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# Practice Makes Perfect

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# Payoff Letters – Routine until Rocky

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**By Kurt Oosterhouse**
Partner | Fund Finance

**By Steve Bleiberg**
Associate | Fund Finance

The practice of law. Why is it called “the practice”? One definition in this context is: “to perform (an activity) or exercise (a skill) repeatedly or regularly in order to acquire, improve or maintain proficiency.”

For those of us with law degrees, we know that there is no magical knowledge download or access to a secret data room that occurs once you graduate law school or pass the bar exam. It brings to mind the well-known joke of the guy on the street asking a stranger how to get to Carnegie Hall, who gets the response: “practice, practice, practice.” Well, that certainly applies to the practice of law. While “practice makes perfect” is part of the practice of law, and “market practice” is a path which we often follow, the core point is that the practice of law is a cumulative process – quite simply, the more you see and “practice,” generally, the more you know.

At least for the authors, no matter how far law school is in your rearview mirror, every once in a while a question is raised that is basic and fundamental, but yet the “legal” answer is: “That’s just how it is always done.” It’s those questions that bring one back to the uncertain days where everything was new, and calls into question why you don’t know the legal explanation to such a basic question that even the 3rd-year version of yourself would be hesitant to ask why that is the case.

So what is that basic question/issue of the day, month or year? Payoff letters. Yes, payoff letters. Not the four-page payoff letter with five annexes contemplating a foreign acquisition in three different currencies (that is mostly funds flow), but the fundamental legal principles underlying the use of and the market practice of payoff letters.

### Existing Lender Signature Pages “In Escrow”

First, well actually, this was going to be the last point, but we wanted to get it out of the way. When your client is getting paid off and you are issuing the payoff letter, you cannot put your signature pages “in escrow.” This conversation used to be only with junior lawyers (and then only occasionally), but this conversation seems to be occurring more and more, including at the end of the longest payoff letter experience (discussed in more detail below). In that deal, a very senior opposing counsel for the lender being taken out insisted that his client’s signature page to their payoff letter was to be held in escrow “pending receipt of the funds set forth in the

payoff letter." Granted, in the transactional space, we throw around the term "in escrow" much more cavalierly than in, for example, a real estate transaction in which there is often a true escrow agent and agreement, but nevertheless, at the core, there is a legal timing issue at play that is extremely substantive.

A payoff letter is more than just a statement of the payoff amount. A payoff letter also sets forth the conditions upon which the existing lender will terminate the loan documents and release its liens on the borrower's collateral. Thus, the releases (UCCs, etc.) in the payoff letter are conditional upon the conditions in the letter (receipt of the funds, etc.), not the enforceability of the letter itself, which would be the case by putting your pages "in escrow." In a payoff scenario, someone must take the first step, and that first step needs to come from the existing lender providing an enforceable agreement stating the conditions to its release. The existing lender's protection is if the conditions in the letter aren't satisfied (*i.e.*, they don't get 100% of their money), they don't have to release anything. On the other hand, from a risk standpoint, if the payoff letter remains "in escrow" pending the receipt of the funds, the new lender is being asked to fund the payoff (secured loan) based on a yet-to-be effective payoff letter. Thus, the new lender has no enforceable agreement (except for the legal remedies discussed below) that the UCCs, etc. will be released when the new lender sends the existing lender the payoff amount, and thus, it is exposed if the existing lender changes its mind and decides to pull back its "in escrow" pages while the payoff is in transit. If timing of the payoff affecting the amount is an issue (or something else), add a per diem or an expiration date to address those concerns.

**Payoff Disputes**

From there, let's pivot the discussion to the question of: what is the law underlying the payoff letter process? Since the payoff letter process is usually pretty rote, that task is often delegated to more junior lawyers, since the more "seasoned" among us think we have long since added that to our "practice of law" library – that is, until you have a borrower client that says: "I will not under any circumstance agree to any payoff letter that has a release of the lender in it, so what are my options?"

Since most every transactional lawyer has worked the payoff letter process, it's probably safe to say we have all had discussions regarding the correct payoff amount related to fees, argument over breakage, etc., which are eventually worked out. Further, it's not uncommon to have situations regarding whether to include a general release or not, but eventually cooler heads, a plea to market convention, and/or a relationship call prevails, and an adequate payoff letter is agreed to and the transaction closes.

Unfortunately, the context of the question in this case didn't have any of those practical options available. Instead, the question came from an operating company trying to refinance a non-traditional lender with a traditional lender. Let's just say that the relationship between the operating company and their existing non-traditional lender was "rocky" (think *Rocky IV*, not *Rocky I-III*).

The fundamental impasse was: (i) the existing lender demanded a general release from the borrower as a condition to providing a payoff letter and (ii) the borrower refused to grant any general release so as to preserve possible claims against the existing lender.

The legal/practical question was: how do you close a secured transaction in which the existing lender and borrower cannot agree to a payoff letter and as a result, no payoff letter will exist? Not unlike most of the issues faced in the transactional world, what we found out was that there were two distinct paths: the legal, litigation ("what would a court/judge do?") path and a practical, market practice ("what needs to be done to close the deal?") path. Spoiler alert: those paths don't cross.

**The Legal Path – Voluntary Payment Doctrine**

Absent a requirement in the loan agreement, a lender being paid off is not obligated to provide a borrower with a payoff letter/lien release, but they are obligated to provide a payoff amount. Under NY UCC 9-210, a borrower has a right to request "an accounting of the unpaid obligations secured by collateral" or to get approval or correction of "what the debtor believes to be the aggregate amount of unpaid obligations secured by collateral as of a specified date." N.Y. U.C.C. Law § 9-210 (McKinney). Further, if a borrower tenders the amount of the requested payoff to the existing lender, the existing lender is required to release its liens. "There can be no lien without a debt, and that therefore, there can be a valid mortgage and lien only if and so long as there is a debt." In re Cichanowicz, 226 F. Supp. 288, 291 (E.D.N.Y. 1964) and "Where, however, there has been actual payment or the debt has, in fact, been retired, a mortgage given as security for that debt is extinguished." Home & City Sav. Bank v. Sperrazza, 204 A.D.2d 836, 837, 612 N.Y.S.2d 259, 260 (3d Dep't 1994). As a practical matter, however, while the debt is extinguished, without a payoff letter explicitly authorizing the borrower to terminate the financing statement (in order to get their new lender comfortable), the borrower must attempt to obtain authorization from the now paid off lender to terminate its financing statements. Pursuant to Section 9-513(c) of the UCC, if the obligations have been terminated and the borrower sends an authenticated demand to the paid off lender requesting termination, the lender then has 20 days to either terminate or authorize the termination of the filing. If this does not happen within the 20-day time frame, the borrower is authorized to file the termination statement pursuant to Section 9-509(d) of the UCC.

What if there is a dispute as to the payoff amount or, as in our case, the borrower wants to preserve non-payoff related claims against the existing lender? What is the impact of making a payment (relative to preserving claims) or making a payment of the disputed amount demanded by the existing lender and simply fight about the correct amount later? The answer to the second question is pretty clear. The voluntary payment doctrine "bars recovery of payments voluntarily made with full knowledge of the facts, in the absence of fraud or mistake of material fact or law." (Dillon v. U–A Columbia Cablevision of Westchester, 00 N.Y.2d 525, 760 N.Y.S.2d 726, 790 N.E.2d 1155 [2003]). The onus is on a party that receives what it perceives as an improper demand for money to "take its position at the time of the demand, and litigate the issue before, rather than after, payment is made." (Gimbel Bros. v. Brook Shopping Ctrs.,118 A.D.2d). 532, 535, 499 N.Y.S.2d 435 [2d Dept.1986]). [DRMAK Realty LLC v. Progressive Credit Union, 133 A.D.3d 401 (2015).] Therefore, if the borrower simply pays off the existing lender, the borrower will lose the ability to recover the disputed payoff amount after the fact. "In order for a protest to be characterized as appropriate, it must be in writing and must have been made at the time of payment." (Neuner v. Newburgh City Sch. Dist., 92 AD2d 888, 459 NYS2d 874 [2nd Dept 1983]).

With respect to the preservation of claims, the answer is much more murky. The safest route for a borrower wanting to preserve claims against an existing lender in connection with its payoff would be to express its reservation of rights, in writing, no later than the payoff. The reason: based on an extension of the voluntary payment doctrine, if a borrower doesn't provide a reservation of rights at the time of payoff, any existing claims are deemed waived.

Applying our fact pattern to the legal path, the conclusions were: (i) the borrower has the right to demand a payoff amount; (ii) once the borrower sends the existing lender the full payoff amount, the existing lender is required to release its liens; and (iii) the question of reservation of rights isn't clear beyond the strongest position requires some prior notice of a reservation of rights. The remaining open question was whether an existing lender's prior or simultaneous notice of a borrower's reservation of rights would be grounds for a lender to refuse a full payment. While not clear, we believe the "right answer" should be that an existing lender could not refuse full payment because of a reservation of rights "string attached," since that payment (and not a general release) is all the lender is legally owed.

**The Practical Path – How to Close the Transaction**

Based on the above, while an existing lender isn't required to provide a payoff letter, a borrower can ultimately get to the same place as it would with a payoff letter – and likely preserve non-payoff related claims against the lender. So, borrower wins? If this were a law school question, we believe the answer is yes. If a borrower were to pursue the legal path (litigation, demands of specific performance, authenticated demand under the UCC, etc.), yes – eventually, we believe that a court would require an existing lender to accept payment, subject to a reservation of rights, and release its liens following the lender's acceptance of payment.

As noted in the spoiler alert, however, the legal path wouldn't likely be a practical answer to a payoff letter stalemate or a way to get your deal closed. Why? First, timing. As we all know, most transactions need to close within some period of time dictated by a borrower need, maturity, etc., and thus, the idea of pursuing an open-ended litigation path simply is not practical unless the benefit (lender liability claim, etc.) is worth the cost of an infinite delay. Second, speaking of cost, while we are not litigators, we can attest to the inordinate amount of time that was spent on this issue before a single motion was filed, and thus, we can only imagine the costs of a protracted litigation. Finally, the lack of a willing partner (new lender). Similar to the payoff letter "in escrow" discussed above, while all risks ultimately fall on the borrower, for the litigation path to work, the new transaction either needs to be placed on hold or, to proceed, the borrower would need its new lender to agree to bear the risk of funding a secured loan to a borrower into a situation in which it knowingly has no written legal assurance that once it sends the payoff funds to the existing lender, the new lender's liens on the borrower will be first priority. Absent special circumstances, it is unlikely that a new lender would accept that risk.

**Conclusion**

While practice makes perfect, and generally the more you see, the more you know, there is also a reason (most of the time) that "market practice" is the path we follow. While the legal path generally leads to the "right answer," in the transactional world, the time and expense of pursuing that path simply isn't feasible, since we have a deal to close.

As a result, whether it is your own practice experience that guides your advice or simply market practice, in the case of payoff letters, there are legal and practical underpinnings as to why we (almost) without hesitation expect and rely upon the existence of payoff letters. So what do you say to a client who says, “I will not under any circumstance agree to any payoff letter that has a general release of the lender in it, so what are my options?” Our answer is: there are two paths. The first: if you are willing to put your closing on indefinite hold and spend the time and money choosing to litigate your dispute, you will likely get to the same place as you would with a payoff letter. The second and better path: rely upon the time-tested practical alternatives of appealing to cooler heads, citing market convention and/or a timely placed relationship call to ensure that an adequate payoff letter is agreed to so that the transaction can close as planned.

## 'Fund Finance Friday: Industry Conversations' — An Update on FFA 'Virtual Week' (8 minutes)

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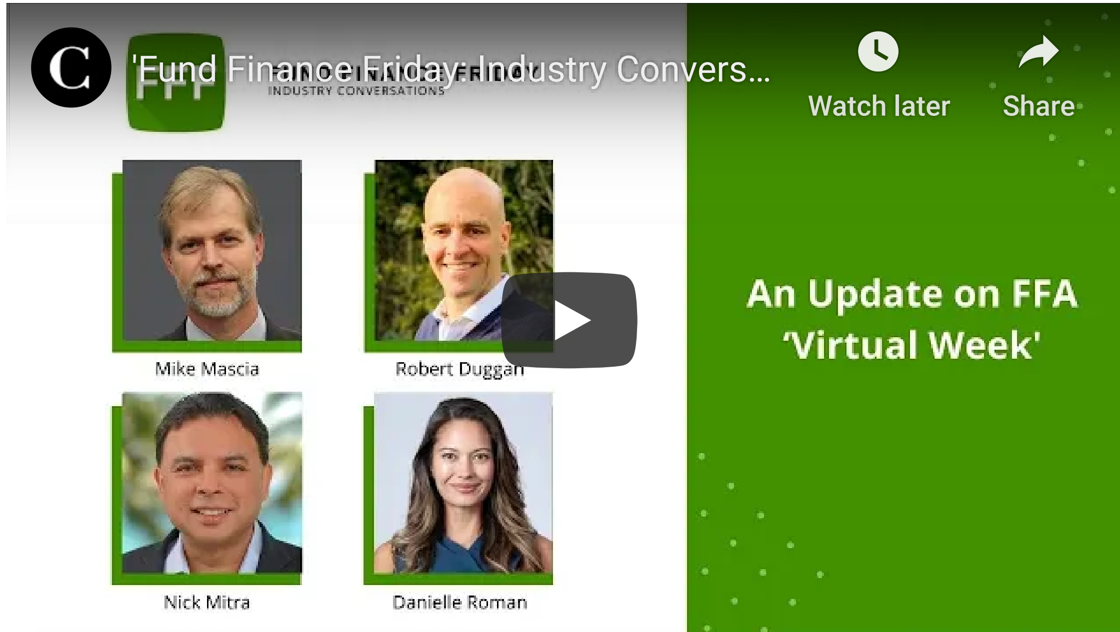
In this week's *Fund Finance Friday: Industry Conversations*, Robert Duggan, Nick Mitra and Danielle Roman join Mike Mascia to discuss the content and speakers for the FFA's upcoming Virtual Week.

If you cannot access the video below, please **click here** to watch.



## FRB Provides PE Data Analysis in Quarterly Report

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First Republic Bank explains why the fund finance industry and subscription credit facilities have passed the COVID-19 test in spite of fundraising and broader economic challenges. FRB analyzed 2020 private equity data and trends, predicting that a stronger, more diverse fund finance market will emerge. See the following link for more details: **First Republic Bank Report.**

## Walkers Reviews Market Trends for Q4 and Q1 2021

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In *Walkers Offshore Fund Finance Update – Asia, Europe & US Markets*, Walkers notes recent trends, including differences in the range of deals they are seeing across the markets, their anticipated activity for deals going into 2021, and general observations on how long deals are taking to close and the potential impact on financing terms. In addition, Walkers notes some of the activity around the Private Funds Law and the response of lenders and funds to address compliance. The update is available **here**.

## Ganryu Capital Partners’ NAV Facilities Playbook

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In its “NAV Facilities Playbook,” Ganryu Capital Partners has put together a guide to designing tailored NAV facilities, and shows how these bespoke, asset-backed arrangements can be used to supplement traditional subscription credit facilities throughout the life of a fund. The playbook lays out the general purposes, terms, and structuring options for NAV facilities and explains how managers can utilize these “strategic fund finance tool[s]” to manage a fund’s liquidity needs, provide portfolio support, and maintain access to third-party financing after the end of the investment period. Complete the form **here** to download a copy of the playbook.

## Lexology Article on Concentrated NAV Facilities

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*Lexology* recently featured an article – authored by Khizer Ahmed, Managing Partner, Hedgewood Capital Partners; Matthew Kerfoot, Partner, Dechert; and Edward Newlands, Partner, Dechert – titled “NAV Facilities: The ‘Small’ Approach That’s Big News in Fund Finance” that considers the so-called “concentrated NAV facilities,” and highlights how such facilities are distinguished from traditional NAV facilities. The article provides insight on general partners’ recent interest in concentrated NAV facilities, addresses uses and benefits of this type of facility and provides some helpful considerations for borrowers before seeking a concentrated NAV facility. Click **here** to read the full article.