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COVID-19 Update: Draft Legislation Sparks HOPE of a New Commercial Real Estate Preferred Equity Facility by the Department of Treasury

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U.S. Rep. Van Taylor (R-TX) has circulated a draft bill that would require the Department of the Treasury (the "Treasury") to establish and administer a facility to guarantee certain preferred equity investments in commercial real estate borrowers affected by the COVID-19 pandemic. The bill will be called the "Helping Open Properties Endeavor Act of 2020" or the "HOPE Act of 2020" (the "Act").

Although the Federal Reserve has created a variety of lending facilities to provide liquidity to various markets affected by the COVID-19 pandemic, such as the Term Asset-Backed Securities Loan Facility, the Paycheck Protection Program Loan Facility, the Main Street New Loan Facility, the Main Street Priority Loan Facility, and the Main Street Expanded Loan Facility,[1] the Federal Reserve has yet to directly address the pending crisis in the commercial real estate ("CRE") market and, in particular, the commercial mortgage backed securities ("CMBS") market. Given that most CMBS loan documentation greatly restricts a borrower's ability to take on additional debt and CMBS servicing agreements do not typically provide servicers with the flexibility to materially modify loans that have been securitized, many borrowers (and their parent companies) whose loans have been securitized and sold into the CMBS markets have found it difficult to obtain financial assistance under the existing COVID-19 federal response programs.

The Act is intended to fill the gap in the existing federal programs by providing financial assistance to CRE borrowers, including those borrowers with CMBS debt, by guaranteeing the purchase by eligible financial institutions of preferred equity instruments issued by eligible CRE borrowers. The facility would be funded by utilizing amounts already appropriated for providing liquidity to eligible businesses under Section 4003(b)(4) of the CARES Act (15 U.S.C. 9042(b)(4)).

The Act incentivizes financial institutions to purchase the preferred equity instruments by (a) guaranteeing that the Treasury will purchase the preferred equity instruments after a certain period of time, (b) reimbursing the financial institutions for a portion of the preferred equity instruments (*i.e.*, paying the functional equivalent of an origination fee) and (c) paying the financial institutions an annual servicing fee. Unfortunately for the CRE market, the Act does not provide a path to forgiveness of such equity investment for CRE borrowers like the Paycheck Protection Program provides for its borrowers.

Financial Institution Eligibility

The Act would allow financial institutions to participate in the program if (a) such institutions are authorized to make or approve loans under (i) the Paycheck Protection Program or (ii) Section 1109 of the CARES Act or (b) the Secretary of the Treasury (the "Secretary") otherwise approves such financial institutions. However, entities that are "covered entities" as defined in Section 4019(a) of the CARES Act (*i.e.*, entities controlled by senior members of the executive branch or members of Congress) will not be permitted to participate in any program established under the Act.

Borrower Eligibility

In order to be eligible for the new program, a CRE borrower must be able to establish both that it has been adversely affected by the pandemic and that the related property's revenue was not significantly reduced immediately prior to the COVID-19 pandemic taking hold on the United States.

More specifically, as currently drafted, the Act would require that:

(a) a borrower's revenue from the property securing the commercial mortgage during any consecutive three-month period between March 1, 2020 and February 28, 2021 is at least 25% less than the borrower's revenue from such property during the same consecutive three-month period in the previous year;

(b) the Borrower was not in default under the commercial mortgage as of March 1, 2020;

(c) either (i) the debt service coverage ratio with respect to the commercial mortgage loan was at least 1.3x on an annual basis during 2019 or (ii) the debt service coverage ratio with respect to the commercial mortgage loan was at least 1.3x on an annual basis during both 2017 and 2018;

(d) the property securing the commercial mortgage is not owner occupied; and

(e) the borrower has not already received financial assistance under the Act.

Preferred Equity Instrument Terms

In order to be eligible to be guaranteed by the Treasury, the Act would require preferred equity instruments to satisfy the following criteria:

(a) the amount paid for such instrument must not exceed 10% of the outstanding amount owed on the commercial mortgage;

(b) the purchase amount of the instrument must be made available by the financial institution to the borrower in an account that the borrower may draw down, at any time, for any purpose that the borrower determines may "help the property," during the one-year period following the date such purchase is made;

(c) the instrument may be unsecured and provide no right of foreclosure;

(d) the instrument must not provide any voting rights to the financial institution;

(e) the instrument must (except for default interest described below) have an annual interest rate of 2.5%, which will accrue and compound monthly, on all amounts that have been drawn from the account described in subparagraph (b) above;

(f) the instrument may be redeemed by the borrower at any time, without penalty;

(g) the instrument must require payments to be first due after the end of the two-year period beginning on the earlier of:

> (i) the date on which all funds in the account described above in subparagraph (b) have been drawn by the borrower; or
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> (ii) the end of the one-year period beginning on the date of purchase of the preferred equity instrument;

(h) the instrument must fully amortize over the seven-year period beginning on the date payments are first due;

(i) the instrument must require immediate redemption if there is more than a 50% change in the ownership of the Borrower, except via death, compared to the date on which the preferred equity instrument is purchased;

(j) the instrument must be approved in advance by the Secretary (the Secretary will have 30 days for such approval or denial); and

(k) the proceeds from such purchase of the preferred equity instrument may only be used by the borrower for the benefit of the property and the preferred equity interest, such as principal, interest, insurance, taxes, utilities and fees (we would note that although the bill specifically contemplated the use of proceeds for the payment of the foregoing, it does not limit the use of proceeds to such enumerated expenses).

If the Borrower fails to make payments as and when due on the preferred equity instrument, the interest rate will increase pursuant to a formula of escalating interest rates based on what point in the repayment term the default occurs. Beyond an initial 30-day cure period after notice, the current draft of the bill is silent on whether the borrower will have the right to cure the default and revert back to the regular interest rate. In either case, in the event of payment default(s) by the Borrower, any interest owed on a preferred equity instrument in excess of 2.5% will be owed to the Treasury, rather than the financial institution that purchased the preferred equity instrument.

We find it noteworthy that the interest is only paid on the portion of the preferred equity investment that has been drawn by the borrower and that there is no

remuneration provided to the financial institution for the portion of the investment that has been made available to be drawn on, other than the origination reimbursement, which, as described below, would have to be repaid to the Treasury if the borrower defaults on the entire amount it has withdrawn. We also find it worth noting that the financial institution would not be entitled to any of the default interest, but, as described below, would not have the right to sell the preferred equity interest to the Treasury until 10 years after it was purchased by the financial institution, which could result in the financial institution going 10 years without any return on its investment other than the 1% servicing fee described below (given that, in the event of a payment default by the borrower, the financial institution would not necessarily receive its 2.5% interest until the Treasury purchases the instrument after 10 years).

Payments to Financial Institutions

In order to incentivize financial institutions to purchase and administer the preferred equity instruments under the program, the Secretary will pay each financial institution that purchases a preferred equity instrument guaranteed under the program an annual servicing fee and reimburse the financial institution a variable percentage of the purchase price based on the size of the instrument (the functional equivalent of an origination fee).

Servicing Fee

The Secretary will pay each financial institution that purchases a preferred equity instrument guaranteed under the program an annual servicing fee equal to 1% of the outstanding amount on such instrument, paid annually. However, if a financial institution fails to assess the default interest described above or fails to notify the borrower of such required default interest being due and payable, the financial institution will only be eligible to receive half of such servicing fee.

Reimbursement for Origination

The Secretary will reimburse each financial institution that purchases a preferred equity instrument guaranteed under the program a portion of their purchase price according to the following formula:

(a) 5% for a covered amount (*i.e.*, the full amount available to the borrower, whether or not actually drawn by the borrower) up to $350,000;

(b) 3% for a covered amount of more than $350,000 and less than $2,000,000; and

(c) 1% for a covered amount of $2,000,000 or more.

In the event that a borrower defaults on the entire amount that it draws down, the financial institution must repay any reimbursement paid to it by the Treasury per the above. In other words, if there is a total failure on the preferred equity investment, the purchasing financial institution waives its origination fee and refunds the same to the Treasury.

Guaranteed Purchase

In order to further incentivize financial institutions to purchase the preferred equity instruments, a financial institution that has purchased a preferred equity

instrument satisfying the requirements under the Act would have the right to sell ("put") such instrument to the Treasury after the end of the 10-year period beginning on the date on which the financial institution purchased the instrument from the Borrower. The purchase price by the Treasury would be at par, plus unpaid interest, less the origination fees.

The Secretary would also have the right, at the Secretary's discretion, to purchase ("call") the preferred equity instrument from the financial institution any time after the end of the seven-year period beginning on the date payments are first due with respect to the instrument. Additionally, the Secretary would have the right to sell any preferred equity instrument purchased by the Secretary and to contract with a private servicer to service any preferred equity instrument purchased by the Secretary.

Capital Treatment

Another noteworthy feature of the Act is a provision stating that for purposes of calculating any capital requirement, the appropriate Federal banking agencies shall treat preferred equity instruments that are guaranteed under the Act in the same manner as loans guaranteed under the Paycheck Protection Program (*i.e.*, a preferred equity instrument guaranteed by the Treasury will receive a risk weight of zero percent under risk-based capital requirements).

Restrictions on Borrowers

In order to protect the government's interests, the Act would restrict the owner of any borrower under the program from removing value from the borrower. For example, the related borrower would be prohibited from paying any dividends, increasing any fees paid to an affiliated property manager compared to the amount of such fee before such instrument is purchased, or lending money to any direct or indirect owner of the borrower or to any related person.

Applicability to CMBS Loans

It is important to look at the proposed terms of the preferred equity investment through the lens of a CMBS borrower. The Act seems to have avoided the hurdles that a CMBS borrower would typically face. As mentioned earlier, CMBS loans have strict covenants against additional indebtedness whether at the borrower level or an upper-tier entity level, and any indicia of secured debt would put the rating agencies on high alert. Additionally, generally speaking, a change of control over the CMBS borrower is not permitted. The preferred equity facility proposed under the Act is structured to be an upper-tier equity transaction as opposed to the issuance of debt to the CMBS borrower. Further, although referred to as "preferred equity", the proposed structure of the preferred equity interest purchases is really more reflective of an equity investment with a "preferred return" by reason of the following:

- the purchasing financial institution is not required to have any collateral related to its purchase; it is merely becoming a minority interest holder in the CMBS borrower (*e.g.*, there is no requirement for a pledge of distributions or cash flow);

- there will be no voting rights given to the purchasing financial institution and thus the CMBS borrower is not at risk of a "change of control" being triggered;

- there is no mandatory redemption date although the rate of interest will get more expensive if not paid by the borrower in accordance with the amortization schedule;

- there are no specified "remedies" available to the purchasing financial institution (or, ultimately, the Treasury) if the funded amount is not repaid by the borrower.

Given the above features, although the devil is in the details to be analyzed on a loan-by-loan basis, fundings through the facility established under the Act would appear to fit into the CMBS structure without requiring additional consent of the CMBS servicer.

Although we are probably still some distance away from the enactment of the HOPE Act of 2020 and the implementation of a preferred equity facility, the submission of the draft bill does indeed provide renewed hope that the Federal Government will tap the funds available under the CARES Act to inject additional liquidity into the commercial real estate markets. We will continue to update you with any legislative updates related to the Act.

1 See, e.g., our prior Clients & Friends memos: "COVID-19 Update: Federal Reserve Launches TALF (Again)", "COVID-19 Update: The Paycheck Protection Program – Loan Participation Transactions", "COVID-19 Update: The SBA's Paycheck Protection Program Explained", "COVID-19 Update: The Paycheck Protection Program and the Secondary Market," and "COVID-19 Update: Federal Reserve Announces Main Street Lending Program".