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Conduit loans merit lots of spade work

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GREATER METROPLEX — Over the last decade, conduit loans have become something of the darlings of the world of commercial real estate finance, successfully competing with traditional sources of mortgage financing such as insurance companies and banks.

Very simply, a conduit loan is one that is pooled with other loans, then "securitized." Securitization is the process of pooling assets and then issuing new publicly traded financial instruments, such as bonds, that are secured by the pooled assets.

Conduit loans are popular for a number of reasons, including favorable fixed interest rates, longer terms, higher leverage/less required equity and limited personal liability.

Conduit loans deserve much acclaim, but they are not the best product in all situations. Before getting too excited about a conduit lender's irresistible quote, a borrower should fully understand what's involved, lest some unpleasant surprises arise.

Here's an abbreviated list of factors a borrower should consider before using this type of loan to finance a commercial real estate project.

Single-asset entity:

Conduit lenders require that the project being financed be owned by a single-asset entity — an entity that owns no other assets other than the project. To avoid any surprises, a tax professional should be consulted before either creating a single-asset entity or transferring a project into one. A borrower also will be required to include somewhat cumbersome covenants in the entity's organizational documents and, in some instances, an unaffiliated person must be a member of the board of directors.

Relationship:

A conduit loan will be administered by several loan servicers, each with a different role, but none with a true relationship with the borrower. Unlike a local banker with whom there is an existing relationship, the servicer won't care if the borrower goes elsewhere for the next loan. Additionally, servicers are required to follow the loan documents precisely.

The market for securitized loans requires a large amount of standardization in the loan documents. As a result, the loan documents should be read carefully with the understanding that the borrower's counsel will not be successful in substantially revising them.

Inflexibility:

Once the loan is securitized, servicers are limited from doing anything that would change the collateral; therefore, the terms of a conduit loan generally prohibit the borrower from granting easements, or adding to, releasing or expanding the property. As a result, a conduit loan is generally unsuitable for phased developments or projects subject to redevelopment or other changes. In those rare instances where a servicer permits such a change, it's normally very time-consuming and expensive.

Reserves:

Conduit loans generally afford borrowers with a higher amount of leverage compared to other loans. However, they frequently require large up-front cash reserves to cover certain future costs, such as taxes, insurance, capital replacements and, depending on the project, immediate improvements and lease rollover costs.

Prepayment/sale:

Generally, conduit loans cannot be prepaid for a certain period, typically two years from securitization. This is known as the "lock-out period." Prepaying after the lock-out period, but before the maturity date, can prompt a penalty of at least 1% of the principal amount of the loan or, in some instances, require the borrower to make a substitution of collateral. Either alternative is expensive.

Because of prepayment limitations, borrowers are locked into conduit loans for a substantial period of time. Most conduit loans are assumable, however, but the buyer will need to qualify with the lender and the lender will charge assumption, application and processing fees. An assumption takes time to process, so it pays to plan ahead.

Nonrecourse *(Almost)*:

Conduit loans normally provide that, upon a default, the lender can foreclose but cannot pursue the borrower or the guarantor for any deficiency between the loan balance and property value.

But the devil is in the details. Common exceptions, or "carve-outs," include transferring the property without the lender's consent, creating or allowing a subordinate lien, and filing bankruptcy — all of which automatically convert the loan to full recourse.

Other standard exceptions are failing to pay taxes or insurance premiums and misapplying rents, insurance proceeds and condemnation awards.

Legal counsel for the borrower and guarantor should review these provisions carefully. Occasionally, conduit lenders will allow some variation and clarification of these provisions.

Conduit loans can be a good choice under the right circumstances. But before applying for a conduit loan, borrowers should make sure they understand both the advantages and the disadvantages of this type of mortgage.

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