Development projects often come in multiple pieces, with separate ownership and financing, joined together through a reciprocal easement agreement. Here’s how a lender looks at that picture.

WHEN A DEVELOPER CREATES A COMPLEX REAL ESTATE ASSET, such as a regional mall or a multi-use project, different owners will often own the different components, and different lenders will take the various components as collateral. To pull it all together, and make each component work in the context of the overall project, the developer will often record a reciprocal easement agreement. In a project, each component could consist of a parcel of land and the improvements built on it. In other cases, a component could consist of a three-dimensional volume of space in the project. All of this can vary widely in size and complexity. Either way, the project will look like a single building or a single development, but legally it will consist of multiple separately owned components. It will also include common areas that serve the entire project or one or more components. Typically some central authority, controlled by the developer or manager of the project, will operate the common areas and administer the project.

Sometimes, each owner will own a three-dimensional condominium unit carved out of the larger project. The
condominium structure defines the rights and obligations among the various owners, covering many of the issues discussed in this article, along with a few others. We won’t cover any issues unique to the condominium structure in this article. This article focuses only on the arrangement in which each owner owns land and the improvements on that land (as part of a larger project) or a defined three-dimensional block of real property not constituting a condominium unit.

So this gets us back to reciprocal easement agreements. They go by various names, including “operating agreements,” “common maintenance agreements,” “covenants, conditions, and restrictions,” “restrictive declarations,” “project declarations,” or the like. This article will refer to these generally by the acronym “REA.”

Once negotiated, the REA becomes part of the package of long-term legal rights that makes up and defines each component. It travels with that component as the component changes hands—including to a lender as collateral for a loan and potentially through foreclosure under that loan. The REA is very much like a privately negotiated statute or a treaty between nations. It can cover a wide range of issues—essentially every project-related issue that could affect the owner of more than one component. In some ways, the REA covers much of the same ground as a lease. Unlike a lease, though, all parties to an REA play both landlord- and tenant-like roles, so the relationships between them can be more balanced and mutual.

This article begins by summarizing the basic principles that both borrowers and lenders apply in reviewing the REA, then considers some mechanical matters that arise in reviewing an REA, including the review process itself and how the REA ties to the rest of the transaction. It will then move on to major issues that can arise in an REA, including some discussion on which of those are likely to create trouble. That will be followed by a brief summary of a lender’s unique concerns.

Everything discussed here will also come into play when a developer’s counsel prepares the REA, or when a purchaser of a component wants to evaluate the REA as part of its due diligence for the component and the project.

**THE LENDER’S PERSPECTIVE** • When a borrower asks a mortgage lender to finance a component within a project, the lender and its counsel must analyze the REA to understand how the project works, how the REA affects the lender’s security package, and whether anything in it creates risks that the lender should consider in its underwriting or insist that the borrower fix.

**REAs Are a Little More Complicated than Leases**

In performing that analysis, the lender and its counsel will start with an agenda similar to that which arises in reviewing any heavily negotiated lease. The process, however, is complicated by the fact that all parties to the REA—and there may eventually be many—will want to negotiate the REA to make it work without gaps or problems. To the extent that the developer establishes the REA before any of those parties have entered the picture, the developer will typically try to reach the same result, but the document will probably be simpler. The developer, however, may enter into separate agreements with some of the owners as they acquire their components. Those separate agreements may add complexity, but the mortgage lender will only see any such agreement that affects its own borrower. On the other hand, leases tend to be more generic and (in most cases) more biased toward a particular party, often the landlord (the borrower).

**The Lender Can’t Terminate the REA in a Foreclosure**

In considering any REA, the lender and its counsel also need to remember that, for most purposes, the REA will be “prior” to the mortgage. A
foreclosure of the lender’s mortgage will not typically affect the REA; the REA will simply continue. Since it cannot be terminated or eliminated, the REA must be something the mortgage lender can live with after foreclosure. That fact underscores how important it is for the lender and its counsel to understand the REA and accept its terms. If the REA contains just one particularly lethal “gotcha” clause, it can severely impair the lender’s security.

BORROWER’S AND LENDER’S OVERLAPPING AGENDAS • In reviewing the REA, the borrower’s and lender’s agendas overlap even more than they would in reviewing a lease. For the most part, both borrowers and lenders want to ensure that the REA provides satisfactory answers to these questions:

• Integrated Project. Does the project function as an integrated whole? Does each Owner have a set of rights and controls consistent with its expectations for the entire Project?

• Practicalities. Does the project function properly and predictably, in a way that helps the parties reliably achieve their expectations? Does each owner obtain whatever access, operational benefits, and utilities it needs in order to operate as planned? Do the rights and benefits work, considered as a whole? Depending on the level of complexity of the project, the lender’s consulting engineers or inspectors might need to get involved here.

• Allocations. Are any costs that the owners share allocated in a reasonable and proportionate way, so that each owner will pay its fair share? If an owner will pay more than its fair share, it (and its lender) must fully understand that fact and factor any misallocation—and its future impact over time—into the valuation of that owner’s position.

• Freedom vs. Control. Does the REA create a workable balance between freedom and control? Each owner would like to control what the other owners do; at the same time, the owners will each want the appropriate freedom and flexibility to control their own components.

• No Disconnect. Does the REA match up with the owner’s rights against, and obligations to, its own tenants?

• Changed Circumstances. Does the REA deal with possible future changes in circumstances in a way that is consistent with the principles just suggested? “Changes of circumstances” will of course include every real estate lawyer’s most beloved – or at least most analyzed – possibilities: casualty and condemnation.

In addition to the agenda that a borrower and lender share in any REA, a lender will also want to consider a narrower set of concerns that relate solely to the lender’s position as a mortgagee and owner waiting in the wings:

• Information and Status. Does the REA give the lender adequate rights to information and knowledge if problems arise with the borrower’s performance, as owner, under the REA?

• Defaults. If the borrower defaults under the lender’s mortgage, with or without a default under the REA, does the REA give the lender rights and remedies that allow it to take control of the situation without losing any of its collateral?

• Lien Priority. What is the relative priority between the lender’s mortgage and any lien that arises under the REA for unpaid charges?1

• Taking Over the Component. If the lender ever became owner of the component, will anything in the REA—or that could happen relating to the...

1 The lender will rarely expect the REA itself to be subordinate to the mortgage, because the lender understands that the REA is part of what defines the very asset the lender is financing. The lender will, however, want to confirm, as part of its due diligence, that the same priority applies for every component of the project, so that some other mortgage lender cannot “wipe out” the REA as it affects that other component. And the priority of the REA itself is not the same thing as the priority of any lien that arises under the REA.
REA—create an unacceptable situation for the lender?

Lender’s counsel will need to apply these general principles again and again in reviewing any REA, and in considering each of the more specific REA agenda items described below.

“MECHANICAL” ISSUES IN REVIEWING REAs •

Defining the Collateral

In reviewing any REA, the first question a lender or its counsel will ask is this: exactly what piece of this project does the borrower plan to deliver as collateral for the loan? The REA will always help define the various components. Once the lender and its counsel understand which component the borrower is offering as collateral, they can proceed as follows:

• **Legal Description.** When the mortgage describes the real property being encumbered in favor of the lender, the description of that real property should include the entire REA component being mortgaged, as well as the borrower’s rights under any ancillary or related agreements, as disclosed by the REA or the public record. How should the mortgage present that description, and how does that tie to the survey and other due diligence materials that the lender and its counsel received?

• **Partial Component.** Is the lender’s collateral a complete, separately conveyable, and separately taxed parcel of real property? This question is no different than any lender’s review of land and buildings that a borrower owns without the complexities of an REA.

• **Underwriting.** Confirm that the lender understands exactly what it is receiving as collateral. Does the collateral include one anchor store? Two anchor stores? None? Specific parking places? General rights to park in the parking lot? The right to expand in a particular area? Does the lender’s appraisal correlate to the description of the component as it appears in the REA?

• **Completeness.** Is there any way in which the particular component is not a complete unit? If any problems exist along these lines, does something else in the REA solve them? For example, the REA may define one component — the component being financed — as consisting of all stores in the east wing of the project. If the component does not also include the walkways in front of the stores, they might be land-locked and useless, unless something else in the REA solves that problem. A general access easement might help, for example, but does its precise terms provide for the access actually needed? Lender’s counsel will often want to confirm with a written memo that the lender understands any such technicalities, even if the analysis provides a satisfactory solution.

• **Dealing with Problems.** In most cases, the REA cannot realistically be amended, at least not in the closing period for any individual loan. To the extent that problems exist, counsel will need to bring them to the lender’s attention. The lender will then usually have these choices: revalue the component based on the problem and adjust the loan amount accordingly; set up some credit support mechanism to mitigate whatever problem appeared in the REA; live with the problem; or not make the loan. Because of the general infrequency of significant problems with REAs (even imperfect REAs), the lender will not usually want to hear about minor problems with an REA; in almost all cases, it will ignore them. That will dictate the approach to be taken in reviewing the REA, but if a lender instructs counsel to disregard a possible problem because it is “minor,” counsel will want to plan ahead for the phone call from the lender three