CADWALADER

In Light of COVID-19 ...

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We're Here to Help

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Let us take this opportunity to wish all of you a safe and healthy road through the ongoing pandemic we are all experiencing. These are unprecedented times and, first and foremost, please accept our wishes that we all weather this storm quickly and safely.

The pandemic, along with the legal issues we are seeing, are fast-moving and change on a daily and hourly basis. As the markets gyrate and government acts and reacts to an ever-changing health and economic crisis, we continue to track and analyze the evolving nature of the legal ramifications we are experiencing.

The following are some articles of interest pertaining to this crisis in particular and our industry in general. We will continue to monitor these events on a daily basis and disseminate information of interest as needed in the days and weeks to come. Issues of defaults, forbearance, force majeure, material adverse effect, notice requirements, consent requirements, business interruption insurance, rent holidays or deferrals, debt service deferrals, workouts, restructurings, constructive eviction, condemnation, impossibility or frustration of contracts and similar issues are at the forefront of everyone’s minds right now. As facts and circumstances evolve, undoubtedly there will be other issues to consider. While we will endeavor to produce written content for your consumption, please feel free to reach out to us to discuss these and any other issues which may arise.

And one more thing: trying times like these often remind us of our good fortune in the real estate, financial and legal communities. There are so many amazing charitable organizations that now, perhaps more than ever, need financial assistance to serve vulnerable clients. Think about making a difference.

Stay safe.

COVID-19 Update: Immediate Considerations

March 29, 2020 | Issue No. 10

By **Duncan Hubbard**
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As the world enters into lockdown and the economy braces for impact, we plan to publish special *REF News and Views* alerts with insights into how the market is responding and guidance on some of the actions lenders and borrowers may wish to consider in these unprecedented times of uncertainty.

Let's begin with some of the immediate effects and potential responses in this ever-changing situation from a European perspective. For real estate lenders and borrowers, as well as their servicers and investors, there are (notwithstanding national economic rescue/stimulation programs) highly likely to be matters which will require urgent immediate assessment and will require consents, concessions and negotiations within their equity and debt structures.

At the time of writing, we are still in a period of considerable flux and uncertainty. In particular, the market is waiting to see what, if anything, the Government will do through legislation and/or bailout to assist the commercial property lending market. Due to the unprecedented state of affairs, we have also included an analysis of Material Adverse Change provisions as this has become a topic of much discussion.

Immediate issues resulting from lockdown and impaired business activity

With the blanket lockdowns across the board (save for essential services), industries which traditionally operate with a physical presence have had their cash inflow cut off with immediate effect. Worst affected are the food & beverage, leisure and travel industries. Tenants in various subsectors are likely to request renegotiation of rents, rent holidays, deferrals and the like very quickly. As of the time of writing, retail giant John Lewis has **requested** various landlords to apply a 20% discount on services charges. The cessation of trading will have flow-on effects on immediate cash flow, debt service covenants and general compliance under Finance Documents, which include:

1. Finance Documents contain cessation of business representations. Any suspension of activity within the Borrower/Obligor Group itself needs to be considered in light of the drafting of the Finance Documents to avoid defaults;
2. Breach of financial covenants – as cessation continues, it is a matter of time before the cash flow position and/or covenant forecasting will cause the financial covenant breaches. The testing period will make a significant difference. For example, an interest cover ratio tested on a rolling 12-month period is likely to deteriorate at a much slower pace than a quarterly test due to the fact that cash earned in previous quarters may provide some buffer against the current situation;
3. In addition, testing of loan-to-value covenants might also present its own set of challenges. Firstly, as a practical matter, valuations will require physical inspection and attendance on the site, which in this current environment would prove difficult (if not impossible); and secondly, as valuations slow down across the board in the current climate, there may be a lack of comparable sites to conduct the analysis. Both lenders and borrowers will need to give consideration to these factors when requesting a valuation;
4. Cash trap mechanisms – in deals where cash traps were negotiated, these will kick in. However, this may be of limited effect in structures where the income is closely tied with revenue/sales (in the case of hotels) due to the nature of the closure as there will be minimal cash coming in (if at all);
5. Exercise of cure rights – borrowers who have the backing of sponsors with a favourable cash position may use cure provisions. There are a variety of cure rights in the market, but cure provisions, which may be of use for a dip in valuation and therefore useful in an LTV breach, may not necessarily be a good tool to address debt yield or interest cover if the underlying issue is due to lost income;
6. Even without mandated closures, some industries, such as the Hotel/Leisure sector, are likely to be affected given the drop in occupancy being witnessed as travel has slowed dramatically. Drops in Key Performance Indicators give rise to breaches of Franchise Agreements in addition to Finance Document breaches and may

give rise to termination of the brand licence – care must be taken when liaising with the franchisor in maintaining the exclusive licence in place;

7. Certain actions with respect to Occupational Tenants (cessation of business, as a result of being required to shut their premises by law to prevent COVID-19) or insolvency of such Occupational Tenants may trigger breaches in Finance Documents (in particular, anchor tenants and materiality thresholds);
8. Be mindful of litigation reporting requirements and representations. It is quite conceivable that disgruntled Occupational Tenants could bring health and safety claims against Landlords in respect of common parts;
9. Negotiations of rent needs to be considered carefully. It is highly likely some occupational tenants and/or the property managers will look to switch to monthly rent payments to avoid cash flow issues around quarterly rent payment obligations. Material amendments to occupational leases are likely to require the consent of Lenders depending on how they are agreed, notwithstanding that debt service is maintained;
10. KPIs under Franchise Agreements could be breached (such as occupancy levels) which means Non Disturbance Agreement rights should be considered carefully by Lenders so as not to prejudice their rights. In particular, Lenders will need to be careful not to prejudice their positions where they enter into Forbearance Agreements and or standstills; and
11. General concession arrangements may also require consent, depending on baskets and thresholds. In addition, when granting consent/waiver, care should be taken by lenders that such concession/waiver is sufficiently confined to ensure it does not undermine any future rights of enforcing their rights over other breaches or consequential breaches under the facility. With respect to documentation, it may be more appropriate to adopt standstill/suspension arrangements such as forbearance agreements or standstill agreements, given the temporary nature of the situation, until things settle. Standstill agreements would prevent lenders from taking enforcement action for an agreed limited period of time, buying some time for the borrower to see things through in such period. On the other hand, the lenders also reserve their rights to take action once the standstill period is over. Moreover, on Saturday 21 March 2020, the State of New York passed **emergency legislation** ordering all banks regulated by the state's Department of Financial Services to provide 90 days of forbearance to "any person or business who has a financial hardship as a result of the COVID-19 pandemic." Although it remains to be seen whether this would be adopted in other countries/cities, there is certainly a movement towards these discussions.

Can a MAC clause be triggered?

One of the other key considerations in the current climate is whether Material Adverse Change ("MAC") clauses could be used to trigger refinancing negotiation. MAC clauses are often heavily negotiated and so there are many formulations in the market, ranging from ones that are very narrow and confined to only Obligor's ability to perform its obligations under the Finance Documents and lenders to act reasonably in determining whether a change is materially adverse, to those which are wider in scope that cover business operations and prospects of the Obligors, and determined by the lenders. Suffice to say, it is very important to familiarise your MAC clauses now.

In unprecedented times like these, a question at the forefront of lenders' minds would be whether the COVID-19 pandemic is a trigger for these clauses. Historically, MAC clauses, although heavily negotiated, are rarely called by lenders as there are severe implications if the basis for calling a MAC proves to be unfounded; namely, the lender being liable to pay the borrower damages to put the borrower in the position it would have been in if the lender hadn't called the MAC. This can prove to be serious if the MAC triggers a draw stop and/or cross-defaults Borrower's other facilities and/or results in Borrower becoming insolvent. In addition, the party calling a MAC is the party which has the onus of proof to show that the deterioration of circumstances has materially and adversely affected the Borrower's ability to perform its obligations under the loan. Therefore, even during the financial crisis, often lenders would use other triggers to call default and MAC has been used to serve as a catch-all provision.

In addition, guidance from the courts on what constitutes a MAC is limited and often heavily dependent on the particular facts of the circumstances and also the negotiated language. A leading judgment on this matter is *Grupo Hotelero Urvasco v Carey Value Added SL and Another [2013] EWHC (Comm) 1039* (*Grupo Hotelero*). Justice Blaire outlined some useful interpretation of MAC clauses generally:

- There must be a change – this test is quite clear. If at the time of the loan, the lender is aware of the particular circumstances, they cannot claim there is a MAC as the status quo remains the same. Suffice to say, new loans that are written after lockdown measures have been introduced can rely on COVID-19 as a reason to trigger MAC clause.
- The change is considered "material" if it affects Obligor's ability to perform its obligations. In *Hotelero*, this was considered to be affecting the ability to repay the loan. In the circumstances surrounding COVID-19, one could argue that store closure is effectively cessation of business and will inevitably lead to non-payment as a result given

there is no income. That said, one should also consider the cash position and strength of balance sheet of the borrower against the timeframe in which suspended trading is likely to last.

- The change must be “significant” given the lender’s ability to call a draw stop and accelerate the loan would impose serious implications and can push the borrower towards insolvency.
- The adverse change must not be temporary in nature – this is a key point in this particular outbreak. As it is uncertain as to how the pandemic develops, no one knows for sure how long the lockdown measures will last, and, therefore, whether business can recommence trading and pick up lost revenue. The secondary question to this is whether the adverse event has a lasting impact on the business which then renders it unlikely for the business to recover.
- General external economic or market changes alone would not constitute a MAC and the borrower’s particular position and performance should be looked at individually.

It follows to say that, with regards to MAC clauses, one should review the negotiated MAC clause carefully and when considering calling a MAC, but the position taken by the court is that the MAC must be so materially adverse and significant and it is apparent the borrower is unlikely to meet its obligations under the loan. What this means in practice is that if the borrower is in such a precarious position, it is unlikely that the MAC will serve much of a purpose in allowing the lender to call a MAC default before any other default provisions. In particular, in the case of cessation of trading due to COVID-19, other triggers such as financial covenants which are linked to income (*i.e.*, debt yield, interest cover and EBITDA tests) are likely to present themselves as key covenants which will show first signs of deterioration on the financial condition of the borrower, and therefore serve as much more reliable measures as default triggers.

In the days and weeks to come, we will cover some of the more substantive issues and longer-term potential consequences relating to the real estate industry from this crisis.

COVID-19 Update: Recording Issues and Title Insurance

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By **Parker Ihrie**
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While the long-term effects of the COVID-19 pandemic on commercial real estate transactions are not yet known, lenders and their counsel must consider the title insurance company's ability to record mortgages and take immediate action to ensure a safe path to closing transactions with adequate title insurance coverage. Clear and early communication with each title company on each transaction is imperative, as requirements vary by county and laws vary by state. Policies will even vary by title company and, most notably, some recording offices throughout the country have already closed.

In order to understand issues related to recording real property instruments, a basic understanding of the types of recording acts is necessary. Every state has adopted a recording act, which generally falls into one of three categories of recording acts: (1) a notice act, (2) a race act, and (3) a race-notice act, which is a combination of the race and notice acts. A notice act, which is almost as common as the race-notice act, provides that a subsequent interest will be valid against a prior interest so long as the holder of the subsequent interest did not have notice of the prior interest. The act of recording provides the whole world with constructive notice. A race act, the least common recording act, provides that a prior interest will be void against a subsequent interest if the subsequent interest is recorded first, regardless of whether the subsequent interest holder had notice of the prior interest. A race-notice act, the most common recording act, protects a subsequent interest against prior interests if the subsequent interest holder both recorded first and did not have notice of the prior interest.

All 50 states, with the exception of Vermont, and the District of Columbia have authorized electronic recording of mortgages. At the county level, approximately 2,054 of the 3,141 U.S. counties and county equivalents allow electronic recording, which figure represents approximately 85% of the U.S. population. In those counties, the title company may be willing to close, record and issue title insurance in the ordinary course of business. However, even if the mortgage can be recorded electronically, if the county's electronic indexing system cannot be updated, the title company will not have the ability to "update title" immediately prior to closing, which prevents the title company from ensuring that no other instruments have been recorded (or are in line to be recorded) prior to the related mortgage. In addition, even if a mortgage can be electronically recorded, certain states may require other real property instruments (*e.g.*, mechanics liens) to be filed by attorneys or other specific parties in courts or other government offices, which may be closed. Accordingly, title companies will then either be forced to take one or more exceptions for such shortcomings or make a decision on whether they can insure the "gap" on a deal-by-deal basis.

The "gap" is the time period between the closing date of the transaction (or the last search of the record which pre-dates closing) and the date the mortgage is recorded. As the effective date of the title insurance policy is the date the mortgage is recorded, the title company assumes the risk that no other instruments will be recorded or matters will arise during the gap. The title company minimizes its risk by sending documents for recording as soon as practicable, performing a title update immediately prior to closing, as previously discussed, and obtaining an indemnity from either the borrower/sponsor/buyer or seller. Pursuant to such a gap indemnity, the borrower/sponsor/buyer or seller will indemnify the title company against any defects, liens, encumbrances, adverse claims or other matters which may arise during the gap. In these uncertain times, more careful consideration will be given to the financial viability and reputation of the borrower/sponsor/buyer providing such gap indemnity. Some title companies may just decline to insure the gap altogether.

It is likely that transactions in counties that require in-person recording will not be able to close given the inability to record at all if the local recording office is closed. If the title company cannot update their title search and the mortgage cannot be accepted for recording, it is unlikely that the title company will insure the gap. Without title insurance coverage, closing would need to be delayed because the title company would only be able to issue their policy based on a title update that happens at some point after closing. Recording offices in New York City, for example, are currently only accepting electronic mortgage filings. Additionally, specifically related to New York City transactions, absent a special arrangement with the title company, if a transaction includes a "building loan agreement" and related "building loan mortgage," that transaction cannot close until the recorder's office re-opens, as these documents must be recorded in person. "Building loan agreements" are required by statute to be recorded within ten days of closing, and the related "building loan mortgage" cannot be recorded until the "building loan agreement" has been recorded.

Therefore, given the inability to record, the transaction will likely not be able to close with title insurance because title companies may not take on this risk.

On the other hand, certain title companies have indicated that if the recording office cannot both provide a title update and record, closings may nevertheless proceed, provided that certain conditions are met. Such conditions may include additional exceptions to coverage and broader gap indemnities. Title companies are also limiting the amount of insurance for such transactions, such limits ranging from $10 million to as low as $3 million. In addition, construction mortgages are being especially impacted as at least one title company has refused to close any construction mortgages, or mortgages where work has been recently performed, without direct contact with such title company’s internal legal counsel. Generally, if these types of transactions do not satisfy the title company’s conditions, the parties are being directed to contact the title company’s internal legal counsel.

In some cities and counties, although the offices may be closed to the public, there may be personnel working to process delivered recording packages. In this instance, if the jurisdiction is able to process the recording package and the related index is being reliably updated, transactions will be able to close with appropriate title insurance in the ordinary course.

There are a number of scenarios that could unfold, especially given the variation in city, county and state closures in addition to the related state’s title insurance regulations. Given the circumstances surrounding COVID-19, conditions and guidelines issued by title companies are constantly changing. Therefore, lenders and their counsel must initiate early discussion with the title company on each transaction in process during the COVID-19 pandemic and take into consideration the various obstacles created in its wake.

While some jurisdictions, such as New York, have enacted emergency executive orders which permit virtual notarization to facilitate closings, there will be a need in the days ahead to address a myriad of issues in order to facilitate the transaction of business in the current new normal. We will continue to provide periodic updates regarding issues of interest to our industry through this venue and other means. Most importantly, stay safe.

COVID-19 Update: Thoughts on Force Majeure and Impossibility of Performance

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By **Amanda Reasoner**
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Force majeure clauses are provisions in contracts that either defer or release parties from contractual obligations due to specific circumstances beyond the control of the breaching party. Such clauses allocate the risks of certain unforeseeable events that might result in a party's nonperformance and in each case are (or at least should be) highly tailored to the nature of the transaction. Qualifying events that constitute force majeure, the contractual obligations to which the clause is applicable, as well as the rights and obligations of the parties upon the occurrence of such an event in order to invoke a force majeure defense, are specifically defined in and limited by the agreed upon terms of the force majeure clause. Some common examples of what might constitute force majeure include acts of God, war, riots, strikes, labor disputes, casualty, terrorism, civil commotion, earthquakes, floods, shortages of, delays in obtaining or an inability to obtain labor, utilities or materials, and generally any event beyond the control of the relevant party. Typically, parties will agree that force majeure is applicable to only certain types of breaches, such as a borrower's obligation to restore its collateral after a casualty or to complete the construction of improvements by a certain date pursuant to a construction loan. In some documents, force majeure may apply to any breach of the agreement without limitation. However, many agreements provide for a limit or "cap" on the period of time that a force majeure may apply, such as ninety days. In addition, it is typical that lack of funds is carved out as an event that is beyond the control of a party seeking to invoke force majeure. Typically, a force majeure provision will *not* apply to an obligation to pay rent or an obligation to pay debt service.

In the absence of a looming natural disaster or pandemic, force majeure clauses are sometimes treated as boilerplate language and the implications are easily overlooked. However, the increasing economic effects of the coronavirus (COVID-19) have underscored the potential significance of force majeure clauses, especially with respect to commercial real estate lending. Over the past week, in an effort to slow the spread of COVID-19, multiple governors have issued state-wide orders closing all non-essential businesses, and in some states, governors have issued "shelter-in-place" orders mandating residents to stay inside. At this rate, it is not difficult to imagine scenarios in which some borrowers may no longer have adequate cash flow to pay the monthly debt service on their loans or may be in breach of other non-monetary obligations or covenants as a result of tenants whose businesses have been shut down and are no longer able to pay rent. In these cases, borrowers may begin to look to force majeure clauses for protection from what is hopefully a temporary condition.

Even if the specific language of a contract or lease would arguably give rise to a claim of force majeure, the claim must satisfy the following:

- the event must be beyond the reasonable control of the applicable party;
- the applicable party must have been prevented from performing its obligation;
- the applicable party must have taken all reasonable steps to avoid its non-performance and have satisfied its duty to mitigate damages as a result thereof; and
- applicable and timely notice must have been given to the counterparty in accordance (and usually in strict accordance, time being of the essence) with the relevant agreement.

Whether a borrower can successfully invoke force majeure will depend on the language of the force majeure clause itself and the nature and cause of the breach. For example, if the breach in question is the borrower's failure to pay the monthly debt service and the force majeure clause specifically excludes breaches for failure to satisfy monetary obligations, then the force majeure clause may not provide the borrower any relief. However, if the borrower's failure to pay its monthly debt service is the direct result of the government mandate requiring its tenants to shut down and the definition of force majeure includes governmental restrictions without any exclusion as to monetary breaches, then the protection of the force majeure clause may apply.

In the absence of a qualifying event that is ancillary to COVID-19 and can be identified as the cause of a borrower's breach, such as a government-mandated shutdown of a tenant's business operation, it is not clear whether and in what circumstances the COVID-19 outbreak alone would successfully provide the basis for a borrower to claim force majeure. As previously stated, the bargained-for language of the clause would first determine whether the clause is applicable to COVID-19 at all. Assuming the force majeure clause contains language such that it applies to "pandemics," "epidemics," "disease," or similar events and the specific breach in question is subject to the force majeure clause, the borrower would still have to show that its failure to perform was caused by COVID-19. It is unclear when a pandemic rises to the level of interfering with performance of contractual obligations, especially monetary obligations. Further, to the extent that a borrower's non-performance is the result of its tenants voluntarily shutting down as a preventative measure, the virus is unlikely to be viewed as the direct cause of the breach.

In addition to force majeure provisions, there remains the doctrine of impossibility of performance, which is applicable to all contracts and may excuse performance in limited circumstances. Generally speaking, impossibility of performance of a contract would require that the event in question was not the fault of either party to the contract, the event occurred after creation of the contract, and that there was an intervening event, which was both unforeseeable and destroyed either the subject matter of the contract or the means of performance. This doctrine is applied narrowly and the current case law specifically states that the performance of a contract is not excused where impossibility or difficulty in performance is caused by financial difficulty or economic hardship, even in the case of bankruptcy or insolvency.

These are unprecedented times and with each passing day, they become more unprecedented. While it is common knowledge that under New York and Federal law, courts will generally enforce as written commercial agreements entered into between sophisticated parties represented by counsel and will not "read into" an agreement a force majeure provision to relieve a party from its obligation to perform, it remains unclear what a court might hold given a dramatic set of facts such as the ones we are currently experiencing. Additionally, force majeure provisions are strictly construed, which means that the specific language will need to be analyzed to determine if the facts and events will give rise to relief from the applicable obligation. However, even if the language of a force majeure clause does not contain the specific words "pandemic," "epidemic" or "COVID-19," the language still needs to be examined to determine whether the current pandemic or its effects fall within language such as a "governmental restriction," "an act of God" or some other catch-all such as "events outside of the reasonable control" of the applicable party. It remains unclear whether the current pandemic would satisfy such a provision.

While a tenant or borrower can always make a claim that it is absolved from its obligations due to force majeure or the doctrine of impossibility of performance regardless of the language in its documentation, claims of that sort are very difficult to prevail upon absent extraordinary facts and circumstances, which may weigh upon the discretion of the courts. Given the unprecedented nature of the events we are living through, we would suggest that many of these claims and issues will be resolved through good old-fashioned negotiations between reasonable parties who are cognizant of the severity of the facts at hand.

Finally, there have been and will no doubt continue to be governmental proposals, executive orders and regulations promulgated to address some of the distress impacting tenants and borrowers. Please see the following links to recent publications outlining some of these relief measures: **New York Governor Issues Executive Order on Forbearance Actions**; **DFS Releases Emergency Regulation on Forbearance Actions**.

When Should a Guarantor's Liability Terminate under a Carry Guaranty?

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By **Loren R. Taub**
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In construction lending, a Carry Guaranty is a standard and typical requirement whereby a Guarantor will guaranty the payment by Borrower of all costs incurred in connection with the operation, maintenance and management of the Property (or some subset of the same) for the term of the Loan (or, if the Property is operating but not at capacity, until the Property is generating sufficient revenue as determined pursuant to the satisfaction of one or more financial tests). In addition, a Carry Guaranty may also be required in financing transactions where the mortgaged Property is not generating sufficient revenue to pay all of the operating expenses with respect to the Property.

The greatest point of contention for a Lender and Guarantor in negotiating a Carry Guaranty is when, pursuant to the Guaranty, will the Guarantor be released from its obligations thereunder in connection with a foreclosure, the acceptance by Lender of a deed-in-lieu of foreclosure or the tender by Borrower of the Property to Lender. Guarantors take the position that their liability under the Carry Guaranty should terminate in connection with the transfer of the Property to the Lender. Lenders contend that, although the Lender or a designee thereof now has title to the Property, since the Lender never made a loan to own the Property and the Property still cannot support itself, the Guarantor should be responsible for the expense of maintaining the Property (post transfer) for a period of time to enable the Lender to sell the Property or for the Property to sustain itself. This period of time is referred to in the market as "tail." Many Lenders seek to have a period from thirty (30) days up to one (1) year of "tail." Guarantors obviously seek to have little to no "tail" on their obligations.

In addition, most Lenders will not release the Guarantor from its obligations under a Carry Guaranty (with or without "tail") upon a tender of the Property by Borrower to Guarantor (*i.e.*, the delivery of a deed to the property by Borrower to Lender even if the Lender does not accept such deed), unless the Guarantor satisfies certain conditions in connection with such tender. Some Guarantors argue that there should be no conditions to the tender of a deed-in-lieu of foreclosure since that is what a Lender would obtain pursuant to an actual foreclosure. However, since the Guarantor is obtaining relief from its obligations under the Carry Guaranty, most Lenders will require that certain pre-conditions are satisfied. The following is a list of customary conditions to a release from a Carry Guaranty upon a tender of the Property:

- delivery of a clean environmental report with respect to the Property;
- delivery of a deed executed by Borrower, together with any necessary transfer tax forms;
- payment of all transfer taxes that are payable in connection therewith;
- delivery of a title commitment which demonstrates that the Lender would receive good and marketable title, subject to only permitted encumbrances;
- payment of all title insurance premiums with respect to such Owner's Policy of Title Insurance;
- delivery of a FIRPTA affidavit and all other affidavits, certificates and registration forms required in the applicable jurisdiction;
- delivery of a bill of sale with respect to the personal property, if any;
- delivery of an assignment of all contracts, licenses and permits necessary for the operation of the Property;
- delivery of an assignment of leases and rents executed by Borrower;
- delivery of the books and records with respect to the Property;
- delivery of an assignment of any warranties and guaranties with respect to the Property;
- delivery of a legal opinion issued by Borrower's counsel as to such tender;
- delivery of all organizational documents, consents and certificates of good standing as reasonably requested by Lender;
- delivery of all tenant security deposits or deposits under sales contracts, as applicable;

- delivery of a release from the Guarantor and Borrower in favor of the Lender and its affiliates, employees, agents, officers, directors, shareholders and members;
- delivery to Lender of all real property taxes with respect to the Property for the term of Borrower's ownership thereof;
- evidence that Guarantor has paid all amounts then payable by Guarantor under any other Guaranty (or, with respect to the applicable Completion Guaranty, Completion of the Improvements shall have occurred) or Environmental Indemnity executed by Guarantor with respect to the Loan transaction;
- confirmation that neither the Borrower nor the Guarantor is the subject of a bankruptcy action; and
- confirmation that there exists no action, suit, proceeding or investigation with respect to Borrower or the Property that may result in the forfeiture of the Property.

Again, the Lender and Guarantor will negotiate the foregoing list of conditions to a tender. From the Lender's perspective, Guarantor should not be relieved of its obligations under the Carry Guaranty by tendering the deed if the property is not in the condition in which Lender would accept such tender and Guarantor is responsible for all costs which would be incurred by Lender in accepting such tender. From Guarantor's perspective, the tender conditions should not put the Lender in a better position than the Lender would otherwise be in the case of foreclosure and therefore many Guarantors will take the position that they should not be responsible for the payment of title premiums or transfer taxes, among other things.

There are many considerations involved in negotiating a Guarantor's potential release from a Carry Guaranty. At the end of the day, the Guarantor and Lender may also be negotiating a completion guaranty, a carveout guaranty and, perhaps, a payment guaranty, and the Lender will negotiate based on the package of guaranties it is receiving.

Issues to Consider When a Revocable Trust Is a Guarantor

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By **Kevin Sholette**
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A trust is a legal entity that is created by a person (the "grantor") to hold and manage assets "in trust" for the benefit of a designated beneficiary. There are two basic types of trusts: revocable trusts and irrevocable trusts. A revocable trust allows the grantor to change the terms of the trust at any time prior to his or her death, whereas the terms of an irrevocable trust are generally unable to be changed once the trust agreement is executed. This article will focus on the unique issues presented when dealing with a revocable trust as a guarantor on a loan.

Revocable trusts are a popular estate-planning tool because they provide a number of valuable benefits to the grantor. Such benefits include the ability to avoid probate upon the death of the grantor while maintaining the flexibility to amend or revoke the trusts at any time while the grantor is still alive. Given the various benefits of revocable trusts, some high-net-worth individuals may hold a majority of their assets through a revocable trust rather than in their own names. Consequently, when these individuals want to obtain commercial real estate loans, we often see them propose their revocable trusts as the guarantor on their loans. In these instances, the inclusion of the revocable trust as a guarantor will be necessary in order to have a deep pocket on the hook, but it also creates several concerns that lenders need to consider.

The first issue that lenders need to think about is how to calculate the net worth or liquidity of a revocable trust for purposes of both underwriting the loan and formulating any ongoing net worth or liquidity covenants for the guarantor. Because of the level of control that a grantor can maintain over a revocable trust, courts in most states treat revocable trusts as an "alter ego" of the grantor and do not allow individuals to use a revocable trust to shield their assets from creditors. As a result, in such states the revocable trust will not be treated as a separate legal entity and the assets of the trust will be available to satisfy the debts of the trust's grantor. If the grantor has liabilities that exceed his or her assets, the failure to consider the liabilities of the grantor when calculating the net worth or liquidity for the trust would result in an over-inflated valuation. Therefore, in order to accurately calculate the net worth or liquidity of a revocable trust, any liabilities of the grantor in excess of his or her assets should also be factored into the calculation.

The second issue that lenders need to consider is whether the revocable nature of the trust will impede their ability to collect on a guaranty if the trust is the only guarantor on the hook for the loan. If a lender makes a claim on a guaranty where the guarantor is a revocable trust and the grantor of the trust responds by revoking the trust, what happens to the assets of the trust? Will the lender still be able to collect against such assets even if the ownership of such assets reverts back to the grantor? Other types of commonly used legal entities (*e.g.*, limited liability companies) have to first undergo statutorily prescribed procedures for the liquidation of assets and winding up before dissolution. Such procedures typically require the repayment of creditors prior to the distribution of assets to its beneficial owners. Any transfer of assets outside these procedures to avoid the repayment of creditors would be easy to establish as a fraudulent conveyance in most jurisdictions. However, because revocable trusts can simply be revoked in accordance with the applicable trust documents, without undergoing any such statutorily mandated dissolution procedures, it opens the door to debate whether the transfer of assets back to the grantor due to the revocation of the trust constitutes a fraudulent conveyance. Although there is a persuasive argument that the revocation of a trust to avoid paying creditors should also constitute a fraudulent transfer, unfortunately this issue is an unsettled matter of law in most jurisdictions. Even if a lender is able to prevail on its claim that such revocation constitutes a fraudulent transfer, it may suffer significant delays and legal costs litigating the matter due to the scant legal precedent on the issue.

The good news is that Lenders can fairly easily address this concern by requiring the grantor for the trust to also sign onto the guaranty on a joint and several basis in their individual capacity. Although we have seen some pushback on this request at times, it should not be a controversial ask and, in our experience, is usually expected and accepted without objection. If the grantor is added in their individual capacity, this also solves the issue discussed above pertaining to calculating the guarantor's net worth or liquidity.