The Operating Trust Advisor: Here Today, Here Tomorrow

July 10, 2011 by Devin M. Swaney

A new kid showed up on the CMBS block in 2010: the operating trust advisor, sometimes also referred to as, among other things, the senior trust advisor (the "OTA"). During the great recession and credit interregnum, investors dreamt of an independent third party who would represent the interests of investment-grade investors to protect them from the conflicted and potentially nefarious behavior of special servicers who were considered by some to be in bed with the B-piece buyer and to facilitate an improved flow of information on a real-time basis. Someone who would somehow be there for bondholders when pools began to wobble. When the New York Fed was rooting around for a structure for TALF that would not only execute well but would also provide a learning opportunity for the market, they listened to the IG bondholders, and the OTA was born.

For the regulatory community and some elements of the investor community, it was love at first sight. But by late 2010, some thought that the OTA was going the way of the Edsel. A one-hit wonder. Then, in April 2011, the regulators embraced the OTA in their proposed risk retention rules. And now the OTA may be here to stay. Perhaps bowing to the inevitable, most recent 2011 CMBS conduit deals (and some single asset deals) have utilized some form of an OTA.

The OTA is, at this point, less a distinct structural feature than a notion built around the idea that a third-party ombudsman would be a good thing for investors. It is very much still in the process of evolving. While clearly not yet jelled, here and now, the core characteristics shared by most of the 2011 OTAs include: (1) the OTA conducts an annual audit of the performance of the special servicer and reports in some fashion to the bondholders; (2) the OTA exercises non-binding consultation duties with respect to major decisions related to specially serviced loans after the B-piece buyer has lost control; and (3) the OTA reviews and verifies certain calculations (e.g., with respect to appraisal reduction and net present value determinations). More as outliers, in some deals the OTA consults on whether a loan should be transferred to special servicing and, in some deals, the OTA is entitled to recommend the termination of the special servicer under certain circumstances. In at least two atypical cases, the OTA actually functions as something like a controlling class representative, in one case, for any period during which the related B-buyer is affiliated with borrowers in the pool, and in another case, at such time as the B-buyer's interest burns off.

So what's in it for the OTA? The OTA's compensation typically consists of a per-annum strip from the deal, similar to servicing or trustee compensation. In some deals, the OTA is entitled to additional compensation in the form of consulting fees, e.g., based on a range of fees on a per-loan basis in connection with the OTA's review of specific major decisions (e.g., workout or modification decisions) with respect to specially serviced loans. In those deals, payment of the OTA's consulting fees is often limited by the right of a servicer to waive or reduce the consulting fees, the seniority of a servicer's right to similar consent fees or a servicer's limited obligation to collect the consulting fees from the related borrower under the mortgage loan documents. So query as to whether an OTA will ever get those consulting fees. At least one lesson learned so far regarding consulting fees: if a loan hasn't closed yet, incorporate specific references into the underlying loan documents that clearly require the borrower to pay the fees.

The OTA is also typically entitled to reimbursement from the deal of its expenses, although some deals cap the reimbursement of the OTA's expenses by prohibiting reimbursement through a reduction of interest or principal payments otherwise ear-marked for the B-piece, thereby insulating the B-buyer from risk associated with the reimbursement of the OTA's expenses.

What rights do deal parties have to terminate the OTA? Termination of the OTA is similar to termination of a servicer or trustee. Upon certain events of default or upon an affirmative vote of bondholders, the trustee may be required to boot the OTA. And, typically, the OTA has fairly standard resignation rights, e.g., including the right to resign because legal compliance demands it or upon seeking a bondholder vote or finding an appropriate replacement.

Under the Dodd-Frank risk retention NPR, if risk retention will be met by a B-piece buyer in a deal with an affiliated special servicer, an OTA will be required. The regulators' OTA would have consultation rights regarding major servicing decisions and the right to recommend the replacement of the special servicer through a byzantine voting structure where such recommendation would be implemented by the trustee unless a majority of each class of certificateholders votes to retain the servicer. As B-buyer risk retention is seen as a preferred modality for satisfying risk retention, this provision, if included in the final rule, will assure a future for the OTA in CMBS. So maybe the OTA is here to stay. But the risk retention NPR itself is subject to uncertainty and a recently extended comment deadline, so stand by to see what the regulatory elves will ultimately give us.

It is hard to declare that either the current OTA or the regulators' vision of an OTA is a game changer thus far. It seems that some deal parties may prefer to eliminate the role, and it isn't clear that the role really does all of the things that the IG investors dreamt about during the interregnum. The OTA's authorities and compensation are limited. Nevertheless, the deals keep calling for the OTA, and its consultation duties are currently in effect for some deals. Because the OTA is only beginning to spring into action on some deals, the jury is still out as to what extent the OTA's role will mitigate conflict risk and provide enhanced, useable information to bondholders. One thing is clear no matter your point of view: we may as well welcome the OTA to the party.