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Changes in real estate credit - Part II: Direct bond purchase transactions

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In our last article we discussed a significant shift in the real estate secured credit market - specifically, the movement away from credit enhancement in the forms of letters of credit or insurance and toward the direct bond purchase debt structure. Rating agency downgrades of banks and insurers, re-marketing failures, capital and regulatory changes brought on by Basel III, the Dodd-Frank Act and federal bank regulatory agencies have led to a retreat by financial institutions and borrowers from the credit enhanced structure. In fact, except in unique circumstances, the letter of credit structure has largely disappeared and the direct bond purchase credit structure now dominates this segment of the market. Given its prevalence in today's market it is worthwhile discussing significant business issues that arise when negotiating a direct bond purchase, as well as typical bond purchase documentation executed in these transactions.

As a first step in a direct purchase transaction, a borrower should consider engaging a private placement agent to manage the bond purchase process. The private placement agent will solicit direct purchase proposals through a request for proposal (RFP) or bidding process and assist the borrower in navigating the application process with the government agency issuing the bonds. Given the large number of financial institutions interested in purchasing bonds directly and the wide range of deal terms and pricing options, a thorough and competitive RFP process conducted by a private placement agent can be quite useful. In other instances, however, where a borrower intends to refinance its debt with the same bank, a private placement agent may not be necessary.

The business terms in a direct purchase transaction can vary widely depending upon the credit worthiness of the borrower or its sponsor, as well as the structure and the substance of the transaction. The length of the bond purchase commitment will typically range from five years on the low end to as long as fifteen years. We have also seen a few instances where banks have agreed to even longer bond purchase periods. Direct purchases are typically secured by real estate and the collateral package can also include an all asset pledge or be limited to a pledge of gross revenues. A financial institution may also require a guaranty from a borrower's affiliate. In limited instances, unsecured direct purchases are available to credit-worthy borrowers but the purchaser will usually require at minimum a negative pledge covenant over the borrower's real estate assets. Interest on the debt can be tied to either a fixed rate based on the purchaser's cost of funds or a variable rate tied to an interest rate hedge instrument. Note that some bond counsel will require that a borrower engage a swap advisor to ensure that the borrower is properly advised on the interest rate and hedging risks associated with a hedge instrument. Prepayment fees are standard and are typically tied to a traditional "yield maintenance fee" for the term of the bond purchase period or in some cases, a fixed percentage for a period of years that reduces over time (i.e. 5%, for a designated number of years and reducing 1% each year thereafter). In many cases a debt service reserve fund will be required which can range from three months to one year. Banks will generally charge a commitment fee up to 100 basis points. In some instances, a bank that refinances its own debt may agree to reduce the commitment fee.

Documenting a direct bond purchase transaction is somewhat different than documenting a credit-enhanced transaction. While disclosure documents (including a continuing disclosure agreement) are generally not required, the private placement agent for the transaction will usually require a short form private placement memorandum. Instead of the reimbursement agreement, the bank will most likely require that the borrower enter into a bond purchase and continuing covenants agreement (BPCCA) with the bank. This agreement is entered into at closing and contains representations and warranties, covenants and conditions to the bank's obligation to purchase the bonds. Events of default and remedies in direct purchase transactions are very similar to those in a credit enhanced transaction (including cross defaults with other debt). The BPCCA will include an increased cost provision in favor of the bank tied to Dodd-Frank, Basel III and other bank regulatory requirements. Indemnification provisions are standard but the risk of loss and therefore the potential liability exposure to the borrower is more limited since there are no securities offering or limited disclosure documents. Most issuers will include restrictions on the transferability of the debt to third parties but will usually permit transfers to bank affiliates, as well as certain accredited investors. Such transfers typically can occur without the borrower's consent unless negotiated otherwise.

Another distinction between direct bond purchase and credit enhanced structures is how a direct purchase transaction is documented from the bank's perspective. For example, language contained in the credit documents can impact whether the debt is deemed to be a loan or a security for accounting purposes. The absence of a CUSIP number or a rating for the bonds from a rating agency; the existence of a note evidencing the debt; the requirement that interest payments be made to the bank (directly to the bank or through a trustee) are all factors that support the conclusion that the debt is a loan and not a security. The distinction of whether the debt is deemed to be a security or a loan is important because if the debt is a security it must be regularly priced and maintained as an investment on the bank's books, based on its mark-to-market value. Pricing on a mark-to-market basis can be difficult since there are few readily available markets for debts of this type. Mark-to-market pricing requirements can also lead to earnings volatility. Documenting the debt as a loan eliminates many of these risks.

In an evolving credit market place the direct bond purchase structure has clearly filled a void created by the departure of the letter of credit and in filling that void is meeting the practical needs of both lenders and borrowers. As you can see these transactions are complex and the business terms and documentation requirements can vary widely. It is essential that borrowers and bond purchasers engage legal counsel and financial advisors experienced with these types of transactions. In light of current market and regulatory trends, we expect that the direct bond purchase structure will continue to play a significant role in the real estate secured credit markets in the years to come.

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