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CMBS Lenders Begin Invoking MAC Clauses With Investors

Many commercial real estate loans originated in the United States are resold to investors as commercial mortgage-backed securities (CMBSs). Under these programs, lenders originate the loans, but then later resell them as parts of larger pools into the CMBS market. In the fourth quarter of 2007, the national crisis in residential subprime lending spilled over into the commercial real estate loan arena, causing increased volatility in the CMBS market. As a result, many lenders are experiencing difficulties reselling their commercial real estate loans into the CMBS market. In this new lending environment, lenders are increasingly seeking to renegotiate, or even back out of, their loan commitments and/or rate lock agreements with investors. Lenders often use the material adverse change, or so-called "MAC" clauses, in their documents to renegotiate investors' loan commitments and/or rate lock agreements.

Market Background

Driven by the combination of highly valued commercial real estate and low interest mortgages, national lenders were — up until the recent subprime lending crisis — utilizing CMBSs in ever-increasing numbers. In 2000, CMBSs represented around 14 percent of the outstanding domestic commercial real estate loans; by 2006, this percentage had risen to 26 percent. In fact, by November 2007, the outstanding volume of domestic CMBSs was estimated to be approximately $870 billion.[1]

The CMBS market provides a profitable secondary market for commercial real estate debt, which in turn, has spurred national lenders to originate ever-increasing numbers of commercial real estate loans. It also has meant that lenders who resell their loans in this market do not need to use their own deposits to back their mortgage loans, since the loans ultimately are funded through money borrowed from Wall Street investors and investment banks.

Unfortunately, toward the end of last year, the crisis in residential subprime lending resulted in a volatile CMBS market. For instance, the benchmark CMBX-NA-AAA index of derivatives

[1] "Ups and Downs for CPDOs," *Structured Credit Investor,* November 14, 2007.

tied to the safest commercial mortgage securities rose to 102 basis points in November 2007 from 44 in September 2007.[2] This means that the cost of derivatives protecting investors from defaults on the highest rated bonds backed by properties more than doubled. According to data collated from New York-based Citigroup, Inc., banks were holding $54 billion of commercial mortgages last November that they could not resell into the CMBS market.[3]

This volatility in the CMBS market is resulting in increased risks to real estate investors, particularly when dealing with lenders that plan to resell their loans into the CMBS market. Prior to the recent subprime lending crisis, lenders were flooding the loan markets with liquidity. This surplus of liquidity helped push down the spreads between 10-year treasury notes and the interest rates charged in CMBS loan programs. As recently as six months ago, the spread between a 10-year Treasury and a loan packaged for the CMBS market was as low as 1.2 percent or 120 basis points. However, with the recent CMBS market volatility, these spreads have increased dramatically. For instance, in the period between September and November of 2007, these spreads rose as much as 150 basis points. Now, in light of the potential credit crunch, these spreads are increasing quickly. In response, lenders are renegotiating commitment and rate lock agreements, scrutinizing the collateral used to secure these loans, and in some cases, looking to back out of loan commitments and rate lock agreements with investors.

The Dilemma

Most real estate investors purchase properties subject to the satisfactory completion of a due diligence investigation. These due diligence periods often include a financing contingency period, during which the investors work with a lender toward securing a loan for a large portion of the property's acquisition price. Typically, once the lender issues its loan commitment and the other due diligence is satisfactorily completed, the investor waives its contingencies and is contractually obligated to close.

[2] Deadbeat Developers Signaled by Commercial Property Derivatives, November 28, 2007.
[3] Id.

After the expiration of the due diligence period, the typical real estate investor stands to lose a substantial amount of earnest money if, in breach of its purchase agreement, it is unable to close on the property's acquisition. Without a loan, many commercial real estate investors are unable to come up with the proceeds to close on their acquisitions. Thus, the lender's commitment to fund a property's acquisition is a crucial factor in an investor's ability to perform under its purchase contract.

Often, investors also will enter into rate lock agreements with their lenders prior to closing. Under these arrangements, the lender agrees to lock, in advance of the closing, the investor's interest rate in exchange for certain fees. Once the rate lock fee is deposited, the lender enters into hedging transactions that allow it to commit to make the loan at the locked interest rate. Rate lock agreements help investors ensure that they can realize their anticipated rates of return, by removing the risk that their lenders' interest rates will rise before the closing.

The Risks

Traditionally, most loan commitments contain some form of a MAC clause. Such clauses provide that the lender's commitment to lend to an investor is contingent upon the absence of a material adverse change in either the property itself or the financial markets prior to the closing. For instance, a loan commitment often will contain a MAC clause stating that the "issuance of a commitment and the closing of the loan is subject to the absence of any material adverse change, as determined by the lender, in the tenants, property, borrower or key principals."

Similarly, many rate lock agreements contain MAC clauses stating that "the rate lock is contingent upon the absence of a material adverse change in the financial, real estate, banking or capital markets, including the mortgage-backed securities markets, and that the lender reserves the right to increase the spread at any time prior to the loan closing based on a material adverse change to the then current CMBS or CMBS market conditions as determined by lender."

With the volatility in the CMBS market, lenders are using the MAC clauses contained in loan commitments and rate lock agreements to back out of, or at least renegotiate, their loans to investors. See, for example, *Whitnall Glen, LLC et al v. Citigroup Global Markets Realty Corp. et al,* recently filed in the U.S. District Court for the Eastern District of Wisconsin, Case No. 08-C-0023. In this environment, investors should be aware that these clauses provide their lenders with a potentially costly "out" to funding a loan. For instance, if a tenant misses a rent payment, a casualty occurs at the property, spreads in the CMBS market change, or the borrower's principals suffer losses, MAC clauses may give a lender the potential opportunity to revisit its commitments to the investor.

Suggestions

Given this background, it is important for investors to carefully negotiate the MAC clauses contained in their loan commitments in an attempt to narrow their application. For instance, MAC clauses can be modified to include reasonableness and good faith standards as well as financial thresholds above which an adverse change must be valued in order for the lender to back out of the transaction. Thus, if a material adverse change is defined as something that would cost the investor over $250,000 to cure in any one year, the lender would be obligated to still close even if a tenant simply missed one month's rent payment or the property was subject to a casualty that could be cured for less than $250,000. Also, investors can attempt to retain the express right to recover damages from their lenders in the event the lenders back out of transactions based on material adverse changes outside of the investors' control.

Similar to loan commitments, rate lock agreements could quantify the material adverse change that would allow the lender to reprice the loan. For example, a rate lock agreement could contain a MAC clause that states a material adverse change in the financial markets would only occur in the event that the CMBS market spreads increased more than two percent, or 200 basis points, according to an index (such as the RBS Greenwich Capital Index). Furthermore, investors could attempt to have their rate lock fees and loan fees refunded if their lenders invoke the MAC clause due to market conditions beyond the investors' control.

MAC Clause Case Law

If a lender does choose to invoke the MAC clause in a loan commitment or a rate lock agreement, investors also can refer to the case law involving the use of such clauses. The success of a lender's attempt to back out of a loan commitment or rate lock agreement by invoking a MAC clause will be based upon the event that the lender cites as having had a "material adverse effect" on the investor. For instance, the 9/11 terrorist attacks gave rise to numerous cases involving material adverse changes clauses. See for instance, *River Terrace Associates, LLC v. Bank of New York,* a case involving an $83 million construction loan.

A review of recent case law dealing with MAC clauses shows that very few judges have developed a standard test to determine when a "materially adverse" event has occurred. However, some courts seem to be questioning lenders' use of the MAC clause. For instance, in the recent case *Langley v. Prudential Mortgage,* the plaintiff/borrower sought to enjoin its lender from collecting payments under a rate lock agreement where the lender refused to honor a rate lock agreement at 6.3 percent, but offered to fund the loan at the higher rate of 6.9 percent. In this case, the lender argued that the loan application clearly set forth that the interest rates were subject to change. The lender relied on the MAC clause to further its argument that the disruption of the capital markets, which occurred in 2007, allowed for the change in interest rates. The borrower/plaintiff acknowledged that it was aware of the MAC provision, but considered the rate lock agreements to remove the risk that adverse changes in the capital markets could affect the interest rates on its loans. In ruling for the borrower/plaintiff and enjoining the lender's collection of fees, the judge noted that for the bank to "claim the rate was not locked smacks of fraud." While this ruling dealt only with a preliminary injunction and was not a dispositive ruling on the parties' dispute, it does demonstrate the climate of increased tension between borrowers and lenders in these times of interest rate volatility.

Conclusion

The increased volatility in the CMBS market has trickled down to real estate investors, making the MAC clause in such investors' loan commitments and/or rate lock agreements more important than ever. Real estate investors (and their legal counsel) should be particularly careful of such MAC clauses and devote extra attention to the drafting of MAC clauses in the future.