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Borrower Beware! Selected Silent Issues in CMBS Loan Documents[1]

Negotiating loan documents requires a borrower's counsel to seriously contemplate the needs of the borrower, the operation of the property and the interplay of both considerations with the proposed financing. Unlike other types of agreements that focus on the past, loan documents are almost entirely focused on the unknown future, which is decidedly more challenging.

Loan documents are living agreements that govern the relationship between the borrower and the lender for the duration of the loan. The goal of both borrower and lender should be for the agreements to cover every scenario that may arise so as to avoid any ambiguity or surprise down the road. This is particularly important to a borrower on a CMBS loan, given that the lender after a securitization will be replaced by a servicer that services potentially thousands of loans and whose interests and motivations may be very different than the lender at closing. Borrowers are anxious to document each potential pitfall when negotiating loan documents, but borrowers are at a disadvantage given that there are no standard CMBS loan documents to provide for an easy comparison of basic terms. The form of loan documents can vary depending on the lender and the lender's legal counsel.

Document Issues

Typically, the key business and legal terms that are fundamental to both borrower and lender are reflected in an agreed term sheet that counsel will use to draft the documents. Most form documents, however, contain a number of issues that are important to nearly every borrower and that do not clearly and easily present themselves to the borrower and its counsel. These key issues fall into one of two categories that make them particularly challenging and "silent." First, there are terms potentially missing from the forms circulated by lenders that are vital to the borrower. The second category are terms that on their face appear reasonable, but can create issues for the borrower unless appropriately modified. Loan documents often number hundreds of pages and these issues, to the unsuspecting borrower and its counsel, can cause significant problems when the parties, and potentially a court, will be reading each word as a guide to resolve a conflict.

This article presents some examples of these issues that the authors have encountered in loan documents used in the CMBS market. The issues are organized generally by topic. In addition to raising the issues, the article provides the borrower with suggested resolutions and, where appropriate, the reasoning behind the suggested approach. Each loan, just like each property and each borrower, is unique and has its own characteristics and requirements that the lender requires in order to close the loan. In most cases, however, a lender should be willing to consider these suggestions without the need for serious negotiation given the general market consensus on these points.

Payments, Prepayments and Defeasance

Late Fees

If the borrower is late in making any required payment a lender will typically charge a flat late fee calculated based on the amount of the late payment. Late fees are meant to compensate the lender for the hassle and additional costs incurred as a result of the late payment and are in addition to any default interest charged. Although late fees apply to late payments of interest and amortized principal (to the extent applicable), it is not customary to require the borrower to pay a late fee for a failure to repay the outstanding principal and interest on the maturity date or upon acceleration of the loan. A late fee, which is often up to 5% of the defaulted amount, calculated on the outstanding principal amount of the loan, could result in an enormous windfall to the lender if there is a default at maturity (even if, for example, the refinancing is delayed by only one day). Borrower's counsel should ensure that an appropriate exception from the general rule to pay a late fee is included in the loan agreement for maturity defaults.

Prepayment following Casualty/Condemnation

Following a casualty or condemnation, a lender will typically have the option under certain circumstances to require that the insurance proceeds or condemnation awards be applied to prepay the loan. A borrower should ensure that such a mandatory prepayment not be subject to a prepayment penalty or fee. This issue is well covered and is oftentimes a standard exception from the general rule requiring a prepayment fee. Another issue exists, however, with respect to prepayments following a casualty or condemnation that may be less obvious. If the lender applies casualty or condemnation proceeds to prepay a portion of the loan, the borrower should have the ability to voluntarily prepay the remainder of the loan (or the release price of the effected property in a multi-property transaction) without requiring the payment of a penalty or fee, even if the loan is not otherwise be prepayable at that time. If a casualty occurs and the lender requires that the insurance proceeds be applied to prepay the loan, the borrower may not have the necessary funds to restore the property to the condition it was in prior to the casualty and will need a construction loan or some other refinancing in order to complete the restoration.

LIBOR Replacement

Given the expected death of LIBOR as a benchmark rate, loan agreements with an interest rate tied to LIBOR need to contain a clear mechanism for a replacement benchmark rate with an appropriate adjustment to the spread over LIBOR to reflect the difference between the new benchmark rate and LIBOR. Although floating rate loan agreement have traditionally contained mechanisms to replace LIBOR if it is unavailable these mechanisms require new scrutiny to reflect the expected permanence of the unavailability of LIBOR.

If a loan agreement requires a replacement of the interest rate cap agreement during the term of the loan (e.g., upon a loan extension) the borrower should discuss with the lender a mechanism to comply with the loan agreement requirement if a LIBOR based interest rate cap becomes unavailable. Although it has always been advisable for a borrower to consult with a hedging advisor on the provisions that govern the purchase of an interest rate cap, the need has heightened given the expected unavailability of LIBOR.

Prepayments in the Context of Property Releases and Loan Extensions

The conditions that a lender will require in order to extend the maturity date of the loan or release a property in a multi-property loan can vary. These conditions often require that the property meet a minimum debt service coverage ratio threshold and/or a minimum debt yield ratio. If the loan is not otherwise prepayable without penalty at the time of such extension or property release, the borrower should request the ability to prepay or defease a portion of the loan without penalty so that the property satisfies the required debt service coverage ratio and/or debt yield thresholds. The purpose of the financial tests is to demonstrate the health of the property as it relates to the loan and, therefore, the Borrower should not be prevented from extending the loan or releasing a property if it can reduce the principal amount of the loan to meet the required thresholds.

Defeasance

Defeasance securities generate payments that serve as a direct replacement for the steady monthly payments that the borrower previously paid under the loan agreement prior to defeasing the loan. Some form loan agreements require the borrower to purchase defeasance securities that provide for monthly payments through the maturity date instead of the beginning of the period when the loan could otherwise be prepaid by the borrower, or are ambiguous on this point. A borrower should make clear that it only needs to purchase enough defeasance securities to make payments through the first day of the prepayment period or, at borrower's option, any other day during the prepayment period. This construct avoids the need to replicate interest payments that might never have been made and gives the borrower the flexibility to structure the final defeasance payment to fall out on the day in the permitted prepayment period that is most cost effective for the purchase of the defeasance securities.

The ability to defease a loan is a mainstay of fixed rate loan agreements that are destined to be included in either a stand-alone or conduit securitization. Defeasance can be an expensive and a very involved process, necessitating multiple parties and steps to successfully defease a loan. The defeasance provisions require a keen understanding of this process. There are a number of companies with expertise in the process and borrowers on large loans should consider having these experts review these provisions as part of the negotiations.

Transfers and Ownership Implications

"Direct or Indirect" Restrictions

A borrower should pay particular attention to negative covenants and transfer restrictions formulated as prohibiting an action or transfer by a "direct or indirect" equity owner of the borrower. These restrictions could have implications beyond what the lender contemplates as being integral risks associated with the loan and the property and could be particularly problematic for private equity fund borrowers. Without proper crafting, limited partners could be restricted from transferring their interests or the fund could be required to give advance lender notice of a transfer.

A similar issue arises in connection with restrictions on the incurrence of debt by indirect owners of the borrower and restrictions on pledging upper-tier ownership interests. Although these restrictions should apply to any entity the lender deems as being directly necessary to ensure that the borrower doesn't add unwanted preferred equity or mezzanine debt, a lender will typically allow the fund itself and upper-tier entities that own significant other properties to incur debt and pledge their ownership interests. The contours of the restrictions and exceptions are specific to the facts and circumstances of each ownership structure. These issues are being raised in this article, however, only to highlight some of the more thorny and difficult pitfalls that borrowers need to be aware of.

Individual Owners

If a borrower is owned by a natural person, the individual should consult with estate planning advisors regarding transfers of its ownership interest to accommodate estate planning, including potential transfers following death. A lender may be amenable to permitting certain pre-designated transfers or condition-light transfers to the extent the lender understands the nature and purpose of the estate planning related transfers.

Rating Agency Approval

On a CMBS loan, the Lender will require that the rating agencies that rated the securities approve certain matters that may also require lender approval. The rating agencies typically only agree to review and then approve or disapprove certain requests, but decline to review others. With respect to any matter that a borrower is required to receive rating agency approval before taking an action, the borrower should insist that the rating agency approval requirement be deemed satisfied if the relevant rating agencies decline to review the request. This avoids the pitfall of a borrower not being able to take an action if the rating agency decides not to review it.

Guaranties

Termination of the Guaranty for Individuals

If the guarantor on a loan is a natural person, the borrower and guarantor should consider whether the guaranties should automatically extend to the guarantor's heirs and estate or terminate following the guarantor's death. Guaranties that extend to the estate and heirs could complicate the estate after death and may also have unintended consequences (e.g., forcing the estate to maintain a minimum net worth and liquidity) that could be challenging for the estate. A borrower should consider asking for the ability to terminate the guaranties following death upon the lender receiving a replacement guarantor that meets the pre-agreed requirements set forth in the loan agreement.

Replacement of Guarantor upon an Event of Default

Borrowers should consider requesting the ability to replace the guarantor upon an event of default that arises solely as a result of a failure to satisfy the guarantor financial requirements. This request is sometimes granted by lenders, though it may be challenging to receive if the lender puts significant weight on the guarantor at closing remaining the guarantor during the term of the loan.

Notices to Guarantor

If a guarantor is not involved in the management of the borrower it may consider requesting that the lender add it as an additional notice party under the loan documents in order to get direct notice of any issues that arise. Advance notice may give the guarantor the ability to interject and fix problems before they become recourse to the guarantor.

Recourse

Objectivity of Recourse Carveouts

A Borrower should be careful that the recourse carveouts are drafted clearly and whether the recourse carveout is triggered can be determined objectively. For example, the carveout of a "misappropriation of funds" in violation of the loan documents points to a clear set of guidelines in the loan agreement that could result in recourse. Conversely, a "misapplication of funds" might be interpreted subjectively to second-guess decisions made by the borrower in spending funds on one item over another, even though neither purpose was expressly prohibited.

Recourse for Economic Failures

Recourse items resulting from a borrower's failure to satisfy monetary obligations to third parties (such as a failure to pay insurance premiums or to prevent unauthorized liens on the property) should only be recourse to the extent of the lender's losses In addition, the recourse liability should be limited only to the extent the property is able to generate funds to cover such expenses, lender does not block the borrower's access to those funds and the borrower nonetheless fails to satisfy the obligations. Without these limitations, the guarantor is essentially agreeing to full recourse for those obligations as the guarantor will be required to fulfill obligations of the property that the property itself cannot sustain.

Full Recourse

A borrower should limit the matters that cause the loan to be fully recourse to the guarantor to only material unauthorized voluntary acts, such as an unauthorized transfer of title to the property or the placing of a lien on the property for borrowed money. A borrower should be careful to exclude minor liens, easements and ordinary course disposal of personal property from the transfer restrictions so that they do not trigger the full recourse provisions.

Conclusion

The foregoing points raised in the article give borrowers and their counsel some examples of "silent" issues that could arise in the future and upset the borrower and its otherwise overall business plan for the property. Borrower's counsel are encouraged to develop their own list of "silent" issues over time (be it through the process of negotiating loan documents or guiding clients through unintended results) to use in counseling borrowers to avoid these thorny pitfalls. Being prepared not only allows borrower's counsel to efficiently identify the issues as they arise during the review of loan documents, but it also enables the borrower and its counsel to focus on the issues that may be unique to the property and to quickly present lenders with market established positions on these issues.

1 The authors recognize the "Landlord's Checklist of Silent Lease Issues" and "Tenant's Checklist of Silent Lease Issues," by Joshua Stein and S.H. Spencer Compton, as the inspiration for the title.