CADWALADER

Where Things Stand

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A Transitional Period

By **Steven M. Herman**
Partner | Real Estate

Volatility, prudence, cautious optimism, outright fear, stagnation, doldrums. These and many other terms are being bandied about concerning the current state of the real estate markets.

Needless to say, we are in a “transitional” period where prognostications abound. Will the fed continue to increase rates and will there be a flattening, slowdown or reversal of course? Will another shoe drop in the banking sector? Every day brings another pundit or economic commentator’s views.

There are deals getting done. We know this, but when and how we get back to what we knew as normal or what a new normal will look like is anyone’s guess. The general consensus, however, seems to be that the current cycle is not nearly as consequential as the cycle we experienced in 2008 during the “Great Recession.” Economic growth continues. Liquidity has not dried up to anywhere near what we experienced then, and credit fundamentals remain strong. Inflation continues to be top of mind and a driving force.

What we are beginning to see and I hazard to guess we will continue to experience are stress and workouts in various sectors and markets. Certain aspects of the real estate market have experienced an exacerbation of transition which was thrust upon them by a combination of the COVID shutdown and a rising interest rate environment. Certain properties and certain markets, particularly in the office sector, will struggle to find tenants whose needs have shrunk due to “work from home” policies. Certain properties will struggle due to the continued amelioration of certain retail trends and tendencies. Many will take a wait-and-see attitude.

What we do know for sure is that the real estate markets are resilient. As the old adage goes: they aren’t making any more of it. I for one have always been a glass half-full proponent. There will be transitions and repurposing. There will be workouts and, unfortunately, foreclosures. But the real estate market will remain and as always come out of the cycle stronger and smarter.

Gimme Shelter: New York Local Law 18

By **Steven M. Herman**
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By **Caleb Eiland**
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New York Local Law 18, the so-called "Anti-Airbnb Law," was enacted by the New York City Counsel on January 9, 2023. The new law – which took effect March 6, 2023 – is aimed at reducing undesirable short-term rentals in the city, making it illegal for owners to operate short-term rentals unless the unit is registered with the Mayor's Office of Special Enforcement (the "OSE"). The law only applies to Class A multiple dwelling units like apartments designed to be permanent residences, exempting Class B multiple dwelling units like hotels designed for transient lodging. As the moniker indicates, the law also affects booking services like Airbnb, Vrbo, Sonder, etc. by making it illegal for them to facilitate short-term rentals for unregistered units or those no longer in good standing. The law provides for fines of up to $5,000 ($1,500 for booking services) per infraction. Enforcement of Local Law 18 will begin in July of this year.

Registration

While registering may seem like a simple administrative task, applicants will quickly find that the registration requirements are quite stringent. The first requirement applies to the applicant itself. They must be a natural person who permanently occupies the unit and is either (i) the owner of the unit, or (ii) a tenant of the unit that can certify that they are not prohibited from operating a short-term rental under the terms of their lease. If the applicant satisfies the first requirement, then the applicant needs to submit its application which must (i) describe the area(s) of the unit available for occupation, (ii) certify that the unit is in compliance with applicable zoning, housing maintenance and city construction codes, and (iii) where a booking service is employed, the applicant must provide the name of the service along with the uniform resource locator. In addition, to submit the application, the applicant must pay a $145 application fee.

After the application is submitted, the OSE will notify the owner of record and then verify that the unit (i) does not have outstanding violations under applicable city codes, (ii) is classified to be used as a short-term rental, and (iii) is not in a building that appears on the prohibited building list.

Booking Services

When facilitating short-term rentals, booking services must use the designated electronic verification system to verify that (i) the unit is associated with the rental registration number, (ii) the uniform resource locator is associated with the rental registration number, and (iii) the host and physical location matches the information provided by the verification system. Once verified, the verification system will provide a unique confirmation number. Each month, booking services must submit a monthly report to the OSE describing the booking service's public

uniform resource locator and the respective unique confirmation number provided by the verification system for each transaction.

Reporting

For all registered units, the OSE will make the following information available via a designated website: (i) registration number, (ii) uniform resource locators associated with such registration, (iii) address and unit number (including latitude and longitude), (iv) status of the registration, and (v) expiration date of the registration.

Each year, the administering agency will generate a report with (i) the number of active registrations, (ii) the number of short-term registration applications and renewals, (iii) the average time to process applications and renewals, (iv) a summary of reasons for rejected applications or renewals, and (v) the total amount of penalties imposed and collected.

Proponents of Local Law 18 point out that short-term rentals undermine existing zoning requirements and pose security and use and enjoyment concerns for surrounding neighbors. In their eyes, the law serves to crack down on illegal short-term rentals by requiring booking services and owners to comply with existing requirements. On the other hand, opponents claim the law will hurt small business and drastically reduce the number of short-term rentals available to tourists. Owners claim the law unfairly restricts their ability to use their property. With the new law in effect and enforcement actions to begin July 1, only time will tell if Local Law 18 can make illegal short-term rentals fade away, leaving tourists to get shelter – somewhere else.

No Need to Pretend – Just Extend – if Borrowers Ask to Delay Repayment

Today's high interest rate environment presents a challenge to many commercial real estate borrowers whose loans are now reaching maturity. Some borrowers are unable to repay their loans, while others are approaching the loan servicers in commercial mortgage-backed securities ("CMBS") transactions to request an extension in the hopes of refinancing later when market conditions have improved. Servicers have generally been willing to grant extensions when it is prudent to do so, but have sought concessions such as the paydown of some principal, an increase in the interest rate or the posting of reserves.

For mortgage loans securitized in a real estate mortgage investment conduit ("REMIC"), servicers should understand the interplay between the REMIC rules and the more generally applicable tax rules regarding modifications to loans. An agreement between borrower and lender to extend the maturity date of a loan is a "modification" under the tax law, and an extension that is "significant" will cause the modified loan to be treated as having been newly issued in exchange for the original, unmodified loan. The REMIC rules prohibit a REMIC from acquiring newly issued loans, including any loans that have been significantly modified, more than three months after the closing date of the securitization. However, the REMIC rules do permit significant modifications that are "occasioned by default or a reasonably foreseeable default." This generally means greater latitude for modifications involving borrowers facing financial trouble.

Where an actual default has not yet occurred, the servicer must reasonably believe that there is a "significant risk of default." Accordingly, servicers faced with a request to grant an extension prior to an actual default should have detailed knowledge of the circumstances of the borrower and the underlying property in order to determine whether a default is reasonably foreseeable. IRS guidance suggests looking at "credible written factual representations" made by the borrower, but it also indicates that a servicer may conclude that there is a significant risk of default even though the possibility of default is more than one year in the future, and even if the loan is currently performing.

As for borrowers seeking to extend in order to take advantage of their existing lower interest rate – but where there is no apparent risk of default – more modest modifications may still be permitted under the tax rules without a deemed exchange for new debt. Treasury regulations provide a safe-harbor period for extensions that are less than 50% of the original term (or five years, whichever is less). Indeed, a short-term extension may be just enough time for borrowers of CMBS loans to refinance under better market conditions, although a servicer would still be limited by any non-tax provisions in the servicing agreement. Further, any contemporaneous changes to the loan, such as increasing the interest rate or adding an extension fee, must also be aggregated and tested for significance under section 1001 by examining the change in yield. For example, if an extension fee were to increase the yield on the modified loan by more than the greater of 25 basis points or 5% of the annual yield, then the modification would be "significant" notwithstanding the length of the extension.

Given the current interest rate environment, many borrowers are unable (or merely reluctant) to repay their loans when due, but the REMIC rules provide some flexibility. Servicers should determine whether a modification is “occasioned by default or a reasonably foreseeable default” for maximum flexibility in making loan modifications and carefully document their conversations with borrowers to preserve a record of the parties’ concerns regarding timely repayment. However, servicers may still be able to accommodate more modest extensions even if such a determination is not certain.

(This article originally appeared in BrassTax, Cadwalader's monthly tax newsletter.)

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

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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.

National Security and Investment Act 2021, Part 1 – Background and Key Features

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By **Carl Hey**
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In a series of articles in the coming months we will consider the National Security and Investment Act 2021 (the "NSI Act") and its impact on the real estate finance market.

In this month's article, we will provide some background on the NSI Act and introduce some of its key features. In the following months, we will discuss the notification and intervention provisions, sanctions for non-compliance, and impact on the real estate finance market in respect of the NSA Act.

Background

The NSI Act came into force on 4 January 2022. The NSI Act is a significant piece of new legislation which establishes a stand-alone statutory regime for government scrutiny of, and intervention in, acquisitions and investments for the purpose of protecting national security in the United Kingdom (the "UK").

The provisions of the NSI Act replace the existing public interest merger regime provisions of the Enterprise Act 2002 to the extent that a transaction involves national security considerations. The NSI Act gives the UK Government the power to screen transactions where there is a change of control of entities or assets, even when these assets are based overseas.

Key considerations

Lenders and investors should give due consideration to the NSI Act in order to protect their transactions and officers from potential criminal liability. They should also ensure that they are cognisant of the new rules given the broad scope of the mandatory notification system under the NSI Act.

Lenders should also carefully consider the implications of the NSI Act in respect of their secured lending transactions, especially when it comes to share security and enforcement.

Some key issues for investors to consider are:

- whether their transaction requires mandatory notification? and if not, may a voluntary notification be advisable?

- ensuring that NSI Act considerations are factored into deal timelines and documentation to manage the risks of delay or Government intervention.

As noted above, we will explore these issues during the course of this series in the coming months.

Key features of the NSI Act

The key features of the NSI Act include:

- mandatory notification of some transactions in 17 specified sectors (see below);
- voluntary notification for certain transactions that may give rise to national security concerns; and
- call-in powers under which the government's powers to "call-in" transactions across all sectors of the economy on national security grounds are significantly extended.

We will explore the notification requirements in next month's issue.

What are the 17 designated sectors?

The NSI Act establishes a mandatory notification requirement where a change of control occurs in relation to an entity with "specified activities" within any of the 17 designated sectors, namely: (a) Advanced Materials; (b) Advanced Robotics; (c) Artificial Intelligence; (d) Civil Nuclear; (e) Communications; (f) Computing Hardware; (g) Critical Suppliers to Government; (h) Critical Suppliers to the Emergency Services; (i) Cryptographic Authentication; (j) Data Infrastructure; (k) Defence; (l) Energy; (m) Military and Dual-Use; (n) Quantum Technologies; (o) Satellite and Space Technologies; (p) Synthetic Biology; and (q) Transport (the "sensitive sectors").

The sensitive sectors and final definitions for these sectors are set out in a Statutory Instrument – the National Security and Investment Act 2021 (Notifiable Acquisition) (Specification of Qualifying Entities) Regulations 2021. The sector definitions are relatively detailed and technical and, recognising their complexity, the Department for Business, Energy and Industrial Strategy has published guidance to help explain what the definitions are intended to capture and how to apply them.

Closing thoughts

Despite this guidance, parties may also need to consider several of the sector definitions given a number are closely linked, and take care that even if a target's core activities are not within one of the sensitive sectors it does not have other activities that are caught (*e.g.*, a technology product involving artificial intelligence or advanced robotics).

In next month's edition of *REF News and Views* we will further expand on the NSA Act's notification and intervention provisions.

LMA Senior/Mezzanine Facility Drafting Guide and LMA Intercreditor Agreements for Real Estate Finance Transactions – Updates Published

By **Duncan Hubbard**
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By **William Lo**
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The Loan Market Association has just published updates to its (a) drafting guide for its senior/mezzanine single currency term facility agreement for real estate finance multi-property investment transactions and (b) its recommended forms of intercreditor agreement for real estate finance transactions.

Senior/Mezzanine Guide

The purpose of the drafting guide for senior/mezzanine single currency term facility agreement for real estate finance multi-property investment transactions (the "Senior/Mezzanine Guide**"**) is to provide guidance to the market on the drafting of real estate finance multi-property investment transactions where the structure of the transaction envisages senior and mezzanine third-party lender debt.

The guidance is provided in the form of a template senior facility agreement (the "Senior Facility"), which is based on the LMA's recommended form of senior single currency term facility agreement for real estate finance multi-property investment transactions (which the LMA updated in September 2022) that is marked up to illustrate and explain the changes that may typically be made to adapt the Senior Facility into a mezzanine facility agreement.

On 22 March 2023, the LMA published the updated Senior/Mezzanine Guide, in which section 6 includes the updated mark-ups showing the recommended changes (subject to, and based on, certain specified assumptions) to be made to the Senior Facility when drafting a mezzanine facility.

The update was published principally to align the template with the Senior Facility that was updated in September 2022, with one of the key updates being the changes to the underlying interest rate provisions to the use of a compounded risk-free reference rate.

The updated Senior/Mezzanine Guide is available on the LMA website to members under the heading "RFR Facility Documentation" of the Real Estate Finance section.

LMA Intercreditor Agreement

The LMA also updated its recommended forms of intercreditor agreement for real estate finance transactions. The purpose of the updated intercreditor agreements is to reflect the transition to risk-free rates and the UK's withdrawal from the EU.

The revised intercreditor agreements, together with comparisons against the previous versions, were published on 19 April 2023 and are available on the LMA website to members under the heading “Intercreditor Agreement” of the Real Estate Finance section.

Closing thoughts

The Senior/Mezzanine Guide and the recommended forms of intercreditor agreement are not exclusive or definitive, but are intended as guiding principles of typical changes to the Senior Facility that could provide a corresponding mezzanine facility agreement for real estate finance multi-property investment transactions. Please feel free to get in touch with the Cadwalader team to discuss the contents of these updates.

Welcoming Our New Partners: Smridhi Gulati and Ryan McNaughton

We are pleased to welcome two new partners to Cadwalader: Leveraged Finance & Private Credit partner Smridhi Gulati in London and Specialty Finance & Securitization partner Ryan McNaughton in New York.

Smridhi joins Cadwalader from Dechert in the latest in a series of high-profile additions to the practice. London partners Matthew Smith and Bevis Metcalfe joined in 2022, and a four-partner, U.S.-based team – Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky – joined in January. Also recently joining the group in London were ESG Finance and Investment partner Sukhvir Basran and special counsel Andrew Vickers.

Smridhi advises private credit funds, banks, private equity sponsors and corporate borrowers on domestic and international leveraged and acquisition finance transactions. She also has considerable experience in executing and restructuring complex private credit transactions at all levels of the capital structure.

Read more on Smridhi here.

Ryan joins Cadwalader from King & Spalding and represents banks, broker-dealers and other financial institutions and private equity and asset management firms as issuers, underwriters, lenders and investors in structured and corporate finance transactions, securities offerings (public and private) and credit facilities. Ryan has a particular focus on esoteric asset-backed securities (ABS), including asset classes and transactions such as whole business and other operating asset securitizations, music and media royalty transactions, oil and gas interests, franchise concepts, digital infrastructure, cell towers, data center and distributed antenna operators, solar and renewable energy assets, transportation assets, outdoor advertising receivables, ground leases, and specialty real estate lending transactions.

Ryan's addition expands Cadwalader's leveraged and acquisition finance capabilities, as he regularly advises private equity and asset management firms and investors in the structuring, diligence and execution of asset-based acquisition financings and related warehousing and securitizations. Ryan will be reunited with his former colleagues Ronald Lovelace, Patrick Yingling, Jared Zajac and Joseph Polonsky, a market-leading leveraged finance team from King & Spalding that also recently joined Cadwalader, and who had all worked closely with Ryan in executing some of the largest whole business securitizations and novel structured leveraged finance transactions in the market.

Read more on Ryan here.

Recent Transactions

Here is a rundown of some of Cadwalader's recent work on behalf of clients.

- Represented the lenders in connection with a $180 million loan secured by a portfolio of 7 mixed-use properties across the United States.
- Represented the mortgage lender in connection with a $46 million financing for ground-up construction of an apartment complex in Ferndale, Washington as part of a capital stack that included mezzanine debt and C-PACE financing.