has sold Christmas trees in the parking lot every year for the last 15 years but has no lease. A borrower may want to have the lender pre-approve these elements of the rental stream as part of the commitment letter, rather than have to deal with issues in the closing process or at closing. This is also the stage at which to try to limit the lender's requirements regarding delivery of tenant estoppel certificates and non-disturbance agreements.

Non-disturbance agreements

As a starting position, for example, the borrower might consider trying to eliminate any requirement for non-disturbance agreements,⁴ under the theory that non-disturbance agreements are more trouble than they are worth. A strong borrower, with a high quality property and a low loan-to-value ratio, may succeed in this request. As another basis to persuade a lender to do away with non-disturbance agreements, the borrower may offer a creditworthy guaranty of at least some of the risks from which a non-disturbance agreement is intended to protect the lender.

As a more typical treatment of this issue, the borrower might be able to persuade the lender to agree in the commitment letter that the borrower needs to obtain non-disturbance agreements and estoppel certificates from only specified major tenants and tenants collectively occupying a specified percentage of space in the mortgaged property. If the borrower cannot reach that level of deliveries, then the borrower should try to build in a 'fallback' measure, such as the right to deliver so-called 'landlord estoppel

Pre-approval of documents

certificates', in which the landlord certifies the same facts that the tenant would have certified.⁵

To the extent that existing leases require tenants only to enter into a particular form of estoppel certificate or non-disturbance agreement, the borrower will often ask the lender to agree (in the commitment letter) to accept those documents. Similarly, if tenants have previously delivered particular forms of these documents to other institutional lenders that previously financed the property, the borrower might ask today's lender to agree to accept documents in the same form.

For chain store tenants, the borrower might be able to persuade the lender to agree to use a form of non-disturbance agreement that the lender previously negotiated with the same tenant at some other location. Virtually every major institutional lender, for example, has negotiated non-disturbance agreements with Gap, and can simplify the next such negotiation by copying the results of the last one.

Lease requirements

Finally, if any leases require the landlord to obtain non-disturbance agreements from future lenders, the borrower should ask the lender to agree, in the commitment letter, to comply with those requirements. The borrower may want the lender to agree to sign these documents at the closing or within a short time thereafter, as following through on such agreements often falls to the bottom of the lender's pile after closing. Tenants that deliver such agreements also sometimes impose such requirements. To the extent that the lender expects more than the tenants must provide, the borrower may set itself up for an awkward and difficult closing.

Preserving flexibility

If the lender specifies the form of non-disturbance agreement that the borrower must obtain from tenants, then the borrower will want to make sure that the non-disturbance agreement does not disrupt the relationship between the borrower and its tenants. For example, if the borrower negotiates a right to amend leases in certain ways without the lender's consent, the borrower should not agree to obtain a non-disturbance agreement that would take away that right by requiring the lender's consent to every lease amendment. Although a non-disturbance agreement is largely a document between a lender and a tenant, the borrower needs to pay attention to what it says.

Single-purpose entities

The lender may want the borrower to form a new 'single-purpose entity' to hold the property, or rewrite the organisational documents for the existing property ownership entity, particularly if the lender plans to securitise the loan. Although any such requirement in and of itself usually creates no significant problems for a borrower, a borrower and its counsel may want to give some thought to unexpected consequences and issues. They may want, for example, to consider the answers to the following questions:

- *Minority investors.* Does the borrower include limited partners or

Practical issues for single-purpose entities

other minority investors, whose cooperation the borrower will need in order to form a new entity or modify the existing entity documents to meet the lender's requirements? Will such cooperation be forthcoming?

- *Transfer taxes.* Will the borrower incur transfer taxes or other significant expenses by moving the mortgaged property from the existing ownership entity into a newly formed 'single-purpose entity'?
- *Other tax issues.* Will the change create issues under any real estate tax abatements or trigger a real estate tax reassessment? Will the change create income tax issues?
- *Approvals.* Will the change require any third-party approvals or notices?
- *Independent director.* If the lender requires not only a single-purpose entity but also an 'independent director', what will that cost and how much bother will it cause?
- *Future funding.* If the borrower is a single-purpose entity, will it be able to borrow on an unsecured basis from its principals if necessary for future capital projects, leasing expenses or to cover losses? Does the borrower anticipate any possible need to incur additional debt?
- *Tax returns.* Will the borrower have to file separate tax returns? Will that work? Perhaps not, if the borrower files consolidated returns with other entities or to the extent that the applicable tax laws disregard a single member limited liability company. In that event, the borrower may not want the loan documents to require separate filings. It may prefer to be able to file consolidated or combined returns, with a footnote somewhere in the return indicating that the borrower is a legally separate entity.
- *Other.* Does the borrower have any other plans or strategies that might argue against the use of a 'single-purpose entity'?
- *Reality.* Do the single-purpose-entity covenants in the loan documents track the actual manner in which this borrower will conduct its business? Those covenants typically go far beyond what would be minimally necessary to prevent 'substantive consolidation'. (A borrower might regard these covenants as the loan documentation equivalent to using a laser-guided nuclear-powered rocket to eliminate a nearby sleeping flea that is already on life support.) If a lender agrees to some level of flexibility in the single-purpose-entity covenants, the borrower can argue that the likelihood of a 'substantive consolidation' will still remain asymptotically close to zero. If the borrower anticipates it will need to incur some indebtedness or obligations, the loan documents should allow for it. Also, should the borrower not be able to incur obligations related to the property and the closing, such as indemnifications given to the title insurance company? In their endless beefing up of single-purpose-entity covenants, securitised lenders and the rating agencies that guide them may prohibit activities that overlap the actual reasonable business

Borrower's business practices

practices of borrowers, prohibitions that are probably not necessary to prevent substantive consolidation.

To the extent that the answers to these questions argue against creating a new ‘perfect’ single-purpose entity, formed at the closing under documents that embody every possible ‘single-purpose-entity’ restriction known to real estate lawyers, a borrower may want to try to persuade the lender to accept something less than such an entity.

Unexpected personal liability

Because lenders will often ask that any violation of the ‘single-purpose-entity’ covenants automatically triggers personal liability under any guaranty of non-recourse carveouts, it becomes all the more important for a borrower to consider and understand the exact scope of these covenants. As a particularly worrisome example, if the borrower covenants to maintain a particular level of capital — eg sufficient capital for its anticipated business activities — or covenants to remain solvent, then such a covenant when coupled with a non-recourse carveout guaranty could convert a non-recourse loan into a loan with full recourse to whoever has guaranteed the non-recourse carveouts.

Tax and insurance escrows

Basic costs of ownership

More loans than ever require monthly escrows for taxes and insurance — a procedure that creates extra work, extra potential for mistakes and negative arbitrage for the borrower, all premised on doubt that the borrower will pay the most basic costs of ownership when due. A borrower faced with a request for tax and insurance escrows may want to consider the following responses.

- *No escrows.* A borrower may try to persuade the lender not to require such escrows unless an ‘Event of Default’ has occurred — at which point, of course, the lender also has the option to accelerate the entire loan (and, from the lender’s perspective, the horse is already out of the barn door). Nevertheless, lenders are often willing to agree, particularly at the commitment letter stage, to waive tax and insurance escrows so long as no Event of Default exists. The borrower’s argument to waive escrows is particularly compelling to the extent that taxes and insurance costs are passed through to tenants (especially creditworthy tenants), under leases that only require annual or semi-annual payments when taxes are due.
- *Personal guaranty?* As a fallback position, a borrower may be able to persuade a lender to drop these escrows by offering, for example, a limited personal guaranty that the borrower will apply any cash flow first to pay taxes and insurance when due. Many borrowers refuse to provide personal guaranties of any kind under any circumstances, though. On the other hand, a limited personal guaranty of this type tracks the liability that the principal would already incur under a typical ‘carveout guaranty’.

Timing and administration of escrows

- *Interest/investment.* If the borrower cannot avoid tax and insurance escrows, the borrower will at least want to assure that they bear interest or, if the numbers are substantial, can be invested in low-risk short-term investments. In either event, the borrower will want to receive the interest or earnings, or at least assure they are added to the principal of the account.
- *Seasonality.* If the borrower's income varies seasonally, such as in a hotel, the borrower may want to adjust escrow deposits to reflect that seasonality. A borrower may be more likely to make this suggestion when the seasonality would tend to defer rather than accelerate escrow deposits.
- *Administration.* A borrower stuck with a tax and insurance escrow will want to assure that the escrow is being properly administered and the taxes and insurance premiums are in fact being paid. Towards that end, the borrower may ask the lender to provide copies of receipts for payment or paid bills. If any bills may be paid in instalments, the borrower will typically want the lender to agree to do so — and not necessarily on the due date, but instead on the last date payable without penalty or other risk.

Other reserves

Reserve requirements

A borrower will want to define as early as possible the scope of any other reserves that the lender will require the borrower to maintain — such as a monthly reserve for capital expenditures, re-leasing costs or for particular categories of necessary (or possibly necessary) work. In many cases, however, the lender will refuse to commit itself until it has completed its due diligence about the property.

If a borrower can foresee a request for a particular type of reserve — such as a re-leasing reserve — the borrower may want to raise the issue proactively and confirm in the commitment letter that no such reserve will be required for any lease whose remaining term exceeds a certain threshold or where the tenant satisfies certain credit standards.

Whatever the magnitude of the reserves, the borrower will probably want the right to invest them in a particular way. The borrower will want to make the conditions and procedures for the release of reserves to be as simple as possible and the permitted uses of reserves as broad as possible.

If the borrower's needs change — for example, the borrower can avoid renovating the lobby because a new tenant of the entire building does not care about the lobby — then the borrower may want the right to reallocate unnecessary funds to other reserve accounts, or have those excess funds released to the borrower.

Insurance

Extra insurance

If the commitment letter and the loan documents will require more or better insurance than the borrower would typically expect to provide, this will in effect impose an extra cost on the financing. The borrower should identify the lender's specific insurance

requirements, compare those requirements against the borrower's regular practices, and try to cut back on any that seem too costly.

The following are some common examples of extra insurance requirements that lenders impose, each of which can either cost more money or require more work:

Extra cost of work

- *Rating*. A minimum required rating for the insurance carrier, higher than the borrower would otherwise expect to obtain;
- *Deductible*. A maximum deductible amount, lower than what the borrower would otherwise expect to obtain;
- *Cash flow coverage*. Extended coverage periods for business interruption or rent insurance, such as 18 months when the borrower would otherwise maintain 12 months of coverage;
- *Flood*. Flood insurance coverage requirements that go beyond the low-cost insurance that the federal flood insurance programme offers;
- *Earthquake*. Requirements to maintain earthquake insurance;
- *Liability*. Coverage amounts for liability coverage beyond what the borrower would otherwise provide;
- *Future changes*. Possible future changes in insurance requirements, particularly if not constrained by 'reasonableness' or a comparison with current standards for comparable properties in the same general area;
- *Closing documents*. Requirements to deliver a 'certified copy' of the policy, as opposed to merely a certificate of insurance; and
- *Terrorism coverage*. Insurance against terrorism risks in excess of what the borrower would otherwise obtain.

In addition to trimming back requirements like those suggested above, a borrower may also want to request the following changes in the insurance provisions of the loan documents:

Coordination with leases

- *Blanket insurance*. A borrower may want the right to provide any required insurance in the form of a 'blanket' policy for multiple properties. In this case, the borrower will not be able to 'assign' the entire policy to the lender, but can usually obtain a certificate of insurance and satisfy other common and reasonable requirements that adequately protect a lender.
- *Insurance under leases*. Major leases may require the tenants to provide insurance coverage that a loan would require a borrower to provide. In such cases, the borrower will want to confirm that the tenant-provided insurance meets the requirements of the loan documents, or that the lender will overlook any differences. As a mechanical matter, the borrower will need to obtain from the tenant's insurance broker (or insurance department) whatever evidence of insurance the lender requires for closing. This process will not necessarily be easy or quick.
- *Unobtainable insurance*. If insurance markets change and particular insurance is unobtainable (or not available at a

‘commercially reasonable’ price), a borrower may want the right to suspend its obligation to provide that particular insurance. If a lender is willing to accept that proposition, the lender would probably insist that it apply only to ‘secondary’ insurance coverages — not to basic property insurance coverage.

- *Notice before force-placement.* Standard loan documents allow the lender to ‘force-place’ any required insurance that the borrower fails to maintain. For exotic, unusual or controversial types of insurance (for example, terrorism insurance), the borrower may want substantial prior notice before the lender can take such an action.
- *Original policy.* Particularly for a ‘blanket’ insurance policy, the borrower will want to avoid delivering the original insurance policy to the lender.

Insurance advisers

In addition to negotiating specific changes in the insurance provisions of the loan documents, a borrower and its counsel would be well advised to ask the borrower’s insurance advisers to review the insurance requirements, to confirm they are acceptable, ‘industry standard’ and consistent with the borrower’s insurance programme.

Casualty

Restoration after casualty

If the building burns down or some other loss occurs, a borrower will want the right to use insurance proceeds to rebuild, subject only to typical and customary conditions that the borrower knows it will be able to control. Lenders have become more accommodating on this issue. A borrower can, at any stage in loan negotiations, go into any level of detail about how the rebuilding process will work. This is, however, one area where a broad-brush approach, something less than absolute precision and certainty, will often suffice, even in the final loan documents themselves. The borrower will want to make absolutely clear, in any event, that the borrower does have the right to rebuild subject to tolerable limitations and may want to raise the following issues regarding restoration and casualty:

Control of insurance proceeds

- *Adjustment.* Particularly if no Event of Default has occurred, the borrower will want to control the insurance adjustment process as much as possible. Even if an Event of Default has occurred or the loss exceeds a certain level, the borrower would like the lender to agree to ‘consult’ with the borrower or with third-party experts with whom the borrower is comfortable.
- *Payment.* If the loss is below a certain threshold, then the borrower may want any insurance proceeds to be paid directly to the borrower, so the borrower need not deal with a complex and possibly cumbersome disbursement procedure under the loan documents.
- *Restoration.* What conditions must the borrower satisfy in order to restore? If the borrower can restore to the same physical condition as before the casualty, does it make sense to require the

Conditions to restore

borrower also to demonstrate a certain value after restoration? After all, if the borrower completes restoration, the lender is fully restored to the position it had before the casualty. On the other hand, the casualty will probably lead to termination of most of the leases in the building. The lender may therefore want the borrower to demonstrate that it will achieve a certain level of rental income after restoration.

- *Personal liability.* A borrower should try to negate any need to deliver a bond or a personal guaranty as a condition to restoring the mortgaged property.
- *Leases.* A borrower does not want to be in a position where the leases require restoration but the loan documents do not allow it. Furthermore, what if the leases give the tenant the right or obligation to restore and the right to use insurance proceeds for that purpose? The borrower needs to consider the answers to these questions in negotiating the loan documents.
- *Excess proceeds.* If any insurance proceeds remain after restoration — or after use of rent insurance to pay debt service and operating expenses — the borrower would like to receive that money free of any lender claims.

A borrower will typically be willing to accept limitations on the right to rebuild, such as the following:

Disbursement procedures

- *Control of proceeds.* The lender can control the insurance proceeds, at least above a certain threshold.
- *Shortfall.* If any shortfall exists at any time — ie if the cost to restore at any time exceeds the remaining funds available — then the borrower must deposit with the lender an amount equal to that shortfall before any restoration begins.
- *Disbursement procedures.* Other disbursement procedures and conditions like those of a construction loan, particularly a requirement for progress disbursements rather than a single disbursement at the end of restoration.
- *Plans.* The plans and specifications for restoration must comply with law; must restore the entire building or its equivalent; and may be subject to lender's approval, not to be unreasonably withheld.

It is the author's opinion that issues of restoration and restoration procedures consume far more time, effort and paper than they justify. As long as the documents memorialise the basic point — ie the borrower will be allowed to rebuild — a detailed treatment of the topic seems unnecessary; others disagree. Recent events confirm again that substantial casualties and insurance claims do occur.

Transfers

Rights to transfer

If a borrower will want the right, while the loan is outstanding, to transfer the property or interests in the property-owning entity to a third party, the time to raise this issue is in the commitment letter.

Borrower's internal structure

Those issues, and any related fees and conditions, should be negotiated as early as possible.

The importance and complexity of 'permitted transfers' will vary depending on the structure and business agenda of the borrower. If the borrower consists of two or more separate groups, the interests of the varying groups may conflict on this issue. For example, the documents may give one group the right to buy out another group under certain circumstances. Whoever anticipates being the 'victim' of an involuntary transfer of this type may like the idea that the loan documents prohibit that particular transfer. Moreover, the likely 'victim' will often be the general partner or the managing member actually negotiating the loan documents. For example, the 'money' partner may have the right to replace the general partner if the investment fails to achieve certain threshold levels of profitability, but the first draft of the loan documents will probably prohibit such a change.

If a limited partner or passive investor cares about these issues, it may want its counsel to participate in the loan document negotiations or may want the borrower's organisational document to require that any loan documents track the treatment of these issues in the organisational document.

The following are some examples of transfer rights — both affecting the property and the equity within the borrower — that some or all investors in the borrower may care about and may want the loan documents to permit:

Conflicting interests

- *Change of management.* Do the borrower's limited partners or other passive investors have the right to replace the general partner or managing member?
- *Buy-sell right.* Does the borrower's organisational agreement contain a buy-sell right? If so, the loan documents should allow any resulting transfer, regardless of who buys out whom.
- *Permitted transfers.* Are certain investors automatically permitted to make certain categories of transfers? Should the loan documents categorically allow transfers among the partners or members of the borrower, or to their affiliates? If not, what about transfers resulting from the exercise of a 'squeeze down' procedure within the borrowing entity? Furthermore, if an individual owns any of the borrower's equity, the borrower will want the right to make transfers within the family, for estate planning purposes or upon death.
- *Securitisation.* If a loan will be securitised, a borrower might ask for the right to consummate any transfer at all, provided that the relevant rating agencies issue a 'no-downgrade' letter, confirming that the transfer will not lead to any reduction in the rating of any securities issued pursuant to the securitisation.
- *Investment horizon.* Does any investor group within the borrower have an investment strategy and time horizon that might require a sale of their interest before the maturity date of the loan?

- *Forced sale.* Do the organisational documents allow one party or another to force a sale of the property at some point?
- *Passive investors.* Does the borrower contain passive investors that should simply have the right to sell their interests to other passive investors? For example, if much of the equity is being sold through a ‘syndication’-type investment structure, with numerous individual limited partners at some level of the ownership structure, the loan documents need to allow both the initial syndication sale and subsequent resales without limit. If the lender cannot live with the resulting uncertainty, it should not make the loan.
- *Sale of property.* Might the lender agree to allow a single sale of the property to a purchaser that satisfies certain objective criteria (or perhaps even subject to lender’s approval, not to be unreasonably withheld), provided that the borrower pays an assumption fee (typically 1 per cent)? (Although such an assumption right is better than nothing at all, not every potential purchaser will find the package attractive. Also, the borrower will want to carve out transfers to affiliates and the like, as an exception to the fee.)
- *Personal property.* Does the borrower need some flexibility to deal with personal property (movables) included in the collateral? For example, the borrower might want the ability to enter into personal property leases or dispose of personal property that it no longer needs.

Lender education

If the answer to any of these questions is ‘yes’, the borrower — or at least certain groups within the borrower — will want to assure that the commitment letter and eventual loan documents address the topic in a favourable way.

These issues often require the borrower to ‘educate’ the lender about the borrower’s ownership structure, business agenda and exit strategy. If the borrower fails to perform that education (as early as possible in the loan closing process), and does not negotiate appropriate concessions in the transfer restrictions, the borrower (or at least some of its investors) may find that the loan documents take away benefits and flexibility that were probably hard fought in the borrower’s organisational documents and frustrate the borrower’s fundamental business strategy.

These ‘transfer’ restrictions and permitted transfers become more important to the extent that the loan documents prohibit prepayment. A borrower may sometimes ask a lender to agree that if the borrower ever proposes a transfer, and the lender disapproves it, then it will have the right for a certain period to prepay the loan with no prepayment premium.

Non-recourse/carveout liability

For any non-recourse financing, a borrower should not settle for a reference to ‘customary carveouts’ in the commitment letter.

Limiting personal liability

Instead, the borrower should try to define exactly what those carveouts are, and try to assure that no one has any liability for them except the borrower itself. The borrower and its counsel would be well advised to attach the actual text of the non-recourse carveouts to the commitment letter or application.

Although the subject of non-recourse carveouts can be analysed in depth to any degree, this paper seeks only to set forth a few general principles that borrowers should typically consider. In the area of non-recourse carveouts, those general principles include the following:

- *Control.* Try to avoid incurring recourse liability for anything the borrower cannot control, although a lender will probably reject this position at least as it relates to environmental liability.
- *Multiple principals.* If multiple principals have assumed recourse liability for the non-recourse ‘carveouts’, each should try to limit its liability solely to problems or issues it caused, for two reasons. First, each principal should (as noted above) hesitate to assume liability for anything it did not cause and hence could not control. Secondly, issues of fault, causation and blame will complicate and prolong any litigation in which the lender actually tries to enforce the non-recourse carveouts against any principals.
- *Carveouts to the carveouts.* In general, a borrower should try to negate any ‘carveout’ liability that might otherwise arise, if a particular problem or issue: (a) arose from a lack of net operating income; (b) did not cause a materially adverse problem for the lender, the property or the loan; (c) can be blamed on anyone except the borrower and its principals; or (d) was not intentionally caused by the borrower. Each of these ‘carveouts’ to the ‘carveouts’ makes some logical sense and has the added advantage (to a borrower and its principals) of creating factual issues that will complicate and slow down any litigation, hence creating leverage.
- *Notice and opportunity to cure.* A borrower will want to confirm that no carveout liability can arise unless the lender gives the borrower — and any individual that guaranties the non-recourse carveouts — reasonable notice and opportunity to cure.
- *Market standards.* Lenders can always identify great new non-recourse carveouts almost without end. But other borrowers and lenders have already walked down these paths and resolved these issues in ways that borrowers generally accept or at least tolerate. A borrower and its counsel should try to persuade the lender to accept ‘market standard’ non-recourse carveouts based on the argument that this is how everyone else closes loans, even if a thoughtful lender can find some basis for improvement.
- *Scope of liability.* Many non-recourse carveouts poorly define just how much liability a borrower or its principals will incur under any particular carveout. Depending on the wording of the particular non-recourse clause, a borrower may appreciate this

Placing blame

vagueness, as it will create issues and delay in litigation. If, however, the language might reasonably be read to make the borrower or its principals liable for the entire loan under circumstances where the liability should cover only a particular loss, the borrower and its counsel may want to negotiate back the carveouts accordingly.

Fraud and waste

- *Five-letter words.* A borrower will typically want to avoid recourse liability for open-ended concepts like ‘fraud’ or ‘waste’. Each of these words is a grain of sand around which creative lender’s counsel can easily build a pearl in court if the loan ever goes into default. Lenders have also built theories for recourse liability based on such things as ‘implied covenants of good faith and fair dealing’, so a careful borrower will ask its counsel to plan ahead to try to prevent such theories.
- *Cash on hand.* If a borrower holds any significant amount of cash when the loan goes into default, the lender can be expected to assert some theory to obtain access to that cash. The lender may have that access automatically if (a) the borrower maintains its deposits in a bank account with the lender; and (b) the borrower agreed to ‘standard’ loan document language allowing the lender to ‘set off’ any deposits against the loan. A borrower may prefer to take the opposite approach and insist that the lender affirmatively waive any right to recover any cash in the borrower’s possession.

Closing conditions, generally

Any commitment letter will establish conditions to the closing of the deal. A borrower must consider those conditions and confirm that nothing in them imposes an unusual or inordinate burden on the borrower. Set forth below are some specific issues for a borrower to consider:

Acquisition loans

- *Acquisition loans.* If the loan will finance the borrower’s acquisition of the property, how do the closing conditions in the commitment letter match up to the closing conditions in the acquisition contract? For example, if the commitment letter requires estoppel certificates from 75 per cent of the tenants but the acquisition contract requires only 50 per cent, the borrower may find itself in an awkward position at closing. Moreover, if the acquisition fails to close (for reasons other than the borrower/buyer’s default), the borrower may be particularly justified in asking the lender to agree to refund as much of the commitment fee as possible.

Title insurance

- *Title insurance.* Does the lender expect to obtain title insurance that goes beyond typical industry expectations in the particular state? Does the lender expect the borrower to pay for expensive and unusual — or unobtainable — endorsements? Some examples might include comprehensive coverage, usury, zoning and survey. This issue will vary from state to state.

Third party documents

- *Catch-alls.* The commitment letter may list a dozen or more closing conditions, but then also let the lender require whatever else it deems appropriate. A borrower should try to cut back that broad discretion (see ‘Lender approvals, consents and discretion’, below).
- *Forms.* Where the commitment letter will require deliveries from third parties — ie a survey certificate, estoppel certificates or non-disturbance agreements — a borrower should try to attach the required form of these deliveries to the commitment letter (or at least obtain it as soon as the lender issues the commitment). To make life easier and reduce the likelihood of closing delays, the borrower should try to assure that the lender’s expectations are reasonable and consistent with industry standards. Also, a borrower should try to persuade the lender to agree to be ‘reasonable’ about accepting some other form where necessary.
- *Alternatives.* For closing conditions that may prove to be particularly difficult, a borrower may want to build in alternatives and options. For example, if the commitment letter contemplates use of a particular title insurance company, the borrower may want an option to replace that company if it creates issues that another company is willing to overlook.
- *Syndication.* If the closing is conditioned on the lender achieving some level of syndication of the loan at or before closing, then it is not really a commitment, but instead merely a statement of aspiration. Moreover, it will often require the borrower to ‘cooperate’ to some degree with the syndication, which could imply an open-ended obligation to agree to changes in the economics of the loan. If a borrower is willing to (or must) accept any such provisions, the borrower should insist on narrowing the scope of required cooperation as much as possible. Among other things, the borrower should negate any obligation to change the economic terms of the loan. (This will not do much good, though, if the lender has a general ‘out’ for any inability to syndicate the loan.)
- *Failure to meet conditions.* If the borrower cannot meet some of the closing conditions, particularly those of a ‘third-party’ nature, the borrower should try to have the lender agree to extend the closing date, rather than not close at all. Lenders, of course, have reasons to want to close or walk by a certain date, but in practice they will typically be accommodating on issues of this type.

Syndication risks

Lender discretion

Lender approvals, consents and discretion

Both during the closing process and under the final loan documents governing the property for the entire term of the loan, a borrower should try to limit the areas where the lender can exercise unrestricted ‘discretion’ in approving or disapproving anything. The more ‘discretion’ a lender has, the more easily the lender can prevent a borrower from taking actions that make sound business sense down the road. Wherever the lender wants approval rights — particularly in the loan documents themselves and to a lesser degree

in the commitment letter — a borrower should try to trim back the lender's discretion and approval rights through some combination of the measures suggested below, which partly overlap.

Reasonableness

- *Reasonableness.* The borrower should ask the lender to agree to be 'reasonable' about granting or withholding consent. Of course, no one is ever sure what 'reasonable' means. It may mean only that the parties will have an opportunity to go to court. The threat of such litigation, of course, may give the borrower all the leverage it needs. A borrower with enough negotiating strength may be able to persuade the lender to agree to a general requirement of 'reasonableness' regarding all approvals and discretionary actions by the lender.

Leasing guidelines

- *Standards and thresholds.* A borrower should try to define standards both for the lender's decisions and for decisions that do not require the lender's approval. For example, if a lease falls below a certain level or complies with certain objective tests, the borrower would not need the lender's approval. The same could apply for future lease amendments. If, after the amendment, the lease would continue to satisfy the objective tests in the loan documents, then the borrower could proceed without lender approval. Borrowers often accomplish this flexibility by establishing 'leasing guidelines', so that if a lease complies with the guidelines and is written on the borrower's standard form (or something close to it⁶) then it requires no further lender approval. This gives the borrower flexibility and protects the lender from a flurry of approval requests for minor non-controversial leases. The documents might provide for possible changes in the guidelines as market conditions change. If a borrower negotiates such a mechanism, the borrower should, well before the closing, focus on what the guidelines should say. In the author's experience, even if a borrower negotiates the use of leasing guidelines, it can rarely identify what they should say, at least at the closing. This is probably because the borrower wants any such guidelines to establish as low a standard as possible for leases. Too low a standard, though, may cast doubt on the borrower's optimistic numbers that supported making the loan. Once the loan has closed, the borrower may be more willing to show its cards about the rent levels the borrower really thinks it will achieve. For that reason, the borrower will often ask that the loan documents allow the borrower to establish and modify leasing guidelines at any time, with the lender's reasonable approval.

Deemed approvals

- *Deemed approval.* Where possible, a borrower should try to set a time limit for the lender to respond to a request for a decision. Silence would be deemed approval. If a lender agrees to such a 'deemed approval' provision, the lender will probably insist that either or both: (a) the request for approval contain a prominent reminder of the 'deemed approval' process; and (b) the lender

Planning ahead

receive a second notice before the ‘deemed approval’ would become effective. A lender’s willingness to agree to any of this may depend on the type of approval at issue. For example, lenders will probably show more flexibility for approval of leases and alterations than for approvals of transfers.

- *Pre-approval.* If the borrower anticipates taking specific future actions that could require lender approval — such as a lease with a particular tenant or an expansion of an existing major lease — the borrower should raise the issue during the loan negotiations and try to have the lender approve it as part of the loan documents. Some of these potential issues are so fundamental (eg major alterations after closing) that they define the nature of the loan and the borrower should put them on the table long before seeking a lender.
- *Term sheet approvals.* For future leases, try to have the lender agree to approve (or disapprove) leases based on term sheets rather than on the final lease. If the final lease, as negotiated, is substantially consistent with the term sheet, then it would require no further lender approval.
- *Alterations.* Although the loan documents will often give the lender the right to approve future alterations, try to carve out routine alterations such as any that leases might require — particularly leases that the lender has approved or that do not require the lender’s approval. Otherwise, the lender can use the approval requirements for alterations as a ‘back door’ way to control leases that it might not otherwise be able to control.
- *Partial approval.* Ask the lender to approve as much of a particular decision as the borrower can define at the time of the closing. For example, if the borrower anticipates entering into a lease with one of three possible tenants, ask the lender to pre-approve the three tenants and the minimum rent per square foot (but without disclosing it in the recorded mortgage), thus reducing the scope of what needs approval later.
- *Third-party validation.* If the borrower can obtain a third party’s validation of a particular decision — such as a broker’s letter saying that a lease is at or above market — perhaps that decision should require no lender approval or an expedited or simplified approval procedure.
- *‘Good faith’.* As a fallback, a borrower might sometimes live with a requirement that the lender act in ‘good faith’ in granting or withholding consent. A lender might, however, regard such a requirement as merely trading one litigation (about the meaning of ‘reasonableness’) for another.
- *Fees for review.* A borrower should try to avoid any obligation to reimburse the lender’s legal fees or other costs and expenses for reviewing any matter that requires the lender’s approval.

Review fees

These suggestions for dealing with lender approval requirements will be particularly important for future leases, future alterations and

possible transfers of interests within the borrower. Any particular loan may raise its own issues. To the extent that the lender has approval rights, the borrower's counsel should unambiguously remind the borrower of those requirements shortly after the closing, so that the borrower will remember and comply with them.

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Notes

- (1) Instead of a commitment letter, the first 'deal summary' document might be a non-binding term sheet or application. Either is functionally the same as a draft commitment letter.
- (2) This assumes the borrower intends to comply with the loan documents in accordance with their terms. Another school of thought — call it the 'Wild West' approach to lender-borrower relations and real estate finance — says that once the loan closes, the borrower has the lender's money and as long as the borrower makes its payments it can probably do what it wants regardless of what the loan documents say, for several reasons. First, the lender will probably never find out. Secondly, even if the lender does find out, the lender probably will not care and probably will not do anything. Thirdly, even if a lender does care and does do something, the courts may make the enforcement process so difficult that the lender will wish it had not raised the issue. The 'Wild West' approach represents a minority view, whose adherents take a narrow and short-term view of business relationships.
- (3) One could argue that as soon as opinion requirements go beyond the opinion described in this paragraph, they mostly require borrower's counsel to provide assurances about which borrower's counsel has no particular expertise or knowledge — and certainly expertise and knowledge no greater than lender's counsel. Each issue that one of these 'other' opinions covers represents an issue that the lender and its counsel should, in the course of properly closing the loan, consider, handle and get completely comfortable with, without help from borrower's counsel. This argument would suggest that most opinions serve no useful purpose beyond confirming that the lender's counsel properly structured and closed the loan, a confirmation that should not require an opinion.
- (4) In these agreements, lenders and tenants agree to recognise and protect each other's interests in certain important ways.
- (5) A lender may hesitate to accept such certificates — really 'warranty' certificates rather than 'estoppel' certificates — because they give the lender nothing more than the representations and warranties in the existing loan documents. On the other hand, if it comes from the borrower's creditworthy principals, then such a certificate is meaningful. Whoever delivers it will want the right to nullify it later by delivering a standard 'tenant estoppel certificate' to replace it.
- (6) The borrower will want some flexibility — as much as possible in the circumstances — to negotiate the standard form of lease with tenants. Otherwise, the usual run of tenant negotiations may force the borrower to obtain lender approval of most leases, thus defeating the purpose of the whole provision.

Best practices in commercial real estate financing: The borrower's agenda in negotiating loan documents part 2

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Abstract

How should a borrower respond to a draft set of commercial mortgage loan documents? This paper, consisting of four quarterly instalments appearing in the 2003/2004 volume of this publication, seeks to answer that question. The author discusses business and legal issues that mortgage loan documents typically raise for a borrower; some structural variations and the special concerns they might create; the closing process; and some issues that a borrower may want to raise on its own initiative.

Keywords:

mortgage loan structuring, lockboxes, personal guaranties, financial covenants, ground leases, equity pledges

COMMON STRUCTURAL ELEMENTS AND THE ISSUES THEY CREATE

Commitment letters and deal structures for commercial real estate loans consistently raise a series of questions and issues for borrowers, which were discussed generically in the first instalment of this paper. The present instalment turns to some less common questions and issues that may or may not arise in a particular loan, depending on the larger business context of that loan. In each case, industry expectations would require the lender to address these matters as part of the commitment letter, not in the first draft of the loan documents. Still, because the elements listed here do not consistently arise in most deals, they are not covered in the earlier discussion of commitment letter issues.

A. Lockbox

If the lender wants to establish a lockbox to control rental income, the borrower loses control over perhaps the most crucial function of

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any business: collecting revenue. Instead of collecting its own revenue, the borrower ends up with a seat on the sidelines — often some distance from the action. A borrower's first reaction to any lockbox arrangement may be to try to avoid the need for it, perhaps by offering a personal guaranty that the borrower will not apply rental income in violation of the loan documents.⁷ But borrowers do not like signing personal guaranties. Lenders do like lockboxes and borrowers like the lower interest rates or other more favourable deal terms they can sometimes achieve by agreeing to lockboxes.

Revenue collection

As another way to avoid a lockbox, the borrower might offer cash collateral equal to a month or two of property income, representing the lender's exposure by not having a lockbox. The lost interest on the cash collateral may be less than the incremental cost of negotiating and administering a lockbox.

When a borrower does agree to a lockbox, the borrower and its counsel should consider at least the following points:

- *Suspension of lockbox.* The borrower should try to persuade the lender to suspend the requirement for a lockbox, or let the borrower otherwise control the rental income, so long as the borrower satisfies certain conditions (such as a specified debt service coverage ratio or absence of a default).
- *Define the lockbox.* The borrower may want to define in the commitment letter exactly what kind of lockbox the lender has in mind. To some lenders, a 'standard' lockbox might mean nothing less than having the lender collect all the rent and sign every expense cheque from the first day. Other lenders may require less control or may settle for a 'soft' lockbox. For example, so long as no default exists the borrower might collect property income and hand it over to the lender daily or, if the lender collects the rental income, the borrower can freely withdraw it from the collection account. Like the 'standard' non-recourse carveouts, a lockbox can mean different things to different people, and should be defined early in the transaction.
- *Simplicity.* Lockbox agreements and lockbox arrangements tend to be far more complicated, with many more moving parts, documents, procedures and opportunity for problems, than strictly necessary. A borrower can usually not do much about this, except as follows. First, if all the lockbox accounts (the collection account, the disbursement account and any other accounts) are at one local institution with which the borrower has a good relationship, the borrower may avoid substantial agony. Secondly, the borrower and its counsel can try to encourage the lender not to overcomplicate the documents and procedures for a process that does not really need to be all that complicated. Finally, one can prevent a great deal of incremental complexity by allowing the lender to use the lockbox funds to pay debt service and escrows, and then disburse anything left directly to the borrower, so that the borrower can pay all the other expenses of

What is a 'standard' lockbox?

the property. Collectively, those other expenses are relatively small, and yet they produce most of the complexity if the lender wants to disburse them through the lockbox (which sometimes happens).

Two banks

- *Collection bank.* Many lockboxes establish a two-step process in which one bank — typically the borrower's local bank — actually receives the rental income, and then 'sweeps' the incoming cash on a daily basis to the lender's main lockbox bank. Even if the loan documents do not provide for the use of a local 'collection bank', the borrower may want to request it, to avoid too much dislocation for the borrower and the tenants.
- *Tenants in default.* If a tenant is in default, the borrower might not want the lockbox operator to deposit automatically that particular tenant's rent cheque, because acceptance of a partial payment might create issues in the borrower's eviction proceeding against the tenant. If the borrower received the rent directly, the borrower could step in and reject cheques under these circumstances. With a lockbox mechanism, though, a borrower might not be able to take these steps so easily. If the borrower wants to avoid this problem, it may want to set up a procedure so it can warn the lockbox to watch out for cheques from particular tenants or review each day's receipts before the lockbox administrator deposits the cheques. Whether either of these measures can work depends on the mechanics of the particular lockbox. If these measures are not realistic, these risks may just be part of the burden (along with lost flexibility and incremental costs) that a borrower incurs by agreeing to a lockbox.

Investment of funds

- *Investment.* If the lockbox is structured so that substantial sums may accumulate, the borrower will want the right to invest those sums in a way that produces higher income than might a routine banking account. A lender, particularly one that intends to securitise the loan, will care a great deal about exactly how these funds are invested. Any interest or investment earnings should go to the borrower.
- *Reporting.* The creation of a lockbox turns the table a bit regarding reporting requirements. The lender and its servicer can obtain all the information they want about cash flow, but the borrower will want to obtain enough information from them to be able to manage its own property. Moreover, if the lockbox administrator does not give the borrower full and timely reports, the borrower will probably not be able to prepare its own financial statements on time — and thus perhaps violate its loan documents. The borrower may want the loan documents to state that any such delayed reporting does not constitute a default.
- *Lockbox failures.* If a loan payment is missed or late because the lockbox administrator did not release funds on time, the borrower will want to assure that the lender cannot assess late charges. This concession is a free giveaway for lenders, because a court would probably never enforce such a late charge. A borrower may want

Defaults

to go a step further and require the lockbox administrator to agree to pay any third-party late charges or penalties that arise because of lockbox mismanagement (a problem that a borrower often considers far too common).

- *Reserves.* The borrower should avoid giving the lender the right to establish new reserves in the future as part of the lockbox mechanism. A lockbox may make it too easy for a lender to identify new reasons to withhold money from the borrower. Once the usual expenses have been adequately funded, any remaining funds should go to the borrower.
- *Budgeting and payment of expenses.* What does the borrower need to do in order to release funds from the lockbox? How much flexibility does the borrower have to the extent that expenses vary from budget? Can the borrower reallocate funds between budget lines? Does the lender need to be reasonable about approving any budget or changes in the budget? What about emergency expenditures? A borrower will want to assure that the lockbox procedures answer these questions in a favourable way.
- *Trust funds.* The borrower will want to assure that the lender cannot include as part of its collateral any funds that the borrower (or the lockbox administrator acting for the borrower) holds in trust for particular purposes. For example, security deposits should not be available to the lender, except to the extent that the borrower has the present right to apply them against a tenant's obligations. Until then, the borrower may be willing to let the lender hold the security deposits, but in trust and subject to whatever limitations state law and the leases themselves impose on how the landlord can hold or apply the security deposits. Similarly, if the borrower collects or withholds any funds to pay any taxes, the borrower would probably incur substantial fines and penalties if those funds were not remitted to the appropriate taxing authority. Therefore, the borrower will want to assure that the lender does not claim any security interest in those funds and that, despite the lockbox arrangements, the borrower will still be able to deposit trust funds with the appropriate governmental authority when required to do so, even if the loan has gone into default.
- *Waiver of claims.* Except for any claims relating to the loan, the lender should waive any claims (such as banker's right of setoff) relating to any lockbox account (or other reserve account) that the lender maintains.

Budgets

B. Guaranties

To the extent that the lender expects to obtain a personal guaranty of part or all of the loan, the commitment letter represents the appropriate stage for the borrower to try to define and limit the scope of that guaranty. The borrower might want to raise and resolve the following issues, each of which can be quite important to the guarantor:

Issues for a guarantor

Scope of liability

- *Sequence of liability.* Must the lender exhaust its remedies against the borrower and the collateral before proceeding against the guarantor?
- *How much liability?* For a partial guaranty, exactly how much liability does the guarantor have and how and when does that liability go away? If the borrower repays part of the loan, does that diminish the amount of the guaranty? Does the guarantor guaranty the first or the last loss the lender incurs?
- *Financial thresholds.* If the borrower achieves certain levels of debt service coverage (or meets some other financial test), does the guaranty drop or terminate? If so, the borrower will want to assure that the guaranty cannot be reinstated if debt service coverage (or whatever test applies) later worsens, because any such reinstatement may make the reduction of liability meaningless.
- *Multiple guarantors.* If more than one guarantor will guaranty the loan, is their liability several?
- *Definition of cap.* If the guaranty is subject to a dollar cap, a guarantor will try to have the dollar cap also apply to the lender's attorneys' fees. Of course, the lender will try to define the guarantor's liability as the dollar amount plus attorneys' fees. If the wording of the guaranty is complicated enough, the borrower may be able to provide for such a cap in a non-obvious way.
- *Carry guaranties.* If the guaranty covers some form of carrying costs (eg taxes, interest or insurance), how and when does the guarantor get out from under that liability? When does the liability end?

Ratios and financial covenants

C. Financial covenants

A lender will sometimes require a borrower to maintain a certain loan-to-value ratio or a certain debt service coverage ratio (ie the ratio between net operating income and debt service). To a lender, financial covenants like these create an 'early warning mechanism' that lets the lender act proactively to prevent a default or assume greater control when the property begins to head in the wrong direction. If a lender requires such covenants, a borrower should consider raising at least the following points in response. Nuances like these will translate into money in the borrower's pocket over the term of the loan.

Adjustments and calculations

- *Definitions.* For any financial covenant, a borrower will want to give the lender as little discretion as possible in determining whether the covenant has been satisfied. For example, a borrower will hesitate to give a lender an open-ended right to 'adjust' income or expenses in measuring net operating income. A borrower should also scrutinise the definitions that underlie any financial covenant. For example, if reserves are treated as an operating expense when deposited into a reserve account, then any expenses later paid from those reserve accounts should be

ignored in defining operating expenses. Do operating expenses reflect actual expenses, or projected or assumed amounts? In calculating the outstanding amount of the loan for any financial covenant, the borrower may want the lender to subtract the amount of any cash collateral (including reserve accounts) the lender holds, under the theory that the 'true' loan balance secured by the real estate should exclude any part of the loan that is cash collateralised.

- *Effect of particular circumstances.* Are there any specific circumstances or facts about the property that justify particular treatment of particular revenues or expenses? For example, to the extent that a credit tenant occupies the property, the borrower might insist on limiting or eliminating the vacancy allowance for that part of the rental income.⁸ If the property has unusual income sources, such as a very reliable Christmas tree vendor every winter, the borrower may want to have the lender agree in advance to include that income for purposes of any debt service coverage test.
- *Frequency and timing.* A borrower would like to run the 'financial covenant' gauntlet as infrequently as possible. That may mean testing compliance annually (or quarterly or monthly) rather than whenever the lender feels like doing so. Moreover, if the borrower has recently acquired the property or plans to undertake a redevelopment or repositioning programme, the borrower may want the right to use projected numbers rather than actual numbers, or may want a grace period before it must demonstrate compliance with the financial ratios.
- *Consequences.* What happens if the borrower is out of compliance? If the borrower simply promises to maintain particular financial ratios, then non-compliance could mean an event of default and potentially a foreclosure. A borrower would prefer to give the lender only certain limited rights that do not require the borrower to go 'out of pocket' to correct the problem. Typically, a financial issue with the mortgaged property will merely mean the lender can capture excess cash flow (a 'cash trap' or 'sweep'), either to repay the loan or, more typically, as cash collateral. Alternatively, the lender might have the right to impose a lockbox or perhaps even adjust the interest rate. If the loan contemplates future advances, the lender could block those advances. But a borrower would not want the lender to have the right to accelerate the loan.
- *Margin calls.* If the borrower's non-compliance with financial covenants entitles the lender to require partial repayment of the loan (a provision that borrowers would not expect or want to see), the borrower will want to assure that any such prepayment does not incur a prepayment premium. The borrower will also want a reasonable time to find the money and may prefer to have the right to deliver a letter of credit or cash collateral rather than pay down the loan. If the loan documents prohibit the borrower

Noncompliance

from borrowing elsewhere, the borrower may want an exception for any borrowing necessary to fund a payment of the type described in this paragraph.

Hedges

D. Interest rate protection agreements

Borrowers will often want (or be required) to obtain interest rate protection products ('hedges') for floating rate loans — either interest rate caps or swaps or occasionally some other measures. These requirements raise the following issues:

- *Security.* If the borrower anticipates obtaining a swap, the borrower should also expect that the swap counterparty will require security for the swap. The only security that makes sense will probably be the mortgaged property itself. To facilitate such security, the borrower will want to make sure the loan documents allow and provide for it.
- *Assignment to lender.* The lender will want the borrower to assign the hedge agreement to the lender, so that the lender can control any payments. The borrower may want to ask that any such payments go to the borrower unless and until the loan is in default, based on motivations similar to those which drive resistance to lockbox arrangements.
- *Termination.* The borrower may want the right to terminate or sell the hedge if it turns out to make economic sense to do so. A lender may be willing to allow such a transaction if the borrower meets certain conditions, such as a minimum level of debt service coverage.
- *Interaction with debt service coverage.* Once a borrower obtains a hedge, the borrower will want any calculations of the actual debt service coverage ratio to take into account the effect of the hedge.

Termination rights

E. Future advances

Earn-outs

To the extent that the lender agrees to make future advances of the loan — or agrees to release funds from reserves or escrows the lender might establish — the borrower and its counsel should review the release conditions to confirm they are both consistent with the business deal and capable of being satisfied without great difficulty. The borrower should try to squeeze out lender discretion and control from those funding conditions.

No matter how much a borrower tries to trim back these conditions, though, the lender will often still retain significant controls and discretion. If the lender does not want to release funds, it will almost always be able to find a basis not to do so. In that light, this issue might be one to drop (in exchange for a concession somewhere else) or not even raise (if a borrower wants to minimise negotiations and expense).

In that case, of course, the borrower has no legal assurance that the lender will actually advance funds when needed. The borrower's practical experience may confirm that problems are unlikely as

long as the loan is basically on track (and if it is off track, the lender would almost certainly have some basis not to fund anyway even if the borrower heavily negotiated these provisions). Just how hard to push on these issues is a matter of taste for the particular borrower.

Equity pledges

F. Equity pledges

If a lender wants to simplify and perhaps speed up enforcement of the loan after a default, it may ask the owners of the borrower to pledge the equity (their ownership interests) in the borrowing entity as additional collateral for the loan. When a borrower agrees to such measures, it should consider the following possible issues:

- *Expedited enforcement.* Lenders want equity pledges in part because they think they can enforce their security interests more quickly under an equity pledge than under a mortgage. But if the transaction is in substance a mortgage loan, why should the borrower's principals run the risk of losing their equity with relatively little notice? The borrower may want to extend the time periods for enforcement of the equity pledge to match those under the mortgage documents and mortgage law.
- *Permitted transfers.* If the mortgage loan documents allow the borrower to transfer equity (such as to affiliates or within the family), the borrower will want the equity pledge documents to facilitate the same transfers, by allowing a transfer of equity subject to the pledge.
- *Mezzanine financing.* Does the borrower plan at some later date to use its equity interests to support future mezzanine financing? If so, the borrower will hesitate to agree to an equity pledge to the mortgage lender or will want, at a minimum, the ability to release the equity pledge under certain circumstances.

Transfers

G. Ground leases

If the borrower's interest in the mortgaged property consists of a long-term leasehold rather than outright fee ownership, the borrower potentially exposes itself to a series of risks and complexities far more substantial than those arising from space leases, as discussed elsewhere in this series.

Leaseholds

Any lender that accepts a leasehold as collateral will care very much about what the lease says. The range of lenders' concerns and expectations may vary quite widely, depending on (among other things) the particular lender's appetite for risk, exit strategy and confidence in the borrower.

Early approval

Therefore, if the borrower plans to pledge a ground lease as collateral for the loan, the borrower should consider obtaining the lender's sign-off on the ground lease as part of the commitment letter. A lender will hesitate to issue such a sign-off unless its counsel has reviewed the lease. The borrower may find that it makes sense to bear the costs of such review, even before a commitment letter has been issued, to avoid problems later.

As a fallback position, the borrower might ask the lender to commit that as long as the ground lease meets the minimum criteria of the rating agencies, the lender will not disapprove it. Rating agency requirements on ground leases may not be as extensive as those which some portfolio lenders might impose. The rating agency requirements are also relatively definable, and a borrower's counsel should be able to determine without great difficulty whether a ground lease meets them.

The borrower and its counsel should also consider what other documents and deliveries the lender will require from the landlord under the ground lease. For example, as much as the lender might want an opinion of counsel regarding the landlord, it is probably not going to happen unless the ground lease requires one. Therefore, the borrower needs to protect itself from the risk of being required to deliver one. Although the borrower should expect to obtain an estoppel certificate from the landlord, the borrower will want to assure that the lender's requirements go no further than those of the lease.

Lease restrictions

A borrower and its counsel should also recognise that, taken together, the ground lease and the loan documents will give the lender a wide range of rights and protections and the ability to restrict the borrower's flexibility in dealing with the ground lease. The borrower should consider whether it can live with these measures. To the extent that the borrower cannot, it should seek appropriate concessions from the lender.

H. Loans to be securitised

Securitisation

Many lenders originate their loans with the intention of promptly securitising them. The requirements of the securitisation market run throughout the loan closing and negotiating process, raising issues and concerns for borrowers at every turn, only some of which this paper addresses. Beyond those issues and concerns, borrowers may wish to raise a few issues related specifically to the securitisation process itself. These would include the following:

Disclosures

- *Certifications.* A lender may want the borrower to agree to sign certifications regarding the accuracy of information, to help the lender (or the securitisation sponsor) comply with its obligations under the securities laws. A borrower will want its obligations to be as narrow as possible, and limited only to information uniquely within the borrower's possession.
- *Disclosure of information.* Unfortunately for borrowers, any securitisation requires the extensive disclosure of information, both for the initial closing (sale and issuance of securities) and on a continuing periodic basis thereafter. Borrowers may want to ask just how much information will be disclosed and, if possible, try to build limitations into the loan documents. Lenders will typically hesitate to agree to limitations, because they cannot predict what the securitisation process will require at the time of

any actual securitisation. A lender might, however, allow the borrower to review and comment on any disclosures and request changes in any language that describes or refers to the borrower or covers issues the borrower might find sensitive. This right would probably not rise to a full right of approval or disapproval.

- *Loan modifications.* To facilitate a securitisation, the lender may ask the borrower to agree to make whatever modifications to the loan documents and ownership structure the rating agencies may require at the time of the securitisation. Because of the open-ended nature of the rating agencies' requirements (and possible future changes in those requirements), any such obligation can be onerous or at least unpredictable. A careful borrower will want to define and limit its obligation to protect itself from any change that might materially alter the economics of the transaction or have any other adverse impact on the borrower. More generally, the borrower will want any such change to be subject to the borrower's approval (perhaps subject to a reasonableness standard).

Timing

- *Timing.* Given the timetable of any typical securitisation, by the time the lender requests the borrower's cooperation, the lender or the securitisation sponsor may be under extreme time pressure. Although the borrower will probably try to accommodate the lender's requests, it will want to assure that the loan documents build in some reasonable turnaround time. The borrower may also want the lender to agree not to securitise the loan until a certain time has passed since the closing or until certain loose ends or issues have been resolved (such as leasing guidelines for the mortgaged property). Even then, the borrower may want the lender to give certain minimum notice before the securitisation closes.

Costs

- *Securitisation-related costs.* Even though a borrower agrees to reimburse the lender's expenses generally, the borrower may want to carve out any expenses related to securitisation of the loan. In addition, a borrower might consider asking the lender to reimburse the borrower's costs (or at least third-party costs such as legal fees) for the securitisation.
- *Changes in consent requirements.* The borrower may propose that if a securitisation ever occurs, some consent requirements in the loan documents are automatically loosened, to compensate for the delays and inefficiencies that often result from the need to deal with a loan servicer. As a common compromise on these issues, the borrower may obtain flexibility, but only if it obtains a 'no downgrade' letter from the relevant rating agencies regarding whatever action it later wants to take.

Transfer restrictions

If, on the other hand, the lender has told the borrower that it intends to hold the loan for portfolio and not securitise it, then the borrower may want to ask the lender to commit to that proposition in the loan documents. This is especially true if the borrower chose a

particular lender precisely because that lender is a portfolio lender (rather than a securitised lender), and even more true if the borrower agreed to pay a slightly higher interest rate in exchange for that benefit.

I. Tenant letters of credit

If tenants of the mortgaged property have delivered to the borrower substantial letters of credit in place of security deposits, the lender may ask to control those letters of credit, a result that a lender can achieve in various ways to various degrees. To the extent that the lender controls the tenants' letters of credit, the borrower will want at least the following assurances from the lender:

- *Responsibility for letters of credit.* If the lender retains physical custody of the letters of credit, the lender should agree to be responsible for them. The borrower should not lightly accept general language that exempts the lender from liability for anything relating to a letter of credit. If the lender loses a letter of credit, fails to draw it or misapplies its proceeds, the borrower may face claims from the tenant. A borrower would argue that the lender should face the same claims.
- *Drawing.* As long as the loan is not in default, the borrower should have the right to decide when and how to draw a tenant letter of credit. If the borrower does decide to draw, the borrower should make sure that the procedure for doing so is workable — even with the lender's involvement — and can be handled quickly.
- *Use of proceeds.* If the lender does draw the letter of credit, any proceeds need to be applied in compliance with the tenant's lease and cannot necessarily be applied against the loan. To the extent that the lease allows the landlord to keep the letter of credit proceeds, the borrower will want to negotiate the right to use them to pay debt service and retenanting costs. If the loan is otherwise on track, the borrower may even want the right to retain the letter of credit proceeds for its investors.

Drawing procedures

CONCLUSION

The first instalment of this paper, in the previous issue of this publication, started with an overview of the loan document negotiation process and how a borrower's leverage changes during that process. It also covered fundamental issues that a borrower may wish to raise at the commitment letter stage.

The present instalment turned to certain structural elements that often appear in commercial mortgage loans, and discussed how a borrower and its counsel might respond to them.

The next instalment in this series will discuss some of the legal and business issues that commonly arise in the loan documents themselves, and changes and improvements that a borrower can request. The discussion will then turn to a few more technical legal

Proactive issues

issues. The fourth instalment will conclude by identifying some issues that a borrower may want to raise on its own initiative.

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Notes

- (7) A typical 'guaranty of non-recourse carveouts' would already cover any such misapplication of rental income.
- (8) If the lender agrees to this concept, it may want the concession to apply only as long as the credit tenant in fact retains a specific level of creditworthiness.

Best practices in commercial real estate financing: The borrower's agenda in negotiating loan documents part 3

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Abstract

Loan documents raise many issues for borrowers. This instalment of a four-part paper describes some legal and business issues that are less fundamental than the issues that arise at the earliest stages of a transaction.

Keywords:

legal issues in loan documents, prepayment rights and calculations, financial reporting, property management, transfer restrictions

INTRODUCTION

When borrowers and their counsel negotiate a commitment letter (or term sheet or application) or the final loan documents for a commercial mortgage financing, they need to consider raising a wide range of issues. This paper, consisting of four instalments (of which this is the third), seeks to summarise all significant 'borrower issues' in any commercial mortgage financing.

The first instalment discussed the borrower's leverage and the dynamics of the loan negotiation process. It also covered fundamental issues that a borrower may wish to raise at the commitment letter stage. The second instalment considered how a borrower might respond to structural elements that often appear in commercial mortgage loans. The present instalment turns to legal and business issues that frequently arise in the loan documents themselves (less so in the commitment letter), and how a borrower might respond to them. It also addresses a few issues of a more technical nature. The fourth instalment, which will appear in the next issue of this publication, concludes by describing some issues that a borrower may want to raise on its own initiative.

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LEGAL/BUSINESS ISSUES IN THE LOAN DOCUMENTS

The following discussion considers some issues that commonly arise in loan documents — including some substantive requirements — and summarises how a borrower might respond to those issues and requirements. The topics covered here raise ‘legal’ issues that are usually ‘business’ issues as well.

A. Prepayment

The borrower’s substantive right to prepay and the pricing of any prepayment will typically be a fundamental economic issue that the parties will negotiate as part of their fundamental business deal, without involving counsel. The commitment letter will, however, often disregard a handful of important issues about the prepayment process. The borrower will want to address those issues in the loan documents. They include the following:

- *Notice and effect.* How far in advance must the borrower notify the lender of the upcoming prepayment? And what happens if the borrower gives that notice? Some loan documents say the loan automatically accelerates on the specified prepayment date. This potentially puts the borrower in an awkward position if for any reason it cannot prepay as planned. A borrower will want to prevent that result and assure that a notice of prepayment does not create an obligation to prepay. For example, what happens if the borrower anticipates closing a refinancing, but ultimately cannot do so or cannot do so precisely as scheduled?
- *‘Yield maintenance’ premiums without more detail.* If the commitment letter provides only for a ‘yield maintenance’ prepayment premium without more detail, the borrower may be able to negotiate the intricacies of the formula in a way that reduces the amount of the possible premium. For example, instead of referring to a treasury bill rate for the remaining term of the loan, the lender may be willing to build in some spread above that rate. Although lenders try not to give up much in calculating prepayment premiums, they will usually agree to apply a present-value discounting to the date of prepayment, if the documents do not already provide for it. The borrower should also try to confirm that the yield maintenance formula takes into account the amortisation that would have occurred over the remaining term of the loan. If the formula automatically treats the remaining term of the loan as interest only, this will increase the amount of the yield maintenance payment. To the extent that the loan documents would allow any future ‘free’ prepayments, the yield maintenance formula should assume the borrower would have made those prepayments at the earliest possible moment. (For example, if the borrower can freely prepay the loan at any time in the last four months before maturity, the yield maintenance formula should assume the borrower would have exercised that right at the earliest possible moment, and should

Economics of prepayment

Timing, notice and other details

Factoring in amortisation

Date of payment

calculate the yield maintenance payment period only through the date four months before the scheduled maturity date.)

- *Timing.* Loan documents often say that a borrower may prepay only on a particular day of the month and the lender need not accept a prepayment on any other day. (This is especially true for securitised loans.) Such provisions substantially limit the borrower's flexibility and can turn a prepayment into a dramatic ordeal. Borrower's counsel should, if possible, try to avoid such provisions and build in greater flexibility on the exact timing of prepayment. That process should begin with an analysis of the precise words of the prepayment clause and a determination as to when the borrower can prepay, by drawing a timeline back from various hypothetical dates of prepayment.
- *Exempt prepayments.* Even if the borrower agrees to pay a prepayment premium, the borrower will want to argue that certain types of prepayments should not incur the premium — in general any prepayment that the borrower did not initiate. This will typically include prepayments resulting from casualty or condemnation,⁹ but may also extend to other triggering events, outside the borrower's control. These might include usury problems, subsequent illegality of the loan (eg if a LIBOR-funded loan can no longer be funded as a LIBOR loan) and certain changes in real estate taxation. More generally, these 'free' prepayments might arise from any event that gives the lender the right to require early repayment or the borrower an option to prepay to avoid incurring certain incremental costs (eg the cost of new reserve requirements or capital adequacy rules) that the borrower did not expect to incur.
- *Deal-specific prepayments.* If the lender requires the borrower to pay down the loan to maintain compliance with financial covenants (a 'margin call'), the borrower will want any such prepayment not to incur a prepayment fee. A borrower may ask for the same right if the lender disapproves any proposed transfer of the mortgaged property and the borrower decides to prepay instead.
- *Releases of collateral.* A borrower should try to avoid paying a premium for any prepayment that arises from a release of collateral. (Of course, a lender will argue that because the borrower initiated the release, it has no valid claim to an exemption in such circumstances.)
- *Breakage.* Whenever the last few paragraphs suggest that a borrower might ask a lender to forgo a prepayment premium, the borrower may also want to ask a LIBOR-based lender to forgo any 'breakage' charges that might otherwise arise if the borrower prepays the loan at any time other than on the last day of an interest period. If the lender rejects that position, as it usually will, the borrower might counter by requesting the right to deposit the required prepayment in a pledged deposit account until the end of the interest period, to avoid incurring any

Covenant compliance

Breakage

‘breakage’ payment. (Whether the borrower will save any money through such an arrangement is another question, but one that the borrower can consider later.)

Effect of partial prepayment

- *Prepayment window.* Even if the borrower is resigned to paying a prepayment premium, it may want to have the right to prepay towards the end of the loan — in the last year or the last few months — without paying a premium.
- *Minimum prepayment premium.* If the lender requires a minimum prepayment premium (eg 3 per cent), the borrower will usually want that minimum to drop over the term of the loan.
- *Partial prepayment.* Do the loan documents let the borrower prepay in part rather than only in full? To the extent that the borrower might partly prepay the loan, whether voluntarily or because of one of the exempt prepayments described above, how does such a prepayment affect the subsequent amortisation schedule for the loan? Typically loan documents will say a partial prepayment does not defer the amortisation schedule at all. That may make no sense to a borrower if the loan will later require substantial amortisation payments, or if the circumstance that triggered the prepayment also reduced the borrower’s cash flow (for example, a hypothetical condemnation of half the building).
- *Defeasance.* As an alternative to prepayment, the borrower may negotiate the right to ‘defease’ the loan — ie replace the real estate collateral with a pool of United States treasury securities that throw off a payment stream exactly equal to the payments the lender would have received from the loan over its scheduled term. Because the interest rate on treasury obligations is lower than the rate on real estate loans, though, the borrower may find that the cost of purchasing the necessary treasury securities substantially exceeds the principal amount of the loan. This will be financially painful to the borrower. It will also give the lender a windfall by giving the lender an income stream that compensates the lender for taking real estate risk, while removing all real estate risk from the transaction. Defeasance may also incur substantial transaction and structuring costs. Nevertheless, in some cases a defeasance transaction may make sense, such as if the property has appreciated so dramatically that it can now support a much larger loan. In structuring any defeasance, the borrower should scrutinise the defeasance procedures to confirm that they are practical and the formula gives the borrower the benefit of scheduled amortisation and any optional amortisation that the loan documents might have permitted.
- *Substitute collateral.* As an alternative to prepayment, a borrower may be able to negotiate a right to substitute new collateral for old collateral. For example, if a loan is secured by a portfolio of 25 shopping centres, the borrower might be able to obtain the release of one shopping centre by adding to the collateral pool a similar shopping centre that satisfies particular criteria. A lender typically will not consider such a substitution for a loan secured

Defeasance as an alternative

Large collateral pools

by only one asset or a handful of assets. If the size of the collateral pool gives the loan some of the characteristics of a corporate (rather than pure real estate) loan, a lender may be more receptive to the idea.

- *Revolver.* If the loan is a revolving loan, then the transaction will by definition include wide-open prepayment rights. If, however, the borrower wants the ability to terminate the revolver — and obtain a release of whatever security the lender holds — the borrower will need to go a step further and have an express right of termination. Otherwise, the lender might say that even if the revolver has been paid to zero, and even if the borrower has no intention to reborrow, the loan contract and the security for potential reborrowings should remain in place for the entire contract period. Such a position would mean the borrower could not use the collateral to secure a new loan.

B. Reporting requirements

Particularly for a loan that will be securitised, the lender will care a great deal about how the property performs. The documents will include very specific reporting requirements and perhaps a general catch-all so the lender can obtain whatever additional information it later requests. Although a borrower will generally accommodate this request, it may want to consider the following:

- *Open-ended requirements.* Borrowers should be wary of undefined or vague requirements for delivery of information, as these could later produce expensive surprises.
- *Confirm existing reports.* If a borrower has standard reporting procedures in place, the borrower should ask the lender to confirm that those procedures will meet the lender's needs. If they do not, the borrower should identify exactly what additional reports and information will be required and how much they will cost. Ideally, the lender will require only what the borrower would already prepare anyway.
- *Auditing.* To the extent that a lender requires audited financial statements — or that particular accountants perform any audit — this may require a borrower to do more (and pay more) than it otherwise would have done (and paid). Borrowers should compare the loan document requirements against their ordinary practices. If a borrower is willing to deliver audited financial reports, it will want to be able to replace the auditor, and from as wide a range of candidates as possible.
- *Accounting standards.* If financial statements will not be audited, a borrower will prefer to prepare its financial statements in accordance with a relatively low standard, such as 'proper accounting practices', rather than under the more rigorous 'generally accepted accounting principles'. If the statements are to be certified by the borrower, the borrower will care about exactly

Additional reports

Audits

who must certify and whether the certification is subject to a ‘knowledge’ standard or something higher.

- *Timing.* Can the borrower and its accounting department meet the reporting schedules in the loan documents?

Late charges and default interest

C. Late payments

Loan documents will generally say that if a borrower makes any payment late, the lender can collect a ‘late charge’ (a percentage of the payment) and/or ‘default interest’ (interest at a rate above the contract rate). These measures give lenders remedies short of accelerating the loan, and they give borrowers incentives to pay on time. A borrower will recognise, though, that these fees will mean money out of pocket, perhaps repeatedly, if the borrower inadvertently makes a payment late. Moreover, if the loan will be securitised, the borrower will often realise that the servicer of the loan may be entitled to keep any late charges, as a significant component of its compensation. This means the borrower under a securitised loan cannot expect the lender to overlook or waive late charges. To the contrary, the servicer may, in effect, look forward to late payments as a revenue opportunity. Against that backdrop, a borrower may seek the following changes in the loan documents:

- *Lower percentages, etc.* The borrower’s first request may be to lower the late charge, lower the incremental interest charged on a ‘default’ and obtain a few extra days to pay before these remedies start to apply. If the commitment letter does not address these issues, and sometimes even if it did, these issues will often be among the handful of final issues resolved on a ‘business’ level for the transaction.
- *No late charge on maturity.* If the borrower fails to repay principal on the maturity date, a lender will often agree that no ‘late charge’ applies to that payment.
- *Base for default interest.* Lenders may try to charge default interest on the entire loan — rather than just the late payment — if any payment is late. A borrower should try to limit the default interest so it applies only to the late payment.
- *Either but not both.* A borrower may want to ask that a lender agree to collect either a late charge or default interest on any particular payment — but not both on the same payment.
- *Notice.* Particularly if the borrower must pay regular monthly interest without receiving notice of the amount, a borrower may ask that the lender not collect late charges and default interest unless the lender has given the borrower notice of the payment and a certain time has elapsed, longer than whatever time the loan documents already provide. Securitised lenders, in particular, rarely agree to any such provisions — at least for regularly scheduled payments of interest and principal — as such provisions will tend to defer the receipt of cash and create timing issues for bondholders under the securitisation. A lender will be

Calculation details

Notice

more likely to agree to give notice, and a time period for the borrower to pay, for any payments due to the lender for anything except regularly scheduled principal and interest.

- *Payment deadline.* If the loan documents set an early payment deadline (for example, 11am), a borrower may be able to negotiate a much later deadline, reflecting the reality that the lender will probably still be able to reinvest any money it receives late in the afternoon.
- *Slightly later payment date.* Instead of requiring payment on the first day of the month, the borrower might prefer to pay on the tenth or some other day of the month, allowing a few extra days to collect any straggling rents.

To the extent that a lender agrees to any of the foregoing concessions, it will often insist that if the borrower pays late more than a certain number of times in a certain period, the concessions go away.

D. Further encumbrances

In addition to prohibiting transfers of the property or the borrower's equity, a lender will generally forbid the borrower from creating additional mortgages or other encumbrances on the property — even if subordinate to the lender's mortgage. Because of the requirements of the securitisation market, bad experiences in the real estate depression in the early 1990s, and the significant 'downside' to a first mortgage lender of allowing any second mortgage loan, lenders rarely agree to any concessions in this area. Nevertheless, a borrower may want to suggest the following changes:

- *'Deeply subordinated' second mortgages.* A lender may be willing to allow a borrower to grant a second mortgage on the collateral, if the second mortgagee's rights are extremely limited — nothing more than the rights to know when and where the foreclosure sale will take place, to bid at the sale and to receive any excess proceeds after the first mortgage has been paid in full. A lender will be more likely to accommodate such a request if the proceeds of the subordinate loan will be used to improve the property or perform obligations under the first mortgage, rather than released to the borrower's equity owners.
- *Other permitted encumbrances.* A lender may agree to permit certain types of encumbrances, such as utility easements, and may even agree to subordinate its mortgage to such encumbrances. Such a lender will probably insist, however, that all documents, including the subordination document, be satisfactory to the lender. A borrower will also want to carve out the following items: leases that comply with the loan documents, mechanics' liens that the borrower is contesting in compliance with the loan

Liens and other financing

'Deep' second mortgages

Mezzanine loans

documents and any assessments that might be imposed against the mortgaged property.

- *Mezzanine financing*. If the borrower intends to obtain mezzanine financing — an additional loan secured by pledges of the borrower's equity or backed by a 'preferred' position in the borrowing entity — then the loan documents should provide for it or at least not prohibit it. Beyond merely obtaining consent, the borrower should consider whether any mezzanine financing or the mezzanine lender will require anything further from the mortgage lender. If so, the borrower should ask the mortgage lender to agree in the loan documents to cooperate as needed. (More commonly, mezzanine financing would be closed at the same time as the mortgage loan, raising a wide variety of issues and structural considerations that are outside the scope of this paper.)

Management

E. Property management

The loan documents will typically try to prevent the borrower from changing the management of the property without the lender's consent. Conversely, the documents may also require a change in management if certain circumstances occur. The borrower may want the lender to agree to pre-approve certain possible alternative managers or a conversion to self-management. The borrower may also want to trim back the lender's ability to require a change of management, particularly if the manager is an affiliate of the borrower. To the extent that a change in management or a change in the management agreement requires lender approval, the borrower should have the lender pre-approve as much as possible at closing.

Prohibited distributions

F. Distributions

Particularly for a construction or rehabilitation loan, the loan documents may prohibit the borrower from distributing available cash to its owners until the borrower satisfies certain conditions (relating to progress and payments). Before agreeing to any such provision, the borrower should consider whether its equity investors are counting on distributions as the source to make required payments — such as for taxes or to pay any fees that the borrower's organisational documents might require. This issue will take on particular importance if the loan documents treat a 'prohibited distribution' as an event that produces personal liability for the borrower's guarantor(s).

The borrower may want to go a step further and insist that the lender waive any claim to 'claw back' distributions that the borrower makes at any time when the loan is not in default.

G. Defaults and cure periods

Loan documents usually let a lender exercise its rights and remedies against the borrower only if an 'Event of Default' has occurred. (If the borrower is merely in default — but the facts have not yet risen

to an ‘Event of Default’ — the lender cannot exercise remedies.) Any borrower should assume that as soon as an Event of Default occurs, the lender will try to exercise remedies, so the definition of ‘Event of Default’ matters a great deal. The following are the usual battlegrounds:

Notice and cure

- *Notice requirements.* Before any problem can become an ‘Event of Default’, the borrower will want to receive notice of the problem and an opportunity to cure it. Lenders will typically agree to give such notice, except perhaps for regularly scheduled payments of principal and interest, and the payment due on maturity.
- *Cure periods.* Once a borrower receives notice — or once a default has occurred, if the lender has not agreed to give notice of the default — the borrower will want some time in which to try to cure the default. For monetary defaults, the cure period will typically be five to ten days (‘business days’, if possible), with exceptions as noted above. For non-monetary defaults, the cure period is typically 30 days with a right to extend — often subject to an outside limit — so long as the default is in fact curable and the borrower is diligently trying to cure it. Lenders may want to cut these cure periods back if multiple defaults occur in any particular period.
- *Representations and warranties.* A breach of a representation or warranty will typically constitute an Event of Default. Here again a borrower should seek a right to correct the problem. For this particular species of default, a lender will often agree to allow 30 days (sometimes longer) to cure, if the breach was not fraudulent or otherwise egregious, and can in fact be cured.
- *Bankruptcy Events of Default.* For an involuntary bankruptcy filing or similar event, a borrower should typically expect to receive (without the need to negotiate) a cure period of up to 180 days — ie that amount of time to have the involuntary filing dismissed — before it becomes an Event of Default. A borrower may also decide not to spend too much time on cure periods for bankruptcy defaults, on the basis that they are not enforceable anyway. That is not an unreasonable approach to the issue, but a borrower must be wary of Events of Default triggered by bankruptcy (or similar events) affecting a party other than the borrower — such as a guarantor, major tenant or principal of the borrower. Any such bankruptcy-related Event of Default will usually be enforceable against the borrower, and the borrower will want ample time to cure it. (Of course, the borrower might take the position that any such Event of Default is beyond the borrower’s control and therefore unacceptable in any case.) The treatment of involuntary bankruptcy can also shade into the treatment of ‘recourse carveouts’, at which point it becomes far more important to the borrower.
- *Material adverse change.* Occasionally, loan documents say that the occurrence of any material adverse change in the borrower’s

Bankruptcy

financial or other condition constitutes an Event of Default. A borrower may want to argue that such language is not ‘industry standard’, at least in the context of pure real estate loans, and should be deleted. As a fallback, a borrower should try to define thresholds for the definition of ‘material’, and otherwise trim back the scope of this possible Event of Default.

Transfers

- *Transfer restrictions.* Lenders often want to treat a borrower’s violation of transfer restrictions as an incurable default. For a borrower, this is particularly onerous given the wide range of possible transactions that can fall within the broad scope of modern transfer restrictions. As a result, borrowers will want to obtain notice and opportunity to cure any violation of transfer restrictions. Lenders sometimes allow up to 30 days, although perhaps only for certain types of prohibited transfers, including perhaps a requirement that the violation was unintentional.
- *Continuing Events of Default.* Throughout any set of loan documents, the borrower’s rights and the lender’s remedies will often change if an Event of Default occurs. A borrower routinely asks to modify these references to refer instead to whether an ‘Event of Default has occurred and is continuing’. This way, even if the borrower’s cure periods have expired and an Event of Default has occurred, the borrower can still potentially cure the Event of Default and thereby put the parties back to their positions as if the Event of Default had not occurred. Lenders sometimes object to this change, under the theory that it gives the borrower a perpetual right to cure any default, even after it has become an Event of Default. More often, however, lenders agree to the change, although they may add language indicating that the wide-open right to cure terminates once the lender accelerates the loan or otherwise starts to exercise its rights and remedies.

Tenants

- *Tenant obligations.* If the loan documents require the borrower to take some action that the borrower has passed through to a tenant (such as payment of taxes), then the borrower will not want the tenant’s failure to perform to constitute a default under the loan. A borrower will often propose that as long as it tries to enforce the tenant’s obligations, the tenant’s failure to perform should not constitute a default under the loan. A lender may accept this proposal so long as the tenant is not in bankruptcy and the failure lasts only for a certain period and creates no immediate risk of disaster (eg a tax sale). A lender would also probably not make this concession for any failure to provide insurance.

Carveouts

- *Non-recourse carveouts.* If a particular default might trigger liability under the non-recourse carveouts, the borrower’s case for notice and opportunity to cure is particularly strong. The following are three categories of default that might especially justify a cure period based purely on considerations relating to the non-recourse carveouts: violation of single-purpose entity covenants, failure to deliver financial statements and environmental-related defaults.

Loan funding

- *Lockbox problems.* If a default arises because of an administrative problem with a lockbox for the loan, the borrower should ask that it not be deemed an actionable default. For example, if the lockbox contained enough money to pay real estate taxes, and the lockbox administrator received instructions to make the payment, but the lockbox administrator somehow failed to do so, then failure to pay the real estate taxes should not constitute a default. A lender will typically agree to such a proposal, particularly because most lenders would never try to assert a default under such circumstances, and a court would probably not allow it anyway.
- *Anticipated funding.* If a default arises because the lender fails to advance loan proceeds when the documents require it (for example, interest to be funded from an interest reserve), the borrower will want to be protected from any resulting default. The lender may want protection as well by giving the borrower a ‘free pass’ only if all funding conditions were satisfied and the lender still failed to fund. The parties then end up where they started — with a dispute over whether the lender should have funded.

The issues just listed will run throughout the loan documents. A careful borrower may want to raise them repeatedly, wherever the loan documents impose burdens or obligations on the borrower.

RELATIVELY TECHNICAL LEGAL ISSUES

In reviewing any set of loan documents, borrower’s counsel may wish to raise certain issues that are of no interest to the borrower’s business people, assuming counsel can resolve each such issue in a reasonable way. Of course, any ‘legal’ issue can always become a ‘business’ issue if the lawyers cannot resolve it. Here are some such issues:

LIBOR calculations

A. LIBOR interest rate calculations and related costs

If a floating rate loan is priced based on the ‘LIBOR’ index, not all the language defining the interest rate is necessarily ‘standard’. A borrower may want to raise at least the following issues in negotiating a ‘LIBOR’-based interest rate.

Reserves

- *Reserve adjustment.* Does the LIBOR rate definition include an adjustment to reflect any reserves that the lender must maintain against LIBOR loans? Some borrowers consider such an adjustment to be inconsistent with the market, both because the lender separately has the right to pass through reserve-related costs, and because any such costs (as well as any other increased costs of maintaining a LIBOR loan) will quickly be factored into the market-based pricing of LIBOR interest rates and therefore do not merit separate compensation to the lender in any form. As a compromise, the lender might be entitled to compensation only until the next rate adjustment date.

Calculations

- *Rounding.* In determining the LIBOR rate, a lender will usually include some form of rounding formula — either to the next sixteenth of a per cent or to the next hundredth of a per cent. Occasionally, a lender will try to round twice, once in setting the LIBOR rate and again after making any ‘reserve adjustment’ of the type described above. Collectively, such ‘rounding’ can add up to a significant increase in the interest rate. A borrower might question why ‘rounding’ is necessary at all, given that the lender’s computers can deal with thousandths or even millionths of a per cent just as easily as sixteenths of a per cent. If the borrower loses that argument, it may try to have the lender round to the ‘nearer’ rather than the ‘higher’ multiple of one-sixteenth or one-hundredth of a per cent. Finally, if the loan documents say that a rate can be rounded ‘up’ but never ‘down’, the borrower should try to get as fine a gradation for rounding as possible (hundredths rather than sixteenths of a per cent).
- *Extra taxes/costs.* Although a borrower will usually agree to reimburse a lender for extra costs resulting from possible future increases in reserve requirements, or from newly enacted tax or withholding requirements, a borrower should attempt to limit this obligation to costs and taxes that apply to a whole category of lenders generally, as opposed to just one particular lender because of its special circumstances. If the borrower cannot persuade the lender on this point, it may ask the lender to agree to replace — within a certain short period — any bank group member that has unique cost problems and refuses to waive the borrower’s obligation to reimburse those costs. Also, if a lender can eliminate or diminish the problem by funding the loan from a different lending office, the borrower should insist that the lender agree to do so.
- *Short period.* The borrower should try to persuade the lender to agree to a short ‘statute of limitations’ for claiming any LIBOR-related extra costs, under the theory that the borrower needs prompt notice so it can try to do something about the problem.

Taxes and costs

B. Choice of law

If the property is located in one state, the lender may nevertheless try to have the law of another state — typically New York’s — govern the underlying loan, as opposed to the mortgage and real property documents. A borrower may reject this idea, arguing that a ‘bifurcated’ choice of law imposes extra costs on the borrower, such as the possible need to obtain a New York opinion of counsel.

C. Environmental matters

A lender will typically try to shift to the borrower’s principals or parent company all risks of any environmental contamination of the property, coupled with procedures so the lender can identify and control those risks. The borrower’s response might include some or all of the following:

Environmental

Audits

- *Environmental audits.* If the loan documents allow the lender to require environmental audits or further inspections, the borrower should try to limit the frequency of those inspections, or condition them on the occurrence of some event that justifies a particular concern. For example, the borrower might insist that the lender exercise this right no more than once a year, or only if the lender has a reasonable basis to believe that new environmental problems (ie problems not reflected in the environmental report delivered at closing) exist. The borrower might insist that the lender pay for any additional reports out of pocket, which will create a substantial practical disincentive for the lender. Generally, any borrower or environmental indemnitor will prefer less new information and disclosure rather than more, and should hesitate to agree to anything that invites a lender to exercise initiative to identify new problems that were previously unknown. A borrower will usually prefer to prevent the lender from kicking the sleeping dogs just to see if they wake up.
- *Liability termination.* Environmental indemnities should, if possible, terminate for events that occur after the lender takes title (through foreclosure or the like), and even for prior events upon the passage of some reasonable time after the lender takes title. If a third party (eg foreclosure sale purchaser) acquires the property, the environmental indemnity should not benefit the purchaser, although the original lender might retain the right to sue on the environmental indemnity itself. If the borrower transfers the property with the lender's consent, the original indemnitor will want to be released, although the lender will probably insist on receiving a replacement indemnitor that satisfies the lender or meets particular standards.

Fault

- *Fault.* A borrower should try to carve out liability for any environmental problems that the borrower did not cause. (This is typically a non-starter, as the lender wants protection against all environmental risks categorically, not just the hypothetical possibility that the borrower will somehow cause an environmental problem.) As a fallback, a borrower can try to negate liability for specific types of environmental problems, such as any that originate on other land and migrate underground to affect the mortgaged property.

Other deep pockets

- *Other indemnitors.* To the extent possible, a borrower should try to persuade the lender to agree to look to: (a) environmental insurance; or (b) an assignment of creditworthy third-party indemnities, such as from tenants, the seller or any other prior owner of the property. If these sources of comfort are strong enough, perhaps the borrower can persuade the lender to do without an environmental indemnity from the borrower or its principals.
- *Control.* If an environmental problem arises, any indemnitor should receive notice of the problem and an opportunity to correct it if possible, and should have relatively wide flexibility

Scope

in deciding what to do about it (within the limits of governing law).

- *Known problems.* If an environmental assessment of the property discloses existing problems, the borrower should try to carve those out of the indemnity.
- *Limit scope.* A borrower should try to limit the indemnity to cover only: (a) correction of any problems that violate environmental law, and (b) third-party claims actually made against the lender. Any indemnitor will want to avoid liability for diminution in value of the property, lost profits, consequential damages, proactive remediation activities by the lender, environmental problems that the lender perceives but that do not violate applicable law or the like.
- *Limit liability.* If possible, cap the indemnitor's liability. As a variation, if an environmental problem arises, the indemnitor might want the right to pay the loan, require the lender to transfer the loan to the indemnitor or its designee and be relieved of further liability.

Movables**D. Personal property**

The lender's collateral will usually include all personal property (movables) associated with the mortgaged real estate. In most commercial real estate loans, the personal property is not significant. For hotels, construction loans, multifamily loans, and some other categories, however, personal property may be important. Personal property collateral raises at least the following concerns for a borrower:

Exclusions

- *Excluded property.* To the extent that the personal property belongs to anyone except the borrower, the borrower will want to exclude it from the collateral. An easy way to achieve this is to limit the granting clause to the borrower's 'right, title and interest' in the personal property. A slightly more complicated way is to carve out from the lender's collateral any ownership rights of tenants, unaffiliated managers, bona fide equipment lessors and other third parties. (If the borrower might want to enter into equipment leases, it must also add appropriate exceptions to any negative covenants that might apply.)
- *Counterparty consents.* If the personal property consists of a contract (such as the general contract for a construction job), the lender will often ask the borrower to obtain an agreement from the counterparty (such as the general contractor) by which the counterparty consents to the borrower's collateral assignment of the contract to the lender, and agrees to perform under the contract for the lender if the lender ever forecloses. Depending on how aggressive the lender's requirements are, it may be rather difficult and time-consuming to obtain such consents. (Problems arise to the extent that the lender tries to make the counterparty, rather than the lender, bear: (a) the risk of problems with the

project or the contract or (b) the responsibility for ‘policing’ the borrower.) A borrower should try to identify the lender’s requirements of this type early on and limit them as much as possible. As for any other third-party closing requirements, the borrower should try to provide for some alternative or backup measure if the borrower ultimately cannot obtain the required agreement — such as a personal guaranty to protect the lender from whatever risk concerned the lender or an agreement that the lender will drop the requirement.

- *Flexibility.* If the lender identifies contract rights or other similar property as part of the collateral pool, its next step will be to limit the borrower’s ability to amend, modify, waive, etc any of that collateral. To the extent that the borrower wants greater flexibility, such as the right to terminate contracts or replace obsolete equipment, the borrower should negotiate it into the loan documents.

E. Representations and warranties

Factual assurances

Every lender will ask a borrower to make a number of representations and warranties about the property and related matters. In response, a borrower or its counsel might ask for the following:

- *Materiality.* Where possible, qualify any representation or warranty by saying that it is true ‘in all material respects’ or it applies only to any ‘material’ matters.
- *Knowledge.* Whenever a borrower wants to trim back representations and warranties, one of the first tools will be to add a ‘knowledge’ qualifier wherever possible. The borrower will represent and warrant the truth of a particular statement, but only to the extent of the borrower’s knowledge. This, however, raises a new issue: what does ‘knowledge’ mean? Does it imply an obligation to investigate? Is the borrower ‘deemed’ to know facts that it reasonably should have known? Exactly whose knowledge matters? The individual borrower representatives who work on the loan? The property manager? Anyone related to the borrower? A borrower may want the loan documents to answer these questions, all in a way that limits the scope of knowledge as much as possible. The borrower will also prefer words like ‘actual knowledge’ rather than ‘best of knowledge’.
- *Opportunity to cure.* Before a breach of representation or warranty gives the lender any rights or remedies, the lender should give the borrower notice of the problem and an opportunity to correct it. If the lender agrees to any such provision, it will want to limit the cure period and exclude any fraudulent or incurable breach.
- *Timing.* A borrower will want any representation or warranty to be effective only as of the closing date. A borrower will object, for example, to language saying that a representation and warranty is

The meaning of knowledge

Timing

‘deemed made’ as of every payment date or on a continuing basis after the closing. Such a provision effectively obligates the borrower to do whatever is necessary so the representation or warranty remains true at all times after closing — hence turning a representation and warranty into a continuing obligation.

- *Title warranty.* Lenders usually ask borrowers to represent and warrant that they have some form of good title to the real property collateral. Although this sounds reasonable enough, a borrower may object because it is already paying for the lender’s title insurance, and if any title problems exist, the lender should look to the title insurance instead. A borrower should be particularly forceful about this issue if the non-recourse carveouts create personal liability for any breach of representations and warranties. A borrower that cares about this issue will also want to avoid making an implied representation and warranty as a result of the ‘granting’ language in the mortgage, and will limit such language to refer only to borrower’s ‘right, title and interest’ in the mortgaged property. Such a borrower should also be very careful about the scope of any title affidavits it signs for the title insurance company.

Third parties

- *Third-party assurances generally.* If the lender obtains a third party’s report on any particular subject, the borrower may decline to make any representation or warranty about that subject. The borrower might argue that the lender should rely on the third-party consultant, whose services the borrower paid for and who probably knows more than the borrower about the particular issue. The borrower may want to take this position not only for title, but also for environmental issues, engineering issues and zoning. As a fallback, the borrower might offer to represent and warrant that it knows of nothing inconsistent with the third-party reports delivered at closing.
- *Disclosures.* To the extent that a borrower discloses any adverse facts to the lender during the closing process, the borrower will want to carve those disclosed facts out from any relevant representations. The lender will usually insist on more specific language (describing exactly what was disclosed) or at least require that the disclosures were made in writing, perhaps with proof of delivery. The borrower will want to include in the list any facts set forth or referred to in any lease or service contract that the borrower delivered to the lender for the closing. In any event the borrower will want to show unambiguously that the lender knew about a particular problem and therefore cannot complain about it after the closing.

Acquisitions

- *Acquisition loans.* If a borrower acquires the real property collateral at the same time as the loan closing, it will not be as familiar with the collateral as if it had already owned the collateral. Under such circumstances, to the extent that the borrower makes representations and warranties about the collateral itself, the borrower will particularly care about adding a

'knowledge' qualifier. The lender may go along with such a request, or may argue that the borrower's knowledge is irrelevant. In the latter case, the representation and warranty becomes merely a mechanism to allocate risk rather than a knowledge-based assurance.

F. Multiple lenders

Bank syndicates

Large loans will often be originated by — or syndicated after origination to — a group of banks. Such loans raise a number of potential issues for a borrower, including the following:

Future advances

- *Syndication costs.* Do the documents require the borrower to pay or contribute to the costs of syndicating the loan? If the borrower cannot eliminate such a requirement, the borrower may at least cap it.
- *Lender obligations.* If a loan requires future advances (such as a construction loan), the documents will sometimes say that the obligations of the lenders are 'several', meaning that if one lender fails to advance when required, then the borrower can sue only that one lender. Occasionally, the documents go a step further and say that in such case, the other lenders are excused from their obligation to fund. If a borrower cannot negotiate away such a provision completely, the borrower may be able to reduce its impact by having the right to use equity funds to cover the shortfall, and then require the other lenders to advance their shares of the loan.
- *Confidentiality.* If the borrower persuades the lender to preserve the confidentiality of any information the borrower provides, the borrower may also reasonably insist that any future lender obtaining any interest in the loan also agrees to the same confidentiality restrictions — in the form of a direct confidentiality agreement with the borrower.
- *One contact.* A borrower may insist that it be able to deal with only one lead lender, regardless of how many other lenders ultimately have interests in the loan. This means, for example, that the borrower needs to give notices to only one lead lender. Furthermore, if the lead lender issues any approval or consent or agrees to any amendment or waiver, then the lead lender's action should unambiguously bind the bank group, with no need for the borrower to ask whether the lead lender obtained whatever consents it should have obtained.
- *Inter-lender issues.* Even if a borrower never needs to deal with more than one lender, a borrower may also care about how the lenders make decisions within their group. If routine decisions require approval by a large group of lenders, a borrower may find that the process is unworkable and slow. Therefore, a borrower may want to assure itself that the lead lender retains authority over as many decisions as possible. The borrower should also try to minimise any requirement to obtain consent from all members

Contact person

Enforcement

- of the bank group (as opposed to a majority) for any given matter that does require bank group consent. Finally, the borrower will want to see a quick internal approval procedure, perhaps with ‘deemed consents’ if lenders fail to respond within a certain time.
- *Workouts and enforcement.* Although no borrower ever plans to default, it should care about how the lenders will make decisions about possible workouts or enforcement of the loan. Loan documents sometimes say that significant decisions of this type require unanimous approval, and absent such agreement the lead lender must accelerate the loan and foreclose. A borrower may prefer to see a structure that is more conducive to a negotiated workout if the loan gets into trouble.
 - *Participations.* A borrower may want assurance that if a bank in the bank group grants a ‘participation’ interest to some other lender, the participant’s approval and other rights will be as limited as possible — ie much more limited than the rights of a bank that holds a direct interest in the loan.
 - *Resignation of lead lender (agent).* A borrower may want the lead lender (or ‘agent bank’) to agree not to resign unless and until a replacement has assumed its responsibilities. The same qualification might apply to the case where the bank group decides to replace the agent bank.

G. Guaranty issues

Guaranties

A lender’s form of guaranty will include a wide range of waivers and consents, designed to protect the lender from defences, problems and theories that a myriad of guarantors have raised in decades of prior litigation. Although most of those waivers and consents are not unreasonable, borrower’s counsel should try to preserve for the guarantor at least a few defences. In particular, a guarantor may want to protect itself as follows:

- *Subrogation.* Although a guarantor will generally waive subrogation, contribution or indemnity rights against the borrower, a guarantor may want to be able to assert those rights if the guarantor has paid the entire loan. On the other hand, because these rights are not likely to have any value, they may not merit much negotiation effort.
- *Lender’s default.* If the borrower has defences against the loan because of the lender’s acts or omissions (eg failing to fund or failing to comply with the loan documents), then the guarantor will probably want to preserve those defences against its obligations under the guaranty.
- *General waiver.* A guarantor should hesitate to agree to a general catch-all waiver (eg a waiver of ‘any and all legal or equitable defences’) because it will want to retain the right to assert a variety of defences, starting with those suggested above. In general, a guarantor should be no worse off as guarantor than if it had borrowed the loan directly. If the borrower could have

Waivers

validly asserted some particular defence (other than bankruptcy or the like), the guarantor will want the right to assert the same defence.

- *Release of liability.* If the borrower can transfer the property subject to the mortgage, perhaps by paying an assumption fee, the transfer right will be of little practical value if anyone has personally guaranteed any of the loan (including any liability under any 'carveout' guaranty) and the lender has not agreed to release such guaranty in connection with such a transfer. Therefore, the borrower should insist on having the right to replace the guarantor with another satisfactory guarantor — based on objective criteria in the documents — upon such a transfer. The lender should agree to release the original guarantor from liability when such a transfer and replacement occurs.
- *Death or disability.* Loan documents will often make the death or disability of an individual guarantor an Event of Default. The borrower may want the right to replace any such guarantor with another guarantor that meets objective criteria. If multiple guarantors have guaranteed the loan, the borrower might want the right to demonstrate that the remaining guarantors are enough, and thereby avoid any need to replace a dead or disabled guarantor. If possible, that determination should reflect objective financial tests rather than 'reasonableness' or the lender's determination at the time the problem arises.
- *Other guarantor issues.* Guaranties can raise a wide range of other issues that are not addressed in this discussion. The guarantor protections suggested above are not exhaustive.

Death

H. Lender's expenses

Loan documents generally require a borrower to reimburse a wide range of expenses and costs that a lender incurs in making, administering and enforcing a loan. Here are some limits a borrower may request in defining such an obligation:

- *Reasonableness.* A borrower will usually want to limit the lender's expenses — regardless of category — to 'reasonable' amounts. A lender will typically agree, recognising that courts will probably impose the same limitation automatically.
- *Backup.* A borrower may want the lender to provide reasonable backup documentation for any reimbursible expenses before the borrower must make a reimbursement.
- *Lender's overhead.* Certain categories of a lender's expenses may amount to overhead and the cost of being in the business of lending money. Such categories may include: servicing, monitoring, lender's staff, filings necessary for the lender to qualify in a particular state, legal advice on administration or monitoring of the loan (absent a default); loan amendments the borrower initiated and any other lender costs not directly caused by the closing or enforcement of the loan or the borrower's

Overhead

actions or omissions. Borrowers may want to avoid any obligation to reimburse the lender for such overhead expenses.

- *Exclude certain categories.* A borrower might try to avoid any obligation to reimburse the lender for particular categories of expenses, such as those associated with approving leases or lease amendments. Other expenses might be subject to caps, or fixed amounts, such as entering into subordination and non-disturbance agreements.
- *Copies of documents.* Whenever a borrower pays a lender for any appraisal, report or document, the lender should agree to give the borrower a copy of it. Some states (eg New York) impose such a requirement by statute (at least for appraisals and certain reports); otherwise, a borrower should request it. The lender may agree in principle but also say that any obligation to deliver copies is subject to the terms of the lender's agreements with its third-party consultants. In that case, a borrower can argue that because the lender's third parties work for the lender, it is the lender's job to have them consent to the disclosure.
- *Closing costs.* The concept of capping a lender's closing costs has been covered elsewhere in this outline. In the alternative, a borrower can insist that the lender submit all bills for closing costs at the closing, and waive any right to recover any post-closing costs. Such a proposal may, however, induce the lender to include overly ample estimates for its post-closing costs. Ultimately whether to pursue such a proposal is a matter of the borrower's tastes.

Closing costs

I. Power of attorney

Power of attorney

Loan documents often state that the borrower appoints the lender as the borrower's attorney in fact for various purposes. A borrower may fear that a lender will exercise its rights under that appointment in a way that hurts the borrower — although lenders rarely if ever actually exercise such rights anyway. A borrower that is concerned about these risks might request some or all of these changes:

- *Event of Default.* The lender should agree not to exercise the power of attorney unless an Event of Default has occurred. Lenders often agree to this change.
- *Liability limitation.* Even if the lender exercises the power of attorney, anything the lender signs must contain a non-recourse clause, limiting the borrower's liability to its interest in the mortgaged property.
- *Notice.* If the lender exercises its rights under the power of attorney, it should give the borrower notice of such exercise. A careful lender may hesitate to give prior notice, because it may not want to alert the borrower of its need to have a particular document executed (eg a document that plugs a newly discovered gap in the lender's security package). A lender's concern on that issue will apply whether or not an 'Event of Default' has

occurred. A borrower may, therefore, have to settle for notice after the fact.

Alterations

J. Alterations

If the borrower wants flexibility for alterations it might undertake, it will want to cut back the lender's approval rights. The following suggestions may help build some flexibility into the loan documents:

Approvals

- *Pre-approved alterations.* If the borrower wants to undertake alterations that any lease requires — and the lender has approved the lease or the lease did not need the lender's approval — then the borrower should not need to obtain the lender's approval for those alterations. The same would apply for alterations required by law or a change in law. If the borrower plans to undertake specific alterations, it may want to have the lender pre-approve them in the loan documents.
- *Thresholds.* If the borrower undertakes any alterations other than major expansions or overall changes in the nature or quality of the mortgaged property, such work should not require the lender's approval. This is particularly true for alterations that are merely cosmetic or relate to signage or the like. The parties might negotiate thresholds for lender approval based on such matters as: cost of construction, square footage added or subtracted, impact on parking, amount of cash flow lost during construction, other interruption of building operations, requirements for other consents (eg from major tenants or under reciprocal easement agreements) and the degree to which any newly constructed space has been pre-leased.
- *Scope of approval.* Even if a borrower agrees to seek lender approval for particular alterations, it should try to limit what the lender can review. For example, perhaps the lender does not need to see complete plans and specifications. Instead, it could agree to consider merely exterior elevations or preliminary schematics for the alterations plus, perhaps, a budget and an architect's certificate that the alterations will comply with code and any recorded agreements. This approach lets the borrower submit a simpler approval package earlier. It also speeds up and streamlines the lender's review process, and reduces the lender's outside fees, which the lender will presumably want the borrower to reimburse. The approval process should also seek to negate any continued lender involvement in alterations.
- *Required alterations.* A borrower should be wary of anything that might give a lender the right to require the borrower to undertake particular improvements or alterations.

Approval packages

K. Indemnification

Wherever a borrower agrees to indemnify a lender, the borrower should ask for certain concessions, such as:

Indemnities

Separate counsel

- *Termination of indemnity.* The borrower's indemnity obligations should terminate for any matters that arise after the borrower repays the loan or loses the property in foreclosure (or by deed in lieu of foreclosure). Even for matters that arise before then, the borrower may want its indemnification obligation to terminate a certain period after repayment or foreclosure.
- *Control of litigation.* The borrower/indemnitor would like to be able to control any litigation, including selecting counsel and making any decisions that arise in the course of the litigation. If the lender insists on having the right to approve counsel, try to have the lender pre-approve whatever counsel the insurance carrier provides.
- *No payment for separate counsel.* Although the lender can hire separate counsel if it wishes, the borrower should not have to pay for such counsel, so long as the borrower is diligently defending the action.
- *Right to settle.* The borrower/indemnitor should be able to settle any litigation on any terms, as long as the settlement includes delivery of a release to the lender.

Leasing

L. A few more leasing issues

A borrower may also want to consider the following issues that relate to the borrower's leasing programme for the mortgaged property:

Lease termination

- *Terms of major leases.* The loan documents should track the relevant terms of major leases. If a major lease gives a tenant substantial flexibility about subletting, alterations, change of use or the like, then the loan documents should not hold the borrower to tighter standards for the affected part of the property.
- *Terminations.* Although the loan documents will probably prohibit the borrower from terminating any leases, the borrower may want the right to terminate leases when the tenant is in default or if the termination meets other tests. For example, if the lease is below market, the borrower may want the ability to terminate it without the lender's consent. The same would be true for leases below a certain size or for space for which the borrower has already signed a new lease.
- *Enforcement of leases.* A borrower will usually not be comfortable with a general obligation to enforce all leases in accordance with their terms. So long as the loan is performing, a borrower will want flexibility to exercise its business judgment regarding enforcement of leases.
- *Residential leases.* Covenants, representations, warranties and approval requirements that may make sense for commercial leases (eg office or retail) often make no sense for residential leases in an apartment building. For residential leases, a borrower should try to get the lender's consent to use an approved lease form and enter into leases substantially consistent with the market. If the

Residential

leases are subject to any form of rent regulation, the borrower may also need to modify its lease-related obligations under the loan documents to ensure that they track the borrower's obligations under rent regulation.

M. Miscellaneous

The following are a few of the miscellaneous 'legal' issues that often arise in negotiating loan documents:

Materiality

- *Materiality.* Any borrower will often want to add a 'materiality' qualifier to practically every representation, warranty, condition or non-monetary obligation in the loan documents. While such a qualification surely cannot hurt, in practice it probably does not give the borrower much more than it already has, because (a) most lenders are unlikely to make an issue (or even know) about immaterial defaults or problems; and (b) even if a lender wanted to do so, a court would probably not allow it.
- *Material adverse effect.* Under the theory that a borrower's actions and omissions should have no consequences unless they cause harm to the mortgaged property or the lender, a borrower will often request that the loan documents qualify many of the borrower's obligations to apply only where a 'material adverse effect' would otherwise occur. For example, a borrower would agree to comply with law only where failure to do so would have a 'material adverse effect' (an affirmative covenant); would agree not to grant additional liens if the additional lien would have a 'material adverse effect' (a negative covenant); and would represent and warrant a particular fact is true only to the extent that any untruth would have a 'material adverse effect' (a representation or warranty). The 'material adverse effect' threshold comes from the world of corporate lending. To the extent that a borrower's obligations are subject to a 'material adverse effect' qualifier, the lender will face an issue of fact and judicial discretion whenever it tries to enforce any non-monetary obligations under the loan documents. The difference may not matter much, though, for the same reasons as detailed in the previous paragraph.

Exceptions

- *Exceptions, generally.* When considering any obligation under the loan documents, any borrower should consider whether to request exceptions. Are there any circumstances at all where the obligation should not apply? For example, the loan documents will typically prohibit a borrower from consenting to a governmental taking of part of the property. But what if the taking merely facilitates a road widening, which will benefit the property? The possible need to identify exceptions of this type will run throughout every issue in the loan documents, and could trigger dozens of borrower comments. On the other hand, before seeking an exception, a borrower should assess whether the particular issue is truly ever likely to be troublesome.
- *Attorneys' fees.* A borrower may want to try to get the lender to

Attorneys' fees

agree to reimburse the borrower's attorneys' fees if a dispute arises between the two parties and the borrower wins. Lenders rarely agree to mutuality of this type, although in some states such a provision is unnecessary because any attorneys' fees clause is automatically mutual.

Notices

- *Notices.* A borrower should pay close attention to the notice procedures in the loan documents, and assure that its address is specific enough that any notices from the lender will not get lost within the borrower's organisation. The borrower may want to require the lender to agree to give more than one copy of any notice (perhaps a copy to someone else in the borrower's organisation and another copy to outside counsel), as a condition to the notice becoming effective. Also, the borrower may want to add language stating that notices can be given by counsel, although the lender will usually care about this more than the borrower.

Right of contest

N. Right of contest

Although loan documents typically require the borrower to comply with law, pay any mechanics' liens and pay real estate taxes, the borrower should request the right to contest any of these items and suspend performance or payment during the contest. The borrower also should scrutinise any conditions that the lender establishes to a right of contest. In particular, a borrower should be alert to the following:

- *Security requirements.* A borrower will prefer not to provide security for a contest, at least below a certain threshold.
- *Timing.* Sometimes lenders require that a contest be resolved within a certain time period, which may or may not be realistic under the circumstances.

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Note

- (9) As variation or fall-back, the borrower might be willing to treat such prepayments as exempt from a premium only if the borrower offered to restore the mortgaged property instead of prepaying the loan. And a borrower may need to consider the nuances of eminent domain law in determining what position to take on condemnation proceeds. For example, a prepayment premium may be separately compensable as an additional element of loss, without thereby decreasing any amounts otherwise payable for the condemnation. In that case, a borrower should not object to the lender's collecting a prepayment premium upon condemnation — but may want to limit the lender's premium to the amount the borrower can separately collect for the prepayment premium from the condemning authority, without reducing the borrower's own award.

Best practices in commercial real estate financing: The borrower's agenda in negotiating loan documents part 4

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Abstract

Three earlier instalments of this paper discussed a range of legal and business issues that a borrower and its counsel will often want to raise in response to a typical set of loan documents. But what about the issues that borrowers should raise without being reminded?

Keywords:

commercial mortgages, proactive negotiations, loan documents, release right, transfers, servicing

PROACTIVE ISSUES TO RAISE AND QUESTIONS TO ASK FOR ANY MORTGAGE LOAN TRANSACTION

In any commercial mortgage loan transaction, a borrower's counsel should not merely respond to the lender's commitment letter and loan documents, but also consider raising issues that the lender will not propose to address at all — the so-called 'silent' issues. The following list describes some issues that borrower's counsel may wish to add, proactively, to the agenda between borrower and lender.

A. Timing

Does the borrower have any special need to close the loan by a certain date? For example, the borrower may be acquiring the property under a 'time of the essence' contract; may need to refinance before a looming maturity date; or may face an iron-tight deadline under a tax-free exchange. In any of these cases, or even if the borrower simply wants to get the deal closed quickly on general principles (and there will always be some reason why the borrower needs to close quickly), the borrower may want to take special

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Tax-free exchange closing

measures to assure the transaction closes on time. These might include the following as well as many of the other measures suggested in the previous instalments of this paper.

- *Forms of deliveries.* Obtain as early as possible the lender's required estoppel, non-disturbance agreement, surveyor's certification, title insurance requirements and the like.
- *Awareness.* Make sure the lender is aware of the expedited timing requirements and include appropriate language in the commitment letter.
- *Trim back negotiations.* See if the borrower's principals want to try to cut corners in negotiating the loan documents, such as by having borrower's counsel raise only those issues that are likely to matter. Of course, invariably, whatever issue borrower's counsel decides to ignore will end up being the one issue that matters tremendously. If the client instructs counsel to cut corners, counsel will want to be able to defend why the documents turned out the way they did when the borrower is unhappy with them five years later.
- *Pre-negotiated documents.* See if the lender will have its counsel work from documents from a previous similar transaction, either with a related borrower or with a similar borrower that was well represented. As the price of any such arrangement, the borrower will probably need to limit any further comments on the documents.

Documents

Separate property

B. Outparcels and excluded property

Does the mortgaged property include any property of any kind that the borrower may want to develop or finance separately? To the extent that the lender's appraisal and underwriting did not include these items — or the borrower never said they would be part of the mortgaged property — the borrower may legitimately ask to exclude them from the lender's collateral. Some examples would include the following:

- *Outparcels.* In a shopping centre project, the borrower may own excess land that does not presently produce income but that the borrower intends to develop separately.
- *Roof-top/signage/antennas.* If the lender is not relying on cash flow from these sources, the borrower may want to keep them out of the collateral pool. Figuring out how to structure this exclusion may be tricky. The resolution will vary depending on the circumstances and legal structure of the particular project.
- *Equipment leases.* If the borrower intends to enter into equipment leases for certain equipment at the mortgaged property, the loan documents should exclude that equipment from the collateral.
- *Non-real-estate assets.* Does the borrower own any assets related to the property that the borrower might want to exclude from the collateral for some other reason? For example, if the property is a

Intellectual property

single shopping centre operated under a national brand name, the borrower may be willing to include the name of the specific shopping centre (eg ‘Anytown Mall’) as part of the collateral, but not the borrower’s national brand name (eg ‘Westsimon Retailtown’).

Once a borrower decides what property it wants to exclude from the collateral, it should also think about what it will need later on from this lender, if the borrower ever finances or sells any of that excluded property separately. For example, if the borrower enters into an equipment lease, the equipment lessor may want a waiver from the mortgagee. These potential future requirements should be identified in the loan documents and today’s lender should agree to cooperate with tomorrow’s requirements.

Transferability

C. Lender transfer restrictions

In some parts of the real estate finance market — relationship-based quasi-corporate loans with large high-quality borrowers — the borrower may have enough leverage to require the lender to agree to restrictions on the transfer of interests in the loan. Some issues in this area include:

- *Notice.* A borrower can at a minimum ask the lender to notify it when any transfer has occurred. Even to the extent that a borrower cannot negotiate any limits on the lender’s ability to assign or participate out the loan, the borrower can often obtain this notification right.
- *Transferee.* The borrower may also be able to set substantive limitations on the types of parties that can acquire interests in the loan. For example, a borrower may be less concerned about institutional lenders than about, for example, real estate opportunity (aka ‘vulture’) funds. Depending on the exact nature of the borrower’s business, the borrower may also be concerned about having its competitors buy the loan or any piece of it. Unfortunately for the borrower, if a lender is willing to agree to any limitations on who may acquire interests in the loan, the lender will probably insist that the limitations fall away if the loan ever goes into default — precisely the moment when the borrower will care most about who holds the loan. As a variation on some of these restrictions, the borrower may demand a ‘right of first refusal’ — a pre-emptive opportunity to purchase the loan before the lender sells it to someone else. (Of course, if the borrower were in a position to acquire the loan under such a right, the borrower might not have needed the loan in the first place.)
- *Minimum hold.* Even if the original lender ‘sells down’ pieces of the loan to other banks, the borrower may want the original lender to agree to retain a certain ‘minimum hold’ and perhaps to hold the largest interest in the loan of any bank in the group.
- *Bank group issues.* To the extent that the borrower cannot prevent

Vulture funds

transfers by the lender, the borrower will be concerned about the ‘Multiple lenders’ concerns discussed in an earlier part of this paper.

Servicing

D. Servicing transfer restrictions

Aside from ownership of the loan and the possibility of an outright transfer, a borrower may also fear a transfer of servicing of the loan, whether in conjunction with a transfer of the loan (such as for securitisation) or merely because the original lender decides it does not wish to continue to service the loan. As the starting point in any such discussion, the borrower may want to request that the lender agree not to transfer servicing responsibility for the loan, except perhaps in connection with an outright sale of the loan. Similarly, if the original lender plans to syndicate the loan, the borrower might want the original lender to agree to remain ‘administrative agent’ for the group. As a fallback to the positions just suggested (ie where a borrower cannot prevent a transfer of servicing altogether), the borrower may want to raise the following issues:

Audits

- *Choice of servicer.* The borrower might insist that any replacement servicer satisfy certain standards or be chosen from a list of approved servicers. In the alternative, the borrower might affirmatively forbid use of a particular servicer with whom the borrower has had bad experiences.
- *Audit of accounts.* If the lender ever does transfer servicing of the loan (or, for that matter, the loan itself), the borrower might insist that, whenever such a transfer occurs, the borrower should have the right — ideally at the lender’s expense — to audit the outgoing servicer’s receipts and disbursements to correct any mistakes that occurred. Such mistakes are particularly likely to affect escrow and reserve accounts, but might also relate to interest calculations, or other loan payments. Absent such an audit, after a transfer of servicing any such mistakes will rarely if ever be identified or corrected. (A borrower should probably perform such audits periodically anyway.)
- *Single contact person.* After (and perhaps even before) any transfer of servicing, the borrower may want the loan documents to require that the servicer of the loan designate a single contact person for all inquiries, requests and issues related to the loan. This way, the borrower can deal with that one individual person for all communications with the servicer. Based on sad experience with major servicers, the borrower might also want to require that this particular individual have a direct-dial telephone number. If the borrower is unhappy with that particular individual’s accessibility, responsiveness, or performance, the borrower might want to have the right to require the servicer to replace that individual. If for any reason the servicer replaces that individual, the borrower might want to require the servicer to give prompt notice of the change.

Communications

E. Consequences of transfer

As another technique to resolve some of the issues discussed above, a borrower may want to propose that as long as the original lender holds the loan, the lender will be entitled to certain consent rights and controls. If that lender ever transfers the loan, or perhaps if that lender merges into some other institution or undergoes some other major corporate transaction, then the lender's rights would be trimmed back, in recognition of the loss of whatever borrower-lender relationship might have motivated the original provisions of the documents.

Conversely, as a compromise on some issues the borrower may suggest that the loan documents grant greater flexibility to the original borrower, with some of that flexibility going away if the borrower ever transfers the mortgaged property to someone else.

F. Non-disturbance

For future leasing, the borrower may want the lender to agree to enter into non-disturbance agreements with tenants, although the borrower may be willing to limit that obligation to apply only to leases that satisfy some reasonable conditions (as objective as possible). Although a borrower will often want to attach the form of non-disturbance agreement to one of the loan documents, the borrower will also realise that any future major tenant will want to use its own form of non-disturbance agreement. The loan documents should build in some flexibility.

If the loan documents allow the borrower to modify, amend, or cancel leases, the borrower will want to assure that the non-disturbance agreement does not take away that flexibility. For example, if the non-disturbance agreement says the lender will not be bound by any of these transactions without the lender's consent, the borrower just lost all the flexibility it negotiated in the loan documents.

G. Release rights

If the real property collateral consists of multiple parcels — eight shopping centres, for example — the borrower may want the right to sell off particular parcels by paying down the loan. The lender, on the other hand, will want to assure that the remaining collateral pool satisfies certain standards, such as loan to value, debt service coverage and a minimum paydown formula for any release. In connection with any right to obtain partial releases, the borrower may want to consider the following issues:

- *Reserves and related property.* If the lender maintains reserves and escrows for the loan, the borrower may want the lender to release any reserves and escrows that relate specifically to the mortgaged property being released. (Of course, the lender may prefer to reallocate those reserves and escrows to make them available for other properties instead.) More generally, the lender should agree

Major tenants

Mechanics for release

Formulas

to release not only the mortgaged property but all other collateral related to it — contracts, personal property, leases, security deposits and so on. Also, if the lender has required a lockbox, the lender should agree to cooperate expeditiously to transition the rent collection procedures to reflect the release of the property.

Release conditions

- *Calculation formulas.* The borrower should try to make the release-related formulas as objective as possible, to reduce the degree to which the lender can exercise discretion in calculating release prices or determining whether the borrower is entitled to a release. The borrower should also consider the issues that arise in the calculations for any financial covenants, as discussed in earlier instalments of this paper.
- *Conditions to release.* A lender will always require that a series of conditions be satisfied for the borrower to obtain a release, such as a requirement that the loan not be in default. As long as the borrower has satisfied whatever financial tests apply to a release, the borrower may question whether any other conditions should apply — particularly if the borrower may have promised a third party to deliver the released property free and clear of the mortgage.
- *Interaction with other components of the loan.* In negotiating for the right to obtain partial releases, the borrower should consider how these provisions interact with the rest of the loan transaction. For example, if the overall loan to value ratio is 75 per cent, then the borrower may propose, as a starting point, that only 75 per cent of the proceeds from the sale of a released parcel should go to reduce the principal amount of the loan. If the loan provides for a fixed amortisation schedule, the borrower may want to slow down the amortisation of the remaining balance to take into account the partial release.

Confidentiality

H. Confidentiality

A borrower may want a lender to agree to maintain the confidentiality of any information about the borrower or the property. If the lender objects, the borrower might limit the request to apply only to financial information or the terms of leases. Before raising this issue at all, a borrower should consider the degree to which governing law already imposes on lenders an implied obligation of confidentiality. If such an implied obligation exists, it may be stronger than whatever the borrower would get through its own negotiations with a wary lender.

Changes in collateral

I. Future changes and events

Does the borrower anticipate making any future changes in the collateral? Does the borrower anticipate that any particular events may occur during the life of the loan (eg construction on vacant land, reconfiguration of parking, loss of a major tenant, installation of new utility systems, admission of new investors, or any other change in circumstances)? In any of these cases, the borrower may

want to build into the loan documents an obligation for the lender to cooperate. For example, if the borrower anticipates needing to record a new reciprocal easement agreement with an adjacent property owner (including perhaps an outparcel released from the mortgaged property as suggested above), it may want to require the lender to agree to join in or subordinate to the reciprocal easement agreement. The lender will, of course, want to be able to approve the easement documents when they become relevant. The borrower may, in turn, want the lender to agree not to unreasonably withhold that approval. In some cases, it may make sense to attach the draft or final easement documents — or at least a summary of their terms — to the loan agreement. Issues like these are particularly important to cover in the loan documents for a loan that will be securitised.

Tenants' financing

J. Landlord consents/waivers

If the mortgaged property is located in a state where a landlord has a lien on a tenant's personal property, the borrower should look ahead to the possibility (likelihood) that the major tenant will ask the borrower (as landlord) to issue landlord's consents and waivers in favour of the tenant's asset-based lenders. Those major tenants may request such documents not only from the borrower but also from its mortgagees. If the borrower foresees such requests, it may want to ask the mortgagee to agree to comply and deliver (or join in) customary landlord's waivers when requested by a major tenant.

Additional financing

K. Mezzanine financing

If the borrower anticipates obtaining 'mezzanine' financing — a separate loan secured by a pledge of equity, or backed by a 'preferred' position within the mortgage borrower entity — the borrower will, of course, want the lender to consent in advance to such financing (and probably close it simultaneously with the mortgage loan). Beyond merely obtaining consent, the borrower should consider whether it or the mezzanine lender will require anything further from the mortgage lender. If so, the borrower should ask the mortgage lender to agree in the loan documents to cooperate as needed.

Mortgage assignments

L. State-specific issues

Occasionally, a loan will create state-specific issues that a borrower will want to raise (although state-specific issues are more typically the lender's domain). For example, if the mortgaged property is located in New York, the borrower will want the lender to agree to 'assign' the mortgage to any new lender that refinances the loan. This will enable the borrower to save substantial amounts of mortgage recording tax on the next loan. (Even outside New York, a borrower may find that an assignment of the existing loan may facilitate and simplify the closing of the next loan, although this would be atypical.) Any other state may also have its own unique

issues, for which the borrower must understand and consider that state's law and practice, or consult local counsel.

M. Pay-off and related planning

Typically, neither borrower nor lender focuses on the mechanics of how the loan will be paid off upon maturity or prepayment. As a result, when it comes to consummating a pay-off, lenders are sometimes non-responsive and uncooperative, and borrowers are sometimes not as effective as they could be at getting the job done. These problems are often not apparent until a day or two before the closing, when the lender finally focuses on the upcoming loan pay-off and imposes impractical procedural requirements for closing it. Any borrower that has had problems and last-minute emergencies arising from the logistics of pay-offs in the past may recognise the value of adding provisions such as these to the loan documents:

Per-diem calculations

- *Pay-off statement.* Upon request, the lender should agree to issue a pay-off statement, calculated as of a specified date, but also providing for per-diem interest for up to (at least) ten days thereafter.

Original notes

- *Original documents.* If necessary to accommodate the refinancing (for example, in New York), the lender should agree to assign the mortgage to the new lender — rather than deliver a satisfaction — and also deliver at the pay-off closing the original notes, endorsed in blank. (A lender will prefer to close the pay-off based purely on a pay-off letter, with the original documents to follow. Although this usually works, sometimes the refinancing lender will insist on receiving the original documents at closing. The borrower does not want to be stuck between two lenders imposing inflexible and inconsistent requirements.)

Turnaround time

- *Estoppel certificates.* If requested, the lender should agree to issue an estoppel certificate about the loan.
- *Response time.* The lender should agree to respond quickly to any response for a pay-off letter and cooperation with a pay-off of the loan. It may be in the interests of both parties to add to the loan agreement a precise description of how the pay-off process will work, including even (as an exhibit) a form of notice for the borrower to use to initiate the process. Although such provisions are not industry standard, they could substantially simplify and speed up the pay-off process.
- *Escrow.* The lender should agree to cooperate with whatever reasonable escrow arrangements the borrower and its new lender request.
- *Releases.* The lender should agree to release or assign whatever other security interests it holds, and any rights against third parties that have been assigned to the lender. The borrower may want to provide for having its own counsel prepare all necessary release documents for approval and signature by the lender, as

this will usually speed up the process and reduce its cost. The lender would typically still prepare the pay-off letter itself.

Doesn't hurt to ask

CONCLUSION

This paper and its predecessors present most or all of the major issues a borrower may wish to raise in negotiating a commitment letter or a set of loan documents. Whether a lender will agree to a particular request, or how those discussions may turn out, represents an entirely different discussion. But a borrower will never obtain any concessions at all without asking for them first. This four-part paper should help borrowers identify where to start and what to request.

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