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# Real Estate Reserves

# October 28, 2021

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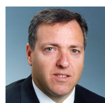
## Basics of Reserves



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Reserves are amounts deposited with a lender as security for an obligation expected to occur at a future date, and can serve various functions. The following is an overview of typical reserves in a real estate finance transaction.

**Required Repairs**

Lenders typically commission property condition reports in connection with a financing which detail immediate repairs anticipated to be required in the short-term for a property. The time frame ranges from work needed immediately to work which should be accomplished over the next 6-12 months. Work beyond that time frame would typically be characterized as a capital expenditure project, which would be addressed in another potential reserve. The anticipated cost of required repairs would be held back from the loan proceeds at closing and funded into a reserve account for such work. Such funds are then released either as progress payments to fund such work or in a lump sum as such work is completed.

**Real Estate Taxes**

Since most real estate taxes, if not paid, are a lien on real property which is senior to the lien of a first mortgage, many lenders require that a borrower maintain a reserve for real estate taxes. Typically, a borrower would make deposits into such reserve on a monthly basis in an amount equal to one-twelfth of the annual real estate taxes such that when real estate tax payments (usually semi-annual payments) are due, the appropriate amount is on deposit. Disbursements from these reserves are either made directly to the taxing authority or to the borrower against evidence of the payment of the real estate tax obligation.

**Insurance**

Since most real estate financing is structured as non-recourse, whereby upon a default the lender's remedy is to foreclose and obtain title to the real estate without recourse to a creditworthy entity for any deficiency, the maintenance of insurance on the property is critical. If the building is destroyed and there are no insurance proceeds available, then the lender's recourse is limited to a piece of land with a partially or totally demolished building. Consequently, it is typical for a borrower to make monthly deposits into a reserve equal to one-twelfth of the premium anticipated to be due on the insurance policy such that the lender has a sufficient amount to pay such premium when due. Disbursement of the premium payment is either made directly to the insurer by the lender or to the borrower against evidence of payment of the premium.

**Capital Expenditures**

Similar to immediate repairs, over the long-term, properties require repairs and maintenance which are capital in nature. To ensure that funds are available to pay

for such significant items as they come due, lenders will typically require that a certain amount (usually codified as an amount per square foot) be deposited in a reserve for future capital improvements. Mechanisms and requirements for disbursements from this reserve, while similar to that for immediate repairs, tend to be a bit more robust given that these items tend to be more significant and are in larger sums. Consequently, the requirements for disbursement are more consistent with slimmed-down requirements for disbursements which are typical for a construction loan.

**Tenant Improvements and Leasing Commissions**

In order to lease vacant space, landlords have to expend significant sums in order to pay brokerage commissions and costs of tenant improvements. In order to be competitive in the leasing market, landlords must expend such sums to induce tenants to rent space in their buildings. Consequently, in order to anticipate the amounts that will be needed to re-lease existing vacant space and space anticipated to be vacant during the term of a loan due to the "roll-over" of existing tenants (*i.e.*, the renewal of an existing lease or the reletting of such space to a new tenant), lenders will require amounts to be deposited into a reserve which will typically include a lump sum amount at closing, together with monthly deposits to accumulate sufficient amounts to pay such sums. Disbursements are made after a new lease is signed to pay such brokerage commissions and to fund required payments of the reimbursement to tenants of tenant improvement work in the form of a tenant allowance or to fund work which a landlord performs to induce such tenant to rent such space.

**Ground Rent**

To the extent that a property is not owned in fee, but is owned pursuant to a long-term ground lease, the efficacy of such ground lease is critical to the lender since, should the ground lease terminate, the lender's collateral disappears since its mortgage lien is limited to the ground leasehold interest, not the fee. In addition to the numerous protections afforded the lender in a ground lease to make it a "financeable" ground lease, such as notice and cure rights in the event of a default, lenders will require that a reserve for the payment of the anticipated ground rent be established. The reserve held by the lender will be funded with monthly amounts such that an amount equal to the required ground rent payments are always available to pay such rent directly to the ground landlord.

**FF+E**

In financings of hotels, it is customary to reserve funds for FF+E or furniture, fixtures and equipment. Hotels, in general, refurbish and update their entire property on a periodic basis. This practice is driven mainly by requirements of the manager or "flag" running the hotel. Management contracts require that hotels are refreshed and updated periodically so they are consistent with the franchise requirements and, theoretically, will attract customers to a newly refurbished property. Consequently, lenders will require that a percentage of gross revenues, usually 4%, is deposited into a reserve to pay for such refurbishment. Many management contracts with the major flags will require that this reserve is maintained by the manager, but if not, the lender will maintain same. Disbursements from the reserve are typically made against evidence of completed work or purchase.

**Free Rent**

Many tenants, as part of their economic deal or package of inducements to lease their space, may receive a certain amount of rent abatement or free rent. Many times, this is just reflected in the lease as the tenant having no obligation to pay rent over the first 1, 3, 6, 9 months or longer of the lease term. In certain cases, the abated rent may be spread out over longer periods of the lease term on a periodic basis such that the tenant receives the abatement during the first 3 months of each of the first, fifth and seventh year of the lease term, for example. Regardless of the arrangement, many lenders are concerned about the interruption of the cash flow of the property and may require an upfront or periodic deposit of sums equivalent to this free rent such that the cash flow of the property does not have significant shortfalls. Disbursements from this reserve would mirror the applicable free rent periods.

**Conclusion**

The foregoing outlines some of the more typical reserves seen in real estate financing. It should be noted, however, that there are many other reserves that are used in real estate financings to address deal-specific or property-specific issues. As outlined, reserves are a useful way for lenders to address property-specific issues, smooth out cash flow and protect against various issues.

# Limited Recourse Finance Series, Part 4: Other Common Issues in Limited Recourse Structures

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In the final part of this four-part series, we explore some of the common issues that may arise in limited recourse structures, as well as ways to address or mitigate the risks and costs.

**Intra-Group Transfers – Stamp Duty Land Tax (SDLT)**

For some portfolio companies, one of the due diligence issues for the lender is to ask whether properties and/or companies were subject to intra-group transfers as a result of corporate restructure, or whether there are any plans to do so during the term of the loan. Although intra-group real estate transfers are generally not subject to UK stamp duty on the basis that SDLT intra-group relief applies[1], this relief would be subject to clawback where (among other things) the Transferee leaves the SDLT group within three years of the transfer of the property.[2]

From a lender's perspective, there are two methods in practice to address the risk of any SDLT relief being clawed back:

1. that there are adequate restrictions in the facility documentation to ensure that any restructuring, or any Obligor or member of the same tax group leaving the Borrower's SDLT group, is prohibited if such action would give rise to a withdrawal of SDLT group relief; and
2. any enforcement action which may constitute breaking up the SDLT group, and thereby triggering the SDLT clawback, should be considered carefully and adequate measures should be included to mitigate the risks and also the potential liability.

The clawback provisions of SDLT group relief are not mirrored in the stamp duty provisions applicable to intra-group share transfers, but the reliefs are broadly similar in other respects. Where partnership entities are involved in an SDLT group relief claim (whether the partnership interest is itself being transferred or there is a partnership within the group), particular care needs to be taken to avoid the loss of intra-group relief which might jeopardize the economics of the limited recourse financing.

**Tax Group Consolidation**

It is common for group companies to form a corporation tax group in the UK. Tax grouping enables members in the same tax group to allocate gains and surrender losses between members of the group on a current-year basis. Although each member of the tax group is subject to its own primary corporation tax liabilities, where such tax liabilities are not paid by one particular member, it is then possible

for HMRC to recover that tax as a secondary liability from another member of the group.

Given that the nature of limited recourse financing is to ensure all assets and liabilities are ring-fenced in the same borrowing group, the sponsor may therefore wish to ensure that the borrowing entities are separated from the rest of the group for tax-grouping purposes, so as to avoid any cross liabilities which may arise.

If, however, the financing group is part of a wider tax group, one of the liabilities that may require investigation by the lender is the possibility of unpaid liabilities from members of the group outside the ring-fenced security structure. The lender may wish to include covenants and other safeguards against this potential risk.

**Shareholder Security – Some Common Considerations**

As discussed in Part 3 of this series, it is often expected that the holding company of the SPV Borrower grant security over (i) the Borrower's shares and (ii) to the extent applicable, any shareholder debt. The security over these two assets is to ensure that, upon enforcement, the lender has an option to undertake a corporate sale of the Borrower, free from the subordinated sponsor debt.

From the sponsor's perspective, because the security is only provided for a very particular set of assets (shares of the Borrower SPV and related debt into such SPV), care must be taken to ensure the recourse to the shareholder is limited to these assets only, and not beyond. Therefore, the shareholder security is often one of the more negotiated documents.

Some of the provisions which may be negotiated include:

1. enforcement of the shareholder security should not trigger insolvency proceedings on the shareholder. This is often quite important where the shareholder is the holding company for multiple SPVs and intends to obtain separate limited recourse financing for other SPVs and other real estate projects;
2. restrictions on non-competition or ability to claim on the debt by the shareholder; however, the shareholder may wish to retain the ability to claim its debt upon the insolvency of the Borrower. It is often expected that the lender, being a first-ranking secured party, would want to dictate when and how enforcement may take place over the assets. With respect to the subordinated debt, the lender would require the debt to be fully subordinated at all times whilst the loan is outstanding and payments are only allowed in specific circumstances (usually if there is a surplus cash flow after servicing the loan). Therefore, the lender would usually include a host of restrictions on the shareholder such as restricting its ability to make any claims on the debt or call in the debt, if such action is in competition with the interests of the lender. That said, if insolvency proceedings have been commenced with respect to the Borrower, the shareholder would want to make a claim on its debt to ensure its liabilities constitute part of the overall liabilities of the borrower in the insolvency proceedings.

**Final Thoughts**

Over the past few months in *REF News and Views*, we have discussed some of the key characteristics of limited recourse financing, which remains a common and preferred approach with respect to real estate financing in Europe.  We also explored some of the common issues that may arise in these structures and also issues to be considered in taking security. We encourage our readers to keep this **four-part series** on-hand as a reference guide.

[1] Paragraph 1, Schedule 7, Finance Act 2003

[2] Paragraph 3, Schedule 7 of Finance Act 2003

## Recent Transactions

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

Recent transactions include:

- Represented the lender in a $414 million securitized mortgage loan to finance the acquisition of One Memorial Drive, a Class A office building located on the Charles River in Cambridge, Massachusetts by MetLife Investment Management, the institutional asset management business of MetLife, Inc., and Norges Bank Investment Management, representing the largest single-asset U.S. office transaction to date in 2021.

- Advised on the financing of Medline Industries' U.S. real estate operations as part of a majority investment from a partnership comprised of funds managed by Blackstone, Carlyle and Hellman & Friedman.

- Represented the lender in a $340 million securitized mortgage loan to refinance the 258-room Montage Laguna Beach oceanfront resort in Laguna Beach, California.

- Represented Reliance Standard Life Insurance Corporation as mezzanine lender in a $29 million mezzanine loan to refinance The Centre at Purchase, an office building campus in Purchase, New York.

- Represented Bank of America, N.A. as mortgage and mezzanine lender in a $211 million financing in connection with the acquisition of a portfolio of industrial "flex" properties in Victorville, California.