CADWALADER


# Looking Ahead

# December 19, 2019 | Issue No. 7

## Table of Contents:


- Welcoming 2020
- Looking for Limits: The Negotiation of Environmental Indemnity Agreements
- The Benefits of Opco/Propco Financing
- Now's Not the Time for Secrets: Evaluating Confidentiality Provisions in Your Leases
- Congratulations!

# Welcoming 2020

**December 19, 2019 | Issue No. 7**

By **William P. McInerney**
**Partner | Real Estate**

By **Duncan Hubbard**
**Partner | Real Estate**

Before we close out 2019 and move into a new decade, the 2020s, we wanted to take a moment to share a few thoughts and to say thank you to our loyal readers of *REF News and Views*.

Looking ahead to 2020, every indication we are getting from our clients is that we expect the coming year to continue to be a robust period for real estate and real estate finance, in particular. There continues to be a great deal of money in the marketplace that is eager to transact, and we continue to see a great deal of demand. We're very excited about the prospects for 2020 and beyond.

And now a chance to say thank you. We started this monthly newsletter earlier this year to share with you our observations on important real estate developments from our vantage points in the United States and the United Kingdom, as well as related legal considerations. We appreciate the consistently high readership statistics and the kind and helpful comments from clients and friends. We are committed to producing great content in the coming year.

Best wishes to all this holiday season.

# Looking for Limits: The Negotiation of Environmental Indemnity Agreements

**December 19, 2019 | Issue No. 7**

By **Molly Lovedale**
**Special Counsel | Real Estate**

One of the key ancillary documents in commercial real estate loans is the environmental indemnity. Under federal and state environmental laws, an owner of real property is strictly liable for the remediation of contamination from hazardous substances on such real property.

Environmental indemnities are typically executed by the borrower and the guarantor collectively as the indemnitor and include representations and covenants relating to hazardous substances and, most importantly, from a lender's perspective, an indemnification in favor of the lender for any claims or losses arising from hazardous substances on the mortgaged property. Unless otherwise negotiated by the indemnitor, the indemnity survives indefinitely. Consequently, much of the negotiation between the borrower and the lender centers around trying to limit when the lender can make a claim under the indemnity.

The following are three major avenues available to indemnitors to limit their liability under environmental indemnities.

*Release Provisions*. Given that the standard form of environmental indemnity survives indefinitely, in the event of a foreclosure, the indemnitor would still be liable to the lender for environmental liabilities arising after such foreclosure when the borrower no longer owns and controls the property. It is understandable that the indemnitor would not want to be liable for the actions of a third party after it no longer owns the property. Therefore, the lender will often agree to add a release provision specifying that the indemnitor is not liable for any losses suffered by the lender to the extent such losses arose solely from acts, conditions or events after the date the lender acquired title to the property through a foreclosure or deed in lieu of foreclosure. However, these provisions should not release the indemnitor from any ongoing contamination or ongoing events at the time of foreclosure. Additionally, if there is a mezzanine loan that is secured by a pledge of the equity interests in the mortgage borrower, then it is customary to include a release in the environmental indemnity for the mortgage loan upon the foreclosure by the mezzanine lender of the equity interests of the mortgage borrower. In this instance, only the guarantor should be released since it will no longer have an interest in or control the borrower after a foreclosure. The mortgage borrower, however, should not be released as the mortgage loan will remain outstanding, and the mezzanine lender will then control the mortgage borrower.

*Sunset Provisions.* One of the most common ways for an indemnitor to cut off its liability under an environmental indemnity is through the addition of a sunset provision, which provides that after the repayment in full of the loan, the environmental indemnity will terminate after a certain period of time and upon the satisfaction of certain conditions. While borrowers often ask for a one-year sunset, lenders will generally insist on having the environmental indemnity survive for two, if not three, years after repayment in full of the loan. With respect to the conditions the indemnitor must satisfy in order to receive the sunset, the most important condition is that the borrower must deliver a clean environmental report, in form and substance reasonably acceptable to the lender, at the time the loan is repaid in full (or closer to the date of the sunset) so that the lender is comfortable that there is not any current environmental risk.

*Environmental Insurance*. Another way indemnitors can limit their exposure under environmental indemnities is to ask the lender to rely on environmental insurance policies first before making a claim under the environmental indemnity. While this is not as common as the release or sunset provisions, more and more indemnitors are starting to make this request. If a lender is willing to agree to this, there are certain protections to consider for inclusion in the environmental indemnity. Of course, the policy must be approved by the lender, the policy must be in full force and effect at the time a claim is made under the policy, and the amount of the losses must be in excess of the amount of the deductible under the policy. Most importantly, the lender cannot hold off on making a claim under the environmental indemnity indefinitely. If a claim under a policy is not paid and the lender has not received reimbursement for its losses within a certain number of days, the lender needs to be able to make a claim against the indemnitor. The lender should not be required to pursue an insurance company for an extended period or commence litigation as a pre-condition to pursuing the indemnitor. Indemnitors will try to extend this forbearance period as long as possible, but lenders generally try to limit the forbearance period to three months.

At the end of the day, the environmental indemnity is an important document for the lender so it can protect itself against environmental risks, but there is some room for the lender and the indemnitor to negotiate.

# The Benefits of Opco/Propco Financing

**December 19, 2019 | Issue No. 7**

By **Duncan Hubbard**
**Partner | Real Estate**

By **Catherine Richardson**
**Partner | Tax**

Across the real estate industry, "Opco/Propco" structures continue to be used as a method of raising debt against the real estate assets of a business. This article discusses key issues that a lender should look at in its credit assessment and potential exit strategies when considering Opco/Propco financings.

The classic Opco/Propco structure involves an operating business ("Opco") transferring ownership of its real estate assets to a special purpose property holding vehicle ("Propco"). The model was largely pioneered by private equity and investment banks as a way of raising cheaper debt in acquisition financing structures and is often used by hotel groups.

By essentially transferring the real estate assets of the operational business into a newly formed special purpose property holding structure with leasebacks in place, owners can create ring-fenced cashflows which can be secured over that real estate to achieve significantly more attractive commercial mortgage terms as opposed to more expensive leveraged finance.

Over the last 20 years, the appetite amongst borrowers and lenders for sale and leaseback transactions and ground rent schemes has been very significant.

Some of the typical advantages of the Opco/Propco structure include:

1. Ring-fenced mortgage deals are workable within commercial mortgage departments of banks and compatible to covered bond structures such as *Pfandbrief*. The risk profile and thus the cost of debt is significantly lower as the leverage is entirely different – typically, a fully collateralised mortgage on a 60% Loan to Value Covenant deal with the income servicing the loan (essentially, the lease rent under the sale and leaseback arrangements) being prioritised.
2. The trading business releases value in capital assets.
3. There may be tax advantages – holding property in an offshore vehicle may permit transfers of the shares in PropCo to be made free from UK registration duties (neither stamp duty land tax nor stamp duty applies to transfers of shares in an offshore Propco, at least under current UK tax law).
4. VAT planning is sometimes easier with an Opco/Propco structure because the grant of an intra-group lease may allow Propco to recover VAT.

As with any structure, the method of the structure's original construction and how it fares when it is unwound for a potential sale are highly significant. This is the case not only for the borrower but also the lender, given that the credit assessment of such a loan will require (or should require) legal due diligence being undertaken on the effects of any enforcement of security.

Lenders should therefore focus early on the intra-group lease structure/post-sale re-organisation which would be required to effect the Opco/Propco split. In particular:

- How do the cash flows work? Is the equity for the financing subject to related transactions around the sale of the business? What protective measures are needed when debt is advanced?
- Is sufficient and effective security being granted over the entire sale and leaseback arrangement and group so that the lender has options on enforcement? Can the lease be terminated or amended by the lender so that it can be repackaged for exit?
- Are cash flows and intra-group lending arrangements fully secured so that intra-group liabilities can be expunged by the lenders?

- Has appropriate tax analysis been undertaken in conjunction with the structuring, and what are the tax ramifications of unwinding the structure?
- What are the effects of splitting the group on enforcement in relation to any intra-group reliefs utilised during the re-organisation period? For instance, can a revenue authority claw back taxes in situations where the vehicle to which the property was transferred leaves the group?
- Can revenue authority challenge relief applied for around the re-organisation period, or is the relief applied for just process?
- How have capital gains tax ("CGT") liabilities been dealt with within the group? We would refer you to our **tax article** in the first edition of *REF News and Views* which dealt with the UK's new non-residents capital gains tax regime. On any enforcement sale, Propco may be liable for any CGT in respect of the property, and the lenders may look to exit via a sale of the property and leave the CGT liability with Propco. So, essentially, the lenders' enforcement options are more limited – the sale of shares in the Propco being unlikely unless the CGT liability is something the purchaser is willing to take. Suffice it to say it does not automatically follow that the property will have dropped so considerably in value at the time of enforcement that all CGT liability is extinguished.

The above matters are all considerations that a prudent lender would wish to take, as they could affect the cash flow front end of the deal and any enforcement. Clearly, a number of these scenarios will be more relevant than others depending on whether the preferred exit strategy is a sale of the real estate or an indirect sale (the Propco). In situations where there is a genuine risk of a clawback, the lender may wish, on a case-by-case basis, to have discussions with the borrower as to retentions or other options.

# Now's Not the Time for Secrets: Evaluating Confidentiality Provisions in Your Leases

**December 19, 2019 | Issue No. 7**

By **Christopher Dickson**
**Special Counsel**

A real estate finance attorney representing borrowers is forced to wear many hats through the course of a transaction. You are tasked with negotiating the debt documents, drafting legal opinions, and reorganizing your corporate structure for “special purpose entity” or “bankruptcy remoteness” purposes, among countless other tasks. However, one of the items that is often lost in the weeds in the early stages of the transaction is an analysis of potential confidentiality provisions in your client’s leases.

As part of the lender’s underwriting process, the client will need to be able to disclose lease terms and often provide copies of the leases to the financing party. Additionally, depending on the lender’s exit strategy for the loan, the lender may need to make disclosures of those lease terms to potential investors and other third parties. Understanding the nuances of the confidentiality provisions contained in your leases will be critical to a smooth closing for your client and a successful execution by your lender.

A few key points to consider:

**Who is the restricted party?** This may seem obvious, but oftentimes the confidentiality obligation is unidirectional and binds only the tenant, particularly if the landlord has offered concessions under this specific lease that it does not want publicly known.

**What is the duration of the confidentiality restriction?** Is disclosure prohibited in perpetuity, just for a number of years or until the tenant is actually in occupancy, or until the fact of the tenant’s occupancy becomes otherwise publicly known?

**What is the content that is deemed confidential?** The broadest confidentiality restrictions would prevent the disclosure of the existence of the lease. Others may restrict the disclosure of any material lease terms. In other instances, the restriction may be crafted to address a very specific concern of one of the parties. For instance, if part of the landlord work includes the construction of certain proprietary systems utilized by the tenant, perhaps the restriction prohibits only disclosure of those systems. Perhaps the tenant has agreed to deliver financial statements to the landlord, but only if those financial statements are kept confidential.

**What is the tenant’s remedy if the provisions are breached?** A tenant’s typical remedy would include injunctive relief to enjoin the disclosure. However, the lease may entitle the tenant to very specific remedies, such as a rent abatement for each identifiable breach of confidentiality restrictions or a right of early termination.

Once you understand the nuances of the related confidentiality provisions, the next step is to analyze whether or not the provisions apply to your client and the information that they may need to disclose. Assuming that they do, what are the next steps and potential pitfalls?

First, you must ensure your client complies with the provisions themselves. You should consider if there are certain permitted recipients of the confidential information. It is common for leases to permit disclosure to the landlord’s agents, mortgagees, attorneys, accountants and other professionals. However, permissive disclosure may be conditioned upon receipt of a confidentiality agreement from the recipient, and the lease most likely does not provides guidance on the form of confidentiality agreement.

Second, you should consider whether your lender’s planned exit for the financing will make it difficult, or in some circumstances impossible, to comply with the provisions as drafted. While disclosure is often permitted to lenders or mortgagees, the lease may not contemplate disclosure to *potential or prospective* lenders. If your lender plans to syndicate the loan, they will likely need to disclose lease information to potential lenders. What if the lease permits disclosures to mortgagees, but your client is also obtaining mezzanine financing secured by a pledge of equity interests in the property owner? Another pitfall involves loans intended to be sold in publicly offered securitizations. The offering documents for those loans will require disclosure of certain lease terms for material tenants of large loans in the collateral pool in order to comply with securities laws, which typically includes the identity of the tenant, occupied square footage, lease expiration dates, rental rates and renewal options. Those offering documents will be publicly filed with the Securities and Exchange Commission and available in the EDGAR database, so any disclosure that your

lender needs to make will need to be unrestricted by the lease terms or such restrictions otherwise waived by the tenant.

If your client is unable to comply with the confidentiality provisions as drafted, you will need to negotiate a separate agreement with the tenant. As this may prove to be time-consuming, we would suggest starting this process as early in the deal as possible.

## Congratulations!

**December 19, 2019 | Issue No. 7**

Cadwalader's 2020 promotion round included members of our global real estate team.

Charlotte's Aaron Benjamin and Christopher Dickson were elected to the firm's partnership, while Matthew Pawling and Michael Ruder were promoted to special counsel, along with Catherine Richardson, who contributed an article to this month's *REF News and Views*.

Aaron’s practice is concentrated in structured finance transactions of all types, with a focus on asset-based finance, security and mortgage loan repurchase transactions and related capital markets transactions, including commercial real estate CLOs. Christopher focuses on real estate finance origination and syndication, and he represents financial institutions, debt funds and separate accounts in connection with the origination of mortgage loans secured by all asset types and including multi-state, multi-property pooled transactions, construction loans, bridge loans and loans intended for securitization.

Matthew and Michael focus on CMBS securitizations, and Matthew also works on CRE CLOs. Catherine advises clients on all aspects of UK and international tax (both direct tax and indirect tax) and has experience in advising on a variety of different types of corporate M&A transactions, international capital markets transactions and general banking and finance matters.

In all, the firm's 2020 promotion class included five new partners. In addition to Aaron and Christopher, Daniel Raglan and Joanna Valentine (in corporate) and Nathan Parker (in fund finance) were all named partner.

In addition to Matthew, Michael and Catherine, the firm promoted four other attorneys – Joseph Gambino and Danielle Katz (in capital markets), Casey Servais (in financial restructuring) and James Treanor (in global litigation) to special counsel. Capital markets lawyer Lorien Golaski was also promoted to counsel.