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Secured Real Estate Financing: Just Because You Are Cross-Defaulted, Does Not Mean You Are Cross-Collateralized

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Author: Kym Stasiuk

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In the business of real estate financing, it is not uncommon for a lender to make more than one loan to the same borrower (or affiliated entity) in exchange for mortgages, among other security, on the real property related to each loan. This is because experienced developers of real property are seldom involved in only one project at a time and funding from a consistent, reliable source is always a key component of such ventures.

When one of these loans goes sideways, however (e.g. a payment default by the borrower), the lender will want to consider its willingness to continue with *all* of its loans made to that borrower. In these situations, the lender will benefit from having certain language in its loan documents, such as cross-default and cross-collateralization provisions.

Let us say, for example, that a lender makes a loan for $1 million to a borrower in respect of property A and a loan for $2 million to the same borrower in respect of property B. As security for the repayment of these loans, the lender will get a mortgage on property A in the face amount of $1 million, which states that it is securing the indebtedness of the borrower under the commitment letter for the $1 million loan, and a mortgage on property B for $2 million, which states that it is securing the indebtedness of the borrower under the commitment letter for the $2 million loan. The lender will typically include in the provisions of each of these two mortgages a general cross-default clause along the following lines:

“A default by the borrower under any other agreement in favour of the lender shall be a default under this loan”.

This means that if the borrower defaulted under the $1 million loan this would constitute a default under the $2 million loan as well, entitling the lender to enforce on either loan, or both.

Just because the loans are cross-defaulted, however, does not mean that they are cross-collateralized.

Cross-collateralization looks at what the mortgage secures and at the total amount of indebtedness of the borrower to the lender. In other words, is the mortgage that secures one loan also capable of being used as collateral for another loan? Without properly drafted cross-collateralization provisions, the answer is no and the benefits of cross-collateralization will not be realized by the lender.

These provisions are particularly important to a lender in a situation where the lender is in a subordinate priority position and/or there is risk that the lender's realization on its security will be not sufficient to pay off the loan.

Now, let's go back to our example and assume that proper cross-collateralization is *not* in place when the borrower defaults on the $1 million loan. If the lender ranks behind some other lender and/or the lender does not expect that the proceeds of selling property A will be enough to pay off this loan, the lender can enforce on the $2 million mortgage on property B based on the cross default provision. Once property B is sold under power of sale, however, the lender can only apply the proceeds of sale (subject, of course, to the rights of any senior creditor) to reduce the indebtedness owing by the borrower on the $2 million loan, since the mortgage stated that it was security only for that loan.

If the lender wants the loans to be properly cross-collateralized, then specific provisions must be inserted into both mortgages stating that they secure both loans. In addition, the face amount of both mortgages should be $3 million, so that both loans can be repaid on the enforcement of just one of the mortgages (assuming that the property is worth that much and, again, subject to the rights of any senior creditor). Further, inserting cross-collateral language alone and not increasing the face amount of the mortgages in our example would mean the lender could only utilize up to $2 million of the proceeds to reduce the indebtedness on both loans, since that was the face amount of the mortgage.

While a borrower may prefer that each of its loans (projects) be stand-alone in nature, carefully crafted cross-default/cross-collateralization language used in a common borrower situation will no doubt reduce risk for the lender in a default scenario. Without such provisions, the lender may not be entitled to utilize the proceeds of sale of one property to reduce indebtedness owing by the common borrower on another property and the amount of available proceeds to reduce such indebtedness will be limited to the face amount of the mortgage.

Kym Stasiuk is a partner in Blaney McMurtry's corporate/commercial practice group, specializing in real estate financing transactions. Acting for both private and institutional lenders, *and for developers, Kym has extensive experience in preparing and negotiating loan and security documentation for a variety of transactions including acquisitions, development/construction lending, refinancings, mezzanine/subordinated debt financings, and related intercreditor arrangements.*

Kym may be reached directly at 416-593-3995 or kstasiuk@blaney.com