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# The New Normal?

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## Coming Back

By **Steven M. Herman**
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This is the news we've been waiting for but have been a bit reticent to say out loud: the rebound of real estate finance is upon us.

The markets were very active at year-end, and that activity level has continued unabated through the first half of 2021.

None of this should suggest that we are fully out of the woods and back to normal. Far from it.

Of all the industries most affected by COVID-19, commercial real estate is right up there with retail (and there are obviously close ties here) as topping the list of most impacted. Pardon the hackneyed phrase, but it's still unclear what the New Normal will resemble in commercial real estate. While words like "concessions" and "abatement" are still common, it appears that as tenants get back to work, the trepidation around real estate is tempering. It is still unclear what the shrinkage will be for office usage or the what the longer-term effects will be in different asset classes.

And there still will come a point when we will all need to step back and look at where we were and if there were things we could have done collectively to "protect" the industry. And are there lessons learned here the next time a seminal event (and hopefully not one that caused so much personal tragedy and such an unraveling of our economic fabric) wreaks havoc around us?

There will be time for all of that. For now, though, heads down and hold on tight. Things are coming back.

# Make Me a Right of Refusal I Can't Refuse

By **Loren R. Taub**
Special Counsel | Real Estate

The New York State rule against perpetuities is based on the common law rule and provides that "no estate in property shall be valid unless it must vest, if at all, not later than twenty-one years after one or more lives in being at the creation of the estate and any period of gestation involved." The purpose of the rule against perpetuities in the real estate context is to prevent any interest in real property from remaining non-transferable for an exceedingly long period of time. For example, if a transferor grants to a transferee a right of first refusal to purchase real property (a "ROFR") – that is, the contractual right to purchase real property after the seller has received an offer to purchase the same from a third party (generally on the same terms as the third-party offer) – and any such ROFR runs to the benefit of the transferee's successors and assigns with no termination date, the same would violate the rule against perpetuities and be void.

How do we know that the foregoing ROFR violates the rule against perpetuities? Technically, the ROFR could benefit the transferee's heirs and distributees for a period which exceeds twenty-one (21) years after all "lives in being at the creation of the estate and any period of gestation" – *i.e.*, the ROFR would remain in effect after all of the heirs and distributees of the transferee which are alive (or in gestation) at the time of the grant have died plus an additional twenty-one (21) years. A violation of the rule against perpetuities will result in the intended grant – in this case, a ROFR – being deemed null and void.

The Appellate Division of the Fourth Department of the Supreme Court of New York recently reviewed a claim that a ROFR was void, in part, because it violated the rule against perpetuities in a case entitled *Jeffrey P. Martin and Michele R. Martin, as plaintiffs, v Willard L. Seeley, Doris J. Seeley and Todd T. Schilling, as defendants*.[1] In this case, the Martins purchased a piece of real property from the Seeleys ("Parcel 1") and, in the contract and the deed relating to Parcel 1, the Seeleys gave to the Martins a ROFR to purchase another piece of real property adjacent to Parcel 1 ("Parcel 2"). Several years after the Martins purchased Parcel 1, the Seeleys sold Parcel 2 to Todd T. Schilling (one of the defendants), and the Martins claimed that the Seeleys violated the Martins' ROFR with respect to Parcel 2. The ROFR provided as follows: "[t]his [r]ight of [f]irst [r]efusal shall run with the land and inure to and be for the benefit of the [plaintiffs] but not their successors and assigns tenants subtenants licenses mortgagees and possession [sic] and invitees."

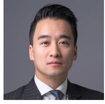
The Seeleys claimed that the ROFR violated the rule against perpetuities because the same "ran with the land" and therefore was not "personal to plaintiffs and may be exercised by their heirs and distribute more than 21 years after plaintiffs' deaths." The language of the ROFR was ambiguous in that the drafter specifically stated that the same would benefit the Martins but not their successors and assigns, and the language of the ROFR also stated that the ROFR ran with the land which suggests that the same does benefit anyone who owns the land in

perpetuity. The lower court (as affirmed by the Appellate Division) looked to the common law rule of construction which provides that "parties who make grants of real property interests presumably intend their grants to be effective and that reviewing courts should, if at all possible, avoid constructions which frustrate their intended purposes," and ruled that the ROFR in question did not violate the rule against perpetuities because the language in the deed provided that the ROFR was for the benefit of the Martins only. The lower court (as affirmed by the Appellate Division) determined that the ROFR could not vest in the Martins' heirs and distribute more than 21 years after the Martins' deaths without also vesting in the Martins' successors and assigns (and the grant clearly stated that the option did not run to the benefit of successors and assigns).

In New York State and other states that have codified the rule against perpetuities, it is of the utmost importance that when drafting a ROFR (as well as other options to purchase real estate, such as a right of first offer) to clearly state that such right is personal to the grantee of such right and that the same does not run to the benefit of successors and assigns or that the same runs with the land.

[1] All quotations in this article are from the *Martin v Seeley* court decision.

# Negative Pledges in Commercial Real Estate Financings – Why Do We Need Them?


By **William Lo**
Associate | Real Estate

Negative pledges are contractual constructs widely used in many financings – from simple mortgage loans to complex, large-scale real estate financing transactions – and, as a result, are often taken as a market standard inclusion in finance documents. That said, why do lenders insist we have them? Why are they necessary even in secured financings where the lender has the benefit of first ranking security? Why do lenders insist that they feature in the security documents even though the loan agreement has them? This article seeks to provide a wider understanding of negative pledges' existence and purpose.

**What is a negative pledge?**

A negative pledge is an undertaking granted by the borrower and, if applicable, obligors not to create, or permit to subsist, any security over any of its assets. The generally accepted European market standard construct of a negative pledge clause can be found in clause 22 (*General Undertakings*) of the Loan Market Association ("LMA") form of the real estate finance loan agreement, which goes further to covenant that the obligors "*shall not:*

- *(i) sell, transfer or otherwise dispose of any of its assets on terms whereby they are or may be leased to or re-acquired by an obligor;*
- *(ii) sell, transfer or otherwise dispose of any of its receivables on recourse term;*
- *(iii) enter into any arrangement under which money or the benefit of a bank or other account may be applied, set-off or made subject to a combination of accounts; or*
- *(iv) enter into any other preferential arrangement having a similar effect,*

*in circumstances where the arrangement or transaction is entered into primarily as a method of raising financial indebtedness or of financing the acquisition of an asset.*"

**Why are negative pledges needed?**

Negative pledge clauses are important in lending transactions. As with other negative covenants in a loan agreement, they aim to give the lender control over the activities of the borrower by preventing it from, at the expense of the lender, creating security over its assets in favour and support of any indebtedness owed to other creditors.

A negative pledge covenant therefore becomes even more crucial for an unsecured lender because, in the absence of security, such lender would be vulnerable to the

risk of security being created by the borrower in favour of another creditor, positioning it ahead of the unsecured creditor on the borrower's insolvency, which could have the effect of reducing the pool of assets available for the unsecured creditors. As such, a negative pledge covenant will assist the unsecured lender in preserving its priority upon a borrower's insolvency.

**Why are negative pledges required by secured lenders?**

Most European real estate financings are done on a non-recourse basis such that the security group is ring-fenced. However, regardless of whether a lender has first-ranking security, negative pledges should nonetheless be an important requisite for secured lenders for both priority and practical reasons. For instance, even if a lender has the benefit of a mortgage or fixed charge security, thus any further security granted by the borrower shall rank behind the original security (assuming, of course, that it has been properly created and perfected), the new creditor may have rights to enforcement that may impede on the original lender's position, or obstruct a restructuring by refusing to agree to certain actions proposed by that original lender.

Furthermore, in circumstances where the secured lender has the benefit of a floating charge security, under English law such priority could be undermined by any subsequent fixed charge security, as a fixed charge will have priority over a floating charge, even if such floating charge was created earlier in time.

**Why do lenders require that the negative pledge covenant be featured in both the loan agreement and security agreements?**

As noted earlier, the LMA form of real estate financing loan agreement indeed has a negative pledge covenant in it, and it would be expected to remain as a feature of the loan agreement in any financing. However, the secured lender may also require a negative pledge covenant to be drafted into the security documents.

The reason for this is because under the Companies Act 2006 (Amendment of Part 25) Regulations 2013, almost all charges must now be registered, which means that the right of security granted by the borrower to a secured lender, together with details of its particulars such as the negative pledge covenant, can be noted on a public register available to all parties to view. A full and complete copy of the security document must also be submitted as part of the registration, with accessibility to a copy of the agreement being available to the public on request. This has significant implications in respect of notice to subsequent lenders or prospective creditors, and it greatly increases the likelihood that any subsequent creditor will have notice of the negative pledge.

Notice can potentially be achieved in two ways:

- (i) Actual notice: if the new creditor is informed of the negative pledge, or as part of their due diligence, the creditor reviews the charge register of the borrower at Companies House and identifies such negative pledge, then the new creditor shall have actual notice of it, and will therefore take its security interest subject to any security the original lender may have; and
- (ii) Constructive notice: if the new creditor does not have actual notice of the negative pledge, it is arguable that constructive notice is imputed to third

parties by virtue of the registration of such security and noting of the negative pledge, the result of which is that it shall take security subject to any security that the original lender may have. However, it must be noted that there is some debate surrounding registration of security automatically giving rise to constructive notice, and so whether a party does indeed have constructive notice will depend on the facts of the scenario in question.

The borrower should not take issue with a negative pledge covenant being featured in both the loan agreement and the security document, but it is important for them and their counsel to ensure that the terms and obligations under the negative pledge clause in both the loan agreement and the security documents materially mirror one another.

**What if there is existing security granted in favour of a third-party creditor?**

Ultimately, the borrower needs to be able to continue its business effectively, and as such there may be instances where security will need to be granted – for instance, set-off or netting arrangements of credit balances that are often made in the ordinary course of the borrower's banking arrangements. It is therefore important for the borrower and its counsel to consider the negative pledge covenant carefully in the wider context of the transaction and include exclusions and qualifications where appropriate, as the default qualifications under the LMA are limited to the following:

- (i) security granted in connection with the transaction and finance documents (that is, security granted in favour of the lender);
- (ii) liens arising by operation of law and in the ordinary course of trading; and
- (iii) security that is released prior to the first drawdown.

If the borrower has any existing security, then the new lender will need to consider whether it is prepared to allow such security to subsist and remain in place during the life of its loan. This is important as any such security may prejudice the new lender's position. To the extent that the lender agrees that the existing security shall remain, such security would need to be expressly carved out from the negative pledge clause as "permitted security."

Furthermore, if the new lender is also taking security from the borrower, then it may wish to also consider putting into place a deed of priority or intercreditor agreement in order to govern the priorities of the security interest and enforcement rights. This will need to be entered into between the borrower and the competing creditors, so will be a matter for negotiation at the time.

**What if security was created in breach of a negative pledge?**

It must be acknowledged that a negative pledge covenant is ultimately just a contractual obligation, and therefore in theory the borrower could in practice grant security notwithstanding such promise not to do so. Of course, a prudent borrower would, and should, comply with the terms of a negative pledge covenant that it has agreed to, but in a situation where a borrower does create security in breach of its negative pledge, it is worth noting the consequences of such actions for the borrower, original lender and new lender:

- (i) Borrower: a breach of the negative pledge clause would likely be an event of default under the finance documents, and typically this would trigger some fundamental powers for the original lender.

- (ii) Original lender: when an event of default has occurred and is continuing, the original lender will have the power to accelerate the loan and, if the loan is secured to enforce its security, such as its mortgage over the property. As alternative actions, in particular for unsecured lenders, it may also be possible to consider obtaining an injunction against the granting of security to a new lender, and if the new lender had notice of the negative pledge, then the original lender could bring a claim against it in tort for inducement to breach contract.

- (iii) New lender: a key issue will be priority. Ultimately, whether the new lender's security takes priority over the original lender's security, or vice versa, is dependent on a number of factors and thus must be considered on a case-by-case basis, such as:

    1. the nature of the security (*e.g.*, a fixed charge will take priority over a floating charge);
    2. whether the security has been perfected (security that has not been perfected may not be enforceable); and
    3. whether the new lender had notice of the negative pledge (if the new lender has notice of the negative pledge, then its security interest shall be made subject to the security of the original lender).

**Final thoughts**

Negative pledge clauses are a market standard covenant in any real estate financing, and so as a borrower the goal should be to negotiate in the right qualifications and exclusions to ensure that the negative pledge does not impede on its ability to run its business, as opposed to expending efforts to remove it. As a lender, however, it is important to understand why we have negative pledges and their effectiveness and limitations to ensure that the benefits and risks in light of the broader circumstances of the transaction are factored into the loan terms.

## The Importance of Springing Members

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By **Peter Dodson**
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Springing Members are a tool that a structured finance Lender can use to reduce the risk that a Borrower will dissolve under state law. Under most state laws, an LLC that does not have at least one member will dissolve. The risks of a state law dissolution proceeding are similar to those of a bankruptcy, and typically involve the liquidation of the LLC's assets and the distribution of proceeds in accordance with the LLC Agreement.

Borrowers in structured finance transactions are often single member LLCs. To reduce the risk that the Borrower will be dissolved under state law if the LLC ceases to have a member, Lenders should require the Borrower to have two "Springing Members."

A Springing Member is a person or entity that signs the Borrower's LLC Agreement for the limited purpose of springing into place as a "Special Member" of the Borrower in the event that the Borrower's existing member ceases to be a member for any reason. This mechanism ensures that the Borrower is not dissolved under state law for lack of a member.

**How it Works**

Here's how the process works:

- Springing Members should be used for every Borrower that is a single member LLC.
- In transactions where the Borrower is required to have Independent Directors, the Independent Directors typically fill the Springing Member role. However, the Springing Members do not have to be independent from the Borrower or provided by a nationally recognized provider of Independent Directors. The Springing Members can be any person or entity in the Borrower's organizational structure, other than its current member.
- Even when a Borrower is not required to have Independent Directors, the Lender should still require Springing Members. Springing Members are an important protection against dissolution of the Borrower and, because they can be any person or entity, the cost of having Springing Members can be very low.
- The Borrower's LLC Agreement should provide that upon the occurrence of any event that causes the Borrower's member to cease to be a member of the Company, the Springing Members shall automatically become Special Members of the Company and continue the Company without dissolution.

The Springing Members should be a signatory to the LLC Agreement so that no further action on the part of the Springing Members is required for these provisions to work.

- The Special Members do not receive any economic interest in the Borrower, and do not have any interest in the profits, losses or capital of the Borrower. Special Members have no right to receive distributions from the Borrower, and are not required to make any capital contributions to the Borrower.
- Except as required by mandatory provisions of applicable state law, the Special Members do not have any right to vote on matters with respect to the Borrower, so they do not have general control over the Borrower's business affairs.
- The Borrower's LLC Agreement should also provide that within 90 days after the date on which the member ceases to be a member of the Company, the personal representative of the member (or its designee) shall become the member of the Borrower.

The Special Members automatically cease to be members of the Borrower upon the admission of a substitute member of the Borrower.

## Cadwalader Advises on Major Real Estate Finance Transactions

Cadwalader's Real Estate Finance team finalized the two biggest transactions in the CMBS markets in recent weeks.

Our team advised JPMorgan, Citibank and Deutsche Bank as co-lenders in a $4.65 billion financing of Blackstone and Starwood's acquisition of Extended Stay America. The transaction has been described by *Commercial Observer* as one of the largest single-asset/single-borrower CMBS loans of the last decade, and is the first large hotel transaction post-pandemic. The transaction is secured by approximately 570 hotels across 40 states. After some pushback from shareholders and an increased bid from Blackstone and Starwood leading up to the shareholder vote, the Cadwalader team worked tirelessly to pull off this public-private transaction on a portfolio that showed little comparative COVID impact and maintained relatively stable occupancy.

Cadwalader also advised Wells Fargo and Goldman Sachs as co-lenders in a $3 billion single-asset/single-borrower securitized refinancing of the newly developed One Vanderbilt skyscraper in Midtown Manhattan, the second-tallest building in New York and a Class A, LEED Gold and Platinum office tower, for a partnership led by SL Green Realty. The transaction is the largest-ever fixed rate CMBS financing secured by a single asset.

## Recent Transactions

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

Recent transactions include:

- Represented the mortgage and mezzanine lenders in connection with an aggregate financing package of $600 million for a portfolio of multifamily properties located in New York City.
- Represented the mortgage and mezzanine lenders in connection with an aggregate financing package of $250 million for a condominium unit in an office building located in New York City primarily leased to various New York City governmental agencies.
- Represented the lender in a $99 million loan-on-loan transaction secured by a pledge of a mortgage and mezzanine loan to refinance a multi-family property located in Washington, D.C.
- Represented the lender in a $421.8 million mortgage and mezzanine financing, including a future funding component for renovations and leasing costs, secured by an office complex in Atlanta, Georgia.
- Advised the lenders on a $370 million mortgage loan secured by the office portion of AMA Plaza, a 52-story Class A tower in Chicago, Illinois, and an adjacent parking garage.
- Advised the administrative agent and initial lender on a $108 million mortgage loan secured by the Montage Palmetto Bluff, a 200-key luxury hotel in Bluffton, South Carolina.