

Cash Management Structures, Waterfall Provisions and Reserves in Commercial Real Estate Finance Transactions

Negotiating Lockboxes, Waterfalls and Deposit Account Control Agreements

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Cash Management Structures, Waterfall Provisions and Reserves in Commercial Real Estate Finance Transactions

Kilpatrick Team - Christopher Fernandez, Sally Ridenour, David Simpkins, and Susan Tarnower

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Part I

TERMINOLOGY

David H. Simpkins

1. What is a:

- lockbox account?
- clearing account?
- deposit account?
- rent account?
- restricted account?

For this presentation, we will use “**Deposit Account**” to refer to the account into which Rents from the collateral property are deposited.

2. What is the difference between a Soft Lockbox and a Hard Lockbox?

- Who deposits the Rents into the Deposit Account?
- If the answer is Borrower or manager, then it is a Soft Lockbox.
- If the answer is the tenants, then it is a Hard Lockbox.

3. What is a “Springing lockbox”?

The loan documents may state that under certain circumstances cash management provisions will be triggered. For example, it may be triggered upon a particular tenant lease expiration, or the income level of the property falling below a certain amount, or if a large tenant lease is going to expire in a short period of time and funds will be necessary to re-tenant the space. Once the trigger event occurs, all cash flow from the property will flow through an account that is controlled by the Lender and will be disbursed according to the terms of the loan documents.

From:
https://www.crefc.org/uploadedFiles/CMSA_Site_Home/Industry_Resources/Borrowers_Page/Frequently%20Asked%20Questions.pdf

CREFC Lockbox Status Legend

Current Lockbox Status Legend (L113, T)	
H	Hard - Borrower's tenants deposit rental payments directly into account controlled by servicer. The borrower has view only access to the account activity details. The cash flow received into the account is applied/distributed in accordance with the loan documents by the servicer, or by the lockbox bank at the direction of or with the oversight by the servicer.
SH	Sprung Hard - Relates to loans that met certain conditions under the loan documents post closing that required a Hard Lockbox.
F	Soft - Borrower or property manager collects tenant rental payments and deposits them into account controlled by servicer. The borrower has view only access to the account activity details. The cash flow received into the account is applied/distributed in accordance with the loan documents by the servicer, or by the lockbox bank at the direction of or with the oversight by the servicer.
SF	Sprung Soft - Relates to loans that met certain conditions under the loan documents post closing that required a Soft Lockbox.
S1	Springing With Established Account - Rents are deposited into an existing lockbox account (either directly by tenants or indirectly by the borrower or property manager) under the control of the borrower or servicer. The lockbox bank remits all lockbox collections to the borrower and provides them with access to the account activity details. Upon the occurrence of an event as defined in the loan documents, the servicer would instruct the lockbox bank to remit all collections to the servicer to be applied/distributed in accordance with the loan documents (i.e. cash managed) and provide the borrower with view only access to the account activity details. NOTE: Once the servicer takes control of the lockbox (i.e. springs), the code is changed accordingly to SH or SF.
S2	Springing Without Established Account - Upon the occurrence of an event as defined in the loan documents, the borrower is required to establish a lockbox account under the servicer's control for the collection of all tenant rent (either directly by tenants (hard) or indirectly by the borrower or property manager (soft)). However, no lockbox account or agreement was established with this loan at origination. Once established, a hard or soft lockbox would be implemented by the servicer with the cash flow received into the account applied/distributed in accordance with the loan documents by the servicer or by the lockbox bank at the direction of or with the oversight by the servicer (i.e. cash managed). NOTE: Once the servicer takes control of the lockbox (i.e. springs), the code is changed accordingly to SH or SF.
N	No Lockbox - Revenue from the related mortgaged property is paid to the related borrower and is not subject to a lockbox as of the origination date, and no lockbox is contemplated to be established during the mortgage loan term.

4. What are “Trigger Events”?
What are “Cash Sweep Events”?
What are “Trigger Cure Events”?
What are “Cash Sweep Cure Events”?

5. What is a “Tenant Direction Letter”?
What is a “Credit Card Payment Direction Letter”?

6. What is a “Cash Management Account”?

7. What is a “Waterfall”?

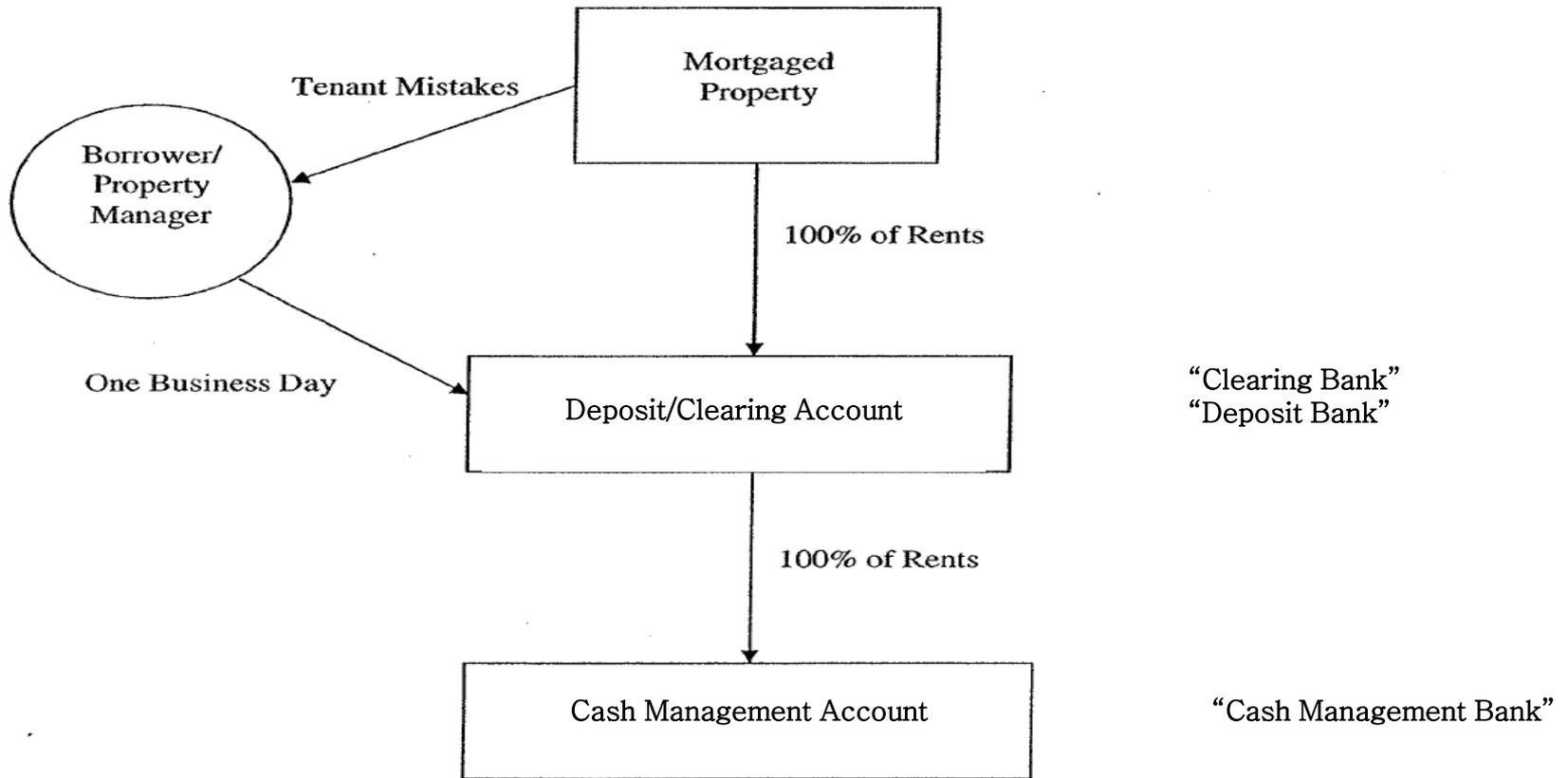
8. What are “Reserves” or “Escrows”?

Part II

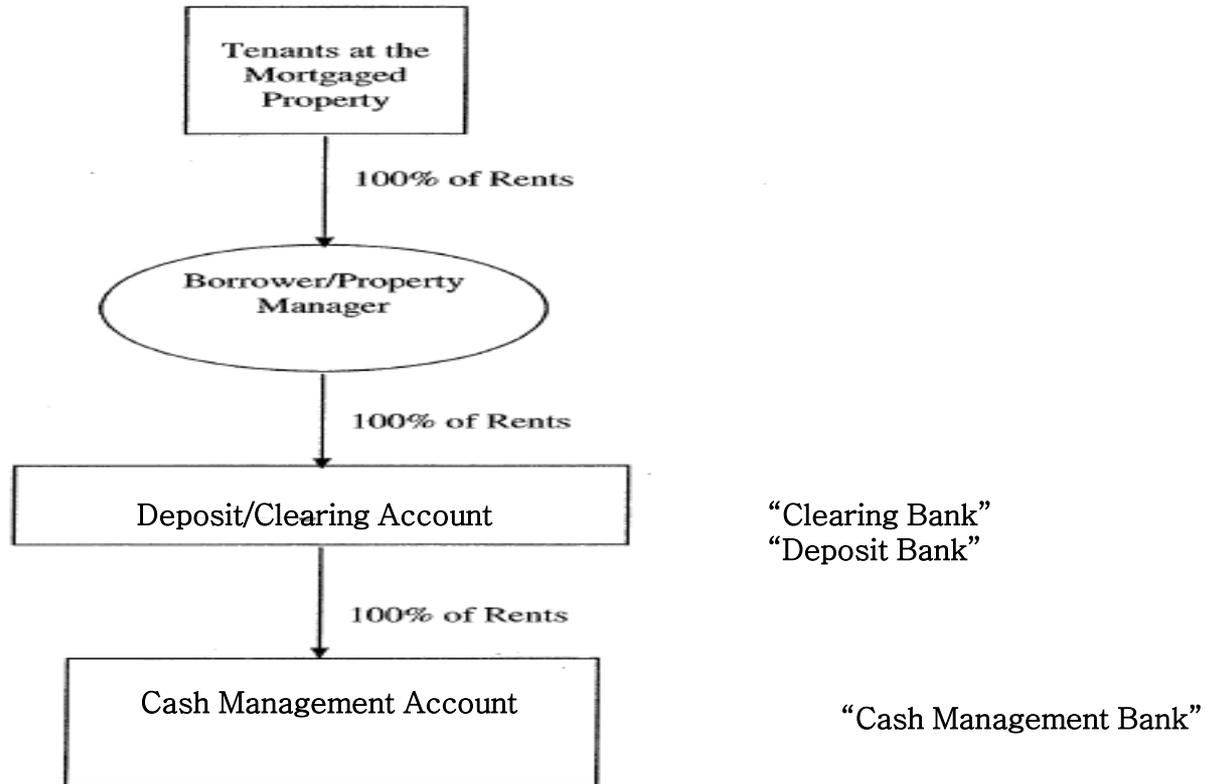
STRUCTURES

Christopher J. Fernandez

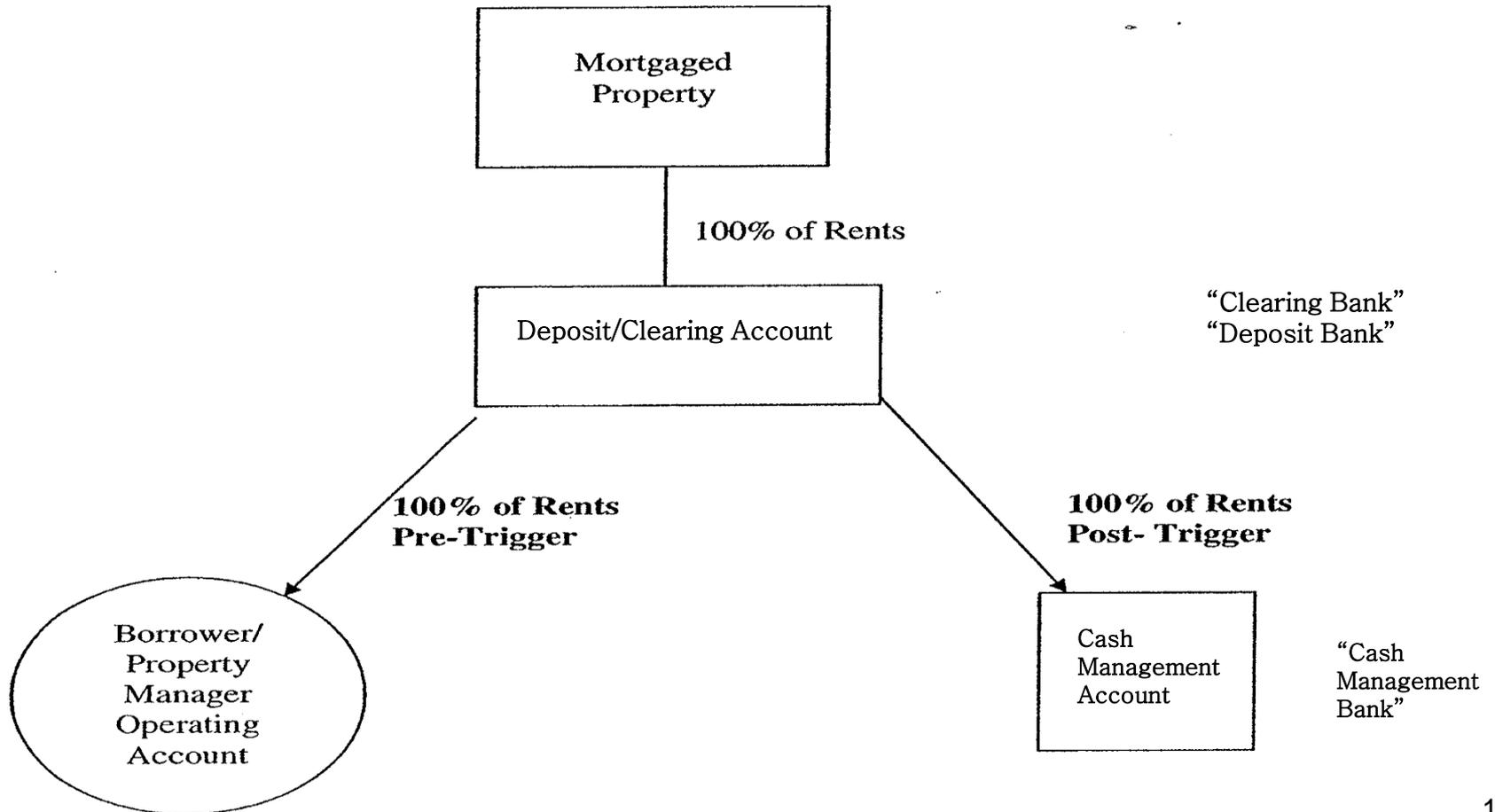
Hard Lockboxes



Soft Lockboxes



Springing Lockboxes



Part III

KEY DOCUMENTS IN CASH MANAGEMENT

Christopher J. Fernandez

The basic cash management structure consists of two accounts, the Deposit Account and the Cash Management Account.

THE DEPOSIT ACCOUNT. a/k/a the Rent Account, the Clearing Account, the Property Account, the Restricted Account, the Blocked Account or the Lockbox Account.

- The Deposit Bank is typically selected by Borrower, provided that it is acceptable to Lender and meets the eligibility criteria set forth in the loan documents.
- All Rents from the property are required to be deposited into the Deposit Account.
- The Deposit Account takes the clearing risk on deposited items.

A. Deposit Account Control Agreements.

The Deposit Account is controlled by a Deposit Account Control Agreement, a 3-Party Agreement among Borrower, Deposit Bank, and Lender.

The Deposit Account Control Agreement is form driven. Very little is negotiable.

There are two general types of account control agreements:

Springing. The funds in the Deposit Account are swept to a Borrower-designated account until such time that a trigger event occurs. Upon the occurrence of a trigger event, Lender will instruct Bank to administer and transfer funds on deposit pursuant to Lender's instructions.

Hard. At all times, the funds in the Deposit Account are transferred to the Cash Management Account pursuant to Lender's instructions.

Key Components of Deposit Account Control Agreement

1. Account Number.
2. Minimum Balance. The purpose of the minimum balance is to have available funds to cover the Deposit Bank's fees, returned items, etc. A higher minimum balance reduces the Deposit Bank's risk. The amount of the minimum balance is usually heavily negotiated between Borrower and the Deposit Bank.

3. Eligible Account Requirements mirror the eligibility requirements in the Loan Documents for accounts such as the Deposit Account. In CMBS deals, the “Eligible Account” definition corresponds to specific criteria published by the rating agencies.

Typical requirements are that the Account is separate and identifiable and that the deposit bank:

- is a federal or state-chartered depository or trust company.
- is insured by the FDIC.
- is subject to supervision or examination by federal and state authority.
- meets certain capital requirements.
- meets ratings requirements (short term unsecured debt obligations or commercial paper ratings).
- is subject to regulations regarding fiduciary funds on deposit substantially similar to 12 C.F.R. § 9.10(b).

4. Grant of Security Interest to Lender in all funds held in the Deposit Account. Lender appoints Bank as its agent to perfect by control.
5. Lender Control. Borrower acknowledges that all funds held in the Deposit Account are subject to the sole dominion, control and discretion of Lender. Borrower acknowledges that it has no right to withdraw or access funds in the Deposit Account.
6. Disbursement instructions. Directs funds to Cash Management Account, or if no “trigger” exists, to Borrower’s operating account. Sets forth the sweep frequency.
7. Subordination of Bank’s Security interest to that of Lender, except for Bank’s right to set off against and to charge the Deposit Account for Bank Fees, returned items, and items in error.

8. Indemnification. Lenders, especially in CMBS deals, will not give an indemnity. Borrower typically provides the sole indemnity. Exceptions are Deposit Bank's gross negligence or willful misconduct. Borrowers do not want to be the sole indemnitor. Because Lender is not giving an indemnity, the Deposit Bank may seek a higher minimum account balance to offset its risk.

9. Termination. Lender or Bank may terminate at any time, typically by giving thirty (30) days' notice. Agreement may be terminated immediately upon written notice from Lender to Bank upon the release of Lender's security interest in the DACA Account, typically in connection with a payoff, assumption or defeasance.

The Borrower will usually not have termination rights.

THE CASH MANAGEMENT ACCOUNT.

- Opened at a bank that is usually selected by the Lender and subject to the eligibility criteria set forth in the loan documents.
- Funds from the Deposit Account are periodically swept to the Cash Management Account.
- Funds in Cash Management Account are allocated to various subaccounts in accordance with the priorities set forth in the Loan Documents and the Cash Management Agreement.

B. The Cash Management Agreement.

The Cash Management Agreement is the key document that sets forth the specific cash management structure. It is deal-specific and highly negotiated.

Key Components of the Cash Management Agreement

Trigger Events and Cash Sweep Events:

- a. Debt Service Coverage Ratio.
- b. Default.
- c. Tenant's Credit rating.
- d. Expiration, termination or default under a major lease.
- e. A date certain prior to maturity.

Typically, but not always, each trigger will have a cure.

For example:

- If the trigger is DSCR below 1.1:1, the cure may be a DSCR exceeding 1.25:1 for two consecutive calendar quarters.
- If the trigger is the termination of a major lease, the cure may be the commencement of a replacement lease under which the tenant is paying rent.
- Other cures may include the posting of a letter of credit, a cash deposit, or the grant of an additional guaranty.

The Accounts/Subaccounts. Typically, the Cash Management Account will be an Eligible Account with various subaccounts.

Typical Subaccounts include:

- Tax Escrow
- Insurance Escrow
- Debt Service
- Capital Expenditure Reserve
- Leasing /Tenant Improvement / Rollover Reserve
- Operating Expense
- Extraordinary Expense
- Excess Cash Flow Reserve

TERMS:

The Cash Management Agreement will set forth the requirements for the deposit of Rents into the Deposit Account.

- By Borrower/Manger (known as a soft lockbox).
- Directly by Tenants according to a Tenant Direction Letter (known as a hard lockbox). Tenant direction letters are not feasible for Multifamily or Hotel Properties.
- Credit Card Payment Direction Letters (typical for Hotels).
- PO Box/Lockbox with mailing instructions (most common for retail and office properties).
- Wire/ACH instructions.

Funds deposited to the Cash Management Account will be applied in the order of priority set forth in the Cash Management Agreement.

Typical order:

1. Tax and Insurance Escrows
2. Bank and Lender Fees
3. Debt Service
4. Reserves
5. Approved Operating Expenses
6. Approved Extraordinary Expenses
7. Excess Cash Flow

See Example of Waterfall on next slide.

Provided no Event of Default shall have occurred and is continuing, commencing on the Monthly Payment Date, Cash Management Bank shall apply all funds on deposit in the Cash Management Account in the following amounts and order of priority, or as otherwise directed pursuant to the written instructions of Lender (or its designee):

First, funds in an amount sufficient to pay the monthly deposit for Taxes, if such a deposit is then required pursuant to the terms and provisions of Section ___ of the [applicable Loan Document], shall be deposited in the Tax Escrow Subaccount;

Second, funds in an amount sufficient to pay the monthly deposit for Insurance Premiums, if such a deposit is then required pursuant to the terms and provisions of Section ___ of the [applicable Loan Document], shall be deposited in the Insurance Escrow Subaccount;

Third, payment to Cash Management Bank or Lender of the monthly portion of fees charged by the Cash Management Bank or Lender in accordance with this Agreement and any other fees or expenses due to Lender under the Loan Documents;

Fourth, funds in an amount sufficient to pay the next Monthly Debt Service Payment Amount shall be deposited into the Debt Service Subaccount;

Fifth, funds in an amount sufficient to pay the monthly deposit to the [replacement/repair reserve] as required pursuant to the terms and provisions of Section ___ of the [applicable Loan Document], shall be deposited into the Replacement Reserve Subaccount;

Sixth, funds in an amount sufficient to pay the monthly deposit to the [lease rollover reserve] as required pursuant to the terms and provisions of Section ____ of the [applicable Loan Document], shall be deposited into the Rollover Reserve Subaccount;

Seventh, funds in an amount sufficient to pay any interest accruing at the [default rate] (less amounts already paid pursuant to clause (c) above), late payment charges and any other amounts due under the Loan Documents, if any, shall be deposited into the Debt Service Subaccount;

Eighth, during a Cash Sweep Event Period, payments for monthly Approved Operating Expenses for the applicable period in accordance with the related Approved Annual Budget shall be deposited into the Operating Expense Subaccount;

Ninth, during a Cash Sweep Event Period, payments for Extraordinary Expenses for the applicable period approved by Lender, if any, shall be deposited into the Extraordinary Expense Subaccount;

[Conform to transaction requirements: Tenth, during a Cash Sweep Event Period, all amounts then remaining after payment of items (a) through (i) (the “**Excess Cash Flow**”), shall be deposited into the Borrower Remainder Subaccount to be held by Lender as additional security for the Loan; and]

[Conform to transaction requirements: Eleventh, if no Cash Sweep Event Period exists, all Excess Cash Flow shall be disbursed to, or at the written direction of, Borrower.]

Notwithstanding the foregoing, upon the occurrence of, and during the continuation of, an Event of Default under any of the Loan Documents, Lender shall be entitled to disburse all, and any portion, of the funds held in the Cash Management Account as set forth in Section 5.2 of this Agreement. 34

Disbursements from the subaccounts (running the waterfall). Typically occurs on the monthly payment date.

- Funds in the Tax and Insurance Escrow Subaccounts will be disbursed to Lender for deposit into the corresponding escrow or reserve accounts.
- Funds in the Debt Service Subaccount will be disbursed to Lender for the payments of debt service.
- Funds in the Reserve Subaccounts will be disbursed to Lender for deposit into the corresponding reserve accounts.
- If applicable, Funds in the Approved Operating Expenses Subaccount will be disbursed to Borrower for the payments of operating expenses.
- If applicable, Funds in the Extraordinary Expenses Subaccount will be disbursed to Borrower for the payments of extraordinary expenses.
- Excess Cash Flow will be disbursed to Borrower or Lender pursuant to the terms of the Cash Management Agreement.

Other Typical Provisions:

- Account Number.
- Minimum Balance.
- Eligible Account Requirements.
- Grant of Security Interest to Lender in all funds held in the Cash Management Account.
- Lender Control.
- Lender's rights upon default.
- Indemnification. Lenders, especially in CMBS deals, will not give an indemnity.
- Termination and Resignation.

Part IV

Details to Watch: Sample Scenarios

Sally M. Ridenour

Scenario 1

Borrower's loan is now cash managed due to a Debt Service Coverage Ratio deficiency. Borrower claims that it has cured the deficiency and the DSCR is at an acceptable level.

What happens now?

What is the required test/timing for a cure? The loan documents may not be clear. For example, with a DSCR test, does the Lender require a full quarter/year for retesting? It is also not unusual to find conflicting language regarding trigger cure requirements in the loan agreement and the cash management agreement.

Scenario 1, con't.

If there is a cure, what's next?

- a) Loan Documents may or may not address the process if there is a cure.
 - Sometimes the waterfall stays in place and the excess cash is sent back to the Borrower, but the cash management account stays open until the loan terminates.
 - The loan documents may require cash management for the term of the loan once any trigger occurs, regardless of any cure.
 - Often, the cash management account will be closed. If so, the clearing account may or may not remain open with cash sent directly to the Borrower by the clearing bank.

Scenario 1, con't.

- b) Loan Documents are often silent on the status of the accounts after a cure.
- The parties will then negotiate the cash distribution and termination of the clearing and cash management accounts going forward. The Borrower may want to request an amendment to the cash management documents at this point to clarify the treatment for the future.
 - Current trend: Lenders are agreeing to terminate cash management accounts upon Borrower's agreement to reopen the accounts if another trigger occurs absent loan document provisions directing otherwise. Banks are facing increasing compliance issues with dormant accounts and are working with Lenders closely to either maintain active accounts or terminate accounts.

Confirm in documents: Because the Borrower wants to control the cash and stop incurring fees for the clearing and cash management accounts once any trigger is cured, the issue regarding the process after any cure should be clearly addressed in any cash management structure.

Scenario 2

Borrower's loan is cash managed and upon a trigger event all cash is "trapped" by Lender and disbursed under the waterfall with the excess cash deposited into a cash reserve account.

How and when does Borrower get funds to pay its expenses to operate the property?

- a) Loan Documents will address payment of operating expenses in waterfall, but the conditions or timing of payments may not always be completely addressed.
- b) An approved annual budget is often required so that operating funds can be sent by the Lender to the Borrower per the budget with no additional delay.

Note: If an annual budget is not approved in a timely fashion, the Lender will typically rely upon the prior approved budget until a new budget is approved.

Scenario 2, con't.

- c) Payments will generally be made on the payment date for the loan, and operating expense payments may be made for the prior month or for the next month per the loan documents.
- d) The Lender will need to approve any operating expenses not expressly authorized in the approved budget or the loan documents and authorize the cash management bank to make the payment to Borrower.
- e) What about unexpected extraordinary expenses? These may not be approved for payment in a waterfall if they are not provided in a budget. These expenses typically will require approval of the Lender and often invoices and back-up data regarding payment.

Confirm in Documents: Because any extra approval process required will be time-consuming, Borrowers will want to have the exact details for all payments due for their property accurately set forth in the transaction documents.

Scenario 3

Borrower's loan is subject to a hard lockbox with all cash disbursed under the waterfall. Property management fees are approved as an operating expense under the loan documents and disbursed to Borrower under the waterfall provisions. Borrower has requested Lender's approval of a new property manager with an increased management fee.

How does this management change affect the cash management structure?

- a) The cash management agreement will likely limit the amount of fees to be paid to Borrower under the waterfall for a property manager in a hard lockbox scenario. For example, the provisions may provide payment in an amount not to exceed x%.

Scenario 3, con't.

- b) If the new property manager is an affiliate, this may create an issue to be resolved because the waterfall provisions in a cash management agreement may exclude payments to any affiliate in a hard lockbox scenario. Particularly if there is a default under the loan, the loan documents typically will prohibit payments to an affiliate.

Sample waterfall provision with restriction:

- (i) Amounts to make payments for the Approved Operating Expenses and Extraordinary Expenses, *less management fees payable to affiliates of Borrower*, to be paid by Lender directly to the Borrower Operating Account.

Confirm in Documents: Borrowers should carefully review any cash management provisions relating to payments for property management functions at their property and confirm any restrictions relating to payments to an affiliate property manager.

Part V

CURRENT TRENDS

Mezzanine Lending and Non-securitized Loans

Susan C. Tarnower

Mezzanine Loans

General rule: Mezzanine Loan is subordinate in payment and priority to the mortgage loan

Mezzanine Loan Structure

- Secured by a pledge of equity interests in the property owner
- Separate borrower/separate collateral
- Parallel loan documents with cash management provisions likely in mortgage loan documents but may also have separate agreements if different bank involved

Effect on waterfall

- Payments to Mezzanine Lender likely included in cash management agreement waterfall provisions so Mezzanine Lender does not have to rely on borrower for payment.
- Payments to Mezzanine Lender typically after all payments owed in connection with mortgage loan but prior to release of excess cash to borrower; but in some instances, prior to operating expenses.
- Be sure all parties agree to the cash flow, and the waterfall is correctly setup.

Practice Tips:

- Identify all parties clearly in recitals and definitions.
- Be sure Mezzanine Lender provides written directions for monthly disbursements and performs any related calculations.
- Be sure mezzanine loan documents and mortgage loan documents are synchronized.
- Clarify what happens to mezzanine payment during a sweep period or upon default in mortgage loan and upon the cure of such events.
- Clarify what is to happen to insurance and condemnation proceeds – should go to mortgage lender with no claim made by Mezzanine Lender.
- Add default under mezzanine loan as a trigger event in mortgage loan documents.
- Acknowledge that upon the occurrence of an Event of Default under the mortgage loan documents, mortgage loan lender can disburse funds in its own discretion.

Practice Tips (continued):

- Payments to Mezzanine Lender should typically be limited to monthly debt service payments.
- Once mortgage loan is paid in full, if mezzanine loan is outstanding, remaining funds usually go to Mezzanine Lender.

Non-securitized loans:

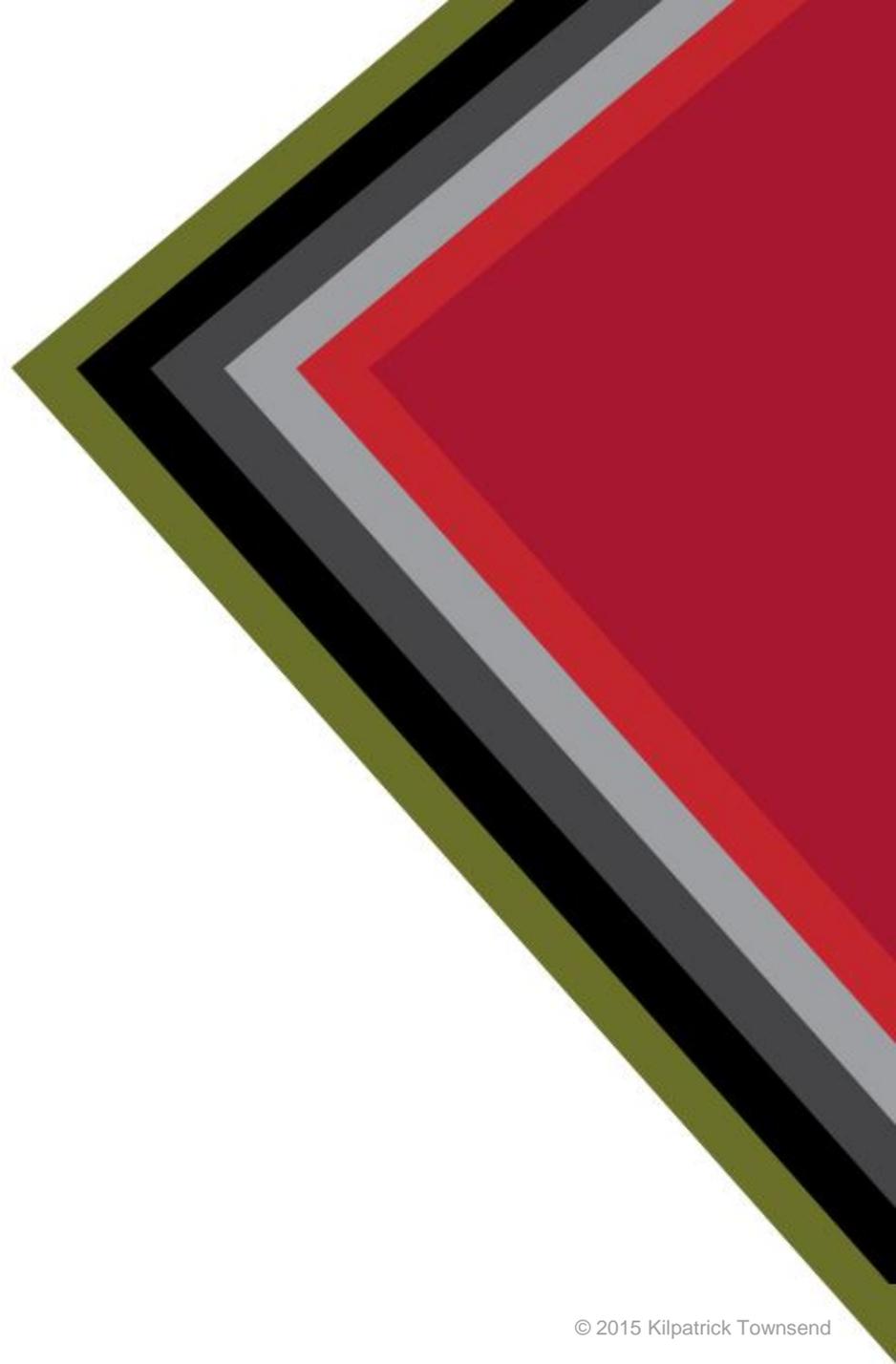
- Identify all parties.
- Is there an agent or servicer involved?
- Will there be monthly directions for disbursements?



Part VI

TIPS

Susan C. Tarnower



General:

- Be sure everyone is using (and understands) the terminology.
- Make sure the waterfall has the appropriate buckets, and the order is correct.
 - (i.e., extraordinary expenses; unusual but anticipated expense that needs to be paid – ground lease rent, condo fees, special assessments; mezzanine debt)
- Distribute the excess cash appropriately.
- Get everything to match across all documents and agreed upon up front.
- Get all appropriate parties to sign the documents.

Triggers:

If a DSCR test is involved, how will it be calculated?
How often? By whom? Can it be cured? When?

If a space goes dark, look at the cure language. Do you have to lease the entire space to one tenant at the same rate or higher? Can the space be broken up? What do rents have to be?

If the bankruptcy of a tenant is a trigger, how is, or can this be, cured? When? What if they are still paying the rent? What if the lease is on the list to be assumed under the Plan?

Bank form documents:

- Limited flexibility in negotiating terms.
- Provide all the KYC information promptly and accurately.
- Do not expect to be paid interest.
- Pay attention to minimum balances.
- Pay attention to fees and how everything is scheduled.
- Understand the way accounts/subaccounts/ledger accounts work.

Property Level Information:

What kind of property is this?

What kind of payments are received? Any credit cards?

How many tenants are there?

Can the tenant(s) wire funds in?

Accounts:

When will the account be closed?

Where will any remaining funds go?

Make sure the timing of the sweeps and payment work.

Note: Borrower – do not unilaterally close an account.

Bank:

When choosing a bank:

- Check to be sure it meets requirements in the loan documents, as eligible account/eligible institution.
- Find out how many of these accounts the bank handles.
- Determine the bank's level of comfort and degree of familiarity with these types of transactions.

What if things change during the life of the loan? (Parties, addresses, terms)

- We are not addressing what occurs as part of an assumption, but keep track of funds/accounts during that process.

AMENDMENTS TO DACA

- Identify correct parties at this time.
- Change sweep timing.
- Change account information.
- Form is too old.
- Change peg balance.
- Change notice information.
- Change direction letter instructions.

HOW TO ACCOMPLISH THIS:

- New Direction letter
- Bank form
- Simple side letter
- More formal amendment

Thank You

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