REAL ESTATE LOAN DOCUMENTATION/WORKOUT LESSONS LEARNED FROM THE ECONOMIC DOWNTURN

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The recent economic downturn is not the first to occur, even in the last few decades, and likely will not be the last. Each downturn affords the opportunity to revisit how lenders do business, including how they document loan transactions, administer the loan after closing and handle loans during workouts. The goal is to make their loans clearer, safer and more efficiently administered and enforced, to protect their collateral, and to make sure they can sell the note prior to foreclosure or the collateral after foreclosure. Here are a dozen ideas for current and future transactions.

1. **Put all the collateral and debt in a single deed of trust or mortgage**. This would seem to be a simple, efficient and logical rule. However, because different loans have different collateral, there is a tendency to have individual pledges, assignments and transfers of personal property in multiple documents. Enforcing them requires an expensive and time-consuming Uniform Commercial Code (UCC) "disposition" of personal property under security agreements or other types of personal property pledges.[1]

   (a) One Place, One Remedy. However, if the lender has real estate collateral, UCC 9.604 permits the lender to list the collateral in the deed of trust and to foreclose personal property, together with all real property, in the same manner as provided under State real estate law for foreclosure of real property. In a state with a quick, easy and relatively certain non-judicial foreclosure process (like Texas Property Code 51.002 et seq.), this is a much easier and more certain process than the provisions applicable to dispositions under the UCC. All the collateral can be foreclosed at once, and legal challenges to the foreclosure sale are less likely to be successful. Additionally, there is nothing in UCC 9.604 that requires the personal property to be related to the real estate.[2] The lender may also describe the collateral in both the deed of trust and a separate security agreement in the event it wants to foreclose on the real property and dispose of all or part of the personal property in separate actions.

   (b) Exceptions. Sales of collateral consisting of stock or other equity interests or promissory notes are subject to state and/or federal securities laws requiring registration

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[1] The term used in the Uniform Commercial Code (UCC) analogous to foreclosure is "disposition."

[2] For a more detailed discussion on this topic, including suggested language and forms, *see* Philip D. Weller, *Dispositions Under Article 9 for the Real Estate Lawyer*, State Bar of Texas 15th Annual Advanced Real Estate Drafting Course (2004).

and disclosures and are not suitable for non-judicial real estate sales. These types of collateral are better addressed in separate security agreements. Deposit accounts, collateral letters of credit (including proceeds) or other obligations providing for direct payment to the lender (e.g. municipal utility district bond proceeds) will still require separate direct agreements with the account depository, letter of credit issuer or obligor. It also will not eliminate the need for consents to assignments or pledges where required for the particular collateral.

2. **Put all the debt in a single deed of trust or mortgage**. When cross-collateralizing, consider citing all the debt in a new or deed of trust or mortgage. This may be an issue in States with recording taxes and cash strapped Counties, where amending and increasing individual deed of trusts or mortgages on properties in different Counties is more cost efficient. If all the property is in the same County, however, it may be about the same cost to file one deed of trust or mortgage on all the property securing all the debt, as it is to amend and increase each existing deed of trust or mortgage. Where title insurance costs or regulations make it expensive to increase the existing deeds of trust or mortgages, it might be more advantageous to have an additional uninsured deed of trust or mortgage listing all the debt and all the property rather that separate deeds of trust or mortgages on each property securing only the cross collateralized debt.[3]

   The reason is that a lender is faced with multiple foreclosures in the event the cross-collateralized debt is secured by separate deeds of trust on a property. If multiple properties are in one County listing all the debt in the a single, additional deed of trust on all the properties, provides the right to bid all or part of the debt at one foreclosure sale. This is particularly recommended when multiple loans were made to acquire and/or develop phases of a project, and the lender later decides that cross-collateralization is a condition to a future modification of those loans. Filing an additional deed of trust covering all the phases and securing all the debt will have then consolidated multiple foreclosures into one foreclosure

3. **Make sure third party agreements aren't a problem if you foreclose**. It is always the agreements with third parties that cause the most problems and delays. This is a hard issue to describe because every transaction is different, and the importance is less clear before the lender finds itself as owner of the mortgaged property.

   (a) The Obvious Ones. Obviously, the ability to remove borrower-affiliated managers and other vendors is important, and subordinations of management agreements

[3] Texas title insurance rules for a P9(b)(3) endorsement to a Texas title policy in connection with a modification of a deed of trust prohibit a title company from issuing an endorsement if new debt is secured or if new property is added to an insured deed of trust lien. Therefore, to cross-collateralize property to other debt, lawyers typically put a new second deed of trust (that will be uninsured) on the property to secure the cross-collateralized debt. In most cases that is fine because in the event that there is equity in the property, the lender will just need to be careful to foreclose its first deed of trust and not overbid it to the extent that it will lose the benefit of the other collateral that supports the cross-collateralized debt. In other words, once the lender credit bids over the first deed of trust debt, that overbid portion of the collateralized debt is extinguished and can no longer be bid on a foreclosure of the other collateral. Also, *see* footnote 2, supra.

should condition any payment to the manager for work prior to foreclosure on a complete turnover of keys, deposits and property documentation. Subordination, attornment and non-disturbance agreements (SNDAs) should be obtained from important tenants. Conventional wisdom would mandate SNDAs for leases executed after the deed of trust is recorded because those leases may be extinguished by foreclosure in many states. Lenders may also want to obtain SNDAs on leases executed prior to the recording of the deed of trust to make sure the lease cannot be amended without the lender's consent, that the lender will not be bound by additional build-out obligations after initial construction (e.g. upon lease renewal), that the lender will not be liable for damages caused by the prior landlord, and so the lender will receive notice and opportunity to cure any defaults by the borrower under the lease.[4]

(b) The Less Obvious Ones. Examples of third-party agreements that, if not foreclosed, may cause a significant problem for the lender as owner and seller are development agreements with adjacent landowners, condominium or subdivision declarations when the borrower may control as declarant, private utility supplier agreements (for example, propane suppliers in a subdivision that has no natural gas supply), utility capacity rights that might be subject to a separate agreement with the municipality, reimbursement agreements with municipalities, including sums deposited to assure completion of improvements, and reimbursements or payments by utility districts for infrastructure construction and tap fees. After the loan is closed, the deed of trust should be amended to add these types of agreements that are entered into after the loan is closed. This will require a higher degree of due diligence between the loan administration areas and loan officer areas than may be customary. Real estate lenders' lawyers do not typically amend deeds of trust in Texas, as the primary reason for amending deeds of trust is for cross-collateralization where additional debt or additional property is added. As set forth below, under Texas title insurance rules, title policies cannot be endorsed for those types of transactions so lenders' lawyers have been reluctant to risk voiding the title insurance policy as a result of such amendment. However, deed of trust amendments to add personal property as collateral should not be subject to such restrictions and should be freely endorsable by the title insurance company.[5]

(c) Really Obscure Ones. Other types of property, such as notes and liens on so-called municipal utility district lots, should be secured by separate security interests to avoid the registration and disclosure issues described in Section 1 above. The lender will also want to make sure that critical easements are created and subordinated. Take the

4 *See particularly*, *Otniveros v. MBank Houston, N.A.*, 751 F. Supp. 128 (S.D. Tx. 1990), a Texas case where the lender had to repay the tenant for build-out costs incurred upon renewal of the lease by the landlord without the knowledge of the lender, and *see generally* Joshua Stein, *Needless Disturbance? Do Non-Disturbance Agreements Justify All the Time and Trouble?* 37 REAL PROP. PROB. & TR. J. 701 (Winter 2003).

5 Conversation with Timothy Hardin, Senior Vice President, Fidelity National Title Company. Texas title insurance does not cover personal property, and although Procedural Rule P9(b)(3) of the Texas Title Insurance Basic Manual, published by the Texas Land Title Association, provides no endorsement shall be issued if the deed of trust is modified to cover property not described on Schedule A of the policy, Schedule A provides a real property legal description and does not include the personal property typically listed in deeds of trust.

example of a borrower who prepays a loan when tract one is released from the deed of trust and pledged to another lender, leaving tract two as the lender's collateral. If tract two's only access to a utility (e.g. sewer or water) or to a public road is under a later-created easement, a foreclosure by the other lender will wipe out that easement, leaving the original lender's tract one undevelopable.

4. **Make sure your syndication and participation intercreditor provisions protect you rather than hurt you**. Construction loans have been participated for as far back as layers can remember and have been syndicated since the late 1990s.[6] However, they have never been tested more than they have been in the last few years. Lead lenders and agents have been aggressive in exercising their discretion. Participants and syndicated lenders, particularly when they purchased their rights from the FDIC as an asset of a failed bank, have been aggressive in their claims against lead banks and agents.

(a) Defaulting Lenders. Make sure the participation or syndicated loan agreement provides that lenders who default in their obligations to fund their portion of advances lose their right to vote. Make sure the agreement provides that a non-defaulting lender that funds for such defaulting lender is to be paid out of the defaulting lender's portion of any recovery at par with interest at the note rate prior to any payment to the defaulting lender. Make sure the agreement provides that the lead lender is permitted to make protective advances or complete the project after an event of default.

Consider a situation without these provisions where participant lender, who purchased a fifty percent interest of a loan (and the lead retained the other fifty percent), failed and is taken over by the FDIC. The FDIC will typically send out an "1821 Repudiation Letter" stating that they will not fund any future advances and then be unresponsive.[7] Oftentimes months can pass before a purchaser buys the note from the FDIC. In that time, construction may not be complete, and the lead lender must make a determination whether to continue funding. Purchasers of these notes from the FDIC are only interested in collecting at par. If the lead lender funds in order to complete the project after an event of default by the borrower, the participant will claim that the lead lender should have obtained the participant's consent to fund and also that the value of the collateral went down after the funding (hindsight is always 20/20). If the participation agreement stated that a defaulting lender lost its right to vote, these claims would not be valid.

Defaulting lender provisions become even more important when you are the agent in a syndicated transaction in which you are obligated under swing lines or letter of credit issuance provisions.[8] The defaulting lender will not reimburse you if the borrower does

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6 Charles A. Guerin, *Construction Loan Syndication on Participation Issues*, State Bar of Texas Advanced Real Estate Loan Course (2003).

7 The United States Bankruptcy Code does not apply to banks, thrifts, credit unions and domestic insurance companies. 11 U.S.C. §109(b)(2) (2010). Upon its appointment as a receiver or conservator of a failed bank, the FDIC succeeds to all rights of the bank, including the right to repudiate burdensome contracts. 12 U.S.C. §1821(e) (2010).

8 A swing line is a revolving line of credit that enables the borrower to obtain loans from the agent on a short-term basis prior to a formal draw under the line of credit. Usually the agent is reimbursed by the next

not repay you. Swing line and letter of credit provisions should contain a requirement for a reduction in the total amount available under these provisions by the amount of the defaulting lender's commitment so that the lender's total exposure will not be increased, and a corresponding increase in the percentage of that reduced commitment that each lender is obligated to fund so that the agent is fully protected.

(b) Minimum Holds. A minimum hold should never be expressed as a dollar amount in case the total commitment is reduced after a lender defaults. For example, a lead lender might sell fifty percent interest in a $40,000,000 loan but agree to always hold a $20,000,000 minimum amount. If a participant defaults after it funded $10,000,000 and the lead lender thereafter funds an additional $10,000,000 ($5,000,000 of which the participant should have funded), you would have a total of $30,000,000 advanced. If the total commitment is then reduced to that amount, the participant will maintain that it has no further funding obligation beyond the $10,000,000 it initially funded, despite the fifty percent participation, because the lead lender must always maintain a $20,000,000 minimum hold. If the minimum hold is expressed as a dollar amount, the commitment should not be reduced. Rather, the obligation to fund the commitment in the future should be limited by a trigger, such as a loan-to-value threshold.

(c) Minority Lenders at Risk. Lenders that hold a small portion of a loan such that they are not required to be a participant in a vote by the Required Lenders (usually one-half or two-thirds of the lenders) should pay particular attention to provisions outside the typical ones requiring "all lender" consent. For example:

(1) Should the Required Lenders be able to extend a date for completion of construction to the maturity date when the budget contemplated a period for leasing up the project after completion of construction? I have not seen any case law that has determined whether an extension of the completion date by the Required Lenders, which extends all lenders' obligation to advance, is an "**extension**" of the lender's commitment, which typically requires all lenders' consent.

(2) Similarly, if all lenders must usually consent to an extension of the maturity date for repayment of the loan except for loan extension options in the agreement, can the Required Lenders waive a loan-to-value requirement or a net operating income requirement in a loan extension option permitting the loan to be extended without meeting these requirements? What if there was also an extension requirement that the guarantor must not be in default of it's liquidity covenant, but the Required Lenders lowered the liquidity covenant amount six months prior to maturity (e.g. in exchange for a paydown)?

(3) Should the lead lender or administrative agent be able to exercise its discretion in determining whether net operating income will be applied to interest on the loan and project expenses and costs prior to further advances of the loan?

draw, but if an event of default occurs and no draw is made, the loan agreement requires the lenders to repay the agent.

(4) Should the Required Lenders be able to change the definition of Permitted Assignee to enable them to sell their portion of the loan to a hedge fund at a discount, leaving the minority lenders with a hedge fund as administrative agent.

These types of issues should be negotiated in more detail in the future.

5. **Intercreditor Agreements with junior lenders may need updating**. A number of recent bankruptcy cases either validate existing provisions in, or suggest that lenders may need to update certain provisions in their Intercreditor Agreements with subordinate lenders. While some of these may not be enforceable in the bankruptcy, they may be enforceable in a separate action for damages against a subordinate lender outside of the bankruptcy. These include:

(a) No Payments after Default. No payment of principal, interest, fees or other amounts shall be made on account of the Subordinate Loan Obligations at any time when a default or event of default, or any event which with the giving of notice or the passage of time or both would result in a default or event of default, is existing under the Senior Loan Obligations.[9]

(b) Post Petition Interest. Senior Lender shall first be entitled to receive payment in full of the principal of and interest on the Senior Loan Obligations and all fees, costs, expenses and any other payments (including post-petition interest and all post-petition fees, costs, expenses and any other payments)[10]due pursuant to the terms of the Senior Loan Documents, before Subordinate Lender is entitled to receive any payment on account of the Subordinate Loan Obligations;

(c) Voting Rights. To effectuate the foregoing, Subordinate Lender does hereby irrevocably assign to Senior Lender all of Subordinate Lender's rights as a secured or unsecured creditor in any Proceeding and authorizes Senior Lender to take, or refrain from taking, any action to assert, enforce, modify, waive, release or extend Subordinate Lender's lien and/or claim in such Proceeding, including but not limited to (a) filing a proof of claim arising out of the Subordinate Loan Obligations, (b) voting or refraining from voting claims arising from the Subordinate Loan Obligations, either in Senior Lender's name or in the name of Senior Lender as attorney-in-fact of Subordinate Lender,[11] (c) accepting or rejecting any payment or distribution made with respect to any claim arising from the Subordinate Loan Obligations and applying such payment and

9 *In re TCI 2 Holdings, LLC,* 428 B.R. 117 (Bankr. D. N.J. 2010). May not be enforceable in a cramdown, but see Section 5(e)(ii) which may be enforceable to prevent subordinate lender from proposing a cramdown and *see In re Erickson Retirement Cmtys, LLC,* 425 B.R. 309 (Bankr. N.D. Tex. 2010), which, with Section 5(c) and waivers of Sections 361 through 365, 502(e) and 509 of the Bankruptcy Code and Sections 5(e), (f) and (g) may be used to deny subordinate lender's right to have an examiner appointed.

10 *In Re Bank of New England Corp.* No. 10-1456 (1st Cir. June 23, 2011), which contains a good summary of case law resulting in the determination that creditors expect that allowing for post petition interest and other claims of the Senior Lender should be articulated precisely, rather than using language such as "all interest" or, as in this case "all interest due or to become due."

11 *In re Aerosol Packaging, LLC,* 362 B.R. 43 (Bankr. N.D. Ga. 2006) but see *In re 203 North LaSalle St. P'ship.,* 246 B.R. 325 (Bankr. N.D. Ill. 2000).

distribution to payment of Senior Lender's claim until the Senior Loan Obligations are paid and satisfied in full in accordance with their terms, and (d) taking any and all actions and executing any and all instruments necessary to effectuate the foregoing and, among other things, to establish Senior Lender's entitlement to assert Subordinate Lender's claim in such Proceeding.

(d) No Representation on Lien Validity. Subordinate Lender acknowledges that Senior Lender has made no warranties or representations to it with respect to the due execution, legality, validity, completeness, perfection or enforceability of the Senior Loan Documents or the collectability of the Senior Loan Obligations evidenced thereby, and Subordinate Lender agrees that this Agreement shall not be affected or impaired in any manner whatsoever, including any failure or defect in the due execution, legality, validity, completeness, perfection or enforceability of the Senior Loan Documents or the collectability of the Senior Loan Obligations evidenced thereby, including whether the lien of any Senior Loan Document purportedly securing the Senior Loan Obligations is legal, valid, complete, perfected or enforceable, is avoidable in any Proceeding, or is otherwise set aside, invalid or lapsed.[12]

(e) Waivers of Rights. Subordinate Lender hereby expressly, unconditionally and irrevocably waives all rights to:

(i) oppose any confirmable plan of reorganization of the Borrower proposed by Senior Lender or propose or support a plan of reorganization competing with or in opposition to Senior Lender's plan,[13]

(ii) take a position inconsistent with or contrary to that of Senior Lender (including a position by Senior Lender to take no action) if Borrower seeks to use, sell or lease Collateral (or the proceeds or products thereof) under Section 363 of the Bankruptcy Code, including any right to object to bidding procedures therefor[14] and

(iii) oppose the use of cash collateral[15] or seek adequate protection in respect of Collateral (or the proceeds or products thereof) under Section 363 or 361 of the Bankruptcy Code.[16]

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12 *In re Ion Media Networks, Inc.,* 419 B.R. 585 (S.D.N.Y. 2009), *appeal docketed,* No. 09-10596 (S.D.N.Y. Dec. 30, 2009).

13 *In re TCI 2 Holdings, LLC,* 428 B.R. 117 (Bankr. DN.J. 2010). Even if unenforceable in bankruptcy, senior lender may have contractual claim against subordinate lender in state or federal court for violating agreement.

14 *In re Boston Generating, LLC,* No. 10-14418 (SCC) (Bankr. S.D.N.Y. Oct. 4, 2010); also beware of letting the sale proceed. 600 F.3d 231 (2d Cir. 2010). *See also* Berman and Brighton, "Second Lien Financings: Part V-Who Gets What?," Vol. XXV, No. 6, *ABI Journal* (July/August 2006); a contrary view is expressed in *Clear Channel v. Knupfer (In re PW LLC),* 391 B.R. 25, 35-36 (9th Cir. B.A.P. 2008), where the court found a right to eliminate certain features of the sale even after it had closed. But see *In re Stadium Management Corp.,* 895 F.2d 845, 848-49 (1st Cir. 1990).

15 *Aurelius Capital Master, Ltd. v. TOUSA Inc.* (S.D. Fla. Feb. 6, 2009).

(f) Other Waivers. Subordinate Lender hereby expressly, unconditionally and irrevocably waives any principles or provisions of law, statutory or otherwise, which are or might be in conflict with the terms of this Agreement and any legal or equitable discharge of the Subordinate Loan Obligations.[17]

(g) Standstill. Until the Senior Loan Obligations are paid in full, Subordinate Lender agrees not to exercise any rights or remedies or take any action or proceeding to collect or enforce any of the Subordinate Loan Obligations.[18]

6. **Prepare for a future sale of the Note**. Rather than foreclosing on collateral, many lenders would rather sell the note and avoid the risks of bankruptcy or foreclosure. Some find it advantageous to be able to sell multiple notes together, sometimes bundling better assets with less desirable ones. Make sure you don't have surprises that prevent you from selling a note:

(a) Set aside letters or Letters of Credit. These are issued to assure completion and adequacy of public improvements will come back to haunt you. Oftentimes lenders are willing to take a slightly greater loss if they can sell a note and not have to spend the time or money on, or take the risks associated with, foreclosing and owning the property or dealing with a potential bankruptcy of the borrower. However, note buyers rarely qualify as letter of credit issuers, and set-aside letters require that loan proceeds will be withheld. Both of these risks are rarely assumed by note buyers, and the banks will keep this exposure for an indefinite time as set-aside letters or letters of credit often do not put an expiration time limit on the public entity. To solve this problem, letters of credit and set-aside letters should, if at all possible, expire during the term of the loan. If that is not possible, they should reduce in fixed amounts as the applicable obligations are met. Lastly, there should be a mechanism to substitute a cash deposit or an account pledge, either by the borrower at the lender's discretion or by the lender or its assignee, which, if drawn, would become part of the indebtedness owed under the loan agreement and secured by the deed of trust.

(b) Note sale restrictions. Oftentimes strong borrowers restrict note sales to certain types of institutions, and specifically exclude potential competitors. Sometimes they may even negotiate approval rights over a sale of the note by the lender. These types of restrictions may be perfectly valid if you have a performing loan. However, these restrictions should not apply during the existence of an Event of Default. A lender's highest bidder for a note may be a distressed fund specializing in a type of real estate asset. That fund could arguably be a competitor. Other times an actual competitor is the highest bidder because they have the most experience with the asset type and community in which it is located.

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16 May not be enforceable under *In re Hart Ski Mfg. Co.,* 5 B.R. 734 (Bankr. D. Minn. 1980), but see *In re TCI 2 Holdings, LLC,* 428 B.R. 117 (Bankr. D. N.J. 2010). Even if unenforceable in bankruptcy, senior lender may have contractual claim against subordinate lender in state or federal court for violating agreement.

17 See id. at footnote 12.

18 See id. at footnote 12.

7. **Do a better job of avoiding mechanics' and materialmen's liens**. In some States it is almost impossible to achieve full lien priority, even if the lender's lien is recorded when no work has been done on the property. This is a bitter pill to swallow if the lender made sure that its lien was in place prior to inception of the mechanic's lien's priority under state law, whether that be by making sure the lender's lien was recorded prior to commencement of construction, like Texas, or execution of a construction contract or first work on the structure or improvements (e.g. an architect's initial concept drawing), like Colorado.

(a) Title Company Coverage. If the premium has been paid and if all the steps have been followed then you might have coverage. If not, when the lender attempts to sell the property after foreclosure, the title company usually will not remove any exception for recorded mechanics' liens from their policy commitment for the future purchaser. They have claimed it is because they do not want to be required to defend a lawsuit by the contractor. In Texas, insurers are prohibited from covering mechanic's liens on construction loans. They often claim that they cannot remove the lien because, under Texas law, the contractor always has priority for "removables", regardless of the priority of the lender's lien recordation.

(b) Payment Bond. In documenting the loan, one solution usually is to require the contractor to provide a payment bond which would remove the exception, but if the contractor is not paid on the contract, the bond issuer will claim their bond is void. Further, the payment bond addresses only the failure of the general contractor to pay subcontractors, not the failure of the borrower to pay the general contractor, which is a common problem when the contractor applies for a payment amount that the owner believes is in excess of the amount they are due. Also, these bonds can be costly and are often waived.

(c) Better Conditional Lien Waivers. Solving this problem with less expense requires a two-fold documentation solution. The first is to always obtain recordable conditional mechanics' and materialmen's lien waivers with each draw. That is the best evidence of what the contractor has been paid and, more importantly, what they are owed. That waiver, along with evidence of payment to the contractor of the remaining amount, should be enough for the title company to remove the exception. However, the title company may still refuse to remove the exception because the contractor may also claim some last-minute changes to the contract or change orders to the work. Recently, creative contractors have maintained that additional work was outside the contract. Therefore, they refuse to give final lien waivers because they want to preserve their rights to file liens if that additional work is not paid. Thus, it is important that the lien waivers obtained with each draw release **all** liens and state the contractor has been paid for **all work** to date on the project, not just **all invoices** to date on the project. Sometimes those invoices don't seem arrive until late in the project and subcontractors are filing liens because their statute of limitations for filing (months after they did the work) is about to expire. The lender should also obtain subcontractor and material supplier waivers, to the extent possible, as the borrower may contract with them directly outside the general construction contract.

(d) Better Contractor's Consent and Agreement. Additionally an often overlooked document is the Contractor's Consent and Agreement that may or may not be a required loan closing document. It should be and should not be a point of contention. Usually the contractor is interested in being paid what it is owed. As long as the lender agrees to that, the contractor will not typically object to provisions that require the lender's consent to any changes that increase the price of the contract or any change orders over a certain specified amount. It should also require lender consent for **any** other amounts that may be owed to the contractor for **any** work done on the project. The author has used the agreement as a response and counterclaim to a contractor's lawsuit against a borrower and the lender for priority over the lender's lien for payment amounts in excess of the unapproved amounts. It is also time to revisit that specified amount. Typically, on a $30,000,000 loan, the lender's approval might be required for individual change orders over $100,000 and for aggregate change orders over $500,000, a small percentage of the total loan amount. This is because change orders will likely occur, and no one wants to have to seek lender approval for changes in the normal course of construction. However, these change orders are often a surprise at the end of construction. If you ask for a final lien waiver only to find out $500,000 in change orders or some other additional amount is being added to the last draw, that number is significant if the project is distressed. One solution would be to require lender approval for **all** change orders or **other** additional amounts requested by the contractor anytime after ninety days prior to the anticipated completion date.

8. **Watch those major personal property fundings outside of the general construction contract**. This relates to fundings for the borrower's direct payment to vendors for items such as furniture, fixtures and equipment (e.g. for hotels), particularly where the lender knows the vendor is supplying those items. Under UCC 9.324, a purchase money security interest (PMSI) vendor in inventory will have priority over any other lender's inventory lien if: (a) they have sent the other lender a notice of their PMSI lien prior to delivering the inventory to the borrower; and (b) they filed a financing statement in the inventory before the borrower received the inventory. At a minimum, the non-PMSI lender should obtain a copy of each contract with such PMSI vendors, and the loan agreement should authorize the lender to: (a) make direct payment to PMSI vendors; (b) search UCC records to determine if they have filed a lien; (c) obtain an acknowledgment and release with each payment; and (d) obtain a UCC-3 termination upon payment in full of amounts owed to them.

9. **Lenders need better tools to stop advances on a troubled project**. This author negotiated a note purchase sale agreement for almost par on an apartment project that had been completed for over six months. The sale fell through because there was a considerable undrawn portion of the loan and no specific provisions in the loan agreement limiting post-completion funding. Additional significant funding would cause the loan to be in excess of one-hundred percent loan-to-value. Rarely will note purchasers risk an obligation to make further advances on a loan.

(a) Completion Dates should work better. Sometimes loan documents don't contain a completion date for construction. If they do, usually it does not specifically limit further construction funding and does not cut off post-construction funding (e.g. for soft costs on tenant improvements) obligations under a construction loan. Most lenders would like a project to be complete, but once complete, a completion date provision should eliminate further payments for hard cost line items or other line items associated with construction of the base improvements for a project, or, at a minimum, advances for hard costs should be at the discretion of the lender after expiration of the completion date or actual completion of the project, whichever occurs first. Other costs anticipated after completion of construction should be limited to specified line items in the budget.

(b) The Borrower should not be able to draw while pocketing NOI. Some loan documents do not require net operating income (NOI) to be applied to payment obligations prior to loan funding. Loan agreements should require all NOI to be applied to the project, not just loan interest, before loan funding. As a side note, participants and syndicated lenders may want to make sure this requirement is not subject to lead lender or agent discretion as the lead lender, agent or even other lenders in the transaction may have other loans to the borrower or borrower affiliates to which they would like the NOI applied.

(c) LTV Balancing. This author also recently saw documents from another bank which required appraisal loan balancing, a requirement to provide additional borrower equity in the amount that the loan exceeded the loan-to-value percentage of an appraisal as ordered by the lender during the loan term. This is a classic balancing provision that disappeared in the 1990s. I'm not sure it could be revived when the market recovers, but it might be revived in a limited capacity to apply that no further loan fundings will be required after the completion date if a loan-to-value test is not met. That would also have saved the above note sale. Alternatively, a stricter limit could have been placed on post-construction fundings to make sure large, undisbursed line items were not required to be disbursed further after project completion.

10. **Carve out Guaranties have provided unexpected benefits, but can be improved to cover unanticipated situations.**

(a) Springing Recourse Works. In carve out guaranties expect more negotiation over "springing recourse" or "exploding recourse" clauses. Typically nonrecourse carve out guaranties provide that the guarantor will be liable for "bad acts," such as the borrower's fraud, misapplication of rents, failure to maintain the property, failure to pay taxes and insurance, etc[19] Additionally a "springing recourse" clause makes the guarantor fully liable if the lender's foreclosure is challenged or the borrower is subject to a voluntary or involuntary bankruptcy proceeding. ("Proceeding"). Similarly "exploding guaranty" provisions provide a guarantor is fully liable until the lender takes title to the property if the lender's foreclosure is not challenged and the borrower is not subject to a Proceeding. These clauses were originally designed to make sure that the borrower and guarantor did not oppose the lender's ability to get to the collateral. These provisions and the single asset bankruptcy rules have been credited to stemming the tide of bankruptcies of single asset commercial real estate loans.

[19] For a discussion on carve outs, *see* Charles A. Guerin, *A Non-Recourse Carve Out Checklist*, State Bar of Texas Advanced Real Estate Drafting Course (2003).

(b) The Unexpected Benefit of Collateral Preservation. However, carve out guaranties have been more beneficial to lenders than originally thought. In some cases the lender is willing to let the loan mature, not collect interest and not take the property back, despite the borrower's desire to "deliver the keys". Even though the borrower is not performing, as long as the lender does not foreclose or otherwise take title to the property, the carve-out guarantor guarantees any loss due to the borrower's failure to maintain the property, pay taxes, etc. until the market recovers. Lenders should become more aware of the springing and exploding aspects of guaranties, especially seeking to include springing recourse in a carve out guaranty. Guarantors too will be more sensitive to these provisions, likely wanting to negotiate an end to liability for bad acts once the borrower offers to deliver the keys, and the lender has the ability to take title to the property without opposition or the existence of a Proceeding.

(c) Constituent Entity Bankruptcy Problem. In carve out guaranties, the bankruptcy of not only the borrower but also any partner, member or other entity that is required to sign conveyance documents should trigger full liability. This is particularly important where the borrower is wholly-owned by one individual or entity. When a lender forecloses on a project, even if it has made a sincere effort to obtain a lien on all the agreements, permits, licenses and other rights to operate and sell the project, it may find that it will be easier to acquire these directly from the borrower rather than foreclose on them. Some governmental entities will require a signature to transfer rights even if foreclosure occurred. A lender may also find that it missed some items or the borrower has entered into agreements affecting the property but did not give it notice of them. This may have been considered insignificant from a collateral value standpoint but ends up being very important to selling the project. Assignment by the lender (as seller) of a number of these items to the purchaser may be a purchaser requirement at a time when alternative purchasers are in short supply.

The author represented a lender that foreclosed a project where the borrower did not file bankruptcy but the borrower's general partner did. The general partner owned the borrower and was required to execute all documents for the borrower. A number of property-related items were not specifically described as part of the collateral or required a specific signature for transfer. For example, the borrower had to specifically sign an application to transfer a Texas Commission on Environmental Quality wastewater permit. While the borrower required to sign the permit was not in bankruptcy, the general partner entity that was required to sign on behalf of the borrower was in bankruptcy. In order for the permit to be transferred, the bankruptcy trustee had to approve the signature since the entity that signed owned an interest in the borrower, which was an asset of the bankruptcy estate. That process took almost three months at a significant legal cost. If the guarantor was independent of that entity and credit worthy to pay off the lender, that carve out would have helped add pressure for a quicker resolution of the issue or provided additional recourse for the lender.

11. **Make SPE Requirements part of limited liability and limited partnership documents, not just a clause in the loan agreement**. Although the widely reported

General Growth decision[20] is cited for the proposition that cash collateral from an SPE can be used in the parent's bankruptcy without substantive consolidation,, the more vexing portion of the ruling held that the SPE agreement permitted the independent directors to be replaced, and that SPE's could file bankruptcy because an SPE's independent manager's fiduciary duties were to its owners, not its creditors. Lenders' counsel have seized upon the unpublished DB Capital Holdings decision[21] and certain aspects of DE limited partnership and limited liability company law to provide hope that bankruptcy remote special purpose entities ("SPE's") can escape these problems. The crux and potential pitfall of reliance on this unpublished opinion is that it held that a limited liability company agreement could contain an enforceable bar against bankruptcy, but also concluded the record was not sufficient to determine if "under the right set of facts, an LLC's operating agreement containing terms coerced by a creditor would be unenforceable."

Nevertheless, expect lenders to favor Delaware limited liability companies as the preferred SPE borrower, the next round of SPE clauses to require their insertion into the actual limited partnership and operating agreements, and new clauses similar to the following be included:

(a) Lender Consent to Independent Director Removal. "This LLC shall at all times have two Members which are Independent Members, which shall not be removed or replaced without the Lender's prior written consent, unless the Lien has been fully and finally released. Notwithstanding anything to the contrary in this Agreement, no Independent Member shall be required to acquire a interest in or make a contribution to this limited liability company."[22]

(b) No Liability of Independent Director. "Except for an act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing, no Independent Member shall have any duties (including for breach of contract and breach of duties, including fiduciary duties) at law or in equity to this LLC or to another member or manager or to another person that is a party to or is otherwise bound by this Agreement." [23]

"Notwithstanding anything to the contrary in this Agreement or otherwise, no Independent Member shall be liable to this LLC or to another member or manager or to another person that is a party to or is otherwise bound by this Agreement for breach of fiduciary duty for the Independent Member's good faith reliance on the provisions of the Agreement."[24]

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20 *In re General Growth Props., Inc*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

21 *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC and WestLB AG*, BAP No. CO-10-046 (10th Cir. Dec. 6, 2010).

22 Permitted by Delaware Limited Liability Company Act Sections 18-101 (7) and 18-301 (d).

23 Permitted by Delaware Limited Liability Company Act Section 18-1101 (c) and (e).

24 Permitted by Delaware Limited Liability Company Act Section 18-1101 (d).

(c) Certain Actions require Independent Director approval and duty to Lender. "This LLC may take any action in accordance with the provisions in this Agreement, provide however without the consent of the Independent Members, this LLC shall not (1) dissolve, institute dissolution proceedings or consent to the institution of dissolution proceedings, (2) agree to the sale or pledge of any membership interests, or to the merger or consolidation of this LLC with any other person or other business entity, (3) sell or liquidate all or substantially all of its property, (4) become part of any centralized cash management system with any other entity, fail to maintain its accounts and cash management separate and apart from any other entity, or use any of its cash or (5) institute a Proceeding or consent to the institution of a Proceeding [without a report from _______________, or such other auditor approved by Lender in its sole discretion, that this LLC is insolvent]. In considering whether to consent to any of the above actions, the Independent Members shall only consider the interests of the LLC and the Lender, and shall not consider the interests of other Members or affiliates of this LLC or its Members____. Any vacancy in the position of Independent Director must be filled before any of the above actions can be approved."[25]

(d) Lender Consent to change certain provisions. "None of the definitions of Lender, Lien, Independent Member or Independent Members, or the provisions in Sections __________ or this Section ___ may be amended or eliminated without the Lender's prior written until the Lien has been fully and finally released."[26]

12. **Pay attention to the notice addresses and procedures**. Notices that always must be sent by certified mail are expensive and time consuming. The notice provision should allow for delivery by a nationally-recognized or local courier or, if specified, via facsimile or email. If you are involved in litigation or foreclosure, specific requirements for notice may apply. However, the procedures for sending notices of default should be simple.

Also, make sure the notice address is complete. If faxed or emailed notices are permitted, the fax number and email address should be listed. If those provisions are not completed, you can't confirm you have given proper notice in a manner where the information required for such notice is missing from the documents. As an additional practice point, if the client would like to save some legal fees, they should list the addresses in the loan documents for borrowers, guarantors, pledgors and other obligors in an email to their

[25] In clause (1), except as otherwise provided in provided in its limited liability company agreement, Section 18-801 (a) (1) of the Delaware Limited Liability Company Act provides a limited liability company shall be perpetual unless dissolved by a member vote taken in accordance with Section 18-801 (a) (3) of the Delaware Limited Liability Company Act. In clause (2), "other business entity" is defined in Section 18-209 (a) of the Delaware Limited Liability Company Act, and a Delaware limited liability company can only merge or consolidate with the types of entities listed. Clause (5) is permitted under *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC and WestLB AG, BAP*, No. CO-10-046 (10th Cir. Dec. 6, 2010) The provision in the last sentence is patterned after the Joint Plan of Reorganization approved in *In re General Growth Props., Inc*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009) and arguably a reading of Sections 18-1001(c), 18-101(7) and 18-1101(c) of the Delaware Limited Liability Company Act).

[26] Permitted by Delaware Limited Liability Company Act Section 18-101 (7).

counsel with a reference to the document section. They should also send any more current address, even if they don't have an official change of notice address letter.