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[Richard Fries and Joshua Stein published this two-part article in the New York Law Journal. Both parts of the article are reprinted here.]

A 20-Year View of Commercial Real Estate Finance: Part I

Looking back over the last two decades, commercial real estate finance has gotten more complex, but also smarter.

By **Joshua Stein and Richard Fries** | March 13, 2019

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 role too.

If one considers only basic commercial mortgage loans, not much has changed. Each loan still starts with a promissory note, a security interest in commercial real estate, and a package of promises to try to protect the lender's collateral and maximize the likelihood of repayment.

Just as we saw after previous downturns, after the Great Financial Crisis real estate lenders' rights and remedies remained relatively unscathed by creative arguments made by borrowers and their counsel when deals have gone bad. And we still endure the recording system, the antiquated legal principles that go with it, legalistic formalisms rooted in history, lien priority, and (in New York, at least) a mortgage recording tax that is often incompatible with modern real estate finance. Our documents continue to grow to handle nuances of these traditional and often cumbersome and impractical concepts.

Many other things have changed in major ways. And they may change in more ways as a result of the continued effects of the 2016 election and the mid-term elections in 2018.

September 11 spawned federal concern on terrorism and money laundering. The results: new due diligence requirements and delays and new verbiage, paperwork, and disclosures. But deal structures and documents remained about the same.

The 2008 Great Financial Crisis led to a spate of new legislation, still working its way through the regulatory and deal-burdening process. That's not necessarily bad, because the federal government ultimately bears all the risks of the entire banking system. Remember TARP?

Dodd-Frank, Basel III, and the international regulatory environment have led banks to tighten their purse strings and reduce their risk tolerance. That now complicates credit decisions on a macro and micro basis, as never before. The Trump Administration may dial back some of that, but that's still to be determined. 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, and private "real

estate family" lenders—to make first mortgage loans, a business the banks once owned.

Those alternative lenders didn't noticeably exist in real estate 20 years ago. Now they're extraordinarily active, and probably a permanent part of the lending landscape. 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.

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 may be about to turn, but has also perhaps been about to turn for nearly the last half-decade. Their investment committees are nimble. They offer more loan proceeds, though at higher cost, than traditional lenders such as banks. They can compete aggressively for virtually every loan. They can execute swiftly, forcefully, and reliably, and they do. All of this makes them a "go-to" source for acquisition and development capital, even at higher (though still unthinkably low) interest rates.

Some, but not all, alternative lenders have little reticence toward the "loan to own" end-game strategy in a cyclical real estate market that may be heading at last toward a soft landing. Twenty years ago, the last thing institutional portfolio lenders—largely banks and insurance companies—wanted to own was their collateral. Some of the current alternative lending sources do not have that institutional reservation. That is 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 and may serve to change the loan origination and enforcement landscape.

In recent years, part of what drove that expansion was a set of new federal regulations that took aim at traditional construction lending. As a monumental new burden on banks, half a decade after the Great Financial Crisis the regulators responded to international Basel III banking rules by imposing new risk-based capital reserve requirements for so-called "high volatility commercial real estate" (HVCRE) loans, effective Jan. 1, 2015. If a loan counted as HVCRE, it became extraordinarily expensive for any traditional institutional lender to make. Any such loans probably wouldn't get made at all.

The 2015 HVCRE rules had a significant impact on acquisition, construction, and development financing by commercial banks—and, as a result, new development slowed since then. Fortunately, after concerted industry-wide lobbying, the rules were changed in May 2018. The new federal law, enacted as Public Law 115-174 and Senate Bill 2155, now clarifies and improves the treatment of HVCRE ADC (Acquisition, Development and Construction) loans.

To avoid HVCRE classification, before the lender advances a dollar, the borrower must invest in cash (or a few equivalents) at least 15 percent of the "appraised as completed" value of the borrower's project. Under the original (2015) HVCRE rules, land appreciation did not count toward the required investment. Thus, if a borrower paid $3 million ten years ago for a site now worth $50 million, only the $3 million cash investment counted toward the required 15 percent cash investment. This represented a wild departure from the usual logic of construction lending, which very appropriately treats land appreciation as a valued and measurable part of the borrower's equity in the project.

The 2018 changes in the HVCRE rules solved that problem. The rules now say the borrower's contributed capital (in the form of cash, marketable securities, or the current value of real estate that the borrower contributes to the project) must equal at least 15 percent of the "current appraised as completed value" of the borrower's project. The borrower now, rightfully, obtains the benefit of property appreciation. This makes complete sense. The lender wants to mitigate risk by assuring the borrower has sufficient equity invested in the project—"skin in the game." That goal is achieved perfectly well by giving the borrower credit for bona fide appreciation of real estate. The new rules include appropriate safeguards, such as requiring a fully compliant FIRREA appraisal to measure the value of the borrower's contribution.

If, for example, a construction loan is $150 million and the borrower's land, bought many years ago, is now worth $50 million, then that sizable "sponsor's equity," pledged as collateral, certainly minimizes the risk of loan default. If the sponsor acquired the property 20 years ago for $3 million, but its value has risen to $50 million, the construction lender should be able to recognize that contribution of value as equity. The lender's risk is correspondingly reduced. This is a tremendous change in the rules, with industry-wide impact and benefit.

Another substantive improvement to the HVCRE rules eliminates the original requirement that the borrower could not withdraw any "internally generated revenue" (from any source, such as rent) of a project until the borrower had repaid the construction loan or converted it to permanent financing. That restriction impeded construction of improvements, such as an elevator or lobby renovation, for existing income-producing property. Until the 2018 amendments, a loan might be branded as HVCRE if the loan documents allow the borrower to distribute any cash, such as rent or hotel room receipts, "internally generated" by the project. This restriction, alone, further chilled institutional construction lending since 2015. The industry screamed, and with good reason.

The new HVCRE statute made two very sensible changes. First, once the development/construction risk period has passed and the project is cash flowing, borrowers may remove and use internally generated cash outside the project so long as 15 percent of borrower's equity remains in the project. Second, loans made for general upgrades and other improvements on existing properties with existing or continuing rental income, even after acquisition, do not trigger the HVCRE ADC risk weight capital penalty. These changes in the HVCRE rules introduce practicality and make it much easier for institutional lenders to provide construction loans, while still wisely protecting against reckless behavior in construction lending.

Another traditional element of commercial real estate finance will, however, probably soon bite the dust: the London Interbank Offered Rate (LIBOR), the benchmark interest rate used for most floating rate loans. Various scandals and disclosures about how that rate was set led banking regulators to decide LIBOR should be replaced by 2021 with some other globally workable benchmark.

This was a great idea in the abstract. But it turns out not to be so easy to implement in practice. At the time of writing, the marketplace seemed to be heading toward replacing LIBOR with something called the Secured Overnight Financing Rate (SOFR). But news reports have already suggested that SOFR may have too much volatility, prompting calls for the Federal Reserve to step in to steady this proposed new benchmark at times of stress. It is hardly a good start for an index that is supposed to be market-driven. ICE Benchmark Administration, which now oversees the eventually-to-be-replaced LIBOR index, has just suggested a new gauge for interest rates, the United States Dollar ICE Bank Yield Index. ICE Benchmark Administration is seeking feedback from market participants, as has occurred with SOFR during the past several months. Those discussions will continue.

As always, tax has continued to play a role in loan documents and structures. Tax avoidance concerns led to the Foreign Account Tax Compliance Act, which produced new requirements for foreign banks plus a bit of new language in loan agreements. Again, FATCA did not change how commercial real estate finance works.

One risk that seems more manageable these days relates to environmental issues. Lenders and other real estate players seem to have gotten better at understanding, evaluating, and quantifying environmental risks. Favorable availability of environmental insurance has helped. So an area that caused massive fear a few decades ago has become more manageable.

We've also seen new developments involving European "bail-in" requirements to deal with bank insolvency (more magic language for loan agreements) and 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). Financial innovations such as swap protection and more complex prepayment formulas have also become more prevalent in real estate financing, as it has continued to converge with general

corporate financing.

Then there's the capital stack, ever more filled with diverse lenders, interests and economics. Today, unlike 20 years ago, many major real estate finance transactions often include layers of debt far beyond traditional first mortgage loans. Capital stacks with many tranches now stand behind many major deals. Twenty years ago, mainstream commercial real estate finance was more traditional. A lender made a loan. That loan was secured by a mortgage on the property. The lender held the mortgage in its portfolio. There may have been a subordinate mortgage on the property. While there may have been a mezzanine loan or two (mezzanine finance did exist), that structure wasn't nearly the market staple it is now.

Today, even though the wounds of the Great Financial Crisis have not entirely healed, many tranches of debt—subdivided, packaged, rated, and sold—are now often the norm. Any loss of momentum on this front has dissipated, especially when often-conservative first lien lenders will not meet a sponsor's need for loan proceeds. That, too, is likely to remain a core ingredient of commercial real estate finance. Equity interests in the sponsor entity are likewise sliced and diced and pledged and repledged. Loans are made on loans. Any major deal has co-lenders, with complex contractual relations among them. Agents; co-lenders; servicers; master servicers; special servicers—all with a role, all 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." We recognized "silent," and identified "disclosed," participants. 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. 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 fifteen years or so. It has evolved since its initial iteration. The "market standard" intercreditor agreement of ten years ago is no more. The massive and important Stuyvesant Town decision changed the landscape among lenders in the capital stack and their enforcement rights.

The industry-wide shock from that decision drove changes in standard documents. No longer does any argument exist that the junior lender must "cure all defaults" (i.e., repay the accelerated senior loan) before enforcing 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 and enforcement nuances than the loan documents themselves.

Negotiations among lenders, participation in the commercial real estate collateral and decision making, enforcement of remedies—all new, all far more sophisticated than 20 years ago. That's why the capital stack endures, from a collateral enforcement perspective, as we shall describe in Part II of this article. Part II will also explore changes in loan workouts, nonrecourse carveout guaranties, dual collateral pledges, and lender liability.

[Part II of this Article appears below.]

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Article Link: https://www.law.com/newyorklawjournal/2019/03/13/a-20-year-view-of-commercial-real-estate-finance-part-i/

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A 20-Year View of Commercial Real Estate Finance: Part II

Commercial real estate finance today is quite different from decades past. This continues to make commercial real estate an exhilarating—and often fascinating—asset class to finance.

By **Joshua Stein and Richard Fries** | March 14, 2019

Part I of this article took a broad look at changes and similarities in commercial real estate finance structures and relationships over the past 20 years. Part II of this article will cover changes in the capital stack, loan workouts, nonrecourse carveout guaranties, dual collateral pledges, and lender liability.

The capital stack has always started with mortgages. It expanded to include mezzanine loans. Going beyond that, preferred equity, even more opportunistic, has become a far more prevalent financing form than it was 20 years ago. Commercial real estate mortgage "loans" (whether to capture return on investment, or equity) are now often structured as preferred equity in the sponsor entity. 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 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 sea 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.

After the Great Financial Crisis, we heard that CMBS 2.0 would be more rigid and conservative. The new risk retention rules under Basel III, which took effect in December 2016, are changing 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 percent of the debt. The mortgages themselves aren't all that different, though.

Commercial real estate lenders and lawyers also need to deal with 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 stayed low. That was true even during the Great Financial Crisis.

At one point not too long ago, borrower defaults often led to borrower bankruptcies. In that strange world, a bankruptcy judge would often "cram down" the lender's lien, rewriting it to equal the temporarily impaired value of the collateral. Then, when markets recover, as they inevitably do, any future increase in value would belong to the "reorganized" borrower, its principals and equity investors. It was a great borrower-side play while it lasted.

In the last decade or two, the bankruptcy risk has been almost completely squeezed out of commercial real estate finance. Lenders learned to demand that the principals of commercial real estate borrowers agree to become personally liable for the loan (full recourse) 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.

That changed completely with the advent of nonrecourse carveout guaranties. We now see these guaranties in virtually every commercial real estate loan, even if it is otherwise nonrecourse. The carveouts are sometimes negotiated, sometimes heavily (especially in the last few years, when excess liquidity has been chasing fewer available projects), and with varying success. But 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.

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, even for the most commonplace of "full recourse bad acts" such as bankruptcy. Partial recourse—say $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 be made whole; and, if the lender requires full recourse on these facts, the sponsor will ably and easily find financing from some other institutional lender down the street with more relaxed and borrower-friendly underwriting criteria.

We shall see, this late in the real estate cycle, whether this "partial bad boy recourse" will become market, or continue to be 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. Then those balloons blew up in guarantors' faces when opportunistic loan buyers 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 agreed to trim the carveouts back to a more sensible level.

Any borrower now knows the first conversation about any loan proposal should cover the specific scope, and the exact wording, of the nonrecourse 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 absurd results), have focused on "intentionality."

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.

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.

A recent New York case slightly opened the door to the use of 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 quasi-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.

In that world of mortgage foreclosure, 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. "Judicial sympathy" (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 (e.g., 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 (e.g., frustrating a potential favorable sale by the borrower); (xii) breach of fiduciary duty; (xiii) unequal bargaining position; and (xiv) champerty (the notion that it is somehow bad to sell a loan to someone who plans to sue to recover the debt).

The casebooks are filled with these defenses and claims. Many merely reflect the results of a scrivener's 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.

Today we have a new flavor of lender liability, a new form of judicial sympathy, and a new set of techniques to stave off foreclosure when a borrower decides not to repay its loan. These new claims and

theories first appeared in a cascade of Great Financial Crisis residential foreclosure actions throughout the country. Their borrower-friendly outcomes do bring the potential leverage of stare decisis to the commercial setting.

They include a wide range of mostly procedural defenses and arguments: (1) standing to sue (proof of ownership of the note and the underlying debt); (2) chain of title (the lender must hold notes evidencing all debt secured by all mortgages being foreclosed); (3) 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"; (4) predatory lending; (5) expiration of the statute of limitations (failure to "de-accelerate" within the time allowed to start an action); (6) "loan to own" predation; (7) impossibility of performance ("credit tsunami"); (8) alleged unsuitability of loan participants or syndicate members (whose unanimous consent is required for major decisions); (9) lender's duty to ascertain borrower's financial wherewithal to service and repay the loan; (10) the doctrine of "deepening insolvency"—fraudulent extension of the life of a dying entity by doing nothing; (11) rejection of an "allonge endorsement" attached to a note by a paper clip; and (12) tortious interference with prospective contractual advantage.

We shall see how these new and still largely untested defenses and claims unfold, as they find their way into commercial mortgage litigation.

Undeniably, real estate finance structures, participants, underwriting, credit enhancement, and lenders' rights and remedies have changed in other important ways 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.

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