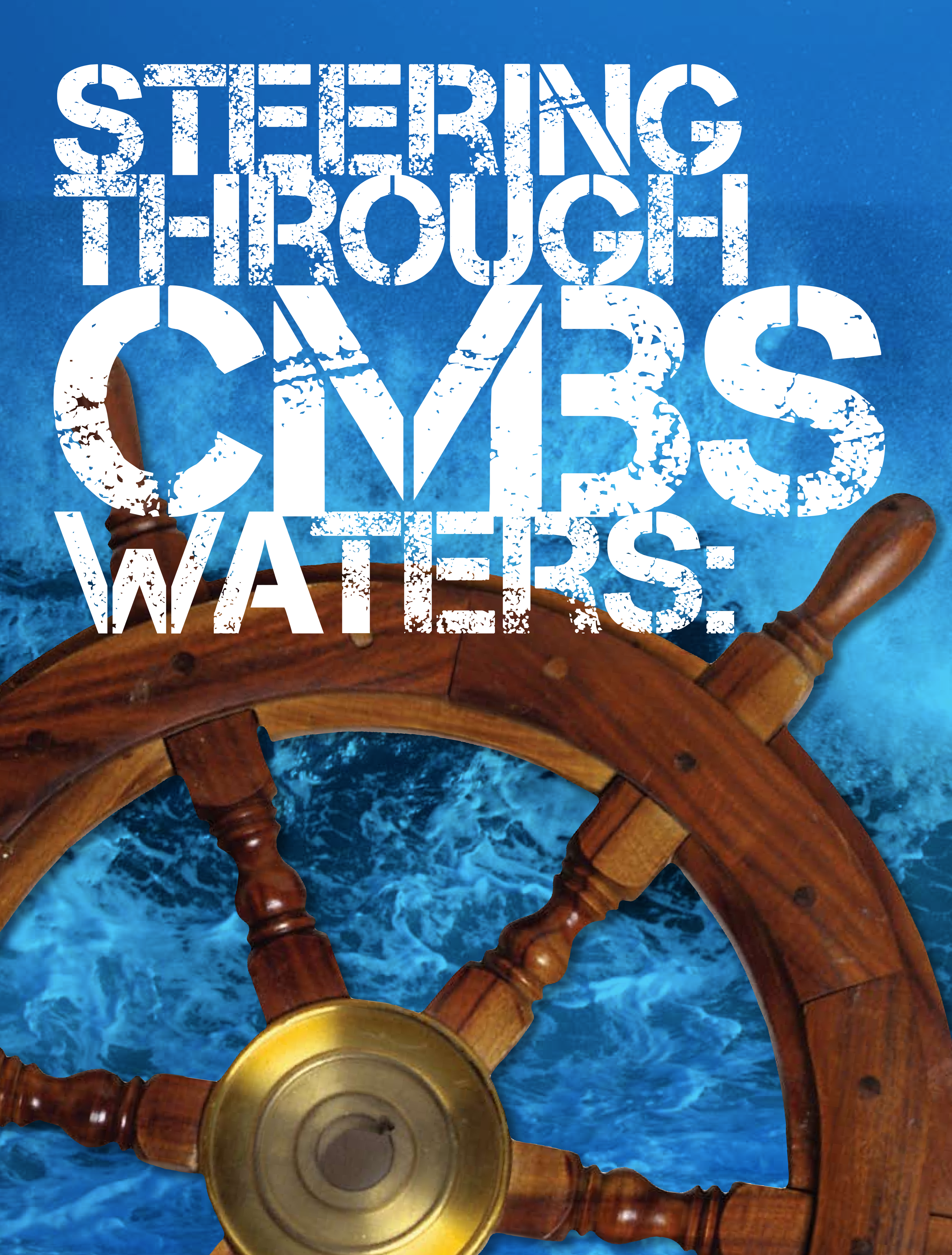
STEERING THROUGH CMBS WATERS:



A Primer for Troubled Loans

It's Monday morning and you're getting ready for work with the news on the TV in the background. By now, you're practically immune to the daily dose of doom and gloom that has become business news, particularly with regard to real estate and mortgage-backed securities. So you're not overly concerned when you hear the anchor say, "Vital signs are dangerously low in the commercial mortgage-backed securities market. We're suffering from a trifecta of decimated bond prices, weakening mortgage performance and drastically reduced loan originations. The threefold combination has pummeled portfolio values and deprived borrowers of a primary source of commercial real estate financing."[1] As you turn off the television and head out the door, you find solace in the fact that you work for a public healthcare company and not a financial services firm.

Your phone is ringing as you walk into your office. It's your CFO explaining that a $5 million loan on one of your office buildings in Michigan is maturing in three months. He asks you to help the company's internal business unit that is desperately searching for new financing while, at the same time, communicating with the commercial mortgage-backed securities (CMBS) loan servicer who manages the loan. Did he just say CMBS? Loan servicer? Find financing upon maturity? What do you need to know about the CMBS industry and its participants to navigate through this mortgage mess that just fell into your lap?

By Amy Natasha Howell and Courtney Davis Bristow

A Primer for the Uninitiated: What Is a CMBS?

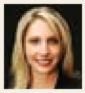
Lenders basically make two types of commercial mortgage loans: portfolio loans and loans to be securitized. A portfolio loan remains in the originating lender's portfolio until maturity. A securitized loan is pooled with other loans and transferred to a commercial mortgage-backed securities or CMBS trust.

Here is how the CMBS market works: A bank loans a borrower $10 million secured by a piece of commercial real estate. If that loan remains on the bank's balance sheet, then the bank has up to a $10 million risk exposure in the event that the borrower defaults. To help mitigate that risk, the bank places the commercial mortgage into a CMBS trust, along with other commercial mortgages of varying types and locations. The trust then issues a series of bonds that have varying yields, payment priorities and durations. Rating agencies assign ratings to the different categories, or tranches, of bonds. Investors (called "certificate holders") can then purchase various classes of bonds depending on their desired return and risk tolerance. The trust retains one or more servicing companies, also known as servicers, who manage the loans, including collecting payments, monitoring the borrower's compliance with the loan requirements and distributing interest payments to the trustee for disbursement to certificate holders.

For years the CMBS market has provided a robust source of capital for commercial real estate loans, which in turn, motivated lenders to make more loans. The centrifugal force of this cycle, beginning in the early 1990s, grew almost exponentially year-over-year, culminating in 2007 when over $230 billion in new CMBS issuances, according to the Mortgage Bankers Association, accounted for more than 22 percent of the US commercial real estate lending market that year.

But the CMBS market came to a screeching halt in 2008, with only $12 billion in new CMBS issuances according to Moody's, an incredible 94 percent decline from the prior year. So far in 2009, not a single new CMBS issuance has been brought to market. Whereas a healthy CMBS market turbo-charged commercial real estate lending in prior years, a closed CMBS market is one of the major obstacles between would-be borrowers and their would-be loan proceeds. The absence of the CMBS market means lenders must keep significantly more commercial real estate loans on their balance sheets. This, in turn, means lenders cannot as easily mitigate and diversify their credit risk after extending a loan, which limits the amount of loans lenders are willing to make.

Compounding the problem is the decrease in the overall value of commercial real estate in the United States. The trade group Real Estate Round Table recently estimated that the total value of US commercial real estate is around $6.5 trillion and financed by $3.1 trillion in debt.[2] Deutsche Bank recently predicted that "of $154.5 billion of securitized commercial mortgages coming due between now and 2112, about two-thirds likely won't qualify for refinancing" due to an anticipated decline in commercial property values.[3] As the economy pushes more businesses into financial trouble, property values fall and landlords face past-due rent payments and tenants vacating in record numbers. In light of these dire predictions and the pervasiveness of current CMBS loans, commercial mortgage holders and their counsel must have at least a minimal understanding of the CMBS process, particularly regarding the role of servicers.



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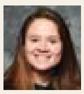

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Who Do I Talk to About My CMBS Loan?

Typically, the job of servicing the pooled commercial mortgages falls upon the master servicer and the special servicer, and is governed by a contract called a pooling and servicing agreement (PSA). Generally, the master servicer handles day-to-day activities such as collecting payments from the borrowers, holding and disbursing escrow funds and performing most of the routine loan administration functions. The master servicer only transfers the loan to a special servicer, who is a specialist in handling troubled loans, upon the occurrence of certain specified triggering events defined in the PSA, such as an actual or imminent default or reasonable likelihood of default. In the current market, borrowers are likely to have fewer tenants and thus significantly fewer refinancing options as their loans approach maturity. As a result, special servicers are becoming involved with increasing frequency as loans mature into the present lending environment.

Special Concerns of Special Servicers

The PSA sets forth the special servicers' "servicing standard," which is essentially the special servicer's mandate. In most PSAs, the servicing standard says that the special server must seek to maximize the recovery of principal and interest on each mortgage loan based on an analysis of collection alternatives using a net present value methodology. Put another way, a special servicer seeks to resolve loan defaults and execute optimal recovery strategies on defaulted and troubled loans for the benefit of the certificate holders. In doing so, special servicers take a proactive role in communicating with the borrower to assess the situation quickly and set their expectations about the special servicing process.

Commercial mortgage loans are typically pooled in a structure known as a real estate mortgage investment conduit (REMIC), which is a creature of tax law that establishes the loan pool as a pass-through entity not subject to taxation. There are certain transactions, called "prohibited transactions" in which the special servicer cannot engage because they could subject the loan pool to entity — or corporate level — taxation. CMBS borrowers often pursue solutions to loan troubles that are unfortunately not permissible under the loan documents, PSA or REMIC tax laws. Therefore, while a special servicer has a degree of flexibility in carrying out its servicing standard, that flexibility only goes as far as the loan documents, the PSA and the REMIC rules allow.

What Are the Expected Work-Out Options for a Special Servicer?

While no two work-outs are ever the same, the special servicer typically chooses among five, non-exclusive courses of action. They may:

- enter into a forbearance agreement;
- modify the loan;
- accept a deed in lieu of foreclosure;
- request appointment of a receiver; and/or
- foreclose on the collateral.

Forbearance Agreements

In a forbearance agreement, the Special Servicer okays the temporarily delayed exercise of its remedies on a defaulted loan, on the condition that the borrower either cure the defaults or obtain financing. As part of the forbearance agreement, the special servicer typically allows the borrower to delay making certain payments for a short period of time, commonly no longer than two or three months. Interest that accrues during the forbearance period remains the borrower's responsibility and is added to the principal balance of the loan. Special servicers may consider this option if the issues affecting the loan or the borrower are purely short-term.

Loan Modifications/Extensions

With the CMBS market essentially shut down, borrowers are requesting loan extensions with increasing frequency. Under the REMIC tax rules, renegotiating a loan's maturity date is considered an "insignificant change," and therefore does not risk converting the loan pool from a pass-through to a taxable entity. Special servicers may consider this option where a borrower has made a good faith attempt to obtain financing beginning at least several (typically 10 or more) months before the loan's maturity date. As with any decision involving a special servicer, the fundamental question is whether granting an extension will maximize cash flow to the loan pool. For example, if there is a likely chance the borrower will be able to obtain refinancing within a few months, an extension might make sense. On the other hand, special servicers probably will not entertain a borrower's request for an extension if it only serves to delay the inevitable. As confirmed in a recent Commercial Mortgage Alert, loan modifications and extensions are extremely case-specific, and vary widely depending upon the particular facts and circumstances.[4]

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Deeds in Lieu of Foreclosure

The special servicer may also consider a deed in lieu of foreclosure, which is the quickest way to transfer title in a loan work-out scenario. A deed in lieu of foreclosure has the effect of accomplishing the transfer of title that the special servicer could accomplish through a foreclosure — but without the notices, time delays and attendant costs. At the same time, however, it may expose the trust to risks that are not inherent in a foreclosure action. For example, a special servicer will generally not consider a deed in lieu of foreclosure unless it is satisfied that:

- the value of the deed in lieu of foreclosure is not outweighed by the value of a deficiency judgment;
- the property is not subject to any junior liens or encumbrances;
- the borrower's offer is not conditioned on unacceptable terms, such as a reservation of rights or a right of first refusal to repurchase, unless sufficiently limited to avoid the possibility that a court would construe the deed as a continuing security device;

- the total expense of accepting the deed in lieu of foreclosure would be less than the expense of foreclosing;
- the trust would gain a substantial advantage by acquiring the title with immediate possession of the property;
- the borrower has no equity in the property as determined by the current market value; and
- a title insurance company will provide an owner's policy without exceptions for preferential transfer and fraudulent conveyance claims and without the "creditor's rights" exclusion or exceptions for equitable mortgage claims.[5]

Additionally, a special servicer will typically only consider a deed in lieu of foreclosure if the borrower is willing to provide indemnities in order to minimize the risk to the trust.

Receiverships

If the note is accelerated, another potential alternative work-out is the appointment of a receiver over the real

ACC Extras on…Real Estate Regulations

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- *An Environmental Due Diligence Checklist for Real Estate Transactions (June 2000).* The authors discuss the various levels and elements involved, and the factors that determine an appropriate level. *www.acc.com/docket*

Program Materials

- *Corporate and Securities Litigation Update (Oct. 2008).* It is impossible to keep up with all of the changes, but this session will help. This panel provides an update on some of the most recent and significant litigation and regulatory decisions affecting both private and public companies. *www.acc.com/legalresources/resource.cfm?show=163963*
- *A Sub-Primer (Oct. 2008).* Panelists representing mortgage companies, investment banks and regulators provide a concise but comprehensive "sub-primer" on the origins and potential long-term effects of one of the most expensive financial events in modern times. *www.acc.com/legalresources/resource.cfm?show=159467*

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To appoint a **receiver** to **protect** the **value** of the **property,** the special servicer must obtain a **court order.**

property. Occasionally, when borrowers know the special servicer is preparing to foreclose, they may cease maintenance and repair, or abandon the property altogether. In this situation, there is a greater potential for diminution in the value of the property.

To appoint a receiver to protect the value of the property, the special servicer must obtain a court order. If granted, the court appoints an independent third party to act as an agent of the court, who has authority to maintain the property, thereby protecting it from diminution in value during the foreclosure process. Appointing a receiver is one of the greatest benefits to the special servicer. Charged with the authority and responsibility over collecting revenues generated by the property, the receiver remits to the trust after expenses are paid.

If the request to appoint a receiver is filed in federal court, the receivership rules allow that receiver to sell the property, subject to court approval. State courts' receivership rules are less specific on this matter and such rights must generally be granted by the court. It is not uncommon for a receiver to be appointed by mutual agreement of the special servicer and the borrower, in which case the process becomes significantly faster, more streamlined and less expensive. Yet in the case of imminent danger to the property, the court will usually appoint a receiver despite any objections from the borrower.

Foreclosure

A successful non-foreclosure workout depends on two equally critical elements: (a) the property must be capable of being turned around, stabilized, and profitably sold or refinanced and (b) the borrower must have the right background, reputation, commitment and experience to manage the property. However, when a borrower cannot, or will not, contribute or create any additional value with respect to the property, foreclosure is the special servicer's only option. Foreclosure often presents a relatively safe alternative for special servicers to carry out their standard of care under the PSA, while at the same time preserving the trust's REMIC status and pursuing the alternative that best maximizes recovery on a net present value basis.

Will the New Government Programs Help?

On May 19 in a move that couldn't come soon enough for the CMBS industry — the Federal Reserve announced that AAA-rated CMBS issued before January 1, 2009, will be eligible collateral for loans under the Term Asset-Backed Securities Loan Facility (TALF).[6] By expanding the program to CMBS, it is hoped that the pricing of whole loans that are financed through new CMBS issues will become more competitive, thereby increasing liquidity and providing a much-needed source of additional capital to refinance a growing pipeline of maturing commercial loans.[7] While the program still faces the stiff challenge of winning over skeptical financial markets, it has emerged as a significant step to provide availability and lower-cost credit to commercial real estate borrowers in this brave new world.

Planning Ahead Helps Navigate CMBS Waters

CMBS loans are clearly unique compared to traditional portfolio loans. But if borrowers are realistic, plan ahead, avoid surprising the servicers, understand the options and know their loan documents, they can navigate the CMBS waters for a successful resolution of their CMBS loan. On the other hand, borrowers do themselves no favors by waiting until a few months before their loan matures to start communicating with their loan servicer and pursuing new financing options. This is generally an area in which borrowers are better-served by being proactive as opposed to reactive.

Have a comment on this article? Email editorinchief@acc.com.

Notes

1 Matt Hudgins, "Reviving the CMBS Market," *National Real Estate Investor*, Feb 1, 2009.
2 Lingling Wei, "Commercial Property Faces Crisis," *The Wall Street Journal*, March 26, 2009.
3 Id.
4 Commercial Mortgage Alert, March 27, 2009, "Servicers Vary on Loan Extensions."
5 *See* John C. Murray, "Deed in Lieu of Foreclosure: Practical and Legal Considerations," in *Real Property Probate and Trust Journal* 26, 459 – 534 (1991).
6 For the terms and conditions specific to CMBS, *www.newyorkfed.org/markets/talf_cmbs_terms.html*, and for frequently-asked questions specific to CMBS, see *www.newyorkfed.org/markets/talf_cmbs_faq.html.*
7 See Mark Gallaher, "TALF to the Rescue?" *CBRE: Torto Wheaton Research*, May 29, 2009.