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Top 10 Lessons from the Recession for Commercial Real Estate Lenders

In the memorable words of David Clayton-Thomas, "What goes up must come down."[1] Fortunately for the commercial real estate lending business, that maxim also works in reverse. Industry experts now generally agree that the fundamentals of the commercial real estate market are stabilizing and improving. Commercial real estate lenders have in large measure reopened for business and new start-ups have emerged to fill the void left by those that have exited the market. But the enthusiasm for new loan origination should be tempered with more than a measure of circumspection. Before diving into new transactions, lenders should refamiliarize themselves with the lessons learned from the recent downturn. We offer the following as a list of the "Top 10" such lessons.

[1] The song "Spinning Wheel," by Blood Sweat & Tears, peaked at No. 2 in July, 1969. There have been no fewer than three major real estate cycles during the intervening years.

10.Give Reporting Requirements Teeth.

When times get tough, borrowers are frequently in arrears on financial (and other) reports required to be delivered to their lenders. But developing a coherent strategy for dealing with a defaulted loan is enough of a challenge even with timely and accurate financial reports in hand. When faced with tardy or deficient reporting, lenders often grapple with the appropriate response. A lender may be loath to declare a default over what could be viewed by a court as a technical loan administration issue. Lenders (perhaps validly) fear that making such a move would appear disproportionately harsh, and would much prefer a clear-cut monetary default. As a result, lenders have increasingly included in loan documentation a provision to the effect that, in the event of late or deficient reporting, the lender has the option (but not the obligation) to levy a monetary fine (perhaps in the hundreds of dollars per day) for each day the deficiency persists. The failure by the borrower to pay the fine would be a monetary default. Alternatively, reporting defaults could entitle the lender to additional audit or appraisal rights, or to a temporary interest rate increase, with similar consequences stemming from non-payment.

9.Deal With "Self-Dealing".

It is not unusual for a borrower (or its affiliates) to also function as lessee, broker, licensor, construction manager, material supplier, contractor, decorator, etc., and for a mortgage lender to also serve as mezzanine lender, equity provider or investment banker. From the lender's perspective, it is important to keep a short leash on borrower affiliate relationships, and to appropriately insulate itself from liability for its own affiliate relationships.

Keep a Leash on Borrower Affiliates. During the recent downturn, some lenders found that their borrowers had not fully disclosed all affiliate involvement in the project. Others found that their borrowers signed sweetheart deals which had been initially presented as arms-length arrangements. Such arrangements could have a number of adverse consequences, including allowing the borrower to siphon off cash from the project. Loan documentation can mitigate these risks in three principal ways: (i) representations and warranties from the borrower that all affiliate relationships have been disclosed, (ii) covenants by the borrower that all contracts will be timely disclosed and on arms-length terms unless approved in advance by the lender, and (iii) provisions which cut off payments to borrower affiliates and other insiders following a default under the loan documents. Also, consideration should be given to adding payments made by the borrower under affiliate contracts that have not been been disclosed or approved by the lender to the list of non-recourse carveouts as a specific example of a misapplication of funds.

Don't Wear Too Many Hats. One lender liability theory raised by litigious borrowers (and co-lenders) has been that the originating lender must have had a conflict of interest by virtue of its different roles in a project. For example, in *Sun American Bank v. Fairfield Financial Services, Inc.*[2], a court found that Fairfield, which had sold a participation interest in a loan to Sun American, and maintained other banking relationships with the sponsor in addition to the loan at issue, breached a "duty of complete openness" to Sun American when it failed to advise Fairfield of sponsor financial difficulties of which Sun American had become aware. This and other potential issues can be mitigated in two ways. First, both the loan documents and intercreditor documents should include broad disclosures that such conflicts may exist, an acknowledgment and approval by the borrower and co-lenders of such conflicts, and a waiver by borrower and co-lenders of any claims arising out of such conflicts. Second, in situations where a lender wears a number of hats, the lender should continually monitor the situation and, where the objectives of one affiliate participant are irreconcilably divergent from those of another, the lender should, when possible, recuse itself from one of these roles, sell one of the conflicting positions and/or, at a minimum, create an ethical wall to separate the two roles and retain separate counsel for each.

8.Maturing Loans May Need "Long Term Care Insurance".

Prior to the recent downturn, loan documents often failed to anticipate that the nature of the asset securing the loan could change over time, including after final maturity. For example, in the construction loan context, a project under construction will eventually become an operating asset. But construction loan documents may not effectively deal with the management of operating cash flows, the establishment of appropriate operating reserves or the leasing guidelines that should apply to space leases once the project is completed. A lender may expect that its loan will be repaid before such topics become relevant. But such provisions should ideally be included in loan documentation at origination, rather than added during workout negotiations. Further, sufficient detail should be included in remedy provisions to ensure that the lenders have the unfettered right to make protective advances, to appoint a receiver as a matter of right, and to deal directly with third party service providers following an event of default. Depending on the circumstances, forbearance periods and workout negotiations can last for many months. During challenging times, the fewer loan document "interpretation" questions that arise, the better.

7.The Recourse Carveouts May Save the Day.

During the recent downturn, lenders found the list of recourse carveouts guaranteed by guarantors to be extraordinarily important both in their own right and in respect of their influence on workout discussions.

[2] 690 F. Supp. 2d 1342 (M.D. Ga), subsequent determination, 2010 WL 1487172 (M.D. Ga. 2010).

Recourse guaranties will generally be enforced as written.[3] As a result, creditworthy guarantors are substantially less likely to push borrowing entities into bankruptcy, engage in unpermitted transfers or commit other "bad-boy" acts in their efforts to avoid (or delay) loss of a property. On this topic, three areas deserve special attention:

Check the List Twice. Lenders could consider adding to the list of recourse carveouts certain provisions which borrowers tend to resist. These include: (i) liability for enforcement costs following an event of default, (ii) full recourse for the entire loan in the event of any interference by the borrower or an affiliate with the lender's exercise of remedies, (iii) liability for any losses resulting from the failure to timely pay real estate taxes or insurance premiums, and (iv) liability for any transfer taxes triggered by a foreclosure or deed in lieu.

Resist Watering Down the Recourse. Recently, some borrowers and their counsel have begun to suggest limitations on recourse liability. These suggestions have included, among others, eliminating recourse to the guarantor if (i) the borrower offers, but is unable to effectuate, a deed in lieu of foreclosure due to a fractious lender group, (ii) the borrower's counsel advises that a bankruptcy filing is required by reason of the fiduciary obligation of directors or (iii) a bankruptcy filing is made after the guarantor has lost control of the borrower (e.g., after a mezzanine loan foreclosure). Such limitations are defended as necessary to address certain inequities that only became apparent in recent court cases.[4] Lenders are well advised to resist such limitations as unwarranted.[5]

Get a "Warm Body" Guarantor. Lenders quickly discovered during the recent downturn that "warm body" individual guarantors are of much greater value than entity guarantors, even where the nominal creditworthiness initially appears the same. Not surprisingly, individual sponsors tend to be reasonably cooperative when the lender's "hooks" are in them as compared to a case where recourse can only be had to an entity guarantor. To this end, the new Commercial Real Estate Finance Counsel model representations for CMBS loans require a guarantor "which is a natural person or persons, or an entity distinct from the Mortgagor (but may be affiliated with the Mortgagor) that has assets other than equity in the related Mortgaged Property that are not *de minimis*".[6]

[3] *See Blue Hills Office Park LLC v. J.P. Morgan Chase Bank,* 477 F. Supp. 2d 366 (D. Mass. 2007) (holding non-recourse carve-out guarantors to be liable for the full amount of the debt where their misapplication of settlement proceeds triggered a "full recourse" event).

[4] *See In re Extended Stay Inc.,* 418 B.R. 49, 52 Bankr. Ct. Dec. (CRR) 47 (Bankr. S.D.N.Y. 2009), *aff'd in part*, 435 B.R. 139 (S.D.N.Y. 2010); *Bank of America, N.A. et al. v. Lightstone Holdings LLC and David Lichtenstein,* Index no. 601853/2009, Supreme Court, New York County (Guarantor David Lichtenstein grapples with a divided lender group and is allegedly forced to choose between the Scylla of a bankruptcy filing to preserve the operations of the real estate and avoid "waste", and the Charybdis of committing "waste", either of which trigger recourse liability).

[5] But see the discussion of replacement guarantors in Number 5 below.

[6] Note that a guarantor that is an entity would still appear to meet this requirement.

6.Don't be Held up by Defaulting Lenders.

There is nothing worse than mapping out a clear path forward on a defaulted syndicated loan only to discover that (a) the path forward requires unanimous lender approval, and (b) a single syndicate member will not (or cannot) obtain the requisite approval. Loan documents must grant lead banks adequate flexibility to appropriately manage and administer the loan, while giving due consideration to the rights of syndicate members (so as not to hamper syndication efforts). Proper documentation should address (i) the lenders' rights to make protective advances post-default and the obligation of syndicate members to join in such advances, (ii) the obligations of the parties if a lender fails to fund when required, including provisions whereby a defaulting lender forfeits voting rights and the borrower is required to post cash collateral to cover any fronting exposure posed by the defaulting lender's default, and (iii) voting rights among the lenders in respect of exercising remedies or adopting a post-foreclosure plan (from the agent's perspective, it is better to have a majority lenders requirement here than a unanimous lenders requirement).

5.The Intercreditor Agreement is a Prenuptial Agreement.

Like a prenuptial agreement, an intercreditor agreement (or the agency section of a syndicated loan agreement) is negotiated when times are good and mutual affection is in the air. Once the time comes to read the fine print, however, relations may have soured. The recent downturn has brought to light several possible deficiencies in intercreditor and agency arrangements. It is best to address such matters at the outset of the transaction.

Don't Be Blindsided by a Deed in Lieu. Intercreditor documents usually provide junior lenders with notice and an opportunity to cure defaults under senior loan documents. One issue that many intercreditor agreements fail to adequately address is the risk of a deed or assignment in lieu of foreclosure. As a consequence, some intercreditor agreements would permit a borrower to execute a deed in lieu in favor of a senior lender without affording the junior lenders any notice or cure rights. Some junior lenders have addressed this issue with a provision to the effect that the junior lender is entitled to notice of any deed in lieu transaction, and some period of time thereafter within which the junior lender may purchase the real estate from the senior lender. In such cases, the purchase price would typically equal the amount of the senior loan plus the senior lender's costs and expenses.

Require a Replacement Guarantor. Some intercreditor documents entered into prior to the recent downturn did not require a foreclosing mezzanine lender to post replacement guaranties as a condition to consummating its foreclosure. While absent such a requirement the original guarantors would be expected to remain on the hook for any recourse liabilities, the enforceability of the original guaranties may be in doubt, especially with respect to matters that occurred (or failed to occur) after the date the foreclosure by the mezzanine lender is completed. A more equitable solution would be to require the mezzanine lender, upon foreclosure (and as a

condition to the exercise of its right to foreclose), to replace the existing guaranties with substantially identical new guaranties from creditworthy guarantors.

4. Bankruptcy Remote is *NOT* Bankruptcy Proof.

Immediately after the General Growth Properties ("GGP") bankruptcy filing[7], many lenders started to question whether single purpose entities could ever again truly be considered "bankruptcy remote". However, as a result of subsequent court cases and refinements to independent director, springing director and lender consent provisions in limited liability company operating agreements, Delaware LLCs are again being accepted by commercial real estate lenders as satisfactorily bankruptcy remote. Even outside of Delaware, protections built into limited liability company operating agreements have withstood scrutiny reasonably well. In the recent *DB Capital Holdings*[8] case, a bankruptcy appellate panel for the Tenth Circuit ruled that general bankruptcy prohibitions in the operating agreement of a Colorado limited liability company were enforceable. "Lessons learned as a result of the GGP case include the following:

Scrutinize Staffing Agreements. The GGP borrowers replaced their existing independent directors with independent directors who were expected to be favorably disposed to a bankruptcy filing. There are several methods whereby a lender may guard against this. *First*, the borrower should covenant to provide the lender with advance written notice prior to the replacement of any independent director. *Second*, the loan documents should require that each independent director have some length of experience acting as an independent director. *Third*, each independent director should be required to be the employee of a nationally-recognized corporate services provider. *Fourth*, the loan documents should give the lender a right to approve the services agreements for the independent directors, and the lender (and its counsel) should review the agreements to ensure that they include the foregoing terms.

Make Upstream Bankruptcy Defaults Optional. One of the arguments successfully advanced by GGP in support of the bankruptcy filing for its borrower subsidiaries was that a bankruptcy of the GGP parent (which was inevitable) would, by reason of cross-default provisions in the property-level loan documents, trigger corresponding events of default under the loan documents to which the subsidiaries were party, thus rendering the subsidiaries unable to pay their debts as they came due. In response, some lenders are now including a

[7] *In re General Growth Properties Inc.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009). In this case, the debtor companies included certain property-level special purpose entity borrowers that had been ostensibly structured as "bankruptcy remote" companies with independent directors. The debtor replaced a number of these independent directors immediately prior to taking the vote in which the bankruptcy filing was unanimously approved by the directors, thereby presumably eliminating any dissenting votes.

[8] *In re DB Capital Holdings, LLC*, 2010 WL 4925811 (B.A.P. 10th Cir. 2010).

provision in their loan documents stating that an event of default resulting from a guarantor's bankruptcy will occur only at the option of the lender.[9]

3.Make the Cash Management System Watertight.

The GGP cash management structure provided for a periodic sweep of all funds from the property level up to the parent level. This upstreaming (which may have violated the SPE covenants in GGP's property-level loan documents) was one of the factors the bankruptcy court took into account when approving the use by the GGP parent for corporate family purposes of cash collateral generated at the property level. A better approach for the property-level lenders might have been to establish hard lockboxes and reserves at the property level with distributions to upstream entities only after all property-level expenses, holdbacks and reserves had been funded.[10] Under a standard set of loan documents, following a default the cash management accounts would be blocked, thus cutting off any leakage to the parent entity or its affiliates (at least through upward distributions). At that point, any funds remaining after disbursements for property expenses and required reserves would be available to the lender to pay down the loan or accumulate as additional cash collateral.

A lender should not assume that a borrower will at all times strictly adhere to the SPE covenants in the loan documents. For a matter as important as cash management, a lender should employ a "trust but verify"[11] approach. A borrower might be required, for example, to deliver periodic account statements where a soft lockbox has not yet sprung.[12] This would allow the lender to confirm that property revenues are being collected and disbursed in the ordinary course of business in a manner that complies with all applicable SPE covenants and cash management requirements.

2.Don't Throw Good Money After Bad.

During the recent downturn, some lenders were forced to continue to fund loan proceeds into severely distressed projects or portfolios. There are a number of ways loan documents can be drafted to protect against this scenario. *First*, the loan documents should not only contain adequate ongoing financial covenants, but also rights in favor of the lender to retest those covenants on a frequent basis. Ideally, such tests would be allowed at any time, but at a minimum they should be required in advance of (and as a condition to) any milestone event

[9] Note that such a provision should not run any risk of being construed as an unenforceable "ipso facto" clause because the bankruptcy at issue is the bankruptcy of a guarantor rather than the bankruptcy of the borrower itself.

[10] When a hard lockbox is established, rents are paid directly into an account controlled by the lender, and typically the borrower only obtains control of property cash flow after the lender has funded property-level operating expenses and reserves.

[11] A signature phrase used frequently by Ronald Reagan during the Cold War to describe relations with the Soviet Union.

[12] A typical set of loan documents incorporating a soft lockbox would provide that following an event of default or a specified financial covenant trigger (such as the failure to meet a debt service coverage ratio test), the lockbox (comprised of a pledged account through which funds flow directly to the borrower without the requirement that reserves be established) would "spring", after which reserves for taxes, insurance, interest payments or other items would be required.

such as a scheduled maturity date extension. Sufficient lead time should be provided for any required appraisal or other reports to be prepared and reviewed by the lender to ensure a meaningful test. *Second*, the lender should include in the loan documents a material adverse change ("MAC") funding condition, which would permit the lender to cut off further funding in the event of a material adverse change to the borrower or the property. To be effective, the MAC language should be tied to a specific reference date, such as the last day of the fiscal year prior to the closing of the loan. *Third*, the representations and warranties in the loan documents should be reasonably comprehensive. When coupled with the standard condition precedent to any advance that all representations and warranties must remain true and correct, comprehensive representations and warranties may provide valuable protection against unanticipated events that could not have been accounted for at the underwriting stage.

1.Consider the Worst Case Scenario.

Always consider what the picture will look like when the unthinkable happens – the maturity date arrives and the loan is not paid. Exercising remedies may involve the payment of transfer taxes, the making of protective advances or, in the case of a mezzanine loan, paying off one or more senior loans at par. As the *Stuyvesant Town* case[13] demonstrated, few lenders underwrote the full expenses of foreclosure. In that case, it was a transfer tax that ranged, depending on the source of the estimate, from $85 million to $200 million. Transfer taxes are but one of a panoply of potential risks that a complex transaction may present. Inadequate loan documentation or intercreditor arrangements, or not having access to capital sufficient to protect its rights or cope with the realities of a loan foreclosure, may result in a mezzanine lender forfeiting its entire position. Query whether some of the loans still in "workout mode" today would ever have been made if the worst case scenario (however seemingly unlikely) had been accurately presented and considered at the time the loans were originated. Significant risks are best taken with eyes wide open.

Conclusion

Solid underwriting and documentation standards will be essential in the post-recession commercial mortgage lending business. The strong lending platforms will be those that anticipate the economic cycles endemic to the real estate industry. Lenders that adopt a long-term view should pay particular attention to the "Top Ten List" summarized in this article. There is much to be learned from recessionary times. Now the challenge is to never forget!

[13] *Bank of America, N.A. v. PSW NYC LLC,* No. 6512293/10 N.Y. Slip Op. 51848(U), at *1-5 (Sup. Ct. N.Y. County 2010). Transfer taxes figured prominently in a protracted battle over Stuyvesant Town and Peter Cooper Village in Manhattan. Indeed, one of the holders of interests in the first mortgage loan sued in Federal Court to stop the mortgage foreclosure, arguing that it would result in the unnecessary payment of transfer taxes.

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