

# SHOW ME THE MONEY! CASH MANAGEMENT FOR CMBS AND CONVENTIONAL LOANS (WITH FORM)



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The original version of this article appeared in the March 2021 issue of The ACREL Papers.

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The term "cash management" describes a variety of methods, tools, products, and platforms offered by banks and other providers to help businesses manage their accounts receivable, accounts payable,

and other cash operations. The focus of this article is the use of cash management in loan transactions to control and balance the competing interests in revenues from real property collateral for a loan.

## OVERVIEW

Cash management products and their structures are built on a unique language while employing elements common to the various structures. Therefore, we begin with a brief description of the vocabulary and the basics.

### Lockbox/clearing account

A lockbox is a location to which rent payments are directed in a cash management arrangement. In past years, this was often a post office box to which checks were sent by mail and then deposited into a linked bank account. Now, with electronic payments being the primary form of payment, a lockbox often is only the bank account to which those payments are directed, although post office boxes are still used. Either way, the lockbox is typically managed by a third party, commonly a depository bank, which is charged with collecting the directed payments and seeing that the collected funds are deposited into a prescribed account housed at the bank. The bank account into which third-party payments are deposited may be referred to as a lockbox, or a clearing, collection, restricted, controlled, blocked, or deposit account. We will refer to the account into which the rents or revenues are deposited alternatively as the lockbox or the clearing account.

The clearing account is a borrower account opened in the borrower's name and the money in the clearing account remains the borrower's money, subject to security interests granted in favor of the lender. However, the clearing account is sometimes referred to as a "blocked" account because the borrower generally has limited control or no control over the clearing account or the money held on account. The deposit bank is paid a fee to hold and manage the clearing account and follow the lender's instructions with respect to the operation of the account.

### Hard, soft, or springing lockbox or clearing account

The lockbox or clearing account is the initial account in the cash management arrangement into which rents and other payments from tenants or other

third parties are directed. It serves as a collection account avoiding the need for funds to flow through the landlord/borrower. For the lender, requiring all rents to be deposited directly into the clearing account creates a lender control mechanism over the funds in the account, which helps ensure that no rent payments are diverted and eliminates delays in the application of rents according to the cash management arrangement.

Whether the lockbox is "hard" or "soft" depends on when the borrower is obligated to cause all rents to be paid into the account. With a soft lockbox, the borrower or the property manager is permitted to collect payments from tenants and other third parties and then deposit the payments into the clearing account. With a hard lockbox, the borrower directs all rents to be paid directly to the clearing account by delivering payment direction letters to the tenants or other parties who may make payments to the borrower such as, in the case of hotels in particular, credit card companies. These payment instructions can only be altered by a writing signed by the lender.

Sometimes the lockbox is springing, meaning that no clearing account is opened at loan closing, and the implementation of the lockbox arrangement is conditioned upon the occurrence of one or more prescribed events, at which time the borrower must take necessary steps to implement a hard lockbox arrangement. These steps can range from simply delivering pre-signed direction letters and account opening paperwork to the applicable parties to requiring the borrower to sign documents and cooperate in issuing the payment instructions to the tenants and the opening of the clearing account.

### Hard or springing cash management

The funds collected in the clearing account usually do not remain there; instead, the funds are "cleared" through the clearing account into another account. Depending on the arrangement, the monies are swept or transferred to one or more deposit accounts under the control of either the lender or the borrower.

In hard cash management, the funds in the clearing account are automatically swept to a lender-controlled account, commonly referred to as a cash management account. The terms of the loan documents govern the use of the funds in the lender-controlled cash management account. On the other hand, in springing cash management, the monies flow periodically through the clearing account to a borrower-controlled account until the occurrence of a trigger event such as a default under the loan or a drop in the debt service coverage ratio for the loan. When the trigger event occurs, the monies flowing through the clearing account are automatically diverted away from the borrower's account and directly to a lender-controlled cash management account. In a springing cash management arrangement, the necessary documentation is typically in place to cause the funds in the clearing account to either be transferred to a lender-controlled cash management account upon the occurrence of a trigger event or, in the case where such account has not been opened, to remain in the clearing account pending direction from the lender. In either case, while the trigger event is ongoing, the borrower has no right to receive the funds in the clearing account and the use of such funds will be governed by the terms of the relevant loan documents.

### **Control**

The term "control" has both a practical and a legal meaning in the discussion of cash management. On a practical level, it refers to the various contractual provisions in the loan documents between the borrower and the lender or collateral agent as to when and how revenues from the collateral can be used or distributed. However, in the context of the Uniform Commercial Code (UCC),<sup>1</sup> control refers to various methods of perfecting a security interest in deposit accounts (including the clearing and cash management accounts), investment property, electronic chattel paper, and letter-of-credit rights, as will be discussed later.

### **Purposes and rationale**

Fundamentally, cash management is a contractual arrangement that uses one or more depository

accounts to provide a lender with varying levels of control over the cash generated by the real estate project securing the lender's loan. This arrangement is meant to:

- Ensure that cash from the project is held and applied in a manner consistent with the terms of the loan;
- Reduce or eliminate the risk that any cash might be diverted or misapplied by a borrower or property manager, especially following an event of default or other significant credit event; and
- Provide the lender with the means to perfect its security interest in, and quickly take control of, the cash generated by the real estate project.

There is a wide range of approaches as to whether and to what extent a lender will require a cash management arrangement. These approaches are often grounded in basic loan underwriting and documentation strategies. Common considerations include: (i) whether the loan will be securitized; (ii) the underlying credit quality of the loan; (iii) whether the transaction involves a single-tenant property; (iv) whether the borrower or its affiliates already have a banking relationship with the lender; and (v) specific deal risks such as significant lease roll-overs.

Cash management negotiations navigate the tension between: (i) the lender's quest to maintain all property revenues separate from other revenues and operations of borrower and affiliates, to ensure uninterrupted proper application of property revenues to property purposes and debt service, and to prevent misapplication of those revenues; and (ii) the borrower's desire to maintain control of its business and its revenues, to have discretion over decisions on how to spend property revenues, to insure that necessary actions can be taken without undue delay, and to guard the landlord-tenant relationship from intrusion by lender control. Many borrowers use third-party property managers to operate the real estate, and these managers may have some control over the accounts into which property revenues are deposited and may have contractual rights to reimbursement from the accounts for property expenditures. The role of any property manager and

any rights it may have with respect to a property's cash flow need to be accounted for in any cash management arrangement.

Cash management arrangements are essentially a form of contractual receivership of cash collateral. They provide lenders with a built-in remedy that can be executed quickly upon default outside of any judicial process. Hard cash management arrangements provide certainty pre-default that reserves will be funded for ground rent, taxes, insurance, debt service, capex/FF&E costs, tenant roll-over expenses, and other required reserves, that operating expenses will be paid in accordance with an approved budget, and that mezzanine debt and preferred equity returns will be paid at the proper time and in the proper order or priority. The payment order is commonly referred to as the "cash management waterfall." Within the waterfall, the levels of cash allocation are sometimes called "buckets." The cash deposited into the cash management account flows down the waterfall filling the buckets in the priority and amounts prescribed by the loan agreement or the cash management agreement. The Appendix at the end of this article includes a sample reserves and cash management provision, including a sample waterfall.

Once agreed expenses are paid and reserves are funded in accordance with the waterfall, any remaining cash is either paid over to the borrower or is retained and held in accordance with the loan documents. The latter arrangement is commonly referred to as a "cash trap" because cash is trapped at the bottom of the waterfall, and no remaining cash is released or "escapes" from the cash management account. Upon the occurrence of an event of default, the cash management waterfall is often superseded in its entirety by the lender's right to apply all cash to the debt or for other purposes in such manner as the lender may determine.

### **Cash management as credit enhancement**

The use of cash management controls has become an underwriting standard for certain types of loans. Specific credit risks associated with the borrower,

the deal, or both may warrant a greater level of control over a project's cash flow. Examples can include a highly leveraged transaction, a project that has not stabilized, is being repositioned or has a significant number of leases rolling over during the term of the loan, or a single-tenant arrangement where the credit of the tenant is the credit basis for the transaction. In these cases, prudent loan structuring may warrant an enhanced cash management arrangement, though the extent of that cash management arrangement can vary from lender to lender and deal to deal. Diligent lenders and borrowers endeavor to set out and agree upon the primary cash management terms in the loan term sheet or application to avoid or limit any disagreement or delay when negotiating loan documents and closing the loan.

### **CMBS loans and S&P (rating agency) standards**

For commercial mortgage-backed security (CMBS) loans, cash management implements certain securitization and rating agency standards as found, for example, in S&P's US CMBS Legal and Structured Finance Criteria issued on May 1, 2003. A CMBS loan structure contains numerous elements designed to ensure the uninterrupted cash flow from all mortgage loans in the pool to pay the bondholders, which influences CMBS bond ratings. Cash management aims directly at the cash generated by the mortgaged property, to capture and allocate the cash under the appropriate circumstances to pay debt service and to fund reserves that cover property expenses to maintain the integrity of the income-producing collateral, all for the benefit of the bondholders. Cash management for CMBS loans tends to follow a pattern resulting in general uniformity among the loans in a securitized pool with variations addressing unique credit issues and collateral characteristics, though, from a loan administration perspective, the potential rigidity of this arrangement may raise operational issues for a borrower, especially if property-specific circumstances change over the course of the loan. The sample reserves and cash management provision that appears in the Appendix illustrates a simplified cash management arrangement that may be used for a CMBS loan.

## **Recourse liability for failure to implement cash management**

Borrower's failure to comply with cash management requirements is commonly a loan default and may also trigger liability under an exception or carveout from the limitations on a lender's recourse to the borrower under the loan documents. The carveout liability resulting from a breach of the cash management provisions may flow directly to a loan guarantor under a non-recourse carveout guaranty. The rationale underlying the non-recourse carveout is that the borrower's failure to comply with cash management denies the lender the benefit of its bargain to make a non-recourse loan so long as the lender can have recourse to the mortgaged property and other collateral including the rents. Failure to comply with the cash management requirements interferes with the lender's access to the cash flow produced by the property warranting such recourse liability. The carveout liability of the borrower and guarantor may be limited to the loss or damage suffered by the lender as a result of the breach, or the breach could trigger liability for the entire loan amount, depending on the lender's requirements and the relative bargaining position of the parties.

### **Legal precedent**

The bankruptcy filing of General Growth Properties, Inc.<sup>2</sup> (GGP) tested the integrity of the cash management structure and the ability to isolate cash flow from the collateral property and direct the cash to payment of property expenses and other property-related purposes. When GGP filed for Chapter 11 bankruptcy protection, it caused 166 solvent bankruptcy-remote entities that were all current on their debt to also file Chapter 11 petitions. GGP used a centralized cash management system in which surplus cash was upstreamed from project level entities to a central cash management account that operated for the benefit of the entire enterprise. There were a variety of cash management arrangements with individual property lenders, some that isolated cash at the property level more than others, but the majority of the property-level loan documents facilitated the funding of the centralized account which ultimately benefitted the GGP enterprise. The

company's centralized cash management enabled GGP to use cash at the enterprise level from stronger properties to support weaker properties, and to fund the parent company's debt obligations.

In the bankruptcy, the individual property lender's efforts to isolate and retain excess cash at the property-level became intertwined with GGP's debtor-in-possession (DIP) financing. The court allowed the DIP financing to obtain a senior lien on the central cash account and cash management system. The court ruled that the property-level debtors were not obligated to hold excess cash flow at the property level, even if the property-level cash management arrangement required it, and that upstreaming was not a violation of the debtors' single-purpose entity covenants. Lender instructions regarding disposition of excess cash were ineffective. In approving the DIP financing, the court granted the property-level lenders adequate protection in various forms.

The case highlights the importance, and weakness, of cash management controls that isolate cash at the property level. When drawing lessons from the case, some have suggested that, since lenders' instructions will be overridden in a borrower bankruptcy, lenders should require hard cash management from the outset to help ensure stricter cash controls that retain cash at the property level. However, the GGP case suggests that a bankruptcy court may disregard the lender's requirements on use of cash collateral where the cash collateral is essential to the borrower's reorganization. Hard cash management arrangements frequently allow excess cash to be returned to the borrower until a trigger event occurs, such as a default, and only then will cash be trapped in the lender's cash management account. As in GGP, a bankruptcy court may view the interests of the enterprise or corporate family as a whole rather than on a property-by-property basis. It will remain difficult for a lender to structure around a centralized cash operation of a debtor's parent in which the property-level debtor funds the parent's operations.

## UCC principles

Apart from the contractual restrictions on the use of cash, at the heart of every cash management arrangement is the lender's desire and need to remain continually perfected in its security interest in the rents, proceeds, and profits from its real property and personal property collateral, and to maintain that security interest's level of priority consistent with the initial underwriting. To that end, it is important to recognize the different forms that the collateral may take during the life of the loan and how security interests in those forms of collateral must be perfected. A security interest in rents, which is specifically excluded from the scope of the UCC in section 9-109, must be perfected under local real property law, but when rents are deposited in a deposit account, they become subject to the UCC. Rights to payment for the temporary use of space, such as hotel guest rooms and meeting facilities, may not be rents but "accounts" under the UCC. A security interest in such accounts must be perfected by the filing of a UCC financing statement.

1. Most accounts in the cash management structure are deposit accounts. Unless a deposit account constitutes cash proceeds<sup>3</sup> of other collateral in which a security interest was perfected by another method under the UCC, a security interest in a deposit account may only be perfected by control.<sup>4</sup> Section 9-104 provides three methods by which a secured party may obtain control of a deposit account for perfection purposes:
2. If the secured party is also the bank with which the deposit account is maintained (often called the "deposit bank"), the secured party is automatically perfected.
3. A secured party may obtain control if the debtor, the secured party, and the deposit bank enter into an agreement in which the deposit bank agrees to comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent of the debtor. This agreement is commonly called a deposit account control agreement (DACA), although some institutions

use the name "blocked account agreement" to document a hard cash management control agreement and "shifting control agreement" to refer to a springing cash management control agreement.

A secured party "may obtain control over a deposit account by becoming the deposit bank's customer with respect to the deposit account. This means that the secured party has the right (but not necessarily the exclusive right) to withdraw funds from, or to close, the deposit account."<sup>5</sup>

Section 9-104(b) provides that a secured party that has satisfied the requirements of one of these three methods of control has control even if the debtor retains the right to direct the disposition of the funds from the deposit account.

Under section 9-327, a secured party that has control over a deposit account has priority over a secured party that does not have control, such as a secured party whose perfected security interest in a deposit account is as cash proceeds of collateral in which a security interest was originally perfected by filing. A secured party that is the deposit bank's customer has priority over any security interest held by the deposit bank, but in all other situations a security interest held by the deposit bank has priority over all other perfected security interests. Security interests perfected by DACAs rank according to priority in time of the secured party obtaining control.

Both Delaware and New York have additional non-uniform methods of perfecting a security interest in a deposit account as original collateral. In 2007, Delaware added the following to subsection (a) of section 9-104:

[T]he debtor, secured party, and bank have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the specific deposit account in which the secured party claims a security interest, and (iii) contains one or more provisions addressing the disposition of funds in the deposit account or the right to direct the disposition of funds in the deposit account; or

[T]he name on the deposit account is the name of the secured party or indicates that the secured party has a security interest in the deposit account.<sup>6</sup>

In providing these two alternate means of perfecting a security interest in a deposit account, Delaware also added three rules of interpretation to section 9-104, confirming that:

1. The deposit bank's execution of a control agreement imposed no additional duties on the deposit bank other than those to which it expressly agreed.<sup>7</sup>
2. A secured party has control under section 9-104(a)(2) or (a)(4) even if the instructions originated by the secured party directing the disposition of funds in the deposit account or the provisions of the DACA addressing the disposition of funds or the right to direct the disposition of funds in the deposit account are subject to conditions (other than further consent by the debtor).<sup>8</sup>
3. The addition of the two other means of obtaining control could not be used to interpret the sufficiency of compliance with subsections (a)(1), (a)(2) or (a)(3).<sup>9</sup>

In 2014, New York followed Delaware's lead by adding its own two non-uniform methods of control over a deposit account to section 9-104 of its version of the UCC. While New York's section 9-104(a)(4) is identical to Delaware's section 9-104(a)(5) ("the name on the deposit account is the name of the secured party or indicates that the secured party has a security interest in the deposit account"), New York's section 9-104(a)(5) patterns after section 8-106(d)(3), which provides for obtaining control over security entitlements, by allowing a secured party to perfect its security interest in a deposit account when a third party (not the debtor or the secured party) has control of the deposit account on behalf of the secured party or, having previously acquired control of the deposit account, acknowledges that it has control on behalf of the secured party.<sup>10</sup> In sections 9-104(c), (d), and (e), New York adopted rules of interpretation similar to Delaware's. In making its recommendation

for passage of these non-uniform provisions, the New York City Bar's Committee on Commercial Law and Uniform State Laws acknowledged the Delaware model, but also pointed out that the addition of subsection (a)(4) was really a clarification of section 9-104(a)(3) that effectuated the legislature's original intent of providing secured parties with "a straightforward, cost effective mechanism to perfect its security interest" by confirming that a secured party could obtain control by listing its name on the debtor's deposit account without necessarily assuming the obligations of the debtor with respect to the deposit account.<sup>11</sup> The Committee also noted that the addition of subsection (a)(5) was consistent with New York agency law and would facilitate second lien financing transactions by subordinate lienholders to have control through the first lienholder if properly acknowledged.<sup>12</sup> Furthermore, the addition of subsection (a)(5) confirms that lenders in syndicated loans can have agents and representatives with respect to deposit accounts, as is permitted under section 9-502(a)(2) on financing statements.

Occasionally certain accounts used by the borrower may in fact be securities accounts, in which the cash is invested in a money market fund, treasury securities, or other permitted investment. A security interest in a securities account may be perfected under the UCC by a financing statement or by control.<sup>13</sup> To have control over a securities account, a secured party must have control over all the security entitlements in the account.<sup>14</sup> The methods of obtaining control over a security entitlement may seem similar to those for deposit accounts, but there are some nuanced differences, which make it important to discern whether an account is a deposit account or a securities account. Under section 8-106(d), a secured party may obtain control over a security entitlement if:

- The secured party becomes the entitlement holder or the person identified in the records of the securities intermediary as having the security entitlement;<sup>15</sup>
- The securities intermediary has agreed that it will comply with the entitlement orders originated by the secured party without further consent by

the entitlement holder (usually called a securities account control agreement); or

- Another person has control of the security entitlement on behalf of the secured party or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the secured party.

## **IMPLEMENTING THE CASH MANAGEMENT STRUCTURE**

### **Establishing the lockbox arrangement**

As described above, the initial step in establishing a cash management arrangement often removes the borrower from the flow of funds from the property and is intended to ensure that rent payments are made directly to the lockbox or clearing account. This is accomplished through the issuance of tenant direction letters pursuant to which the tenants are instructed to make all payments under their leases to a designated account rather than to the borrower or the borrower's agent. Once established, this hard lockbox arrangement cannot be changed without the approval of the lender. Absent this initial step, a lender is dependent on the borrower or a property manager to direct rent payments to a designated account. To avoid reliance on the borrower's cooperation, a lender may require a springing lockbox, insisting that all necessary documents, including tenant direction letters, be executed at the time of closing and held by the lender, or by arranging for the account(s) to remain dormant until, in either case, a triggering event occurs.

Managing the collection of rents and other payments to which they are entitled is important to most property owners for obvious reasons. Most property owners have collection and/or accounting systems in place that are intended to track and properly book payments and to alert a property owner to a late or missed payment. Redirecting payments to a lockbox or clearing account bypasses a property owner's typical arrangement and will often require additional measures to allow the property owner to track such payments in real time so they can address payment and other potential issues as promptly as possible.

Though payment direction letters are critical in any properly structured hard lockbox cash management arrangement, lenders may forego this step in favor of allowing the borrower or the property manager, who may be an affiliate of the borrower, to collect rents and other property receipts for deposit into either the lockbox or clearing account or another operating or deposit account, in which case the arrangement is referred to as a soft lockbox. These provisions may be included in the loan agreement or in a separate cash management agreement. The distinctions between a hard lockbox and a soft lockbox and what happens to the funds once released from the lockbox account are important ones that should clearly be set out in the loan term sheet or application consistent with the parties' expectations. Ultimately, whether funded directly from tenant payments or from deposits made by a borrower or its property manager, the funds in the clearing or lockbox account are moved to either the borrower's operating account or to a cash management account controlled by the lender out of which day-to-day expenses and other items will be paid or funded (usually, absent an event of default) in accordance with the loan documents.

### **Setting up the lockbox/clearing account and cash management account**

As described above, the lockbox account or clearing account is most often the initial account into which a property's rents and other cash receipts will be deposited. Thereafter, the funds will be moved to borrower's operating account or a cash management account that is under the control of the lender. These accounts are held at one or two commercial banks acceptable to the lender that, if not specifically identified in the loan documents, must meet certain eligibility requirements stated in the loan documents, such as ratings, minimum net worth, and/or total assets requirements.

In addition to standard deposit account opening paperwork such as any required account agreements and signature cards, the depository bank's Know Your Customer requirements will also need to be met. It should be noted that these requirements

apply to not only the named account holder, but also the account holder's primary owners, which often means any entity or person holding a 20 percent or greater direct or indirect ownership interest in the borrower.

The clearing account is usually a borrower account in the borrower's name, and the lender is granted a security interest in and control over this account as additional security for the full repayment of the loan. The lender's security interest in the account is perfected through a DACA, as explained above. The lender's control includes the right to change any existing payment or sweep instructions.

The DACA tends to be a standard form established by the clearing bank, and the opportunity to negotiate the form is limited, though clearing banks may entertain adjustments to governing law, limits on the lender's liability with respect to overdrawn accounts and account fees, and adjustments to minimum deposit amounts. The lender routinely declines to provide any indemnities to the clearing bank, which requires the deposit bank to rely solely on borrower indemnifications.

As described above, a key component of any deposit account control agreement or similar agreement for the lender is the granting of "control" of the account to the lender for UCC perfection purposes. This grant of control is often the mechanism by which the lender perfects its security interest in the relevant accounts. The depository bank, its account opening requirements, and its required form of DACA should be identified as early as possible in the loan closing process to provide sufficient time to complete the account opening process including finalization and execution of the DACA without delaying the closing of the loan or the need to close without having properly opened, and perfected the security interest in, the necessary accounts. Alternatively, if a required account will not initially have any funds deposited into it, some depository institutions will accept the necessary account opening documentation but will not open the account until the depository bank receives a written request from the lender to do so. This approach avoids the fees associated

with opening and maintaining the account while it is not used.

Following the 2008 downturn, special servicers and their counsel often discovered that the required cash management accounts and agreements were never properly established or finalized and executed as the primary loan documents had contemplated. Lawyers representing lenders need to be abundantly clear about the risks associated with a lender's willingness to defer implementing some or all of the necessary components for a properly functioning cash management arrangement. Counsel should also be clear as to who will be responsible for all post-closing follow-up to avoid later disagreements if all of the necessary steps are not taken.

### **Cash management arrangement**

As mentioned above, funds that are deposited into the clearing account, either initially or after a triggering event, usually are transferred or "swept" on a daily or other regular basis into one or more other accounts. If the funds are swept into a lender-controlled account (cash management account) to be disbursed in accordance with specific cash management provisions set out in the loan documents, the arrangement is referred to as "hard" cash management. In situations where the funds in the clearing account are not being transferred to the lender-controlled cash management account, but rather are being transferred to borrower's operating account, the loan documents can provide that the cash management arrangement will spring into effect upon the occurrence of a triggering event such as an event of default, a key financial covenant (e.g., a debt service coverage ratio or debt yield) not being met, or a key leasing event occurring. This arrangement is referred to as "springing" cash management. Depending on whether the necessary documentation was previously executed and delivered, the cooperation of the borrower may be required to actually cause this arrangement to be put in place. To induce the borrower to cooperate, many lenders will provide that borrower's failure to comply with all cash management covenants, including the turning over of all required funds and the execution of

all required documents, may result in liability under a non-recourse carveout guaranty. The cash management account is usually held in lender's name, and the security interest is perfected either by the lender also being the bank holding the account, or if the account is at another bank, the security interest may be perfected by a DACA or the lender becoming customer of the bank.

The specific springing cash management triggers, and the resulting consequence(s), are often deal-specific and subject to negotiation by the parties. For instance, in some cases, a higher default standard may be appropriate such as a monetary default or other material default or a default that results in the acceleration of the loan. In other situations, a debt service coverage ratio that is below some minimum level may be treated as an early warning sign of a poorly performing loan that requires greater control over the property's cash flow rather than an automatic event of default. Such a trigger may result in the lender having full control over the use of cash while still allowing the release of funds, either to the borrower or otherwise, to pay operating and other necessary expenses or to fund certain agreed reserves. Another common trigger is the termination of a key lease or the decision by a key tenant not to renew its lease (including by allowing the renewal notice period to lapse). Most lenders will want to respond proactively to such a situation and control a property's cash flow, often with the goal of accumulating sufficient cash to address anticipated lease rollover expenses or any operating income deficit that may result.

Whether in place from inception or springing into place following a cash management trigger, at the core of any cash management agreement are the provisions setting out how the funds on hand will be used. The negotiation of these provisions can be fraught with risk, especially for the borrower, if unanticipated cash needs or unintended uses are not adequately addressed. In the first case, a borrower may be prevented from properly operating or leasing-up a property, which can adversely affect the performance and value of the property; in the latter case, a lender may find funds siphoned off and

not available for more critical uses or for application to the loan.

With all of the project receipts going into one or more prescribed accounts, it is critical for both the lender and the borrower to state in sufficient detail how the funds will be used for the benefit of the project or, potentially, as determined by the lender following a default or other triggering event. Sample items typically covered in a cash management "waterfall" include:

- Payment of debt service on the loan;
- Payment of real estate taxes and insurance premiums;
- Payment of other operating expenses, often pursuant to an agreed budget;
- Payment of other key items such as leasing expenses, required ground lease payments, and required or necessary capital expenses permitted under the loan documents;
- The funding of necessary reserves for capital improvements, tenant rollover expenses or, in the case of a hotel, a required or anticipated property improvement plan (PIP); or
- Payment of any mezzanine loan payments though the mezzanine loan payments may be cut off if cash is necessary at the property level.

To the extent there are funds remaining after the payment of all identified expenses and the funding of any required reserves, the balance may be retained ("trapped") and accumulated for a designated future use or as additional collateral for the loan, paid to the borrower for its use or possible distribution to its owners, or paid to the lender for application against the outstanding loan balance, subject to possible alternative handling upon the occurrence of an event of default.

### **Cash management for hotels**

Negotiation of cash management agreements for hotel properties merits special consideration because the inflows and outflows of cash differ from leased properties. While some hotel properties may

have long-term tenants that make monthly rent payments, most hotel revenue is generated on a daily basis from a variety of users using a variety of payment methods under a variety of contractual arrangements. Payments may be received at various on-site locations (e.g., front desk, restaurant, bar, spa, gift shop) or through the hotel website, a franchisor's website, an online travel agent, or corporate billings and may be in the form of cash, check, credit card payment, or Automated Clearing House (ACH) or wire transfer. It is important for the lender to understand the various sources of revenue, who is charged with collecting the revenue, and where it is deposited. Hotels often have multiple bank accounts, such as a local bank account for depositing cash received at the property at the end of each day, an account for receiving credit card payments, a general operating account, and a furniture, fixtures, and equipment (FF&E) replacement reserve account that may be required by the hotel management agreement or franchise agreement. Borrower and lender negotiations may include discussions of whether every account has a sufficient average daily balance to justify the cost of negotiating and implementing cash management controls. Most hotel revenue is subject to the UCC as proceeds of "accounts" (rights to payment for the license to use guest rooms and other hotel spaces), rather than rents under real property law, and to the extent such proceeds remain identifiable cash proceeds, the lender's security interest in such proceeds remains perfected by the financing statement covering the accounts under section 9-315(d), although perfection by control affords higher priority against competing security interests.

Revenue and expenses associated with hotel properties may vary greatly from month to month or seasonally, and it may be necessary to place operating expenses higher in the waterfall ahead of some reserves so that the hotel may operate during months when revenues are down. Revenue may be received months in advance but may also be subject to being refunded. This requires a higher minimum balance to be left in the clearing account sufficient to cover the chargebacks.

The outflows of cash to operate a hotel also require special consideration and may not fit squarely in the typical cash management waterfall of subaccounts. Worker salaries may need to be paid more frequently than monthly. Hotel occupancy taxes and sales taxes need to be paid on the schedule required by local law. It is important that lenders and borrowers understand the cash needs of the hotel and negotiate cash management provisions that allow cash to be released to the property when needed. Because hotels are in the business of providing daily room rental and other services, they are at greater risk for suffering reputational damage and loss of asset value if cash is too restricted.

Consideration must also be given to the role of any third-party manager operating the hotel. Hotel managers often have access to the hotel's bank accounts to make deposits and withdrawals. If so, the manager may need to join in the DACA or cash management agreement. The hotel manager may be fronting the payment of salaries and other operating expenses on behalf of the hotel owner and may have setoff rights against hotel revenues collected that it is unwilling to subordinate to the debt service owed to the lender. If so, the lender may only be able to impose a cash trap on the net distributions to the borrower from the manager after payment of the hotel's operating expenses.

## **LEGAL OPINIONS RELATING TO CASH MANAGEMENT**

A lender may or may not require legal opinions with respect to the cash management documents in a transaction. Much may depend on what jurisdiction's law governs the attachment and perfection of the security interests in the various accounts and whether those jurisdictions are covered in other opinions being given in connection with the transaction. As most deposit banks and securities intermediaries have standardized account control agreements, many lenders may be comfortable with the general enforceability of those agreements and may require only that those agreements be included as transaction documents for purposes of the authorization, execution and delivery opinions being

given by borrower's counsel, rather than require the borrower to retain separate counsel only to give enforceability and perfection opinions on the cash management agreements.

The law chosen by the parties to govern the agreement in which the security interest was granted will be the jurisdiction's law that governs attachment of the security interest in the cash management accounts. Such agreement may be the loan agreement, the deed of trust, a separate security agreement, or the control agreement. Pursuant to section 9-203(b), attachment occurs when value has been given, the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party, and in the case of deposit accounts or securities accounts, either the debtor has authenticated a security agreement that provides a description of the collateral or the secured party has control pursuant to the debtor's security agreement.

On the other hand, the law of the deposit "bank's jurisdiction"—as defined in section 9-304, or in the case of a securities account and perfection by control, the "securities intermediary's jurisdiction" as specified in section 8-110(e)—will govern the perfection, the effect of perfection or nonperfection, and

the priority of a security interest in the cash management accounts, except in the case of identifiable cash proceeds of other collateral in which a security interest has been perfected by other means.<sup>16</sup> To provide certainty as to the law governing perfection, most control agreements will stipulate to the bank's jurisdiction or the securities intermediary's jurisdiction, eliminating the need for further analysis under those sections of the UCC.<sup>17</sup>

## CONCLUSION

Ultimately, lenders and borrowers will need to take a practical, balanced, and realistic approach to arrive at a workable cash management arrangement that permits the successful operation of the property while preserving cash when the property or loan is experiencing stress. Tying the use of cash to known expenses and agreed budgets, approved leases, expected lease roll-overs, anticipated capital improvement needs, and emergency requirements can help develop the framework for a cash management arrangement, including distinguishing between default and non-default cash management periods, that meets the needs of both the lender and the borrower. 🍀

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## Notes

- 1 Unless indicated to the contrary, section references in this article are to the UCC.
- 2 *In re Gen. Growth Props.*, 412 B.R. 609 (Bankr. S.D.N.Y., May 14, 2009); *In re Gen. Growth Props.*, 412 B.R. 122 (Bankr. S.D.N.Y., May 14, 2009).
- 3 The definition of "cash proceeds" in UCC § 9-102(a)(9) includes cash, checks and deposit accounts.
- 4 UCC §§ 9-312(b) and 9-315(c)-(d).
- 5 See Official Comment 3 to UCC § 9-104.
- 6 Del. Code Ann. tit. 6 § 9-104(a)(4)-(5).
- 7 *Id.* § 9-104(c).
- 8 *Id.* § 9-104(d).
- 9 *Id.* § 9-104(e).
- 10 N.Y. UCC § 9-104(a)(5).
- 11 New York City Bar Committee on Commercial Law and Uniform State Laws, Report on Article 9 of the Uniform Commercial Code, p. 1. (June 2011).
- 12 *Id.*
- 13 The Hague Securities Convention, an international treaty to which the United States is a party, may also affect the method of perfection of certain securities accounts governed by laws outside the United States.
- 14 UCC § 9-106(c).
- 15 See definition of "entitlement holder" in UCC § 8-102(a)(7).
- 16 UCC § 9-305(a)(3).
- 17 Reference is made to Uniform Commercial Opinions in Real Estate Finance Transactions, 53 Real Prop. Tr. & Est. L. J. 163 (2019), for further guidance and discussion on giving attachment and perfection opinions with respect to deposit accounts in real estate finance transactions, including appropriate assumptions, qualifications and diligence.
- 18 Schedule 1 is not included as part of this Appendix.
- 19 Sections 5.2 and 7.1 do not appear as part of this Appendix.

## APPENDIX

### Sample loan covenants concerning cash management

#### 1. CASH MANAGEMENT AND RESERVES

##### 1.1. Cash Management Arrangements

- a. Borrower shall at all times cause all Rents to be transmitted directly by non-residential tenants of the Property into an account (the "Clearing Account") established and maintained by Borrower at a local bank selected by Borrower and reasonably approved by Lender, which shall at all times be an Eligible Institution or other institution approved by Lender (the "Clearing Bank"), as more fully described in the Deposit Account Control Agreement (the "Clearing Account Agreement") among Borrower, Lender, Manager and the Clearing Bank. Without in any way limiting the foregoing, if Borrower or Manager receive any Rents, then: (i) such amounts shall be deemed to be collateral for the Loan and shall be held in trust for the benefit, and as the property, of Lender; (ii) such amounts shall not be commingled with any other funds or property of Borrower or Manager; and (iii) Borrower or Manager shall deposit such amounts into the Clearing Account within one (1) business day of receipt.
- b. *[Drafting option: springing cash management]* Funds deposited into the Clearing Account shall be swept by the Clearing Bank on a daily basis into Borrower's operating account at the Clearing Bank, unless a Cash Management Period (as defined below) is continuing, in which event such funds shall be swept on a daily basis into an Eligible Account at the Deposit Bank controlled by Lender (the "Deposit Account") and applied and disbursed in accordance with this Agreement.  
*[Drafting option: hard cash management]* Funds deposited into the Clearing Account shall be swept by the Clearing Bank on a daily basis into an Eligible Account at the Deposit Bank controlled by Lender (the "Deposit Account") and applied and disbursed in accordance with this Agreement.]
- c. Funds in the Deposit Account if invested, at Lender's discretion, shall be invested in Permitted Investments.
- d. Lender will also establish subaccounts of the Deposit Account which shall at all times be Eligible Accounts (and may be ledger or book entry accounts and not actual accounts) (such subaccounts are referred to herein as "Subaccounts"). The Deposit Account and any Subaccount will be under the sole control and dominion of Lender, and Borrower shall have no right of withdrawal therefrom. In the event of a termination of the existing Clearing Account Agreement on or before the effective date of such termination and provided no Event of Default has occurred and is continuing hereunder, Borrower shall appoint a successor Clearing Bank reasonably approved by Lender. Any failure by Borrower to do so shall be an Event of Default hereunder. Borrower shall pay for all expenses of opening and maintaining all of the above accounts.
- e. A "Cash Management Period" shall commence upon Lender giving notice to the Clearing Bank of the occurrence of any of the following: (i) the Maturity Date, (ii) a Default or an Event of Default, or (iii) if, as of the first day of any calendar quarter, the Debt Service Coverage Ratio is less than:1; and shall end upon Lender giving notice to the Clearing Bank that the sweeping of funds into the Deposit Account may cease, which notice Lender shall only be required to give if (1) the Loan and all other obligations under the Loan Documents have been repaid in full or (2) the Maturity Date has not occurred and (A) with respect to the matters described in clause (ii) above, such Event of Default has been cured and no other Event of Default has occurred and is continuing or (B) with respect to the matter described in clause (iii) above, Lender has determined that the Property has achieved a Debt Service Coverage Ratio of at least [\_:1] for two (2) consecutive calendar quarters.

- f. A “Cash Trap Period” shall commence, if, (i) a Default or Event of Default has occurred and is continuing, and shall end if such Default or Event of Default has been cured and no other Default or Event of Default has occurred and is continuing or (ii) as of any Calculation Date, the Debt Service Coverage Ratio is less than [ :1], and shall end upon Lender’s determination that the Property has achieved a Debt Service Coverage Ratio of at least [ :1] for two (2) consecutive calendar quarters.

## 1.2. Required Repairs

- a. Borrower shall perform and complete each item of the repairs and environmental remedial work at the Property described on Schedule 1<sup>18</sup> hereto (the “Required Repairs”) within six (6) months of the date hereof or such shorter period of time for such item set forth on Schedule 1 hereto, which may be extended at Lender’s option if diligently pursued. On the date hereof, Borrower shall deposit with Lender the aggregate amount set forth on Schedule 1 hereto as being required to complete the Required Repairs and Lender shall cause such amount to be transferred to a Subaccount (the “Required Repairs Subaccount”). Provided no Default or Event of Default shall have occurred and is continuing, Lender shall disburse funds held in the Required Repairs Subaccount to Borrower, provided: [itemize requirements]. Provided no Default or Event of Default shall have occurred and is continuing, upon Borrower’s completion of all Required Repairs in accordance with this Section 1.2, Lender shall release any funds remaining in the Required Repairs Subaccount, if any, to Borrower.

## 1.3. Taxes and Insurance

Borrower shall pay to Lender: (i) \$ \_\_\_\_\_ on the date hereof on account of Real Estate Taxes; (ii) \$ \_\_\_\_\_ on the date hereof on account of insurance premiums; and (iii) on each payment date, (x) one-twelfth (1/12) of the Real Estate Taxes that Lender estimates will be payable during the next twelve (12) months (initially \$ \_\_\_\_\_ per month) in order to accumulate with Lender sufficient funds to pay all such Real Estate Taxes at least thirty (30) days prior to their respective due dates, and (y) one-twelfth (1/12) of the Insurance Premiums that Lender estimates will be payable (initially \$ \_\_\_\_\_ per month) for the renewal of the coverage afforded by the Policies upon the expiration thereof in order to accumulate with Lender sufficient funds to pay all such Insurance Premiums at least thirty (30) days prior to the expiration of the Policies. Such amounts will be transferred by Lender to a Subaccount (the “Tax and Insurance Subaccount”).

Provided that no Default or Event of Default has occurred and is continuing, Lender will (a) apply funds in the Tax and Insurance Subaccount to payments of Taxes and Insurance Premiums required to be made by Borrower pursuant to Section 5.2 hereof and Section 7.1 hereof,<sup>19</sup> or (b) reimburse Borrower for such amounts upon presentation of evidence of payment.

## 1.4. Capital Expense Reserves

- a. Borrower shall pay to Lender: (i) \$ \_\_\_\_\_ on the date hereof; and (ii) on each Payment Date an amount initially equal to one-twelfth (1/12) of the product obtained by multiplying \$ \_\_\_\_\_ by the aggregate number of rentable square feet of space in the Property (initially \$ \_\_\_\_\_ per month). Lender will transfer such amounts into a Subaccount (the “Capital Reserve Subaccount”).
- b. Provided that no default or event of default has occurred and is continuing, Lender shall disburse funds held in the Capital Reserve Subaccount to Borrower, within fifteen (15) days after the delivery by Borrower to Lender of a request therefor (but not more often than once per month), in increments of at least \$5,000 provided that [itemize requirements].

## 1.5. Rollover Reserves

- a. Borrower shall pay to Lender: (i) \$ \_\_\_\_\_ on the date hereof on account of outstanding Approved Leasing Expenses with respect to the Leases set forth on Schedule \_\_\_ hereto; and (ii) on each Payment Date an amount initially equal to one-twelfth (1/12) of the product obtained by multiplying \$ \_\_\_\_\_ by the aggregate number of rentable square feet of space in the Property (initially \$ \_\_\_\_\_ per month). Lender will transfer such amount into a Subaccount (the "Rollover Reserve Subaccount").
- b. Provided that no Default or Event of Default has occurred and is continuing, Lender shall disburse funds held in the Rollover Reserve Subaccount to Borrower, within fifteen (15) days after the delivery by Borrower to Lender of a request therefor (but not more often than once per month), in increments of at least \$5,000, provided [itemize requirements].

## 1.6. Casualty/Condemnation Subaccount

Borrower shall pay, or cause to be paid, to Lender all Proceeds or Awards due to any Casualty or Condemnation to be transferred to a Subaccount (the "Casualty/Condemnation Subaccount") in accordance with the provisions of Article \_\_\_ hereof. All amounts in the Casualty/Condemnation Subaccount shall be disbursed in accordance with the provisions of Article \_\_\_ hereof.

## 1.7. Security Deposits

- a. Borrower shall keep and hold all security deposits under Leases in accordance with applicable Legal Requirements and at a separately designated account under Borrower's control so that the security deposits shall not be commingled with any other funds of Borrower.
- b. [During a Cash Management Period,] [After the occurrence of an Event of Default,] Borrower shall, upon Lender's request, if permitted by applicable Legal Requirements, turn over to Lender the security deposits (and any interest theretofore earned thereon) under Leases, to be held by Lender in a Subaccount (the "Security Deposit Subaccount") subject to the terms of the Leases.
- c. Security deposits held in the Security Deposit Subaccount will be released by Lender upon notice from Borrower together with such evidence as Lender may reasonably request that such security deposit is required to be returned to a tenant pursuant to the terms of a Lease or may be applied as Rent pursuant to the rights of Borrower under the applicable Lease.

## 1.8. Cash Collateral Subaccount

- a. If a [Cash Trap] [Cash Management] Period shall have commenced, then on the immediately succeeding Payment Date and on each Payment Date thereafter during the continuance of such [Cash Trap] [Cash Management] Period, all Available Cash shall be paid to Lender, which amounts shall be transferred by Lender into a Subaccount (the "Cash Collateral Subaccount") as cash collateral for the Debt.
- b. Any funds in the Cash Collateral Subaccount and not previously disbursed or applied shall be disbursed to Borrower upon the termination of such [Cash Trap] [Cash Management] Period.
- c. Lender shall have the right, but not the obligation, at any time during the continuance of an Event of Default, in its sole and absolute discretion to apply all sums then on deposit in the Cash Collateral Subaccount to the Debt, in such order and in such manner as Lender shall elect in its sole and absolute discretion, including to make a prepayment of Principal (together with the applicable Yield Maintenance Premium applicable thereto).

## 1.9. Grant of Security Interest; Application of Funds

- a. As security for payment of the Debt and the performance by Borrower of all other terms, conditions and provisions of the Loan Documents, Borrower hereby pledges and assigns to Lender, and grants to Lender a security interest in, all Borrower's right, title and interest in and to all Rents and in and to all payments to or monies held in the Clearing Account, the Deposit Account and all Subaccounts created pursuant to this Agreement (collectively, the "Cash Management Accounts"). Borrower hereby grants to Lender a continuing security interest in, and agrees to hold in trust for the benefit of Lender, all Rents in its possession prior to the: (i) payment of such Rents to Lender; or (ii) deposit of such Rents into the Deposit Account.
- b. Upon the occurrence and during the continuance of an Event of Default, Lender may apply any sums in any Cash Management Account in any order and in any manner as Lender shall elect in Lender's discretion without seeking the appointment of a receiver and without adversely affecting the rights of Lender to foreclose the Lien of the Mortgage or exercise its other rights under the Loan Documents.
- c. Provided no Event of Default is continuing, all interest which accrues on the funds in any Cash Management Account (other than the Tax and Insurance Subaccount) shall accrue for the benefit of Borrower and shall be taxable to Borrower and shall be added to and disbursed in the same manner and under the same conditions as the principal sum on which said interest accrued.
- d. Upon repayment in full of the Debt, all remaining funds in the Subaccounts, if any, shall be promptly disbursed to Borrower.

## 1.10. Property Cash Flow Allocation

- a. [During a Cash Management Period, all] [All] Rents deposited into the Deposit Account during the immediately preceding Interest Period shall, provided no Event of Default is continuing, be applied on each Payment Date as follows in the following order of priority:
  - i. First, to make payments into the Tax and Insurance Subaccount as required under Section 1.3 hereof;
  - ii. Second, to pay the monthly portion of the fees charged by the Deposit Bank in accordance with the Deposit Account Agreement;
  - iii. Third, to Lender to pay the Monthly Debt Service Payment Amount due on such Payment Date (plus, if applicable, interest at the Default Rate and all other amounts, other than those described under other clauses of this Section 1.10(a), then due to Lender under the Loan Documents);
  - iv. Fourth, to make payments into the Capital Reserve Subaccount as required under Section 1.4 hereof;
  - v. Fifth, to make payments into the Rollover Reserve Subaccount as required under Section 1.5 hereof;
  - vi. Sixth, funds in an amount equal to the Monthly Operating Expense Budgeted Amount and any then-current Approved Additional Operating Expenses shall be disbursed to Borrower (or to an account designated by Borrower); and
  - vii. [Drafting option: springing cash management] Lastly, to make payments in an amount equal to all Available Cash on such Payment Date into the Cash Collateral Subaccount in accordance with Section 1.8 hereof.
  - viii. [Drafting option: hard cash management] Lastly, to make payments in an amount equal to all Available Cash on such Payment Date:
    - (1) during the continuance of a Cash Trap Period, into the Cash Collateral Subaccount in accordance with Section 1.8 hereof; or

(2) otherwise, to Borrower.

- b.** The failure of Borrower to make all of the payments required under clauses i. through vii. above in full on each Payment Date shall constitute an Event of Default under this Agreement; provided, however, if adequate funds are available in the Deposit Account for such payments, the failure by the Deposit Bank to allocate such funds into the appropriate Subaccounts shall not constitute an Event of Default.
- c.** Notwithstanding anything to the contrary contained in this Section 1.10 or elsewhere in the Loan Documents, after the occurrence of a Default or an Event of Default, Lender may apply all Rents deposited into the Deposit Account and other proceeds of repayment in such order and in such manner as Lender shall elect. Lender's right to withdraw and apply any of the foregoing funds shall be in addition to all other rights and remedies provided to Lender under the Loan Documents.