STEIN'S LAW

Can an Email or a Phone Call Create a Legal Obligation to Sell a Loan?

Loan trading is big business in New York. It's also an informal business. Traders confirm huge trades by email or even by telephone. When a loan seller organizes an auction, bids come in through the same channels. The seller collects bids, chooses one—typically the highest—and the parties sometimes sign a standard loan sale agreement.

In an auction sale for a loan, when does the seller lose the right to change its mind? Recent litigation on that question, *Stonehill Capital Management v. Bank of the West*, went all the way to the New York Court of Appeals, the state's highest court.

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In the *Stonehill* case, the seller identified and confirmed the highest bid. But the seller's confirming email said the sale was "[s]ubject to mutual execution of an acceptable" loan sale agreement. The buyer and seller had some technical and trivial conversations about how that agreement should look. Before they concluded those discussions, the seller decided not to sell.

The buyer sued, arguing the seller became legally bound as soon as it confirmed the successful bid. A signed loan sale agreement was just a technicality. Its absence didn't detract from the parties' binding obligations. The seller, on the other hand, said lack of a signed loan sale agreement meant the seller could withdraw.

The Court of Appeals agreed with the buyer, in a long discussion that focused on industry practices and expectations. The court said the seller had the burden of showing its confirmation of the winning bid wasn't intended to be binding. This particular seller hadn't done that.

To the contrary, the court stated, the auction documents said the parties would become bound as soon as the seller confirmed the highest bid. Execution of an actual loan sales agreement was just part of what the parties agreed to do. It wasn't a condition to their being obligated in the first place. Moreover, the seller had included a sample agreement in the information package for the auction. The parties never discussed any significant deviation from that template.

At first blush, the *Stonehill* decision sounds alarming. It means the parties became bound by an agreement without actually signing it—a scary and counterintuitive prospect. On the other hand, in a typical loan sale, like a typical real estate sale, at least 80 percent of the deal boils down to price. Most of the rest of the document deals with unlikely eventualities, mechanics (mostly obvious) and matters that a court can, if necessary, fill in based on "reasonableness" or "doing it the way everyone else does it."

Nevertheless, we do expect to negotiate and sign verbose documents for any significant commercial transaction. In *Stonehill*, though, the court regarded this particular agreement as an afterthought. If the parties are bound without signing an agreement, why bother to sign one?

Maybe they shouldn't bother, at least for a loan trade. The Loan Syndications and Trading Association sets standard terms for loan trading. If a bid confirmation incorporates those terms, an actual signed agreement adds little. And, although loan traders do sometimes sign loan sales agreements, the industry also expects confirmed auction bids alone to bind the parties.

The *Stonehill* decision reflects market expectations and practices. It is neither controversial nor surprising. It provides comfort for the loan-trading world, where traders often expect to be bound by oral agreements to buy and sell, not even evidenced by a confirmatory email. The binding nature of those oral trades represents a lynchpin of the secondary market for syndicated loans.

How does the *Stonehill* case apply to commercial real estate contracts as opposed to loan sales? A New York law invalidates any oral contract for the sale of real estate. That hasn't changed. Real estate contracts are different from loan sale contracts. But that's not the end of the discussion.

The *Stonehill* case does remind buyers and sellers of real estate to beware of "preliminary" signed agreements that, by their terms, sound binding. Even if a deal summary says it's subject to the technicality of a formal contract, if it has signatures the courts might still decide to enforce it. The courts just might conclude, as they did here, that the parties, once bound by some form of preliminary agreement, also agreed they would sign an ordinary and typical purchase and sale agreement.

If parties to a real estate deal don't want that—and they shouldn't want it—they might need to do more than just say a signed deal summary is "subject to contract" or the like. They should go a step further, and say their deal summary doesn't bind anyone in any way. Maybe they shouldn't even sign it, except perhaps to confirm that it isn't binding.

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GREEN GRASSO

Preferred Equity: the Preferred, Negotiable Financing

As the debt markets constrict and property values increase or remain stable, owners and developers continue to look for sources of additional capital to fund their acquisitions, repositioning or development projects. Of course, mezzanine debt financing remains a very active source of alternative financing, but preferred equity can be a viable option in order to get a deal done.

Preferred Equity: A Familiar Animal With Different Stripes

Preferred equity—like the name implies—is an equity investment into a joint venture that owns a 100 percent interest in a property. The investment is typically made into a newly formed entity so that the equity investor does not need to conduct entity-level diligence or analyze any entity-level liabilities. If the asset is encumbered by senior debt, the preferred equity investor will conduct an analysis to ensure that the investment is made in compliance with the loan documents. One of the biggest misconceptions about preferred equity is that its legal structure is the same as a mezzanine loan. It is not a loan, and it is typically not secured.

Preferred Returns, Not Secured Creditor

The preferred equity investor is entitled to a "preferred return" on its investment, which can be structured to either accrue or to have periodic payments irrespective of cash flow. The payments to the preferred equity investor will be set forth in the distribution provisions of the joint venture in order to ensure that the preferred return is paid first. Any preferred equity investment will have an end date or a mandatory redemption date on which the equity investment is required to be redeemed. Extensions of the mandatory redemption date can be negotiated, but generally it is coterminous with the senior loan maturity date or, in some instances, it is a date that immediately follows the loan maturity.

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To the surprise of many parties in this alternative lending space, preferred equity is typically not secured. Pledges of ownership interests are not unheard of, but they are not typical in the same way that they are for mezzanine loans. If there is no pledge, the concern, of course, is what remedies can be made available to the preferred equity investor if the investment, together with the preferred return, if a default occurs. Since there is no loan, pledge or loan agreement, all remedies available to the preferred equity investor are set forth in the joint venture agreement with the other partners. These remedies typically include a lockdown on cash flow.

'Take over' Right

The most important remedy available to the preferred equity investor is the ability to "take over" the deal, become the sole manager of the asset and make all property related decisions, including the determination of whether to sell the property and at what price. The investor will want to be in complete control with no interference from the other partners. To have control, there is no foreclosure action or Uniform Commercial Code process that the preferred equity investor has to commence and complete. The right to "take over" is contractual.

The other partners who now no longer have control of the deal will generally retain their economic interests in the deal, but they will be deeply subordinated in terms of payment. In more rare instances, the other partners completely forfeit rights and economic interests. Some deals are structured in a manner so that the other partners (or credit-worthy persons or entities acceptable to the preferred equity investor) indemnify the preferred equity investor against any claims or losses that the investor may suffer if the other partners interfere with this "take over." This is akin to a "bad-boy" guaranty in the mezzanine loan space.

Like mezzanine loans, any remedies that investors may have negotiated in their joint venture agreement must take into consideration any senior loan restrictions or requirements. If the senior loan documents do not sufficiently allow the preferred equity investor to exercise its remedies in a timely manner, the investor will need to pursue certain amendments to the loan documents or negotiate a separate recognition agreement with the senior lender. The form and substance of recognition agreements are rapidly evolving.

Specialized Negotiation Needed

Preferred equity can be an effective alternative financing source, but investors need to be fully informed of all the concepts and protections that are necessary to include within a joint venture arrangement and understand that joint ventures are more specialized and highly negotiated than we typically encounter with loan documents.

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