ALSTON & BIRD

STRUCTURED FINANCE SPECTRUM

SUMMER 2022

In this issue

Editor's Note

I hope you all enjoyed the holiday weekend. I want to thank my amazing partner Aimee Cummo for trusting me to take the reins for this edition. A Brit guest editing, on the heels of the July Fourth holiday! Who'd have thought it? As a treat we have spelt everything the 'English way' 🙂.

It's hard to believe we are at the halfway point in 2022, and whilst the pandemic is beginning to seem a memory, it's clear there are some dark clouds on the horizon for the global economy. The pandemic disruption to our markets has been overtaken with inflationary pressures; rising labour costs; increases in energy, food, and fuel prices; supply chain issues; and geopolitical events disconcerting to even the hardiest market participant. Market participants on both sides of the Pond need to come up with strategies designed to cope with all of these and a new generation of employees demanding flexibility. But we have all seen challenges before – and come through them.

This edition focuses on the opportunities that come from stressed markets – especially when we embrace and take advantage of opportunities that present as we move along our sustainable journey. Despite the dislocation, it is clear from the Fireside Chat with Ali Cooley that there is a massive demand for sustainable products, and markets should react to this. Likewise, changes to our restructuring laws, with the new restructuring plan highlighted inside, can be seen as a facilitator to save businesses.

In these changing times, we at Alston & Bird look forward to keeping you abreast of the latest market developments and guiding you on what we think are opportunities to take advantage of the market conditions. Please enjoy the issue and the rest of the summer!

Andrew Petersen
Partner, Finance

Fireside Chat

Guest editor Andrew Petersen connects with Alexandra Cooley, co-founder and CIO of Nuveen Green Capital, to discuss the transition from Greenworks Lending to Nuveen Green Capital and what lies ahead in the commercial property assessed clean energy (C-PACE) space.

Alexandra Cooley

Andrew: As more senior lenders get comfortable with C-PACE, this formerly niche financing looks to be a driving force in ESG lending. How did you get involved?

Alexandra: After college, I was working in private equity for oil and gas companies, and I became more passionate about getting involved in climate change issues. I decided to get my MBA and master's in environmental policy, and afterwards started working for the Connecticut Green Bank, where I learned about C-PACE financing for clean energy improvements and other energy-efficiency initiatives for commercial buildings. I was immediately struck by the potential for C-PACE to scale by enabling the commercial real estate industry to go green.

Andrew: What makes C-PACE attractive to building owners?

Alexandra: One of the key competitive edges of C-PACE is that it is a fixed-rate and long-term financing.

The major challenge with financing commercial and industrial real estate at scale is tremendous diversity of credit. There are many different property types, geographies, submarkets. C-PACE helps standardise underwriting because it's a senior lien on a piece of real property.

The senior lien in C-PACE financing confers the same security to lenders like special property tax assessments. States with C-PACE programs allow private lenders to utilise this tax assessment structure to essentially secure lending against clean energy measures.

This structure can be extremely beneficial for building owners because the long-term, fixed-rate financing can remove the need for complicated payback calculations and enables them to expand capital budgets to go green. The improved building transfers to the next owner, they get the upgraded building, and they get lower costs.

Andrew: How did you transition from Connecticut Green Bank to founding Greenworks Lending?

Alexandra: It became clear to me that, if we could standardise the credits, there was insatiable capital market demand for this type of structure, even though it was new. There was also tremendous demand on the building owner side, just in Connecticut, proving there was going to be a supply of C-PACE assets. And we were seeing states call us and ask for advice on creating their own programs. Those three signals gave me and my co-founder, Jessica Bailey, the confidence to launch a national C-PACE financing platform in 2015, Greenworks Lending.

In 2017, Greenworks structured the first-ever rated securitisation of C-PACE assets and issued senior notes against a pool of $78 million in C-PACE assets backed by 148 C-PACE assessments in more than 10 states.

Andrew: How did you become Nuveen Green Capital?

Alexandra: As C-PACE expanded nationwide, so did Greenworks. From 2015 through 2021, we expanded from one to over three dozen states, from zero to over 400 individual assets, and two to over 70 employees.

We knew that we always needed to be as close to the source of capital as possible to enable the most efficient financing terms, so we started looking for potential strategic partners at the end of 2019.

Nuveen's private placement group had been a long-time partner starting with our 2017 securitisation when they were the sole purchaser of our senior rated notes. Since then, we'd built an incredibly strong relationship. Because Nuveen is also a large real estate owner, we knew that expertise could really help Nuveen Green Capital scale its C-PACE platform. So when it came time to compare potential partners, Nuveen was the clear frontrunner.

Andrew: What has the last year been like?

Alexandra: It's been an exciting ride. We've doubled our originations and expanded to 27 states. We now have the resources to pursue targets in larger markets like New York City. In fact, we funded one of the first C-PACE pilots in our own building at 730 Third Avenue. The office tower is the headquarters of Nuveen and our parent company, TIAA. The project was a $120 million full-building renovation with C-PACE financing covering multiple energy efficiency measures of the property's retrofit project, including lighting, roof insulation, and the replacement of all windows with View Glass smart windows that adjust to light automatically to help control the interior temperature.

The C-PACE-financed measures will also reduce the property's greenhouse gas emissions and help the building owner avoid nearly $100,000 in annual fines under New York City's Local Law 97, which will require larger buildings to reduce their carbon emissions or face fines.

Andrew: That's a great NYC story. What are some of your other targets?

Alexandra: C-PACE financings have expanded nationwide since we started in 2015. Our major markets have historically been the West Coast, New England, and the Midwest, but with cities like NYC, Boston, and Washington, D.C. mandating decarbonisation, we feel like there's a lot of potential here. Local Law 97 requires significant decarbonisation of buildings in NYC, and there's a concentration of office and retail properties. Both of those sectors are undergoing tremendous amounts of change and shift. And then there's the relatively high power prices in the city.

Andrew: What are some of the challenges you are facing in NYC?

Alexandra: NYC has its own C-PACE policy. The governing body of the program, NYCEEC, started a pilot program and have since begun incorporating what they've learned. We expect revised guidelines in the near future.

Andrew: What's next for you and for Nuveen Green Capital?

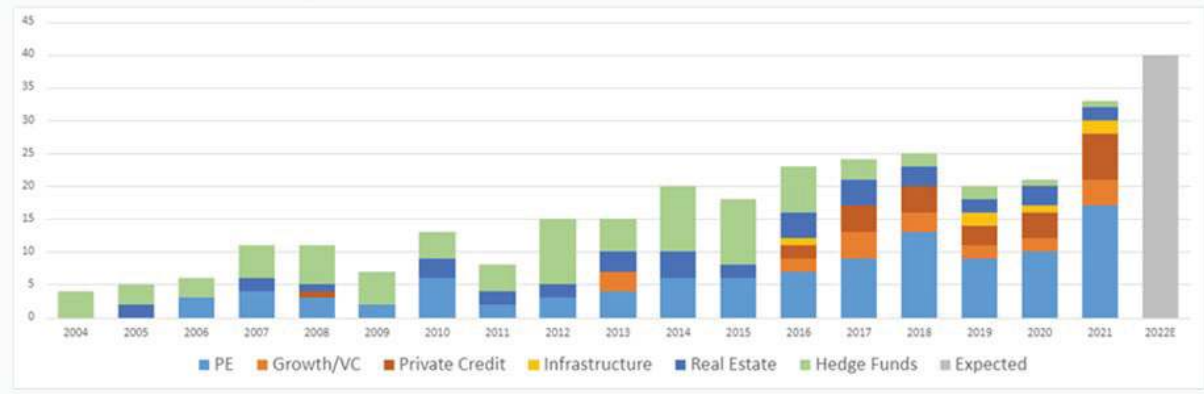
Alexandra: I've seen a seismic shift in our market since we started Greenworks in 2015. Both push and pull factors for commercial building owners to improve the energy performance of their buildings have strengthened.

On the push side, governments are beginning to update building and business requirements for climate. One of the earliest examples is, of course, the NYC climate mobilisation act as well as the Securities and Exchange Commission (SEC) proposed climate disclosure. I'm hopeful that the SEC disclosure requirements will lead to more standardisation of data and eventually price in a 'greenium' because we'll be able to show that green companies, buildings, etc. have lower risk over time.

On the pull side, it's hard to overstate the subtle but far-reaching impact of asset managers focusing on climate. More and more real estate investors are demanding climate action. I've seen firsthand how corporate commitments can clear a path for innovations like C-PACE that make a big difference. Corporate commitments are driving the amount of investment, the willingness of established companies to innovate in smaller niches they wouldn't have otherwise looked at but for their focus on sustainability. ■

Insights – The Rise of the GP Capital Market

Thomas Liaudet, partner at Campbell Lutyens and global head of GP Capital Advisory, provides this quarter's insight. After decades of relatively steady, but quiet, growth, the GP capital market is finally approaching maturity in the private markets. The market comprises the financing of general partners (GPs) at the management company (ManCo) level, typically through the form of minority equity transactions. Campbell Lutyens estimate that about 214 transactions have taken place since 2012, with just over a third of those having closed in the past three years alone.



Number of minority equity transactions at ManCo level for private market managers
Notes: Only includes transactions of at least $40 million. Source: Campbell Lutyens Research 2022.

Below, Campbell Lutyens explore nine drivers underpinning the growth of this market.

1. Succession management

With generations of private market fund managers preparing to step down, a minority transaction helps provide an alternative to what may have typically been a GP valuation based on retained earnings or other metrics, which usually does not reflect its true market value. A minority transaction supports succession by (1) setting an independent, external pricing of the ManCo; and (2) providing capital, thus bridging the financial wealth gap that may exist between different generations.

2. Legacy sponsor replacement

It's not uncommon for GPs that were born out of a spinout from a financial institution to find themselves with a passive minority stake that had been granted to the parent at inception. With legacy sponsor replacements, both parties can benefit. For the GP, it might be desirable to replace the original cornerstone ManCo investor and welcome a new minority partner, which might be better suited to support it going forward. For the financial institution, the transaction can enable it to achieve liquidity for its investment.

3. Talent management

Minority stake transactions offer the ability to re-organise or implement a wider equity pool for the fund manager. In a world where the war for investment talent has intensified, the equity pool can offer the ability to better finance a succession as well as grant shares with a vesting period and avoid a penal tax bill up front, whilst valuing the GP closer to market value for its original founders.

4. Boosting GP commitments

2% seems to be the new 1% when it comes to GP commitments to new funds being raised. Furthermore, with the acceleration of flagship fundraising and the pressure to launch platform extensions, the quantum and the frequency of GP commitments become a real challenge for many fund managers. The proceeds of the minority stakes help to finance GP commitments; it's also common that the structuring includes non-dilutive preference equity alongside.

5. Strengthening the balance sheet

Even the most successful fund managers tend to be relatively balance-sheet light, relative to companies of similar profitability operating in other industries. The proceeds of a minority transaction may be directed towards accelerated hiring, developing larger operating teams, or opening new offices. The key element to consider is time and how the minority capital may support the GP in accelerating its development.

6. Acquiring large LP stakes

As the secondary market has matured over the years, most GPs of scale will see a steady amount of secondary trading in their own funds. The GP capital financing can support the GP that seeks to buy back a limited partner (LP) interest in one of its own funds, with LTVs of up to 80% being achievable. That particular type of GP financing, like the financing of GP commitments, tends to be structured through an acquiring special-purpose vehicle structure with preference equity financing, rather than an equity deal at the ManCo level.

7. Consolidating the industry

When considering expanding across asset classes and geographies, GPs have to consider that hiring a team, seeding them, and raising the first two funds may take anywhere from two to three years or more. The alternative is to acquire another fund manager that fits the GP's criteria for expansion. Again, the proceeds of a GP minority capital transaction may be directed towards financing all or part of such acquisitions.

8. Building a strategic partnership

A number of minority capital investors will offer significant financial flexibility for the structuring of the transaction and will remain passive, non-controlling minority investors. However, a large portion of the market includes investors who bring more than capital. In particular, they could bring expertise such as the ability to penetrate new geographies, special distribution channels (e.g. access to HNW or retail networks), strategic advice, access to talent pools, etc. No investor has an exhaustive offering, but several can offer a compelling strategic partnership to the GP. As part of this, LP capital can play a dominant dimension in the strategic partnership with the investor offering material LP capital in the form of multiple fund commitments or through separately managed accounts.

9. Managing the GP valuation path

This is a more recent approach that a small number of GPs have undertaken. The objective is to manage the path to the finish line, whether via an IPO, a trade sale, or an in-house succession. A minority transaction sets the GP valuation at a given point in time and provides more perspective at the next valuation event. The trajectory between two valuation events can be better articulated against growth of assets under management (AUM) and the development of fee-related earnings and performance-related earnings.

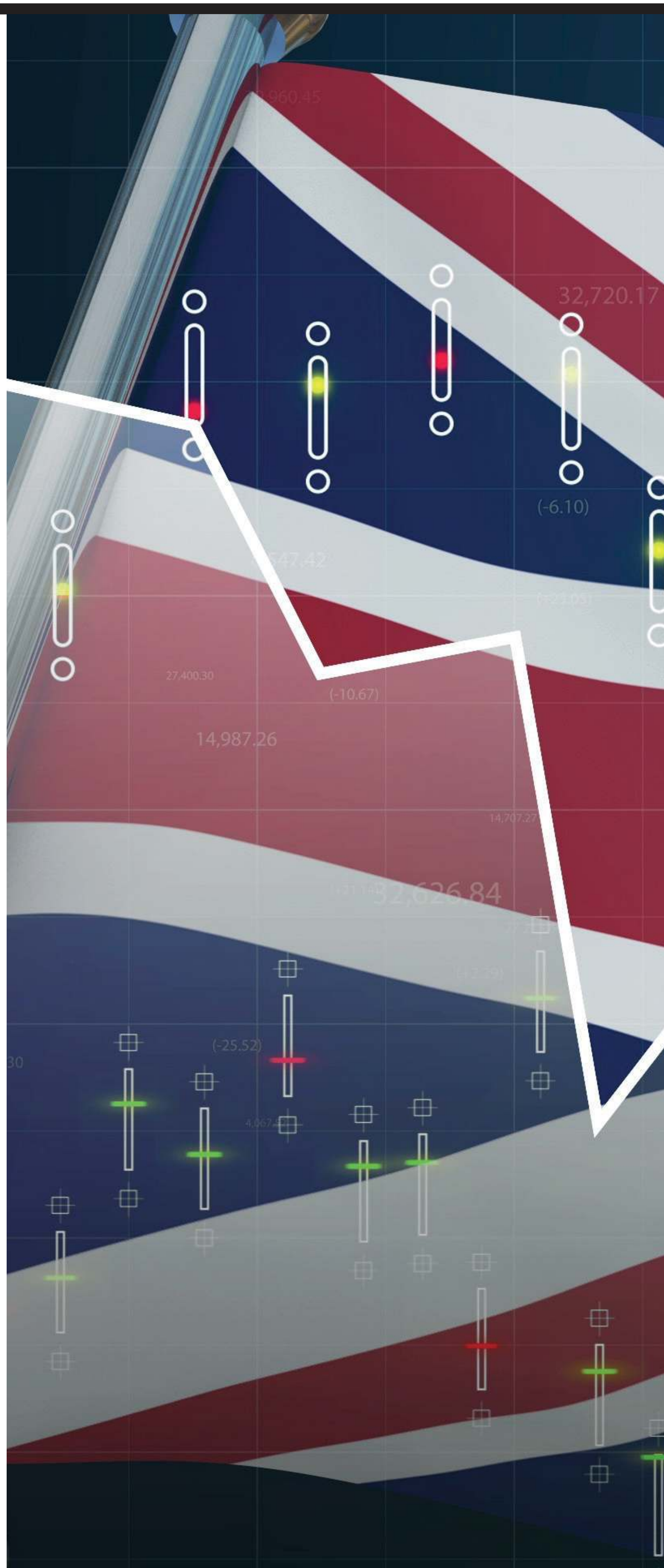
Conclusion

In Campbell Lutyens' experience, there are usually at least two, if not three or four, of the above factors that lead to a minority transaction for a GP ManCo.

In the face of increased demand, the universe of investors targeting these transactions, whether systematically or opportunistically, has developed dramatically in the past few years, with about $50 billion of capital targeting the space. Overall, Campbell Lutyens expect this market to continue growing as the race for AUM accelerates across the private markets and as GPs become increasingly sophisticated in managing their own firms.

Thomas is a partner at Campbell Lutyens, where he leads the global GP Capital Advisory practice, advising private market fund managers on such topics and transactions. He has 24 years of experience in private markets. Campbell Lutyens is a leading global and independent private market advisor, focused on fund placement, secondary advisory, and GP capital advisory, with 180 employees in eight offices across North America, Europe, and Asia-Pacific.

The original bulletin can be found here.



ESG in the NPL Market Panel Discussion at NPL Europe 2022 Conference

Alston & Bird proudly sponsored the SmithNovak NPL Europe Conference, Europe's leading event of the European non-performing loan (NPL) market. London partner Andrew Petersen and counsel Anna Nolan hosted a panel discussion where they discussed specific implications of ESG for originators, servicers, and investors in the European NPL market. The conference was attended by key buyers, sellers, servicers, and advisors and attracted more than 50 sponsors and 400+ delegates from all of the European market. In particular, the panel discussion proved to be popular amongst the delegates, with every seat taken and some excellent feedback received with follow-up meetings arranged.

Moderated by Andrew, the panelists included:

Oliver Platt – Arcida Advisors

Robert Meyer zu Starten – Octane Capital

Saleem Malik – Ernst & Young LLP

Emily Fitzgerald – CBRE

Gayatri Desai – CIBC

The audience left with answers to many questions, including:

- What are ESG and socially responsible investments, how are they relevant to the NPL market, and for which specific business operations should they be implemented?
- How can ESG principles be used to facilitate value creation for investors searching for yield in the current low-interest environment?
- What are the benefits of ESG for originators, servicers, and investors in the European NPL market?
- What steps and resources are required to implement a companywide ESG strategy?
- Are we facing a new era of ESG revolution in the distressed space?
- What will happen with non-sustainable loans? Non-performing loans versus non-sustainable loans?

The discussion was supplemented by the distribution of the article 'Non-Performing Loans Through the ESG Looking Glass', authored by Andrew and Anna and featured in *Pratt's Journal of Bankruptcy Law*. You can view the article online here and on page 10, below. ■

The Finance Forum Returns!

In April, Alston & Bird held our annual Finance Forum in New York, bringing together market players to address timely issues, opportunities, and business challenges to confront a variety of asset classes. The Forum began with a Fireside Chat, an engaging discussion between Kristi Leo, president of the Structured Finance Association, and Shanell Cramer, Alston & Bird Finance co-chair and partner. They discussed the current impact of inflation and rising interest rates and the geopolitical and enforcement risks facing the industry. Two concurrent educational breakout sessions followed, focusing on the future of SFR, strategic opportunities in consumer ABS, an update on the mortgage market, and a discussion on the effects and implications of ESG on the structured finance industry. Attendees came from over 60 companies representing a mix of corporate borrowers, issuers, originators, fund managers, private equity sponsors, commercial banks, alternative lenders, and other market participants.

Attendee quotes

'Informative and insightful'

'Excellent programming; so good to be back in person!'

Non-performing Loans Through the ESG Looking Glass: Applying ESG Considerations to the Creation of a New Type of Investment Opportunity for Creative Investors

The call from investors for lenders and borrowers to embrace environment, social, and governance (ESG) is too loud to ignore. Our Finance and Financial Restructuring & Reorganization Groups explore why a marriage of the NPL and ESG markets is the perfect union to take advantage of a rich vein of opportunity for savvy investors.

- The traditional NPL market, the growing ESG investment market, and how to generate revenue between them
- Reimagining the current approach to NPLs
- How to overcome the challenges of forming a new frontier of NPLs and ESG

As the world emerges from the COVID-19 pandemic and begins to embrace and address the economic and societal challenges that have been presented, and in some cases accelerated, by the greatest global public health crisis in living memory, a number of challenges face our financial markets – not least of which is to address the onset of inflation and the impact of the withdrawal of governments' and central bodies' fiscal stimuli that effectively saw our European loan portfolio markets suspend activity and that will lead to a consequential lag effect of economic shock.

Political risks could significantly increase the levels of non-performing loans (NPLs). For instance, the Ukraine crisis has driven up global energy prices (oil and gas prices are soaring). Some financial institutions have exposure to Ukraine, Russia, and Belarus and, therefore, need to ensure that they comply with the new sanction regimes. It remains to be seen what the actual impact of the Russia–Ukraine conflict will be on the NPL levels in Europe. But we expect that the Ukraine crisis combined with rising inflation, the supply chain crisis, and the prevailing uncertainty will result in an increase in non-performing exposures over time.

In addition to the increasing political risks, the threat of rising inflation (alongside the threat of real interest rates possibly remaining lower than needed to control inflation) will lead to increased volatility in our financial markets and investment decisions that search for yield and seek out value-add products to generate increased returns. The search for yield and volatility could be combined with a wave of possible defaults and insolvencies (threatened for so many years) across Europe, and the prospect of many financial institutions and banks across Europe having to delever their risk to their stressed or distressed portfolios (especially those banks that have been slow in prudently marking down the value of their portfolios) could result in NPLs being viewed in a different light and a gradual increase in loan portfolio sales and investors that have targeted NPLs in the past facing a busy and opportunistic few years.

Political risks could significantly increase the levels of non-performing loans (NPLs).

This is nothing new. But what is of interest is how those loan sellers can market their loans when embarking on a deleveraging process and how those loan buyers can deploy capital in a way that results in an expected return on that capital for them and their investors. Those investors may not have targeted NPLs in the past due to the reputation of NPLs and not having the creative mindset to distribute capital in a way that enhances values and deals with the constant threat of stranded assets brought about by the momentous investor demand to reduce the carbonisation of our portfolios and deploy capital based on environment, social, and governance (ESG) considerations.

The world of NPLs is on a journey to consider if the worlds of NPLs and ESG can collide in a way that creates a rich vein of opportunity for investors, loan sellers, loan buyers, and those that may own or manage stranded assets over which there is a large portion of secured debt.

The Traditional European NPL Market

According to Deloitte's *Deleveraging Europe 2021* report,

- Portfolio markets went into deep freeze in early 2020; even with some markets renewing deal activity in the second half of the year, deal volumes dropped 60%.
- Italy (€44 billion of transactions in 2020) and Greece (€12.4 billion) drove European deal volumes in 2020 largely using government-guaranteed NPL securitisation schemes. Both countries demonstrated good levels of NPL portfolio sales in H2 2020, driving improved NPL volumes and ratios.
- The average NPL ratio across European Banking Authority (EBA) banks has continued to fall (to 2.6% at Q4 2020), reflecting a reduction in NPL volumes, unprecedented levels of government stimulus and regulatory forbearance measures, and a rise in total loans and advances.
- Since the start of the pandemic, €900 billion of European loans have received support through EBA-eligible moratoria, of which 70% were granted by banks in France, Spain, and Italy, making these jurisdictions potential hotspots as measures unwind.
- Despite overall declining trends in total NPL volumes across Europe, repeated lockdowns and the level of loans still under loan moratoria mean that higher new NPLs are widely expected and may reach peaks not seen since the global financial crisis.
- In anticipation of a deterioration in asset quality, the largest European banks covered in this report provisioned €118.1 billion in 2020, more than double 2019 levels of €54.5 billion. Banks are, however, starting to tail off or

reverse provisions given growing confidence from asset quality improvements and macro recovery.

- Legacy portfolios, where disposal processes were paused due to the pandemic, are likely to be the first brought back to the market. So far in 2021, transactions totalling €29.1 billion have closed, with an expected additional €70.2 billion in the pipeline for the year, bringing it close to 2019 levels of €119.2 billion.

All of the above, we would argue, presents tremendous opportunity for loan sellers and loan buyers in 2022 and beyond – it is clear that the NPL securitisation and sales market is set to grow in Europe and may become a central target for those investors that want to take advantage of the economic situation that COVID-19 has been a catalyst for, especially when one considers this opportunity in light of the ESG movement we have seen over the last few years.

The Growing European ESG Investment Market

As we described in our previous advisory, even though the securitisation market has been slower to adapt to the trend to focus on ESG considerations, largely due to the complex nature of the market, investor interest in ESG is growing and the securitisation market is evolving quickly across products, such as asset-backed securities (ABS) and residential and commercial mortgage-backed securities (RMBS and CMBS, respectively), with increasing green, social, and sustainability issuance, for example, where the underlying collateral positively impacts housing infrastructure and the environment and meets energy- and water-saving standards. Many deals refer to the International Capital Market Association's green, social, and sustainable principles or the United Nations Sustainable Development Goals.

Investors are also looking more closely into not just the 'E' in ESG but the 'S' as well – what is the societal impact of making the investment? Sustainable investing is an investment category that incorporates ESG factors into investment decisions to better manage risk and enhance long-term returns for investors. In recent years, largely due to the demand of institutional investors, ESG considerations have become increasingly important among all stakeholders and investors in key asset classes, including leverage loans and bonds. In some respects, the trend outlined above can be distilled into two words – 'risk management'. As ESG has become an increasing issue for credit quality, and financial market stakeholders and investors have identified a growing number of ESG-related risks, the question has been asked about how such ESG risks may be measured, and how financial market stakeholders and investors are increasingly trying to reduce their exposure to such ESG risk in the products they invest in.

Banks are facing intense public scrutiny over the impact of their lending practices on human rights, social cohesion, gender equality, carbon emissions, biodiversity, and other ESG topics.

But as well as risk management, it is clear that such demands are also underpinned by a desire to have a more positive environmental and societal impact. High ESG standards are increasingly critical to a financial institution's reputation and its license to operate. Banks are facing intense public scrutiny over the impact of their lending practices on human rights, social cohesion, gender equality, carbon emissions, biodiversity, and other ESG topics. Activist investors and stakeholders and environmental groups are working on shareholder and stakeholder resolutions that single out banks for poor ESG practices. A lack of ESG consideration can cause a lot of damage to someone's reputation, but a well-thought-through ESG strategy can give rise to new revenue streams.

According to a report issued by Covenant Review in October 2021, ESG margin ratchets were present in 53% of new European leverage loans in Q3 2021. It is a significant share of the European leverage loans market, given that the first broadly syndicated, primary issuance, European leveraged loan containing an ESG margin ratchet was recorded by Covenant Review in June 2020. And whilst the European leveraged loan market has not yet seen a pricing differential between transactions that include a margin ratchet linked to ESG-related criteria, it's only a matter of time before the brown discount becomes such a size that it affects investors' interest, and so investor interest in green and sustainability-linked bonds will continue to grow. Such bonds may further come with increased tax incentives (tax exemption and tax credits) to enhance their attractiveness.

Can Investors Generate Revenue from NPLs Reinvented in Compliance with ESG Principles?

NPLs are loans with payments of interest or principal more than 90 days past due or where the lender determines that the borrower is unlikely to be able to make its scheduled payments. Essentially a distressed loan.

Given the development of ESG considerations, we believe that ESG issues are capable of reaching all asset classes (including distressed loans) and become core to any investor's approach to managing and improving performance of loans that are regarded as distressed.

The combination of NPLs and ESG is a novel issue, but we anticipate that over time, the traditional type of distressed investors and credit opportunities funds will start thinking about ESG across all asset classes, including NPLs, and the two will become a perfect fit for dealing with some of the stock and loans secured by challenging existing buildings as we move towards 2050.

How Distressed Loans and ESG Can Work Together

There is a lot of distressed debt in the hands of lenders following the COVID-19 pandemic, and there is also a lot of dry

powder that needs to be deployed, but everyone is seeking product and the available opportunities are limited. This new opportunity presents a solution to the problem of a limited pool of opportunities and could be attractive to green buyers and green sellers. But how would that work in practice?

Case study – Project Mercatus

In the UK in 2021, NatWest sold a £400 million portfolio of shopping-centre loans. NatWest believed that the winning buyers will collectively be able to support the long-term potential of these shopping centres, with NatWest achieving its aim to secure a buyer that is good for both the customers involved and the communities these shopping centres serve. There will no doubt be an underlying societal benefit injected into the repositioning or repurposing of the underlying retail assets, including the debt secured thereon, as the shopping centres could be repossessed by the new lenders, or alternatively the NPL lenders could focus on working with the NPL borrowers and asset managers to develop long-term ESG-compliant solutions to increase the value of the assets and improve the functioning of the borrowers' businesses. This could require funding, which could be provided by a co-investor or another financing provider working with a borrower to improve the asset – maybe Opex or Capex facilities are offered – maybe before a refinancing or repayment based on a sale of the asset.

One can easily see that projects involving turning existing grey or brown buildings owned by NPL borrowers into renovated and energy-efficient less grey or less brown or even green buildings (investments in energy efficiency, shift to LED lights, clean heating and cooling, and requirements to renovate a certain proportion of buildings) can not only quickly become popular with NPL lenders and the investors that may fund them but also is badly needed given the percentage of existing stock which is already built as we move towards 2050. Moreover, ESG considerations could also be deployed or integrated into a workout process. All of these plays do not come easily to a traditional NPL buyer that often just wants a return on capital as quickly as possible. We believe that this may be a scenario that would play out across Europe if loan sellers are faced with attractive bids from loan buyers driven by a different determination other than just buying for the lowest cost.

Investor Profiles

There is a perception in the market that ESG investors are mostly focused on the more vanilla end of the capital markets – safe and uncontroversial assets. Interestingly, as we set out in our previous advisory, ESG is becoming important in the context of collateralised loan obligations, so is there a consistent ESG movement from uncontroversial assets to the securitisation and NPL market?

The current NPL buyers often buy distressed loans at a discount (e.g., 30 pence in a pound) and offer the borrower debt relief (the debt gets rescheduled, with a new interest rate, and decreased principal) or enforce their security. As a result, their internal rate of return is high.

Is it possible to change the face of NPLs so that they are no longer considered a murky asset class for vulture funds, but something with a positive, social label that can attract new investors such as longer-term fixed-income investors such as sovereign wealth, insurance, or pension funds? We believe that this can be done.

Reinventing the Current Approach to NPLs

Of course, some businesses might be structured in such a way that there is nothing that can be done to improve the business, and the purchasers of distressed loans will enforce security – given the scale of repurposing existing stock to green, it's inevitable that there will be stranded assets. However, we expect that the majority of distressed loans can be turned into performing loans if the ESG strategy is applied in the right way. There could also be money directed towards stranded assets in particular through the NPL market, and this may be a very interesting development yet to be executed in scale.

Arguably, there is a lot of social good in offering the borrower debt relief (effectively writing down debt). However, if the borrower works together with the buyer of NPLs and other third parties to turn the bad assets subject to security to assets with good ESG credentials, then there would be even more social good and positive PR generated as a result. This will be good for the loan sellers and the loan buyers – after all, rescue capital, venture capital, and distressed hedge funds could always benefit from some good PR!

Real estate assets – which in the current economic environment remain a very good hedge against inflation – could be turned into green buildings that are energy efficient, with solar panels and other green features. The owners of NPLs could also focus on diversity and inclusion along with gender equality in the company and boardroom; the NPL borrowers might be encouraged to engage with the local community. Another issue is engagement with credit servicers and understanding their approach to ESG, which will come about following the NPL Directive.

What Are the Advantages of This New Approach to Distressed Loans?

The ultimate investors in the special opportunities funds and other investors often expect that the relevant investments are ESG compliant, and this trend will continue. So ESG focus would attract more capital to the NPL market and boost secondary markets.

We believe that the new ESG-conscious players might be prepared to accept lower returns on their investment than the current NPL players. This might mean that the sellers of NPLs would achieve a higher return and might encourage banks to sell more NPLs, so the NPL market might become more active.

ESG touch would help everyone – the NPL sellers, buyers, credit servicers, and NPL borrowers. For example, ESG touch would assist the financial sector within the EU with sustainability disclosure obligations. In addition, investments funds would be able to report back to their investors about ESG-compliant initiatives.

Given that NPLs and ESG is a new concept, there are some opportunities for creative investors to be one of the first players in this market and set up new funds with a new set of investment criteria focused on this segment of the market. What would be attractive for the ultimate investors is that their expected return on investment should be higher than more conservative ESG-compliant strategies. Higher interest rates combined with ESG-friendly initiatives would be very attractive in the current low-interest-rate environment.

A Regulatory Push?

Like all conversations surrounding ESG, there is typically a carrot and stick. In a stricter regulatory environment, the stick has wielded amazing results in Europe through regulatory frameworks such as the EU Sustainable Finance Disclosure Regulation (SFDR). The first provisions of the EU sustainability-related disclosures in the SFDR came into force in March 2021, as part of the EU Commission's policy focus on sustainable finance and of the EU's ambition to be climate-neutral by 2050. Broadly, the SFDR applies to a broad range of financial market participants and aims to increase transparency and prevent 'greenwashing' by requiring enhanced disclosure of ESG products. Although these regulatory changes are being spearheaded in Europe, their repercussions will have a wider reach, as all financial market participants wanting to operate in the EU will have to comply.

Further regulatory movement in Europe comes from the EU taxonomy for sustainable activities – a classification system establishing a list of environmentally sustainable economic activities. The EU is also working towards an EU green bond standard. In the United States, regulatory movement comes from the new Biden Administration and its recommitment to the Paris Agreement; the Green New Deal proposals in Congress; the SEC's request for public input from investors, registrants, and other market participants on climate change disclosure; and the Commodity Futures Trading Commission establishment of a new climate risk unit.

In the NPL world also there is movement that fits with existing European policy to lower the cost of NPL sales, attract more capital to the deleveraging process, and boost secondary markets in NPL disposals. The recent Directive (EU) 2021/2167 on Credit Servicers and Credit Purchasers relating to NPLs took effect on 28 December 2021. EU Member States are expected to implement the NPL Directive by 29 December 2023.

The main purpose of the NPL Directive is to ensure that an NPL borrower is not disadvantaged by the sale of an in-scope NPL, mostly through the mandatory engagement of credit servicers.

The NPL Directive also imposes rules designed to ensure a more transparent and well-functioning NPL secondary market by regulating the interactions between the banks and the NPL buyers. Whilst the NPL Directive does not apply to NPLs not originated by an EU-established bank or NPLs purchased by an EU-established bank, it does provide a useful framework which may be replicated across the globe.

The NPL Directive imposes various requirements on the credit servicers, including some requirements about the credit servicing agreement under which a credit servicer is acting. Any such agreement must include (1) a detailed description of the credit servicing activities that are to be undertaken; and (2) a clause requiring the fair and diligent treatment of the NPL borrowers (the ESG strategy described in this advisory would be helpful here).

The main purpose of the NPL Directive is to ensure that an NPL borrower is not disadvantaged by the sale of an in-scope NPL, mostly through the mandatory engagement of credit servicers.

We believe the NPL Directive could lead to banks more closely monitoring their default-prone NPL situations and come up with creative solutions to delever and manage these distressed assets or sell them to NPL buyers so they can also focus on financing solid assets – having these default-prone situations off their balance sheet could also result in them providing vendor financing or co-investment financing to the new NPL lenders to integrate ESG policies.

Are There Any Challenges to Forming a New Frontier of NPLs and ESG?

All new initiatives present some challenges, and it is important to understand these challenges at the outset to be able to come up with robust action plans.

- New investors in this asset class would need to understand and comply with the regulatory framework.
- It is not clear that there will be a large wave of NPLs in the coming years – the uncertainty surrounding scale and volume may not be attractive to some.
- Would the borrower engage with the credit servicer in ESG initiatives without the threat of enforcement?
- How would you isolate the good parts of NPLs from the bad ones that may end up in an enforcement process?
- Would the NPL purchase that is going to factor in any ESG initiatives present an attractive investment for the traditional NPL investors (would the internal IRR criteria be met)?
- How would you obtain funding for ESG projects at the NPL borrower level designed to increase value and longevity of the borrower's business? Are there any local government or EU-backed schemes that could help with this?

How Would You Overcome These Challenges?

ESG-related initiatives should attract investor capital, and this approach to NPLs and ESG is designed to complement the EU agenda on the sustainable finance landscape.

We recommend taking the following key steps:

- Be proactive in forming alliances with those institutions that have exposure to default-prone situations – a private NPL deleveraging may be more attractive than a public NPL sale.
- Those institutions that have exposure to default-prone situations should take a thorough inventory of their portfolio – know your risks (KYR) is something we cannot stress enough.
- EU NPL market participants, including U.S. and UK NPL investors, should consider the information, disclosure, reporting, and conduct requirements imposed by the NPL Directive.
- Relationships with credit servicers will need to be established and relevant due diligence undertaken.
- Start with due diligence and then develop a sustainability strategy together with credit servicers and any other relevant third parties.
- Develop bespoke action plans at each NPL borrower to help them grow sustainably and to drive positive impact.

Concluding Remarks

It is clear that the call from investors for all lenders and borrowers to embrace ESG is just too loud to ignore – investors will increasingly only concentrate their money on the ESG-compliant and taxonomy-compliant sectors of the markets. Investor demand for ESG-related investments is not going away, and it is expected that this will only increase as demographics and public opinion on social and justice issues, the aftermath of the COVID-19 pandemic, and climate change continue to evolve, especially because there is more of a focus on climate change, climate-neutrality, and reduction to net zero emissions for all of our assets and investments than ever before. ESG leaders are now statistically shown to be better performing and generate better returns than ESG laggards. The deleveraging loan market and NPL market in particular are perfectly placed to embrace these developments, and we should expect more interaction between the NPL world and the ESG world. The future is indeed bright (if only renewable and decarbonised carbon-neutral bright!).

The original advisory can be found here.

Restructuring Practice Expands with Four New Hires

Eric Wise

Matthew Kelsey

Leah Fiorenza McNeill

Stephen Blank

Alston & Bird recently welcomed partners Eric Wise, Matthew Kelsey, and Leah Fiorenza McNeill, as well as counsel Stephen Blank. All have considerable experience representing major stakeholders in Chapter 11 cases and out-of-court workouts, and their arrival demonstrates the firm's commitment to strategic growth and development of the group as economic markets continue to show signs of disruption and uncertainty.

Wise and Kelsey join from Gibson Dunn & Crutcher LLP, where their restructuring practice also involved M&A, debt and equity financings, and other transactions aimed at balance sheet restructurings to protect valuable, over-leveraged assets. They represent secured lenders, ad hoc creditor groups, official committees, debtors, equity holders, agents, and trustees, among others. Their practices span a broad range of industries, including shipping, telecommunications, health care, pharmaceuticals, hospitality, real estate, retail, steel, automotive, chemicals, energy, transportation, financial services, construction, infrastructure, and paper and forest products. Wise and Kelsey are thought leaders on important restructuring topics and leverage their experience to advise on divergent lender interests and complex debt structuring, garnering significant attention from professional services audiences.

Fiorenza McNeill joins from Bryan Cave Leighton Paisner, where she represented distressed health care organizations in Chapter 11 cases and out-of-court workouts, including community hospitals, skilled nursing facilities, health care REITS, and retirement communities. In addition, her experience advising clients in the food and beverage distressed space – and on matters involving the Perishable Agricultural Commodities Act in particular – provides additional depth to the group's food and beverage restructuring capabilities.

Arriving from King & Spalding, Blank counsels borrowers, lenders, investors, agents, ad hoc lender groups, and creditors on distressed and non-distressed financial situations, including debt restructurings and workouts, financing and securitization transactions, and distressed merger and acquisition transactions. His practice also encompasses forbearance agreements, debt-for-equity exchanges, intercreditor arrangements, 363 asset sales, out-of-court distressed investing, Chapter 15 and cross-border proceedings, and all aspects of prepackaged and prearranged Chapter 11 cases. Notably, Blank served as a law clerk to the Honorable James M. Peck of the U.S. Bankruptcy Court for the Southern District of New York. ■

Can UK Restructuring Plans and Schemes of Arrangement Be Used to Restructure Structured Finance Products, and Should CLO Managers and Sponsors of Securitisation Structures Embrace Them?

Emergence of a Super Scheme with a Cross-Class Cram-Down Mechanism

In June 2020, the United Kingdom introduced a new Part 26A restructuring plan (RP), which became a new tool in its restructuring toolbox, in addition to a well-tested scheme of arrangement under Part 26 of the Companies Act 2006 (CA 2006) and a company voluntary arrangement under the Insolvency Act 1983. The RP, dubbed a 'super scheme', is only available to companies in financial difficulties and should be proposed to eliminate, reduce, prevent, or mitigate the adverse effect on a company's ability to carry on business as a going concern. There is no statutory guidance that limits the meaning or scope of 'financial difficulties', which is given a broad interpretation.

The requirements for RPs are set out in Part 26A of the CA 2006 (company/corporate legislation rather than insolvency legislation), which means that RPs are not formal insolvency processes such as administrations, liquidations, or company voluntary arrangements. An RP is a court-supervised restructuring process, which unlike a scheme of arrangement can be imposed on a dissenting class of creditors (a 'cross-class cram down'). The requirement for approval of an RP is for a 75% majority in value of each voting class. There is no requirement to obtain an additional simple majority in number of creditors of a given class (such a numerosity test is required to approve a scheme of arrangement).

The cross-class cram-down mechanism allows the court to sanction the RP as binding on all plan creditors even if a dissenting class of creditors or members objects to the RP. This provision is intended to stop obstructive creditors holding the company to ransom and trying to derail the RP or obtain some sort of leverage. It is important to mention that the cross-class cram-down mechanism can be used by the court only if the affected dissenting creditors will be no worse off under the plan than in the event of the relevant alternative (often, liquidation of the business or administration) and if at least one in-the-money class of creditors approves the plan.

RPs are flexible restructuring tools based on the existing scheme of arrangement provisions under Part 26 of the CA 2006. Having said that, plans have some limitations – they cannot create new obligations, for example, force creditors to lend new money to the group undergoing a restructuring, or amend proprietary rights.

Despite being the newest restructuring tool in the UK, the RP is already a powerful tool which has changed the way many UK restructurings have been implemented. Importantly, the RP made the UK restructuring landscape appear to be closer to the U.S. Chapter 11 model, which also features the cross-class cram-down mechanism.

This article provides an overview of the main features of an RP and explores if the structured finance world should embrace this powerful tool and to what extent the collateralised loan obligation (CLO) managers and sponsors of securitisation structures should be aware of its impact on fund investments.

Who Can Propose an RP and How a Sufficient Connection to the UK Can Be Established

A company incorporated anywhere in the world can propose an RP provided that certain conditions are met. The plan company must be in financial difficulties and the purpose of the RP must be to eliminate, reduce, or prevent, or mitigate the effect of, any of the financial difficulties.

A plan company must have a sufficient connection to the UK, and this requirement is the same as in the case of a scheme of arrangement. It is relatively easy to artificially establish a sufficient connection to the UK (e.g. through co-obligor structures or changes to the governing law of the debt that will be compromised under the RP from local law to English law). Notably, there is no requirement that a company must have its centre of main interests in the UK (though that will be sufficient to meet the sufficient connection test).

The RP could be relevant to CLOs and their managers either because certain of the loans or bonds held by the CLO become subject to an RP or potentially because the CLO itself becomes subject to an RP. Although potentially available as a tool to restructure a distressed CLO vehicle, we expect this application to be limited for the following reasons.

Any amendment to a U.S. CLO indenture to (1) change the governing law of an indenture from New York to English law; or (2) add a UK-domiciled co-obligor to the issued tranches would normally require the consent of either 50% or 100% of each tranche that would be materially adversely affected. If the purpose of the amendment was to facilitate the adoption of an RP that would change the indenture's allocation of losses in the deal's portfolio, the threshold could be 100% of each tranche that would be materially adversely affected. This means that the availability of an RP to compromise the debt under a U.S. CLO indenture depends on the terms of each transaction and on what the parties are trying to achieve.

The U.S. CLO market views indentures – through their waterfalls, liquidation provisions, non-petition covenants, and subordination provisions – as effectively containing a 'pre-packaged insolvency plan' that is 'administered' by the indenture trustee in a non-judicial context. In the past, in the very few instances where investors have attempted to put distressed CDOs/CLOs into bankruptcy (and thereby circumvent the indenture's pre-packaged insolvency plan), the market has reacted very negatively (Taberna Preferred Funding IV, Zais Investment Grade Limited VII, Zohar CDO 2003-1 Limited, Zohar II 2005-1 Limited, and Zohar III Limited). We think attempts to utilise RPs would need to be carefully planned; otherwise, they might elicit similar reactions.

U.S. Companies Can Use the UK Restructuring Plan – Syncreon Case Study

On 10 September 2019, the UK High Court sanctioned two schemes of arrangement of Syncreon Group Holdings B.V.'s Dutch subsidiary, Syncreon Group BV, and its English subsidiary, Syncreon Automotive (UK) Ltd., to restructure debt issued by this U.S.-based international group. The same legal principles should apply to RPs as schemes in this context.

Syncreon is a provider of global logistics services to technology and automotive manufacturers, and it has a complex organisational structure. Its secured loans and notes were issued and guaranteed by entities in a multitude of countries throughout the world, including the U.S., the UK, the Netherlands, Canada, Germany, Ireland, Hungary, Poland, and the Isle of Man. In order to strengthen the connection to the English jurisdiction for the purposes of establishing jurisdiction for the schemes, the parties to the restructuring support agreement agreed to amend the governing law and jurisdiction clauses of the facilities agreement, the guarantee agreements, and the notes indenture from New York to England. During the required consent solicitation process with the lenders and the noteholders, it was expressly disclosed that the purpose of the governing law change was to create a sufficient connection to the English jurisdiction with a view to implementing a restructuring by way of English schemes of arrangement.

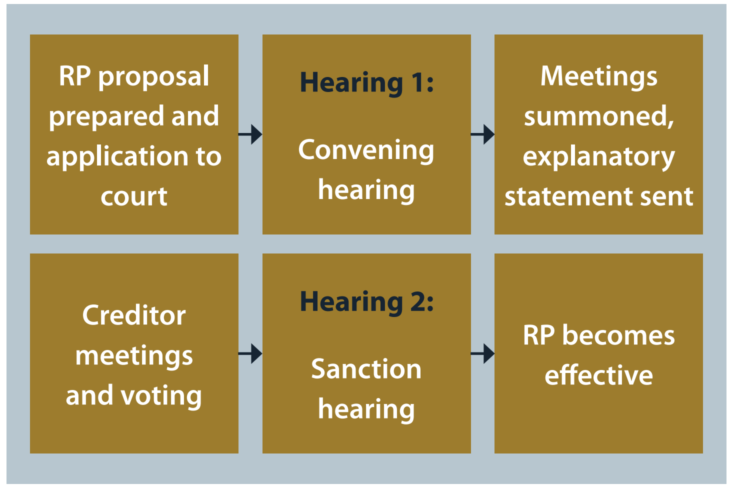
Stakeholders have decided to use an English restructuring tool rather than Chapter 11 because, among other things, unlike Chapter 11 (where, absent special circumstances, a party benefitting from a release of guarantees must be a Chapter 11 debtor), an English scheme can be used to release guarantees even if the guarantor is not a party to the scheme. Under the terms of the schemes, the relevant obligors and guarantors (including non-scheme companies in the United States and Canada) in the Syncreon group have been released from their obligations under a senior secured credit facility granted in favor of Syncreon Group BV.

Recognition in the United States under Chapter 15 of the U.S. Bankruptcy Code and in Canada under Part IV of the Companies' Creditors Arrangement Act has been obtained to ensure the effectiveness of the schemes and releases contemplated by the schemes.

Plan Process

Two court hearings and a creditor and/or member meeting are required to implement an RP.

Convening hearing



The plan company, a creditor, member, or an administrator or liquidator appointed over the plan company may apply to the court for directions to convene a meeting of creditors or members to consider a restructuring plan. Adequate notice must be given to plan creditors and members to enable them to consider the plan proposal, to take advice, and if so advised, to attend the convening hearing. Once the court has made a convening order, the court may temporarily stay other conflicting court proceedings against the plan company.

The plan company needs to separate creditors into different classes and convene a separate meeting for each class (unless its plan creditors or members fall into a single class).

At the convening hearing, the court will assess class constitution by reference to the creditors' (or members')

legal rights. The basic principle remains that a class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest' (*Sovereign Life v Dodd* test).

Sanction hearing

The court may exercise its discretion to sanction the RP at the sanction hearing if at least 75% in value of the creditors or members of at least one class, which is in the money, have voted in favour of the plan proposal. Although there are no provisions which expressly set out how the court should exercise its discretion, the court will rely on the principles that apply to schemes of arrangement. For example, the court may refuse to sanction the RP, despite the procedural requirements being met, if it considers that the RP is not just and equitable (*Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch)).

The court will also consider whether the plan is likely to be given effect in every relevant jurisdiction. The court will test whether there is a reasonable prospect that the restructuring plan will be recognised in the jurisdictions in which it is necessary for it to be effective (those in which any material member of the group has material assets or carries on material business).

The order sanctioning the RP is binding on all affected creditors and members.

Impact on CLO Market Participants

There has been increased CLO issuance in the last three years, and as a result CLOs in Europe hold a lot of debt in the form of bonds or loans. CLO managers are therefore becoming significant players in European restructurings to the extent that distressed loans and bonds are retained and not sold by the vehicle before the restructuring. Because CLO managers often have different considerations to the other players (traditional lenders or distressed investors who have bought the debt at a discount from par investors), they may often require separate legal representation to protect their rights if there is an RP on the horizon.

RPs might be more problematic for CLO managers than for other lenders if the transaction involves an exchange into equity, PIK or similar instruments that do not pay a cash coupon, or a new debt instrument that is issued only to those lenders that are prepared to commit new money. Lenders that do not participate in the new money might find themselves with a restructured instrument with covenants or even collateral stripped away. In capital structures with many CLOs that are unable or unwilling to commit new money, it may be that the CLO lenders carry sufficient voting power to prevent such consequences. However, in more diverse capital structures (including when some CLOs are able to advance new money but not others) this could be a real issue, and one that is magnified by the RP's cross-class cram-down feature.

Questions CLO managers might want to consider in order to formulate the right approach to restructuring plan negotiations depend on the type of RP the plan company seeks to adopt:

- Debt for equity swap
  - Under what circumstances is the CLO allowed to hold equity under the transaction documents?
  - Will any remaining debt instruments be tradable independently of the equity or be 'stapled'?
- Up-tier exchange
  - To what extent do the transaction documents permit the CLO to participate in a restructuring and inject new money? Without sufficient latitude to participate, a CLO might need to sell debt before the restructuring (at a discount) in order to limit losses, and mitigate the impact of being crammed down or 'left behind' in a stripped-down instrument.
- Amend and extend the underlying debt
  - Is the extended maturity in line with the CLO's life cycle?
  - Is the coupon cash pay or PIK/PIYC, and are non-cash-pay instruments permitted investments under the transaction documents?
  - Will the restructured instrument be rated, and if so what is the expected rating? How would such a rating impact the CLO portfolio?

Case Study – Lessons from Grand Scheme of Arrangement

There have been only a handful of times that the English scheme of arrangement has been used in the context of structured finance. One example was GRAND plc, a €5.4 billion CMBS sold at the height of the structured finance boom in 2006 as a result of Terra Firma purchasing Deutsche Annington and Viterra. The GRAND scheme involved a €504 million equity injection from sponsor Terra Firma, a five-year bond extension in return for higher coupons, and an amendment of the underlying documents.

These changes required formal agreement, and it was unclear whether such majorities could be achieved (or in some cases, what majorities the documents required). In order to give effect to the amendment and extension, the issuer proposed a scheme of arrangement.

In the scheme, noteholders voted as a single class, rather than within the confines of their individual tranches. In order for the scheme to be structured as a single class, the sponsor and issuer were required to demonstrate that all the tranches were likely to be paid in full if the collateral were realised on a controlled basis. A single class meant that noteholders of one tranche could not veto the scheme by failing to approve it on a tranche-by-tranche basis. This analysis and structure may have been different if cross-class cram down had been available in 2012 because there would have been less risk that dissenting tranches could have held out.

Is an RP a Threat or an Opportunity for the Structured Finance World?

Turning to the structured finance world, there might be some securitisation structures where the sponsor sets up the issuer (as an SPV), which issues notes to investors and then on-lends the money to finance its own business. For example, Etihad Airways has obtained financing for a number of airlines it owns wholly or partially through a securitisation structure. Some airlines went into an insolvency process, which caused a default under the notes. As a result, the underlying borrowers subject to insolvency proceedings (Alitalia, Air Berlin, and Jet Airways) did not repay principal, which in turn decreased recoveries to the noteholders.

If we contrast this situation with a counterfactual where the maturity of the notes is extended and the underlying borrowers go through a restructuring plan in the UK to amend and extend the underlying debt to match the maturities of the notes, then one could envisage that the total recovery to the noteholders could potentially be improved. In that case, the RP would be perceived as a value-accreditive action.

Similarly, in the current circumstances some borrowers may default due to sanctions. This in turn would mean that the lender under the underlying loans would not have sufficient cash to pay coupon on the notes it has issued on each interest payment day. Depending on the facts of each case, there might be an opportunity to use an RP to extend maturities of the notes and the loans and to allow for sufficient time for the sanctions to be lifted or the licence to be obtained in order

to proceed with payment to comply with the transaction documents.

Conclusion

There are some dark clouds on the horizon for the global economy. Borrowers need to come up with strategies designed to cope with higher interest rates, higher labour costs and a new generation of employees demanding flexibility, rising fuel costs, and supply chain crisis. Armed conflict in Ukraine and a property crisis in China also impact the global economy. It seems unavoidable that RPs, schemes of arrangement, and other restructuring tools will be utilised as last-resort rescue tools deployed by companies running out of runway to complete a refinancing. Due to changes in the micro- and macro-economic outlook, changes in technology, increases in sustainable investing, and new consumer behaviour patterns, some capital structures won't provide lenders with sufficient comfort to facilitate a refinancing and a more complex restructuring via an RP might be the only option to save the business as a going concern.

Turning to the structured finance world, there might be some securitisation structures where the RP could be used to restructure notes and the underlying loans whose borrowers are affected by the factors set out above, but it remains to be seen if sponsors of securitisation structures are going to consider this new powerful tool. In addition, it appears that CLO managers should be aware of the main features of English RPs given that CLOs became significant players in European restructurings. CLOs may often require separate legal representation to protect their rights if there is an RP on the horizon since they might not be able to participate in the proposed restructuring. It's time to embrace UK restructuring tools given the current state of the global economy, and it remains to be seen to what extent these tools will be used to restructure structured finance products in the coming years. ■

LSTA Updates Model Credit Agreement Provisions for Disqualified Lenders

Over the last decade, it has become common practice for syndicated, leveraged corporate credit agreements to include prohibitions against a lender's ability to assign (and in certain cases, participate) its loans to certain entities set forth on a disqualified institution list (DQ List). Beginning in 2014, the Loan Syndications and Trading Association (LSTA) incorporated standard DQ List provisions in its Model Credit Agreement Provisions (MCAPs). In formulating the provisions, the LSTA sought to balance the competing interests of the borrowers/sponsors versus the lenders.

From the borrower/sponsor perspective, they will typically want the ability to preclude certain entities (and their subsidiaries/affiliates) from being able to become a lender for legitimate business reasons (e.g. believe the entity is a difficult/litigious party) and will typically want to exclude any competitor (and its subsidiaries/affiliates) from being able to become a part of the syndicate (whether as an assignee or participant). Borrowers/sponsors will not want competitors to be able to receive confidential syndicate information that could be used by the competitor to the borrower/sponsors' detriment. From the lenders' perspective, they will want the DQ List provisions to be narrowly tailored so as not to limit their ability to sell their loans to third parties.

On 4 May 2022, the LSTA updated its MCAPs. In the updated MCAPs, the defined term 'disqualified institution' now reads:

> '**Disqualified Institution**' means (a) any Person designated by the Borrower as a 'Disqualified Institution' by written notice delivered to the Arranger on or prior to [date of the Commitment Letter], (b) any other Person that is a Competitor of the Borrower or any of its Subsidiaries, which Person has been designated by the Borrower as a 'Disqualified Institution' by written notice delivered to the Administrative Agent from time to time and (c) as to any entity referenced in either of clauses (a) and (b) above (the '**Primary Disqualified Institution**'), any of such Primary Disqualified Institution's Affiliates designated by the Borrower by written notice delivered to the Administrative Agent from time to time or otherwise reasonably identifiable as an Affiliate of a Primary Disqualified Institution solely on the basis of the similarity of such Affiliate's

name to the name of any entity set forth on the DQ List, but excluding any Bona Fide Debt Fund.

The DQ List now includes designated entities identified by the borrower/sponsor on or before the date of the commitment letter (instead of the date of the credit agreement). The borrower can still update the DQ List from time to time to include designated competitors of the borrower or any of its subsidiaries, and the process for doing so is now less onerous (e.g. the borrower must simply deliver notice to the administrative agent).

The LSTA's approach in the MCAPs is not to nullify settled transfers done in violation of the DQ List provisions, but to afford the borrower certain remedies. Such remedies include: (1) limiting the DQ entity from receiving syndicate level information, attending lender meetings, and participating in votes and decisions; (2) terminating any revolving commitment of a DQ entity and repaying any funded revolving loans held by such DQ entity; (3) purchasing or prepaying term loans by paying the lesser of (x) par and (y) the amount the DQ entity paid to acquire such loans; and (4) forcing the DQ entity to sell all of its interests to an eligible assignee at the lesser of (x) par and (y) the amount the DQ entity paid to acquire such interest. Clauses (3) and (4) are known as the 'yank-a-bank' provisions. Interestingly, in the updated MCAPs the LSTA removed the market price option that was previously included in the yank-a-bank provisions.

In order to promote the visibility and accessibility of the DQ List, the LSTA's MCAPs authorise the administrative agent to post the DQ List on the lender platform that is designated for 'public side' lenders. As noted in the LSTA market advisory published in conjunction with the updated 2022 structure, this is critical. The LSTA DQ List structure provides administrative agents with essentially no liability for any transfer completed in violation of the DQ List. Hence, the responsibility to ensure that transfers are done in compliance with the DQ List falls on the parties involved in the trade. Most importantly, each buyer will want to ensure that it is not a party to a DQ List because there are material negative implications that can arise upon a buyer acquiring a loan when it is a party to a DQ List. Hence, improving access to the DQ List for sellers and prospective buyers is vitally important and continues to be a focus of the LSTA. ■

U.S. Sanctions and Export Controls Against Russia Continue Expansion as Efforts to Target Sanctions Evasion Come into Clearer Focus

As the Russian invasion of Ukraine enters its fifth month, the United States continues to enact economic measures to discourage Russia from continuing hostilities, as well as impair its military operations in the country. Our International Trade & Regulatory Group outlines multiple new developments in sanctions and export controls targeted at Russia.

- Prohibiting new investments in Russia and banning the provision of certain financial services in Russia
- Blocking U.S. banks from processing Russian debt payments and expanding industry restrictions
- Other notable sanctions on Russian financial institutions, industrial companies, and individuals

On 2 June 2022, the U.S. Office of Foreign Assets Control (OFAC) imposed full blocking sanctions on several prominent Russian government officials; a close associate of President Putin and money-manager, Sergei Roldugin; various yachts linked to Putin and the owners and managers of such yachts; a 'Kremlin-aligned yacht brokerage'; and a number of other persons, yachts, and aircraft. With these moves, the U.S. Department of the Treasury announced that it 'can and will go after those responsible for shielding and maintaining these ill-gotten interests.' Along with other actions taken in recent weeks, we see clear signals that the U.S. government is focusing on sanctions evasion worldwide and targeting those who engage in or enable it.

Notable new measures expand on past initiatives to impede Western financing of Russian state and economic activities that contribute to the war effort in Ukraine.

Prohibiting New Investment in the Russian Federation

On 6 April 2022, the White House issued Executive Order (EO) 14071, Prohibiting New Investment in and Certain Services to the Russian Federation in Response to Continued Russian Federation Aggression, which prohibits new investment in Russia by U.S. persons, including U.S. companies, wherever located. EO 14071 also prohibits U.S. persons, wherever located, from approving, financing, facilitating, or guaranteeing a transaction by a foreign person involving new investments in Russia if the transaction by that foreign person would be prohibited if performed by a U.S. person or within the United States.

On 6 June 2022, OFAC provided public guidance on this new investment ban in Russia. According to OFAC guidance on the ban, 'new investment' means 'the commitment of capital or other assets for the purpose of generating returns or appreciation,' pursuant to an agreement entered on or after

6 April 2022. New investment also includes commitments pursuant to the exercise of rights under an agreement entered into before 6 April 2022 if such commitment is made on or after 6 April 2022.

However, new investment excludes the 'maintenance' of an investment in Russia made before 6 April 2022. Such maintenance includes all transactions ordinarily incident to performing under an agreement in effect before 6 April 2022, provided that such transactions are 'consistent with previously established practices and support pre-existing projects or operations.' Additionally, the investment ban does not prohibit 'the export or import of goods, services, or technology, or related sales or purchases, to or from the Russian Federation, provided that such transaction is made pursuant to ordinary commercial sales terms.' Furthermore, U.S. companies can continue to fund projects or operations, in existence before 6 April 2022, of their subsidiaries and affiliates located in Russia as long as the use of the funds by the subsidiary or affiliate is for maintenance.

The investment ban also does not prohibit U.S. individuals or entities from lending funds to, or purchasing an equity interest in, entities located outside Russia, if such funds are not specifically intended for new projects or operations in Russia and the revenues of the entity located outside Russia are not predominantly derived from its investments in Russia. However, U.S. parties are prohibited from purchasing debt or equity securities issued by an entity in Russia, but not prohibited from selling or divesting, or facilitating the sale or divestment of, debt or equity securities issued by an entity in Russia to a non-U.S. party.

Prohibitions Related to Certain Accounting, Trust and Corporate Formation, and Management Consulting Services

Additionally, EO 14071 announced that the Secretary of the Treasury, in consultation with the Secretary of State, is now authorised to prohibit the exportation, re-exportation, sale, or supply, directly or indirectly, from the United States, or by a U.S. person, wherever located, of any category of services to any person located in the Russian Federation. On 8 May 2022, pursuant to EO 14071, Treasury announced that it had determined that it would apply this prohibition, starting 7 June 2022, to accounting, trust and corporate formation, and management consulting services. Treasury identified these specific services because they provide Russian elites and Russian government-owned companies critical support to accrue the capital needed for furthering Russian aggression, as well as evade sanctions.

Further guidance provided by OFAC clarifies that:

- 'Accounting services' include services related to the measurement, processing, and evaluation of financial data about economic entities, such as a credit rating and audit services.
- 'Trust and corporate formation services' include services related to assisting persons in forming or structuring legal persons; providing a registered office, business address, correspondence address, or administrative address for legal persons; and providing administrative services for trusts.
- 'Management consulting services' include services related to strategic business advice; organisational and systems planning, evaluation, and selection; development or evaluation of marketing programs or implementation; mergers, acquisitions, and organisational structure; staff augmentation and human resources policies and practices; and brand management.
- 'Credit rating services' means services related to assessments of a borrower's ability to meet financial commitments, including analysis of general creditworthiness or 'with respect to' a specific debt or financial obligation.
- 'Auditing services' means examination or inspection of business records by an auditor, including checking and verifying accounts, statements, or other representation of the financial position or regulatory compliance of the auditee.

Despite this prohibition, the determination allows these services to be provided: (1) to an entity located in the Russian Federation that is owned or controlled, directly or indirectly, by a U.S. person; and (2) in connection with the wind down or divestiture of an entity located in the Russian Federation that is not owned or controlled, directly or indirectly, by a Russian person. Additionally, General License 34 allows for transactions ordinarily incident and necessary to the wind down, directly or indirectly, from the United States, or by a U.S. person, wherever located, of accounting, trust and corporate formation, or management consulting services to any person located in the Russian Federation through 12:01 a.m. eastern daylight time, 7 July 2022. Similarly, General License 35 allows for transactions ordinarily incident and necessary to the wind down, directly or indirectly, from the United States, or by a U.S. person, wherever located, of credit rating or auditing services to any person located in the Russian Federation through 12:01 a.m. eastern daylight time, 20 August 2022.

As these novel prohibitions affecting accounting, trust and corporate formation, and management consulting services take effect, a number of questions remain about the reach of these prohibitions to the delivery of ordinary account holder statements to individual Russian investors, shareholders, and account holders in U.S. financial institutions and investment vehicles.

Treasury Blocks U.S. Banks from Processing Russian Debt Payments

Since 28 February 2022, Directive 4 under EO 14024 has prohibited U.S. persons from transacting with certain entities of the Russian government, specifically the Central Bank of the Russian Federation, the Russian National Wealth Fund, and the Ministry of Finance of the Russian Federation. However, OFAC issued a general license that permitted U.S. financial institutions to continue processing U.S. dollar-denominated sovereign debt payments by the three Russian government entities, allowing the Russian government to avoid default on its sovereign debt obligations.

The U.S. government renewed the general license as different versions became close to expiration. However, OFAC declined to renew the most recent version of the license, General License 9C, when it expired on 25 May 2022, closing this carve out that allowed for Russian sovereign debt to be paid in U.S. dollars. This follows an earlier U.S. decision, on 6 April 2022, to stop allowing the Russian government to pay bondholders via foreign currency reserves held by the Russian government at

U.S. financial institutions in an effort to deplete its holdings of U.S. dollars. Russia has yet to announce a plan for paying its U.S. dollar debt obligations to international lenders.

While elements of General License 9C have expired, General License 13A allows, with certain exceptions, U.S. persons and entities to pay taxes, fees, or import duties, and purchase or receive permits, licenses, registrations, or certifications, that are otherwise prohibited under Directive 4, through 12:01 a.m. eastern daylight time, 30 September 2022. This general license requires such transactions to be 'ordinarily incident and necessary to the day-to-day operations in the Russian Federation of such U.S. persons or entities.'

While there was a general consensus that General License 13A and its predecessor allowed for transactions to apply for, renew, and maintain intellectual property, OFAC responded to industry requests for clarity and longer-term certainty when it issued General License 31, which authorises a wide range of activities related to the protection of intellectual property in Russia. It has no expiration.

Notable Sanctions on Russian Entities and Individuals

The United States is continuing to place full blocking sanctions on Russian financial institutions to isolate the financial sector of the country from Western financing. On 6 April, full blocking sanctions were imposed on Russia's largest financial institution, Sberbank, and 42 of its subsidiaries, and Russia's largest private bank, Alfa-Bank, and five subsidiaries. This action freezes Sberbank's and Alfa-Bank's assets touching the U.S financial system and prohibits U.S. persons from taking part in transactions involving either entity.

Sberbank holds nearly one-third of the overall Russian banking sector's assets and is systemically critical to the Russian economy. Alfa-Bank is Russia's largest privately owned financial institution and Russia's fourth largest financial institution overall. Joint Stock Company Moscow Industrial Bank, a Russian-state owned bank, and 10 subsidiaries and Transkapitalbank and one subsidiary are also subject to full blocking sanctions because they have been accused of helping other sanctioned Russian banks and clients circumvent U.S. sanctions. In some instances, general licenses authorise continued wind-down activities involving these sanctioned banks for a limited time.

In addition to Russian entities, OFAC is also continuing to place full blocking sanctions on Russian government figures, elites, and their family members. These include sanctions on President Putin's adult children, Foreign Minister Lavrov's wife and daughter, and members of Russia's Security Council including former president and prime minister of Russia Dmitry Medvedev and Prime Minister Mikhail Mishustin. Sanctions were also levied against various ministers of Russian government agencies, including its ministers of economic development, transport, and construction, housing, and utilities, along with Deputy Prime Minister Dmitry Grigorenko. Senior executives of Sberbank and board members of Gazprombank are also among those now cut off from the U.S. financial system and whose assets in the United States are now frozen.

Conclusion

As the conflict in Ukraine persists, companies that continue to engage in business activities in Russia should continue to adjust to new U.S sanctions and export controls to ensure compliance during this extraordinary time. While the recent tranches of sanctions and export controls have targeted Russian individuals, entities, and market sectors, there are still sanction targets available if the United States elects to further escalate sanctions in response to the situation on the ground in Ukraine.

Future economic measures by the United States are expected to aim to further degrade Russia's military and economic capabilities through expanded targeting of Russian industries, financial entities, and elites. The U.S. government can also be expected to utilise multiple sources to identify, prevent, and punish evasion of sanctions imposed thus far. Companies should continue to monitor and adapt their screening mechanisms and compliance programs to address current and future developments in U.S. sanctions and export controls focused on Russia.

The original advisory can be found here. ■

Sharing Income Rather Than Drawing Student Loans: The Structure, Economics, and Regulation of Income Share Agreements

Income share agreements (ISAs) are continuing to gain traction as an alternative to private student loans and other traditional forms of federal student aid. The finance product is frequently leveraged to enable students to attend smaller higher education programs, credentialing programs, or a non-degree-granting institution (e.g. a coding bootcamp). The finance product is perhaps most attractive to investors and lenders when the underlying ISA origination platform criteria is focused on educational and training programs in fields with a high likelihood of sustained employment.

An ISA is structured to finance all or a portion of a student obligor's tuition up front in exchange for a pre-determined percentage of their post-graduation gross income for a determined period of time or until the student obligor reaches a payment cap. Assuming she does not drop out of the program, the student obligor's obligations under the ISA to repay do not commence until after successful completion of the education program and a grace period. The ISA provider will disburse the tuition proceeds directly to the educational institution for payment of the tuition of the related student obligor's program.

Is an ISA a Loan?

ISA providers long maintained that their product falls outside state and federal regulation of consumer loans. Unlike loans, ISAs do not have a set repayment amount and do not accrue interest on unpaid amounts. Rather, the obligor's repayment obligation is triggered once the obligor's salary reaches a certain minimum amount; the obligation consists of a set percentage of the obligor's salary so long as the obligor remains employed at a salary above the minimum level.

While loan payments extend until the amount owed is repaid, ISAs have a set number of years during which they may be payable. Repayment occurs during a set period, which is typically extended for a set number of additional months

when the obligor is either unemployed or not earning sufficient salary. Once the payment period ends, the obligor has no further payment obligations, regardless of how much was paid. Regardless of the obligor's salary, their repayment obligation may not exceed certain caps, which include a given multiple of the borrowing and potentially deemed interest rate and other caps. Certain differences in principal, interest, and repayment structure and timing exist between ISAs and consumer loans.

However, on 7 September 2021, the Consumer Financial Protection Bureau (CFPB) announced a consent order with an ISA provider, Better Future Forward Inc. (BFF), which further clarified federal ISA regulation but did not impose any monetary penalties on BFF in consideration for good faith and substantial compliance with the CFPB's consent order. Notably, the CFPB found that ISAs are extensions of credit under the Consumer Financial Protection Act and Truth in Lending Act (TILA) and are 'private education loans' under TILA. This determination required several changes to BFF's product, including:

- Discontinuing any deceptive misrepresentations that ISAs are not loans and do not create consumer debt.
- With certain exceptions due to the nature of ISAs, incorporating disclosures required by TILA and its implementing Regulation Z for closed-end credit, including amount financed, finance charges and APR, and other disclosures required for private education loans.
- Removing any fees or other charges that constitute prepayment penalties in violation of TILA and, for certain ISAs, recalculating the payment caps to eliminate any implicit prepayment penalty.
- Continuing its practice of not objecting to discharge of ISAs in bankruptcy, including not contesting that repaying a student's ISA would present an undue hardship.

Further statements of government and regulatory bodies have continued the trend set by the consent order. In January 2022, the CFPB updated its examination procedures for private student lending in which it explicitly addressed ISAs as a form of non-traditional private education loans. Congress, the U.S. Department of Education (DOE), and state regulators have also begun to focus on these finance products and have taken steps such as outlining disclosure requirements, restricting high and unusual fees, and prohibiting conflicts of interest on college-endorsed financial products. On 2 March 2022, Rich Williams, the DOE's chief of staff for the Office of Postsecondary Education, announced that 'ISAs used to finance expenses for postsecondary education are private education loans for the purposes of the department's rules on preferred lender arrangements.'

With an increasing trend towards enhanced federal and state regulation of such finance products, it is in the best interest of ISA providers to pre-emptively comply with federal consumer financial law to avoid any potential liability down the road.

These changes have provided some welcome clarity on federal regulation of ISAs, but disparities remain among state-law ISA regulations: do ISAs constitute loans, and are ISA providers subject to state lending laws and license requirements?

Potentially, the CFPB consent order may influence state regulators, leading to a broader requirement for loan licensing for ISA providers, but this movement had traction even before the ruling – Illinois, for example, is currently developing legislation that would require state licensing. Meanwhile, other states have adopted laws making ISAs significantly less viable, with a small number of states currently being quite restrictive. One ISA provider, Meratas Inc., even proactively entered into a consent order in California before the state's Department of Financial Protection and Innovation could declare that the ISA they were providing was a student loan for the purpose of California's Student Loan Servicing Act.

ISAs Moving Forward

The economics of ISA structures depend heavily on the obligor promptly obtaining steady employment post-graduation. This requirement may limit the breadth of the ISA market, and the limit may be narrowed further by the current economic uncertainty. Moreover, differing state regulations can create significant hardships for operations, so remaining aware of the state ISA regulatory landscape is imperative.

With an increasing trend towards enhanced federal and state regulation of such finance products, it is in the best interest of ISA providers to pre-emptively comply with federal consumer financial law to avoid any potential liability down the road. This involves compliance with the private education loan requirements in 34 C.F.R. Part 601, including critical disclosure, consumer protection, and reporting requirements. Ongoing reassessments of the state of play of ISAs and federal and state governments' oversight of those products will be necessary for a successful and thriving business model. ■

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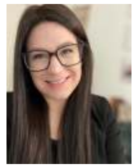

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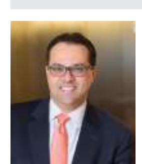

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