Thursday, October 24, 2024
2:45 PM – 3:45 PM

Seminar 16

Retail Issues in Loan Documents: The Few Things You Shouldn't Forget

Presented to

2024 ICSC+U.S. LAW
JW Marriott Orlando Grande Lakes, Orlando, Florida
October 23-25, 2024

by:

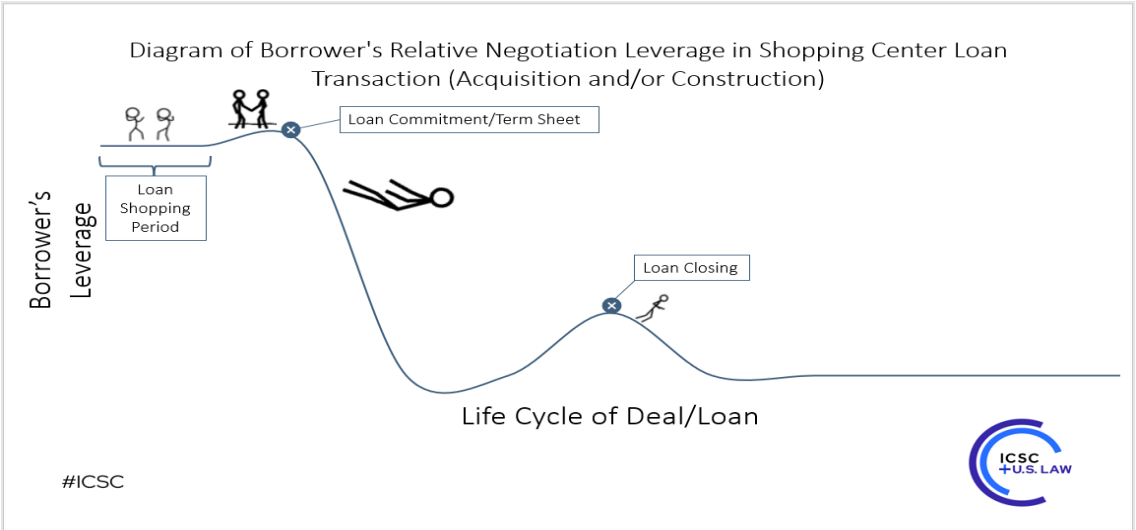
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1. Introduction.

There are always key provisions to pay attention to when negotiating commercial loan documents, but there are particular provisions that borrowers should take special note of when negotiating loans for retail properties, such as debt service coverage ratio ("DSCR") covenants, insurance provisions that may not match insurance provisions in tenant leases, approval requirements for new leases, lease amendments, and leases assignments, tenant improvement and leasing commission reserves, and SNDA and estoppel delivery covenants. In this paper, we will speak to these topics from the Retail Borrower's perspective.

Key takeaway/Practice Tip – *NEGOTIATE THE KEY POINTS EARLY* (e.g., DSCR and lender approval rights for new leases, amendments, and reserves) and, by "early", we mean pre-letter of intent or loan commitment-stage.



Too often, our clients (whether we are in private practice or are in-house legal) get us involved after it is too late. In negotiating the letter of intent or loan terms with lenders during the loan shopping process, the client or mortgage broker is often overly focused on the rate, term, loan-to-value, etc., and the very important, more operational aspects of the loan (e.g., DSCR or lender approval rights) are ignored until the loan document negotiation phase. The problem is that when the loan documents are delivered and closing is just weeks later, with the Retail Borrower sometimes facing a "hard" closing date under an agreement of sale or a loan maturity date, the Retail Borrower's leverage to negotiate these important loan terms is very low, particularly in 2024's credit climate. Best practice is to work closely with your client, during the letter of intent/loan commitment phase, to *at least* have a discussion with the lender (or prospective lenders) about the operational aspects of the anticipated retail property loan, ideally *before* a lender is chosen, *before* the loan commitment is finalized. or *before* your client pays a deposit to the lender and the lender's counsel prepares the loan documents or incurs significant expenses.

2. Debt Service Coverage Ratio Covenants.

Lenders often require Retail Borrowers to agree to a financial covenant, such as a debt service coverage ratio covenant (also known as a "DSCR covenant") pursuant to which the ratio of the net operating income from the property to the required debt service under the loan must exceed a certain ratio, such as 1.25.

a. **Debt Service Reserve Account.** Lenders sometimes require Retail Borrowers to deposit funds into a debt service reserve account to pay the debt service when the property will not generate enough income to meet the Retail Borrower's debt payment obligations. This can occur when the property, for example, is a new shopping center or where a major renovation is taking place and the project cannot be leased up sufficiently to have the income stream required to pay the debt service.

b. **Calculation of the DSCR.**

The equation for DSCR is:

$$\text{DSCR} = \frac{\text{net operating income}}{\text{debt service}}$$

where "**net operating income**" = operating income - operating expenses, "**operating income**" includes rent and any other income generated by the property and "**operating expenses**" include real estate taxes, property insurance, management fees, repairs and maintenance, utilities, other miscellaneous expenses.

Terms generally not included in the net operating income calculation include debt service, depreciation, income taxes, tenant improvements, leasing commissions, reserves for replacement, and capital expenditures.

When calculating DSCR, the net operating income and debt service amounts should be for the same limited period (e.g., 12 month period).

c. **Certification of the DSCR.** Lenders typically require a certification of compliance with the DSCR covenant on a regular periodic basis (e.g., annually).

Practice Tip – Work closely with your business team on the definition of gross revenue (operating income) to be as inclusive of all of the income of the real property as possible and the definition of operating expenses to be as exclusive as reasonably possible. The goal, of course, is to make the net operating income amount as big as possible so that the calculated DSCR is favorable to the borrower and the DSCR covenant can be satisfied. Additionally, on the certification of the DSCR, be careful about the calculation of DSCR, the calculation periods, and annualizations of periods that may not be favorable to the borrower.

3. Insurance Provisions.

a. **Insurance Requirements.** Lenders will require Retail Borrowers to obtain insurance to protect Lender and its interests under the loan. Lenders will require Retail Borrowers to deliver certificates of insurance and will often also require certified copies of each insurance policy.

b. **Evidence of Insurance.** Lenders will require insurance issuers to issue an endorsement with a standard mortgagee clause that recognizes the lenders' interest.

c. **Flow-down Provisions in Leases.** Retail borrowers' leases should include provisions that require their tenants to obtain and maintain the insurance required by their lenders from time to time and to deliver any evidence thereof as may be required by the loan documents.

d. **Other Agreements.** Lenders will look for industry standard insurance coverage in easements and will expect Retail Borrowers to maintain appropriate coverage under these agreements.

Practice Tip – If this is a refinance or acquisition loan, review the insurance provisions in the anchor/major leases and negotiate the "flow-down" provisions in the loan to harmonize the insurance requirements.

4. New Lease, Amendment, Assignment Approval Requirements.

Foreshadowing, the battleground here is on the definitions—pay attention to them. Retail loans often contain provisions requiring the lender's approval on:

a. the form of lease to be used with tenants (*note*, largely impractical so negotiate this);

b. the execution of a negotiated lease with a tenant prospect;

c. lease amendments/modifications/terminations; and

d. assignments.

However, these same provisions often give the borrower greater latitude to execute smaller (non-major leases) *without* lender approval. These sample provisions from a lender-form credit agreement highlight the importance of paying attention to definitions:

> **Borrower's Right to Sign Leases**. Provided that no Event of Default is continuing, Borrower may sign new leases and renewals, amendments and modifications of Existing Leases without the prior approval of Lender provided: (a) the new lease is not a ***Major Lease*** or the Existing Lease as amended or modified or the renewal Lease is not a ***Major Lease***: (b) the new Lease shall be written substantially in accordance with the standard form of lease reasonably approved by Lender (subject only to such changes as are necessitated by the business terms); and (c) such Lease: (i) is not entered into with an Affiliate of Borrower and is otherwise entered into at arm's length with an unrelated third party tenant; (ii) is automatically self-subordinating to the Mortgage and requires the tenant thereunder to attorn to Lender and its successors and assigns (at Lender's or such successor's or assign's sole option) upon Lender's (or such successor's or assign's) acquisition of title to the Property; (iii) does not contain any option to purchase, right of first refusal to purchase, or termination option (other than termination options in the event of a material casualty or condemnation, in the event of Borrower's breach of such lease or as a result of the failure by any party to meet any conditions precedent in such lease to tenant's commencement of operations, such as the receipt of any necessary permits or licenses); and (iv) does not contain any extraordinary, uncustomary or unduly burdensome landlord obligations, including any obligation which an unaffiliated landlord would have difficulty performing. Borrower shall deliver to Lender copies of all Leases which are entered into pursuant to the preceding sentence together with Borrower's certification that it has satisfied all of the conditions of the preceding sentence within ten (10) days after the execution of the Lease.
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> **Leases Requiring Lender's Approval.** Without the prior written consent of Lender, which consent shall not, so long as no Event of Default is continuing, be unreasonably withheld or delayed, Borrower shall not enter into a proposed ***Major Lease***, a proposed renewal, extension or modification of an existing Major Lease or any proposed new lease or renewal, amendment or modification of any Existing Lease which is not allowed in accordance with the preceding paragraph (all, a "***Proposed Lease***"). Prior to seeking Lender's consent to any Proposed Lease, Borrower shall deliver to Lender a copy of such Proposed Lease blacklined to show changes from the standard form of Lease approved by Lender and then being used by Borrower, along with, in the case of a Proposed Lease which is a ***Major Lease***, appropriate financial or other information which shall allow Lender to evaluate the creditworthiness of the proposed tenant. For the avoidance of doubt, Borrower shall obtain Lender's prior written approval with respect to an Acceptable Replacement ***Key Lease***.
>
> Definitions:
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> ***Major Lease***- collectively, (a) the Key Leases, and (b) any other Lease affecting the Property which covers 5,000 or more rentable square feet of the Improvements. *[borrowers will want this SF higher; lenders will want it lower].*
> ***Key Lease*** – any Lease described on Schedule 4 attached hereto. *[borrowers will want a short schedule; lenders will want a long schedule] [Note, the loan agreement will typically contain numerous covenants with respect to Key Leases]*

Practice Tip – Try to negotiate a "deemed approval" clause, wherein a lease is "approved" if the lender does not reply in a given time period, even if such clause requires you to give a 2nd notice before a lease is deemed "approved."

5. Tenant Improvement and Leasing Commission Reserves.

Lenders will require a Retail Borrower to deposit funds in tenant improvement and leasing commission reserve accounts to pay for tenant improvement costs and leasing commissions as they arise in the operation of the Retail Borrower's property.

a. **Amount of the Tenant Improvement and Leasing Commission Reserve.** The loan documents will prescribe how much will be deposited initially and how much each month the Retail Borrower will be required to deposit in the reserve account. The loan documents will often state a minimum and a cap for the amount required to be deposited in the reserve

account. If the cap is reached, deposits into the account may be suspended; once the reserve account minimum is reached, the Retail Borrower must resume making the reserve deposits.

b. **Disbursements of the Tenant Improvement and Leasing Commission Reserve.** The loan documents will prescribe how and when the amounts in the reserve account may be used by the Retail Borrower.

i. *Disbursements for Tenant Improvements.* Disbursements for tenant improvements will need to be available to the Retail Borrower for costs and expenses paid or incurred by Retail Borrower for tenant improvements for any new lease or any modification, renewal or extension of an existing lease. Disbursements will also require the satisfaction of certain conditions such lien-free performance of the work, the cost of the tenant improvements being market, reasonable and customary and the tenant improvements being constructed in accordance with the requirements under the tenant's lease. Lender will likely push to require the tenant to be occupying the premises and paying rent.

ii. *Disbursements for Leasing Commissions.* Disbursements for leasing commissions will need to be available to the Retail Borrower to pay or reimburse Retail Borrower for leasing commissions incurred in connection with a new lease, modification, renewal or extension. Disbursements will also be conditioned upon the commission being determined pursuant to an arm's length commercially reasonable agreement, and a lease being fully executed and approved by lender (where lender's approval is required by the loan documents). Sometimes a lender will require the tenant to be in possession of the premises and paying rent.

c. **Increase of the Amount of the Tenant Improvement and Leasing Commission Reserve.** Lenders may require the ability to increase the amount of the tenant improvement and leasing commission reserve from time to time where it determines that the amount that they are collecting are not sufficient. Borrowers should attempt to qualify this determination as much as possible to curb the lender's ability to increase the reserve for little or no reason.

6. <u>SNDA and Estoppel Delivery Covenants</u>.

a. **SNDAs.** Perhaps not immediately relevant to the topic of negotiation of loan documents, but incoming lenders in shopping centers ordinarily require that SNDAs are obtained with the existing tenants as a condition of the loan. This raises important considerations for your tenants (if you are a landlord or represent one) or for you (if you are a tenant or represent one), especially in light of the credit climate where interest rates have gone up substantially, so in theory, there may be more lenders in possession in the future, thus making SNDAs more relevant. Typically leases require tenants to sign these often ignored, often non-negotiated documents if requested from lenders. The focus here will not be on the basics of subordination and attornment, but instead, on what could become crucial provisions in these documents if lenders start taking over properties given the relatively large recent increase in interest rates and where loans mature where borrowers do not have the equity to "save" their properties.

<u>Practice Tip</u> (from a tenant's perspective) – The fundamentals of the deal you struck in the lease itself (who pays/does what and when) should not change just because a lender takes over a property, so watch for provisions in SNDAs that do this and negotiate them. A common, and theoretically, timely issue, is what happens if a lender takes over a property before a tenant improvement allowance is paid from a landlord to a tenant (pursuant to the lease terms) for work the tenant performed in the premises.

Borrower's Perspective- "Show me the money! Seriously, I just improved your collateral and I still have to pay the rent to you!"

Lender's Perspective- "What are you talking about? I approved a $5million dollar loan that the borrower drew it down entirely before handing me the keys and advancing this tenant improvement allowance to you will make it a $5,500,000 loan."

Here is a "blacklined" provision showing this negotiation and a possible solution that arguably preserves the benefit of the bargain for the tenant under the above fact pattern relative to tenant improvement allowances:

Lender shall not be bound by any obligation to make any payment to Tenant which was required to be made prior to the date Lender became the owner of the Property, ***provided that Lender or any purchaser shall grant Tenant (i) the Rent credit granted to Tenant pursuant to Section 2.2 [i.e., section containing the tenant improvement allowance] of the Lease, pursuant to which if Lender does not pay the Allowance (as defined in the Lease) to Tenant by the Due Date (as defined in the Lease), such unpaid amount shall accrue interest at the Interest Rate (as defined in the Lease) until the day the Allowance (with interest) has been fully reimbursed by application of said Rent credit plus an additional Rent credit equal to one (1) day of Rent for each day after the Due Date that the Allowance is not paid or until the day the Allowance (with interest) has been fully reimbursed by virtue of the foregoing Rent credit, whichever first occurs****.*

Additional Practice Tips/Issues to watch for:

i. Provisions that say the lender will not be obligated to perform the construction obligations of the landlord – a borrower should negotiate self-help with a rent offset credit, like with the improvement allowance provision above.

ii. Disclaimers of liability for offsets, say "except those contractually provided to the Tenant under the Lease."

iii. Bound by amendments not approved by lender- try to limit to material monetary and financial amendments.

iv. Liable for defaults that occurred before the lender took over—borrower should negotiate "except to the extent such default is continuing in nature."

As you can see, the theme here is about preserving the benefit of the bargain negotiated in the lease itself. The actors may change but the play should not.

b. **Estoppels.** As a part of a loan closing, typically a closing requirement will be the delivery of estoppel statements from the existing tenants so a lender can confirm, from the tenants' perspective, that there are no defaults under the leases that provide the cash flow to service the loan. Back to the main takeaway for this session—negotiate early! A borrower will want to limit this requirement to obtain estoppel statements to the anchor and larger tenants, not small in-line shops. Borrowers will not want their loans held up because of a non-responsiveness of a small-shop tenant. Typically, the larger national tenants are more organized, so it is less of an issue. This is a good thing to sort out in the term sheet phase.

In terms of the negotiation of estoppels, form the Tenant perspective, they should not, after negotiation, result in the waiver of items that are in controversy such as ongoing maintenance disputes or disputes on whether the full amount of an allowance has been paid, AND they should not create new obligations. An estoppel should just report the facts and should not create new obligations for a Tenant. So be careful here, read them, and "fact check."