CADWALADER

Accepting the Challenge

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Social Distancing for Distressed Loan Negotiations: The Role of Reservation of Rights Letters

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In the wake of the global COVID-19 pandemic and the related economic fallout, Borrowers and Lenders have found themselves in a novel and challenging business environment. Commercial mortgage Lenders have been, and will continue to be for the foreseeable future, inundated with loan modification and workout requests from Borrowers who have defaulted under their loans, are facing an imminent Default or just need some "breathing room." In light of the difficulties facing many commercial mortgage Borrowers, the FDIC and other federal agencies have issued statements encouraging banks to work with Borrowers to find constructive methods for alleviating the temporary hardships imposed by COVID-19. However, Lenders face a delicate balancing act of working with Borrowers to reach a mutually beneficial loan workout or modification and protecting their rights, remedies and powers pursuant to the loan documents and applicable law. In this context, many Lenders will utilize a reservation of rights letter or include the substance of a reservation of rights letter in correspondence with a Borrower in any distressed situation.

A typical example of a reservation of right is as follows:

> "The Agent hereby informs you that the Lender Group has not waived any Default or Event of Default which may exist currently or hereafter pursuant to the Loan Documents. The Lender Group further reserves the right to identify potential Defaults and Events of Defaults, that have either already occurred, whether with knowledge of the Lender Group or otherwise, or shall occur and to pursue the Lender Group's rights and remedies in connection therewith.
>
> Each of the rights, remedies and privileges of the Lender Group pursuant to the Loan Documents, at law, in equity or otherwise are cumulative and exercisable and enforceable by the Lender Group at any time and from time to time. Nothing contained herein or in any correspondence with the Borrower, any Guarantor or their respective Affiliates shall constitute a waiver of the rights of the Lender Group in connection with the Loan, or any Default or Event of Default under the Loan Documents.
>
> Nothing contained herein or in any correspondence, communications, discussions or negotiations with the Borrower, any Guarantor or their respective Affiliates shall (i) prejudice, waive, modify or constitute a forbearance with respect to, and the Lender Group hereby reserves the rights of Lender Group fully to invoke, any and all rights, remedies, powers and privileges pursuant to the Loan Documents, at law, in equity or otherwise at any time the Lender Group deems appropriate with respect to any Default or Event of Default that may exist; or (ii) constitute, or be deemed to constitute a waiver, modification or forbearance with respect to the Loan Documents or acceptance of any event, occurrence or circumstance, which may constitute a Default or an Event of Default under the Loan Documents."

There are various circumstances when the use of a reservation of rights letter is prudent. First, Lenders may want to send a reservation of rights letter prior to or contemporaneous with administering draw requests under a loan when there may be the potential for a Default in the near future due to the property's operation or the Borrower's business. In this instance, the Lender may believe the Borrower will be in violation of its financial covenants when the next monthly or quarterly financial reports are due.

Second, if, after a Default or an Event of Default has occurred, a Lender desires to accept an interest payment from the Borrower or grant a Borrower's request for a release of reserve funds or take any other action with respect to the Loan, then any such action by the Lender or delay in enforcing its rights and remedies could be grounds for a Borrower's claim that the Lender has waived its rights and should be estopped from taking any further action in connection with the Default or Event of Default in question. In this context, a reservation of rights letter is warranted as a manner in which a Lender can preserve its rights and remedies while simultaneously making it clear that any previous or subsequent communications between the parties and their respective representatives or attorneys will also not constitute a waiver of any Default or Event of Default. While any negotiations or discussions between a Borrower and Lender with respect to a forbearance, modification, waiver or other matter once a loan is in distress or a Default or an Event of Default has occurred should be preceded by the execution and delivery by the relevant parties of a pre-negotiation agreement (please see our **prior publication** on these agreements), a reservation of rights letter can further insulate a Lender from specious claims of a Borrower.

As with any notice, when drafting a reservation of rights letter, it is vital to check the notice provisions within the relevant loan documents to ensure that the notice is given in strict compliance with such provisions and that every party that is entitled to such notice is provided with a copy of such letter at the correct address. Care should also be

given to notify any Guarantors or additional environmental indemnitors. The letter should, if possible, include an express statement identifying the Default, Event of Default or circumstances that prompted Lender to send the letter and explicitly include an express and unconditional reservation by the Lender of its rights to pursue all of its available legal rights, powers and remedies under both the loan documents and applicable law in connection with such Default or Event of Default. It is important to note that the letter itself should include a broad definition of the term “loan documents” to ensure the Lender’s rights under all applicable loan documents (including all guaranties and indemnities) are encapsulated in the reservation.

Since a reservation of rights letter is also meant to act as a shield against any Borrower’s claims that past or future communications or delays on the Lender’s behalf estop the Lender from taking any enforcement actions, it is typical, following the express reservation, to include a statement that Lender’s rights, powers and remedies are, and will remain, in full force and effect. Additionally, the letter should include language making it clear that the letter and any action or inaction by the Lender is not a waiver of any Default or Event of Default, or its rights, powers and remedies following such Default or Event of Default. In order to reinforce the estoppel function of the letter, a provision is required stating that nothing in the letter itself and any previous or future communications among the parties and/or their respective representatives or counsel will constitute a waiver.

Reservation of rights letters not only act as a conduit to open and productive communications among the parties, they protect Lenders at a time where Borrowers are often looking for any and every opportunity to avoid or delay the enforcement of remedies by the Lender. When the lending relationship becomes tenuous or contentious is when the Lender should exercise the utmost care in protecting their rights and remedies.

Hotel Financing Series, Part 1: How a Hotel Loan Differs from Other Real Estate Loans

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As business and trade are slowly re-opening up across the UK, in this issue of *REF News and Views* we are revisiting articles commenting on real estate finance legal matters. Clearly, the pandemic isn't over, and we continue to closely observe changes in the regulatory environment and movements in the market and will share any important updates as and when they arise.

One of the key industries that was growing rapidly prior to the pandemic is the hotel industry. Although heavily affected by the pandemic, we are seeing green shoots from the re-openings, and also several opportunity acquisitions currently in progress. We use this opportunity to introduce a specific hotel financing series, given this area will no doubt return to its former glory post-pandemic.

In this six-part hotel financing series, we will take a close look at some of the common issues and terms in hotel financing facilities. The commentary has a European focus, especially with respect to security and cash control mechanics.

In this Part 1 of the series, we discuss the key differences between a hotel financial facility compared to a general real estate facility. Obviously, real estate financing has many specialties in itself, and the approach taken differs from transaction to transaction. As a general comment, hotel financing is one such area which requires a very different approach. The key distinction here is also attributed to the fact that a hotel property is a single-purpose real estate, and so understanding how (well) the hotel business runs is key to the analysis of the business and, therefore, the appropriate terms of the facility.

In addition, it is important to bear in mind that, as with many businesses, the cashflow is not fixed and often cyclical, unlike real estate facilities where the rent is somewhat fixed, subject to any issues which may arise with tenancy. This has two implications. Firstly, covenants should therefore be specifically tailored to the hotel business and measured against the success of the business, as opposed to conventional real estate covenants. In particular, the financial covenants and cash controls are quite specific, and we will be covering these in more detail in later parts in the series. It is important for lenders to analyse the underlying business by looking at the profit and loss statement and management accounts, as well as other reports – such as projected revenues and expenses, capital expenditure (both incurred and projected), labour issues, regulatory issues, etc. – when analysing the hotel business. In addition, it is common for lenders to keep closely monitoring the reporting given the cyclical nature of the business.

A second implication of the cyclical cashflow is that it is not uncommon for borrowers to ask for some flexibility with respect to the use of cash. A traditional real estate facility may require the borrower to deposit all net rental income into a controlled account with the lender, but with hotel facilities this may not be possible. This is because the timing of the cash outlays may not necessarily coincide with the deposit of the gross profit for each specified period, and so the borrower may need to retain some of the cash in order to meet expenses anticipated for the next period, or pay some of the expenses upfront prior to the cash coming in. As a countermeasure for this, often lenders may look at setting up a buffer against the periodic debt service, such as cash reserves. Additionally, the franchisor may require control over operating accounts and capex sums to be retained as part of the franchise arrangement. These may be for the purposes of providing a guarantee or towards minimum capital expenditure towards renovations/improvements. This is discussed in more detail later in this series.

Many hotels operate under a particular brand, and the brand name/reputation plays a substantial role in the value of the hotel. Due diligence on the franchise arrangement and the hotel management arrangement (if the owner hires a professional manager to run the hotel) are of prime importance. With franchise agreements, often the franchisor has a specific list of requirements (also called the "brand standards") which needs to be adhered to in order for the hotel to stay part of the brand. The franchisor also conducts periodic reviews to ensure the quality of the brand is maintained, and also provide requests on the owner to make certain improvements. It is important for these items to be addressed, as failure to do so may attract certain penalties (for example, the franchisor may step in to take over, or even terminate the franchise agreement if they are of the view that the franchisee fails to maintain brand standards). For the lenders, this means taking care in conducting due diligence with respect to the running of the hotel, the suitability/track record of the hotel management, and also reviewing the relevant franchise agreement and/or hotel management agreement. Finally, the franchisor sets standards with respect to maintenance and ongoing updating/refurbishing of the facilities, and so it is also important to also look at the underlying sponsors and confirm they have the financial resources and projected cashflow to meet any required capital expenditure.

With respect to exit strategy, unlike other real estate which usually boils down to looking to sell the property and/or secure tenants (where a key tenant is involved), the exit strategy for lenders in a hotel financing facility is more complex. One can't simply sell the hotel quickly where the loan is distressed, as chances are the hotel business wasn't performing in the first place, which resulted in issues with complying with the terms of the facility. Therefore, the lender must be prepared to run the hotel business, or appoint a nominee who has the requisite experience and capability to do so until the lender can find a purchaser. In addition, the pool of potential purchasers are also narrower given hotel operation requires expertise in the area, and often the franchisor may want to approve the potential purchaser. This is where the agreement with the franchisor (and, if applicable, the hotel operator) becomes key. In hotel financing transactions, the lender usually enters into tripartite agreements with the franchisor (a non-disturbance agreement) and if applicable, a duty of care agreement with the hotel manager. These documents set out the circumstances in which the lender may step in to take over the obligations of the hotel owner/operator if they are in breach of the relevant agreement, and also provides other protections to the lender (and also the franchisor) by requiring the franchisor to first notify the lender if there is any breach by the hotel owner (borrower) which would give rise to termination rights, and so the lender may take steps to cure the default and avoid the franchise agreement being terminated. This is discussed in more detail later in this series.

DRANO Revisited: Further Updates on the Doctrine of Clogging the Equity of Redemption

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On June 2, 2020, in *HH Mark Twain LP v. Acres Capital Servicing LLC*,**[1]** the Supreme Court of the State of New York (the "Court") denied the defendant's motion to dismiss the plaintiff's "clogging" claim, thereby providing a piece of an answer to a cliffhanger from two years ago regarding whether a lender can safely structure a loan that is secured by both a mortgage and an equity pledge without violating a borrower's equitable right of redemption. Previously, in June 2018, the Court refused to issue a preliminary injunction to prevent the foreclosure sale of the equity interests in HH Cincinnati Textile L.P. and HH KC Mark Twain, L.P. (together, the "Borrowers").**[2]** Some saw the June 2018 decision as an answer to the "clogging" question that has long puzzled lenders and practitioners, but as the June 2, 2020 decision makes clear and as discussed in a Clients & Friends Memo from July 27, 2018 entitled *Unclogging the Equity of Redemption Without "DRANO": Recent New York State Decision Sheds Light on Mortgage Loans Additionally Secured by Equity Pledges***[3]** (the "2018 Memo"), the earlier decision was a narrow one that left the question unanswered for now.

Background

The Borrowers owned and financed redevelopment projects on real property located out of state in Cincinnati and Kansas City.**[4]** Instead of entering into a mortgage loan secured by real property and entering into a separate mezzanine loan secured by limited partnership interests in the Borrowers, Acres Capital Servicing LLC, as agent for DW Commercial Finance, LLC (the "Lender") and the Borrowers entered into a single loan secured by both forms of collateral.**[5]** Ultimately, the Borrowers failed to repay the loan, and the Lender sought to conduct a UCC foreclosure sale of the limited partnership interests in the Borrowers.**[6]** The Borrowers then filed a suit claiming, among other things, that by conducting a UCC foreclosure sale of the limited partnership interests, the Lender unlawfully "clogged" the Borrowers' equity of redemption.**[7]** The Court, in June 2018, did not decide on the merits of the "clogging" claim, but instead ruled against Borrowers' motion for a preliminary injunction because the Borrowers failed to show that they would suffer irreparable harm without the preliminary injunction.**[8]** Shortly thereafter, the Lender completed the UCC foreclosure sale, and acquired control of the properties.**[9]**

As one might expect, that was not the end of the story.

One of the Borrowers, along with Andrew Greenbaum and Steven Michael, the principals of Hudson Holdings, LLC (the "Guarantors"), brought a complaint alleging, among other things, "that in conducting the sale of the collateral securing the loan, the [Lender] acted in a commercially unreasonable manner" and "that [the Lender's] purported right to sell certain security interests under the contracts at issue also vitiated [the Borrower's] right to equitable redemption in violation of longstanding New York public policy."**[10]**

Mezzanine Financing

In typical commercial real estate finance, a borrower grants a mortgage on its real property as the principal collateral which secures its obligation to repay a loan.**[11]** A mortgage is a security interest in real property that is owned by a borrower (the mortgagor) and granted to a lender (the mortgagee) as assurance for the payment of the debt between them.**[12]** In the event the mortgagor defaults on the payment of the debt underlying the mortgage, the mortgagee has the right of foreclosure —the right to take possession and ownership of the real property in order to satisfy the debt. **[13]**

If a financing secured by a first mortgage does not provide sufficient funds, second lien financing may be used to borrow additional funds against the property.**[14]** Mezzanine debt is the most common form of second lien financing in commercial real estate finance.**[15]** It is the level of debt between traditional debt secured by a mortgage on a property and equity ownership. A mezzanine loan is made to a pledgor that is the equity holder of a mortgagor.**[16]** The loan is secured not by the real property itself, but by a pledge of the mezzanine borrower's equity interests in the mortgagor. **[17]** Upon a default, the mezzanine lender has the ability to foreclose on the equity interests in the mortgagor, and thus, assume effective control of the property.**[18]** Mezzanine financing is also advantageous because it permits a much faster foreclosure procedure, as the equity interests are considered personal property, and thus subject to a UCC foreclosure rather than a judicial foreclosure.**[19]** Unlike a judicial foreclosure that may take many months or years to complete in some jurisdictions, a UCC foreclosure can be carried out within a few months.**[20]** One major distinction between a typical mortgage and mezzanine financing and the structure of the instant case is that in a typical structure, the loans are segregated as separate and distinct loans to separate borrowers by separate lenders.

Equity of Redemption: The Anti-Clogging Doctrine

The equity of redemption, also known as the anti-clogging doctrine, is an indispensable right that protects mortgagors facing foreclosure of their real property interests transferred as collateral.[21] The doctrine holds that every mortgagor has the right, at any time after default, to redeem the collateral by repaying the debt in full before the lender has completed a foreclosure (typically an auction) on the collateral.[22] Traditionally, courts have been hostile to clauses and devices that "clog" the equity of redemption; that is, clauses and devices that purport to recognize the equity of redemption, but whose practical effect nullifies or restricts the doctrine's operation.[23]

HH Mark Twain LP v. Acres Capital Servicing LLC

The Facts

The Borrowers were established by Hudson Holdings to own and seek financing in connection with Hudson Holdings' redevelopment projects on real property located in Cincinnati and Kansas City.[24] On February 29, 2016, the Borrowers entered into a loan agreement with the defendants, Acres Capital Servicing LLC and DW Commercial Finance, LLC.[25] The loan was in the principal amount of $20,300,000, and was secured primarily by two forms of collateral: (i) a mortgage on the real property associated with each project; and (ii) a pledge by HH Mark Twain LP and Hudson KC Real Estate Manager (the "Pledgors") (plaintiffs in the June 2018 decision) of their limited partnership interests in the Borrowers.[26]

The loan and pledge agreements provided that if the Borrowers failed to repay the loan by August 29, 2017, the Lender was entitled to foreclose upon any part of their collateral.[27] The Borrowers failed to repay the loan, and thus defaulted.[28] Afterwards, the Lender initiated a marketing campaign regarding a potential UCC foreclosure sale of the limited partnership interests in the Borrowers.[29] As discussed in the 2018 Memo, the Borrowers filed suit seeking a preliminary injunction, which the Court ultimately denied.[30] The UCC foreclosure sale went on, and the Lenders took control of the property.

Pledgors and the Guarantors (the "Plaintiffs") filed suit in *HH Mark Twain LP* alleging that in conducting the sale the Lenders (the "Defendants") had acted in a commercially unreasonable manner and that the structure of the loan "clogged" the Borrowers' right of redemption by including both a mortgage and an equity pledge. The plaintiffs brought four causes of action: "(1) for a declaration that the Loan Agreements are null and void because they violate Borrowers' and Guarantors' equitable right of redemption; (2) violation of UCC § 9-610 (UCC sale was unreasonable); (3) breach of implied covenant of good faith and fair dealing; [and] (4) breach of 'duty:'" The Lenders moved to dismiss the complaint, which the Court granted as to the third and fourth causes of action and denied as to the first and second causes of action.

The Decision

In rendering its decision as to the first cause of action, the Court noted that the Defendants' motion to dismiss was based on the argument that the "clogging" claim was rejected by the Court in the June 2018 decision. The Court rejected this argument and reiterated that it had not ruled on the merits of the Plaintiffs' clogging claim in 2018, and that the June 2018 decision rejecting the preliminary injunction was based on the fact that the Plaintiffs' claims could be adequately remedied by monetary damages, and therefore an injunction was not an appropriate remedy.[31] The Court also permitted the second cause of action to continue as the Court determined that commercial reasonableness or unreasonableness of the UCC sale is a question of fact that cannot be determined on a motion to dismiss.[32]

The third and fourth causes of action were dismissed as being substantially related to the underlying contracts (*e.g.*, the loan documents), and therefore were substantially duplicative to the breach of contract claims and facts alleged in the first and second causes of action.[33]

Conclusion

In denying the Defendants' motion to dismiss the clogging claim, the Court in *HH Mark Twain LP* clarified that its June 2018 decision had not answered the longstanding question of whether under New York law, a loan can be secured by both a mortgage and an equity pledge. Perhaps a trial on the merits of the Plaintiffs' claim in *HH Mark Twain LP* will provide an answer. Until then, lenders should exercise caution in structuring loans with both a mortgage and equity pledge. Given the current judicial landscape, a dual collateral loan can expose a lender to years of litigation as exemplified by the instant case.

[1] *HH Mark Twain LP v. Acres Capital Servicing LLC*, Index No. 656280/2019, 2020 N.Y. Misc. LEXIS 2515 (N.Y. Sup. Ct. June 2, 2020).

[2] *HH Cincinnati Textile L.P. v. Acres Capital Servicing LLC*, No. 652871/2018, 2018 N.Y. Misc. LEXIS 2472 (N.Y. Sup. Ct. June 19, 2018) (order denying preliminary injunction).

[3] *Unclogging the Equity of Redemption Without "DRANO": Recent New York State Decision Sheds Light on Mortgage Loans Additionally Secured by Equity Pledges*, July 27, 2018, available at **https://www.cadwalader.com/resources/clients-friends-memos/unclogging-the-equity-of-redemption-without-drano-recent-new-york-state-decision-sheds-light-on-mortgage-loans-additionally-secured-by-equity-pledges**

[4] *HH Cincinnati Textile L.P.*, 652871/2018, at 1–2.

[5] Id.

[6] Id. at 2.

[7] Id.

[8] Id. at 3–4.

[9] *HH Mark Twain LP*, Index No. 656280/2019 at 2.

[10] Id.

[11] Andrew R. Berman, "Once a Mortgage, Always a Mortgage" - *The Use (and Misuse of) Mezzanine Loans and Preferred Equity Investments*, 11 Stan. J.L. Bus. & Fin. 76 (2005).

[12] *See* Restat 3d of Property: Mortgages, § 1.1 (3rd 1997).

[13] Id.

[14] *See* Berman, *supra*.

[15] Adam J. Levitin & Susan M. Wachter, "The Commercial Real Estate Bubble", 3. Harv. Bus. L. Rev. 83, n. 51 (2013).

[16] Id.

[17] Id.

[18] Georgette Chapman Poindexter, "Dequity: The Blurring of Debt and Equity in Securitized Real Estate Financing", 2 Berkeley Bus. L.J. 233, 240 (2005).

[19] Levitin, *supra* at n. 51.

[20] *See* id.

[21] *See* Restat 3d of Property: Mortgages, § 3.1 (3rd 1997).

[22] *See* id.

[23] Id.

[24] Complaint at 4, *HH Cincinnati Textile L.P.* (652871/2018).

[25] Defendant's Memorandum at 4, *HH Cincinnati Textile L.P.* (652871/2018).

[26] Id.

[27] Id. at 5.

[28] Id.

[29] *HH Cincinnati Textile L.P.*, 652871/2018, at 2.

[30] *HH Mark Twain LP*, Index No. 656280/2019 at 2.

[31] *HH Mark Twain LP*, Index No. 656280/2019 at 4.

[32] Id.

[33] Id.

COVID-19 Update: Draft Legislation Sparks HOPE of a New Commercial Real Estate Preferred Equity Facility by the Department of Treasury

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U.S. Rep. Van Taylor (R-TX) has circulated a draft bill that would require the Department of the Treasury (the "Treasury") to establish and administer a facility to guarantee certain preferred equity investments in commercial real estate borrowers affected by the COVID-19 pandemic. The bill will be called the "Helping Open Properties Endeavor Act of 2020" or the "HOPE Act of 2020" (the "Act").

Although the Federal Reserve has created a variety of lending facilities to provide liquidity to various markets affected by the COVID-19 pandemic, such as the Term Asset-Backed Securities Loan Facility, the Paycheck Protection Program Loan Facility, the Main Street New Loan Facility, the Main Street Priority Loan Facility, and the Main Street Expanded Loan Facility,[1] the Federal Reserve has yet to directly address the pending crisis in the commercial real estate ("CRE") market and, in particular, the commercial mortgage backed securities ("CMBS") market. Given that most CMBS loan documentation greatly restricts a borrower's ability to take on additional debt and CMBS servicing agreements do not typically provide servicers with the flexibility to materially modify loans that have been securitized, many borrowers (and their parent companies) whose loans have been securitized and sold into the CMBS markets have found it difficult to obtain financial assistance under the existing COVID-19 federal response programs.

The Act is intended to fill the gap in the existing federal programs by providing financial assistance to CRE borrowers, including those borrowers with CMBS debt, by guaranteeing the purchase by eligible financial institutions of preferred equity instruments issued by eligible CRE borrowers. The facility would be funded by utilizing amounts already appropriated for providing liquidity to eligible businesses under Section 4003(b)(4) of the CARES Act (15 U.S.C. 9042(b)(4)).

The Act incentivizes financial institutions to purchase the preferred equity instruments by (a) guaranteeing that the Treasury will purchase the preferred equity instruments after a certain period of time, (b) reimbursing the financial institutions for a portion of the preferred equity instruments (*i.e.*, paying the functional equivalent of an origination fee) and (c) paying the financial institutions an annual servicing fee. Unfortunately for the CRE market, the Act does not provide a path to forgiveness of such equity investment for CRE borrowers like the Paycheck Protection Program provides for its borrowers.

Financial Institution Eligibility

The Act would allow financial institutions to participate in the program if (a) such institutions are authorized to make or approve loans under (i) the Paycheck Protection Program or (ii) Section 1109 of the CARES Act or (b) the Secretary of the Treasury (the "Secretary") otherwise approves such financial institutions. However, entities that are "covered entities" as defined in Section 4019(a) of the CARES Act (*i.e.*, entities controlled by senior members of the executive branch or members of Congress) will not be permitted to participate in any program established under the Act.

Borrower Eligibility

In order to be eligible for the new program, a CRE borrower must be able to establish both that it has been adversely affected by the pandemic and that the related property's revenue was not significantly reduced immediately prior to the COVID-19 pandemic taking hold on the United States.

More specifically, as currently drafted, the Act would require that:

(a) a borrower's revenue from the property securing the commercial mortgage during any consecutive three-month period between March 1, 2020 and February 28, 2021 is at least 25% less than the borrower's revenue from such property during the same consecutive three-month period in the previous year;

(b) the Borrower was not in default under the commercial mortgage as of March 1, 2020;

(c) either (i) the debt service coverage ratio with respect to the commercial mortgage loan was at least 1.3x on an annual basis during 2019 or (ii) the debt service coverage ratio with respect to the commercial mortgage loan was at least 1.3x on an annual basis during both 2017 and 2018;

(d) the property securing the commercial mortgage is not owner occupied; and

(e) the borrower has not already received financial assistance under the Act.

Preferred Equity Instrument Terms

In order to be eligible to be guaranteed by the Treasury, the Act would require preferred equity instruments to satisfy the following criteria:

(a) the amount paid for such instrument must not exceed 10% of the outstanding amount owed on the commercial mortgage;

(b) the purchase amount of the instrument must be made available by the financial institution to the borrower in an account that the borrower may draw down, at any time, for any purpose that the borrower determines may "help the property," during the one-year period following the date such purchase is made;

(c) the instrument may be unsecured and provide no right of foreclosure;

(d) the instrument must not provide any voting rights to the financial institution;

(e) the instrument must (except for default interest described below) have an annual interest rate of 2.5%, which will accrue and compound monthly, on all amounts that have been drawn from the account described in subparagraph (b) above;

(f) the instrument may be redeemed by the borrower at any time, without penalty;

(g) the instrument must require payments to be first due after the end of the two-year period beginning on the earlier of:

> (i) the date on which all funds in the account described above in subparagraph (b) have been drawn by the borrower; or
>
> (ii) the end of the one-year period beginning on the date of purchase of the preferred equity instrument;

(h) the instrument must fully amortize over the seven-year period beginning on the date payments are first due;

(i) the instrument must require immediate redemption if there is more than a 50% change in the ownership of the Borrower, except via death, compared to the date on which the preferred equity instrument is purchased;

(j) the instrument must be approved in advance by the Secretary (the Secretary will have 30 days for such approval or denial); and

(k) the proceeds from such purchase of the preferred equity instrument may only be used by the borrower for the benefit of the property and the preferred equity interest, such as principal, interest, insurance, taxes, utilities and fees (we would note that although the bill specifically contemplated the use of proceeds for the payment of the foregoing, it does not limit the use of proceeds to such enumerated expenses).

If the Borrower fails to make payments as and when due on the preferred equity instrument, the interest rate will increase pursuant to a formula of escalating interest rates based on what point in the repayment term the default occurs. Beyond an initial 30-day cure period after notice, the current draft of the bill is silent on whether the borrower will have the right to cure the default and revert back to the regular interest rate. In either case, in the event of payment default(s) by the Borrower, any interest owed on a preferred equity instrument in excess of 2.5% will be owed to the Treasury, rather than the financial institution that purchased the preferred equity instrument.

We find it noteworthy that the interest is only paid on the portion of the preferred equity investment that has been drawn by the borrower and that there is no remuneration provided to the financial institution for the portion of the investment that has been made available to be drawn on, other than the origination reimbursement, which, as described below, would have to be repaid to the Treasury if the borrower defaults on the entire amount it has

withdrawn. We also find it worth noting that the financial institution would not be entitled to any of the default interest, but, as described below, would not have the right to sell the preferred equity interest to the Treasury until 10 years after it was purchased by the financial institution, which could result in the financial institution going 10 years without any return on its investment other than the 1% servicing fee described below (given that, in the event of a payment default by the borrower, the financial institution would not necessarily receive its 2.5% interest until the Treasury purchases the instrument after 10 years).

Payments to Financial Institutions

In order to incentivize financial institutions to purchase and administer the preferred equity instruments under the program, the Secretary will pay each financial institution that purchases a preferred equity instrument guaranteed under the program an annual servicing fee and reimburse the financial institution a variable percentage of the purchase price based on the size of the instrument (the functional equivalent of an origination fee).

Servicing Fee

The Secretary will pay each financial institution that purchases a preferred equity instrument guaranteed under the program an annual servicing fee equal to 1% of the outstanding amount on such instrument, paid annually. However, if a financial institution fails to assess the default interest described above or fails to notify the borrower of such required default interest being due and payable, the financial institution will only be eligible to receive half of such servicing fee.

Reimbursement for Origination

The Secretary will reimburse each financial institution that purchases a preferred equity instrument guaranteed under the program a portion of their purchase price according to the following formula:

(a) 5% for a covered amount (*i.e.*, the full amount available to the borrower, whether or not actually drawn by the borrower) up to $350,000;

(b) 3% for a covered amount of more than $350,000 and less than $2,000,000; and

(c) 1% for a covered amount of $2,000,000 or more.

In the event that a borrower defaults on the entire amount that it draws down, the financial institution must repay any reimbursement paid to it by the Treasury per the above. In other words, if there is a total failure on the preferred equity investment, the purchasing financial institution waives its origination fee and refunds the same to the Treasury.

Guaranteed Purchase

In order to further incentivize financial institutions to purchase the preferred equity instruments, a financial institution that has purchased a preferred equity instrument satisfying the requirements under the Act would have the right to sell ("put") such instrument to the Treasury after the end of the 10-year period beginning on the date on which the financial institution purchased the instrument from the Borrower. The purchase price by the Treasury would be at par, plus unpaid interest, less the origination fees.

The Secretary would also have the right, at the Secretary's discretion, to purchase ("call") the preferred equity instrument from the financial institution any time after the end of the seven-year period beginning on the date payments are first due with respect to the instrument. Additionally, the Secretary would have the right to sell any preferred equity instrument purchased by the Secretary and to contract with a private servicer to service any preferred equity instrument purchased by the Secretary.

Capital Treatment

Another noteworthy feature of the Act is a provision stating that for purposes of calculating any capital requirement, the appropriate Federal banking agencies shall treat preferred equity instruments that are guaranteed under the Act in the same manner as loans guaranteed under the Paycheck Protection Program (*i.e.*, a preferred equity instrument guaranteed by the Treasury will receive a risk weight of zero percent under risk-based capital requirements).

Restrictions on Borrowers

In order to protect the government's interests, the Act would restrict the owner of any borrower under the program from removing value from the borrower. For example, the related borrower would be prohibited from paying any dividends,

increasing any fees paid to an affiliated property manager compared to the amount of such fee before such instrument is purchased, or lending money to any direct or indirect owner of the borrower or to any related person.

Applicability to CMBS Loans

It is important to look at the proposed terms of the preferred equity investment through the lens of a CMBS borrower. The Act seems to have avoided the hurdles that a CMBS borrower would typically face. As mentioned earlier, CMBS loans have strict covenants against additional indebtedness whether at the borrower level or an upper-tier entity level, and any indicia of secured debt would put the rating agencies on high alert. Additionally, generally speaking, a change of control over the CMBS borrower is not permitted. The preferred equity facility proposed under the Act is structured to be an upper-tier equity transaction as opposed to the issuance of debt to the CMBS borrower. Further, although referred to as “preferred equity”, the proposed structure of the preferred equity interest purchases is really more reflective of an equity investment with a “preferred return” by reason of the following:

- the purchasing financial institution is not required to have any collateral related to its purchase; it is merely becoming a minority interest holder in the CMBS borrower (*e.g.*, there is no requirement for a pledge of distributions or cash flow);
- there will be no voting rights given to the purchasing financial institution and thus the CMBS borrower is not at risk of a “change of control” being triggered;
- there is no mandatory redemption date although the rate of interest will get more expensive if not paid by the borrower in accordance with the amortization schedule;
- there are no specified “remedies” available to the purchasing financial institution (or, ultimately, the Treasury) if the funded amount is not repaid by the borrower.

Given the above features, although the devil is in the details to be analyzed on a loan-by-loan basis, fundings through the facility established under the Act would appear to fit into the CMBS structure without requiring additional consent of the CMBS servicer.

Although we are probably still some distance away from the enactment of the HOPE Act of 2020 and the implementation of a preferred equity facility, the submission of the draft bill does indeed provide renewed hope that the Federal Government will tap the funds available under the CARES Act to inject additional liquidity into the commercial real estate markets. We will continue to update you with any legislative updates related to the Act.

1 See, e.g., our prior Clients & Friends memos: “**COVID-19 Update: Federal Reserve Launches TALF (Again)**“, “**COVID-19 Update: The Paycheck Protection Program – Loan Participation Transactions**“, “**COVID-19 Update: The SBA’s Paycheck Protection Program Explained**“, “**COVID-19 Update: The Paycheck Protection Program and the Secondary Market**,” and “**COVID-19 Update: Federal Reserve Announces Main Street Lending Program**“.

COVID-19 Update: Controversial Rent and Mortgage Payment Relief Bill Introduced

July 30, 2020 | Issue No. 14

By **Sulie Arias**
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A new bill canceling rent for residential tenants, and mortgage payments for some qualified homeowners, was announced recently in New York. This new bill calls for the cancellation of residential rental payments, and mortgage payments for primary residences with less than six units, for a period lasting until 90 days after the termination of New York's state of emergency. Similar to the moratorium on evictions and foreclosures mandated by Governor Andrew Cuomo in response to the COVID-19 pandemic, the proposed bill would prohibit landlords and lenders from imposing late fees and/or fines, commencing evictions proceedings, and obtaining money judgments, against non-paying tenants and residential homeowners due to non-payment during the rent and mortgage payment cancellation period. However, the new bill would not require tenants and qualified residential homeowners to demonstrate a COVID-19-related hardship in order to qualify for such relief, or pay back any past-due rent at the end of such period.

The new bill, proposed by Manhattan Assemblywoman Yuh-Line Niou and Senator Julia Salazar, differs in other significant ways from earlier legislation and executive orders providing New Yorkers with COVID-19-related protections from evictions and foreclosures. In contrast with legislation introduced this spring, the new bill would also provide some relief to affected landlords. Specifically, the new bill calls for the establishment of certain relief funds to be administered by the Division of Housing and Community Renewal. These funds will be used to reimburse qualifying landlords and public housing authorities for all cancelled rents. In order to qualify for such reimbursements, however, landlords and public housing authorities must agree to not increase residential rents for a period of five years, and to not evict (unless such eviction is for "good cause"), or retaliate against, non-paying tenants. Some landlords may, however, be able to qualify for an exemption to the above-mentioned conditions, if they can demonstrate excessive financial hardship due to the rent cancellation.

The legislators and other commentators do not expect that Governor Cuomo will support this proposed legislation, as he has not supported similar proposed legislation calling for the cancellation of rent payments in New York. This proposed legislation is emblematic of other proposed legislation in other jurisdictions, and it is likely that we will continue to see similar proposals during the pendency of the pandemic. Hopefully, our elected officials will carefully analyze the effect that these proposals will have on all parties including landlords, lenders and other parties other than tenants. As many commentators have opined, it may be more prudent to extend grants directly to tenants in the form of tax benefits, unemployment benefits or direct payments, rather than asking the real estate industry to disproportionally bear this burden.

We will continue to monitor these and other proposed legislation of interest and provide updates as needed.

COVID-19 Update: Oregon Law Prohibits Foreclosures During COVID Emergency

July 30, 2020 | Issue No. 14

By **Matthew Robertson**
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By **Eunji Jo**
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On June 30, 2020, Oregon Governor Kate Brown signed House Bill 4204 entitled "Relating to strategies to protect Oregonians from the effects of the COVID-19 pandemic; and declaring an emergency" (the "Oregon Statute"). In response to the COVID-19 pandemic, the Oregon Statute establishes temporary limitations on lenders' ability to enforce default remedies during the period of time beginning on March 8, 2020 and ending on September 30, 2020 (which may be extended by executive order no later than September 1, 2020) (the "Emergency Period").

Specifically, during the Emergency Period, a lender may not default a borrower for failure to make a payment on a mortgage loan if at any time during the Emergency Period, the borrower notifies the lender that the borrower will not be able to make such payment. Unless the lender and borrower otherwise agree to modify, defer or otherwise mitigate a loan, the lender must: (a) defer from collecting the payment during the Emergency Period; and (b) permit the borrower to pay the deferred amount on the maturity date. A borrower does not need to notify the lender of its inability to pay more than once. If the mortgaged property is commercial property, or residential property with more than four dwelling units, the notice must include financial statements or other evidence that shows a loss of income related to the COVID-19 pandemic. The notice must also disclose any funds the borrower received under the Paycheck Protection Program or other state or federal relief programs.

Additionally, the Oregon Statute prohibits the lender from taking any of the following actions during the Emergency Period: (a) imposing or collecting charges, fees, penalties, attorneys' fees or other amounts in connection with the borrower's failure to make a payment; (b) imposing a default rate of interest for failure to make a payment; (c) treating the borrower's failure to make a payment as an ineligibility for a foreclosure avoidance measure; (d) requiring or charging for an inspection, appraisal or broker opinion of value, not otherwise permitted in the absence of a default; (e) initiating cash management or implementing lockbox procedures not already in existence before June 30, 2020; (f) taking control of the operating revenue from the mortgaged property unless the control was established before June 30, 2020; or (g) declaring a default based on a borrower's failure to meet financial covenants due to inadequate operating revenue resulting from the COVID-19 pandemic. The lender is further prohibited from foreclosing by advertisement and sale, bringing an action or suit to foreclose a mortgage, enforcing a forfeiture remedy, or bringing an action or suit to foreclose a lien or other security interest on the mortgaged property.

If a lender takes any of the foregoing prohibited actions, and as a result the borrower suffers an ascertainable loss of money or property, the Oregon Statute permits the borrower to bring an action to recover its actual damages. A borrower who prevails in the action may also recover the borrower's court costs and attorney fees. **Within 60 days after June 30, 2020 (*i.e.*, before August 29, 2020), each lender authorized to do business in Oregon must provide written notice to all of its borrowers of a borrower's rights under the Oregon Statute.** Note, however, that the Oregon Statute does not apply to judgments of foreclosure that: (a) were issued before the Emergency Period began; (b) occur in connection with a tax foreclosure proceeding; or (c) occur after a person has recorded a notice of intent to abandon real property or a judicial order that authorizes an abandonment of real property.

The Oregon Statute is not the first measure that a state government has taken to limit a lenders' default remedies in light of the COVID-19 pandemic, and it likely will not be the last. For example, New York's Executive Order No. 202.28, as extended by Executive Order No. 202.45, prohibits, until August 19, 2020, the initiation or enforcement of: (a) foreclosure of any commercial mortgage for nonpayment of a mortgage; and (b) the initiation of a proceeding or enforcement of eviction for failure to pay rent for commercial tenants, in each case where the property is owned or rented by someone that is eligible for unemployment insurance or benefits under state or federal law, or is otherwise facing financial hardship due to the COVID-19 pandemic. The State of Ohio introduced Senate Bill 297 on March 25, 2020 (referred to committee on May 6, 2020), which would mandate a stay of foreclosure filings and proceedings during the state of emergency declared due to the COVID-19 pandemic. After the termination of the state of

emergency, any foreclosure proceedings initiated due to a default during the state of emergency and 60 days thereafter would be stayed and referred to mediation.

We recommend that all lenders with borrowers in Oregon send the required notice described above as soon as possible. In addition, since the Oregon Statute allows borrowers and lenders to make other arrangements with respect to their loans, lenders should consider working out more favorable terms with their borrowers to avoid the statutory outcome. Lenders may also consider prohibiting or penalizing a borrower for invoking the statute, but it is currently unclear if such agreements would be enforceable.

We will continue to provide any new information on the Oregon Statute or any similar measures taken in other states as the country grapples with this unprecedented crisis.

Avoiding Title Insurance Pitfalls in Portfolio Transactions

July 30, 2020 | Issue No. 14

In commercial real estate finance transactions involving a portfolio of properties located in multiple states, lenders must consider certain title insurance issues unique to such transactions. Lenders will need to request specific types of coverage and be cognizant of certain state-specific and timing issues that are often associated with large portfolio transactions.

In the context of a single property transaction, a lender would generally obtain a single loan policy for the full amount of the loan. In portfolio transactions, there are typically multiple mortgages which secure the full amount of the loan which raises an additional set of issues. First, it is unwieldy to include multiple properties on the same loan policy, especially as the number of sites increases. Second, while a mortgage might secure the full loan amount in jurisdictions where there is no mortgage tax, multiple policies cannot be issued with coverage equal to the full loan amount for each property since the premium would be excessive. Third, separate and distinct policies with coverage amounts equal to the individual allocated loan amount for such property would have to stand on their own, meaning that a loss at one property in excess of the insured amount for such property would leave the lender uninsured for the loss of such excess. While a mortgage in a non-mortgage tax state will usually secure the full loan amount which will exceed the value of the specific property, the amount of title insurance on such property will not.

The ALTA Endorsement 12-06 (Aggregation), often called a “Tie-In” endorsement, addresses the foregoing concerns and is therefore a necessary endorsement in any portfolio transaction. The “Tie-In” endorsement allows a title company to issue separate policies for each mortgaged property with insured amounts equal to a “grossed up” portion of the total loan amount allocated to such property (usually 125%), and then aggregates the insured amount of such policy together with the insured amounts of the policies listed in the “Tie-In” endorsement such that the total insured amount will be at least equal to the total loan amount. In essence, this produces the same result as the title company issuing a single policy covering the entire portfolio. It allows the lender to take advantage of any increases in the value of individual properties, since if there is a loss at a single property in excess of its allocated loan amount then the lender can then take advantage of the remaining portion of the insurance coverage to make itself whole. In addition, this type of insurance protects lenders against fluctuations in the value of individual properties in a portfolio.

The “Tie-In” endorsement is not available in all states, however. Title insurance is regulated by each state and therefore there are variations as to the availability and forms of endorsements from state to state. Specifically, Florida, Delaware, and Pennsylvania will only “tie-in” policies for properties that are located within their own states. For states that will only “tie-in” intrastate policies, the total coverage amount for those properties should be increased to account for the inability to “tie-in” with the remainder of the portfolio. In addition, lenders should be aware that certain states have capped liability amounts for aggregated policies. In that situation, the ALTA Endorsement 12.1-06 (Aggregation – State Limits) is used, which merely states that if the land is located in a restrictive state then the aggregate insured amount for that state is capped at such amount.

In addition to aggregation considerations, portfolio transactions also raise co-insurance concerns, especially those transactions with high loan amounts. Many banking institutions have maximum risk guidelines that require them to diversify the insurance risk among multiple title companies in the event the loan amount is over certain thresholds. These guidelines further depend on which title company is providing insurance. In a portfolio transaction, especially one closing on a tight timeline, it is best to bring the co-insurer into the deal as early as possible. This can be a lead time item that may prevent a timely closing due to the fact that a co-insuring title company may potentially need to take the time to perform their own due diligence before they agree to co-insure, essentially requiring them to start from the preliminary title commitment stage. Lenders providing financing for large loan portfolio transactions should ensure that the ALTA Endorsement 23-06 (Co-Insurance), also known as a “Me-Too” endorsement, is obtained and that it is requested early on in the transaction timeline.

Lenders should also consider reinsurance in order to further manage risk attributed to the creditworthiness of the title insurance company. Reinsurance is title insurance purchased by the original title company from third-party title companies to cover liabilities above a specific dollar amount. Reinsurance can be used in the same transaction as co-insurance, thus further diversifying credit risk. When reinsurance is obtained, Lenders should be sure that it is issued in a form which gives the insured “direct access” to the insurer in order that the coverage is not derivative.

Knowledge of the correct title insurance coverage, state-specific nuances and timing concerns will help move your portfolio financing through to a smooth closing, avoiding unnecessary time delays and potential pitfalls.