CADWALADER

REAL ESTATE FINANCE news and views

No Celebrations

March 31, 2022

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Resilience in the Face of Humbled Concern

March 31, 2022

It is difficult to celebrate economic success when every day on the news we are confronted with unimaginable horrors and human suffering. With this as a backdrop, we would like to offer our comments on the state of the real estate markets.

Resilience is the word that comes to mind. Omicron, pandemic, rising interest rates, Ukraine, World War III. There seem to be ominous signs everywhere, yet the real estate markets seem to be resilient. Busy is the word of the hour, week, month, quarter, year. Whether transactions are securitized or balance sheet, the markets are busy. There has been some trepidation around rising rates, with the situation in Ukraine, and also where “flex” is appearing in term sheets, deals are being repriced or “slow-walked.” But, overall, the markets seem to be, on the whole, resilient.

And, yet, this resilience is being tested every day. The issuance of new term sheets and their pricing have slowed a bit with all of the “noise” in the world. But unlike prior instances where markets shut down completely, this seems like thoughtful, cautious professionals being cognizant of many different headwinds requiring attention. There still remain difficulties in pricing the office markets due to “work from home” and its impact on space consumption over the longer term. And retail continues to be a concerning food group for many, with the continued erosion of anchors and even “inline” tenants being impacted by the ongoing expansion of online retail, which was kicked into high gear by the pandemic. Yet resilience continues in this sector as well, as fitness centers, religious institutions and day care centers, among others, replace traditional anchors. Logistics, warehouse, extended stay, medical facilities, lab space and tech space continue to be the rage, while hotels again are resilient, and post-pandemic (I shudder to use that phrase) usage for business and leisure continue to tick up. Finally, multifamily has remained strong.

Cautious optimism in the face of looming clouds. I am running out of metaphors, but resilience seems to be the right word. Fingers crossed for our markets but, more importantly, for some of the chaos in the world to abate.

Understanding Future Advance Conditions

March 31, 2022

While some commercial real estate loans are fully funded at loan closing, others are funded in whole or in part through future advances. Some loans provide for future advances to fund tenant improvement work and leasing commissions and/or capital improvements. Loans on transitional properties that do not have a rent stream sufficient to fully fund the property's operating expenses may also include future funding for shortfalls in debt service payments and other carry costs such as real estate taxes, insurance premiums, management fees, etc. Construction loan advances will typically cover all construction costs, including both hard and soft costs, and all debt service and other carry costs, in excess of the borrower's required equity contribution. From the lender's perspective, each future advance increases its exposure, and for that reason, loan documents typically include "future advance conditions," which consist of requirements that must be satisfied to trigger the lender's obligation to fund a requested advance. The borrower needs to be able to draw down post-closing advances in order to operate, and in some cases develop, its property and to make payments required under the loan documents and third-party contracts as they become due; and from its perspective the future advance conditions need to be limited to those that it can satisfy, preferably without creating an excessive administrative burden.

We can think of most future advance conditions as falling into at least one of four categories: (i) requirements intended to prevent the lender from having to throw good money after bad by funding into a default or distress situation or a situation that is likely to become a default or distress situation; (ii) requirements intended to assure the lender that the costs being funded have actually been incurred and are in accordance with the requirements and standards imposed by the loan documents; (iii) requirements intended to preserve the priority of the lender's security; and (iv) requirements intended to meet the lender's operational constraints. While not all future funding conditions fall neatly into these categories, and while some could be said to fall into more than one category, these categories are useful as a framework for understanding the various requirements. This article discusses examples of typical future advance conditions that fall into each category. It does not attempt to cover all typical future advance conditions.

Avoiding Funding into Distress Situations

(a) No Default. The most basic future advance condition is that the loan not be in default. It is difficult for a borrower to argue that its lender should be obligated to fund a loan where there exists an event of default, *e.g.*, a default where any required notice calling the default has been given and any period during which the borrower has the right to cure has expired. But what about a situation where the borrower still has a period in which it has the right to cure the default? The lender does not want to increase its exposure in a situation where it knows there is a problem and it may be just be a matter of time before the default ripens into an event of default. The borrower, however, may need the advance to fund debt service or other costs that need to be paid in order to avoid additional defaults, or to keep a construction project on track, and wants to have sufficient time to cure the default without coming out-of-pocket to fund costs that need to be paid during that period. Typically, the lender will insist on the condition that no monetary default exists, which is difficult for the borrower to object to because monetary defaults can be cured simply by making a payment. Non-monetary defaults, however, might take time to cure. Lenders will sometimes agree to limit the funding condition to the absence of material non-monetary defaults and will sometimes eliminate the condition entirely as it relates to non-monetary defaults. Another potential lender concession is to agree to fund advances for debt service and certain other carry costs such as insurance premiums and taxes notwithstanding a material non-monetary default, but to refuse to fund other costs until the default has been cured. This gives the borrower some breathing room in that it provides the funds necessary to make payments that if not paid when due will trigger an event of default, while not funding costs that the borrower may be under less pressure to pay timely and that it might be able to stretch out. Because the lender is the recipient of the debt service payments and would likely have to make protective advances for taxes and insurance if the loan were to go into default, it might view making these advances in the face of an unmatured non-monetary default as more acceptable than funding other costs.

(b) Balancing. Balancing requires the borrower to post cash collateral with the lender in the event that the lender determines that the aggregate of unadvanced loan proceeds, amounts held in lender-controlled reserves and any projected rents and other property revenues are not sufficient to pay all carry and construction costs required to be paid under the loan documents through loan maturity (or some other negotiated period) or that such available amounts, taking into account restrictions on the use of loan advances, reserve funds and property revenues, are insufficient to pay any category of such expenses. Balancing requirements are intended to provide the lender with assurances that the property will not run out of money before construction is completed and/or the loan matures. Although balancing calls are an anathema to borrowers because they force them to contribute additional unanticipated capital, they are common in construction loans and in loans where carry costs are being funded from loan proceeds.

(c) Bringdown of Representations and Warranties. The representations and warranties made by the borrower in the loan documents provide the lender with the borrower's certification that the facts relating to the loan that the lender understands to be true at the time of the loan closing are in fact true. The lender wants a similar certification with respect to the relevant facts as they exist at the time that each advance is made. This is accomplished by conditioning the borrower's right to obtain post-closing advances on its representations and warranties remaining true as of the date of each future advance and its certifying the same to the lender. But what if underlying facts have changed? For example, the loan documents will likely include a representation with respect to the accuracy of the property's rent roll provided to the lender at closing. Rent rolls, however, are not static, and changes over time will typically not violate the loan documents. Other representations, such as compliance with single-purpose entity requirements, are intended to remain true throughout the term of the loan, and non-compliance with these requirements will trigger a default. So, the future advance condition relating to a bringdown of representations and warranties should be crafted to provide that those representations required to remain true throughout the loan term do in fact remain true and to permit changes in the underlying facts with respect to the balance of the representations. Prudence dictates a careful review of each representation to determine which category each representation falls into.

Substantiation of Costs

Before making advances to fund the payment of particular costs, the lender will want to see evidence that the costs have in fact been incurred. The related loan document requirements will vary depending on the type of costs being funded. For some types of costs, this might be as simple as a borrower certification backed by an invoice. Construction loan draw requirements are much more extensive and include the submission of documentation intended to substantiate not only that the costs have been incurred but that the work being paid for satisfies the requirements of the loan documents with respect to quality, compliance with legal requirements, conformance with approved plans and specifications, etc. While a detailed discussion of construction loan draw requirements is beyond the scope of this article, it may include, for example, an Application and Certificate of Payment (usually in the form of AIA Document G702) signed by the general contractor and architect as to the work completed, retainage held and conformity of the work to the approved plans and specifications, payment requisitions from trade contractors, an anticipated cost report that sets forth the anticipated costs of various construction line items, copies of contracts and subcontracts for which payment is being made and approval by the lender's construction consultant based on its review of the documentation submitted and on-site inspection of the work. Draw requirements for advances to fund tenant improvements and other capital improvements are usually abbreviated versions of construction loan draw requirements.

Preservation of Priority

The lender's concern here is to assure that its mortgage lien insofar as it secures post-closing advances will have the same priority that it has with respect to amounts that it advanced at loan closing, at the time that its mortgage was recorded and its loan title insurance policy was issued, and that such priority will be insured under its title insurance policy. In other words, the lender wants to make sure that there are no liens or other encumbrances that arose post-closing that will have priority over its mortgage insofar as it secures post-closing advances. In a construction loan context, mechanics liens are of particular concern. Note that in many jurisdictions a mechanics lien may be filed within a specified period after work was performed and the filing will "relate back" to the date on which the work was commenced, meaning that in some jurisdictions it will have priority over mortgage loan advances made after the work was commenced. The rules relating to mortgage lien priority vary substantially from jurisdiction to jurisdiction. In some jurisdictions, post-closing advances secured by a mortgage recorded at the time of closing that states that it secures future advances up to a stated amount will have priority over encumbrances arising after the recording of the mortgage notwithstanding that they may have arisen prior to the making of the post-closing advance in question. In other jurisdictions, encumbrances arising after the recording of the mortgage but prior to the making of the post-closing advance in question will have priority over the mortgage insofar as it secures the post-closing advance. In those jurisdictions, it is necessary to include a future advance condition that requires the borrower to deliver a title continuation or endorsement issued by the title insurer that, based on an updated title search, increases the amount of the policy to include the amount of the post-closing advance and amends the effective date of the policy to the date of the advance without taking any additional exceptions to coverage. Future advance conditions will also typically require delivery of lien waivers from all contractors, subcontractors, material suppliers and any other potential mechanics lien claimants that performed work to be paid for out of the requisitioned disbursement, pursuant to which such party waives lien rights to the extent of the payment made.

Lender Administration

In order to properly administer a loan, the lender needs to make sure that it receives sufficient information to determine whether the conditions to the advance have been satisfied and has sufficient time to review that information. It also needs sufficient time to obtain the funds with which the loan advance will be funded, which in the case of a syndicated loan, will entail the administrative agent's collecting from each syndicate member its proportionate share of the advance, and in the case of other loans, may involve obtaining the funds from an investor or a party providing financing to the lender. In addition, since reviewing draw requests can be time-consuming, particularly in construction lending, the lender will want to put limitations on the frequency of draw requests. This is typically accomplished by limiting draw requests to one per month and sometimes imposing a floor on the amount that can be requisitioned, and by giving the lender a specified period to fund the draw, which does not commence until the lender receives the draw request and all required supporting materials.

From both the lender's and the borrower's perspectives, future advance conditions are among the most important loan document provisions. Unlike many provisions that come into play only upon the happening of certain contingencies, the borrower and the lender will have to deal with the draw conditions on a regular basis. The lender needs the ability to make sure that it understands what it is funding and that it is not unnecessarily increasing its exposure on what may become a problem loan. The borrower is entering into the loan transaction for the purpose of drawing down loan proceeds, and constraints on its ability to do so are usually at or near the top of its concerns. Accordingly, the draw requirements warrant the close attention of both parties at the negotiation stage.

Navigating the Latest on Russia Sanctions – A Perspective from European Real Estate Financing

March 31, 2022

It's been just over a month since Russia launched its invasion of Ukraine, and, along with the atrocities of the war hitting the headlines, a whole host of countries, led by the United States, United Kingdom and European Union, have been responding with a series of crushing economic sanctions. These measures have ranged from "blocking" sanctions, which generally prohibit any dealings with specific designated parties (and entities they own), to more limited "sectoral" sanctions, which ban some dealings with the target (*e.g.*, related to their new debt or equity). As a result, when it comes to dealing with Russia, the Russian government, and individuals linked to the Russian government, the sanctions regime has changed dramatically in a short period of time.

Between 24 February and 24 March 2022, the UK Government significantly extended existing financial sanctions against Russia to include a large number of Russian legal entities and individuals. The current list of individuals and entities targeted by asset freezes can be found on **OFSI's Consolidated List**. In addition, the UK also adopted financial sanctions which prohibit persons from dealing directly or indirectly with transferable securities or money-market instruments issued after 0:01 on 1 March 2022 by or on behalf of persons "connected" with Russia. There are also restrictions on extending loans and credit arrangements after 0:01 on 1 March 2022 to Russian legal entities and the government of Russia.

Similarly stringent sanctions have been announced by the European Union and the United States. For a summary of the current landscape of the sanctions announced in the United States, UK and European Union, our colleagues from our White Collar Defense and Investigations and Regulatory teams have published an update of the Russia Sanctions landscape which can be accessed **here**.

What does this mean for lenders for REF transactions?

Given the array of sanctions imposed, lenders around the world are no doubt paying close attention to the latest announcements in order to ensure that their compliance controls and systems remain adequate and up to date.

In the context of European real estate financing, in comparison with other financing/equity investments, given that borrowed funds are generally utilised to fund the purchase/refinancing of real estate assets located in UK/Europe, the latest changes to sanctions have a smaller impact on the existing sanctions procedures, as the asset funded is not located in a sanctioned country (in contrast to heavily affected industries such as oil/infrastructure, or investments located in Russia or owned by Russia). However, it is very important to bear in mind that with the ever-changing sanctions landscape, care must be taken with respect to the due diligence of the flow of funds and also the ultimate beneficial owner/investors, as sanctions apply beyond the simplistic view of looking only at the underlying investment.

As a general reminder, with regard to real estate financing provided for real estate investment (*i.e.*, ownership of real estate) in Europe, the asset itself is not located in a sanctioned country and so there is no restriction from a sanctions perspective with respect to the ownership of the asset unless that asset is being acquired from a blocked person − for example, a sanctioned Russian oligarch who owns property across the continent, which may be sometimes through opaque ownership structures. The focus therefore is on the Borrower(s), the Sponsors and also the control of such persons and their use of funds. Each lender has its own sanctions policies and compliance procedures, and these are subject to different sanctions regimes. Broadly speaking, in the context of real estate financing, the matters which a lender should focus on include the following:

1. ultimate beneficial owner and control of the investor/borrower, to ensure there are no dealings with a "sanctioned person";
2. the same applies with respect to the seller of the real estate where an acquisition is being funded – a transaction acquiring assets from a blocked person would be in breach of sanctions, and, therefore, the ultimate beneficial owner and control of the vendor should also be subject to due diligence as per point 1 above;
3. flow of funds – both inflow and outflow to a sanctioned person or territory may be subject to restrictions; this would include injection of equity, payment of distributions/dividends, etc.;
4. the Borrower must have a compliance regime/policy to comply with the latest sanctions requirements to ensure it will not breach applicable sanctions requirements;
5. the Borrower must not use the lender's funds to do business with sanctioned parties, including by acquiring properties from sanctioned sellers; and
6. the Borrower must not repay its obligations using funds that are obtained from dealings with a sanctioned person or territory.

These are some examples of sanction covenants which are required by most lenders in providing finance. As mentioned above, due to the different compliance requirements and sanctions regimes that different lenders are subject to, the sanctions covenants may vary. As noted, any use of funds from the lender to conduct a transaction with a sanctioned person, entity or territory will be in breach of sanctions. This means that, in an acquisition transaction, the lender should screen both the borrower (purchaser) and also the seller of the asset(s) to ensure all parties involved are not subject to sanctions restrictions at the time.

From the Borrower's perspective, it is important to ensure there are adequate sanctions compliance policies in place. The Borrower would need to be in a position, if requested by the lender, to provide information regarding ultimate beneficial owner and flow of funds. These sanctions covenants are ongoing throughout the life of the facility.

Finally, for a more in-depth discussion on this topic, our Funds and White Collar Defense and Investigations colleagues have published an article recently on this topic in *Fund Finance Friday*, which can be accessed **here.**

Green Loans Series, Part 2 – The Four Core Components of the Green Loan Principles

March 31, 2022

In our February edition of *REF News and Views,* we introduced the Green Loan Principles ("GLP") that were published by the Loan Market Association ("LMA"). The GLP seeks to help facilitate and support environmentally sustainable economic activity by providing a framework of market standards, guidelines and methodology that can be consistently adopted across the green loan market.

One key point regarding the GLP is that they are currently still voluntary and for guidance only, so it is ultimately incumbent on the lenders to define their internal standards with regards to eligibility criteria for what they would classify as a green project. This being said, we fully expect to see continued growth in the use of the GLP as the guiding core principle for green loans products, as well as an evolution and development in the GLP, over the coming years.

In this article we dive deeper into the GLP to discuss each of its four core components.

The four core components of the GLP

To qualify as a GLP-compliant green loan, such loan product must align itself with the following four core components: (1) use of proceeds; (2) process for project evaluation and selection; (3) management of proceeds; and (4) reporting.

1. Use of proceeds

Under the GLP, the utilisation of the loan proceeds must be for green projects that provide clear environmental benefits that can be assessed, quantified and measured by the borrower. Such purpose should be appropriately described in the finance documents and, if applicable, marketing materials. Such projects should be aimed at addressing key environmental concerns, such as climate change, natural resource depletion, loss of biodiversity and pollution.

The GLP recognises a number of broad categories of projects as having such an objective; these include renewable energy, energy efficiency, environmentally sustainable management of living resources and land use, sustainable water and wastewater management, and climate change adaption. However, the GLP does not provide an exhaustive list as it recognises that green projects may vary depending on many factors such as sector and geography.

2. Process for project evaluation and selection

The GLP requires the borrower to communicate (i) its environmental sustainability objectives, (ii) the process by which the borrower determined that its project fits within the GLP green project eligibility criteria, and (iii) the related eligibility criteria including, to the extent applicable, any excluded criteria and the processes to be applied to identify and manage potentially material environmental risks associated with the project.

3. Management of proceeds

The GLP recommends that the proceeds of the green loan are tracked in an appropriate manner to promote and maintain transparency and integrity of the green loan product. This can be achieved in many ways − for instance, by separating out a specific tranche of the facility that shall be designated to the green project, or for the green loan funds to be credited to a dedicated account.

4. Reporting

The GLP recommends borrowers to keep readily available up-to-date information on the use of proceeds and details of material developments. This should include details of the green projects and the amounts to be allocated, together with their expected impact. It is clear in the GLP that transparency is of particular value in communicating the expected impact of the green projects. As such, the GLP recommends the use of qualitative performance indicators and, where possible, quantitative performance measures, as well as the disclosure of key underlying methodology and/or assumptions used.

Next month

Whilst the GLP is intended to support the general expansion of the market for sustainable finance products, it is also intended to be used in a real estate-specific context, and in October 2020 the LMA published two guidance papers to specifically address some of the more frequently asked questions on the application of the GLP in real estate financing. In next month's *REF News and Views* we will discuss this in greater detail.

Recent Transactions

March 31, 2022

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

- Advised Wheeler Real Estate Investment Trust, Inc. (NASDAQ: WHLR) in its acquisition of Cedar Realty Trust (NYSE: CDR), a real estate investment trust focused on grocery-anchored shopping centers, in a transaction valued at approximately $291 million.
- Advised JPMorgan Chase Bank, N.A. as lender in a $611.5 million securitized mortgage loan and two mezzanine loans with an aggregate value of $63.5 million in connection with the $837 million acquisition of the American Copper Buildings, a two-tower luxury apartment property in midtown Manhattan.
- Represented the preferred investor in a $20 million preferred equity investment for the acquisition of the leasehold interest in an office and retail property located in Soho (New York City) and related building renovations and upgrades.
- Represented the lender on a $360 million syndicated mortgage loan and a $40 million mezzanine loan secured by an office building in Dallas, Texas.
- Represented the lender in connection with the purchase of a $26 million B-note secured by two multifamily apartment complexes in Dallas, Texas.
- Represented the lenders in connection with a $1.04 billion mortgage loan secured by 109 hotels located in 22 states.