CADWALADER

REAL ESTATE FINANCE news and views

The Changes Continue

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Ch-Ch-Ch-Changes: NY Commercial Landlords' Duty to Mitigate

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The fluidity of New York's legal landscape continues to accelerate in the wake of the pandemic. Proposed legislation in New York may disrupt long-established law that commercial landlords do not have a duty to mitigate their damages when a tenant vacates its premises in violation of the terms of its lease.

When a tenant vacates its premises in violation of its lease, a landlord suffers damages such as lost rents through the remainder of the lease term and expenses of re-letting. The extent of those damages depends on the amount of effort that a landlord expends in finding a new tenant. If a landlord is slow to take steps to re-let the premises, or "mitigate its damages," it takes longer to find a new tenant. The longer it takes to find a new tenant, the higher the damages accrue. If a landlord takes no mitigation action at all, its damages pile up throughout the remainder of the lease term.

Since 1995, New York commercial landlords have been free of any duty to mitigate their damages when a tenant vacates its premises prior to the end of the stated term of the lease. *Holy Properties Ltd., L.P. v. Kenneth Cole Productions, Inc.*, a 1995 New York Court of appeals decision, definitively held that since a lease is a present transfer of an estate in real property and not an executory contract, leases are not subject to the general rule that upon a breach of contract, the injured party must make reasonable "exertions to minimize the injury." To the contrary, the case specifically holds that the landlord is free to sit back and sue to collect its rent without any duty to mitigate its damages. However, pursuant to NY Real Prop § 227-e, a residential landlord has a statutory obligation to mitigate its damages when a tenant vacates a premises in violation of its lease. Section 227-e explicitly applies to leases covering dwellings only, thereby carving out commercial leases. On January 7, 2021, Senate Bill 1129 was introduced which would amend Section 227-e to delete that carve-out, bringing commercial leases within its scope.

New York landlords may soon be unable to sit idly by waiting for the violated lease term to expire, incurring more damages each month and collecting those damages from their existing tenant. Landlords would be required to spring into action, find a broker and otherwise take reasonable and customary steps to lease their space. While it is important to note that this is the fourth time that this legislative amendment has been proposed since August 2019, it is certainly fair to say that the times – they are a changin'.

We will keep you apprised of any further developments of this proposed legislation.

Brexit Update – Changes to Loan Documentation

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Following the expiry of the transition period which ended on 31 December 2020 at 11pm GMT (known as "IP Completion Day"), the UK is no longer a member of the EU. During the transition period (between 31 January 2020 when the UK has formally withdrawn from the European Union) to the IP Completion Day, the UK has implemented certain key pieces of legislation to ensure that following its exit from the European Union, the majority of the EU laws which apply in financing transactions in their current form continue to apply, albeit with some changes to the scope and application. In this article, we discuss some of the key changes from a documentary perspective for financing transactions.

Choice of law

The use of English law for finance documentation is largely unaffected post-UK's withdrawal from the European Union. English law remains the dominant and preferred choice of law (subject to local law requirements, especially with respect to taking security) in the market due to the English law's commercial orientation and its transparency. English contract law is largely unaffected by EU law and, therefore, the UK's withdrawal from the European Union does not result in any material changes.

The choice of law will continue to be recognised by the courts of EU member states. Prior to Brexit, Rome I Regulation provides that all EU member states give effect to the parties' choice of law. This includes the law of an EU member or non-EU member (*e.g.*, New York law). Whilst the UK is now no longer a member of the EU and therefore not a member to Rome I Regulation, the UK has legislated to incorporate Rome I and Rome II into English law, under the ***Law Applicable to Contractual Obligations and Non-Contractual Obligations (Amendment etc.) (EU Exit) Regulations 2019***. This means that English courts will give effect to the parties' choice of law, whether this is English law, EU law or law of a non-EU member state. The EU courts will continue to apply Rome I and Rome II, and therefore give effect to the choice of any law (including English law as a law of a non-EU member state). Therefore, the choice of law and recognition of choice of law is largely unaffected by Brexit.

Choice of jurisdiction

It has been common practice in loan documentation for lenders to nominate the use of "one-sided exclusive jurisdiction" clauses. These clauses provide that the borrower must take proceedings in the courts of England only, whereas the lenders may take proceedings in any court of competent jurisdiction. This has been the favoured approach for lenders for many reasons. It enhances their flexibility in choice of forum yet provides certainty that the borrower can only take the matters to English courts to adjudicate on matters relating to English law and, therefore, exposure is only limited to the one jurisdiction.

This one-sided exclusive jurisdiction clause was possible by virtue of the Brussels I Regulation, which provides that any one court in the EU has jurisdiction and that such court's judgment is enforceable across the EU. Post-Brexit, however, the UK is no longer part of this convention and so the reciprocity no longer applies. This means that, unless the UK signs up to any other convention with the EU**[1]** or implements other similar legislation, enforcement of foreign judgments fall back to the 2005 Hague Convention, to which the UK is a party.

Under the Hague Convention, all EU member states will be required to respect the parties' choice of court and enforce English judgments on a contract containing a "two-way exclusive jurisdiction clause." Unlike the one-way exclusive jurisdiction clause, the two-way exclusive jurisdiction clause is where both parties nominate the same court to which proceedings may be initiated.

EU member state courts will generally respect two-way exclusive English jurisdiction clauses and enforce the resulting judgments under the Hague Convention, and the English courts will likewise do the same with respect to the two-way exclusive jurisdiction clause of an EU member state court.

The question, then, for lenders is to consider whether, under the current circumstances, a two-way exclusive jurisdiction clause should be used in place of a one-sided exclusive jurisdiction clause given the recognition of exclusive jurisdiction provisions under the Hague Convention. On the one hand, adopting the two-way exclusive jurisdiction clause will assure the judgment to be recognised and enforced in any EU member state. On the other hand, if the judgment doesn’t qualify for the Hague Convention, enforcement will depend on the national rules of the relevant EU member state, which may or may not be as straightforward. Therefore, appropriate local law advice would be required to form an assessment of the potential enforceability or otherwise of a Non-Hague Judgment pursuant to the national rules of any EU member state.

Application of European law

Pursuant to the European Union (Withdrawal) Act 2018, as amended by the European Union (Withdrawal Agreement) Act 2020 (the "EUWAA")) (the "EUWA"), existing EU law which applied in the UK before the expiry of the transition period will continue to apply as retained EU law.

In particular, section 2 preserves UK law that implements EU law and section 3 onshores directly applicable EU law into UK law. Furthermore, section 8 of the EUWA provides that retained EU law can be amended by statutory instrument going forward.

It follows that legislative references will have to change to the relevant statutory instrument as and when they are implemented. The Loan Market Association (“LMA”) is in the process of updating these references in their published finance documentation.

Article 55

The UK will become a third country for the purposes of Article 55 of the Bank Recovery and Resolution Directive (“BRRD”). What this means is a bail-in clause will be required in the relevant English law-governed document. Article 55 of the BRRD is also a retained EU law and, therefore, a bail-in provision of the UK bail-in legislation will be required in any EEA law-governed contract.

Inclusion of the bail-in clause has been recommended by LMA prior to the IP Completion Day, and market participants have been including the bail-in clause in English law contracts for some time. The practice will remain the same post-IP Completion Day.

[1] There are currently discussions around the UK signing up to the 2007 Lugano Convention (which applies between EU member states and Iceland, Norway and Switzerland), in which case jurisdiction and enforcement as between the countries to this convention remains largely the same compared to the pre-Brexit position.

New York Assembly-Sponsored Legislation Proposes New Tax on Mezzanine Debt and Preferred Equity

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By **Michael Schromm**
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Assembly Bill A3139 was introduced by Assembly Member Harvey Epstein on January 22, 2021. The bill is currently in committee but, if enacted, it will amend New York's Real Property Law and Tax Law to require the recording of mezzanine debt and preferred equity investments and subject it to the mortgage recording tax. These amendments will force borrowers and lenders to reconsider the economic costs of mezzanine financing.

The first major change is the requirement for the recording of mezzanine debt and preferred equity investments entered into simultaneously with mortgages secured by real property. If enacted, the law will amend Real Property Law, Section 291-k to require mezzanine debt or preferred equity investments to be recorded whenever a corresponding mortgage is recorded against real property. This provision encompasses "debt carried by a borrower that may be subordinate to the primary lien and is senior to the common shares of an entity or the borrower's equity and reported as assets for the purposes of financing such primary lien." The proposed bill specifies that the definition includes "non-traditional financing techniques such as direct or indirect investment by a financing source in an entity that owns the equality [sic] interests of the underlying mortgage where the financing source has special rights or preferred rights such as: (i) the right to receive a special or preferred rate of return on its capital investment; and (ii) the right to an accelerated repayment of the investors capital contribution." It does not encompass, however, debt on cooperative or common shares of residential units where (i) the unit owner of a cooperative apartment is a shareholder of the ownership entity, (ii) has exclusive occupancy of such dwelling unit, and (iii) has established and delimited rights under a proprietary lease. Section 9-601 of the Uniform Commercial Code (the "UCC") would be amended to provide that security interests in mezzanine debt and preferred equity related to real property will be perfected only by the filing of a financing statement and payment of any taxes due. While not 100% clear from the proposed language of the bill, it appears that the bill would require the recording of mezzanine security instruments along with their mortgage counterparts.

The proposed bill would also amend Section 250(2)(a) of the Tax Law to provide that "mezzanine debt" and "preferred equity investments", as defined in Section 291-k of the Real Property Law, are now taxable. Section 253 of the Tax Law would be amended so that the tax would be imposed upon the filing of a financing statement and measured by the amount of the principal debt obligation secured by a security agreement pertaining to mezzanine debt financing and/or preferred equity investments in relation to real property upon which a mortgage instrument is filed. The proposed rate of tax would be as follows: (i) mezzanine debt and preferred equity investments of less than $500,000 will be taxed at $1 per each $100 of debt secured; (ii) mezzanine debt and preferred equity investments affecting one, two, or three-family houses and individual residential condo units securing $500,000 or more will be taxed at $1.125 per each $100 of debt secured; and (iii) mezzanine debt and preferred equity investments of all other real property will be taxed at $1.75 for each $100 of debt secured. Counties and cities will also be authorized to adopt and/or amend local laws to impose a county or city tax on the filing of financing statements pertaining to mezzanine debt and/or preferred equity investments. Additionally, Section 291-k of the Real Property Law would be amended to provide that no remedy otherwise available under Article 9 of the UCC will be available to enforce such mezzanine debt unless the contemplated taxes have been paid. The bill is silent as to any restriction on the enforcement of remedies available to a preferred equity interest short of remedies available pursuant to the UCC.

The proposed bill is unclear, however, on whether the foregoing amendments will apply to mezzanine debt unrelated to underlying mortgage debt. The current language appears to encompass mezzanine debt whenever "a mortgage instrument is recorded" but it does not expressly address mezzanine debt that is created independent of debt secured by real property. Consequently, it remains to be seen whether the proposed law will apply to just mezzanine debt subordinate to a primary mortgage loan secured by real property or to all mezzanine debt generally.

Assembly Bill A3139, if passed, will impose significant new requirements for mezzanine debt and preferred equity investments transactions. Under the proposed legislation (like the mortgage tax in New York) lenders will be required to file and pay tax on mezzanine debt and preferred equity investments as a precondition to exercising remedies. A similar bill was introduced in January and August of 2020, both of which died in committee. If this legislation moves forward, we will update this Article.

Upcoming Webinar: Defeasance in Real Estate Finance: Process and Timing, Prepayment and Lockout Provisions

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By **Andrea Weitzman**
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We are pleased to announce that we will be speaking in an upcoming Strafford live video webinar, "**Defeasance in Real Estate Finance: Process and Timing, Prepayment and Lockout Provisions,**" scheduled for Tuesday, March 16, 1:00-2:30 p.m. EDT.

Defeasance allows a borrower to prepay its existing loan after a specified lock-out period by substituting for the real estate collateral a basket of U.S. government-backed securities that generate cash flow sufficient to pay the ongoing debt service and the principal amount due at maturity. Defeasance thus results in yield protection for CMBS and other lenders that have been promised continued payments throughout the loan term.

The decision to refinance may be governed by the cost of defeasing the existing loan. Counsel must weigh the economic costs and benefits of defeasing a higher interest rate loan with lower yielding securities. Documentation is significant and typically includes the formation of a new SPE and transfer of the mortgage. Additional issues must be considered in states with significant mortgage taxes. If allowed, simple prepayment (with a prepayment penalty) might be the better option.

When involved in a refinance or sale that will require a defeasance to close, counsel must consider the transaction process and timing. All parties must agree to the closing timeline because once the borrower "pushes the defeasance button," the borrower must purchase securities and close the defeasance and the new loan within the allotted window or incur high breakage costs. In the CMBS context, servicer and rating agency approval must be obtained before closing.

We will examine the mechanics of defeasance in CMBS and other yield-protected commercial real estate loans. We will discuss restrictions inherent in yield maintenance and lockout provisions, the timing complexities and documentation of defeasance transactions, CMBS servicing issues, and additional steps required to avoid mortgage taxes in states like New York and Florida.

We will review these and other key issues:

- What is the rationale for requiring defeasance in CMBS and other commercial real estate loans?
- How should borrowers calculate the cost of defeasance? Why does defeasance make more economic sense later in the loan term?
- Are there times when a cash prepayment is an option? When is prepayment preferable to defeasance?
- How should the transaction be structured in a heavy mortgage tax state?

After our presentation, we will engage in a live question-and-answer session with participants so we can answer your questions about these important issues directly.

We hope you'll join us.

For more information or to register >

Or call 1-800-926-7926
Ask for Defeasance in Real Estate Finance on 3/16/2021
Mention code: RA1HU1-R9OCAZ

Recent Transactions

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Here is a rundown of some of Cadwalader's recent work on behalf of our clients.

Recent transactions include:

- Representation of the borrower in the $121 million financing of an office building in San Diego, California.
- Representation of the lender in connection with the financing of a single-tenant headquarters office building located in the greater Washington, DC metropolitan area in an amount up to $49,975,000, providing for future advances to fund tenant improvements, leasing commissions and potential operating cost and debt service shortfalls arising from rent concessions.
- Representation of the lender in a $128.8 million non-recourse loan-on-loan transaction related to two multifamily properties in California and Washington, D.C.
- Representation of the administrative agent and lender in a $106 million financing of a property located in California in connection with which the borrower is repositioning a portion of the property for life sciences uses.
- Representation of the administrative agent and lender in the up to $120M financing of a life sciences building in Boston, MA, including a future advance component to fund tenant improvements and capital expenditures.