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How to Prepare for a Real Estate Enforcement in Europe, Part 1


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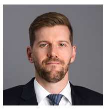
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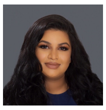
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This is the first article in our mini-series on European real estate enforcements and restructurings. Given the continued financial stress being experienced across the global economy, we expect that lenders in the real estate finance space will be actively reviewing their portfolios and considering how a downside enforcement scenario may play out. In this introductory article we cover the key points lenders should address when preparing for an enforcement.

A quick note: Not all enforcements will look the same and a “one size fits all” approach is therefore not available. We have covered here the key considerations that arise in enforcements. Similarly, we appreciate that the sequencing laid out in this article may not always be appropriate to all enforcement scenarios, and the early involvement of legal advisors is recommended.

Step 1: Recognizing the early warning signs of distress

Before preparing for an enforcement, lenders should be on the lookout for the early warning signs of distress. These signs can be obvious or may be more subtle and will differ from deal to deal. That said, some of the key signs that lenders should look out for are outlined below.

Signs of stress

This may include:

- occupancy rates decreasing;
- an increase in tenant rent arrears and in tenants giving vacancy notices;

- in a development deal, contractors withholding work or taking recovery action in relation to work completed;
- interest/debt service reserves being utilised to pay interest;
- less engagement from the propco/sponsor, servicing standards falling, and dwindling information flow and quality;
- contractor/developer insolvency; and
- capex or opex spend reducing below sustainable levels.

Impact of distress in documentation

There may also be indications within the transaction documentation, such as:

- financial covenant and reporting breaches;
- general covenant breaches particularly around leases/property covenants; and
- misrepresentations.

Step 2: Engage advisors

It is advisable that legal and valuation experts are engaged at an early stage. These advisors are needed to undertake key preparatory steps. Lawyers should be engaged to review the terms of the credit agreement to determine: (i) if there are any continuing events of default (as to which, see below); (ii) what actions need to be taken by which percentage of the lenders to accelerate the loan; (iii) what security is held and how it can be enforced; (iv) the terms of any intercreditor agreement ("ICA"); and (v) whether any consents are required. The ICA is a very important document. It will usually set out the powers of the security agent, which creditors can control the enforcement process, and the agency granted to the security agent by each lender and obligor to take actions under the ICA to facilitate enforcement. This is commonly referred to as the "distressed disposals" regime.

Engaging a valuer can also be critically important to an enforcement. In the vast majority of cases there is a need to undertake a marketing exercise or desktop valuation of the assets to be enforced over. We will cover the importance of establishing value in the next edition of this mini-series.

Step 3: Determine which events of default have occurred

When it comes to enforcement planning, not all events of default are created equal. Lenders should consider which events of default have occurred and are continuing. This is an important aspect of the role of the lender's legal advisors. Generally, it is always preferable for lenders to accelerate and take enforcement action on the basis of a clear event of default – such as payment default, breach of a financial covenant or breach of an important undertaking (such as breaching a negative pledge covenant). These types of events of default are easier to establish and generally go the heart of the "bargain" between borrower and lender. For example, proving that a borrower has failed to make a payment when due under a credit agreement is not difficult. By contrast, establishing certain other events of default will not always be clear cut. For example, if the lender wants to enforce on the basis that a borrower has breached a representation in the credit agreement, it is easier for the borrower to contest this. This creates execution risk. Regardless of the merits of the challenge, these actions by borrowers may make lenders hesitant to enforce if there is the threat of litigation risk.

(Step 3A: Do not forget directors' duties)

The duties of directors comes into sharp focus when a company is experiencing financial distress, even if the director is appointed to a property-owning SPV. Under English law, during periods of solvency, the directors owe a duty to the company's members to promote the success of the company. During times of financial distress a shift in the directors' duties occurs, and the directors will also owe duties to the company's creditors to avoid increasing losses to creditors. These duties, and the additional risk of being found liable for wrongful trading, can be powerful incentives for directors to co-operate with lenders in times of distress. The scope and content of directors' duties does differ from jurisdiction to jurisdiction so it is important to anticipate how directors in the relevant jurisdiction will behave. Notably, the Supreme Court recently clarified the scope of director's duties under English law (*see here a link to our Clients and Friends Memo on the Sequana decision*).

Step 4: Formulate your "Plan A – Consensual Solution" and your "Plan B – Enforcement Strategy"

Ideally, enforcement planning should always involve a "Plan A – Consensual Solution" and a "Plan B – Enforcement Strategy." Enforcements can be expensive and are subject to real execution risk. Unpredictable management, contractors, and a lack of access to key information and personnel are just some of the factors that can complicate an enforcement. As such, lenders will always prefer a consensual solution where the terms are acceptable.

Plan A – Consensual Solution

A well-advised sponsor whose asset is distressed will often engage with its lenders with a view to agreeing a revised deal. For example, if a propco anticipates that it will not be able to comply with certain provisions under the credit agreement – such as a breach of a financial covenant – it will approach its lenders to seek a waiver. At this juncture, lenders can consider negotiating a consensual outcome with the sponsor in exchange for agreeing to the waivers sought by the sponsor. Ultimately the viability of a "Plan A – Consensual Solution" will depend on valuation, debt service capacity, and the attitude and financial means of the sponsor. The Consensual Solution could be in the form of "soft" waiver conditions, such as: (i) more stringent information requests; (ii) tightening up "permissions," for example, reducing leakage through payments to the sponsor as managing agent/servicer or contractor; and (iii) obtaining additional credit support. Or, depending on the relative bargaining strength of the parties, the lenders may seek to impose more stringent, "hard" waiver conditions. These could include:

- replacing the sponsor as managing agent/servicer;
- requiring cash injections from the shareholders;
- appointing receivers;

- imposing new milestones around the delivery of key items, such as regulatory consents; and
- adding restructuring professionals to the board, for example, a chief restructuring officer or board observer.

Indeed, these measures can also aid the lenders if an enforcement is eventually required.

Plan B – Enforcement Strategy

Ideally, while the “Plan A – Consensual Solution” is being structured, work on the “Plan B – Enforcement Strategy” should be “dual-tracked” to save time and costs and to give the lender leverage in negotiations; lenders want to be in a position to swiftly action an enforcement if the “Plan A – Consensual Solution” negotiations become stymied. When preparing the enforcement strategy, the following points should be considered by the lenders and their legal and financial advisors:

- What assets form part of the security net and in which jurisdiction are they located?
- Is court involvement required? The process of enforcement can differ significantly from jurisdiction to jurisdiction.
- Should enforcement be by way of a share enforcement or an asset sale?
- Are there tax implications depending on how the sale takes place?
- Are any regulatory consents required?
- Could enforcement trigger change-of-control provisions in other transaction documents?
- How should the sale be implemented? For example, via an administrator or receiver sale, or other remedy? We will cover these issues in depth in a latter edition, including how to assess the pros and cons of each remedy.
- Is a “light-touch” enforcement possible? This could involve lenders exercising their powers under share security to replace the board. This can have its upside as it can be less disruptive and may be appropriate in development scenarios where there may be a project that needs to be completed to maximise recoveries.
- Will the enforcement action by the lenders trigger insolvency breaches in any key supply and/or work contracts that the borrower is party to? This is particularly relevant if the lender is financing a development which is in progress. Are there any restrictions on enforcement in key operational contracts? For example, the propco may be party to a non-disturbance agreement requiring the lenders to provide notice to a counterparty that it intends to take enforcement action.
- How should value be established? We will cover this in detail in our next edition.
- Is management input required to execute the enforcement?

A final word

Finally, we want to address two key points that will feature throughout any enforcement process – namely, (1) timing and (2) communications between the lenders and the propco group. It is important that planning with legal, financial and valuation advisors commences at an early stage. In an ideal situation, all of the preparatory steps and diligence items would be completed before enforcing. However, this is not always possible. If the propco group tried to disrupt the lender's actions, for example, by filing for insolvency, the lenders may be required to take swift defensive action. We will consider how to deal with these kinds of borrower manoeuvres in a latter edition. On communications, it is important that all correspondence with the propco group is recorded on file and that file notes are kept of any conversations with the propco group. This can provide useful evidence and be used to establish that the lender has acted properly. Particular care should be given to the use of reservation of rights letters. In a recent Clients and Friends Memo we canvassed the key points of a High Court decision that considered these issues in detail and which in our view is required reading for lenders and restructuring professionals.