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Alterations Provisions

April 28, 2022

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Alterations Provisions in Loan Documents


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In real estate financing, most loan documents restrict a Borrower's right to alter the collateralized real property. Alterations provisions in loan documents pertain to any alterations, improvements, or demolition of any improvements to the property. Since most real estate financing is non-recourse in nature, the Lender is rightly concerned that alterations to the collateralized property may impact the Lender's only asset in the event of a Borrower default. Even when a financing is not non-recourse, a Lender is also rightly concerned with alterations to the real estate collateral since it is looking, either wholly or partially, to that collateral as security for its loan.

In a typical transaction, alterations to the property which are above a threshold or are "material" or "structural" in nature will require the Lender's prior written consent. The threshold under which the Borrower may alter the property without the consent of the Lender is defined in the loan agreement as either a dollar amount or a certain percentage of the sum of the aggregate original principal amount of the loan. In addition, many loan agreements provide that the Lender's prior written consent is not required with respect to alterations that would not reasonably be expected to result in a material adverse effect, often defined as any event or condition that has a material adverse effect on the use of the property, the business of the Borrower, the enforceability, validity, perfection or priority of the lien of the mortgage or other loan documents, or the ability of the Borrower to satisfy any of its material obligations under the loan documents. Notwithstanding this threshold, many loan documents will list specific types of alterations that do not require the Lender's consent, some of which may include the following:

- repairs based on life safety or emergency conditions or which are required to comply with applicable legal requirements;
- preapproved alterations;
- non-structural or decorative work performed in the ordinary course of the Borrower's business;
- alterations made pursuant to an approved annual budget;
- alterations with respect to any existing lease as of the closing date; and
- alterations and repairs arising out of a casualty or condemnation.

While this list is not exhaustive, the specifics of a transaction will dictate the list of alterations that do not require the Lender's consent.

If the Borrower’s requested alterations exceed the threshold amount, in addition to requiring the Lender’s consent, the Borrower is required to post collateral as security for the completion of the work in a lien free manner. This may be in the form of cash, acceptable government securities, a letter of credit, or a guaranty executed by a guarantor in favor of the Lender. The Borrower’s requirement to post collateral is to ensure that the parties completing the alterations are paid for their work and to avoid any liens on the property. Once the alterations are complete, the collateral is returned to the Borrower after the Lender is provided with lien waivers and a clean title report of the property.

Alterations provisions in loan documents are necessary to ensure the Lender is aware and consents to any major alteration projects. Constraints to alterations in favor of the Lender include consent, as well as the Borrower’s requirement to post collateral once a threshold amount is exceeded. In non-recourse lending, alterations provisions in loan documents are essential to the Lender’s protection of the collateralized property.

Further Developments in Mezzanine Foreclosures

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The New York State Supreme Court, New York County Commercial Division (the "Court") decided in *U.S. Bank, N.A. v. 342 Property LLC*,[1] on February 14, 2022, that a mezzanine lender that is not a party to loan documents that evidence a concurrent mortgage loan does not have standing and, therefore, no basis, to preclude a mortgage lender's motion for summary judgement in a foreclosure action against a mortgage borrower that is an affiliate of a mezzanine borrower.

Background

342 Property LLC (the "Mortgage Borrower") received a $40,000,000.00 mortgage loan (the "Mortgage Loan") secured by real property located in New York State and the hotel located thereon (collectively, the "Property"). The Loan was evidenced by a mortgage, promissory note, and other loan documents governed by New York law (the "Mortgage Loan Documents") in favor of U.S. Bank National Association, as trustee for Mortgage Stanley Capital I Inc. (the "Mortgage Lender"), by assignment from a previous lender.[2]

Additionally, Mortgage Borrower's parent company ("Mezzanine Borrower") received from Axonic Credit Opportunities Master Fund, L.P. (the "Mezzanine Lender") a $16,000,000.00 mezzanine loan (the "Mezzanine Loan") secured by a pledge of membership interests in Mortgage Borrower and evidenced by loan documents governed by New York law (the "Mezzanine Loan Documents").

Concurrently, Mortgage Lender and Mezzanine Lender entered into an intercreditor agreement, dated May 21, 2015, which established, *inter alia*, Mezzanine Lender's right to pay off the Mortgage Loan, conduct a UCC sale, and pursue recourse claims against Mezzanine Borrower to the extent that Mezzanine Borrower defaulted under the Mezzanine Loan Documents.[3]

Subsequently, Mortgage Borrower failed to pay the amounts then due and owing under the Mortgage Loan and defaulted under the Mortgage Loan Documents, ostensibly having suffered financial hardship resulting from COVID-19 restrictions.[4] After Mortgage Borrower and its affiliates agreed not to contest a foreclosure action in exchange for Mortgage Lender agreeing not to seek recourse against Borrower's principals, Mortgage Lender then brought a foreclosure action against Mortgage Borrower for failure to pay the Loan under the terms of the Mortgage Loan Documents.

The Mortgage Lender moved for summary judgment against the Mortgage Borrower in the underlying foreclosure action. Mezzanine Lender then asserted that Mortgage Borrower agreeing to allow Mortgage Lender to bring the instant

foreclosure action and the appointment of a receiver constituted a default under the Mezzanine Loan Documents and adversely affected Mezzanine Lender.[5]

The Court reviewed the Mortgage Lender's motion for summary judgment to determine, absent any material facts in dispute, whether Mortgage Lender's foreclosure claim may be decided as a matter of law.

Decision

Deciding in favor of Mortgage Lender, the Court granted Mortgage Lender's motion for summary judgment and held that Mezzanine Lender had "no basis to contest the Mortgage Lender's right to foreclose" on the Property.[6] That is, the Court held that Mezzanine Lender was not a party to the Mortgage Loan Documents and held no interest in the Property. As such, absent an agreement between Mortgage Lender and Mezzanine Lender providing otherwise, Mezzanine Lender lacked standing to assert claims or defenses against the instant motion.

The Court's decision in *U.S. Bank, N.A. v. 342 Property LLC* reaffirms the established principle that a mezzanine lender's recourse is subject to a mortgage lender's rights and defenses against an affiliate mortgage borrower that subsequently defaults under the mortgage loan, which also constitutes a default under the mezzanine loan.

We will continue to monitor future developments in this area and advise accordingly.

[1] *U.S. Bank N.A. v. 342 Prop. LLC*, 2022 N.Y. Slip Op. 30488(U).

[2] Complaint, dated October 08, 2020, Index No. 655136/2020 (Dkt. No. 2).

[3] Decision and Order on Motion Seq. 005, dated February 14, 2022, Index No. 655136/2020 (Dkt. No. 189).

[4] Decision and Order on Motion Seq. 005, dated February 14, 2022, Index No. 655136/2020 (Dkt. No. 189).

[5] Axonic Credit Opportunities Master Fund, L.P.'s Memorandum of Law in Opposition to Motion for Summary Judgment (Mot. Seq. 005), dated October 26, 2021, Index No. 655136/2020 (Dkt. No. 167).

[6] *See supra* fn. 4.

Green Loans Series, Part 3 – Green Loan Principles in Real Estate Finance

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In our March edition of *REF News and Views*, we focused on the four core components to qualifying as a Green Loan Principles ("GLP")-compliant green loan product. As a reminder, the GLP seeks to help facilitate and support environmentally sustainable economic activity by providing a framework of market standards, guidelines and methodology that can be consistently adopted across the green loan market, with the four key components being:

- Use of proceeds
- Process for project evaluation and selection
- Management of proceeds
- Reporting

Whilst the GLP is intended to support the general expansion of the market for sustainable finance products, it is also intended to be used in a real estate specific context, and in October 2020 the LMA published two guidance papers (the "Guidance") to specifically address some of the more frequently asked questions on the application of the GLP in real estate financing.

What qualifies as a real estate green project?

There is no qualified market definition for the term "green projects." It is therefore the responsibility of the market participants to agree to and clearly define the appropriate and applicable eligibility criteria for that green loan. The Guidance also recommends that this be documented carefully in the finance documents; in doing this, it could also help to mitigate accusations of "greenwashing."

The Guidance provides useful details of retrofit projects that qualify as green projects. Ultimately, retrofit projects should result in a material improvement in the energy efficiency of the building/portfolio of buildings being funded. It should also result in a material reduction in the carbon emissions associated with that building/portfolio of buildings.

Evaluating the real estate green project

Most green loans used in real estate financing are to develop and invest in green buildings. Like a '"green project," however, there is yet to be a recognised market standard definition and classification for a "green building." The Guidance therefore advises lenders to use external standards and certifications in order to measure the "greenness" of buildings, and it is recommended that the lenders detail such principles in the finance documents in order that the parameters are clear.

The Guidance also notes that lenders need to be wary that buildings which may be classified as green at the start of a loan term can cease to meet the requirements during the life of the loan. As such, it is prudent for the lenders to agree the methodologies and parameters for assessing the eligibility criteria not just on day one, but throughout the lifetime of the loan; such mechanisms can be addressed in the loan documentation. This also further extends to the principles mentioned above regarding segregating out the green loans from the non-green loans in order that such green loan proceeds can be appropriately tracked, together with its progress and application.

Reporting

The Guidance makes references to reporting, with recommendations that borrowers should aim to report at least annually on the use of the proceeds and on any material developments throughout. That said, it does recognise that such reporting requirements can depend on the size and nature of the transaction, project and borrower.

Closing thoughts on GLP

Whilst the GLP are ultimately voluntary, there are an increasing number of national and international measures and initiatives being discussed, created and imposed on corporate governance, climate change and sustainability that are starting to change how companies and the financial markets are operating and approaching their businesses.

With increasing socio-economic pressures, we fully expect to see a continued growth of green loans, as well as an evolution and development in the GLP over the coming years.

Recent Transactions

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

- Represented ACRES Loan Origination, LLC, as agent and lender, with respect to a mortgage loan in an amount up to $73,375,000 which will fund the construction of the Reflection Condominium located in St. Petersburg, Florida.
- Represented the administrative agent and lender in connection with a $646,900,000 mortgage and mezzanine financing secured by 75 industrial properties.
- Represented the administrative agent and lender in connection with a $420,000,000 mortgage and mezzanine financing secured by an office building located in the District of Columbia.
- Represented the administrative agent and the lender in connection with a $250,000,000 upsize to an existing credit facility to finance the acquisition of a self-storage portfolio of 26 assets located in 11 separate states.