Take the right approach: Start with the key issues.

**SOME REAL ESTATE** lawyers begin the commercial real estate loan process from the wrong starting point. Too many lawyers get bogged down in unimportant details of the loan documents. While the details should not be ignored, they should not overshadow an approach that begins with the key issues of importance to your client. So in this article we will take a look at 10 of the most important: Prepayment premium issues; Recourse liability issues/carveouts; Due on sale issues; Secondary financing issues; Partial release rights; Single purpose entity requirements; Casualty issues; Lease approval issues;
1. PREPAYMENT PREMIUM ISSUES • Most commercial real estate notes, at least those in which there is a fixed interest rate, contain a prepayment premium. There are two primary methods of calculating a prepayment premium. One such method is the “yield maintenance” formula and another method is the “specified percentage” or the “declining balance” formula. In this type of formula, the prepayment premium may be five percent of the principal amount if prepaid in the first year, four percent in the second year, three percent in the third year, and so forth. This method is less precise in calculating the loss to Lender arising from the prepayment but is still used in some situations.

The issue of the enforceability of prepayment premiums has been the subject of substantial litigation. In River East Plaza, L.L.C. v. The Variable Annuity Life Company, 498 F.3d 718 (7th Cir., 2007), the United States Court of Appeals for the 7th Circuit upheld the application of a yield maintenance provision in a commercial promissory note when the Borrower voluntarily prepaid the loan in order to sell the property at a substantial profit. In cases in which the Lender has tried to collect the prepayment premium as a result of an involuntary acceleration due to the loan going into default, the results have been somewhat more mixed. For an excellent discussion of the enforceability of prepayment premiums, see the exhaustive treatment of the subject by John C. (“Jack”) Murray, Enforceability of Prepayment-Premium Provisions in Mortgage Loan Documents at www.firstam.com (Jack Murray Reference Library).

Negotiating Points

Although the enforceability of the prepayment premium has been the primary issue focused on by the courts, it is not likely be the issue negotiated by the Lender and Borrower. Rather, the primary issues in a loan negotiation are as follows:

Is the prepayment premium formula understandable? Generally, a yield maintenance formula will identify a specific treasury obligation or similar benchmark security to be used calculating the amount of the formula. Sometimes, it may be beneficial for both the Borrower and the Lender to have an example of how the prepayment premium is calculated;

What are the exceptions to the prepayment premium? Some Lenders provide no window prior to maturity. Others, such as in the Fannie Mae excerpt at Appendix 1, have a 90-day window before maturity to allow for refinancing. Some Borrowers are successful in obtaining as much as a 180-day window before maturity for payment without a premium;

Does the prepayment premium apply to the application of proceeds of casualty or condemnation? Although the loss to the Lender is the same whether the prepayment premium arises as a result of a casualty or as a result of a voluntary election by the Borrower, many Lenders do not charge a prepayment premium upon a casualty or condemnation because these are outside the control of the Borrower;

Are partial prepayments permitted? Many Lenders do not allow for a partial prepayment; instead, the loan may only be prepaid in its entirety. There are various business reasons why a partial prepayment might be allowed. For example, if a part of the mortgaged property is to be sold, a partial prepayment will be essential;

Does the prepayment premium apply upon a default and foreclosure? This is primarily an issue for the Lender. Of course, in most cases, Lenders will want to have the prepayment premium apply upon a foreclosure. Occasionally, however, the loan documents are not clear on this issue;
Lockout period issues. Frequently, a secured note cannot be prepaid at all for a certain period of time (the “Lockout Period”). For example, in a shopping center, a tenant might have an option to purchase an outparcel or a pad site that is exercisable at any time. Any such exercise of that purchase option will need to be accompanied by a prepayment premium right and a partial release right. If there is a possibility that exercise of this right could occur during the lockout period, the basic structure of the deal does not work. It is surprising how often a Borrower will agree to a lockout period, only to discover during due diligence that the lockout period will not accommodate previously negotiated lease terms. Most notes also provide that if there is a default foreclosure during the lockout period, there is some specified percentage of principal that applies as the prepayment premium formula during that time frame to compensate the Lender for the avoidance of the prepayment lockout.

2. RECURSE LIABILITY ISSUES/CARVEOUTS • A nonrecourse loan is a loan in which the Borrower is not personally liable for repayment of the loan. Upon the occurrence of an event of default, the Lender’s only recourse is against the property securing the loan. The Lender may not look to the personal assets of Borrower for repayment of the Loan (except to the extent it is specifically granted to Lender as secured property).

Fifteen or 20 years ago, the nonrecourse or “exculpation” clause of a note or mortgage was generally brief, and may have simply recited the fact that the Borrower had no personal liability under the loan documents, and that in the event of default, the Lender’s sole recourse was against any property securing the loan. This broad release from personal liability enabled Borrowers to utilize the cash flow from the property, while neglecting the property by, for example, failing to pay real estate taxes or failing to make necessary repairs to the property (in violation of the loan covenants). There was little risk to the Borrower for this course of action (other than the likelihood that the Borrower would not likely receive a loan from that Lender again). While the Borrower was accumulating cash flow, the property, which was the only asset against which the Lender could seek recourse, was being devalued. Although the Lender in a nonrecourse loan assumes the natural economic risk inherent in the real estate market, the Lender does not believe it should be exposed to these additional liabilities which are, or may be, imposed by the Borrower’s conduct.

In some degree to protect against abuses of the nonrecourse clause, but also to alter the economic risks of the loan transaction, Lenders have added significant exceptions to the non-recourse nature of the loan. Under these exceptions or “carveouts” to the nonrecourse nature of the loan, the Borrower and the guarantor are personally liable for certain specified breaches, defaults’ or indemnities.

**Negotiating Points**

The Borrower typically wants to negotiate some limitations on its recourse liabilities. For example, recourse liability is often imposed for the Borrower’s failure to pay real estate taxes and assessments. These items generally have priority over a Lender’s prior mortgage, so they will need to be paid by the Lender upon foreclosure. This issue is particularly critical if there is no requirement by the Lender for monthly escrow payments for real estate taxes. Such taxes are often paid only once or twice a year, and a substantial liability for unpaid real estate taxes can be amassed before the time an event of default is declared. If there is no specific carveout for real estate taxes, the Borrower’s covenant in the loan documents to pay real estate taxes will likely be held to be subject to the general non-recourse nature of the note.
The likely dispute between Borrower and Guarantor and Lender on this issue will be the time period for which the Borrower and Guarantor is personally liable for the payment of taxes. The Borrower and Guarantor may argue, on a philosophical level, that personal liability should be imposed only for “bad acts” or “misconduct,” and the Borrower and Guarantor should not be responsible if the property, as a result of general economic forces, fails to produce enough revenues to allow Borrower to pay real estate taxes. The Lender will argue that this issue is simply an allocation of risk, and the Lender should not be forced to take back the property subject to any prior liens. The Lender will generally terminate the recourse liability for real estate taxes upon the occurrence of a foreclosure sale or sale under power. The Borrower and Guarantor will argue that such liability should terminate as of the date a receiver is appointed, or at such time as Lender otherwise assumes control of the revenues from the property.

Another hot button issue for the Borrower relates to those carveout items that trigger liability for the entire indebtedness under the note. A violation of the due on sale clause often triggers such liability, as does a violation of the single-purpose entity (“SPE”) provisions. However, the most controversial issue is whether a bankruptcy filing by the Borrower should cause the entire loan to become a recourse obligation.

3. DUE ON SALE ISSUES • A typical due on sale clause is drafted very broadly so that it effectively prohibits the transfer of the ownership interest in the Borrower, or in entities upstream from the Borrower, without the Lender’s consent. The broadness of this provision is purposeful from the Lender’s standpoint. Provisions that only prohibit the sale of the real estate or of an interest in the Borrower can be rendered ineffective by crafty Borrower’s counsel, who can effectively transfer control of the property by shifting ownership interest in entities that are upstream from the Borrower.

Negotiating Points

Unfortunately, by casting such a broad net in terms of prohibiting transfers of ownership interests, many legitimate and ordinary ownership transfers are prohibited without the Lender’s prior consent. As a practical matter, neither party really wants to consent to minor changes in ownership, such as transfers of minority interests in stock among the existing owners, or transfers from one of the owners to a trust or to children for estate planning purposes. Many Lenders will want to ensure that certain key parties continue to own a majority interest (directly or indirectly) in the Borrower, but are nevertheless willing to permit changes in ownership interest (provided that it is a minority ownership interest). This is one aspect of the documents that should be narrowly tailored to fit the particular situation.

In response to the due on sale clause, the Borrower and Lender frequently negotiate a provision whereby the Borrower can transfer the property to a purchaser who assumes the obligations under the Loan subject to certain approval rights of the Lender relating to its underwriting criteria for the transferee and of the property at such time. Key negotiating issues arising out of this transaction are:

How much discretion the Lender has in terms of its approval rights of the proposed transferee; and What happens to the liability of the existing Borrower after such loan has been assumed by the purchaser.

4. SECONDARY FINANCING ISSUES • Most due on sale clauses also contain a “due on further encumbrance” clause. In other words, if the Borrower creates or permits any further liens to be filed