CADWALADER

Turning to Fall

September 29, 2022

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‘You Can’t Always Get What You Want’ – Exercising an Option

On March 21, 2022, the Court of Special Appeals of Maryland (the “Court”) decided in *Peterbilt of Baltimore LLC v. Capitol Gateway Properties, LLC*[1] that provisions of an option to purchase (the “Option”) pursuant to the tenant’s lease are conditions precedent, which must be satisfied to exercise such Option.

Peterbilt of Baltimore LLC (“Peterbilt”) entered into a lease agreement with Capitol Gateway Properties, LLC (“Capitol Gateway”), as landlord, on January 13, 2014 (the “Lease”). The Lease of the real property located at 8300 Ardwick Ardmore Road, Landover, Maryland (the “Property”) was for an initial term of ten years. In exchange for Peterbilt’s agreement to pay above market rent for the Property, Capitol Gateway agreed to include the Option to buy the Property after the first and second five-year terms. On January 22, 2019, Peterbilt sent Capitol Gateway written notice that it sought to exercise the Option. Peterbilt’s notice triggered a multistep process to determine the purchase price of the Property (the “Option Procedures”).[2]

Under the Option Procedures, the purchase price was required to be the fair market value (the “FMV”) of the Property as of the date Peterbilt exercised the Option. If Peterbilt and Capitol Gateway could not agree upon the FMV, the parties were required to obtain certified real estate appraisers, advise one another of their respective appraiser’s information, and provide the opposing party a copy of such appraiser’s report once issued. If the difference in the two appraised values was greater than ten percent, the respective appraisers were required to meet and agree upon the FMV. If the appraisers could not agree on the FMV, they would have to jointly agree on the appointment of a third appraiser.[3]

Peterbilt had applied for financing to acquire the Property in the amount of the lesser of $6,000,000 or 80% of the appraised value.[4] As such, the potential lender hired an appraiser (the “Peterbilt Appraiser”) in connection with the application, who appraised the Property at $2,800,000. Peterbilt notified Capitol Gateway of such appraisal on February 26, 2019. Capitol Gateway notified Peterbilt of its appraiser (the “Capital Gateway Appraiser”) on March 7, 2019, and the Capitol Gateway Appraiser delivered an appraisal of $4,530,000 to Peterbilt on May 7, 2019.[5] As the difference in appraisals was greater than ten percent, the Capitol Gateway Appraiser contacted the Peterbilt Appraiser to meet and discuss their valuations, but the meeting never occurred. The Peterbilt Appraiser refused to comply with the Option Procedures because he was engaged by the potential lender, rather than specifically engaged by Peterbilt. For the same reason, Capitol Gateway contended it was not required to appoint a third appraiser because Peterbilt had already failed to satisfy the Option Procedures in not hiring its own appraiser.[6]

The Court held that the Circuit Court for Talbot County did not err in finding the Option Procedures were conditions precedent to the exercise of the Option, as opposed to covenants, which would have allowed Peterbilt the opportunity to cure. The Court reasoned that the Option Procedures were material terms of the Lease, and where a step was not completed by one party, performance by the other party would not arise.[7] The Circuit Court concluded that the Lease required the parties to obtain an appraiser who would go further than solely appraising the Property, but, rather, would communicate the appraisal value to the opposing party, confer with the other appraiser if their values were not within ten percent, and jointly appoint a third appraiser if the original appraisers could not agree on the FMV.[8]

Peterbilt failed to retain an appraiser who would comply with the Option Procedures; thus, Capitol Gateway was not required to perform under the Option by naming a third appraiser. [9] Furthermore, because the Option Procedures constituted conditions precedent to the exercise of the Option, the Court upheld the circuit court’s finding that Peterbilt’s noncompliance was not a breach of contract. Accordingly, Peterbilt was not entitled to cure and Capitol Gateway was not entitled to attorney’s fees.[10]

Successful exercise of an option requires unequivocal compliance with the terms of such option. Strict adherence to the specific provisions of a purchase option is necessary to effectuate the option; thus, drafting of option provisions should be carefully considered. This is another example, albeit not relied upon by the Court, of the doctrine of strictissimi juris or “strict construction.” This doctrine generally provides that a court will apply strict construction of a contract and especially a lease when it affects the alienation of property. Courts are loathe to divest parties of real property, and consequently will strictly construe provisions which purport to alienate property or constitute restraints on the alienation of property. Since a lease is both a contract and a conveyance, courts typically will apply this rule of strict construction.

[1] *Peterbilt of Baltimore LLC v. Capitol Gateway Properties, LLC*, 2022 WL 833362 (Md. Ct. Spec. App. Mar. 21, 2022) (unreported).

[2] *Peterbilt v. Capitol Gateway Properties*, 2022 WL 833362, at 1.

[3] Id.

[4] Id. at 2.

[5] Id. at 3.

[6] *Peterbilt v. Capitol Gateway Properties*, 2022 WL 833362, at 4.

[7] *Peterbilt v. Capitol Gateway Properties*, 2022 WL 833362, at 10-11.

[8] Id. at 7.

[9] Id. at 8.

[10] Id. at 12-13.

Sustainability-Linked Loans Series, Part 5 – Application of Sustainability-Linked Loans Principles to Real Estate Finance Transactions

In our August edition of *REF News and Views*, we continued our deep dive into the Sustainability-Linked Loan Principles ("SLLP") core components ("Core Components") and looked at loan characteristics, reporting progress against sustainability performance targets, and verification.

As a reminder, the SLLP set out a framework, enabling all market participants to clearly understand the characteristics of a SLL. The framework is based around the five Core Components, namely:

- selection of key performance indicators ("KPIs");
- calibration of sustainability performance targets ("SPTs");
- loan characteristics;
- reporting progress against SPTs; and
- verification

In this installment in our Sustainability-Linked Loans Series, we will discuss the application of the SLLPs to real estate finance ("REF") transactions and consider some associated issues.

SLLPs in a Real Estate Finance Context

In March 2022, the Loan Market Association ("LMA") published a guide on the application of the SLLP to real estate finance and real estate development finance transactions (the "**REF Guidance**").

In response to the rising demand in the real estate finance and real estate development finance industry to integrate sustainability in their financing solutions, the LMA launched this initiative. Following the LMA's launch of the SLLPs in 2019, SLLPs became increasingly popular in the syndicated loans market. SLL volume began to surpass that of green loans. However, the real estate finance industry has not yet benefited from this rise in SLL popularity. In the REF market, green loans are significantly more prevalent than SLLs.

This REF Guidance sets out what borrowers, finance parties and their advisers should consider when looking to align their transactions to the SLLP. It adds a REF focus to the existing SLLPs and accompanying guidance and includes sections on:

- the roles of the parties involved in a SLL in ensuring the transparency and integrity of the SLL product;
- selection and disclosure of KPIs (with examples tailored and applicable to REF deals – which we will discuss further below);
- calibration of SPTs;
- reporting and verification; and
- documentation considerations.

The LMA has previously published similar guides for the application of the Green Loan Principles to REF transactions. The REF Guidance does not apply to residential mortgages or any other form of retail lending.

Issues with the Use of SLLs in REF

The use of SLLs to date in the REF and real estate development finance context has largely been focused on financing real estate investment trusts ("REITs") and in relation to social housing projects, but the LMA has acknowledged that in general there are certain practical challenges that may arise in applying the SLLPs to the REF and real estate development finance context.

These challenges are set out in the REF Guidance:

- REF lending is typically made available to a borrower that is a special purpose vehicle ("SPV") with no trading history. Such an SPV borrower is unlikely to have a pre-existing sustainability strategy and/or access to historical

environmental, social and governance data. To the extent that there is no available data, then this may cause challenges with a SLL in selecting KPIs and calibrating SPTs. As the REF Guidance acknowledges, this may be easier where (i) there is a portfolio of properties being financed, (ii) capex is required to finance retrofit works or (iii) where the property being financed is an operating asset.

- Generally, on REF investment finance transactions, the borrower does not itself occupy the property being financed and in fact may not have direct control over the fit-out or day-to-day operation of the property. The borrower may have some ability to require its tenants to adhere to the SLLPs or green loan principles via provisions in the underlying leases. However, as the borrower cannot in practice control the actual activities of the tenant occupying the property, it may be reluctant to commit to targets that are outside of its day-to-day control.
- There are still divergences in the market as to what is considered “doing enough” in terms of improving sustainability performance in the REF and real estate development finance contexts. This can lead to concerns over greenwashing (*i.e.*, the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact it does not meet basic environmental standards) that can cause reputational damage to both borrowers and lenders.

Notwithstanding the above issues, there have still been various SLL deals in the REF and real estate development finance contexts. The REF Guidance notes that there is still significant potential for further growth of SLLs in the REF and real estate development finance contexts due to a number of factors, such as: (i) the need to decarbonise existing building stock to meet global climate targets, (ii) to improve the sustainability of construction methods and materials, and (iii) to tackle the shortage of affordable housing globally.

REF-focused KPIs

The REF Guidance sets out some common categories of KPIs seen in the REF and real estate development finance contexts, together with an example of the improvements which a KPI in this category might seek to measure. Examples include:

- **Energy efficiency**: Improvements in the energy efficiency rating of building(s) owned or leased by the borrower (often demonstrated using a sustainable building rating, standard or certification). Improvements in energy efficiency can relate to in-use performance and/or the fabric of the building(s).
- **Sustainable sourcing**: Increase in the use of verified sustainable raw materials/supplies in the construction or refurbishment of building(s) or development being financed.
- **Embodied carbon**: Reductions in embodied carbon associated with the development being financed.
- **Clean transportation**: Improvements in the use of low carbon transport and related infrastructure, including electric vehicle charging points and dedicated bicycle spaces.
- **Affordable housing**: Increases in the number of affordable housing units developed by the borrower.

For more examples, please see the **REF Guidance**. We note that the examples contained in the REF Guidance are not exhaustive and are intended to be indicative only.

Second Circuit Rules in Favor of Citibank in Accidental $500m Transfer in Revlon Loan Transaction

In a decision rendered on September 8, a three-judge panel for the United States Court of Appeals for the Second Circuit vacated a February 2021 decision by the United States District Court for the Southern District of New York in favor of the defendant loan managers of certain institutional lenders, which held that the Loan Managers were not obligated to return an accidental payment by Citibank N.A. of approximately $500 million. Citi served as administrative agent to the lenders for an $1.8 billion syndicated seven-year loan to Revlon, Inc. pursuant to a credit agreement entered into in 2016. Read our Clients & Friends Memo **here**.

Recent Transactions

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

- Represented the lender in a $356.5 million securitized mortgage loan secured by 29 self-storage properties in 12 states and the administrative agent and lender in a $221.8 million balance sheet mortgage loan secured by 12 self-storage properties in seven states.
- Represented the lender in the origination of a $90 million construction loan to finance the construction of a waterpark hotel.
- Represented a national bank in a $462.5 million balance sheet financing of 108 self-storage properties across nine states.
- Represented a national bank in a $170 million balance sheet financing of 32 self-storage properties across 16 states.
- Represented an insurance company in connection with the acquisition financing of an extended stay hotel in Charlotte, NC. The financing included a future funding component intended to finance the conversion of the hotel to a multi-family apartment complex.
- Represented the lender in a $28 million balance sheet mortgage financing of a multi-family property located in Allen, Texas.