CADWALADER

A Closer Look at EU Loan Syndication, U.S. Financing Trends and CMBS

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Inside this Issue

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Welcome to the second issue of Cadwalader's *REF News and Views*.

Our new monthly newsletter will feature news and commentary around legal matters concerning mortgage finance, mezzanine finance, loan sales and construction finance, among other topics. In this issue, we have updates on the *Europe Economics* paper on EU loan syndication; for the U.S., current trends on the liability of guarantors and also the use of LTV tests; and a comparison between European CMBS and U.S. CMBS and CRE CLOs.

In case you've missed our inaugural issue, it can be accessed **here**. If you have any comments on our articles or suggestions on how we can make *REF News and Views* an even more valuable part of your industry reading and research, please drop us a note **here**.

Current Trends and Issues Arising in U.S. Real Estate Transactions: Several Versus Joint and Several Liability of Guarantors

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In this issue of *REF News and Views*, we will discuss the use of several versus joint and several liability of guarantors in real estate finance transactions. Of late, some borrowers have been successful negotiating several liability for sponsors under guarantees in their transactions.

Historically, if there were multiple guarantors on a matter, their liability was joint and several. The thinking for a lender was that any contribution among the parties was the sponsor's "problem" in that if there was liability caused by one or the other parties, they would work it out among themselves in their organizational documents through cross indemnities. Since it is not uncommon that various parties which constitute the sponsorship of a borrower have differing economic profiles, some parties have questioned their ability to recover against their "partner" and try to shift this risk to the lender.

When liability is joint, a lender can sue either party or both and can recover the obligation it is owed from either. The lender is receiving the joint credit of both parties. If the parties have a different percentage of liability among themselves, then if one paid more than its fair share, it would have a claim for contribution from the other and could seek recovery. The lender would not be taking on the *individual* credit risk, but would be obtaining the *joint* credit of the parties.

If the liability is several, then simply put, a lender is usually limited in its recovery against each party to the respective percentage of liability it has in the deal. So if the "joint venture" is between a "money" partner who has 90% of the deal and a "developer" or "operating" partner who has 10% of the deal, then the lender would be limited in its recovery against each such party to that respective percentage. Leaving aside the shifting of credit risk, the lender is also taking on additional litigation cost and exposure.

While there are a multitude of reasons why a lender should not or would not agree to such a shift, in reality there are instances where the identity of the parties, leverage of the deal, overall economics of the deal and other factors persuade a lender to accept this departure from the norm.

The jury is still out as to whether this development will become the new normal. We are skeptical that it will evolve as such.

There are many ways to satisfy the concerns that one partner may have as to the financial wherewithal of its partner and, consequently, there are many reasons that a lender should not be asked to take on this additional liability. In addition, each guaranty in a transaction is different, and a payment guaranty will be approached differently than a completion guaranty, a carve-out guaranty, a carry guaranty or an environmental indemnity.

As we all know, each transaction is different and what works in one may not work in all. This development is just another "deal" term to be worked out among sophisticated parties.

Europe Economics Publishes Competition Report on EU Loan Syndication

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Europe Economics has published its final report on “EU loan syndication and its impact on competition in credit markets” ("Report"). The full Report can be accessed **here**.

The Report examines the practices and structure of origination and syndication departments within banks, across several jurisdictions in Europe, and highlighted practices in the origination and syndication process which may cause concern from a competition perspective. Although this Report does not produce any recommendations with respect to legal and/or regulatory changes, the observations will nevertheless serve a highly influential role in assisting competition authorities and regulators with respect to ongoing competition law/regulatory developments.

The study focuses primarily on a sample of six Member States -- namely, France, Germany, the Netherlands, Poland, Spain and the United Kingdom -- and on specific segments of the syndicated loan market: those connected with Leveraged Buy-Outs ("LBOs"), project finance and infrastructure finance. However, parallels could be drawn with respect to other syndicated loan markets (for example, real estate finance or corporate finance) as the structure of the loan desks and syndication teams are similar and therefore comparable.

The Report discusses extensively the entire bidding and syndication process, and how the common practices taken by lenders may lead to certain behaviours and therefore presents risks resulting in adverse competition outcomes. Set out below is a summary of the areas which have been identified in the Report as key risk areas. Please refer to the Report for full discussion.

1. ***Competitive bidding process for appointing individual banks to the lead banking group***

It has been found that in a bidding process, there is evidence of generic market soundings by mandated lead arrangers ("MLAs") with investors prior to submitting bids, and specific transaction details may be communicated to the origination desks (although this isn’t supposed to happen given the separation). If there is no significant separation between the origination and syndication desks, then the risk is even higher. The Report suggests that there is a risk that the practice of soundings (whether generic or specific) could be abused by MLAs, which lead to lenders colluding and therefore achieving some degree of collective bargaining power against borrowers. The Report also points out that although information-sharing is governed by non-disclosure agreements ("NDAs"), this in reality doesn’t adequately address the risk due to the fact that NDAs are difficult to enforce. Therefore, the Report suggests that consent should be acquired from the borrower as to who should be contacted.

2. ***The allocation of ancillary services across banks, and the pricing of such services***

The Report found that, in most cases, ancillary services are offered either as part of the initial discussion in loan terms or as part of a competitive process after the loan is in place. It was found that, in both cases, the borrower was able to choose between lenders’ offers and therefore competitive pressure is maintained. However, there is a small minority where MLAs make it a condition of the loan to provide ancillary services, and this is considered to heighten the risk of reducing competitive pressure in favour of the borrower/sponsor. It was noted that this practice was only found in Spain, and not present in other markets.

In addition, any loan requirement to include “first right of refusal” or “right to match” have been banned in the UK by the Financial Conduct Authority, and this was viewed as a positive development in the Report.

3. ***Refinancing in conditions of default***

Due to the nature of the process in restructuring the facility in a default scenario, which involves members of the syndicate to act collaboratively, the Report has made some observations as to behaviours and training which these teams should undertake to avoid any anti-competitive behaviour. It is important to note that the Report has not found any evidence of any abuse of power stemming from the conduct by the lenders, but it does point out a few factors which would enhance/decrease the level of risk in these scenarios:

1. the presence of outside banks – the presence of new financing would be a limit on the bargaining power of the existing group of banks, although the Report also acknowledges that sometimes negotiating with the existing syndicate may be the only option;
2. competition policy training – this is generally undertaken by bank restructuring teams to ensure staff are aware of the risks and also to avoid certain behaviours.

The Report also found that there is some evidence of tying ancillary services with the restructuring negotiations and, therefore, this area deserves future monitoring.

Safeguards

The Report recommends a few safeguards which can be taken by both banks and borrowers. These include:

1. Where the borrower sources debt advice and the adviser is the same lender who wishes to act as MLA, it is recommended that there should be adequate training and policies for the relevant staff about managing conflicts of interest, and also the duty of care (as an adviser) to the borrower and the need to provide neutral advice.
2. Prior to aligning loan pricing terms to the highest common denominator, MLAs should ensure that they have looked at all available alternative options before doing so (e.g., inviting other lenders who were not involved in the process to participate). This is especially relevant for situations where the loan is being re-structured, as there is a tendency for the same group of banks to provide the loan terms without reaching to outside lenders. The borrower can also engage in bilateral negotiations with the banks to enhance competition in the process.
3. Banks should be aware of safeguards that can be put in place when exchanging information between origination desks to syndication desks and have protocols around how (and the content) the information should be released/dealt with to minimise risks of anticompetitive alignment of prices.
4. “Right of first refusal” and “right to match” with respect to ancillary services are seen to impair the competition of these services and their prices, and so it has been advised that syndicates limit the cross-sale of these services and keep them outside of the syndication process.

Loan-to-Value Tests in U.S. Real Estate Finance Transactions

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The financial test of the Loan to Value (LTV) ratio in U.S. syndicated lending continues to be used in underwriting and certain covenant conditions. While we have seen a shift from the use of Debt Service Coverage Ratios (DSCR) to Debt Yields (DY) since the 2008 recession, the LTV ratio continues to be used in certain circumstances.

First, an LTV test or LTV ratio is a test that is contingent upon a current FIRREA Appraisal. The test is not an ongoing test or covenant but a financial test calculated at a moment in time. It is the ratio of the outstanding principal amount of the applicable loan to the appraised value of the collateral property. Sometimes in a construction loan or a loan with a future advance or earnout there are negotiations concerning what is the outstanding principal amount. Is it the actual outstanding principal amount or the amount that is capable of being advanced since the lender has an obligation to advance such amount and has reserved such funds? Typically, most lenders will calculate an LTV on the total debt that is capable of being advanced unless the future advance is very tenuous or subject to conditions which are unlikely to be satisfied. It should be noted that sometimes lenders have an ongoing charge for reserving funds to be advanced, which is typically called an "unused commitment charge." It is in effect an interest charge (albeit a much lower rate) on the amount of unadvanced funds to compensate the lender for being obligated to advance such funds. This charge is not as common nowadays in syndicated and construction loans. The second prong of the test is the appraised value of the collateral property. The appraisal needs to be FIRREA compliant, current and reviewed and verified by the lender.

An LTV test is universally a part of the underwriting process but less likely a part of ongoing financial covenants since the test requires an appraisal rather than just a calculation based upon a borrower’s financial statements. For this reason, it is rare to see an LTV test in a “Trigger” test which typically triggers the imposition of cash management or a cash sweep. For underwriting purposes, a loan will usually have in its term sheet an LTV test which is used to size the loan. Since this test is satisfied as part of the origination process, it is not contained in the loan documentation.

The two instances where an LTV test is typical are extension conditions and resizing or curtailment provisions. Sometimes, as a condition to a right of extension, the borrower will need to satisfy an LTV test as of the date of extension. Consequently, the borrower will need to obtain a current FIRREA appraisal, and the LTV test must be met as a condition to being able to extend the loan. In many instances, if the LTV test is not met, a borrower will still be able to extend the loan if it pays down the loan to comply with the LTV test or posts cash or a letter of credit as ongoing collateral to comply with the LTV test.

In addition, some loans will require periodic LTV tests during the term of the loan. Again, the borrower would need to obtain an appraisal and, to the extent that the LTV test is not satisfied, the borrower would then be required to resize or curtail the loan by prepaying an amount such that the loan would then satisfy the LTV test, or alternatively, post such amount, as ongoing, collateral cash or a letter of credit.

While not as common as DSCR or DY tests, LTV tests do continue to be used in real estate finance.

A Tale of Two Continents -- European CMBS v U.S. CMBS & CRE CLOs

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U.S. CMBS issuance equalled approximately $171[1] billion during 2018. In the same period, European CMBS issuance equalled approximately €4 billion which, whilst not close to the issuance levels of the U.S. CMBS market, represents a significant increase for the European market compared to any other period since the financial crisis. Issuance of U.S. CRE CLOs during 2018 equalled approximately $14.5 billion.[2] The activity levels in 2019 for all of these products continue at a strong pace reflecting the global demand for commercial mortgage-backed securities.

Why is a comparison of European CMBS against U.S. CMBS & CRE CLOs important?

While both jurisdictions are seeing sustained growth in their markets, the European and U.S. markets are not always directly comparable. For example, European CMBS is secured by properties in various jurisdictions and, therefore, the legal frameworks[3] and requirements, in addition to the associated risks, may vary from transaction to transaction. However, the size and consistency of the U.S. market and the presence of significant loan sponsors (which often have growing European operations) mean that developments in U.S. CMBS will have a strong influence on structural features that are incorporated into European CMBS. In addition, the growth of commercial mortgage direct lending and loan-on-loan finance in Europe (which will require additional sources of take-out financings) are strong indicators of the development of a CRE CLO market in Europe. To help anticipate the continued development of these products in Europe, we have set forth below a comparison of certain important considerations and trends in the CMBS and CRE CLO markets and related jurisdictions.

Read the full report **here**.

[1]   Includes agency and pre-originated Senior Loans. *See* footnote 13 in **https://www.cadwalader.com/resources/clients-friends-memos/the-evolution-of-european-cmbs-20** for an explanation of agency v pre-originated.

[2]   Currently, there is not an equivalent market for CRE CLOs in Europe.

[3]   Generally, the note level documentation is governed by the laws of England and Wales even if the assets are located outside the UK.

Cadwalader Tops CMBS Tables for 19th Straight Year

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Cadwalader once again sits atop the midyear commercial mortgage-backed securities (CMBS) tables published by *Commercial Mortgage Alert*. With as much humility as we can muster, we are proud to say that the firm is ranked No. 1 as both “Issuer Counsel” and “Underwriter Counsel” through June 30. We have been ranked first in the issuer counsel category for 19 consecutive years.

Commercial Mortgage Alert notes that Cadwalader advised issuers on 38 of the 66 U.S. offerings floated in the first half of 2019, representing 58 percent of such representations. On the underwriter side, we advised on 29 CMBS transactions, or 44 percent of the available assignments.

Real Estate Events

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Main Events

Sept. 4-6, 2019	**CMBA Western States CREF 2019** *Location:* Las Vegas *Organizer:* CMBA
Jan. 13-15, 2020	**CREFC January Conference 2020** *Location:* Miami *Organizer:* CREFC
Feb. 9-12, 2020	**CREF/Multifamily Housing Convention & Expo** *Location:* San Diego *Organizer:* MBA
June 8-10, 2020	**CREFC Annual Conference 2020** *Location:* New York *Organizer:* CREFC

Events in the U.S.

Sept. 5-6, 2019	**Real Estate CFO & COO Forum East** *Location:* New York *Organizer:* IMN
Sept. 9-10, 2019	**Middle-Market Multifamily Forum Mid-Atlantic** *Location:* Washington *Organizer:* IMN
Sept. 12-13, 2019	**Bank Special Assets & Credit Officer's Forum** *Location:* Chicago *Organizer:* IMN
Sept. 23-24, 2019	**Real Estate Private Equity Forum on Land & Homebldg.** *Location:* Las Vegas *Organizer:* IMN
Oct. 10, 2019	**CRE CLO 2019** *Location:* New York *Organizer:* CREFC
Oct. 15, 2019	**CMF: Overview of CMF Insurance Compliance 2019** *Location:* webinar *Organizer:* MBA

Oct. 16-17, 2019	**Middle-Market Multifamily Forum Midwest** *Location:* Chicago *Organizer:* IMN
Oct. 23-25, 2019	**Fall Conference** *Location:* San Diego *Organizer:* Trigild
Nov. 7, 2019	**Real Estate Mezzanine & High-Yield Debt Forum** *Location:* New York *Organizer:* IMN
Nov. 18-19, 2019	**Middle-Market Multifamily Forum Southeast** *Location:* Atlanta *Organizer:* IMN
Dec. 4-6, 2019	**Single Family Rental Forum West** *Location:* Scottsdale, Ariz. *Organizer:* IMN
Jan. 21-23, 2020	**NMHC Annual Meeting** *Location:* San Diego *Organizer:* NMHC

Events in Europe

Nov. 20-21, 2019	**Autumn Conference 2019** *Location:* London *Organizer:* CREFC Europe