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Tips to Avoid the Botched or Delayed Closing

By Chuck Jacaman

By anticipating certain issues, borrowers and their representatives can make their closings run more smoothly. Here are some suggestions:

Sponsor issues

It's much easier to deal with any sponsor or known property condition troubles at the front end. The loan application usually asks for this detail anyway, but sponsors should anticipate the need to explain sponsor issues such as threatened or existing litigation, bankruptcies, prior foreclosures, or felony convictions, as well as property conditions like past environmental issues. If you have all the mitigating circumstances pulled together, lender sign-off is much simpler, and it will save you time and expense ultimately.

Ground lease issues

There are detailed requirements in CMBS transactions for loans that are secured either entirely by a leasehold interest or by a part fee/part leasehold interest. Lenders will typically require their counsel to prepare summaries of the ground lease provisions and evaluate the lease against the representations and warranties they have to provide in a securitization. Older ground leases that pre-date the advent of secondary market requirements can be particularly challenging. Borrowers should factor in that lead time, and appreciate that lenders may have to structure around ground lease-created problems with special escrow or recourse requirements. Since ground lessor estoppels or consents to certain amendments may also be involved, this should be a threshold element in any borrower's financing strategy.

Borrower structure issues

- Limited liability companies (LLCs): Many borrowers use LLCs as an entity form due to its flexibility and pass-through tax benefits. If the lender is mandating that "Level III" or "additional level" single-purpose entity (SPE) requirements be satisfied due to loan size or past sponsor issues, there are advantages to using a Delaware LLC with a "springing member" as borrower or as a managing member of the borrower, following the accepted protocol for that structure. LLCs formed in a state other than Delaware can involve additional opinions from the borrower's counsel dealing with non-dissolution.
- Pre-existing entities: Lenders frequently require that borrowers be formed as an SPE because that reduces risks associated with past or future ownership of other assets. Borrowers can usually use an existing entity if it hasn't owned other property in the past, and if the sponsor can make certain representations as to its operations. This is referred to as a "recycled" SPE. Where the existing entity has owned other property, qualifying as a recycled SPE may not be possible or practical because of additional real estate due diligence that's required. If as a borrower you want to use an existing entity, check with the lender beforehand to assure that you can satisfy the related requirements.

Zoning issues

Lenders have to give a variety of representations relating to zoning compliance, licenses and permits, and the ability to rebuild following casualty. Zoning information can be difficult to obtain, and extensive analysis may be required. If you are aware of past zoning violations or non-conforming conditions, raise the issue early so that you can agree on appropriate mitigants for the related risks. Depending on the responsiveness of governmental officials can be a dicey proposition.

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- **Declarations and restrictive covenant agreements:** Projects that have split ownership or financing, or that depend upon shared facilities, will usually have some type of declaration recorded of record addressing these issues. You can expect that the lender will need to review them, and that can require some lead time. These types of instruments can impact loan underwriting if, for example, the borrower ends up being responsible for offsite expenses. There can also be issues with use conflicts or purchase options or rights of first refusal. Typically, lenders get comfortable with declarations and restrictive covenants so long as there is no material adverse impact on the use of the property, the lender's lien, the marketability of the property, or the borrower's ability to generate income. In some cases, it may be necessary to amend the declaration to address lender concerns.
- **Purchase options and rights of first refusal:** These types of provisions (usually contained in leases and other recorded agreements) ripple through CMBS transactions in ways that can go unappreciated. Purchase options will be evaluated for their effect on the loan's prepayment provisions, the sufficiency of the option price, and, if the loan is permitted to be assumed, prospective changes of control. Rights of first refusal are easier to manage, but the lender will expect, at a minimum, that the foreclosure of the loan or a deed-in-lieu not constitute a trigger event. These changes are usually accomplished in the Subordination, Non-Disturbance and Attornment Agreement that is routinely circulated to major tenants.

Survey Issues

For multiple property loans, survey coordinators can provide value by providing a consistent presentation that will satisfy the lender's informational requirements. If the surveyor has to go back out on the ground to provide additional information, that is both time-consuming and costly. Questions about the type of survey and the required information ideally should be resolved when the surveyor is initially engaged.

Environmental Issues

Identify any potential or existing environmental issues at the loan commitment stage. This will help the lender determine the scope of its environmental due diligence requirements, raise any potential securitization issues prior to signing the loan commitment, and help the borrower estimate any additional potential closing costs to be incurred in connection with such environmental issues. A phase II environmental report, a clearance letter from the applicable environmental authority (confirming that the clean-up work has been completed), an acceptable environmental insurance policy, and/or an indemnity and undertaking agreement from a responsible party, might assist the loan to proceed to closing.

Payoff of existing indebtedness

The majority of CMBS loans are refinancings. Many of the underlying loans to be taken out have lockout periods (when the loan is not prepayable) and/or prepayment restrictions (e.g. the loan is prepayable only on the first day of the month or on a scheduled payment date, or the loan may not be prepaid for a specified period, or the lender requires a specified prior notice of prepayment). Certain loans may only be defeased, which requires, among other things, an SPE assumptor borrower, the purchase of specified government securities to replace the collateral property, legal opinions, and, in some cases, rating agency approval. In the case of an existing loan that must be defeased, several other parties will be involved and early coordination of their respective duties and requirements will be necessary to a cost efficient and smooth closing. Establishing early communication with the lender whose loan is being defeased can avoid untoward delays or additional requirements.

Tenancies-in-Common: CMBS Market Concerns and Mitigants

By Jong Kim

Loans to tenancy-in-common borrowers are on the rise, as 1031 exchanges and syndicated TIC investments gain favor. Lenders and CMBS investors are likewise requiring that TIC-related risks be addressed. In general, a TIC structure involves a relationship among two or more co-tenants that own a parcel of real property. However, unlike a limited partner or limited liability company member, each co-tenant has a direct, undivided ownership interest in the real property, and absent an

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agreement to the contrary, has the legal right to use, manage and operate the entire property and to partition or divide the real property based on its ownership percentage.

Lender and investor concerns with a TIC structure include: dealing with multiple borrowers with unsophisticated commercial real estate experience; the risk of serial bankruptcies; each co-tenant's right of partition; satisfaction of single purpose entity ("SPE") criteria by each co-tenant; and restrictions on the transfers of interests during the loan term. Since TIC structures often have multiple borrowers who have already received the lion's share of their economic return, there is also heightened default risk because investors are less likely to provide additional capital.

Compared to conventional borrower structures, TIC's create greater risks that a loan default will lead to complicated and expensive loan servicing and workout issues. What safeguards should lenders look for?

- A sponsor and property manager with significant real estate experience.
- TIC agreement among the co-tenants appointing a single manager who is authorized to be the sole contact and notice party and have complete authority to deal with the lender.
- Each co-tenant should be jointly and severally liable for the loan so that a lender may foreclose on the entire property (instead of on the interest of a particular co-tenant only).
- There should be lender approval rights for any material changes in the manager, the property management agreement and the TIC Agreement.
- Where co-tenant borrowers have entered into a master lease with a manager, as lessee, the master lease should be subordinated and all material and economic terms of the master lease reviewed. All underlying property leases must be assigned to the lender as security for the loan.
- Each co-tenant should be formed as a bankruptcy-remote SPE and, for large loans, have an independent director, and a non-consolidation opinion should be delivered covering each TIC.
- Each co-tenant should waive its right of partition in the TIC Agreement and covenant in the loan documents that it will not seek to partition the property.
- The entity documents for the TIC borrower should require that the unanimous consent of the company's managers and members, including applicable independent manager/directors, for bankruptcy-related actions, and that the bankruptcy or dissolution of the sole member will not cause the entity to dissolve.
- The TIC Agreement should provide that if a co-tenant seeks partition or becomes a debtor subject to the bankruptcy code, any one or more of the other co-tenants shall have the right to purchase such interest at fair market value.
- Breaches of TIC covenants in loan or entity documents should be backstopped by recourse liability to the loan's sponsors.
- Finally, TIC sponsors and borrowers should be aware of lenders' and investors' concerns about the transfers of interests by co-tenants during the term of the loan. The TIC structure typically permits the transfer of a co-tenant's interest to another entity, subject to certain constraints. For example, each assignee should meet lender's SPE and underwriting criteria and execute satisfactory assumption agreements and amendments to the TIC Agreement. Moreover, the experienced sponsor typically must retain a minimum ownership interest in the property. Transfer fees and expenses will be charged to some degree, but sponsors are advised to pre-wire the loan documents with the anticipated scope and requirements for subsequent TIC transfers.

TIC-structured loans pose some challenges, but by understanding the lender and investor concerns, as well as the mitigants required by the marketplace, TIC loans can still be successfully securitized.

Thinking Beyond the Closing: Streamlining Dealings with Servicers

By Farley Houston

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Changes to the property or borrower will typically trigger lender approval in CMBS loan documents, including the transfer of the mortgaged property or interests in the ownership of the borrower, the change of the property manager, executing a new lease in excess of a certain square footage, or executing longer-term lease extensions. Also, before escrows are released, borrowers may have to provide supporting information that addresses underwriting concerns (such as an upcoming expiration of a major tenant's lease, a higher-than-normal vacancy rate, or an anticipated near-term tenant improvement or capital expenditure).

Once the loan is securitized, a loan servicer will represent the securitization trust in processing any approval requests of the borrower. The servicer must administer the loan in accordance with the Pooling and Servicing Agreement (PSA), which not only sets ground rules directly governing the servicer's conduct, but may also grant approval rights under certain circumstances to the special servicer or other designated parties. The servicer is also required to administer the loan in strict accordance with the provisions of the loan documents.

Borrowers should focus on post-closing requirements in their loan documents. Approval conditions and mechanics should be drafted with servicer authority in mind. If the loan documents do not provide a servicer with adequate guidance (which sometimes occurs even on typical borrower approval requests), this creates delay while the servicer and other necessary parties consider the request. Loan documents must be pre-wired to anticipate future issues in the clearest language possible under the circumstances (including the form and contents of borrower certificate and release of fund requests).

Here are a few issues and questions borrowers should try to anticipate and address early in the loan documentation process:

Loan assumptions and changes in ownership of the borrower

The borrower should know what he can and can't do regarding future property and ownership transfers. Are estate planning transfers permitted? If a controlling equity transfer is planned, the lender will require sole discretion approval rights unless the borrower can get the transferee pre-approved. If the borrower entity consists of multiple parties as tenants-in-common (TICs), any future changes (such as roll-up or consolidation of those interests within a certain period of time, or the addition of any further TICs), should be clearly anticipated and conditioned with reasonable detail in the loan documents.

New leases, lease extensions, and sublease approvals

For shopping center and other lease-intensive properties, loan documents should identify reasonable lease parameters for any new lease, lease assignment or lease extension, or sublease (with respect to square footage, financial strength of the tenant, operating history of the tenant, nature of the tenant's business, build out and capital improvement requirements, and guarantor requirements), as well as including minimum requirements for which no prior lender consent would be necessary. Any borrower expectations with respect to this approval process (and any informational submission requirements) should be addressed in the loan documents.

Escrows and holdbacks

The loan documents should clearly describe the triggering events permitting either the release or further retention of escrowed funds with sufficient reasonable detail to allow the servicer (who was not involved in the loan closing) to carry out the agreement of the borrower and lender. If, for example, a holdback escrow is to be released when the borrower achieves a certain level of "cash flow after debt service" within a certain specified time period, the manner of calculation should be as explicit as possible to provide the servicer with reasonably objective guidance when making such a calculation but at the same time granting the servicer adequate discretion to apply applicable underwriting standards and other considerations. If a holdback release is conditioned on the lease-up of the collateral property to a minimum occupancy rate, the loan documents should outline any specific requirements applicable to the new leases (such as a minimum lease term, base rental and tenant financial strength) while providing the lender with reasonable discretion to apply its more general underwriting criteria in evaluating whether to release the escrowed funds.

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Other lender approvals

What else might the property require? Releases of unimproved property, reciprocal access agreements, easements? Without specific documentation or terms, there is no way to expedite later servicer review.

It is important to note that due to securitization concerns and other considerations, including potential increases in servicing costs, limits on the lender's discretion under REMIC rules, and approvals required under the servicer's PSA, even the most cooperative lender may not be able to accommodate every borrower requested change to the loan documents with respect to anticipated post-closing matters requiring prior lender approval. Nevertheless, considering these issues as loan documents are drafted is critical to a positive servicing experience for both borrower and servicer.

Franchisor Rights: A Trap for Lenders?

By Brigitte Kimichik

Loans that are secured by franchised properties involve remedies issues that, if unanticipated, can complicate the future operation of the property and frustrate the lender's recovery strategy.

For example, the borrower has defaulted on his loan secured by 60 fast-food restaurants. The lender successfully gets an appointment of a receiver to take control of your collateral, and the receiver has received court authority to implement an orderly disposition of the collateral. Can the lender sell the restaurants as franchised? The loan default and acceleration of debt have likely caused a termination of the franchise agreement, and before the court approves the receiver's disposition authority, the lender needs to evaluate the impact of its pursuing remedies on that franchise relationship.

If the franchise agreement has been terminated, the borrower no longer has authority to operate the restaurants under the franchise name and likely has to remove logos and signs from the premises within a certain time period. Continuing operation under the terminated franchise agreement will expose the lender or the receiver to litigation.

If the lender negotiated a "franchisor comfort letter" at closing of the loan, that can help, because certain lender protections are provided following a franchisee default under the franchise agreement and loan. If not, the lender may not have a right to operate the restaurants under the franchise name after the lender takes control of the collateral, whether by foreclosure, receivership, or otherwise. The franchisor may have gone further to restrict operation of its franchise by any third party, to prohibit the sale of the restaurants to a third party, or even to prohibit the closure of any of the restaurants, without first obtaining the prior written approval of the franchisor. Regardless of the court order authorizing the receiver to dispose of the collateral, the franchisor may seek an injunction preventing a sale under the franchise agreement or sue the lender or receiver for breach of contract. The court order should clearly authorize the receiver to dispose of the collateral regardless of any agreements between the borrower and the franchisor. Without this, courts have recognized and protected the interests of a franchisor in former franchised locations and enforced post-termination provisions in franchise agreements.

Consider a "franchisor comfort letter" at the outset of the loan that is simple and straight forward. The lender should have a right, without obligation, to cure a borrower/franchisor uncured default for some defined time period and to step in to the shoes of the franchisee under the franchise agreement without any successor assignee or operator qualifications. If one has not been executed and the receiver seeks a temporary license agreement, the lender should seek a court order requiring prior written lender consent before any agreement affecting the lender's collateral can be signed.

Intercreditor Agreements: A Primer on the Rights of *Pari Passu* and Subordinate Lenders

By John Tucker

The increased amount of lending up the capital structure gives borrowers and lenders more options, but creates documentation and servicing issues among the creditors. The intercreditor provisions for *pari passu*, mezzanine and A/B financing structures are discussed below.

***Pari passu* financings**

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Pari passu financings involve co-equal multiple lenders where a loan is either originated as a split loan or later split into two or more parts. Each component is represented by a separate promissory note secured by the same mortgage lien. For example, the loan originator may split a promissory note representing a \$100 million loan into a \$50 million A-1 note and a \$50 million A-2 note. Both the A-1 note and the A-2 note generally contain identical interest rates and payment terms, and the security instrument securing the loan secures both notes.

The intercreditor agreement governing the A-1 and A-2 noteholders' rights typically provides for an equal priority with respect to payment rights (regarding principal, interest and other amounts, including, for example, default interest and prepayment yield maintenance fees), enforcement of security interests and other remedies, and allocations of losses and expenses.

Although noteholders in *pari passu* structures enjoy equal treatment concerning their respective rights and obligations (i.e., each holder maintains a priority commensurate with its *pro rata* ownership percentage of the loan as a whole), the intercreditor agreement delegates one of them the authority to administer and service the loan in its entirety. The holder of the first component note to be securitized usually has this authority, and the entire loan will be governed by the related pooling and servicing agreement for that deal.

While the servicer in the securitization of the first note has authority in the administration of the loan, many intercreditor agreements require the majority or unanimous approval of the other noteholders before certain actions can be taken by the servicer. Such actions may include:

- modifications or waivers resulting in the extension of the maturity date, reduction in the interest rate or monthly debt service payment amount and other monetary terms of the loan;
- modifications or waivers resulting in a discounted pay-off of the loan;
- foreclosure and/or the institution of any equivalent proceedings;
- any sale of the property or properties securing the loan;
- any replacement or substitution of collateral;
- any attempt to bring the collateral property into compliance with environmental laws, rules or regulations;
- any waiver of "due-on-sale" or "due-on-encumbrance" clauses;
- any release of the borrower or any guarantor of its obligations under the subject loan documents; and
- any approval of additional indebtedness to be secured by the collateral property.

Mezzanine financings

Unlike the *pari passu* situation described above, mezzanine financings involve a loan by the mezzanine lender to the equity owners of the property-owning borrower. While the senior lender's loan is secured by the borrower-owned property, the mezzanine lender's loan is not a debt of that borrower and is not secured by such property; rather, the mezzanine loan will be secured by a pledge of the controlling ownership interest in the borrowing entity. The mezzanine lender's remedy following a mezzanine borrower's default is the foreclosure of its security interest in such equity interest and to "step into the shoes" of the mezzanine borrower. As a result, the senior lender and rating agencies require the mezzanine lender to meet minimum suitability, experience, and net worth requirements.

The senior/mezzanine intercreditor agreement subordinates all payment and other rights of the mezzanine lender to those of the senior lender. As long as no default exists under the senior loan, the mezzanine lender is entitled to receive payments on the mezzanine loan. Upon a default by the borrower under the senior loan, however, the intercreditor agreement will usually prohibit the mezzanine lender from accepting and receiving any loan payments from the mezzanine borrower until the senior loan has been fully paid. The mezzanine lender is also generally prohibited from:

- instituting or soliciting any bankruptcy or insolvency proceeding against the borrower under the senior loan or the mezzanine borrower while the senior loan is outstanding;

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- taking any action against the borrower under the senior loan or the mezzanine borrower in any bankruptcy or insolvency proceeding without the prior consent of the senior lender; and
- receiving any casualty or condemnation proceeds until after the senior lender is fully-compensated.

In addition to foreclosing upon its pledged security, in some instances the mezzanine lender may purchase the senior loan upon a default by the borrower under the senior loan. In such cases, the purchase price will equal the amount necessary to pay the amount of outstanding principal and interest and any advances, expenses, default interest, late charges and other fees. The mezzanine lender may also have the right to cure certain defaults of the borrower. For example, the mezzanine lender may make the requisite debt service payments of the borrower under the senior loan. This ability may, however, be limited to a certain consecutive time period.

A/B financings

The "A/B" financing arrangement constitutes a hybrid of the *pari passu* and the mezzanine structures: (i) similar to the *pari passu* structure, there are 2 or more notes executed by the same borrower and secured by the same collateral and (ii) like a mezzanine financing, an A/B financing has a senior component and a junior component, where the payment rights and remedies of the holder of the B note are subordinate to those of the holder of the A note.

The most significant structural difference for the senior lender is that this additional subordinate debt is owed by the same borrower, and therefore the subordinate lender would be a competing adversary in a borrower bankruptcy. Consequently, the A/B intercreditor typically provides that the B noteholder cannot accelerate the loan, institute foreclosure or take equivalent actions, file a petition of bankruptcy or insolvency against the borrower or exercise any other remedies against the borrower. The A noteholder will have the authority to administer the loan, subject to the terms and conditions of the applicable PSA and intercreditor agreement. This authority may include the absolute right of the A noteholder, without the consent of and to the exclusion of the B noteholder, after an event of default, to:

- modify or waive any of the economic terms of the loan documents;
- consent to any action or failure to act of the borrower;
- accelerate the entire loan;
- foreclose upon or take any other action with regard to the collateral property; and
- vote all claims regarding the loan in bankruptcy or other insolvency proceedings.

In addition, the intercreditor agreement may also require the A noteholder, prior to a default, to obtain the consent of the B noteholder before taking actions which require the unanimous or majority consent of noteholders in a *pari passu* intercreditor agreement.

While the A-2 noteholder in a *pari passu* loan can expect to receive a remedy proportionate to its interest in the loan, the subordinate status of the B noteholder results in the extinguishment of its junior security interest in the event of foreclosure. As such, after a default, the B noteholder's primary remedy is to purchase the A note from the A noteholder, although it may have certain limited cure rights as well.

These three levels of capital structure funding give both borrowers and lenders more options, but create documentation and servicing challenges.

Defeasance Liabilities: Are New SPEs Really Necessary

By Patrick Sargent

Most borrowers are accustomed to industry-required single-purpose entity (SPE) provisions limiting purpose, the incurrence of indebtedness and adhering to separate operations covenants. Where a refinancing involves the defeasance of an existing loan, however, there can be a collision between the conditions required for the defeasance and those required for refinancing. The result can impose a hardship on the borrower, particularly in transfer tax jurisdictions. What lies behind the

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conflict? Are there alternatives?

Most defeasances are effected by the SPE borrower's simultaneously acquiring defeasance collateral, assigning the prior loan to a successor borrower that meets SPE criteria (typically a defeasance entity established for the particular securitization pool), and executing loan documents for the new loan. The successor borrower and the existing borrower will enter into an assumption and assignment agreement, together with other related documents, that allocate risk and responsibility for the assumed loan and the defeasance collateral. A defeasance is simply exchanging the property collateral for AAA-rated securities, so the holders of the prior loan have stronger collateral. Rating agency and capital markets requirements deal with defeasance-related risks as to adequacy of security, lien and document enforceability through various assurances: (i) accounting certification that the collateral is sufficient; (ii) legal opinions that there is a perfected security interest in the defeasance collateral and no adverse impact on REMIC status, and that the defeasance documents are enforceable; and (iii) for larger loans, confirmation from the applicable rating agency as to the form and documentation of the defeasance.

The issue revolves around the current SPE borrower's having residual liability for the defeasance transaction. If the current borrower is obligated to indemnify or be obligated to any person for problems that could arise under the defeasance, there is a collision with the new lender's SPE requirements that its SPE borrower not have any debts/obligations unrelated to the new loan or the operation of the property, and the defeasance provider's reluctance to release the borrower from residual liability. To avoid the requirement that a new SPE borrower be created for the refinancing loan and the property be transferred to it, several options exist:

1. require that the successor borrower defeasance entity assume all obligations under the defeasance documents, so the existing borrower has no residual liability thereunder;
2. require that a sponsor of the borrower (i.e., the existing carve-out guarantor) assume any liability that may remain under the defeasance documents; or
3. provide in the non-recourse carveout guaranty for the new loan that the non-recourse carveout guarantor will pay directly any costs, liabilities or claims owed by the borrower associated with the defeasance.

Any one or more of the foregoing options should be more desirable to the borrower than requiring that the borrowing entity be cleansed from residual defeasance liability by a transfer to a newly created SPE. Likewise, defeasance and new loan providers should be comfortable that their related concerns are addressed.