

Introducing the Carveout: A Commercial Real Estate Finance Blog

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Categories:

The Carveout

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Welcome to the inaugural post of ***The Carveout***, a Frost Brown Todd legal blog geared toward sophisticated capital market participants and focused on the commercial real estate finance (CREF) industry, with particular emphasis on what are often the most heavily negotiated and critical terms of CREF lending—non-recourse carveouts. With that lens in mind, this article and subsequent posts on *The Carveout* will provide perspective on (a) current trends and developments with these provisions, (b) how to effectively bring lenders and borrowers together to solve challenging negotiations, and (c) case law and legal proceedings involving carveouts. The emphasis will be on the kind of real-world application that helps borrowers and lenders avoid undue risks and see critical deals to completion.

Carveouts in CREF and How to Leverage Them

As background, commercial real estate loans are typically made to special purpose entity (SPE) borrowers whose sole asset is the property being encumbered by the loan. A core tenet with some of these transactions is that such loans may be non-recourse, or limited recourse, to designated guarantors that are part of the sponsorship group owning and/or controlling the SPE borrower. As a result, if there is an event of default under the loan, the lender forecloses or takes the property back through a deed-in-lieu of foreclosure without recourse to any guarantor, except for the specific recourse items agreed to by the parties.

These recourse items (typically referred to as "carveouts") drive much of the legal negotiations in closing commercial real estate loans. The carveouts were initially designed to protect the lender against "bad boy" acts that could negatively impact the performance and operations of the property—and thus the ability for the borrower to repay the loan. The challenge that borrowers face is that, over time, the standard set of carveouts has arguably expanded beyond punishing bad acts and instead attempts to

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mitigate other risks inherent in non-recourse commercial real estate lending and provide general credit support for such loans.

That potential divide between borrowers and lenders is going to be the subject of many future Carveout blog posts, where we'll also delve into well-established solutions that help to reconcile the objectives of various parties. We are emphasizing issues related to carveouts because they are the essence of the deal. They can be complicated, and different parties can understandably have different perspectives on how these issues should be resolved.

Carveouts and Lender Protections

Although every set of loan documents may provide its own form carveouts, generally speaking, carveouts are designed to protect the lender from the following:

- Fraud or misrepresentations
- Failure to pay taxes
- Failure to comply with the insurance covenants and obligations
- Failure to comply with the condemnation covenants and obligations, specifically regarding condemnation proceeds
- Failure to comply with the SPE covenants
- Bankruptcy or creditors' rights covenants
- Violating transfer provisions
- Unpermitted indebtedness or voluntary liens
- Waste to the property
- Environmental covenants and indemnities
- Failure to comply with key leasing covenants (e.g. misapplication of rents or security deposits)
- Costs of lender's enforcement of the loan documents
- Certain other unique items related to the property type involved, such as cash management provisions, hotel, condominium, or ground lease provisions, and other legal issues

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Losses vs. Full-Recourse Carveouts

The carveouts listed in the preceding paragraph are typically broken into two categories: (1) losses carveouts, also known as "above the line" carveouts and (2) full-recourse carveouts, also known as "below the line" carveouts. As the name implies, losses carveouts are designed to protect the lender against acts or omissions by the borrower and/or borrower sponsor group that result in an actual loss to the lender. Once such loss is established, the borrower and any designated non-recourse guarantor will be personally liable only for the amount of the loss the lender incurred.

Alternatively, upon a breach of a full-recourse carveout, the loan becomes full recourse, and the borrower and any non-recourse carveout guarantors become liable for the repayment of the loan in full. A common negotiating tool borrowers use, and one that will be discussed in the context of specific carveouts in future posts, is to attempt to move full-recourse carveouts "above the line" to the losses section to limit borrower's and guarantor's liability.

Carving Out a Space for CREF Dialogue

Future posts on this blog will dive deep into the common carveouts listed above, as well as other specific carveouts and related considerations, providing greater detail as to what lenders are trying to protect against and what borrowers are focused on negotiating. We will also draw on the experience of attorneys that represent different stakeholders to show how parties can find a way to get deals closed while considering these issues from multiple perspectives. Be sure to visit ***The Carveout*** blog page and add it to your favorites, as we'll be posting regularly there as we get questions or topic suggestions from our readers.

You can also check out our next blog post here on the historic (at least from a CREF lawyer's perspective) *Cherryland Mall* case that was a byproduct of the Global Financial Crisis and how parties should appreciate the ramifications of a strict judicial constructionist approach to carveout provisions. Our goal with *The Carveout* is to help both borrowers and lenders appreciate the perspectives of their counterparts in resolving concerns around

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carveouts and thereby foster productive dialogue within the industry.

If you have questions as it relates to any of the topics or issues addressed above, please reach out to the authors or any attorney with Frost Brown Todd's Commercial Real Estate Finance Team.

The Carveout

A legal blog geared toward sophisticated capital market participants, The Carveout provides insight into current trends and developments in commercial real estate finance (CREF)—with a particular focus on non-recourse carveouts and CREF loan platforms including CMBS, debt funds, private capital, REITs, life insurance companies, and other complex sources of capital.

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