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COVID-19: What It May Mean for European CMBS Loan Servicers

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It is a challenging time for UK landlords (as well as their tenants and lenders). According to published data for the March rent payment date, landlords received on average only 48% of the contracted rent due from tenants, with the percentage being lower for office tenants and higher for commercial tenants. This level of nonpayment will leave some landlords unable to meet their debt service obligations or comply with their financial covenants.

In our previous advisory, we discussed nonpayment, financial covenant breaches, and other ways COVID-19 is likely to have an impact on CRE facility agreements and how lenders and borrowers may look to address these issues.

These issues span not just balance sheet transactions but also loans that are securitised through the commercial mortgage-backed securities (CMBS) market. Rating agencies have already begun to downgrade a number of UK and European CMBS transactions that are exposed to retail properties in recognition of the potential effect COVID-19 may have on the CMBS notes.

However, unlike balance sheet deals, the ability for borrowers of loans that have been securitised to readily negotiate amendments and waivers to their loan obligations is subject to additional complexity. This is because CMBS loan servicers – those with the power and authority to act on behalf of the CMBS issuer (as lender of record) – must navigate a fairly complicated contractual framework prescribing what they can (or can't) do with amendments and waivers and how they may otherwise act on such loans.

Furthermore, as underlying borrowers see income degradation, the concern for lenders is not just the ability of their borrowers to meet debt service but also, in severe cases, the risk that their borrowers may be unable (absent any fresh equity injections) to meet their ongoing property expenses, such as ground rents, insurance premiums, service charge items, and VAT. In that regard, CMBS loan servicers will also need to consider their obligations to property protection advances.

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Time for the Proactive Servicer

More than ever, prudent and effective servicers will be those that are proactively appraising each of their serviced loans and underlying borrowers to determine which are going to or most likely to default and, like any other prudent lender, engage in meaningful dialogue with those borrowers at the earliest opportunity, particularly those most severely affected by COVID-19. At the same time, servicers should be communicating with any operating advisors at the earliest opportunity about any proposed amendments or waivers on their loans and, where necessary, also carefully consider their communications with noteholders.

The contractual hurdles and practical challenges inherent in CMBS transactions make it even more important that servicers (acting on behalf of the issuer as lender) try and get ahead of the issues that are likely to arise when considering and, if appropriate, seeking amendments and waivers to the underlying loan terms.

Servicer Consents

CMBS servicers are granted the full power and authority to exercise all the rights and powers of the issuer (as lender) on the underlying loan agreement. This power and authority extends to providing instructions, consents, and approvals to the loan facility agent and security agent in any matter arising under the loan documentation, including dealing with any defaults and any amendment or waiver consent requests. However, that express power and authority is subject to the typically extensive set of limitations and restrictions set out in the servicing agreement.

These will be more restrictive, and the borrower may see greater time delays in being informed if any requested amendment or waiver has been approved than may be experienced on non-securitised CRE loans (noting of course that borrowers on non-securitised loans may also face delays when they have a large and diverse syndicate of lenders, making it difficult to obtain majority lender or all lender consent and/or various tranches of debt where different classes of lender require each other's consent to proceed).

Servicers are required to consult with any operating advisor appointed by the controlled class of notes in the CMBS (the controlling class being the most junior class of notes that, in very simple terms, are expected based on the most recent valuation to recover more than 25% of the principal balance outstanding on that class) on certain key amendments and waivers such as the following (may vary from transaction to transaction):

- Dates of payments.
- Amendments to the principal or interest rate.
- Extending or shortening the loan term.
- Deferring interest for any period of time.
- Forgiveness of any component of the indebtedness.
- Release of any material obligations (including waiving any events of default).
- Release of security.

- Changes to the calculation of any payments.
- Modifying key provisions such as cash reserves, rent collection, cash management, hedging financial covenants, and insurance requirements.
- Commence formal enforcement proceedings or entering into any agreement with any insolvency practitioner; consent to any sale of the loan.

This process usually requires the servicer to provide the operating advisor with at least five business days' notice of its intention to agree to any such amendment or waiver. If the operating advisor doesn't provide any confirmation (whether positive or negative) within that period, then the operating advisor will be deemed to have consented. If, however, the operating advisor responds that it disagrees and proposes an alternative course of action, then the servicer is required to submit a revised proposal within a five-business-day period, subject to that proposal not violating the servicing standard. This process will continue until either the operating advisor approvals a proposal, fails to respond within five business days of the latest proposal, or 30 days in aggregate have elapsed. If no agreement is reached, then the servicer is entitled to decide the course of action in accordance with the servicing standard.

The servicing agreement is also likely to include a number of additional restrictions that apply irrespective of whether the operating advisor has provided consent and irrespective of whether the consultation period has expired, and thus for these actions the servicer's powers may well be curtailed unless it seeks noteholder consent, in particular:

- A primary servicer may find it's prohibited from releasing a borrower from any of its material obligations or from any security (outside of release contemplated by the loan document) (this restriction may not apply if the loan is in special servicing).
- Loan extensions (whether formal or through the grant of standstills) won't be permitted if they extend the loan term by more than one year or within two or three years of the note maturity date.

Therefore, at a time when borrowers require lender flexibility and relative speed in agreeing to amendments and waivers particular to payments obligations, financial covenants, and events of default, they may find that, despite the best intentions of the relevant loan servicer, matters are likely to take longer or, irrespective of there being no operating advisor or if the operating advisor is not engaged, certain key matters might not be capable of being resolved by the servicer at all.

Furthermore, borrowers may find servicers have more flexibility to agree to amendments and waivers if their loan is in special servicing. Despite some arguments that transferring to special servicing is often about the servicer obtaining special servicing fees, in practice, special servicing is often the most appropriate place for defaulted loans since servicers are required to provide more intensive care to such loans. Loans will typically transfer to special servicing upon default at maturity, if the borrower goes insolvent, or if any other event of default occurs or is imminent and in any case in the servicer's opinion such default is not likely to be cured within a finite period and is likely to have a material adverse effect on the CMBS issuer. It will remain to be seen therefore the extent to which, outside the hardwired transfer events, servicers are willing to make the determination under the last limb.

It's important for servicers to note that notwithstanding any noteholder consent or operating advisor consent/consultation process it is engaged in, servicers will most likely be required to ensure they respond to the underlying facility agent within any period stipulated in the underlying facility agreement to avoid any deemed consent being given or the issuer's participation in the securitised loan not counting towards any determination if majority lender or, as applicable, all lender consent has been obtained. If necessary, and if the servicer hasn't received the appropriate direction or instruction from the noteholders or operating advisor to instruct the facility agent within any required periods, then the servicer is likely to be required to vote in the negative and thus reject the borrower's request. This naturally could place borrowers in a more difficult position than they might otherwise face owing to these types of negative fallback provisions.

Noteholder Consent Issues

More recent CMBS transactions permit servicers to request the CMBS issuer to convene noteholder meetings of any class and to propose noteholder resolutions of any matter relating to the securitised loans. Validly passed resolutions are binding on all noteholders, offering certainty to investors, the issuer, and servicers. But procuring noteholder resolutions isn't a straightforward process. Firstly, it's more difficult for communications about securitised loans to be made to noteholders and for discussions to be conducted, not least because market abuse rules require material nonpublic information that might impact the price of the notes to be disseminated to all noteholders at the same time, which in practice is only possible via written notices issued via the clearing systems and published on the relevant exchange in the case of listed notes. Secondly, the process of obtaining noteholder consent is inherently time-consuming and can be unwieldy when multiple tranches of notes are involved. Convening noteholder meetings typically requires 21 clear days' notice, and the practical challenges of convening meetings in the current climate are obvious. Any meeting would still require the requisite quorum to be a valid meeting (usually 50% of the aggregate principal amount outstanding for a class for an ordinary resolution meeting and 75% for an extraordinary resolution meeting), and then the requisite percentage at the meeting must the pass the resolution (usually 50% of the votes cast for an ordinary resolution, 75% for an extraordinary resolution). Resolutions can often be passed in writing (through the clearing systems), but this generally requires 75% of the principal amount outstanding of a class to pass an extraordinary resolution and 50% to pass an ordinary resolution. In some cases, if the process is hardwired in detail into the transaction documents, noteholder resolutions might be possible through a negative consent process, which sees resolutions deemed as passed and binding on the noteholders (although the negative consent process can't be used for basic terms modifications or note maturity plans) if 25% or more have not informed the paying agent (through the clearing systems) that they object to any extraordinary resolution within 30 days of receipt of notice (50% or more in the case of an ordinary resolution).

Property Protection and Liquidity Facility Advances

Servicers are typically under an obligation to monitor the underlying borrower's compliance with its insurance obligations under the loan agreement, particularly the obligation to maintain all-risk coverage for the property and loss of rent/business interruption coverage. If the borrower fails to maintain this coverage, then the servicer will be under a reasonable endeavours obligation to put such coverage in place (but without any obligation on the servicer to expend its own funds). Aside from insurance premiums, there may well be other amounts that need to be paid to third parties to protect or preserve the property, its value, or the

finance parties' interests, such as the payment of ground rent or service charges. Whilst loan agreements typically allow lenders to make property protection loans to the borrower for these purposes, it becomes more complicated on securitised loans because the servicer is usually required to determine, in accordance with the servicing standard, if it's in the CMBS issuer's interest to see these amounts paid rather than remain unpaid. If it determines such payment ought to be made, then the servicer will be required to request via the CMBS cash manager that a property protection drawing is made by the liquidity facility provider to the CMBS issuer to fund such payment (via the making of a property protection loan to the underlying borrower). Current market conditions will likely test the responsiveness of liquidity facility providers, and consequently there may be timing issues in obtaining a drawing under the liquidity facility. However, those delays in practice may be no different to delays balance sheet lenders may themselves face when going through the internal credit committee processes or for those lenders that aren't sitting on capital, making capital calls to fund such payments.

Alston & Bird has formed a multidisciplinary task force to advise clients on the business and legal implications of the coronavirus (COVID-19). You can view all our work on the coronavirus across industries and subscribe to our future webinars and advisories.

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