

PUBLICATION

Lockboxes - Tips from the Trenches

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Lockboxes and Cash Management Agreements¹ are being required with increasing frequency in loan originations and workout deals. When carefully planned, lockbox implementation can be seamless. When enforced as an afterthought, problems ranging from delayed closings to unnecessarily divisive negotiations can ensue. Below are pointers to consider when a lockbox is introduced into a deal.

Start Early

As soon as the words "cash management" are uttered in a negotiation, start the process of opening the lockbox by contacting the bank that will provide the lockbox services. Do not wait to work through the waterfall or for all of the documents to be drafted. Although there is nothing inherently difficult about opening a lockbox, there is a good deal of paperwork for the (often reluctant) borrower to complete. Additionally, it takes time for the lockbox bank to work through its process of background checks, authorizations, and lockbox assignments.

So, start early and check on the progress of the bank and the borrower opening the lockbox often. The old "squeaky wheel gets the grease" adage is especially true here.

Know Your End Game

Lockboxes and Cash Management Agreements are essentially about imposing transparency, accountability, and control on the borrower's spending. But, the degree to which each of these is important with regard to the particular deal is a decisive factor in the negotiating stance. Deciding upon the desired effect of the lockbox in advance can shorten negotiation time. For example:

- **End Game: Transparency.** If the lockbox is being implemented with a new borrower that has a strong credit history, the point of the lockbox may be primarily to monitor the cash flow. In this situation consider using a soft lockbox that allows the borrower direct access to the funds in the account.
- **End Game: Accountability.** If the lockbox is being implemented in conjunction with a distressed loan to a cooperative borrower, the point of the lockbox may be primarily to ensure that debt service and taxes are paid first. Knowing this up front may allow some leniency in the cash flow waterfall negotiations such that directly after debt service and taxes, a generously allocated operating expenses budget falls next in the priority line.
- **End Game: Control.** If the lockbox is being implemented in conjunction with a distressed loan to an uncooperative borrower, the point of the lockbox will be to regulate every penny of cash flow being produced by the property. This may lead to heavy negotiation regarding a stringent budget for operating expenses, which might fall low in the priority line of the cash flow waterfall. However, leniency may be possible regarding the distribution of any excess cash flow to the borrower after all of the required payments, taxes, and reserve requirements are met.

Watch Out For Unintended Consequences

In all cases it pays to think about the real world effect of the lockbox. For example:

- Will a strongly worded letter to the borrower's tenants instructing them to deposit their rents into the lockbox give the impression that the borrower is tanking and further cripple borrower's chances of success in a small town?

- Will an extremely stringent line item in the cash flow waterfall for operating expenses stretch the borrower so thin that the maintenance of the property or quality of the staffing suffer and hurt the loan performance further?
- Will implementing a soft lockbox with a cash trap trigger for events of default without defining a cash flow waterfall make the initial negotiation go smoothly, but set up for failure any negotiation after an event of default?
- Will a complex cash flow waterfall that accounts for all spending complicate the cash management implementation for the servicer beyond what is reasonable?

The Takeaway

Planning is everything when it comes to a smooth lockbox implementation. From setting the logistical wheels in motion early to giving careful forethought to both the intention behind setting up the lockbox and its resulting consequences, a methodical approach is the key to seamlessly implementing a lockbox as a useful tool.

¹ Cash Management Agreements often contain provisions requiring that all cash receipts from a secured property be deposited into a lender or servicer controlled bank account. Lockboxes are actually the post office boxes the bank sets up to receive checks to be deposited into the restricted account. However, in common parlance, many refer to the restricted account itself as the lockbox.