Managing Reserves, Impounds and Holdbacks: Legal Strategies for Lenders

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A Broader Perspective℠

Overview of Cash Accounts

- Basic Terminology
  - **Reserves** – Loan funds disbursed and held in a pledged account for later application for specific purposes
  - **Holdbacks** – Loan funds held back in the loan for later disbursement upon satisfaction of specific conditions
  - **Impounds** – Borrower funds (or property cash flow) deposited with lender and held in a pledged account for later application for specific purposes
    - Pre-Default Impounds paid to lender for application for project-related purposes
    - Post-Default Impounds are triggered by occurrence of default and held to pay critical property expenses

Differences Between Cash Collateral And Pledged Accounts

- Pledged Reserve/Impound Accounts
  - Pledged accounts established for the collection of funds to apply to specific costs/expenses
    - Funds usually deposited into and out of these accounts
    - Usually managed by borrower prior to default
    - Additional collateral is secondary purpose
- Pledged Cash Collateral Account
  - Pledged account established for the collection of funds to be held as additional collateral in case of default
    - Additional collateral is primary purpose

Types of Security Agreements

- Security Agreement
  - Disbursement Account Type
    - Borrower controlled account opened with Bank
    - No restrictions on use of funds
    - Basic collateral provisions upon occurrence of loan default
- Deposit Agreement
  - Deposit and Disbursement Account Type
    - Borrower controlled account opened with Bank
    - Specific restrictions on use of fund
    - Specific remedies upon occurrence of loan default
- Cash Management Agreement
  - Soft or Hard Lockbox Account Type
    - Lender controlled account opened with Bank;
    - Specific restrictions on use of funds with “waterfall” provisions
    - Retain excess funds for additional collateral or limited use by borrower
    - Specific remedies upon occurrence of loan default

Deposit Account Agreements

- Basic Account Issues
  - Account established with lender or third party bank
    - Differences between Deposit Agreement (2-parties) and Control Agreement (3 parties)
  - Who controls account:
    - Pre-default (usually borrower);
    - Post-default (always lender)
  - "Waterfall" provisions
    - Typically required with cash management arrangements
    - Standard priority – Property expenses; lender costs and expenses; interest; principal; impounds; excess cash flow to borrower or held as cash collateral

Deposit Account Agreements II

- Basic Legal Issues
  - Lender granted “control” under Uniform Commercial Code
    - Control is legal concept that does not prevent borrower from directing or having access to account
    - Requires consent of deposit bank
  - Account held either in name of the lender or in the name of the borrower “for the benefit of lender”
  - Treatment of interest
    - Retained in the account and applied as pledged funds
    - Deemed income for borrower for tax purposes
  - Role of deposit bank
    - Very limited liability; protected if relies on lender instructions

Common Uses of Pledged Accounts

- Holdbacks or Reserves for Property Purposes
  - Funded by loan or by borrower to pay future costs and expenses for the benefit of the collateral property
- Cash Flow Sweep
  - Initiated at loan closing to sweep cash flow for specified purposes
    - Can be suspended and triggered depending on property performance issues
  - Springing or triggered during the loan term based on property performance

Common Uses of Pledged Accounts II

- <u>Pre-Default Impounds</u>
  - Funded by borrower to pay future costs and expenses for the benefit of the collateral property (i.e., taxes and insurance)
  - Also established for immediate repair, capital expenditures and deferred maintenance
  - Can establish cap and replenishment requirements
- <u>Post-Default Impounds</u>
  - Initiated upon loan default to pay protective funds for the collateral property (i.e., taxes and insurance)
  - Can be continued or suspended once the loan is cured

Common Uses of Pledged Accounts II

- Borrower's Funds Account
  - Typically used for remargin, loan balancing and loan deficiency payments
  - Always provide that Borrower's Funds in pledged account are applied to pay costs and expenses or re-balance/re-margin loan before resuming loan disbursements
    - Be careful if use of funds changes upon the occurrence of a loan default because of one-action issues
  - Typically non-interest bearing because funds held in account for very short periods
    - In contrast, long term cash management, reserve and cash flow sweep account more typically bear interest

Application of Pledged Funds

- Pre-Default Application of Funds
  - Must be specific on use of funds
  - Can apply funds for any purpose
    - Pay property costs and expenses
    - Pay for future property needs such as improvements, repairs, expansion, leasing costs, etc.
    - Pay down the loan (hyper-amortization)
  - Must be specific on the use of excess funds
  - Role of Cash Collateral in bankruptcy
    - Presumption of part of the lender's security, but can be seized by trustee, particularly if cash flow funds

Application of Pledged Funds II

- Post-Default Application of Funds
  - Must be specific on use of funds both prior to and following default
  - Can apply post-default funds for any property purpose
    - Pay property costs and expenses
    - Pay for future property needs such as improvements, repairs, expansion, leasing costs, etc.
    - Hold excess funds as additional collateral
  - If default triggers use of funds to pay down loan, then have CCP 726 (one-action rule issues)
    - Typically use receiver to continue to collect cash flow and hold pending foreclosure before application to the loan
  - Similar bankruptcy issues

Alternative to Pledged Funds

- Letter of Credit
  - Issued directly to Bank as an Asset Owned by the Bank, not by the Debtor
    - Bankruptcy protected
    - One-Action rule protected
  - Can apply funds for any purpose
    - Pre- or Post-Default uses
    - Partial draws that "burn down" the LOC
    - Held as strict additional collateral protection
  - Must be specific on the use of funds in loan documents
  - Common issues include renewal requirements, assignability, credit strength of issuing bank, the applicant (i.e., who is responsible to the issuing bank raises consideration issues)

Additional Collateral Issues

- Alternatives Uses of Pledged Funds
  - If need to change use of funds, formally amend deposit agreement to avoid triggering one-action issues
- Consensual Use of Funds
  - Borrower can always consent to use of funds, but need separate consent if use of funds will change following event of default to avoid triggering one-action issues
- Post Bankruptcy
  - Differences in applying pledged funds and debtor-in-possession ("DIP") financing
    - DIP funds get super priority over all other debt

Title Considerations

- Use of Pledged Funds
  - Not deemed protective advances, even if reserves funded from loan and not borrower funds
- Title Policy
  - Get Mechanics' Lien protections for loan funds held for direct or indirect construction related purposes