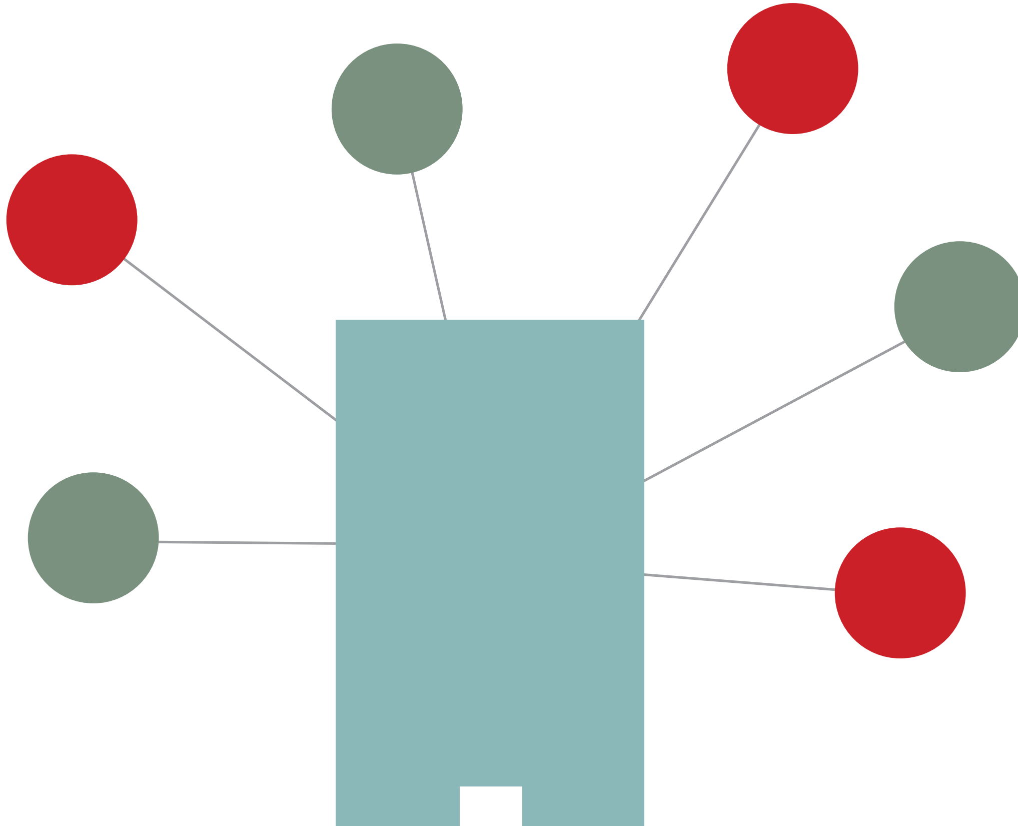
DRIVING FORCE



Gary A. Goodman
Partner
Dentons

Gregory Fennell
Partner
Dentons

Jon E. Linder
Partner
Dentons

In this first of a special two-part series, Dentons explores the opportunities—and intricacies—multi-tiered financing.[1] As syndication grows in popularity among lenders, a host of legal issues are affecting the market.

Syndication continues to grow in popularity among lenders. Here, the authors explain the significant legal issues surrounding such transactions.

According to a recent report, commercial real estate and multifamily mortgage borrowings in 2023 are forecasted to reach $645 billion, a slight decrease from the overall total commercial real estate and multifamily mortgage borrowings in the previous two years.[2] Notwithstanding such overall decrease in volume, commercial mortgage loans have continued to escalate in size and complexity, and as such, lenders have been forced to further develop methods to adequately diversify their risk.

While most mortgage loans are sold into the commercial mortgage-backed securitization (CMBS) market, mortgage loans held for syndication still represent a significant share of the loans made by many real estate lenders. The syndication market provides mortgage originators with an opportunity to create a customized lending product which extends beyond the standard requirements of the rating agencies.

The syndication market has recently gained significant momentum for "value-added" lenders who are willing to: (i) incur above-average risk by placing loans in higher-leveraged loan positions in the capital stack; or (ii) provide financing outside a conduit structure for construction projects, land acquisitions, and/or lease-up projects.

The primary incentive for syndicating loans in today's market is diversifying risk and, thus, increasing the granularity of a lender's loan portfolio. Other considerations for lenders who sell loan participations include leveraging income and reducing capital weight while building and maintaining relationships with clients.

Access to the know-how and deal flow of established real estate lenders is an incentive for lenders who purchase loan participations to join a syndicate group. Most key players in real estate loan syndication in the US include US lenders and international lenders from such countries as Germany, France, Canada, and England, serving in roles of both agent lenders and participant lenders.

As these trends continue, it becomes increasingly important for syndication participants to understand the driving forces behind syndication, as well as the legal issues that arise in connection with these transactions, including issues often negotiated between members of the syndicate group. The respective interests among loan participants vary to the extent that pari-passu loan shares, subordinate loan shares, A/B loan structures, or mezzanine loan interests are involved in the capital stack.

Similarly, since an estimated $1.1 trillion of outstanding mortgage loan debt will mature in 2024, the need for mezzanine financing will increase.[3] As the mezzanine market continues to expand to feed the ever-growing demand, it is necessary for lawyers and clients alike to understand the special relationship which exists among the mortgage and mezzanine lenders in multi-tiered financings. In particular, lawyers and clients need to have an intricate understanding of the single document which codifies the senior-junior class relationship; the intercreditor agreement.

DRIVING FORCES BEHIND LOAN SYNDICATION

The major benefit of loan syndication is that it allows arranging lenders (who are often the loan originators) to diversify risk while maintaining close relationships with their customers. To minimize credit risk and to ensure acceptable levels of diversification, lenders monitor and impose limits on their exposure with regard to a particular project as well as the amount of loans made to a particular sponsor. As development projects become more complex and expensive, developers require larger loans, which may exceed a particular lender's loan exposure limits or the maximum amount that a particular lender is willing to extend to a sponsor.

By creating a syndication group and, thus, dividing the obligations to lend the entire loan amount among several lenders, participating lenders are more likely to be able to stay within their credit exposure limits. The participating lenders also can access the expertise, business relationships, and deal-flow of arranging lenders, allowing the participants to extend their customer base without investing large amounts for marketing costs and administrative capabilities.

Lenders that arrange the syndication group or serve as the administrative agent for the participants (oftentimes the same lender) can enhance their own profitability by charging additional fees and other compensation for arranging and administering the loan without the need for committing capital for the entire loan amount. To a certain extent, agent lenders may also expect their participant banks to bring future syndication deals back to the agent lender. All the lenders in the syndicate group benefit financially from their loan participation by collecting pro-rata interest and fees, particularly commitment fees.

Mezzanine debt is the level of debt between the senior secured debt and the equity, and was typically used by borrowers to fund development projects. However, as mortgage lenders have been reluctant in recent years to finance projects with high loan-to-value ratios, borrowers have increasingly turned to mezzanine debt to bridge the gap between the levels of debt desired by such borrowers and the amount of financing offered by mortgage lenders.

As development projects become more complex and expensive, developers require larger loans, which may exceed a particular lender's loan exposure limits or the maximum amount that a particular lender is willing to extend to a sponsor.

PARTICIPATION STRUCTURES FOR REAL ESTATE LOANS

Direct participation

In a loan involving **direct participation**, each participant lender acts as co-underwriter and becomes a party to the loan documents at the closing of the loan.

Although each participant lender has its own contractual relationship with the borrower (and, thus, is called a co-lender), typically one of the lenders (in most cases the originator of the mortgage) will serve as the administrative agent for a group of participants. Such deals may be executed in a "club" format, in which several lenders partner to form a small lender group for transactions that exceed the risk appetite of each individual lender. The agent lender is responsible for administering the loan and maintaining the day-to-day relationship with the borrower. Each of the co-lenders owns its respective portion of the loan, which obligates the co-lender to fund to the borrower the amount to which it has committed to lend and entitles such co-lender to the benefits (i.e., interest and fees) arising out of its portion.

Each co-lender often acquires a promissory note in the amount of its share of the loan, made by the borrower payable to the order of such co-lender, as payee. However, the notes often provide that the payments made under the note be sent to the agent lender, who collects the payments and distributes to each co-lender its respective share of the funds.

Regular participation

In a loan involving **regular participation**, direct participants join as participant lenders after the initial closing of the loan.

An existing lender often the arranging lender who typically also serves as the administrative agent sells a portion of the loan to the incoming participant lender (who is also called a co-lender). This sale is documented by an assignment and assumption agreement (or assignment and acceptance agreement) between the selling lender and the co-lender.

The co-lender will acquire by assignment an undivided participation interest in the loan on a pro-rata basis, which means that it will accept the obligation to advance its portion of the loan and will receive a direct interest in the amount of its participation in the right to repayment of the loan and the collateral given to secure the loan. In most other respects, the rights and obligations of the lenders in a regular participation are similar to those in a direct participation.

Indirect participation

If a loan is syndicated through **indirect participation**, the participant lenders are not and do not become parties to the loan documents. An indirect participant enters into an agreement with the selling lender to purchase interests and obligations under the loan and receives a participation certificate executed by the lead lender, and not a note executed by the borrower. The participant lender incurs only a guarantee-like funding obligation and must reimburse the selling lender for any loan expense in connection with the loan documents. As a result, the borrower may not have knowledge of an indirect participant's existence.

Certain lenders' regulations or internal guidelines require a direct claim against the borrower and the collateral and therefore such lenders are prohibited from purchasing indirect participation interests in loans. Some loan structures involve a combination of direct and indirect participations, and some structures may have varying levels of priority among participants in terms of rights to receipt of payments and ability to exercise remedies.

In a co-lending arrangement, the lead lender has certain duties to the other members of the loan group, known as the Servicing Standard. The Servicing Standard requires the lead lender to service the loan (or manage the property) in "a commercially reasonable manner" that benefits all co-lenders, without regard to its relationships with or ownership of any other parties to the agreement.[4] It is sometimes stated as the higher (i) the standard by which the lead lender services its own loans; and (ii) the customary standard for servicing in the industry.

DOCUMENTING SYNDICATION RELATIONSHIPS

Because syndication involves multiple parties, it is very important that the primary and syndication loan documents clearly define the role of each party and set forth the relative rights, obligations, and priorities among the parties. Many provisions are standard, but some may be heavily negotiated or modified by side letters between the agent lender and a co-lender.

Although loan syndication enables lenders to increase diversification and engage in transactions they might otherwise be obligated to turn down, lenders within a syndicate group give up the flexibility to make decisions with respect to the loan independently. Although the agent lender is generally granted the power to make the day-to-day decisions alone, loan documents often require consent and/or approval from some or all participant lenders for certain decisions.

In some syndications, co-lenders execute the primary loan documents with the borrower at the closing of the loan. More commonly, in a secured mortgage loan, the loan agreement, the promissory note, the mortgage and the other ancillary documents executed in connection with the closing of the loan are executed by the main underwriter.

The main underwriter, as agent, is the only lender at the closing and intends to sell portions of the loan in the secondary market. To facilitate the future sale interests in the loan the agent lender must consider market pricing, loan terms, and reasonable agent/co-lender provisions at loan closing. The co-lenders do not have a real-time opportunity to review or comment on the primary loan documents or participate in negotiations with the borrower even though many provisions regarding the agency/participant lender relationship are contained in the loan agreement.

In cases where multiple underwriters execute the loan agreement as direct co-lenders and participate in the primary closing with the borrower these concerns do not arise. Co-lenders signing the primary loan documents at closing are granted co-underwriter privileges (such as primary market pricing and co-agent and co-underwriter titles related to the transaction and can negotiate loan provisions to some extent, especially the sections relating to the agent/co-lender relationship.

In the absence of clear documentation, disputes can emerge regarding the roles and authority of the group vis-à-vis its individual members. The New York Court of Appeals, in *Beal Savings Bank v. Sommer*, established a presumption in one such dispute.[5] The court found that one member of a lending group could not, in contravention of the syndicate's decision, act against a guarantor of debt obligations following the default on that debt. As the court noted: "Had the parties intended that an individual have a right to proceed independently, the Credit Agreement . . . should have expressly so provided."[6]

Several other considerations should be accounted for in the loan documents. For instance, they may require a party to disclose the existence of any intercreditor agreements to potential assignees.[7] Loan documents should also clearly define the lead lender's authority to act as administrative agent for the syndicate and what levels of consent from co-lenders are required before administrative agent takes various actions. These guidelines give all members of the lending group a voice in determining key factors yet allow specific issues to be decided without "too many cooks" getting involved.[8] In addition, a lending group must determine if it would be willing to offer seller financing for the sale of a property and, if so, on what terms and in respect of what legal and tax structuring considerations.[9]

ASSIGNMENT AND ASSUMPTION AGREEMENT

When lenders sell participations in a loan, the sale is documented by an agreement sometimes called an assignment and assumption or assignment and acceptance agreement. This document describes the purchase and sale of the participation interest and assigns to the buying lender both the obligations under and interests in the portion of the loan purchased from the selling lender. The assignment agreements usually provide sufficiently detailed true-sale language to support favorable treatment under capital adequacy rules.

The purchasing lender may appoint the agent lender and authorize the agent lender to act on its behalf in the agreement. This document usually the agent lender's standard form and possibly attached to the loan agreement is not negotiated, or revised heavily, because it often refers back to the rights and obligations set forth in the loan agreement. An agent lender is very unlikely to go back to the borrower to renegotiate and amend the primary loan documents. All this has made the loan assignment the preferred participation device in today's real estate syndications market.

INFORMATION RIGHTS OF CO-LENDERS AND NOTICE PROVISIONS

Generally, the primary loan documents will require third parties and the borrower to give notices with respect to the loan to the agent lender rather than to each of the co-lenders directly. The primary and/or syndication loan documents typically address the types of information that the agent lender is obligated to provide to the co-lenders and the timeframes within which the obligations must be carried out.

The co-lenders often negotiate for rights to as much information as possible relating to the loan, such as notices of borrower default, recording information, and copies of all loan documents. The agent, however, will prefer to keep the obligation to provide information to a minimum, by negotiating to exclude obligations to provide such information altogether or limit the obligation to instances in which a co-lender requests such information.

When lenders sell participations in a loan, the sale is documented by an agreement sometimes called an assignment and assumption or assignment and acceptance agreement.

LIABILITY AND RELIANCE ON AGENT LENDERS

Agent lenders usually limit liability to co-lenders under the primary and syndication loan documents to willful misconduct or gross negligence resulting in actual damages. The agent lender is usually held to the standard that it would use in its own transactions. The courts usually accept these provisions and do not read a fiduciary relationship into the agreements between agent lender and participants. Most primary and/or syndicated loan documents provide that agent lenders have actual knowledge of a borrower's default. Some very large agent lenders, with far-flung operations, are concerned about being deemed to have knowledge because of employees' actual knowledge. Therefore, they seek to limit their liability to those defaults of which they have received written notice from either the borrower or their co-lenders.

Because a borrower will not ordinarily give a lender notice of its own default, it is unlikely that the co-lender will obtain knowledge of a default before the agent lender. While it might be fair to limit imputed knowledge of the borrower's default to employees working on the subject loan transaction, large agent lenders rarely agree to that compromise. Rarely do prospective co-lenders terminate negotiations over this point.

In order to avoid liability to co-lenders, agent lenders require that co-lenders perform their own due diligence and credit analysis with the information provided by the agent lender. To memorialize the lack of co-lender reliance on the agent lender's analysis, the agent lender will typically require representations from each co-lender that such co-lender has not relied on the financial analysis of the agent lender and that the co-lender has done its own credit analysis and made its own decision with respect to joining the syndicate group. Therefore, the agent lender is usually protected when making day-to-day decisions with regard to a real estate loan. Liability issues do arise for an agent lender if a real estate loan requires specific skills, and the agent lender explicitly commits to apply such skills in administering the loan under the primary and/or syndication loan documents.

(Editor's Note: The second part of this series will be published in the next issue of Summit Journal, to be released February 2025.)

The agent lender is usually held to the standard that it would use in its own transactions.

ABOUT THE AUTHORS

Gary Goodman and Jon Linder are partners in the New York office of Dentons US LLP and Gregory Fennell is a partner in the San Diego office of Dentons US LLP.

NOTES

[1] The authors gratefully acknowledge the assistance of Jordan Lee, Esq., a real estate associate in the New York office of Dentons US LLP, in the preparation of this article. This article is an updated version of an article authored by Messrs. Goodman, Fennell and Linder entitled "Special Problems of Syndicated Loans and Multi-Tiered Financings", which appeared in the September 2023 issue of Practical Real Estate Lawyer, which article significantly updated a paper presented by Messrs. Goodman and Fennel, with the assistance of Jonathan Jacobs, Esq., then a real estate associate in the New York office of Dentons US LLP, at Strafford Publications, Inc.'s Syndicated Real Estate Loans: Structuring Agreements to Balance Differing Rights and Obligations of Lenders and Agents Commercial Real Estate Financing program in September 2014. Even earlier versions of this article, one authored by Mr. Goodman, appeared in Commercial Real Estate Financing 2014, and the other co-authored by Mr. Goodman, Michelle C. Yip, Esq., now an Associate Counsel with Boston Properties, Inc., and Dr. Robert W. Becker, Senior Vice President of Landesbank Hessen-Thüringen Girozentrale's New York Branch, appeared in the January 2007 issue of Banking Law Journal.

[2] TMN Editor, "Commercial/Multifamily Lending to Fall 20 Percent in 2023", May 11, 2023, available at https://www.themortgagenote.org/multifamily-commercial-lending-to-drop-20-in-2023/

[3] Jim Garman, Ben Johnson, Marco Willner, et al, "Commercial Real Estate Into The Headwinds", June 29, 2023, available at https://www.gsam.com/content/gsam/us/en/advisors/market-insights/gsam-insights/perspectives/2023/commercial-real-estate-headwinds.html#:~:text=For%20private%20credit%20investors%2C%20the,creates%20immediate%20capital%20deployment%20opportunities.

[4] Hilary Metra Gevondyan, "Keys To Co-Lending Agreements In Commercial RE," Law360, May 16, 2012.

[5] 8 N.Y.3d 318 (2007).

[6] Id. At 332.

[7] Kara Bruce, "Should distressed debt investors or other assignees be held to the terms of intercreditor agreements?", email to the Advisory Committee Subgroup on Intercreditor Agreements (for what organization?), Oct. 20, 2013 (on file with author??).

[8] Eric M. Schiller, "Co-Lender Issues on Defaulted Loans", March 2010 ACREL Paper, available at https://cdn.ymaws.com/www.acrel.org/resource/collection/A8884E11-BB06-403B-A32B-B5035F9613C3/Schiller_-_S10-Syndicated_Loans_in_Default__Special_Issues_for_Borrowers_and_Lenders.pdf.

[9] Id.