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Commercial Mortgage-Backed Securities

What Next For Distressed Commercial Mortgages? – Lessons Learned

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As the subprime residential mortgage crisis expands into the rest of the economy, participants in the commercial real estate market are awakening to the relevance of the subprime experience to their own business. Here are some questions and answers learned from the experience with subprime residential loans in the last 18 months.

1. Who owns the loan?

This would seem like an easy question but it is fraught with complexity if the loan was "securitized," i.e., sold by the originator into the secondary market, either in a whole loan trade, a commercial mortgage-backed securitization (CMBS) or collateralized mortgage obligation (CMO), a repackaged CMBS or CMO in the form of collateralized debt obligation (CDO), or even a (relatively simple) loan participation. All players have an interest in this – the borrower, the originator, the tenant, the potential purchaser, and just about any other party with an interest in the loan or the underlying real estate. The secondary mortgage market has become so huge and complicated that the identity of the owner is not always obvious. And until the owner is identified, it is not possible to start any process to purchase, sell or modify the loan, pay it off, or purchase the underlying property.

Actually, these days, most commercial mortgage loans have more than one "owner." There is the entity (or a group, called a syndicate in the case of participations, and certificate holders, in the case of CMBS, CMO and CDO transactions) that has the financial risk of the lender under the loan. There also

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may be a trustee that holds legal title to the loan for the benefit of investors who bought the resulting security. There is probably a servicer, who acts as agent for the trustee and the investors in collecting debt service payments from the borrower. The servicer is likely to be the entity the borrower thinks of as its lender, since that is where payments are sent. If the loan has become delinquent, however, there may be a special servicer that takes over for the regular servicer, at least until the payments are back on track.

Finally, there may be a credit enhancer, such as an insurer that insured the CMBS certificates, or a mortgage insurer that insured individual mortgage loans. Under the transaction documents, the credit enhancer usually has the right to "step into the shoes" of the lender when it makes good on its contract of insurance, guaranty or other credit enhancement. Therefore, it bears the economic risk of a borrower default, and often has contractual rights to direct the servicer regarding loan enforcement. These contractual control rights may exist even if the credit enhancer has lost its own high credit rating.

2. Why is ownership of the loan important?

As recent court cases have made clear, unless paperwork has been properly prepared, recorded, and presented to the court, the ability of any one of these "owners" to foreclose on the underlying real estate to realize its value or to otherwise obtain judicial relief can be stymied.

It is not uncommon for ownership of loans to be transferred (either to a single buyer, or to a trustee for all investors) without recordation of the assignment of mortgage. This is especially true where the seller retained the servicing relationship with the borrower and it was simply more convenient for the parties to leave the record ownership with the seller. Under the laws of many states, moreover, such an arrangement does not jeopardize the purchaser's ownership of the loan in the event of a bankruptcy of the seller. Thus, the practice has developed in many secondary market transactions, including securitizations, to hold but not record the assignments. Should it be necessary to foreclose or initiate other proceedings with respect to the loan, however, there is a question whether it is better to record the assignment and to initiate the proceedings in the name of the real owner (or the trustee), or to leave the loan in the name of the servicer, and initiate the proceedings in the servicer's name. Courts have become sensitive to processes that they deem too fast and loose as to matters of legal standing, and have been offended by a failure to disclose fully, in the pleadings, what the ownership structure really is. These details are important in any recovery plan.

3. What room do the parties have to negotiate a change in the loan terms?

When the subprime crisis started, there were rumors that securitization had made it nearly impossible to negotiate a workout. This was an exaggeration. The servicer of most securitization transactions will have at least some room to maneuver in negotiating a resolution of an "underwater" loan. The governing documents vary considerably, though, in the extent of that authority, what findings must be made to support the workout decision, and whose consent is needed to implement it. The governing documents also differ as to whether the loan can be sold out of the securitization, rather than being worked out inside the securitization trust. Thus, a critical examination of the underlying documents is essential to this process.

4. How can interested parties find the governing documents?

The starting point in sorting all of this out is to obtain copies of the governing documents. If the loan is part of a securitization (including CMBS, CMO or CDO), the key documents will be either a "Pooling and Servicing Agreement" or an "Indenture" and "Servicing Agreement." If the securitization was issued publicly, then these documents will have been filed with the Securities and Exchange Commission as exhibits to a registration statement.

If, however, the securitization was sold in a private placement transaction, it may not be available from public sources. For rated securities, the documents (or at least summaries) may be available through the rating agency publications. Or the private parties to the secondary market transaction may make the documents available. Unless a person is an actual investor, though, he may be unable to obtain copies of the documents.

5. Can the governing documents be revised to accommodate the changed circumstances?

Suppose a loan is part of a securitization that does not have adequate authority for negotiation of a loan modification. Is it possible to amend the governing documents to expand the servicer's authority? That depends on the amendment provisions of the documents themselves. As with other document provisions, the amendment provisions vary considerably. Typically, there are some categories of amendments that can be made by the trustee and servicer, without consent of investors. A certification or opinion of legal counsel may be required as to the fact that a particular amendment falls within these categories. Other amendments may require the consent of all investors, or of a stated percentage of one or more classes of investors. Where a securitization transaction includes credit enhancement from a certificate insurer or other credit support, the consent of the provider of the credit support is usually required as a condition to amendment.

Experience demonstrates that the oddest sorts of things may necessitate amendment of securitization transaction documents. When selling a mortgage servicing platform out of bankruptcy – the servicing platform being the most valuable asset of the bankrupt subprime lender – we found that the definition of "Person" needed to be amended, so as to enable a limited liability company to step in as the successor servicer. At the time the governing documents were drafted, evidently nobody had considered that possibility.

Amendment of the documents can be especially challenging when the required parties have ceased to exist – a situation that is occurring with greater frequency. It is not unusual for the required consents to include those of the "depositor," which is typically a special-purpose entity without personnel or other operating business. Furthermore, many securitizations remain in existence for many years. Some amendments have called for the consent of entities that ceased to exist more than a decade ago. It has been necessary to trace successive sales and consolidations of businesses, simply to ascertain who succeeded to the right of approval for an amendment, or whether the approval right was extinguished in some years' old bankruptcy.

6. Who can assist with document due diligence?

Understanding the variations among securitization documents, including the rights and powers of the servicer and other parties, and the financial interests of different investor groups, should be a collaborative effort. While the lawyers are best able to tease out the nuanced rules for the operation of the securitization transaction, there is also a need for experienced business analysts to understand the cash flows, based on the real-world characteristics of the loans.

Also, there is some variation among the trustees and other third-party service providers in regard to their level of involvement, and their demands for reimbursement of expenses, when enforcement, modification, amendment or bankruptcy actions occur. Practical experience with the parties who have these roles can be helpful in anticipating obstacles and costs that may be encountered in dealing with specific situations.

7. Are there ways to scale up?

Unfortunately, there are many variations among loans, as well as among sets of securitization documents. It is therefore difficult to apply a single set of analytical principles across the board. There is simply no substitute for studying all the pertinent portions of all the governing documents.

As we observe the U.S. Treasury's nascent efforts to design a program for the acquisition and workout of $700 billion in loans and mortgage-backed securities, we are daunted by the challenge that such an effort will face. Private investors – both buyers and sellers – face these same challenges.

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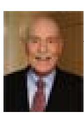

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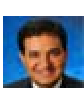

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