CADWALADER

Logical Logistics and More

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Logistics as the Logical Commercial Real Estate Investment

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While industrial assets may lack the glitz and glamour of the hospitality industry or the name recognition of architects attached to towering skyscrapers, warehouses and distribution centers have emerged as an area of growth for astute investors in commercial real estate.

Warehouses and logistics properties or industrial buildings with the capacity to receive, store and process an increasing volume of e-commerce orders for delivery are in particularly high demand. According to data from the U.S. Census Bureau, from 2012-2017, e-commerce sales grew 14.4 percent annually, and e-commerce deliveries tripled between 2013 and 2018. Such rapid growth has produced a growing need for additional space in and near densely populated areas to facilitate the delivery of orders in a timely fashion. As an increasing number of consumers take advantage of e-commerce and, with it, shorter, less expensive shipping options, such as Amazon Prime and similar offerings, the warehouse and industrial sectors of the real estate industry continue to grow. “Final mile” distribution facilities are integral to the strategy of companies like Amazon to provide services such as same-day and 2-day shipping to consumers in urban areas. Additionally, while major markets with larger populations have dominated the industrial market, a national network of distribution centers that allows for goods to reach less-populated areas in shorter time frames creates a spreading demand beyond major cities and into secondary markets. Lastly, industrial properties are experiencing a historically low vacancy rate at around 4%.

Large real estate investors are betting big on logistics. Ken Caplan, co-head of the Blackstone Group’s real estate business, was quoted in a June 3 article in *Forbes*, calling logistics Blackstone’s “highest conviction global investment theme today,” in response to the announcement that Blackstone signed an $18.7 billion deal for the U.S. logistics assets of Singapore’s GLP. This follows the company’s $7.6 billion purchase of the industrial REIT, Gramercy Property Trust, in 2018 and its investment in the European logistics company, Logicor.

In the New York City area, while the sales of multifamily assets are facing valuation issues and potential stalled development in the face of changes in rent regulation legislation, commercial and industrial property sales have increased. The owner of a pair of warehouse properties in the Bronx was able to sell the properties for a record $603 per square foot last year, according to the *Commercial Observer*, after securing Amazon as a tenant, and Amazon is reportedly considering another distribution facility in Industry City in Brooklyn. Unique challenges in the New York City market, such as high premiums and low availability of land and potential zoning concerns, will continue to shape the market for industrial properties, and it is likely that vertical warehouses are more likely to develop as was the case in Asian markets.

As the sector continues to grow, however, challenges to the pace of growth are likely to arise. There is a strong demand for industrial space, and a typical e-commerce order requires significantly more space than traditional retail transactions. With the rapid growth of e-commerce relative to traditional retail and a low vacancy rate, a lack of available space may lead to a slow-down in the number of sales of industrial assets. Automation and changes in technology will likely result in older facilities requiring significant capital expenditure projects for updates to meet the demands of the industry. Increases in interest rates and macro changes in the economy are also likely to impact this sector as well. As certain e-commerce markets become saturated, there will likely be some contraction in those markets and, with that, a reduction in the need for specialized spaces for those retailers.

Despite potential challenges, nearly all models suggest the industrial sector is poised for continued growth over the next year, as demand for goods delivered both quickly and conveniently continues to increase.

Modifications of Loan Documentation

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Invariably, over the course of a loan, it may need to be modified. This primer will address various issues that arise when a loan is modified in a non-workout scenario. For purposes of this article, we will assume that the loan has aged a bit and is not being modified within a few days or weeks after the initial closing. In addition, the complexities of the modification may also impact the extent of the diligence and documentation which may be required.

Modifications within a Short Time after Closing

When there are modifications within a few days of a closing, most often these are not treated as formal modifications and are typically handled through "slip page" or "changed pages" being inserted to replace the modified page. If documents which are being recorded need to be changed and the "slip page" can be replaced prior to recordation, then there should be no need for a formal modification and, in addition, title coverage would not be impacted.

Formal Modification

When loan documentation is the subject of a formal modification, whether it be titled as an amendment or merely a letter agreement, various considerations should be addressed. Any formal modification should be viewed as a closing unto itself, and the formalities should be considered and, in many cases, implemented. In addition to the operational document which modifies the loan agreement, the balance of the loan documents should be reviewed to ascertain if there is any need to modify same. At a minimum, the modification document should contain a ratification of the loan documents, an omnibus provision that the loan should now constitute the loan "as modified," certain standard representations, warranties and estoppels and, in many cases, a release of the lender to the date of the modification.

While most guarantees have boilerplate provisions confirming that no modification of the underlying loan being guaranteed will impact the viability of the guarantee, it is common practice and highly recommended that a guarantor ratify its guaranty and vitiate any claims that its obligation was discharged by the modification. Some may argue that this is merely "belts and suspenders," that is, redundant lawyering, but the benefit of a simple ratification cannot be underestimated. At a minimum, any claim or defense of the guarantor has been eliminated and, when analyzing remedies for a lender, not having to litigate a claim of this sort can't be stressed enough.

Mortgage priority and title insurance are seminal issues in any mortgage financing, and due regard for these issues should not be overlooked when entering into a modification. If a title endorsement can be obtained for a nominal or no charge, it should be. Unfortunately, in many jurisdictions, this type of coverage is either unavailable or cost-prohibitive. The alternative is that a title search should always

be obtained and reviewed to confirm that there are no new surprises of record, which could be an intervening lien. The issue on title priority is that if there are junior liens at the time of the modification, and the modification is deemed to be a "material modification," then a court in hindsight might give the junior lienor priority over the mortgage, "as modified," in that the junior lienor was only junior to the mortgage, did not consent to the modification, and thereby was harmed through no fault of its own. The way to mitigate this risk is to get title insurance, and regardless of the availability of the insurance, to confirm that there are no junior liens which could potentially prime the mortgage and to record a simple mortgage modification which now puts future junior lienors on notice that the lien they are junior to has been modified.

As with every closing, due consideration should be given to "corporate formalities" and due diligence. As to the first, authorizing documents, consents, resolutions, officer's certificates and the like should be obtained but in abbreviated form when possible, such as a certificate of no change for delivery of organizational documents. Good standing certificates should be obtained and when possible, legal opinions should be rendered. When legal opinions are appropriate, such as when the modifications are significant, due consideration should be given to the opinion being rendered on the documentation "as modified" rather than solely an opinion on just a modification document. As to due diligence, in addition to title searches described above, consideration should be given as to the need for typical searches of borrower, guarantor and any other relevant loan party. While this may seem like a big "ask," it would be quite embarrassing if after a significant modification, a significant litigation or UCC filing which was unanticipated was discovered.

While all of the foregoing may be appropriate when the modification being implemented is significant, the foregoing is not an exhaustive list, and many of these items may not be practical when the modification is not as significant. As always, it is prudent to outline the laundry list of options and then agree upon what is appropriate given the specifics of the transaction at hand.

CVA and Its Prominence in Restructuring the Retail Sector

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The use of company voluntary arrangements ("CVA") in the UK has risen in the last few years, especially in the retail sector where many companies are struggling with the current landscape of increased competition from online retailers and a depressed sentiment in the economy. It has been reported in the *Financial Times* that since 2016, the number of retailers opting for CVAs has in fact doubled, with prominent retailers such as Carpetright, Mothercare, Homebase and, most recently, Debenhams all taking the same strategy.

The use of CVA has led to some critique around its use (and potential abuse), given that it is not a formal insolvency process and yet it binds all the unsecured creditors of the said company. It also raises concerns for landlords in particular where companies whose rent encompass a large portion of its ongoing costs are said to use this procedure to reduce/renegotiate rents with landlords.

In fact, the British Property Foundation has called the Government to conduct an urgent review of CVA regime, citing that the lack of transparency and unfair discrimination between different creditors result in the CVA regime being misused.

In this article, we discuss and explore the general procedure involved in a CVA and some of the key issues which are relevant for the property sector.

What is a CVA?

In summary, a CVA is a procedure undertaken between a company ("Company") and its creditors under Part I of the *Insolvency Act 1986* ("IA 1986"). A CVA is implemented under the supervision of a licensed insolvency practitioner (also known as a "Nominee" when they first make the application, then as a "Supervisor" when implementing the approved CVA). CVA is an informal procedure which aimed to assist the Company and its unsecured creditors to come to a binding agreement, and therefore avoid the need to go down the path of terminal insolvency proceedings. One of the key distinctions of CVA compared to other insolvency procedures (such as administration, liquidation) is that any approved CVA binds all unsecured creditors of the Company. Secured creditors, although notified, do not get to vote and their rights as secured creditors are not affected.

The general steps of a CVA would include the following:

1. the persons proposing a CVA (this could be a director, or if the Company is already in administration or liquidation, the administrator or liquidator, as applicable) sets out the proposal to the Nominee;
2. the Nominee then has 28 days to submit a report to the court and to also submit its opinion as to whether the proposal should be considered by the

Company's creditors or members (in reality, however, most Nominees are involved way before the notification and would be assisting with putting together a proposal);
3. the proposal must also include a statement of the Company's affairs, which should contain information such as the Company's creditors, debts, other liabilities and assets;
4. the Nominee then seeks approval by carrying out the "decision procedures" set out in Part 15 of *the Insolvency (England and Wales) Rules 2016* ("IR 2016") from the creditors. Notice is to be provided to all creditors, although only unsecured creditors will get to vote; approval by creditors is achieved if at least 75% in value of the Company's creditors who respond approve the proposal. If there are "connected" creditors, then a second round of voting is required where only "unconnected" creditors are allowed to vote and at least 50 per cent of "unconnected" creditors voting by value must vote in favour before the CVA is approved;
5. members may also vote on the CVA as well, with the approval threshold being 50%; however, lack of approval from the members will not invalidate a CVA otherwise approved by the creditors; and
6. once approved, a CVA *binds all unsecured creditors* (*i.e.*, this includes any person who did vote, or is not aware of the CVA).

CVA and Its Use in a Commercial Property Context

In the context of CVAs proposed by retail companies, these entities tend to be tenants of a large number of leasehold properties and, therefore, a large proportion of their ongoing outlays are rent. Due to the fact that CVAs provide a lot of flexibility (given that the proposal in the CVA can propose virtually any change, provided it is not unfairly prejudicial to certain creditors nor consists of material irregularity, which can then lead to the CVA to be challenged) and, unlike administration, do not necessarily compel the Company to pay its debts on a strictly parri passu basis, CVAs are therefore often used in the retail industry for struggling retailers to renegotiate their lease terms.

Although there is a written lease, and therefore a contractual commitment to pay rent, if the CVA proposal is to either reduce the rent or terminate the lease, it is binding on all unsecured creditors and, therefore, if approved, the landlord will have to accept the new terms. In the context of rent, this would include all rent in arrears, and also the tenant's liability for all other sums that are due or that will become due under the lease (*i.e.*, future rent) *Re Cancol [1995] BCC 1133*. In determining the future rent, the current standard practice is to provide an estimate of the market value, and in coming to this calculation, certain assumptions can be made about when the next break clause is, and the timing and likelihood of the landlord re-letting the property.

With respect to contingent liabilities, the accepted view is that contingent creditors are also subject to the CVA and, therefore, the contingent liability would form part of the debt pool to which the votes may be cast.

Rental Guarantees and Rent Deposits

It is important for landlords, when taking rental guarantees and deposits, to consider the implications of these instruments if the tenant undergoes a CVA. A rental guarantee is usually given by a parent of a tenant to guarantee the rent

payment for a certain period of time. Since the underlying liability (otherwise known as the principal debt) of the tenant's obligations to pay rent may be changed under an approved CVA, the guarantor may be released from the guarantee as the guaranteed obligation has changed. Therefore, a rental guarantee needs to be drafted carefully so as to ensure it is unaffected by the compromise of the principal debt, and therefore not affected by the terms of the CVA.

With respect to rental deposits, depending on how the guarantee is drafted and constructed, rental deposits can be seen as security for the rent in favour of the landlord. Given that the secured creditor's debt is not affected by the CVA, it is worth structuring in a way to ensure it is considered security and therefore not easily altered by a CVA.

Challenges by Landlords

Once a CVA is approved by the requisite majority of creditors, a creditor may only challenge the CVA on grounds of (i) unfair prejudice or (ii) material irregularity.

Whether the CVA is unfairly prejudicial is a question of fact, and it depends, firstly, whether the proposal is prejudicial to certain creditors, and, secondly, whether such prejudice is also unfair. In determining this, the courts would look at the following:

- whether the creditor in question is treated less favourably than other creditors in a similar position without justification;
- whether the creditor is in a worse position under the CVA than if the Company went into administration or liquidation.

For example, a CVA which implemented compensation for landlords of premises that had to be discarded (and therefore leases terminated) but retained full rent for some landlords whose premises continued was held to be prejudicial, but it was not unfair. *Re Cancol Ltd [1995] B.C.C. 1133.*

The Position for Lenders

For lenders who have provided property financing with respect to retail properties, issues arising with respect to the underlying retail tenants (depending on the size of the lease as a proportion to the overall rental income) may be a material concern, as this ultimately affects the ability of the borrower to meet ongoing financial covenants and, ultimately, debt service. The usual position in a loan agreement puts the focus on the Borrower/Obligors by looking at their solvency and also the financial performance of the Obligors as a whole with respect to financial covenants, such as debt yield, which more or less puts an assumption that the rental income agreed in the leases will be honoured by the tenants and legally enforceable. Loan agreements rarely have a direct link to the financial capability and financial performance of the underlying tenants. A well-constructed loan agreement which has a focus on major tenants would include robust information reporting, which requires the Borrower to notify the Lender of material changes regarding certain "key tenants" to the lender, and any insolvency or similar action (such as initiation of a CVA) may trigger draw stop and/or event of default. Given the change in the retail industry and the increasing trend for retailers to adopt CVAs, it may in turn change the traditional property financing terms for lenders

who provide financing in the industry. This may be the inclusion of additional early warning triggers such as changes to the financial covenant thresholds, increasing the need to have buffers, increase in reporting, and perhaps even a closer examination of the underlying financial condition of the tenants (such as reviewing their financial performance and tightening of rent collateral required for material leases).

Designating an Agent for Service of Process

By **Nicholas E. Brandfon**
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So your loan has gone bad, you and your borrower have been unable to work out a deal, you have determined that you need to begin enforcing remedies and your litigators put together a summons and complaint. Now it's time to serve your borrower and/or sponsor.

In the U.S., service of process rules vary from state to state and under Federal law. In New York, service of process on a domestic or foreign limited liability company may be made by personally delivering a copy of the summons to a member of the limited liability company (if the management is vested with the members), to a manager of the limited liability company (if the management is vested with the managers) or to any agent authorized or other person designated by the limited liability company to receive process. Service of process on a limited partnership may be made in a similar manner. Additionally, any entity that is qualified to do business in New York may be served at the New York Secretary of State.

While the LSTA Model Credit Agreement provides for each party to consent to service of process in the manner provided for notices in the applicable section of the credit agreement, it is customary in loan agreements for real estate loans for the borrower to designate and appoint an entity to serve as its authorized agent to accept service of process. Requiring the borrower to designate an agent for service of process provides a lender with certainty that they will be able to effectively and properly serve their borrower, sponsor or other potential defendant and prevents the potential defendant from evading service.

Designating an agent for service seems like it should be a simple task – the borrower provides the name of a person or entity who they agree can accept service of their behalf – but there are potential pitfalls to be aware of and best practices to which a prudent lender should try to adhere. Ideally, an authorized agent for service will be a nationally recognized corporate service company with an address in New York (or the jurisdiction the lender is located in and has elected as its governing law and jurisdiction for lawsuits) or the Secretary of State of the applicable jurisdiction. If the underlying property is located in New York or the borrower is otherwise qualified to do business in New York, this is generally uncontroversial – entities formed in New York and most types of entities that are qualified to do business in New York are required to have a registered agent in New York. If the property is located outside of New York and the borrower is not otherwise required to be qualified to do business in New York, the borrower may object to engaging a service company solely to act as a registered agent for service. A potential fallback – assuming the facts are right – is to have either the borrower's law firm or a sponsor entity, if they are located in New York, serve as the agent for service. In that case, it is very important to ensure that the agent for service is not an individual and, if there is an attention party, it is to a generic type name such as "general counsel." While the law provides for alternatives if an individual is no longer with an organization or is evading service, having to pursue those

alternatives can increase the costs and delay service (and therefore enforcement). In the event that none of the borrower, sponsor, their attorneys or the property have any relationship to New York, it is possible to face objections to the requirement that the borrower designate an agent in New York at all. In that case, the next best option is to have a nationally recognized service company in the entity's state of formation designated.

Having an agent for service in New York has a couple of advantages – namely, it subjects an entity to venue in Federal courts in New York and provides a measure of convenience for a lender trying to serve a summons on a borrower. Additionally, a lender should avoid having an individual named as an agent for service to prevent the need to track down a single person to serve who may be incentivized to evade service.

Real Estate Finance a Key Focus of 4th Annual Finance Forum on October 17

Our fourth annual Finance Forum at The Ritz-Carlton in Charlotte, North Carolina is just weeks away.

The half-day program, scheduled for Thursday, October 17, begins with a welcome and keynote address at 12:30 p.m. and ends at 5:45 p.m., with a networking cocktail hour to follow.

We had a record number of more than 500 attendees last year – all leaders in the real estate finance, financial services, investment management, private equity and legal communities.

This year's program will feature a keynote address by North Carolina Attorney General Josh Stein, who will speak about the rising prominence of state AGs in enforcement and how this shifting power dynamic is impacting the financial industry.

In addition to AG Stein's keynote address, the current agenda includes the following:

Commercial Real Estate

- The CRE Borrower's Perspective: What Now, What's Next?
- CRE Lending Standards: Competing in a Late-Cycle Market
- CMBS Trends, Challenges and Opportunities
- State of Play: Focus on Commercial Real Estate CLOs and Bridge Lenders

Fund Finance

- Behind the Numbers: The 2019 Fund Finance Global Market
- A Conversation with Judith Erwin, CEO of Grasshopper Bank

Middle Market Lending

- Middle Market CLOs: Risks & Rewards
- Middle Market Traditional and Non-Traditional Lending: What's Next?
- Bank Credit Processes: Everything You Always Wanted to Know (But Were Afraid to Ask)
- Middle Market Lender Financing: An Overview

Market and Regulatory Developments

- Talking LIBOR Transition: An Update from Industry Leaders

- Volcker 2.0: Key Takeaways
- Chapter 11 Bankruptcy: As a Sword and a Shield
- Government Enforcement and Litigation Trends in the Financial Industry

Speakers will include Cadwalader partners and leading practitioners from across the country.

There is no charge for the Finance Forum, and Cadwalader has arranged for very favorable hotel rates for Forum participants attending from out of town.

Click here to register for the Finance Forum.

Contact Cori Niemann for general information and hotel reservation information.