Cash Management for Commercial Real Estate Loans

PRACTICAL LAW REAL ESTATE

This Practice Note excerpt explains typical cash management structures for mortgage and mezzanine loans secured directly or indirectly by commercial real estate. It describes the flow of cash from the property as it progresses through a lockbox, clearing account, cash management account and reserve accounts, identifying issues that arise for borrowers and lenders at each stage. This Note also discusses the perfection of a security interest in accounts under the Uniform Commercial Code (UCC), as well as the role cash management plays when a borrower files for bankruptcy. To access the complete online version of this resource, please visit *http://us.practicallaw.com/8-595-5927*.

Cash management is a critical feature of mortgage and mezzanine loans that are secured directly or indirectly by commercial real estate. Lenders who depend on the cash flow from the property to repay their loans want to make sure that the cash is available as and when it is needed, especially if the borrower defaults under the loan or becomes subject to a bankruptcy proceeding.

CASH AS COLLATERAL

The revenue that a commercial real property generates, such as the rent paid by tenants of an office building or the receipts from hotel guest rooms, is an important component of the collateral for a commercial real estate loan.

The lender relies on this cash to:

- Provide funds to the borrower so it can pay amounts that are due to the lender during the term of the loan (including amounts that the borrower must deposit into escrow reserve funds), such as:
  - debt service on the loan (that is, periodic payments of interest and, if the loan is amortizing, portions of the loan principal);
  - real estate taxes due on the property;
  - premiums for insurance policies covering the property;
  - operating expenses for the property;
  - the costs of capital expenditures at the property; and
  - brokers' fees and tenant allowances used in replacing tenants who leave the property.
- Pay carrying costs of the property if the borrower defaults on the loan and any of the following occurs:
  - the lender (or, more likely, a receiver that a court appoints at the lender's request) is operating the property before consummating a foreclosure;
  - the lender owns the property after credit bidding for the property at its foreclosure sale; or
  - the borrower is in bankruptcy and the lender is unable to foreclose due to the automatic stay.

This Note refers to all revenue as "cash," although the vast majority of revenue from a commercial property is usually in the form of electronic transfers and not physical money. In addition, references in this Note to:

- The borrower also includes any property manager acting as the borrower's agent.
- Tenants includes any other person or entity that must pay the borrower for the use or occupancy of space at the property or for services rendered at the property, including credit card companies that forward payment to the borrower on behalf of hotel guests or similar users (see *Box, Credit Card Payments*).

For more information on commercial real estate loan defaults, receivership and foreclosure, see *Practice Notes, Borrower Defaults and Lender Remedies in Commercial Real Estate Loans (http://us.practicallaw.com/9-535-5345)* and *Commercial Real Estate Loans: Workouts (http://us.practicallaw.com/7-505-9925)*.

When the loan is nonrecourse, the lender relies more heavily on the cash flow from the property than when the loan is recourse. Because the lender has no right to sue the borrower personally for payment of the loan or any reserve fund deposits, its only recourse for recouping its principal and for covering accrued interest and property expenses is to the property and the cash the property produces.

CONTROL OF CASH

Given the importance of a property's cash to the lender, the lender wants to control the cash flow, rather than leaving it in the borrower's hands. If the borrower has unsupervised control over the cash, the lender risks the cash becoming unavailable for its intended uses due to negligence (for example, failure to collect rent from tenants), fraud or bankruptcy (see *Bankruptcy of Borrower*).

The lender typically requires the borrower to route the property's cash through a series of control mechanisms:

- **Lockbox.** A post office box into which the borrower causes its tenants to deposit payments owing to the borrower (see *Lockbox*).
- **Lockbox account.** A bank account controlled by the lender, which receives funds from the lockbox. This account should not to be confused with the lockbox itself (see *Lockbox Account*).
- **Cash management account.** A cash management account to which funds on deposit in the lockbox account sweep daily (or on another regular basis) (see *Cash Management Account*).
- **Cash management subaccounts.** Subaccounts of the cash management account into which the cash management bank segregates funds on deposit in the cash management account for further application to specific uses (see *Cash Management Subaccounts*).
- **Reserve accounts.** Accounts opened by the lender (or the servicer that administers the loan for the lender), into which the cash management bank transfers funds from the related subaccounts to be held until the borrower meets certain conditions for withdrawal (see *Reserve Accounts*).

These mechanisms give the lender both:

- The practical benefit of tracking cash from the property and protecting it from loss.
- The legal benefit of perfecting its security interest in the cash under the Uniform Commercial Code (UCC) (see *UCC Perfection*).

LOCKBOX

A lockbox is a physical post office box. The lender obligates the borrower to send a letter (called a tenant direction letter) to all tenants who use physical checks to pay their rent, directing those tenants to send their checks to the lockbox. The bank that services the lockbox clears the checks and deposits the funds into a bank account that the lender controls, which is known as the lockbox account (see *Lockbox Account*).

Although the borrower is the named owner of the lockbox, the lender controls the lockbox through a lockbox agreement with the bank that the borrower contracts to service the lockbox. Under the terms of the lockbox agreement:

- The borrower has no contact with the lockbox or with any of the checks sent to the lockbox.
- The lender, on behalf of the borrower, has the sole right to give instructions to the bank that services the lockbox, including instructions regarding:
  - when and how to open and process checks received in the lockbox; and
  - where to deposit the funds cleared from those checks.
- The lockbox agreement may not be amended, modified, supplemented or terminated without the lender's written consent.

The use of a lockbox and the lender's control over it prevents the borrower from interrupting the property's cash flow by redirecting, retaining or losing any of the checks, whether inadvertently or deliberately.

With the widespread use of wire transfers, Automated Clearing House (ACH) and Electronic Payments Network (EPN) transfers and other electronic funds transfer (EFT) systems and online applications, physical lockboxes are now uncommon in commercial real estate. If there is no physical lockbox, parties to a loan transaction may still refer to a "lockbox," but in that instance they mean the lockbox account.

Multiple Lockboxes

In a loan transaction that is secured by multiple properties, the borrower may establish multiple lockboxes so there is a lockbox located near each individual property. A given lockbox may receive rent from only one individual property, or from several properties that are located in the same area. Each separate lockbox may have its own associated lockbox account, or there may be only a single lockbox account that receives the funds cleared from all of the lockboxes (see *Lockbox Account*). For more information on commercial real estate loan transactions involving multiple properties, see *Practice Note, Multistate Real Estate Finance: Overview (http://us.practicallaw.com/2-500-5402).*

LOCKBOX ACCOUNT

The lockbox account is a bank account that the borrower opens to receive rents from the property. The lockbox account may also be referred to as a blocked account, a clearing account or a restricted account. The lockbox account should not be confused with a physical lockbox (see *Lockbox*).

Property cash flow may arrive into the lockbox account through various channels, including:

- The bank that services a physical lockbox depositing funds cleared from checks received in the physical lockbox.
- The property's tenants depositing funds directly through an EFT or similar method in compliance with a tenant direction letter from the borrower.
- The borrower depositing money physically collected at the property (such as banknotes and coins from payments by guests at restaurants and bars at a hotel property, see *Box, Physical Money*).

The lockbox account is often held at a local bank near the property. The borrower may prefer to use a local bank for its lockbox account because, for example:

- The local bank is familiar to the tenants, in contrast to a new, distant rent payment destination that might give the tenants the impression that their landlord (the borrower) is becoming less accessible to them.
- The local bank already handles the rent collection, so the borrower does not have the administrative difficulties and delays associated

with getting tenants to switch the destination of their rent payments every time the borrower refinances its property.

- The borrower has strong relationships with its local bankers and wants to keep its business with them.

Deposit Account Control Agreement

The borrower owns the lockbox account, but the lender controls the lockbox account through a deposit account control agreement (DACA) (also known as a lockbox account agreement, a blocked account agreement, a clearing account agreement or a restricted account agreement). The DACA obligates the lockbox account bank to accept instructions regarding the lockbox account from the lender only, and not from the borrower. Under the DACA, the lender has the sole right to instruct the bank on behalf of the borrower regarding actions such as:

- Changing the name of the lockbox account.
- Changing the lockbox account number.
- Transferring ownership of the lockbox account.
- Making withdrawals from the lockbox account.
- Directing sweeps of funds in the lockbox account to another account.
- Closing the lockbox account.

The DACA is a loan document evidencing and securing the loan transaction, and therefore an event of default by the borrower under the DACA triggers a cross-default under the other loan documents, which entitles the lender to accelerate the loan and exercise its remedies under those other loan documents.

For more information on remedies generally, see *Practice Note, Borrower Defaults and Lender Remedies in Commercial Real Estate Loans (http://us.practicallaw.com/9-535-5345).* For a sample DACA, see *Standard Document, Deposit Account Control Agreement (http://us.practicallaw.com/8-383-3165).*

Sweep from Lockbox Account

The lender usually requires the local lockbox account bank to sweep funds out of the lockbox account to an account at another bank. This other bank is called the cash management bank, and the account receiving the swept funds is known as the cash management account (see *Cash Management Account*). The lender requires this sweep because:

- The local lockbox account bank may not be equipped for complex cash management tasks like running a waterfall (see *Cash Management Waterfall*).
- The lender may have a cash management bank with which it customarily works and has previously negotiated an acceptable form of cash management agreement for use on all of the lender's loans.
- The local lockbox account bank may not have high credit ratings, so the lender may be uncomfortable allowing cash to remain for more than a few days at the local lockbox account bank (where it is subject to claims by the bank's other depositors and creditors, and may be lost if the bank fails).

Most DACAs provide for an automatic sweep of funds from the lockbox account to the cash management account pending any contrary instruction from the lender. The sweep occurs on a regular basis, anywhere from daily (or even multiple times daily) to once a month.

The frequency of sweeps is often a point of negotiation because:

- The lender wants many sweeps in a given month to minimize the risks associated with keeping the funds at the local lockbox account bank.
- The borrower prefers fewer sweeps to cut down on the cost of repeated wire transfers or other administrative charges imposed by the lockbox account bank.

If the property's revenue arrives predictably at a certain point each month, for example payments from the tenants of a shopping center whose rent is all due on the first of each month, then the parties often agree to one sweep shortly after that point (such as the fifth day of the month), followed by a final sweep at the end of the month to capture any straggling late payments.

Multiple Lockbox Accounts

If there are multiple properties securing a single loan transaction, the borrower may set up multiple lockbox accounts so there is a lockbox account located at a bank near each individual property. A given lockbox account may receive rent from one property or from several properties that are located in the same area.

In a situation with multiple lockbox accounts, the borrower may set up an additional account, usually referred to as a concentration account (or a clearing account), to which each of the individual lockbox accounts sweeps. The concentration account aggregates the funds from all the individual lockbox accounts before itself being swept to the cash management account. The concentration account is subject to a DACA and otherwise treated like a standard lockbox account.

The sweeps from the individual lockbox accounts to the concentration account and the sweep from the concentration account to the cash management account may occur with:

- **Identical frequency.** The individual lockbox accounts sweep to the concentration account and the concentration account sweeps to the cash management account simultaneously on the same day or days each month.
- **Varying frequencies.** For example, the individual lockbox accounts may sweep once per week into the concentration account, while the concentration account lets those funds build up and sweeps to the cash management account only at the end of the month.

For more information on commercial real estate loan transactions involving multiple properties, see *Practice Note, Multistate Real Estate Finance: Overview (http://us.practicallaw.com/2-500-5402).*

Negotiations Regarding Lockbox Accounts

The identity of banks holding lockbox accounts and concentration accounts, the number of the accounts required and the frequency of sweeps from those accounts are matters of negotiation between the borrower and the lender that depend on:

- The degree to which the lender is comfortable with the credit ratings and performance of each bank that the borrower proposes hold an account.
- The nature of the property and the amount of cash that it generates on a daily, weekly or monthly basis.
- The frequency of distributions from the cash management waterfall (see *Cash Management Waterfall*).

- The demands by the account banks for peg balances or other protections, such as indemnities or reimbursement obligations (see *Lockbox Account Bank Protections*).

Lockbox Account Bank Protections

All funds in lockbox accounts are usually swept out to the cash management account (or an intermediate concentration account, if applicable) soon after those funds are first deposited. If there is a problem with any of the deposits, such as a bounced check or other returned item, that comes to light only after the lockbox account bank has swept the account, the lockbox account bank is left with a deficit in the lockbox account.

To address these potential liabilities, the lockbox account bank includes protections for itself in the DACA, which may include:

- An agreement by the borrower, and sometimes the lender, to reimburse the lockbox account bank for the returned item.
- The right to set off the amount of the returned item against other accounts of the borrower (or an affiliate of the borrower) that the lockbox account bank holds.
- A guaranty of payment of all returned items from a guarantor affiliated with the borrower.
- A peg balance, which is a static minimum balance that the lockbox account bank excludes from the sweeps. The peg balance serves as a cushion to absorb any deficit. The size of the peg balance is based roughly on the average size of the property tenants' monthly rent payment (or average daily receipts in the case of a hotel or resort property), so that the peg balance can absorb several returned items in a given month.
- An indemnity by the borrower (and, rarely, the lender) of the lockbox account bank for damages or losses the lockbox account bank suffers as a result of any returned item.

In commercial mortgage-backed securities (CMBS) finance, the lender cannot agree to reimburse or indemnify the lockbox account bank for returned items. After securitization, the loan is held by a trust that has no assets of its own to cover these types of obligations to the lockbox account bank. In CMBS loan transactions, the borrower and the lender must persuade the lockbox account bank to be satisfied with a peg balance or other comforts that the borrower or its affiliate provide (such as set-off rights or a guaranty). For more information about CMBS finance, see *Practice Note, Commercial Mortgage-backed Securities (CMBS) Finance: Overview (http://us.practicallaw.com/9-583-9145).*

CASH MANAGEMENT ACCOUNT

The cash management account receives the funds swept out of the lockbox account (or the intermediate concentration account, if applicable). The borrower owns the cash management account, but the lender controls it through a cash management agreement that contains language necessary to grant the lender a security interest in the account under the UCC and to perfect that security interest through control (see *UCC Perfection*). The lender, on behalf of the borrower, has the sole right to give instructions to the cash management account bank regarding disbursements and other actions involving the cash management account.

Cash Management Waterfall

On a recurring basis, usually once per month on the monthly payment date for the loan, the cash management bank disburses funds out of the cash management account to various destinations.

The cash management agreement sets out a specific order for monthly disbursements in a section of the document called the cash management waterfall. The cash management bank must determine that there are sufficient funds in the cash management account available for disbursement to pay the first item in the waterfall (such as an escrow deposit for an upcoming payment of ground lease rent) in full before the cash management bank may disburse any cash to pay the second item (such an escrow deposit for upcoming real estate taxes), and so on. If the cash management account features subaccounts, the cash management bank looks at its bookkeeping allocation of funds to those subaccounts as an easy way to make these determinations each month (see *Cash Management Subaccounts*).

This progression from one item to the next reminds real estate professionals of water falling down a series of terraces holding buckets, where the water must fill the bucket on the highest terrace to the brim before there is any excess water available to flow down into the bucket on the next lower terrace. In keeping with this metaphor, each item required to be paid in the waterfall is often referred to as a "bucket."

For an example of a typical cash management waterfall when a property secures a mortgage loan and indirectly secures two mezzanine loans, see *Box, Waterfall Example*.

Cash Management Subaccounts

A cash management account often has subaccounts into which the cash management bank allocates funds as they are received into the cash management account. The subaccounts each hold funds that are designated for a particular purpose. The cash management bank fills the subaccounts in the order set out in the cash management waterfall (see *Cash Management Waterfall*).

The subaccounts are not separate accounts. Rather, they are bookkeeping entries to enable the cash management bank, the borrower and the lender to determine easily whether, when the cash management account is emptied on the coming monthly payment date:

- Every bucket of the waterfall will be fully funded and all required payments out of the cash management account can be made.
- One or more of the buckets at the end of the waterfall will not be fully funded, and the borrower will have to make a direct deposit out of its own personal funds into the cash management account to cover the shortfall.

Cash Management Account Instructions

The cash management agreement requires the cash management bank, when allocating funds into subaccounts and making monthly disbursements out of the cash management account, to follow instructions provided by the lender or the lender's loan servicer only, and not any instructions provided by the borrower. Besides the lender's general desire to control the cash flow, sole control by the lender is necessary to preserve the lender's perfected security interest in the cash collateral (see *UCC Perfection*).

These instructions usually take the form of a general framework contained in the cash management agreement, with the lender (or the lender's servicer) providing supplemental, detailed instructions before each disbursement date. For example:

- The cash management agreement provides generally that the cash management bank is to pay debt service to the lender out of the cash management account on the first of each month.
- The lender's monthly instructions state the exact dollar figure of debt service that the cash management bank must allocate to the debt service subaccount that month, based on:
  - the number of days in that month; and
  - the current interest rate.

If there are any mezzanine loans involved in the transaction, each mezzanine lender (or its respective loan servicer) must provide detailed instructions regarding its mezzanine loan debt service and any other amounts owed to it that are to be paid out of the applicable bucket in the waterfall.

CASH TRAP

The excess cash that remains at the "bottom" of the waterfall after all buckets have been filled (that is, any funds remaining in the cash management account after the cash management bank has disbursed funds from the subaccounts for all the items on the waterfall list) may go to either:

- The borrower's operating account, where that excess cash is available to the borrower for any purpose at all (in other words, it is the profit or net cash flow from the property available to the borrower).
- A reserve account, where the lender traps that excess cash as additional collateral for the loan.

The chosen destination is a point for negotiation between the borrower and the lender, often at the term sheet stage. If the property is financially strong and performing well, the lender usually permits the borrower to receive the excess cash. If there are problems affecting the property, however, the lender wants to trigger a cash trap and hold the excess cash as additional collateral (see *Cash as Collateral*).

Cash Trap Triggers

Events that commonly appear in loan documents as cash trap triggers include:

- An event of default under any loan document.
- A bankruptcy of:
  - the borrower;
  - any general partner of the borrower, if the borrower is a partnership; or
  - the sole member or managing member (as applicable) of the borrower, if the borrower is a limited liability company.
- A bankruptcy of the property manager.
- Failure of the property to meet one or more financial tests, usually based on the property's:
  - debt service coverage ratio (DSCR); or
  - debt yield (that is, the ratio of the net operating income of the property to the outstanding principal balance of the debt secured by the property).

When a problem occurs, the lender traps the cash by instructing the cash management bank not to disburse any excess cash to the borrower's operating account, and instead to transfer it to one of the lender's reserve accounts, usually referred to as the cash collateral reserve account or the excess cash reserve account (see *Borrower's Operating Account* and *Reserve Accounts*).

Cash Trap Trigger Cures

The lender holds the excess cash in the cash collateral reserve account until the cash trap trigger is cured, which occurs when:

- For an event of default:
  - the borrower tenders cure of the event of default; and
  - the lender accepts the cure.
- For a bankruptcy of the borrower or applicable affiliate, the bankrupt entity succeeds in having the bankruptcy dismissed or discharged.
- For a property manager bankruptcy:
  - the manager succeeds in having the bankruptcy dismissed or discharged within a specified period of time (typically 60 or 90 days); or
  - the borrower replaces the bankrupt manager with another manager that satisfies the requirements of the loan documents.
- For a financial trigger, the property's financial performance recovers. The test to exit a cash trap is often more stringent than the test that triggers a cash trap. For example, the trigger for a cash trap may be the DSCR of the property being less than 1.10:1.00 at the end of any calendar quarter, while the lender may require the property to achieve a DSCR of 1.15:1.00 at the end of two consecutive quarters to exit the cash trap. This more stringent test ensures that the lender does not give up its extra cash collateral at the first sign the property is recovering, only to find that the recovery was short-lived and the property is continuing to underperform.

The lender usually imposes deadlines for a cash trap cure to take place (for example, the borrower must discharge its bankruptcy within 90 days of its filing). If the deadline passes before the cure occurs, then the cash trap remains in place even if the cure does finally occur on some later date.

Mezzanine Loans and Cash Trap Triggers

If there is a mezzanine loan indirectly secured by the property, the mezzanine lender may ask the mortgage lender to agree in an intercreditor agreement not to declare a cash trap trigger to have occurred without first consulting with the mezzanine lender. (The mezzanine lender may even request that the mortgage lender condition the trigger on the mezzanine lender's consent, but most mortgage lenders refuse to agree to that.)

The mezzanine lender does not want the mortgage lender to trap cash when the mezzanine lender does not believe a trigger has occurred (for example, if there is a dispute about whether or not the property really failed to meet a financial test) for the following reasons:

- If the cash management waterfall does not include buckets for payments to the mezzanine lender, then the mezzanine lender depends on the excess cash providing a source for funds that the mortgage borrower can distribute up to the mezzanine borrower to pay off the mezzanine loan.

- If the mortgage borrower cuts corners at the property because it has lost access to the excess cash, the value of the property may decline. Since the mezzanine loan is subordinate to the mortgage loan, the mezzanine loan is secured only by the mezzanine borrower's equity in the property (that is, the property's value after subtracting the amount of the mortgage loan). Therefore, a decline in the property value impacts the mezzanine lender long before it impacts the mortgage lender.

For a visual depiction of a typical mortgage and mezzanine loan structure, see *Real Estate Mezzanine Lending Chart (http://us.practicallaw.com/2-539-3505).*

Mezzanine Loans and Cash Trap Trigger Cures

The mezzanine lender also does not want the mortgage lender to release a cash trap without the mezzanine lender's consent (or at least consultation).

When a mezzanine lender foreclosures on pledged equity interests in a property, the mezzanine lender effectively steps into the shoes of the mortgage borrower as the owner of the property (and the borrower under the mortgage loan secured by that property). If there are problems at the property that triggered a cash trap, the mezzanine lender does not want a scenario like the following to occur:

- There is a temporary improvement in the problems at the property that seems to cure the cash trap.
- The mortgage lender releases the trapped cash to the mortgage borrower.
- The sponsors of the mortgage borrower pocket the released cash and do not re-invest it in the struggling property.
- The problems at the property worsen again and it becomes apparent that the mortgage lender released the cash trap prematurely.
- The mezzanine borrower defaults, leading the lender to foreclose on the pledged equity and take ownership of the mortgage borrower (and therefore the property) from the former sponsors.
- The mezzanine lender is now stuck using its own money to fix the problems at the property because the mortgage borrower no longer has any trapped cash left on reserve with the mortgage lender.

RESERVE ACCOUNTS

Reserve accounts are separate accounts from the cash management account. They should not be confused with subaccounts of the cash management account (see *Cash Management Subaccounts*). Usually there is a subaccount corresponding to each reserve account that is intended to receive distributions from the cash management waterfall (see *Cash Management Waterfall*), but the subaccount and the reserve account are completely separate.

For example, the lender may require the borrower to make monthly deposits into a reserve account for capital expenditures to the property. In this situation, the cash management account may have a subaccount for capital expenditures reserve deposits. The cash management bank allocates the appropriate portion of the funds on deposit in the cash management account each month into this subaccount. On each monthly payment date, the cash management bank transfers the funds allocated to this subaccount to the lender's capital expenditures reserve account (which is a separate account, either at the cash management bank or at a different bank chosen by the lender). The transferred funds stay in the capital expenditures reserve account until the borrower complies with all conditions set by the loan documents for withdrawals from that reserve account.

Lenders handle reserve accounts in different ways depending on the type of loan involved:

- **Traditional mortgage loans.** In a traditional mortgage loan (that is, a loan that the lender originates and then holds on its books for the life of the loan, often referred to as a portfolio loan or a balance sheet loan), the lender usually opens dedicated reserve accounts in the name of the borrower. The lender does not commingle a particular borrower's reserve funds with the reserve funds of the borrower under any other loan.
- **CMBS loans.** In a CMBS loan, the lender generally deposits the reserve funds into trust accounts owned by a loan servicer that also contain reserve funds from the other loans that the servicer administers. The borrower continues to own the funds in that reserve account that are allocable to it, as a beneficiary of the trust account.

In both cases, the lender (or its servicer) holds the account in trust for the borrower, either:

- Itself, if the lender (or its servicer) is a bank.
- At a third-party bank if necessary.

The borrower grants the lender a security interest in the funds contained in the reserve accounts that are owned by the borrower. The lender perfects this security interest by controlling the reserve accounts as provided in the cash management agreement and the other loan documents. The borrower's right to receive disbursements from the reserve accounts is subject to the borrower's compliance with applicable withdrawal conditions.

Upfront versus Ongoing Reserves

Reserve accounts may be filled in one of two ways:

- **Upfront.** On the closing date of the loan, the lender holds back a portion of the loan proceeds that it is funding to the borrower and deposits the held-back amounts into various reserve accounts.
- **Ongoing.** On each monthly payment date (or some other periodic date agreed to by the parties) the lender collects a fraction of the required reserve funds from the borrower. The lender may collect the first installment in advance on the closing date.

The lender usually collects reserve funds upfront when there is a known, quantified expense that the borrower needs to pay at some point during the loan term (especially when the payment due date is relatively soon after the closing date). For example, the lender may collect upfront reserve funds for:

- Required repairs to the property that the lender's engineer identified when it inspected the property (as opposed to general capital expenditures that are expected to arise in the future but not specifically identified at the time the loan closes).
- Specific tenant improvement reimbursements or leasing commissions that are due to tenants who have signed leases or are about to sign leases at the time the loan closes.

- Other defined amounts that are payable (or likely to become payable) during the term of the loan, such as:
  - a one-time renewal fee for use of a third party's parking lot serving the property that comes due halfway into the loan term;
  - the cost for a proposed buyout of an under-market tenant that the borrower is negotiating;
  - the penalty assessed for a building code violation that the municipality has not yet fully processed into its system, and is consequently not yet payable; or
  - the amount of a mechanic's lien that appears on the property's title and is subject to a dispute.
- Other quantifiable amounts that may or may not become payable during the term of the loan, but for which the lender wants the comfort of knowing there are funds set aside to pay. For example, the lender may want to set aside the maximum amount claimed in a lawsuit against the borrower that is not covered by the borrower's insurance if the borrower loses its case.

By contrast, the lender collects reserve funds on an ongoing basis if the reserve funds are intended to cover:

- Items that fluctuate during the term of the loan, such as real estate taxes and insurance premiums, which rise and fall on an annual basis depending on circumstances and market conditions.
- Expenses that recur regularly but are not specifically identifiable now, such as rollover costs for currently occupied tenant spaces expected to open up in the future.

Borrower's Preference Regarding Reserve Funds

When negotiating the loan, the borrower may strongly resist depositing funds into reserve accounts, preferring instead:

- To receive all loan proceeds and available property revenue and be trusted to pay expenses out of its pocket as they become due.
- To deliver to the lender one or more letters of credit with a face amount equal to the required reserve funds, granting the lender the right to draw on the applicable letter of credit if the borrower fails to pay the required expense when it is due (or if there is another event of default under the loan) (see *Cash Collateral Remedies*).
- If the lender insists on establishing reserve funds for certain expense items, to make monthly deposits (from the cash management waterfall, if applicable) that are each one-twelfth of the total required amount, instead of a lump-sum upfront reserve account deposit. For example, rather than depositing upfront on the loan closing date the entire amount of real estate taxes expected to be due for all ten years of the loan term, the borrower deposits each month one-twelfth of the total real estate taxes for that particular year of the loan term.

From a borrower's perspective, requiring the borrower to deposit loan proceeds or a portion of the property's revenue into a reserve account, rather than giving the borrower a free hand with its money, has the effect of:

- Depriving the borrower of the use of the reserve funds for any other purpose during the waiting period before the funds are needed for their particular expense item.
- Burdening the borrower with administrative conditions on withdrawals from the reserve account. For example, the lender may condition withdrawal of funds from a required repairs reserve account on:
  - receipt of invoices from contractors that the borrower intends to pay with the withdrawal;
  - delivery of waivers by those contractors for all mechanics' liens relating to the work performed; and
  - inspection by the lender's architect of the completed repairs.
- For upfront reserve deposits made out of the loan proceeds, obligating the borrower to pay interest to the lender for the reserve funds even though they are not unconditionally available to the borrower (the interest that the borrower owes to the lender on the reserve funds may be partially offset by the interest or investment earnings accrued on the reserve funds themselves) (see *Reserve Accounts Interest and Earnings*).

BORROWER'S OPERATING ACCOUNT

There are various categories of funds that the borrower is typically entitled to receive out of the cash management waterfall, such as:

- Property operating expenses.
- Extraordinary expenses.
- Excess cash, if there is no cash trap (see *Cash Trap*).

The borrower should set up an account to receive these funds. This account, which is referred to as the borrower's operating account, is:

- Owned by the borrower.
- Controlled by the borrower (unlike the lockbox account and the cash management account, which are typically controlled by the lender) (see *Lockbox Account* and *Cash Management Account*).

The borrower is free to use the funds in the operating account for any purpose and has the right to transfer those funds out of that account to any destination it chooses. For example, it may distribute excess cash up to its parent as profit.

While the amount transferred to the borrower's operating account from the waterfall may include amounts allocated for the payment of ordinary and extraordinary operating expenses, usually there is no obligation on the borrower to use specific funds in the operating account for any designated purpose. There is no way to track the borrower's usage, since cash is fungible (meaning it is not possible to tie any specific dollar that the cash management bank deposits into the operating account with any specific dollar that the borrower spends out of the operating account). If the borrower can operate the property successfully using less than the anticipated amount of operating expenses, that is the borrower's choice.

However, the borrower cannot ignore the property and convert every dollar in the operating account for its own personal use, since it must always comply with the covenants in the loan documents that require it to:

- Maintain the property in good order and repair.
- Comply with all laws and regulations regarding the property, including its physical state and its satisfaction of environmental and life-safety requirements.

- Comply with all leases and other contractual obligations with third parties regarding the property.
- Pay all required debt service and other amounts to the lender (which becomes more difficult if the borrower's cost-cutting impacts the performance of the property).

SPRINGING COMPONENTS

Borrowers often resent the delays and complications that cash management systems create in the operation of the borrower's property. To give themselves leeway, many borrowers negotiate for some or all of the components of the cash management system to be springing. A springing feature is one that is not effective at the time the loan closes, but springs into existence when a trigger event happens.

SPRINGING COMPONENT STAGES

The springing concept can appear at any stage in the cash management system. For example:

- **Springing lockbox.** The borrower is not required to send tenant direction letters to tenants until the occurrence of a trigger event. In the absence of a trigger event, the borrower receives rent checks directly.
- **Springing lockbox account.** The borrower sends tenant directions letters at closing, but the lockbox agreement provides that, until a trigger event occurs, the bank that services the lockbox is to deposit funds cleared from the rent checks directly into the borrower's operating account, rather than into the lockbox account. This is often referred to as a "soft" lockbox account, as opposed to a "hard" lockbox account that always sweeps to the cash management account.
- **Springing cash management account.** All rent must be deposited into the lockbox account, but the lockbox agreement provides that, until a trigger event occurs, the lockbox account bank is to sweep the lockbox account directly into the borrower's operating account, rather than into the cash management account.
- **Springing waterfall.** All rent must be swept from the lockbox account into the cash management account, but the cash management agreement provides that, until a trigger event occurs, the cash management account bank is to transfer all funds on deposit in the cash management account directly into the borrower's operating account, rather than run it through the waterfall.
- **Springing buckets and reserve accounts.** The cash management bank runs funds through the waterfall, but certain buckets (such as the rollover reserve bucket and its corresponding reserve account) are inoperative until the occurrence of a trigger event.
- **Springing cash trap.** Cash traps by their nature spring into operation on the occurrence of a cash trap trigger event (see *Cash Trap*).

OPEN AND CLOSED SPRINGING LOCKBOX AND ACCOUNTS

When the physical lockbox, the lockbox account or the cash management account is springing, a borrower may request that the borrower not be required to open the lockbox or applicable account until the trigger event occurs. This saves the borrower trouble during the closing process and relieves the borrower of the cost of keeping the lockbox or account open before it is actually needed.

The lender may be reluctant to agree to this. Trigger events by definition occur when there is a problem affecting the property, and the lender fears that the problem can:

- Distract the borrower's attention from its administrative obligations relating to cash management.
- Eliminate any incentive the borrower has to comply with its obligations to open the lockbox or account.

For example, if the trigger is an event of default such as a failure to make a debt service payment, the borrower may not care that it is causing an incremental event of default by ignoring its springing cash management obligations. Furthermore, even a conscientious borrower may be too distracted by trying to address the causes of the underlying event of default to complete paperwork and take other administrative steps to open the lockbox or account.

UCC PERFECTION

Control of cash is important to the lender in a commercial real estate transaction, not only for the business reason that it provides certainty about the location and use of the property's cash flow, but also because as a legal matter it perfects the lender's security interest in the cash.

CREATION OF SECURITY INTEREST

The borrower creates a security interest in each account in favor of the lender by signing and delivering to the lender loan documents that recite the consideration for the grant of the security interest and contain appropriate granting clauses. A granting clause contains words to the effect that the borrower grants to the lender "a continuing lien on, and a security interest in, all of the borrower's right, title and interest in and to" the desired assets of the borrower.

The lender's counsel and the borrower's counsel have different goals regarding the granting clause:

- **Lender's counsel.** The lender's counsel must be sure that the granting clause encompasses all of the borrower's accounts that are intended to be collateral for the loan. The granting clause must identify the accounts with specificity, usually by defining the account through reference to the account's name, number and bank. If there are multiple accounts, the definition may refer to a schedule listing the pertinent information for each account.
- **Borrower's counsel.** The borrower's counsel must be sure that the granting clause does not cover accounts that the borrower intends to exclude from the collateral for the loan. For example, the lender should not have a security interest in:
  - the borrower's operating account (see *Borrower's Operating Account*); or
  - accounts held by the borrower in trust for other persons or entities, for example accounts that hold gratuities collected on behalf of the servers at a hotel or sales and use taxes collected on behalf of a taxing authority (see *Box, Employee Gratuities* and *Sales and Use Taxes*).

PERFECTION OF SECURITY INTEREST

Under the UCC, a secured party perfects its security interest in deposit accounts and securities accounts by controlling the account. In a typical commercial real estate transaction, the lender controls:

- Each lockbox account (and any concentration account when there are multiple lockbox accounts) through a DACA (see *Deposit Account Control Agreement*).
- The cash management account through the cash management agreement (see *Cash Management Account*).
- The reserve accounts by virtue of being the holder of the account (see *Reserve Accounts*).

To ensure that the lender's security interest is properly perfected, the lender's counsel should confirm that any agreement that is intended to give the lender control over an account does not:

- Condition the bank's obligation to follow the lender's instructions on any confirmation of those instructions from the borrower.
- Require the bank to obtain the borrower's consent to any action regarding the account.
- Permit the bank to follow any instructions given by the borrower regarding the account.

If the agreement includes a springing component of cash management, it may permit the bank to follow the borrower's instructions until the trigger event occurs and the lender delivers new instructions. This does not impair the perfection of the lender's security interest, as long as the bank agrees that after the trigger event occurs, it will follow only the lender's instructions without requiring the consent of the borrower.

For more information on security interests in deposit accounts, securities accounts and other collateral, see *Practice Note, UCC Creation, Perfection and Priority of Security Interests (http://us.practicallaw.com/6-381-0551).*

UCC PERFECTION OPINION

To give the lender comfort that it has a perfected security interest under the UCC in all accounts in the cash management system, the lender's counsel should request that the borrower's counsel deliver a legal opinion regarding perfection for each account.

To determine which state or commonwealth's UCC governs each account (and therefore needs to be analyzed in the related legal opinion letter), the lender's counsel should check with each bank that will hold an account to identify the bank's jurisdiction for the purpose of the UCC.

The lender's counsel should be aware that the state or commonwealth whose UCC governs the security interest in the account may be different from the state law governing the applicable DACA or cash management agreement. For example, a bank based in San Francisco may use New York law to govern its DACA but may have California as its jurisdiction for the purpose of UCC perfection.

For more guidance on UCC opinions, see *Practice Note, Legal Opinions: Commercial Real Estate Finance: UCC Security Interest Legal Opinions (http://us.practicallaw.com/3-590-8127).*

BANKRUPTCY ISSUES

Cash collateral plays a major role in bankruptcy cases. This is true in commercial real estate finance as in other fields, and comes into play in a bankruptcy of:

- The borrower (the owner of the property).
- A parent or other affiliate of the borrower.
- The property manager.

BANKRUPTCY OF BORROWER

Usually, if the owner of commercial real estate becomes bankrupt, the bankruptcy estate has no source of cash to continue its operations except for the cash generated by the property itself. The trustee or other administrator of the bankruptcy estate, along with the creditors of the estate, have a strong incentive to:

- Keep cash in the possession of the bankruptcy estate rather than letting it go to the lender through operation of the cash management system.
- Challenge the lender's security interest in the cash collateral.

If successful, the bankruptcy estate and its creditors may be able to divert the cash away from the lender to use for other purposes. These parties may argue that using the cash for a purpose such as performing repairs to the property is ultimately beneficial to the lender as the mortgagee of the property. However, from the lender's perspective, it should be the one who makes the decision about whether, when and how to apply the cash from the property, since it is the secured party who bargained for a first-priority interest in that cash.

To prevent these kinds of challenges in bankruptcy, the lender ideally has a cash management system in place from the day the loan closes and includes a valid and perfected security interest in every account associated with the loan.

BANKRUPTCY OF PARENT OR AFFILIATE OF BORROWER

When a parent or other affiliate of the borrower becomes bankrupt, there is a danger that the cash owned by the borrower may be substantively consolidated with the assets of the bankruptcy person or entity. Substantive consolidation occurs when two entities that are legally distinct entwine their affairs so extensively that creditors are justified in viewing them as a single economic unit.

If a borrower commingles its cash with cash owned by its affiliate, then in the event of a bankruptcy of that affiliate, the bankruptcy court may find that creditors of the affiliate are justified in relying on the availability of the borrower's cash to pay the bankrupt affiliate's debts. This is true even if the borrower was intended to be a special purpose entity (SPE).

In this situation, the court, acting on equitable grounds, would substantively consolidate the borrower's assets with those of the bankrupt affiliate. As a result of the consolidation, each of the bankrupt affiliate's creditors would take its place alongside the borrower's lender as a party with a potential interest in the cash. The lender would have to engage in difficult and expensive litigation to protect its rights to the cash. The other creditors would attack the validity and perfection of the lender's lien, and if successful would cause the lender to lose its priority over those other creditors.

In re General Growth Properties, Inc.

The risks posed to a lender's interest in a borrower's cash by the bankruptcy of a parent or other affiliate of the borrower are not just theoretical. In the bankruptcy case *In re General Growth Properties, Inc.*, certain parent entities had several subsidiaries that were SPEs (*No. 09-11977 (ALG), 409 B.R. 43 (Bankr. S.D.N.Y. 2009)*). The SPEs owned individual shopping centers that were mortgaged to various lenders and securitization trusts. The SPEs participated with the parent entities in a combined treasury management system that commingled cash generated by each individual SPE's shopping center with cash belonging to other SPEs and the parent entities. When the parent entities filed for bankruptcy, the bankruptcy court issued a cash collateral order that allowed cash from individual SPEs to be upstreamed to the bankrupt parents. The bankruptcy court did this to preserve the overall organization's treasury management system as it had existed before the parent entities' bankruptcy, so as not to disrupt the operations of the shopping centers.

The bankruptcy court stopped short of an actual substantive consolidation of the SPEs' assets with the parents' bankruptcy estates, and it provided adequate protection to the SPEs' mortgage lenders for the loss of their cash collateral. Nevertheless, the mortgage lenders were unhappy that as a result of the SPEs allowing their cash to be commingled, the lenders lost control of their properties' cash and had to get involved in the parents' bankruptcy case to ensure they would ultimately recover it.

BANKRUPTCY OF PROPERTY MANAGER

The bankruptcy of the property manager ideally does not have an effect on the mechanics of a property's cash flow. The manager is merely the agent of the borrower and does not own the property or the property's cash. If the manager becomes bankrupt, the property and cash are not assets of the bankruptcy estate.

To better ensure that the property and its cash are treated properly in a manager bankruptcy, both the property management agreement and the manager's subordination, non-disturbance and attornment agreement (SNDA) with the lender should contain provisions in which the manager expressly:

- Disclaims any personal right, title or interest in or to the cash generated by the property, except in its capacity as agent for the borrower.
- Acknowledges that if the manager holds or controls any of that cash, it does so in trust for the borrower.

Even though the protections described above should isolate a property's cash from the manager's bankruptcy, the lender may still be concerned about the more general impact that the bankruptcy may have on the property. For example:

- The manager is likely to be distracted by the bankruptcy and may devote less attention to its duties at the property.
- Tenants, or hotel or resort property guests, may be apprehensive about a decline in standards caused by the bankruptcy, and seek to terminate leases or cancel reservations.
- Adverse publicity from the bankruptcy may scare off potential new tenants or guests.

To create a cushion to absorb any impact on the property's performance from a manager bankruptcy, the lender may include a manager bankruptcy as a cash trap trigger and trap the excess cash from the property until the bankruptcy is discharged or the manager replaced (see *Cash Trap*).

For more information and form language regarding the relationship of a property manager to accounts holding the cash generated by the managed property, see *Standard Document, Property Management Agreement (Non-affiliated): Drafting Note: Bank Accounts (http://us.practicallaw.com/6-555-4407).*

For general information about property manager SNDAs, see *Practice Note, Hospitality Law: Overview: Subordination, Non-Disturbance and Attornment Agreements (http://us.practicallaw.com/4-583-6149).*

OTHER SUBSTANTIVE CONSOLIDATION ISSUES WITH CASH MANAGEMENT

In addition to the risk of substantive consolidation between the borrower and its parent, cash management systems create other risks of substantive consolidation (see *Bankruptcy of Parent or Affiliate of Borrower*). The lender's counsel should carefully review the cash management structure and documentation with nonconsolidation counsel to address risks created by:

- The cash management waterfall.
- The borrower's operating account.

Substantive Consolidation Issues with Cash Management Waterfall

If the cash management waterfall contains buckets for payments to mezzanine lenders, there is a risk that in a bankruptcy of a mezzanine borrower, the bankruptcy court would consider the payments made from these buckets to be direct payments by the mortgage borrower of its affiliate's debt (see *Cash Management Waterfall*).

In the court's view, the mezzanine borrower (and its creditors) depended on the mortgage borrower to pay the mezzanine borrower's debts before the bankruptcy. The court may therefore find that the mezzanine borrower and the mortgage borrower were not truly separate. As a result, the court may make the mortgage borrower's assets, including the mortgaged property, available to pay the bankrupt mezzanine borrower's creditors.

This result is unacceptable to the mortgage lender, so to avoid this risk, the mortgage lender's counsel should ensure that the cash management agreement includes a statement that all payments made to a mezzanine lender out of the cash management waterfall are deemed to have been:

- Distributed by the mortgage borrower to its parent, the mezzanine borrower.
- Paid by the mezzanine borrower to the mezzanine lender for application to the amounts then due and payable under the mezzanine loan.

Each mezzanine borrower and each mezzanine lender should be a party to the cash management agreement to acknowledge and agree to this deemed distribution and payment concept.

Substantive Consolidation Issues with Borrower's Operating Account

For nonconsolidation purposes, the lender should insist that the borrower's operating account be owned by the borrower itself, and not by the borrower's parent or any other affiliate of the borrower. (If there are multiple co-borrowers, any one of the co-borrowers may own the operating account, since it is expected that the bankruptcy court treats all co-borrowers as a single economic unit in any event.)

If the borrower's parent or other affiliate owns the borrower's operating account, there is a risk that a bankruptcy court may find that the parent or affiliate (and its creditors) relied on the borrower to pay its debts directly, and substantively consolidate the assets of the borrower with that parent or other affiliate.

Nonconsolidation Opinion Regarding Cash Management

Each mortgage and mezzanine lender should obtain a nonconsolidation opinion that describes the cash management system and pairs that lender's borrower with each other borrower having a direct or indirect interest in the property. A "pairing" is an analysis of the relationship between two entities (including their participation in any cash management system) followed by a legal opinion to the effect that the entities' identities and activities are separate enough that it is unlikely a bankruptcy court would substantively consolidate their assets.

For more information on substantive nonconsolidation, see *Practice Note, Substantive Consolidation in Bankruptcy (http://us.practicallaw.com/7-521-6812).*

For more information on legal opinions in commercial real estate finance transactions, see *Practice Note, Legal Opinions: Commercial Real Estate Finance (http://us.practicallaw.com/3-590-8127).*

INTEREST, INVESTMENT EARNINGS AND TAXES ON ACCOUNTS

Depending on the parties' deal, the interest or other investment earnings on the funds in the various accounts making up a typical cash management system may belong to the borrower or the lender.

The parties may treat the various accounts differently, awarding the interest and earnings on one account to the lender and on another account to the borrower.

Most accounts in a cash management system are deposit accounts that hold only cash. In some instances, the parties may set up a securities account instead so that the funds in the account may be converted into investment property and earn investment income that potentially exceeds the amount of interest offered by a cash deposit account.

If the funds in a cash management system account are to be invested, the lender usually provides a list of permitted investments. These investments are generally conservative investments, such as obligations of the US government that are considered equal to cash.

In CMBS financing, the rating agencies have strict guidelines about permitted investments. For more information on rating agency requirements for CMBS loans, see *Practice Note, Commercial Mortgage-backed Securities (CMBS) Finance: Overview: Criteria for Structure and Terms of CMBS Loans (http://us.practicallaw.com/9-583-9145).*

LOCKBOX ACCOUNT INTEREST AND EARNINGS

The amount of potential interest or investment earnings on a lockbox account is relatively insignificant (see *Lockbox Account*). This is because:

- Funds deposited into a lockbox account usually do not remain on deposit in that account for long, since the lockbox bank sweeps them regularly to the cash management account (or, if applicable, an interim concentration account) (see *Sweep from Lockbox Account*).
- The individual deposits into a lockbox account are relatively small, representing only one month's rent payment from each tenant (or daily or weekly receipts from a hotel or resort property).

Even if a sizeable amount of funds builds up in the lockbox account between sweeps, the lockbox account bank may not offer to pay interest or to invest those funds because:

- The cost to the lockbox account bank of maintaining and servicing the lockbox account may make it uneconomical to pay interest on the funds.
- The fees that the lockbox account bank would have to charge the borrower for withdrawing funds, placing them in investments, managing the investments and tracking the investment earnings and losses may outweigh the potential amount of investment earnings (especially if the lender permits only certain conservative investments).
- The lockbox account bank may not want the headache of having to seek reimbursement from the borrower or another party if any investment results in the loss of lockbox funds.

For these reasons, the parties to commercial real estate loans often agree that:

- Each lockbox account must be a deposit account that can hold only cash, as opposed to a securities account that can hold other investments.
- If there is interest earned on the lockbox account funds, the lockbox bank simply adds that interest back into the principal balance of the account.

CASH MANAGEMENT ACCOUNT INTEREST AND EARNINGS

Interest and investment earnings on the cash management account can be substantial (see *Cash Management Account*). This is true even though the cash management account, like the lockbox account, sweeps out on a regular basis (see *Cash Management Waterfall*). The difference is that the cash management account aggregates deposits from all tenants and properties that are involved in the transaction, while a given lockbox account may:

- Serve only a single property in the portfolio.
- Receive rents from different tenants at different times during the month (meaning that, if there are multiple sweeps per month, the lockbox account never holds the aggregated rents from all tenants at one time).

As a result, negotiations over who is entitled to receive the interest or investment earnings from the cash management account may be more intense than in the case of the lockbox account. Depending on the deal, the parties may agree that interest or investment earnings on the cash management account should either be:

- Added back into the principal balance of the account for the benefit of the borrower.
- Paid by the cash management bank to the lender or its servicer.

RESERVE ACCOUNTS INTEREST AND EARNINGS

The most significant interest and investment earnings in a typical commercial real estate loan transaction are those generated by the reserve funds. Reserve funds serve many different purposes, and depending on the size of the property or the number of properties involved, may contain many millions of dollars. Depending on the purpose of a particular reserve account, the funds it holds may remain untouched for months or even years (see *Reserve Accounts*). For this reason, both borrowers and lenders usually pay close attention to the allocation of interest and investment earnings on reserve accounts.

Often the parties "split the baby" by awarding interest and earnings on:

- Basic reserves (like those for real estate taxes and insurance premiums) to the lender.
- Specialized reserves to the borrower.

In CMBS loans and other loans for which the lender employs a third-party servicer to administer the loan, the lender often promises the interest or earnings on the reserves for real estate taxes and insurance premiums to the servicer as additional compensation. If the borrower has a particular desire to retain these amounts, then it should discuss this with the lender when negotiating the term sheet for the transaction. The lender may put the servicing out to bid shortly after signing the term sheet, so a subsequent change to the arrangements for reserve account interest may cause delays or other difficulties while the lender amends its request for bids.

BANK FEES AND TAXES ON INTEREST AND EARNINGS

The funds on deposit in all of the various accounts that constitute a cash management system are the property of the borrower, even though the lender controls the accounts. Therefore, the borrower:

- Must pay all taxes on interest and earnings of the accounts.
- May claim any investment losses incurred on the accounts.
- Must replenish the accounts as needed to cover any investment losses.
- Must pay all fees charged by the bank for the administration of the account.

Know-your-customer and Anti-money-laundering Due Diligence

To comply with banking and tax laws, each bank that holds an account for the borrower needs to:

- Assign the name, address and tax identification of the borrower to the account (or of one of the co-borrowers if there are multiple borrowers).
- Conduct know-your-customer (KYC) and anti-money-laundering (AML) due diligence on the borrower.

Depending on the bank, the KYC and AML processes may take several weeks. As early in the transaction as possible, the borrower's and lender's counsel should work together to:

- Identify which banks hold which accounts.
- Find the appropriate contacts within each bank for KYC and AML matters.
- Incorporate or form the borrower entity that owns the account and obtain a tax identification number.
- Deliver all necessary KYC and AML documentation for that entity to each bank.
- Follow up regularly with the KYC and AML contacts at the bank to confirm the process is moving smoothly and that they are on track to grant approval as soon as possible.

CASH COLLATERAL REMEDIES

The lender has a perfected security interest in all accounts constituting the cash management system (other than the borrower's operating account) (see *Borrower's Operating Account*). These security interests serve as additional collateral for the loan. The documents governing each of the accounts contain language granting the lender all rights of a secured party, so that if an event of default occurs, the lender may realize on this collateral.

This means that the lender may withdraw cash on deposit in each of the accounts and apply it to any missed monthly payment, late charge or other amount that is then due and payable from the borrower to the lender. If the lender chooses to accelerate the loan in response to the event of default, then the lender can apply all the cash in the cash management system to pay down the principal amount of the loan.

NEGOTIATED EXCEPTIONS TO CASH COLLATERAL REMEDIES

In some instances, a borrower with significant negotiating leverage may get the lender to agree to refrain from exercising certain remedies against the cash management system's various accounts even after an event of default occurs. In this instance, the lender agrees that the cash management system may continue to operate as usual (or in some modified fashion) until a second trigger occurs, such as the lender deciding to:

- Accelerate the loan.
- Commence foreclosure proceedings against the property.

The borrower does not want the lender to interfere with the cash flow of the property while the borrower and the lender discuss how to work out the defaulted loan (or for the lender to use its control of the cash as a hammer during the workout negotiations). The borrower also fears that if the lender starts applying all the property's cash to pay down the loan, the borrower may not have any funds left to pay operating expenses or other necessary property-related expenses, and that additional events of default may start to snowball at the property.

Some possible negotiated remedy exceptions are for the lender to agree, until the occurrence of a second trigger, to take one of the following approaches:

- **Full waterfall.** The lender allows the entire cash management waterfall to run, but with the lender trapping excess cash (see *Cash Management Waterfall* and *Cash Trap*).
- **Partial waterfall.** The lender allows the cash management waterfall to run partially, meaning that the borrower is responsible for paying out of its own funds items that are less urgent in nature, such as capital expenditures and tenant improvement and leasing commission reserve deposits. The borrower at least has assurance that cash generated by the property remains available to pay basic, fixed expenses (for example, the earlier buckets in the waterfall), such as:
  - reserve deposits for ground rent;

- reserve deposits for real estate taxes and insurance premiums;
- debt service; and
- budgeted operating expenses (excluding operating expenses that are payable to any affiliate of the borrower like an affiliated property manager).

- **No waterfall, but intact reserves.** The lender cuts off the cash management waterfall (meaning that the borrower would have to pay all debt service and property expenses out of its own pocket or else request that the lender make discretionary disbursements to the borrower for them), but leave some or all of the reserve accounts intact so that:
  - those reserve funds remain available for their intended uses even during the continuance of the event of default; and
  - the borrower does not have to start over with filling the reserve funds from zero once the borrower has cured the event of default.

POSITION OF MEZZANINE LENDER DURING MORTGAGE LENDER'S EXERCISE OF REMEDIES

If there is any mezzanine loan secured indirectly by the property, the mezzanine lender may object to the mortgage lender shutting off the cash management waterfall following an event of default. The mezzanine lender may want to continue receiving distributions from the waterfall to pay its debt service even during the continuance of an event of default.

However, the mortgage lender is unlikely to agree to this. The mezzanine loan is subordinate to the mortgage loan, so the mortgage lender can foreclose on the property without any obligation to pay the mezzanine loan after foreclosure. For this reason, continued use of the property's cash flow to pay mezzanine loan debt service after a mortgage loan event of default does not benefit the mortgage lender.

WATERFALL EXAMPLE

The following is an example of a typical set of buckets and order of priority applicable to a single, ground-leased property that secures a mortgage loan and indirectly secures two mezzanine loans:

- **First,** an escrow deposit of one-twelfth of the annual ground lease rent that the borrower owes for the property (see *Box, Sales and Use Taxes* regarding an alternative first bucket in the cash management waterfall for a hotel or resort property).
- **Second,** an escrow deposit of one-twelfth of the annual real estate taxes that the borrower owes on the property.
- **Third,** an escrow deposit of one-twelfth of the annual premiums that the borrower must pay for the property's insurance.
- **Fourth**, a payment to the cash management bank for its monthly fees and reimbursable expenses accrued during the preceding month.
- **Fifth,** a payment of monthly debt service to the lender as the holder of the mortgage on the property (payable in arrears, meaning interest that accrued over the preceding month).
- **Sixth,** a payment of any other amounts due to the mortgage lender, such as default interest, late charges and other fees and reimbursable expenses, that accrued during the preceding month (other than the outstanding principal balance of the mortgage loan) (see *"Other Amounts Due and Payable" Buckets*).
- **Seventh,** a transfer to the borrower's operating account of funds sufficient to pay the property's operating expenses for the coming month (including the property manager's fees if the property manager is not an affiliate of the borrower), based on a budget that the borrower previously submitted to the lender (see *Borrower's Operating Account*).
- **Eighth,** an escrow deposit in an amount approved by the lender for the payment of capital expenditures at the property.
- **Ninth,** an escrow deposit in an amount approved by the lender for rollover costs (that is, costs to replace a tenant leaving its space in the property with a new tenant). Rollover costs include:
  - the leasing broker's fees;
  - the value of free rent afforded to the new tenant as an incentive to sign its lease; and
  - initial tenant improvements to be funded by the borrower as landlord (the cost to build out the leased premises to the new tenant's specifications).
- **Tenth,** a payment to the senior mezzanine lender of monthly debt service (in arrears) under the senior mezzanine loan.
- **Eleventh,** a payment of any other amounts due to the senior mezzanine lender, such as default interest, late charges and other fees and reimbursable expenses that accrued during the preceding month (other than the outstanding principal balance of the senior mezzanine loan).
- **Twelfth,** a payment to the junior mezzanine lender of monthly debt service (in arrears) under the junior mezzanine loan.
- **Thirteenth,** a payment of any other amounts due to the junior mezzanine lender, such as default interest, late charges and other fees and reimbursable expenses that accrued during the preceding month (other than the outstanding principal balance of the junior mezzanine loan).
- **Fourteenth,** a transfer to the borrower's operating account of:
  - the property manager's fees if the manager is an affiliate of the borrower (since the mezzanine lenders want to make sure a borrower affiliate receives cash only after the mezzanine lenders are paid); and
  - funds sufficient to pay any extraordinary expenses for operation of the property that did not appear in the borrower's budget (typically, disbursements for extraordinary expenses are conditioned on the prior written consent of the lender or its servicer to avoid the borrower draining the cash management account to pay spurious or exaggerated expenses).
- **Fifteenth,** if no cash trap is in effect, a transfer of all remaining funds to the borrower's operating account (see *Cash Trap*).
- **Sixteenth,** if a cash trap is in effect, a transfer of all excess cash to an excess cash reserve account.

Each escrow deposit and any transfer of excess cash when a cash trap is in effect is made by the cash management bank into the corresponding reserve account held by the mortgage lender (see *Reserve Accounts*).

See *Box, Seasonality Reserve Account* regarding the application of seasonality reserve account funds to the cash management waterfall for hospitality properties.

OPERATING EXPENSE BUCKET

The operating expenses bucket (seventh in the example) only allows disbursement of operating expenses that are contemplated by the borrower's budget for that month. Since the borrower sets its budget at the beginning of the year, it may find that its actual operating expense needs for a particular month exceed the budgeted amount. In that situation, it may need to make up the difference for that month out of pocket (that is, using its own personal funds).

If the borrower expects this to be an ongoing issue at its property, it may request an additional bucket at the end of the waterfall (before any cash trap) for reimbursement to the borrower of out-of-pocket expenditures it made in the previous month. The lender may require the borrower to provide proof of these expenditures before permitting any disbursement from this bucket.

"OTHER AMOUNTS DUE AND PAYABLE" BUCKETS

The occurrence of an event of default typically results in the lender shutting off the cash management waterfall and applying all property cash flow to pay down the loan (or to pay property expenses, in the lender's sole discretion). In some transactions, however, the borrower may convince the lender to agree to keep running the cash management waterfall even after an event of default and acceleration (see *Negotiated Exceptions to Cash Collateral Remedies*).

It is also possible that a mezzanine loan may be accelerated after a mezzanine loan event of default occurs, even though the mortgage loan is not in default and the cash management waterfall is otherwise operating normally.

Given these potential scenarios, if the cash management waterfall contains separate buckets for "other amounts due and payable" to the lender and the mezzanine lenders beyond their applicable monthly debt service (sixth, eleventh and thirteenth in the example), the language for those buckets should expressly state that if the applicable lender has accelerated its loan, the accelerated principal balance of the loan is not an "other amount" for that bucket. If one of those buckets did capture the accelerated principal balance as an "other amount," then it would use up all the cash that reached it and nothing would remain to fill subsequent buckets.

CASH MANAGEMENT FOR HOSPITALITY PROPERTIES

Mortgage loans secured by hospitality properties such as hotels and resorts often have unique cash management systems because of the major role that third-party managers may play in the operation of those properties.

CREDIT CARD PAYMENTS

For virtually every hospitality property, the majority of revenue reaches the owner (or the property manager on the owner's behalf) in the form of electronic transfers from credit card providers. When guests at the property pay charges with their credit cards, the credit card provider advances the amount of the payment to the property and bills the guest later.

To capture this credit card revenue, the lender should require the borrower to send direction letters to each credit card provider instructing them to send all payments directly to the borrower's lockbox account. These credit card direction letters operate in the same way that tenant direction letters do for office or retail properties (see *Lockbox Account*).

If the manager is a major third-party manager with a strong negotiating position, it may require the borrower to direct the credit card companies to send their payments to an account controlled by the manager rather than to the lender's lockbox account. In this instance, the manager's SNDA with the lender should obligate the manager to forward all cash received from the credit card companies to the lender's lockbox account, after deducting:

- The management fee.
- Deposits into any reserve funds that the manager requires (see *Cash Collected by Property Manager*).

For general information about property manager SNDAs, see *Practice Note, Hospitality Law: Overview: Subordination, Non-Disturbance and Attornment Agreements (http://us.practicallaw.com/4-583-6149).*

CASH COLLECTED BY PROPERTY MANAGER

Most large third-party hospitality property managers such as Marriott or Hilton insist on taking their management fees upfront out of the property's receipts before forwarding any cash to the borrower. They also insist on creating their own reserve funds for certain property expenses such as:

- Real estate taxes.
- Insurance premiums.

- Replacement costs for new fixtures, furnishings and equipment (commonly abbreviated as FF&E) such as beds, bathtubs, linens and air conditioners, which wear out quickly under the pressure of daily use and must be continually replaced if a hotel or resort is to stay competitive and comply with brand standards.

Therefore, hospitality property owners have largely convinced mortgage lenders to allow these major branded managers (and smaller managers on a case-by-case basis) to collect the property's cash flow directly from the guests and tenants and use the cash to fill the manager's reserve funds and pay its management fees before distributing anything to the property owner (or to the property owner's lender for the benefit of the property owner). The manager agrees to deposit all cash flow that remains after it has withheld its reserve fund deposits and management fees into a lockbox account, from which the cash flows through the cash management system as usual (see *Lockbox Account*).

As long as the manager is collecting a reserve fund for substantially the same amount and same purposes as a lender would require, the lender typically waives the requirement for a similar reserve fund under the loan (see *Reserve Accounts*).

In this situation, the lender's counsel should draft the cash management waterfall so that there is a springing bucket for each reserve fund that the manager is already holding (see *Cash Management Waterfall* and *Springing Components*). The language should provide that the appropriate bucket and related reserve account spring into operation if:

- The manager decides to cease holding a particular reserve fund for any reason.
- The lender determines that a particular reserve fund that the manager is holding:
  - has insufficient funds for the intended purpose; or
  - is not designed to reserve for all the purposes for which the lender intended to reserve (for example, if the manager's reserve fund for required repairs is expressly dedicated to roof repairs, the lender may spring its own required repair reserve fund to collect money for swimming pool repairs and other necessary repairs to the property).

Affiliated Property Managers

Lender's counsel should make sure that only major branded property managers that are not affiliates of the borrower are permitted to collect the property's cash directly without using a lockbox account. The lender does not want the sponsors of its borrower to use an affiliated property manager as a back door to control the property's cash at a time when the loan is in default and the lender is trying to resolve the problems at the property or exercise its remedies (see *Cash Collateral Remedies*).

CASH

A hospitality property may take a small but still significant amount of its monthly revenue in the form of cash, which guests may use to pay for their room charges as well as items such as food and beverages, activity fees or transportation charges.

The cash management agreement should require the borrower and the property manager to deposit all cash received into a lockbox account within a short period after receipt, typically one to three business days (see *Lockbox Account*).

The borrower may wish to build in an exception for a small amount of petty cash to be kept at the property. Most lenders readily grant this request since the requested amount of petty cash is so miniscule compared to the cash flow of the property.

Employee Gratuities

The cash management agreement should contain an exception for any gratuity that a guest leaves for an employee at the property. This money belongs to the employee. If the borrower or the manager accepts a gratuity on behalf of the employee, the money received does not become the property of the borrower or manager. Instead, the receiving party must hold that money in trust for the employee and turn it over.

The borrower's counsel should make sure that the mortgage or other security instrument does not purport to grant the lender a security interest in any employee gratuities, since the borrower has no right, title or interest in or to those funds.

SALES AND USE TAXES

Most hospitality properties are located in jurisdictions that require them to collect sales or use taxes on their room rentals and other services. By law, the amounts collected belong not to the property owner, but to the governmental authority that is levying the tax. In recognition of this fact, the cash management documents should either:

- Exclude amounts collected by the borrower (or the property manager on the borrower's behalf) for these taxes from the cash management system entirely.
- Require these amounts to flow through the cash management system, but establish a new bucket at the beginning of the cash management waterfall to receive these amounts. The lender must agree to permit the cash management bank to disburse amounts in this bucket to the borrower at the appropriate interval regardless of whether an event of default has occurred and the lender is exercising remedies against the cash management system (see *Cash Management Waterfall* and *Cash Collateral Remedies*).

If funds collected for sales and use taxes do flow through the cash management system, the borrower's counsel should ensure that:

- The mortgage or equivalent security instrument does not purport to grant the lender a security interest in these funds.
- The lender acknowledges that if it holds or controls any of these tax funds, it is doing so in trust for the borrower as the agent for the applicable taxing authority and will turn over the funds to the that taxing authority as legally required.

For an overview of hospitality law generally, see *Practice Note, Hospitality Law: Overview (http://us.practicallaw.com/4-583-6149).*

SEASONALITY RESERVE ACCOUNT

The cash flow from hospitality properties is often highly seasonal. Depending on the location of the property, there may be months when the property is:

- Fully booked and cash flow is strong (for example, the winter months at a tropical resort).
- Sparsely booked and the cash flow is weak (for example, July and August at a tropical resort).

In the low season, there may be shortfalls in the cash management waterfall. The borrower normally would need to deposit some of its own personal funds into the cash management account to make up the difference and prevent a monetary default. To avoid this, the borrower may request that the lender deposit some of the excess cash flow that the property generates during the high season into a seasonality reserve account. This account builds up during the high season and provides a pool of funds to cover shortfalls during the low season.

The cash management agreement provides that if the borrower expects a shortfall in any bucket, it may request a draw from the seasonality reserve. On the monthly payment date when the waterfall runs, the lender disburses the necessary amount from the seasonality reserve account into the cash management account. If the funds on deposit in the seasonality reserve are themselves insufficient to cover all shortfalls, the borrower must deposit additional personal funds out of pocket.

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