C A D W A L A D E R

REF news and views

Limitations and LTVs

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New Limitations on Cooperative and Condominium Conversions

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Certain new provisions of the new New York State rent regulation and tenant protection laws will have a significant impact on condominium and cooperative conversions in New York State. The New York Housing Stability and Tenant Protection Act of 2019 (the "Tenant Protection Act") was enacted and became effective on June 14, 2019.

Prior to the enactment of the Tenant Protection Act, developers were permitted to convert rental apartment buildings into cooperative or condominium forms of ownership pursuant to an "eviction plan" (*i.e.*, the developer would have the right to evict current tenants) or a "non-eviction plan" (*i.e.*, the developer would not have the right to evict current tenants). The Tenant Protection Act has eliminated the right to convert a building pursuant to an "eviction plan."

However, New York State will now require that the effectiveness of any "non-eviction plan" for the conversion of a rental apartment building to a cooperative or condominium form of ownership will be conditioned on at least 51 percent of the tenants then renting apartments in the building entering into contracts with the sponsor to purchase their apartments. Prior to the Tenant Protection Act, in order for a "non-eviction plan" to be declared effective, the developer was required to enter into contracts of sale with respect to 15 percent of the units in the applicable building. These contracts could be with current tenants in the building or with bona fide non-tenant purchasers with the intent to reside in the applicable apartment. It is important to note that it is necessary for a condominium or cooperative offering plan to be declared effective before the developer can commence closing the sale of units in the building.

Furthermore, the Tenant Protection Act provides that existing tenants of the applicable building will have the exclusive right to purchase their apartments for a 90-day period after the applicable offering plan has been accepted by the New York Department of Law. An apartment cannot be shown to a potential third-party purchaser during such 90-day period unless the developer receives a waiver from the applicable tenant. In addition, the existing tenant will have a 6-month right of first refusal (from and after the expiration of the 90-day exclusive period) to purchase their apartments under the same terms and conditions agreed to by a bona fide purchaser.

The Tenant Protection Act also prevents developers from (1) evicting eligible senior citizens and eligible disabled persons who reside in free-market apartments (except for evictions related to non-payment of rent or lease violations) and (2) unconscionable rent increases with respect to eligible senior citizens and eligible disabled persons who reside in free-market apartments.

Given the dramatic change this new law effects, there has been quite a lot of press coverage about how these changes will effectively prevent the conversion of existing buildings to a cooperative or condominium form of ownership. In addition, some commentators have opined that these new requirements were designed to "protect" the affordable housing stock of New York City and protect tenants' rights to remain in their homes and, in effect, retain housing that can be rented by tenants in the future. Other commentators have suggested that the new statute will reduce housing stock since many developers will not enter the marketplace since it has become overregulated and hard to have economically viable rental properties. Time will tell, but the sweeping (and some would say draconian) nature of these provisions effectively may shut down the conversion market. There will still be ground-up construction of condominiums, but we would wager that we will not be seeing cooperative or condominium conversions any time soon unless these new provisions are amended to be more developer-friendly.

The ‘Range’ When Valuing for LTV Covenants


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Value preservation of the underlying real estate asset is fundamental in any conventional real estate financing transaction. With ongoing covenants and undertakings that seek to regulate the maintenance of the property and the conduct of business activities within it during the life of the loan, it is a common market practice that the borrower would be obliged under the loan agreement to ensure that the value of the property, and ultimately the lender’s collateral, is, at the very least, maintained.

Most conventional senior debt real estate origination financing loans are structured and credit approved based on loan to value (“LTV”), and whilst this is more commonly a Day 1-only measure in the U.S. market, in the European market monitoring of the LTV is an ongoing covenant. As such, valuations obtained during the life of a loan that accurately reflect the true market value of the property are critical when considering LTV covenant compliance, with the problem of non-compliance being that it could lead to a default in the loan. However, with evolving market conditions in the ever-changing real estate landscape, the range as to what is the “true” market value has potentially widened, opening up to some fascinating views on “permissible margins of error.” This article seeks to explore this further.

The ‘Range’

In the majority of senior debt real estate origination financing loan agreements, it is the lender who instructs the valuer, such valuation shall be conclusive evidence of the market value, and the borrower has little, if any, scope to challenge such valuation. The borrower is, however, always entitled to obtain its own valuation and, whilst it is unlikely that it would be used for the purposes of the LTV test (which would be reserved for the lender’s own valuation), in most instances the loan agreement will require that the borrower provides the lender with a copy of such valuation. The question then is: what happens if the lender’s valuation and the borrower’s valuation yield very different results?

Lewison J considered the issue in Goldstein v Levy Gee [2003] PNLR 35, and his approach subsequently has been followed in at least two further cases: Dennard v PricewaterhouseCoopers LLP [2010] EWHC 812 (Ch) and K/S Lincoln v CB Richard Ellis Hotels Ltd [2010] PNLR 31 (TCC). In Goldstein v Levy Gee, Lewison J stated that:

“The process of valuing real property has strong subjective elements ... this leads to the concept of 'the bracket,' or 'the permissible margin of error'... Pinpoint accuracy in the result is not, therefore, to be expected by he who requests the valuation. There is a permissible margin of error, the 'bracket' as I have called it.

What can properly be expected from a competent valuer using reasonable care and skill is that his valuation falls within this bracket."

The issue, therefore, is not whether the final valuation figure is "wrong," but whether it is "outside the bracket."

Buxton LJ in Merivale Moore plc v Strutt & Parker [2000] PNLR 498 at 515-517 also said the following:

"A valuation that falls outside the permissible margin of error calls into question the valuer's competence and the care with which he carried out his task. But not only if, but only if, the valuation falls outside that permissible margin does that enquiry arise. To find that his valuation fell outside the 'bracket' is … a necessary condition of liability, but it cannot in itself be sufficient."

The Courts seem to therefore suggest that for a valuer to be negligent, the claimant must first demonstrate that:

(a) the valuer fell in some way below the standards to be expected of a reasonably competent professional; and

(b) the valuation fell outside of the range within which a reasonably competent valuer could have valued the asset.

Conversely, this also would seem to suggest that if the valuation is within the range, the valuation will not be found to have been negligent, even if some aspect of the valuation process can be criticised as having fallen below reasonably competent standards. That said, it also suggests that even if the valuation is outside the range, the professional may escape liability if he can prove that he exercised reasonable skill and care.

Determining the Applicable 'Range' for Valuations

How to determine the range is notably subjective. Ultimately, in order to assess what is a competent valuation and what the size of the permissible range should be will depend on the particular facts of the case.

As summarised in K/S Lincoln v CB Richard Ellis:

(a) for a standard residential property, the margin of error may be as low as plus or minus 5 per cent;

(b) for a valuation of a one-off property, the margin of error will usually be plus or minus 10 per cent;

(c) if there are exceptional features of the property in question, the margin of error could be plus or minus 15 per cent, or even higher in an appropriate case.

However, a range of 14.5 to 23 per cent has been described as "absurd" (Staughton LJ in Nykredit Mortgage Bank plc v Edward Erdman Group Ltd [1996] 1 EGLR 119).

Conclusion

In almost all English senior debt real estate origination financing loan agreements, it will be the lender who gets to instruct the valuer, and such valuation is often deemed as conclusive evidence of the market value of the property for the purposes of that loan agreement. That said, if the borrower does wish to challenge such valuation, there is some merit in obtaining further valuations as it may prove useful in determining what is the “permissible margin of error.”

Things to Consider When Your Guarantor Is a Fund


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Here are some practical points to consider when the guarantor of a loan is a fund.

(1) *The Lifespan of the Fund*

Most funds have a finite lifespan. This fact can be problematic if the fund is scheduled to wind down or liquidate during the loan term. Consequently, such term should be ascertained to determine if the eventual wind-down of the proposed guarantor will result in the inability of such entity to satisfy its potential obligations under a guaranty during the term of the loan. The diligence required here is a review of the organizational documents related to the proposed guarantor, which many sponsors are reluctant to share due to confidentiality concerns. Many sponsors will provide redacted documentation but, if not, lenders can consider relying on certain third-party opinions, which are addressed in more detail below.

(2) *Calculating the Net Worth and Liquidity of Guarantor*

When a guarantor is required to maintain a minimum net worth and/or liquidity during the term of the loan, the lender is ensuring that the guarantor, at all times, has the necessary capital to satisfy the potential liabilities that may arise under a guaranty. If the proposed guarantor is a fund, the lender should consider how it is calculating such entity's net worth and/or liquidity. Specifically, the lender should consider whether to include uncalled capital commitments in calculating the guarantor's net worth and/or liquidity.

If such capital commitments are pledged to secure credit facilities, earmarked for specific investments or are contingent upon conditions unrelated to the loan, they should not be counted toward the guarantor's net worth or liquidity. Additionally, some lenders count only uncalled capital commitments which are from individuals or entities which would be considered "institutional investors" according to standards set forth by the lender, which may include ratings requirements and other eligibility requirements. In addition, if the limited partners of the fund are not large institutional investors but are only "accredited investors," the lender should consider the creditworthiness of such individuals and/or entities as well.

(3) *Third-Party Opinions*

To the extent that a review of organizational documents is limited or unavailable, a third-party opinion may serve to give the lender comfort (i) as to the organizational structure of the guarantor and enforceability of the guaranty, (ii) that the guaranty does not violate or contravene the proposed guarantor's organizational documents, and (iii) that the execution, delivery and performance of the guaranty has been properly authorized.

If the fund is foreign-based or has substantial foreign investors, the lender should include provisions in the guaranty that the guarantor has submitted to U.S. jurisdiction with respect to the enforcement of the guaranty and that any judgment and amounts recovered under the guaranty will be in U.S. dollars. In addition, the lender typically would get an opinion in each applicable foreign jurisdiction that such provisions are enforceable and that a foreign court would honor a U.S. judgment.

(4) *Replacement or Supplemental Guarantor*

While a replacement or supplemental guarantor provision may be requested by a borrower in connection with its flexibility concerning transfers and assumptions, lenders should consider these provisions in the context of a fund guarantor to potentially solve some of the issues identified above. Including mechanisms to require a replacement or supplemental guarantor may prove to be a simple solution.

Save the Date: Finance Forum 2019

It's time to mark your calendars for our fourth annual Finance Forum at The Ritz-Carlton in Charlotte, North Carolina, on October 17.

We had a record number of more than 400 attendees last year – all leaders in the financial services, investment management, real estate finance, private equity and legal communities. We are still finalizing the agenda, but we plan to provide updates on some of the key topics from last year, as well as a number of new areas of focus. You can expect comprehensive coverage of fund finance, the loan market, commercial real estate and other timely and important topics, including industry diversity. Speakers will include Cadwalader partners and leading practitioners from across the country.

This is a half-day program, beginning with a welcome and keynote address at 12:30 p.m. and ending at 5:45 p.m., with a rollicking networking cocktail hour to follow.

There is no charge for the Finance Forum, and Cadwalader has arranged for very favorable hotel rates for Forum participants attending from out of town.

Click here to register for the Finance Forum.

Contact Cori Niemann for general information and hotel reservation information.