CMBS 2.0: Has the time come for an industry-form A/B Colender?

June 2, 2011 by Matthew Clark

Early last decade, two Dechert partners, Tim Stafford and Dave Forti, published Mezzanine Debt: Suggested Standard Form of Intercreditor Agreement (pdf) in CMBS World. The article proposed a standard form of mortgage-mezzanine intercreditor that provided a portion of the bedrock upon which the architecture of CRE mezzanine lending would be built for the years to follow. At the time of its publication, burgeoning demand for mezzanine debt (and mezz lenders' desire to create liquidity in their positions) had created a tension among mezz lenders, bond investors and rating agencies - the absence of a form ICA resulted in mezz debt being an inconsistent and pricey financing alternative. The CMSA (now CREFC) form ICA made mezz lending more predictable, less expensive and easier to trade.

Having closed on the acquisition of several A/B structures in past months, I'm wondering if, as our recovery continues, it could be time for a form A/B Colender? The basic architecture of the A/B Colender is already largely understood and could be effectively reduced to a widely-accepted formula. The waterfall, absent any deal-specific fee sharing arrangement, is pretty standard (pre-triggering event, Servicer fees, A interest, B interest and pro-rata fees; post-triggering event, Servicer, A interest, A principal, A costs and then to the B). Cure rights and purchase options could be standardized without necessarily limiting a B Note holder's ability to negotiate changes from deal-to-deal. (That said, I've never quite understood how a B Note holder cures a non-monetary event of default, and in the past few years I think the A would be more than happy to accept a par pay-out on a defaulted loan regardless of whether the requirements of the Colender had been fulfilled). Limitations on transfers of interests in the B Note (more than 49% only to a Qualified Transferee) and the rights of the B Note holder to pledge or finance its interest are, again, largely standard across deals.

I think the two areas where some disagreement could arise would be the servicing transfer mechanic (from interim to PSA) and Controlling Holder control rights. Generally, the loan is administered by a servicer acting on behalf of the A Note - initially, pursuant to an interim servicing agreement; post securitization, pursuant to the PSA. The transition mechanic between interim and PSA can vary from deal-to-deal. Sometimes, the B note holder will have a chance to review and comment on the PSA, sometimes the parties will agree to a form of PSA (something much easier in the days when issuers had form PSA's to attach), and sometimes, the Colender will limit changes to certain material terms or definitions (control appraisal events, for instance). With CREFC spearheading an effort to produce a form PSA (presumably containing market-standard provisions that adequately protect the holders of non-pooled components), at least some of the heartburn felt by issuers ("I can't have the B Note holder holding me up!") and B note holders ("I'm not getting jammed with a terrible PSA!") could be averted.

Controlling Holder control rights are probably among the most negotiated portions of these agreements - the list of consent and consultation rights ranging widely from deal-to-deal. In practice, however, it's not always clear that a long litany of controlling holder rights beyond the basics (i.e. rights that put the Controlling Holder at the nexus of a proposed workout) are necessarily that helpful when things hit the fan. And, of course, these rights could easily be negotiated on a deal-by-deal basis – why not start from a form? In addition, a form would allow for a more streamlined control appraisal mechanism (including standard rights for additional appraisals and threshold collateral) – especially if a form PSA should gain traction.

Like a lot of us, my experience with Colenders during the Crunched Credit era often followed a similar pattern - debt syndicated on co-lending arrangements that anticipated - no, needed - the A to be securitized; the servicing arrangements outside of the predicted PSA left vague, ill-defined (or, in some cases, just broken). And then the music died. (This is all more than somewhat understandable - few clients found it worthwhile to commission robust, fully-textured interim servicing agreements to administer freshly-minted mortgage loans during the months between origination and securitization. It's just that loose interim servicing arrangements and co-lenders dependent on a future PSA only work until they don't).

To be clear – I'm not suggesting each deal could be spit out on a standard form or that there isn't significant value in thoughtful, zealous negotiation between parties on these points (I mean, I've spent the better part of my career having these conversations). But as CMBS 2.0 loans continue to be originated and sold, a model Colender could contribute to a more efficient market with reduced transaction costs.