

Lending Issues

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A. Trends in Lending Requirements

Real estate lenders once again become active and many of the issues are the same. However, the underwriting has become more conservative. As a developer, it is beneficial to understand what the lender is looking for.

Underwriting Approaches. Most regular lenders are finished with 100% financing and require a debt service ratio of at least 1.20 and higher. They also have placed a higher premium on personal liability in the form of recourse loans. They also are obtaining much more conservative appraisals than many borrowers are used to and insist upon interest and additional collateral besides the subject real estate. To go along with this, they are requiring greater borrower equity and/or a greater amount of pre-leasing if leases are involved. This poses some difficulties with developing relationships with smaller developers than with major owners and developers.

Impound Accounts. Lenders will often require impound accounts on a fairly large loan, particularly if the lender intends to sell the loan into a larger securitization package. As a result, a lender may require the borrower to prepay taxes, insurance premium payments and any monies received from ground lease payments to be paid to the lender to be placed into an account in order to avoid having a borrower miss or default on any of the requirements. Additionally, they may require the borrower to place into the impound account all security deposits, any and all leasing commissions, and other lease-up costs. Finally, if there are capital improvements contemplated, the lender might require the

borrower to deposit into an impound account any and all required contemplated capital improvements reserves.

Junior Liens. Lenders have become much more stringent on what they will allow and not allow with regard to the borrower having a junior lienholder on the collateral. A lender normally will require that the junior lienholder waive the "marshalling of assets" doctrine and any right to assert priority as to future advances or addition to the collateral and acknowledge that the senior lender is not over secured; (ii) that a maximum loan to value ratio not be exceeded and that the junior loan proceeds will only be used for purposes related to the collateral and not for distribution. The Lender also might cross default his documents with the junior loan documents and the senior lender might require the right to approve the junior loan documents and any amendments to the loan documents. Additionally, a senior creditor could require a written subordination and intercreditor agreement from the junior lender which will include terms such as an acknowledgment by the junior lender that it agrees to the terms of the senior loan documents, that the proceeds of the senior loan may be used for purposes unrelated to the property.

Guaranties. Guaranties are becoming more and more a traditional staple of real estate financing. Until now, they were traditionally part of construction lending but not often seen in permanent loans. However, guaranties are difficult to enforce as guarantors usually have several defenses, even though there may be no waiver language in the guaranty itself. Some defenses used are lack of consideration, modification of the underlying debt without consent and lack of approval for the guaranty.

Recourse versus non-recourse. Lenders, if they feel risk or perhaps that the property is a risky loan, will oftentimes require personal liability (recourse) on the loan. Conversely, the borrower doesn't want any personal liability, only wanting to limit his losses to the property and not to prejudice other developments or personal assets. Consequently, the use of limited partnerships and limited liability companies has become more prevalent as a reason to avoid recourse issues. However, lenders are beginning to insist on recourse protection more and more (even against single-asset entities). Reasons for such fear are that the lack of personal liability has encouraged borrowers to be reckless in workout negotiations, and to take cash flow from the property. If the parties agree to a non-recourse loan, there are several carve-outs which are typical and which are negotiable.

(a) Bad Boy Provisions. Fraud or misrepresentation in the making of loans could trigger recourse on the borrower. Misapplication of loan proceeds or insurance or condemnation funds, misapplication of tenant security deposits for prepaid rents, misapplication of revenues from improvements, failure to pay mechanic's liens and taxes are some of the intentional fraudulent acts which often can trigger recourse. Other events which lenders may insist upon are violation of due on sale clauses, violation of hazardous materials covenants, or filing for bankruptcy.

B. What Is Negotiable in a Loan and What Is Not.

Not Negotiable

(1) As a general rule, if the lender requires a guaranty, the guaranty will stay in place and is not negotiable.

(2) Rewriting post-default language which slows down foreclosure.

(3) Due-on -sale clause - essential.

(4) Assignment of rents clause - essential.

Negotiable

(1) Recourse vs. non-recourse.

(2) Prepayment penalties are negotiable.

(3) Application of insurance proceeds and condemnation proceeds for rebuilding.

(4) Due on encumbrance clause.

(5) Restrictions on leasing activity.

(6) Subordination and non-disturbance agreements.

(7) Junior lender restrictions.

C. Standard Financial Covenants.

"Section 5

AFFIRMATIVE COVENANTS

Borrower covenants and agrees that, so long as this Loan Agreement is in effect and until all the Indebtedness shall have been paid and all of the Obligations shall have been

fully performed and discharged, unless compliance shall have been waived in writing by Lender, Borrower shall do the following:

5.1 Payment and Performance. Borrower shall pay the Indebtedness as and when due in accordance with the Loan Documents, and shall perform and discharge all of the Obligations, in full and on or before the dates same are to be performed.

5.2 Payment of Expenses of Lender. Subject to the provisions of Section 10.13, Borrower shall pay on demand all Expenses of Lender. Any amounts due and owing by Borrower to Lender pursuant to this Section 5.2 shall bear interest from the date payment is made to such third party by Lender until paid to Lender by Borrower at the Default Rate, all of which shall constitute a portion of the Indebtedness. Except to the extent that Expenses of Lender are included within the definition of "Indebtedness," the payment of Expenses of Lender shall not be credited, in any way and to any extent, against any installment on or portion of the Indebtedness.

5.3 Litigation. Borrower shall promptly give written notice to Lender of (a) any action, proceeding or claim, of which Borrower may have notice, which may be commenced or asserted against Borrower or related to any of the Loan Documents, and (b) any dispute which may exist between Borrower and any Governmental Authorities, which may substantially affect the financial condition of Borrower.

5.4 Statement from Borrower. Borrower shall, at any time and from time to time, upon the written request of Lender, promptly furnish Lender a written statement or affidavit in such form as may be required by Lender, stating that the Loan Documents are valid and binding obligations of Borrower, enforceable against Borrower in accordance with

their terms; stating the unpaid principal balance of the Indebtedness; stating the date to which interest on the Indebtedness has been paid; stating that the Loan Documents have not been released or subordinated or modified; and stating that there are no offsets or defenses against the enforcement of any of the Loan Documents; or, if any of the foregoing statements are untrue or cannot be made by Borrower, specifying the reasons therefor.

5.5 Notice of Default. Forthwith upon Borrower's obtaining knowledge of the existence of an Event of Default, or of any fact, condition or event that only with the giving of notice or passage of time or both, could become an Event of Default, Borrower shall deliver to Lender a certificate signed by Borrower specifying the nature thereof, the period of existence thereof, and what action Borrower proposes to take with respect thereto.

5.6 Supplemental Opinions. If requested by Lender, Borrower shall provide such favorable supplemental opinions of counsel covering such matters incident to the Loan or any of the Loan Documents or any of the Mortgaged Property as Lender may reasonably request.

5.7 Further Assurances. Borrower shall make, execute or endorse, and acknowledge and deliver or file or cause the same to be done, all such vouchers, invoices, notices, certifications and additional agreements, undertakings, conveyances, deeds of trust, mortgages, transfers, assignments, financing statements or other assurances, and take any and all such other action, as Lender may, from time to time, deem reasonably necessary or proper in connection with this Loan Agreement or any of the other Loan Documents, the obligations of Borrower hereunder or thereunder, or for better assuring and confirming unto Lender all or any part of the security for any of such obligations, or for granting unto Lender

any additional security for any of the obligations which Lender may request from time to time.

5.8 Records, Statements and Reports. Borrower shall keep at all times proper books of record and account in which full, true and correct entries will be made of all dealings or transactions in relation to the business and affairs of Borrower, and will furnish or cause to be furnished to Lender such reports and financial information as is required by Lender. The office where the records of Borrower with respect to the accounts, contract rights and other general intangibles concerning the assets of Borrower are kept is located at the address shown on the signature page hereof, and Borrower agrees that the place at which such records are kept will not be changed without the prior written consent of Lender. Borrower will provide adequate protection against the loss or damage to such books of records and account.

5.9 Financial Statements. Borrower shall furnish to Lender: (i) within forty-five (45) days after the last day of each fiscal year of Borrower, current annual unaudited Financial Statements of Borrower for such year; (ii) within forty-five (45) days after filing with the Internal Revenue Service the federal income tax return of Borrower each year; and (iii) with reasonable promptness, such other information regarding the business affairs and financial position of Borrower as Lender may reasonably request.

5.10 Preservation of Existence. Borrower shall, and shall cause each Constituent Party to, maintain and preserve its existence and its right to do business in the State of Texas, together with its rights, franchises, and tradenames. Borrower shall deliver to Lender promptly upon the execution of same a copy of any amendment to Borrower's or any

Constituent Party's Organizational Documents, showing filing data from the appropriate state filing office.

5.11 Preservation of Assets. Borrower shall keep all of its assets in good repair, working order and condition and from time to time make all needful and proper repairs, renewals, replacements, extensions, additions, betterments and improvements thereto, so that the business carried on by Borrower may be properly and advantageously conducted at all times in accordance with prudent business management and in compliance with all Governmental Requirements.

5.12 Compliance with Material Agreements. Borrower shall comply in all respects with all existing and future agreements, indentures, mortgages, or documents which are binding on it or affecting Borrower's business or any of the Mortgaged Property.

5.13 Compliance with Governmental Requirements. Borrower shall promptly and faithfully comply with, conform to, and obey all Governmental Requirements.

Section 6

NEGATIVE COVENANTS

Borrower covenants and agrees that so long as this Loan Agreement is in effect and until all the Indebtedness shall have been paid and all of the Obligations shall have been fully performed and discharged, unless compliance shall have been waived in writing by Lender, Borrower will not do any of the following:

6.1 Change in Capital Structure. Borrower will not permit any change in the capital structure or ownership of Borrower, if the effect thereof is that those Persons owning in excess of fifty-one (51%) percent of the ownership interests of Borrower as of the date

hereof shall own less than fifty-one (51%) percent of the ownership interests of Borrower ordinarily entitled to vote.

6.2 Distributions. Borrower will not return any capital to its owners or authorize or make any other distribution, payment or delivery of property or cash to its owners as such, or redeem, retire, purchase or otherwise acquire, directly or indirectly, for a consideration any of its ownership interests or set aside any funds for any of the foregoing purposes.

6.3 Consolidation, Merger and Sale of Assets. Borrower will not wind up, liquidate or dissolve its affairs or enter into any transaction or merger or consolidation or convey, sell, lease, or otherwise dispose of (or agree to do any of the foregoing at any future time) all or substantially all or a substantial part of its property or assets or any part of such property or assets essential to the conduct of its business substantially as now conducted, or any of its notes receivable, installment or conditional sales agreements or accounts receivable; or purchase, lease or otherwise acquire all or any substantial part of the property or assets of any Person.

6.4 Change in Nature of Business. Borrower will not conduct any business other than, or make any material change in the nature of, its business as carried on as of the date hereof.

6.5 Investments. Borrower will not invest in (by capital contribution or otherwise), or acquire or purchase or make any commitment to purchase the obligation or ownership interest stock of, any Person except (a) temporary investments in securities of the United States having maturities not in excess of one (1) year, and (b) certificates of deposit

issued by the United States branches of commercial banks and savings and loan associations organized under the laws of the United States or any state thereof and having capital and surplus of not less than \$[20].

6.6 Advances and Loans. Borrower will not lend money or credit or make advances to any Person, except (a) advances made to employees of Borrower for the payment by them of items for which an expense report or voucher will be filed and which items will constitute ordinary and necessary business expenses of Borrower, and (b) those loans and advances as reflected on the most recent Financial Statements of Borrower furnished to Lender prior to the execution of this Loan Agreement, which may not be increased.

6.7 Guaranties and Other Liabilities. Borrower will not purchase or repurchase (or agree, contingently or otherwise, to do so) the indebtedness of, or assume, guaranty (directly or indirectly or by an instrument having the effect of assuring another's payment or performance of any obligation or capability of doing so, or otherwise), endorse or otherwise become liable, directly or indirectly, in connection with the obligations, ownership interests or distributions of any Person; except by endorsement of negotiable instruments for deposit or collection in the ordinary course of business.

6.8 Conditional Purchases. Borrower will not purchase or install any materials, equipment, fixtures or any other part of the improvements under security agreements, conditional sales contracts or lease agreements, or other arrangements wherein a security interest or title such property is retained or the right is reserved or approved to anyone to remove or repossess any such items or to consider them as personal property.

6.9 Other Indebtedness. Borrower will not create, contract, incur, assume or suffer to exist any indebtedness (including any liability for the deferred purchase price of property or other liability evidenced or to be evidenced by bonds, debentures, notes or other similar instruments), except:

- (a) Indebtedness arising out of the Note and the other Loan Documents;
- (b) Indebtedness secured by the Permitted Encumbrances (as defined in the Deed of Trust);
- (c) Indebtedness incurred under so-called "key man" insurance policies if the proceeds of any such indebtedness are applied solely to the payment of premiums on the policy under which incurred;
- (d) Current liabilities for taxes and assessments;
- (e) Current accounts payable or accrued or other claims (other than for borrowed money or purchase money obligations) incurred in the ordinary course of business, provided that all such liabilities, accounts and claims shall be promptly paid and discharged when due or in conformity with customary trade terms, unless the same shall be currently contested in good faith by Borrower;
- (f) Guaranties permitted by this Loan Agreement; and
- (g) Indebtedness of Borrower reflected on the most recent Financial Statements of Borrower furnished to Lender prior to the execution of this Loan Agreement.

6.10 Arm's Length Transactions. Grantor will not enter into any transactions with any Affiliate, except a transaction upon terms that are not less favorable to Grantor than would be obtained in a transaction negotiated at arm's length with an unrelated third party.

6.11 Salaries. Borrower will not pay or accrue any salary or compensation of any nature to any officer, director, employee or agent of Borrower unless after giving effect thereto, the aggregate of all salaries paid or to be paid in any fiscal year will not exceed [20]% of the aggregate amount paid for all such salaries of Borrower during the previous fiscal year.

6.12 Leasebacks. Borrower will not enter into any arrangement with any bank, insurance company or other lender or investor providing for the leasing to Borrower of any property (i) which at the time has been or is to be sold or transferred by Borrower to such lender or investor, or (ii) which has been or is being acquired from another Person by such lender or investor or other party acting on behalf of any such lender or investor or, if real property, on which one or more buildings have been or are to be constructed by such lender or investor or such other party, for the purpose of leasing such property to Borrower.

6.13 Purchase or Sale Agreements. Borrower will not enter into or be a party to (i) any contract for the purchase or use of materials, supplies or other property or for the performance of services if such contract requires that payment for such material, supplies or other property, or the use thereof, or for such services, shall be made by Borrower regardless of whether or not delivery is ever made of such materials, supplies or other property, or if such services are performed, or (ii) any contract for the purchase or sale of materials, supplies or other property if such contract provides that the payment for such materials,

supplies or other property or the use thereof, shall be subordinated to or otherwise subjected to the prior payment of any indebtedness (or any instrument evidencing such indebtedness) owed or to be owed by any Person.

6.14 Consolidated Net Worth. Borrower will not permit at any time the Consolidated Net Worth of Borrower to be less than \$[14]. The term "Consolidated Net Worth" shall mean the amount by which (i) the sum of (1) the par or stated value of the capital stock of all classes of Borrower and (2) the additional paid-in capital of Borrower and capital transferred from retained earnings and (3) the accumulated and retained earnings of Borrower exceeds (ii) the sum of the value stated on the books of Borrower for good will, patents, trademarks, trade names, copyrights, design rights, organization expenses, franchises, bond discounts, underwriting expenses, treasury stock, unamortized debt discount and expenses, deferred charges, excess of cost of investments in consolidated subsidiaries over fair value underlying net assets at dates of investment and other similar intangibles (including any intangibles which are shown on the Financial Statements), all determined in accordance with generally accepted accounting principles applied on a basis consistent with those used in the preparation of the Financial Statements.

6.15 Ratio of Consolidated Debt to Consolidated Net Worth. Borrower will not permit at any time the ratio of Consolidated Debt of Borrower to Consolidated Net Worth of Borrower to exceed [15] to [16]. The term "Consolidated Debt" shall mean all debt created, affirmed or guaranteed by Borrower payable more than one year from the date of calculation, which under generally accepted accounting practices is shown on the consolidated balance sheet of Borrower as a liability, plus (without duplication) amounts

equal to the aggregate net rentals (after making allowance for any interest, taxes and other expenses included therein) payable more than one year from the date of creation thereof under leases and subleases which are capital leases, as such term is defined by the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 13, dated November, 1976.

6.16 Consolidated Current Ratio. Borrower will not permit the ratio of Consolidated Current Assets of Borrower to Consolidated Current Liabilities of Borrower at any time to be less than [17] to [18]. The term "Consolidated Current Assets" means as of the date of any determination thereof, such assets of Borrower (excluding intercompany items) as generally accepted accounting principles would include within the term "current assets," in the case of a corporation conducting a business the same as or similar to that of the particular corporation concerned, after deducting adequate reserves in each case where a reserve is proper in accordance with generally accepted accounting principles. The term "Consolidated Current Liabilities" means, as of the date of any determination thereof, the aggregate, after eliminating intercompany items, of all current liabilities of Borrower [*** (including the current portions of all amounts outstanding under the Loan Agreement [and any other long term debt]) ***], consolidated in accordance with generally accepted accounting principles applied on a basis consistent with those used in the preparation of the Financial Statements [*** (except that in determining current liabilities under this Section 6.3, all amounts outstanding under the Loan Agreement shall be excluded in such determination) ***]."