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They're Back! CMBS Lending in 2013:
Lender and Borrower Pointers; A Practitioner's Approach
to Negotiating CMBS Loan Transactions for Both Lenders and
Borrowers; What is Negotiable, Non-Negotiable, and Why

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The commercial mortgage-backed securities (“**CMBS**”) market, once a primary source of capital for owners of commercial real estate, saw a tremendous setback amid the global financial crisis of last decade. Though it suffered a decline from the height of \$230 billion of deployed capital in 2007 to near non-existence (\$2.8 billion) by 2009, the CMBS market began to see a resurgence in 2010 and the prospects for continued growth remain positive. See *Figure 1*.

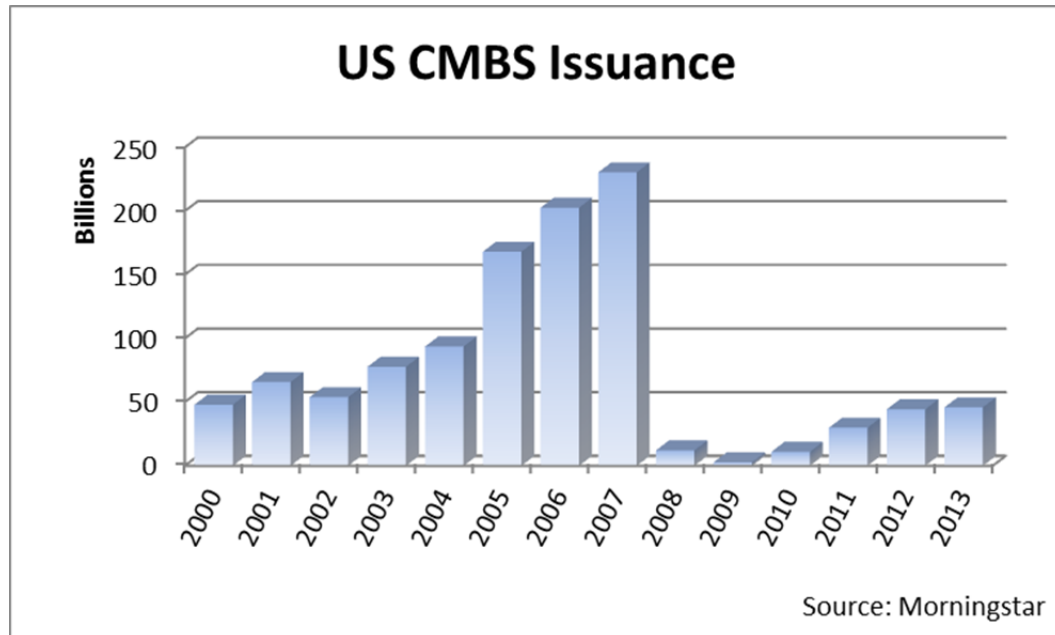


Figure 1

Due to the immense volume of CMBS capital deployed between 1995 and 2007, few transactional real estate attorneys escaped that period without representing a borrower or lender within a CMBS loan. In contrast, many practitioners have entered the legal market in recent years and developed a real estate practice devoid of CMBS experience. For the uninitiated, this article will act as a general overview of the CMBS process, an introduction to the underlying characteristics of a CMBS loan, and a guide to certain inflexibilities that result. Also, just to throw out a few buzz words to use during the next cocktail party discussion of the CMBS industry, the CMBS transactions originated through 2009 are generally referred to as CMBS 1.0 and those that originated in 2010 and beyond are generally referred to as CMBS 2.0.

ORIGINATION

CMBS loans begin their life cycle much the same as any other permanent loan, and are originated by a large number of financial institutions. The target asset types for CMBS lenders are stabilized retail, multifamily, office, and hotel properties.

Once funded, however, CMBS loans are not intended to be held by the originating financial institutions but are intended to be transferred into a real estate mortgage

investment conduit (“**REMIC**”) trust composed of a pool of other qualified mortgage loans. Each loan in the pool is evaluated individually and in the aggregate, and the pool will be divided into separate tranches of securities which are priced according to the risk assessments made by the rating agencies (S&P, Fitch, Morningstar, etc.). Each tranche of securities will ultimately be sold to institutional CMBS investors. The transfer (sale) of the CMBS loans into the pool frees the originator’s capital to be reallocated to additional CMBS loans, and the cycle repeats.

When an originator transfers a loan into a CMBS pool, it makes a series of representations and warranties regarding the structure of the loan and due diligence matters related to the loan, the borrower, any guarantor(s), the property (including title and survey matters), and the legal effect of the loan documents. Though it will differ from pool to pool, there are often nearly 100 specific representations (and exceptions thereto) that must be addressed by each originator regarding each loan. These representations and warranties (and more importantly, exceptions thereto) are a key factor in determining the rating of a particular asset within a securitized pool and act as an additional verification that the assets within the pool do not result in a violation of the REMIC tax rules. Notably, if there is a future default on a loan and any of the representations and warranties regarding that particular loan are discovered to have been false or misleading, the originator may be required to repurchase the loan from the pool.

Unlike portfolio lenders, those that specialize in securitized products rarely service the loans. Day-to-day contact between the “lender” and the borrower is handled by the “**Master Servicer**”, which is responsible for collecting mortgage payments, securitization accounting, administration of the escrow accounts, divvying up the debt service payments for the benefit of the CMBS investors, and a myriad of other administrative matters. The Master Servicer is also the main point of contact for the borrowers and will evaluate and act upon requests for collateral release, tenant approval, equity transfers and other borrower requests. Upon certain events (such as an actual or imminent loan default) the servicing of an individual loan will be transferred from the master servicer to a “**Special Servicer**” which has greater authority to resolve issues and exercise remedies than the Master Servicer. The actions of both the Master Servicer and Special Servicer with regard to any loan are governed by the Pooling and Servicing Agreement (the “**PSA**”), which can be very restrictive. The PSA’s primary purpose is to prevent action which would endanger the REMIC’s special tax treatment (for instance, if the REMIC tax rules are violated, the entire pool may be subject to 100% tax – a subpar result).

RATING AGENCY REQUIREMENTS

Included in the rating agency criteria for CMBS loans are many of the characteristics that, taken together, distinguish the CMBS product from a documentation perspective. Though supplemented by many other works, the U.S. CMBS Legal and Structured Finance Criteria published by Standard and Poor’s in 2003 remains the baseline that each CMBS loan and all borrower-requested change are measured against.

Whenever a CMBS lender's counsel says that a requested change is not allowed due to "rating agency requirements," these are the standards to which they are referring. The following key criteria are almost universally required by the rating agencies.

Special Purpose Bankruptcy Remote Entities

A special purpose entity (an "**SPE**") is, in its most basic terms, an entity that is designed to resist bankruptcy as a result of its own actions (through controls in its governing documents and the loan documents) or the actions of its affiliates (through substantive consolidation). Since borrower sponsors in CMBS transactions are generally not directly liable for the underlying debt (save certain specific recourse obligations), the lender's protection of the real estate collateral from bankruptcy proceedings is crucial. The utilization of the SPE is the primary protection of the CMBS lender's rights and can be generally divided into the following categories:

- Limiting the purpose of the SPE to the purchase, ownership, maintenance, and operation of the real estate collateral;
- Restricting the ability of an SPE to incur liabilities other than the CMBS indebtedness (and small amounts of trade payables);
- Restricting the operations of the SPE such that it will be insulated from the liabilities of its affiliated entities (see the "separateness provisions" below);
- Corporate formalities (documentation) that prevent the accidental or intentional dissolution of the SPE; and
- Corporate formalities that prevent the voluntary or permissive bankruptcy of the SPE or its constituent entities.

Separateness Provisions

An SPE borrower will be further isolated from substantive consolidation in the bankruptcy proceeding of an affiliate if it takes certain measures to keep itself legally separate from other entities with regard to its day-to-day operations. Historically, CMBS lenders, led by rating agency criteria, would require that each SPE borrower:

- Maintain its financial statements, accounts, books, and records separate and apart from any other person or entity;
- Not commingle its assets with any other person or entity;
- Observe all corporate formalities;
- Maintain arms' length relationships with its affiliates;

- Pay the salary of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
- Not guarantee or become obligated for the debts of any other entity;
- Not acquire obligations or securities of its shareholders, partners, or members;
- Fairly and reasonably allocate overhead for shared office space;
- Use separate stationery, invoices, and checks;
- Not pledge its assets for the benefit of any other entity or make any loans to any entity;
- Correct any known misunderstanding regarding its separate identity;
- Hold itself out as a separate entity and conduct business in its own name;
- Pay its own liabilities and obligations from its own funds; and
- Maintain adequate capital in light of its contemplated business operations.

Independent Directors

Another key element to the CMBS lenders' battle against bankruptcy is the requirement that an SPE have an independent director (or two) whose affirmative vote(s) would be necessary for the SPE or its constituent entity to voluntarily file bankruptcy. Though the existence of an independent director is not an absolute prevention of an affirmative bankruptcy vote (think GGP[†]), the independent director(s) would be required to consider the interests of the SPE's creditors as well as its investors in making such a decision. Typically, an independent director is hired from a nationally-recognized service (such as CT Corporation, Corporation Service Company, National Registered Agents, Inc., Wilmington Trust Company, etc.), but generally can be anyone who is not and has not been in the prior five (5) years a person that is a creditor, supplier, employee, officer, director, family member, manager, or contractor of the SPE or any of its affiliates or directly or indirectly owns or controls the SPE or any of its affiliates.

[†] In 2009, General Growth Properties ("**GGP**") removed its independent directors and voluntarily filed bankruptcy for 388 affiliated entities involving 166 of its retail mall facilities, many of which secured CMBS loans. Of the 166 loans, 161 were current on debt service payments and the borrowers on the remaining five loans, which had matured, were paying current interest – far from a situation that lenders could foresee being the basis of a wholesale reorganization action. Though the precise mechanics through which GGP orchestrated the removal of its independent directors is beyond the scope of this article, it should be noted that the GGP scenario has changed the landscape of bankruptcy remoteness for CMBS lenders and heightened their sensitivity to changes requested in this portion of their loan documents.

Nonconsolidation (a/k/a Non-Con, a/k/a Insolvency, a/k/a No Substantive Consolidation) Opinions

Another rating agency requirement is an opinion from borrower's counsel that the SPE is properly structured such that a bankruptcy court would not exercise its broad power to consolidate the assets of the SPE into the estate of an affiliated entity that has filed bankruptcy. This nonconsolidation opinion should analyze the relationship, documentation and circumstances as between the borrower SPE and certain of its affiliates (referred to as "pairings"), generally upstream parent entities and affiliated property managers, to determine whether the bankruptcy of the affiliate would result in the SPE or its assets becoming substantively consolidated with those of the affiliate.

NEGOTIATING CMBS LOAN DOCUMENTS

CMBS lenders have (fairly or otherwise) developed a reputation for rigidity regarding loan document negotiation. The source of the rigidity rarely has anything to do with the lender's policies or zealousness of its counsel, but rather the REMIC tax rules, the future pooling and servicing agreement, and the rating agency requirements. The farther any given loan strays from the normative guidelines of the rating agencies, the less it will be worth to the securitization. For a CMBS lender, negotiating loan documents is a balancing act between accommodating a potentially repeat borrower's needs and extracting as much value as possible. This should be the underlying consideration in any negotiations of CMBS documents, whether representing the lender or borrower.

Recourse

The popularity of CMBS loans among borrowers is not difficult to understand; prior to the broad availability of CMBS loans, commercial real estate loans were typically given by banks and other lenders on a recourse basis. Upon default, the lender could sue the borrower and guarantor on the note and guaranty and/or foreclose on the real estate collateral. If the lender chose to foreclose, it would retain the right to pursue the borrower and guarantor for any deficiency arising from the foreclosure sale. In contrast, a CMBS loan is generally non-recourse – that is, if the loan does not perform, the lender's only recourse is against the collateral (and the cash flow it generates) and not against any other person or entity.

There are exceptions to a CMBS loan's non-recourse nature, however, which are divided into two different categories: limited recourse obligations and full recourse obligations (often referred to as "above the line" and "below the line" respectively). Upon the occurrence of an "above the line" event under a CMBS loan, the borrower and guarantor will be liable for losses or associated costs that the lender incurs due to the particular event. Such "above the line" items typically include the SPE borrower's misapplication of rents, waste at the property, or failure to comply with covenants under the loan documents, such as environmental covenants and representations, the payment of insurance premiums or taxes. Since many of these types of costs are escrowed monthly, a

prudent document change relates to carving out liability to the extent funds to cover such costs have already been deposited with lender. *See Figure 2.*

(g) Insurance. Borrower shall fail to maintain in full force and effect all Policies required hereunder unless such failure results from Lender's failure to pay the applicable premiums therefore when sums sufficient for such purposes are on deposit in the Basic Carrying Costs Escrow Account and no other Event of Default exists.

Figure 2

“Below the line” triggers, on the other hand, create full recourse liability for the SPE borrower and the guarantor for the entire debt and associated costs incurred by the lender. Typical examples include: missing the first debt service payment (it can create substantial problems in the securitization process if a newly-originated loan has a first-payment default); voluntarily declaring bankruptcy or colluding with others in an involuntary filing; obtaining subordinate financing secured by the property; and selling the underlying real estate collateral or transferring the ownership interest in the SPE borrower (without lender’s consent); and a violation of the SPE covenants.

Including the violation of a borrower’s SPE covenants as a “below the line” item may seem a reasonable hedge by the lender against the possibility of an unwanted substantive consolidation, but the language many lenders have traditionally used has led to some unintended consequences to borrowers in the CMBS marketplace. For instance, some recent courts have taken a very literal reading of the SPE covenant to maintain adequate capital, resulting in an inadequately capitalized borrower (such as one that cannot make its debt service payments due to reduced rent caused by tenant vacancies) becoming fully liable for the entire debt and taking its guarantor along for the ride. The CMBS industry’s forms have largely been revised to account for these situations, but borrower’s counsel should analyze the loan documents carefully regarding borrower solvency requirements. *See Figure 3.*

~~remains solvent and maintains adequate capital~~ shall not make distributions, other payments or transfer proceeds from the Property which results in Borrower failing to remain solvent and not being adequately capitalized in light of its contemplated business operations as of the date of such distribution, payment or other transfer of proceeds (provided that the foregoing shall not require such Person's partners, members or shareholders to make any additional capital contributions to such Person).

or

has remained and ~~will~~ intends to remain solvent and has maintained and will maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations, provided, however, this provision shall not require the equity owner of such entity to make any additional capital contributions to such entity.

Figure 3

Defeasance

In order to ensure the predictability and consistency of cash flow to the REMIC trust, prepayment of CMBS debt is almost universally prohibited until the last 60-90 days of the loan term. If a borrower needs to release the lien on the real estate earlier than this period (in the instance of a refinance or sale), defeasance is typically the solution. Defeasance, in the CMBS context, is the substitution of one type of collateral for another, namely the exchange of a lien on real estate collateral (more specifically, income stream) for a security interest in fixed-income government securities. The process entails purchasing a bundle of securities, the income from which is carefully calculated to provide the REMIC trust with the originally scheduled monthly debt service payments and maturity payoff. In return, the lender releases its lien on the real estate, which can then be refinanced or sold.

As currently drafted, many CMBS loan documents require that the defeasance collateral pay the debt service through the original maturity date, without regard to the prepayment period allowed under the loan documents. Borrowers have been appropriately successful in shortening this defeasance period to the beginning of the prepayment period. An additional revision should be considered to address instances where securities with the requisite maturities may not be available to match up with the beginning of the prepayment period. Thus, the date through which the defeasance collateral should pay the debt service should be at some point between the beginning of the prepayment period and the original maturity date. *See Figure 4.*

(i) an amount equal to that which is sufficient to purchase U.S. Obligations that provide for payments (A) on or prior to, but as close as possible to and including, all successive scheduled Monthly Payment Dates after the Release Date through a Monthly Payment Date between (and inclusive of) the Open Prepayment Date and the Stated Maturity Date ~~and~~ (B) in amounts equal to or greater than the Monthly Debt Service Payment through and including the Stated Maturity Date together with payment in full of the Outstanding Principal Balance as of the Stated Maturity Date (the "Defeasance Collateral"), each of which shall be duly endorsed by the holder thereof as directed by Lender or accompanied by a written instrument of transfer in form and substance wholly satisfactory to Lender (including, without limitation, such instruments as may be required by the depository institution holding such securities to effectuate book-entry transfers and pledges through the book-entry facilities of such institution) in order to create a first priority security interest therein in favor of Lender in conformity with all applicable state and federal laws governing granting of such security interests;

Figure 4

The single most important factor in determining the cost of the defeasance is the yield of the underlying securities that make up the defeasance collateral. In many instances, CMBS loan documents allow for defeasance collateral to be made up of "U.S. Obligations", "U.S. Treasury Obligations" or simply "government securities." Expanding this universe of potential securities to include agency securities (Fannie Mae and Freddie Mac securities) gives the borrower access to securities with higher yield (resulting in

lower defeasance costs) and greater liquidity (resulting in easier defeasance packaging). See Figure 5.

“U.S. Obligations” shall mean direct non-callable obligations of the United States of America (or any agency thereof), including non-callable obligations of the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation.

Figure 5

Release of Realty Collateral

With many portfolio lenders, a request from a borrower for a modification of the loan or release of collateral could be presented to a loan officer and approved and put into effect by the lender with little obstacle. Due to the restrictive REMIC tax rules on CMBS trusts, however, the release of property is generally outside the authority of Master Servicers absent an express release requirement with specific conditions outlined in the loan documents. Though it has become easy sport to complain about the inflexibility of CMBS servicers, the REMIC tax rules (and in turn, the PSA) effectively tie the hands of the servicers. Thus, any release of real estate collateral must be considered at the origination and thoroughly laid out in the loan documents with objective, easily verifiable criteria.

Independent Directors

As discussed above, rating agencies, when rating particular loans and loan pools, will look to whether the borrower has appointed independent directors to protect against a borrower filing for bankruptcy protection. While the inclusion of independent directors is a rating agency “requirement” (in that it is part of the rating agency criteria in evaluating CMBS debt), it is a requirement that is often waived by lenders for loans under a certain threshold (typically \$15-\$20 million). A loan that is not protected by independent directors, however, may suffer in its ratings evaluations, so lenders carefully consider the input of rating agencies and the ultimate purchasers of the trust certificates before waiving the requirement. In reality, the independent directors are not going to get in the way of running day-to-day operations at the property; they are simply engaged to vote on whether to file bankruptcy, and may spring to life as the “special member” of a single member limited liability company in the event of the single member’s bankruptcy, death etc. Based on the size of the loan and/or the reputation of the borrower, the lender may require two (2) independent directors, but this is often negotiable. The cost of independent directors typically runs between \$1,300 - \$1,500 per year per director.

Nonconsolidation Opinions

The requirement for a nonconsolidation opinion itself is typically non-negotiable and will either be absolutely required or waived by the lender based on the size of the loan. Typically, for loans under \$15-20 million, the opinion can be waived. Early consideration of nonconsolidation opinion requirements is important since they are

expensive to issue and not all firms are prepared to give them, sometimes requiring the engagement of special counsel. The actual language of the opinion is obviously negotiable between borrower's and lender's counsel, but the ins and outs of these negotiating points are outside the scope of this article.

Governing Law

In CMBS 1.0, the loan documents were typically governed by the law of the state where the property was located. In CMBS 2.0, however, most lenders are requiring that all loan documents be governed by New York law (except for the creation, perfection, and enforcement of liens, which are still governed by the state where the property is located). For small-balance CMBS loans, borrowers may be able to negotiate the governing law, but for large-balance loans, the use of New York law is usually non-negotiable. Accordingly, in addition to non-consolidation opinions and formation/authorization opinions, borrowers are required to provide New York enforceability opinions.

CONCLUSION

Through the market downturn beginning in late 2007, CMBS has survived its biggest challenge and is now well positioned to regain a lot of lost ground. As we move from CMBS 1.0 to CMBS 2.0 (and onward), CMBS will likely continue to regain market share and the fundamentals outlined in this article will give the new CMBS practitioner a sound foundation.