STEIN'S LAW

Carving Back the Carveouts

When lending against a stabilized project, a mortgage lender will typically agree that if the borrower defaults, the lender will foreclose and not seek further recourse for payment of the loan, hence the term "nonrecourse financing." But the loan documents will usually "carve out" certain matters from nonrecourse treatment. For those, the lender will have a claim against the borrower's principals as guarantors, making the carveouts the scariest part of the deal. They can force the guarantor to pay the entire loan, even though it was supposed to be nonrecourse.


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Term sheets often used to say the loan documents would contain "lender's standard carveouts." The borrower would fund an expense deposit—pay to see the lender's documents—then try to negotiate the guarantor's exposure. Today's borrowers and guarantors often won't take that risk. By the time they realize the carveouts are troublesome, it will be too late to choose another lender. Therefore borrowers and guarantors often insist that the precise words of the carveouts appear as an exhibit to the term sheet. In reviewing and potentially negotiating those words, what should a guarantor and its counsel care about? Here's a quick guide to the high points, or low points.

Lenders often want guarantors to cover unpaid real estate taxes, insurance and sometimes other expenses. If a property gets into trouble, though, those carrying costs could become burdensome and perpetual—shifting risks to the guarantor in a way inconsistent with the logic of nonrecourse financing. A guarantor should have no responsibility if the property couldn't carry these costs simply because it had insufficient cash flow. That's the lender's risk. Guarantors should face exposure only if the property could have covered these costs but the borrower misused available funds.

If any prohibited transfer or indebtedness occurs, then a lender's "standard carveouts" often require the guarantor to pay the entire loan. But the intricacies of loan documents may define prohibited transfers or indebtedness to capture trivial glitches—sometimes the simple result of insufficient cash flow—going far beyond an outright transfer or second mortgage. And a guarantor might not be able to control some prohibited transfers, such as those involving passive investors. A careful guarantor will want to face liability only if the borrower does something egregiously bad, such as selling the property or encumbering it with a second mortgage.

Lenders sometimes want to chase guarantors if the borrower does anything to defend a foreclosure or any other exercise of the lender's remedies. But what if the lender was wrong and the borrower right? It can happen! At a minimum, the guarantor will want no liability unless the borrower's defenses were frivolous and asserted in bad faith. And even if they were, the guarantor will want to cover only the lender's extra costs and perhaps interest, not the entire loan.

Many mortgage loan documents devote extraordinary attention to the idea that the borrower should always be a "single-purpose entity," a structure that seeks to minimize the likelihood of a bankruptcy and keep it simple if it does happen. Until the 2008 financial crisis, guarantors often agreed to pay the entire loan if the borrower violated the SPE covenants. But those covenants turned out to be so intricate, and often so excessive, that lenders could claim the borrower tripped the SPE covenants just by suffering financial problems such as not paying ordinary payables or the loan itself. This disconnect meant, for example, that lenders could try to collect the entire loan from guarantors just because the borrower didn't pay it—not at all consistent with the logic of a nonrecourse loan.

Today's guarantors know they should watch out for that perversion of nonrecourse financing. If a borrower violates an SPE covenant, guarantors might be willing to be responsible for any direct loss the lender suffers—hard for the lender to prove and hence not too scary. A guarantor will also want to avoid any implied obligation to contribute capital to cover shortfalls to maintain SPE compliance.

Guarantors for years accepted liability for things like "fraud" and "waste." A careful guarantor knows those words can, with some creativity, capture almost any misfortune that befalls a loan. A guarantor can prevent that creativity by trimming the scope of these terms. References to the borrower's "gross negligence" create similar concerns.

Though the carveout traps just described are the most common ones, others lurk. More may creep in over time.

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DAN WITH A PLAN

The Holy Grail: A Life Insurance Company Mortgage

"You can check out anytime you like, but you can never leave."—The Eagles

Equating lenders to various tranches of a commercial mortgage-backed securities pool, the hard-money lenders are the C, or unrated, slice—and the life insurance companies are the AAA tranche. It is likely hyperbole to discuss the impact of another potential meltdown of the capital markets on life insurance lenders. As one originator recently told me, "Insurance companies are unwilling to sacrifice credit quality, and they will not increase their lending volume simply because there is more demand for their product." Therefore, any comments about eroding credit quality or lending bubbles do not directly apply to the life companies. But any credit risk officer would quickly agree that we cannot just put our heads in the sand since—as we saw in the last crisis—when the subprime loans default, it affects the entire capital stack.

Currently, insurance lenders have a huge competitive advantage on CMBS. During the peak of the securitized commercial real estate debt market in 2006, the interest rate coupon of the two groups was essentially the same. In fact, since the CMBS lenders had essentially the same spreads as the life companies, CMBS briefly became preferable because they would generate higher loan proceeds.

Today, a typical life company quote is 160 to 170 basis points over swaps, approximately 100 to 130 basis points below CMBS pricing. The latter have no choice as the AAA tranche has widened out to 150 basis points over swaps and the junior tranches have widened substantially too. The real estate lending world has become bifurcated with the top quality deals going to the insurance companies and the CMBS and other lenders getting the remainder.


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For non-multifamily deals, insurance lenders should always be the first call. What are their preferences? Class A office buildings in gateway markets and grocery-anchored shopping centers with strong sales. The life companies are far less active when it comes to Class B properties and markets that are susceptible to economic slumps, such as Houston. Many of them also cautiously underwrite deals in markets that are experiencing massive development, such as Los Angeles and Miami. Hospitality loans from the life companies are reserved only for top-tier hotels.

Insurance lenders now hold $362.7 billion of commercial real estate loans, according to Federal Reserve data. This is a 12.7 percent market share for non-multifamily and a 5.3 percent market share for multifamily (the disparity due to Freddie Mac and Fannie Mae). The top 30 insurers wrote $59.1 billion of real estate loans in 2015, according to Trepp. The biggest players in 2016 are MetLife, Prudential, Northwestern Mutual, Pacific Life, Mass Mutual, New York Life Insurance Company, Principal Financial Group and TIAA-CREF.

MetLife remains the largest of them all, having originated more than $12 billion in each of the last two years. And with $230 billion of maturing CMBS in 2016 and 2017—which is more than the combined amount from 2010 to 2014—the life companies could increase their market share substantially if they wanted.

However, insurance lenders have historically shown that they won't stretch to win deals and they won't lend on tertiary or transitory assets. With Reg AB II now being imposed on issuers of CMBS, those lenders have little room to maneuver. Meanwhile, banks are feeling the pressure to hold more reserves against their $1.77 trillion of commercial real estate loans and are also burdened by their poor performing commercial and industrial loan portfolios. So if the CMBS lenders can't digest all of the maturities and the life companies won't budge on their standards at the same time that banks are already showing limitations due to increased regulation, how can all of the borrowers refinance these loans?

Opportunity funds and other alternative lenders will have to fill the void and the resulting effect will be increasing cap rates.

The recent stock market sell-off was a long time coming. A few bold souls have stated that it could actually have a positive effect on real estate, as investors will eschew stocks for property. But if the contagion effect overflows into real estate, few will be spared. The ones who will be the beneficiaries will be those with the dry powder to pick up bargains, owners with little or no leverage, and insurance companies who will simply keep doing their thing—writing conservative loans on high quality assets.

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