ALSTON & BIRD

STRUCTURED FINANCE **SPECTRUM**

In this issue

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- Brave New World: Are NFTs the Next Frontier of Securitization?
- SASB's Late Entrance to the SOFR Party
- CRE CLOs: Kicking A$$ and Taking Names
- New Bicoastal Disclosure Requirements for Commercial Financing Transactions
- Even Better Than the Real Thing? The Use of Synthetic LIBOR
- HM Treasury's Review of the UK Securitization Industry Concludes, and There's Much to Think About
- Banner Year for the U.S. CLO Market
- Regulatory Roundup: Marketplace Lending Rate Caps
- The Never-Ending LIBOR Transition Ripple Effect: Modifications to LSTA and LMA Secondary Trading Documents
- Corporate Debt + Structured Finance Sitting in a Tree… Early Stage FinTech Platforms Leverage Hybrid Structures to Scale Up Faster
- Lenders and Servicers Ghost Office Space: It's Not You, It's Me

Editor's Note

We are midway through the first quarter(!), and the frenzy that was 2021 is just beginning to calm down a tad. It has been a wild ride, and we are cautiously optimistic that 2022 is shaping up to be better than its immediate predecessors. The market for structured finance remains strong. We are seeing lots of new market participants, some new structures, and robust deal volume. All good signs! It has also been heartening to be back in the office a few days a week and reconnecting in person with colleagues, friends, and clients. With Valentine's Day season here, the human element of what we do day in and day out cannot be understated. People need people! In any event, I hope each of you feels similarly encouraged, and we at Alston & Bird look forward to keeping you abreast of the latest market developments. Please enjoy the issue.

Aimee Cummo
Partner, Finance

Brave New World: Are NFTs the Next Frontier of Securitization?

Everyone in the structured finance space knows that anything that flows cash is an asset that can be securitized. The more esoteric the asset, the more difficult it is to conceptualize, but the maxim still applies. That said, could the principle apply to non-fungible tokens (NFTs), assuming one grasps what an NFT is (forget about explaining it). Hypothetically, when an NFT is purchased and sold, cash is exchanged for the NFT. NFTs trading on a cryptocurrency-based platform (have we lost you yet?) could generate, for example, Ethereum that could be distributed to investors in Ethereum-backed NFT asset-backed securities (ABS). NFTs, while of limited value in their own right (although no less than any other intangible), may include rights to access the NFT, which might generate cash flow outside the purchase and sale of the NFT. Access rights derived from owning the NFT may also contain value. For example, BAYC's (Bored Ape Yacht Club) NFTs may generate cash from the ability to access. Someone, for example, may want to pay money to draw graffiti on the walls of the yacht club bathroom.

While there is no risk of "loss" per se, there is quantifiable risk in the amount of potential cash flow. Let's take an example.

A group of 100 promising musicians[1] each create an NFT out of a song, or maybe the conceptual equivalent of a single with A and B sides, and pool any potential NFT revenue. Some artists will succeed, some will fail. But all artists would get paid up front, possibly not taking the risk of that initial venture into the art form.

> "There's enormous potential value to investing in NFT ABS.

Investors would get diversification among the artists, without having to evaluate the relative chances of success, but feel supportive of the type of music generally. And the number of times their particular song is accessed could be noted, to determine relative value for future NFT ABS. So an investor not wanting to evaluate the individual artists may purchase them all at once. This could be isolated to a particular form of music, such as Irish folk music, reggae, or some kind of new techno-pop.

This is where it gets weird. NFT platforms have a fascinating feature whereby revenue from the NFT is distributed among its creators according to fixed percentages. Pooled NFTs could create crypto-backed NFT ABS where the bonds themselves could be NFTs. There may be some value in owning an NFT ABS by owning a unique asset, which would create an intrinsic premium.

But there's enormous potential value to investing in NFT ABS. Take the Irish folk music NFT ABS example: the investor would get its own NFT percentage, would get paid in cryptocurrency, and would get the value of owning the unique ABS NFT asset. If individual NFTs could be created for those investments in NFTs (maybe a leprechaun with different colored hats and clovers), that could add value to the investment as well. This is a newer and potentially more appealing form of crowdfunding.

Regardless, Web3, whether real or not, the future or not, may be a way for artists to enhance their revenue through NFTs. Securitization may make it more lucrative—and more interesting and fun. While certain logistical, technological, and legal issues may arise, the foundation is there for exploration. At Alston & Bird, we are always looking for ways to spread the benefits of securitization, especially those artists who have lost revenue streams in the current technological environment. ■

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[1] Note that this could be other artists or combinations of artists. See for example the recent exhibit of NFTs involving music and photography at the Gallery of Photography of Ireland. Some of the NFTs created have a securitization-like feature where specified percentages of generated revenue are given to the musician and the photographer.

SASB's Late Entrance to the SOFR Party

The year 2021 marked an unexpected rise in the number and size of single-asset, single-borrower (SASB) commercial mortgage-backed securities (CMBS) transactions. The SASB market increased from $23.8 billion over 47 SASB CMBS transactions in 2020 to $79.1 billion over 110 CMBS transactions in 2021. The vast majority of these deals were floating-rate transactions.

What did not occur in the 2021 SASB market was the expected transition from LIBOR-based deals to secured overnight financing rate (SOFR) (or another alternative index) based deals. As 2022 has arrived and new deals prepare to come to market, the transition at long last appears to be happening.

The first SASB deals to come to market in 2022 began hitting the lawyers' desks in late December. After much talk of whether the new deals would be based off of CME Group's Term SOFR, compound SOFR, BSBY, or perhaps something else, each of the deals initially focus on Term SOFR, the forward-looking term rate based on SOFR, currently identified on the CME Group's website. SOFR is administered by the Federal Reserve Bank of New York.

Lenders and borrowers are prepared for potential changes to the current environment. Documents provide for loans to become alternate-rate loans based on an index other than Term SOFR. They also provide for a fallback to a prime-rate loan should an alternate index not be available.

The provisions do their best to account for differences in potential indexes at least initially, although that may shift over time.

With that said, the initial wave of deals no longer rely on LIBOR, and while Term SOFR appears to be the index, it is not yet certain it will remain. ■

CRE CLOs: Kicking A$$ and Taking Names

No one predicted the enormous growth of the commercial real estate collateralized loan obligation (CRE CLO) market last year. Early reports show 2021 rocketed to $45.4 billion in issuance through 51 deals compared with 2020 issuance of $8.7 billion and 2019 issuance of $19.2 billion. Managed deals, allowing acquisition of new loans during a ramp-up period and funded participations during a reinvestment period, have gained favor with investors as they composed nearly 70% of 2021 transactions compared with 20% for 2020.

Capital has flooded into the space and sponsors are eager to deploy it after seeing relatively small losses during the pandemic crisis. Borrowers are pursuing floating-rate debt for transitional properties while showing less interest in the less flexible 10-year fixed-rate conduit funding for stabilized properties. The ability to structure future funding into the loans to match the borrower's rehab and redevelopment schedule is another advantage over conduit loans. There were over 27 different sponsors in 2021 compared with just eight in 2020. Investors have expressed some preference for the veteran issuers over the upstarts, as evidenced by tighter spreads on those deals.

Not surprisingly, the maturity of the market has been facilitated by a strong multifamily loan component (69%), but new product concentrations are also emerging, including recent health-care-only and hotel-only issuances. Investor appetite seems positive, with a return premium and the ability to diversify into a specific sector. Part of the investor comfort level is the CRE CLO structure itself, which represents the quintessential risk retention application: sponsors typically retain the bottom 15%–20% of the transaction, aligning their interests with the investors, in contrast to conduit transactions. Borrowers also have higher comfort levels because the lender remains invested and involved in the loan with much ongoing interaction on business plans and funding requests, and the sponsor is often also the special servicer and collateral manager, unlike conduit deals.

The growing receptivity of managed deals is facilitated by eligibility criteria providing important guardrails such as property type limitations, LTV limits, minimum DSCR, maximum loan amounts, geographic concentration limits, Herfindahl scores, note protection tests, and rating agency no-downgrade confirmation for new loan additions. Sponsors have also received greater flexibility in loan administration through the expansion of administrative modifications and criteria-based modifications, which may be effected without rating agency approval or subject to the servicing standard; rather, the collateral manager may direct such actions, but is bound by the collateral manager standard. Other limits and certain rating agency approvals may apply.

So long as sponsors continue to present transition loans with rational business plans and solid underwriting, this market should flourish and provide both attractive returns to investors and a useful capital source for lenders. Updates to the CREFC investor reporting package addressing the dynamic differences between conduit and CRE CLOs are also important and eagerly anticipated. Bottom line: 2022 should be another banner year for CRE CLOs. ■

New Bicoastal Disclosure Requirements for Commercial Financing Transactions

As a general matter, state regulation of commercial lending is relatively light, and few states impose licensing requirements on commercial loan origination. In two noteworthy state developments, however, New York and California will require loan "providers" to furnish certain consumer-like disclosures before the consummation of commercial financing transactions.

The New York requirements took effect on January 1, 2022. The California requirements will not take effect until the effective date of final implementing regulations promulgated by the California Department of Financial Protection and Innovation (DFPI), which has not yet occurred. Notably, both laws exempt commercial financing secured by real property, but it is unclear whether mezzanine lending is included in such exemptions.

The New York Law

The New York law requires "providers" of non-real-estate commercial credit to provide Truth in Lending Act (TILA)–like disclosures to applicants at the time they extend a specific offer of the financing of $2.5 million or less. Providers include both lenders and brokers. The New York law applies to closed-end financing, open-end financing, and sales-based financing, including merchant cash advances and factoring transactions.

Exemptions

The New York law provides a de minimis exemption for "any person or provider who makes no more than five commercial financing transactions in [New York] in a twelve-month period." Further, financial institutions, which include banks, and certain other chartered depository institutions authorized to conduct business in New York are also exempt from the new commercial loan disclosure law, but the subsidiaries or affiliates of such exempt financial institutions are not exempt. Commercial mortgage financings over $2.5 million are exempt from the law as are transactions secured by real property. It is unclear whether mezzanine lending of $2.5 million or less would be covered by the new law.

Required disclosures

The New York law requires providers to furnish the following type of disclosures, depending on the form of the transaction:

- The total amount of the commercial financing (or maximum amount of available credit) and, if different, the disbursement amount.
- The finance charge.
- The annual percentage rate (APR), calculated largely in accordance with TILA and Regulation Z.
- The total repayment amount.
- The term of the financing.
- The amounts and frequency of payments.
- A description of all other potential fees and charges.
- A description of any prepayment charges.
- A description of any collateral requirements or security interests.

The California Law

The California law (SB 1235), which was signed into law on September 30, 2018 but is not effective until the DFPI promulgates final regulations, amends the California Financing Law (CFL) to require "providers" licensed under the CFL who facilitate "commercial financing" to a "recipient" to disclose to the recipient at the time of extending a specific offer of commercial financing specified information relating to the transaction and to obtain the recipient's signature on that disclosure before consummating the commercial financing transaction.

The California law otherwise applies to, among other things, commercial loans, certain commercial open-end plans, factoring, merchant cash advances, and commercial asset-based lending. Unlike the New York law, which applies to brokers as well as lenders, under the California law "provider" is primarily limited to entities extending credit, such as lenders/originators, but it also includes a nonbank partner in a marketplace lending arrangement that facilitates the arrangement of financing through a financial institution. Further, the California law defines "recipient" as the applicant of commercial credit of $500,000 or less.

Exemptions

The California law exempts, among others, depository institutions and entities that make no more than one commercial financing in a 12-month period or make five or fewer commercial financing transactions in California in a 12-month period that are incidental to the business of the entity relying on the exemption.

Further, the California law does not apply to transactions greater than $500,000 or to real-estate-secured commercial loans or financings. It is unclear, however, whether mezzanine lending of $500,000 or less would be covered by the California law.

Required disclosures

Once implemented, the California law will require the provider to disclose, among other information:

- The total amount of funds provided.
- The total cost of the financing.
- The term or estimated term.
- The method, frequency, and amount of payments.
- A description of prepayment penalties.

The DFPI has issued several sets of proposed regulations and has solicited public comment on these regulations. The DFPI issued its most recent version of the regulations for public comment on October 12, 2021, and the comment period ended on October 27, 2021. It is uncertain when the DFPI intends to promulgate final regulations with a mandated effective date.

Up to this point, state regulation of commercial lending has been relatively light. The New York and California laws are not only burdensome to lenders, they could be harbingers of developments to come in this area. ■

Even Better Than the Real Thing? The Use of Synthetic LIBOR

On December 31, 2021, the UK's Financial Conduct Authority (FCA) announced that the publication of 24 of the 35 London inter-bank offered rate (LIBOR) settings had ceased. This included all seven sterling, all seven Japanese yen, the 1-week and 2-month U.S. dollar, all seven Swiss franc, and all seven Euro LIBOR versions. Though most market participants had been preparing for the cessation of LIBOR for some time, the FCA remained concerned that the sudden cessation of LIBOR may cause significant disruption to markets, market participants, and (most importantly for the FCA) consumers if interest payments in loans and bonds that had not switched to an alternative calculation methodology could no longer calculate LIBOR.

Accordingly, the FCA published a notice on January 1, 2022 requiring the ICE Benchmark Administration (IBA), LIBOR's administrator, to publish the six most widely used sterling and Japanese yen LIBOR versions on a synthetic basis from January 1, 2022 until the end of 2022 to allow more time to complete the transition. The FCA stated that the publication of LIBOR on a synthetic basis is required because the FCA "considers it: (1) appropriate to do so having regard to the desirability of securing that the cessation of each of the 6 LIBOR Versions takes place in an orderly fashion; and (2) desirable to do so in order to advance both our consumer protection and integrity objectives."

In the FCA's view, sustaining the six LIBOR versions on a synthetic basis minimizes market disruption by allowing relevant contracts to continue to function in an orderly manner, maintains transparency and resilience in the market, and allows outstanding LIBOR-referencing contracts to continue to function in line with the already defined rights and obligations in the contracts through the wind-down period. The availability and use of synthetic LIBOR may be viewed as representing a welcome relief to the financial sector.

But it is important to note that such welcome relief is limited and can only be used sparingly. The FCA has further made it clear that synthetic LIBOR is temporary. The use of the six LIBOR versions is limited to legacy contracts only. The six LIBOR versions will be short term, with a maximum of 10 years for sterling (with an annual review) and one year only for yen. The synthetic LIBOR methodology is not based on panel bank contributions and is not representative of the underlying market or economic reality the setting is intended to measure.

The methodology used to calculate is as follows:

- For synthetic sterling LIBOR, the FCA selected the ICE Term SONIA Reference Rate (TSRR). The TSRR measures the expectation of SONIA interest rates over the relevant forward-looking time period. It is based on the fixed rates offered in SONIA-referencing derivatives markets, which provide information on market expectations of the varying overnight SONIA rates over a forward-looking one-, three-, or six-month period.

- For Japanese yen LIBOR, the FCA selected the Tokyo Term Risk Free Rate (TORF) as a component for the purpose of producing 1-, 3-, and 6-month Japanese yen LIBOR versions under the changed methodology. TORF, provided by Quick Benchmarks Inc., is recommended by the Japanese Cross-Industry Committee and is the only forward-looking term risk-free rate for the yen. TORF measures the expectation of Tokyo overnight average (TONA) interest rates over the relevant forward-looking time period. It is based on the fixed rates offered in TONA-referencing derivatives markets (e.g., OIS) that provide information on market expectations of the varying overnight TONA rates over a forward-looking one-, three-, or six-month period. The FCA decided that TORF should be adjusted as TORF*(360/365) in calculating a synthetic yen LIBOR to take into account day count differences between yen LIBOR and TORF/TONA rate.

Finally, for both sterling and yen synthetic LIBOR, the FCA considers that adding the ISDA spread adjustment to the relevant forward-looking risk-free rate provides for a reasonable and fair approximation of the relevant LIBOR version and reduces the value transfer that would occur if only the forward-looking risk-free rate were used.

In practical terms, it is likely that synthetic LIBOR will appear as one amount (rate + spread), on the same page and at the same time the relevant LIBOR currently appears.

Following the notice (with effect from January 1, 2022), the IBA is calculating the six LIBOR versions as follows:

1) 1-month sterling LIBOR as the sum of the ICE 1-month Term SONIA Reference Rate and the ISDA Spread Adjustment for 1-month sterling LIBOR.

2) 3-month sterling LIBOR as the sum of the ICE 3-month Term SONIA Reference Rate and the ISDA Spread Adjustment for 3-month sterling LIBOR.

3) 6-month sterling LIBOR as the sum of the ICE 6-month Term SONIA Reference Rate and the ISDA Spread Adjustment for 6-month sterling LIBOR.

4) 1-month yen LIBOR as the sum of the QBS 1-month TORF *(360/365) and the ISDA Spread Adjustment for 1-month yen LIBOR.

5) 3-month yen LIBOR as the sum of the QBS 3-month TORF*(360/365) and the ISDA Spread Adjustment for 3-month yen LIBOR.

6) 6-month yen LIBOR as the sum of the QBS 6-month TORF*(360/365) and the ISDA Spread Adjustment for 6-month yen LIBOR.

In another effort to ensure continuity through the use of synthetic LIBOR, on December 15, 2021, the Critical Benchmarks (References and Administrators' Liability) Act 2021 obtained Royal Assent.

In an effort to deal with contract continuity, the Act seeks to provide more certainty for parties to legacy contracts that contain references to LIBOR and aims to allow contracts to continue operating if the FCA exercises certain powers in relation to LIBOR (i.e., a change to synthetic LIBOR). Under the Act, such contracts should be treated as referencing LIBOR after the FCA has exercised its powers. It provides that a contract is to be treated as having always provided for the reference to LIBOR to be interpreted as synthetic LIBOR (except to the extent that this is expressly excluded by contract; local law advice should be sought on whether a contract governed by non-English law should be so treated). Moreover, this would not override contracts that reference a benchmark but have a fallback mechanism allowing for a different benchmark to be used in certain circumstances.

In terms of litigation risk and potential disputes surrounding the use of synthetic LIBOR to calculate payments following December 31, 2021, while the Act does not contain a general safe harbor (unlike the New York legislation), it does grant administrators of benchmarks immunity from legal action when complying with requirements imposed on them by the FCA.

Finally, it should be noted that although five U.S. dollar LIBOR settings will continue to be calculated by panel bank submission until the end of June 2023, on November 16, 2021, the FCA also confirmed that the use of U.S. dollar LIBOR will be prohibited for UK-regulated firms in most new contracts written after December 31, 2021. Firms must convert any legacy U.S. dollar LIBOR contracts by mid-2023.

It is clear that the provision and use of synthetic LIBOR (even on a sparing and temporary basis) provides a continuing step in strengthening the foundations for a more stable financial market landscape to continue the process of transitioning away from LIBOR in an orderly fashion. This clarity, along with the passing of the Act, is to be welcomed. ■

HM Treasury's Review of the UK Securitisation Industry Concludes, and There's Much to Think About

Following the significant role securitisation played in the global financial crisis, the European Union's Securitisation Regulation (EU) 2017/2402 aimed to strengthen the legislative framework surrounding securitisations and to revive securitisation markets. Before its exit from the European Union, the United Kingdom played a full role in the design of the EU Securitisation Regulation as a Member State of the EU. On January 1, 2021, the end of the EU exit transition period, the Securitisation (Amendment) (EU Exit) Regulations 2019 addressed deficiencies that arose from the withdrawal of the UK from the EU, and the EU Securitisation Regulation was "onshored."

One of the requirements of the Securitisation Regulation is for HM Treasury to conduct a review of the functioning of the Securitisation Regulation and submit a report to Parliament by January 1, 2022. This review, HM Treasury's "Review of the Securitisation Regulation: Call for Evidence," closed on September 2, 2021.

A number of organizations from across the securitisation industry have responded to HM Treasury's call for evidence on the Securitisation Regulation. They have called on the UK government to rethink the capital and liquidity treatment of simple, transparent, and standardized (STS) securitisations, to amend the disclosure requirements for private securitisations, to make changes to the regulatory framework, and to improve market access for market participants.

Article 46 of the Securitisation Regulation places a legal obligation on HM Treasury to review the functioning of the Securitisation Regulation. The review, which must be presented to Parliament, is required to assess:

a. The effects of the Sec Reg – including the introduction of the STS framework – on the functioning of the securitisation market, the contribution of securitisation to the real economy (in particular on access to credit for Small and Medium-sized Enterprises (SMEs) and investments), and the interconnectedness between financial institutions and the stability of the financial sector;

b. Risk retention modalities;

c. Disclosures related to private securitisations;

d. An STS equivalence regime;

e. Environmental, Social, and Governance (ESG) disclosures;

f. The third-party verification regime; and

g. Limited licensed banks.

HM Treasury's two overarching aims for the review are:

a. To bolster securitisation standards in the UK, in order to enhance investor protection and promote market transparency; and

b. To support and develop securitisation markets in the UK, including through the increased issuance of STS securitisations, in order to ultimately increase their contribution to the real economy.

Since the Securitisation Regulation has only been applicable since January 1, 2019, there is little data available for this review. In addition, the securitisation market (as with wider financial markets) has been impacted by the COVID-19 pandemic. The issuance of securitisations in the UK was less than previous years (see fig. 1). It may therefore be difficult to distinguish the effects of the pandemic from the wider effects of the implementation of the Securitisation Regulation.

As can be seen from fig. 1, the number of securitisation transactions and issuance volume increased significantly between 2014 and 2018, followed by a drop-off in volume in 2019 (following the onshoring of the Securitisation Regulation) and again in 2020 (as the effects of the pandemic were felt).

As a comparison, during the same time period, the European securitisation market remained relatively flat, while the U.S. securitisation market grew steadily. The U.S. market even saw an increase in issuance volumes into 2020. The review also seeks to query why these differences might have occurred.

Among others, the Association for Financial Markets in Europe and UK Finance (AFME/UKF), which submitted a joint response, Commercial Real Estate Finance Council for Europe (CREFCE), and Prime Collateralised Securities (PCS) have submitted responses to the review.

These respondents agree that, although it is difficult to distinguish the effects of the introduction of the Securitisation Regulation and the STS regime from the wider effects of the pandemic and the loose monetary policy in place since the STS regime's introduction, securitisation has not driven meaningful growth for the real economy. They agree that one of the main reasons for this is that the prudential benefits of STS treatment are modest, especially compared with other funding tools (e.g., covered bonds) and investment options (e.g., corporate bonds).

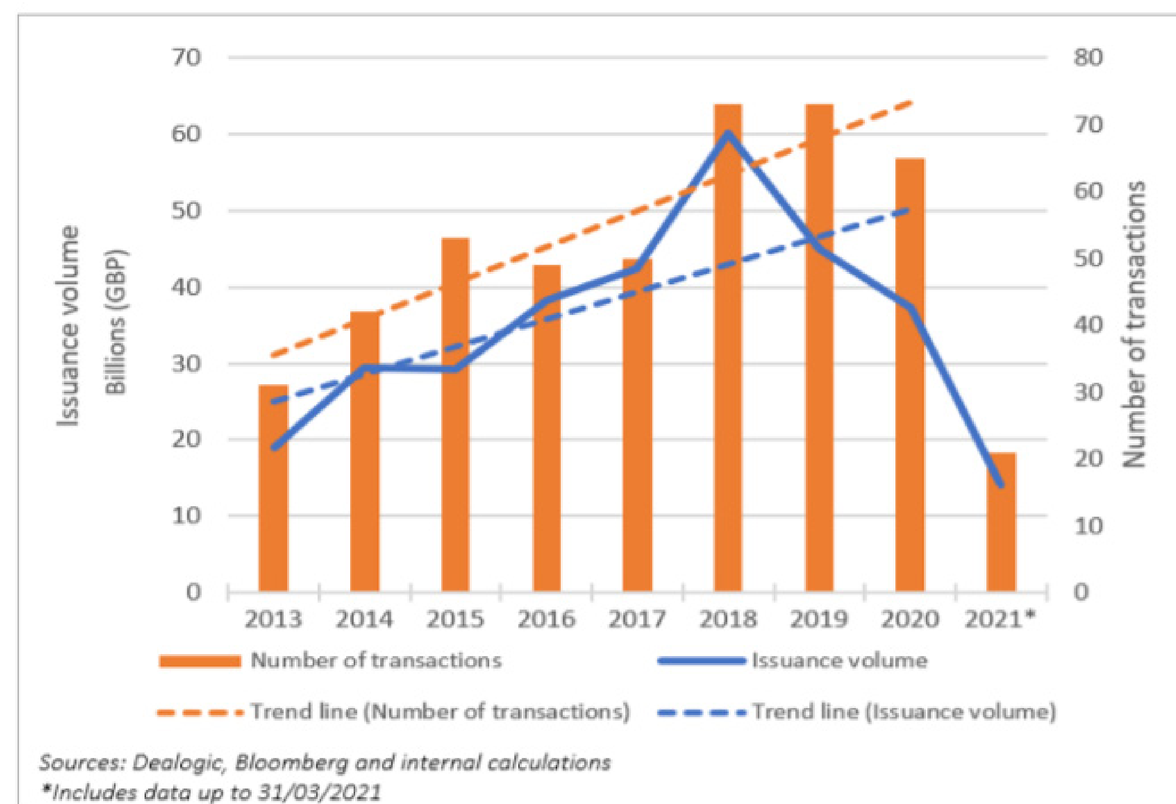

Fig. 1, source: Her Majesty's Treasury

AFME/UKF argue that the government should use the review to transfer the more detailed rules from primary legislation to secondary legislation. In other words, the regulators, rather than Parliament, should have more of a say in the production of legislation on securitisation. This would "facilitate a more flexible, adaptable set of regulations that is more able to meet the needs of a constantly evolving market without sacrificing prudence or accountability."

CREFCE's response supports "the joint submissions of AFME and UK Finance, both specifically in relation to a more principles-based regulatory framework for securitisation in the UK and more broadly." CREFCE agrees with AFMR/UKF that the review should be used to "significantly reduce the level of detailed regulation of securitisation currently contained in the primary legislation" and that "prescriptive rules and a 'one size fits all' approach should be avoided, including for the way disclosure requirements apply to different types of transaction."

All these respondents agree that a challenge facing the Securitisation Regulation, in particular in the context of Brexit, is that of access to other securitisation markets (in particular the U.S. and Europe). AFME/UKF argue that consideration will need to be given to the fact that most publicly placed UK securitisations will "require access to EU investors, US investors or both, to say nothing of significant investors in other regions, including APAC." This means that public securitisations, even when the selling entities are based in the UK, will often need to consider and, in many cases, comply with the regulations of those jurisdictions. AFME/UKF do not think that means the UK should seek to align itself to the rules of those jurisdictions, but that weight should be given to the "interoperability of the regimes" in order for UK entities seeking access to investors will not be unnecessarily burdened attempting to comply with the rules of multiple jurisdictions. CREFCE is in agreement: "interoperability with other relevant regulatory frameworks for securitisation – notably those of the EU and US – is very important if securitisation is to fulfil its potential in the UK."

For CREFCE, from the commercial real estate perspective, "the Securitisation Regulation did not support the growth of well-structured and robust commercial real estate debt securitisation." In CREFCE's opinion, this review provides an opportunity to improve the situation through better regulatory capital and liquidity treatment for commercial mortgage-backed securities under the Capital Requirements Regulation and Solvency II and improved eligibility for the purposes of the liquidity coverage ratio and the Bank of England's Sterling Monetary Framework.

Among other things, PCS uses its response to make the argument that HM Treasury should "see the potential of the UK securitisation market as transcending merely its role as a useful additional funding source for banks with benefits for financial stability." PCS looks to the financial structure of the United States to make the argument that securitisation can be used to provide ample and flexible funding to the real economy. PCS says this can be achieved in three ways:

- First by becoming a flexible tool for banks to manage proactively and on an ongoing basis their capital to be able to meet the real economy's funding needs.
- Secondly, by allowing the growth of a meaningful nonbank financial sector (especially around fintech) that will grow the funding envelope available to the real economy while – properly supervised – reducing the systemic risk associated with deposit taking institution.
- Thirdly, by generating a large volume of high quality/low risk capital market instruments providing UK based investable assets for UK insurance companies, pension funds and asset managers.

The findings of the review were presented to Parliament January 1, 2022. ■

Banner Year for the U.S. CLO Market

Setting a host of new issuance highs, 2021 was a record year for U.S. collateralized loan obligation (CLO) transactions. According to Leveraged Commentary & Data (LCD), cumulative "new issue" deal activity totaled $186.7 billion, easily eclipsing the prior record of $128.8 billion set in 2018 and more than doubling the $93.5 billion mark set during 2020, a year financial markets were buffeted by the emergence of the COVID-19 pandemic. Moreover, the pace of new issuance increased as the year went on: each successive quarter of 2021 set a new quarterly volume record. LCD reports that 128 collateral managers printed new CLOs in 2021, a significant jump over the previous record of 108 set in 2019.

Transactions to adjust the funding costs and deal terms of legacy CLOs also set new issuance records in 2021. Refinancings and resets swelled to $110.1 billion and $134.4 billion, respectively—the highest levels for such transactions since LCD began tracking them.

As recently noted by *The Wall Street Journal*, the U.S. CLO market is now the largest securitized-credit sector in the country, at $850 billion outstanding.

Last year's record CLO activity was driven by several key factors:

- **Strong Collateral Performance** – Booming supply (institutional leveraged loan issuance volume reached $615 billion in 2021, according to LCD) and a benign corporate environment of improved earnings and low default rates (the leveraged loan default rate at year's end was 0.6%, according to Fitch) created fertile conditions for CLO portfolio construction. Closely watched CLO portfolio metrics such as weighted average spread, weighted average rating factor, overcollateralization ratio cushions, and exposure to defaulted and "triple C" assets saw significant improvement in most deals compared with 2020.

- **Attractive Interest Costs** – Given the overall low-rate environment, many yield-hungry investors found CLO debt tranches to be particularly attractive in 2021. Some of the appeal stems from the fact that CLO debt generally pays interest based on a floating rate, which for holders can mitigate some of the effects of inflation. Strong investor demand helped push CLO spreads across the capital stack lower in 2021. By LCD's calculation, the average CLO weighted-average cost of capital dropped 21 basis points over the prior year.

- **LIBOR Deadline** – Banks faced a December 31, 2021 deadline imposed by the Federal Reserve Board and other regulators to cease entering into new contracts that reference USD LIBOR. Although the secured overnight financing rate (SOFR) selected by the Alternative Reference Rates Committee is widely expected to replace LIBOR as the standard reference rate for U.S. CLO liabilities, collateral managers were incentivized to issue LIBOR-based CLOs before the 2021 year-end deadline, given that the vast majority of outstanding leveraged loans continue to reference LIBOR and uncertainty surrounds the implementation of SOFR.

- **Large Refinancing / Reset Inventory** – Last year featured a larger-than-usual inventory of CLOs eligible for refinancing or reset. That inventory accumulated from several sources: 2017- and 2019-vintage deals that were priced at relatively higher spreads; 2016- and 2018-vintage deals that could have been refinanced or reset in 2020 but were not, due to that year's market volatility; and 2020-vintage deals that were issued with non-call periods of one year or less.

Not only was deal activity up significantly, several trends emerged or accelerated over the course of 2021:

- **Loan Tranches** – Senior CLO debt tranches have been issued in loan format (as opposed to the customary security format) for many years, but until recently, such issuances tended to occur only sporadically. Last year saw more widespread use of loan tranches, a format that provides certain CLO debt investors with particular legal investment, capital, and other benefits.

- **Changes in Duration** – Throughout 2021, the market largely transitioned away from the one-year non-call periods and three-year reinvestment periods that characterized so much of broadly syndicated loan (BSL) CLO issuance in 2020 in favor of the two-year non-call periods and five-year reinvestment periods that had become market standard before the emergence of the COVID-19 pandemic. Some reversion to "1/3" deals was noticeable toward the end of 2021, which likely reflects market uncertainties about the transition away from LIBOR.

- **Continued Evolution of ESG Provisions** – The trend of including environmental, social, and governance (ESG) factors in new issue U.S. CLOs, which appreciably emerged only in 2020, accelerated in 2021. U.S. CLO documentation increasingly incorporates ESG factors in portfolio eligibility criteria and reporting requirements, although criteria is limited to negative screening of loans with exposure to prohibited industries, such as controversial weapons and thermal coal. Per LCD, at the end of 2021, 65 U.S. CLO collateral managers, managing $480 billion in CLOs, were signatories to the UN's Principles for Responsible Investing (PRI). PRI signatories commit to incorporate ESG factors into their investment analysis and decisions.

- **Single Rating of CLO Debt Tranches** – The market witnessed a minor sea change in the number of rating agencies typically brought into rate CLO debt tranches, with each tranche in the capital stack sometimes receiving a rating from only one rating agency. This is perhaps not surprising in a year in which rating agencies—like other market participants—experienced noticeable capacity constraints; but it also seems to reflect an increased comfort level among buyers of senior CLO debt that previously required a minimum of two ratings. As a result, some 2021 deals were rated by only one of Fitch, Moody's, or S&P; and some deals had a mix of agencies up and down the stack (e.g., Moody's-rated senior AAAs, Fitch-rated junior AAAs through BBBs, and Moody's-rated BBs).

- **Continued Evolution of Distressed/Workout Asset Provisions** – Toward the latter part of 2019, CLO collateral managers and equity investors began an earnest effort to incorporate features that provide managers with increased flexibility to deal with distressed assets and otherwise participate in workout scenarios into CLO deal documentation. Refinement of those provisions continued in 2021, including the incorporation of multiple categories of distressed/workout assets and often elaborate rules

on the application of cash toward, and the treatment of proceeds received for, distressed/workout assets.

- **Bond Buckets** – At the start of 2021, the amendments to the Volcker Rule adopted in 2020 by five federal agencies were still subject to invalidation under the Congressional Review Act. Before the end of 2021, however, the period for invalidation expired, finally clearing the way for the widespread return of "bond buckets" in U.S. CLOs.

Looking Ahead

Market observers generally expect that U.S. CLO issuance in 2022 will continue to benefit from strong collateral performance and investor demand, as well as robust CLO debt and equity returns. However, according to LCD, analysts project $155 billion to $160 billion in primary market new-issuance activity, a 14% to 17% decrease from 2021.

CLO issuance in 2022 may be affected by a few factors:

- **SOFR** – CLO issuance in the first quarter may proceed slowly until the market settles on the credit spread levels that will facilitate pricing of SOFR-linked CLO liabilities. CLO assets are also expected to transition to SOFR, but at the start of 2022, SOFR-linked leveraged loans represent a relatively small proportion of CLO portfolios—approximately $2.9 billion across 780 CLOs (which is only 0.6% median exposure across CLOs), according to LCD. As the proportion of SOFR-linked loans in CLO portfolios increases, basis risk should lessen for CLOs with outstanding SOFR-linked liabilities. However, basis risk should worsen for CLOs with outstanding LIBOR-linked liabilities, at least until the asset replacement percentage triggers in such deals (which have typically been included in the documentation of recent vintages) are reached and a change in the reference rate for such liabilities is initiated. Uncertainties around SOFR pricing and the optimal management of basis risk may incentivize collateral managers and equity investors to issue new deals with shorter non-call periods, or to delay the timing of refinancings and resets of legacy CLOs until a greater proportion of the underlying portfolio has transitioned away from LIBOR.

- **ESG** – U.S. CLO managers can be expected to continue incorporating ESG factors into their investments in 2022. In the short term, ESG criteria in U.S. CLOs will likely remain varied and focus on negative industry screening. However, the U.S. market may begin moving toward positive screening investment models, particularly if a consensus emerges on what constitutes an "ESG-compliant" CLO or robust and standardized information for making ESG evaluations of leveraged loans becomes available.

- **Monetary Policy** – In addition to the uncertainty of pricing CLO assets and liabilities in the post-LIBOR world, the Federal Reserve's expressed intention to undertake quantitative tightening and rate hikes sooner, and at a faster pace, than previously expected could slow CLO and leveraged loan issuance in the short term. The timing and balance of the Federal Reserve's rate and balance sheet activity remains uncertain, as does the impact that such actions will have on the shape of the yield curve. The market's reaction to multiple rate hikes and drain of liquidity is difficult to predict, but investors may remain wary while the Federal Reserve determines the framework and sequencing of its policy mix. Typically, a rising rate environment benefits CLO equity; however, new-issue CLOs in 2022 will wear basis risk unlike any previous vintage of CLOs, which could diminish (or enhance) equity returns. ■

Regulatory Roundup: Marketplace Lending Rate Caps

In the 2021 legislative sessions, some states, including North Dakota, South Dakota, and a few others, adopted measures affecting the rate of the finance charge on consumer loans. States continue to impose rate caps—or to adjust existing rate caps—on consumer loans. North Dakota and South Dakota have imposed 36% all-in rate caps on finance charges that apply to licensees. With the adoption of its Predatory Loan Prevention Act, Illinois imposed a 36% rate cap on loan charges that applies, with limited exceptions, to any person or entity that offers or makes a loan to a consumer in Illinois.

In addition, a new trend is emerging that potentially expands the application of these rate caps, and Illinois is the harbinger. Specifically, several states have adopted new legislation, or are considering legislative proposals, that could effectively subject certain nonbanks that partner with banks in the origination of consumer loans (e.g., FinTech or marketplace lenders) to these rate cap limitations, even including in such provisions new licensing requirements for the nonbank partners, like Hawaii's installment lender license. In such structures, the bank originating the loan will generally export an interest rate permitted in the state where the bank is located, which may exceed the permissible interest rate in the state where the borrower resides.

The Illinois Predatory Loan Prevention Act couples its rate cap with an anti-evasion provision that utilizes a multifactor test to ascertain if the nonbank partner constitutes the "lender" for purposes of the statute. If the nonbank partner satisfies the test, then the consumer loan would be subject to the Illinois rate cap and not to the rate cap, if any, of the state where the bank ostensibly originating the loan is located.

Illinois is no longer alone in this approach to regulation. The Maine legislature amended the Maine Consumer Credit Code to add anti-evasion provisions that are substantially the same as those in the Illinois Predatory Loan Prevention Act. When the Maine amendment became effective, consumer loans originated under certain marketplace lending arrangements could become subject to the tiered rate cap structure of the Maine Consumer Credit Code. As in Illinois, violations could render the loan void and any principal, fee, interest, or charge uncollectible, which could result in serious consequences for secondary market purchasers of such loans.

Although many existing state statutes contain generic anti-evasion language, the specific adoption of provisions that target marketplace lending arrangements is a new legislative phenomenon, although the antecedents trace to judicial decisions and to state regulatory enforcement actions. Other states are considering similar legislation. These state initiatives arise in the broader context of the joint resolution of disapproval that Congress enacted and that President Biden signed in June 2021 pursuant to the Congressional Review Act of the Office of the Comptroller of the Currency's "True Lender" rule, which negated a uniform standard that applied to loans originated by national banks and savings associations that provided a modicum of regulatory certainty and which returned the legal environment to a state-by-state consumer protection approach. Moreover, the Illinois and Maine amendments arguably undermine the "valid when made" doctrine (i.e., the principle that interest on a loan that is permissible under the laws of the state where a national bank or a savings association is located is not affected by the sale, transfer, or other assignment of the loan), which, again, carries serious implications for purchasers of such consumer loans on the secondary market.

To illustrate the trend further—although no law has yet been enacted, we continue to monitor New Mexico, where legislation was introduced earlier this year that would have amended the New Mexico Small Loan Act of 1955 to increase the dollar amount for the loans subject to the Act from $5,000 to $10,000, to lower the current 175% rate cap to a 36% rate cap, and to add anti-evasion provisions that follow the Illinois text. Although Democrats control both the House and the Senate in the New Mexico state legislature, passage of the bill failed in March 2021 because the two chambers reached an impasse over the rate cap that would apply to loans of $1,100 or less (i.e., an elevated rate cap of 99% or the general rate cap of 36%). However, the two chambers had agreed on the inclusion of the anti-evasion provision.

Passive investors in consumer loans originated in marketplace lending arrangements should engage in a robust regulatory and state licensing due diligence before consummating any transaction involving such loans. As we continue with an Administration highly focused on preserving consumer financial protection and an age in which state regulators have the latitude and authority to enforce state licensing requirements against passive investors outside the formal legislative process, passive investors must remember the lessons learned in the wake of the housing crisis. Remain active, diligent, and well-informed of regulatory and state licensing trends. ■

The Never-Ending LIBOR Transition Ripple Effect: Modifications to LSTA and LMA Secondary Trading Documents

Both the Loan Syndications and Trading Association (LSTA) and the Loan Market Association (LMA) recently published new form trading documents that now govern the terms of any new secondary LSTA or LMA trade entered into by market participants during 2022. These changes were made to the calculation of the cost of carry component of delayed settlement compensation. As secondary trading market participants of corporate syndicated loans are aware, such compensation is intended to compensate the seller (and the buyer under limited circumstances) for failure to receive the payment of the purchase price due to a delayed closing.

Under LSTA secondary trading documentation for par/near par trades, delayed settlement compensation begins to accrue on T+7 (trade date plus seven business days); whereas under LMA documentation for par/near par loan trades, delayed settlement compensation begins to accrue on T+10 (trade date plus 10 business days). Under both LSTA and LMA secondary trading documentation, cost of carry begins to accrue on distressed loan trades on T+20 (trade date plus 20 business days).

These changes were necessitated by the syndicated loan market's forced transition away from use of the London inter-bank offered rate (LIBOR) due to dates established for the permanent cessation of publication of various LIBOR. Historically, before these revisions, both the LSTA and LMA primarily calculated cost of carry owed based on 1-month LIBOR.

LSTA Modifications

LSTA trading documentation has now been simplified when cost of carry will be based on the secured overnight financing rate (SOFR) with a fixed spread adjustment. The cost of carry rate owed to a seller (or to a buyer) will be the sum of all the individual daily simple SOFRs during the delay period plus a spread adjustment equal to 11.448 basis points. The LSTA has indicated that the cost of carry rate utilized will be reviewed on an ongoing basis and market participants should expect some rate changes consistent with the overall market. Before the revisions, cost of carry under LSTA documentation was based on LIBOR or alternative benchmarks, including those referenced in the credit agreement of a traded facility. By revising the trading documentation to apply to a single-reference rate of SOFR, the LSTA has simplified the cost of carry calculation.

LMA Modifications

Likewise, the LMA modified its trading documentation in response to the dates established for the cessation of LIBOR.

However, unlike the LSTA approach, the rate used in calculating cost of carry owed depends on the interest accruing on the loans traded under the underlying credit agreement.

For credit agreements traded when interest accrues on the traded portion by reference to an interbank offered rate (IBOR), cost of carry shall be calculated the same way as historically done by averaging the applicable 1-month IBOR rate currency over the course of the delay period. If the relevant 1-month IBOR is no longer available, the cost of carry rate will be the daily simple risk-free rate for such currency.

For credit agreements traded when interest accrues under the underlying loans pursuant to a risk-free reference rate (RFR), the default cost of carry rate is now based on a simple daily risk-free rate (such as the sterling overnight index average (SONIA) applicable in the British sterling market and SOFR applicable in the U.S. dollar market). Additionally, a credit adjustment spread (CAS) equal to the CAS payable under the credit agreement must be added to the daily risk-free rate unless CAS is not payable under the credit agreement or the parties specify in the confirmation that CAS does not apply.

Another new feature under LMA trading documentation provides parties the option to have a "zero floor" for cost of carry purposes. By checking the zero-floor box under the new confirmation, the parties ensure that the cost of carry cannot be a negative number and therefore payable by the seller to the buyer (or by the buyer to a seller). As market participants utilizing LMA trading documentation are well aware, for many years negative interest rates have been utilized in the euro area, often resulting in the odd result of buyers benefiting from delayed settlement.

Takeaways

With the transition well underway from LIBOR-based loans toward RFR-based loans under syndicated corporate credit agreements both in the United States and internationally, the LSTA and LMA have made corresponding changes to their suites of secondary loan trading documents. These changes modify the calculation of cost of carry owed by a buyer to a seller (or by a seller to a buyer) during the applicable delay period. Whereas the LSTA has simplified the calculation of such rate to utilize a single reference rate of SOFR plus a credit adjustment spread, the LMA has a more complex set of rules to follow. Under the LMA secondary trading documents, the determination of whether the cost of carry rate is based on IBOR or RFR depends on whether interest on the underlying loans being traded accrues under an IBOR rate or an RFR rate.

This is only a high-level synopsis of the recent changes made to secondary loan trading documents. As always, the devil is in the details, and market participants are strongly encouraged to carefully review the underlying changes to fully understand the economic impact. For more information about these changes, please refer to two market advisories previously published by the Distressed Debt & Trading Group Team: "LSTA Trading Documents Revised to Simplify Cost of Carry Calculation" and "What You Need to Know About Changes to LMA Secondary Trading Documents Due to Shift from LIBOR-Based to RFR-Based Loans." ■

Corporate Debt + Structured Finance Sitting in a Tree…

Early Stage FinTech Platforms Leverage Hybrid Structures to Scale Up Faster

Despite the disruption caused by the COVID-19 pandemic of the global financial markets and general economic activities, the last 18 months have presented many strategic financing and refinancing opportunities for seasoned consumer finance and commercial lender platforms. Pent-up liquidity has also presented certain strategic financing opportunities for early-stage ventures and new technologies across different consumer and commercial asset classes, including elective health receivables, rent-to-own receivables, charge cards, merchant cash advance receivables, car rideshare receivables, property leasing, and income share agreements.

Traditional bank credit is largely absent until later in the life cycle of a FinTech platform due to a lack of collateral performance, corporate and credit history, and tight bank credit-underwriting criteria and risk mitigation. Nevertheless, during the last few years, early-stage FinTech platforms have seen a wider range of financing options due to increased interest by specialty finance and other nonbank lenders in those platforms. These nonbank lenders often look to provide smaller committed or uncommitted lines of financing to younger or earlier-stage FinTech platforms structured as a hybrid corporate debt and structured finance transaction, leveraging a newly formed bankruptcy remote special purpose entity (SPE). These structures may help FinTech platforms transition from seed and series funding to more traditional financing on a shorter timeline and by transferring the assets into an SPE with relatively healthy advance rates, help such businesses continue to scale and ramp up originations at a faster pace.

In leveraging an SPE, the transaction is structured to satisfy true sale and nonconsolidation requirements, thus ring-fencing corporate level credit risk at the parent. The parent typically provides a "bad boy" guarantee, protecting creditors from losses arising due to certain egregious actions, and provides a pledge of the SPE's equity for the benefit of the secured parties. Lenders also often request a cooperation guaranty from one or more of the founders or key persons that are intimately familiar with the FinTech platform and its operations, which obligates such parties to agree to work with the lenders after a default to run and unwind the business in a way that is favorable to the lenders.

These transactions incorporate certain corporate debt characteristics that create tighter restrictions on the parent compared with most structured finance transactions and generally include broader representations and warranties, and more restrictive covenants, that are in line with a corporate debt transaction where the parent or operating entity is the borrower. Financial covenants often include more restrictive minimum tangible net worth, minimum liquidity, and debt-

to-equity ratio requirements that may be tested monthly or quarterly. Since the collateral package includes the consumer or commercial receivables that are being originated by the FinTech platform, the eligibility representations are carefully negotiated. These eligibility representations, subject to lender due diligence, may include the lender's ability to finance or test newer products at an earlier point in the platform's life cycle than normally seen in a structured finance transaction.

Lender due diligence is key from a consumer finance regulatory perspective if the FinTech platform is in the business of originating receivables to consumers, and certain regulatory considerations may apply if the FinTech platform is in the consumer space. Certain important considerations include review of the origination and servicing licenses of the entities in the corporate structure that are performing these activities and in the states where such assets are originated and determining whether certain secondary market licenses are required to be held by the SPE in connection with the purchase of such receivables.

If the FinTech platform leverages a bank partnership, the lender will need to ring-fence any potential "true lender" risk by reviewing the underlying bank partnership agreements that evidence the relationship between the partner bank and the platform, as well as the underlying consumer-facing documentation, including related regulatory disclosures, to confirm, among other things, that the bank and not the platform plays the primary role in the underwriting and credit decision-making.

From a due diligence perspective, SPE lenders can provide meaningful assistance to younger platforms, enabling them to continue to shape and tighten their underlying origination and servicing platform in accordance with feedback received and limitations imposed after the regulatory due diligence review process is completed. Lender protections and mitigants against increased federal and state regulatory scrutiny may include certain "regulatory event" triggers that monitor change of law or regulatory action that prohibits or materially impacts the enforceability of the underlying receivables. Often, the eligibility criteria are negotiated to exclude states that have either brought enforcement actions or are anticipated to enforce or regulate platforms originating such assets or against similar platforms.

Best of Both Worlds

A hybrid financing structure offers many intangible benefits to an early-stage FinTech platform, and from a documentation and covenant perspective, the best of both worlds for a specialty finance lender. From a treasury perspective, the structure allows a FinTech platform to diversify and move away from an early-stage funding strategy and more restrictive financing terms if it is beholden to a financing at the parent level. It also allows a FinTech platform to develop a system of servicing and reporting that is internally compliant and conducive to a more traditional warehouse financing or securitization down the road.

Creating a hybrid financing structure requires significant and thorough diligence of the FinTech company, its operations, the FinTech's products, and the collateral. Such efforts across the industry have created an efficient financing for FinTech startups that retains the attractive potential upside for early-stage ventures while incorporating sufficient protection to make the financing creditworthy. ■

Lenders and Servicers Ghost Office Space: It's Not You, It's Me

As COVID-19 enters its third year as a global pandemic, remote and hybrid work arrangements appear increasingly entrenched for many businesses. Despite initial hopes that vaccinations would allow for a return to regular, in-person operations, the appearance of highly contagious variants of the virus in late 2021 put many employers' return-to-office plans on indefinite hold. In response to these shifting employee expectations and continuing pandemic challenges, employers are now considering whether to maintain, reduce, or eliminate their existing office footprints. For commercial lenders and loan servicers, this has led to increasing concerns interpreting pre-pandemic loan provisions—particularly those provisions relating to office tenants "going dark."

Before 2020, it would not be uncommon for commercial loan documents to provide for certain cash triggers upon office tenants terminating their lease, vacating their space, and "going dark." The purpose of these triggers was to allow lenders and loan servicers to mitigate potential risks to the loan if a major tenant was on the brink of terminating its lease, reducing its leased footprint, or not renewing its lease upon expiration.

With tenants across the country allowing or requiring their workers to work remote because of COVID-19, many lenders are concerned that those same tenants will be looking to alter or eliminate their leases in the near future. For loans that pre-date the pandemic, lenders and loan servicers have begun examining ways to leverage existing clauses within their agreements to mitigate the risk of losing a major office tenant.

For example, a lender might look to a loan's cash management provisions that are triggered when a tenant is no longer in "actual, physical possession" of a certain percentage of its leased space. However, if the agreement fails to define "actual, physical possession," the lender must instead rely on the agreement's governing law. This has led some lenders to question whether reduced occupancy or use of the space by the tenant's employees might demonstrate a change in possession and trigger the protections of cash management.

If, for example, a loan was subject to New York law, the borrower would have a relatively low burden to establish that its tenant was still in possession of the leased space. While a

precise determination of a go-dark provision's application depends on the individual facts and circumstances of a given situation, generally speaking, a tenant that maintains control over the premises, i.e., that comes and goes from the premises, will generally be considered in possession. New York courts have also held that, absent an explicit provision in the lease, possession does not require the tenant to physically occupy the space, such as by having employees or furniture, fixtures, and equipment physically on site. Again generally speaking, a tenant that removes personal property (such as office furniture) has not necessarily demonstrated an intent to abandon the lease and surrender possession as a matter of law.

Given this broad view of tenant occupancy, a lender seeking to impose cash management or exercise any other loan remedies based solely on reduced occupancy or use of an office due to remote or hybrid work may face pushback from both the borrower and a court applying New York law. Even if a tenant has stopped using entire floors of office space altogether during the pandemic, the tenant will likely still be considered in possession of the premises if it continues to control who has access to the space. This is a fact-intensive inquiry, and there can be a host of real-world factors that cut for and against an argument that a go-dark provision has been triggered under a loan agreement.

Despite these challenges, lenders still have a number of tools to address and effectively manage these new risks imposed by the pandemic. For example, lenders concerned about tenants going dark might add explicit language to any future commercial loan origination, refinancing, consolidation, or workout. These provisions could include language that triggers cash management when a tenant goes dark and defines "going dark" based on occupancy or continued operations instead of possession alone. The provisions could also explicitly note that subleases of any unused space would also trigger cash management. Exceptions for brief closures (e.g., 180 days) due to COVID-19-related or other pandemic-related government closures may also be appropriate. More specific provisions, such as triggers based on occupancy of a specific number or percentage of floors or floor space, can further address potential risks associated with a particular specified tenant, property, or borrower.

While the future of work in a post-COVID-19 world remains uncertain, careful planning now can ensure that lenders and loan servicers have additional tools to manage these risks and protect their investments going forward. ■

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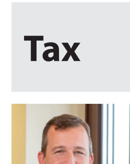

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