CADWALADER

The Beat Goes On

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The Basics of Interest Rate Protection

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Interest rate protection is a hedging tool commonly used by lenders to mitigate the risk that an increase in variable interest rates could inhibit a property's ability to service its debt. Though a property owner may only see a slight, gradual increase in rental income over time, the market may see a significant spike in a floating rate at any time. In order to hedge the risk that borrowers can't meet heightened interest payments, many lenders will require borrowers to obtain a ceiling or "cap" on a floating rate index in the form of a derivative commonly known as an interest rate cap, allowing borrower and lender to shift exposure to a third party-rated entity at a predetermined cost.

An interest rate cap essentially acts as an insurance policy, where the purchaser (borrower) pays a premium to a third party so that should the specified event occur – in this case, should the agreed-upon floating rate index increase interest rates above the rate (or strike price) the property can foreseeably service – the third party will cover the difference. The purchaser pays a one-time, up-front fee to a rate cap seller (or counterparty), a rated financial institution, to lock in the maximum interest rate it will be required to pay on the loan. After the premium is paid, the purchaser has no further obligations – thus no further debt and no residual credit risk. Should interest rates increase above the agreed-upon "strike price," the borrower pays the interest amount and receives a payment from the rate cap seller in an amount equal to the interest which would have been due on what is known as a "notional amount" (which is the amount of the loan) for the difference between the strike price and the actual interest rate index payable for such period. By purchasing a cap, the borrower still benefits from the advantages of a variable rate loan and potential rate declines but now has the additional security of a maximum interest rate, allowing it to make its loan payments even if interest rates skyrocket. Usually, the interest rate cap is auctioned out to a number of banks to secure the most favorable terms and lowest price for the premium. This is sometimes done post-closing, but the parties agree upon terms of the bid package for the auction beforehand; such package also usually includes the timeline for which the auction must be completed. The finalized terms should conform with the terms negotiated in the loan agreement. Review should specifically scrutinize payment dates for the cap purchaser and cap provider, the reset date for determining the floating rate index and the formula for determining floating rate calculation periods.

The cost of the cap is based on the seller's risk exposure, which is determined by a number of factors, including the term the agreement covers, the percentage of the strike compared to current market interest rates, the notional value of the loan, the volatility of the market and the bank's rating requirements.

The duration of the cap has the greatest impact on the premium amount. This is due to the uncertainty of floating rate projections over a long period of time and the Federal Reserve's transparency on the likelihood of rates in the near-term. The longer the period requested to be covered, the higher the cost of the premium, as the risk exposure increases due to uncertainty of the market and resulting interest rates. Because of this, most borrowers purchase a two-year cap agreement. Extensions of the loan are then conditioned on the purchase of a new rate cap for the extended period, the price of which can differ from the initial purchase. It's important to note, however, that the cap agreement only protects from fluctuations in the interest rate environment during the term of the cap, by insuring each month's interest payment. The interest rate cap won't help if, at the expiration of the agreement, rates are prohibitively high and the borrower can't refinance or sell.

Rating requirements of the institution providing the cap also impact the premium amount. Many lenders will require the cap provider or "counterparty" to meet and maintain a certain rating level. This is especially true for loans slated to be securitized, due to the rating agencies' specific commercial mortgage loan standards. Higher rating requirements will increase the cost of the cap and shrink the pool of banks bidding, as well as the pool of banks the cap provider can potentially replace itself with, if necessary. Determined at the outset, the downgrade trigger is the rating threshold below which the cap provider is no longer qualified to provide the cap for that loan. If the provider falls below the downgrade trigger, the borrower is usually given the option to (i) replace the interest rate protection agreement with one from a new provider meeting the qualifications, (ii) cause the provider to deliver collateral to secure its exposure to borrower in an amount acceptable to the lender and the rating agencies, or (iii) require the provider to supply a guaranty from a creditworthy entity meeting the qualifications. In practice, the options usually implemented are options (i) or (iii) since determining an appropriate amount of collateral can be difficult as risk profiles of interest rates and of the provider can and do change frequently.

Rate cap agreements are typically entered into at closing, and all right, title and interest to receive payments under the agreement are assigned by borrower to lender as additional collateral for the loan, until the expiration of the agreement or the loan is repaid in full. As such, in the case of a foreclosure, the winning bidder will also receive the remaining term of the rate cap.

However, in environments such as our current market climate, when floating rate indexes reflect low interest rates, some borrowers have been successful in negotiating an agreement not to purchase a rate cap unless and until rates rise above a certain percentage and maintain that level over a certain period of time.

While interest rate protection agreements are a common and useful way to hedge risk against uncertainty in a floating rate loan, there are many factors that must be considered when negotiating terms of a bid package and considering the cost of the premium.

Disposal of Assets to Discharge Debt Ahead of Enforcement by Receivership

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As COVID-19 lockdowns are sustained and business activity deteriorates, loans secured against properties which are reliant on certain business activities will be affected, both from loan covenants and ultimately value perspective. In particular, COVID-19 could exacerbate valuations for sectors that were already seeing signs of distress, such as the retail sector.

Where the income streams are under pressure (due to non-payment of rent or rent reductions otherwise) this may ultimately affect debt service. Where debt service gets close to a critical 1:1 ratio, then risk parameters and strategies are likely to change – negotiations will focus around the viability of deferred amortisation or, in the case where only interest is payable, requesting lenders to consider capitalising interest in the loan and restructuring the facility. At this point in time, it would be prudent for both lender and borrower to consider exit strategies such as disposing the asset.

Understanding and reviewing your security structure

It is important to understand the security around the asset and also the corporate structure, as this would determine how the disposal should be structured. A typical security package for vanilla real estate loans should cover:

(i) mortgage over the property;

(ii) debenture over all assets of the borrower and each guarantor/operating company;

(iii) fixed charge over all receivables and key contracts; and

(iv) most of the time, security over the shares of the borrower/obligor group and any intragroup debts along with full subordination of any such intragroup debt and restrictions around any equity payment (dividends or repayment of subordinated debt).

A security package such as the one set out above is structured in such a way to ensure that on enforcement, sale of the underlying assets as a whole package (*i.e.*, the asset is sold along with the structure which would ensure that any disruptions to the income streams and third-party arrangements are kept to a minimum) can be achieved and therefore maximise value. In addition, any intragroup liabilities or any sponsor debt which are subordinated should be severed so that the package can be sold free of such liabilities to the new purchaser.

Lenders will need to think carefully about their position and have strategies in place if the event of default might warrant enforcement action; it will be prudent for the lender to conduct security reviews of the existing security package to ensure the security taken remains fit for purpose for their enforcement strategies. This would also include confirming all security assignments have been perfected.

Sale strategy: appoint a receiver or borrower-led sale?

Upon enforcement, a legitimate and most common strategy is for the lender group to appoint a receiver to sell the secured assets. Appointment of a receiver is often the last resort because, as a distressed sale, it is often unlikely to achieve maximum value. There are many reasons for this:

- receivers/administrators will need to be engaged, which will involve payment of fees and such fees to be paid out ahead of disbursing proceeds;
- indemnity arrangements in favour of receivers with respect to them undertaking the role;
- appointment of receiver/administrators will take over the existing management, and therefore there will be disruptions to the trading of the business, as well as amendments/assignments which need to take place with

respect to existing contracts (for example, a receiver as the bank's nominee will step into any duty of care arrangements with property managers, and also any third-party contracts and effectively take over the contract);
- sale by receivers often obtain a lower value as there are limited warranties receivers can provide to the purchaser (sales are often provided with limited title guarantee and also limited scope for responses to buyer's queries).

As an alternative to forced sale under receivership, borrowers may seek to negotiate with the lender and enter into an arrangement for the borrower to dispose the asset to repay the loan, whereby the borrower fronts the sale process.

This can be done in many ways. Most common would be to sell the SPV holding the real estate asset along with the entire structure so that the entire package is sold as a whole. In other words, the SPV propco will be sold as a corporate disposal, which will include all its assets – namely the real estate, all the key contracts, leases and receivables. With respect to any intragroup debt and financing, depending on the existing structure, these may need to be re-structured (*e.g.*, intragroup debt that is directly provided by the sponsor will need to be severed), and with the support of the lenders, the existing debt repaid from the purchase, and the lenders may decide to inject new lending into the new structure so that the debt is "stapled" with the asset for sale.

The benefits in having a borrower-fronted sale (as opposed to appointment of a receiver) include:

- for reasons mentioned above, the net disposal proceeds achieved may be higher due to less disruptions by having assistance from the borrower, and costs;
- dealings and issues with third parties with respect to key contracts is also minimised. If a receiver is appointed, the receiver will need to take over the borrower's contractual obligations under the existing contracts, as well as picking up where things were left off before the borrower's exit. In addition, there may be consent requirements to be dealt with before the receiver, as bank's nominee, can step into the relevant contract. As a result, this can prove to be a time-consuming process;
- co-operation of the obligor group and their directors and agents in a consensual plan strategy can avoid a lot of administrative delays and the support of the lenders in such a plan should avoid complications of directors vacating office due to concerns over wrongful/preference trading;
- for the borrower, reputational damage is minimised as it is not a forced sale; and
- for the lenders, opportunity to continue to participate in funding of the new asset by providing packaged debt to move with the asset.

However, there are also points to note with this strategy:

- This is only an option where the borrower still has an opportunity to discuss (and convince) the lenders to reach an agreement with respect to a borrower-led sale. This may not be possible in scenarios where the loan or the market is deteriorating quickly and the lenders are looking to exit at all costs. Therefore, this type of strategy is only available during a narrow window before the lenders commence enforcement and the borrower gets a seat at the table to discuss options. Therefore, for the borrower, it would be prudent to consider whether this is a viable option when there is a Default (*i.e.*, before such Default becomes an Event of Default and therefore triggering enforcement rights).
- This strategy only works if the lenders are of the view that the borrower's interests are sufficiently aligned and the co-operation is possible.
- Lenders may also want to control the sale process relatively tightly to ensure the borrower is taking steps to minimise expenditure and maximising net proceeds from the sale and that the sale is progressing in a timely manner.
- Although the borrower remains in the picture and continues with the day-to-day management of the asset whilst it's being put to the market, the lenders would most likely want to exert higher controls and restrictions. Therefore, the borrower will effectively require consent from the lenders on any non-ordinary items and any additional costs or actions to be taken which is beyond any minimal maintenance of the asset.
- The borrower's directors may wish to obtain independent advice as to their duties and the exercise of their duties. As the loan is in Default (or Event of Default), the question as to whether the company remains solvent is an important issue to consider as directors' duties change when the company is considered insolvent and directors' liabilities and their conduct will come into focus. That said, if the strategy has the full support of the creditors, solvency may not be an issue.

- For borrowers, care should be taken in the process of unwinding the structure and exiting from the sale. There will be many contracts related to the property which will either remain in place (with obligations performed and/or outstanding) and assigned across, or such contracts novated to the purchaser. These will need to be worked through so that the borrower can achieve a clean exit. In addition, any guarantees or investment commitment (whether funded or unfunded) by the sponsor will need to be taken out of the structure.

COVID-19 Update: Governor Cuomo Extends Eviction and Foreclosure Moratorium and Allows Tenants to Apply Security Deposits to the Payment of Rent

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On May 7, 2020, New York State Governor Andrew Cuomo issued **Executive Order 202.28** (the “New Order”) to provide additional relief to renters impacted by the COVID-19 pandemic and extended the time periods for certain other protections that had been previously granted to renters and property owners pursuant to **Executive Order 202.8** (the “March 20 Order”).

The March 20 Order provided for a moratorium on evictions of residential and commercial tenants and foreclosures of residential and commercial properties for 90 days. The New Order extends the moratorium on evictions and foreclosures for an additional 60 days beginning on June 20, 2020, if the basis of the eviction or foreclosure is the nonpayment of rent or the mortgage, as applicable, and the tenant or owner, as applicable, is eligible for unemployment insurance or benefits under state or federal law or is otherwise facing financial hardship due to the COVID-19 pandemic. This is a slight modification from the March 20 Order, which contained a flat prohibition on the enforcement of evictions and foreclosures regardless of the basis, employment state or impact of COVID-19.

The New Order also allows landlords and tenants of residential properties, upon the consent of the tenant, to enter in an agreement by which a security deposit, and any accrued interest thereon, may be used to pay rent. The New Order requires that landlords provide such relief to tenants who request such relief and are eligible for unemployment insurance or benefits under state or federal law or are otherwise facing financial hardship due to the COVID-19 pandemic. While the New Order permits security deposits to be applied to rent, tenants are not ultimately relieved from the obligation to maintain security deposits. Any security deposit that is used to pay rent is required to be replenished by the tenant by paying 1/12 of the amount of the security deposit used as rent each month beginning no later than 90 days from the date the security deposit is used. In lieu of the monthly security deposit replenishment, the tenant may, at their option, retain insurance that provides relief for the landlord.

Additionally, pursuant to the New Order, residential landlords may not demand or be entitled to any payment, fee or charge for late payment of rent occurring between March 20, 2020 and August 20, 2020.

Beware of Pushing the 'Defeasance Button' Too Soon

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One of the rights a borrower has in a fixed-rate CMBS loan transaction in lieu of prepayment is called defeasance. In general, defeasance allows the borrower to “prepay” its existing loan after a specified lock-out period by substituting for the real estate collateral, which serves as security for the loan, a basket of U.S. government-backed securities, which will mirror and generate cash flow sufficient to pay the ongoing debt service of the loan and pay the principal amount due at maturity. The reason for this collateral substitution is that the bondholders of CMBS loan transactions purchase their securities with an expectation of receiving a certain yield, and they expect their interest payments to match their yield expectations. A prepayment would reduce the yield the buyers of bonds expect, especially those that purchased at a premium or interest-only buyers. Accordingly, when the real estate collateral is substituted for matching U.S. government securities, the CMBS transaction continues to receive debt service payments on the existing loan from the securities as if the real estate collateral were still in place. It is also important to note that because most CMBS loan transactions are intended to qualify, for U.S. tax purposes, as a real estate mortgage investment conduit (a “REMIC”), the loan defeasance provisions must meet certain requirements in order for the trust to continue to qualify as a REMIC. This includes, among others, that the collateral consist of qualifying U.S. government securities, and that the defeasance not take place within two years of formation of the REMIC. When the election to defease is made, there are several logistical steps that must be accomplished for a defeasance to close simultaneously with a refinance involving a new lender. The closing of both the defeasance and the new loan must happen within a specified 24-48 hour period or the borrower will incur significant breakage costs and fees.

In a non-mortgage tax jurisdiction, there are several steps that are required in a defeasance. First, the underlying existing loan documents must expressly give the borrower the right to defease, which provisions generally require, among other things, the length of the lock-out period before the borrower may defease (typically 2 to 3 years from the closing date of the existing loan) and the type of securities that can replace the real estate collateral (as mentioned above, these must be solely “government securities” as defined in Section 2(a)(16) of the Investment Company Act of 1940 and within the meaning of Treasury Regulation Section 1.860G-2(a)(8)). Once the borrower elects to defease, they must send a notice to the servicer 30-60 days before the desired closing date of the defeasance and the new loan. The borrower would then typically engage a defeasance consultant and accountants to structure the basket of securities that will replace the real estate collateral to provide a stream of debt service payments in at least the amount that the existing real estate collateral would have provided. The borrower must also form a successor borrower entity which will assume the existing borrower’s obligations under the existing loan and own the new substituted securities collateral.

In these beginning stages, the servicer’s counsel is also engaged to draft the defeasance loan documents. The core defeasance documents are: (1) a pledge and security agreement, under which the existing borrower pledges the U.S. government securities as collateral to the existing lender (this pledge replaces the mortgage), (2) an account agreement, which establishes an account with a securities intermediary (usually a bank) that will hold the pledged U.S. government securities and governs the intermediary’s role in the administration of the securities account, and (3) an assignment, assumption and release agreement, under which the existing borrower assigns, and the successor borrower assumes, the new pledged collateral, the pledge and security agreement and the account agreement, which results in the successor borrower becoming the borrower under the existing loan with the existing lender. The new lender is not a party to these documents and does not play a role in the defeasance transaction, unless the existing real estate collateral is in a state like New York that levies significant mortgage tax (as discussed in the next paragraph). Once the defeasance documents are finalized, the securities portfolio has been selected and approved by the borrower and the servicer, and the new loan is ready to close, the borrower will then give the servicer’s counsel authorization to cause the securities to be purchased. Once the borrower has given this authorization, it is then obligated to complete the purchase of the securities and the defeasance transaction (which must close within 24 hours of this authorization). The next day, amounts necessary to defease the existing loan and purchase the securities must be funded into an escrow account (along with any other closing transaction costs, new loan proceeds, etc.), and then the escrow agent releases the required defeasance amount to the intermediary in order to allow the intermediary to purchase the securities for the securities account established pursuant to the account agreement. The existing borrower owns these new securities for a moment in time and then pledges them to the existing lender, who simultaneously releases the real estate collateral, and then the successor borrower assumes the new securities and obligations under the defeasance and existing loan documents. Once the escrow agent has confirmation that the defeasance has closed, the rest of the funds for the new loan transaction are disbursed and the entire transaction is then considered closed. There are usually early cut-off times for the defeasance funds to be received by the intermediary in order for the entire loan to close on that second day.

In jurisdictions which levy significant mortgage tax when a borrower incurs new mortgage debt (such as New York), the incoming lender will usually agree to take an assignment of the existing debt from the existing lender so that the borrower does not have to pay mortgage tax as if it were a new loan. The borrower will only be required to pay mortgage tax on the difference in any increase from the outstanding balance of the existing loan to the new or refinanced loan. In a "New York"-style defeasance, the end result is the same: a successor borrower becomes obligated to the existing lender and the loan is instead secured by U.S. government securities. The mortgage tax issue adds an extra step to the defeasance and the new lender becomes a key player. This extra step involves assigning the existing loan to the new lender first. In order to accomplish this, the following additional defeasance documents must be drafted and executed: (1) an allonge to assign the existing note from the existing lender to the new lender, (2) a new defeasance promissory note under which the new lender issues a new note to the existing borrower which mirrors the existing note in the amount of the outstanding balance of the existing loan and is secured by the pledge agreement and the account agreement (which are both signed by the existing borrower and the new lender instead of the existing lender), (3) an allonge to the new defeasance note which is endorsed by the new lender and assigned back to the existing lender, and (4) an additional assignment and assumption agreement whereby the new lender assigns the new defeasance note, the pledge agreement and the account agreement to the existing lender. The new lender will hold the securities as collateral for a period of time before it receives the real estate collateral. Once the defeasance documents are finalized and the new loan is ready to close, the same closing steps are followed as in a standard defeasance outlined above, except that the securities to be purchased are circled (*i.e.*, identified and committed to be purchased) by the securities intermediary for an additional day. In this case, the closing must occur within 48 hours of the borrower "hitting the defeasance button" instead of the next day because of the extra day needed to "circle" the securities.

Because the proceeds from the new lender's loan are used to purchase the securities and close the defeasance, the new lender needs to be ready to close on the same day as the closing of the defeasance. In a perfect world, the new loan closes within the 24-48 hour window that is allotted for the defeasance to close. Once the borrower "hits the defeasance button," the borrower becomes obligated to purchase the securities within the window allotted for closing the defeasance. If there is an issue with the new loan transaction and the new lender decides not to close within that window, the borrower will be responsible for all breakage costs of the defeasance, including costs incurred by the securities intermediary and legal fees.

When involved in a loan transaction that will require a defeasance in order to close, it is important to consider how the various steps, the location of the real estate collateral and the role of the parties will affect the timeframe for the closing. As a practice tip, the incoming lender's counsel and the borrower's counsel should have a conversation early on in the transaction to make sure all the parties (including the servicer and servicer's counsel) are on the same page regarding the closing timeframe because once the borrower "pushes the defeasance button," the borrower must close the defeasance and the new loan within the allotted window or face incurring significant costs in "breaking" the defeasance transaction.

Recent Transactions

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- Represented the lender in a $110 million mortgage loan in connection with the acquisition of the long-term lease of 27 Drydock Avenue located in the Boston Seaport.
- Represented the administrative agent and lender in a $100 million revolving credit facility. The proceeds from the loan are expected to be used to acquire and/or refinance industrial properties located in multiple states.
- Represented the lender in splitting and severing a $1.55 billion loan originally secured by 150 industrial properties that was originated in 2019 into two loans: an approximately $900 million loan that will continue to be held on the lender's balance sheet and a new $650 million loan secured by 68 properties comprised of floating rate revolving debt and fixed rate debt, a portion of which will be contributed into CMBS deals.
- Represented the lenders in a $550 million securitized mortgage loan secured by City National Plaza, a retail and office plaza located in Los Angeles.
- Represented the lender in a $225 million mortgage loan for The Podium, an office and retail building located in Boston.
- Represented the administrative agent and lead arranger in a $133 million construction loan to finance the construction of a 15-story apartment tower in Washington, DC.
- Represented Civitas Social Housing PLC on revolving credit facilities to refinance secured housing loans with Lloyds Bank.