This Common CRE Lending Clause Can Put A Property In Default — Even If The Borrower Is Paying

With more than $2.2T in U.S. commercial property loans coming due by the end of 2027 and real estate fundamentals weak, the relationship between lenders and their CRE borrowers is likely to become even more fraught than it is. As maturities loom, both sides are searching for an edge.

One potential advantage lenders possess is murky covenants in loan documents known as material adverse effect clauses. Though the clauses can be quite complex, they can, in theory, allow a lender to put a loan in default even if payments are being made because there has been an event that adversely affects the underlying property or other collateral, such as a drastic devaluation.

“It's one tool in the toolkit of lenders,” said Trilogy Law Managing Partner Fran Mastroianni, a real estate development and finance specialist based in Massachusetts. “It's there and can be invoked, and it's something that lenders can bring to the table when negotiating with borrowers.”

In this environment, lenders are looking for technical defaults under the terms of the loan documents, Mastroianni said. For example, a breach of the agreed-upon debt service coverage ratio could become a case for default.

“And ‘by the way,’ the lender might add, ‘that's also a material adverse change or effect,’” Mastroianni said, noting that MAE clauses tend not to be the primary tools lenders might use but can be strong secondaries.

There may be 10 elements in that loan agreement that could constitute default, said Dilworth Paxson partner Joseph Kessler, a real estate attorney.

“The first and most favored is the borrower hasn't paid,” Kessler said. “And then you have provisions about compliance with laws and one if litigation starts or bankruptcy.

“But then the ninth or 10th provision is going to be the omnibus MAE provision. If there's any material adverse effect on the financial condition, properties, operation or business of the borrower, and maybe its guarantors and its subsidiaries, that constitutes a default.”

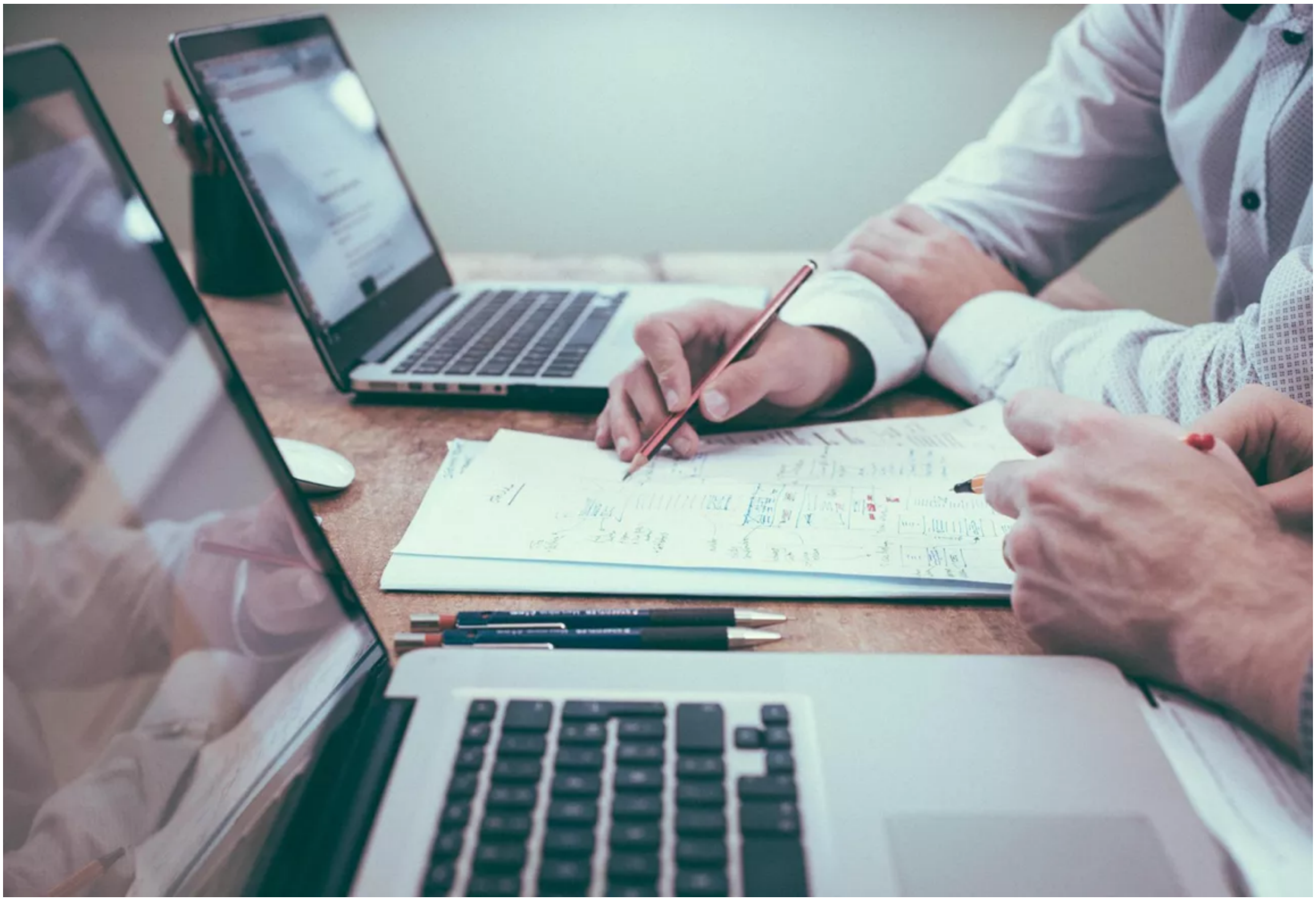
Most commercial loan agreements have a material adverse effect clause embedded in them, according to Kanreki Capital Managing Member Antonio Marquez, who has spent about 40 years in the lending industry. In theory, these clauses could be used when valuations go south.

“Certainly with office buildings there has been a material adverse change in the value of the underlying collateral. But there are probably other, better levers that can be utilized in negotiating with a borrower,” he said.

The situation between borrower and lender is quite specific and nuanced, Marquez said, depending on a variety of factors.

As with many things, the larger the borrower, the more leverage they have to either avoid an MAE clause or negotiate one that is less potentially damaging in the event it is acted upon.

“Every story will have a different narrative, and every negotiation will have different twists and turns,” he said. “If the borrower has 20 loans with a bank, and they have a good relationship or they have just one loan, that's going to have a big impact on the way the negotiations are carried out between a lender and a borrower in a troubled situation.”



During negotiations, larger borrowers can put parameters on exactly what constitutes a material adverse effect, which might be in the form of a list of carve-outs in a loan agreement, Mastroianni said. Such carve-outs might include such eventualities as a change in overall economic or political conditions, which a borrower would argue is out of its control.

“That would be one side of the spectrum,” Mastroianni said. “The other side of the spectrum is smaller borrowers. If you don't have a lot of leverage, you may be forced to accept very broad material adverse effects, without a lot of opportunity to articulate carve-outs or specific events.”

Though an established part of lenders' toolbox, it isn't something that they like to talk about. *Bisnow* asked the U.S. banks with the 10 largest real estate loan portfolios about their use of the clauses. Three of them, JP Morgan Chase, Truist and PNC, declined to comment, while the others didn't respond.

The clauses aren't native to real estate but rather have migrated in recent years from the world of mergers and acquisitions, where they are used between buyers and sellers of companies.

Their inclusion in commercial deals started even before the pandemic, Mastroianni said. Even in periods of a strong economy, lenders became more interested in material adverse effect clauses as protection against unforeseen events, such as losing an anchor tenant at a shopping center or a major tenant in an office tower.

“Material change clauses have become standard, particularly in large bank portfolios,” Integra Realty Resources CEO Anthony Graziano said, meaning that if there's a material change in the balance sheet of the borrower, then the lender has the right to evaluate the loan.

Graziano stressed that banks aren't in a rush to push performing loans into default. The MAE is most useful for generally healthy lenders that are trying to protect against a borrower that had a change in its financial condition.

“But if the borrower signs personally, and there's a material change, borrowers need to keep an eye on that,” he said.

That isn't going to be as much of an issue for larger borrowers that have banking relationships, Graziano said, and a MAE clause isn't likely to be used as a hammer if one particular project goes sideways. However, for smaller borrowers with notes at a single bank, one of them going bad means the bank will reevaluate all of them.

“It's like a hidden hook, that even if you're not in default on your current loan, your decision to default on another loan could bring challenges, or bring you into a situation where it becomes a snowball effect. If one project has a problem, 18 other deals could be reevaluated, and that could put you in a very serious cash crunch.”