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Preface

Commercial real estate financing requires both lenders and borrowers to look at the world in a certain rather unusual way. That worldview reflects a combination of skepticism, an emphasis on property rights over promises, and a logical structure driven by rules of the game that have built up over many centuries.

Against that backdrop, real estate lawyers play a central role in turning business agreements into closed real estate loans. As long as I have practiced law, I have always enjoyed every part (almost) of that process.

Starting about 10 years ago, I decided that in addition to closing one deal after another, I wanted to think more systematically about how commercial real estate financing works. I wanted to see if I could better identify, understand, explain, and perhaps improve upon the pratices and structural considerations that drive these transactions.

I started by trying to understand the dynamics and logic of nondisturbance agreements. I did this in part because I had noticed that one nondisturbance agreement after another was causing a great deal of disturbance for my clients, whether borrowers, lenders, or tenants. I thought there might be a better way to understand, think about, and deal with them. One of my first publications (and, coincidentally, also one of my most recent publications) related to the issues, practicalities, and legal principles that underlie nondisturbance agreements.

On some other transactions, my borrower and lender clients started asking many good questions about nonrecourse clauses and carveouts, such as which carveouts make sense and why, and how a borrower or a lender should negotiate them. After I thought through these issues and wrote some client memos about them, I decided the area merited some further exploration in print. That led to two articles and the publication of a model nonrecourse clause, which has since been updated, reprinted, and republished several times.

Over time, as other questions and issues arose in transactions I closed, I repeatedly used those questions and issues as the starting point to publish articles and model documents relating to many important areas of commercial real estate finance.

A few years ago I realized that my publications on commercial real estate finance collectively covered nearly every important area of the subject. I proposed to the Mortgage Bankers Association to update, expand, and integrate those prior publications, turn them into a single well-structured book, add a few chapters to fill some gaps, and publish the result as the book you are about to read.

This book seeks to give lenders (primarily) and borrowers (secondarily) a roadmap of the major issues, processes, dynamics, options, and strategies that can arise in any commercial real estate mortgage transaction. My roadmap covers a wide range of commercial real estate finance topics. It is intended both for newcomers to the area and for seasoned professionals who might want a summary or a reminder of how a particular area works and some ideas about how to understand and deal with the problems that arise again and again. This book also gives attorneys, whether they represent borrowers or lenders, an explanation of some of the "business" issues that they need to understand.

Beyond explaining the processes, procedures, and principles of commercial real estate finance, I have tried to focus on the practicalities of structuring and negotiating documents that meet the needs of both parties, and on how borrowers and lenders can accommodate one another's competing agendas. I also emphasize the process of getting a deal done and closed in a finite period and at an acceptable cost.

This book is not a legal text. It is a practical "business-oriented" text written in part from a "legal" perspective. I include no case citations or legalistic discussions. I do, however, shed light on how legal considerations drive business agendas as well as the loan closing and documentation process.

Far more than is the case in many other areas of the business world, commercial real estate lending inextricably raises a variety of legal issues. The creation of a mortgage lien and the possibility of foreclosure are always the essential elements and drivers of every commercial real estate loan. Lien creation and foreclosure are legal processes. Interests in real property, and the transfers of those interests, whether voluntary or involuntary, are creatures of the legal system. If and when a lender reaches the dreaded point of needing to foreclose, everything about the loan and its structure and documentation will be tested in court. A lender and its counsel must assure the loan will pass that test. Hence the importance of considering legal issues as a crucial part of the business process of closing and documenting any commercial real estate loan.

This book is aimed primarily toward lenders and their counsel. It focuses primarily on lenders' agendas. Any borrower and its counsel will, of course, want and need to understand why lenders and their counsel write particular documents in a particular way and view the world as they do. This book seeks to provide that understanding.

In Chapter 16, though, this book shifts from its general lender orientation and pulls together and systematically discusses many concessions and compromises that a borrower will often request in a set of loan documents. The appendix to that chapter continues that discussion by offering some sample language for common "borrower concessions." Just as borrowers and

their counsel can benefit by reading the lender-oriented bulk of the book, lenders and their counsel can benefit from understanding the borrower's agenda as summarized in Chapter 16 and Appendix 16.

This book includes some model documents that lenders and their counsel may want to use, or at least refer to for cross-checking, in dealing with most of the areas this book covers. In each model document, I have tried to meet these goals:

- *Completeness.* I have tried to offer model documents that are more complete rather than less complete. Each model document seeks to cover all significant issues that typically arise in a particular subject area. Each model document also offers some options that may not always apply. I take this approach because I want to provide a starting point for subtraction, rather than a minimal starting point that forces the reader to try to figure out what's missing. In preparing model legal documents, it is safer to ask the reader to subtract than to expect the reader to add. On the other hand, any document can always be lengthened. Any attorney can always identify new issues to cover or better ways to cover old issues.[1] Therefore, it is virtually certain that each model document in this book omits some provision that it could have included and that some lender or its counsel, somewhere, would like it to include. That fact alone underscores the importance of the caveats that appear in the Introduction to this book.
- *Choice of Documents.* The model documents included in this book primarily represent documents that are relatively nonstandardized in the marketplace. This book could have included an entire mortgage, note, and loan agreement, but it did not, in the belief that these documents are relatively well defined and understood. Instead, this book emphasizes documents for which lenders and their counsel are more likely to demonstrate a range of practices and expectations, or that raise nonstandard issues.
- *Clarity.* I have tried to write (not "draft") all model documents in straightforward and understandable business English. Many lawyers seem to believe substantial legal documents must be written ("drafted") in a weird language that appears to be a bastardization of English. No such requirement actually exists. This book tries to prove it.[2]

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[1] This is one of several reasons legal documents only become longer and more complex, never shorter and less complex. See Joshua Stein, "Cures for the (Sometimes) Needless Complexity of Real Estate Documents," *Real Estate Review*, Fall 1995, at 63.

[2] For more on "Plain English" legal writing, see Joshua Stein, "Short and Simple," *The American Lawyer*, October 2002, at 59; and "Writing Clearly and Effectively: How to Keep the Reader's Attention," *New York State Bar Association Journal*, July/August 1999, at 44; *Secured Lender*, November/December 1999; and *The Daily Record* (Rochester, N.Y.), May 2, 3, & 4, 2001; reprinted in Carol Bast & Margie Hawkins, *Foundations of Legal Research & Writing* (2d ed. 2002) at 355; previously published in *The Practical Litigator*, September 1998 (under title "Good Writing").

- *Flexibility.* I have tried to identify variations, options, and different ways to handle particular issues, allowing a user to pick and choose based on the user's tastes and business agenda.
- *Context and Explanation.* I have included some instructions and comments on how to use the particular model document, including some references to substantive issues addressed in other chapters.

I welcome comments and questions from readers about any model document included in this book or any issue this book raises, whether for a particular transaction or on a hypothetical and general basis. I will also be happy to arrange company-specific seminars on any topic in this book, or to authorize appropriate reprints of any of these chapters elsewhere. I can be reached at joshua.stein@real-estate-law.com or through my website, www.real-estate-law.com.

Introduction

When a borrower and a lender enter into a commercial real estate financing transaction, they walk down a road that is hardly new. It is, however, a road with some twists and turns, some potholes, and occasionally some detours along the way. The path they take requires some planning, an understanding of how others have walked down the same road, and some insight and judgment on how to deal with unexpected circumstances and the nuances of each particular real estate financing transaction.

Any commercial real estate loan raises a wide variety of legal, business, and practical issues, for both lenders and borrowers. Many of these issues arise from the lender's need to control and preserve the real property collateral, and from specific characteristics of that particular real property. A borrower, in contrast, will want to preserve its flexibility and assure that over the term of the loan it can manage its real property in a way that makes business sense.

These themes run through all 10 of the general areas of commercial real estate finance that this book covers. In the aggregate, these 10 parts of the book probably define the "top 10" categories of issues, questions, and concerns that any seasoned commercial lender will expect to see in negotiating, underwriting, closing, and administering any commercial mortgage loan.

Part 1 of the book introduces the "Underwriting and Closing Process," and describes all the documents and other elements that a lender must bring together to close a substantial commercial real estate loan.

Chapter 1, "Due Diligence, Documents, and Deliveries," goes over the entire underwriting and closing process from beginning to end, focusing both on the substantive issues that any lender cares about and all the procedural steps that go into a closing. It provides an overview of everything else in the book.

Part 1 then provides a series of sample documents that relate to the closing process: a loan data sheet in Appendix 1A to capture required information about the loan; an exhaustive closing checklist in Appendix 1B that lists every possible loan document a lender might want; and some closing instructions and a related acknowledgment in Appendices 1C and 1D. Finally, Appendix 1E provides a set of title insurance specifications consistent with industry expectations.

Part 2 considers the threshold issue of setting up the entity (or approving the existing entity) that will actually be the borrower and enter into the loan documents.

For a single-asset real estate loan, Chapter 2 discusses how a lender or its counsel might review the borrower's organizational documents, and what issues they should consider and why.

For a portfolio loan with multiple borrowing entities, Chapter 3 explores the special bankruptcy and insolvency problems that these structures can create, and suggests a handful of solutions to the problem.

Part 3 turns to insurance. Chapter 4 offers a narrative discussion of insurance in commercial real estate loans, with an emphasis on problem prevention, followed by Appendix 4, which contains a thorough and up-to-date set of model insurance provisions for a loan agreement.

Part 4 offers numerous resources on the relationship between lenders and tenants, exploring in depth how a lender looks at rental income and tries to preserve it.

Chapter 5 discusses exactly why (and how) lenders care about leases, and what they look for when they review a lease. Appendix 5A supplements that discussion by offering a sample lease review form, both in blank and filled out for a hypothetical retail lease.

As part of any closing, lenders often require estoppel certificates from tenants. Appendix 5B offers a clear, straightforward, and flexible model estoppel certificate, which includes optional provisions that may apply in particular circumstances.

Although reciprocal easement agreements are not leases, they are quite common in commercial real estate loans, particularly for large shopping centers, and they raise issues very much like some of those raised by leases. Lenders often think of these agreements as being variants on leases. Therefore, a discussion of reciprocal easement agreements appears in Chapter 6, within Part 4 of the book.

Finally, Chapters 7 and 8 turn to the subject that may cause more headaches, confusion, questions, wasted time, and needless agony than almost anything else in the commercial mortgage loan closing process: nondisturbance agreements, the agreements between tenants and lenders about their relationship and the possible consequences of a foreclosure.

Chapter 7 consists of a "model" nondisturbance agreement promulgated by a New York State Bar Association Subcommittee previously chaired by the author of this book, along with a report that explains the basis for many of the provisions in any nondisturbance agreement.

Chapter 8 takes a more critical look at nondisturbance agreements, suggesting that they consume far more time and effort, and create more issues and antagonism, than they really justify.

Part 5 explores some credit issues that arise again and again when negotiating and closing commercial real estate loans. The central issue in this area is, of course, "nonrecourse" — the proposition that if a borrower defaults on a commercial mortgage loan its liability will be limited to its interest in the mortgaged property. The proposition turns out not to be as simple as it sounds.

Chapter 9 discusses in detail the workings of a nonrecourse clause and particularly the many "carveouts" to nonrecourse treatment that have accumulated over the years. That chapter explores the basis for each carveout, possible alternatives, and some issues in defining recourse liability.

Appendix 9A offers a "model" nonrecourse clause that seeks to distill the "state of the art" in nonrecourse carveouts, more for reference and comparison than for actual use in transactions.

Appendix 9B offers a straightforward model guaranty, suitable for either a "full" or a "partial" guaranty of any commercial real estate loan. This chapter also offers variations appropriate for a guaranty limited to the "nonrecourse carveouts."

Chapter 10 focuses on letters of credit, starting with a discussion of how they work, and why and how real estate lenders might use them.

A model letter of credit appears in Appendix 10A. Finally, Appendix 10B explores a lender's view of the leasing transaction in which a major tenant gives the borrower a substantial letter of credit instead of a security deposit, and the lender wants to obtain control over that letter of credit. Appendix 10B includes a sample tri-party agreement to govern the relationship among tenant, borrower, and lender.

Part 6 covers the very common arrangement where a borrower does not own the mortgaged property, but instead leases it from a third-party landlord, under a long-term occupancy arrangement known as a "ground lease."

Chapter 11 briefly introduces how ground leases work and what a lender cares about in considering the acceptability of ground leased collateral.

A lender will, among other things, want any ground lease to contain a couple of dozen provisions, commonly known as "mortgagee protections," that help make the ground lease attractive and useful as collateral for a loan.

Appendix 11 offers a model set of mortgagee protections that represent a "middle ground" approach to these issues. That model is much shorter than the 20 pages or so that some lenders' counsel might like to see, but it is also significantly longer than the "bare minimum" that might minimally satisfy the ground lease criteria applied in the secondary market. These "middle ground" mortgagee protections cover all the bases in a reasonable way and are supplemented by extensive footnotes discussing why they are written as they are and some of the many issues that ground leases can create for lenders.

Part 7 focuses on a particular type of commercial real estate loan: a loan to finance a hotel, a motel, or other form of lodging property. Collateral of this type is usually more complex than an office building, a mall, or an apartment complex, mostly because a lodging asset is a hybrid between commercial real estate and an operating business, and it has many moving parts.

Chapter 12 introduces a wide range of issues that are unique to lodging loans, followed by Appendix 12, which sets out sample loan document language to cover many of these issues.

Chapter 13 looks at how a lender analyzes the management and franchise arrangements for any hotel or other lodging property. Depending on the nature and structure of these arrangements, the lender may need to document only a few understandings with the manager of the property or, potentially, a very large number, or anywhere in between.

Appendix 13A consists of a sample agreement between a hotel lender and the manager of the hotel. It contains a wide-ranging menu of provisions that may be appropriate to govern this relationship.

The often-much-simpler relationship between a hotel lender and the licensor or franchisor of the hotel is addressed in Appendix 13B, which consists of a model "comfort letter" that a licensor or franchisor might sign to accommodate a loan closing for a hotel or motel.

Another important category of real estate lending cuts across all property types, and involves a borrower that acquires an older property and plans to upgrade and improve it to enhance its value. These loans are primarily quasi-permanent and secondarily quasi-construction loans, and are covered in Part 8.

The discussion begins in Chapter 14, which focuses on the special issues of redevelopment and repositioning projects of this type.

Chapter 15 supplements that discussion by describing the special issues that arise whenever a borrower acquires the mortgaged property simultaneously with the loan closing. This chapter explains how a lender reviews a purchase and sale contract, and what a lender should look out for at the closing.

Part 9 turns the tables, at least briefly, by looking at loan closings from the borrower's perspective. Although this book speaks primarily to lenders, any lender will be well served by knowing how a borrower approaches the process, the issues a borrower may raise, and some reasonable ways to compromise and resolve those issues. Chapter 16 provides all that.

Appendix 16 supplements the discussion by offering some sample compromise language on many issues that borrowers often raise.

Part 10 considers the life (and death) of a loan after the closing.

Chapter 17 briefly discusses the loan payoff process and how it can go wrong. Appendix 17 supplements that discussion with a model payoff letter, designed to prevent problems.

Sometimes, though, a borrower can't pay off a loan, typically because the mortgaged property or its marketplace is in some form of distress. Eventually the loan may go into default.

Chapter 18 discusses how lenders approach loans in distress or default, offering some overall strategic advice and point by point checklists on what a lender should do when it sees trouble ahead. This chapter also offers several menus of "workout" terms that borrowers and lenders often negotiate.

Due Diligence, Documents, and Deliveries 1

For any commercial real estate loan in the United States, the closing and documentation process combines traditional principles and practices of American real estate law — some dating back centuries to English common law — with the global capital markets, a fast-moving market place, and painful lessons learned in America's real estate depression of the early 1990s. Against that backdrop, lenders and borrowers must bring together dozens of processes, participants, and other pieces to document and close any commercial mortgage loan. Over time, a lender and its counsel may close loans in a random variety of states all over the country, because many lenders are willing to lend anywhere they can find the right deal.

The increasingly national scope of financing arises in large part from the appetite of the capital markets for securitizable product. Many commercial mortgage lenders originate their loans to include them in a future securitization, a transaction where the sponsor creates a stand-alone pool of mortgage loans and then sells bonds or other securities funded solely from the income stream of the mortgage loans. The bonds' ratings will depend largely on the degree to which the mortgage loans meet rating agency standards and criteria. Lenders and their counsel must therefore pay special attention to those standards and criteria, some (though by no means all) highlighted in this chapter and elsewhere in this book.

Even lenders that plan to hold their loans for portfolio rather than securitize them will, more than ever, lend on properties almost anywhere. Plus, all categories of lenders want continuing relationships with solid borrowers that will be the sources of repeat business. "Deal flow" will come from wherever good borrowers find good deals.

At the same time, borrowers have become increasingly impatient with delays and transaction costs. They press lenders to figure out new ways to squeeze time and money out of the closing process, because if this lender won't do it, the next lender will, and the closing costs are just another part of the cost of money. Increasingly, participants in real estate finance believe that the closing of every loan should require little more than "pushing a button" twice — once to generate documents and a second time to send money.

Appendix 1A: Model Loan Data Sheet

VIA EMAIL

To:	Borrower's Counsel	Date:	[Date]
		File No.:	_____ _____
From:	Lender or Lender's Counsel	Copies to:	_____

Subject: Loan Data Checklist and Information Request — Loan to Be Secured by Premises Located at _____

We attach a list of the information and documents we will need to start the documents for this loan. While we would appreciate receiving everything as soon as possible before we start work, it is particularly helpful and cost-effective if we receive all the "Identifying Information" and "Information Needed to Start Work" in a single complete package and all the "Initial Preclosing Deliveries" in a second single complete package. A full closing checklist will follow.

To the extent that anything we request is irrelevant, inapplicable, or inappropriate for this transaction, please let us know as soon as possible.

Lender and borrower can "share" local counsel, provided that local counsel is willing to provide lender with the assurances lender needs regarding the effectiveness under state law and terms and conditions of our loan documents (not just "enforceability") and certain related matters. This may require a conflict waiver.

At the end of this memorandum, we have included contact information for the attorney(s) and paralegal(s) on this transaction.

Appendix 1B: Comprehensive Lender's Closing Checklist for Commercial Mortgage Loan

This appendix offers two sample closing checklists for commercial mortgage loans.

The first closing checklist is intended to include all documents and deliveries that a lender or its counsel could conceivably require for a commercial mortgage loan (or related) closing, including preclosing and postclosing documents and deliveries. No single transaction would ever require everything (or even a majority of the documents) listed here. This checklist does not constitute an implied recommendation of any particular document for any particular closing. This checklist is for reference and cross-checking only, to help a lender and its counsel consider whether a transaction requires particular documents and assure that nothing falls between the cracks. Many documents can be combined. They appear separately here, to reflect common practice or to remind the user to consider each item and whether and how to handle it.

If this checklist were used for any particular transaction, it would need to be updated and modified and, for the most part, vastly shortened.

Certain documents could go in multiple sections. Documents of this type are usually listed only within the narrowest category that would typically include them. For example, a substantive consolidation opinion could be listed under opinions of counsel or under securitization requirements. It appears only in the latter category.

The second closing checklist offered in this appendix consists of a basic and minimal checklist for a typical "plain vanilla" commercial mortgage loan with no special issues or unusual collateral. This latter checklist disregards nearly all the "bells and whistles" included in the former checklist.

Regardless of the closing checklist used for any particular transaction, in the course of that transaction as soon as any new document or delivery is identified, add it to the checklist. To the extent possible, make each document or delivery a separate entry in the list. Set up a separate checklist entry for each exhibit. Try not to combine any items.

Appendix 1C: Model Remote Closing Instructions

This model document provides a flexible set of instructions to a title company to facilitate a loan closing at another location. Under these closing instructions, the lender may fund to the title company (though not technically "in escrow") before all closing conditions are satisfied; these closing instructions may be accompanied by closing documents, a final marked title commitment, and a closing statement, or any or all of these may follow; and the title company will not handle UCC filings. Exhibit B describes closing procedures. Although these are "routine," review and edit as needed.

These closing instructions can and should be signed as soon as a transaction begins. They do not need to be deferred until the last minute. They can be signed, and the closing framework reliably established, even before the lender has seen a title report or anyone has prepared a closing statement or even a single loan document. By signing these closing instructions early in the process, the lender's counsel establishes a workable structure for the actual closing. The pieces can fall into place over time. In contrast, if the lender's counsel waits until the last minute to send out these closing instructions, the title company may want to negotiate and will always delay signing these closing instructions, thus often causing a perfectly avoidable emergency.

These closing instructions assume the same individual at the title company will handle both title clearance and the closing/escrow process. If this assumption is wrong, edit as appropriate or require the title company to simplify the arrangements. Ideally, the lender's counsel should deal with only one person for all title and escrow services. Bifurcated title/escrow arrangements cause extra work and last-minute problems.

This letter is addressed to a title agent, acting for a title insurance company, but is written as if the counterparty is the title insurance company. Both agent and title insurance company must countersign. If they object to having two counterparties, choose the title insurance company, not the agent, as the counterparty; have the agent sign the letter, but obtain an insured closing service letter; or find a more cooperative team.

Although the counterparty to these closing instructions will often be an escrow officer or an escrow department, the letter agreement does not technically create an escrow. Instead, certain documents and deliveries are made in trust for certain limited purposes.

Appendix 1D: Borrower's Acknowledgment for Remote Closing Instructions

This model document is intended to be used in conjunction with Appendix 1C, which provides a set of closing instructions to facilitate escrow-style closings while allowing the lender to pre-fund the closing even before all closing conditions have been satisfied. The following document requires the borrower to acknowledge certain matters about the closing. Consider whether to have someone other than the designated "borrower" (e.g., a guarantor or other principal) sign this Borrower's Acknowledgment, particularly for payment obligations. This Borrower's Acknowledgment can be incorporated into the commitment letter or some other early document. The document begins on the next page.

Appendix 1E: Model Title Insurance Specifications and Checklist

The following document summarizes the information that a lender will want to give a title insurance company at the beginning of a commercial mortgage loan transaction. It also includes a full set of specifications for complete title insurance coverage, including endorsements and particular coverage for some common special circumstances.

[Date]

1. *Transaction Data Summary*

Name of Loan	_____
Lender	_____, and its Successors and Assigns
Borrower	To be determined; obtain from Borrower's counsel.
Scheduled Closing Date	_____, 200__
Earliest Survey Date	_____, 200__
Title Work Deadline	Title Work Deadline _____, 200__
Loan Documents Enclosed (Drafts Subject to Change)	[Loan Agreement] [Promissory Note] [Mortgage or Deed of Trust] [Assignment of Rents and Leases]
Lender's Counsel Contact	Name: _____
	Email: _____
	Direct Dial: _____
Initial Advance Amount	$_____
Future Advance Amount	$_____
Total Coverage Amount	$_____

What to Look for in a Borrower's Organizational Documents 2

When a lender or its counsel reviews a borrower's organizational documents for a routine real estate mortgage loan, that review should consider a range of issues, some "technical" and others very "business" oriented. This chapter summarizes many of those issues. Although they overlap many issues that borrower's counsel should consider in issuing an opinion of counsel, this checklist is not intended to cover all the due diligence necessary for such an opinion of counsel.

If a lender obtains equity pledges, preferred equity, or some other interest in the mortgage loan borrower, any review of that borrower's organizational documents must also consider some additional issues, beyond this checklist. To the extent that the answer to any question suggested in this chapter suggests an issue, concern, exception, or problem, it should be brought to the borrower's attention and resolved as part of the closing process.

The process of reviewing a borrower's organizational documents is a bit like having an opportunity to find out more, though not necessarily all you need to know, about your fiance(e) before you get married. You can find out how your counterparty will think and act; how they might respond to stress; what their main and subsidiary agendas are; who can influence them; how much money they might be able to obtain if they need it (even if it's not guaranteed to be available); how they make decisions; their relationship with their parents; and how these characteristics may change over time — in short, who they really are. A borrower and its counsel should take advantage of that opportunity.

On the other hand, just as in a marriage, people and relationships often change in ways that could not have been predicted, particularly if circumstances place them under stress. Therefore, any lender or its counsel reviewing a borrower's organizational documents should not readily rely on anything in them as a permanent source of comfort. The greatest internal structure in the world will not prevent stressed borrowers from doing bad things.

Any review of a borrower's organizational documents will typically try to identify any problems and issues that become apparent even at this early stage of the process. It is sometimes said that after marriage people only get worse, never better. The same may be true of partnerships, limited liability companies, other entities, and their principals.

Special Problems of Multiple Borrowers 3

Mortgage lenders like property portfolios. By lending against multiple properties rather than just one, a lender diversifies the collateral and mitigates the risk of some local aberrational event or market shift that might impair the value of a particular property.

Therefore, if a borrower can deliver to a lender a mortgage on a portfolio of properties, the borrower will often obtain more loan proceeds (as a percentage of value), more flexibility, or other more favorable terms than it could have by financing each property separately. By increasing the size of the security package, the borrower may catch the attention of lenders that otherwise might have regarded each individual property as being too small. The borrower may also save some transaction costs by closing a single loan for the entire portfolio.

If one entity owns the entire portfolio, the owner can grant a single mortgage on all the properties and the lender can record that mortgage in many recording offices. The entire pool secures the entire loan and no special issues arise of the types covered in this chapter.[1]

Most real estate investors prefer, though, to form a separate entity — typically a limited liability company, sometimes a partnership — to own each property separately. Real estate investors do this for many good reasons, all beyond the scope of this chapter. The use of separate entities means that no single borrowing entity owns the entire portfolio. Each property owner must deliver its own separate mortgage to secure the loan.

Although a multiple-borrower structure makes perfect business sense, it creates some risks for lenders under bankruptcy law and under the law that governs the rights of debtors and creditors generally. This chapter explains those risks, assesses their magnitude, and discusses some techniques to respond to them.

[1] The lender and its counsel will, however, need to consider the issues that arise in single-asset loans, including any state-specific rules that limit a mortgage lender's ability to collect the secured debt after holding a foreclosure sale, or require the lender to exercise its rights in a particular manner or order. These issues often become more complex in multiple-property loans, even where a single borrower owns all the collateral, particularly if the collateral is located in multiple states.

Overview of Insurance in Commercial Mortgage Loans 4

Real estate lenders always need to think about the short list of unlikely events that might undercut their most basic assumption: the assumption that the collateral they've appraised will continue to exist so it can continue to secure their loan.

One of those unlikely events is the possibility that the collateral will burn down or be destroyed by some other hazard (a "loss"). This may not be a very likely event, but it is certainly a conceivable event. Over a large portfolio, losses may occur with some regularity. The mortgage lender's job, and the job of its counsel, is to make sure that even if a loss occurs, the lender will have some form of acceptable security for its loan.

Lenders typically solve this problem (mitigate this risk) by requiring the borrower to maintain insurance on the collateral at all times. Many participants in commercial mortgage closings regard property insurance as a mysterious black box that usually requires some minimal attention but occasionally is the source of problems, crises, and confusion that no one fully understands. This chapter attempts to summarize some practical information that a lender and its advisors need to know about property insurance, and thereby dispel some of the mystery in this area.

Loan Closing

At any loan closing, everyone knows the borrower needs to have property insurance and be able to prove it to the lender. But details matter. The insurance coverage can take different forms and say different things.

Mortgagee Clauses

As a starting point, the mortgage lender should confirm that the property insurance contains a standard "lender's loss payable endorsement" (which has been in use since 1943) or a "union mortgagee clause" or "New York mortgagee clause" (which has been in use for about a century).

Appendix 4: Model Insurance Provisions for a Commercial Mortgage Loan[1]

Real estate loans start from the fundamental assumption that the borrower's building will continue to exist so it can continue to throw off rental income from which the borrower can continue to pay debt service. A fire or other loss affecting the borrower's building can undercut that very fundamental assumption and throw the loan into default rather quickly — unless the borrower has maintained an appropriate package of insurance coverage for the mortgaged property.

Similarly, if the building burns down or suffers some other damage without appropriate insurance coverage, the lender will find that the value of the mortgaged property will decline substantially and will probably not support repayment of the principal of the loan.

For those reasons, any lender will typically regard the borrower's obligation to insure the mortgaged property as one of the most fundamental nonmonetary obligations under any set of loan documents.

To try to define a reasonable benchmark for insurance requirements in any substantial commercial real estate loan, this appendix collects a set of standard insurance requirements that any lender might reasonably seek to impose as part of its standard loan agreement or mortgage. These requirements are intended to be reasonably complete, thorough, and lender-oriented, without being excessive. They approach insurance the same way that a prudent risk manager would, if that risk manager were trying to protect the mortgaged property and its cash flow in a manner consistent with typical expectations in the commercial real estate industry and lending community.

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[1] James E. Branigan, President and Chief Executive Officer of Omega Risk Management LLC, co-authored this Appendix. Mr. Branigan has more than 30 years of experience in insurance and risk management as a consultant for many major lenders, both portfolio- and securitization-based. He reviews, negotiates, and oversees correction of defects in borrowers' insurance packages based on, among other things, his evaluation of loss exposures for particular properties. He has handled more than 1,000 substantial commercial loan transactions and has spoken on insurance and risk management for the Practising Law Institute, bar associations across the country, and major law firms. His firm is a consultancy that does not sell insurance. He can be reached at (631) 692-9866 or jb@omegarm.com.

How a Lender Reviews a Lease 5

Why Mortgage Lenders Care About Leases

Leases in place are usually the major source of value for commercial real property. For that reason, a mortgage lender typically wants to understand the space leases that affect — and are a crucial part of — the proposed real property collateral.[1]

When a mortgage lender begins to prepare for a commercial mortgage loan closing, the lender will often ask its counsel to review some or all of the leases. That review will focus on a handful of lender concerns driven by the lender's basic assumptions and desires about the leases. Any lender's fundamental concerns about any commercial space lease will typically be as follows:

- *Confirmation of Income.* Do the leases support and substantiate the rent roll that the lender reviewed in estimating the value of the mortgaged property? Does the rent roll accurately describe the tenant's obligations to contribute to operating expenses and real estate taxes of the property?
- *Constancy of Cash Flow.* Does anything in the leases create a risk (or at least an unusual risk) of any interruption of cash flow to the borrower (and hence loan payments)?

[1] This chapter considers only "space leases," which are leases from the borrower as landlord to actual users of the real property for occupancy. These leases produce income to the owner of the real property. In contrast, a "ground lease" runs from a third-party owner of the real property to a developer or investor that pays rent and often grants a mortgage on its rights under the ground lease to secure a loan. The negotiation and structuring of such a lease is more a financing transaction than a leasing transaction. See Part 6 of this book. For more on ground leases, see Joshua Stein, "Model Leasehold Mortgagee Protections," The American College of Real Estate Lawyers Papers, October 1999; updated and republished for Chicago Title Insurance Company continuing legal education program (October 2000), Association of the Bar of the City of New York (November 2000), New York State Bar Association (October & November 2000); New York State Bar Association, Real Property Law Section, Advanced Real Estate Practice, December 2000; and New York Mortgage Bankers Association (September 2001). *See also* Joshua Stein, "How Much Protection Does a Leasehold Mortgagee Need?," *Real Estate Finance Journal* (to be published); "Alternatives to Site Acquisition — Ground Leases: An Overview," *Multi-Family Executive/Office & Industrial Properties*, June 2000.

Appendix 5A: Sample Lease Review Form

When a mortgage lender considers a commercial lease for purposes of a commercial real estate mortgage closing, the lender cares primarily about the basic economics of the lease and the range of issues covered in Chapter 5, "How a Lender Reviews a Lease." To help the lender understand what the leases say, the lender may ask its internal personnel, counsel, or a due diligence contractor to review major leases, with an emphasis on those issues. This appendix seeks to provide a framework for any such review.

This appendix begins with a table demonstrating how a lender's counsel might summarize what the leases say. The table lists the major categories that the lender will care about, and leaves room for a brief summary of the terms of the lease.

As always, for any particular loan transaction the scope and format of lease reviews will vary depending on the circumstances and the lender's tastes.

Immediately after the sample loan review form appears an example of how a lender or its counsel might fill out that form for a particular transaction, including some comments that precede and follow the lease review form itself.

Appendix 5B: Tenant Estoppel Certificate

Whenever a lender accepts a mortgage on income-producing real estate, the lender will want to know that the leases the lender has reviewed accurately reflect "the deal" between the borrower and its tenants, the tenants are paying their rent without major issues, and the leases and the tenants will not produce unpleasant surprises after the closing based on problems that existed at the time of closing.[1]

For a typical commercial mortgage loan closing, the lender obtains this comfort by insisting that the borrower obtain "estoppel certificates" from tenants. In these certificates, the tenants confirm certain facts about their leases. The lender then "gets comfortable" with the leases and therefore closes the loan.

In preparing to close any commercial mortgage loan, a borrower and a lender may negotiate (or play a game of "chicken") regarding exactly how many estoppel certificates the borrower must deliver, and from which tenants. A lender's requirements and expectations will vary, but a lender will typically want estoppel certificates from all the "major" tenants and enough other tenants to cover some high percentage of the total square footage of the property. That percentage will typically be at least 5% to 10% higher than the loan-to-value ratio of the loan, although it is entirely a matter of the particular lender's tastes and the circumstances of each particular loan.

This appendix provides a model tenant estoppel certificate, suitable for use in any commercial real estate financing transaction with existing tenancies (i.e., almost all such transactions). This document is prepared from the perspective of the lender. It also includes provisions that accommodate a simultaneous purchase of the same real property, and considers the needs of the purchaser (comparable to the needs of a lender). For a refinancing, tenants may object to having the estoppel certificate benefit the landlord, so these provisions might be deleted.

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[1] Problems that first arise after closing are handled through different mechanisms. This appendix focuses on the condition of the leases at the moment of closing.

How a Lender Reviews a Reciprocal Easement Agreement 6

A regional mall, multi-use project, or other large real estate asset (a "Project") will often actually consist of a number of smaller components (each, a "Component"), each under separate ownership and separate financing. In many cases, particularly for regional malls, each component will consist of a parcel of land and the improvements built on that land. Physically, the project will look like a single building, but legally it consists of multiple separately owned components. The owners of all the components (each, an "Owner") will then enter into an agreement that governs the overall project.

As a variation, sometimes each owner will own a three-dimensional condominium unit carved out of the larger project. The condominium structure will define the rights and obligations among the various owners. A condominium structure raises many of the same issues this chapter considers, along with a few others. The latter issues — unique to a condominium structure — are disregarded here. This chapter focuses only on the case where each owner owns land and the improvements on that land or a defined three-dimensional block of real property not constituting a condominium unit (which is also a possibility).

The agreements among owners in a project are called "reciprocal easement agreements" ("REAs"), "operating agreements," "common maintenance agreements," "covenants, conditions, and restrictions," "project declarations," or the like. In the following discussion, each is referred to as an REA.

Once negotiated, an REA becomes part of the package of legal rights that makes up each component, and travels with that component as it changes hands. The REA is very much like a privately negotiated statute or a treaty between nations. It may cover a wide range of issues — essentially every project-related issue that may affect the owner of more than one component. In some ways, an REA covers much the same ground as a lease, but unlike a lease, each party to an REA plays both a "landlord"-like role and a "tenant"-like role, so the relationship often has a more balanced and mutual character to it than a lease.

Each owner's piece of the REA — a package of rights and obligations that involves all the other owners — remains in place on a long-term basis, as part of the definition of the component that each owner owns.

Report on Nondisturbance Agreements and Model SNDA 7

Report of Subcommittee on Nondisturbance Agreements
Commercial Leasing Committee Real Property Section
New York State Bar Association

The following report was issued in 1993 by a subcommittee that the author chaired. The following reprint of the report corrects typographical errors and updates some dates, but does not update the report and attached model in any material way. These materials do, however, remain relevant and timely. Since this report was issued, major tenants have become less accommodating of lenders, and minor tenants have tried to do the same though not always as successfully. Against those trends, the model form of nondisturbance agreement offered as a supplement to this report is probably more lender-oriented than the typical negotiated outcome. Indeed, critics have charged that this model is overly lender-oriented in any event, and does not meet its goal of providing a "reasonable" and "balanced" document. For that reason and others, the New York State Bar Association Commercial Leasing Committee is expected soon to revisit this report and model form and issue a Second Edition. That process has not yet started. This report and the attached model nondisturbance agreement are reprinted with consent by New York State Bar Association. For a more critical view of nondisturbance agreements, see Chapter 8.

Nondisturbance Agreements[1] 8

Commercial leases create real estate value.[2] Commercial mortgage[3] lenders lend against real estate value. In the course of these transactions, either a tenant or a lender will often ask the landlord to obtain a subordination, nondisturbance, and attornment agreement (an SNDA) from the landlord's other counterparty — the lender or the tenant, as the case may be. Every time that happens, the worlds of leasing and lending overlap, but often in a rather awkward and uncomfortable way.

An SNDA embodies some agreements between a tenant and a lender, relating mostly to what happens to the tenant if the lender forecloses under its mortgage. Absent an SNDA, a lease represents a two-way negotiation and relationship between a landlord and a tenant. An SNDA brings a lender into that relationship. A lender's agenda goes beyond the landlord's.[4]

This chapter explores the practical and legal backdrop of SNDAs, why lenders and tenants think they need SNDAs, and some issues and problems that arise in preparing and negotiating an SNDA. This discussion complements the previously published New York State Bar Association Report on Nondisturbance Agreements, with Model Form of Nondisturbance Agreement ("Report and Model SNDA"), which is reprinted in Chapter 7.[5]

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1 This chapter is based on an article the author published in the American Bar Association's *Real Property, Probate and Trust Journal* in Winter 2003 ("Needless Disturbances? Do Nondisturbance Agreements Justify All the time and Trouble?" Volume 37, page 703). The article included extensive citations and discussions of court cases on the issues discussed in this chapter. Most of the legalistic discussions in that article have been removed for purposes of this chapter, and other editing was performed.

2 The short-term and medium-term value of commercial real estate depends primarily and most directly on the existence of stable tenants that have agreed to pay a reliable stream of rent for a known period. Without reliable rental income, commercial real estate in the short or medium term easily can look more like a liability than an asset. Of course, vacant space has a value, but it is contingent and hypothetical until a real tenant signs a real lease to turn the space into a real income stream.

3 Except where otherwise stated, any reference to a "mortgage" also refers to a "deed of trust."

4 As in so many other areas of commercial real estate, though, if the landlord plans ahead to the inevitable lender, the landlord's agenda will (in part) simply track the anticipated lender's agenda, and life will be easier for everyone.

5 See *Report of Subcommittee on Nondisturbance Agreements*, 22 N.Y. State Bar Ass'n Real Prop. L. Sec. Newsletter, No. 2 (Spring 1994). The author chaired the subcommittee that prepared the Report and Model SNDA, which are reprinted in Chapter 7. The Report and Model SNDA analyzed the terms of an SNDA, paragraph by paragraph, without questioning the fundamental logic of the exercise. This chapter focuses more (and more critically) on the underlying structure, dynamics, rationale, logic, and purpose of an SNDA. The coverage overlaps to some degree.

Nonrecourse Clauses and Carveouts 9

In the mid-1980s, mortgage loan borrowers escaped personal liability for nearly every obligation they undertook in documents for "nonrecourse" loans. This meant that borrowers who defaulted would probably lose their mortgaged property. But they normally faced no further exposure, because lenders agreed by contract not to seek recourse to any assets beyond the mortgaged property (hence, "nonrecourse").

Under any classical "nonrecourse" loan of this type, a borrower effectively made a "tails I win, heads you lose" bet with its lender. A borrower could divert rental income, let the collateral deteriorate, and fight the lender in court for years — but at the end of the day face no meaningful exposure to liability. The borrower's war against its lender imposed on the borrower no incremental cost, no loss beyond the loss of the property — a loss the borrower would have already eventually suffered anyway.[1]

Having learned from sad experience, nonrecourse mortgage lenders now insist that their borrowers assume personal liability for a wide range of risks and obligations under the loan documents.

Nonrecourse "carveouts" have blossomed into long lists of obligations for which borrowers face personal liability. These lists often go on for pages. It often seems to borrowers that modern nonrecourse clauses require borrowers to assume personal liability (i.e., to place at risk assets beyond the mortgaged property) for every possible default, risk, or problem beyond a simple failure to pay principal and interest on the note.

Have lenders gone too far? If so, which of the nonrecourse carveouts should lenders abandon? On what principled basis can a lender shift back to a more borrower-friendly approach? And from the opposite perspective, if a lender favors the use of extensive carveouts, how can that lender make sure those carveouts work? These questions often shape the most important battles in major commercial mortgage loans.[2]

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[1] See J. Stein, "Mortgage Loan Structures for the 1990s," 24 Real Est. Rev. (Spring, 1994); "Nonrecourse Clauses Revisited," 22 Real Est. Rev. (Summer, 1992).

[2] These battles are best fought at the term sheet or commitment letter stage, as described in Chapter 1.

Appendix 9A: Model Nonrecourse Clause

Nonrecourse clauses have exploded in length since the real estate depression of the early nineties. They are also often quite complex, long, and tedious. Partly as a result, many nonrecourse clauses do not clearly say who is personally liable for what, and when that liability arises, as more fully described in Chapter 9.

As Chapter 9 also demonstrates, nonrecourse clauses can raise almost every issue that arises in negotiating a commercial mortgage loan, all viewed through the prism of defining the scope of personal liability for losses a lender might suffer. The possibilities for creative drafting and creative negotiating of nonrecourse clauses and carveouts are almost endless.

This appendix sets out a model Lender's State-of-the-Art Nonrecourse Clause that seeks to raise and demonstrate possible outcomes for all issues that can arise in nonrecourse clauses, including some issues often ignored. Substantively, this model also provides a reliable reference point (a "benchmark" or perhaps a "high-water mark" or perhaps an "unrealistic and extreme example of overkill") against which lenders and borrowers, and their counsel, can compare other nonrecourse clauses.

This model also collects in one place, and clearly identifies, many common borrower negotiations of these clauses.

Finally, the following model nonrecourse clause tries to demonstrate how the use of a logical structure, headings, and defined terms can help a document communicate better.[1]

This Lender's State-of-the-Art Nonrecourse Clause represents a combination of the most aggressive and creative positions that commercial mortgage lenders take in nonrecourse clauses today. Although this model contains little or no duplication, it is quite long. Virtually everything in this model arises directly or indirectly from nonrecourse clauses and negotiations in actual commercial mortgage loan transactions the author has handled.

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[1] The use of defined terms in this model, and in legal documents generally, is discussed in depth in the author's article "How To Use Defined Terms to Make Transactional Documents Work Better," which accompanied an earlier version of this model nonrecourse clause when it appeared in the October 1997 issue of *The Practical Real Estate Lawyer*. That article on defined terms was updated and republished in "ALI-ABA's Practice Checklist Manual on Advising Business Clients II: Checklists, Forms, and Advice from The Practical Lawyer" (2000) and in Joshua Stein, *A Practical Guide to Real Estate Practice* (2001).

Appendix 9B: Guaranty

The following model document consists of a full and unconditional guaranty of payment and performance of a loan. By selecting the appropriate definition of "guarantied obligations" and using optional paragraphs, this guaranty can be converted to a guaranty of nonrecourse carve-outs or a partial or limited guaranty.

This model guaranty consists of "basic" and "extended" language.

The "basic" language would appear in even a relatively short guaranty. Guaranties are never truly short, though, because they must respond to decades of litigation in which guarantors have successfully disclaimed liability based on an incredible range of theories. Each of those theories has often led to a new paragraph, or at least a new clause, in subsequent guaranties.

The "extended" language offered in this model guaranty covers special circumstances and extra lender protections. Some of these "beefed up" provisions could be included in any guaranty but often are omitted from a plain vanilla "simple" guaranty. Of course, if the transaction goes into default, whatever provision was omitted for brevity will inevitably turn out to be the very provision that would have helped most.

This model document is written almost completely from the perspective of the lender. Brackets indicate provisions to modify or delete as appropriate.

The heart of this guaranty, like any other, consists of a long list of waivers by guarantor, each arising from one theory or another that guarantors have used as a defense against liability under a guaranty in previous cases. The breadth of these defenses drives the breadth of the waivers.[1] The waivers in this guaranty will not necessarily all be fully enforceable.

[1] See Freeman, M. and Gurev, E., *An Overview of Defenses Available to Guarantors of Real Property Secured Transactions Under California Law*, 38 Santa Clara L. Rev 329 (1998, not limited to California law); Stein, J., *Cures for the (Sometimes) Needless Complexity of Real Estate Documents*, Real Estate Review, Fall 1995.

Letters of Credit 10

When a lender identifies a potential monetary exposure or gap in a commercial real estate financing transaction, the lender often asks the borrower to deliver a letter of credit (an "L/C") as a mechanism to protect the lender from the particular issue identified in the transaction.

This chapter explains why and how borrowers and lenders use L/Cs in commercial real estate finance. In each case an L/C enters the transaction whenever a party, such as a borrower (the "Account Party") agrees to pay money or perform an action or grant additional assurances for or to some other party, such as the lender (the "Beneficiary" of the L/C). In commercial real estate finance, a lender might require an L/C to back promises such as the following made by the borrower:

- *Replacement of Tax Escrow.* The borrower may offer an L/C to back the borrower's obligation to pay real estate taxes, instead of maintaining an escrow account for real estate taxes. The L/C might equal six months of taxes.
- *Contingent Amortization.* A particular tenant has an early termination option, but rather than reduce the loan to reflect the risk, the borrower offers to repay a specified dollar amount of the loan if the tenant exercises that option. The lender is unwilling to look just to the real property security to recover the required paydown. Therefore, the borrower backs its obligation with an L/C in the same amount, which the lender will release if the tenant does not exercise its termination option.
- *Title Problems.* The lender's collateral is already subject to an existing mortgage that the borrower believes is invalid. If the borrower is wrong, the lender wants a source from which to repay the prior mortgage. To enable the lender to stop worrying about the prior mortgage, the borrower gives the lender an L/C equal to the face amount of the prior mortgage plus a cushion for interest accrual.
- *Projected Capital Outlays.* The lender fears that the roof may need replacement halfway through the life of the loan, but the borrower disagrees. Rather than set up an escrow or reserve account that the borrower believes will never be needed, the borrower delivers an L/C to cover the possible cost of roof replacement.

In each of these cases, the lender as beneficiary wants a particular obligation to be performed, the obligation is quantifiable in dollars, but the beneficiary does not want to look solely to the credit of the account party (the borrower) or, more likely in a mortgage loan transaction,

Appendix 10A: Model Letter of Credit

This appendix offers a model letter of credit (L/C), appropriate for use in commercial real estate financing transactions. The same model L/C is also appropriate for use with almost any other obligation to be backed by an L/C.[1]

This model L/C is prepared mostly from the perspective of the beneficiary of the L/C (the "Beneficiary"), typically the lender in a commercial real estate loan. Because an L/C is a fairly standard document, this model could also be used, with care, when acting for the party[2] that issues an L/C (the "Issuer")[3] or for the party whose credit backs the issuance of the L/C (the "Account Party").[4]

The model L/C offered here was not intended for use as an import-export (so-called "commercial") L/C, where the parties anticipate the L/C will be drawn in the ordinary course by presentment of a bill of lading or other trade documents. Parts of this model L/C can be used when drawing on any standby or commercial L/C, or transferring any standby or commercial L/C that allows transfer, if that L/C does not already provide the necessary forms of documentation as exhibits.

Points Not Covered

This model L/C seeks to achieve minimalism and simplicity, consistent with the usual goal of keeping any L/C as short and simple as possible. Any party to an L/C transaction, or its counsel, can readily think of ways to complicate and lengthen any document, including any L/C,

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1 Because of the "independence principle" of L/Cs, as described below and in Chapter 10, a standby L/C should require relatively little customizing regardless of the transaction for which it is being used. It should simply confirm the issuer's unconditional promise to pay the beneficiary if the beneficiary presents an appropriate sight draft. Everything of a transaction-specific nature belongs elsewhere.

2 That party is typically but not necessarily a bank.

3 The issuer's concerns are addressed briefly in Chapter 10.

4 An account party will, however, want to try to defer, frustrate, and complicate any L/C draw. Techniques to do this can readily be inferred by reading these comments and considering them from the account party's perspective rather than the beneficiary's. A careful beneficiary will try to reject the account party's proposals, regardless of how rational and earnest they may sound. (The account party may be the borrower, the borrower's principals, a tenant, or in the old "New Economy" or dotcom world, the venture capitalists that backed the tenant.)

Appendix 10B: Tri-Party Agreement for Letter of Credit

When a borrower or a landlord (the "Landlord") negotiates a commercial space lease (the "Lease"), the Landlord may persuade the space tenant (the "Tenant") to deliver a substantial letter of credit (an "L/C") in place of a security deposit.

Whenever this happens, the landlord's mortgage lender (the "Lender") will often want to control that L/C. Unless the lender controls the L/C, the lender will probably not want to be responsible for the L/C after foreclosure (a major tenant concern when negotiating a subordination, nondisturbance, and attornment agreement ["SNDA"]); regard the lease as being too risky; more heavily discount the tenant's rent and the lease for underwriting purposes; hesitate to approve the lease; and fear that any funds drawn under the L/C may end up in the wrong place.

The last of these concerns is particularly compelling when the lender requires a "hard lockbox" to collect rent. The logic of any "hard lockbox" dictates that the lender must control the L/C. Otherwise, the "hard lockbox" has a gaping hole in it. Even without a "hard lockbox," i.e., even if the lender will otherwise let the landlord collect the monthly rents, the lender may still want to control the L/C if the amount at risk substantially exceeds a month or two of rent.

The use of large L/Cs became quite popular during the dot-com bubble (and landlords' leasing market) of 1999 and early 2000, when a tenant would often give a landlord an L/C for a year's rent or more. The use of an L/C in place of a security deposit is not, however, limited to high-tech tenants or landlords' markets. The bursting of the dot-com bubble taught Landlords, among other things, that L/Cs can and do give landlords a highly reliable source of payment when tenants default. In some cases, an L/C may place a landlord in a better position than would a cash security deposit.[1] Therefore, although the dot-com tenants may be gone, the use of L/Cs in place of security deposits remains a perfectly valid technique and will probably continue, though perhaps not with the frequency and magnitude seen during the dot-com era.

[1] That can happen when the security deposit exceeds the amount of the claim that the bankruptcy code allows the landlord to make in the tenant's bankruptcy. See 11 U.S.C. § 502(b)(6). When a security deposit (or L/C) reaches that level, it introduces a whole new spectrum of bankruptcy issues and planning possibilities, all outside the scope of this chapter. This chapter assumes an L/C for up to a year's rent, a level at which the bankruptcy problems just mentioned cannot arise.

Ground Leases from the Ground Up 11

When an owner doesn't want to sell a site but a developer wants to develop it, the parties sometimes will give the developer site control through a ground lease. This lets the owner of the site keep long-term ownership while receiving a rental stream that the owner regards as just about equal in value to the site itself. If the owner has held the site a long time, a ground lease will also typically let the owner avoid or defer any need to pay income tax on the owner's gain.

At the same time, a developer will often prefer a ground lease to an outright purchase. A ground lease can avoid the need to raise capital to pay for the purchase price of the land (a non-depreciable asset) and any existing building. Instead, the developer pays rent, most or all of which is deductible. And a ground lease gives the developer strong enough control over the site to justify making a substantial investment to develop its project.

Most of the developer's investment in any ground-leased project will usually consist of borrowed money, so the developer will want to be able to use its rights under the ground lease as collateral for a mortgage loan — a "leasehold mortgage" loan. To achieve that goal, the ground lease must consider the interests of any future lender, which in some ways go beyond those of the developer/tenant.

Because a ground lease can meet the needs of all the parties, it can bring about a development project that otherwise might never have occurred. Governmental bodies, universities, and other public or quasi-public property owners often use ground leases when they have a long-term development strategy for land they own, but want more control than an outright sale would leave them.

Private owners and investors sometimes use ground leases to transfer control of a site where the owner hesitates to sell because of a potentially huge tax bill, but wants to realize the value of its position and create an annuity for future generations.

Although a newly negotiated ground lease will typically cover vacant land for development — hence a "ground" lease — it can just as well cover an existing building. Real estate investors will refer to the latter type of lease as a "ground lease" if it covers the entire building for a substantial period, imposes virtually no obligations on the landlord, and gives the tenant flexibility almost comparable to ownership.

Appendix 11: Medium Leasehold Mortgagee Protections[1]

How Much Protection Does a Leasehold Mortgage Need?

Every real estate attorney, developer, or investor who negotiates a long-term ground lease (a "Lease")[2] knows it must be "financeable." That means the lease must contain certain provisions (the "Leasehold Mortgagee Protections") to protect the interests of a likely future leasehold mortgagee. Those interests boil down to assuring that a leasehold mortgagee can always take and readily enforce a leasehold mortgage; preserve the lease and its value, even if the transaction goes into default or surprises occur; or abandon a bad investment.[3]

To achieve these goals, a tenant (or leasehold mortgagee) and its counsel might say a lease should contain every possible leasehold mortgagee protection any real estate lawyer has ever devised; absolute clarity and full detail about every single element of every single one of those leasehold mortgagee protections, leaving nothing to be resolved later and no possible hypothetical sequence or confluence of events unaddressed; and perhaps as many words and pages as possible devoted to protecting any possible future leasehold mortgagee.

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[1] The author acknowledges the contributions of his partners Richard L. Chadakoff and James I. Hisiger, and of the following other individuals: Arthur S. Adler, Sullivan & Cromwell; Hugh P. Finnegan, Siller Wilk LLP; Gary A. Goodman, Sonnenschein Nath & Rosenthal; Andrew L. Herz, Bingham McCutchen LLP; Donald H. Oppenheim, Meyers Nave PC; and Benjamin Suckewer, Fischbein Badillo Wagner Harding. An earlier version of this Chapter appeared in *The Real Estate Finance Journal*, Spring 2003, at 5.

[2] The sample leasehold mortgagee protections below define many capitalized terms. Obvious definitions of other capitalized terms are omitted. "Lease" should include permitted amendments.

[3] A tenant does not directly share the special concerns of a leasehold mortgagee — at least if the tenant knows with absolute certainty that it, and its successors and assigns, will never need leasehold financing. A more typical tenant will, of course, care a great deal about leasehold mortgagee protections. These provisions make a lease financeable and hence more valuable to a broader universe of future debt and equity investors.

Business Issues, Economics, and Underwriting of Lodging Loans 12

Although real estate always represents a crucial first piece of any hotel loan, these loans are far more complex than traditional "pure" real estate loans. This is because hotel loans are, in essence, loans to operating businesses of a particularly volatile nature. The security for these loans consists not only of real property, but also of a wide range of other assets that can be difficult to understand, preserve, and control.

Lenders that finance hotels must understand a variety of issues that do not arise in typical real estate loans. Hotel lenders must grasp what makes a hotel work, and obtain the right security package and other controls to protect all those pieces of the puzzle.

Hotel lenders must also understand hotel finances. They must analyze a hotel's operations and business strategies. Documents for a hotel loan must reflect reality while protecting the lender's interests. Those documents may, for example, require financial covenants and procedures of a complexity atypical for a routine commercial mortgage loan. If a hotel lender ever needs to foreclose on its loan, the lender needs to know it can take over the entire operations of the hotel and control all the cash flows.

A lender that controls or obtains a lien on most of a hotel's assets, but somehow manages to miss a few, may after foreclosure face a situation that may range from awkward to disastrous. In the worst case, the lender may have to pay the foreclosed borrower to give up claims to property that was intended to be part of the lender's collateral package, but was overlooked. Hotel lenders and their counsel therefore need to scrutinize every piece of the lender's collateral package, both to understand it and to assure that the lender obtains a good claim to it.

Franchise and Management Issues

As one of the first items on any hotel lender's agenda, the lender will want to understand the hotel's franchise — the agreement with a hotel franchisor that gives the hotel its brand name and defines the standard under which the hotel will operate.

Appendix 12: Language for a Hotel Loan Agreement

This appendix collects many provisions that a lender might want to add to a real estate loan agreement where the collateral consists of a hotel rather than an office building or retail facility. These provisions have been collected from a variety of hotel-related loan documents, each with varying terms reflecting the deal structure of that particular hotel. Given that provenance, these provisions are not internally consistent and must be reviewed and edited to make them consistent as appropriate for the particular transaction. The emphasis here has been to identify and remind the user of all substantive issues that must be considered for a hotel loan, rather than to provide complete and perfect language to deal with all issues in all cases.

Any individual hotel is often unique. The language offered in this appendix will therefore often need to be tailored and supplemented for the particular case. For example, whether the hotel has a license agreement or a management agreement or both will drive a number of provisions in the loan documents. Does the hotel have an "FF&E reserve" (furnishings, fixtures, and equipment reserve) or a similar reserve with a different name, or some other type of reserve entirely? Who controls it? The manager or the owner? What does the management agreement already say about that reserve? Who pays the taxes and insurance? How much retail space does the hotel have? Is the hotel part of a larger mixed-use project?

Depending on the answers to these questions, these provisions will need to be edited. They will also need to be blended with the particular lender's "base" loan agreement to interact as appropriate with the structure already in place. Similarly, other provisions in the loan documents will need to be edited and conformed to these provisions.

Although some form of lockbox is common for hotel transactions, these provisions do not cover lockboxes.

Moreover, the provisions offered here seek to cover only the "basic bases" rather than every possible hotel-related provision that a lender or its counsel might conceivably imagine.

Management and Franchise Issues 13

Hotel loans create a number of issues — not always obvious or straightforward — about the relationship between the lender and the hotel manager.

At first blush, a hotel manager is not too different from an anchor tenant. Both have the right to possess the lender's collateral. In exchange for that possession, they should generate a stream of income for the borrower. If that income cannot support the loan, the lender will eventually foreclose.

Hotel managers like being hotel managers, though. Therefore, they do not like being removed from control of the hotel if the lender ever forecloses. A hotel manager will say, "It's not my fault the borrower couldn't pay its loan," and therefore will argue that a foreclosure should have no effect on the hotel manager.

This argument has an aura of fairness to it. Like so many other propositions that sound "fair" at first blush, though, this proposition fails to recognize an important reality: the unique strengths and weaknesses of a particular hotel manager have significantly more impact on the success of a hotel than do the unique strengths and weaknesses of a typical anchor tenant on the success of a shopping center.

For these reasons, if a hotel lender can get away with it, the lender will seek the right to terminate the hotel manager after any foreclosure. Whether the lender will actually obtain that right depends on all the facts and circumstances of the particular negotiation, including such matters:

- Is the hotel manager already in place (i.e., a refinancing of an existing hotel loan), or is the loan being negotiated in the context of a new management contract as well?
- If the management contract already exists, what does it say about the hotel manager's obligations to facilitate subsequent financing?
- Must the hotel manager cover any operating shortfalls or otherwise in some way invest in the hotel? If the hotel fails to achieve specified levels of cash flow, has the manager agreed to defer some of its fees in the hope of a better tomorrow?
- Does the manager's management of this hotel indirectly give the hotel manager special marketing benefits for its brand name (such as visibility at a "trophy" property)?

Appendix 13A: Lender-Manager Agreement

A hotel lender (the "Lender") and a hotel manager (the "Manager") each benefits from the existence of the other. Depending on the structure of the particular hotel, though, each of those parties may also need certain assurances and agreements from the other. Because of the wide range of deal structures for hotels, the relationship between a lender and a manager may raise a tremendous range of issues, which are introduced in Chapter 13.

This appendix supplements that discussion by presenting a comprehensive lender-manager agreement showing how a lender and a manager may accommodate one another regarding a wide range of possible issues. Those issues go far beyond those addressed in a subordination, nondisturbance, and attornment agreement with a space tenant, even a long-term and fundamentally important space tenant.

The complexity of the relationship between and a Lender and Manager arises because:

- A hotel can be a very complex asset;
- The value of the hotel to a lender depends very much on what the manager does and does not do;
- Far more than for pure commercial real estate (e.g., an office building or shopping center), a hotel borrower can readily impair or destroy the lender's collateral or important pieces of it, whether intentionally or unintentionally; and
- The manager has physical control of the lender's collateral, including particularly its cash flow.

As Chapter 13 demonstrates, the fundamental "starting point" issue in the lender-manager relationship is simply whether the lender can terminate the management agreement after a foreclosure or similar event. If the lender has that right, then much of this lender-manager agreement becomes moot and can be disregarded. The model document offered here starts from that base and then reflects ideas from Chapter 13 plus the author's experiences in negotiating many hotel loans.

Appendix 13B: Licensor Comfort Letter

When a lender (the "Lender") finances a hotel, one crucial element of the hotel will always be its brand name, which the hotel often obtains from a third-party franchisor (the "Licensor") under a franchise license. If the hotel loses its brand name, it will probably lose much of the cash flow that the lender relied upon as the basis for making its loan.

Any hotel lender will want to do what it reasonably can to protect the franchise license of its hotel. As a starting point, the lender will usually require at closing that the licensor enter into a letter agreement with the lender, covering some of the same ground as the lender-manager agreement in Appendix 13A, but also covering some other issues and taking a somewhat different approach.

This appendix offers a sample letter agreement between a lender and a licensor. These letters are often called "comfort letters" or, more realistically, "cold comfort letters," because the licensor rarely gives the lender very much protection or comfort — at least when the license agreement is already in place and the lender is refinancing an existing hotel.

This model comfort letter is reasonably (and in some ways unrealistically) lender-oriented, but it also includes protections and limitations that any Licensor will virtually always demand and any lender will usually accept. This model could easily be made more lender-oriented or more licensor-oriented, both by editing the existing provisions and by adding further provisions, samples of which can be found after the signature blocks.

The unfortunate reality for most lenders on most loans is that "cold comfort letters" usually remain exactly that, so a lender should not expect much. In the occasional case where a lender or the hotel owner has a bit of leverage, this model comfort letter represents a reasonable middle-ground outcome of the usual negotiations.

Redevelopment Projects: Lender's Risk and Responses 14

Instead of developing new projects from the ground up, many investors look for existing properties and try to turn them around. After acquiring an older property at an attractive price, investors of this type might replace tenants (major, minor, or both); reconfigure the physical layout; enlarge or shrink the building; turn a strip center into a mini-mall or a mini-mall into a strip center; reposition the property in the marketplace; add or subtract parking; move parking around; upgrade the exterior; and do whatever else they think will cost effectively increase cash flow and turn a tired old property into an exciting and well-positioned new property in the current market.

Lenders looking for good loans to make will often agree to finance these projects. In some ways, this financing is much like a construction loan. In other ways, it is a routine permanent loan with a few special bells and whistles. Any loan of this type creates plenty of potential traps for borrowers and lenders.

This chapter focuses on the many issues that redevelopment projects can create for a lender. To some degree, the focus is on retail projects, but many of the same principles apply to office and even apartment or other projects as well. And many of these issues also arise in other types of financing. The importance of these issues in any given transaction will depend on the nature of the transaction itself and the "hot buttons" and agenda of each party. This discussion disregards generic issues that apply to any mortgage loan closing (which are discussed in the other chapters of this book), as well as many concerns of construction lending in general.[1] This chapter limits itself to redevelopment loans that are not quite construction loans.

[1] For an overview of construction lending, see Saft, Stuart M., "Reducing the Risks of Construction Lending," Real Estate Finance Journal, Spring 1999.

Checklist for Purchase and Sale Agreement 15

A lender will very often finance a real estate asset for a borrower that will acquire it simultaneously with the loan closing. In other words, instead of refinancing an existing loan on real estate the borrower already owns, the lender will finance the borrower's initial acquisition of the real estate. In these cases, part of the lender's background "due diligence" for the loan will include a review of the purchase and sale agreement between the borrower and its seller.

This chapter offers some suggestions for what a lender or its counsel should look for when reviewing a purchase and sale agreement.

Early Review

Try to obtain the purchase and sale agreement as early as possible, to prevent last-minute timing problems if issues arise. The borrower will usually try to delay delivering the contract, because it's not final; the exhibits aren't ready; it's still being negotiated; it's bulky; it's in escrow; it's being handled by other counsel; the dog ate it; or any other convenient excuse.

The lender and its counsel should nevertheless insist on receiving the contract as early as possible despite these excuses, all of which are driven by the fact that the borrower knows the lender wants to see the contract for all the reasons this chapter implies. If the contract is in escrow for some reason, ask to see the escrow agreement and treat that latter agreement as part of the contract.

Postclosing Obligations

Does the agreement obligate the seller to perform any substantial obligations after the closing? If so, the lender should identify those obligations and consider obtaining a security interest in the borrower's rights against the seller. If the loan transaction includes a "hard lockbox," then perhaps the seller should agree to make any postclosing payments into that lockbox. Even without such a lockbox, the lender may want to notify the seller of the lender's security interest.

A Complete Guide to Loan Document Negotiations 16

In a real estate owner's perfect fantasy world, if the owner needed money, it would simply borrow a lender's money; give that lender a valid mortgage lien, so the lender could foreclose and take the borrower's property if the borrower did not repay; and go on with life just the same as before, which would include continuing to manage and operate its real estate competently and strategically. In the real world, however, when a real estate owner decides to borrow against its real estate, it must sacrifice some freedom it otherwise would have had. It must also assume burdens and responsibilities that it did not otherwise need to bear.

From a lender's perspective, as soon as any mortgage loan has closed, the borrower obtains the lender's money. The lender has only its loan documents and any promises, obligations, security, assurances, and credit these documents contain. The lender must rely on these loan documents as the mechanism — in many cases the only mechanism — to preserve its collateral and collect its loan.

Because loan documents are so important to a lender, any lender's counsel should and usually does write them primarily to protect the lender and the lender's collateral. Loan documents usually give the lender as much control, information, leverage, and as many rights and remedies, as possible. To accomplish these goals, commercial mortgage loan documents generally cover a wide set of issues, imposing on the borrower a correspondingly wide range of obligations and restrictions.

Although the wording, scope, and details of loan documents vary and sometimes change over time, generic mortgage loan documents represent a familiar starting point for any commercial real estate finance transaction. That starting point has amassed over many decades (even centuries), based on a combination of real estate finance law, changes in the business world, trends in commercial real estate, past mistakes, lenders' lessons learned the hard way, and the requirements of the secondary market. Exactly how mortgage loan documents became the way they are is beyond the scope of this chapter, though other chapters offer some hints.

Appendix 16: Language for Common Concessions to Borrowers

As Chapter 16 demonstrates, any borrower can negotiate a wide range of issues in any set of loan documents. Within that range of issues, certain issues arise more often than others. On many of the borrower-lender issues, borrowers and lenders often reach more or less the same compromises.

This appendix collects some sample compromise language for many of the usual borrower-lender issues. This sample language covers only selected topics where this presentation seems appropriate. Many borrower negotiations cannot readily be packaged into standard paragraphs. They will instead take the form of reactions to a lender's standard language — adding a sentence here and a qualification there, and deleting language where appropriate. Even the language proposed here would typically need to be converted into line-by-line changes to particular provisions of the loan documents as the lender proposes them.

The following paragraphs would certainly not all appear in one place in the loan documents. Instead, each paragraph would be added wherever it is relevant and then edited and negotiated as appropriate. The opening paragraph expresses some conditions that a lender would typically impose for any concession(s) like those proposed here. If these concessions were used in an actual transaction, those conditions might need to be repeated wherever one of these concessions appears.

Neither the substance nor the wording of these concessions represents "approved" or "recommended" concessions that a lender might make to a borrower. This language merely represents an example of language a borrower might propose or the parties might eventually agree upon as a compromise. In representing a lender, the author would not necessarily accept any of these concessions. They are included here only because borrowers request them (or their substantive equivalent or a variation thereon) with some frequency.

As in all sample language offered in this book, definitions of capitalized terms are not always included.

Other possible concessions to a borrower are suggested throughout this book. This chapter should not at all be regarded as a complete collection of all possible borrower concessions.

Loan Payoff Process 17

When any borrower closes a new mortgage loan, many small problems can arise. Sometimes one of those problems will delay or even derail the transaction. From the perspective of a lender closing the loan, any last-minute problem the borrower suffers may cause delays, extra expense, and perhaps last-minute funding problems. So even if a problem is "the borrower's fault," a careful lender will want to do what it can to identify and prevent the problem before it happens.

Of all the possible small problems in any mortgage loan closing process, perhaps one of the most common, yet the most surprising, is the process of paying off the borrower's existing mortgage loan. Time and again, a major closing will be delayed a day or two at the last minute because of unexpected problems dealing with the existing lender, who isn't ready to close.

These problems are particularly remarkable because they are particularly avoidable. Unlike many other problems with the loan closing process, the process of paying off the existing lender is almost entirely within the control of the borrower. Unlike some other third parties, existing lenders are typically quite willing to cooperate. So why do mortgage payoffs cause so many last-minute problems at closings? Becaise paying off an existing mortgage loan is so easy that borrowers and their counsel often don't even think about it until the last minute. And when they finally do think of it, they don't leave the existing lender with enough time to handle the process gracefully and undramatically. Or perhaps the lawyers think the business people will handle the payoff, but the business people think the lawyers or perhaps the accounting department will handle the payoff. Or the borrower and its counsel may assume the lender and its counsel will handle the process — an assumption that the lender and its counsel should do their best to prevent beginning as early as possible in the life of the transaction.

If the parties close their loan through a professional third-party escrow with a reasonable closing schedule, many of these problems go away because the escrow handles the process automatically. The remainder of this chapter discusses the problems that can arise absent an escrow company.

As step one in preventing problems with mortgage payoffs, a borrower and its counsel should identify the payoff of the existing lender as just another step they need to coordinate as part of the overall closing. It's not hard. Someone just needs to remember, early in the process, that it needs to be done and figure out who will do it.

Appendix 17: Payoff Letter

[Date]

VIA FACSIMILE TRANSMISSION

[Borrower] (the "Borrower")
[Address]

[Title Insurance Company]
(the "Title Company")
[Address]

PAYOFF LETTER

Lender	
Loan No.	
Property Location	
Anticipated Closing Date	
Outside Closing Date	
Incoming Wire Deadline	[Noon]

To Borrower and Title Company:

Please refer to Lender's Loan identified above made to the Borrower identified above, as previously amended and assigned (the "Loan"). We confirm that **Exhibit A** sets forth a statement of all amounts required to be paid to Lender (the "Pay-Off Amount"), as of the Anticipated Closing Date, on account of the Loan.

The Pay-Off Amount should be wire transferred to Lender's bank account as specified in **Exhibit A**. Any funds Lender receives before the Incoming Wire Deadline on a business day shall be treated as having been received that day. Otherwise they shall be treated as having been received the next business day and additional per-diem interest shall accrue as set forth in **Exhibit A**.

Loans in Distress and Default 18

This chapter reviews the options and strategies that a mortgage lender (the "Lender") might pursue when it believes that a real estate mortgage loan (the "Loan") will soon go into default, either because the borrower under the loan (the "Borrower") will fail to pay the loan upon maturity or because the borrower will suffer financial distress before then.

The discussion begins by describing steps the lender can proactively take, or at least consider taking, to prepare for battle, to gain control of the mortgaged property and its income stream as early as possible, and to maximize and understand its options.

This chapter also includes a menu of less confrontational possibilities a lender might ultimately prefer to take to "work out" the loan, either when it has gone into default or when the lender sees an obvious default looming ahead. Each of these possibilities assumes the borrower and the lender still have a constructive relationship and the lender still has confidence in the borrower.

This chapter considers defaults and workouts as a generic matter. Any particular comments here might not apply to any particular loan, and any particular loan will always raise its own issues. The terms of the governing documents will be extremely important — particularly the degree to which any principals of the borrower are personally liable for the loan or for any "non-recourse carveouts." The lender should always involve counsel in forming any strategy to deal with a loan. If the lender has a servicer for the loan, the servicer would perform some of the tasks this chapter suggests, depending on the details of the servicing arrangement. The tasks themselves will not change much.

Parts of this chapter consider the very common case where a loan is secured by multiple properties, including some in California and some in other states. This chapter does not consider construction loans (which raise their own morass of issues and practical problems) or hotel, motel, or lodging loans (whose unique issues are suggested in Chapters 12 and 13).

The issues and options in dealing with defaulted loans are potentially open-ended — far more varied, complex, and interesting than the issues that arise in closing a loan in the first instance. This chapter therefore attempts to cover only the major issues and choices, and does not cover everything that could possibly apply.

Appendix 18A: Preworkout Agreement

The document in this appendix is a preworkout letter agreement, prepared primarily from the lender's view. It should be signed before any loan workout discussions commence. Any user of this letter agreement may wish to note the following:

- *Standstill.* The borrower may ask this lender to agree to stand still in exercising its remedies, under the theory that "we can't fight and talk at the same time." This theory is generally ridiculous given the excessive delays the lender will encounter if and when it ever begins exercising its remedies. The lender should be free to proceed with the exercise of its remedies up to the moment of foreclosure sale even while the borrower and the lender meet and talk.
- *All Necessary Parties.* Consider who else, beyond the borrower, should sign this agreement. For example, all guarantors should sign.
- *Pending Litigation.* If litigation is pending, the agreement should refer to it and consider such matters as tolling, cure periods, notice periods, admission of service, etc.
- *Costs and Expenses.* First draft preworkout agreements often require the borrower to reimburse the lender's attorneys' fees and other expenses of the discussions. The borrower will typically object. If the underlying loan documents already require such reimbursement, the lender may be better off not raising the issue in the preworkout agreement, unless the lender seeks a cash deposit for these expenses.
- *Term Sheets.* When distributing draft term sheets under this letter agreement, include appropriate legends stating they are distributed pursuant to the preworkout agreement and do not bind anyone.

Appendix 18B: Workout Agreement

This model document is an Amendment of Loan Agreement for use in a workout. This document is written from a lender's point of view. Brackets indicate blanks to fill, options, and issues. This document covers three general areas: (1) provisions that apply to almost every workout; (2) reminders of documents and deliveries that a lender may require, depending on circumstances; and (3) model language for some common and typical substantive changes that lenders and borrowers often agree to in a workout. This workout agreement will always need to be edited (and shortened) for any particular workout transaction.

Depending entirely on circumstances and the business deal, this document may need various exhibits, related documents or deliveries, additional information, conforming provisions in other documents, etc. These could include the following:

- *Preworkout Agreement.* As soon as workout discussions begin, consider the need for a "preworkout" letter, in which the borrower acknowledges that no agreement is binding until reduced to final agreed-upon documents and signed. For an example, and a discussion of potential issues, see Appendix 18A.
- *Defined Terms.* This document uses definitions from the loan agreement. All defined terms in this document must be cross-checked against the loan agreement and modified as appropriate. This document assumes that the definition of "Loan Documents" in the loan agreement includes the loan agreement itself.
- *Section Headings and Numbering.* Section headings and numbering contained in provisions of this document that modify the loan agreement must be conformed to the loan agreement.
- *Title and UCC Search.* The lender should obtain an updated title and UCC search on all collateral and a modification endorsement for lender's title policy.
- *Notice Recipient Information.* Attach as an exhibit a table of names, addresses, and fax numbers for all of the borrower's notice recipients.
- *Existing Liens.* Attach a list of existing liens on the mortgaged property as an exhibit.

Appendix 18C: Deed-in-Lieu of Foreclosure Agreement

Sometimes both the borrower and the lender guess wrong about a mortgaged property. Instead of maintaining or increasing its value, the mortgaged property might lose value, because of bad management, bad neighborhood trends, a bad local economy, or bad luck.

When bad things happen to mortgaged property, a typical nonrecourse loan always gives the borrower the option to "walk away" from it. The borrower can let the lender foreclose and take the mortgaged property, but the lender will have no right to chase the borrower if the value of the mortgaged property won't cover the entire loan.

If a borrower has resigned itself to losing the mortgaged property and wants to maintain its reputation with this lender and others, the borrower will often not force the lender to go to the trouble of holding a foreclosure sale. Instead, the borrower will simply deed the mortgaged property to the lender or the lender's designee, saving all parties the time, trouble, expense, and bad publicity of a foreclosure action.

A transaction of this type, a "deed-in-lieu of foreclosure," formalizes the borrower's exercise of its option to "walk away" from a bad investment. The borrower recognizes that it has lost its equity investment in the mortgaged property. Although the borrower might have an opportunity to "leverage" the lender by taking advantage of the delays and uncertainties of the foreclosure process, the borrower declines to do so. Instead, the borrower makes life (or at least the transfer of the mortgaged property) easy for the lender.

A borrower that "walks away" gracefully will often find that the same lender that "took back" an unsuccessful investment will happily do business with the same borrower again on another property. Nonrecourse lenders recognize that "taking back" bad investments is part of the risk they've agreed to assume. They can't necessarily complain when the risk actually "hits."

For any "deed-in-lieu of foreclosure" transaction, both borrower and lender often want to memorialize the circumstances of the borrower's abandonment of the mortgaged property. And a lender fears that after the transfer the borrower will somehow try to undo it — a risk that the lender can mitigate by obtaining certain assurances from the borrower. For these reasons, a borrower and a lender that consummate a deed-in-lieu of foreclosure will often enter into a deed-