CUTTING THROUGH THE JARGON: A Basic Primer on Commonly Used Terms in Commercial Real Estate Mortgage Transactions.

Similar to many other industries, the world of commercial real estate has a language all its own, including some strange and confusing often bandied about in the course of a transaction. Getting a handle on these terms may help to level the playing field with the brokers, bankers, attorneys and other professionals who frequently resort to the trade lingo. To that end we have provided a list of some commonly used vernacular and simple accompanying explanations. While this list is by no means exhaustive, we thought that this list should provide the reader with a basic introduction to the dialogue and hopefully take some of the seeming complexity of the world of commercial mortgages.

Adjustable Rate Loan (also called a floating rate loan or a variable rate loan) refers to a loan that does not have a fixed rate of interest over the life of the loan. Such a loan typically uses an index and some base rate for establishing the interest rate for each relevant period. One of the most common rates to use as the basis for applying interest rates is the London Inter-bank Offered Rate, or LIBOR (the rates at which large banks lend to each other).

Bad Boy Carve-outs (to non-recourse loans) are exceptions within the loan documents that result in full-recourse liability to the borrower and the guarantor when certain "bad-boy" behaviors exist. Examples of these "bad-boy" behaviors are (i) fraud or intentional misrepresentation by the borrower; (ii) waste occurring to or on the mortgaged property; (iii) gross negligence or criminal acts of the borrower that result in the forfeiture, seizure or loss of any portion of the mortgaged property; (iv) misapplication or misappropriation of rents, insurance proceeds or condemnation awards received by the borrower after the occurrence and during the continuance of an event of default; and (v) any sale, conveyance, mortgage, grant, bargain, encumbrance, pledge, assignment or transfer of the mortgaged property, or any part thereof, without the prior written consent of the lender.

Balloon Payment Mortgage a mortgage which does not fully amortize over the term of the note, thus leaving a balance due at maturity (see also “Bullet Loan”).

Boilerplate these are standard contract clauses which use universal language as a type of template. Usually found at the end of a contract, boilerplate clauses include insurance terms, arbitration clauses, notice provisions, jurisdictional and governing law clauses and force majeure clauses. In loan documents these terms are often ignored but may be important in the event of a property casualty, loan default or other issue concerning the property.

Bridge Loan a short-term interim loan, often at a higher than market interest rate and with larger than usual origination fees (points), used to quickly effect the purchase of real property while pursuing more conventional longer term real estate financing, Bridge Loans in the real estate context are very often also referred to as “Hard Money Loans” (see below).
**Bucket** a category of economic rights or obligation within a Waterfall provision (see below).

**Bullet Loan** a loan without amortization where the payment of the entire principal of the loan, and sometimes the accrued principal and interest, is due at the end of the loan term.

**Cap** a limitation on the maximum interest rate that can be charged on an adjustable rate mortgage during the term of the loan.

**Capitalization Rate** (or "Cap Rate") is the ratio between the net operating income produced by an asset and its capital cost (the original price paid to buy the asset) or alternatively its current market value. The rate is calculated in a simple fashion as follows:

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\text{Capitalization Rate} = \frac{\text{annual net operating income}}{\text{cost (or value)}}
\]

Cap Rates provide a tool for investors to use for roughly valuing a property based on its net operating income. For example, if a real estate investment provides $160,000 a year in Net Operating Income and similar properties have sold based on 8% cap rates, the subject property can be roughly valued at $2,000,000 because $160,000 divided by 8% (0.08) equals $2,000,000. A comparatively lower cap rate for a property would indicate less risk associated with the investment (increasing demand for the product), and a comparatively higher cap rate for a property might indicate more risk (reduced demand for the product).

**Capital Stack** refers to all of the capital invested in a project, including pure debt, hybrid debt, and equity. The stack is generally described from top to bottom going from the category of capital with the most risk at the top going down the stack to the position with the least risk. The higher the position in the stack -- the higher the returns that can be expected for that capital because of the increased risk. Typically, the stack is arranged as follows.

1. Sponsor equity;
2. Preferred Investors equity;
3. Mezzanine investors (hybrid debt and equity);
4. Second and other junior mortgages; then
5. Investment-grade first mortgages.

**Carve Out Guaranty** the guaranty typically required by a lender of one or more principals of a borrower in connection with the non-recourse carve out obligations under a mortgage loan.

**Cash Sweep (or Cash Trap)** the process by which any net cash flow (beyond a borrower’s operating costs and debt service) goes into a lender-controlled account. Often activated by the borrower’s failure to meet a financial test and accompanied by a Lockbox (see below).

**Debt Stack** the total structure of mortgage and other debt for a property. Part of the Capital Stack; may include a permanent loan, Mezzanine Loans (see below), and other varieties of debt.

**Draw Funds** are funds taken from a construction loan through a process referred to as a "draw". A draw is the method by which funds are taken pursuant to a construction budget to pay material suppliers and contractors. Each lender has different requirements for processing a draw. This process helps ensure that the loan proceeds are actually used for the construction and that the construction process is moving smoothly.
Due Diligence means the investigative process that persons involved in buying, selling, lending, and managing of real estate routinely need to perform to understand both the physical and economic condition and of a property. There a variety of types of property due diligence that are typically conducted. Environmental due diligence during can include Phase I and Phase II Environmental site assessments. An engineering or property condition assessment (PCA) would include a review of building systems to evaluate deferred maintenance items that can materially affect the operation and value of a property. Building systems would include the foundation, roof, HVAC, electrical, plumbing, vertical transportation, and building envelope (windows and walls). The due diligence should also include an analysis of financial statement, income and expense statements, rent rolls and tax returns relating to the property. All of these reports are useful for negotiating the price of a property as well as financial planning. The due diligence in a real estate transaction also includes a title search regarding the ownership of the property and the encumbrances to which it is subject as well as research as to the applicable zoning laws, building code compliance and property taxes and other special assessments applicable to the property.

Equity Kicker typically refers an ownership position or other profit participation in connection with the advancement of a loan. For instance, a hedge fund that lends money to a real estate developer might receive as an equity kicker a negotiated percentage of ownership in a project when completed. In return for that equity kicker, the borrower may be able to obtain a lower interest rate on the loan.

Go Dark refers to a shutdown of operations by a big box or other major anchor retail tenant, often without assigning the lease or subletting the space to another operator. This shutdown can potentially damage other tenants and, in the worst case, destroy an entire shopping center.

Go Dark Clause is a provision in a lease giving the tenant the option to terminate a lease or receive a reduction of rent, if another identified tenant (typically a large recognizable name tenant (anchor or big box tenant) goes out of business or leave the premises. The lease clauses are very often found within the context of retail shopping centers.

Go Hard means that a buyer has determined not to exercise a due diligence “out” of the contract or that the expiration of the deadline to cancel the contract has occurred. After this point Buyer may forfeit the contract deposit if it does not or can not close the transaction on the closing date.

Hard Costs means the direct costs relating to construction or improvement of a building or other structure, as opposed to other “soft costs” such as legal, financing, architects', and similar fees required for the project.

Hard Money Loan is a mortgage loan with an above market interest rate and expensive closing fees (points) usually from a nontraditional lender often obtained as a Bridge Loan (see above), because of borrower distress or in order to meet financial requirements of a project beyond the acquisition.

Holdback Funds refers to monies held back by a lender from a loan until such time as a certain conditions at the property are met such as the leasing up of a certain percentage of the property, the completion of certain capital improvements or repairs or the disposition of a legal action.

Interest Reserve instead of paying each month during construction, almost all construction loans require the borrower to borrow extra funds at the initial closing of the loan which are stored in a locked account known as an "interest reserve". Each month the monthly payments are taken from the account so that the borrower does not have to start paying out of pocket until the project is completed.
Leakage refers to the ability of the borrower to receive some cash from property sales (often in a condominium project) before the loan has been fully repaid.

Lockbox (cash management agreement) refers to an arrangement by which rent gets paid by tenants directly to a particular bank account (subject to a lender security interest) to be applied in accordance with a Waterfall (see below).

Mezzanine Loans typically refers to secondary financing on a project, similar in purpose to a second mortgage, except that a mezzanine loan is secured by the equity interests of the company that owns the property, as opposed to the real estate. If the company fails to make the payments on the loan, the mezzanine lender can generally foreclose on the equity in a much simpler and expedited time in comparison to the often complex and timely mortgage foreclosure process. Once lender owns the company that owns the property it controls the property.

Mortgage-backed Securities (also Collateralized Mortgage-backed Securities or CMBS) are a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities are grouped and rated by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. The underlying mortgages must have originated from regulated and authorized financial institutions.

Permanent Loan usually means long-term financing for real property that has achieved Stabilization. These loans typically requires monthly amortization and include a fixed rate of interest.

Proceeds (or Loan Proceeds or Net Proceeds) means the net amount of funds disbursed by a lender to a borrower (after the deduction of lender, fees and other transactional expenses), under the terms of a loan agreement.

REO (“Real Estate Owned” or “Other Real Estate Owned”) refers to real estate that a bank has acquired through foreclosure or a deed in lieu of foreclosure and is carrying on its balance sheet.

Securitization the process pursuant to which mortgage loans are purchased from banks and other lenders and assigned to a trust, assembled into collections or "pools", then securitized through the issuance of Mortgage-backed Securities.

Shotgun refers to a mechanism sometimes inserted into some joint venture agreement pursuant to which one partner can force a buyout procedure by naming a price for all the assets of the joint venture (commonly that price is based on the distributions that the join venture would make if it sold all its assets for the stated price). The other partner must then either buy out the initiating partner, or sell to the initiator at the stated price.

Single Purpose Entity means a newly formed entity, the sole purpose of which is to own and operate a particular property or project, which is often required by lenders (particularly CMBS lenders).

Sizing means a lender’s determination of the final loan amount.

Stabilization means the point at which a project, development or acquisition has become income-producing real estate by achieving a certain level of completion, lease-up and/or net income.

Swap an agreement in which a borrower (typically under a floating rate loan) agrees to pay a fixed rate and a counterparty agrees in exchange to cover the borrower’s floating rate loan payments.
**Sweat Equity** generally refers value that is added to a property by a developer or sponsor who add value through its intangible efforts such as by obtaining favorable zoning rights, obtaining municipal consents, negotiating favorable rights with adjacent property owners or assembling other properties required for the development, creativity in project design, or lining up future tenants. The sponsor/developer will often negotiate for the right to convert its sweat equity into a larger share of the profits or future value of the completed project.

**Takeout** refers to a lender’s commitment to provide a permanent loan for a property (i.e., refinance of the construction loan) after completion of construction and, in many cases, Stabilization.

**Tranche** usually refers to the particular priority a loan has for application of foreclosure sale proceeds. Higher tranches have lower risk and lower interest rates than “lower” Tranches.

**Waterfall** means the provision in an agreement which dictates the order of priorities with respect to the application and distribution of available cash proceeds from a particular project or property.

**Workout** means the negotiated resolution of a troubled loan.