Best practices in commercial real estate financing

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Multi-state loan transactions

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Abstract
Lenders undertaking multi-state finance transactions need to be aware of the impact of the various states' laws on documentation, structure, the lender's rights and its remedies. Thoughtful analysis of these issues can help the lender avoid the legal pitfalls of such transactions.

Keywords:
multi-state finance, real estate finance

INTRODUCTION

It seems as though a significant merger of real estate companies occurs almost every day. Whether it is a friendly acquisition by a home builder or a hostile takeover by a real estate investment trust, the market seems to be preoccupied with consolidation among large public and privately traded real estate holding companies.[1] The consolidation among mega-real estate companies creates a climate for large, multi-state portfolio transactions. Indeed, even while so-called 'conduit' or 'CMBS'[2] lenders require the use of 'single asset, single purpose' borrowers,[3] some lenders (often life insurance companies or foreign lenders) prefer the portfolio loan, as it allows them to spread risk while at the same time focusing on a single sponsor.

A multi-state portfolio transaction is not without its challenges. Certainly, the administrative aspects of the transaction are critical, as inefficiencies at either the counsel level or underwriting level will be magnified. Beyond this, such transactions raise unique legal questions, all directed at how best to allow the lender to realize on its collateral pool. Some of these questions will be found in any transaction involving more than one property; the factor that makes the multi-state transaction substantially more challenging than a multiple property transaction in which all of the property is located within a single state is that there will be tension between the laws of the various states.

THE STARTING POINT — DETERMINING THE STRUCTURE OF THE LOAN

The starting point for both the lender and its counsel is to structure the loan in a manner that best suits all parties. In a perfect world, the lender and sponsor will agree that there be one, newly formed borrower. The borrower will be 'single purpose', in the sense that it owns only the portfolio to be financed, which provides numerous advantages for the lender, including, without limitation, (a) making it less likely that the borrower will engage in activities unrelated to the portfolio (which 'unrelated activities' could expose the portfolio to risks that are not underwritten by the lender) and (b) limiting the number of creditors that may have claims against the borrower.

Often, despite the lender's desires, there may be constraints on the ability of the sponsor to have a single borrower. Because of the cross-default and cross-collateralization features common in a multi-state portfolio loan, use of multiple borrowers raises enforceability issues—simply put, how can a lender enforce remedies against one borrower (and its properties) for the liability of another borrower? The most simplistic approach is merely to have all of the borrowers jointly and severally liable for the 'loan' (i.e. the total amount to be originated by the lender). This approach, however, raises a significant question as to the enforceability of the obligations of each borrower. In particular, some states and federal laws raise the issue as to whether the cross-guaranties of each borrower creating the joint and several liability for the loan are enforceable, because one could argue that each borrower is effectively a guarantor of the other, and that the 'guaranty' (i.e. the posting of collateral to secure all borrowers' obligations) is without 'reasonably equivalent value' and therefore unenforceable as a fraudulent transfer under state or federal law. Obviously, the more states there are involved, the more (and possibly contradictory) laws that must be analysed.

To grapple with the fraudulent transfer risk and to minimize the impact of the 'cross-guaranties' not being upheld, many lenders prefer a structure pursuant to which the loan is divided into individual loans made to each borrower, with each individual loan in an amount equal to an allocation of each borrower's *pro rata* loan proceeds based on the value of the borrower's property. Each borrower then gives the lender a guaranty of all of the other borrowers' obligations. By entering into what amounts to two tiers of obligations, the lender insulates itself against a challenge on the 'guaranteed' obligation; if the guaranty is invalidated, the primary loan still survives. As discussed below, this structure is also useful in addressing certain state law remedies which, if not properly addressed, can severely hamper a lender's collection efforts.

Choice of law

CHOICE OF LAW

The next threshold issue for the lender is to decide which state's law shall govern the loan documents. Certainly, the 'choice of law' is not unique to multi-state portfolio transactions, as all lenders typically grapple with this issue. Lenders routinely try to pick a governing state that has the most lender-friendly structure for enforcing loans. This goal often runs up against a state's desire to have its laws govern a transaction within its jurisdictional borders.

While there is no national standard for which laws apply at particular points in time, there do appear to be some common principles: first, generally, courts will respect a choice of law as long as there is a logical nexus or substantial relationship between the parties, the transaction and the choice of law; second, most states reserve the right to 'retain' jurisdiction (despite a choice of law) over issues of fundamental policy; third, if the law of a state is to be applied absent a choice of law provision, and the application of the law of the chosen state would be contrary to fundamental policy, then the choice of the chosen state's law would be honoured only if the court were to determine that the state did not have a materially greater interest than the chosen state in the resolution of such issue; and fourth, the courts have held that if the parties have a substantial relationship to two separate states, even if one state has a contrary provision to another state law, the choice of law provision may be upheld if one state has an interest in ensuring the justified expectations of the parties to an agreement and that one state's interest in the enforcement of the local policies are not materially greater than the other state's interest.

Ironically, because the 'nexus' and 'public policy' issues become less clear in a multi-state transaction, the validity of any particular choice of law provision may be more likely than would be the case in a conventional loan. For example, one may question whether a choice of law for State X would be upheld in a situation in which the lender's office is in State X but both the borrower and lender have used lawyers in State Y, whereas the borrower is incorporated in State Y and owns real estate in State Y. However, if there are multiple properties, multiple borrowers, lawyers through out the USA (for both parties), any state (including the resident state of the lender) with a logical nexus may be upheld *vis-à-vis* the choice of law.

Enforceability issues

ENFORCEABILITY ISSUES

After the lender has determined which law will govern the multi-state portfolio loan and whether there will be one borrower or multiple affiliated borrowers, the lender then needs to determine whether there are any unique issues within each state's relevant laws that will affect either underwriting or enforceability. Indeed, the upshot of the choice of law analysis is that the lender will probably be able to pick its governing state for the 'primary loan' document. However, each state-specific security instrument will need to address the 'situs' state's law governing creation, perfection and enforcement of the security instrument. The issue that makes the duelling states' laws on enforceability potentially dangerous is that taking steps in one state to enforce rights and remedies may lead to unintended consequences (an inability to enforce the loan documents) in another state.

The most significant enforceability issue is confronted if any of the subject states have one form of action rules and/or anti-deficiency rules, which must be considered when structuring the transaction. A 'one form of action' rule provides that there can be but one form of action for the recovery of any debt or the enforcement of any right secured by mortgage upon real property or an estate for years therein. Although anti-deficiency rules differ to a degree, the general concept is that a real property secured creditor is barred from obtaining a personal judgement against the debtor for any deficiency remaining after foreclosure. If the loan is not structured properly to address the one form of action and anti-deficiency laws, a lender can then take an action in one state (which may or may not have one form of anti-deficiency rules) and accidentally lose its right to a deficiency judgement or its right to have the debt satisfied first from the remaining real property collateral in another state.

The multiple borrower loan structure outlined above ameliorates the one form of action and anti-deficiency risk. If done properly, even if there is a viable defence, the defence only goes to the 'guaranteed portion', leaving the primary obligations and security intact.

A second issue is that many states have a very large mortgage recording tax. In some instances, the mortgage recording tax may be based on the entire portfolio, not just the portion of the loan secured by a particular mortgage. Depending on the state, there may be numerous ways to address the issue, such as recording duplicates of one mortgage in each county to avoid having a separate mortgage recording tax charged on each mortgage being recorded (or using allocated loan amounts which will result in a recording tax taken on the allocated loan amount, which will be less than if based on the entire loan).

A third issue is that some states charge extremely high taxes each time the property is transferred, even if such transfer is done pursuant to a foreclosure. One way to avoid the transfer tax in connection with a lender's exercise of its rights and remedies under the mortgage is to appoint a receiver and cause the receiver to dispose of the subject property, thereby avoiding a tax when the lender forecloses on the property and takes possession.

Guaranties provide yet another pitfall. Many states have their own peculiar guaranty laws, and statutory authority and case law in those states often have resulted in a cache of 'state-specific waivers'. Because there will always be some level of uncertainty in choice of law, it is critical that every state's laws and statutes be considered.

Finally, there are a multitude of 'administrative matters', which a lender and its counsel must keep at the forefront. For example, many jurisdictions have rules as to the acknowledgement forms attached to the documents, the information which must be included on the cover page of the document, the title of the document, whether witnesses will be required to witness the signatures to the loan documents and whether a corporate seal is required on the signature page, which seal may be required to be either embossed or simply ink stamped. Indeed, some jurisdictions have very specific and unique rules relating to the colour of ink that the document must be signed in and the size of the margins and font of the documents to be recorded. Lastly, some states have a requirement that all documents be held in escrow for a certain number of days prior to recording; this can have an impact on the timing of the execution of documents in relation to the funding and closing of the loan.

Title insurance considerations

TITLE INSURANCE CONSIDERATIONS

Another issue for a lender to consider when making a multi-state portfolio loan is the additional coverage or endorsements that the lender should be requesting from the title company issuing the title insurance for each of the properties included in the portfolio loan. The lender should receive a separate title policy for each property included in the portfolio, with the amount of each title policy to be that portion of the total loan allocated to the particular property. The title policies will most likely be coordinated through the national office of the title company, such that the lender is in contact with a national representative and the national representative works with the individual title officers in the respective counties in which the property is located. Such an arrangement is more efficient, as there will be only one person to whom the lender needs to relay comments to the title policies, and the title policies for each property are more uniform. While most states offer similar endorsements to title policies, some states have different laws, with the consequence that different endorsements are available, or that endorsements are not available at all, in other states. In addition to the standard endorsements that a lender should obtain to a title policy in a single site transaction, a lender making a portfolio loan should also acquire a tie-in/aggregation endorsement. The tie-in/aggregation endorsement provides insurance that the insurance coverage for each title policy issued for each individual property in the portfolio is related to the insurance coverage for each other title policy issued for the other properties in the portfolio. However, several states do not offer this tie-in/aggregation endorsement, or if such state does offer such endorsement, they will not issue it with respect to properties located out of state. If such endorsement is not provided, then the lender shall have the amount of the coverage under title policy for the property located in the state in which the endorsement is not offered increased to allow for any possible losses in connection with the related properties in the portfolio.

Furthermore, in terms of coordinating the logistics of the closing of a multi-state portfolio loan, a lender must consider that the loan documents, which are to be recorded, will all be sent to the centralized national representative. The national representative will hold the recorded documents until the closing of the loan and then send the documents to be recorded to an escrow officer in the appropriate county. While this is much more efficient than the lender sending loan documents all over the country, there is a delay in the recordation of the loan documents, which the lender must consider. Generally, it may take several days for the loan documents to reach the respective local escrow officers. In order to protect against any possible losses associated with the properties subject to the loan between the period that the lender funds the loan and the date that the loan documents are recorded in the respective counties, the lender should require gap coverage from the title company. The national representative at the title company can provide gap coverage, which insures the lender against any loss arising between the date of funding and the date of recording, and the cost and risk of such gap coverage is borne by the borrower.

Opinion letters

OPINION LETTERS

Along with selecting the most appropriate choice of law to govern the multi-state loan transaction, and structuring the loan documents to ensure the enforceability in the particular states where the properties are located, a lender may receive additional protection in regard to the enforceability of the loan documents by requiring that the borrower provide an enforceability opinion from counsel in each state in which the properties in the portfolio are located. Typically, the borrower engages counsel in each state to review the loan documents and to provide advice to the borrower as to the laws of such state. The borrower should engage such counsel to issue an opinion that the loan documents are enforceable under the laws of that particular state, that the loan documents are in the proper form for recording in the appropriate jurisdiction and that the court located in such jurisdiction will uphold the choice of law provisions set forth in the loan documents. The lender may then rely on such opinions as to the enforceability of the loan documents.

CONCLUSION

While there are many benefits to carrying out a multi-state portfolio loan, there are many factors for a lender to bear in mind to ensure that the lender's security interest in the collateral subject to the loan is adequately protected. Before making the decision to enter into a multi-state portfolio loan, lenders should consider these provisions and engage their own counsel in the each state in which a property in the portfolio is located, to ensure that the loan is structured appropriately, in regard to the various states in which the properties subject to the loan are located. While the borrower will have its own counsel, a lender should also engage its own counsel because waivers or statute references are often for the benefit of the lender in enforcing its rights and remedies under the loan documents, and the borrower's local counsel may not alert the lender to the necessity of including such information.

Notes

1. See, for example, *The Wall Street Journal*, 24 December, 2004 (article discussing the acquisition by Macerich Co., a real estate investment trust, of closely held Wilmorite Properties, Inc., for $1,450,000,000).
2. 'CMBS', or Commercial Mortgage Backed Securities, refers to the process pursuant to which a lender groups a series of loans and then issues certificates in the trust vehicle (a REMIC, or real estate mortgage investment conduit).
3. A single purpose entity is an independent entity formed for the sole purpose of owning and managing a single piece of real estate, which will serve as collateral for a lender's loan. (See Weissburg, A, and Trott, J. (2004) 'Special purpose bankruptcy remote entities', *Los Angeles Lawyer*, January, p. 12).