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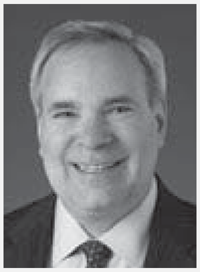
How Commercial Real Estate Finance Has Changed in the Last Two Decades



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Looking back over the last two decades, commercial real estate finance has gotten more complex but also smarter. CMBS has imposed some unusual measures and discipline. Federal law and regulators have played a major role as well.

If one looks only at basic commercial mortgage loans, not much has changed. The indebtedness is still evidenced by a promissory note; it's still secured by a lien on commercial real estate. A loan agreement—a package of promises, covenants, and requirements that seek to protect the lender's collateral and maximize the likelihood of repayment—still memorializes the business deal. The deal probably includes some form of third-party recourse, for part of the principal (occasionally), debt service, carrying charges, environmental risks, or certain "bad acts" committed by the property owner.

Traditional rights and remedies for mortgage lenders remain. They have been relatively unscathed by creative arguments from borrowers and their counsel when deals have gone bad, either as part of a cyclical decline of the commercial real estate market or episodically when a particular deal hasn't worked out as planned.

We still endure the recording system, the antiquated legal principles that go with it, legalistic formalisms rooted in history, quaint traditions for describing and conveying real property, lien priority, and (in New York, at least) a mortgage recording tax that is often incompatible with any modern real estate finance structure that goes beyond a mortgage securing a simple term loan. Our documents keep growing to handle nuances of these traditional, often cumbersome and impractical concepts and multi-faceted relationships among an expanding collection of parties.

Many other things have changed in major ways. They may change in more ways as a result of the continued effects of both the 2016 election and the 2018 midterm elections. Regardless of how it turns out, the upcoming 2020 election will only add to the stew.

Dodd-Frank, Basel III, and today's risk retention regulatory scheme have led domestic banks to tighten their purse strings and reduce their risk tolerance. That now complicates and constricts credit decisions on a macro and micro basis in unprecedented ways. The Trump administration may dial back some of that, but that's still to be seen. For now, the ever-growing regulatory burden on banks has created an opening for less-regulated lenders—shadow lenders (such as private equity, hedge funds, debt funds, opportunity funds, and mortgage REITs) and private "real estate family" lenders—to make first mortgage loans, a business the banks once owned, as well as other real estate-secured loans and investments.

Those alternative lenders didn't noticeably exist in real estate 20 years ago. Now they're extraordinarily active. They're here to stay. They covet most commercial real estate loans and virtually every asset class. They aren't afraid of their shadows, or the regulators. Today's market gives them ample opportunities and advantages.

Alternative lenders are not constrained by regulation. Nor are they necessarily as wary as conservative banks about an ebullient, decade-long real estate market that has for years felt like it is about to turn. Their investment committees are lean and nimble. They may offer more loan proceeds than traditional lenders such as banks—though at higher cost. They can compete aggressively for any type of real estate loan. They have the ability to execute swiftly, forcefully, and reliably. And they do. All of this makes them a "go-to" source for acquisition, development, and joint venture investment capital, even at interest rates that are higher than traditional bank rates, though still unthinkably low.

Some, but not all, alternative lenders have little reticence about the "loan to own" end-game strategy in a cyclical real estate market that may be heading at last toward a soft landing. They welcome it. Twenty years ago, the last thing institutional portfolio lenders (largely banks and insurance companies) wanted to foreclose, or ultimately own, was their collateral. Some of the current alternative lending sources do not have that institutional reticence. That is new. They view a loan as just a variation on an acquisition, with the alternative possibility, entirely acceptable, that they will recover their money with a healthy contractual return on their investment. That mindset is also new.

Hedge funds, private equity funds, mortgage REITs, and real estate developers' new lending affiliates—regulation-free, risk tolerant, and opportunistic—have spread like wildfire in real estate finance. This phenomenon is quite new versus 20 years ago. It changes the loan origination, enforcement, and regulatory landscape.

Commercial real estate finance has always started with first mortgage loans. Then came second (subordinate) mortgage loans. Those quickly morphed into mezzanine loans secured by equity interests in the mortgage borrower, as a secured financing device to convert property appreciation into more loan proceeds.

Going beyond that, preferred equity, even more opportunistic, has become a far more prevalent financing form than 20 years ago. Commercial real estate mortgage "loans," whether to monetize return on investment or equity in the underlying asset, are now often structured as preferred equity in the sponsor entity for the deal. Indeed, in some hybrid transactions one private equity "lender" makes a mezzanine loan to the members of the entity and its affiliate acquires preferred equity in the deal sponsor.

This way, the private equity shadow lenders who provide the preferred equity investments potentially achieve the outsized return their investors want. This well recognized and broadly accepted financing device simply did not exist in commercial real estate 20 years ago.

These new sources of capital, new regulatory pressures, and other changes in the world have led to a sea of changes in the market, especially for larger transactions and borrowers that want to borrow as much as they possibly can. That trend has continued unabated and undeterred in the decade since the Great Financial Crisis—and in a market that historically has not experienced cycles longer than seven years.

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After the Great Financial Crisis, we heard that CMBS 2.0 would be more rigid and conservative. The risk retention rules under Basel III, which took effect in December 2016, have changed how we view CMBS and its pricing and profitability. Smart investment bankers and their smart counsel are creating in each new CMBS transaction new ways for the sponsor to "hold" on its balance sheet 5% of the debt. The mortgages themselves aren't all that different, though.

We've also seen new developments involving European "bail-in" requirements to deal with bank insolvency. The "bail-in" rules need to appear in agreements between European financial institutions and non-European parties. These rules are supposed to enable and facilitate the orderly wind-down of distressed financial institutions. They cover unsecured liabilities, such as the obligation of lenders to make future advances, governed by third country (such as United States) law. They give the European banking authorities the power to write down those liabilities and potentially convert them into equity.

Environmentalists have come up with the idea of property assessed clean energy (PACE) liens—someone's great new idea but ultimately signifying nothing beyond the need for a new prohibition in loan documents. And, financial innovations such as swap protection and more complex and exotic prepayment formulas have also become more prevalent in commercial real estate financing, as it has continued to converge with general corporate financing.

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Then there's the capital stack itself, ever more filled with diverse lenders, interests, and economics. Today, even though the wounds of the Great Financial Crisis have not entirely healed, multiple tranches of debt—subdivided, packaged, rated, and sold—are now often the norm, a staple of today's commercial real estate finance. Any loss of momentum on this front has dissipated, especially when often-conservative first lien lenders will not meet a sponsor's hunger for loan proceeds. That, too, is likely to remain a core ingredient of commercial real estate finance deal structures.

Equity interests in the preferred equity sponsor entity are, likewise, sliced and diced and pledged and repledged. Loans are made on loans. Any major transaction has co-lenders, loan participants, senior and subordinate debt holders, and preferred equity (e.g., Senior Note A, Senior Note B, Mezzanine Loan A, Mezzanine Loan B, preferred equity), with complex contractual relations among them. Agents, co-lenders, servicers, master servicers, special servicers—each with a role, each with rights and obligations, many of them new or at least expanded and made more complex.

Perhaps the biggest change of all in structured or layered real estate loans has been the evolution of the intercreditor agreement. We once called that agreement a "pancake subordination." That was all. The senior lender controlled the collateral and the foreclosure. The second lien lender had no rights. Instead, the second lien position had a seat at the table in a foreclosure, refinance, or sale of the property, with an empty wheelbarrow at its side, to be filled with money only after the senior lender was paid in full. If lucky, it would have the "opportunity" to bid at the foreclosure sale on the first mortgage. That was victory enough. The agreement between the senior and junior debt often said that if the junior debt wanted to exercise remedies, it needed to "take out" or repay the senior loan.

How far we have come from this.

The model "intercreditor agreement" has been a creature of the past 15 years or so. It has evolved since its initial iteration. The "market standard" intercreditor agreement of the early years no longer exists. The massive and important *Stuyvesant Town* decision changed the landscape among lenders in the capital stack and their enforcement rights.

The industrywide shock from that decision drove changes in standard intercreditor documents. The senior lender can no longer require the junior lender to "cure all defaults" (i.e., repay the accelerated senior loan in its entirety) if the junior lender wants to enforce any of its remedies. In securitized finance, the junior lien holder now controls loan enforcement. Exactly how that works often leads to intercreditor negotiations and documents that create far more complexity, negotiations, and enforcement nuances than the underlying loan documents themselves.

Negotiations among lenders; loan syndication; layers of participation among lenders in the commercial real estate collateral and decision-making; the agent's rights, role, and duties; procedures for enforcement of remedies—all new, all far more sophisticated than 20 years ago. That's why the capital stack endures and excites from a collateral enforcement and asset disposition perspective.

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Commercial real estate lenders and lawyers also need to master the rules and realities of distressed loan workouts and foreclosures, which have ebbed and flowed over the years. Although all documents and deal structures must fully cover the possibility that the borrower will default, the actual frequency of defaults has remained low. This was true even in the Great Financial Crisis.

At one point not too long ago, borrower defaults often led to borrower bankruptcies, where the lender's lien would be "crammed down" to equal the temporarily impaired value of the collateral. Then, when markets later recovered, as they often did, any future increase in value—recovery of value after the nadir at the moment of cramdown—would belong to the "reorganized" borrower and its principals and equity investors. The lender would lose the opportunity to wait for better times.

In the last decade or two, the bankruptcy risk has become almost irrelevant because mortgage lenders learned to demand that the principals of commercial real estate borrowers agree to assume full recourse for the loan if a borrower filed bankruptcy or committed other "bad acts." Until then, single asset real estate bankruptcies were a way of life in distressed real estate. We lived through them and counseled around them. The bankruptcy was filed—it was an obligatory (some would say automatic) borrower tactic—to avoid receivership or to stop foreclosure, often for years and often causing great pain to lenders. For fully nonrecourse loans, the "shield" of bankruptcy protection became a weapon, wielded often and very successfully in court and in negotiations. Investors learned that in tough times the key to success might lie in the crafty manipulation and leveraging of lenders, partly through the bankruptcy process.

That changed completely with the advent of nonrecourse carveout guaranties. We now see these guaranties in virtually every commercial real estate loan, even if otherwise nonrecourse. Though the carveouts are sometimes negotiated, at times heavily (especially in the last few years, when excess liquidity has chased fewer available projects), and with varying success, full recourse for a voluntary bankruptcy remains a sacrosanct element of commercial real estate finance, one that until quite recently has been rarely negotiated, let alone waived.

Because courts tend to enforce full recourse carveout guaranties, those guaranties have essentially eliminated single asset real estate bankruptcies. Sponsors in 2009 knew where to find the bankruptcy courts, but they steered clear of them then, since then, and now. That is fact. The carveout guaranty works. Borrowers' principals know that if they initiate a bankruptcy, they will become personally liable for the entire loan.

In late 2018, we started to see the most prominent and coveted sponsors begin to negotiate for—and obtain—a limitation on their guarantors' full recourse for the entire loan, even for the most commonplace of "full recourse bad acts" such as bankruptcy. Partial recourse (e.g., $25 million on a $100 million loan secured by a $150 million asset) signals to the lending community that a sponsor's reputation and track record for performance is pristine; the equity cushion in the asset is large and secure; partial recourse, or recovery, from the guarantor is all the lender will ever need to achieve to make itself whole; and, if the lender requires full recourse on these facts, the sponsor will ably and easily find financing from some other institutional lender with more relaxed and borrower-friendly underwriting criteria.

We shall see, this late in the real estate cycle, whether "partial bad boy recourse" will become market or remain an aberration, sparingly available only for loans secured by the best, most secure (from a collateral value perspective), "trophy"-type, income-producing real estate projects.

Outside of full recourse for bankruptcy, carveout guaranties have seen more change in the last 20 years than virtually any other area of mortgage loan documents and negotiations. First they ballooned as smart lawyers came up with great new carveouts, each supportable by one lender concern or another. Then those balloons blew up in guarantors' faces when opportunistic loan buyers applied their magnifying glasses to the complex interactions among various clauses in the loan documents and the guaranty. Those loan buyers then asserted, often with success, entirely uncontemplated theories of carveout liability, many times inconsistent with and going far beyond the principles that motivated the carveouts in the first place. In response, many lenders have trimmed their carveouts back to a more sensible level.

Any real estate borrower knows that the first conversation on any mortgage loan proposal should cover carveouts—right after rate, proceeds, and term and before lesser economic issues such as prepayment or yield maintenance. We have recently seen extensive negotiations on scope and magnitude of nonrecourse carveouts. Borrowers and guarantors, having heard the voice of the courts on the side of the lenders (a "contract is a contract" even if it produces an absurdity), have tried to narrow the scope of carveouts to focus on intentionality and the commission of actual misdeeds.

A few courts have held that a subordinate mortgage, or a mechanic's lien, may rise to the level of an impermissible transfer (or encumbrance) triggering full recourse. Mindful of that, guarantors' counsel studiously try to trim back anything that might trigger liability for encumbrances that are otherwise "unintentional" or involuntary.

"Single purpose entity covenants" have also become fertile ground for unintended surprises for guarantors, and hence a major focus in any discussion of carveouts. That discussion sometimes goes a step further and addresses the proposition that the borrower should have the affirmative right to walk away from an investment that turned out badly and eliminate any further accrual of guarantor liability. The walkaway conditions then become a new battleground, with lenders trying to make them so restrictive that walkaway becomes nearly impossible without lender cooperation.

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Beyond the legitimacy of the bankruptcy protection, and that core "bad act," the theory behind partial recourse ties to the doctrine of election of remedies, which is available by statute, equity, or judicial pronouncement in many states. This doctrine prevents a windfall in favor of the lender. The lender cannot be repaid (let's say, in full) out of a liquidation of its collateral and then paid again out of the guarantor's other assets. That's an impermissible "double recovery."

To prevent that, if a lender has recourse against a guarantor, the lender must elect either to pursue that recourse or to foreclose its mortgage, but not both at the same time. These principles abide: real property cannot be secreted or "relocated"; generally there's income from tenants; and the loan is underwritten on the strength of that revenue stream and resulting collateral value. Thus, invariably, the lender will foreclose its real property collateral first, realize on its value, credit the guarantor for that value, and then seek to recover the deficiency—to the extent covered by the guaranty—from the guarantor.

Because of this reality, and the inherent value in the real estate collateral, most commercial real estate loans do not need full guarantor recourse for the lender—at least in theory, or under the documents—to be made whole. Ergo, the partial principal guaranty, a creature of the law, sponsor leverage, and liquidity in the market. Partial principal guaranties, as well as separate debt service and carry guaranties, look like they are here to stay.

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Commercial real estate lenders that look ahead to the rigors and delays of judicial foreclosure have always wondered if there might be a better way. Yet they have continued to resist the temptation to obtain equity pledges as additional collateral for their mortgage loans—a "dual collateral" technique that would replace the ordeal of mortgage foreclosure (a slow judicial process in many states, especially New York) with a stunningly fast personal property foreclosure procedure under the Uniform Commercial Code. Under that procedure, a lender can swiftly acquire all the equity interests in the borrower entity without having to deal with the judicial mortgage foreclosure process.

A recent New York case slightly opened the door to using that technique. Few commercial real estate finance lawyers are willing to rely on that case, though. They worry that courts will apply the time-honored doctrine that "equity abhors a forfeiture" and might decide that a dual-collateral structure somehow "clogs the borrower's equity of redemption" in the property. Thus, until an appellate court endorses that somewhat favorable decision or delivers more judicial guidance on the topic, commercial real estate lenders will continue to live with mortgage foreclosure as the exclusive remedy for commercial mortgage loans.

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In that world of mortgage foreclosures, lenders have recently faced an entirely new category of defenses and "lender liability" claims, spawned by the Great Financial Crisis, the avalanche of residential foreclosures that accompanied it, and a widespread backlash against the lenders that drove those foreclosures. Those lenders allegedly lent "too much" and then had the temerity to enforce their loans when their borrowers failed to repay them. "Judicial sympathy" (the proposition that mortgage foreclosure is an equitable proceeding in a court of equity) drives "judicial scrutiny."

In short, although the judiciary has seen and adjudicated virtually every type of classic lender liability defense or claim, in the last decade or so, the courts have faced anew, pondered, and adjudicated a saucy brew of "new lender liability" claims coming from the world of residential foreclosures.

Classic lender liability historically included theories (and once in a while facts) like: (i) breach of the covenant of good faith and fair dealing implied in every contract; (ii) reversal of established course of conduct, in the context of past waivers of defaults or enforcement and concessions; (iii) duty to act consistently; (iv) creation of a false sense of security, such as inducing a borrower's principals or new investors to contribute new equity; (v) detrimental reliance (someone contributes that new equity); (vi) selective enforcement, targeting particular sponsors or asset classes; (vii) fraud, duress, overreaching, and unconscionability, as defined after the fact; (viii) waiver; (ix) a lender's excessive oversight and control of the borrower, cash flow, or mortgaged property; (x) misrepresentations or misleading statements by lenders; (xi) tortious interference with contract, such as frustrating a potential favorable sale by the borrower; (xii) breach of fiduciary duty; (xiii) unequal bargaining position; and (xiv) champerty, i.e., the notion that it is somehow bad to sell a loan to someone who plans to sue to recover the debt.

The reported foreclosure cases, especially for residential loans but also sometimes for commercial loans, are filled with discussion of these defenses and claims. Many merely reflect the results of scriveners' creative word processing and borrowers' delay tactics. The reported judicial decisions have broadly rejected most of these theories, or found them unsupported by the facts. Occasionally they have prevailed, though, just often enough to cause caution and concern among lenders and their counsel.

Going beyond classic theories of lender liability, today we have a new flavor of lender liability, a new form of judicial sympathy, and a new set of techniques a borrower can use to stave off foreclosure when it decides not to repay its loan. As noted, these new claims and theories first appeared in a cascade of Great Financial Crisis residential foreclosure actions throughout the country. Their borrower-friendly outcomes in the residential world do bring the potential leverage of *stare decisis* to the commercial setting.

They include a wide range of mostly procedural defenses and arguments: (i) standing to sue (proof of ownership of the note and the underlying debt); (ii) chain of title (the lender must hold notes evidencing all debt secured by all mortgages being foreclosed and proper assignments and other transfer documents); (iii) lack of affiant's personal knowledge (in the complaint and the affidavits) of the debt and the defaults, evidenced by "robo-signing" and "robo-verifying"; (vi) predatory lending; (v) expiration of the statute of limitations (failure to "de-accelerate" within the time allowed to start an action); (vi) "loan to own" predation; (vii) impossibility of performance (the "credit tsunami"); (viii) alleged unsuitability of loan participants or syndicate members (whose unanimous consent is required for major decisions); (ix) lender's duty to ascertain borrower's financial wherewithal to service and repay the loan; (x) the doctrine of "deepening insolvency" (fraudulent extension of the life of a dying entity by doing nothing); (xi) rejection of an "allonge endorsement" attached to a note by a paper clip; and (xii) tortious interference with prospective contractual advantage.

We shall see how these defenses and claims unfold as they find their way into commercial mortgage litigation, where the courts have not really tested or applied them all that much.

Undeniably, real estate finance structures, participants, underwriting, credit enhancement, and lenders' rights and remedies have changed in other important ways over the last couple of decades. Suffice it to say, commercial real estate finance today is quite different from decades past. To us, this continues to make commercial real estate an exhilarating—and often fascinating—asset class to finance.

The authors are commercial real estate lawyers in Manhattan. This article reflects only their views and does not constitute legal advice.