Representing the Borrower in a CMBS Loan

by Michael Werner, Fried, Frank, Harris, Shriver & Jacobson LLP

When making a mortgage loan on a commercial real estate asset, instead of holding the loan on its balance sheet until maturity, the lender may intend to securitize and sell the loan as commercial mortgage-backed securities (CMBS). This practice note provides guidance for counsel representing a borrower in connection with a CMBS loan and starts with a general overview of the securitization process. The remaining portions of the practice note (1) explain, and offer negotiating tips and drafting suggestions for, certain loan document provisions unique to CMBS loans (e.g., defeasance provisions and rating agency confirmation requirements); (2) offer negotiating tips and drafting suggestions for certain standard loan document provisions that require careful attention in a CMBS loan; and (3) discuss closing conditions unique to CMBS loans or not commonly encountered in balance sheet loans.

While this practice note includes many suggested loan document changes that benefit the borrower, whether a lender will actually agree to any of these changes for a particular loan will depend on a variety of factors, including the size of the loan, the quality of the property, whether the property is located in a major or secondary market, the strength of the borrower’s sponsorship, and macro-economic factors.

Securitization Overview

To effectively represent a borrower in a CMBS loan, it is important to have a general understanding of (1) the securitization process (including rating agency requirements, real estate mortgage investment conduit (REMIC) rules, and investor expectations) and (2) how the loan will be serviced following securitization. In a typical CMBS securitization, many loans are pooled together and transferred to a REMIC trust. A REMIC trust issues separate classes of bonds that vary in payment priority, risk, and returns. The bonds are typically sold to institutional investors. The applicable investor’s risk/return parameters will dictate which class of bonds it purchases.

Securitization attracts additional capital to the real estate market (i.e., the capital of investors who are only comfortable investing in real estate if they are able to manage their risk exposure). Historically, CMBS loans have generally offered borrowers lower interest rates than balance sheet loans, because the bonds are typically worth more than the sum of the value of the whole loans. The securitization market has also enabled financing of assets that may not be eligible for a lender’s balance sheet loan portfolio.

Rating of Bonds

Typically, at least two nationally recognized rating agencies assign credit ratings to the various rated bond classes. Each rating agency has its own legal and underwriting criteria for the rating of CMBS loans. If a CMBS lender materially deviates from those criteria when originating a loan, it may impede the lender’s ability to successfully securitize the loan. Certain rating agency criteria (including single-purpose, bankruptcy-remote entity (SPE) criteria) are discussed in later sections of this practice note.

There is an inverse relationship between a bond’s rating and its risk level or interest rate (i.e., the highest rated bond class has the lowest risk and the lowest interest rate). Loan payments are paid sequentially, from the highest rated class to the nonrated. Losses arising from non-performing loans are allocated in reverse order of priority, from the nonrated class to the highest.

The bond ratings assigned at securitization assume that there will be no material adverse change in the credit quality of a particular loan. Therefore, CMBS loan documents typically require that each applicable rating agency issue a rating agency confirmation (i.e., confirmation that the proposed action will not result in such rating agency qualifying or downgrading its rating of any class of bonds) for certain actions that may occur after securitization (e.g., loan assumption or change in property management).
**Investor Expectations**

During loan negotiations, CMBS lenders will be focused on the expectations of the ultimate CMBS investors (in particular, the “B-piece buyer,” the investor buying the most subordinate class(es) of bonds in a given securitization). CMBS investors generally expect the loans in the pool to, among other things (1) be secured by stabilized properties, (2) be conservatively underwritten and fully funded, (3) have adequate loan reserves for any anticipated interruptions in cash flow (e.g., major lease expiring shortly after closing), (4) be nonrecourse subject to limited exceptions, and (5) be insulated as much as possible from interruptions in cash flow. In originating a CMBS loan, the lender will be particularly concerned with how the B-piece buyer will view the treatment of any given underwriting or legal issue. The B-piece buyer thoroughly reviews each loan proposed to be included in a particular securitization, conducting extensive due diligence and re-underwriting the loan. The scope and precision of the B-piece buyer’s review is comparable to that of a junior mortgagee. If a loan is slated for a particular pool and the B-piece buyer has been selected, it is not unusual for a lender to obtain the B-piece buyer’s feedback on material issues before closing the loan.

**Servicing**

As described in greater detail in later portions of this practice note, once a CMBS loan is securitized, the originating banker typically has no further decision-making authority. Following securitization, all loan servicing and other decisions will be handled by the applicable servicer(s) under the pooling and servicing agreement (PSA) that governs the servicing of the loans in the securitization.

**REMIC Rules**

Pursuant to federal tax law, a REMIC is generally not a taxable entity (i.e., like a partnership, a REMIC passes through all of its income to its interest holders). Adherence to REMIC rules is crucial as a CMBS transaction is structured and priced based on the assumption that the trust will not be subject to tax. REMIC rules are discussed in greater detail in later sections of this practice note.

**Lender Representations and Warranties**

As part of a CMBS securitization, each originating lender must make substantial representations and warranties regarding each of its loans. Topics addressed in those representations and warranties include:

- The loan documents
- The loan’s lien status
- Compliance with REMIC tax rules
- The mortgaged property
- The borrower
- The guarantor
- The originating lender’s origination standards

If a loan does not conform to a required representation and warranty, the lender will need to take what is commonly referred to as a “rep exception.” If a loan requires any material rep exceptions, it could affect pricing in the securitization; before agreeing to close, the lender may require additional credit support and/or other loan structuring as a mitigant. The loan documents typically require the borrower to make the same representations and warranties as the lender (at least insofar as the representations and warranties relate to the borrower, the mortgaged property, or other items with respect to which the borrower has knowledge). The lender’s representations and warranties survive the closing of the securitization. If there is a material breach of the representations and warranties that is not cured within the applicable cure period, the applicable originating lender is required to repurchase the related loan or, if such obligation arises within two years of the securitization closing date, the lender may choose to substitute another commercial mortgage loan meeting certain qualification requirements in place of the defective loan.

**SPE Requirements**

CMBS loans are typically nonrecourse; if the loan goes into default, the mortgaged property and the cash flow therefrom may be the lender’s only source of repayment. CMBS investors and rating agencies expect that any potential disruptions in property cash flow will be minimized. In particular, CMBS investors and rating agencies expect “asset isolation” (i.e., minimizing the risk of bankruptcy-
related disruptions in cash flow unrelated to the loan and the mortgaged property). Requiring that the borrower be an SPE is the primary way that CMBS lenders accomplish asset isolation.

**Categories of SPE Requirements**

The SPE requirements of a typical CMBS loan, many of which are set forth in published rating agency criteria, can be categorized as follows:

- **Limited purpose.** An SPE’s purpose is generally limited to owning and operating the mortgaged property, on the theory that unrelated business activities could drain property cash flow or otherwise impede the SPE’s abilities to timely pay the CMBS loan obligations.

- **Limited indebtedness.** An SPE generally cannot incur any indebtedness other than the CMBS loan and limited, unsecured trade payables. Limiting the SPE’s indebtedness minimizes the likelihood that another creditor of the SPE will file a bankruptcy petition against the SPE.

- **Separateness covenants.** An SPE must adhere to certain separateness covenants designed to insure that the SPE acts as an entity separate and distinct from its affiliates, on the theory that if the entity does not act independently, a court may use equitable principles such as substantive consolidation to include the SPE’s assets in an affiliate’s bankruptcy proceeding. Examples of separateness covenants include, among others, covenants of the SPE to:
  - Maintain separate books and records
  - Not commingle its assets with those of any other entity
  - Hold itself out as a separate and distinct entity
  - Maintain separate financial statements
  - Correct any known misunderstanding as to its separate identity
  - Not guarantee the debts of any other entity, nor permit any affiliate to guarantee obligations of the SPE (other than certain customary limited indemnity obligations)
  - Maintain an arms-length relationship with affiliates
  - Fairly allocate expenses shared with affiliates
  - Use its own stationery, accounts, checks, and invoices

- **Independent director.** A voluntary bankruptcy filing and certain other material actions with respect to the SPE must first be approved by an independent director. The main purpose of the independent director is to minimize the risk of a voluntary bankruptcy proceeding by a solvent borrower (e.g., where the borrower’s filing is used as a delay tactic or benefits an insolvent parent). For smaller loans (e.g., loans less than $15 million), the lender may be willing to waive the independent director requirement. For larger loans (e.g., loans of $50 million or more), the lender may require two independent directors.

- **Reducing risks of dissolution.** The SPE will be subject to certain restrictions intended to minimize dissolution risk, including (1) prohibitions on liquidation and consolidation and (2) the requirement that, except for a corporation or a properly structured Delaware limited liability company with a “springing member” (Acceptable LLC), the SPE have appropriate single-purpose, bankruptcy-remote equity owners (e.g., an SPE limited partnership borrower should have an SPE general partner that is either a corporation or an Acceptable LLC).

The SPE requirements are typically included in both the loan documents and the applicable entity’s organizational documents.

**Recycled Entities**

To minimize the risk of a bankruptcy or substantive consolidation resulting from prior actions, CMBS lenders strongly prefer that the SPE borrower be a newly formed entity. If your client is unwilling to transfer the property to a newly formed entity for any reason (e.g., it would cause transfer taxes, a property reassessment, and/or licensing issues), you should recommend that the client confirm as early as possible (ideally, prior to signing the term sheet) whether the existing owner can satisfy the lender’s recycled entity requirements (many of which are prescribed by published rating agency criteria), including that the existing owner certify that it has always operated as if the lender’s SPE requirements were in place since its formation.
SPE Negotiating Points

SPE requirements are not unique to CMBS loans; they are found in many balance sheet loans as well. However, because of rating agency requirements and investor expectations, a CMBS loan typically has more stringent and extensive SPE requirements, including upwards of 20 separateness and other SPE covenants. These covenants are included in the loan documents and, except for certain smaller loans, are also required to be included in the applicable entity’s organizational documents.

Operating Practices

As a general matter, when representing the borrower, you should ask the borrower to carefully review the lender’s SPE covenants to make sure that they are consistent with its operating practices. If there are any inconsistencies, the covenants may need to be deleted or modified; however, if the deletion or modification violates rating agency requirements or precludes issuance of an acceptable nonconsolidation opinion (see below), the lender may not agree. The following bullet points set forth certain covenants that are often requested by the lender and that may be inconsistent with the borrower’s operating practices.

- **Separate financial statements.** If the borrower’s assets are included in a consolidated financial statement, the borrower will want to make sure this is expressly permitted. The lender is likely to require that (1) the borrower’s assets are also listed on its own separate balance sheet and (2) there be a notation on the consolidated financials to reflect that the borrower’s assets are not available to satisfy the debts of any other entity.

- **Separate stationery, etc.** Many borrowers do not use separate stationery or checks. The comments underlined below limit the standard SPE covenant regarding required use of such items.

  Borrower shall not fail to use separate stationery, invoices and checks bearing its own name, as and to the extent applicable; except that in no event shall the foregoing be deemed to be violated by (x) any notices or invoices sent or prepared by Manager or any business services manager (on its behalf and as its agent) or (y) any such stationery, invoices or checks delivered solely to Lender by it which reference “[Sponsor]” or any derivation of the [Sponsor] name.

- **Conduct business in own name.** The comments underlined below may be added to the standard SPE covenant below requiring the borrower to conduct business in its own name.

  Borrower shall not fail to (A) hold itself out to the public as a legal entity separate and distinct from any other Person, (B) conduct its business solely in its own name or (C) correct any known misunderstanding regarding its separate identity; except that business conducted by Manager or any other Person on behalf of Borrower pursuant to the Management Agreement or any other business services management agreement shall not be deemed a violation of the foregoing.

- **Separate tax returns.** Loan documents frequently require the borrower to file separate tax returns. If the borrower is disregarded or otherwise not required to file separate tax returns, you will need to negotiate an appropriate exception.

- **No affiliate access to bank account.** An affiliated manager typically has the right to access the borrower bank account(s) under the management agreement and an exception should be negotiated to the standard SPE covenant prohibiting affiliates to access the borrower’s accounts.

Solvency and Similar Covenants

Violations of SPE covenants typically trigger recourse liability under standard CMBS loan documents. As discussed further below, depending on the negotiations, not every SPE violation will trigger recourse liability (e.g., the SPE violation may need to be material or actually result in a substantive consolidation of the borrower), and the recourse liability will either be for the lender’s losses or the entire amount of the debt.

Cases decided after the most recent economic downturn have generally deferred to the plain language of guaranties and related loan document provisions (even if contrary to the original intent of the parties). Certain courts have imposed full recourse liability on guarantors of nonrecourse loans where (x) the SPE covenants included a post-closing solvency covenant and (y) the nonrecourse carveout guaranty provided for full recourse in the event of a SPE violation. These decisions essentially converted a nonrecourse carveout guaranty into a full payment guaranty, a result neither the lender nor the borrower likely intended or imagined as a possibility at the time of loan origination. In light of these decisions, particular attention should be paid to any SPE covenants that require solvency, adequate capital, or payment of expenses irrespective of the sufficiency of property cash flow. Examples include covenants of the SPE to (1) remain solvent and pay its debts as they come due, (2) maintain adequate capital, (3) pay trade payables before their due date (see the discussion of limitations on indebtedness below), (4) pay its liabilities from its own funds, and (5) pay its own employees and maintain a sufficient number of employees. As most of the foregoing covenants are required by published
rating agency criteria (although notably a solvency covenant is not), a lender is unlikely to agree to a wholesale deletion. For any such covenants that the lender will not delete, comments similar to those underlined below may be accepted by the lender.

_Borrower shall maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations (to the extent there exists sufficient cash flow from the Property (after payment of all payments required under the Loan Documents and all operating expenses of the Property) for the then current time period to do so and Lender makes such cash flow available to it); provided, however, that the foregoing shall not (x) require its members, partners, shareholders, or other direct or indirect owners to make additional capital contributions or loans to it or (y) prohibit capital distributions in accordance with its organizational documents._

**Limitations on Indebtedness**

You and your client should carefully review the limitations on indebtedness to make sure any existing or potential indebtedness of the borrower is identified and specifically permitted. Under standard CMBS loan documents, basically any contractual obligation of the borrower to pay money falls within the broad definition of indebtedness, and the borrower is not permitted to incur any indebtedness other than (1) the CMBS loan and (2) unsecured trade payables capped at a specified percentage (typically 1%–4%) of the loan amount. Examples of customary borrower payment obligations that would technically be prohibited under a standard provision include tenant improvement allowances and leasing commissions. Additionally, trade payables are typically only permitted if they are due no later than a specified outside date (e.g., 30–90 days after the date incurred) and paid on or prior to that outside date. The latter requirement is problematic and akin to the solvency, adequate capital and similar SPE covenants described in the preceding bullet point—the borrower and guarantor(s) are obligated to pay for the trade payables irrespective of the sufficiency of the property cash flow. If this latter requirement cannot be omitted (it does not appear to be required under published rating agency requirements), you may need to qualify that provision with language similar to that suggested in the preceding bullet point and also make the payment obligation subject to any rights of contest that the borrower has under the loan documents.

**Look Out for Overbroad Covenants**

Many SPE covenants are overbroad and encompass items that do not exclusively relate to SPE matters. For example, SPE covenants oftentimes require the lender’s consent for any amendments of the borrower’s organizational documents instead of amendments to the SPE provisions.

**Duration of Compliance**

Both the loan and organizational documents should make clear that compliance with the SPE covenants is only required until the earliest to occur of (1) the payoff of the loan, (2) the assignment of the note and mortgage in connection with a refinancing, and (3) the assumption of the loan by another borrower (e.g., in connection with a defeasance or a loan assumption).

**Recourse**

While CMBS loans are generally nonrecourse, CMBS loans also include certain nonrecourse carve-outs or exceptions (i.e., certain “bad acts” or events for which a borrower and any guarantor(s) assume personal liability under the loan documents). There are two categories of nonrecourse carveouts: “above-the-line carve-outs,” which make the borrower and any guarantor(s) personally liable for the lender’s losses resulting from certain bad acts and events, and “below-the-line carve-outs,” which make the borrower and any guarantor(s) personally liable for the entire amount of the debt. Nonrecourse carveout guaranties were originally designed to deter certain inherently bad acts (e.g., misappropriation of rents or insurance proceeds, fraud, and voluntary bankruptcy filing) that a borrower’s sponsorship may be more inclined to take if insulated from personal liability. However, as nonrecourse financing has evolved, the carveouts have gradually expanded, particularly in CMBS loans. Examples of the expanded carveouts include:

- Failure to pay taxes or insurance premiums
- Failure to timely deliver required financial reports
- Violation of cash management provisions
- Failure to appoint a new property manager upon the lender’s request
- Raising defenses to any enforcement action by the lender
- Gross negligence
Recourse to an SPE borrower (an entity that is not permitted to have other assets unrelated to the property) is essentially meaningless. Most CMBS loans require execution of a nonrecourse carveout guaranty by at least one guarantor that has the ability to control the borrower. The guarantor must be either an individual or an entity with substantial assets other than its interest in the property. The lender will likely have to take a rep exception for any loan that does not have such a guarantor. Most guaranties also require the guarantor to satisfy certain net worth and/or liquidity covenants throughout the loan term, although lenders are sometimes willing to waive such covenants for individuals.

A thorough discussion of all possible items to be negotiated in a nonrecourse carveout guaranty is beyond the scope of this practice note. This practice note instead addresses a few general principles to keep in mind when reviewing the lender’s carveouts as well as a few drafting suggestions.

- **Limit below-the-line carveouts.** Limit the number of below-the-line carveouts to the maximum extent possible. If damages are easy to assess, generally the carveout should be above-the-line. Ideally, the below-the-line carveouts would be limited to voluntary and collusive bankruptcy filings and material violations of the transfer provisions resulting from voluntary transfers or encumbrances.

- **Negotiate carveouts at term sheet stage.** Term sheets rarely enumerate the carveouts. Rather, they often make a generic reference to customary nonrecourse carveouts. The lender and the borrower may have very different opinions on what carveouts are customary. It is better to specifically negotiate the carveouts at the term sheet stage, when the lender is still competing to originate the loan and the borrower has more leverage. It is better to find out sooner rather than later whether the lender is able to offer a recourse package that will work for the borrower.

- **Eliminate or narrow carveouts requiring payment of property expenses.** Any carveouts that require payment of property expenses directly (e.g., carveouts for failure to pay of taxes or insurance premiums) or indirectly (e.g., carveout for waste) should either be eliminated (a guarantor for a nonrecourse loan should not be providing a carrying costs guaranty) or narrowed to the maximum extent possible. If any such carveouts remain, recourse should not apply if (1) the property fails to generate sufficient net operating income during the applicable time period to permit timely payment of the item in question, (2) the item in question is being contested by the borrower in accordance with the loan documents, (3) there are adequate reserve or other borrower funds to pay the item in question and the lender fails to use those funds to make the payment, or (4) the lender has acquired possession and control of the property pursuant to an exercise of remedies. These concepts are reflected in the comments underlined below to a typical carveout for failure to pay taxes.

Borrower’s failure to pay Taxes in accordance with the terms hereof to the extent that (x) the applicable Taxes accrued prior to the earlier to occur of (A) the date on which the Property is transferred pursuant to foreclosure, power of sale, deed or assignment in lieu thereof or other exercise of remedies under the Loan Documents and (B) the date on which Lender or its nominee or designee otherwise takes possession or control of the Property pursuant to the exercise of its remedies and (y) the Property generated sufficient net operating income for the immediately preceding three (3) month period (after taking into account (i) all other Property expenditures not prohibited by the Loan Documents and (ii) interest payments, deposits into the Reserve Funds and other payments due or made under the Loan Documents) to pay the applicable Taxes and such net operating income was made available to Borrower by Lender to pay such Taxes; provided, however, Borrower shall have no liability for Losses to the extent (1) a sufficient amount to pay the applicable Taxes is on deposit (or available to Lender from funds in the Deposit Account or Cash Management Account) in the Tax Account and Lender or Cash Management Bank fails to disburse (or otherwise fails to make available) the same for the payment of such Taxes or (2) the applicable Taxes are then being contested by Borrower substantially in accordance with the terms of the Loan Documents.

- **Beware of SPE violations as part of below-the-line carveouts.** Many CMBS lenders include SPE violations as part of their standard below-the-line carveouts. This is extremely problematic as isolated, immaterial SPE violations that are unlikely to materially increase the risk of substantive consolidation (e.g., employee inadvertently sends a notice on the wrong letterhead) could make the borrower and the guarantor personally liable for the entire loan amount.

  - Carefully review the SPE covenants. First and foremost, as discussed above, you and your client should carefully review the SPE covenants. Any solvency, adequate capital, or other monetary SPE covenants should be eliminated or modified as discussed above (even if they are modified as discussed above, in an abundance of caution, it may be best to also specifically exclude such covenants from the recourse carveout for SPE violations). Other SPE covenants should be revised to match the borrower’s actual operating practices. If the borrower’s operating practices run afield of rating agency criteria or preclude issuance of a clean nonconsolidation opinion, the borrower will need to adjust its operating practices going...
forward or risk recourse exposure.

○ **Move SPE violations above-the-line.** The lender may be willing to move SPE violations above-the-line.

○ **Obtain lender’s agreement on materiality.** The lender may also agree that recourse liability will not be triggered unless the violation is material.

○ **Negotiate a notice and cure period for carveouts.** The lender may be willing to provide a notice and cure period before recourse liability is triggered. Additionally, sometimes the lender will agree that a cure is not required if the borrower obtains an updated nonconsolidation opinion that confirms the failure does not negate or impair the prior nonconsolidation opinion.

○ **Modify carveout to trigger full recourse only if substantive consolidation occurs.** If the lender is unwilling to move SPE violations above-the-line, oftentimes the lender will modify the carveout such that full recourse is triggered only if there is a material SPE violation that actually results in substantive consolidation of the borrower.

• **Ensure that all carveouts are within the guarantor’s control.** All carveouts (other than environmental indemnities) should be items within the guarantor’s control (i.e., the guarantor should be able to prevent all violations). Similarly, ideally the loan documents should provide that the guarantor has no ongoing liability in certain situations where it will be divested of control. A few examples are set forth in the two bullet points below.

○ **Limit the guarantor’s liability where mezzanine foreclosure occurs.** If there is a mezzanine loan in place at closing or the loan documents permit a future mezzanine loan, it is important to include a provision that the guarantor’s liability does not apply to carveout violations first occurring after a mezzanine foreclosure or transfer in lieu thereof; otherwise the guarantor would be on the hook for violations that it would no longer be in a position to prevent. The lender can require the mezzanine lender to furnish an acceptable replacement guarantor as a condition to foreclosure in the applicable intercreditor agreement.

○ **Provide for execution of replacement guaranty for permitted voluntary transfers.** The guarantor should be released for events first occurring after the execution of a replacement guaranty pursuant to the provisions of the loan documents (e.g., in connection with a permitted loan assumption or a permitted equity transfer).

• **Beware of overbroad carveouts.** Watch out for carveouts that are overbroad. For example, carveouts for transfer violations (including the definition of “transfer” used therein) are typically extremely broad, capturing inadvertent and immaterial transfer violations as well as involuntary transfers. Examples of items that would typically trigger full recourse liability under a standard carveout for transfer violations include (1) disposing an item of personal property (if the borrower does not negotiate an exception to the transfer restrictions allowing disposal of personal property which is obsolete or which is being replaced), (2) a condemnation, (3) space leases entered into in violation of the loan documents, and (4) consummation of an otherwise permitted transfer but forgetting to send the lender the required prior written notice. The comments underlined below narrow an otherwise overbroad full recourse carveout so that it applies only to material and voluntary transfers that are appropriate for full recourse liability. If a lender is willing to accept comments similar to those below, the lender may still insist on recourse for losses for any other prohibited transfers not captured by the full recourse carveout.

> the occurrence of a Prohibited Transfer in violation of Article—hereof without the consent of Lender caused by (a) any voluntary transfer by Borrower of fee simple title to all or any material portion of the Land and Improvements, (b) any voluntary transfer of the ownership interests in Borrower which results in a change of Control of Borrower, or (c) the granting by Borrower of a deed of trust or other voluntary monetary lien against Borrower’s fee simple title to all or any material portion of the Land and the Improvements.

**Legal Opinions**

It is important to confirm at the term sheet stage all legal opinions that will be required by the lender. Unless the loan falls below the lender’s loan size limit (typically $15 million or $20 million), a nonconsolidation opinion and certain special Delaware opinions may be required. These opinions will increase the borrower’s legal fees and may require the hiring of additional counsel (e.g., Delaware and/or bankruptcy counsel).

**Nonconsolidation Opinion**

A nonconsolidation opinion is a reasoned opinion that a bankruptcy of one or more of the designated equityholders or affiliates of the borrower would not result in the assets of the borrower being included in such a bankruptcy. Because these opinions are extremely fact-specific and the law relating to substantive consolidation is rather uncertain, these opinions can be very expensive, and many law
firms refuse to render them. Further complications arise if the borrower entity is recycled. If a nonconsolidation opinion is required at closing, the borrower will be required to deliver a new nonconsolidation opinion with respect to certain actions under the loan documents that affect the opinion pairings (e.g., guarantor substitution, engagement of a replacement property manager that is a borrower affiliate, and certain equity transfers).

**Special Delaware Opinions**

When the borrower or another deal-required SPE is a Delaware limited liability company, special Delaware opinions may be required. Examples include (1) an opinion that SPE will not dissolve by reason of the bankruptcy or dissolution of a member, (2) an opinion that a court applying Delaware law would enforce the provisions of the operating agreement requiring the prior written consent of the independent director for the SPE to file a voluntary bankruptcy petition, and (3) a reasoned opinion that a federal bankruptcy court would determine that Delaware law (and not federal law) governs what persons or entities have authority to file a voluntary bankruptcy proceeding with respect to the SPE.

**Financial Reporting**

CMBS loan documents require extensive financial reporting. Pre-securitization, monthly reporting is almost always required; post-securitization, quarterly reporting may be permitted.

The borrower’s financial reporting obligations are strictly enforced before and after securitization. Pre-securitization, delinquent reporting could hinder the lender's ability to securitize the loan as it needs to include up-to-date financials in its offering materials. Post-securitization, delinquent reporting could impede the servicer’s ability to prepare the periodic investor reports to the bondholders. Given the importance of timely reporting both before and after securitization, CMBS loan documents oftentimes include monetary penalties and recourse liability for delinquent reporting.

The financial reporting obligations should be carefully reviewed with the client. Considerations include:

- **Inconsistencies with operating practices.** Oftentimes, the financial reporting requirements are contrary to the borrower’s operating practices (e.g., financial reports are required to be audited or prepared using a different accounting method). If the lender does not agree to modify all requirements to match the borrower’s operating practices, the borrower will need to modify the applicable operating practices going forward. A particular hot button issue for many borrowers is the lender’s requirement that the applicable financial statements be audited. If a lender is unwilling to completely waive audited financials, it may agree that audited financials are not required so long as certain triggering events have not occurred (e.g., event of default or failure to satisfy a minimum debt service coverage ratio).

- **Closing financial statements.** To avoid any potential arguments with the servicer about whether the borrower’s financial reports satisfy the loan document requirements, deemed approval language similar to the following should be included in the loan documents for each required financial report.

  “with Lender having been deemed to have approved the form of [INSERT APPLICABLE FINANCIAL REPORT] delivered by Borrower in connection with the entering into and closing of the Loan.”

- **Limit catch-alls.** Catch-all provisions should be narrowed to the maximum extent possible, although the lender may need to preserve some, particularly for larger loans. The borrower should only be required to deliver items that are within the borrower’s possession or control, and ideally there should be a cap on the number of catch-all requests that a lender can make in any 12-month period.

- **Recourse.** Try to eliminate the carveout for financial reporting failures as this is not one of the traditional bad boy acts. If the carveout remains, it should only be for losses and the lender should be required to provide the borrower with notice and opportunity to cure (including a conspicuous reference to the potential recourse liability) before recourse is triggered.

- **Monetary penalties.** CMBS lenders rarely agree to eliminate the monetary penalties altogether. However, it may be possible to (1) lower the penalty amount, (2) require a notice and cure period before the penalty applies, and/or (3) obtain a waiver for the first reporting failure in any 12-month period.

- **Event of default.** Standard CMBS loan documents may not provide the borrower notice and adequate time to cure a reporting failure before the lender can declare an event of default. Ideally, the borrower should be entitled to notice and at least 30 days to cure.
Cash Management

To reduce the risk of a borrower or a property manager misapplying property revenue, almost every CMBS loan requires some form of cash management. As discussed below, there are several cash management structures, and the borrower’s ability to control property revenue will depend on the cash management structure. The required cash management structure should be described with specificity in the term sheet.

Cash management for CMBS loans involves two accounts, a “lockbox account” and a “cash management account,” each of which must satisfy certain account criteria set forth in the loan documents. To ensure that the property revenue is secure, the account criteria require that the accounts be held in reputable financial institutions having certain minimum credit ratings.

Lockbox Account

A lockbox account (also referred to as a deposit account, a clearing account, a collection account, or a restricted account) is an account of the borrower where all property revenue is required to be deposited. The lockbox account is established at a bank selected by the borrower (typically a local bank with which the borrower’s sponsorship has a good relationship) that has the required minimum credit ratings. A tri-party agreement between the bank, the borrower, and the lender (usually referred to as a “deposit account control agreement” or a “restricted account agreement”) establishes the lender’s first-priority security interest in, and control of, the lockbox account. The method of depositing property revenue into the lockbox account will vary depending on the type of lockbox account. There are three types of lockbox accounts: hard, soft, and springing.

Hard Lockbox

Most loans have a hard lockbox. In hard lockbox, tenants or other regular sources of property revenue (e.g., credit card companies for hotel properties) will be required to deposit the rent or other payments directly into the lockbox account.

Soft Lockbox

Sometimes the lender will agree to a soft lockbox (most commonly for multifamily properties). In a soft lockbox, tenants pay rent directly to the borrower or property manager, who must then deposit those rents into the lockbox account shortly after receipt.

Springing Lockbox

A springing lockbox is not activated at closing; it is only activated if a specified triggering event (e.g., termination of a material lease, failure to satisfy a financial test or an event of default) occurs. Unless and until a triggering event occurs, the borrower retains complete control over the property revenue. This type of lockbox is not common in CMBS loans.

Lockbox Negotiating Points

Set forth below are key points for counsel to understand and negotiate regarding lockboxes:

- **Request waiver or springing lockbox.** At the term sheet stage, the borrower typically requests that the lender waive the lockbox or agree to a springing lockbox. These requests are not likely to be successful: almost every CMBS loan requires a lockbox of some type, and springing lockboxes are rare in CMBS loans.

- **Have local bank preapproved.** It is best to have the borrower’s preferred local bank preapproved as a lockbox bank in the term sheet. The lender may preapprove a local bank that does not strictly meet the account criteria in the loan documents. If so, make sure the account criteria include an exception for that bank so long as there is no material downgrade in its ratings post-closing.

- **Use existing control agreement.** Negotiation of deposit account control agreements can be costly and lengthy. For example, many standard bank forms require various lender indemnities (e.g., for the bank’s account fees) that are nonstarters for many CMBS lenders. If the bank is unwilling to remove these indemnities, the lender may require recourse or other structuring as a mitigant. Significant time and expense can be saved if the lockbox bank selected by the borrower has recently entered into a deposit account control agreement for a CMBS loan (preferably with the lender in question) and the lender agrees to use that form of agreement.
• **Obtain lowest minimum balance.** Deposit account control agreements almost always require that a specified minimum balance (e.g., $5,000) remain in the account to cover account fees, returned items, etc.; the borrower should attempt to obtain the lowest minimum balance possible.

• **Verify account fees.** Make sure the amounts of all monthly and other account fees are specifically enumerated and are not subject to increase.

**Cash Management Account**

Depending on the cash management structure, funds in a lockbox account are swept periodically (e.g., each business day) either to the borrower’s operating account or to a cash management account. A cash management account is a lender-controlled account established at a bank selected by the lender. The cash management account must satisfy the account criteria set forth in the loan documents. There are two types of cash management structures, hard and springing.

**Hard Cash Management**

Hard cash management is the most onerous for the borrower; at all times while the loan is outstanding, funds in the lockbox account are swept to the cash management account to be applied by the lender or the servicer (as more particularly described below). The borrower has no access to (or control over) property revenue except to the extent the cash management waterfall (as described below) requires a disbursement to the borrower.

**Springing Cash Management**

For springing cash management, absent a triggering event, lockbox funds are disbursed back to the borrower. Once a triggering event occurs, lockbox funds are swept periodically to the cash management account.

**Cash Management Account Negotiating Points**

Any borrower will obviously strongly prefer springing cash management to hard cash management. If the lender agrees to springing cash management, considerations include:

• **Limit triggering events.** From the borrower’s perspective, there should be as few triggering events as possible. Common triggering events include an event of default, termination or non-renewal of a major lease, and failure to satisfy a specified financial test.

• **Specify when each triggering event ends.** The loan documents should make clear the circumstances under which each triggering event ends. A triggering event for an event of default would end once the applicable event of default is no longer continuing. For other triggering events, it may be appropriate for the borrower to have multiple ways of ending a trigger period. For example, a triggering event for failure to satisfy a specified financial test could end upon the earliest to occur of (1) the date on which the property once again satisfies the financial test, (2) the borrower prepaying the loan in an amount sufficient to satisfy the applicable financial test (the loan documents would need to expressly provide the borrower the right to make such a partial prepayment and hopefully would exclude any yield maintenance or similar premium), and (3) delivery of an acceptable letter of credit with a face amount equal to the principal prepayment that would be required for the loan to satisfy the applicable financial test.

• **Carefully read the financial tests and all related definitions.** All financial tests that constitute triggering events (including all defined terms referenced therein) should be carefully reviewed by you and the client. The tests oftentimes calculate net operating income using a methodology similar to that of the rating agencies. Net operating income is typically calculated for the trailing 12-month period or other “backward-looking” formula (e.g., annualizing revenues from a short period preceding the date of the calculation (e.g., prior month or prior quarter) and subtracting the expenses for the trailing 12-month period). Then, various cash flow exclusions (e.g., non-recurring or extraordinary income, free rent and rents attributable to any tenant that is a borrower affiliate or that is in default under its lease) and adjustments (e.g., imminent expense increases will be included and the market vacancy rate will be assumed if the property’s actual vacancy rate is lower) are applied. This is an area where business direction of the client is particularly important. It is unlikely that the lender will agree to eliminate all exclusions and adjustments or to always use a “forward-looking” formula to calculate revenues (i.e., by counting revenues that are anticipated to be generated during the 12-month period following the date of the calculation), but the borrower may have convincing business reasons for certain eliminations and modifications or for using different formulas to calculate revenues based on the circumstance giving rise to the test (e.g., triggering versus ending an excess cash flow trap).
• **Specify and limit fees.** The amounts of any fees for administering or maintaining the account should be specifically enumerated and not subject to increase.

• **Provide access to statements.** The loan documents should provide the borrower the right to periodic statements, as well as the right to electronic read only access to cash management account activity.

**Typical Cash Management Waterfall**

Absent an event of default, funds in the cash management account are applied (typically on each payment date) in accordance with a waterfall specified in the loan documents. In a typical waterfall, funds are applied in the following priority:

1. **Taxes and insurance.** Funds are first applied to monthly tax and insurance reserve deposits. The rationale for paying these items first is that (1) delinquent taxes could result in a superior tax lien and (2) delinquent insurance premiums could result in an uninsured casualty.

2. **Debt service.** Funds are next applied to monthly debt service.

3. **Reserve deposits.** Funds are next applied to monthly reserve deposits (other than operating expense reserve deposits).

4. **Operating expenses.** If applicable (typically only during a triggering event), funds are next applied to fund an operating expense reserve with funds sufficient to pay monthly operating expenses consistent with the applicable budget or otherwise approved by the lender. The lender typically has the right to withhold approval of non-budgeted expenses in its sole and absolute discretion. Request that the lender will not unreasonably withhold its approval.

5. **Excess cash flow or borrower.** If applicable (typically only during a triggering event), all remaining funds (if any) are deposited in an excess cash flow reserve. Otherwise, all remaining funds (if any) are transferred to the borrower’s operating account.

During an event of default, the lender typically has the right to apply funds in the cash management account and reserve accounts in its sole and absolute discretion.

**Cash Management Waterfall Negotiating Points**

For hotels or other properties with significant operating expenses, substantial changes to the standard waterfall may be required. Failure to timely pay basic hotel operating expenses could force the hotel to close or otherwise quickly lose value. To avoid this, hotel borrowers typically request (and most lenders agree) that funds in the cash management account are first used to pay sales and occupancy taxes, credit card fees, and other specified basic operating expenses (to the extent consistent with the applicable budget or otherwise reasonably approved by the lender), even when an event of default is continuing. Hotel borrowers also oftentimes obtain the right to have funds disbursed to the borrower for payment of such expenses each business day, instead of waiting for the lender to run the waterfall on the next payment date.

**Misapplication of Cash Management Funds**

• The lender should not have the right to declare an event of default or impose recourse liability for defaults that could have been prevented if funds in the cash management account or in a reserve account were properly applied.

• A borrower may also want to request that the lender agree to reimburse the borrower for any late charges or other expenses arising from misapplication of funds in the cash management account or in a reserve account.

**Reserves**

CMBS loans tend to have more reserves than other commercial real estate loans. CMBS loans are expected to be essentially self-sufficient. B-piece buyers and other investors expect reserves as a means of mitigating possible shortfalls in (or misapplication of) property cash flow, and rating agencies may penalize loans without such reserves. The reserve accounts must also satisfy the account criteria set forth in the loan documents and are often sub-accounts of the cash management account. Investment of reserve funds is typically limited to “permitted investments” acceptable to the rating agencies (e.g., obligations of the U.S. Treasury). The borrower should request the right to receive all investment income (or to have the investment income added to the applicable reserve accounts). Whether the lender will agree will depend on loan size and other factors. Master servicers receive much of their income in the form of earnings on reserve and other funds received from borrowers; accordingly, most CMBS loans will entitle the lender to retain earnings on the tax and insurance reserves at a minimum.
Tax and Insurance Reserves

Most CMBS loans include reserves for real estate taxes and insurance premiums, and any desired waivers should be negotiated at the term sheet stage. Set forth below are waiver examples and negotiating points for the borrower.

- **Waiver examples.** The lender may agree to waive tax and insurance reserves:
  - So long as the taxes and insurance premiums are timely paid, the borrower provides the lender satisfactory evidence of timely payment and no event of default or other triggering event (e.g., low debt service coverage ratio) occurs (such a waiver is uncommon)
  - If another creditworthy party unaffiliated with the borrower is responsible for paying the taxes and insurance premiums (e.g., a hotel franchisor or a single tenant) subject to satisfaction of certain conditions set forth in the loan documents (e.g., the hotel franchisor or tenant must maintain a specified minimum credit rating and the lender must receive evidence of timely payment)
  - If the property is insured under a blanket policy satisfying the applicable loan document requirements

- **Negotiating points.**
  - The borrower will want to make sure the loan documents require the lender to (x) consult the borrower and be reasonable in estimating the applicable monthly reserve deposits and (y) provide the borrower paid receipts or other evidence of timely payment.
  - The borrower will also want to make sure that the tax reserve accurately reflects any applicable local tax nuances. For example, if the locality offers a discount for early payment, the borrower will want to ensure that the lender is required to pay the taxes early. For localities that do not offer an incentive for early payment, the borrower may want the lender to agree to pay taxes on the last date payable without penalty.

Other Reserves

Examples of other common reserves include:

- Holdback reserves for any immediate repairs identified in the lender’s property condition report and/or other material unfunded payment obligations of the borrower as of loan closing
- Monthly reserves for tenant improvements and leasing commissions (TI/LC) and other costs of replacing tenants under leases expiring soon (oftentimes referred to as a “rollover” reserve)
- Monthly reserves for capital expenditures
- Operating expense reserves (typically only required to be funded monthly during a triggering period)
- Excess cash flow reserves (typically only required to be funded monthly during a triggering period)

Conditions for Releasing Other Reserves

The conditions for releasing reserve funds should be as simple as possible. In this regard:

- Interim disbursements should be permitted for reserve funds relating to work to be performed at the property (i.e., except for the final disbursement, release of funds should not be conditioned on completion of the work or payment in full).
- The borrower should have the right, at its option, to use the reserve funds to pay the applicable third party (as distinguished from the borrower first paying the third party out-of-pocket and then seeking reimbursement from the reserve funds).
- The lender should be required to respond quickly to reserve requests (e.g., within five business days of receiving the borrower’s request and any required supporting documentation).
- Make sure the borrower is comfortable with any minimum disbursement amount and/or disbursement frequency cap (servicers expect these features to be included in CMBS loan documents to limit the number of reserve requests that the servicer will have to handle).
• Make sure the borrower is comfortable with the disbursement mechanisms for operating expense reserve funds (ideally, on each payment date, the applicable funds would be disbursed automatically to the borrower’s operating account for borrower’s payment of the applicable operating expenses pursuant to the applicable budget or otherwise approved by the lender)

• To the maximum extent possible, the conditions should be objective and not subject to lender discretion.

• Revise any conditions that are inconsistent with other provisions of the loan documents (For example, TI/LC reserves typically condition disbursement on the lender’s approval of each lease for which a disbursement is requested. The condition should merely be that the lender’s approval has been obtained to the extent required under the leasing restrictions: the TI/LC reserve should not provide the lender increased leasing approval rights)

Permitted Uses of Other Reserves

The permitted uses of other reserve funds should be as broad as possible. In this regard:

• The borrower should have the right to request that funds in an excess cash flow reserve be used to fund (1) debt service and/or operating expense payments during periods of insufficient cash flow, (2) any cost with respect to which a reserve fund has been established where the applicable reserve funds are insufficient, and (3) other expenditures reasonably approved by the lender.

• If an excess cash flow reserve is only required during a triggering event, the borrower should request that the funds be returned to the borrower once a triggering event no longer exists.

• If the reason for originally establishing the reserve no longer applies or the reserve was miscalculated and there are excess reserve funds, the associated funds should not sit in a reserve account for the life of the loan (Appropriate alternative uses (or a refund to the borrower) should be permitted in the loan documents)

Cash Reserve Substitutes

In some cases, the lender will agree to allow the borrower certain cash reserve substitutes, such as a letter of credit or reserve guaranty or as detailed below.

• Letter of credit. The lender will sometimes permit the borrower to deliver a letter of credit in lieu of a cash reserve. Both the letter of credit and the issuing bank must satisfy the applicable loan document criteria.

• Reserve guaranty. The lender may also permit an affiliated guarantor to provide a guaranty in lieu of a cash reserve. Typically, the affiliated guarantor must be a rated entity and must maintain a certain minimum credit rating so long as the guaranty is in effect.

If the lender is willing to accept a letter of credit or a reserve guaranty, the borrower’s counsel should be aware of the impact this may have on the nonconsolidation opinion that is typically required. Affiliate guaranties are a “bad fact” for nonconsolidation opinions, as they tend to suggest the lender is not relying on the separate credit of the borrower. Not only a reserve guaranty, but also a letter of credit (an affiliate of the borrower is typically the reimbursement party), can present an issue for a nonconsolidation opinion if their amount is significant in relation to the loan amount (typically the threshold is 10% of the loan amount). The law firm issuing the nonconsolidation opinion will need to get comfortable with any reserve guaranties or letters of credit in place as of loan closing. Any right under the loan documents to substitute a letter of credit or reserve guaranty for a cash reserve after loan closing may be conditioned on delivery of a new nonconsolidation opinion; however, the lender will typically agree to forego the opinion if the amount in question is less than ten percent (10%) of the loan amount.

Servicing

Servicer in Charge, Not Originating Lender

Once a CMBS loan is securitized, the originating banker (who is more familiar with the loan and has an incentive to act reasonably in dealings with the borrower in hopes of future loan business) typically has no further decision-making authority, not even with respect to routine borrower requests for expedited lease approval, waiver of a reserve disbursement condition, or correction of a loan document that does not accurately reflect the business deal. All loan servicing and other decision-making will be handled by the applicable servicer(s) under the PSA. This servicing structure is arguably one of the most frustrating aspects of CMBS loans from a borrower’s perspective.
**Types of Servicers**

A CMBS loan will have a master servicer and a special servicer. Each servicer must act in the best interests of the investors (as a collective whole) and in accordance with the servicing standard set forth in the PSA. Each servicer also has the right to contract with third parties (referred to as sub-servicers) to perform certain of its obligations under the PSA. The master servicer is generally responsible for servicing performing loans, and the special servicer is generally responsible for servicing non-performing loans. It is unlikely that the borrower will have one main point of contact at the applicable servicer. Servicing personnel are responsible for a voluminous number of loans and oftentimes have very specialized roles (e.g., one individual may handle reserve requests, another handles cash management, and yet another handles leasing consents).

**Limited Authority of Master Servicer**

Both the PSA and REMIC rules (discussed below) severely limit the master servicer's authority to process borrower requests for consents, waivers, and modifications. When it does have such authority, rating agency confirmation may be required, and the special servicer, the controlling class, and/or the operating advisor may have consent or consultation rights. When it does not have authority (e.g., the loan is performing and the borrower requests a significant modification not permitted under REMIC rules until the loan is in default or a default is reasonably foreseeable), a modification that makes perfect business sense may not be possible.

**Borrower Strategies to Minimize Potential Servicing Problems**

Because of this complex and oftentimes inefficient and inflexible servicing scheme, when negotiating the loan documents, the borrower will want to (1) incorporate the maximum amount of flexibility and optionality into the loan documents and (2) minimize scenarios where the borrower will need to obtain the lender’s approval.

**Flexibility and Optionality**

The bullet points below set forth ways that the borrower can achieve maximum flexibility and optionality in the loan documents.

- **Releases and other changes to collateral.** The borrower should identify any potential material changes to the collateral during the loan term (e.g., outparcel release), and the loan documents should provide the borrower an unequivocal right to consummate those changes subject to satisfaction of objective conditions. Even if the applicable changes would not violate REMIC rules (e.g., lien releases are generally permitted so long as the principally secured test (as described below) is satisfied following the lien release), unless they are specifically addressed in the loan documents, instead of an unequivocal right, the borrower will have the unenviable task of convincing the servicer why it should provide its consent and/or why providing consent doesn’t violate the applicable servicing standard.

- **Permitted uses of reserve funds.** As discussed above, permitted uses of reserve funds should be drafted as broadly as possible.

- **Replacement guarantor.** The loan documents should include the right to substitute a replacement guarantor subject to satisfaction of objective conditions. This flexibility is important for various reasons. Examples include:
  - **Net worth/liquidity covenants.** CMBS loans oftentimes require the guarantor to satisfy certain net worth and/or liquidity covenants throughout the loan term. If a guarantor’s financial condition significantly declines after loan closing and the guarantor is no longer able to satisfy such requirement(s), a loan default may be avoided if the documents provide a right to substitute a replacement guarantor.
  - **Equity transfers.** Equity transfer provisions typically state that various categories of transfers are permitted so long as certain conditions are satisfied, including that the guarantor continues to control the borrower after the transfer. Certain categories of permitted transfers may involve transfers of controlling interests (e.g., transfers among joint venture partners or transfers to a qualified investor). If there is no right to substitute a replacement guarantor, these transfers would require lender consent.

**Minimize Lender Consent Requirements**

CMBS loan documents contain numerous negative covenants prohibiting the borrower from taking certain actions without the lender’s prior written consent. Areas requiring lender consent include leasing activity, equity transfers, property transfers, changes in property management, and alterations.
**Negotiate Exceptions**

To minimize lender consent requirements, the borrower will want to negotiate as many exceptions to lender consent as possible. In particular, to the maximum extent possible, the borrower will want to make sure the loan documents do not require consent for items outside of the borrower’s control. Below are examples of exceptions that a borrower may want to negotiate to lender consent requirements for leasing activity and alterations:

- **Leasing activity.** Examples of negotiated exceptions to lender consent for leasing activity include leasing activity that:
  - Does not relate to a major lease (e.g., lease that accounts for more than a specified percentage of the property’s total rental income or rentable square footage)
  - Conforms to objective leasing parameters specified in the loan documents
  - Was preapproved by the lender in the loan documents (e.g., if the borrower is in the processing of negotiating a major lease at closing, the borrower may want to have that lease preapproved)
  - Results from a tenant’s exercise of a right (e.g., renewal or expansion right) afforded to it under an approved lease (or a lease that does not require approval)

- **Alterations.** CMBS loan documents typically require lender consent for alterations:
  - That may have a material adverse effect
  - Whose costs exceed a specified alterations threshold (oftentimes stated as a specified percentage of the loan amount)
  - That are structural in nature
  - That reduce the property’s rentable square footage

The borrower will want to narrow the material adverse effect and structural prongs as much as possible; otherwise, it would be difficult for the borrower to know if the clauses are applicable to the alterations in question. Additionally, from the borrower’s perspective, certain alterations should never require consent, including:

  - Restoration being performed following a casualty or condemnation in accordance with the restoration provisions of the loan documents
  - Alterations required under approved leases (or leases that do not require approval)
  - Alterations required under reciprocal easement agreements or other title documents
  - Alterations required under applicable law
  - Alterations required to respond to imminent life/safety issues at the property

On a related note, regardless of whether lender consent is required, CMBS loan documents will require the borrower to deliver alterations security in an amount equal to any unpaid alterations costs in excess of the alterations threshold or a multiple thereof (e.g., 110 – 125%). Alterations security is required by the rating agencies and is typically non-negotiable, but the lender may be willing to make exceptions for alterations (1) covered by other reserves (e.g., leasing reserves); (2) performed by a third party (e.g., tenant) at such third party’s sole cost and expense; or (3) in connection with a restoration following a casualty or condemnation, which alterations should be governed by the separate restoration provisions of the loan documents. Ideally, the loan documents will afford the borrower the right to select from multiple types of alterations security (e.g., cash, guaranty, letter of credit, and government securities).

**Limit Sole and Absolute Discretion**

Most CMBS loan documents have a boilerplate provision to the effect that, unless another standard is expressly provided, the lender may withhold consent in its sole and absolute discretion. When the lender’s approval is required (particularly for leasing and other routine operational matters), request that the lender will not unreasonably withhold, condition, or delay consent. The lender will likely require a sole and absolute discretion with respect to prohibited transfers and certain other material items.

**Deemed Approval**

Careful borrowers also request a deemed approval provision whereby the lender’s approval is deemed granted if the lender does not notify the borrower of its disapproval and the reasons therefor within a reasonable period of time (e.g., seven business days).
Whether the lender will agree to deemed approval will depend on the materiality of the item requiring approval. The lender may also want to impose additional requirements for deemed approval to be effective (e.g., the request for approval must contain a conspicuous reminder that deemed approval may apply and the borrower must deliver a second approval request).

**Duplicative, Inconsistent, or Absurd Requirements for Approval**

The borrower’s counsel should look out for any duplicative, inconsistent, or absurd requirements for approval and should try to eliminate these to the maximum extent possible. Some examples include:

- **Absurd.** A condemnation technically requires lender consent under the extremely broad transfer restrictions (which expressly apply to involuntary as well as voluntary transfers).

- **Inconsistent.** Even though a lease does not require approval under the leasing restrictions, if the borrower wants a disbursement of leasing reserve funds for the associated leasing costs, standard leasing reserves frequently require the lender’s approval of the lease as a condition to disbursement.

**Rating Agency Confirmations**

Rating agency confirmations can be expensive and time-consuming, and any loan document requirements for rating agency confirmations should be limited to the maximum extent possible. Examples of items that typically require a rating agency confirmation include a change in property management, consummation of a defeasance, a loan assumption, and a transfer of a specified percentage of ownership interests (e.g., in excess of 49%).

If a replacement property manager (1) satisfies certain manager criteria (see sample definition below) or (2) is specifically preapproved in the loan agreement and there has been no material adverse change with respect to such manager, the change may be considered “ratings neutral,” and the lender may be willing to remove the requirement for a rating agency confirmation.

**Manager Criteria** shall be deemed satisfied with respect to any Person to the extent that, as of the applicable date of determination, such Person (i) is a reputable management company having at least five (5) years’ experience in the management of [___________________] in major metropolitan markets (such properties, the “Comparable Properties”), (ii) has, for at least five (5) years preceding the applicable date of determination, managed at least five (5) Comparable Properties of approximately the same size as the Property or larger, (iii) is then managing Comparable Properties (exclusive of the Property) with at least [___________] aggregate leasable square feet and (iv) is not the subject of any proceeding under any applicable Creditor’s Rights Laws.

Similarly, as discussed further below, the lender may be willing to waive the rating agency confirmation for a loan assumption if the transferee is a “qualified transferee” (see sample definition of this term in Schedule I at the end of this practice note) or an entity majority owned and controlled by a qualified transferee. The loan documents should make clear that any rating agency confirmation requirements only apply if the loan is included in a securitization at the time in question, and that a rating agency confirmation will be deemed granted if the applicable rating agency (x) waives, declines, or refuses to review or (y) fails to timely respond.

**REMIC Rules Applicable to Modifications and Lien Releases**

As mentioned above, a REMIC trust is a pass-through entity, and it generally does not pay entity-level taxes. Securitizations are structured and priced assuming that the trust will remain a pass-through entity at all times while the bonds are outstanding. To maintain the favorable tax treatment, the REMIC rules require the trust to act like a holding entity, not a business entity, and substantially all of the trust’s assets must be qualified mortgages and permitted investments. Qualified mortgages are generally loans that are (1) principally secured by an interest in real property (oftentimes referred to as the principally secured test) and (2) acquired within three months of the REMIC’s startup day (typically, the closing date).

**Borrower’s Counsel Should Have Basic Understanding of Material REMIC Rules**

To ensure the trust maintains its favorable tax treatment, certain actions under the loan documents (e.g., lien release, disbursement of condemnation proceeds, defeasance, and loan assumption) will not be permitted if they would violate REMIC rules, and the borrower will typically be required to deliver, at the borrower’s sole cost and expense, a REMIC opinion confirming that the matter in question will not cause the trust to lose its REMIC status or otherwise violate REMIC rules. When representing a borrower, it is important to have a basic understanding of REMIC rules, in particular the rules governing when a loan will lose its status as a qualified mortgage.
due to a significant modification and/or a failure to satisfy a required retesting of the principally secured test. This understanding will enable you to (1) persuasively argue for the deletion of any loan document requirements for delivery of a REMIC opinion for matters that clearly do not implicate REMIC rules (e.g., disbursement of casualty insurance proceeds) and (2) more effectively explain to the borrower the types of actions that the REMIC rules may prohibit the borrower from taking if not negotiated into the loan documents as unilateral options of the borrower.

**Significant Modification Rules**

Subject to limited exceptions (some of which are discussed below), if a significant modification of a loan occurs more than three months after the REMIC's startup day, the loan will cease to be a qualified mortgage. Essentially, the loan (as modified) is treated as a new loan, and the REMIC is deemed to have disposed the pre-modified loan in exchange for the new loan. This treatment can have numerous adverse consequences for the REMIC, including (1) imposition of a 100% prohibited transactions tax on any gain realized from the deemed disposition, (2) imposition of a 100% prohibited transactions tax on the post-modification income from the loan, and (3) loss of REMIC status (if the modification causes the REMIC to fail the asset test described above).

**Not a Modification**

The tax rules expressly stipulate that certain loan changes are not modifications. For example, changes that occur automatically (or after the exercise of a unilateral option by the borrower or the lender) pursuant to the original terms of the loan documents are generally not modifications.

**Not Significant**

The tax rules also expressly stipulate certain modifications that are not significant. Examples include:

- The substitution of a new obligor on a nonrecourse loan
- Changes in timing of payments that do not result in a material deferral of scheduled payments
- Improvements to the mortgaged property
- A minor change in the collateral or credit enhancement

**Significant Modification Exceptions**

The tax rules also expressly permit certain modifications even if they would otherwise be significant. Examples include:

- Modifications "occasioned by default or reasonably foreseeable default"
- Waiver of a due-on-sale clause
- Converting a nonrecourse loan to a recourse loan so long as the loan satisfies the principally secured test following the conversion
- A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral so long as the loan satisfies the principally secured test following the modification

**Principally Secured Test**

The principally secured test is typically tested only once, and it is satisfied if the fair market value of the real property securing the loan is at least 80% of the loan’s adjusted issue price (typically, its principal amount) at origination or on the REMIC’s startup day. However, the REMIC rules require retesting after securitization in limited circumstances (e.g., releasing a lien on an interest in real property). If a lien release or other action requiring a retesting is consummated and the retest is not satisfied, the loan would cease to be a qualified mortgage, exposing the REMIC to adverse tax consequences.

**When Is Retesting Required?**

The most encountered circumstance is releasing a lien on an interest in real property. Except for a lien release in connection with a permitted defeasance (see the defeasance discussion below for the REMIC rules applicable to a defeasance), REMIC rules require
retesting for absolutely any release of a lien on an interest in real property, including a release pursuant to a unilateral option in the loan agreement and an involuntary release resulting from a condemnation. Certain other modifications (e.g., converting a loan from recourse to nonrecourse) also require a retesting.

**How to Satisfy the Retesting?**

The principally secured test is deemed satisfied if:

- The value of the real property as of the date of the lien release or other applicable modification is at least 80% of the loan’s post-modification adjusted issue price
- The value of the real estate collateral immediately after the lien release or other applicable modification is no less than the value of the real estate collateral immediately prior thereto (this portion of the test would typically only apply if there was a collateral substitution of some kind), or
- The modification at issue is a lien release, and the borrower makes a principal repayment of the loan in a qualifying amount concurrently with the lien release (A principal repayment is a qualifying amount if it equals or exceeds any one of four different amounts set forth in the REMIC rules, including (1) an amount such that, immediately after the lien release, the ratio of the “adjusted issue price” of the loan to the fair market value of the real property securing the loan is no greater than what that ratio was immediately before the release and (2) an amount equal to the fair market value of the real property released.)

**Condemnation**

For a taking, CMBS loan documents require the borrower to prepay the loan in a qualifying amount if the principally secured test is not satisfied based on the value of the remaining real property collateral. Negotiating points include:

- When retesting the principally secured test, the loan documents should require that any planned restoration be included in the value of the remaining real property collateral.
- A prepayment should not be required if the borrower delivers a REMIC opinion confirming that the loan will continue to be a qualified mortgage after the lien release without a prepayment.
- If the lender is holding the condemnation proceeds, the loan documents should make clear that (1) the lender must use those proceeds to make the required prepayment and (2) any proceeds remaining after such application will still be made available for restoration if the applicable loan document conditions are met.

**Restrictions on Prepayment**

CMBS investors expect their bonds to provide predictable and uninterrupted payments. For this reason, CMBS loans restrict voluntary prepayments more than typical balance sheet loans. Voluntary prepayment prior to the open period (typically a two to six month period prior to the scheduled maturity date during which the borrower has a right to prepay the loan without payment of a yield maintenance charge or other prepayment premium) may be prohibited altogether. In most cases, if a borrower wants to sell or refinance its property free of a CMBS loan prior to the open period, defeasance (CMBS investors’ preferred method of addressing prepayment) may be the borrower’s only option.

**What Is Defeasance?**

Defeasance is not an actual prepayment. Rather, it is an alternative to prepayment involving:

- A substitution of government securities for the real estate collateral
- A release of the liens on the real estate collateral
- A release of the borrower and guarantor(s) from their obligations under the loan documents, except for limited surviving liabilities (e.g., environmental indemnities)
- An assumption of the loan by a special purpose entity, commonly referred to as the successor borrower
For defeasance to be a viable option for the borrower (1) the loan documents must specifically provide the borrower the right to defease, (2) the defeasance cannot occur during the lockout period (pursuant to REMIC rules, the lockout period must be at least two years after the REMIC's startup day), and (3) the defeasance must otherwise be consummated in accordance with the applicable loan document provisions and REMIC rules.

**Why Is Defeasance Preferred by CMBS Investors?**

Defeasance preserves the status quo for all investor classes, but prepayment does not. If a loan is prepaid, the PSA typically provides that certain classes of investors (e.g., the interest-only class) are not entitled to the yield maintenance premium.

**Which Government Securities May Be Used?**

The REMIC rules permit use of any government securities as defined in the Investment Company Act. U.S. Treasury and federal agency securities (e.g., Fannie Mae or Freddie Mac securities) constitute government securities under the Investment Company Act. However, many CMBS lenders’ form loan documents only permit use of U.S. Treasury securities that are perceived as being more secure than federal agency securities. The loan documents will also require that the selected government securities (1) have an income stream that replicates the remaining loan payments and (2) are not subject to prepayment, call, or early redemption.

**Borrower Costs for Defeasance**

In addition to costs incurred purchasing the applicable government securities, the borrower may incur anywhere from approximately $50,000–$100,000 in other transaction costs and fees, including: (1) borrower’s and lender’s legal fees (including fees for negotiating the defeasance documents and the REMIC compliance and other required legal opinions), (2) cost of the accountant’s report verifying the adequacy of the defeasance collateral, (3) fees for any required rating agency approval, (4) fees of the securities intermediary, (5) fees of the borrower’s defeasance consultant, (6) fees and costs of the company forming the successor borrower, and (7) servicer processing fees.

**Defeasance Negotiating Points**

As counsel to the borrower, successfully negotiating one or more of the following points in the term sheet / loan documents could result in significant cost savings for the borrower:

- **Open period payments.** Request the right to purchase defeasance collateral that makes payments through any payment date during the open period (as distinguished from the loan maturity date).

- **No duplicative calculations.** Make sure the defeasance provisions do not require duplicative payments. As an example, the defeasance collateral definition typically covers all payments subsequent to the date of the defeasance. If the defeasance provisions also separately require the borrower to pay accrued and unpaid interest through the date of the defeasance, the borrower would essentially be required to pay that interest twice if the defeasance does not occur on a monthly payment date.

- **Federal agency securities.** Request that federal agency securities (which typically have higher interest rates than U.S. Treasury securities) are permitted in addition to U.S. Treasury securities and that the borrower have the right to select the securities.

- **Right to designate successor borrower.** There can be significant residual value if the maturity and coupon dates of the defeasance collateral do not exactly match the corresponding loan payment dates. Each defeasance collateral payment will sit in an interest-bearing account of the successor borrower until disbursed on the corresponding loan payment date. The accrued interest (or float) is the sole property of the successor borrower, and it cannot be applied to loan payments or withdrawn from the successor borrower’s account prior to maturity. Request that the borrower have the right to designate the successor borrower so that it can recover at least a portion of any residual value via a sharing agreement or otherwise.

- **“New York-style” defeasance.** If the property is located in New York or another state that permits a defeased mortgage to be assigned to the refinancing lender to save mortgage recording tax, make sure the loan documents obligate the lender (if requested by the borrower) to conduct a New York-style defeasance (instead of releasing the mortgage).

- **Timing.** The loan documents will require the borrower to provide the lender prior written notice of its intent to defease. The notice must specify the proposed defeasance date and typically must be delivered 30–60 days prior to that date. A defeasance
is an involved transaction that typically takes at least a month to finish, and it is difficult to predict with certainty the exact defeasance date. Accordingly, the loan documents should require as little advance notice as possible, and the notice should be revocable and extendable.

**Defeasance Alternative—Prepayment with Yield Maintenance**

While defeasance is the preferred and most common method of addressing prepayment in the CMBS market, a borrower may be able to negotiate at the term sheet stage the right to prepay with yield maintenance (either in lieu of, or in addition to, the defeasance right, although it is atypical for a borrower to have the right to choose between yield maintenance and defeasance under a CMBS loan). CMBS lenders will often require an increased spread in exchange for the right to prepay with yield maintenance.

Yield maintenance formulas vary, but they typically seek to compensate the lender for the loss in yield it will incur as a result of the prepayment. Formulas typically specify the replacement rate as the current yield on the corresponding U.S. treasury with a maturity date closest to the scheduled loan maturity, and that replacement rate is used both to calculate the loss in yield and the discount rate that will be used to calculated the present value of the loss in yield. Most formulas also include a minimum payment typically ranging from 1%–3% of the principal prepaid.

**Yield Maintenance Negotiating Points**

If a loan includes the right to prepay with yield maintenance, as counsel to the borrower, successfully negotiating one or more of the following points in the term sheet / loan documents could result in significant cost savings for the borrower:

- **Get the benefit of the open period.** Similar to defeasance, careful borrowers argue that the yield maintenance calculation should not include the open period, as the borrower would have the right to prepay the loan during that time without penalty.

- **Make replacement rate as high as possible.** A higher replacement rate results in a lower yield maintenance premium.
  - **De-compounding.** Certain yield maintenance premium formulas require the applicable treasury rate (which is quoted as an annual rate) to be de-compounded to a monthly rate. This results in a lower replacement rate, which results in a lower discount rate, all of which serve to increase the yield maintenance premium. A prudent borrower would want to try to eliminate or minimize any interest rate de-compounding.
  - **Add spread.** The interest rate under a fixed rate loan typically corresponds to the prevailing treasury rate at the time of loan closing plus a spread. Arguably, for the yield maintenance formula to be an accurate calculation of the lender’s loss of yield, the replacement rate should include the same spread. On occasion, borrowers are able to negotiate a basis point increase to the applicable treasury rate, but the increase is typically less than the spread used to calculate the loan’s interest rate.

- **Include amortization calculation.** Some yield maintenance formulas assume that an amortizing loan is interest-only. From the borrower’s perspective, if a loan is amortizing, the loss in yield should be calculated separately with respect to each applicable debt service payment so that the borrower gets the benefit of its amortization (i.e., the monthly loss in yield should gradually decrease).

- **Eliminate or minimize floor.** If the purpose of the yield maintenance premium is to compensate the lender for the present value of its loss in yield, technically a floor should not be required. However, most CMBS loans include a floor, and the borrower may be better-served by attempting to reduce the applicable percentage than eliminating the floor altogether. Form documents typically provide for a floor equal to 3% of the amount prepaid, but depending on loan size and other factors, the floor may be reduced to as low as 1% of the amount prepaid.

- **Minimize advance notice requirements and allow for mortgage assignment.** Similar to a defeasance:
  - The loan documents should require as little advance notice of the prepayment as possible.
  - The prepayment notice should be revocable as well as extendable.
  - If the property is located in New York or another state that permits a note and mortgage to be assigned to the refinancing lender to save mortgage recording tax, the loan documents should obligate the lender (if requested by the borrower) to cooperate in that assignment.
• **Exclude certain voluntary prepayments.** The borrower may be able to negotiate that certain voluntary prepayments do not require payment of a yield maintenance premium (e.g., a partial repayment resulting from a permitted lien release or the borrower’s exercise of a right to prepay the loan to satisfy a loan-to-value or other financial test under the loan documents).

• **Negotiate a waiver for involuntary prepayments.** Most CMBS form loan documents require a yield maintenance premium whether the prepayment is voluntary or involuntary. Examples of involuntary prepayments include:
  
  - Lender’s exercise of a right under the loan documents to apply casualty or condemnation proceeds to pay down the loan
  - Any prepayment occurring during the continuance of an event of default

  The borrower may be able to negotiate a waiver of the yield maintenance premium for certain involuntary prepayments. However, the premium is almost always required during the continuance of an event of default, and in many instances, the loan documents require an increased amount pursuant to a default yield maintenance formula (e.g., the loss in yield is calculated using the default rate instead of the regular interest rate and/or the floor is calculated using a higher percentage).

**Other Defeasance Alternatives**

As detailed below, some alternatives to defeasance (which may be less expensive) include loan assumption and mezzanine financing.

**Loan Assumption**

In the context of a sale, a loan assumption may be less expensive than defeasance and/or prepayment with yield maintenance. Most CMBS loan documents permit a loan assumption subject to satisfaction of numerous conditions, including:

- Payment of an assumption fee
- The lender’s approval of the transferee
- Execution of assumption documents and replacement guaranties
- Receipt of a rating agency confirmation
- The lender’s approval of the transferee

Ideally, there would not be a cap on the number of assumptions that could occur during the term of the loan. Standard assumption fees are typically 1% of the loan amount; however, lower fees (e.g., 0.25% of the loan amount) are sometimes negotiated. Where more than one assumption is permitted, a lender may agree to a low assumption fee for the first assumption with increased fees thereafter. Additionally, if the transferee is a qualified transferee (see sample definition of this term in Schedule I at the end of this practice note) or an entity controlled and majority owned by a qualified transferee, the lender may be willing to waive the assumption fee, lender approval, and/or requirement for a rating agency confirmation.

**Mezzanine Financing**

If a property appreciates significantly and the borrower wants to refinance to increase its loan proceeds, a mezzanine financing may be less expensive than defeasance and/or prepayment with yield maintenance. For mezzanine financing to be a viable option, the borrower would need to negotiate the right for future mezzanine financing at the term sheet stage. The loan documents would then include numerous conditions to the exercise of the right, including:

- Satisfaction of specified loan-to-value, debt-service-coverage ratio, and other financial tests, in each case, taking into account the loan and the mezzanine loan
- The maturity date of the mezzanine loan must be co-terminus with the loan or longer
- The mezzanine lender must not be an affiliate of the borrower and must be a qualified mezzanine lender (see sample definition of this term in Schedule II at the end of this practice note) or otherwise approved by the lender
- The mezzanine lender’s execution of an intercreditor agreement acceptable to the lender
- Receipt of a rating agency confirmation
Interest Shortfall

If a prepayment or defeasance does not occur on a regularly scheduled payment date, CMBS loans almost always require the borrower to pay the corresponding interest shortfall (i.e., the amount of interest that would have accrued on the amount prepaid or defeased through the end of the interest period in which the prepayment occurs). This requirement is designed to avoid a mismatch in the interest payment rights of the bondholders and the interest payment obligations of the borrower.

- **Make sure payment is not duplicative.** Careful borrowers will make sure the interest shortfall is not already captured in the yield maintenance or defeasance collateral calculations. An interest shortfall payment should not be required for a prepayment with yield maintenance where the interest shortfall is already captured in the yield maintenance calculations. Similarly, an interest shortfall payment should not be required for a defeasance if the interest shortfall is already captured in the defeasance collateral calculations.

- **Require escrow of funds.** When an interest shortfall payment is required, the borrower may want to require that the funds be escrowed in an interest-bearing account until applied on the next payment date and that any interest on such funds be promptly paid to the borrower.

Lender Expenses

Careful attention should be paid to expense-reimbursement provisions in CMBS loan documents. While such provisions are also found in most balance sheet loans, they can take on a life of their own in CMBS loans. In addition to the reasonable, out-of-pocket, and documented limitations frequently requested by borrowers negotiating expense-reimbursement provisions in balance sheet loans, careful CMBS borrowers may also want to request one or more of the following additional limitations:

- **Lender’s securitization expenses.** A borrower may want to try to exclude the lender’s securitization-related expenses. While many lenders do not expect the borrower to pay for such expenses, they are often nonetheless captured by the broad expense-reimbursement provisions in their form loan documents.

- **Master servicer fees.** The borrower is generally not responsible for the costs of hiring the master servicer or the regular master servicing fee. A careful borrower may want to request that the loan documents expressly so provide (if they don’t already). The master servicer typically charges other fees, including fees related to processing borrower requests (e.g., request for lease approval). A borrower may want to try to avoid paying for certain such fees. Alternately, the borrower may want the lender to agree to caps for such fees.

- **Rating agency costs.** The borrower should not be responsible for rating agency costs or fees applicable to the initial review of the loan in connection with the securitization. Post-securitization, it is customary for the borrower to be responsible for rating agency costs and fees in connection with any rating agency confirmations required under the loan documents.

- **Special servicing fees.** Most loan documents will obligate the borrower to pay for special servicing fees. Certain borrowers may be able to negotiate caps or other limitations on such fees.

Securitization Cooperation

CMBS loan documents include various securitization cooperation provisions. Such provisions typically obligate the borrower to comply with various lender requests to facilitate the securitization, including to provide updated financial reports and other property information, provide additional legal opinions, and enter into loan document amendments. These provisions tend to be very open-ended, and it is very difficult to know how extensive the lender’s requests will be (or if the borrower will be able to satisfy those requests). A careful borrower will want to narrow its cooperation obligations as much as possible; items to consider include:

- **Loan document amendments.** Most CMBS lenders will not agree to eliminate this cooperation item or to make the amendments subject to the borrower’s approval. However, a careful borrower will want to protect itself from amendments that could materially change the business deal or otherwise adversely affect the borrower, and most lenders understand this borrower concern. The provision below has been marked to reflect commonly requested borrower changes. The lender may not be willing to agree to all of these changes.
Borrower shall execute such amendments to the Loan Documents and Borrower’s or any SPE Component Entity’s organizational documents as may be reasonably requested by Lender or requested by the Rating Agencies in order to effect the Securitization including, without limitation, bifurcation of the Loan into two or more components and/or separate mortgage notes and/or creating a senior/subordinate mortgage note structure (any of the foregoing, a “Loan Bifurcation”); provided, however, that Borrower shall not be required to modify or amend any Loan Document if such modification or amendment would (i) change the weighted interest rate, the Monthly Debt Service Payment, the stated maturity of, the amortization of principal set forth in the Note, if any, or any other economic terms of the Loan Documents or (ii) otherwise impose additional obligations or liabilities on Borrower or be adverse to Borrower (or any of Borrower’s direct or indirect owners (including any Restricted Party or managers) in any other respect, except in connection with a Loan Bifurcation which may result in varying fixed interest rates and amortization schedules, but which shall have provided the same initial weighted average composite interest rate of the original Note (as bifurcated) shall not at such time or at any time thereafter vary from the interest rate on the Note prior to such Loan Bifurcation (other than as a result of the application by Lender of payments and/or proceeds after an Event of Default).

• Lender mezzanine option. CMBS form loan documents oftentimes include an option for the lender to convert a portion of the loan into a mezzanine loan. This option is included to protect the lender if the loan needs to be re-sized in order to be securitized (e.g., “B-piece buyer” indicates it wants to kick the loan from the pool unless the principal balance is lowered to an agreed-upon sum) and a mezzanine loan makes more sense than a pari passu or subordinate mortgage note structure. If the lender were to exercise such an option, it would essentially involve closing a new loan (e.g., negotiation of mezzanine loan documents, creation of a new SPE to serve as the mezzanine borrower, delivery of new legal opinions, and a UCC title insurance policy with respect to the pledged interests). The lender’s exercise of such option may be very time-consuming and expensive. Additionally, it would necessarily be materially adverse to the borrower as it would significantly improve the lender’s ability to take over the property following an event of default: mezzanine foreclosures can be accomplished in less than 60 days, whereas mortgage foreclosures typically take much longer (sometimes years in judicial foreclosure states). If the lender is not willing to delete this option, the borrower may want to negotiate (1) that the lender is responsible for all associated costs (including the borrower’s), (2) that the option expires if not consummated by the earlier to occur of (x) the securitization of the loan and (y) a specified outside date (e.g., one year after loan closing), and (3) limitations on terms that would be adverse to the borrower or the guarantor (e.g., the lender’s foreclosure remedies).

• Updated representations. Securitization cooperation provisions frequently require the borrower to provide updated and/or additional representations and warranties required by the rating agencies. The provision below has been marked to reflect commonly requested borrower changes.

Borrower shall provide updated, as of the closing date of the Securitization, representations and warranties not more extensive than those made in the Loan Documents and such additional representations and warranties as the Rating Agencies may require, and all such representations and warranties shall be subject to any updates Borrower may make there to reflect any changes in facts and circumstances since the Closing Date.

• Reimbursement of borrower costs. The borrower may want to request that the lender pay for borrower’s securitization costs and expenses. Depending on loan size and other factors, the lender may be willing to pay for all or certain categories of such costs and expenses. The lender will typically require that the applicable costs and expenses be reasonable and third party.

• Review of disclosure documents and securitization indemnities. It goes without saying that the loan documents will expressly afford the lender the right to disclose information about the borrower, the loan, the guarantor(s), and the property in the securitization offering materials. If the borrower is not comfortable with such disclosure, a CMBS loan may not be the right
The loan documents will also typically require the borrower to review the disclosure documents, and to indemnify the lender and other securitization parties for inaccuracies in loan-specific information included in the securitization documents. The breadth and complexity of such provisions will vary depending on loan size. As the disclosure documents are very voluminous, if the borrower’s review is required, the borrower will want to require the lender to identify the specific sections of the disclosure documents that the lender would like the borrower to review. The borrower may also want to negotiate a reasonable opportunity to review and comment on the disclosure documents as well as various limitations on the scope of the indemnities. See Schedule III at the end of this practice note for an example of borrower comments to certain securitization indemnity provisions for a large loan.

SCHEDULE I

SAMPLE QUALIFIED TRANSFEEEE DEFINITION

“Qualified Transferee” means one or more of the following:

(a) a real estate investment trust, bank, saving and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, government entity or plan, sovereign wealth fund, private equity fund, REIT or real estate operating company, provided that any such Person referred to in this clause (a) satisfies the Transferee Eligibility Requirements (as defined below);

(b) an investment company, money management firm or “qualified institutional buyer” within the meaning of Rule 144A under the Securities Act or an institutional “accredited investor” within the meaning of Regulation D under the Securities Act, provided that any such Person referred to in this clause (b) satisfies the Transferee Eligibility Requirements;

(c) an institution substantially similar to any of the entities described in clause (a), clause (b) or clause (d) that satisfies the Transferee Eligibility Requirements;

(d) any entity 100% owned by and Controlled by, Controlling or under common Control with any one or more of the entities described in clause (a), clause (b) or clause (c) above; or

(e) any Person approved by Lender in its sole discretion, and, following a Securitization, for which the Rating Agencies have issued a Rating Agency Confirmation with respect to such Person being a Qualified Transferee.

“Transferee Eligibility Requirements” means, with respect to any Person, that such Person either (A) (i) has total assets (in name or under management or advisement) in excess of $[_____________] (exclusive of the Property) and (except with respect to a pension advisory firm, asset manager or similar fiduciary) capital/statutory surplus or shareholder’s equity or net worth of at least $[_____________] (exclusive of the Property) and (ii) has ownership interests in or operates [insert description of applicable property type (e.g., Class A office buildings)] in [insert description of comparable market (e.g., central business districts of major metropolitan markets in the United States)] totaling at least [___________] square feet (exclusive of the Property) or (B) (i) has total assets (in name or under management or advisement) in excess of $[_________________] and (except with respect to a pension advisory firm, asset manager or similar fiduciary) capital/statutory surplus or shareholder’s equity or net worth of at least $[_________________] and (ii) is otherwise reasonably acceptable to Lender.

SCHEDULE II

SAMPLE QUALIFIED MEZZANINE LENDER DEFINITION

“Mezzanine Lender Eligibility Requirements” means, with respect to any Person, that such Person (i) has total assets (in name or under management or advisement) in excess of $[_____________] and (except with respect to a pension advisory firm, asset manager or similar fiduciary) capital/statutory surplus or shareholder’s equity or net worth of at least $[_____________] and (ii) is regularly engaged in the business of making and/or owning (or, in the case of a pension advisory firm or similar fiduciary, regularly engaged in managing investments in) commercial real estate loans (including mezzanine loans to direct or indirect owners of commercial properties, which loans are secured by pledges of direct or indirect ownership interests in the owners of such commercial properties) or owning and/or operating commercial properties.

“Qualified Mezzanine Lender” means one or more of the following:

(a) a real estate investment trust, bank, saving and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, government entity or plan, sovereign wealth fund, private equity fund, REIT or real estate operating company, provided that any such Person referred to in this clause (a) satisfies the Mezzanine Lender Eligibility Requirements;
(b) an investment company, money management firm or “qualified institutional buyer” within the meaning of Rule 144A under the Securities Act or an institutional “accredited investor” within the meaning of Regulation D under the Securities Act, provided that any such Person referred to in this clause (b) satisfies the Mezzanine Lender Eligibility Requirements;

(c) an institution substantially similar to any of the entities described in clause (a), clause (b) or clause (d) that satisfies the Mezzanine Lender Eligibility Requirements;

(d) any entity 100% owned by and Controlled by, Controlling or under common Control with any one or more of the entities described in clause (a), clause (b) or clause (c) above; or

(e) any Person approved by Lender in its sole discretion, and, following a Securitization, for which the Rating Agencies have issued a Rating Agency Confirmation with respect to such Person being the Permitted Mezzanine Lender under the Permitted Mezzanine Loan.

provided that in no event shall an affiliate of any Borrower Party be a Qualified Mezzanine Lender.

SCHEDULE III

SAMPLE BORROWER COMMENTS TO SECURITIZATION INDEMNITY PROVISIONS

(a) If Borrower shall provide in connection with each receive from Lender portions of (i) a preliminary and a final private placement memorandum or (ii) a preliminary and final prospectus or prospectus supplement, as applicable, in each case, identified by Lender as specifically pertaining to Borrower, Borrower’s Affiliates, the Property, the Affiliated Manager, Sponsor or Guarantor (the “Specified Sections”) and a reasonable opportunity to review the same, Borrower shall, upon Lender’s request, enter into an agreement (A) certifying that Borrower has examined such Disclosure Documents Specified Sections specified by Lender and that each such Disclosure Document Specified Section, as it relates to Borrower, Borrower Affiliates, the Property, the Affiliated Manager, Sponsor or Guarantor and all other aspects of the Loan, does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. (B) indemnifying Lender (and for purposes of this Section 11.2, Lender hereunder shall include its officers and directors), the Affiliate of Lender (“Lender Affiliate”) that has filed the registration statement relating to the SECURITIZATION (the “Registration Statement”), each of its directors, each of its officers who have signed the Registration Statement and each Person that controls the Affiliate within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act (collectively, the “Lender Group”), and Lender Affiliate, and any other placement agent or underwriter with respect to the SECURITIZATION, each of their respective directors and each Person who controls Lender or any other placement agent or underwriter within the meaning of Section 15 of the Securities Act and Section 20 of the Exchange Act (collectively, the “Underwriter Group”) for any losses, claims, damages or liabilities (collectively, the “Liabilities”) to which Lender, the Lender Group or the Underwriter Group may become subject insofar as the Liabilities arise out of or are based upon any untrue statement or alleged untrue statement of any material fact contained in such Specified Sections or arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated in such sections or necessary in order to make the statements in such sections, in light of the circumstances under which they were made, not misleading at to Borrower, Borrower’s Affiliates, the Property, the Ground Lease, Affiliated Manager, Sponsor or Guarantor and (C) agreeing to reimburse Lender, the Lender Group and or the Underwriter Group for any legal or other expenses reasonably incurred by Lender, the Lender Group and the Underwriter Group in connection with investigating or defending the Liabilities; provided, however, that Borrower will be liable in any such case under clauses (B) or (C) above only to the extent that any such loss claim, damage or liability arises out of or is based upon any such untrue statement or omission made therein in reliance upon and in conformity with information furnished to Lender by or on behalf of Borrower in writing in connection with the preparation of the Disclosure Document or Exchange Act Filing described in subsection (c) below or in connection with the underwriting or closing of the Loan, including, without limitation, financial statements of Borrower, operating statements and rent rolls with respect to the Property (collectively, the “Provided Information”). The indemnification provided for in clauses (B) and (C)
above shall be effective whether or not the indemnification agreement described above is provided; provided, however, such indemnity shall be limited to the Provided Information and shall only be effective to the extent that Lender accurately states the Provided Information in the applicable Disclosure Document. Borrower shall be provided five (5) Business Days to comment on the Specified Sections as they relate to Borrower, Borrower’s Affiliates, the Property, Affiliated Manager, Sponsor or Guarantor and neither Borrower’s certification nor any indemnities shall cover any portion of any information that Borrower has objected to or otherwise commented on in writing, unless the changes required to remove such objections or otherwise required by such comments are made. Without limiting the foregoing, it is also agreed and acknowledged that Borrower’s certification and indemnities shall exclude and Borrower shall have no liability for third-party reports ordered by Lender and the information contained therein, nor for information regarding Tenants or subtenants or their affiliates (unless such information was prepared or generated by Borrower, Affiliated Manager or such other agent of Borrower and set forth in the Provided Information), the other parties to the Property Documents and their affiliates (unless such information was prepared or generated by Borrower, Affiliated Manager or such other agent of Borrower and set forth in the Provided Information), market conditions or the description of risks (including legal and tax risks). Borrower shall also have no liability with respect to numbers which have been adjusted from the numbers provided by or on behalf of Borrower. The conditions and limitations on Borrower’s obligations and liabilities contained in the preceding three sentences are sometimes referred to herein as the “Indemnification Limitations”. The aforesaid indemnity will be in addition to any liability which Borrower may otherwise have.

(b) In connection with Exchange Act Filings, Borrower shall (i) indemnify Lender, the Lender Group and the Underwriter Group for Liabilities to which Lender, the Lender Group or the Underwriter Group may become subject insofar as the Liabilities arise out of or are based upon the omission or alleged omission to state in the Disclosure Document a material fact required to be stated in the Disclosure Document in order to make the statements in the Disclosure Document, in light of the circumstances under which they were made, not misleading any untrue statement of any material fact relating to Borrower, Borrower Affiliates, the Property, Affiliated Manager, Sponsor or Guarantor and (ii) reimburse Lender, the Lender Group or the Underwriter Group in connection with defending or investigating the Liabilities; provided, however, that Borrower’s liability under clauses (i) and (ii) above shall be effective only to the extent that Lender accurately sets forth the Provided Information in the applicable Exchange Act Filing and shall be limited by the Indemnification Limitations (as if the reference therein to indemnities were a reference to the indemnity and reimbursement obligations contained in this subsection (b)). The obligations of Borrower pursuant to this subsection (b) shall be in addition to but not in duplication of subsection (a) above.

(c) Borrower shall indemnify Lender and its officers, directors, partners, employees, representatives, agents and Affiliates against any Losses to which Lender or its officers, directors, partners, employees, representatives, agents and Affiliates, may become subject actually or in connection with any indemnification to the Rating Agencies in connection with issuing, monitoring or maintaining the Securities insofar as the Losses arise out of or are based upon any untrue statement of any material fact in any information provided by or on behalf of Borrower in writing to the Rating Agencies (the “Covered Rating Agency Information”) or arise out of or are based upon the omission to state a material fact in the Covered Rating Agency Information required to be stated therein or necessary in order to make the statements in Covered Rating Agency Information, in light of the circumstances under which they were made, not misleading, but the foregoing indemnity shall be limited by the Indemnification Limitations (as if the reference therein to indemnities were a reference to the indemnity contained in this Section subsection (c)).