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On Syndicated Loans and Their Potential New Importance to Healthcare

Joseph Brown, Esquire
Deborah Gordon, Esquire
Seyfarth Shaw LLP
Chicago, IL

Introduction

It is no secret—even to those outside of the field—that healthcare is a capital-intensive industry. What may come as a shock to non-experts is just how poorly capitalized the industry stands. The industry will need to raise hundreds of billions in the next few years to finance long overdue and neglected capital projects, and to keep up with demand.[1] A string of lean years has left healthcare providers with fewer chances to complete capital projects[2] that are badly needed to update and repair their facilities and to develop new capabilities.[3] For many providers, putting off capital projects may no longer be possible.[4] While some of the new capital that is needed may come from equity sources and some may come from the government, much will have to also come from private lenders.

Who will those private lenders be? For any healthcare loan facility of more than $25 million in size, the answer to this question is very likely going to be "syndicated lenders."

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[1] *See*, *e.g.*, Reed Abelson, "DISAPPEARING CREDIT FORCES HOSPITALS TO DELAY IMPROVEMENTS," The New York Times, Oct. 15, 2008, at B1.

[2] As of March 2009, 45% of hospitals have postponed capital projects scheduled to start within six months, 82% had place facilities improvements on hold, and 43% had greater than 75% of their capital budget on hold. *See* http://www.hfmmagazine.com, "HOSPITAL CEOS SAY FACILITIES PROJECTS STYMIED BY ECONOMY," March 2009, page four.

[3] *See* Geri Aston, "A CAPITAL PLAN FOR CONSTRUCTION", Health Forum Inc (ABI Inform), May 2009. ("The picture of hospital capital projects is bleak. The recession has caused hospitals' investment portfolios to shrink, patient demand to slide and made the ability to obtain financing difficult.")

[4] The average age of hospital facilities increased for twenty years prior to 2006, when a spate of overdue hospital construction projects finally caused such average age to decline. Hospital construction costs rose 20% in 2006 and 2007, and the resulting capital costs have increased operating costs by at least 2% annually. *See* BEHIND THE NUMBERS (Medical Cost Trends for 2009), by PricewaterhouseCoopers Health Research Institute, June 2008, page eleven. It is suspected that since June of 2008 many of these projects have been put suspended or terminated per footnote two.

As we will discuss, lenders today are extremely risk-averse after the trauma of the last two years. Even in a good economy, healthcare loans are perceived as higher-risk loans because of the high-regulation and low-margin environment in which many healthcare providers operate. To make larger loans to healthcare providers under current conditions, private lenders need to form groups or "syndications" so that no one lender becomes overly exposed to the credit. Group lending allows lenders to work with other lenders in spreading risk and minimizing transaction costs for larger loans. Syndicated lending also allows lenders with little healthcare expertise to gain exposure to healthcare by exploiting the expertise and greater administrative abilities of the larger financial institutions that often serve as "agent" for the syndicated lenders.

Therefore there has always been a special connection—born of high risk and the need for expertise—between syndicated loans and healthcare. Today, that connection is even stronger but is also under considerable stress.

Having just discussed the relevance of syndicated lending to healthcare, this article will now provide the reader: (a) a practical definition of what syndicated lending is and an explanation of some of the special risks associated with it; (b) several practical examples of how syndicated deals work; and (c) a rough understanding of the recent history of syndicated lending with an eye toward understanding today's syndicated marketplace. The article will end with a discussion of what it takes to get a syndicated deal done in today's market.

What is Syndicated Lending?

The term "syndicated lending" means different things to different people. It becomes difficult to understand how such widely differing financial structures could fit within the same definition. What all syndicated structures have in common, however, is that there are multiple sources of capital involved in just one deal. Syndicated lending, in a nutshell, consists of any loan, bond origination, securitization structure, or other credit facility in which there are multiple sources of loan funds and hence multiple lenders.

Loan Execution Risk: What Is It and Who Takes It?

In deals where there is only one borrower and one lender, it is relatively easy to determine who is taking execution risk. Execution risk means the risk that a lender will either refuse to take or at which point the lender will be unable to "execute" a loan deal by lending money as it had originally promised. For example, if a borrower does everything it is supposed to do under a loan agreement but the lender still refuses to lend, then the lender runs the risk of being sued for breach of contract and the borrower runs the risk of not receiving its loan.

With syndications, however, matters become more complex and the parties must specifically spell out who will take execution risk. When bankers refer to an "un-agented" deal (also called committed or principal deals), they are speaking of a deal where a reputable and well-capitalized lead bank promises to loan additional amounts to the borrower to make up for the failure of any other bank in the lending group to lend. Un-agented deals are sometimes also called principal deals because the lead bank has the principal risk for the entire deal. In un-agented deals, therefore, the borrower can be certain that it will always have a certain borrowing power even if one of the syndicated banks defaults. Thus, in un-agented deals the lead bank takes execution risk and will ask to be compensated for that service.

A lead bank taking execution risk may also have certain rights and remedies against a defaulting bank. As a result, a committed lead bank will often need to appraise the credit worthiness of the other banks in the syndicate, in addition to the creditworthiness of the borrower, because an agent that has to front another bank's share of the loan will want to know that it can recoup this money quickly and without hassle. Agents in committed deals may keep a short list of trusted syndicated lenders to minimize execution risk. Borrowers in un-agented deals, however, will remain happily above this fray between the lead bank and other lenders, because borrowers will have the certainty of being able, if necessary, to borrow 100% of the loan facility from the lead bank.

A poor cousin to an "un-agented" deal can be found in loan participations. In these simple deals, a bank sells a ratable portion of its loan to a "participating" lender. The participating lender allows the selling bank to limit its economic exposure to the

borrower because the participating bank will share losses. However, the bank selling the participation continues to be the only party having a contract with the borrower, and remains "on the hook" for lending the entire amount of the loan and for compliance with the loan documents. In fact, the borrower may not even know that the loan participant exists and the participant will usually have no independent rights with respect to the borrower.

In "agented" deals, which are more common than un-agented deals, the lead bank promises to do its best to find additional lenders. Hence these deals are also called "best efforts" deals, as opposed to committed deals. An agent in an agented deal is under no obligation to advance the face amount of the loan facility if it cannot find other lenders willing to join the lending syndicate. Thus, it is the borrower who takes on execution risk in agented deals. Agented loan agreements may also build creeping interest rate adjustments into the loan document, which will allow lead banks to unilaterally raise the yield on the loan until the entire loan is capable of being syndicated under then-current market conditions. Borrowers, as one might suspect, dislike such provisions and negotiate them often. In today's lending market, however, almost all large loans are contingent upon the lead bank finding sufficient lender participation.

In most syndicated deals, regardless of how execution risk is allocated, a lead bank will usually take responsibility for serving as the administrative liaison between borrower and the lender group. Lawyers will call that liaison bank the "agent" or the "administrative agent," even if it takes no execution risk. Hence, a confusing situation arises in which lawyers refer to the lead bank in an un-agented deal as the agent or the administrative agent. Healthcare providers should therefore keep in mind that there are important legal and economic differences between how lawyers and bankers refer to agents.

Typical Types of Syndicated Deals

In a typical syndicated deal, the lead bank negotiates a loan agreement with a borrower with the understanding that the agent—wearing its hat as agent for the lenders—will only be making a portion of the total loan (again, most deals do not involve the administrative agent taking execution risk). The loan agreement may potentially contain

signature blocks for other lenders that will be funding a portion of the loan at closing, or such lenders may come to “join” the loan agreement after it is signed. Often, a borrower will issue a separate note to each lender. A schedule at the back of the agreement sets forth what percentage of the total loan each lender will be funding.

The syndicated loan agreement may also contain provisions establishing voting procedures by which all of the lenders will make decisions. Alternatively, these types of provisions may be found in a separate intercreditor agreement. Majority thresholds (e.g., the approval of holders of 66% or 75% of outstanding loans) will be established by which certain important creditor decisions must be made, such as the decision to accelerate the loan, declare a default, or exercise remedies. Certain less weighty decisions will be left solely to the discretion of the agent, and the agent will usually receive indemnification from the other lenders for the consequences of any decision it makes in good faith. During the life of the loan, the borrower deals only with the administrative agent on a day-to-day basis. The administrative agent usually receives a closing fee and other fees (in addition to interest) for being the party that puts the deal together and then administers it. Agents may also be responsible for providing a “swing line” under the facility, which is a short-term funding responsibility to allow the borrower to make instant draws without requiring the agent to first collect the funds ratably from every lender in the group. Some syndication arrangements require lenders to lend up to a ratable limit of certain additional amounts.

Bond deals involve the origination of debt securities by the borrower. The debt securities are then sold directly into the capital markets, either through a transaction exempt from securities laws or a SEC-registered transaction. The holders of such bonds could number in the thousands and come from all over the world. They could not, accordingly, present a “united front” to the borrower. So they are usually represented by an indenture trustee, who holds any security interest granted by the borrower securing the bonds, receives payments from the borrower on behalf of the bondholders, and generally serves as representative of the bondholders.

Banks or other financial institutions usually provide “credit support” for the bonds, which boosts attractiveness to buyers. Credit support can come in the form of a standby letter

of credit benefitting the indenture trustee, or otherwise. This credit support not only backstops the issuer's eventual repayment of the bonds, but also allows for short-term liquidity in the event that the bonds have "put" options that allow holders to resell them to the issuer upon the occurrence of certain triggering events. Bondholders, unless they hold "restricted bonds" originated in a private deal, are free to sell and trade the bonds freely. It should be noted that execution risk does not exist in bond deals because the bond holder only becomes party to the deal by buying the bond.

A tax-exempt bond deal is slightly more complicated than a traditional bond deal because tax-exempt bonds are issued to purchasers. The tax exemption boosts their ultimate yield for holders while keeping the issuer's interest rate down. In essence, the government comes to subsidize a component of the interest paid to holders by forgiving taxes on bondholders' gains. Proceeds raised are then paid over to an indenture trustee who services the bonds as described above. The indenture trustee then enters into a loan agreement with the ultimate borrower, which uses the money for some socially beneficial purpose (without which there could be no tax-exempt issuance). Repayments on the loan flow back from the ultimate borrower through the indenture trustee to the bondholders, who then pay no taxes on their yields.

A tax-exempt bond deal can be equally useful for sophisticated and well-financed nonprofit organizations that have the money to directly fund the relevant capital project out-of-pocket, but elect not to. Such organizations may choose to keep their cash in investments while still issuing tax-exempt bonds. They then earn a "spread," which consists of the difference between the theoretically higher rate that their investments are earning them in the open markets and the lower rate that they need to pay to service the bond payments. Well-heeled organizations may be able to rely on banks to provide credit support for their bonds on an unsecured basis, or by allowing the banks to have certain financial covenants in the documents that assure them that they take little risk by not having collateral. During the twenty- to thirty-year life of the bonds, and assuming that they earn normal investment returns, this allows such organizations not only to execute capital projects, but also to accrue sizeable cash arising from the tax "arbitrage." Today's prevailing interest rates, however, make arbitrage harder to come by.

Legally, a "bond deal" is not a loan at all, and certainly not a syndicated loan. As noted just previously, a bond deal involves issuing securities. Nevertheless, those securities are debt securities and not equities. Moreover, a healthcare provider's payments on the bonds will be quite similar to the payments it would make to an administrative agent in a syndicated loan deal. Because bankers tend to define deals by their practical economic functionalities rather than by their technical names, they consider bond deals to be an economic sub-species of the larger family of syndicated financial structures. Regardless of what we might call a bond deal, the deal ends with a healthcare provider owing debt to more than one lender. This puts bond deals—both traditional and tax-exempt—within our definition of syndicated lending.

Finally there is asset securitization, which can be thought of as an even more complicated form of syndication than bond deals. A securitization usually starts out as a receivables financing deal, often by a special purpose company (SPC) that has been created for the sole purpose of buying receivables from "borrowers." SPCs are bankruptcy remote, meaning that their charters often prevent them from incurring significant debts. SPCs then sell securities representing an interest in themselves to the capital markets. SPCs have no operations; the securities they issue are backed only by the performance of the newly acquired financial assets that they hold (hence the phrase asset-backed securities). The ultimate securities purchasers are insulated from the bankruptcy of borrowers because they have dealt only with the SPCs. SPCs, in turn, try to avoid being perceived as creditors of the companies from whom they buy receivables. Rather, they are "purchasers" of assets. The persons buying securities from the SPC are the ultimate source of the funds reaching the borrower (i.e., the seller of receivables). The SPCs "cut" their total asset pool into various distinct sub-pools that backstop particular classes of securities, allocating higher rewards and first loss to risk-loving investors. This process of "cutting" the SPC's asset pool is analogous to the way a vat of fresh cow's milk can be separated into cream, whole milk, 2%, and skim.

Over the history of syndicated loans, the secondary markets and securitizations have taken on greater and greater importance. They have provided an almost unlimited number of secondary buyers all throughout the world who were willing to give primary lenders a ready and easy way to sell their positions, recoup their cash, make their

upfront profits and fees, and then move on to the next deal. The collapse of securitization has done much to chill primary underwriting of loans now that primary lenders cannot be sure that they will be able to easily sell their positions. Lenders must now take the loans that they originate onto their own balance sheets for the indefinite future.

The increased prominence of securitizations over the last twenty years (until recently) has had at least two side effects—both important to healthcare borrowers. First, revolving loan facilities (also called lines of credit) become unattractive to lenders wishing to unload their positions in a securitization because such revolving assets are not prefunded loans that have a particular principal balance that will amortize predictably. They fluctuate in value as borrowers borrow and repay. Revolvers may also require ratable syndicated re-lending—a headache in the syndicated arena and impossible where the ultimate lenders are thousands of anonymous private investors scattered around the globe. Because many healthcare providers prefer to have lines of credit rather than (or in addition to) term loans, securitization's bias against lines of credit increases healthcare's cost of capital.

Second, even term loans backed by mortgages on healthcare buildings and permanent facilities are not always suitable grist for the securitization mill. Again, there is greater risk in making such primary loans because they cannot be easily offloaded into a securitization or the secondary markets. Normally, commercial mortgages create a dependable cash flow stream (dependable cash flow is securitization's ideal quality); picture, for example, a large office building with a diverse group of lessees/tenants each in a different line of business. Such diversity creates dependable cash flow. By contrast, hospital buildings, nursing homes, and other healthcare facilities usually have only one tenant, which is often the landlord company's sister-company that has been charged with healthcare operations (i.e., the actual healthcare provider). These landlords are not diversified and are at the mercy of their tenants' operational risks. Thus, the mortgages they give to banks are not diversified or insulated from the tenant's operational risk, and they cannot be easily sold into securitization pools.

A Brief Recent History of the Syndicated Marketplace

The syndicated loan market matured and took shape in the mid 1980s and expanded significantly in the 1990s. While there were ebbs and flows, the consistent, long-term trend was a general loosening of underwriting standards as more and more players entered the market, causing ever greater amounts of cash to chase a relatively stable number of profitable lending opportunities. Not all of these new syndicated players were banks; certainly there is no syndicated lender status to be a "bank."[5]

As with other sectors in the economy, the monetary loosening that occurred after September 11, 2001, caused cash to flood into syndications. Consumer inflation remained in check, perhaps because the cheap production capabilities of China and other ex-Soviet bloc nations were only then fully coming into their own, as Alan Greenspan has argued. The newly unleashed global productive power caused downward price pressure that kept in check the inflationary pressure caused by cheap money. The lack of consumer inflation allowed the Federal Reserve's rates to remain low. The excess liquidity did cause inflation of one sort, however, that being with real estate valuations. It was, as we now all know, the implosion of the market for high-risk real estate loans that was the first domino to fall in the present economic crisis. The fall of the biggest domino, Lehman Brothers, nearly collapsed the financial system in the Fall of 2008, which has since slowly recovered with the help of massive and unprecedented federal involvement. The pendulum has now swung the other way, as lenders of all types have become extremely conservative in their underwriting. While no lender can make money over the long run without putting money at risk in loan deals, the short-term benefits of conserving cash appear to outweigh the short-term benefits of lending.

To this current level of general lender risk aversion and uncertainty we must then add the risk and uncertainty arising from looming healthcare reform. Much ink could be spilled on conjecture concerning how healthcare reform will affect providers and how it will change how the United States finances healthcare. This article will only make a pair

[5] In fact, by allowing a single bank to serve as liaison to the borrower, syndications allow other types of financial institutions that do not have large administrative staffs (such as hedge funds and insurance companies) to inject capital into the syndicated market.

of points on the subject. First, the current plans on the drawing board will have, if implemented, potentially huge effects on healthcare finance. Many of those effects may be positive but some could create onerous new problems for private capital. Reform might put billions of federal dollars at the disposition of providers and create millions of new healthcare consumers; reform might also result in significant cost-control measures that force margins even lower, and it might, under the guise of fraud-fighting, make the financing of government receivables all the more difficult. Query for example, how the move away from fee-for-service and toward new pay-for-performance Medicare reimbursement policies might affect healthcare providers, or who potential winners and losers will be. We simply do not know what the future holds.

Second, uncertainty creates risk. Even though reform could do a great deal of good for healthcare finance, no one knows what its final consequences will be, or what unintended effects will cascade from the statutes that are eventually signed into law. As a result, healthcare lenders may sit on the sideline in the short run. This will make obtaining short-term syndicated loans all the more difficult. Ironically, the current climate of risk aversion will also make syndicated loans potentially the only source of large loans because few lenders will be willing to single handedly take on large exposures. In other words, it is doubtful that many large syndicated healthcare loans will be made in the short-term future.

What It Takes to Complete a Syndicated Deal Today

Although slightly improving elsewhere, the appetite for making large syndicated healthcare loans remains quite limited for the reasons discussed above. To complete a syndicated deal today, a healthcare provider very likely needs a strong pre-existing relationship with a bank that is capable of serving as agent. To further sweeten the deal for the bank, a healthcare provider may very well need to offer the banks highly profitable ancillary business opportunities, such as cash management, payroll, and other service contracts. Few lenders may be interested in doing loan deals right now, unless such loans are keys that open up other profitable opportunities to make fees over the long run while putting little capital at risk. To state the obvious, however, many would-be healthcare borrowers will have neither a relationship with a bank nor ancillary

business to offer. Only healthcare providers with very strong balance sheets and credit ratings may be able to do syndicated deals these days.

Conclusion

This article discusses why syndicated loans are so useful to healthcare lenders and borrowers. Syndicated loans allow qualifying borrowers the ability to borrow relatively large amounts of money from multiple lenders, while maintaining the convenience of dealing with only one lender. They allow lenders the ability to diversify risks, limit exposures, and play in the healthcare arena without the need for expensive healthcare expertise.

Because it is so useful for all concerned parties, syndicated lending is sure to one day recover from its current decline. No one currently has a well-informed answer to when that day will be, however. Much will depend not only on the final healthcare reform legislation's content, but also on how clear it is, how quickly it can be implemented, and how soon its secondary effects can be fully understood.

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