CASH MANAGEMENT IN THE REAL ESTATE CONTEXT

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I. INTRODUCTION

A. Scope

This article seeks to address common cash management arrangements in the real estate lending context; a structure that has historically been utilized heavily in commercial mortgage-backed securities (CMBS) transactions and in large commercial non-CMBS transactions. In light of current economic circumstances related to the COVID-19 pandemic, the impact and importance of cash management regimes in commercial real estate loans has become more apparent. Though the underlying purpose of a cash management agreement is relatively simple, its implementation is often seemingly complicated, a fact exacerbated in large part by widespread inconsistent use of cash management terminology.

If the reader works with cash management agreements frequently in the course of practice, this article will not likely shed new light on any dark corners of the cash management landscape, but the author's hope is that this article will make the cash management arrangement and correlative documentation more approachable for those wishing to gain an understanding of the overall approach.

B. Purpose of Cash Management

The underlying purpose of cash management is, fundamentally, to give the lender (and down-stream certificate holders, in the case of CMBS) comfort that income derived from the mortgaged property (shopping center, hotel, multifamily apartment complex, single-tenant stand-alone store, etc.) will make its way from rents or the cash register to the cash management clearing account (described below) for application to the borrower's loan obligations. The cash management structure also determines the order in which cash is applied to borrower's obligations under the loan documents, which priority will become very important in those months when revenue is insufficient to cover all such obligations. This process is most reliably accomplished (from the perspective of the lender) by taking control of the cash flow away from the borrower. From the point of view of the borrower, however, it is often an uncomfortable and expensive way to be separated (even temporarily) from one's money.

C. Here to Stay

Though the use of cash management arrangements were often waived on small and low leverage transactions during the "blow and go" days of "CMBS 1.0", as the economy recovered cash management arrangements have become a typical part of the overwhelming majority of CMBS transactions as the absence of such arrangements are viewed negatively by the rating agencies.[1]

[1] The rating agencies (Moody's, S&P, and Fitch to name a few of the most active in the securitized loan market) reviews the cash management structure of any rated loan transaction closely. In most stand-alone property-specific and large loan transactions, the rating agencies prefer the use of a "hard lockbox". In a "hard lockbox" arrangement, at origination of the loan, the borrower will typically direct the commercial tenants or, in the case of hotels, the credit card companies, to remit money payable to the borrower directly into lender-controlled lockbox accounts.

These lockbox accounts (if not already eligible accounts pledged to, and under the control of, the holder of the mortgage loan) are swept on a regular basis (preferably, daily) into eligible accounts pledged to the trustee for the benefit of the holders of the rated securities maintained by the master servicer. The master servicer then applies sums to fund adequate reserves for ground rents, if applicable, real estate taxes, insurance premiums, monthly debt service, capital expenditure/FF&E reserves, tenant rollover reserves, and such other

Additionally, more lenient cash management arrangements have seen a sharp decline in favor of more traditional revenue control schemes. This shift has consequently resulted in higher transaction costs and less-immediate access to cash flow for borrowers.

D. The Players

Though the details of each transaction will differ, there are a number of actors that will fill familiar roles in the cash management arrangement. Typically the lender, borrower and cash management bank make up the core of a cash management structure. The cash management bank acts as intermediary between the borrower and lender with regard to the revenue from the mortgaged property, typically sweeping the cash flow from the clearing account into a cash collateral account held by the lender or its loan servicer. Additionally, if the property is managed by a third party, the property manager will often become a necessary party to the negotiation and execution of any cash management agreement, as it will be collecting rents as an agent of the borrower.

Having a cooperative tenant population, however, is perhaps the most important element to the successful implementation of any cash management arrangement. Most cash management structures will require the willing involvement of the tenant to direct its payments to the clearing account. This instruction is given by way of tenant direction letters executed by the borrower and, depending on the circumstances, sent immediately to tenants at loan closing or held by lender until the occurrence of a triggering event. In certain cases, the property manager or borrower are licensed to take possession of the rental payments from tenants, but are required to relinquish those payments to the clearing account within a certain timeframe (one or two business days is typical). Even in these cases, however, a loan default or other triggering event will often terminate the this license and tenants will be directed to forward rent directly to the clearing account.

II. CASH MANAGEMENT GENERALLY

A. Account Types

Though cash management will come in a variety of different structures, there are a number of elements common to each:

- A "clearing account" is the main gathering point for revenue from a property and is generally held at a cash management bank whose primary purpose is to periodically sweep money from that account to specific destinations, depending upon the circumstances. This account is often referred to as a “lockbox account” regardless of whether an actual lockbox or post office box is utilized as a collection point for physical checks.

- A "cash collateral account" is held by lender or its servicer for the purposes of obtaining possession of the cash and as an embarkation point for the distribution of the cash to all other sub-accounts. This is also often referred to as the “cash

reserves as are necessitated by the applicable transaction.

After these applications, provided the loan is not in default, excess funds are remitted to the borrower. If preferred equity or mezzanine financing exists with respect to a mortgaged property, excess funds will typically be remitted to the holder of the preferred equity or mezzanine financing. In this case, the loan waterfall should have a "bucket" for operating expenses in accordance with a budget approved by the trustee (or the servicer on its behalf) prior to the remittance of any funds to the holder of the preferred equity or mezzanine financing.

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