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Introduction to Real Property Financing and Negotiating Techniques* Product Details

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- I. SCOPE AND LIMIT OF CHAPTER
 - A. Overview of Commercial Loan Process **§1.1**
 - B. Residential Loans **§1.2**
- II. LOAN BROKERS AND OTHER CONSULTANTS **§1.3**
 - A. Role of Broker **§1.4**
 - 1. Fees and Costs Charged by Broker **§1.5**
 - 2. Loan Packaging **§1.6**
 - 3. Broker as Negotiator on Borrower's Behalf **§1.7**
 - B. Other Consultants and Professionals **§1.8**
- III. TYPES OF FINANCING TRANSACTIONS **§1.9**
 - A. Acquisition **§1.10**
 - 1. Checklist: Due Diligence **§1.11**
 - 2. Seller Financing **§1.12**
 - 3. Ground Leases **§1.13**
 - B. Refinancing **§1.14**
 - C. Bridge and Gap Financing **§1.15**
 - D. Mezzanine Financing **§1.16**
- IV. SOURCES OF FINANCING **§1.17**
 - A. Main Street Versus Wall Street: Portfolio Versus Conduit Lending **§1.18**
 - B. Commercial Banks **§1.19**
 - C. Savings and Loans; Savings Banks; Thrifts **§1.20**
 - D. Life Insurance Companies **§1.21**
 - E. Pension Plans **§1.22**
 - F. Mortgage REITs **§1.23**
 - G. Industrial Loan Companies; Finance Companies; Other Lenders **§1.24**

* Updated 10/08

V. TERMS USED IN REAL PROPERTY FINANCING §1.25

- A. Adjustable (or Variable) Pay Loan §1.26
- B. Adjustable (or Variable) Rate Loan §1.27
- C. Amortization §1.28
- D. Basis Points §1.29
- E. Blanket Mortgage/Deed of Trust §1.30
- F. Bowtie Loan §1.31
- G. Bullet Loan §1.32
- H. Conduit Loan/Securitized Loan §1.33
- I. Convertible Loan §1.34
- J. Cross-Collateral/Cross-Default §1.35
- K. Debt Service Coverage Ratio §1.36
- L. Earnout §1.37
- M. Grace Period §1.38
- N. Guaranty §1.39
- O. Impound Account §1.40
- P. Interest §1.41
- Q. Loan Participation/Loan Syndicate §1.42
- R. Loan Servicing §1.43
- S. Loan-to-Cost Ratio §1.43A
- T. Loan-to-Value Ratio §1.44
- U. Lock Box §1.45
- V. Lock-In Clause §1.46
- W. Mezzanine Financing §1.47
- X. Pay Rate §1.48
- Y. Points/Loan Fees §1.49
- Z. Prepayment §1.50
- AA. Recourse/Nonrecourse §1.51
- BB. Shared Appreciation Loan §1.52
- CC. Wraparound Deed of Trust/All-Inclusive Deed of Trust §1.53

VI. ROLE OF COUNSEL

- A. Importance of Early Involvement §1.54
 - 1. Structuring the Transaction §1.55
 - 2. Preparing Initial Drafts §1.56
 - 3. Use of Standard and Computerized Forms §1.57
- B. Usury §1.58
- C. Credit Enhancement §1.59
- D. Concerns of Lender's Counsel §1.60
 - 1. Title Matters §1.61
 - a. Preliminary Report §1.62
 - b. ALTA Survey §1.63
 - c. Common Endorsements §1.64
 - 2. Hazardous Substances §1.65
 - 3. Borrowing Entity §1.66
- E. Concerns of Borrower's Counsel §1.67
 - 1. Exit Strategy §1.68

2. Borrower's Choice of Type of Entity **§1.69**
3. Title Issues; Environmental Concerns; Due Diligence **§1.70**
4. Other Issues of Concern to Borrower **§1.71**

VII. NEGOTIATING TECHNIQUES

- A. Commonly Negotiable Terms **§1.72**
- B. Negotiating Mindset: Basic Goals of Lender and Borrower **§1.73**
- C. Loan Amount **§1.74**
- D. Interest Rate **§1.75**
 1. Fixed Versus Variable Interest Rate **§1.76**
 2. Advantages and Risks of Variable Rates **§1.77**
- E. Amortization **§1.78**
- F. Maturity Date **§1.79**
- G. Grace Periods **§1.80**
- H. Notice and Cure Periods **§1.81**
- I. Credit Enhancement **§1.82**
- J. Personal Liability: Exceptions to Nonrecourse Provisions **§1.83**
- K. Due-on-Sale (Transfer of Interests in the Property) **§1.84**
- L. Transfers of Interests in Borrower **§1.85**
- M. Prepayment **§1.86**
- N. Operating Covenants **§1.87**
- O. Impound Accounts **§1.88**
- P. Reserves **§1.89**

VIII. CONDUIT FINANCING; A SUMMARY

- A. Wall Street Comes to a Bank Near You **§1.90**
- B. Advantages of Conduit Financing **§1.91**
- C. Disadvantages of Conduit Financing **§1.92**
- D. Role of Rating Agencies **§1.93**
- E. Threshold Requirements **§1.94**
 1. Uninterrupted Cash Flow to Lender **§1.95**
 - a. Single Purpose, Bankruptcy-Remote Borrower Entity **§1.96**
 - b. Impound and Reserve Accounts **§1.97**
 - c. Lock Box System **§1.98**
 - d. Operating Covenants **§1.99**
 - e. No Subordinate Debt **§1.100**
 - f. Credit Enhancement **§1.101**

2. Prepayment Restrictions **§1.102**
 - a. Prohibition of Prepayment **§1.103**
 - b. Prepayment Premium **§1.104**
 - c. Defeasance **§1.105**
3. Assuring Repayment at Maturity **§1.106**
4. Hyperamortization: The Prepackaged Workout **§1.107**

I. SCOPE AND LIMIT OF CHAPTER

§1.1 A. Overview of Commercial Loan Process

This chapter provides an overview of the process of obtaining financing secured by commercial real property. The main purpose of this chapter is to alert the practitioner to issues arising at the outset of the loan transaction. The roles of both borrower's and lender's counsel in the loan process are discussed in detail. This chapter covers:

- The role of the loan broker (see §§1.4–1.7);
- Types and sources of financing (see §§1.9–1.24);
- Definitions of commonly used terms (see §§1.25–1.53);
- A brief overview of usury issues (see §1.58);
- Concerns of lender's counsel (see §§1.60–1.66);
- Concerns of borrower's counsel (see §§1.67–1.71);
- Negotiating techniques for specific loan terms (see §§1.72–1.89); and
- The advantages, disadvantages, and requirements of conduit financing (see §§1.90–1.107; see also chap 10).

For an excellent discussion of issues a borrower's counsel must address in obtaining, negotiating, and closing a commercial real estate loan, see Carey, *Representing a Borrower in Commercial Real Estate Secured Financing*, 23 CEB Real Prop L Rep 158 (May 2000) [Part I: Getting Started], 23 CEB Real Prop L Rep 195 (July 2000) [Part II: The Big Issues and More].

§1.2 B. Residential Loans

This book does not discuss the specifics of loans secured by residential real estate (other than multifamily, non-owner-occupied property), primarily because the typical homeowner lacks the bargaining power to affect the lender's underwriting and administrative policies. Moreover, residential lenders are typically constrained by state or federal law or regulations, or by the underwriting and other criteria of the Federal National Mortgage

Association (FNMA). All loans purchased by the FNMA from the originating lender must meet FNMA standards. For a discussion of FNMA criteria for residential loans secured by units in common interest developments, see *Forming California Common Interest Developments*, chap 5 (Cal CEB 2004).

§1.3 II. LOAN BROKERS AND OTHER CONSULTANTS

Loan brokers are useful for all but the most sophisticated borrowers. Generally the borrower lacks the time, resources, or knowledge of the lending marketplace to pursue financing without assistance. In addition, with tiered financing (mortgage, mezzanine, preferred equity) becoming more common, especially when the total principal amount is sizable, loan brokers often have relationships with several types of lenders which the borrower does not.

Viewed from a purely economic perspective, loan brokers will argue (often correctly) that their fees are no greater than the cost the borrower would incur in finding and arranging a loan on its own. In this sense, a loan broker can be helpful (and sometimes essential) to procure and close a commercial real estate loan. The enterprise undertaken by the loan broker, consultants, lender, and borrower is best viewed as a partnership, with the various “partners” (even opposing counsel) contributing their expertise and efforts in varying degrees to achieve a closing. Counsel for both borrower and lender should manage these participants to take advantage of their experience and work product in order to ensure that each task is accomplished in a timely fashion.

For further discussion of mortgage loan brokers, see *California Real Property Sales Transactions*, chap 2 (4th ed Cal CEB 2007).

§1.4 A. Role of Broker

Often, the prospective borrower, or its counsel, first contacts a loan broker to initiate the financing process. The term “loan broker” generally refers to independent mortgage loan brokers as well as mortgage bankers. An independent mortgage loan broker represents the borrower in finding and arranging secured financing appropriate to the borrower’s project. Mortgage bankers represent one or more lenders offering a spectrum of loan “products” that vary in type, amount, term, and character and class of security. Certain lenders have developed an expertise in promptly and efficiently underwriting certain types of security (*e.g.*, hotel properties); others provide funding for specific purposes such as construction loans (see chap 9), bridge

§1.8 B. Other Consultants and Professionals

In addition to the loan broker (if any), borrower's counsel should assemble a team of other consultants or professionals, such as environmental consultants, mechanical and structural engineers, appraisers, title officers, and land surveyors, as needed to facilitate the procuring and closing of the loan. Before retaining any such party, however, counsel should prequalify them with the prospective lender, because its internal policies may govern their acceptability. For example, many lenders have a list of prequalified appraisers whose appraisals are generally accepted by the lender for purposes of calculating the loan amount.

When negotiating retention agreements with these consultants and professionals, borrower's counsel should require evidence of adequate insurance to support their indemnities of the borrower and oppose any undue limit on their liability.

§1.9 III. TYPES OF FINANCING TRANSACTIONS

Financing terms and underwriting criteria vary, depending on the purpose of the loan and the nature of the property securing it. The major types of commercial loan transactions include the following:

- Acquisition (see §§1.10–1.13);
- Construction (see chap 9);
- Refinancing (see §1.14);
- Bridge and gap financing (see §1.15); and
- Mezzanine financing (see §1.16).

§1.10 A. Acquisition

One of the more common real estate loan transactions is an “acquisition” loan. Generally, acquisition financing is the debt incurred by a buyer to finance the purchase of existing commercial property or property to be developed. On one hand, the lender's and the borrower's interests are closely aligned in an acquisition loan in that both parties are making an investment in the property, in which they hope to realize a profitable return. On the other hand, the borrower often desires a higher loan amount than the lender proposes because the borrower can maximize its return by minimizing its equity investment, while the lender seeks to minimize its risk through a more conservative loan-to-value ratio (see §1.44).

§1.11 1. Checklist: Due Diligence

Because the parties' investment objectives are aligned, the borrower's due diligence investigation should parallel that of the lender. Both the borrower and the lender should confirm the following information on the property being acquired:

- The operating history (*i.e.*, financial performance) of the property
- Its physical condition and prior use
- Its market value (generally by comparable sales or as a function of the property's cash flow)
- The continued enforceability of leases and service contracts, if any (or the ability to terminate them if so desired)
- The existence and status of all required licenses and permits
- Environmental compliance
- Zoning and other land use designations
- Title matters

For a detailed discussion of due diligence, see California Real Property Sales Transactions, chap 1 (4th ed Cal CEB 2007); for form due diligence checklists, see Real Property Sales, Apps B and C.

Recently, loan commitments have evolved (or devolved) into unenforceable "expressions of interest," or mere loan applications, deferring the lender's true commitment to lend until much later in the process (often, not until the final loan documents are fully negotiated). As a result, the borrower should be especially diligent in its evaluation of the business opportunity in order to avoid being obligated to purchase the property while the lender either denies the loan or offers a drastically reduced loan amount or a loan at an increased interest rate (commonly know as "resizing the loan"). For a detailed discussion of loan commitments, see chap 2.

§1.12 2. Seller Financing

Occasionally, to facilitate an acquisition, the seller takes back a promissory note for all or part of the purchase price secured by a deed of trust against the property purchased. Except on rare occasions when the seller is the only lender, seller financing is generally short term and secured by a junior lien. If the security is an existing commercial project, seller financing functions much like bridge or gap financing (see §1.15), allowing the buyer to purchase the property at the seller's desired price when the buyer's primary acquisition financing is

insufficient. If the security is unimproved property, sometimes the seller finances the land portion of the proposed development project, while the buyer looks to a more traditional source for the construction financing. In either event, the seller is required to subordinate its lien to the buyer's primary loan. If the seller is providing any financing, seller's counsel should inform the seller of the antideficiency protection afforded to buyers under CCP §580b, and buyer's counsel should advise the buyer about the exceptions to that protection. On drafting a deed of trust, see chap 4. For an extensive discussion of California's antideficiency statutes, see California Mortgage and Deed of Trust Practice, chaps 4–5 (3d ed Cal CEB 2000). For a detailed discussion of seller financing, see California Real Property Sales Transactions, chap 9 (4th ed Cal CEB 2007).

§1.13 3. Ground Leases

As an alternative to a land purchase, a prospective buyer might finance an acquisition by entering into a ground lease with the seller. Ground leases are most often used when the buyer intends to develop raw land. Like a financing seller, the ground lessor facilitates the acquisition (of possession, rather than title) of the property by financing the land component of the project. Also like a financing seller, the ground lessor must usually subordinate its interest in the ground lease to the lender providing development and construction financing. Unlike seller financing, however, ground leases are typically long-term arrangements, ranging from 25 to 99 years. For a detailed discussion of ground leases, see Ground Lease Practice (Cal CEB 1971).

§1.14 B. Refinancing

Refinancing an existing secured loan typically occurs for one or more of the following reasons:

- Availability of an increased loan amount or reduced interest rate;
- Changes in the amortization of principal; or
- Pending maturity of the existing loan.

When faced with upcoming maturity of the existing loan, the borrower will need to find replacement financing unless the borrower has sufficient capital from other sources to repay the loan or is willing and able to sell the property. Because refinancing normally involves significant expense (*e.g.*, loan fees, title premiums, escrow fees, consultant and legal fees, and, possibly, prepayment fees), the

borrower must carefully calculate the economic benefits of a new loan.

§1.15 C. Bridge and Gap Financing

“Bridge” and “gap” financing are terms used more or less interchangeably to describe loans that are typically meant for specific, short-term purposes to “bridge the gap” when the initial financing plan provides inadequate proceeds for the borrower’s needs.

Gap financing generally refers to financing that fills a temporary funding shortfall (*e.g.*, when the amount of the senior take-out loan is insufficient to pay off the construction loan). It is frequently secured by a junior deed of trust.

Financing for the period between the completion of construction and the acquisition of desirable permanent financing, before the property is leased (*e.g.*, new office building) or otherwise achieves stabilization (*e.g.*, new hotel), is usually called bridge financing, or sometimes a “mini-perm.” In this instance, the bridge loan has first priority and generally lasts three years or less. Bridge or gap financing is usually expensive because of the lender’s increased risk. Because the need for this type of financing is often unanticipated, the borrower has limited bargaining power to negotiate favorable terms or pricing.

§1.16 D. Mezzanine Financing

“Mezzanine” (*i.e.*, “middle”) financing resembles bridge or gap financing (*i.e.*, additional debt inserted between the first lien and the owner’s equity), but it usually serves a different purpose. The mezzanine debt structure is increasingly selected as an alternative to traditional financing (*i.e.*, 80 percent loan-to-value ratio, first deed of trust) because it provides a greater return to the borrower by using two tiers of debt, obtained from lenders with different investment objectives and tolerances for risk.

EXAMPLE 1 • Assume that a borrower wants to acquire a \$10 million property that has a cash flow of \$100,000 per month before debt service. If the borrower obtains a nonrecourse (see §1.51), first-lien loan for 80 percent of the value of the property (*i.e.*, \$8 million), the interest payments at 9 percent on the \$8 million loan would be \$60,000 per month, and the lender would bear the risk of any loss greater than 20 percent of the property’s initial market value if it is forced to foreclose after default. Alternatively, if the borrower obtains a first loan for only 60 percent of the property’s value (*i.e.*, \$6 million), the lender would be insulated from loss up to 40 percent of the property’s

initial market value, and thus might accept a 7-percent interest rate, resulting in interest payments of \$35,000 per month on the first loan. If the borrower obtains a mezzanine loan for the remaining \$2 million at 12 percent (because the mezzanine lender assumes the higher risk of loss), monthly interest would be an additional \$20,000, resulting in total monthly debt service of \$55,000, for a savings of \$5000 per month over traditional financing.

EXAMPLE 2 • Assume the same facts as in Example 1. As a further option, if the project's cash flow supports an adequate debt service coverage ratio (see §1.36) on the entire debt package, the borrower may be able to increase its leverage by obtaining a \$3 million mezzanine loan (instead of \$2 million) at 14 percent. In that event, the lender accepts a more aggressive loan-to-value ratio (the two loans together total 90 percent of the value of the property, instead of 80 percent) in return for the increased yield (double the 7-percent yield given to the more secure first lien holder). The financing structure outlined in this example provides an annual 36 percent (\$360,000 divided by \$1 million) cash on cash return to the borrower, which is a marked increase over the 27 percent (\$540,000 divided by \$2 million) return obtained in Example 1.

Often, the character of the mezzanine debt becomes something of a hybrid of debt and equity. For example, the first lienholder would probably require that debt service payments on the mezzanine loan be made only to the extent that cash flow is available (or possibly tied to a share in the equity) and that the security be limited to an interest in the borrower entity, instead of the real property. Mezzanine financing sometimes takes the form of a preferred equity investment, with the right to convert a passive interest into management and control as one of the lenders' remedies on default. There are many variations on this theme that may be used to achieve the objectives of the lenders and the borrower. Tax, accounting, and lender liability issues may also be involved, depending on the structure. See Murray, *Filling the Gaps: The Use of Mezzanine Financing in Real Property Transactions*, 15 Cal Real Prop J 3 (Summer 1997).

§1.17 IV. SOURCES OF FINANCING

The following sections (see §§1.18–1.24) provide an overview of the various types of lenders that customarily make commercial real estate loans and the types of loans favored by each. Certain lenders (*e.g.*, banks, savings and loans, and insurance companies) are subject

to regulations governing a number of issues, including the amount of money they may devote to commercial real estate loans—both in the aggregate and to any particular borrower. Regulated lenders may also be required to comply with certain underwriting guidelines (*e.g.*, appraisal) or periodically to recalculate reserves for loan losses based on the performance of their borrowers (whether or not in default), which requires ongoing monitoring of the borrower’s financial statements.

§1.18 A. Main Street Versus Wall Street: Portfolio Versus Conduit Lending

Traditional sources for nonconstruction commercial real estate financing include state or federally chartered banks and savings and loans, life insurance companies, and pension funds. These sources, known as Main Street lenders, typically hold a large proportion of the loans they originate in their portfolio of investments. These “portfolio” lenders are increasingly being replaced by (or are themselves becoming) lenders that underwrite, negotiate, and fund the loans, and then sell them to third party investors, such as mortgage bankers, financial institutions, or investment houses (Wall Street), which package pools of mortgages and deeds of trust into commercial mortgage-backed securities (CMBS). In this respect, the originators of these types of loans, which are not held in their portfolio for any appreciable length of time, are mere conduits. The term “conduit loan” is generally used in the Wall Street, or CMBS, context (see §1.33). Owing to the need for uniformity in conduit loan pools, there is typically little room for negotiation of underwriting criteria or loan documentation. Local commercial banks, savings banks, and thrifts (see §§1.19–1.20) continue, however, to make portfolio loans, as do insurance companies (see §1.21), pension funds (see §1.22), mortgage REITs (real estate investment trusts that invest in loans; see §1.23), credit companies (see §1.24), and other entities. The influence of conduit lenders on commercial lending, even in the portfolio context, is pervasive because Main Street lenders have largely adopted the underwriting and documentation policies of the conduit market. For a detailed discussion of conduit financing, see §§1.90–1.107 and chap 10.

§1.19 B. Commercial Banks

In the area of real estate finance, commercial banks have traditionally provided construction financing and relatively short-term permanent (“mini-perm”) financing for existing real estate projects in

their local market. Smaller, local commercial banks generally provide long-term real estate financing only to their corporate business clients as part of a package of services, including unsecured credit lines and financing secured by inventory or other personal property. In contrast, the larger state or national banks provide all types of financing services to consumers and businesses alike.

National banks are subject to supervision and regulation by the Office of the Comptroller of the Currency and are subject to the National Bank Act (12 USC §§1–216d). National banks may lend on the security of real property, subject to limitations prescribed by order, rule, or regulation of the Comptroller. 12 USC §§371(a), 1828(o); 12 CFR §§34.1–34.87. Although they are members of the Federal Reserve System and are insured by the Federal Deposit Insurance Corporation (FDIC), they are not subject to supervision or general regulation by the FDIC or the Board of Governors of the Federal Reserve System, but a limited number of specific regulations of the FDIC and the Board of Governors of the Federal Reserve System apply to national banks. See, *e.g.*, 12 USC §§3331–3351; 12 CFR §§34.61–34.62, 201.1–281.1, 365.1–365.2.

State banks that are members of the Federal Reserve System are subject to regulation and supervision by the Board of Governors of the Federal Reserve System and the California Department of Financial Institutions (DFI). State banks that are not members of the Federal Reserve System, but are insured by the FDIC, are subject to regulation and supervision by the FDIC and the DFI. The type and the terms of loans made by California banks are governed by Fin C §§1200–1382.

State and federally chartered banks (whether in or outside of California) and certain foreign banks are exempt from California's usury law. Cal Const art XV, §1. For a detailed discussion of usury, see §§3.37–3.44.

§1.20 C. Savings and Loans; Savings Banks; Thrifts

Savings and loan associations were created primarily to provide home financing to private consumers. Over time, they also became an important source of commercial real estate financing. The problems encountered by savings and loans in the 1980s (*e.g.*, massive write-offs in commercial real estate loans, losses from imprudent real estate investments, and costs of funds far exceeding return on existing, fixed-rate loans) decimated the industry, resulting in increased federal regulation (The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (Pub L 101–73, 103 Stat 73)) of both federal and state chartered savings and loans, savings banks, and thrifts. For

example, savings and loans, which were once permitted to leverage their capital as much as 33 times, are now limited to holding nonresidential real estate loans at no more than 4 times their capital base. 12 USC §1464(c)(2)(B).

Although the savings and loan industry is not the factor it once was, it continues to make both commercial real estate and traditional home loans, relying largely on consumer deposits as a funding source. Like banks, they are exempt from California's usury law. Cal Const art XV, §1. See §3.39.

§1.21 D. Life Insurance Companies

For decades, life insurance companies have been a mainstay in commercial real estate lending, frequently being a source for larger scale financings because of their typically large capital base. Although a number of life insurance companies continue to lend to individual commercial borrowers, an increasing portion of their real estate loan portfolio is in commercial mortgage-backed securities (conduit loan pools; see §§1.18, 10.1). These investments typically generate a higher yield than traditional insurance company investments (*e.g.*, government securities and corporate bonds) without requiring additional staffing to procure, underwrite, and administer individual loans and without tying up capital for a long period.

Life insurance companies are subject to state charters regulating their investment activity (including the types of loans made and underwriting standards) and are exempt from California usury laws. On regulation of insurance companies, see Ins C §§1190–1202; on exemption from usury laws, see Cal Const art XV, §1.

§1.22 E. Pension Plans

Pension plans are also an important source for commercial real estate financing, although their tolerance for risk is circumscribed by both internal policies and government regulations. See, *e.g.*, 29 CFR §2510.3–2(a). All “qualified plans,” including pension funds, are subject to the Employee Retirement Income Security Act (ERISA) (29 USC §§1001–1461), which adds another layer of complexity to the selection of borrowers and to loan documentation and limits the parties' flexibility in structuring the transaction. For example, the pension fund lender may impose ERISA requirements that affect the borrower's operations, such as prohibiting leases to certain tenants. See 29 USC §1106(1)(A); IRC §4975(c)(1)(A). See also 29 USC §§1101–1114.

See §3.39 for discussion of pension funds and usury.

§1.23 F. Mortgage REITs

Real estate investment trusts (REITs) are tax-advantaged investment vehicles that must follow strict guidelines to preserve their status. Some REITs invest in equity interests in real estate, while mortgage REITs make loans secured by real estate. The types and amounts of loans made by REITs are governed by the trust's internal documents, and federal tax laws limit the way mortgage REITs can structure their loan transactions. See IRC §§856–859.

EXAMPLE• A REIT may attempt to restrict how the borrower conducts its business (*e.g.*, limiting the borrower's sublease profit, common area maintenance profit, and other types of income). See IRC §§512, 856.

§1.24 G. Industrial Loan Companies; Finance Companies; Other Lenders

Industrial loan companies and finance or credit companies are regulated under California law but are exempt from California usury laws. See Fin C §§18000–18707, 22000–22780. See §3.39. Many other nonbank lenders, investment bankers, or even wealthy individuals are willing to make loans secured by real property.

Nonbank lenders (*e.g.*, mortgage bankers) who originate loans usually fund them from “warehouse” lines of credit (as opposed to their own capital or deposit accounts) and then resell the loans to others, either in pools or otherwise. These lines of credit are called “warehouse” because the originating lenders use the lines to fund loans that will be “stored” until the pool of loans is large enough to be sold and securitized in the CMBS market (see §§1.18, 1.33, 1.90–1.107; chap 10). Frequently, these warehouse lines are made available by the party that will purchase the pool of loans funded by the line of credit, and the proceeds are used to replenish the line. Sometimes the line cannot be used to fund a particular loan until it (including the yield on principal) is approved by, and the originating lender is otherwise in good standing with, the provider of the line. The further removed an originating lender is from the ultimate source of funds, the greater the risk that the loan funds will not be there at closing. Although the risk is greater in times of interest rate volatility, it is always in the borrower's best interest to know the lender.

§1.25 V. TERMS USED IN REAL PROPERTY FINANCING

To assist the reader in understanding the secured loan vernacular, and to provide a quick reference for the concepts discussed in detail in

this book, §§1.26–1.53 provide brief definitions of frequently used terms.

§1.26 A. Adjustable (or Variable) Pay Loan

Adjustable or variable pay loans have payment terms that permit different levels of debt service at different times. Loans for commercial buildings that are new to the market frequently contain variable pay rates that reflect the particular circumstances.

EXAMPLE• After the construction or rehabilitation phase of a project, there is usually a period of relative underperformance while the borrower seeks tenants. Before reaching full occupancy, the project may be able to pay interest only (or may not even be able to pay all of the interest accruing) for some time. By allowing interest-only payments before converting to an amortizing loan, an adjustable or variable pay loan recognizes the economic realities of the project securing the loan, while satisfying the lender's expectations of full debt service.

A variable pay loan may have either a fixed or an adjustable interest rate. See §1.27.

§1.27 B. Adjustable (or Variable) Rate Loan

Adjustable rate loans have interest rates that change over the term of the loan, based on the index rate to which the loan is tied. The most common indexes or reference rates used for adjustable rate loans include the prime rate (which varies among lenders), the London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds Index (COFI), and Treasury bills. The interest rate for the loan is calculated by adding basis points (see §1.29) or percentage points (the “spread” or “margin”) to the index or reference rate. For further discussion of adjustable rate loans, see §§1.76–1.77.

§1.28 C. Amortization

Amortization is the scheduled reduction of principal, paid in installments over time. As principal is reduced, the portion of any future installment payment allocable to interest on the principal is reduced accordingly. If the loan payment amount is fixed, the principal portion of each payment increases over time, further reducing interest accruals. Occasionally, commercial loans are fully amortizing, which means that the loan principal will have been paid in full at maturity. As a general rule, however, commercial loans are amortized over a 15- to 30-year period with a term of no more than 10

years, and sometimes as short as 3 years, thus requiring a balloon payment on the loan's due date. Although secured loans made by certain entities need not be amortized at all (*i.e.*, the payments consist of interest only), most lenders are required by the secondary market (*i.e.*, investors who buy existing loans) to make loans that amortize principal, thus increasing the security of the lender's position.

§1.29 D. Basis Points

One basis point is 1/100 of a percentage point. Generally, the term "basis points" is used in the context of a spread between an interest rate index (*e.g.*, prime or LIBOR; see §1.27) and the rate charged to the borrower.

EXAMPLE • A rate based on the six-month LIBOR of 6 percent plus 175 basis points would be 7.75 percent.

§1.30 E. Blanket Mortgage/Deed of Trust

Although true mortgages are rarely used in California, the term is often used interchangeably with deed of trust. See California Mortgage and Deed of Trust Practice, chap 1 (3d ed Cal CEB 2000). A blanket mortgage or deed of trust describes a single instrument that encumbers several parcels of land or, occasionally, secures more than one obligation. On problems peculiar to multiple security and multiple obligations, see Mortgage & Deed of Trust, chap 9.

§1.31 F. Bowtie Loan

A "bowtie loan" is a type of variable pay loan (see §1.26) under which the payments, at inception, are inadequate to pay all accruing interest. As the economic performance of the asset securing the loan increases, the payments increase, ultimately covering both interest and principal amortization. (If the loan payments and outstanding principal are plotted on a graph, the intersecting lines depict a bow tie.)

§1.32 G. Bullet Loan

A "bullet loan" is a short-term, nonamortizing or partially amortizing loan. The term "bullet" refers to the fact that the borrower will soon be facing a significant principal payment "bullet" that the borrower will have to refinance or otherwise repay, or risk default. Usually prevalent during periods of interest rate instability or uncertainty, bullet loans are used by lenders unwilling to commit

funds for an extended period and by borrowers willing to accept the refinancing risk in order to obtain short-term financing.

§1.33 H. Conduit Loan/Securitized Loan

Securitized or “conduit” loans are commercial loans that are pooled together and in which interests are sold as securities (commercial mortgage-backed securities, or “CMBS”) in the capital markets. Because the originating lender does not hold this type of loan in its portfolio, it acts as a “conduit” between the borrower and the ultimate source of the loan funds. To make commercial loans fungible, conduit loans are subject to stringent, uniform underwriting standards and conforming documentation. For a full discussion of conduit loans, see §§1.90–1.107 and chap 10.

§1.34 I. Convertible Loan

The term “convertible loan” has different meanings, depending on the context in which it is used. A convertible loan sometimes means a loan whose provisions change, depending on the status of the underlying security. For example, a loan may convert from a construction loan that has a high, variable interest rate, no current payments, and a short term, to a permanent loan with a lower, fixed interest rate, amortized payments, and a longer term, after the property becomes (or should become) income producing.

Another type of convertible loan gives the lender (or, sometimes, the borrower) the option to convert all or part of outstanding principal to an equity interest in the borrower. Although less common today, such loans have historically been popular when traditional interest rates are high or capital is scarce, when debt financing is either uneconomic or unavailable, or when an unconventional project presents a high risk to both lender and borrower but also presents an opportunity for very high returns if successful. See also §1.52 on shared appreciation loans. Occasionally, the convertible option is used in mezzanine financing schemes. On mezzanine financing, see §1.16.

§1.35 J. Cross-Collateral/Cross-Default

The concepts of cross-default and cross-collateral, often used in tandem, generally apply when a single lender carries more than one loan with the same borrower (or affiliates of that borrower). Cross-default in this context means that, if a borrower defaults under one loan with the lender (or any other obligation owed by the borrower to the lender), the borrower is also considered to be in default under one or more other loans. Other cross-default provisions consider a

borrower to be in default under a loan from its lender if the borrower is in default under a loan from an unrelated lender (whether or not that separate obligation is secured by property also securing the first lender's loan).

Cross-collateral means that, although certain described real property is security for one loan, it can also be called on to satisfy a different obligation owed to the same lender.

Cross-default and cross-collateral provisions are sometimes called "dragnet clauses" because they reach what would otherwise be unrelated obligations or collateral and tie them to the subject transaction. Lenders frequently insist on these provisions, but they do not benefit the borrower (except, arguably, by increasing the availability of financing to the borrower). Lenders expecting to include these provisions in documents evidencing or enforcing a loan should obtain the borrower's prior approval. See *Fischer v First Int'l Bank* (2003) 109 CA4th 1433, 1 CR3d 162.

§1.36 K. Debt Service Coverage Ratio

Debt service coverage ratio is the ratio between the annual debt service (principal and interest or, for capital leases, secured loan and lease payments) and the annual net operating income from the encumbered property. Along with loan-to-value ratio (see §1.44), debt service coverage ratio is a key underwriting criterion for lenders. Typically stated in relation to the number one (*e.g.*, 1.10 to 1, 1.15 to 1), debt service coverage ratio refers to a project's ability to pay debt service after paying all (or most) other regular expenses. A debt service coverage ratio of 1.10 to 1 means that the property's cash flow for a given period (*e.g.*, monthly or annually) exceeds debt service for the same period by 10 percent.

The ratio required by a lender will always exceed 1 because a lender always requires that cash flow be sufficient to pay debt service on a current basis. Generally, the amount by which a lender requires the ratio to exceed 1 depends on the perceived risk that the property's cash flow will decline in the future owing to business downturns, increased operating expenses, capital expenditure requirements, and the like. Sometimes, if the parties generally agree on the project's operating projections, the lender may accept a lower debt service coverage ratio (and a larger loan amount) if the borrower is willing to pay a higher interest rate.

§1.37 L. Earnout

“Earnout” refers to the ability of a project (*e.g.*, a new retail mall) to qualify for an additional principal disbursement previously negotiated under the loan documents. The operating performance of a project generally improves as the amount of leased space increases. When this improved performance reaches a certain point, the project “earns” additional principal (often representing a portion of the developer’s profit) that the lender was reluctant to disburse at the outset because of the uncertainty of the projected performance. Earnout loans, available from some portfolio lenders, provide greater flexibility than conduit loans, which typically extend for five years or more and prohibit prepayment. An earnout loan permits a borrower with an unseasoned project to incrementally increase its leverage (and the return on its equity) before stabilization, at which time the earnout loan is replaced.

§1.38 M. Grace Period

A grace period is the time following the stated due date during which a borrower may pay a scheduled installment without being considered in default or suffering any other sanction (*e.g.*, late charges, default interest). This period protects the borrower, who rarely wishes to pay early, when the payment is unexpectedly delayed (*e.g.*, slow mail). For negotiating techniques regarding grace periods, see §1.80.

§1.39 N. Guaranty

A guarantor is “one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor.” CC §2787. Lenders often request guaranties from interested third parties (*e.g.*, the borrower’s principals or affiliates) as added assurance for repayment of the debt and for performance of the borrower’s related obligations under the loan. The scope of a guaranty can range from a comprehensive guaranty of payment (including interest installments, the entire outstanding principal, and all other charges against the property, such as property taxes) to a mere affirmation of personal liability for certain limited exceptions to an otherwise nonrecourse loan (see §1.51).

The following are various types of guaranties:

- “Carry” guaranties are generally limited to scheduled interest payments or operating expenses related to the security for a specified period of time (usually some months beyond the maturity date), rather than any obligation to repay principal.

- “Bad boy” guaranties are limited to specified acts of wrongdoing, such as fraud or misrepresentation at the inception of the loan (in which case the guarantor would be liable for full repayment) or misapplication of insurance or condemnation proceeds (in which case the liability is limited to the misapplied amounts).
- “Springing” or “exploding” guaranties are frequently used to discourage the borrower (or any of its principals) from taking legal action to delay the lender’s realization on the security. See §6.45C.
 - Springing guaranties have no present effect on execution but become effective on the occurrence of a subsequent event considered prejudicial to the lender, such as a bankruptcy filing or contested foreclosure.
 - Exploding guaranties are valid on execution but expire on satisfaction of a condition subsequent, such as an uncontested foreclosure.

A guaranty is a common form of credit enhancement (see §1.59). Although guaranties are a valuable tool for both lender and borrower in procuring the most attractive loan from an economic standpoint, they expose both parties to substantial risks and should be carefully analyzed and negotiated as fully as circumstances permit. For a detailed discussion of guaranties, see chap 6; California Mortgage and Deed of Trust Practice, chap 8 (3d ed Cal CEB 2000).

§1.40 O. Impound Account

Impounds are regular deposits, paid together with scheduled debt service, to defray future property expenses such as taxes and insurance premiums. Impounds are sometimes established for other purposes, such as reserves. On reserve accounts, see §1.89. For negotiating techniques regarding impound accounts, see §1.88.

§1.41 P. Interest

Interest payable on a loan is the price paid to the lender for its extension of credit to the borrower. Interest is typically measured as an annual percentage of the principal balance of the loan, is payable in scheduled installments (*e.g.*, monthly, quarterly), and can be fixed or adjustable in rate. On adjustable (or variable) rates, see §1.27. For negotiating techniques regarding the interest rate, see §§1.75–1.77.

§1.42 Q. Loan Participation/Loan Syndicate

Occasionally, the size of the loan or the nature of the security indicates that the risk of the loan should be shared among several lenders, each of whom funds a portion of, or “participates” in, the loan. In a participated loan, the lead lender acts as the agent for the lender group, locates the loan opportunity, underwrites the loan, undertakes appropriate due diligence, negotiates the loan documents, and sometimes funds the entire principal (*i.e.*, “originates” the loan), which is partially repaid by the participants on syndication. (Participants may also purchase their respective interests concurrently with loan funding.) The lead lender always maintains a position in the participated loan, usually at least 25 percent. For undertaking this role, the lead lender receives compensation from the other lenders by keeping all or a substantial portion of the loan fees, retaining the loan servicing for an additional fee, or both. On loan servicing, see §1.43.

Loan syndicates are similar to participations in their origination and administration, but each lender in the syndicate is liable to the borrower to provide only its own commitment amount, adding yet another layer of complexity to the transaction. In a loan syndicate, the borrower must assure itself that each lender is ready, willing, and able to supply its share of the loan funds.

§1.43 R. Loan Servicing

“Loan servicing” is the administration of a loan after it has been funded. Loan servicing functions include keeping track of loan payments, assuring that real property taxes and hazard insurance premiums are paid, confirming compliance with operating covenants, and handling loan default situations. In the recent past, commercial loans were typically kept in the portfolio of the originating lender, who customarily serviced its own loan. Today, the loan servicing function is often divorced from the loan holder and is performed by a separate or related entity known as a “loan servicer.” The loan holder sacrifices a fraction of an interest point for the convenience of simply depositing the loan payments collected by the loan servicer. In conduit financing (see §§1.33, 10.1), loan servicing is never handled by the holders of interests in the mortgage pool, and the originating lender frequently retains the right to service the loan.

§1.43A S. Loan-to-Cost Ratio

“Loan-to-cost” is the ratio of the maximum amount the lender is willing to loan to the total construction costs, stated as a percentage. See §9.4.

§1.44 T. Loan-to-Value Ratio

“Loan-to-value” is the ratio of the loan amount to the estimated value of the encumbered real property (set by the lender or an independent appraiser), stated as a percentage.

EXAMPLE • If a lender requires an 80-percent loan-to-value ratio, and the estimated value of the property is \$1 million, the loan amount will not exceed \$800,000 (80 percent of \$1 million).

Because the property is the main (and sometimes only) recourse for the lender if the borrower fails to repay the loan (see §1.51), the required loan-to-value ratio is always less than 100 percent. Lenders accept a higher loan-to-value ratio for stabilized, improved commercial property than for raw land or property being (or only recently) developed, to reflect the relatively limited market for real property that is not income producing.

A prudent loan-to-value ratio provides a cushion to the lender if the encumbered property is overvalued when the loan is made, or if the value declines in an economic downturn. It also assures that the borrower has an ongoing interest in the viability of the property because a substantial portion of the borrower’s equity remains tied up in the property.

§1.45 U. Lock Box

A “lock box” is a common mechanism in conduit loans in which the cash receipts are swept from the borrower’s operating account on a regular basis (as often as every business day) into a bank account that is in the borrower’s name but is controlled by the lender. The funds in the account are administered by the loan servicer in accordance with a cash management agreement among the lender, the borrower, and the bank holding the account. Expenses relating to the real property security, including debt service, tax and insurance impounds, and deposits to reserves, are paid directly from this account; the remainder is made available to the borrower for cash flow purposes. Since the lock box assures the lender that operating revenues will be properly applied, it is even used in operating businesses (*e.g.*, office complexes, retail shopping centers, or hotels), even though it can make the borrower’s cash flow management extremely difficult. It is ineffective in owner-user situations.

§1.46 V. Lock-In Clause

A “lock-in clause” in a loan prohibits (or makes prohibitively expensive) loan prepayment before the expiration of a certain period (*e.g.*, before the date when a CMBS loan is securitized) or before the

scheduled maturity date. When paired with a due-on-sale clause and a due-on-encumbrance clause (both common in commercial real property loans—sometimes collectively called a due-on-transfer clause), a lock-in clause prevents a borrower from either extracting surplus equity from the property or refinancing to take advantage of lower interest rates: the borrower is “locked in.”

§1.47 W. Mezzanine Financing

“Mezzanine financing” is financing provided between the borrower’s equity and debt secured by a first deed of trust, frequently taking on the characteristics of both debt and equity. See §1.16.

§1.48 X. Pay Rate

“Pay rate” is the regularly scheduled debt service required under the loan. Although most repayment schemes incorporate amortization (retirement) (see §1.28) of principal and interest, the pay rate occasionally varies to accommodate the borrower’s business plan or the economic realities of the real estate project securing the loan.

EXAMPLE• If the long-term prospects for the project are strong but the short-term cash flow is weak, the pay rate may provide for payments of interest only, or even partial interest (negative amortization), in the short term (*e.g.*, during a lease-up period).

On loans with variable pay rates, see §1.26.

§1.49 Y. Points/Loan Fees

In addition to interest, commercial lenders almost always charge loan fees, which are generally expressed as “points.” Each point equals 1 percent of the total loan amount. For example, a 2.5 point fee on a \$1 million loan is \$25,000. Points effectively raise the lender’s yield because interest is earned on the gross loan amount even though the actual amount disbursed to the borrower is net of the points paid. Normally, points are also paid to the loan broker (if any) who arranged the loan.

§1.50 Z. Prepayment

“Prepayment” is the payment of loan principal before the scheduled maturity date. Although it may appear counterintuitive, a borrower has no inherent legal right to repay its debt before the time specified in the promissory note. *Gutzi Assocs. v Switzer* (1989) 215 CA3d 1636, 1644, 264 CR 538. See also CC §1490.

Prepayment rights are often conditioned on the borrower's payment of a fee. On calculating prepayment premiums, see §§1.86, 3.32. On prepayment generally, see §§3.22–3.34.

§1.51 AA. Recourse/Nonrecourse

The term “recourse” means that the borrower has personal liability for the loan, thus permitting a deficiency judgment against the borrower if the property is sold at a judicial foreclosure sale for less than the amount owed to the lender. In a nonrecourse loan, the borrower has no personal liability and the lender's only recourse on default is foreclosure and sale of the property. Even in nonrecourse loans, however, borrowers are often personally liable for losses suffered by the lender as a result of improper conduct (*e.g.*, fraud, waste, misappropriation of funds), or for environmental damages (see §1.83). Commercial real property financing is frequently, but not always, nonrecourse.

§1.52 BB. Shared Appreciation Loan

In a “shared appreciation loan,” the lender receives a share of the expected increase in the value of the security during the loan term, in addition to the stated (usually fixed) rate of interest in the promissory note. If interest rates for a conventional loan are too high for the property to service, but the property is expected to appreciate substantially, the borrower may wish to give the lender a portion of the future appreciation in exchange for a lower interest rate. The lender, in return, receives a greater yield on its principal because the cash participation (when realized) is added to interest received over the term of the loan. Historically popular in times of tight capital or high interest rates, shared appreciation loans generally fall out of favor when loans are easily available and lenders are less apprehensive about interest rate volatility.

Tension can arise between the parties to a shared appreciation loan if the property performs well early in the loan term and the lender realizes its share of the capital appreciation only on sale, refinance, or maturity of the note. In that event, the lender wants the right to force a sale or refinancing, which could sharply reduce the borrower’s return.

In lieu of a share of capital appreciation, the lender may be allocated a portion of the project’s cash flow, which is analogous to an investor’s preferred return, in addition to the stated interest on the loan. Despite the recent relative stability in interest rates, the shared appreciation concept has become popular again as an alternative way to compensate mezzanine lenders. On mezzanine financing, see §1.16. The usury issues that shared appreciation loans would otherwise raise are largely addressed by CC §1917.005.

§1.53 CC. Wraparound Deed of Trust/All-Inclusive Deed of Trust

A wraparound deed of trust is a security instrument that contemplates a subordinate loan arrangement between lender and borrower in which the payments required to be made to the wraparound lender include debt service on senior secured debt. The obligation includes or “wraps around” the principal amount of the senior loan, and payment of the obligation is “all inclusive” of the payments due under the senior loan.

Wraparound financing was popular in the late 1970s and early 1980s when interest rates rose into the high teens and sellers, in essence, sold the existing financing along with the property. Largely because of the increased incidence (and more certain enforceability) of

due-on-sale and due-on-encumbrance clauses, wraparound financing is rarely used in commercial loan practice today. (Due-on-sale clauses are usually fully enforceable according to their terms under the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97-320, 96 Stat 1469)).

For further discussion of wraparound and all-inclusive deeds of trust, see California Mortgage and Deed of Trust Practice, chap 9 (3d ed Cal CEB 2000).

VI. ROLE OF COUNSEL

§1.54 A. Importance of Early Involvement

The importance of counsel's participation (representing either the borrower or the lender) early in the loan process cannot be overemphasized. Several crucial issues arise at the outset of a transaction that, if ignored or decided without the proper level of analysis, could prove prejudicial to one of the parties or fatal to the transaction as initially conceived. All too often, counsel is first contacted after the loan commitment is executed, which usually means that most of the fundamental business and legal issues have been agreed on. Presented with a *fait accompli*, the lawyer's role is reduced to merely implementing the agreement expressed in the loan commitment. Although this role is still important, counsel's expertise is not being used to its full advantage. A prudent borrower or lender will obtain counsel's analysis and advice on the terms of the loan commitment *before* executing it, because several things generally happen on execution of the commitment:

- The parties expect the transaction to close as and when contemplated, without significant changes in the terms expressed in the commitment;
- The borrower has incurred a substantial commitment fee; and
- The borrower has obligated itself to defray due diligence expenses.

For a full discussion of loan commitments and the attorney's role in negotiating and drafting them, see chap 2.

§1.55 1. Structuring the Transaction

The lender's attorney is often instrumental in structuring the financing transaction. Besides ensuring that the transaction meets the lender's internal requirements, the attorney must ensure that the loan, including the collateral pledged by the borrower or third parties and any guaranties provided to the lender, is designed not to interfere with

the lender's remedies on default. For example, the attorney must be sure that the loan and the collateral package are structured with a view toward limits imposed on enforcement by the California one-action and other antideficiency rules, as well as limits imposed by California law on the enforceability of guaranties. See, respectively, California Mortgage and Deed of Trust Practice, chaps 4–5, 9 (3d ed Cal CEB 2000). The lender's attorney must also be mindful of regulatory restrictions affecting the lender.

Although the lender's attorney is usually responsible for structuring the transaction and drafting the loan documents, the borrower's counsel is usually responsible for coordinating matters required to close the loan, including obtaining any required third party consents, furnishing the required due diligence information, and resolving title insurance issues. On due diligence and title issues, see §1.70.

§1.56 2. Preparing Initial Drafts

Lenders usually require that their own loan document forms be used, and the lender's attorney is ordinarily responsible for preparing initial drafts of the documents. Borrowers' attorneys rarely, if ever, draft the documents. The lender's attorney should ascertain whether the client has a preferred set of forms for its transactions; most institutional lenders, including banks, life insurance companies, and pension funds, have developed their own form documents. Nonetheless, counsel should be vigilant in confirming that the documents comply with current California law and in adapting the forms to reflect the terms of the specific transaction. Noninstitutional lenders are less likely to insist on using their own loan forms and often rely on their counsel to recommend the forms.

The role of the borrower's attorney is to review the lender's documents, comment on the provisions, and decide which issues should be negotiated. Because the lender may reject proposed changes, the borrower's attorney must advise the client of the effect of the form provision if the client elects to proceed to closing.

§1.57 3. Use of Standard and Computerized Forms

Some financial institutions use standard printed forms developed by trade associations and other organizations. Private lenders sometimes use printed forms distributed by title insurance companies. Although these forms might be acceptable for relatively simple transactions, they are seldom used for more sophisticated loans. Even in simple transactions, counsel often needs to prepare addendums to the

documents to include additional provisions (*e.g.*, due-on-sale clauses, prepayment provisions, and late charges).

Besides using standard forms, some institutions, such as smaller banks and middle-market lenders, purchase software capable of generating basic loan documents with alternative provisions available to the lender. Although these programs might be acceptable for relatively straightforward, nonnegotiated transactions, they are rarely used for complex financings or sophisticated transactions. The attorney working with computerized forms must usually prepare addendums to supplement the forms and to reflect the terms of a particular loan transaction.

§1.58 B. Usury

California's usury law regulates the interest rate that can be charged by lenders that are not exempt from that law. The California Constitution prohibits lenders in commercial transactions from charging more than the higher of 10 percent per annum or 5 percent per annum in excess of the rate established by the Federal Reserve Bank of San Francisco for advances to its member banks (commonly called the "discount rate"). Cal Const art XV, §1.

The usury issue affects the lender because it may incur severe penalties if it violates the usury restrictions. The borrower may avoid *all* interest payable under the obligation, not just the usurious portion (*Winnett v Roberts* (1986) 179 CA3d 909, 225 CR 82), and may be entitled to recover treble damages on interest actually paid (*Wheeler v Superior Mortgage Co.* (1961) 196 CA2d 822, 17 CR 291). Moreover, any lender accepting usurious interest is guilty of a crime. West's CC §1916-3(b) (uncodified). Usury also concerns the borrower because the lender customarily requires the borrower's counsel to provide a written opinion that the transaction is not usurious. The analysis of the usury issue requires more than simply looking at the stated interest rate, because certain other monies paid to a lender (*e.g.*, fees paid to a lender for originating the loan) could be characterized as additional interest. See, *e.g.*, *Forte v Nolfi* (1972) 25 CA3d 656, 102 CR 455. Counsel for both borrower and lender should ascertain either that the compensation paid to the lender does not exceed the maximum permitted or that the lender or transaction is exempt. For a thorough discussion of usury, including the statutory and constitutional exemptions from usury restrictions, see §§3.37- 3.44. For a list of exempt loans and lenders, see §3.39. See also Lind, *A Real Estate Attorney's Guide to California Usury Laws*, 18 CEB Real Prop L Rep 271 (Oct. 1995).

§1.59 C. Credit Enhancement

To obtain the most favorable interest rate (or, in some cases, just to obtain the loan), the borrower may be required to provide additional assurances to the lender that the loan will be repaid as scheduled. The broad category of these devices is known as “credit enhancement.” Credit enhancement can involve letters of credit, cash security, personal guaranties, and occasionally additional real property security. Counsel for both lender and borrower should discuss the nature of the additional security and whether the borrower is willing or able to comply. Skillful counsel on both sides can provide a valuable service to their clients in negotiating mutually agreeable security arrangements that reduce the lender’s risk to an acceptable level while addressing the borrower’s legitimate economic and other concerns. For negotiating techniques regarding various forms of credit enhancement, see §1.82.

§1.60 D. Concerns of Lender’s Counsel

Lender’s counsel should consult the later chapters of this book for guidance on drafting the documents that evidence and secure the loan. Other issues, however, should be addressed early in the process. Depending on the lender’s level of sophistication, counsel may be asked to advise the lender on several issues that might be considered business, rather than legal, matters. Examples of such issues are discussed in §§1.61–1.66.

§1.61 1. Title Matters

A primary concern of lender’s counsel is to confirm that the party executing the deed of trust securing the debt (usually the borrower) actually owns the security, as sole owner, with no senior liens or encumbrances except those acceptable to the lender. Occasionally, the party offering the security for the borrower’s benefit is not the borrower (an accommodation party). The use of an accommodation party complicates collection remedies for the lender and should be approached with caution. For further discussion, see also §4.3.

§1.62 a. Preliminary Report

Lender’s counsel must scrutinize a preliminary report (or title commitment), together with copies of all enumerated exceptions (as opposed to the standard printed exceptions) in the report, to evaluate any covenants, conditions, restrictions, easements (both dominant and servient), or other matters affecting title. Because the lender may

ultimately take title, or rely on the cash bid of a third party at a foreclosure sale, counsel should confirm that marketable title of the property can be conveyed to any subsequent owner. On review and analysis of preliminary reports, see California Title Insurance Practice, chap 5 (2d ed Cal CEB 1997).

§1.63 b. ALTA Survey

Nearly every commercial loan transaction justifies (or requires by regulation) the preparation and analysis of an American Land Title Association (ALTA) survey, which graphically depicts the location of improvements, easements, and encroachments. In reviewing an ALTA survey, the primary concerns of lender's counsel are to confirm that

- the property described in the preliminary report and the property depicted in the survey are one and the same;
- the property is one or more legal lots (and if more than one lot, that they are contiguous);
- the improvements on the property do not encroach on easements within the property, or on setback lines or neighboring properties;
- improvements on adjacent parcels do not encroach on the property or its appurtenant easements;
- the property has adequate parking to serve its needs and to comply with local regulations;
- adequate vehicular access is available to the property; and
- all necessary utilities are available to the property line (*e.g.*, check for meters, junction boxes, etc.).

Counsel should also confirm (as with all consultants on whose reports the lender will rely) that the civil engineer preparing the report has sufficient financial resources and insurance to answer for any claim resulting from errors and omissions on the ALTA survey.

On ALTA surveys, see California Title Insurance Practice, chap 4 (2d ed Cal CEB 1997).

§1.64 c. Common Endorsements

Lender's counsel should routinely ask for certain endorsements to title coverage (at borrower's expense) to indemnify the lender against losses or claims relating to the following:

- Mechanics' liens;
- Encroachments or easements on adjoining property;
- The effect of recorded covenants, conditions, and restrictions;

- Oil, gas, and mineral rights (if the title review reveals that these rights are not fully held by the borrower);
- Contiguity of the parcels composing the property;
- Variations between the property as described in the policy and as shown on the ALTA survey;
- Lack of street access;
- Subdivision Map Act violations; and
- Usury.

Zoning endorsements are also frequently requested, although borrowers increasingly resist providing them because of their exorbitant cost. In that event, the lender may seek other reasonable assurances (*e.g.*, certificates of occupancy, zoning letters from the local agency, or legal opinions). In addition, the increasing relevance of mezzanine financing has brought on the development of mezzanine specific endorsements which incorporate “Fairway” and non-importation endorsements. On lenders’ policies and these and other lender endorsements, see California Title Insurance Practice, chap 8 (2d ed Cal CEB 1997). See also Cruz & Rogers, *Commercial Title Endorsements*, 22 Cal Real Prop J 4 (Spring 2004).

§1.65 2. Hazardous Substances

In the recent past, the presence of hazardous substances on property offered as security could automatically disqualify the property as collateral for a loan. Although this is no longer true, the preparation and review of environmental assessments are absolutely essential to the underwriting of a commercial loan. On most occasions, the least intrusive report, commonly known as a “Phase I,” is prepared at the borrower’s expense by a consultant approved by the lender. A Phase I assessment typically includes the following:

- A visual inspection of the site, and interviews of onsite property management personnel in order to examine the property’s present use, the composition of building materials, and evidence of improper disposal of hazardous waste;
- A search of city, county, state, and federal databases for relevant information on the property and adjacent property for conditions that have (or could have) an effect on the project, such as leaking underground storage tanks; and
- A historical review of the property from available sources, including aerial photographs.

If the Phase I report uncovers any environmental problems, the report generally contains recommendations for methods of further investigation (known as Phase II), such as air sample monitoring (for asbestos) or drilling to ascertain the composition of soils or groundwater. On Phase I and Phase II reports, see California Real Property Sales Transactions, chap 7 (4th ed Cal CEB 2007).

Lender's counsel should confirm that a competent, thorough, and appropriately licensed consultant prepares the report. In addition, environmental consultants often incorporate into their retention agreements unreasonable limitations of liability, sometimes limiting their exposure for a negligently prepared report to the amount of their fee. (If the report is wrong, it's free.) Counsel should reject such a provision and confirm that the consultant has the financial ability or appropriate errors and omissions insurance to satisfy any reasonable liability claim. Counsel should either ensure that the report is assignable to the lender or at least have the consultant acknowledge that the lender will rely on the report.

§1.66 3. Borrowing Entity

The lender is interested in the borrower's choice of entity because it affects the remedies available to the lender in the event of default, particularly if the loan is made on a recourse basis (see §1.51). Only the persons or entities that sign the promissory note (or a guaranty) will be personally liable for repayment of the loan, subject to any nonrecourse provision in the note (see §1.51) and subject to the one-action, security-first, and antideficiency rules of California law. Thus, to the extent a loan is made on a recourse basis to a borrower composed of one or more individuals, those individuals will be jointly and severally liable for payment of any deficiency on the debt if the lender judicially forecloses. But if the borrower is a corporation or a limited liability company, then only that entity will be liable for repayment of the loan, and the individuals owning the equity in the borrower will generally be shielded from personal liability, no matter what remedy the lender chooses, unless any of those individuals guaranteed the loan. See chap 6 on advantages and pitfalls facing a lender in obtaining guaranties of secured loans. For further discussion of the one-action rule, antideficiency statutes, and guaranties, see California Mortgage and Deed of Trust Practice, chaps 4–5, 9 (3d ed Cal CEB 2000).

Lender's counsel should have a candid discussion with the lender to ascertain its expectations in the event of a loan default and to confirm that the lender understands the impact of California's one-action, security-first, and antideficiency rules. These issues will influence the

lender's requirements for the type of borrower entity and credit enhancement, as well as the lender's pursuit of remedies in a default.

In a conduit loan, the rating agencies dictate the type of borrowing entity that may obtain the loan, and neither lender's nor borrower's counsel will have the leverage to vary from that determination. For further discussion of this issue, see §§1.96, 10.7.

Lender's counsel should inquire about the marital status of individual borrowers even if the loan is clearly for commercial purposes. Although borrowers generally may encumber fractional interests in real property, if the real property security for a business loan is held as community property, a nonconsenting spouse may invalidate the lien of a deed of trust *in its entirety* even if it purports to encumber only the community property interest of the borrower spouse. Fam C §§1100, 1102; *Droeger v Friedman, Sloan & Ross* (1991) 54 C3d 26, 283 CR 584.

PRACTICE TIP • To protect itself, the lender may insist on a spousal waiver (confirming that the collateral is the separate property of the signing spouse and waiving any claim to the contrary) or a spousal consent (consenting to, and joining in, the encumbrance of the community property).

If record title is held by the signing spouse alone and the lender proceeds in good faith without knowledge of the marriage, the encumbrance will be presumed valid under Fam C §1102(c)(2) and the other spouse will have only one year after the recordation of the encumbrance to bring an action to attempt to invalidate it. Fam C §1102(d).

§1.67 E. Concerns of Borrower's Counsel

The negotiating posture of borrower's counsel is inevitably reactive. Unlike purchase and sale agreements, which counsel may prepare for either party (with wholesale changes frequently made by the other party), real estate loan documents are almost always presented on the lender's standard forms. See §1.56. Although requests for changes are not futile, the issues are always framed in the lender's context and concessions are not granted easily. Occasionally, depending on the type of lender and the state of the market, the role of borrower's counsel is largely reduced to a series of cautions to the borrower about its duties under the loan documents (in addition to repayment) and the risks to the borrower on a breach (intentional or unintentional) of those duties.

Borrower's counsel should address the preliminary considerations discussed in §§1.68–1.70 as early as possible in the loan process. For

more detailed discussion of negotiating techniques for borrower's counsel, see §§1.72–1.89.

§1.68 1. Exit Strategy

Although the borrower and the lender focus primarily on procuring and funding the loan, each party should consider the circumstances at the other end of the transaction (*i.e.*, loan payoff or default) to develop an exit strategy.

Typically, a lender has predictable expectations of repayment at maturity or of recovery after loan default (*e.g.*, realization on the security or recourse to other assets through guaranties) that are set forth in the loan documents. Often, however, the borrower fails to fully understand that business considerations might dictate prepayment (see §1.50) or that the lender's exercise of its remedies could result in much more than the loss of the primary security. If interest rates fall substantially during an extended loan term, prepayment fees or charges or prohibitions could put the borrower at a competitive disadvantage, especially if the borrower wishes to sell the property to take advantage of a favorable real estate market. Unless the loan either permits prepayment (with little or no penalty) or is transferable on a sale (*i.e.*, does not include a due-on-sale clause or permits a one-time transfer on payment of a reasonable fee), a sale may be less attractive to the borrower because it would effectively transfer a substantial amount of the borrower's equity to the lender.

Conduit financing has made a huge supply of loan funds available to the borrower at low, fixed-interest rates. In exchange for this benefit, the borrower is locked into the loan for the full term by the prohibition on prepayment. The conduit loan market has attempted to address this golden handcuff aspect of its financing by introducing the concept of "defeasance," which replaces the lender's real property security with United States government securities presumably purchased with refinancing or sale proceeds. For further discussion of defeasance, see §§1.105, 10.21, 3.24A.

§1.69 2. Borrowing Entity

Although loan commitments frequently permit assignment to the borrower's affiliated entities, counsel should consider the type of business entity (and its domicile) used by the borrower. The choice of business organization involves several tax and operating issues, and state statutes vary in their requirements for internal governance of any particular entity.

Because insulation from liability is often the key concern, counsel should advise the borrower of the evolving nature of nonrecourse loans (see §1.51). Although commercial loans continue to be primarily nonrecourse, the borrower's exculpation is limited, and lenders regularly carve out exceptions for fraud and misrepresentation, waste, environmental matters (typically covered in a separate indemnity), misappropriation of rents, misapplication of insurance and condemnation proceeds, and other matters. Often, unless the borrower has substantial assets in addition to the encumbered real property, the lender requires the personal liability of a creditworthy person or entity (usually, one or more of the ultimate owners of the borrower entity; see chap 5A), or other credit enhancement as a condition of funding the loan. Each requirement effectively undermines the limited liability provided by the borrower's organizational documents.

For discussion of the restrictions on borrower entities imposed by conduit lenders, see §§1.96, 10.14–10.17.

§1.70 3. Title Issues; Environmental Concerns; Due Diligence

If possible, borrower's counsel should review the condition of title before its client executes the loan commitment. Procuring a preliminary report is relatively quick and inexpensive, and counsel should be confident that the condition of title will be acceptable to the lender before the borrower pays a substantial commitment fee. For a detailed discussion of preliminary reports, see California Title Insurance Practice, chap 5 (2d ed Cal CEB 1997).

In addition, although environmental issues no longer automatically disqualify properties, lenders have justifiable concerns about hazardous materials located on, or in the vicinity of, the prospective security. If the borrower has access to a preexisting environmental report (*e.g.*, a report obtained by the borrower when it acquired the property), borrower's counsel should become familiar with any issues raised in that report. If no such report is available, it may make sense for the borrower to obtain a current Phase I report (from a consultant on the lender's approved list) even before the commitment is signed. Although a Phase I report can be expensive, that cost is usually less than the loan fees the borrower will become obligated to pay on signing the loan commitment, and may alert the borrower to issues likely to concern the lender.

Inevitably, the lender will require the borrower to provide a separate environmental indemnity at the loan closing (see chap 5A; for form, see §5A.12). Often, such indemnities are drafted so broadly as to subject the borrower (and often its principals) to expansive and

eternal prospective liability for a host of environmental occurrences. At the outset, borrower's counsel should attempt to insulate, if possible, any individual liability under the indemnity, especially when a "clean" Phase I report has been delivered to the lender and the commercial use of the property is unlikely to present any material environmental risk. Any representation made to the lender about the condition of the property should be subject to the matters disclosed in the environmental reports prepared as part of the due diligence process. Covenants on hazardous materials should permit the lawful use of products used in the normal course of the borrower's business. The borrower should be permitted to contest any demand for compliance or remediation, or any claim against the property under environmental or hazardous materials laws, if the lender's interests are reasonably protected.

The lender should not require updated environmental audits unless it has reasonable cause to believe that the property is in violation of environmental law. The indemnity should not extend to losses resulting from activities undertaken by the lender or any successor to the lender, including one taking title at a foreclosure sale. Although standard environmental indemnities provide for the survival of the indemnity after the satisfaction of the loan (through payoff or foreclosure), the borrower's provision of a "clean" Phase I report should suffice to terminate the indemnity.

Ideally, counsel should also have a general understanding of the borrower's business and the applicable licenses and permits, leases, franchises, and service contracts affecting the property to be secured.

§1.71 4. Other Issues of Concern to Borrower

In addition to the issues described in §§1.68–1.70 and the basic economic terms discussed in §§1.74–1.89, other issues of concern to the borrower include the following:

- The borrower's right to a full or partial refund of application and commitment fees and deposits if the loan does not close for any reason beyond the borrower's control;
- The scope of obligations secured by the deed of trust or other security instruments in the lender's favor;
- The reasonableness of costs (including attorney fees) and approval standards for other lender decisions (*e.g.*, sole discretion or reasonable judgment);
- Restrictions on leasing, including the scope of the lender's approval of leases;

- Restrictions on alterations, including scope of the lender's approval of alterations;
- Rights to and application of casualty insurance proceeds (*e.g.*, borrower's right to use proceeds to repair or rebuild damaged property versus lender's right to apply proceeds to pay down the loan);
- Rights to and application of condemnation awards (for both total and partial takings); and
- The borrower's right to contest involuntary liens, property taxes and assessments, alleged violations of the law, and similar matters.

VII. NEGOTIATING TECHNIQUES

§1.72 A. Commonly Negotiable Terms

In virtually every commercial loan transaction, regardless of the relative bargaining strength of borrower and lender, some loan terms will be subject to negotiation. The terms that are usually negotiable are discussed in §§1.74–1.89.

The most crucial issues to the borrower are best negotiated before the lender issues a loan commitment, and sometimes even before an application is submitted, because most lenders have an institutional (rather than an entrepreneurial) culture. Once the transaction is presented in writing to the lender's credit or investment committee with certain parameters, it is limited by those terms and becomes difficult to change. Further, because the loan documents are almost always prepared by lender's counsel, borrower's counsel is consigned to a responsive posture on any issues not addressed before the loan documents are first drawn. On the importance of counsel's early involvement in the negotiating process, see §§1.54, 2.2.

§1.73 B. Negotiating Mindset: Basic Goals of Lender and Borrower

A prudent practitioner will look beyond the minutiae of the lender's standard loan documents and take a broad view of the parties' respective desires. As in any business transaction, if the parties view their negotiations as a cooperative venture, with each party considering its own goals in the context of the legitimate goals of the other, solutions often appear. The lender's objective is to have the loan proceeds repaid as scheduled, together with a return on the funds that matches its perception of the risk in making the loan. Because this goal is not always met, the lender wants to have prompt access to

adequate real estate security, or other means of recovering the amounts owed (*e.g.*, personal guaranties), to obtain the benefit of its bargain. The borrower's objective is to obtain adequate funding at a reasonable rate and with the least risk (minimal security/credit enhancement), while retaining maximum flexibility in operating and disposing of its property. Each major issue in the loan documents should be negotiated with a view toward satisfying all these objectives. Frequently, they can be met by one or more alternative approaches.

§1.74 C. Loan Amount

The principal amount of a loan is typically a function of both the net operating income of the encumbered property and the property's market value. Most institutional lenders require that an independent, qualified appraiser, familiar with the type of property offered as security, evaluate the property. Often, the loan commitment states that the proposed loan amount is subject to confirmation by appraisal and, if the amount of the valuation is less than expected, the loan terms may be modified or the principal amount reduced. The lack of an adequate appraisal may even nullify the loan. To avoid this situation, the borrower should have a realistic opinion of the value of its property before paying a commitment fee and deposit against due diligence (including appraisal) expenses.

The debt service coverage ratio (see §1.36) is based on the property's net operating income, and the loan-to-value ratio (see §1.44) is based on the value of the property. As a rule, the required ratios vary among lenders and are affected by property type. Even after the ratios are established and a preliminary loan amount is proposed, that amount can be changed to satisfy both lender and borrower. For example, if the lender disagrees with the appraised value of the property but is otherwise satisfied with debt service coverage, the borrower may consider offering a credit enhancement, such as additional collateral or a personal guaranty, which could be released or canceled, respectively, on the achievement of some future benchmark valuation.

Another approach is to consider the lender's perceived risk and the interest rate necessary to offset that risk. Depending on the type of lender and the market it wishes to serve, the lender may be willing to increase the loan amount in exchange for a higher interest rate. Alternatively, the lender might agree to lower the interest rate during the term of the loan after an objective operating benchmark is reached (*e.g.*, when the property is fully leased).

§1.75 D. Interest Rate

As discussed in §1.74, the interest rate and the loan amount can be negotiated in tandem (within the parameters of the prevailing market) to achieve a mutually agreeable loan transaction. Similarly, the borrower may obtain a lower interest rate if the lender obtains sufficient collateral, some credit enhancement, and perhaps a series of operating covenants that help assure borrower prudence and increase the likelihood of timely loan payments.

§1.76 1. Fixed Versus Variable Interest Rate

Interest is calculated on either a fixed rate or a variable (“floating”) rate. In a convertible loan (see §1.34), the borrower may have the option to convert a floating interest rate to a fixed rate at some time during the term. In choosing a fixed rate, both the lender and the borrower assume interest rate risk in exchange for certainty. Interest rate risk means the risk of a lost opportunity for the lender to lend funds at a higher rate if interest rates rise in the market, or for the borrower to borrow funds at a lower rate if interest rates fall.

§1.77 2. Advantages and Risks of Variable Rates

A borrower choosing an adjustable interest rate takes the risk that rates will fluctuate during the loan term. If rates rise, the scheduled payments must increase if the principal is to be repaid on time under the agreed amortization (see §1.28). If rates fall, the borrower can reduce its payments while maintaining a steady amortization schedule.

Adjustable rate loans (see §1.27) usually require an immediate change in the next installment payment when the reference rate changes. In a stable interest rate environment, rates could remain unchanged for months or even more than a year. In volatile times, prevailing rates could change more than once a month.

Variable interest rate instruments shield the lender from interest rate risk and permit the borrower to reduce its interest expense (and, usually, its loan payments) in a falling interest environment. The borrower, however, forgoes the ability to predict its debt service expense. Rising interest rates occurring together with falling rents will squeeze the borrower and may put the project at risk. For this reason, borrowers frequently seek a “cap” or a ceiling (maximum rate) on a variable interest rate, and the lender usually requires a “floor” (minimum rate) in return.

Sometimes lenders will require that the borrower procure, at the borrower’s cost, an interest rate protection device from a rated financing “intermediary.” The intermediary, for a fee, will agree to

assume the downside to the borrower's interest rate risk by delivering a "swap" (by which the borrower agrees to pay a fixed interest rate in return for the loan term while the intermediary assumes payment no matter how high the variable rate increase) or a "cap" (by which the intermediary agrees to pay loan interest above a stated level).

§1.78 E. Amortization

There is no inherent limitation on the parties' ability to structure the loan repayment terms to fit the business plan of the borrower, the expectations of the lender, and the nature of the encumbered real estate. Although loans secured by real property are customarily amortized (with incremental payments of principal, increasing over time, being paid on a regular basis until maturity; see §1.28), there may be opportunities for flexibility if the lender's other concerns are met. For example, in certain circumstances, the lender may permit a limited period of interest-only payments, or even negative amortization (interest accruing under the loan is not fully paid, and the shortfall is added to principal), at the outset of the loan. Typically, the lender will consider such arrangements only if the project's net operating income, although temporarily impaired (*e.g.*, because of renovations to the building, or during a lease-up period), is eventually expected to be sufficient to service a fully performing loan.

To induce a lender to accept an interest-only or negative amortization loan, the borrower should be prepared to provide credit enhancement, on at least a temporary basis, in the form of additional collateral (*e.g.*, a letter of credit) or a guaranty from a creditworthy entity.

§1.79 F. Maturity Date

Depending on the circumstances, either the borrower or the lender may desire flexibility in selecting a maturity date for the loan. In times of volatile interest rates, the risks associated with a fixed rate affect both parties in a reciprocal fashion (*i.e.*, rates rising after the loan closes benefit the borrower, falling rates benefit the lender). The parties' perception of the future market establishes their willingness to set an earlier or a later maturity date.

The borrower's business plan may dictate its loan term requirements. If the property is just entering the marketplace, the available loan amount is necessarily reduced owing to the lack of operating history and the inherent risks of a new business. The borrower may expect that, after the property is stabilized, it will command a much greater loan amount. If so, the borrower may prefer

a short-term loan because a long-term loan would delay its ability to realize the benefit of its increased equity in the project.

Occasionally, the lender may accommodate a conservative borrower's desire for long-term certainty in its capital requirements by granting one or more options to extend the loan after a relatively short initial term. Option provisions favorable to the borrower require only that the borrower not be in default at the time of exercise. Provisions more favorable to the lender require the borrower to satisfy certain underwriting standards and pay additional fees as a condition of exercising the option and to provide a mechanism for adjusting the interest rate for the extended term. When the criteria for extension are complex, borrower's counsel should attempt to ensure that the borrower has every realistic opportunity to exercise the option. The borrower should have the opportunity to cure any disqualifying physical deficiency in the property and, further, to reduce principal (rather than lose the extension altogether) if certain renewal criteria (*e.g.*, loan-to-value or debt service coverage ratios) are not met on the initial maturity date.

If possible, counsel should avoid provisions resetting the interest rate to reflect the "prevailing market," or other subjective criteria. Such imprecise provisions only lead to dispute and negate the value of the option because the borrower could obtain the same terms with any other lender. Moreover, the borrower's objective is to renew its existing financing if suitable alternative financing is unavailable. More certainty is achieved if, when the loan is negotiated, the parties select for the renewal term an index (*e.g.*, LIBOR, Treasury bills; see §1.27) and a spread (*e.g.*, 200 basis points; see §1.29) that are mutually acceptable whether the interest rate for the option period will be fixed or floating. This strategy should be used with caution, however, because the spread applicable to specific property types varies with real estate cycles.

§1.80 G. Grace Periods

In the past, almost all loan payments were made by check and delivered by mail. Because occasional delays were expected, lenders usually granted borrowers a reasonable period of time after the stated due date during which payments could be received without penalty. Today, alternative payment arrangements that do not rely on the mail (*e.g.*, wire and electronic funds transfers, or automatic debits from other borrower accounts with lender) are increasingly common. Nonetheless, borrowers continue to request, and lenders usually permit, grace periods of up to 15 days (more often 5 to 10 days), before a late charge or default interest is imposed. Because the

borrower may be unaware that the lender has not received a payment due to a failure in the delivery mechanism, borrowers sometimes prevail on the lender to give notice before the grace period runs, but this is not common.

§1.81 H. Notice and Cure Periods

Lenders rarely agree to extend the grace period (see §§1.38, 1.80) for scheduled loan payments. Borrowers usually have more success in obtaining the right to receive notice of, and the opportunity to cure, a breach of a nonmonetary covenant in the loan documents. As discussed in §1.80, the borrower already has the opportunity to “cure” payment defaults during the grace period. In addition, whether certain other loan covenants have been violated, and to what extent the borrower must redress the violation, are often harder to ascertain than whether specific loan payments were made.

EXAMPLE • The timely payment of real estate taxes or insurance premiums is easy to establish, but whether the property is being properly maintained, or whether financial reporting requirements are being met, is more subjective.

Requiring the lender to notify the borrower of defects in performance gives the borrower a chance to address (or dispute) the lender’s demand and gives the parties an opportunity to establish a dialogue before the lender imposes sanctions or exercises its remedies.

Typically, the borrower’s right to cure requires the borrower to promptly take steps to address the problem. Usually, the main issue for negotiation is the proper time period to accomplish the cure. Borrower’s counsel usually seeks “a reasonable time” because that phrase enables a flexible approach. Lender’s counsel, however, may seek a more certain time (*e.g.*, 30 days), and may also require that the borrower diligently proceed to cure in all events.

§1.82 I. Credit Enhancement

As discussed in §§1.74–1.79, the perceived risk to the lender, interest rate, loan amount, and security are interrelated: an adjustment in one requires or justifies an adjustment in another. In certain circumstances, a loan would not be made at all without some credit enhancement (see §1.59). For example, construction loans are virtually always recourse to the borrower (see §1.51) or require a personal guaranty from a creditworthy principal of the borrower.

If the lender is reluctant to make a loan without credit enhancement, borrower’s counsel and lender’s counsel should advise their clients of

the relative risks and benefits of the various types of credit enhancement. Common forms of credit enhancement include full or partial payment guaranties, carry guaranties, letters of credit, and collateral interests in deposit accounts or additional real property. “Springing” or “exploding” guaranties (see §1.39) are designed to secure the borrower’s obligations under exceptions to the exculpation provisions in the loan documents (usually relating to borrower behavior) and are not considered credit enhancement. For a detailed discussion of guaranties, see chap 6.

Counsel should be alert to the opportunities for negotiation presented when the borrower provides additional assurances to the lender about repayment. Frequently, these devices are somewhat interchangeable and need not exist for the life of the loan.

EXAMPLE• A letter of credit intended to secure the borrower’s obligation to fund operating shortfalls after completion of renovations may be allowed to expire once the project shows an adequate debt service coverage ratio (see §1.36) for 12 months.

In variable rate loans, borrowers sometimes wish (or are required) to protect themselves (and the lender) from the risk of rising rates by purchasing an interest rate “swap” or an interest rate “cap.” In a swap, the borrower trades the obligation to pay the variable rate with a creditworthy third party and assumes that party’s obligation to pay a fixed rate for the same principal amount. An interest cap (purchased from a third party financial institution) indemnifies the borrower to the extent the interest rate under the borrower’s loan exceeds a certain agreed maximum.

The creation, execution, and implementation of guaranties, letters of credit, and security interests in additional collateral give rise to other legal issues that are beyond the scope of this chapter. For discussion of security interests in personal property collateral, see chap 7.

§1.83 J. Personal Liability: Exceptions to Nonrecourse Provisions

Traditionally, the only exceptions to nonrecourse provisions were based on common law tort theories (*e.g.*, bad faith waste or fraud in the inception). Over the years, lenders have learned that the value of the security can be seriously compromised by matters that are outside the lender’s control but that are usually, but not always, within the borrower’s control. As a result, lenders have increasingly carved out exceptions to the borrower’s exculpation to impose personal liability for certain acts or events, sometimes to the extent that personal

liability lies in almost all circumstances (subject to antideficiency limitations). On California's antideficiency rules, see California Mortgage and Deed of Trust Practice, chaps 4–5 (3d ed Cal CEB 2000).

Borrower's counsel should attempt to limit these exceptions to borrower misbehavior (*e.g.*, misappropriating funds). Borrower's counsel should also resist any attempt by the lender to convert the entire principal to recourse for technical violations that are subsequently cured or when the harm suffered by the lender can be reasonably quantified (*e.g.*, costs incurred by the lender to repair the property to the standard required under the loan documents). The borrower should also be relieved of all recourse liability if the loan is assumed by a third party in accordance with the loan documents.

The key concerns of lender's counsel are the following:

- Nothing in the exculpation provisions would act to limit the lender's exercise of its remedies;
- The lender is entitled to full recovery on any losses from the borrower's diversion of operating revenues after default or from the borrower's filing bankruptcy proceedings to delay foreclosure;
- The borrower is liable for the lender's attorney fees and costs incurred in enforcing nonrecourse carve-outs; and
- Most important, with a single-asset borrower, a financially responsible entity or individual indemnifies the lender for these liabilities.

Additional lender concerns are environmental hazards (which may be serious enough to justify the lender's abandonment of the security); the borrower's failure to pay property taxes and insurance premiums; and impermissible transfers of, or junior encumbrances on, the property. Frequently, the obligations to satisfy lender losses despite the lender's realization on the security are "springing" (*i.e.*, they arise as a result of an event, such as the borrower's bankruptcy filing) and can expose the borrower (or a third party indemnitor, usually a principal of the borrower) to liability for a specific loss or for the full amount of the debt.

§1.84 K. Due-on-Sale (Transfer of Interests in the Property)

Due-on-sale clauses are generally fully enforceable according to their terms under the Garn-St. Germain Depository Institutions Act of 1982 (Pub L 97–320, 96 Stat 1469), known as the Garn Act. Garn Act §341(b)(1). Blanket prohibitions against transfers of interests in the

real property security (or interests in the borrower entity, see §1.85) to a new owner are common in lenders' standard forms. Borrower's counsel should carefully review these restrictions with the borrower and discuss the borrower's short- and long-term goals for the property. If the borrower can neither prepay the loan without an exorbitant penalty nor transfer the property, the borrower will be unable to realize its equity before the loan matures.

Because even the most carefully thought-out business plans are not always realized, borrower's counsel should request an exception to the due-on-sale provisions for a bona fide sale to an experienced, creditworthy borrower, at least on a one-time-only basis during the loan term. If granted, these provisions almost always require the borrower or the proposed new owner to pay a transfer fee (usually about 1 percent of the outstanding balance of the loan) and the lender's underwriting expenses. The loan documents should specify the new owner's required qualifications and should require the lender to be prompt and reasonable in evaluating a proposed buyer's acceptability as a substitute borrower.

§1.85 L. Transfers of Interests in Borrower

Standard loan documents typically include in the definition of a prohibited "transfer" any significant transfers of ownership interests in the original borrower. Borrower's counsel should carefully review these restrictions with the borrower and discuss the need for flexibility in making any changes in ownership.

At a minimum, counsel should request, and the lender should accept, modifications that permit internal transfers of interests in the borrower among principals and transfers for estate planning purposes. Lenders tend to resist permitting transfers of interests to third parties because loan underwriting relies in part on the expertise and financial standing of certain individual principals of the borrower. If those principals continue to hold substantial equity, however, transfers of interests to outsiders that do not result in a change of management and control might be acceptable.

§1.86 M. Prepayment

Because a borrower may wish to voluntarily prepay its obligation (*e.g.*, if the borrower desires to sell the property before loan maturity, or to refinance it to pull out equity or obtain a lower interest rate), borrower's counsel should expressly address prepayment in the earliest negotiations and attempt to include a prepayment right in both the loan commitment and the promissory note. The lender, however,

may want to control the borrower's right to prepay in order to increase the predictability of its investment return.

Prepayment rights may be conditioned on the borrower's payment of a fee or "premium." The calculation of the prepayment premium is generally a business issue over which counsel has limited control. Borrower's counsel, however, should strive to accomplish at least the following goals:

- There should be a reasonable period at the end of the loan term (at least the last 30–90 days) during which the loan can be paid without penalty;
- The prepayment premium should not apply if principal is reduced by the lender's application of insurance or condemnation proceeds;
- The prepayment premium should not apply when the borrower is required to pay down principal to maintain required loan-to-value (see §1.44) or debt service coverage ratios (see §1.36); and
- If the lender insists on the right to enforce the due-on-sale clause at its sole discretion and insists that it need not consider any purchaser of the security as a substitute borrower, counsel should attempt to have the premium on the resulting prepayment waived on the basis that the lender is the ultimate decisionmaker on prepayment.

As discussed in §1.104, the two most common methods of calculating prepayment premiums are a percentage of the prepaid amount and the yield maintenance formula. The yield maintenance premium is a lump-sum payment that represents the discounted value of a revenue stream at the loan rate less the discounted value of a revenue stream calculated at the then-prevailing interest rate for reinvestment of the prepaid principal. The negotiations usually focus on which rate to use for the proper return on the reinvested proceeds (*e.g.*, prime rate, Treasury bills, market rates for similar loans), and which rate to use for the discount rate.

Because market rates for real estate loans always exceed Treasury bill rates (because of the increased risk posed by real estate), and portfolio lenders would not reinvest in government securities (because the return is too low), the borrower may argue that the lender's losses should be measured by the prevailing rate for real estate loans. The lender may argue that it should not be forced to search for another lending opportunity simply because the borrower has chosen to prepay the loan. Because the spread between a given index rate and loan rate is frequently over 200 basis points (see §1.29), it is worthwhile for the borrower to seek some accommodation from the lender (*e.g.*, setting

the reinvestment rate at 75 to 100 basis points over Treasury bill rates). Certain conduit lenders, who are prohibited from making new loans with prepaid principal, will invariably require that yield maintenance be based on government securities because that is where the funds will actually be reinvested. On prepayment restrictions in conduit loans, see §§1.102–1.105, 10.21.

§1.87 N. Operating Covenants

Although borrowers prefer to have no postclosing obligations other than making scheduled debt service payments, lenders routinely request several operating covenants that require or prohibit certain actions by a borrower during the term of the loan. Even if the borrower continues to make scheduled payments, if the project's operating cash is insufficient to pay all its cash expenses, the lender may have to categorize the loan as “at risk”; otherwise, a rating agency may lower its rating on the applicable mortgage-backed securities pool. Operating covenants are sometimes required by the governmental entities or bond rating agencies that oversee the lender.

The most common operating covenants require the borrower to

- comply with all governmental laws and regulations;
- maintain the real property security in accordance with stated standards;
- timely pay all real estate taxes and assessments (which are senior to any deed of trust);
- timely pay all hazard and liability insurance premiums;
- set aside reasonable reserves for tenant improvements or capital replacement; and
- provide the lender with financial information (at a minimum, a balance sheet and an operating statement) on a regular basis.

On the use of impound accounts to pay taxes and insurance premiums and reserve accounts for tenant improvements, see §§1.88 and 1.89 respectively.

PRACTICE TIP • To the extent possible, the borrower wants reporting requirements to be consistent with those already in place (*e.g.*, the reporting requirements imposed on the general partner, managing member, or manager of the ownership entity in the organizational documents). In particular, the borrower should make sure that of the following:

- • The timing requirements for delivery of financial information are reasonable (*e.g.*, within a manageable period after the applicable quarter or year);
- • Audited statements are required no more often than the borrower would otherwise obtain such statements (although the lender may be unwilling to compromise on this point); and
- • Reports are prepared in accordance with “standard accounting practices” as opposed to the more rigid accrual-based “generally accepted accounting principles” (although, again, there may be little room for negotiation).

PRACTICE TIP• To the extent any financial statement must be certified, the borrower should consider who must make the certification and whether it can be limited to facts within the borrower’s knowledge.

Lenders occasionally require the borrower to obtain the lender’s consent before taking certain actions regarding the property, such as executing leases or making improvements. Borrower’s counsel should attempt to eliminate these requirements or limit them to circumstances outside the borrower’s normal course of business. Lender’s counsel should point out that, if the lender takes too large a role in controlling the borrower’s business affairs, a failing borrower may assert a claim under lender liability theories. In any event, if lender consents are required, they should not be unreasonably withheld, conditioned, or delayed. Another covenant that the borrower should vigorously resist provides that, if the lender deems itself “insecure,” the borrower must deliver additional collateral or risk acceleration of the loan. At a minimum, the borrower should try to establish objective criteria for the lender to consider itself “insecure.” For a general discussion of lender liability issues, see *California Mortgage and Deed of Trust Practice*, chap 12 (3d ed Cal CEB 2000).

On one hand, borrower’s counsel should welcome provisions that reward the borrower for meeting a certain operating benchmark; *e.g.*, by lowering the interest rate on achievement of a more favorable debt service coverage ratio, or canceling a partner’s guaranty of the debt on the stabilized lease-up of the project. On the other hand, borrower’s counsel should resist to the fullest extent possible any provision that allows the lender to accelerate the loan if a financial operating covenant is breached. Instead, the borrower should be permitted to “cure” the default by posting additional collateral or paying down the principal balance of the loan.

Operating covenants should be analyzed carefully and discussed with the borrower to see whether they can reasonably be met in the normal course of operations and in an economic downturn.

§1.88 O. Impound Accounts

Impound accounts are a form of credit enhancement because they reduce the lender's exposure if the borrower fails to make timely payments of certain operating expenses of the encumbered property. Typically, impounds are established to pay real property taxes and insurance premiums, two expenses that pose the greatest risk to a lender: A lien for unpaid property taxes has priority over the lender's deed of trust, and the loss of hazard insurance coverage for the property could be catastrophic. In the past, impounds were used only when the lender faced an increased risk that these expenses would not be timely paid or that the real property would be insufficient to satisfy the debt on default. For example, if the loan was made with aggressive debt service coverage (see §1.36) or loan-to-value ratios (see §1.44), the lender would require impounds to provide simultaneously for a sinking fund for future cash outlays and for additional cash collateral.

Lenders value impound accounts even though the additional security is limited to the impound account balances at any given time. Impounds are usually deposited in a general account and generate interest for the lender, which is not passed on to the borrower. Thus, impounds provide an additional benefit to the lender by incrementally enhancing its yield. In the age of conduit lending, using impounds for real estate taxes and hazard insurance premiums is popular as a reasonable method of assuring uninterrupted cash flow to the lender, which helps maintain favorable ratings for its loans. Many borrowers resist impound accounts, but they can be helpful to a borrower with uneven cash flow.

PRACTICE TIP • Impounds may sometimes be negotiated away with a portfolio lender (see §1.18), or at least limited to circumstances in which the loan is in default or at measurable risk of default, but rarely, if ever, in a conduit loan. See further discussion in §§1.97, 10.13.

§1.89 P. Reserves

Similar to impounds, the concept of capital replacement or tenant improvement reserves addresses the fact that certain substantial expenses are irregularly incurred in the operation of a real property asset. In retail or office projects, the rental stream varies as tenants come and go, and the vacant space may have to be reconfigured for a

new tenant at substantial expense. Depending on the amount of space involved and the state of the rental market, a landlord may provide a tenant improvement allowance based on a “building standard” improvement per square foot. Although tenant improvement allowances (like leasing commissions) are generally recovered over the lease term as part of rental receipts, a reserve required under the loan documents provides a cash fund for defraying these up-front, out-of-pocket expenses.

Multifamily residential, hotel, and restaurant properties also require periodic updating of equipment and structures that are worn out, obsolete, or have otherwise reached the end of their useful lives. This requirement is especially important in the hospitality business because recovering from a “tired” reputation can be difficult, if not impossible. In these businesses, lenders frequently require that a certain percentage (usually from 1 to 5 percent) of the gross revenue from the asset be set aside for capital replacement reserves.

Unlike impounds, however, lenders are usually more flexible in establishing, maintaining, and disbursing these reserve accounts. Occasionally, the lender will permit the borrower to establish reserve accounts in its own name and simply provide the lender with a security interest in them, which gives the borrower greater control over the account, including the right to earn interest. The issues of concern generally relate to the following:

- The dollar amount of the reserves;
- The scope of the expenses that the reserve may be used to defray;
- The process of review and approval by the lender; and
- Whether the borrower must pay the expenses first and seek reimbursement, or whether the fund may be used to pay expenses as they arise.

VIII. CONDUIT FINANCING; A SUMMARY

§1.90 A. Wall Street Comes to a Bank Near You

Commencing in the early nineties and at an accelerating pace since, another source of funding for commercial transactions has become available: Wall Street. Though not a direct lender, the investment banking houses (with the participation of mortgage lenders, real estate professionals, and the real estate bar) have developed a process by which pools of loans are originated, purchased, packaged, and resold as investment vehicles similar to a corporate bond. The ultimate source for funding the individual loan is not the originating lender, which acts primarily as a conduit for the delivery of the funds; hence

the term “conduit loan” (see §§1.18, 1.33). The investment vehicles, generally known as commercial mortgage-backed securities (CMBS; see §1.33), may be offered by any number of entities, including real estate mortgage investment conduits (REMICs) (see §3.24A).

This methodology for providing greater access to capital for commercial properties was not really novel. Home mortgages had been packaged and purchased under the auspices of the Federal National Mortgage Association (FNMA) for decades. Unlike single-family dwellings or condominiums, which are generally occupied by the owner/borrower and share a common property type and loan amount range, investment pools of commercial loans cover a wide range of property types, ownership, and loan amounts. For further discussion, see §§10.1–10.5.

The following sections (§§1.91–1.107) summarize conduit financing characteristics and requirements. For full discussion and sample form clauses, see chap 10.

§1.91 B. Advantages of Conduit Financing

Conduit financing has greatly expanded the pool of accessible capital for commercial loans. Money that would otherwise be invested in traditional debt instruments, such as corporate bonds and Treasury bills, is available for investment in CMBS. In addition, life insurance companies, which have always included a substantial real estate loan component in their investment portfolios, are increasingly investing in pools of diversified commercial loans rather than individual loans underwritten, originated, and serviced by the life insurance company itself. Because the ultimate source for loan funds nationwide (and to some degree worldwide) has increased, capital shortages resulting from local economic conditions are mitigated.

The increase in the supply of loan funds tends to drive interest rates lower, which is another benefit to the borrower. Also, conduit loans generally have a fixed interest rate, providing the borrower a degree of certainty in the future interest costs of its property. The interest rate is set by the market’s perception of the risk at the time the loan is funded. Typically, the loan originator is unconcerned with the interest rate risk (see §1.76) because it does not retain the loan in its portfolio. Instead, the risk is shifted to those who purchase and sell the CMBS in the financial markets.

§1.92 C. Disadvantages of Conduit Financing

The primary disadvantage to the borrower of conduit financing is the lack of flexibility in a financing product that is packaged for wide

marketability. The loan documents greatly restrict the borrower and are largely nonnegotiable. Additional costs are involved to the extent that the borrower must adapt its governing documents and business operations to fit the conduit model of a single purpose, bankruptcy-remote entity (see §1.96). Prepayment of the loan is either prohibited or cost-prohibitive, limiting the borrower's ability to sell or refinance its property during the term of the loan. The borrower has nothing like its traditional, personal relationship with its neighborhood lender, which is helpful when circumstances change or a workout is in order (see §1.43).

EXAMPLE • The loan master servicer generally has little incentive to cooperate with a borrower's postclosing requests to modify the loan documents to take into account any change in circumstances. In addition, if the lender is a REMIC (see §1.90 for definition), it may not be able (without adverse tax consequences) to amend the loan documents to provide for defeasance rights not contained in the original loan documents (see Treas Reg §1.860G-2(a)(8)), and it may also be difficult to make other material changes to the loan documents that the borrower might otherwise assume would be uncontroversial. See Treas Reg §1.860G-2(b)(1). Although there are some exceptions (e.g., when the loan is in default) under the tax laws allowing for amendments (Treas Reg §1.860G-2(c)(3)), other constraints in the pooling and servicing agreement may severely limit the range of permitted modifications. This may not seem significant now, but it will be interesting to see how different the first few conduit loan workouts are. See Murray, *Workouts in the Twenty-First Century*, 17 Cal Real Prop J 1 (Fall 1999).

Borrower's counsel may also find it useful to become acquainted with the statutory and contractual framework governing CMBS loans. See Loubier, *Securitized Commercial Mortgage Loans, Modifications and Workouts*, 22 Cal Real Prop J 31 (Winter 2004). On workouts of problem loans generally, see California Mortgage and Deed of Trust Practice, chap 10 (3d ed Cal CEB 2000).

For further discussion of the lender controls and restrictions imposed on conduit borrowers, see §§1.95-1.107, 10.6-10.23.

§1.93 D. Role of Rating Agencies

Until recently, business (and sometimes legal) issues were subject to the policies and review of a portfolio lender's credit committee. In the age of conduit loans, the ultimate arbiters of a loan transaction's strengths and weaknesses are the credit rating agencies that review the

loan pool in which the loan is packaged. See §10.7. Loans are subject to a “stress test” in which attributes of the security and the loan are evaluated. The less risk posed by the loan pool, the higher the credit rating bestowed on the pool, and the higher the price (and the lower the yield) of the securities backing the loan pool. The more “moving parts” in the loan transaction, the more difficult it is for a rating agency to assess inherent risks. Accordingly, to decrease the number of “moving parts,” originators of conduit loans are generally reluctant to accommodate deviations from standardized loan documentation. Certain requirements, such as the use of single purpose, bankruptcy-remote borrowing entities (see §§1.96, 10.14– 10.17), are mandatory.

Standard representations and warranties are also required of the borrower (as well as the originator and each additional party having an interest in bringing the loan to the securities market). Because a thorough due diligence review of each loan is cost-prohibitive, the representations and warranties are used as a partial substitute for traditional underwriting, and they are treated seriously. If the manager of the pool discovers that any of these representations and warranties is false (typically after default, when the loan file and the property are analyzed in depth), the pool generally has the right to force the originator of the loan to repurchase it from the pool.

§1.94 E. Threshold Requirements

Three fundamental principles must be assured before a conduit loan will be made:

- Uninterrupted payments of scheduled debt service (see §§1.95–1.101);
- No prepayment of principal before the scheduled maturity date (see §§1.102–1.105); and
- Timely principal repayment on the maturity date (see §§1.106–1.107).

These concerns are satisfied by implementing the various techniques discussed in §§1.95–1.107.

§1.95 1. Uninterrupted Cash Flow to Lender

The commercial mortgage-backed security is designed to perform exactly like a low-risk bond obligation. The investor puts its money in, gets a regular, fixed return, and then gets its money back. Anything that would interfere with that arrangement is excised from the transaction to the extent possible.

To ensure a steady cash flow to the lender, a conduit loan may impose all or any combination of the requirements discussed in §§1.96–1.101.

§1.96 a. Single Purpose, Bankruptcy-Remote Borrower Entity

In virtually all conduit loans, the borrower’s business purpose must be limited solely to the ownership and operation of the real estate that secures the loan. The borrower must organize as (or amend its governing documents to convert to) a so-called single purpose entity (SPE) or single purpose vehicle (SPV). If the borrower is an existing entity, it must amend its governing documents to prohibit acquiring additional properties or undertaking other business enterprises. The purpose of this requirement is to isolate the borrower from unrelated activities that could impair the free and direct flow of revenues from the project to the lender. Thus, the financial difficulties of other real estate projects (or the core business of an affiliate of the borrower, in the case of an owner-user) will not compromise revenues of an otherwise successful enterprise.

WARNING• Forming a single purpose entity may involve numerous costs, including transfer taxes and a property tax reassessment resulting from any required (nonexempt) transfer of real property or change in ownership. In California, a transfer to a single-member limited liability company (wholly owned by the transferor) should be exempt from both reassessment (Rev & T C §62(a)(2)) and transfer taxes (Rev & T C §11925(d)). See also Rev & T C §11911(a), which imposes the transfer tax on a document by which “realty [is] sold” (emphasis added), and 82 Ops Cal Atty Gen 56 (1999), concerning a transfer to a wholly owned corporation. The new entity, however, may be subject to California’s annual minimum franchise tax (Rev & T C §§17941, 23153(d)) and an annual gross-receipts fee, which is subject to annual adjustment by the Franchise Tax Board (Rev & T C §17941).

Conduit lenders also require that the borrower’s governing documents make it as “bankruptcy remote” as possible. Changes made in 1994 and 2005 to federal bankruptcy laws (11 USC §§101(51B), 362(d)(3)) have reduced the opportunities available to a single-asset debtor-in-possession to extract favorable results (*e.g.*, using protracted bankruptcy proceedings, under which the lender obtains little or no debt service, as leverage in workout negotiations). Nonetheless,

lenders continue to limit the borrower's access to bankruptcy remedies to the extent feasible.

EXAMPLE • The lender may require that the borrower's governing documents require the unanimous consent of all equity holders in the borrower before a bankruptcy filing, and for a corporate general partner or managing member, require the corporation to have an "independent" director whose consent is required to commence a bankruptcy case.

Lenders also wish to insulate the borrower from the effects of bankruptcy proceedings involving the borrower's affiliated entities. To this end, conduit lenders require that the borrower take certain steps to ensure that its operations are sufficiently independent of other operating entities controlled by the same individuals, such as parent or sister companies. For further discussion, see §§10.14–10.17.

Further, lenders occasionally request borrower's counsel to issue a nonconsolidation opinion, assuring the lender that the borrower's assets will not be subject to a bankruptcy case involving an affiliate. Owing to the factual basis and prospective nature of such an opinion, counsel should resist this request or be very cautious in complying with it. For further discussion of legal opinions, see chap 8.

§1.97 b. Impound and Reserve Accounts

The borrower must establish and maintain impound accounts to pay property taxes and insurance premiums and, frequently, replacement reserves for capital replacement or tenant improvements. These accounts impose discipline on the borrower to properly provide for these recurring property expenses, thus enhancing the prospects for uninterrupted cash flow to the lender. The funds also serve as additional collateral for the lender on borrower default. For a discussion of negotiating techniques regarding impound and reserve accounts, see §§1.88–1.89.

§1.98 c. Lock Box System

In a "lock box" system (see §1.45), the borrower's operating receipts are swept into a bank account controlled by the lender. These funds are then applied first to loan payments and other property expenses (such as impounds and reserves) before remaining funds are made available to the borrower. Lock boxes have become a standard feature on large property and operational loans.

§1.99 d. Operating Covenants

Conduit lenders may require certain operating covenants, such as the use of a standard lease form, or that rents comply with an approved rent schedule. Sometimes the lender may even insist that it approve (or have the ability to remove and replace in certain circumstances) the property's management company.

§1.100 e. No Subordinate Debt

The conduit lender wants to keep the borrower interested in the property's prospects during the entire loan term; therefore, subordinate (or junior) financing that allows the borrower to realize more of its equity (or increases the borrower's return on remaining equity) is generally prohibited. Inherent conflicts between senior and junior lienholders in a workout or foreclosure situation also make conduit lenders (always first lienholders) reluctant to accept additional secured debt. Nonetheless, lenders occasionally permit subordinate financing in order to improve the security. Because any additional debt service reduces the debt service coverage ratio (see §1.36), and thus the senior lender's cushion, subordinate financing is likely to be allowed only when all proceeds are denoted to improvements that are expected to significantly improve the market value or operating cash flow of the property (or both), and when a subordination agreement acceptable to the conduit lender is executed by the junior lender. For further discussion, see §10.19.

§1.101 f. Credit Enhancement

Credit enhancement devices, such as additional real property collateral, letters of credit, guaranties, and holdbacks or reserves, provide additional assurances that the lender will be repaid in full and on time (see §1.59). To the extent that the lender's recovery may be delayed (*e.g.*, pending enforcement of a guaranty, or foreclosure on other collateral), some of these devices are less valuable than others in achieving continuous cash flow to the holder of the debt. For further discussion, see §10.18.

§1.102 2. Prepayment Restrictions

In exchange for the lowest fixed interest rate available when the loan is made, the borrower must pay that rate for the full term of the loan until the maturity date, even if interest rates fall during the term. Again, the conduit loan functions like a bond. If the borrower pays off the loan prematurely in a market of lower interest rates, the lender's

reinvestment of the proceeds will not provide the expected return. Thus, prepayment of conduit loans is either prohibited entirely (see §1.103), severely penalized (see §1.104), or permitted only by “defeasance” (see §§1.105, 10.21). On prepayment generally, see §§3.22–3.34.

§1.103 a. Prohibition of Prepayment

The simplest way for the lender to avoid prepayment is simply to prohibit it. That approach is used on occasion, but it does not take into account the realities of commercial real estate. More often, prepayment is prohibited during the first year or two of the loan (sometimes longer), which is known as the “lock-out period.” The lock-out period reflects the amount of time the originator expects it will take for the loan to be packaged with other commercial loans and for interests in that pool to be sold, *i.e.*, “securitization.” For further discussion, see §10.21.

§1.104 b. Prepayment Premium

After the lock-out period expires (see §1.103), prepayment is usually permitted for a fee or “premium.” The prepayment premium is based either on a certain percentage of the amount prepaid, which may diminish over time (*e.g.*, 5 percent in year three; 4 percent in year four, etc.), or on a yield maintenance formula, which results in a lump-sum payment intended to compensate for the lender’s diminished return when it reinvests the funds in a lower interest rate environment. The latter type of prepayment premium effectively transfers to the lender any savings that the borrower would realize by refinancing at a lower interest rate. A large prepayment premium can cause other problems for a borrower by increasing the borrower’s cost of selling the property, thus reducing the borrower’s return on sale.

§1.105 c. Defeasance

Because certain CMBS (see §1.18) vehicles are prohibited from reinvesting prepayment proceeds, another prepayment device was developed that permits a sale or refinancing of the encumbered property without paying off the loan. “Defeasance” is the term used to describe a method by which the original real estate security is released and replaced with substitute collateral to secure the debt. Because the original loan remains in place, there is no prepayment. See also §3.24A.

The required substitute collateral almost always consists of Treasury bills. The yield realized by the lender on the substitute

collateral must equal the interest rate fixed under the original loan. As a rule, the face amount of the purchased Treasury bills exceeds the “prepaid” principal because the yield on Treasury bills (a virtually risk-free instrument) at the time of the sale or refinance is typically lower than the fixed rate under the original loan (which likely contained a spread over Treasury bill rates or some other interest rate index at the time the loan was made). Ordinarily, the borrower must purchase a number of Treasury bills, with amounts and maturities tracking scheduled debt service installments as closely as possible, to make funds available for amortization of principal.

When defeasance is implemented in connection with a refinancing (as opposed to a sale) of the borrower’s property, the borrower in essence has two loans: the original, which should be self-servicing (because it will be paid from the proceeds of the purchased Treasury bills), and the new refinance obligation, which may be a traditional real estate loan. If the property is sold rather than refinanced, there is only one loan, but the borrowing entity cannot be dissolved until the conduit loan’s original maturity date. Other requirements for defeasance include indemnities, opinions of counsel (that the device will work, without adverse tax consequences to the lender), and the actual arrangements for servicing the original loan.

For further discussion and sample form clauses, see §§10.21, 10.30.

§1.106 3. Assuring Repayment at Maturity

The goal of the conduit loan is to mirror a bond instrument: regular payments of debt service followed by timely repayment of principal at maturity. Although absolute assurance of repayment at maturity cannot be achieved at the inception of the loan, methods have been developed to mitigate the risk that the loan will not be paid at maturity. One method, known as hyperamortization or the prepackaged workout, is discussed in §§1.107, 10.21. The second method, which is often standard procedure for lenders, uses a lock box system (see §§1.45, 1.98) to service the loan and retire principal.

§1.107 4. Hyperamortization: The Prepackaged Workout

In the hyperamortization approach, the loan’s stated maturity date is set at the end of the amortization period (20 to 30 years) while the parties agree to an anticipated or optional maturity date (usually 5 to 10 years) that more accurately reflects when the parties expect the loan to be replaced. If the borrower cannot refinance the loan at the earlier date, the parties negotiate at the inception of the loan the details

of an acceptable workout of the loan (known as a prepackaged workout). A typical provision increases the loan's fixed rate to 200 basis points (see §1.29) above the initial rate (or some other spread above the prevailing Treasury rate for an obligation having a maturity matching the amortization period). Even if the increased interest rate results in operating shortfalls, the loan is characterized as performing because any interest payment shortfalls are accrued, capitalized (interest accrues on the capitalized interest), and become due on acceleration because of default, refinancing, or ultimate maturity. For further discussion and a sample form clause, see §§10.21, 10.31.