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Detective, Liaison, Manager, Psychologist – Acting as the Agent in a Distressed Syndicated Real Estate Loan

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Introduction

The current liquidity crisis in the credit markets is likely to continue unabated for some time. For commercial real estate assets, declining rents and rising vacancies are adding pressure to an already difficult situation. As a consequence, more and more borrowers of syndicated real estate loans will be unable to refinance or repay such loans upon maturity. A significant wave of loan defaults and loan restructurings will soon hit the marketplace and, barring successful loan restructurings, the likely result will be bankruptcies of borrowers and guarantors or the exercise of remedies by administrative agents on behalf of lending syndicates. The administrative agent in a syndicated loan plays a leading role in the workout process. While trying to coordinate a successful restructuring of the loan to maximize recoveries to the lending group, the agent must navigate, juggle and attempt to resolve the competing demands of: (i) the borrower vis-à-vis the syndicate lenders, (ii) individual lenders vis-à-vis the other syndicate lenders, (iii) the agent vis-à-vis the syndicate lenders, and (iv) the syndicate lenders vis-à-vis third parties (such as other creditors of the borrower and its affiliates). In doing so, the agent must be cognizant of protecting itself from potential liability to the borrower and to syndicate lenders. It is an apt time to revisit the role of the agent in distressed syndicated loans and to provide some practical measures the agent may adopt to promote and manage an amicable workout process (to the extent there can be one) and mitigate its exposure to potential claims.

Role, Authority and Exposure of the Agent

In general terms, the role of an administrative agent in a syndicated loan is to communicate with the borrower on a day-to-day basis and to perform the ministerial tasks associated with the loan for the benefit of the syndicate lenders. These tasks include loan servicing-type functions such as monitoring the borrower's compliance with its reporting obligations under the loan documents, collecting loan payments and distributing them to the lenders, granting approvals and consents to the borrower in appropriate circumstances (with the consent of some or all of the lenders, as and to the extent provided in the loan documents) and holding any collateral for the benefit of the lenders. When a loan is not performing, the agent will usually also be responsible for sending default notices to the borrower and any

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guarantors, guiding the syndicate of lenders through the workout process, liaising with the borrower in connection with any proposed restructuring of the loan (whether inside or outside of a bankruptcy), and exercising remedies under the loan documents.

Before the agent enters into any workout discussions or exercises any remedies on behalf of the syndicate lenders it is important for the agent to assess the exact nature and scope of its duties and the protections written into the loan agreement that limit the agent's liability. If the agent acts outside of the scope of its authority, in addition to exposing itself to potential liability to the syndicate lenders and the borrower, the agent could expose itself to potential claims of third parties. The courts have taken a literal approach and have held that the express terms of the agent's appointment in the loan agreement or credit agreement govern and define the agent's duties and scope of authority. Well-drafted loan agreements will often (i) disclaim a fiduciary relationship between the agent and the members of the lending syndicate, (ii) provide that the agent owes no duties to the syndicate lenders except as expressly provided in the loan documents and (iii) clearly define which approvals, consents, amendments and waivers require the approval of all the syndicate lenders versus the "Required Lenders" (often defined as syndicate lenders holding more than 50% of the lending commitments) and, alternatively, which approvals, consents, amendments and waivers, if any, are left to the discretion of the agent.

The agent must also understand the standard of care it is obligated to follow and any protections that indemnification provisions may provide. Liability only in the event of "gross negligence or willful misconduct" is the market standard in syndicated loans. A well-drafted loan agreement will provide a standard of liability such that the agent will only be exposed to potential liability to syndicate lenders for its own gross negligence or willful misconduct and not for simple negligence or a breach of contract that does not rise to the level of gross negligence or willful misconduct. This is important because no agent would want to be in a position where it incurs liability by reason of a mere oversight in the administration of the loan. Also, it is quite customary for the agent to be indemnified by the syndicate lenders (to the extent not reimbursed by the borrower) for any liability incurred by the agent in connection with administering the loan, except to the extent caused by the agent's gross negligence or willful misconduct.

Lastly, a well-drafted loan agreement will contain a number of ancillary but related provisions which protect the agent in the carrying out of its duties. These provisions include acknowledgements from the syndicate lenders that:

1. The agent is not liable for the actions or omissions of third parties (including for any signatures of such parties that have been forged),
2. The agent may act in good faith on the advice of legal counsel, accountants and other experts without being liable to the syndicate lenders,
3. Tthe agent may act or refrain from acting on the direction of the Required Lenders without being liable to the syndicate lenders,
4. The agent may act in its capacity as a syndicate lender and engage in other business dealings with the borrower and its affiliates, and
5. The syndicate lenders have performed their own credit analyses and made their own credit decisions to enter into the loan and have not relied on the agent in this regard.

If the agent is concerned that any of the protective provisions discussed above are absent or deficient, the agent may always approach the syndicate lenders to request an amendment to these provisions. In fact, it is not unusual for loan agreements to provide that these provisions are capable of amendment without the borrower's approval following the unanimous approval

of the syndicate lenders. Any such requests are best made very early in the process, however, because syndicate lenders as less likely to agree to changes which benefit the agent as a loan workout unfolds. This is particularly true given that the agent and its counsel typically drafted the loan agreement in the first place. If the agent's request is declined and the agent is not comfortable continuing in the role as the loan becomes more troubled, which is a time when the agent's risk of liability increases, then it may, as a last resort and if permitted by the loan agreement, resign as the agent or substitute a collective group of "co-agents" to make most or all of the decisions. The loan agreement will provide what right, if any, the agent has to resign or substitute "co-agents".

Lender-Related Issues

Once the loan approaches default or is in default, the agent assumes responsibility for:

1. Sending any default notices and related correspondence to the borrower and responding to the inevitable letters the borrower may send to the agent or the lenders in response,
2. Commencing the workout process (typically by entering into a pre-negotiation agreement with the borrower to preserve the status quo while workout discussions take place) and guiding the syndicate lenders through all restructuring negotiations with the borrower,
3. Exercising remedies on behalf of the lenders under the mortgage and other collateral documents, which may proceed on a parallel course with workout discussions,
4. Seeking lender approvals when required or where prudent,
5. Representing the syndicate lenders in any discussions with or demands made on any mezzanine lenders or other creditors of the borrower or its affiliates,
6. Navigating a maze of differing lender strategic priorities and attempting to establish consensus among the syndicate lenders to enact a reasonable workout plan, and
7. Identifying and diffusing any actual or perceived conflicts of interest.

Directing the Workout Process

Once a loan default appears inevitable or a default under the loan documents has occurred, the agent will be charged with leading the syndicate lenders through the workout process and providing them with status reports and other relevant information on a timely basis. Where the syndicate involves foreign lenders or other lenders who may not be familiar with troubled loans in the applicable market, the agent may as a practical matter also be charged with educating such lenders on the state of the market, the steps to be followed when implementing a workout, the legal framework, procedures and timing applicable to the enforcement of remedies under the loan documents, and the likelihood of possible outcomes. This can require a substantial time commitment by the agent and the retention of experienced legal counsel.

By providing the syndicate lenders with regular updates on the financial condition of the borrower (to the extent such information is available), the status of workout negotiations and the progress of any parallel exercise of remedies, the agent will enfranchise the syndicate lenders in the process. But more important, the agent must remember that enfranchisement for the syndicate lenders necessarily includes an opportunity to be heard and to provide input and direction to the agent as the workout proceeds. Establishing an ongoing, productive dialogue among the lenders early in the process will pay off in the long run as the syndicate lenders will be in a

better position to consider, understand and accept any proposed workout solutions.

Time is Money

Time management is critical in workouts. Delays lead to additional costs being expended by all parties concerned and may adversely affect the value of the underlying collateral or the dollar amounts that can be recovered. Accordingly, the agent should create a timeline of all steps in the workout process that includes clearly defined dates for any significant milestone and actions. The timeline should anticipate and build in additional time for unknown contingencies and should be updated from time to time as the workout progresses. With a timeline in hand, syndicate lenders will be better equipped to appear before their credit committees to answer questions and obtain the internal approvals necessary to agree to any workout.

In the case of distressed loans that are part of a more complex multi-layered debt "capital stack", [1] the agent, borrower and syndicate lenders must also consider and anticipate the rights of other parties in the capital stack (such as mezzanine lenders) to be involved in the workout process. Intercreditor agreements typically provide mezzanine lenders not only with the right to cure events of default under the senior mortgage loan, but also with the right to buy out the senior loan prior to consummation of any mortgage foreclosure. The mezzanine lenders may also have approval rights over maturity date extensions or other material changes to the mortgage loan documents. The agent should factor into the timeline any such rights and account for their potential impact on the expected progression of the workout.

Lender Approvals

The loan agreement should define what approvals, consents, amendments and waivers require the approval of the syndicate lenders. Generally, the loan agreement provides for three levels of lender approval: (i) all lenders; (ii) Required Lenders; and (iii) circumstances where no lender approval is required (i.e., where the agent may act alone). In addition, circumstances may arise as to which it is not clear if any lender approval is required.

It is usual (other than in the case of certain construction covenants) for any waiver or amendment of loan party covenants to require the approval of at least the Required Lenders. It is also usual for the agent to be obligated to act at the direction of at least the Required Lenders when exercising remedies under the loan documents. Additionally, any extension of the maturity date, modification of key economic terms (such as the interest rate or payment terms), release of collateral or release of a guarantor will typically require the unanimous approval of all syndicate lenders.

When the loan agreement does not explicitly address whether a given matter requires lender approval or if the agent is uncertain as to whether lender approval is required, the agent may, nonetheless, find it prudent to seek the approval of the Required Lenders. As indicated above, a well-drafted loan agreement will provide that the agent may act or refrain from acting on the direction of the Required Lenders without incurring liability to the lenders. But there is nothing preventing an agent from seeking the direction of the Required Lenders if it is not comfortable exercising its discretion, particularly if the matter goes to the crux of the loan (such as the fundamental economic terms or the preservation of collateral). On the other hand, approaching the Required Lenders on every decision of any significance relating to the workout will likely result in costly delays in reaching consensus and implementing a workout plan. Moreover, individual syndicate lenders that have not fared well in the current economic environment may have difficulty obtaining even routine approvals in a timely manner (or at all). Thus, the agent should strive to strike a reasonable balance in determining when to seek approvals from the syndicate lenders.

The issue of lender approval is also relevant when the troubled loan is part of a more complex capital structure and the loan documents include one or more intercreditor agreements that require lender approvals at multiple levels for various types of action. Here, the agent must be particularly aware of the lender approvals required under the intercreditor agreements because the borrower, who is often not a party to the intercreditor agreements, cannot necessarily ascertain that for itself. In the context of a distressed loan that is part of a larger debt structure, the agent must seek out, obtain and review all relevant loan documents, including side letters with syndicate lenders, and all intercreditor agreements, so that it may adequately assess the web of approval rights within which it must operate.

Identifying Divergent Lender Interests and Building Consensus

Individual lenders in a syndicate often have different (and sometimes conflicting) agendas, priorities and concerns that are based on their historical and current business relationships with the borrower and its affiliates, their relative exposures to the borrower and its affiliates across different credit facilities, their lending and workout philosophy, their current financial condition, and their personal experiences with other distressed loans. A lender's individual concerns and priorities will affect its decision-making process in a workout context and invariably complicate the workout process if they conflict with the concerns and priorities of its co-lenders.

This complexity presents a challenge for both the agent and the syndicate lenders. For example, an agent might face a scenario whereby a troubled borrower approaches it with a workout proposal requiring unanimous lender consent that appears to be a well-reasoned, win-win solution for all parties only to have the proposal rejected by one or two syndicate lenders who determine that the proposal is contrary to their own interests. To reach consensus, the agent may encourage the borrower to communicate directly with the recalcitrant lenders. Further, the agent may meet with the syndicate lenders to:

1. Review current market conditions, the borrower's financial status and the available legal remedies,
2. Encourage each syndicate lender to be open with the agent and the other syndicate lenders regarding its other lending relationships with the borrower and its affiliates, if any, and
3. Seek common ground with respect to the workout proposal, or, in the alternative, determine that no common ground exists.

As to item 3, many agents will as a standard practice form a steering committee of the largest lenders in the syndicate. If no unanimous agreement can be reached on an otherwise acceptable workout proposal, the steering committee may orchestrate a lender or borrower funded buy-out of the dissenting lenders (often at a discount to face value). That said, a buy-out is an extreme measure that is pursued only in dire circumstances, as buy-outs tend to pit lenders against one another rather than keeping them focused on advancing the workout for the benefit of the collective whole. Further, any buy-out funded by the borrower may be prohibited by the terms of the loan agreement (if it contains standard pro rata sharing provisions) absent an amendment approved by the Required Lenders or all the syndicate lenders.

Developing a clear understanding of each syndicate lender's individual interests in the context of a workout is crucial for the agent to successfully guide the lender syndicate through the restructuring process. By identifying the motivating factors for each syndicate lender, the agent is empowered to find or fashion common ground among the syndicate lenders more readily or, otherwise, to more quickly and economically recognize that no consensus can be reached.

Conflicts of Interest

Conflicts of interest may arise between individual syndicate lenders or between the agent, on the one hand, and the syndicate lenders, on the other hand. Conflicts of interest, whether actual or perceived, may prolong and increase the cost of restructuring negotiations, and conflicts involving the agent may expose the agent to potential claims.

Standard "relationship-based" lending, which often results in a lender making multiple loans to an individual sponsor and its affiliates, can also lead to potential conflicts of interest on individual loan positions (e.g., where the exercise of remedies on one mortgage loan may adversely affect a separate loan due to cross-default provisions, financial covenant triggers or otherwise). However, as stated above, a well-drafted loan agreement will expressly permit the lenders and the agent to engage in other business dealings with the borrower and its affiliates.

Conflicts typically arise where a lender or the agent has additional or different exposures from the lending syndicate as a whole. To take a common example, the agent alone may have provided a hedge product to the borrower. In a defaulted loan context, a conflict could exist between the agent and the syndicate lenders because the agent, as the hedge provider, may be owed termination payments by the borrower and the other members of the lending syndicate do not share in that exposure. Another common example involves lenders who participate at multiple levels of a borrower's capital stack. As compared to other lenders with debt exposures at an individual level in the same capital stack, the lender holding exposures at multiple levels (whether senior or subordinated) may be perceived to have conflicting interests – assuming the lender desires to maximize its overall recoveries.

In the case of actual or perceived conflicts of interest among individual syndicate lenders, the agent should attempt to build consensus wherever possible and should take steps to create group dynamics that will facilitate the building of consensus. Appropriate steps will vary depending on the nature of the conflict, the personalities of the bankers and the agendas of their institutions. In the case of an actual or perceived conflict of interest involving the agent itself, the agent should take steps to conduct itself in a manner that is beyond reproach. This may involve establishing separate teams of bankers or advisors to handle conflicting exposures to the same borrower and otherwise acting to guard against any internal pressures that could interfere with its goals as agent. Those goals are to maximize recoveries for the syndicate lenders while minimizing any potential claims by the borrower or third parties against the syndicate lenders. In the case of an extreme conflict that cannot be resolved, the agent may offer to resign its position as agent or substitute a collective group of "co-agents" to lead the workout negotiations to the extent permitted by the loan documents. Such extraordinary measures can often be avoided, however, if the agent is attuned to the psychology of the lending group and operates at all times in an above-board fashion.

Borrower-Related Issues

In addition to the various lender-related issues that an agent must navigate and manage, distressed loans also implicate a series of separate borrower-related issues that an agent may be required to address. As engaging and distracting as inter-lender issues may be, the agent's handling of the borrower can make or break a workout. It is impossible to anticipate all of the borrower-related issues that the agent may confront. However, properly handling the items addressed below will help the agent maintain an orderly workout process and protect itself and the other members of the lending syndicate from potential claims by the borrower.

Communications with the Borrower

Notwithstanding the agent's function to act on behalf of the syndicate lenders and to "quarterback" the workout process, sometimes individual syndicate lenders will engage in separate conversations with the borrower. During these separate conversations, the borrower may receive mixed messages concerning the possibility of a workout arrangement or the terms that might be accepted. Mixed messages in tense situations are divisive and can easily turn an amicable situation adversarial. What is the agent to do? In most cases it is impracticable to attempt to shut down all separate discussions. Indeed, progress can sometimes be achieved through a side discussion with a borrower that could not have been achieved in a larger group discussion. The agent's goal therefore should be to keep all lenders "on message". Regular meetings of the syndicate lenders (or steering committee) will promote consistency in the messages lenders convey to the borrower. Such meetings can be used as an opportunity to remind the lenders that acting in a unified manner is crucial to a successful workout strategy.

The agent must be cautious to avoid misleading the borrower regarding the prospects of a successful restructuring or the likelihood that the lending group will approve specific proposals. The agent should maintain a clear dialogue with the borrower. Whenever the agent is in doubt about the position of the syndicate lenders or the agent's and the syndicate lender's options relating to a specific issue, it should avoid making assumptions and should check with the syndicate lenders and consult with legal counsel before proceeding. The risk of potential borrower claims can be mitigated with a pre-negotiation agreement. Much has been written about the content of such agreements and the merits of their use. For purposes of this article it is sufficient to note that such an agreement should be entered into between the borrower and the agent as a matter of course and prior to the commencement of any workout discussions with the borrower. A properly drafted pre-negotiation agreement will provide that no modification to the loan documents or other restructuring agreement will be binding unless memorialized in a definitive formal amendment or other written agreement.

Continuing Funding Obligations

Another challenging issue that an agent may face arises in the context of loans with continued funding obligations. Syndicated construction loans or revolving credit facilities include future funding obligations on the part of the syndicate lenders. In today's troubled financing market it is not unusual to find that individual syndicate lenders may be unable to meet these obligations. A well-drafted loan agreement will specifically address this possibility and place the onus on the borrower or a guarantor to accept the funding shortfall or make up the difference with equity. Irrespective of whether such a situation is directly addressed in the loan documents, the borrower would have a claim against the individual defaulting lender (and under a properly drafted loan agreement would not have a claim against any other party). Replacing the defaulting lender or otherwise filling the funding shortfall may be impossible in the current market, as the replacement lender would be required to extend credit at pre-2008 pricing levels. The agent will thus be charged with leading the discussions with the disgruntled borrower and the syndicate lenders to arrive at a satisfactory resolution. Such a resolution could take many forms. Whether the agent or the other lenders would themselves decide to step in to fill the funding shortfall may depend in part on whether the shortfall is likely to jeopardize the borrower's ability to repay the portion of the loan already drawn. Alternatively, new equity capital or some combination of debt and equity (with market-level pricing) may be the answer.

Conclusion

Before an agent immerses itself in the workout process it is advisable that the agent ascertain its duties and authority under the loan documents. The loan documents and related intercreditor agreements largely define the framework within which the agent must operate. Once the agent has a firm understanding of the framework, practical measures can be taken to spearhead the workout process. The agent must reconcile the differing interests and demands of the borrower, the syndicate lenders and third parties (including senior or subordinate lenders), evaluate the facts as they become known and negotiate a sensible solution. The end result may be a restructuring of the loan or the exercise of remedies. Few items may be clear at the outset. One item, however, is certain. The agent's resourcefulness and fortitude will be thoroughly tested.

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Endnotes

[1] The term "capital stack" refers to the practice of "stacking" mortgage and mezzanine loans made to a string of single purpose limited liability company borrowers with the property owning company at the bottom of the string and mezzanine level holding companies above it. In recent years it was quite common to see capital stacks on single properties comprised of a syndicated or securitized mortgage loan above which were stacked four or five levels of holding companies, each of which had issued mezzanine debt.

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