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RETAIL REDEVELOPMENT PROJECTS

The lender's special risks and concerns.

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Instead of developing new projects from the ground up, some investors look for existing properties and try to turn them around. To do this, they may replace lessees (major, minor, or both); reconfigure the physical layout; enlarge or shrink the building; turn a strip center into a mini-mall or turn a mini-mall into a strip center; reposition the property in the marketplace; add or subtract parking or move parking around; upgrade the exterior; and do whatever else they think will cost effectively increase cash flow and turn a tired old property into an exciting and well-positioned new property in the current market.

Lenders looking for good loans to make will often agree to finance these projects. In some ways, this financing is much like a construction loan. In other ways, it is a routine permanent loan with a few special bells and whistles. But loans like these include plenty of potential traps for borrowers and lenders.

This article focuses on the issues that retail redevelopment projects can create, particularly for a lender. Many of these issues also arise in other types of financing, but this discussion will focus mostly on the particular issues and nuances that retail redevelopment projects bring to the agenda. The importance of these issues in any given transaction will depend on the nature of that transaction and the "hot buttons" and agenda of each party. And this discussion disregards generic issues that apply to any real estate closing, as well as many concerns of construction lending generally.[1]

THE LOAN AMOUNT

In any retail redevelopment project, the developer usually expects to achieve a certain level of income eventually. At the time of the loan closing, though, there is usually some uncertainty about the ultimate cash flow and hence the ultimate value of the project. Because a real estate lender usually wants to lend against cash flow and value, the lender might not want to commit to specific loan amounts at the time of the original closing. Instead, the lender will want to wait until the borrower has finished particular elements of the redevelopment project and demonstrated, through signed leases with real lessees, just how much financing the completed project can support.

Therefore, although a lender financing a retail redevelopment project probably will be willing to disburse a good part of the loan at the initial closing, the lender will want to hold back part of the loan to be advanced over time based on the borrower's future financial achievements. "Earn-out" arrangements of this type raise issues that affect (perhaps "afflict" may be a better word) the entire borrower-lender relationship.

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As a starting point, borrower and lender need to provide for the formula to measure net operating income. Then they need to agree on how net operating income determines the loan amount. Typically this calculation starts with definitions of gross revenue and gross expenses, but the lender then will "adjust" each item. The difference between adjusted revenue and adjusted expenses becomes "net operating income." To a borrower, every one of these "adjustments" usually means less money from the lender, so borrowers care a great deal about just how much "adjusting" the lender can do. The following are some of the issues that can arise in this process, and some protections that a borrower or a lender may want:

To a borrower, every one of these "adjustments" usually means less money from the lender.

■ **Vacancy allowance.** The lender will want to apply some vacancy allowance. Even if the property happens to be 100% occupied at the time of the loan closing or the earn-out disbursement date, the earn-out formula needs to reflect the lender's long-term view of the property. Therefore the formula needs to assume some reasonable minimum level of vacancy over time. But just how much? The borrower will want some limit.

■ **Management fee.** If the borrower "self-manages" the property, the lender may want to impute a fair market management fee as an expense of the property—even if today's owner of the property doesn't actually pay such a fee, or pays a discounted management fee.

■ **Reserves.** In adjusting expenses, the lender may want to assume that whoever owns the project will deposit a certain amount every month into replacement or other reserves, a direct reduction of net operating income. These "assumed" reserve deposits will not necessarily be the same as the deposits actually required, in the short term, under the loan documents. The borrower will want to keep these "assumed" reserve deposits as low as possible. The borrower might want to cap them as a percentage of gross income—a very low percentage, particularly in the years immediately after redevelopment. The borrower might also want to limit the "assumed" reserve deposits to the deposits necessary to pay for particular capital projects recommended by particular engineers, rather than the lender's untrammelled view of whatever might be appropriate under the circumstances.

■ **Lessees in default.** What if a lessee is in default or has recently been in default? The lender may want to disregard that lessee's rent completely in calculating revenues. If the default is minor and looks like it will be cured, though, the developer will not want to lose credit for all income from that particular space.

■ **Miscellaneous income.** The parties must agree on whether the lender will include as revenue various categories of "seasonal" income or non-lease-based income (such as payments by a Christmas tree vendor who sets up shop in the parking lot, only during the last two months of every year). The borrower may argue that the property has demonstrated this extra revenue year after year. Although the source of the revenue may not be creditworthy, the revenue has always been there. Will the lender be willing to count on that revenue? Will the borrower's repositioning of the property potentially reduce that revenue in the future? (As retail projects continue to evolve, revenue from sources other than traditional long-term leases is likely to become more important. This revenue might include kiosk and cart rentals, temporary lessees, sponsorship and promotional fees, entertainment-based fee income, credit card licensing fees, and so on. A lender will probably disregard these potential revenue streams at the redevelopment stage. For large regional malls that have been in operation for some time, though, these revenue streams may be quite important and credible. A lender that refuses to consider them may lose a transaction to another lender that will.)

■ **Above-market leases.** If a lease is above market or about to expire, the lender will regard some part of the rental stream as a temporary aberration just like 100% occupancy. So the lender will want to "adjust" the income stream downward to reflect a reasonable projection of rental income over the long term. The borrower, in contrast, will want to "gross up" any leases that are below market to reflect the rental income the borrower believes it could achieve if the space were re-rented in the current market.

■ **Future flexibility and discretion.** Particularly for a retail redevelopment project, circumstances may change between the initial closing

and the funding of the "earn-out." Therefore, as an overall concern, a lender will fear that words in a loan agreement that seemed appropriate at the initial closing may inappropriately "box in" the lender when the time comes to advance the rest of the loan. But the borrower will want the comfort that such words can create.

> Lenders want discretion and flexibility. But borrowers want reliable loan proceeds.

These issues all boil down to some larger and more general issues, each of which puts money into or removes money from the borrower's pocket. Just how much flexibility and discretion will the lender have in "adjusting" rental income in the future? Can the parties agree on an objective standard? Does it make sense to refer to the lender's own internal underwriting guidelines as the standard? Does the lender have such guidelines? Does the lender want them to be a possible topic of litigation and judicial analysis if the parties get into a dispute? And can the borrower assume they will be predictably applied? Might those guidelines change?

The parties need to accommodate the borrower's desire for more loan proceeds and the lender's belief that all these issues, and many similar ones, should not be "set in stone" in the form of rigid formulas. Because lenders "can't think of everything" and because "things might change," lenders want discretion and flexibility. But borrowers want reliable loan proceeds.

The Right Formula.

The problem here, of course, is a common one in any contract negotiation. The parties do not know how the facts will turn out—in this case, who will lease space, how much they will pay, whether the lender will like the lessees, and the exact amounts and components of operating costs for the project after redevelopment. Each party wants to make sure that regardless of how the facts turn out, and whatever surprises come along, the outcome will be acceptable. The wide range of "what might happen" can drive the parties and their attorneys to think through each possible eventuality, play it out, and analyze how it should affect the calculation of "net operating income."

Once the lender has an acceptable definition of "net operating income," how should that variable affect the ultimate amount of the loan (or the next advance on account of the loan)? The formula could be as simple as a capitalization of net operating income at a specified rate. Other lenders may focus instead on debt service coverage ratio or on loan-to-value ratio, with value based on demonstrated net operating income. Regardless of the exact formula used—and they are all variations on a common theme—in each case the loan amount ultimately depends on the amount of net operating income.

When they negotiate a formula of this type, a borrower and a lender should probably think about the following issues, among others:

■ **Cap rate.** If the parties agree on a specific "capitalization rate" for net operating income at the time they sign the loan documents, what happens if markets change between the closing and the date of the future advance? The negotiated "cap rate" may turn out to be too high or too low. This is, of course, a risk that the parties would already have borne if the lender had funded the full loan at the time of the initial closing. Nevertheless, does either the borrower or the lender want the right to adjust the "cap rate" if markets change?

■ **Keeping it simple.** In any formula, the parties need to carefully define each element. The more "moving parts" a particular earn-out formula contains, the more likely it is to contain some mistake, gap, or ambiguity. Therefore, to the extent possible, the parties and their counsel should keep the formula simple.

■ **Keeping it practical.** Whatever formula the parties agree to, they should take some time to play out the literal language of the formula by applying it to particular hypothetical cases. In doing so, they should proceed as if they had never seen the language before and were being asked to interpret and apply the precise words on paper, rather than the concepts that those words were intended to convey. This way, they can make sure that the words produce the right result in each case.

■ **External indexes.** If the parties agree on a formula that refers to an interest rate or some other index maintained by a third party, that particular rate or index should be objectively and easily ascertainable, thus eliminating one possible issue from any dispute and simplifying the process of proving a factual issue in court, if necessary.

■ Interest coverage. In projecting out the disbursement schedule for the loan, how much of an allowance should the loan include to cover interest during the redevelopment process? This "soft cost" of the job may be one of the largest line items in the budget, depending on the nature and timing of the project. Both borrower and lender will want to know how this interest will be paid, and may want to include interest payments as part of the "earn-out" mechanism for the project.

> The lender will regard each advance as a "mini-closing,"

Other Earn-out Requirements

In addition to arriving at the "right formula" for advances, a lender will normally want to establish (a) a definite "outside date" after which the borrower no longer qualifies for additional advances, and (b) a maximum amount, number, and frequency of additional advances.

Funding Conditions

Once the parties have agreed on how to calculate future advances of the loan, they will still probably disagree on how much money the borrower should receive at any particular time. And even if the borrower has demonstrated that a particular advance is appropriate, the lender will want to attach enough conditions to each advance to effectively allow the lender to decide, without interference, whether to continue to fund at each stage of the project. More generally, a lender will want to look ahead to consider every possible "bad thing" that might occur and to make sure that, if a particular "bad thing" occurs, the lender has no obligation to fund. The following are some examples of "bad things" that a lender might be concerned about—each of which might be an appropriate basis to suspend funding:

- An existing lessee falls into default or bankruptcy;
- An existing lessee shuts down its operation at the location, even if "going dark" does not violate that lessee's lease;
- The rating of a publicly-held regional or national lessee is downgraded;
- The general market collapses;
- The developer encounters unexpected construction difficulties or delays;
- Any "material adverse change" occurs in any element of the project. (This phrase probably give a lender a greater sense of comfort and control than it justifies. Even so, every borrower tries very hard to eliminate it.)

If any of these "bad things" (or some others) has occurred when the borrower has otherwise qualified for an advance, the lender wants to be able to suspend or defer funding. The borrower, in contrast, wants to limit the lender's flexibility as much as possible, and to limit the extent to which the lender can reduce an advance because of a particular problem. And if the problem later goes away (e.g., a chronically late lessee stops being chronically late), the borrower will want the right to obtain a disbursement of the funds previously held back.

These issues can become especially contentious if the parties have agreed to an absolute outside date for advances under the loan. The borrower may be concerned that any delay in disbursing funds will push the borrower up against the deadline and ultimately mean the borrower will get no further funds at all.

At the time of any proposed funding, if any "minor issues" remain to be dealt with, the borrower will want to persuade the lender to set up a mechanism to release as much money as possible, with specific conditions attached to any holdback so that the borrower maximizes the likelihood it will see the additional money.

For example, if the lender wants to hold back a disbursement because a liquor store in the project is two months late paying its rent, the borrower will want to tie the amount of the holdback to the amount of rent in jeopardy and allow the borrower to obtain the holdback as soon as the liquor store has paid rent on time for a certain number of months.

Funding Procedures and Deliveries

Even if the borrower has satisfied the basic economic and other conditions to an advance, the lender will regard each advance as a "mini-closing," in connection with which the lender should consider obtaining some or all of the same documentation required at the original closing, as well as documentation and deliveries similar to those which might be required for a full construction loan. The borrower, in contrast, will want the closing requirements for each future advance to be as simple and limited as possible,

A loan to finance a redevelopment project is really two loans.

and to require as little cooperation from third parties as possible.

The process of establishing the "earn-out" formula and working out the nuances of how the formula will be applied, and the conditions to future funding(s), can raise large numbers of small issues between borrower and lender, many of which are suggested by the preceding discussion. Because each of these issues will translate directly into dollars in the borrower's pocket, the time and energy (and legal fees) that it takes to resolve them may be justified.

OTHER FUNDAMENTAL DEAL TERMS

Beyond the loan amount, retail redevelopment loans raise a variety of other issues, including the following:

- Pricing
- Personal liability
- Administration and approvals
- Funding conditions
- Lessee issues
- Approving lessees
- Nondisturbance protections
- Bad leases
- Lease issues
- Leverage with major lessees
- Coordination between old and new leases

Pricing

A loan to finance a redevelopment project is really two loans, with two levels of risk. The first loan is closer to a construction loan than a permanent loan, and the parties hope it will not be outstanding for very long. The second loan involves a lower risk level and probably a longer term. The pricing reflects the "mix" of these two elements and varies with the components of the deal.

During the redevelopment period, the pricing may, for example, be a floating rate with a spread over LIBOR or prime. The spread may be somewhere between the spread for a stabilized retail project and the spread for a construction loan.

When the project is "completed" (a definitional issue of its own), the spread might drop or the loan might even convert to fixed rate, with all the bells and whistles that come with fixed rate loans (yield maintenance, securitizable documents, and the like).

Each element of this pricing analysis raises issues similar to those which go into determining the loan amount and the amount of future advances. They include the following elements, among others:

- When is the project "complete"?
- How much "punchlist" work can remain open?
- When is the project "stabilized"? What does it mean for a project to be "stabilized"? Can the parties agree on a bright line test, such as a particular level of occupancy or debt service coverage?
- How much flexibility does the lender have to reprice the financing if the market has changed? Does the lender's flexibility change over time, such as if the project has not qualified for fixed-rate financing by a certain date?
- Will any remaining "loose ends" in the project require the creation of appropriate reserves at the moment the interest rate converts?

Personal Liability

If a retail redevelopment project is, in part, a construction loan, then a borrower and its principals should not be surprised when the lender asks them to provide meaningful guaranties of completion. But these borrowers may be in a better position to negotiate the exact scope of the guaranties than pure construction loan borrowers. Often, the guaranty can "burn off" (terminate in whole or in part). In that case, the parties should be crystal clear about what event(s) lead to the partial or complete termination of the guaranty. Here are six significant issues:

- **Lessee taking possession.** Is it enough that a particular lessee takes possession? Or does the lessee also need to acknowledge certain facts regarding the lease, such as the fact that the developer has completed certain work and the overall project is satisfactory? Must the lessee begin to pay rent? For a certain amount of time? Does a particular group of lessees have to begin to pay rent? Does the lender want to see the project "stabilize" for a given period, not only as to rental revenue but also as to expenses?

> The key to value is the amount and reliability of rental income from lessees in place.

■ **Burn-off and resolution of certain risks.** Are there any development-related issues or risks that the lender wants to see resolved before it is wiling to give up the guaranty? Must the borrower clear up specific site improvement problems, issues of troublesome permits or approvals, or title concerns?

■ **Loose ends.** How many "loose ends" and "punchlist items" can be left for completion later, even after the guaranty has fallen away? How will the lender obtain comfort that these items will actually be completed?

■ **Performance under the guaranty.** If the guarantor is called upon to perform under the guaranty, just how much must the guarantor pay, and what will the lender do with those payments (e.g., credit them against the loan)? Does the guarantor have enough practical control of the project to "complete" it, if that's what the guaranty covers? If the guaranteed risk relates to failure to complete redevelopment, what is the lender's measure of injury? Is it the entire loan? Not if the deal largely represented "permanent" financing.

■ **Guarantor's needs.** The guarantor will want answers to several important questions about any "partial" guaranty. Does termination of the guaranty require any discretionary approvals by the lender? Or is the test more objective? And if the project fails before the guaranty has burnt off, does the wording of the guaranty suggest the possibility that the guarantor will be liable forever? This latter risk might be particularly likely to arise on a "carry" guaranty that covers, for example, continuing costs such as taxes, interest, and insurance premiums.

■ **Borrower/guarantor issues.** If the guarantor actually spends money under the guaranty, how are those expenditures treated within the borrowing group? Must the other members of the group contribute to the guarantor's losses? Does the ownership of the borrowing entity (i.e., the future "upside" of the project) change if a guarantor actually advances its own funds?

Administration and Approvals

A lender whose business generally consists of permanent mortgage financing of stabilized commercial property might not be adequately equipped to provide the hands-on administration that a retail redevelopment loan may require. This type of lender usually closes a loan and sends it to a servicer for servicing—perhaps little more than processing monthly payments and periodically checking for required insurance, financial reports, and other deliveries.

To the extent that a redevelopment loan is really a "construction" loan, the lender needs to oversee construction in a more pro-active and hands-on way than would be typical for a permanent loan on a stabilized building. The lender must determine whether the borrower's work qualifies for another advance and, if so, how much the advance should be, how much the lender should "hold back," and what additional documents need to be delivered. If a lender is not itself familiar with the construction lending process, it may need to hire someone else who is.

On the other hand, the more people are involved in a lender's approval process, the longer and more complicated that process will be. A borrower will prefer to deal with one person rather than a hierarchy or a committee. The borrower will want to receive decisions quickly, and to be able to resolve disagreements without too much second-guessing, process, and additional participation. So a cautious borrower may want to know the details of the lender's approval procedures, and perhaps have the loan documents say something about the approval process and the standards the lender will apply.

LESSEE ISSUES

The key to value, and hence to loan proceeds, in a redevelopment project is the same as in any other income-producing commercial real estate: the amount and reliability of rental income from lessees in place. Lenders typically do not lend based on potential rental income, nor on the value that could be achieved if a great lessee came along and took some space. Instead, lenders want to see actual rent from actual lessees in actual possession. And the amount, quality, and reliability of the rental stream drives the amount of financing that a property will support.

These issues are of particular importance in a retail redevelopment project because these projects are normally not fully leased at the time of the loan closing. The developer anticipates completing the lease-up as part of the redevelopment process. And the lease-up process raises a whole range of issues, which include the following.

Approvals of Lessees and Leases

Lenders will often want—at least as a starting point—the right to approve all future lessees and leases. The scope and nature of this approval right will often be the most hotly contested issue between borrower and lender. Because future leases will drive value and hence funding, the lender cares a great deal about who those lessees are and what the leases say. Once the project is fully leased, and the borrower's personal liability terminates, the lender ultimately bears more of the long-term risk of bad lessees than does the borrower. Consequently, the borrower's and the lender's incentives regarding lease approvals diverge. The borrower may be willing to "roll the dice" with a less creditworthy or less reliable lessee that is willing to commit to higher rent than would any creditworthy lessee. This lessee allows the borrower to show higher "net operating income," and hence qualify for higher loan proceeds. Two years later, the risk of lessee default belongs to the lender more than to the borrower. The lender will therefore want to protect itself from being left as the "bagholder" if the borrower made the wrong judgment about a lessee.

In many loans, borrowers and lenders resolve the problem of lender approvals by having the lender simply agree to be "reasonable." In the context of a retail redevelopment job, though, a pure "reasonableness" standard may be inappropriate because of a) the importance of the issue; b) the high likelihood of differences of opinion; and c) the complexity of analyzing what makes a particular lease good or bad.

What does it mean if a lender agrees to be "reasonable" about lease approvals? Few cases have analyzed the issue. The meaning of the word may depend on answers to questions like these:

- When a lender rejects a lease, does the lender have to show that no reasonable real estate investor or lender would approve it?
- Does "reasonable" mean that the lender has to approve a lease if the borrower can show it's not too awful in the context of the particular market for the particular property, a complex factual issue that could easily support a dozen depositions?
- Does "reasonable" mean a lender must give a reason for disapproving a lease?

What does it mean if a lender agrees to be "reasonable" about lease approvals?

What if the borrower can show they diligently searched for the best possible lessee (they looked high and low and every place a good lessee might go), but this lessee was all they could find?

When a borrower asks a lender to agree to be "reasonable" about future leases, the lender will regard questions like these as a source of future litigation. A lender will therefore try to insist on an absolutely discretionary standard for lease approvals, simply to reduce the risk of a lender liability claim if borrower and lender disagree.

Unless the borrower is prepared to "roll over" on this issue, both parties are probably well served if they can agree upon an objective set of leasing guidelines. The parties might set out required minimum rents and other financial terms, as well as minimum credit standards for certain types and sizes of lessees. These guidelines might vary over time, depending for example on the overall debt service coverage of the project.

A lender would also try to require that all leases follow a "standard" form used for the building. For smaller lessees, the request is not burdensome. Chain lessees will, however, want to use their own lease forms, which are likely to be very favorable to the lessee. In those cases, the lender will still insist on having the right to approve the particular lease.

At the end of the day, to the extent that the lender has the right to approve leases, the borrower will want to focus on the practicalities of that process. Does the lender have enough staff to respond quickly and constructively to lease proposals? Does the lender have a cumbersome internal approval process? Will the lender involve outside legal counsel in each lease approval? Will the borrower be able to get the lender's attention? Will the lender's lease approval people be able to understand and respond to business decisions such as entering into a below-market lease to an unusual lessee that the developer believes will enhance the overall mix and value of the project? What if the developer's proposal is otherwise a little bit "outside the box"?

Regardless of the standard that applies to the lender's approval of leases, the borrower may want the lender to agree to respond to proposed leases within a particular period. Ideally (from the borrower's perspective), if the lender doesn't

respond within that period, the lease will automatically be "deemed" approved. A lender will regard any "deemed approval" procedure as an embarrassing disaster waiting to happen, and will try to reject it completely. If the lender doesn't have enough leverage to do so, the lender may reluctantly agree to a concept of "deemed approvals," but might insist that the borrower's request for approval clearly remind the lender of the deemed approval process; be sent simultaneously to a long list of specified individuals, and contain particular information the lender will need for reviewing the proposal.

The use of leasing guidelines and deemed approvals gives the borrower some comfort.

The use of leasing guidelines and deemed approvals gives the borrower some comfort. If the borrower can find a lessee within the guidelines, there is no risk of lender disapproval. In addition to avoiding disputes, these measures can save time. And saving time can sometimes save leases because, when everything else is equal, lessees with a choice may choose to go wherever the lease negotiation process is easiest and quickest.

Regardless of how borrowers and lenders negotiate out the "lease approval" process, it is the author's experience that, in practice, borrowers sometimes go ahead and make the best lease deals they can, and then simply sign them up, perhaps informing the lender after the fact. The borrower takes a calculated risk that as long as the borrower makes a reasonable deal under the circumstances, the lender probably won't try to declare a default under the loan. Of course, the borrower also runs the risk that the lender will "punish" the borrower in some other way, such as by not counting the rental income for purposes of loan advances.

Lease Approvals and Borrower Income Calculation

A borrower should care a great deal about limiting the lender's ability to disapprove leases. But the borrower should often go on to ask a second question: Once the lender has approved a particular lease, or the borrower has signed up the lease with or without lender approval, does this mean every dollar of rental income from that particular lessee will "count" toward the calculation of net operating income, and hence calculation of the advance amount?

The issue arises because (as noted earlier) lenders typically reserve the right to "adjust" gross income downwards if they are uncomfortable with a particular lessee. The outcome of some of the issues discussed earlier in this article will determine just how "discretionary" the lender's adjustments can be. And if the adjustments are highly discretionary, the lender could theoretically use the adjustment process as a "back door" way to deny the borrower the benefit of a newly signed lease.

In the worst case, if the lender "adjusts" away a significant part of the rental income from a particular lease, that process can be just like the lender's disapproving the lease, but worse—because once the space is gone the borrower can't find a different lessee for the same space.

In practice, of course, regardless of what the loan documents may theoretically allow, few lenders will use discretionary "adjustment" procedures as a way to ignore a large part of the income from a lease that is otherwise consistent with the loan documents. And a court might not allow it, either, regardless of how much discretion the documents gave the lender.

Still, a careful borrower will want comfort in the documents. That borrower will want to know that if the lender approves a lease, all the rental income from that lessee will "count" toward net operating income. In the alternative, the borrower may want the lender to say, at the time of lease approval, just how much (if any) of the rental income from the particular lessee will be disallowed for purposes of calculating net operating income.

Nondisturbance Protections

To attract any significant lessee(s) to the project, the borrower must be able to deliver nondisturbance protections from the mortgagee. Again, mere approval of the lease does not necessarily meet all the needs of the borrower. Careful borrowers should insist that the lender agree to enter into nondisturbance agreements with any lessee(s) if specified conditions are satisfied, similar to those suggested above under the topic of leasing guidelines.

Borrowers should also try to have the lender commit in advance to issue a particular form of nondisturbance agreement, as opposed to whatever form the lender is willing to enter into at the time. This gives the borrower an opportunity to try to pre-negotiate the nondisturbance

agreement, to try to make it as palatable as possible to future lessees and not scare them away with draconian provisions or the need for lengthy negotiations to correct them. (On the other hand, although nondisturbance agreement negotiations between lessors and lessees can be protracted and unpleasant, they almost never actually derail a lease.)[2]

"Problem lessees" cause problems for redevelopment.

Although prior agreement on the form of nondisturbance agreement can be helpful, it will be of limited use to developers that lease to major chains. The latter will probably have their own forms of lessee-friendly nondisturbance agreement, which the lender will probably find unpalatable. In other words, even by planning ahead and having the lender agree on a form of nondisturbance agreement, the borrower cannot with assurance eliminate the risks of these negotiations.

Existing "Bad" Lessees

A retail redevelopment project may require the developer to try to relocate or remove smaller older lessees who are inappropriate for the reconfigured project. Because of where these lessees are located and the terms of their leases, though, without cooperation from these lessees the developer may need to scale back the project or substantially revise it. Obtaining cooperation from these lessees may create delays and expense. These risks will need to be factored into the business analysis of the deal and underwriting of the loan, and probably the loan documents themselves.

"Problem lessees" of this kind will also probably cause other problems for redevelopment. The same lessees that don't want to relocate will probably also assert that construction work is hurting their business, claim rent offsets or abatements, and otherwise try to make the developer's life difficult.

In analyzing a redevelopment deal, the borrower and the lender must determine just how much cooperation the borrower will need from existing lessees and what happens if the borrower can't get it. In a perfect world, the borrower would make a deal with all problem lessees at the time of the loan closing, and be able to deliver at closing reliable assurances from those lessees that they will cooperate. But if the borrower cannot do this, the lender will probably want to hold the developer to a schedule for negotiating appropriate arrangements with each lessee.

What happens if one or more of the problem lessees never makes a deal with the developer? If that happens, the project may need to be reconfigured. The loan underwriting and documents should therefore consider the answers to the following questions:

- If a problem lessee can block "Plan A," is there an alternative and economically viable "Plan B"?
- When does the developer need to make up its mind about which way the project will go?
- Will the project work—and will the loan be adequately secured—whether or not the holdout lessee ultimately cooperates?
- What effect will a prolonged delay have on project costs? How will the extra costs be funded?

NEGOTIATIONS WITH "MAKE OR BREAK" LESSEES

Redevelopment projects will often require not only removing undesired lessees but adding more desirable lessees or reconfiguring their existing spaces. Often this change will "make" the project. Without agreement with that one crucial lessee, the project might not work. The borrower knows it, the lender knows it—and so, usually, does the crucial lessee.

As a result the lessee will probably have a very strong negotiating position, and will probably be able to force the developer/borrower (and even the lender) to agree to provisions that they might otherwise regard as unpalatable. Conversely, both borrower and lender are likely to insist that these negotiations be concluded and that the final lease documents be signed before the overall loan initially closes.

Whether the developer must undertake lease negotiations with major "make or break" lessees or subsequent negotiations with new lessees who will arrive after the loan closing, the lender and the redeveloper must consider the same long-term issues as in any other major lease negotiations. However, redevelopment projects raise a few special issues in lease negotiations. Nine special issues are considered below:

■ **Late completion.** What happens if the developer/borrower doesn't finish the job on schedule? Does the lessee earn future rent credits or extra free rent? Does the lessee have an option to terminate? How do these lessee remedies for late completion affect the lender's security and the value of the project?

■ **Payment for lessee improvements.** If the developer/borrower has agreed to contribute toward the lessee's costs to finish out its space, will the developer/borrower be able to obtain the necessary funds from the lender at the same time the lessee expects to receive them from the developer/borrower? If not, how will the developer/borrower finance the payment to the lessee? To the extent that the funding conditions in the loan documents are more restrictive than those in the lease, this "disconnect" may build a future default into the deal structure.

■ **Consistency with loan documents.** Has the developer/borrower agreed in the lease to do anything inconsistent with the lender's expectations for the project, either as to scope, timing, or physical improvements?

■ **Development issues.** Does the lease suggest the existence of any issues relating to zoning, permits, appprovals, or community opposition? Has the lender fully taken those concerns into account in underwriting and structuring the loan?

■ **Lender involvement.** A developer will typically negotiate with the major lessee and the lender simultaneously. How involved should the developer ask the lender to become in the lease negotiations? Sometimes the developer's best strategy will be to keep the lender out of those discussions and present the lender with a "fait accompli" at the end. Of course, this approach creates the risk that the lender will reject the "fait accompli" and force the borrower to go back to the major lessee and negotiate harder. On the other hand, if the lender is involved in the process all along, this will tend to slow it down, complicate it, and incur extra legal fees. There is no right answer to whether, when, and how to involve the lender in these discussions. It depends in part on the people involved and the overall dynamics of the transaction. But it is a decision that the developer should make deliberately at the beginning of the lease negotiations, rather than something that happens one way or the other because no one was paying attention.

■ **Interim arrangements.** Does the lease require or prohibit any interim arrangements for the lessee's construction that could adversely affect other parts of the project? Parking restrictions? Access requirements?

■ **Escape clauses.** Are the lessee's obligations under the lease unconditional? Does the lessee have any right to cancel or terminate, whether because of construction delays or other circumstances? Do any conditions remain to be satisfied before the lease becomes fully effective?

■ **Take-over rent.** If the lessee is new to the project, has the developer/borrower agreed to pay the lessee's rent at an existing nearby location to induce the lessee to move to this location? What happens if the developer doesn't make those payments? Would nonpayment jeopardize this lease? Does the project budget adequately provide for these payments? If the developer has taken over the lessee's lease at its old location, does that old lease have value to the developer? Should it be part of the lender's security package?

■ **Other improvements.** Aside from actual construction of the project, does the lease require the developer/borrower to make any other improvements, either on or off the site? Traffic improvements? New landscaping? Improved parking? How does the timing of this work coincide with the timing for the rest of the project? Will there be enough money to pay for it?

Aside from issues like these, which are relatively specific to a retail (re)development project, a lender will also care about all the typical retail lease issues, including: (a) economics; (b) use restrictions (including any affecting the lessor), exclusives, and co-tenancy requirements; (c) lessee's obligation to operate; (d) lender's ability to control any "recapture" rights if the lessee shuts down; (e) coordination of expansion and extension options among multiple lessees; and (f) termination options, rent offsets, and other potential unpleasant surprises.

Coordination Between Old and New Lessees

In a retail redevelopment project, lease analysis will often raise issues regarding the interplay between a new lessee and an existing lessee. For example, an existing video store may have an exclusive right to rent or sell videotapes anywhere

Lease analysis will often raise issues regarding the interplay between a new lessee and an existing lessee.

in the project. The borrower may want to lease a former supermarket space to a multi-line discount store, whose business includes—and must include—the sale of videos.

To satisfy the new lessee, the developer/borrower will need to negotiate a lease amendment with the existing video store. That tiny video store can then become the crucial lease negotiation for the entire project. The lessee may realize it has a "holdout" opportunity, and the lease amendment may turn out to be quite expensive.

The "baggage" that comes with an older retail property will often include older leases that may not have been negotiated with the care and attention usually given to modern-day leases. These old leases may include, for example, sloppy exclusives or vague restrictions that may create problems for future lessees and impede redevelopment. The time for a borrower and lender to identify any of these problems is at the beginning of the project—not when the redevelopment project is underway.

A simultaneous acquisition and loan closing places more pressure on all parties.

SIMULTANEOUS CLOSINGS FOR ACQUISITION AND LOAN

A borrower that plans to redevelop a retail project will often want to close the redevelopment loan at the same time they acquire the property. This way, they can use the first draw under the loan to pay the bulk of the acquisition cost, and they eliminate any possibility that they will own the property without having a loan to pay for redevelopment.

A simultaneous acquisition and loan closing places more pressure on all parties than a simple refinancing of property that the borrower already owns. These closings create both opportunities and special issues for borrowers and lenders.

The Purchase and Sale Contract

The purchase and sale contract between the borrower and the seller of the property can give the lender a great deal of useful information about the property, information that the borrower will not always want the lender to know and that the lender cannot always easily obtain. It is in this document, for example, that the borrower may seek protection from the seller regarding particular environmental issues, physical problems, code compliance, and permitting problems identified at the property.

The purchase and sale contract may also describe unusual elements of the project that might not otherwise be readily identifiable. These could include, for example, easement rights over nearby properties, leases presently being negotiated, outstanding brokerage commissions, pending disputes with governmental agencies or neighbors, former use of part of the project for on-site dry cleaning, and possible issues regarding ownership of the name of the property.

Every issue that the borrower was concerned about in negotiating the purchase and sale contract will potentially concern the lender. By receiving and studying the purchase and sale contract, the lender can "piggyback" on the borrower's due diligence and analysis of the property and cross-check the lender's own due diligence.

In the purchase and sale contract, the borrower has an incentive to paint the property in bleak colors, precisely the opposite of how it would like to describe the property to the lender. Therefore lenders are well advised to review the purchase and sale contract as early as possible. For similar reasons, borrowers usually try to delay handing it over and will tell the lender and its counsel that, for example, a) the contract is a work in process that is still being negotiated; b) other counsel in another state are handling it; c) the exhibits have not been completed; or d) for any number of other reasons, the contract isn't yet available.

SIDE LETTERS AND ADDITIONAL AGREEMENTS

Experienced borrowers know that the purchase and sale contract often reveals more about the project than they care to disclose to the lender. For precisely that reason, these borrowers might try to assure that the purchase and sale contract discloses nothing at all of interest. If a borrower has identified property-specific issues and problems, it is not inconceivable that the borrower would deal with them only in a separate agreement between the borrower and the seller (or perhaps affiliates of these entities)—entirely outside the contract itself.

If a lender seriously thinks that the parties may have entered into a supplementary agreement of this type, the first question the lender should ask goes far beyond the routine and minutiae of the closing process. The lender should ask instead: Does

it make good business sense to have any dealings at all with this borrower? If the borrower acts deviously before the closing, is it likely to suddenly become ethical and straightforward after the closing?

A lender may, however, conclude that in the world of nonrecourse real estate financing, the lender's job is to understand and control the asset in such a way that the behavior of the borrower becomes irrelevant. In the opinion of the author, that approach to underwriting is particularly inappropriate for redevelopment projects, in view of the various risks and concerns described throughout this article.

If a lender is willing to proceed with the transaction even in the face of doubts about the borrower's business ethics, the lender's job is simply to ferret out the entire agreement between the seller and the borrower. That effort should probably include obtaining an appropriate certificate from the seller at the closing, and perhaps a certificate from the borrower's principals that they have disclosed the entire agreement.

If the lender makes it clear that such certificates will be required at closing, the borrower might not bother to try to do anything creative. An early request for these certificates also precludes the borrower from claiming surprise.

The closing is the borrower's last opportunity to "beat up" the seller.

Amendments to the Purchase Agreement and Final Price Adjustments

The lender should also watch for changes in the purchase and sale contract between signing and closing. That period is precisely the period when the borrower's further work on the project will reveal new problems—problems that may lead the borrower to try to renegotiate the price. Even if the contract doesn't provide an opening for these negotiations, the buyer/borrower may threaten to walk away from the deal unless the seller cooperates. Although a default of this type could cost the buyer its contract deposit, the buyer may still find it profitable to play a game of "brinksmanship" with the seller to try to reduce the price.

The same forces continue to apply at the closing itself. This is the borrower's last opportunity to "beat up" the seller. If, in another room, the borrower is negotiating with the seller for a final price reduction, the lender will want to know about this fact—and perhaps reduce the loan amount accordingly. Again, the lender and its counsel simply need to stay aware of what's going on between the borrower and the seller. The possibility of last-minute price concessions is another reason for lenders to obtain a certificate from the seller confirming the final terms of sale of the property.

Borrower's Financial Strategies at the Closing

At the closing itself, the interaction between the purchase and sale contract and the loan transaction gives the borrower some attractive opportunities for arbitrage between the seller and the lender. Most of these "arbitrage" opportunities allow the borrower to convert particular characteristics of the property into "back door financing," thus reducing the amount of cash the borrower needs to deliver at the closing. Five examples follow:

- **Timing of real estate taxes.** Some municipalities collect taxes "in arrears." If the closing occurs late in the tax accrual period, the purchaser/borrower may receive a substantial credit against the purchase price for the pre-closing accrual of real estate taxes that are not due and payable until some time after the closing. If the lender does not set up a tax escrow at closing, the borrower will have free use of this money until the taxes need to be paid. This reduces the borrower's cash requirements at the closing, and hence amounts to additional financing.
- **Unpaid bills.** If the seller has not paid for certain construction work or other expenses of the property, the buyer (borrower) may assume the obligation to do so and receive a credit against the purchase price. The purchaser's obligation to pay those outstanding bills amounts to additional financing until the bills need to be paid.
- **Other deferral opportunities.** Borrowers can create similar opportunities because they receive prepaid rent from major lessees, because they can defer payment of brokerage commissions and/or closing costs, or because they can credit security deposits against the purchase price rather than maintain them in a separate trust account. (In some states, of course, this is not supposed to happen.)
- **No reserves.** If the purchaser/borrower identifies some problem with the property that is the seller's responsibility, the parties may agree that instead of reducing the purchase price, the seller will give the purchaser, at closing, a cash deposit to cover the cost of correcting the problem. If the lender does not identify this cash deposit and hold it as a "reserve"

under the loan documents for the same purpose, the borrower has (again) just arranged additional implied financing for the purchase.

- Brokerage commissions. In a particularly egregious arrangement, the seller may agree to pay a brokerage commission on the sale to an affiliate of the purchaser/borrower. This commission agreement, which does not appear in the purchase and sale contract or any amendments, is an indirect and undisclosed reduction of the purchase price.

Each of these financial tricks reduces the cash that the borrower needs to bring to the table to close its purchase of the property. To the extent that the lender's underwriting of the loan assumes that the borrower will have a certain amount of money "at risk" in the project, these financial tricks undercut that assumption by reducing the amount of the borrower's cash equity investment. A lender may therefore care very much about what goes on between the seller and the borrower at the closing. The lender may want appropriate representations and warranties from the borrower regarding full disclosure of the purchase and sale transaction. This request may, at a minimum, make the borrower think twice before "hiding the ball."

In the opinion of the author, real estate lenders often overestimate the value of representations and warranties made by the borrower. These are ultimately just words. Once a lender has decided that the borrower's words are not enough—and the lender, therefore, requires security rather than a mere promise to repay the loan—lenders should not rely on the borrower's words as the basis for believing anything significant about the collateral or the loan. They should see the borrower's closing statement with the seller; obtain legally binding assurances from third parties (such as the seller); and, as suggested above, obtain certificates from the borrower's principals rather than from the borrower, which is likely to have no assets beyond the project.

> Real estate lenders often overestimate the value of representations and warranties made by the borrower.

MISCELLANEOUS CONCERNS

Borrowers and lenders involved in retail redevelopment projects will also want to consider a number of pure "development" issues, similar to those which arise in any construction loan, but often with special nuances arising from the prior history of the project.

Reciprocal Easement Agreements

In an existing shopping center, a large anchor user (lessee or owner occupying a separate portion of the shopping center) may have already entered into a "reciprocal easement agreement" ("REA") with the developer or the prior owner of the project. The REA typically sets out a wide range of coordinated rules for the development, use, and operation of the site —effectively a private zoning ordinance and building code. Because the REA is "senior" to mortgages, the lender will not be able to terminate it if the project goes into default, and the lender will therefore have to be able to live with the REA.

Any significant change in the project may require consent by the counterparty to the REA. For a redevelopment of the shopping center, the borrower will therefore need cooperation from yet another third party, one that is likely to have substantial negotiating strength and may or may not see the benefit of the borrower's plans.

Whether the existence of an REA is troublesome depends on the facts and circumstances of the particular property. A developer and its lender will want to focus particularly on issues such as the following, taking into account the planned redevelopment of the project:

- Do the developer's plans violate the REA? What consents are needed?
- Do the allocations of cost and responsibilities under the REA still make sense when the borrower/developer completes the current project? Does everything still "work" properly under the REA?
- In today's world, would it make more sense to restructure the REA relationship as a condominium?
- Does the REA give the developer a level of control commensurate with its risk and its role in the project?
- To do a complete job of redevelopment, should the developer also persuade the counterparty to the REA to upgrade or change its own facilities? How much will this cost and who will pay?

Aside from renegotiating particular changes in the REA to facilitate the current project, modern lenders may want more flexibility and greater rights under the REA than earlier lenders might have been willing to live with. The lender must therefore ask questions such as the following:

- Does the REA give the lender appropriate opportunities to know about possible defaults and disputes under the REA? Does the lender have the right to "cure" defaults by the borrower? Are those rights up to current standards?
- Does the REA create a risk of assessments that could be senior to the mortgage?
- Is there any risk of forfeiture?
- Does the REA contain any other elements that current lenders would find unacceptable?

Development Feasibility and Special Legal Issues

All construction lenders must analyze the physical, economic, and legal feasibility of development projects. Lenders that finance retail redevelopment projects must undertake similar analysis of construction issues, an analysis that is generally outside the scope of this article. They must also consider a few construction-like issues and variations on issues that are fairly specific to retail redevelopment projects:

■ **Unusual approvals.** Will the developer need any unusual or discretionary approvals in order to accomplish any reconfiguration or reorientation of the project that may be contemplated? How many of those approvals are already in place? What is the likelihood of problems in obtaining the remaining approvals?

■ **Special zoning problems.** If the existing structure does not comply with present zoning, will its redevelopment in any way jeopardize the entitlement for the structure to remain standing? Are there any similar issues specifically relating to signage? Does any of the contemplated work—or any demolition that might precede it—jeopardize any "grandfathering" presently available to the project?

■ **Traffic problems.** Will any reconfiguration of traffic patterns trigger any additional permitting requirements?

■ **Permit issues.** Does the expansion or remodeling of the property re-open any previously closed issues relating to building and fire issues, or permitting?

■ **Outparcels.** Does the developer plan to sell off or separately develop any "outparcels" not presently developed as part of the project? Should the lender agree to release those outparcels from the mortgage security at a later date? Not even take a lien on them?

CONCLUSION

This article has described some knotty issues that can arise in analyzing, underwriting, and closing a loan for redevelopment of a retail project. These issues often lead a lender to seek extra information and protection from the borrower —measures that can cause delay and hence expense. Because of the complexity of the issues these projects can create, redevelopment projects can also be fertile ground for disputes, delays, saber-rattling, and even litigation.

Developers that are adequately capitalized may choose to avoid involving a lender in the redevelopment process. If they are able to do so, they will instead finance the redevelopment process with equity capital. When they finish the job, without lender involvement, they will be able to refinance a stabilized project, which is a much simpler proposition. For many developers, of course, this is not an option. These developers and their counsel and lenders simply need to figure out a way to understand and deal intelligently with the complexities and constraints of redevelopment loans. ■

NOTES

[1] For more on the mortgage closing process generally, see Stein, J., How to Streamline, Simplify and Save Money in the Loan Closing Process, Real Estate Review, Fall 1998. For an overview of construction lending, see Saft, Stuart M., Reducing the Risks of Construction Lending, Real Estate Finance Journal, Spring 1999.

[2] For a discussion of the typical issues raised by nondisturbance agreements, see *Report on Nondisturbance Agreements, with Model Agreement*, 22 New York State Bar Association Real Property Law Section Newsletter, No. 2 (Spring 1994). For a more critical view of these agreements, see Andrea Paretts Ascher and Joshua Stein, *The Logic of Subordination. Nondisturbance and Attornment Agreements: Overview and Some Questions*, Practising Law Institute, *Commercial Real Estate Financing: What Borrowers and Lenders Need to Know Now* (1997, 1998, or 1999 course handbook).