HOW A LENDER REVIEWS A RECIPROCAL EASEMENT AGREEMENT[1]

BY: Joshua Stein[2]

WHEN A DEVELOPER CREATES A COMPLEX REAL ESTATE ASSET, such as a regional mall or a multi-use project, different owners will often own the different components, and different lenders will take the various components as collateral. To pull it all together, and make each component work in the context of the overall project, the developer will often record a reciprocal easement agreement. In a project, each component could consist of a parcel of land and the improvements built on it. In other cases, a component could consist of a three-dimensional volume of space in the project. All of this can widely in size and complexity. Either way, the project will look like a single building or a single development, but legally it will consist of multiple separately owned components. It will also include common areas that serve the entire project or one or more components. Typically some central authority, controlled by the developer or manager of the project, will operate the common areas and administer the project.

Sometimes, each owner will own a three-dimensional condominium unit carved out of the larger project. The condominium structure defines the rights and obligations among the various owners, covering many of the issues discussed in this article, along with a few others. We won't cover any issues unique to the condominium structure in this article. This article focuses only on the arrangement in which each owner owns land and the improvements on that land (as part of a larger project) or a defined three-dimensional block of real property not constituting a condominium unit.

So this gets us back to reciprocal easement agreements. They go by various names, including "operating agreements," "common maintenance agreements," "covenants, conditions, and restrictions," "restrictive declarations," "project declarations," or the like. This article will refer to these generally by the acronym "REA."

Once negotiated, the REA becomes part of the package of long-term legal rights that makes up and defines each component. It travels with that component as the component changes hands—including to a lender as collateral for a loan and potentially through foreclosure under that loan. The REA is very much like a privately negotiated statute or a treaty between nations. It can cover a wide range of issues—essentially every project-related issue that could affect the owner of more than one component. In some ways, the REA covers much of the same ground as a lease. Unlike a lease, though, all parties to an REA play both landlord- and tenant-like roles, so the relationships between them can be more balanced and mutual.

This article begins by summarizing the basic principles that both borrowers and lenders apply in reviewing the REA, then considers some mechanical matters that arise in reviewing an REA, including the review process itself and how the REA ties to the rest of the transaction It will then move on to major issues that can arise in an REA, including some discussion on which of those are likely to create trouble. That will be

followed by a brief summary of a lender's unique concerns.

Everything discussed here will also come into play when a developer's counsel prepares the REA, or when a purchaser of a component wants to evaluate the REA as part of its due diligence for the component and the project.

THE LENDER'S PERSPECTIVE When a borrower asks a mortgage lender to finance a component within a project, the lender and its counsel must analyze the REA to understand how the project works, how the REA affects the lender's security package, and whether anything in it creates risks that the lender should consider in its underwriting or insist that the borrower fix.

REAs Are a Little More Complicated than Leases

In performing that analysis, the lender and its counsel will start with an agenda similar to that which arises in reviewing any heavily negotiated lease. The process, however, is complicated by the fact that all parties to the REA—and there may eventually be many—will want to negotiate the REA to make it work without gaps or problems. To the extent that the developer establishes the REA before any of those parties have entered the picture, the developer will typically try to reach the same result, but the document will probably be simpler. The developer, however, may enter into separate agreements with some of the owners as they acquire their components. Those separate agreements may add complexity, but the mortgage lender will only see any such agreement that affects its own borrower. On the other hand, leases tend to be more generic and (in most cases) more biased toward a particular party, often the landlord (the borrower).

The Lender Can't Terminate the REA in a Foreclosure

In considering any REA, the lender and its counsel also need to remember that, for most purposes, the REA will be "prior" to the mortgage. A foreclosure of the lender's mortgage will not typically affect the REA; the REA will simply continue. Since it cannot be terminated or eliminated, the REA must be something the mortgage lender can live with after foreclosure. That fact underscores how important it is for the lender and its counsel to understand the REA and accept its terms. If the REA contains just one particularly lethal "gotcha" clause, it can severely impair the lender's security.

BORROWER'S AND LENDER'S OVERLAPPING AGENDAS In reviewing the REA, the borrower's and lender's agendas overlap even more than they would in reviewing a lease. For the most part, both borrowers and lenders want to assure that the REA provides satisfactory answers to these questions:

Integrated Project. Does the project function as an integrated whole? Does each Owner have a set of rights and controls consistent with its expectations for the entire Project?

Practicalities. Does the project function properly and predictably, in a way that helps the parties reliably achieve their expectations? Does each owner obtain whatever access, operational benefits, and utilities it needs in order to operate as planned? Do the rights and benefits work, considered as a whole? Depending on the level of complexity of the project, the lender's consulting engineers or inspectors might need to get involved here.

Allocations. Are any costs that the owners share allocated in a reasonable and proportionate way, so that each owner will pay its fair share? If an owner will pay more than its fair share, it (and its lender) must fully understand that fact and factor any misallocation — and its future impact over time — into the valuation of that owner's position.

Freedom vs. Control. Does the REA create a workable balance between freedom and control? Each owner would like to control what the other owners do; at the same time, the owners will each want the appropriate freedom and flexibility to control their own components.

No Disconnect. Does the REA match up with the owner's rights against, and obligations to, its own tenants?

Changed Circumstances. Does the REA deal with possible future changes in circumstances in a way that is consistent with the principles just suggested? "Changes of circumstances" will of course include every real estate lawyer's most beloved – or at least most analyzed – possibilities: casualty and condemnation.

In addition to the agenda that a borrower and lender share in any REA, a lender will also want to consider a narrower set of concerns that relate solely to the lender's position as a mortgagee and owner waiting in the wings:

Information and Status. Does the REA give the lender adequate rights to information and knowledge if problems arise with the borrower's performance, as owner, under the REA?

Defaults. If the borrower defaults under the lender's mortgage, with or without a default under the REA, does the REA give the lender rights and remedies that allow it to take control of the situation without losing any of its collateral?

Lien Priority. What is the relative priority between the lender's mortgage and any lien that arises under the REA for unpaid charges?[3]

Taking Over the Component. If the lender ever became owner of the component, will anything in the REA—or that could happen relating to the REA—create an unacceptable situation for the lender?

Lender's counsel will need to apply these general principles again and again in reviewing any REA, and in considering each of the more specific REA agenda items described below.

"MECHANICAL" ISSUES IN REVIEWING REAs

Defining the Collateral

In reviewing any REA, the first question a lender or its counsel will ask is this: exactly what piece of this project does the borrower plan to deliver as collateral for the

loan? The REA will always help define the various components. Once the lender and its counsel understand which component the borrower is offering as collateral, they can proceed as follows:

Legal Description. When the mortgage describes the real property being encumbered in favor of the lender, the description of that real property should include the entire REA component being mortgaged, as well as the borrower's rights under any ancillary or related agreements, as disclosed by the REA or the public record. How should the mortgage present that description, and how does that tie to the survey and other due diligence materials that the lender and its counsel received?

Partial Component. Is the lender's collateral a complete, separately conveyable, and separately taxed parcel of real property? This question is no different than any lender's review of land and buildings that a borrower owns without the complexities of an REA.

Underwriting. Confirm that the lender understands exactly what it is receiving as collateral. Does the collateral include one anchor store? Two anchor stores? None? Specific parking places? General rights to park in the parking lot? The right to expand in a particular area? Does the lender's appraisal correlate to the description of the component as it appears in the REA?

Completeness. Is there any way in which the particular component is not a complete unit? If any problems exist along these lines, does something else in the REA solve them? For example, the REA may define one component — the component being financed — as consisting of all stores in the east wing of the project. If the component does not also include the walkways in front of the stores, they might be land-locked and useless, unless something else in the REA solves that problem. A general access easement might help, for example, but do its precise terms provide for the access actually needed? Lender's counsel will often want to confirm with a written memo that the lender understands any such technicalities, even if the analysis provides a satisfactory solution.

Dealing with Problems. In most cases, the REA cannot realistically be amended, at least not in the closing period for any individual loan. To the extent that problems exist, counsel will need to bring them to the lender's attention. The lender will then usually have these choices: revalue the component based on the problem and adjust the loan amount accordingly; set up some credit support mechanism to mitigate whatever problem appeared in the REA; live with the problem; or not make the loan. Because of the general infrequency of significant problems with REAs (even imperfect REAs), the lender will not usually want to hear about minor problems with an REA; in almost all cases, it will ignore them. That will dictate the approach to be taken in reviewing the REA, but if a lender instructs counsel to disregard a possible problem because it is "minor," counsel will want to plan ahead for the phone call from the lender three years later, when it turns out that the problem wasn't so minor after all and the lender doesn't remember anything counsel said about it in the closing process.

Larger Picture. Does anything in the scope of the component vary from the lender's larger understanding of the transaction? For example, does the component include all the spaces that the rent roll shows as income producing?

Burdensome Elements. Don't assume bigger is better. Watch for burdensome parts of the project, and try to make sure they are part of common areas and not part of what the borrower owns. For example, public bathrooms should be a common area, not part of a particular component. Truck docks require attention, management, and money. Unless this particular component has a good reason to want to control the truck docks, try to make sure they are a common area.

Title Review

The lender's title report and ultimate title policy should insure not only title to the component that constitutes the lender's collateral, but also title to the borrower's (and the lender's) interests under the REA in all other components. The title coverage should confirm the priority of the REA over all mortgages encumbering those other components, to assure that any foreclosure under one of those other mortgages cannot terminate the REA as it affects (benefits) the mortgaged component. Therefore, when the lender or its counsel orders a title search, and eventually obtains a title policy, it should cover not only the component being taken as collateral, but also any estate(s) arising under the REA in and to all other components. That requirement will not always be obvious to the title company at the beginning, so counsel may need to proactively raise it.

The lender and its counsel should also consider the need for title insurance tailored to the circumstances of the REA. That title coverage might, for example, confirm:

Status. The REA is in full force and effect, unamended, and not in default.

No Forfeiture. Any default under the REA cannot produce a forfeiture of the lender's mortgage.

Payments. All payments under the REA are current.

Qualified Mortgage. If the REA offers certain protections to mortgagees that meet certain criteria, then this particular mortgage qualifies.

The title insurance company will in turn seek estoppel certificates and other assurances from the counterparties to the REA in order to issue such coverage, which may not be available in every state.

Defining the REA

Over time, most REAs will be amended, as circumstances shift and components change hands. In many cases, therefore, the REA will actually consist of a series of REAs and amendments and separate side agreements, which can become quite complicated. As a rule of thumb, the changes made during this process will be important because they will disclose changes in circumstances and possible problems that arose in the REA. Sometimes, the REA will be amended and restated completely, which often becomes preferable at a certain point.

The review process for any REA will typically begin with the oldest document, then track through the various amendments, restatements, and so on. But before starting at the beginning, it usually pays to get a general sense of what the later documents did. Even when they are not identified as "restatements," they may change so much in the REA that they eliminate the need to spend a lot of time on the earlier documents.

If the REA has been amended more than a few times, it will probably have ambiguities and inconsistencies stemming from sloppiness in the amendment process. The lender may therefore want to ask the borrower to try to restate the REA into a single, updated document. This can rarely be accomplished before the closing, but it could be made a postclosing covenant. On the other hand, a lender must recognize that most postclosing covenants are never performed unless the loan documents attach meaningful consequences to nonperformance. The lender must also decide it is willing to accept the risk of nonperformance; i.e., the lender remains willing to make the loan even if the borrower never performs the postclosing covenant. For that reason, borrowers will often not take postclosing covenants too seriously unless failure to perform produces monetary consequences.

SCOPE AND FORMAT OF REVIEW For any REA review project, the lender and its counsel should first understand exactly what level of review and what form of work product the lender actually wants. This will define the starting point for the job.

Common Themes

Every REA is different. But certain themes run through all REAs. In reviewing the REA, a lender should define its overall approach to REAs—for example, as suggested in this article—and then read the REA while keeping in mind the issues covered here. For the most part, it is not productive to make a list of issues and then search through the REA to see how it treats each issue (as one might in reviewing a lease, which always covers the same list of issues and often in about the same order). It usually makes more sense to take a more general approach and consider the document as a whole.

Estoppel Certificate

As the first consideration in any REA review—a primarily mechanical issue—a lender or its counsel should ask whether the REA requires the owners of the other components (or the association in some cases) to deliver estoppel certificates to facilitate a loan closing. If so, quickly determine the scope and terms of any required estoppel certificate and obtain it. Who needs to receive the request? Must any documents accompany it? How much turnaround time does the REA allow? Usually that turnaround time won't accommodate the borrower’s urgent need to close this particular loan with extraordinary speed.

Major Issues and Likely Problems in any REA

This discussion summarizes the most important issues and concerns in reviewing any REA, and areas where problems and pitfalls will often occur. Even for a relatively minimal summary or analysis of the REA, a lender or its counsel should at least briefly summarize how the REA deals with each of these issues, and any problems or concerns that arise. (Of course, problems can occur in any issue that the REA covers if the issue is not handled in a reasonable way, but the issues listed here may amount to lightning rods for problems.)

Operating Covenants

Often, but not always, the REA will require some or all owners to operate their

components (i.e., keep them open for a certain type of business) for a certain amount of time. In reviewing any operating covenants in the REA, a lender or its counsel will want to consider at least these issues:

Others' Obligations. Exactly what operating covenants apply to the other major owners, or their tenants, in the REA? Must they open for business, if not already open? Must they operate for a certain period? When does that period end? Have the operating covenants expired or do they expire soon? If so, a lender will often regard this as a major problem. Just how specific are any operating covenants? Must any component operate under a particular brand name, or does the owner or tenant of that component have greater flexibility in how or what they operate? Does that flexibility implicitly allow a change of use? If so, does the lender understand the possibility?

Remedies. If one of the other owners stops operating, what rights and remedies will the borrower have? Are they practical and appropriate? If necessary, can the lender control the exercise of those rights and remedies after foreclosure, or is there some reason they might be unique to the borrower, and not travel to the lender after foreclosure?

Borrower's Obligations. Has the borrower assumed any obligation to operate, or to have others operate, any business activities either inside or outside the component being financed? Do those covenants impose obligations and burdens that the borrower (or any future owner of the component) will be able to satisfy? A pure real estate investor may, for example, have trouble satisfying operating obligations that a department store operator would consider routine. Does the operating covenant refer to a particular brand of store, without allowance for a substitute? If the operating covenant sets criteria for whatever store must operate, are those criteria reasonable, with flexibility for possible future changes in circumstances?

Domino Effect. Do the operating covenants for multiple components tie together in a way that a failure of one or two anchor operators would allow a substantial number of other owners or their tenants to cease operating? The lender should fully understand any such risk, and exactly what would have to happen for that risk to hit. Provisions of this type often appear in REAs, and lenders must live with them. Lenders should look for mitigating provisions such as these: long time periods before one operator can shut down because another one did, an ability for the developer to replace a failed "anchor" with a new one from a wide range of permitted uses and brands, and expiration dates for "go dark" rights. Ultimately a lender may demand some form of personal guaranty until the project has gotten past any tenanting problems and reached a stabilization point.

Use Restrictions, Rights, and Exclusives

Aside from any obligation to continue operating, the REA will also restrict uses, to assure the project operates to a certain standard. Except for operating covenants as described above, these use restrictions will usually take the form of prohibitions, designed to prevent operations within the project of a type that would be considered undesirable. A few comments on use restrictions, rights, and exclusives:

Standard of Operation. If the project or a component must operate to a particular standard of operation, that standard of operation is notoriously difficult to define. Definitions such as a "first-class" anything are usually considered almost meaningless. If the REA seeks to define a standard, ask whether it gives a judge enough clarity and specificity to understand and enforce it. Enforceable standards may refer to specific other projects, or define in some numerical way a particular position within the relevant market. But all these circumstances and contexts may change over time.

Generally. Do the use restrictions collectively add up to a project that matches the lender's expectations? If the lender expected to finance a high-end retail mall, for example, the lender might worry about use restrictions that allow fast food, pawn shops, and storefront law offices for real estate lawyers.

Specific Use Restrictions. The exact use restrictions that the REA contains will be crucially important in every case. What uses are prohibited? Exactly what goods and services fall within the scope of any particular exclusive? What exceptions apply? Are the exclusives so broad or the exceptions so limited that they will interfere with leasing elsewhere in the Project? What outdoor activities are prohibited? Does the REA prohibit a department store from being broken into multiple separate stores?

Use Obligations. A space lease may require owner to operate the component, or even the entire project, in a certain way. Does the REA give owner enough control over the project to assure owner can meet those obligations? For example, if a major lease makes the landlord (as owner of the component) responsible for operating the entire project as a regional mall, the REA must give that owner the right to enforce an equivalent obligation against all other owners. If some other owner can, with impunity, convert its component into a community college campus rather than a component of a regional mall, then this particular owner will find it cannot perform under its lease, and thus might face liability and claims.

Term

How long is the term of the REA? How much of the term remains? What happens at the end of the term? Even if the remaining term is very long, any REA review should mention it.

Utility and Other Easements

The REA should give each owner easement and other rights as necessary to obtain access to its component, as well as all necessary utility services. Because circumstances may change over time, each owner also needs the right to relocate and change any utility lines that cross its component, or that cross other components for the benefit of this one. If any such relocation or change ever becomes necessary, the owner should have the right to implement it without potentially being "held up" for payment (or otherwise) by any other owner. The REA should therefore either allow any such changes, subject only to reasonable and objective standards to protect the legitimate interests of the other affected owners, or (second best) allow those changes with the consent (not to be unreasonably withheld) of other owners.

If any owner relocates or expands any utility lines, that owner should restore the project and the surface of the land to their condition immediately before the work began,

and otherwise satisfy reasonable construction-related conditions and requirements, not too different from those in a balanced lease document.

Casualty and Condemnation

Any REA will address what happens if the project burns down or is condemned, in whole or in part. Although a lender might prefer in any such case to take the money and run (i.e., receive all the insurance money or condemnation award and apply it against the loan), the REA will often impose substantial obligations to restore, because the other owners and their lenders will want to assure that the project remains a functional whole, if at all possible. Typically, a lender against a particular component will have to live with those restoration obligations, just as a lender must live with similar burdens in a ground lease, but the lender's counsel will want to consider these issues:

Mutuality. Are all the other owners, and their lenders, subject to the same obligations to restore?

Restoration Procedure. Just how will restoration take place? Will the lender be able to hold any insurance or condemnation money and assure that it is disbursed over time in accordance with satisfactory disbursement procedures? If some third party will hold it, does the lender have any concern about the possible reliability and creditworthiness of that third party?

Changes in Construction. How much flexibility will the borrower or the other owners have to change the configuration, design, and use of the project when restored? Can the lender live with the other parties' flexibility? Does the borrower have enough flexibility in case circumstances have changed by the time of restoration?

Initial Construction

A substantial part of any REA will address initial construction of the project. If the project has not been substantially completed, lender's counsel should focus on what remains to be built and what the REA still requires for that construction. Any incomplete construction will probably lead to problems and surprises, and should be summarized in any review of the REA. On the other hand, if construction has been completed—and there is absolute certainty about that fact with no possibility of complications—then the entire topic can be disregarded.

Future Construction

If a developer will build a project in phases, the REA may govern the entire process or may require amendment for each future phase. If the REA indicates that the project is not yet fully built out, the lender or its counsel will want to consider at least these issues:

Unbuilt Areas. Where are the unbuilt areas, and who owns them? If someone else builds them out, can they interfere with or threaten the borrower's component within the part of the project already built? If the borrower controls those unbuilt areas, are they intended to be part of the lender's collateral? Does the borrower intend to build them out during the term of this loan? Does the loan provide for that? Does the lender understand its exposure to construction risks?

Incomplete Project. If the remaining phases are never built, is the project still an integrated whole, consistent with the lender's underwriting expectations? Can it still operate in an economic way?

Use. What uses are contemplated for the unbuilt areas? Will those uses harmonize with the uses of the component subject to the lender's mortgage? If the lender will not be able to control those components, does that in any way undercut the lender's assumptions?

Transfer Restrictions

If the REA limits who can own particular components, this restriction may cause great concern for a lender. To start with, it may limit the borrower's ability to mortgage the component. But beyond that, it may limit the salability and hence value of the component after any foreclosure. In considering transfer restrictions in the REA, a lender or its counsel should note these points:

Pre-Emptive Rights. Any right of first refusal, right of first offer, or right to match an outside offer for a component should be treated as just another transfer restriction, because it will at best have the same effect. It may also lead to problems or even litigation, because these rights often don't work out as their drafters expect. The lender will want to assure that any grant of a mortgage can take place without regard to the right of first refusal or right of first offer.

Approval Requirements. Even if a third party's approval of a transfer is not to be unreasonably withheld, it will often cause a lender substantial concern. Any approval requirement for a transfer should be summarized and emphasized as part of the REA review process. Assuming the lender will tolerate an approval requirement, the lender may want the approving party to pre-approve the lender and certain other likely transferees of the component.

Foreclosure Transfers. If the REA restricts transfers, including through a right of first offer or right of first refusal, does the restriction extend to transfers resulting from foreclosure or an equivalent transfer? Or does it carve out an exception for such transfers? Ideally, at least from a lender's point of view, once any foreclosure occurs, the restrictions will permanently go away. If the REA contains any limitations at all on free transferability to or by the lender, that fact should go at the top of counsel's "issues list" for the REA.

Preemptive Rights

If the borrower holds any preemptive rights (right of first refusal, etc.), consider whether the borrower's exercise of any such right might violate the "single-purpose entity" provisions in the loan documents and the borrower's organizational documents. Perhaps require that if the borrower exercises its preemptive rights, it must do so in some other entity, unless the lender is willing to finance that transaction as a future advance under the same financing as the initial loan.

Approval Rights and Standards

Beware of any approval requirements, even going beyond approvals of transfers. Does the REA require anyone's approval for leasing? For alterations? Does the REA specify any standard for approval of alterations, or is the standard aesthetic and hence completely discretionary? Who gets to wield that discretion? How far does the approval requirement go? Summarize any approval requirements for the lender's consideration.

Redevelopment Projects

If the borrower plans to redevelop its component of the project, test the developer's plans against the requirements of the REA. How much cooperation and help will the developer need from other owners? Do the developer's plans generally conform to the development the REA contemplated? If not, are they feasible?

For example, in a small enclosed mall, the borrower might own or acquire the component that consists of non-anchor stores. The borrower might plan to reorient those stores so most of them open directly to the outside. Would the REA allow that? Does some other owner or another component (or its tenant) have the ability to block these changes? If so, the lender will want to see that person consent to the change as part of the loan closing.

Nonproportional Allocations

If any allocations in the REA, particularly cost allocations, do not seem substantially reasonable, proportional, or consistent, a lender will want to know about the anomaly. For example, often department stores refuse to pay their "fair share" of certain cost categories, as a reward for the value they bring to the project as a whole. Over time, any such misallocations will often mean that each burdened component will bear an increasingly inequitable share of whatever cost is being misallocated. Misallocations are difficult to correct, so the lender simply needs to know about it and project cash flow accordingly—which could in the worst case lead to a revaluation of the collateral and a resizing of the loan.

The standard for allocations is simply that they must be "substantially reasonable, proportional, and consistent." Counsel usually won't need to delve into the nuances of the allocation formulas, such as any special treatment of basement, mezzanine, and nonselling space, or whether the REA draws the right lines between use of one reasonable formula as opposed to some other reasonable formula for particular categories of expenditures. As long as the allocation formulas seem substantially reasonable, proportional, and consistent, they usually do not require special emphasis in counsel's due diligence review.

On the other hand if, for example, one component (typically a department store) has no obligation at all to contribute to a particular category of expenditures and the REA does not disclose any reasonable basis for that exclusion, then this may amount to an anomaly that the lender should consider.

Fee Structure

Identify any management or operating fees payable under the REA, whether by the borrower or to the borrower. Do these fees correlate to services rendered? In the REA summary, identify the amount and calculation of any such fee, even if it seems clearly reasonable under the circumstances. Identify the payee, and any apparent connection between the payee and other particular party(ies) to the REA.

External Issues

Does anything in the REA suggest the existence of factors outside the REA that the

lender should consider in its due diligence? Does the REA indicate the project has been subject to litigation or to disputes with governmental authorities? Does the REA disclose any offsite or environmental obligations—e.g., traffic improvements, parks, open area, wetlands—that might impose unusual expenses? Counsel should mention in the REA that any issues of this type need to be reviewed. They are not necessarily showstoppers—they are part of the territory for significant development projects in the 21st Century—but they should not come as surprises to the lender after the closing.

LENDER ISSUES Most of what has already been covered in this article applies both borrowers and lenders, both of whom want the REA to establish a reasonable, workable, practical, and proportional structure for shared operation and ownership of a project. A lender, however, will have a set of concerns that relate primarily to the preservation of its own security and its position as a mortgagee. Each of these "lender issues" should be mentioned in any review or summary of the REA.

Lien Rights

Any REA will require owners to contribute to certain operating costs of the project and potentially capital expenditures for the project. If an owner fails to contribute, the other owners or the association may have the right to attach a lien to the affected component, to secure payment of the unpaid amount. If such a lien attaches to the borrower's component, then any mortgagee of that component would want to see that lien be subordinate to the mortgage, so that: (a) if the mortgagee forecloses it can "wipe out" the unpaid lien; and (b) continued failure to pay the lien does not create a risk of a lien foreclosure that could imperil the security of the mortgage.

Most REAs establish precisely that priority structure as between REA liens and mortgages: Even though the REA itself is senior and prior to all mortgages, any lien for unpaid REA charges has priority only as of the date that someone records a notice of lien in the land records. This protects the individual mortgagee of the particular component that failed to make its payments. It also incentivizes the association not to wait too long before starting to enforce any claim for unpaid association fees.

One might argue that any liens for unpaid REA charges should always be prior to all mortgages, because REA charges are functionally rather similar to real estate taxes — part of the cost of preserving the component for the benefit of both borrower and lender — and any component mortgagee is reasonably situated to understand these charges and to assure that they are paid, just like real estate taxes. Moreover, if REA liens were prior to mortgages, they would be more likely to be paid, hence protecting the other owners and their mortgagees from the potential burden of having to make up for the unpaid REA charges. Whatever the merits of the arguments in this paragraph, they seem to have been mostly or totally rejected in the real world of REAs. REA liens are almost always subordinate to mortgages. And the other owners manage to live with that. In that regard, REAs are kinder and gentler to mortgagees than ground leases.

Any review of the REA should typically include a short explanation of the priority of any lien arising under the REA for unpaid REA charges.

Non-Arm's-Length Negotiation

A lender will generally be able to obtain a great deal of comfort about any REA based on the fact that it was negotiated at arm's length between competent players each looking out for its own interests. If, however, anything in the REA suggests that such negotiations did not occur, the lender and its counsel should try to identify that fact and any possible implications.

Restrictions on Financing

Does the REA in any way limit the ability of any Owner to obtain mortgage financing? Any limitation at all should be mentioned, whether it relates to the type or amount of loan, the nature of the mortgagee, or any other characteristic whatsoever. Do those limitations make sense, or do they create ambiguities and practical challenges? How can the lender know its loan complies with the limitations? Does any possible uncertainty exist? How can the lender document compliance as part of the closing?

If the REA requires that a mortgagee must deliver certain documents or enter into certain agreements with—or give notices to—other parties to the REA, lender's counsel must understand exactly what those requirements are. If they are not entirely within the lender's control, or if they impose on the lender any significant obligations, the lender should scrutinize them with counsel and assure they are satisfactory. Whatever the required document may be, the lender should identify the requirement as early as possible, add it to the closing checklist for the transaction, and make sure it is handled as part of the closing. Who actually must receive the document? Does any uncertainty exist about that person's identity or address?

Unperformable Obligations

Does the REA impose on the mortgagee's borrower any obligations that the mortgagee could not perform if it were to take over the borrower's component? As an example, the REA might require the borrower to operate the entire project under a specific brand name (e.g., "Shoppingville of Anytown"). If the lender does not have the legal right to use that name after foreclosure, the lender would find itself unable to perform its obligations as owner of the component after foreclosure, and hence perhaps in default under the REA. Similarly, if the REA restricts use of other real property that the borrower owns—outside the project itself — the lender may be unable to perform that obligation after foreclosure because the lender does not own that real property.

Although each example in the preceding paragraph is rather far-fetched and rare, REA documents do sometimes impose on an owner obligations that a mortgagee could not perform after a hypothetical foreclosure. A lender and its counsel must identify those obligations, consider them, analyze the problems they create, and figure out a way to solve those problems as part of the closing process.

Mortgagee Protections

In some ways the REA is much like a ground lease, because it is a third-party document that creates very important rights and benefits that enhance the value of the lender's collateral. On the other hand, unlike a ground lease, the REA will typically create no risk that the lender will "lose everything" just because the borrower goes into default and doesn't cure the default within a certain time. Taking into account those similarities and differences, the mortgagee of a component will want a handful of

mortgagee protections, similar to those in a ground lease, but much less extensive. For the REA, a reasonable set of mortgagee protections would include these (most important first):

Amendments. The REA cannot be amended, terminated, canceled, waived, and so on, without the mortgagee's consent.

Defaults. If any default occurs under the REA, the mortgagee will receive notice and an opportunity to cure.

No Forfeiture. A mortgagee would like to see an express statement in the REA that any default under the REA will not produce a forfeiture or termination of any mortgage.[4]

Dispute Resolution Procedures. If anyone initiates any arbitration or other dispute resolution mechanism under the REA against the borrower, the mortgagee will be entitled to notice and will have the right to participate.

Certain Approvals. Any major approval (e.g., for a capital project beyond a certain level) by an owner is not effective without its mortgagee's consent.

Effect of Foreclosure. If a mortgagee forecloses, then it has no liability for the pre-foreclosure defaults of its borrower, or at least such liability is limited in some way. This issue and its permutations and variations also arise in nondisturbance agreements. The counterparties to the REA are likely to be even less accommodating on this point than strong and well-represented tenants when they negotiate nondisturbance agreements.

Additional Amendments. If a mortgagee requests an amendment of the REA, the other parties to the REA will provide that amendment as long as it does not materially adversely affect them, or at least they will agree to consider it.

In practice, any REA may contain only a few, or none, of these protections. A lender will rarely refuse to close a loan because of any such omission, but it should be the lender's decision based on full information.

ROUTINE ISSUES In addition to the issues listed above, the REA will cover a wide range of fairly routine and humdrum considerations, mostly having to do with operating. Unless the lender wants a complete summary of the REA, whoever reviews the REA can skim through the sections that cover these issues, confirm that the treatment seems reasonable and consistent with the remainder of the REA, and does not violate any of the principles suggested above, moving on without writing anything. On the other hand, if the REA seems to cover something in an unreasonable, disproportionate, weird, or burdensome way, the REA reviewer should identify any such problem even in a minimal report on the REA. Anyone reviewing the REA should always watch for anything that could impair transferability, financeability, or value, and mention it in the REA summary.

Capital Projects

Any nonessential capital improvement should be subject to an objective standard or, better, an approval procedure that gives the owners (and ideally their mortgagees) the ability to evaluate the need for the improvement and say yes or no. An owner and its mortgagee do not want to bear the risk of having to fund open-ended capital projects that they cannot control.

Circulation and Parking

The REA should establish reasonable rights and restrictions, consistent with the operation and visibility of all components. Exclusive parking areas, walls, fences, and the like tend to create problems. All parking should be required to remain free, unless the REA expressly establishes a reasonable regime for paid parking. The rules for parking validations, time limits, and reserved areas can become crucially important, even in a project with plenty of parking. Ideally, employees should park in a separate location. Parking should be lighted at night. If the project includes uses with particularly heavy parking requirements, the REA may set special procedures to try to mitigate any adverse impact on the rest of the parking for the project. Does the parking regime make sense as a whole?

Common Facilities

The REA should allow all owners and their tenants to use common facilities within the project on a reasonable basis, without the need to incur unusual expenses or jump through unreasonable hoops.

Construction

If any owner, or all the owners acting as a group, initiate(s) any construction, the REA should establish a reasonable and practical set of procedures to create appropriate flexibility, assure completion, and mitigate any impact on the rest of the project during construction.

Governance

If any decisions need to be made, or if any owner wants to initiate an amendment of the REA, what level of approval by the owners is required? Typically, any decision or amendment of a "fundamental" nature will require unanimous approval, and any decision or amendment that adversely affects an owner will require that owner's approval. More routine decisions, such as budget approvals or alterations below a certain level, may require a majority or supermajority vote. If the approval procedures in any way create a risk that an owner cannot control its own destiny and costs, that fact should be noted in the REA summary.

How does the REA define the voting power of each owner? If the allocations reflect square footage, financial contribution, or some other reasonable measure, they do not need to be mentioned. On the other hand, if the allocations do not seem to make sense, or if one owner (e.g., the developer) has substantially inordinate voting power or a veto right, that fact should be noted in any REA review.

Insurance Requirements

The insurance requirements under the REA are similar to those under a ground lease or a mortgage. A lender will have its own ideas about insurance, set forth in the mortgage, and will want to know that the REA insurance matches those expectations, and vice versa. If the REA provides for a combined insurance program for the entire project, the borrower will probably ask the lender to agree to accept that program in place of any separate insurance by the borrower. If the REA provides for a combined insurance program, the lender or its counsel will want to consider these points:

Lender's Rights. The lender should have the same rights to be named in insurance policies as if the component were separately insured.

Full Coverage. The insurance under the REA may not include all insurance the lender will expect to see. The lender and its insurance advisors will need to compare the insurance provided under the REA against the lender's requirements and expectations. The borrower may need to bridge some gaps.

Proceeds. Any insurance proceeds for the component should be paid to the lender, the same as if the component were being separately insured, unless the REA provides for a shared insurance trustee. In the latter case, the lender must get comfortable with the qualifications and creditworthiness of the shared insurance trustee.

Evidence of Insurance. The REA should set a mechanism so the lender will receive both at and after closing the same evidence of insurance that the lender would receive if the component were separately insured.

Reasonable Requirements. If the REA requires individual owners (including the lender's borrower) to maintain insurance, the lender will want to confirm that those requirements are reasonable and customary, preventing future problems and disputes under the REA.

The preceding points do not represent a complete list of insurance concerns for the REA or any other type of ownership structure. Any lender is always well advised to engage an insurance consultant, particularly where a project has any level of complexity. The mere existence of the REA typically implies a level of complexity that justifies use of an insurance consultant.

Marketing Association

If the REA provides for a marketing association, is it on reasonable terms and does it create any risk of uncontrollable costs? Is it really operating, or is it just an additional income source for the developer?

Operating Cost Allocations

Does the REA allocate operating costs in a reasonable way? As noted above, exact precision is not essential, and allocation mechanisms may vary for different types of expenses.

Operational Matters

The REA should define rules, rights, and procedures that enable each owner to operate its component. For example, each owner should have the right to install utilities, receive deliveries, dispose of or recycle its trash and garbage in a reasonable manner, and otherwise operate its component, all without unreasonable interference and without imposing unreasonable burdens on other owners.

Real Estate Taxes

Each component should consist of one or more separate tax lots.[5] If the REA provides for joint tax protests and appeals, the mechanism for those joint actions should be reasonable and should appropriately recognize any differences among components.

Signage

For signage, the visibility, prominence, and contribution to maintenance costs should be reasonable and consistent with the relative roles of the different components. If any component "should" have signage rights, then confirm it actually does. The signage-related concerns under the REA otherwise generally track those under a major space lease.

Visibility and Sightlines

Any major component of the project should have the right to the same visibility and sightlines from the road as it presently has, or the REA should limit, define, and control any future changes in such visibility and sightlines. If the project has any unbuilt areas between the existing improvements and the roadway, what does the developer plan for those unbuilt areas? As a practical matter, can the developer block the view of a particular component? What does the REA allow? Prohibit?

The Future

Any REA must work not only today but also in the future. You'll have to consider possibilities far beyond transfers, foreclosures, fires, and condemnation. How might the uses of any components, or the project as a whole, change? What happens if the contemplated uses become uneconomic? What if it no longer makes sense to have a shopping center or regional mall at this location? How does one undo the arrangement and move on to something else? The answers to those questions tie to the expected useful life of the project, taking into account the likelihood of changes in the marketplace in the world during that time.

CONCLUSION Based on the unique characteristics of a particular project, any given REA may present challenges beyond the ones discussed in this article. In meeting those challenges, a lender and its counsel should take into account the same analytical structures and approaches suggested above. In general, anything specific to a particular project will be material enough that it should be mentioned even in the most condensed summary of the REA.

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[1] Copyright (c) 2018 Joshua Stein, www.joshuastein.com. All rights reserved. This article previously appeared as a chapter in *Lender's Guide to Structuring and Closing Commercial Mortgage Loans*, written by Joshua Stein but now out of print. Electronic copies may be ordered from www.joshuastein.com. The author appreciates helpful contributions to this article made by Joseph DiPietro of *The Practical Real Estate Lawyer* (where a version of this article will appear in the second half of 2014); Alfredo R. Lagamon, Jr., of Ernst & Young LLP; Donald H. Oppenheim of Berkeley, California; and Elizabeth T. Power, the author's managing editor. Please forward to the author any comments, improvements, suggestions or corrections on this article.

[2] Joshua Stein is the sole principal of Joshua Stein PLLC, a boutique commercial real estate law firm that he formed in Midtown Manhattan in 2010 after 20+ years as a partner at a leading global law firm. His practice focuses on acquisitions, development, financing, hotels, leasing (particularly ground leases), and loans. He acts regularly as an expert witness and occasionally as an arbitrator or mediator. He is a member of the American College of Real Estate Lawyers, the Anglo American Real Property Institute, and the American College of Mortgage Attorneys. Since 1997, he has chaired the Practicing Law Institute's annual two-day seminar on commercial real estate financing. He chaired the New York State

Bar Association Real Property Law Section for the year ending in May 2006. He has written five books and more than 300 articles on commercial real estate law and practice, many available at www.joshuastein.com. His name regularly appears in published lists of leading lawyers, such as the Chambers guides, International Who's Who of Business Lawyers, Best Lawyers, and Super Lawyers. He received his undergraduate degree from UC Berkeley and his law degree from Columbia, where he was a Harlan Fiske Stone Scholar and a managing editor of the Columbia Law Review.

[3] The lender will rarely expect the REA itself to be subordinate to the mortgage, because the lender understands that the REA is part of what defines the very asset the lender is financing. The lender will, however, want to confirm, as part of its due diligence, that the same priority applies for every component of the project, so that some other mortgage lender cannot "wipe out" the REA as it affects that other component. And the priority of the REA itself is not the same thing as the priority of any lien that arises under the REA.

[4] Even if the REA is silent on this point, a mortgagee will probably take comfort from the fact that nothing in the REA actually provides for such a forfeiture. Still, particularly if the REA is silent on forfeiture, the mortgagee may want the title insurance company to affirmatively insure the lack of potential for forfeiture.

[5] That is a traditional rule of any real estate lending, hardly breaking new ground. If the demarcation lines of a component do not in fact coincide with tax lot lines, however, creative lender's counsel can potentially find a way around the problem, with some combination of credit support, equity pledges, specific covenants to correct the problem, pricing ("basis points solve all problems"), and other measures. Will a securitized lender accept any such package?