DEBT MARKETS –
DEAD, DELAYED OR DYNAMIC?

DEVELOPMENTS IN MEZZANINE AND CMBS FINANCE IN 2016,

AND THE IMPACT OF NEW REGULATORY REQUIREMENTS

ON THE CAPITAL MARKETS GENERALLY

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This paper examines recent updates in the real estate capital markets, including recent trends in mezzanine finance and CMBS lending. Additionally, this paper discusses recent regulatory developments, including the new Risk Retention Rules and the EU Bail-In Legislation and the effect of such regulations and legislation on mortgage loan origination in each of the CMBS market and the loan syndications market, respectively.

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I. RECENT DEVELOPMENTS IN THE REAL ESTATE CAPITAL MARKETS

A. Recent Developments in Mezzanine Finance

1. Mortgage Loan Portfolio Lenders are Teaming Up with Mezzanine Lenders More Frequently in 2016

The demand for mezzanine finance remains strong in 2016 due to the refinancing boom that is occurring because of the large issuance of commercial mortgage-backed securities ("CMBS") debt in 2006 and 2007 ($198.3 billion and $228.5 billion, respectively).[2] However, due to the softness in the CMBS market for the first two quarters of 2016 (CMBS issuance is at $28.7 billion for the first two quarters of 2016 as compared to $46.7 billion for the first two quarters of 2015),[3] mezzanine lenders are teaming up more frequently with banks and insurance companies that originate portfolio loans instead of working with CMBS lenders who traditionally put together a debt package for a borrower which may have included a component of mezzanine debt. There are currently 86 firms that are providing high yield mezzanine debt on commercial properties.[4] These partnerships of portfolio or balance sheet lenders with the high yield mezzanine debt providers are more common in today's market, and they have highlighted the contrasting approaches and positions by these conservative balance sheet lenders to those historically and currently taken by their CMBS competitors on various covenants, requirements and rights contained and/or granted in the mortgage/mezzanine intercreditor agreements which are entered into in connection with a finance package comprised of both mortgage and mezzanine debt (the "Intercreditor Agreement").

2. The Release of the Mortgage Loan Recourse Carve-Out Guarantor Upon a Mezzanine Foreclosure and the Evolution of the "Deemed Replacement Guarantor" in the Intercreditor Agreement

First, let's examine an issue which arises frequently on mortgage loan recourse carve-out guaranties and environmental indemnity agreements when there is also a mezzanine loan provided

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[2] *Summary of CMBS Issuance: Historic*, COMMERCIAL MORTGAGE ALERT, (Dec. 31, 2015), https://www.cmalert.com/rankings.pl?Q=91.

[3] *Market Monitor*, COMMERCIAL MORTGAGE ALERT, June 3, 2016 at 7.

[4] *Mezz Lenders Shift Tactics as CMBS Slumps*, COMMERCIAL MORTGAGE ALERT, June 10, 2016 at 1.

to the equity owners of the mortgage borrower (and the interplay of corresponding provisions in the Intercreditor Agreement) through the differing lenses of the portfolio lender[5] and the CMBS lender. Many sophisticated mortgage borrowers will request that the mortgage borrower and any mortgage guarantor(s) be released from liability in connection with any events or circumstances which would trigger liability under the recourse carve-out guaranty and/or environmental indemnity on and after the date that the mezzanine lender forecloses on the mezzanine equity collateral or the date that a "Realization Event" occurs under the Intercreditor Agreement (which "Realization Event" may include the date that is the earlier of (1) the date that the mezzanine lender takes title to the mezzanine equity collateral, and (2) the date of the exercise of voting rights to direct the management or the policies of the mortgage borrower by the mezzanine lender pursuant to the mezzanine pledge agreement (which is a more recent addition to the definition)). The significance of a "Realization Event" in the Intercreditor Agreement is the obligation of the mezzanine lender to deliver a replacement recourse carve-out guaranty and an environmental indemnity agreement for the mortgage loan in connection with any such "Realization Event." The recent move toward the "early trigger" in the definition of "Realization Event" based on the exercise of voting rights by the mezzanine lender has evolved as an additional mitigant against the mezzanine lender exercising control over the mortgage borrower and causing the mortgage borrower to file for voluntary bankruptcy with no recourse to mezzanine lender or an affiliate of mezzanine lender for such action. Most mezzanine lenders have accepted the "early trigger" in the definition of Realization Event in the Intercreditor Agreement.

In connection with the release of the mortgage borrower and any mortgage guarantor, most CMBS lenders will agree in the mortgage loan documents to a borrower request for a release of a mortgage guarantor upon the consummation of a mezzanine foreclosure without the express requirement of the delivery of a replacement guarantor by the mezzanine lender pursuant to the Intercreditor Agreement (but many mortgage lenders are hesitant to permit the release of the mortgage guarantor on an exercise of "control" by mezzanine lender, as the definition of "control" may be difficult to define and is not a bright line test). In connection with such release, most CMBS mortgage lenders are willing to rely on their contractual right against a mezzanine lender under the Intercreditor Agreement for its failure to post a replacement guarantor upon a "Realization Event" and their ability to bring an application for a temporary restraining order (a "TRO") or declaratory judgment action to prevent (or set aside) such "Realization Event" due to the mezzanine lender's failure to satisfy a condition precedent (*i.e.*, the delivery of a replacement guarantor) as required under the Intercreditor Agreement. Portfolio lenders, however, typically are not willing to release a mortgage guarantor upon the consummation of a mezzanine loan foreclosure *unless* the mortgage loan documents *expressly* require the delivery of a replacement recourse carve-out guaranty and environmental indemnity agreement by a replacement guarantor, which such replacement guarantor shall either: (1) satisfy the requirements of the Intercreditor Agreement, or (2) be approved by the mortgage lender. Additionally, such replacement guarantor typically must satisfy any on-going financial covenants (*i.e.*, net worth and liquidity covenants that are set forth in the original mortgage loan recourse carve-out guaranty) unless otherwise negotiated in the Intercreditor Agreement.

The foregoing position concerning a release of a mortgage guarantor is typically not acceptable to a sophisticated borrower sponsor, as such borrower is not a party to the Intercreditor

[5] Note, the references to a balance sheet lender or portfolio lender herein shall always include an insurance company.

Agreement or otherwise involved in the posting of a replacement guarantor upon a mezzanine loan foreclosure, and it is unwilling to condition its mortgage guarantor's release on the actions and obligations of a third-party over which such borrower sponsor has no control (*i.e.*, the mezzanine lender). The balance sheet lender and the mortgage borrower are now at an impasse with respect to their contrasting positions on releases. A compromise position which has evolved from a balance sheet lender's unwillingness to rely on its contractual rights against a mezzanine lender under the Intercreditor Agreement and its ability to bring an action for a TRO or declaratory judgment due to their fear of being "uncovered" on a recourse event (including an environmental claim) is the concept of a "Deemed Replacement Guarantor" in the Intercreditor Agreement. Under the "Deemed Replacement Guarantor" alternative, in the event that a mezzanine lender subsequently defaults in its obligation to deliver a replacement guarantor upon a "Realization Event" pursuant to the terms of the Intercreditor Agreement, such mezzanine lender agrees in the Intercreditor Agreement that a guarantor (acceptable to the mortgage lender) provided by the mezzanine lender shall be deemed to have assumed all the obligations and liabilities of the guarantor under the mortgage loan recourse carve-out guaranty and the environmental indemnity agreement as if such "Deemed Replacement Guarantor" shall have executed such agreements. See Exhibit A attached hereto for a sample of a "Deemed Replacement Guarantor" provision for an Intercreditor Agreement. Generally, there is significant pushback from mezzanine lenders with respect to the "Deemed Replacement Guarantor" provision (rarely seen in a CMBS context), though some mezzanine lenders, in an effort to get a balance sheet mortgage loan transaction done, will agree to be a "Deemed Replacement Guarantor" upon execution of the Intercreditor Agreement.[6] This tension concerning releases of guarantors on the mortgage loan and replacement guaranties on the mezzanine loan among mortgage borrowers, mortgage lenders and mezzanine lenders is a point of serious negotiation among the various members that participate in and access the mortgage and mezzanine finance markets today.

3. A "Qualified Transferee" of the Mezzanine Loan – the Differing Requirements of the Balance Sheet Lender and the CMBS Lender

Another issue which highlights the different requirements of a balance sheet lender to those of a CMBS lender is the definition of a "Qualified Transferee" in the Intercreditor Agreement. A sample definition of "Qualified Transferee" is set forth on Exhibit B attached hereto. The definition is relevant with respect to certain rights and obligations set forth in the Intercreditor Agreement and how they relate to the initial mezzanine lender originating the mezzanine loan, the transfer of the mezzanine loan and the exercise of remedies by the mezzanine lender pursuant to the mezzanine loan documents. Balance sheet lenders may require an additional qualification to the definition of "Qualified Transferee" as set forth in Exhibit C attached hereto (*e.g.*, such Qualified Transferee must be a "Customer in Good Standing" and not a "Controversial Person"). These additional requirements (which are not relevant in the CMBS market) affect the liquidity of the mezzanine loan and make it very difficult for the pool of potential purchasers of a particular mezzanine loan to meet the definition of a Qualified Transferee; especially because, among other things, each of the sample definitions of "Customer in Good Standing" and "Controversial Person"

[6] Additional issues that may arise when negotiating the "Deemed Replacement Guarantor" provisions in an Intercreditor Agreement include, among other things, what time period the mezzanine lender is obligated to (1) maintain net worth and liquidity covenants contained in the mortgage recourse carve-out guaranty, and (2) deliver guarantor financial statements and other financial information to the mortgage lender.

contain very low bars concerning litigations and they also extend to such potential purchaser's affiliates. Many of the mezzanine players in 2016 were present in the most recent real estate market downturn and may have an affiliate equity fund, or may have, themselves, foreclosed as a lender on a mezzanine pledge and succeeded to the ownership interests in a mortgage borrower where, in either case, such affiliate of mezzanine lender or the mezzanine lender, itself, may have been involved in a work-out, restructure or litigation that would trigger its inability to be a "Customer in Good Standing," or alternatively, its ability to be a "Controversial Person" in today's market, and thus, unable to qualify as a "Qualified Transferee." Additionally, even if the initial mezzanine lender meets the definition of Qualified Transferee, as qualified above, these additional qualifications found in balance sheet lender Intercreditor Agreements may further have the potential to chill the bid at a public UCC sale when the mezzanine lender exercises remedies on a mezzanine loan in default, as the mortgage lender's consent must be obtained (which may include a rating agency confirmation on a CMBS loan) if such potential bidder does not meet the definition of a "Qualified Transferee." Furthermore, the additional requirements may also impact the "commercial reasonability" of the UCC sale by widely contracting the pool of potential bidders at the mezzanine foreclosure sale. These negative impacts are good reasons for mezzanine lenders to push back on and/or attempt to remove or significantly alter such additional qualifications in order that their execution on their mezzanine loan investments are not meaningfully devalued. Until the CMBS market becomes more robust in 2016, or thereafter, mezzanine lenders will need to meet the challenges they face among balance sheet lenders with the more stringent definition of a "Qualified Transferee" of a mezzanine loan.

Other issues for both mezzanine lenders and mortgage lenders to focus on with respect to the definition of a "Qualified Transferee" include the following questions: At the initial closing of the mezzanine loan, does the mortgage lender rely on a representation (other than being named specifically in the definition of a "Qualified Transferee") that such mezzanine lender is a "Qualified Transferee"? Or does the mortgage lender require the delivery of financial statements? Today, it is not uncommon for both CMBS lenders and balance sheet lenders to require organizational charts and financial statements from mezzanine lenders prior to loan closing or in connection with a mezzanine loan sale. Additionally, most Intercreditor Agreements (for both CMBS and portfolio lenders) require an officer's certificate from the mezzanine lender certifying that all of the applicable requirements of the Intercreditor Agreement have been met with respect to the exercise of remedies under the mezzanine loan documents, and the transfer of the mezzanine equity collateral to the mezzanine lender or a new transferee,[7] but also give the mortgage lender the right to request evidence to support such certificates. On these points, CMBS lenders and balance sheet lenders provide a consistent approach to mezzanine lenders.

Lastly, there have been additional rumblings from some players in the mortgage CMBS and balance sheet markets that there should be additional restrictions on transfers or sales of more than 49% *in a* mezzanine lender that is specifically named in the definition of a "Qualified Transferee." The rationale for this position would be the maintenance of the sponsorship of such mezzanine lender as such "specifically-named" mezzanine lender would not need to meet the

[7] Such certificate shall provide, among other things, that mezzanine lender or new transferee is a Qualified Transferee and a replacement guarantor has been provided which (1) has delivered a replacement recourse carve-out guaranty and environmental indemnity agreement, and (2) meets the net worth and liquidity requirements (or other financial requirements) set forth in the Intercreditor Agreement.

financial tests set forth in the definition of a Qualified Transferee upon the exercise of remedies under the mezzanine loan documents. This additional requirement is not customarily present in the current mortgage/mezzanine market, and would definitely be met with resistance by prospective mezzanine lenders and/or purchasers, as it may have the effect of restricting or limiting the execution on their business plans in the future. Only time will tell if this issue is raised and how the mezzanine market may react.

B. Recent Developments in CMBS Lending

1. The Effect of External Market Factors and New Regulatory Legislation on CMBS Finance in 2016

The first two quarters of CMBS lending in 2016 have been quite sluggish due to external factors such as the Chinese stock market, oil prices, the new risk retention regulations which will be implemented in December (discussed here in depth later), and uncertainty over our new President in November. Issuance as of May 31st is 42% lower than for the same period in 2015, and projections for overall CMBS issuance in 2016 have now been adjusted downward to $70 billion from $100—115 billion.[8] The volatility in the market has made it virtually impossible for CMBS lenders to quote a spread, and those lenders that did so earlier in 2016 found themselves in a position where it was necessary to invoke the material adverse change ("MAC") clauses in their term sheets and increase interest rate spreads in connection with closing, which such re-trades by CMBS lenders did not make borrowers happy. The third quarter of 2016 seems to be calming down a bit; spreads on CMBS securitizations have tightened and there is now increased activity in CMBS lending. The size of securitization pools in recent CMBS offerings in the second quarter has been well below the $1 billion benchmark which is driven by fear of aggregation risk. B notes are almost never seen, and there has been a solid movement by subordinate debt providers to mezzanine loans, as the players in that market want to control their destiny upon borrower default, and *pari passu* loan structures are more in favor in the capital markets today than single-asset securitizations (which seem to be reserved for flagship properties), as investors seem strongly to prefer diversity of asset type, geography, and borrower sponsorship found in conduit pools.

2. New Rating Agency Requirements for Leasehold Financings

From a legal perspective there has been increased scrutiny by rating agencies on leasehold financings in 2016—so beware! Moody's rolled out a piece in January focusing on a handful of key issues concerning leasehold mortgagee protections in ground leases.[9] New lease provisions should be written so they are granted to a leasehold mortgagee on any termination of the ground lease <u>and</u> upon a rejection of a ground lease in a borrower/ground tenant bankruptcy.[10] Due to the uncertainty in case law that a rejection of a ground lease may not be a termination of such lease (but only a breach), a ground lease that contains a new lease provision which is granted upon a "termination for any cause" is not a credit-neutral provision,[11] and the lender will have to suffer the consequences of a rating adjustment with respect to such loan. Loan size (as a percentage of a securitization pool) may well impact the degree of such ratings adjustment, so if a lender is faced with such a non-compliant new lease provision, a *pari passu* loan structure would be recommended in an effort to bring any loan component below a 10% threshold of the pool, which may help the ratings hit, but nothing (as we know) is guaranteed.

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[8] *Expectations for 2016 CMBS Issuance Slashed Sharply*, COMMERCIAL REAL ESTATE DIRECT (Mar. 2, 2016), http://www.crenews.com/general_news/general/expectations-for-2016-cmbs-issuance-slashed-sharply.html.
[9] MOODY'S INVESTOR SERVICE, THE TOP TWO GROUND LEASE FINANCING FLAWS: DEFICIENT "NEW LEASE" CLAUSES AND SUPERIOR FEE MORTGAGES, Jan. 6, 2016.
[10] *Id.* at 1-2.
[11] *Id.* at 2.

Similarly, Moody's has also focused in its recent article on the priority of a ground lease relative to a fee mortgage which may lien the fee estate of a property where such ground lease encumbers the leasehold estate of the same property. Under the foregoing scenario, such ground lease must be prior in lien priority to that of the fee mortgage to be credit neutral.[12] The inherent risk of a prior fee mortgage to a subordinated ground lease is the extinguishment of such ground lease upon a default and foreclosure of such fee mortgage—not a position a leasehold lender wants to finance. In order to avoid the potential risk of a total loss of a leasehold lender's collateral on a fee mortgage default, most fee lenders are comfortable subordinating their fee mortgage to the ground lease and relying on a state's eviction laws to dispossess a ground tenant in default once such fee lender succeeds to a fee owner's position on foreclosure (as opposed to having the direct right to extinguish a subordinate ground lease in default upon a fee mortgage foreclosure).[13] However, there are some older ground leases where a fee owner (with leverage) may have negotiated that a ground lease is subordinate to any existing and future fee mortgage, but such fee lender is obligated to deliver a subordination, non-disturbance and attornment agreement (an "SNDA") to the ground tenant, which would arguably mitigate any risk of termination of such ground lease on a fee mortgage foreclosure.

Historically, many CMBS leasehold lenders would accept such subordinate ground lease subject to an SNDA as its collateral package, but only if such SNDA was properly drafted to mitigate any risk that it would be considered an executory contract (and capable of rejection) upon the bankruptcy, insolvency or receivership of such fee lender (arguably a remote risk in and of itself). An SNDA may be deemed an executory contract that could be rejected under § 365 of the U.S. Bankruptcy Code.[14] If an SNDA is drafted such that the non-disturbance granted by the fee lender to the ground tenant and its leasehold lender is a "present non-executory grant of non-disturbance" which is based upon a condition subsequent—"a ground tenant's default"—arguably such SNDA is not an executory contract, pursuant to § 365 of the U.S. Bankruptcy Code (a "Non-Executory SNDA"). Participants in the CMBS market appeared to accept the foregoing language in the Non-Executory SNDA as a tool to minimize the risk that an SNDA would be deemed executory in a fee lender bankruptcy, insolvency, or receivership proceeding. However, since there is no case law directly on point supporting that the Non-Executory SNDA is not an executory contract under the Bankruptcy Code (but, note, there is also no case law directly supporting that a Non-Executory SNDA is an executory contract), Moody's is not willing to view a ground lease with a prior fee mortgage with a Non-Executory SNDA granted to the ground tenant and the leasehold lender as credit-neutral.[15] A ground lease needs to be structured as a prior encumbrance to a fee mortgage in order to avoid such credit-negative treatment upon securitization of the mortgage loan.

3. A Look at CMBS Underwriting Requirements in 2016

The CMBS market appears to continue to require solid underwriting requirements post-downturn. Deep pocket guarantors are still a must for both the rating agencies and B-Piece Buyers; however, strong sponsors with lower leveraged properties may get the benefit of a cap on some portion of their guarantor's recourse obligations under the loan documents (usually limited to the

[12] *Id.* at 3.
[13] *Id.* at 3.
[14] *Id.* at 3.
[15] *Id.* at 3.

bankruptcy recourse carve-out). Recourse carve-out liability caps of 50% and below will result in a rating adjustment by some of the agencies and/or pricing hits by B-Piece Buyers. With respect to caps above 50%, the treatment is less certain, but the rating adjustment and/or pricing hit will not be as severe. Similarly, net worth and liquidity requirements have evolved to be the "new normal" in the post-downturn CMBS market. The dollar thresholds are a subject of a negotiation, but an "unwritten rule of thumb" is the minimum net worth requirement is typically no less than the principal amount of the mortgage loan, and the corresponding liquidity requirement is 10% of such principal amount. Now that the requirements of net worth and liquidity covenants are commonplace in recourse carve-out guaranties, negotiations do surround the definitions themselves. Borrowers are typically requesting lenders to count lines of credit or capital commitments by investors available to a guarantor as "cash and cash equivalents" when calculating "liquidity." Many lenders will accept the following in connection with the calculation of required liquidity of the guarantor: "(a) funds available to Guarantor pursuant to an Eligible Credit Facility; and/or (b) Eligible Capital Commitments which are in excess of any outstanding loans secured by such commitments."[16]

Similarly, the lender requirement for audited financial statements, a cost issue to borrowers, seems to support continued discipline in the underwriting arena. Audited statements are important to both the rating agencies and B-Piece Buyers. There have been some recent rumblings by some rating agencies that loans in the $25MM - $40MM range without a requirement for audited financial statements may suffer a ratings hit. As December approaches, and the requirement for a sponsor of a securitization to comply with the new risk retention rules by retaining a 5% interest (either vertically or horizontally) in a securitization finally becomes a reality in the CMBS market,[17] CMBS lenders may support these more stringent underwriting standards, and some of these standards (such as audited financial statements for loans with a principal amount of $25MM) may become the "new normal" due to the increased long-term risk that a CMBS sponsor of a securitization may have with respect to the mortgage loans that it is contributing into such securitization pool.

[16] Definitions of "Eligible Capital Commitments" and "Eligible Credit Facility" may include the following:
"Eligible Capital Commitments" shall mean uncalled and unconditional capital commitments of the partners or members, as applicable, of the applicable Guarantor which are subscribed and irrevocable.
"Eligible Credit Facility" shall mean a credit facility or subscription facility, so long as such facility is irrevocable and not subject to any conditions to advance that would not be reasonably expected to be satisfied as of the applicable date of determination.

[17] Please see Part II (A) below for a more detailed description of the new risk retention regulations.

II. THE IMPACT OF RECENT REGULATORY DEVELOPMENTS ON MORTGAGE LOAN ORIGINATION AND LOAN DOCUMENTATION

A. The Risk Retention Rules

1. Background

In an attempt to thwart certain practices it believed destabilized the capital markets leading to the 2008 recession,[18] Congress enacted Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[19] (the "Dodd-Frank Act"). Specifically, Congress referred to an "originate-to-distribute" business model through which lenders originated loans and quickly disposed of the loans by selling them into securitization pools.[20] While this model permitted lenders to enhance their liquidity, thereby making credit more widely available to borrowers, it also resulted in a decline in loan quality since lenders could originate loans without retaining any liability for the heightened credit risks of such loans. Accordingly, Section 941(b) of the Dodd-Frank Act added Section 15G to the Securities Exchange Act of 1934[21] (the "Exchange Act") and directed various federal agencies (the "Agencies")[22] to adopt credit risk retention rules intended to align the interest of sponsors of securitizations with investors, by requiring sponsors to keep some "skin in the game."[23]

On December 24, 2016, the joint Final Rule[24] (the "Final Rule") implementing the credit risk retention obligations required under the Dodd-Frank Act will be effective for all classes of asset-backed securities, including CMBS. The Final Rule generally requires a "sponsor"[25] (or its majority-owned affiliate) of both public and private "asset-backed securitizations"[26] to retain at least 5% of the credit risk of the assets collateralizing the securitization (referred to herein as the "risk retention obligation").[27] In transactions with multiple sponsors, risk retention cannot be apportioned among the sponsors but, instead, each sponsor must ensure that at least one of the

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[18] *See* S. REP. NO. 111-176, at 128 (2010).
[19] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[20] Luis A. Aguilar, *Skin in the Game: Aligning the Interests of Sponsors and Investors*, (Oct. 22, 2014), U.S. SECS. AND EXCH. COMM'N, https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370543250034.
[21] 15 U.S.C. § 78o-11 (2012). Section 15G generally requires the applicable federal agencies to prescribe regulations to (i) require a securitizer to retain not less than 5% of the credit risk of any asset that the securitizer transfers, sells or conveys to a third party (through the issuance of an asset-backed security) and (ii) prohibit a securitizer from hedging or otherwise transferring the credit risk such securitizer is required to retain.
[22] The "Agencies" include: the Securities and Exchange Commission; Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and, with respect to the rules relating to residential mortgages, the Federal Housing Finance Agency and the Department of Housing and Urban Development.
[23] *See* S. REP. NO. 111-176, at 129 (2010), http://www.gpo.gov/fdsys/pkg/CRPT-111srpt176/pdf/CRPT-111srpt176.pdf.
[24] Credit Risk Retention, 79 Fed. Reg. 77,601 (Dec. 24, 2014).
[25] The Final Rule defines a "sponsor" as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." *Id.* at 77,742.
[26] An "asset-backed security" is defined by incorporating the definition of that term in Section 3(a) (79) of the Exchange Act and generally defined to mean "a fixed income or other security collateralized by any type of self-liquidating financial asset (including a loan, lease, mortgage, or other secured or unsecured receivable) that allows the holder of a security to receive payments that depend primarily on cash flow from the asset." *Id.* at 77,741, 77,653.
[27] *See id.* at 77,611.

sponsors complies with the requirements of the Final Rule.[28] In addition, the Final Rule generally prohibits any transfer, hedging or financing of the risk retention obligation, thereby insuring the sponsors are invested in the performance of the assets for the majority of the life of the transaction.[29]

2. Forms of Risk Retention – Vertical, Horizontal and L-Shaped

The Final Rule offers various methods by which a sponsor may satisfy the 5% risk retention obligation. Subject to any exemption or exception discussed herein, CMBS sponsors may satisfy the risk retention obligation under the standard risk retention option, whereby the sponsor must retain an "eligible vertical interest", an "eligible horizontal residual interest," or any combination of the two (often referred to as an "L-Shaped Interest").[30]

Vertical Risk Retention. An "eligible vertical interest" ("EVI") is a pro rata interest in each class of securities issued by the issuing entity and valued at 5% of the *face value* of each such class. An EVI may be held as either (i) 5% of the face value of each class of securities issued or (ii) a single vertical security entitling the holder to 5% of the cash flows (principal and interest) made to each issued security (other than such single vertical security).[31] The "single vertical security" is intended to lessen a sponsor's administrative burden by permitting it to hold the risk retention obligation in just one security.[32]

Horizontal Risk Retention. An "eligible horizontal residual interest" ("EHRI") is an interest with the most subordinate claim to payments of principal and interest and valued at 5% of the *fair value* of all securities issued by the issuing entity.[33] The terms of the EHRI must provide that the interest is a "first-loss position," such that if on any payment or allocation date, the issuing entity has insufficient funds to satisfy its obligations to pay all principal and interest due to the outstanding securities, any shortfall will reduce the amounts payable to the EHRI prior to reduction of amounts payable to any other security issued.[34] Additionally, the EHRI may be held as a single class or multiple classes of securities, provided that the multiple classes are in consecutive order based on subordination level.[35]

In lieu of holding all or part of its risk retention obligation as an EHRI, the Final Rules permit a sponsor to fund a horizontal cash reserve account to be held by the securitization trustee for the benefit of the issuing entity.[36] At the closing of the securitization, such reserve account must hold an amount equal to the fair value of the EHRI or any portion of the EHRI not held as a security issued by the transaction.[37] The amounts held in the account would absorb losses on the issued securities, similar to the way in which an EHRI acts as the first-loss position in the

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[28] *See id.*
[29] *See id.*
[30] *See id.* at 77,614.
[31] *See id.* at 77,615.
[32] *See id.*
[33] *See id.*
[34] *See id.*
[35] *See id.*
[36] *See id.* at 77,615-16.
[37] *See id.* at 77615.

securitization.[38] No amounts held in a horizontal cash reserve account may be released to the sponsor until all securities issued in a transaction have been satisfied or the issuing entity is dissolved.[39]

Unlike vertical risk retention, which is valued based on the "face value" of the securities issued by a transaction, horizontal risk retention requires the sponsor to calculate and retain the "fair value" of the securities issued.[40] However, the Final Rule provides little guidance on the meaning of "fair value" or how to calculate such value. The Final Rule refers only to "a fair value methodology acceptable under U.S. generally accepted accounting principles"[41] and states that the methodology to calculate the fair value of the EHRI may take into consideration "the overcollateralization and excess spread in a securitization transaction as adjusted by expected loss and other factors."[42] Accordingly, sponsors will be left to determine the proper methodology for evaluating fair value and risk the possibility of running afoul of the Final Rule if any of the Agencies disagree.

Moreover, the Final Rule requires the sponsor disclose its valuation method to investors.[43] Sponsors will be required to disclose default, recovery and payment rate assumptions, as well as other historical information that would meaningfully inform third parties of the reasonableness of the assumptions underlying the sponsor's valuation methodology.[44] Formulating the required disclosure will be costly and sponsors risk utilizing a methodology later deemed unacceptable by one or more of the Agencies.

<u>L-Shaped Risk Retention</u>. Sponsors may also satisfy the risk retention obligation through a combination of vertical and horizontal risk retention.[45] The Final Rule does not prescribe any particular proportion of vertical to horizontal risk retention but does require that the percentage retained in the vertical form (held as a percentage of the face value) and the percentage held in the horizontal form (held as a percentage of the fair value) when combined reaches or exceeds 5%.[46] Therefore, a sponsor may hold 3% of the face value of the securities issued in an EVI and 2% of the "fair value" of the securities in an EHRI, for a total risk retention obligation of 5%.

3. Transfer, Hedging and Financing Restrictions

Subject to the exceptions discussed below, the Final Rule prohibits the sponsor from selling or otherwise transferring its risk retention obligation other than to a majority-owned (or wholly-owned) affiliate ("MOA") [47] or, solely with respect to CMBS transactions, to a qualified third-party purchaser after an initial holding period of five years by the sponsor of a securitization. A MOA is a separate entity formed to acquire the interest in a transaction representing the sponsor's

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[38] *See id.*
[39] *See id.* at 77,742.
[40] *See id.* at 77,611-12.
[41] *Id.* at 77,612.
[42] *Id.* at 77,613.
[43] *See id.* at 77,619.
[44] *See id.* at 77,619-20.
[45] Credit Risk Retention, 79 Fed. Reg. at 77,614.
[46] *See id.* at 77,614.
[47] *See id.* at 77,645.

risk retention obligation.[48] Alternatively, a CMBS sponsor that complies with the Final Rule by retaining an EHRI at closing of the securitization may transfer the interest to a qualified third-party purchaser (or "B-Piece Buyer") after holding the EHRI for five years,[49] as discussed in further detail in Section IV below.

The Final Rule further prohibits the sponsor or its affiliates from financing the risk retention obligation and certain hedging activities.[50] Financing of the sponsor's interest is generally impermissible under the Final Rule unless the debt incurred is full recourse to the pledgor.[51] On the other hand, the prohibition against hedging is restricted to hedge positions relating to the credit risk associated with the retained interest. For example, a credit default swap referencing the risk retention obligation or a particular secured asset is prohibited but hedging activities not materially related to the credit risk of the interest retained by the sponsor are permitted.[52] Such permitted activities might include hedge positions related to currency exchange rates, interest rates or an index of instruments that include various asset-backed securities.

Pursuant to Section 15G of the Exchange Act, the Final Rule also specifies the minimum duration that the sponsor must retain its obligation.[53] Accordingly, the transfer and hedging restrictions with respect to CBMS transactions expire on or after the date that is the latest of: (1) the date on which the total unpaid principal balance of the securitized assets that collateralize the securitization has been reduced to 33% of the original unpaid principal balance of the securitized assets as of the cut-off date of the securitization, (2) the date on which the total unpaid principal obligations of the securities issued in the securitization are reduced to 33% of the original unpaid principal obligations as of the closing date of the securitization, or (3) two years after the closing date of the securitization.[54] The Final Rule also states that any risk retention obligation for CMBS transactions terminates once all mortgage loans have been fully defeased.[55]

4. Who is the Responsible Party?

While the sponsor (or its MOA) is generally responsible for satisfying the risk retention requirements, the Final Rule provides some alternatives to sponsor-held risk for CMBS transactions, including originators and third party purchasers.[56] However, despite the option to transfer the obligation to retain risk, the sponsor cannot transfer the obligation to comply.[57] A

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[48] The Final Rule requires that the sponsor must own "more than 50% of the equity of an entity, or ownership of any other controlling financial interest in the entity" in order for such entity to be majority-owned by the sponsor. *See id.* at 77,741.
[49] *See id* at 77,648.
[50] *See generally id.* at 77,666-67.
[51] *See id.* at 77,666.
[52] *See id.*
[53] *See id.* at 77,669-70.
[54] *Id*. at 77,669.
[55] *Id*. at 77,749.
[56] *See id.* at 77,643-44. *See also id.* at 77,661-62.
[57] *See id.* at 77,643-44. *See also id.* at 77,662 n.204.

sponsor that relies on an alternative to sponsor-held risk retention remains legally responsible for the ongoing compliance by the alternative party and liable for any violations of the Final Rule.[58]

Originators

The Final Rule permits a sponsor to allocate a portion of its risk retention obligation to an "originator"[59] of the securitized assets (or a MOA of the originator), subject to certain conditions.[60] Any allocation to an originator reduces the sponsor's risk retention obligation commensurately.[61] In order to satisfy the risk retention requirements, the originator must be the original creditor that created the asset, not a subsequent purchaser or transferee of the asset.[62] In addition, the originator must assume at least 20% of the aggregate risk retention obligation required to be retained by the sponsor.[63] However, the originator cannot assume a percentage of the risk retention obligation exceeding the percentage, by unpaid principal balance, of the securitized assets it originated to the aggregate balance of all assets in the securitization.[64] Furthermore, the originator must acquire the portion of the sponsor's retained interest at the closing of the securitization and must retain its interest in the same manner and proportion (as between an EVI or EHRI) as the sponsor.[65] Finally, the originator must comply with the transfer and financing restrictions that are imposed on the sponsor.[66]

B-Piece Buyers

The Final Rule also permits sponsors of a CMBS transaction[67] to satisfy all or a portion of the risk retention obligation through one or two qualified third-party purchasers ("B-Piece Buyers").[68] A B-Piece Buyer may hold an EHRI from the closing of the securitization or by transfer from the sponsor after an initial five year holding period.[69] The sponsor may utilize the

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[58] *See id.* at 77,643-44. *See also id.* at 77,662 n.204.
[59] The Final Rule defines an "originator" as "a person who: (1) through an extension of credit or otherwise, creates an asset that collateralizes an asset-backed security; and (2) sells the asset directly or indirectly to a securitizer or issuing entity." *Id.* at 77,741.
[60] *See id.* at 77,664-65.
[61] *See id.*
[62] *See id.* at 77,665.
[63] *See id.*
[64] *See id.* at 77,664-65. This cap on originator-held risk retention applies only to an entity holding a portion of the risk retention obligation on behalf of the sponsor. In a transaction with multiple sponsors, the sponsor tasked with satisfying the risk retention obligation may hold a percentage of the risk retention obligation in excess of the percentage of the securitized assets it originated or contributed to the transaction.
[65] *See id.*
[66] *See id.*
[67] Use of a B-Piece Buyer option is only available in transactions securitized solely by commercial real estate loans and related servicing assets. *See id.* at 77,643. The Final Rule defines "commercial real estate (CRE) loan" as "(1) A loan secured by a property with five or more single family units, or by nonfarm nonresidential real property, the primary source (50% or more) of repayment for which is expected to be: (i) The proceeds of a sale, refinancing, or permanent financing of the property; or (ii) Rental income associated with the property; (2) Loans secured by improved land if the obligor owns the fee interest in the land and the land is leased to a third party who owns all improvements on the land, and the improvements are nonresidential or residential with five or more single family units; and (3) Does not include: (i) A land development and construction loan (including 1- to 4- family residential or commercial construction loans); (ii) Any other land loan; or (iii) An unsecured loan to a developer." *Id.* at 77,754-55.
[68] *See id.* at 77,644
[69] *See id.* at 77,648.

B-Piece Buyer option for its entire risk retention obligation or in combination with an EVI held by the sponsor.[70] If the sponsor transfers two EHRI interests to two separate B-Piece Buyers, the transferred interests must be *pari passu* in right of payment.[71]

Any B-Piece Buyer must perform its own due diligence services on the securitized assets and purchase and hold the EHRI in the same form and amount as would be required of the sponsor under the horizontal risk retention option.[72] A B-Piece Buyer is also subject to the transfer and hedging restrictions but, like a sponsor, may transfer the EHRI after a five year holding period so long as the transferee satisfies all requirements of a B-Piece Buyer.[73] However, if a sponsor chooses to utilize the B-Piece Buyer option, the Final Rule requires that an operating advisor be appointed for the related securitization.[74] As holder of the most subordinate claim to payment in a transaction, a B-Piece Buyer is entitled to consultation rights with respect to certain actions by the special servicer. Once the EHRI held by a B-Piece Buyer has been reduced to 25% of its original principal balance, the operating advisor will assume the B-Piece Buyer's consultation rights and act in the best interest of all investors in the securitization.

While certain CMBS sponsors have indicated their intention to satisfy the Final Rule by utilizing the B-Piece Buyer option,[75] reliance on this option has certain risks. As discussed above, the sponsor remains wholly responsible for compliance with the Final Rule, even if a B-Piece Buyer holds the entire risk retention obligation.[76] Sponsors may not wish to rely on a third party for compliance with regulations instituted by multiple federal agencies, despite any indemnification offered.[77] Additionally, the financial institutions willing to act as B-Piece Buyers have traditionally invested in below-investment grade and non-rated securities. Such securities typically represent between 2-3% of the fair value of securities issued in a transaction. As the Final Rule requires risk retention at 5% of the fair value,[78] any EHRI is likely to encompass investment-grade securities, which offer a lower interest rate. Typical B-Piece Buyers raise funds on the premise of high-risk, high-returns and may not be able to raise funds needed to purchase lower yielding interests further up the capital stack, as such purchases are much less profitable.

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[70] *See id.* at 77,644.
[71] In a situation where the risk retention obligation is satisfied by both the B-Piece Buyer (as an EHRI) and the sponsor (as an EVI), the sponsor is still required to retain an interest in each class issued, including the most subordinate class. *Id.* at 77,644. In such circumstances, the EVI would not be considered a B-Piece Buyer interest and would not prevent two additional parties from assisting to satisfy the risk retention requirements.
[72] *See id.* at 77,643-44, 77,647.
[73] *See id.* at 77,647-48.
[74] *See id.* at 77,645.
[75] *See Vertical or Horizontal? Issuers Picking Sides*, COMMERCIAL MORTGAGE ALERT, June 17, 2016, at 1, 6 (stating that at least seven issuers initially favor passing the risk retention obligation to third-party purchasers but such issuers have cautioned that any plans for risk retention remain fluid).
[76] *See id.* at 77,643-44.
[77] The penalties for non-compliance are unclear, including non-compliance by an originator or third-party purchaser, but many industry participants fear a violation of the Final Rule may result in the sponsor's inability to issue new securities.
[78] *See id.* at 77,613-14.

5. Exemption for Qualifying Commercial Real Estate Loans

The Final Rule exempts asset-backed transactions from the risk retention requirements if all or a portion of the assets securing the transaction are commercial real estate loans that satisfy specified underwriting standards ("QCRE Loans").[79] For pools comprised solely of QCRE Loans, the sponsor is not required to retain any risk retention obligation.[80] If QCRE Loans are pooled with non-qualifying assets, the sponsor may reduce its risk retention obligation by the ratio of the principal balance of the QCRE Loans to the total principal balance of all assets in the pool, up to a maximum reduction of 50% (*i.e.*, lowering the sponsor's risk retention obligation to 2.5%).[81]

Underwriting standards for QCRE Loans focus primarily on the borrower's ability to repay and valuation of the collateral. Among other requirements, a QCRE Loan must have a debt service coverage ratio of 1.7 or greater (or, in the case of certain properties with a demonstrated history of stable net operating income, 1.5 or greater (in the case of qualifying leased CRE Loans[82]) or 1.25 or greater (in the case of qualifying multi-family property loans[83])); a loan-to-value ("LTV") ratio of no more than 65% and a combined LTV ratio of no more than 70%; a minimum term of 10 years; and a maximum amortization period of 30 years for multi-family loans and 25 years for other loans.[84] In addition, the loan must be a fixed rate loan (or swapped to a fixed rate through an interest rate swap or capped with an interest rate cap) and may not be an interest-only loan or have an interest-only period.[85] Many industry participants currently believe these criteria are too conservative for the realities of the commercial mortgage market and would permit few (if any) loans to benefit from this exemption.

6. The Preserving Access to CRE Capital Act of 2016

On March 2, 2016, the U.S. House Financial Services Committee passed House Bill 4620, entitled the Preserving Access to CRE Capital Act of 2016 (the "CRE Capital Act").[86] The CRE Capital Act seeks to provide greater flexibility for CMBS sponsors to comply with the Final Rule by, among other things, permitting B-Piece Buyers to hold their interests on a senior-subordinate basis and relaxing the criteria for QCRE Loans. A senior-subordinate structure for B-Piece Buyers would allow the sponsor to attract different investors with different tolerances for risk and appetites

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[79] *See id.* at 77,679, 77,736.
[80] *See id.* at 77,736.
[81] *See id.* at 77,736.
[82] "Qualifying leased CRE loans" are defined by the Final Rule as "a CRE Loan secured by commercial nonfarm real property, other than a multi-family property or a hotel, inn, or similar property: (1) That is occupied by one or more qualified tenants pursuant to a lease agreement with a term of no less than one (1) month; and (2) Where no more than 20% of the aggregate gross revenue of the property is payable from one or more tenants who: (i) Are subject to a lease that will terminate within six months following the date of origination; or (ii) Are not qualified tenants." *Id.* at 77,755.
[83] "Qualifying multi-family loans" are defined by the Final Rule as "a CRE Loan secured by any residential property (excluding a hotel, motel, inn, hospital, nursing home, or other similar facility where dwellings are not leased to residents): (1) That consists of five or more dwelling units (including apartment buildings, condominiums, cooperatives and other similar structures) primarily for residential use; and (2) Where at least 75% of the NOI is derived from residential rents and tenant amenities (including income from parking garages, health or swim clubs, and dry cleaning), and not from other commercial uses." *Id.*
[84] *See id.* at 77,757-59.
[85] *See id.* at 77,681, 77,760.
[86] H.R. 4620, 114th Cong. § 2(1) (2016).

for yields.[87] The financial institutions that have typically acted as B-Piece Buyers could retain the most subordinate 2-3% of the capital stack (with the highest available yield), while other investors, more comfortable with investment-grade securities, could retain the remaining required retention interest. Similarly, the CRE Capital Act seeks to amend the requirements for a QCRE Loan to more realistic standards, including: (i) permitting interest-only loans; (ii) removing the mandatory minimum 10-year term; and (iii) permitting loans with longer amortization schedules.[88] While it addresses certain industry concerns regarding the Final Rule, many industry participants believe that the CRE Capital Act is unlikely to pass (let alone be implemented) prior to the effective date of the Final Rule for CMBS securitizations in December of this year. Accordingly, most sponsors are preparing for risk retention compliance as if no such amendments have been proposed.

7. The Impact of the Risk Retention Rules on CMBS Mortgage Loan Origination

As stated earlier in this article, there has been a significant slowdown in CMBS mortgage loan origination during the first two quarters of 2016 as a result of a very volatile market which was caused by, among other factors, the Final Rule effective for CMBS securitizations in December, 2016. CMBS sponsors have been working feverishly this year to develop their own strategies on how they will comply with the Final Rule and how such compliance will affect their business models. Will such sponsors retain an EVI or an EHRI? Will they enlist the help of an originator contributing assets to their securitization to assume a portion of the sponsor's risk retention obligation? Or will such sponsor opt to sell their EHRI to a B Piece Buyer? How will such sponsor monitor compliance by such originator or B Piece Buyer with the Final Rule (as the sponsor retains the liability for breaches notwithstanding such sale)? Will an indemnity by an originator or B Piece Buyer be enough to protect the sponsor as the penalties for non-compliance with the Final Rule are not clear? These are just a handful of issues and questions that sponsors of securitizations have had to consider this year while developing strategies in the face of implementation of the Final Rule. Additionally, a sponsor must now address whether its underwriting standards will tighten due to the long-term risk such sponsor has with respect to the mortgage loan assets in the pool. Recently, one CMBS lender/sponsor advised that under its lending platform with risk retention contemplated, interest-only loans would likely not be offered. Indicators suggest that underwriting standards may become more stringent; however, the costs resulting from a sponsor complying with the Final Rule which will be passed on to borrowers accessing the CMBS market for loans are still uncertain.[89] 2016 remains a transition year for the CMBS market and risk retention. Wells Fargo is scheduled to launch the first risk retention compliant securitization in July. Wells Fargo plans to satisfy its risk retention obligations as sponsor by retaining an EVI, and Morgan Stanley and Bank of America are expected to contribute mortgage loans to the Wells Fargo securitization. Participants in the CMBS market hope that this first risk retention compliant securitization (and its aftermath) will help to clarify the issues and concerns CMBS lenders and sponsors are wrestling with today. This initial securitization will hopefully enable CMBS lenders and sponsors to develop a more concrete set of underwriting standards and loan pricing models which would be available to borrowers and help lenders and

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[87] *See id.*
[88] *See id.*
[89] Some market experts advise, however, that risk retention obligations may add another 15-30 basis points to interest rate spreads.

sponsors to better understand how their long-term liability with respect to the risk retention rules, as well as the performance of the mortgage loan assets in such securitization, will affect their overall execution (and the profit realized) on each future CMBS securitization.

B. EU Bail-In Legislation

1. Background

Recent developments in European regulations enacted in order to stabilize the European Union's ("EU") banking industry have impacted the U.S. mortgage loan syndication market as well as the loan documentation used to evidence and secure such syndicated mortgage loans.

In particular, the Bank Recovery and Resolution Directive (Directive 2014/59/EU) ("BRRD"),[90] promulgated by the European Parliament and European Council on May 15, 2014, and entered into force July 2, 2014,[91] aims to synchronize the efforts of European regulators to mitigate crises at certain financial institutions. The BRRD's goal in Europe is to "preserv[e] the systemically important functions of the"[92] relevant financial institutions in crisis while "minimi[zing] the costs for taxpayers" inherent to publicly-funded bail-outs typical of the 2007-08 financial crisis.[93] These goals are advanced in part by "ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution,"[94] which the BRRD achieved by requiring all EU member states[95] to grant their applicable regulators, *by January 1, 2016*,[96] certain new powers known as the "bail-in tool."[97]

The bail-in tool granted to the applicable EU regulators consists of both the ability to recapitalize failing financial institutions[98] and the "write-down and conversion powers."[99]

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[90] Directive 2014/59, of the European Parliament and of the Council of 15 May 2014 Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. (L 173) [hereinafter BRRD], http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.
[91] *Id.* art. 131.
[92] *Id.* recital (1).
[93] *Id.* recital (5).
[94] *Id.* recital (67).
[95] Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the United Kingdom. *See EU Member Countries*, EUROPEAN UNION (June 12, 2016, 4:00 PM), http://europa.eu/about-eu/countries/member-countries/index_en.htm. As of May 30, 2016, the European Economic Area ("EEA"), which consists of all European Union member states as well as Iceland, Lichtenstein, and Norway, has not yet amended the EEA Agreement to incorporate the BRRD. *See Adopted EU Acts Marked EEA Relevant or Considered EEA Relevant by EEA EFTA Experts*, EUROPEAN FREE TRADE ASS'N (June 12, 2016, 4:00 PM), http://www.efta.int/media/documents/legal-texts/eea/other-legal-documents/list-eu-acquis-marked-or-considered-eea-relevant/weekly_list.pdf. This may change in the future, and the Bank of England's Prudential Regulation Authority is operating on "the assumption that the EEA Joint Committee will incorporate the BRRD into the EEA Agreement." BANK OF ENG. PRUDENTIAL REGULATION AUTH., IMPLEMENTING THE BANK RECOVERY AND RESOLUTION DIRECTIVE, CONSULTATION PAPER CP13/14 at 1.12 (2014), http://www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1314.pdf. Additionally, following the referendum of June 23, 2016, the United Kingdom's membership in the EU may be ended in the near future.
[96] BRRD, *supra* note 1, art. 130(1) (emphasis added).
[97] *Id.* art. 2(1) (57).
[98] *See id.* art. 43(2) (a).
[99] *Id.* art. 2(1) (66).

Through the write-down power, regulators may "reduce, including to reduce to zero, the principal amount of or outstanding amount due in respect of eligible liabilities, of an institution."[100] The conversion power confers upon the EU regulators "the power to convert eligible liabilities of an institution . . . into ordinary shares or other instruments of ownership of that institution,"[101] a parent thereof, or a "bridge institution."[102] Certain secured liabilities are not subject to the bail-in tool, alongside a few other limited exceptions.[103] For the avoidance of doubt, the aforementioned secured liabilities exception only applies to the liabilities of a covered European financial institution (*i.e.*, an obligation of such European financial institution must be fully collateralized, for example, through a hedging arrangement) and would not be applicable to a European lender participant in a customary U.S. bank syndication as the obligations of the co-lenders and the administrative agent under the loan documents for such syndicate are customarily unsecured.

Application of the bail-in tool on liabilities governed by the law of an EU member state shall be effective as a matter of law, without requiring revision of the governing contracts.[104] Otherwise, "[t]o ensure the ability to write down or convert liabilities when appropriate in third countries, recognition of that possibility should be included in the contractual provisions governed by the law of the third countries."[105] Thus, if a liability may be subject to the write-down and conversion powers and is governed by the law of a non-EU member state (such as New York law), the issuing financial institution is obligated "to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a" European financial regulator—what this paper shall refer to as the "contractual recognition clause."[106] Thus, no bank or financial institution that is part of the EU may be a participant or co-lender in a U.S. mortgage loan syndication unless the loan agreement or credit facility contains a contractual recognition clause.

2. Mandatory Requirements of the Contractual Recognition Clause

To this end, the BRRD required the European Banking Authority ("EBA") to "develop draft regulatory technical standards in order to further determine . . . the contents of the" contractual recognition clause.[107] Promulgated on July 3, 2015,[108] the draft regulatory technical

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[100] *Id.* art. 63(1) (e).
[101] *Id.* art. 63(1) (f).
[102] *Id.* A bridge institution is an entity wholly or partially owned by a public authority, which may include a regulatory authority, and created to own some or all of the converted equity of an institution in crisis. *Id.* art. 2(1) (59) & 40(2).
[103] *Id.* art. 44(2) (b).
[104] *Id.* art. 55(1) (stating that the BRRD provisions requiring contractual recognition of the bail-in tool "shall not apply where the resolution authority of a Member State determines that the liabilities or instruments . . . can be subject to write down and conversion powers by the resolution authority of a Member State pursuant to the law of the third country or to a binding agreement concluded with that third country.")
[105] *Id.* recital (78).
[106] *Id.* art. 55(1).
[107] *Id.* art. 55(3).
[108] EUROPEAN BANKING AUTH., EBA/RTS/2015/06, FINAL REPORT: DRAFT REGULATORY TECHNICAL STANDARDS ON THE CONTRACTUAL RECOGNITION OF WRITE-DOWN AND CONVERSION POWERS UNDER ARTICLE 55(3) OF DIRECTIVE 2014/59/EU (2015) [hereinafter EBA RTS], http://www.eba.europa.eu/documents/10180/1132911/EBA-RTS-2015-06+RTS+on+Contractual+Recognition+of+Bail-in.pdf.

standards "list[ed] . . . mandatory components which must be present in the [contractual recognition clause]."[109] These mandatory components are

> provisions specifying the express acknowledgement and consent of the counterparty to the application of write-down and conversion powers . . . including the reduction of the amount outstanding, including to zero; the conversion of the liability into ordinary shares or other instruments of ownership, for example of the entity under resolution, the parent undertaking or a bridge institution, and that these shares or other instruments of ownership will be accepted in lieu of rights under the relevant agreement; [and] the variation of terms in connection with the exercise of the write-down and conversion powers, for example the variation of the maturity of a debt instrument.[110]

The EBA's draft regulatory technical standards further clarified that the BRRD's contractual recognition requirement would apply not only to newly issued liabilities but also outstanding liabilities whose governing contracts "are subject to a material amendment after" the date the applicable EU member state adopted the BRRD and granted its regulator the bail-in tool (*i.e.*, January 1, 2016, at the latest).[111]

The EBA considered, but ultimately rejected, proposing form language for the contractual recognition clause, as it "may not be effective in all jurisdictions or suitable for all forms of liability falling within the scope of" those for which the BRRD requires the contractual recognition clause.[112] Accordingly, various industry associations have published their own form contractual recognition clause, including the Association for Financial Markets in Europe,[113] the Loan Market Association,[114] and the Loan Syndications and Trading Association ("LSTA").[115]

3. The LSTA Recommended Contractual Recognition Clause and the Capital Markets' Reaction

U.S. banks, insurance companies, and other financial institutions that participate in the U.S. commercial mortgage syndication market have uniformly adopted the model contractual recognition clause developed by the LSTA, as the LSTA in particular has been concerned with mitigating the effects of the contractual recognition clause on U. S. loan markets and documentation. The LSTA form contractual recognition clause is attached as Exhibit D hereto.

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[109] *Id.* 2.1.3(21).
[110] *Id.*
[111] *Id.* 2.1.2(14).
[112] *Id.* 2.1.3(20).
[113] ASS'N FOR FIN. MKTS. IN EUR., MODEL CLAUSE FOR THE CONTRACTUAL RECOGNITION OF BAIL-IN UNDER ARTICLE 55 BRRD (2015), http://www.afme.eu/documents/AFME-Model-Clause-for-the-contractual-recognition-of-bail-in/.
[114] LOAN MKT. ASS'N, THE RECOMMENDED FORM OF BAIL-IN CLAUSE AND USERS GUIDE (2016), http://www.lma.eu.com/documents_download.aspx?T=2&CID=2554 (available only to LMA subscribers).
[115] LOAN SYNDICATIONS AND TRADING ASS'N, EU BAIL-IN RULE FORM OF CONTRACTUAL RECOGNITION PROVISION LSTA VARIANT (2016), http://lsta.org/uploads/DocumentModel/1973/file/final-lsta-contractual-recognition-provision.docx.

The LSTA model provisions have been "prepared for inclusion in a New York law governed credit agreement."[116] By including a European lender that "become[s] the subject of a Bail-in Action" (as defined to include both the write-down and conversion powers of any European regulator) as a "Defaulting Lender" in the applicable loan agreement or credit facility,[117] the LSTA hopes to lessen the negative impacts of the contractual recognition clause requirements of affected European lenders in a syndicated commercial loan in the United States.[118] The write-down and conversion powers granted have the potential to negatively affect the agent and co-lenders in a bank syndicate as well as the borrower under the loan agreement or credit facility. However, any European lender in the syndicate that becomes the subject of a Bail-in Action is deemed to be in default or a "Defaulting Lender," which would then subject such European lender to the remedies and/or restrictions applicable to Defaulting Lenders, including, without limitation, such European lender's loss of consent, approval, and voting rights as a co-lender in the syndicate and the subordination of such European lender's right to payments made by borrowers if such default by such European lender involved a default in its obligation to make an advance or a protective advance pursuant to the loan agreement or credit facility.

The U.S. mortgage loan syndication market has, by and large, initially accepted the contractual recognition clause (with the corresponding Defaulting Lender provisions), as the desire to continue including European lenders as co-lenders in the U. S. syndication market far outweighs any of the potential impacts or concerns with respect to the contractual recognition clause. The continued liquidity of syndicated mortgage loans is significantly more important to both lenders and borrowers that participate in and access this market than the remote risk that a European lender may be subsequently subject either to the write-down or conversion powers of European regulators. In order to further mitigate against the exercise of a Bail-in Action by a European regulator against a European lender in a U.S. syndicate, the agent and the other co-lenders may consider including a requirement that all lenders meet a financial test (such as a total asset, net worth, and/or liquidity test) as a condition precedent to being a "Lender" under the loan agreement or credit facility. This would prevent less capitalized European financial institutions—which are more susceptible to either a write-down or a conversion—from participating in a U. S. mortgage loan syndication. The BRRD still remains novel in 2016, but the U.S. mortgage loan syndication market seems to have digested the breadth and impact of the bail-in tool granted to European regulators; however, the full ramifications remain to be discovered when the first European lender is subject to a Bail-in Action while participating in a U.S. bank syndicate for a commercial mortgage financing.

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[116] *Id.* at 1 n.1.
[117] *Id.* at 3.
[118] *Id.*

EXHIBIT A

Insert from Mortgage/Senior Mezzanine/Junior Mezzanine Intercreditor Agreement

(_) Notwithstanding anything to the contrary contained in this Agreement, and in addition to and without in any way limiting, constituting a waiver of or otherwise affecting the rights and remedies of Senior Lender and, if applicable, Senior Junior Lender resulting from or the effect of any default under or non-compliance or failure to satisfy the applicable conditions of Section 5 **[which sets forth the obligation of the mezzanine lender to deliver a replacement recourse carve-out guaranty and environmental indemnity on a Realization Event]** or any other provision of this Agreement, if a Junior Lender exercises any rights or remedies in respect to its Equity Collateral (including consenting or agreeing to a transfer of its Equity Collateral in lieu of exercising any such remedies or deeming such transfer *void ab initio*) as a result of which title to the Equity Collateral (or any portion thereof) is transferred to any Person or any other Realization Event with respect to such Junior Lender's Equity Collateral shall occur without Junior Lender having complied with the provisions of this Section 5 (such transfer, an "Impermissible Equity Collateral Transfer"), then, effective automatically and immediately upon such Impermissible Equity Collateral Transfer, the Deemed Replacement Guarantor shall be deemed to have assumed all obligations and liabilities of the guarantor under the Senior Loan Guaranty Agreements and, if applicable, the Senior Junior Loan Guaranty Agreements (with respect to such obligations and liabilities arising as a result of or from and after such Impermissible Equity Collateral Transfer) as if the Deemed Replacement Guarantor had been the party that originally executed and delivered the Senior Loan Guaranty Agreements (and, if applicable, the Senior Junior Loan Guaranty Agreements) as the guarantor(s) thereunder. Such assumption shall be fully effective notwithstanding (i) that the original guarantor(s) under the Senior Loan Guaranty Agreements and, if applicable, the Senior Junior Loan Guaranty Agreements, may or may not be released from liability under the Senior Loan Guaranty Agreements or the Senior Junior Loan Guaranty Agreements, as and, if applicable, as a result of such Impermissible Equity Collateral Transfer, and/or (ii) that the Deemed Replacement Guarantor may not have participated in the Impermissible Equity Collateral Transfer (*e.g.*, due to the Deemed Replacement Guarantor having previously Transferred its interest in the Junior Loan in breach of this Agreement or otherwise). For avoidance of doubt, a Deemed Replacement Guarantor shall have no liability as a Deemed Replacement Guarantor for acts committed by any other Guarantor under the Senior Loan Documents or Junior Loan Documents, as applicable.

"**Deemed Replacement Guarantor**" means, (i) with respect to (x) Transfers of interests in the First Mezzanine Loan or (y) a Realization Event in respect of the Equity Collateral pledged pursuant to the First Mezzanine Pledge Agreement, the Original First Mezzanine Lender and (ii) with respect to (x) Transfers of interests in the Second Mezzanine Loan or (y) a Realization Event in respect of the Equity Collateral pledged pursuant to the Second Mezzanine Pledge Agreement, the Original Second Mezzanine Lender, provided that upon the execution and delivery of a Replacement Guarantor Acknowledgement by a Qualified Guarantor, delivered to Senior Lender and, if applicable, Senior Junior Lender, pursuant to and in accordance with Section 4(c), such Qualified Guarantor shall automatically become a Deemed Replacement Guarantor. For the avoidance of doubt, if there shall be more than one Deemed Replacement Guarantor under any Senior Loan Guaranty Agreement, the liability of each such Guarantor thereunder shall be joint

and several, and, if there is more than one Deemed Replacement Guarantor under the Senior Junior Guaranty Agreements, the liability of each such Guarantor thereunder shall be joint and several.

EXHIBIT B

"**Qualified Transferee**" means (i) [**Mezzanine Lender],** or (ii) one or more of the following:

(A) a real estate investment trust, bank, saving and loan association, investment bank, insurance company, trust company, commercial credit corporation, pension plan, pension fund or pension advisory firm, mutual fund, sovereign fund, government entity or plan that satisfies the Eligibility Requirements;

(B) an investment company, money management firm or "qualified institutional buyer" within the meaning of Rule 144A under the Securities Act of 1933, as amended, or an institutional "accredited investor" within the meaning of Regulation D under the Securities Act of 1933, as amended, that, in any case, satisfies the Eligibility Requirements;

(C) an institution substantially similar to any of the foregoing entities described in clauses (ii) (A) or (B) that satisfies the Eligibility Requirements;

(D) any entity Controlled by, Controlling or under common control with any of the entities described in clause (i) or clauses (ii)(A), (B), (C) or (E) of this definition;

(E) an investment fund, limited liability company, limited partnership or general partnership where a Permitted Fund Manager or an entity that is otherwise a Qualified Transferee under clauses (iii)(A), (B), (C) or (D) of this definition acts as the general partner, managing member or fund manager and at least 50% of the equity interests in such investment vehicle are owned, directly or indirectly, by one or more entities that are otherwise Qualified Transferees under clauses (ii)(A), (B), (C) or (D) of this definition; or

(F) a Qualified Trustee (or, in the case of collateralized debt obligations ("CDO"), a single-purpose bankruptcy-remote entity which contemporaneously assigns or pledges its interest in the Mezzanine Loan to a Qualified Trustee) in connection with (aa) a securitization of, (bb) the creation of a CDO secured by, or (cc) a financing through an "owner trust" of, the Mezzanine Loan (any of the foregoing, a "Securitization Vehicle"), provided that (1) one (1) or more classes of securities issued by such Securitization Vehicle is initially rated at least investment grade by each of the Rating Agencies that was chosen to assign and did assign a rating to one or more classes of securities issued in connection with a Securitization; (2) in the case of a Securitization Vehicle that is not a CDO, the special servicer of such Securitization Vehicle has a Required Special Servicer Rating at the time of Transfer and the related transaction documents for such Securitization Vehicle require that any successor have a Required Special Servicer Rating (such entity, an "Approved Servicer") and such Approved Servicer is required to service and administer the Mezzanine Loan or any portion thereof or interest therein in accordance with servicing arrangements for the assets held by the Securitization Vehicle that require such Approved Servicer to act in accordance with a servicing standard notwithstanding any contrary direction or instruction from any other Person; or (3) in the case of a Securitization Vehicle that is a CDO, the CDO Asset Manager (and, if applicable, each Intervening Trust Vehicle that is not administered and managed by a Qualified Trustee or a CDO Asset Manager that is a Qualified Transferee) is a Qualified Transferee under clauses (ii), (A), (B), (C), (D), or (E) of this definition.

Notwithstanding the foregoing, no Person shall be (or be deemed to be) a Qualified Transferee if (i) such Person is the subject of any Proceeding, (ii) such Person is a Prohibited Person or (iii) such Person is Borrower or Mezzanine Borrower, or any Broad Affiliate of Borrower or Mezzanine Borrower.

"**Eligibility Requirements**" means, with respect to any Person, that such Person (i) has total assets (in name or under management) in excess of $[**600,000,000] [TO ADJUST ON DEAL-BY-DEAL BASIS]** and (except with respect to a pension advisory firm, asset manager or similar fiduciary) capital/statutory surplus or shareholder's equity of **$[250,000,000][TO ADJUST ON DEAL-BY-DEAL BASIS]** and (ii) is regularly engaged in the business of making or owning (or, in the case of a pension advisory firm, asset manager or similar fiduciary, regularly engaged in managing or advising investments in) commercial real estate loans (including mezzanine loans to direct or indirect owners of commercial properties, which loans are secured by pledges of direct or indirect ownership interest in the owners of such commercial properties) or operating commercial mortgage properties.

"**Prohibited Person**" means any Person: (a) listed in the annex to, or who is otherwise subject to the provisions of, Executive Order No. 13224 on Terrorist Financing, effective September 24, 2001, and relating to Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism (the "Executive Order"); (b) that is owned or controlled by, or acting for or on behalf of, any Person that is listed in the annex to, or is otherwise subject to the provisions of, the Executive Order; (c) with whom a Person is prohibited from dealing or otherwise engaging in any transaction by any terrorism or money laundering law, including the Executive Order; (d) who commits, threatens or conspires to commit or supports "terrorism" as defined in the Executive Order; (e) that is named as a "specially designated national and blocked person" on the most current list published by the U.S. Treasury Department Office of Foreign Assets Control at its official website or at any replacement website or other replacement official publication of such list; or (f) who is an Affiliate of any Person listed in clauses (a) through (e) above.

"**Qualified Trustee**" means (i) a corporation, national bank, national banking association or a trust company, organized and doing business under the laws of any state or the United States of America, authorized under such laws to exercise corporate trust powers and to accept the trust conferred, having a combined capital and surplus of at least $[100,000,000] and subject to supervision or examination by federal or state authority, (ii) an institution insured by the Federal Deposit Insurance Corporation, or (iii) an institution whose long-term senior unsecured debt is rated either of the then in effect top two rating categories of S&P and Moody's and each of the other Rating Agencies.

"**Required Special Servicer Rating**" means, with respect to a special servicer, (i) in the case of S&P, that such special servicer is on S&P's select servicer list as a "U. S. Commercial Mortgage Special Servicer", (ii) in the case of Moody's, that such special servicer is acting as special servicer in a commercial mortgage loan securitization that was rated by Moody's within the twelve (12) month period prior to the date of determination and Moody's has not downgraded or withdrawn the then current rating on any class of commercial mortgage securities or placed any class of commercial mortgage securities on watch citing the continuation of such special servicer as special servicer of such commercial mortgage securities as the reason for such downgrade or

withdrawal, (iii) in the case of Morningstar, that such special servicer is acting as special servicer in a commercial mortgage loan securitization that was rated by a Rating Agency within the twelve (12) month period prior to the date of determination, and Morningstar has not downgraded or withdrawn the then-current rating on any class of commercial mortgage securities or placed any class of commercial mortgage securities on watch citing the continuation of such special servicer as special servicer of such commercial mortgage securities, and (iv) in the case of Fitch, a special servicer rating of at least "CSS2." The requirement of any rating agency that is not a Rating Agency shall be disregarded.

EXHIBIT C

A provision some portfolio lenders/insurance companies may require as a qualifier to the definition of Qualified Transferee may include one of the following:

1. Such Qualified Transferee shall be a "Customer in Good Standing."

"**Customer In Good Standing**" means a Person (A)(i) which is, at the time of the proposed Transfer, directly (or indirectly through a Person that is Controlled or Controls) a customer of Senior Lender and/or any Affiliate thereof, (ii) which is not and has not been the subject of (1) a Proceeding, or (2) a workout or restructuring on account of its obligations and liabilities to Senior Lender and/or such Affiliate thereof; provided, however, the provisions of the foregoing subclause (2) shall not apply to any Person if Senior Lender, acting in good faith, has determined that notwithstanding such workout or restructuring such Person resolved its obligations to Senior Lender and/or such Affiliate on terms and conditions reasonably satisfactory to Senior Lender and/or such Affiliate, and during such workout or restructuring, such Person did not commence a lawsuit or any other action (including pursuant to a counterclaim or otherwise) against Senior Lender and/or Affiliate in connection with such workout or restructuring, (iii) which has not otherwise commenced, or been a participant in, any litigation or other action against Senior Lender and/or such Affiliate thereof and (iv) which otherwise paid and performed all of its obligations and liabilities to Senior Lender and/or such Affiliate thereof in accordance with the respective terms thereof or otherwise as approved by Senior Lender and/or such Affiliate, or (B)(i) which is not, at the time of the proposed Transfer, a customer of Senior Lender either directly or indirectly through a Person that it Controlled or Controls, but which otherwise satisfies all of the conditions set forth in clause (A)(ii)-(iv) above with respect to each secondary market lender to which such Person is, or has been, a customer, and (ii) for which Senior Lender has obtained, at Mezzanine Lender's sole cost and expense, credit, tax, judgment, litigation, Uniform Commercial Code, bankruptcy, OFAC (as defined in the Senior Loan Agreement) and Patriot Act (as defined in the Senior Loan Agreement) searches, all of the foregoing (as to both (A) and (B)) as determined by Senior Lender in its commercially reasonable discretion.

[OR]

2. Such Qualified Transferee shall not be a "Controversial Person."

"**Controversial Person**" means a Person, or any Affiliate of such Person, that in the past five (5) years, has been the subject of two (2) or more Controversial Person Litigations; provided, however, no Controversial Person Litigation shall be counted in determining whether a Person is a Controversial Person if since final resolution of such Controversial Person Litigation the lender in such Controversial Person Litigation has resumed lending to such Person.

"**Controversial Person Litigation**" means (i) litigation commenced by a lender of the type described in the definition of "Qualified Transferee" (without regard to the Eligibility Requirements) against any Person alleging that such Person (x) failed to repay or failed to make required payments in respect of a commercial real estate loan or (y) breached or violated any covenants in commercial mortgage loan documents or commercial mezzanine loan documents covered by non-recourse carve out provisions of the type included in Section 18 of the Senior

Notes, and in the case of either (x) or (y), (A) such Person contested such litigation and (B) a court of competent jurisdiction ruled in favor of such lender with regard to such allegation or the parties to the litigation settled the litigation pursuant to a settlement in which such Person acknowledged that such Person had failed to repay or failed to make such required payments or had breached or violated any such loan covenants, or (ii) litigation that is commenced by any Person against any such lender alleging that such lender breached or violated any provision of commercial mortgage loan documents or commercial mezzanine loan documents, and a court of competent jurisdiction ruled in favor of such lender with regard to such allegation or in respect of which the parties to the litigation settled the litigation substantially in favor of such lender with regard to such allegation

EXHIBIT D

EU Bail-In Rule

Form of Contractual Recognition Provision

Recommended by LSTA for Inclusion in Applicable

Loan Agreement or Credit Facility

Acknowledgement and Consent to Bail-In of EEA Financial Institutions. Notwithstanding anything to the contrary in any Loan Document or in any other agreement, arrangement or understanding among any such parties, each party hereto acknowledges that any liability of any EEA Financial Institution arising under any Loan Document, to the extent such liability is unsecured, may be subject to the write-down and conversion powers of an EEA Resolution Authority and agrees and consents to, and acknowledges and agrees to be bound by:

(a) the application of any Write-Down and Conversion Powers by an EEA Resolution Authority to any such liabilities arising hereunder which may be payable to it by any party hereto that is an EEA Financial Institution; and

(b) the effects of any Bail-in Action on any such liability, including, if applicable:

(i) a reduction in full or in part or cancellation of any such liability;

(ii) a conversion of all, or a portion of, such liability into shares or other instruments of ownership in such EEA Financial Institution, its parent undertaking, or a bridge institution that may be issued to it or otherwise conferred on it, and that such shares or other instruments of ownership will be accepted by it in lieu of any rights with respect to any such liability under this Agreement or any other Loan Document; or

(iii) the variation of the terms of such liability in connection with the exercise of the write-down and conversion powers of any EEA Resolution Authority.

"**Bail-In Action**" means the exercise of any Write-Down and Conversion Powers by the applicable EEA Resolution Authority in respect of any liability of an EEA Financial Institution.

"**Bail-In Legislation**" means, with respect to any EEA Member Country implementing Article 55 of Directive 2014/59/EU of the European Parliament and of the Council of the European Union, the implementing law for such EEA Member Country from time to time which is described in the EU Bail-In Legislation Schedule.

"**EEA Financial Institution**" means (a) any credit institution or investment firm established in any EEA Member Country which is subject to the supervision of an EEA Resolution Authority, (b) any entity established in an EEA Member Country which is a parent of an institution described in clause (a) of this definition, or (c) any financial institution established in an EEA

Member Country which is a subsidiary of an institution described in clauses (a) or (b) of this definition and is subject to consolidated supervision with its parent;

"**EEA Member Country**" means any of the member states of the European Union, Iceland, Liechtenstein, and Norway.

"**EEA Resolution Authority**" means any public administrative authority or any person entrusted with public administrative authority of any EEA Member Country (including any delegee) having responsibility for the resolution of any EEA Financial Institution.

"**EU Bail-In Legislation Schedule**" means the EU Bail-In Legislation Schedule published by the Loan Market Association (or any successor person), as in effect from time to time.

"**Write-Down and Conversion Powers**" means, with respect to any EEA Resolution Authority, the write-down and conversion powers of such EEA Resolution Authority from time to time under the Bail-In Legislation for the applicable EEA Member Country, which write-down and conversion powers are described in the EU Bail-In Legislation Schedule.

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"**Defaulting Lender**" means, subject to Section [*Defaulting Lender Cure*], any Lender that (a) has failed to (i) fund all or any portion of its Loans within two Business Days of the date such Loans were required to be funded hereunder unless such Lender notifies the Administrative Agent and the Borrower in writing that such failure is the result of such Lender's determination that one or more conditions precedent to funding (each of which conditions precedent, together with any applicable default, shall be specifically identified in such writing) has not been satisfied, or (ii) pay to the Administrative Agent, any Issuing Bank, any Swingline Lender or any other Lender any other amount required to be paid by it hereunder (including in respect of its participation in Letters of Credit or Swingline Loans) within two Business Days of the date when due, (b) has notified the Borrower, the Administrative Agent or any Issuing Bank or Swingline Lender in writing that it does not intend to comply with its funding obligations hereunder, or has made a public statement to that effect (unless such writing or public statement relates to such Lender's obligation to fund a Loan hereunder and states that such position is based on such Lender's determination that a condition precedent to funding (which condition precedent, together with any applicable default, shall be specifically identified in such writing or public statement) cannot be satisfied), (c) has failed, within three Business Days after written request by the Administrative Agent or the Borrower, to confirm in writing to the Administrative Agent and the Borrower that it will comply with its prospective funding obligations hereunder (provided that such Lender shall cease to be a Defaulting Lender pursuant to this clause (c) upon receipt of such written confirmation by the Administrative Agent and the Borrower), or (d) has, or has a direct or indirect parent company that has, (i) become the subject of a proceeding under any Debtor Relief Law, (ii) had appointed for it a receiver, custodian, conservator, trustee, administrator, assignee for the benefit of creditors or similar Person charged with reorganization or liquidation of its business or assets, including the Federal Deposit Insurance Corporation or any other state or federal regulatory authority acting in such a capacity, or (iii) become the subject of a Bail-in Action; provided that a Lender shall not be a Defaulting Lender solely by virtue of the ownership or acquisition of any equity interest in that Lender or any direct or indirect parent company thereof by a Governmental Authority so long as such ownership interest does not result in or provide such Lender with immunity from the

jurisdiction of courts within the United States or from the enforcement of judgments or writs of attachment on its assets or permit such Lender (or such Governmental Authority) to reject, repudiate, disavow or disaffirm any contracts or agreements made with such Lender. Any determination by the Administrative Agent that a Lender is a Defaulting Lender under any one or more of clauses (a) through (d) above shall be conclusive and binding absent manifest error, and such Lender shall be deemed to be a Defaulting Lender (subject to Section [*Defaulting Lender Cure*]) upon delivery of written notice of such determination to the Borrower, each Issuing Bank, each Swingline Lender and each Lender.

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Reallocation of Participations to Reduce Fronting Exposure. All or any part of such Defaulting Lender's participation in L/C Obligations and Swingline Loans shall be reallocated among the Non-Defaulting Lenders in accordance with their respective Applicable Percentages (calculated without regard to such Defaulting Lender's Commitment) but only to the extent that such reallocation does not cause the aggregate Revolving Credit Exposure of any Non-Defaulting Lender to exceed such Non-Defaulting Lender's Revolving Credit Commitment. Subject to Section [*Acknowledgment and Consent to EEA Financial Institution Bail-In*], no reallocation hereunder shall constitute a waiver or release of any claim of any party hereunder against a Defaulting Lender arising from that Lender having become a Defaulting Lender, including any claim of a Non-Defaulting Lender as a result of such Non-Defaulting Lender's increased exposure following such reallocation.