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Commercial Real Estate Lending Checkup Amid Market Unrest

By **Emil Petrossian and Alexander Miller** (April 26, 2023, 1:33 PM EDT)

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As persistent inflation, soaring interest rates and a deteriorating economic outlook continue to sustain volatile lending markets, experience teaches that an ounce of contractual protection today can be worth a pound of litigation firepower tomorrow.

Now may be a good time for lending institutions to dust off their commercial real estate agreements and determine whether those agreements require updating. Based on our experience, here are four things every lending institution should consider when conducting such a review.

1. Confirm that your default provisions are enforceable.

Lenders typically rely on a variety of mechanisms to seek compensation for loan defaults, including the imposition of late fees and default interest to protect themselves in the event of a borrower's nonpayment.

The importance of these provisions is heightened especially when the economic climate is uncertain, as it is now for commercial real estate lending. Therefore, it is prudent for lending institutions to ensure that their default provisions are legally sound and enforceable now, before the specter of increased defaults, and litigation stemming from such defaults, arises.

One key issue to bear in mind in the event of a default is whether provisions authorizing the imposition of late fees and default interest will be treated as liquidated damages.

For example, many jurisdictions treat late fees as a form of liquidated damages, which means that such fees must bear a reasonable relationship to the range of actual damages that the parties could have anticipated at the time of the agreement.

In the lending context, this means that if late fees are excessive and not reasonably related to the lender's actual damages, they may be considered an unenforceable penalty.

Notably, treating late fees as liquidated damages does not necessarily mean that a lender has to conduct a borrower-by-borrower analysis of its estimated damages every time it enters into a new commercial real estate lending transaction.

Any such requirement would be onerous and, in many instances, not practically feasible. But it is helpful for a lender to be able to show, as a general matter, that the late fees it charges are reasonable and designed to compensate the lender for losses occasioned by late payments or nonpayment, and not to compel borrower compliance.

This could include, for example, a general analysis demonstrating the increased risk associated with loans in default, the lost opportunities occasioned by the absence of timely payments, and the increased costs associated with servicing loans in default.

It is imperative that lenders review the validity of, and requirements for, liquidated damages

provisions under the applicable laws governing their agreements.

If the applicable jurisdiction treats late fees or default interest as liquidated damages, then it is important for lenders to do that which is necessary to ensure the reasonableness and enforceability of such fees and interest.

2. Ensure that your fee provisions are both specific and broad.

It is no secret that the lending industry is highly dependent on fees to conduct business and drive revenues.

As such, it is important for commercial real estate lenders to delineate in their agreements, clearly and with specificity, the fees they anticipate charging borrowers to avoid situations in which a defaulting borrower can try to take advantage of ambiguous contract language to gain a litigation advantage.

For example, specifying a borrower's obligation to pay for "document processing" and "recording" fees can help ensure that a subsequent challenge to the imposition of such fees will fail.

At the same time, it is equally important to have sufficiently broad language in lending agreements authorizing fees that may become necessary during the course of the lending relationship, but are not necessarily foreseeable at the time of the agreement.

For example, using standard catchall language, e.g., "including but not limited to," in fee provisions can help lenders ensure that borrowers will be legally responsible for paying not only all specifically enumerated expenses, but also any additional expenses that may become necessary as both sides perform the lending relationship.

3. Include a release of liability when entering into loan modifications or new loan agreements.

Releases of liability are commonplace in many industries, including real estate, as a means of protection in light of continued transactions with a customer.

A release can offer powerful protection against future claims, so it is important to consider whether a release is appropriate when entering into a new loan transaction with an existing borrower, or when materially modifying an existing commercial real estate loan.

A liability release may not always be appropriate from a business standpoint, and in the consumer context, may require heightened disclosures. But conditioning new loan agreements or loan modifications on a borrower's execution of a release may be especially important when the borrower is a sophisticated entity with which the lender has had, or anticipates having, a long-term business relationship involving significant loan volumes.

4. Review the sufficiency of your arbitration agreements.

Arbitration provisions are ubiquitous in lending agreements — and often a flashpoint in costly legal disputes.

Issues surrounding arbitration provisions can run the gamut, including:

- Whether an arbitration provision is enforceable;
- The applicable forum, procedural rules and governing law;
- The number and qualifications of arbitrators;
- The type and amount of discovery permitted;
- Whether a reasoned award will issue; and
- Whether attorney fees and costs are recoverable.

In particular, the rules surrounding the scope and enforceability of arbitration provisions are

continuously evolving. Take the following examples from just the past year, which involve provisions in standard business contracts but are still applicable toward commercial real estate loans.

In Johnson v. Walmart Inc., the U.S. Court of Appeals for the Ninth Circuit held in January that when two separate, independent contracts — one with a broad arbitration agreement, the other without — potentially govern a dispute, the general presumption in favor of arbitrability does not apply, and the court, not the arbitrator, has jurisdiction to determine arbitrability, because the issue at hand is the existence, not the scope, of a binding arbitration agreement.

Also in January, in Cornet v. Twitter Inc., the U.S. District Court for the Northern District of California decided that an arbitration agreement delegating to the arbitrator determination of issues relating to the interpretation, application or validity of the arbitration agreement also delegated the issue of unconscionability, even though unconscionability was not expressly referenced in the arbitration agreement.

By contrast, in MacClelland v. Cellco Partnership in 2022, the same district court — but a different judge — held that a Verizon arbitration agreement's incorporation of the American Arbitration Association's arbitration rules, which specify that arbitrability is to be decided by the arbitrator, did not preclude the court from deciding whether the arbitration agreement was unconscionable and unenforceable.

The court reasoned that unsophisticated parties such as common customers of Verizon should not be expected to understand that incorporating arbitration rules into an arbitration agreement means that an arbitrator decides arbitrability.

The district court then found that a mass arbitration provision requiring arbitration when 25 or more customers represented by the same counsel raise similar claims was substantively unconscionable. This decision is presently on appeal before the Ninth Circuit.

In Suski v. Coinbase Inc. in 2022, the Ninth Circuit held that crypto company Coinbase inadvertently superseded and rendered unenforceable its standard arbitration agreement, found in the Coinbase user agreement at signup, for users participating in Coinbase's Dogecoin Sweepstakes, as the official rules for that contest provided for jurisdiction in California state courts, not arbitration.

The Ninth Circuit also found that arbitrability was appropriately decided by the court and not the arbitrator, because whether the arbitration clauses in Coinbase's user agreements were superseded was a question of the existence, not the scope, of a binding arbitration provision.

The key takeaway from these cases is that details matter when it comes to arbitration provisions, especially when dealing with multiple interrelated lending agreements, as is often the case in complex commercial real estate lending transactions.

If ensuring arbitration of future disputes is an important component of a lender's business strategy, it may be beneficial for that lender to ensure that each agreement contains its own arbitration provision, or at least incorporates by reference a standard arbitration agreement.

Further, specifically referencing the issues to be decided by an arbitrator in the arbitration provision itself may prove to be important, especially if the objective is to have an arbitrator determine not only the scope of the arbitration provision, but also its existence — something that usually benefits the party seeking to enforce arbitration.

Lastly, in the consumer context, it is important to remember how subsequent agreements may impact the enforceability of preexisting arbitration provisions, and to ensure against inadvertently superseding such provisions in subsequent agreements.

These are just a few examples of recent decisions that could have a material impact on lenders' arbitration agreements. Periodically reviewing arbitration agreements to account for changes in the law will help lenders better preserve the right to arbitration, and help avoid costly missteps that could land them in unintended legal battles.

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