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The 'Range' When Valuing for LTV Covenants

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By **Duncan Hubbard**
Partner | Real Estate

By **William Lo**
Associate | Real Estate

Value preservation of the underlying real estate asset is fundamental in any conventional real estate financing transaction. With ongoing covenants and undertakings that seek to regulate the maintenance of the property and the conduct of business activities within it during the life of the loan, it is a common market practice that the borrower would be obliged under the loan agreement to ensure that the value of the property, and ultimately the lender's collateral, is, at the very least, maintained.

Most conventional senior debt real estate origination financing loans are structured and credit approved based on loan to value ("LTV"), and whilst this is more commonly a Day 1-only measure in the U.S. market, in the European market monitoring of the LTV is an ongoing covenant. As such, valuations obtained during the life of a loan that accurately reflect the true market value of the property are critical when considering LTV covenant compliance, with the problem of non-compliance being that it could lead to a default in the loan. However, with evolving market conditions in the ever-changing real estate landscape, the range as to what is the "true" market value has potentially widened, opening up to some fascinating views on "permissible margins of error." This article seeks to explore this further.

The 'Range'

In the majority of senior debt real estate origination financing loan agreements, it is the lender who instructs the valuer, such valuation shall be conclusive evidence of the market value, and the borrower has little, if any, scope to challenge such valuation. The borrower is, however, always entitled to obtain its own valuation and, whilst it is unlikely that it would be used for the purposes of the LTV test (which would be reserved for the lender's own valuation), in most instances the loan agreement will require that the borrower provides the lender with a copy of such valuation. The question then is: what happens if the lender's valuation and the borrower's valuation yield very different results?

Lewison J considered the issue in Goldstein v Levy Gee [2003] PNLR 35, and his approach subsequently has been followed in at least two further cases: Dennard v PricewaterhouseCoopers LLP [2010] EWHC 812 (Ch) and K/S Lincoln v CB Richard Ellis Hotels Ltd [2010] PNLR 31 (TCC). In Goldstein v Levy Gee, Lewison J stated that:

"The process of valuing real property has strong subjective elements … this leads to the concept of 'the bracket,' or 'the permissible margin of error'... Pinpoint accuracy in the result is not, therefore, to be expected by he who requests the valuation. There is a permissible margin of error, the 'bracket' as I have called it. What can properly be expected from a competent valuer using reasonable care and skill is that his valuation falls within this bracket."

The issue, therefore, is not whether the final valuation figure is "wrong," but whether it is "outside the bracket."

Buxton LJ in Merivale Moore plc v Strutt & Parker [2000] PNLR 498 at 515-517 also said the following:

"A valuation that falls outside the permissible margin of error calls into question the valuer's competence and the care with which he carried out his task. But not only if, but only if, the valuation falls outside that permissible margin does

that enquiry arise. To find that his valuation fell outside the 'bracket' is … a necessary condition of liability, but it cannot in itself be sufficient."

The Courts seem to therefore suggest that for a valuer to be negligent, the claimant must first demonstrate that:

(a) the valuer fell in some way below the standards to be expected of a reasonably competent professional; and

(b) the valuation fell outside of the range within which a reasonably competent valuer could have valued the asset.

Conversely, this also would seem to suggest that if the valuation is within the range, the valuation will not be found to have been negligent, even if some aspect of the valuation process can be criticised as having fallen below reasonably competent standards. That said, it also suggests that even if the valuation is outside the range, the professional may escape liability if he can prove that he exercised reasonable skill and care.

Determining the Applicable 'Range' for Valuations

How to determine the range is notably subjective. Ultimately, in order to assess what is a competent valuation and what the size of the permissible range should be will depend on the particular facts of the case.

As summarised in K/S Lincoln v CB Richard Ellis:

(a) for a standard residential property, the margin of error may be as low as plus or minus 5 per cent;

(b) for a valuation of a one-off property, the margin of error will usually be plus or minus 10 per cent;

(c) if there are exceptional features of the property in question, the margin of error could be plus or minus 15 per cent, or even higher in an appropriate case.

However, a range of 14.5 to 23 per cent has been described as "absurd" (Staughton LJ in Nykredit Mortgage Bank plc v Edward Erdman Group Ltd [1996] 1 EGLR 119).

Conclusion

In almost all English senior debt real estate origination financing loan agreements, it will be the lender who gets to instruct the valuer, and such valuation is often deemed as conclusive evidence of the market value of the property for the purposes of that loan agreement. That said, if the borrower does wish to challenge such valuation, there is some merit in obtaining further valuations as it may prove useful in determining what is the "permissible margin of error."