# The Unique Aspects of CMBS Loans: A Primer for Borrower's Counsel

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**The author of this article discusses some of the primary differences between commercial mortgage-backed securities loans and balance-sheet loans. Although the two types of loans are more similar than different, the differences are material and important. Identifying and understanding these differences and the ways in which they may impact a borrower is essential to providing effective borrower representation.**

Commercial mortgage-backed securities ("CMBS") loans and balance-sheet loans are not created equal. While there are many similarities between the two types of loans, the differences are material and important. Identifying and understanding these differences and the ways in which they may impact a borrower is essential to providing effective borrower representation.[1]

## CMBS Loans Overview

### *Generally*

CMBS loans are typically non-recourse loans that materially comply with a standardized set of requirements (e.g., single-asset borrower) and have a term of five, seven, 10 or (rarely) 15 years. The loans may provide post-closing advances for value-add opportunities (e.g., tenant improvements), but the vast majority of principal is advanced at the closing of the loan. Thus, construction loans and loans involving significant redevelopment funded by the lender are not securitized.[2]

Each CMBS loan bears a fixed interest rate.[3] A borrower is required to make a monthly payment of principal and interest, generally based on an amortization schedule of 25–30 years; however, some loans will include an interest-only period at the start of the term. As such (and assuming no defaults), the timing and amount of each loan payment throughout the term is ascertainable when the loan closes.

In a CMBS transaction, multiple individual commercial mortgage loans are pooled together with other commercial mortgage loans and transferred to a trust, typically a pass-through entity (not subject to tax at the trust level) known as a real estate mortgage investment conduit ("REMIC").[4] The trust issues a series of bonds (also referred to as certificates), which are segregated into different classes (also called tranches). These bonds all relate to the same pool of mortgage loan

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collateral but may vary in yield, duration and payment priority.[5] Nationally recognized ratings agencies (e.g., Moody's Investor Service, Fitch or Standard & Poor's) will assign a credit rating (which may fall anywhere in the spectrum between unrated and investment grade) to each bond.[6] The bonds are then sold on a public exchange.

Once the CMBS loan is transferred to the trust and securitized, the loan is serviced in accordance with the applicable loan documents and a Pooling and Servicing Agreement ("PSA"). Each trust has its own PSA, containing a unique set of terms. The PSA governs the allocation and distribution of loan proceeds and losses to the bondholders. It also describes how the loans are to be serviced and includes guidance to ensure that the trust continues to comply with the REMIC provisions in the tax code.

The pool of loans is not serviced by the trust but by two servicers, a master servicer and a special servicer. The master servicer is the primary servicer. Its duties are limited to routine matters (e.g., reviewing financial reports, preparing reports to investors and confirming satisfaction of disbursement conditions).[7] The special servicer addresses loan prepayments, defaults and any other matters that diverge from the express terms of the loan documents (e.g., lease that does not meet leasing requirements).[8] One key difference between portfolio loans and CMBS loans is the servicing. Each portfolio lender applies its own individualized servicing standards to each of the loans it holds. A CMBS servicer acts in accordance with the specific PSA applicable to all of the loans in the pool it governs. It is worth noting that while there are variances in the obligations of a servicer under a PSA, for the most part, the practices and procedures are standardized to meet REMIC requirements and to protect the bondholders.

Commercial mortgage lenders are attracted to the CMBS market because the aggregate value of the bonds backed by a pool of loans are generally worth more than the sum of the value of all of the loans, enabling the lender to profit off of the arbitrage.[9] The securitization market also has enabled lenders to finance assets that would not otherwise be eligible for a lender's balance-sheet. It is also much easier for a lender to sell the bonds than it is for the lender to sell individual mortgage loans.

Investors who buy the bonds are attracted to the certainty of a pre-determined income stream. The diversity among the securitization certificates, including with respect to monthly payment amounts, duration of payments and risk of non-payment, also enables an investor to match the investor's specific needs to the bond's income stream. The public market makes trading the certificates quick and simple, effectively turning illiquid assets into liquid investments.

## *Advantages and Disadvantages of CMBS Loans from the Borrower's Perspective*

### *Advantages*

A borrower is often drawn to a CMBS loan for the following reasons:

- *Lower Interest Rates.* CMBS loans typically have lower interest rates than balance-sheet loans for several reasons. First, there is less risk (and thus a lower return) in a diversified pool of securitized mortgages because the losses from a single defaulted loan may be offset by the strength of the remaining loans in the pool. Second, the original lender earns fees and other income, including premium payments by investors for bonds in specific tranches, from the sale of the loan at securitization, thus increasing the lender's return on investment beyond that it would receive if its only income were debt service payments. Third, the enhanced liquidity and structure attracts a broader range of investors to the commercial mortgage market, resulting in lower interest rates than balance-sheet loans. The delta between the interest rate on a CMBS loan and a balance-sheet loan is less significant when interest rates are low because the benefits to CMBS lenders are compressed; however, as interest rates rise, the delta becomes increasingly significant.

- *Higher Overall Loan-to-Value ("LTV") Ratio.* A balance-sheet lender is often prohibited by its own institutional policies or regulatory requirements from lending more than 70 percent of the appraised value of the property.[10] A CMBS lender is not typically bound by the same type of institutional policies and regulatory requirements because it is not holding the loan for its own account. It is not uncommon to see a CMBS loan with an LTV of 80 percent or, particularly in combination with a mezzanine loan, even higher.[11]

- *Increased Availability of Capital.* There are clear limitations on the amount of capital that a balance-sheet lender can advance because it must reserve against each loan that it holds on its books.[12] These limitations on the aggregate capital that a balance-sheet lender can lend cause the lender to be more selective about the loans that it will make. In contrast, a CMBS lender sells each loan (other than the five percent it is legally required to retain[13]), freeing up its capital and allowing it to continue originating loans. With the notable exception of the 2008–2010 time period, there has been a virtually unlimited supply of capital in the CMBS market.

### *Disadvantages*

A borrower often focuses on the lower interest rate and higher LTV offered by a CMBS loan and fails to appreciate the following disadvantages, which have proved themselves to be problematic for many borrowers:

- *No Continuity of Lender.* A CMBS lender is not a "relationship lender." Its relationship with a borrower is purely transactional. Once a loan is securitized, the original lender (or, if the original lender becomes a servicer, the original lender's personnel) ceases its involvement with the loan. The borrower must now deal with a master servicer and special servicer, each appointed by the securitization trust and with whom the borrower has no pre-existing relationship.

    - *Master Servicer.* One of the principal obligations of the master servicer is to enforce the loan documents.[14] The master servicer has no incentive, and strong disincentive, to vary from the express terms of the loan documents. This is true even when circumstances clearly necessitate a liberal reading or modification of the loan documents.

  - *Special Servicer.* Unlike the master servicer, the special servicer has broad (but not unlimited) power to make decisions that go beyond, or conflict with, the terms of the loan documents as long as the special servicer honors it fiduciary obligation to act in the best interest of the bondholders.[15] The special servicer receives most of its income from the fees that it charges a borrower to address a particular request.[16] If the circumstances of a loan require multiple and extensive interactions with a special servicer, the fees that a borrower pays to the special servicer may negate the benefits that the borrower receives from the lower interest rate. It is worth noting that a borrower can often achieve greater responsiveness and flexibility from a special servicer by increasing the amount of fees it pays.

- *Minimal Structuring Flexibility.* The goal of a CMBS lender is to close and securitize the loan as quickly as possible. During the securitization process, a CMBS lender will be required to certify that, except as otherwise noted, each of the loans meets the CMBS requirements. Any loan that diverges from the CMBS requirements may slow, or even derail, the securitization process. In order to avoid this situation, CMBS lenders frequently respond to a borrower's requests for changes in structuring or changes to the terms of the loan documents by saying "We cannot make that change. CMBS rules prohibit it." Frequently the foregoing statement is inaccurate. There are definitely borrower requests that cannot be accommodated if the loan is to be securitized (particularly as it relates to the REMIC rules), but more often than not, there are no legal reasons that a CMBS lender cannot accommodate the borrower's request. Rather, the CMBS lender is trying to avoid a situation in which it is required to note the matter as an exception on its certification. Accordingly, CMBS lenders are often unwilling to address a borrower's legitimate requests and concerns. Any borrower that wants to effectively negotiate with a CMBS lender should take the time to understand which variances from a lender's standard policies and loan documentation will require the lender to make a disclosure during the securitization process and which variances are legally prohibited.[17]

- *No Unplanned Future Advances.* Real estate projects are not static, and sometimes unanticipated problems arise. While a portfolio lender is reluctant to advance proceeds to a borrower beyond the amount of the original commitment, a portfolio lender may agree to do so if it believes that an infusion of capital will stabilize the project. For example, if the sole tenant at the project files for bankruptcy and rejects its lease during the bankruptcy proceedings, revenues from the property will cease. This situation is problematic for both borrower and lender. If the borrower then procures another tenant willing to pay a reasonable amount of rent, but the borrower does not have enough money to pay for all of the tenant improvements necessary to get the new tenant in place, a portfolio lender might agree to make additional loan advances (above and beyond the original loan commitment) for this purpose. In the CMBS context, once a loan has been securitized, additional loan funds cannot be advanced because there is no lender available to advance them. There are only the servicers and the bondholders, neither of which has the requisite authority (or, with respect to the servicers, source of funds) to make any additional advances.[18]

- *Rating Agency Confirmations.* The need for a borrower to conform to CMBS requirements does not end when the loan closes and continues through the full repayment of the loan. Certain actions, even if expressly permitted by the terms of the loan documents (e.g., loan assumption), are conditioned upon the borrower receiving a confirmation from a rating agency that the action in question will not cause a downgrade to the credit rating of the securities issued in the securitization. A borrower will incur additional fees and expenses in obtaining a rating agency confirmation, and these costs are in addition to the fees that the borrower pays to the servicers. Much like the servicing fees, the costs of a rating agency confirmation can reduce the benefits that a borrower receives from a lower interest rate.

- *Securitization Indemnification Liability.* One typical CMBS requirement mandates that the borrower indemnify the lender from liability under Rule 10b-5 of the Securities Exchange Act of 1934 for any misstatements in information or disclosures to investors, rating agencies or other parties to the securitization.[19]

- *Lack of Confidentiality.* CMBS bonds are publicly traded, and investors in the securities are provided with an opportunity to review loan files and disclosure statements before purchasing the bonds.[20] The information provided to potential investors includes financial information about the borrower, its parents and sponsors, as well as third parties such as tenants and property managers.[21] A borrower should not have any expectation of confidentiality in light of the broad dissemination of information. If confidentiality is important to the success of the underlying property (e.g., a single-tenant data center) or a borrower (e.g., high-profile individual), then a CMBS loan may not be a good option for that borrower.

## Negotiating the CMBS Loan

Many of the representations, covenants and agreements in a CMBS loan mirror those contained in a balance-sheet loan. This article focuses on material differences between the two loans that may create problems for a CMBS borrower.

### *General Matters*

In a CMBS loan, the originating lender, with whom a borrower may have had an ongoing business relationship, ceases to be involved once the loan is securitized, and ongoing loan matters will be handled by the master servicer or the special servicer. Many borrowers find their interactions with CMBS servicers to be very frustrating because of long delays in responses (or no response at all), the need for the borrower to pay additional fees to receive a response, and the borrower's perceived (or real) lack of reasonableness by the servicer. In order to minimize these frustrations, a borrower will want to reduce as much as possible the number of situations that require the lender's approval or otherwise necessitate interaction between the borrower and a servicer.

A borrower also should use extra care to ensure that the loan covenants are specific, tied directly to the property or a loan party and are capable of performance, in accordance with a strict reading of their terms. Loan covenants that are overly broad may have unintended consequences. For example, a strict reading of a covenant to the effect that, "Borrower shall not Transfer any Collateral without the prior written consent of Lender," means that a borrower will breach the covenant (and perhaps trigger liability for a guarantor) if the borrower allows tenants to take candy from a dish in the lobby. While this is clearly not the intent of the provision, a borrower should not rely upon a servicer for a reasonable interpretation of the provision. A borrower would be better served by modifying the sample provision to exclude transfers of property of minimal value.

### *Loan Payments*

Under the CMBS framework, the master servicer collects loan payments from each of the borrowers and then distributes the applicable portion thereof to each the bondholders. In order to simplify this process and consolidate payments to the investors, all of the loans in a CMBS pool will have the same due date for debt service payments.[22] The actual payment date will vary among securitization pools. A CMBS lender also will reserve the right in the loan documents to unilaterally change the payment date at any time prior to the securitization of the loan so that the lender has the flexibility to move the loan to a different securitization than it initially intended. A CMBS lender will not provide a borrower with any notice or right to cure a debt service payment because doing so would mean payments on the various loans in a securitization pool would be made on different days, which is an unacceptable result.

A CMBS loan often requires a borrower to pay interest before it accrues, and even if the borrower repays the loan in full on the maturity date, the borrower will be required to pay interest on the loan past the maturity date. For example, debt service payments might be due on the 10th day of each month, but the interest accrual period will run from the 15th day of a calendar month through the 14th day of the immediately following month. Each payment, including the payment due on the maturity date, must include interest for the entire interest period (i.e., through the end of the interest accrual period, in the example, the 14th day of a month). The original lender may actually be entitled to receive the "excess" interest.[23] A borrower should be aware that although it is common in CMBS loans for each interest period to extend beyond the applicable payment date, a CMBS loan does not have to be structured in this manner. Instead it can be structured like a typical portfolio loan in which interest is paid in arrears (e.g., the interest period is a calendar month and payment is due on the first day of the immediately succeeding calendar month). The only requirement applicable to the interest period in a CMBS loan is that all of the loans in the pool have the same interest period.[24] As a practical matter, this means that a CMBS lender may be unwilling to accommodate a borrower's request for the interest period to end prior to the payment date. A borrower should identify the payment dates and interest period in the term sheet to avoid an unpleasant surprise.

### *SPE Requirements*

CMBS loans are generally nonrecourse (other than traditional carveouts). If a loan goes into default, the property and the cash flow therefrom are the lender's primary (and generally only) source of repayment. CMBS investors and rating agencies want the loan structure to minimize potential disruptions in property cash flow. One means of accomplishing this is to isolate the real property from other assets by requiring that the borrower be a single-purpose entity (SPE), holding a single asset, in order to minimize the risk that the borrower files for bankruptcy as well as the risk of other disruptions in cash flow unrelated to the loan and the asset.

Like CMBS lenders, balance-sheet lenders' loans also typically require a borrower to be an SPE; however, a CMBS lender's SPE requirements are often more extensive and stringent than those of a balance-sheet lender.

A borrower should be aware that many of the SPE covenants in CMBS loan documents are overbroad and may encompass items that do not relate to SPE matters. It is essential that a borrower review each of these items very carefully to ensure that it can be fully compliant with each one. One of the reasons that it is so important for a borrower to ensure that it is capable of complying with the SPE requirements is that violations of SPE covenants may trigger recourse liability under standard CMBS loan documents. In *Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*,[25] an SPE borrower had a loan covenant to "remain solvent." The guarantor executed a limited recourse guaranty that triggered full liability to the guarantor if the borrower failed to comply with the SPE covenants. When the borrower defaulted under the loan, the lender foreclosed and then sought a deficiency against the guarantor on the basis that the borrower's insolvency constituted a breach of the SPE covenant and triggered liability under the guaranty. The *Cherryland* court found in favor of the lender and held that the guarantor was liable for the full amount of the deficiency.[26]

The following is a list of CMBS requirements that are not typically contained in balance-sheet loans (other than those modeled off of CMBS loan documents):

- *Ownership.* Except in unusual circumstances, both the borrower and its parent must be an SPE, and preferably in the form of a Delaware limited liability company.[27]
    - A borrower will need an important and intransigent reason if it wants to alter the SPE or Delaware limited liability requirement applicable to it or its parent. For example, in California, in order to obtain the tax benefits from certain affordable housing projects, the property owner must be a limited partnership, and the managing general partner must be a nonprofit corporation established for this purpose.[28] The foregoing structure will not prohibit a loan from being

securitized, but the borrower may be required to educate the lender about the reasons that the traditional CMBS borrower structure needs to be modified.

- *Separateness covenants.* A CMBS lender imposes a number of requirements upon the borrower to insulate it from other entities.

  - *Independent Director.* One of the customary CMBS requirements is that the organizational documents of each of the borrower and its parent provide for the appointment of one or two (depending upon the amount of the loan) independent professional directors and prohibit a voluntary bankruptcy filing and certain other material actions without the approval of the independent director.[29] The borrower is responsible for the costs associated with retaining and maintaining the independent director.
    - If the amount of the loan is small, a CMBS lender may agree to waive the independent director requirement or at least agree that the independent director does not have to be a "professional."[30]
  - *Operational Matters.* An SPE must adhere to certain separateness covenants designed to ensure that the SPE acts as a separate entity, distinct from its affiliates. These covenants generally include the following: (i) maintaining separate books and records; (ii) not comingling its assets with those of any other entity or permitting any other entity to access its bank accounts; (iii) holding itself out as a separate entity; (iv) maintaining separate financial statements; (v) filing separate tax returns; (vi) correcting any known misunderstanding as to its separate identity; (vii) maintaining an arms-length relationship with its affiliates; (viii) fairly allocating expenses shared with its affiliates; and (ix) using its own stationery, accounts, checks and invoices.[31] A borrower should carefully review the lender's SPE covenants to make sure they are entirely consistent with the borrower's operating practices. If there are any inconsistencies, even small ones, then the borrower should insist that the covenants should be deleted or modified as long as the changes do not violate the rating agency requirements (as opposed to preferences). Otherwise, a borrower runs the risk of default and may create liability for the guarantor for a violation of the SPE covenants. Some common covenants that may be inconsistent with a borrower's operating practices and for which such a borrower should seek (and may be able to obtain) modifications include the following:
    - Separate financial statements
      - If a borrower's assets are included in a consolidated financial statement, the borrower should be able to revise the SPE provisions to ensure that a consolidated financial statement is permitted.
    - Separate stationery
      - If a borrower does not

maintain separate stationery (and many SPEs do not), a borrower may be able to eliminate this requirement or at least seek limited exceptions for routine matters such as invoices.

- ☐ Conduct of business in its own name
  - It is unlikely that a borrower will succeed in eliminating this requirement altogether, but it should be able to obtain reasonable exceptions (e.g., for business conducted on its behalf by third parties, such as a manager).
- ☐ Separate tax returns
  - If a borrower is not legally required to file a separate tax return, then it should be able to remove this requirement.
- ☐ No affiliate access to borrower's bank account
  - If a property is managed by an affiliate of a borrower, the borrower should seek an exception if the affiliate manager has the right to access any of the borrower's bank accounts.

○ *Indebtedness.* The SPE provisions also will include restrictions on indebtedness, typically prohibiting the borrower from having any indebtedness other than the mortgage loan and, possibly, a capped amount of non-delinquent trade payables.

- ☐ Restrictions on indebtedness are set forth in the published rating agency criteria,[32] so it is unlikely that a lender will agree to remove them entirely; however, lenders are frequently amenable to making reasonable modifications.
  - Common matters that often affect borrowers and that lenders are often amenable to adding are equipment leases, encumbrances on title to the extent permitted by the loan documents, obligations under leases (e.g., tenant improvements) and contracts entered into in accordance with the loan documents. Since each borrower's situation is unique, it is important that a borrower carefully review the limitations on indebtedness to make sure any existing or potential indebtedness is identified and specifically permitted.

○ *Solvency.* The SPE provisions will include a covenant regarding solvency of the borrower.[33] At one time virtually all lenders required the borrower to agree that it would remain solvent throughout the loan term. More recently, loan documents seem to be split between that covenant and one linking the borrower's obligation to remain solvent to the cash flow available to the borrower from the real property asset.

- ☐ A borrower should pay particular attention to covenants involving solvency, adequate capital and payment of expenses. A borrower should try to remove all of the covenants regarding borrower's capital and its adequacy, although doing so may be difficult. Alternatively, a borrower should try to limit the covenants in some way. Some examples are as follows:

- "The borrower shall not make a distribution if the immediate result of such distribution would be to cause the borrower to become insolvent, fail to have adequate capital to conduct its business operations or pay its expenses when due and payable."
- "The borrower shall use commercially reasonable efforts to remain solvent, maintain adequate capital to conduct its business operations, and, subject to the borrower's rights to contest payments under Section [XX], pay its expenses when due and payable as long as cash flow is available from the Property to do so."
- "As of the Closing Date, it is the intent of the borrower to remain solvent, maintain adequate capital to conduct its business operations, and pay its expenses when due and payable, subject to the borrower's rights to contest payments under Section [XX]."

In addition to including SPE covenants in the loan documents, a CMBS lender will require that the borrower modify its organizational documents to incorporate the same SPE provisions that are in the documents. In doing so, a borrower should make sure that the SPE provisions in its organizational documents cease to be effective once the loan has been repaid.

### *Cash Management*

CMBS loans almost always require some form of cash management system so that the lender can direct and control the cash generated by the property even if the property is fully stabilized with a high debt coverage ratio. The cash management system is similar to that used with portfolio loans in that there are typically two types of accounts: a lockbox account and a cash management account. Both accounts will be in the name of the borrower. The lender will have a first priority security interest in each account as well as control over each account pursuant to a tri-party agreement between the deposit bank, the borrower and the lender (a "deposit account control agreement").

Although the cash management structure is virtually the same in portfolio and CMBS loans, it is important that a borrower give the structure extra scrutiny in the CMBS context. In both contexts, the cash is critical to the borrower's continued ability to operate, but in the CMBS context, a borrower may not be able to convince the servicer to address any operational issue that prevents the system from working as the borrower and the lender intended when the loan was originated.

A lockbox account is an account into which all property revenue will be deposited. There are three types of lockbox accounts:

(i) hard lockbox, which requires that property revenue is deposited directly into the lockbox account and/or sent directly to a post office box where a bank removes the checks and deposits them into the lockbox account;

(ii) soft lockbox, which allows a borrower or property manager to collect the revenue and then requires them to deposit it into the lockbox account; and

(iii) springing lockbox, which is only activated if a specific triggering event occurs (e.g., failure to meet a debt service ratio or a default beyond applicable notice and cure periods).[34]

Funds in the lockbox account are transferred into a cash management account pursuant to a schedule agreed to by the parties (e.g., daily or monthly). Like the lockbox account, there are three types of cash management accounts:

(i) a hard cash management account, which restricts the borrower from accessing the cash, with debt service and operating expense payments made directly by the servicer, and any excess amounts remaining in the cash management account;

(ii) a soft cash management account, which restricts the borrower from accessing the cash, but provides that excess amounts are released to the borrower after debt service and operating expense payments are made by the servicer; and

(iii) a springing cash management account, where absent a triggering event, lockbox funds are disbursed back to the borrower without first being deposited into the cash management account.[35]

Since there are substantial differences among the various lockbox and cash management structures, it is advisable to agree upon the structure in the term sheet. While it is clearly in the best interest of a borrower to eliminate the lockbox/cash management structure altogether, it is rare that a CMBS lender will agree to do so. The next best option for a borrower is to have a springing lockbox account and a springing cash management account. This may be possible for a stabilized project in which the project's cash flows substantially exceed the debt and operating expenses, but is unlikely in other situations because CMBS lenders have a strong desire to control the cash.

If a borrower is successful in persuading the CMBS lender to agree to a springing cash management account, the borrower's next step should be to limit the triggering events to as few as possible. A default, after the expiration of applicable notice and cure periods, will always be a triggering event. It is also typical for the borrower's failure to satisfy one or more financial covenants to be a triggering event. It is essential that a borrower carefully reviews each of the triggering events, especially the financial covenants, to ensure that it fully understands how they operate and is confident, at least initially, in its ability to satisfy them. A borrower should seek to avoid triggering events that are beyond its control, such as the termination or non-renewal of a major lease, even though doing so is likely to be challenging. A borrower also will want to make sure that the loan documents clearly state that at such time as the triggering events are cured (e.g., financial covenants are satisfied for two consecutive measurement periods), the lockbox/cash management structure will revert back to its original structure (e.g., upon cure, a hard cash management structure will become a springing cash management structure).

Regardless of the type of cash management structure, a borrower should focus on the timing of deposits, nature, amount and order of the payments to be made from the cash management account. A borrower will want to ensure that the timing of the deposits from the lockbox account into the cash management account syncs with the payments from the cash management account. For example, in the first month after the loan closes, a borrower might find itself without any cash in the cash management account if rents are due on the first day of each month, but the tenants have a five-day grace period (meaning that many tenants will not pay until the fifth day of a month), and the lockbox account is swept once a month on the first day of the month. If a lockbox sweep only occurs once a month, then to maximize the likelihood that sufficient cash will be available in the cash management account to make the necessary payments, the cash from the lockbox account should be deposited immediately prior to the time that the disbursements will be made.

Disbursements from the cash management account are generally made on the day on which the debt service payment is due, and a borrower will not be able to change the timing of the disbursements. Disbursements from the cash management account occur in a pre-set order commonly referenced as a “waterfall.” Typically, taxes and insurance are paid first, followed by debt service, operating expenses, capital expenses and reserves, although some lenders will move debt service lower in the waterfall.

The amount of each disbursement is usually tied to the amount set forth in a budget approved by the lender. Frequently, loan documents fail to address what happens if the actual expenses exceed the budgeted amount. A borrower should make sure that there is a mechanism for it to access cash (assuming it is available) to address budget overages. For example, during the construction of a tenant improvement, a borrower will need to pay its contractors on a monthly basis, so it will want to be able to get disbursements from the cash management account throughout the course of construction rather than waiting until the improvements are completed. The importance of understanding the operation of the cash management system and its consistency with the way in which a borrower operates is magnified if a hard cash management account is in place. This is because if a borrower needs funds that cannot be disbursed from the cash management account, then the borrower’s partners or members will need to contribute equity if the expenses are to be paid. It is imperative that, whatever the structure, a borrower has the right to receive periodic reports of the activity in each of the accounts so it knows what is happening and is not relying on the servicer to provide it with information.

In addition to negotiating the structure of the cash management system, a borrower should identify both the lockbox bank and cash management bank at the term sheet stage. Frequently, a borrower will want a local bank to be designated as the lockbox bank for receipt of checks to minimize any delays in the receipt of funds (e.g., designating a bank with offices only in New York instead of a California bank to receive rent checks from a project in California could result in unnecessary delays).

In selecting a lockbox bank and cash management bank, one of the matters that a borrower should consider is whether its desired bank has an existing relationship with the CMBS lender. Negotiating deposit account control agreements can be costly because the lockbox/cash management bank is reluctant to make changes to its form, and the CMBS lender has a set of requirements that must be satisfied.[36] The process will be much more efficient and less expensive if the designated lockbox/cash management bank has recently entered into a deposit account control agreement with the CMBS lender. Additionally, a borrower should seek to minimize the minimum balance requirement for both the lockbox account and the cash management account.

### *Reserves*

CMBS loans virtually always require a borrower to establish reserve accounts. Common types of reserves include real estate taxes, insurance premiums, repairs and maintenance, tenant improvements, capital expenditures and, less frequently, operating expenses. It is not uncommon for the amount of the reserves required in CMBS loans to exceed those in portfolio commercial loans.[37] Accordingly, a borrower should focus on the impact that the reserves will have on its cash flow and ability to satisfy financial covenants.

It is judicious for a borrower to make sure that the material reserve requirements are set forth in the term sheet. Among the key items for a borrower to consider are the following:

- *Amount of the Reserves.* The amount of certain reserves (e.g., deferred maintenance items) may be ascertainable at closing, but other items may be subject to change in the future (e.g., tax and insurance reserves). A borrower will want to make sure that the lender is required to act reasonably in determining the amount of monthly reserve deposits. Also, a borrower should try to negotiate a cap on certain reserves (e.g., leasing and capital expenditures) so that the borrower will not be required to make deposits into the reserve throughout the loan term but only until the reserve reaches a specified level.

- *Use of Reserve Amounts.* While reserves are typically designated for certain purposes, a borrower should seek to have those purposes broadly construed. For example, a leasing reserve typically covers leasing commissions and tenant improvement costs; however, a borrower may incur additional costs related to the leasing of space, such as marketing costs and free rent. Assuming that the additional costs are reasonable, a borrower should be entitled to request reimbursement for them.

- *Release from the Reserves.* Since the funds in a reserve account are of no value to a borrower unless it is able to access them, a borrower should pay close attention to the conditions to disbursement from each of the reserves. Ideally, there will be very few release conditions, and they all will be objective (i.e., not allow the servicer to exercise discretion). In particular, a borrower should make sure that amounts can be released to pay third parties directly when due rather than to reimburse the borrower at the end of a project.

- *Direct Payments by Lender.* If a lender is disbursing money directly to itself so that it can pay a third party (*e.g.*, taxes), a borrower should request that the lender notify the borrower prior to making the disbursement (so that the borrower can confirm that there are sufficient funds in the account to cover the disbursement) and, at least 10 days before the payment is due, provide the borrower with evidence of the payment. It is worth noting that even if the lender agrees to the foregoing, a servicer may not actually send the required notices. A borrower also should make sure that it will not be in default under the loan documents (and that no liability will accrue to a guarantor) if the lender fails to make payments when due.

### *Financial Reporting and Confidentiality*

Prior to a securitization, the CMBS lender will have to provide financial information regarding each loan to the rating agency and the investors.[38] Following the securitization, the master servicer will be required to prepare financial reports on the loan to the investors.[39] Additionally, the securitization trust, as the issuer of the securities, is itself obligated to make reports under securities law and regulations.[40] It is not surprising, then, that CMBS lenders typically require that a borrower provide more extensive financial information than a portfolio lender requires. A borrower's ability to negotiate changes to the nature and timing of the financial reports that it provides will be limited to changes that will not adversely impact the financial reports that the other parties need to provide.

Another distinct attribute of the financial reporting covenants in a CMBS loan is that the information will not be confidential. In some circumstances (e.g., a borrower is a party to a confidentiality agreement with a tenant), it may be problematic for information reported by the borrower to become public. In limited instances and if there is an important reason, a borrower may be able to impose some minimal limitations on the dissemination of the information that it provides to the lender as long as the borrower does not attempt to restrict the dissemination of information that is legally required to be provided under the securities laws. If a borrower needs more than a minimal amount of information to be held in confidence, then a CMBS loan may be difficult for it to obtain.

Other than confidentiality, the considerations for a borrower in a CMBS loan, as they relate to financial reporting, are similar to those in a portfolio loan and include the following:

- *Consistency with Operating Practices.* If a borrower's operating practices (e.g., loan documents require that borrower's financial statements be delivered within 90 days after the end of borrower's fiscal year, but borrower does not prepare its financial statements until 10 days after the end of its fiscal year) do not conform with the reporting requirements, then it should seek to modify the loan documents so that they match the borrower's operating practices.

- *Closing Financial Statements.* A borrower should seek to include language in the loan documents to the effect that the financial reports submitted by the borrower in connection with the origination of the loan are in form and substance approved by the lender.

- *Event of Default.* A borrower should restrict the lender from declaring an event of default as a result of the borrower's failure to deliver financial information until after the borrower has received notice and an opportunity to cure.

During the most recent downturn, many lenders (both portfolio and CMBS) had difficulty obtaining current financial information from borrowers under defaulted loans. In response, many lenders now impose some form of monetary penalty (e.g., an increase in the interest rate) upon a borrower who fails to provide timely financial information. CMBS lenders often take it one step further by imposing full recourse liability upon a guarantor for a failure to comply. A borrower should try to eliminate the carveout for financial reporting failures, or at a minimum, move it "above the line" so that the guarantor is only liable for losses actually incurred by the lender as a result of the non-compliance. And, even if the lender will not agree to provide the borrower with notice and a cure period before declaring an event of default, the borrower should insist that the lender be required to provide the borrower with notice and an opportunity to cure before recourse is triggered against the guarantor.

### Securitization Indemnity

CMBS loan documents contain an indemnity from the borrower (and usually the guarantor) for all claims and liabilities relating to the securitization.[41] Typically, this indemnity is extremely broad in the scope of the matters that it covers. This is one area in which a lender is generally reluctant to make changes; however, the depth and breadth of a borrower's potential liability is so significant that a borrower would be remiss if it did not attempt to limit the reach of the indemnity. First, a borrower should seek to incorporate "standard" liability exclusions (i.e., limit damages to actual (not punitive, special, consequential or exemplary) damages and costs and expenses to out-of-pocket costs and expenses). Second, a borrower should be sure that the indemnity excludes not just gross negligence and willful misconduct of the lender, but also that of the servicers, the securitization trust, the investment banks and any other persons that are not affiliates of the borrower. Finally, a borrower should seek to limit its liability to matters arising directly from a breach of its obligations under the loan documents. For example, if a borrower knowingly provides a lender with false information and then represents to the lender in the loan documents that the information is true and correct, it is reasonable for a borrower to be liable for any losses sustained by the lender in relying on that information. In contrast, if the borrower makes a disclosure to the lender, and the lender fails to make a similar disclosure in the securitization process, then the lender, and not the borrower, should be liable for the error. Similarly, if the lender makes a mistake in the information that it submits (e.g., a typo in the financial covenants), the lender should be liable. While lenders are very reluctant to make changes to the securitization indemnity, reasonable limitations can be negotiated. The importance of limiting the indemnity is magnified if liability extends not just to the borrower, but also to the guarantor.

### Duplicative Covenants

For some reason CMBS loan documents frequently contain an express covenant to the effect that a borrower will perform all of its obligations under the loan documents and another covenant to the effect that a borrower will make all of the payments it is required to make under the loan documents. Covenants of this nature may appear innocuous, simply requiring a borrower to do what it has already agreed to do, but they are dangerous for a borrower. They have the effect of eliminating any notice and cure periods that are applicable to the underlying covenants. A borrower should insist on removing these duplicative covenants. A lender has no reasonable basis on which to object because the covenants are duplicative. If the lender insists on retaining the covenants, then a borrower should add language to make it clear that any notice and cure periods applicable to the underlying covenant are not superseded.

### *Consents*

The CMBS loan documents are living documents that control the actions of a borrower for a period of many years. As discussed above, it may be difficult for a borrower to obtain timely consent from a servicer. Accordingly, a borrower under a CMBS loan should be wary of any matter in the loan documents that requires the lender's consent regardless of how straightforward the matter may appear to be.

Since it is in a borrower's best interest to minimize the number of matters that require the lender's consent, prior to entering into the loan documents, a borrower should try to anticipate, to the best of its ability, changes that might occur in the borrower's operations and in the loan collateral. If the borrower is able to identify potential changes with some specificity (e.g., converting a portion of the project from big box retail into medical office) then the loan documents can grant the borrower an unequivocal right (i.e., no lender consent required) to make such changes as long as the borrower satisfies certain objective criteria.

Some areas to target in limiting consent are the following:

- *Leasing.* With respect to leasing, it is recommended that a borrower seek exceptions to lender consent for leasing activity that: (i) does not relate to a major lease; (ii) conforms to objective leasing parameters specified in the loan documents; (iii) was specified in the loan documents; or (iv) does not require the borrower's consent, approval or agreement under the terms of a lease (i.e., a tenant's exercise of a lease renewal or expansion).

- *Alterations.* CMBS loan documents typically require a borrower to obtain the lender's consent for alterations (i) that could have a material adverse effect on the borrower or the loan collateral, (ii) whose cost exceeds a specified alterations threshold, (iii) that are structural in nature, or (iv) that reduce the property's rentable square footage.

  - A borrower probably will not be able to completely eliminate any of the foregoing requirements, but a borrower should try to limit them as much as possible. Additionally, a borrower should make sure that the loan documents clearly state that the lender's consent is never required for (i) restoration of the property to its original condition following a casualty or condemnation; (ii) any alterations required under leases permitted by the loan documents; (iii) alterations required under reciprocal easement agreements or other recorded documents permitted by the loan documents; (iv) alterations necessary to comply with applicable law, and (v) alterations necessary to respond to imminent life or safety issues at the property.

- *Transfers of Equity Interests.* It is very possible that one or more of the holders of direct or indirect equity interests in borrower or guarantor could change over the course of the loan. This is especially true if one of the owners has a limited lifespan (e.g., private equity fund). Any change in the aggregate ownership of the borrower that, following loan origination, exceeds 49 percent could jeopardize the REMIC status[42] so a borrower will never succeed in getting a CMBS lender to waive its consent rights to such a transfer; however, a borrower should seek to persuade the lender to waive its consent rights for transfers of smaller percentages of interests, transfers by non-controlling parties and transfers among member/partners provided that such transfers comply with specified conditions, which might include notice to, but not consent of, the lender.

- *Change in Guarantor.* If one or more of the loan guarantors is an individual, then it is foreseeable that the guarantor could die or become incompetent during the loan term. Even if the guarantor is not an individual, it could cease to satisfy any financial covenants applicable to it. Accordingly, a borrower should negotiate for the right to substitute a replacement guarantor at any time (and as many times) throughout the loan term as long as the replacement guarantor satisfies the conditions listed in the loan documents.

If a borrower does need the lender's consent for a matter, the borrower faces two major obstacles: responsiveness and reasonableness. As discussed above, it can be very difficult for a borrower to receive a timely response from a servicer to the borrower's request for approval. Many borrowers have found themselves forced to choose between (1) moving forward on a matter without the lender's consent in breach of the loan documents, and (2) waiting for the lender's consent at the risk of a losing a clear value-add opportunity (e.g., a new lease). It may be possible for a borrower to expedite a response by paying a servicer an additional fee, but this can be expensive and may only make sense in limited instances. A better approach is for a borrower to insist that the lender agree to respond to requests within a specified timeframe and also agree that the failure to timely respond shall be deemed approval to the request.

Most lenders are well aware of the problems that borrowers have encountered in obtaining responses from servicers. These lenders are not excited by the prospect of deemed approval, but many will agree to it (at least in certain instances) provided that the borrower provides the lender with at least two notices before the "deemed approval" becomes effective. An example of language that a lender may accept (although a lender is likely to limit it to certain matters, such as lease consents, rather than applying it to all matters requiring consent under the loan documents) is the following:

> *With respect to matters requiring Lender's consent under this Agreement or any of the other Loan Documents, if Lender fails to respond to a request for Lender's consent within ten (10) days after Lender's receipt of Bor-*

> *rower's first request for consent together with all information reasonably required by Lender to review the request, Borrower may deliver a second request for such consent and, provided that such second request contains a bold face, conspicuous legend at the top of the first page thereof to the effect that '**IF YOU FAIL TO RESPOND TO THIS REQUEST FOR CONSENT IN WRITING WITHIN FIVE (5) DAYS, YOUR CONSENT SHALL BE DEEMED GIVEN,**' and Lender fails to respond to such request for consent five (5) days after Lender has received from Borrower such second request, Lender shall be deemed to have given such consent.*

It is very possible that even if a borrower succeeds in getting a lender to agree to respond within a specified time period, the borrower will want a response even faster; however, it is unlikely that the borrower will convince a CMBS lender to shorten its response times in the same way that a portfolio lender might.

In addition to time delays, any consent that permits a lender to use its discretion, even reasonable discretion, can be problematic. Servicers are frequently conservative when exercising discretion. A borrower should endeavor, wherever possible, to eliminate any subjectivity in the lender's approval rights, but it is unlikely that a borrower will succeed in tying all of a lender's consent rights to objective criteria. If the lender does have discretion in granting consent, then prior to requesting consent, a borrower should review the PSA so that it understands the servicing standards applicable to the servicer as well as any other conditions of the consent.

## Rating Agency Confirmation

The credit ratings that a rating agency assigns to the bonds at the time of the securitization are premised on the assumption that the credit quality of the loan pool will not change significantly after the securitization occurs.[43] Under certain circumstances, which will be specified in the PSA,[44] a borrower will be required to deliver a confirmation from the rating agency to the effect that the requested action will not cause a downgrade of any of the bond class ratings. Items that frequently require rating agency confirmation include a change in property manager, consummation of defeasance, a loan assumption, a transfer of more than 49 percent of the aggregate direct or indirect equity interests in a borrower following the origination of the loan and subordinate financing. If the loan is large, there may be additional matters that require rating agency confirmation, including an increase or decrease in cash flow from origination, fluctuations in occupancy levels, significant changes in market rents, a transfer to a special servicer, defeasance or loan repayments.[45] In processing requests for confirmation, the ratings agencies work with the servicer and will not interact directly with the borrower.

Rating agency confirmations can be expensive and time consuming. A borrower should seek to limit requirements for obtaining them. A borrower also should try to ensure that the loan documents make clear that any rating agency confirmation requirements only apply if the loan is included in a securitization at the time in question and that a rating agency confirmation will be deemed granted if the applicable rating agency waives, declines, refuses to review or fails to timely respond.

### *Modifications*

One of the reasons that CMBS loans are best suited for stabilized properties is the existence of limitations on the extent to which a CMBS loan can be modified after it closes. If a single CMBS loan in a loan pool fails to comply at any time with the REMIC's requirements,[46] the REMIC may incur numerous adverse consequences, including the imposition of a 100 percent prohibited transactions tax on any gain and the loss of its status as a REMIC.[47] Accordingly, any "significant modification," as determined by the REMIC rules, of a CMBS loan is prohibited.[48]

Not every matter that constitutes a modification of the loan from a legal perspective is considered to be a loan modification in the CMBS world. Examples of changes to a CMBS loan that do not constitute "modifications" include the following:

(i) changes that occur automatically pursuant to the original terms of the loan documents;

(ii) the substitution of a new obligor on a nonrecourse loan;

(iii) changes in the timing of loan payments as long as such changes do not result in a material deferral of the originally scheduled payments;

(iv) improvements to the mortgaged property; and

(v) minor changes to the collateral or credit enhancement.[49]

There are also matters that, although they constitute modifications of a loan, do not constitute a "significant modification" under the REMIC rules and are legally permitted, which does not mean that they will be approved by the lender. Examples of this type of loan modification include:

(i) modifications occasioned by a default or reasonably foreseeable potential default;

(ii) waiver of a due-on-sale clause;

(iii) the conversion of a nonrecourse loan to a recourse loan provided that, immediately following the conversion, the loan satisfies the "principally secured" test;[50] and

(iv) a modification that releases, substitutes, adds or otherwise alters a substantial amount of collateral provided that, immediately following the modification, the loan satisfies the principally secured test.[51]

There is also a category of CMBS loan modifications that might be permitted but will not be approved unless the borrower delivers a legal opinion to the effect that the specified action does not represent a significant modification of the loan under the REMIC rules and/or a rating agency confirmation stating that the modification will not cause a downgrade of any of the bond class ratings.[52] Examples of this type of loan modification include the following: lien releases, disbursement of condemnation proceeds, defeasance and loan assumptions.[53]

Prior to requesting any modification of the loan, it would be beneficial for a borrower to review the PSA so that it understands how the modification will impact the bondholders. Among other things, the PSA will enable a borrower to identify which class of bondholders will control the approval process, and, related to that, how the allocation and distribution of proceeds and losses are divided among the bondholders. Having this knowledge in advance may help a borrower determine how to approach its request for a modification. This is particularly true of any modification of a distressed loan in which a borrower will need to propose a modification that is beneficial to the class of bondholders that will need to approve the modification.

## Exiting the CMBS Loan

### *Prepayment*

CMBS investors frequently purchase bonds with the expectation that the bonds will provide predictable and uninterrupted payments over the loan term. Bond investors are willing to accept tighter yields in exchange for this protection, and the tighter yields result in more aggressive pricing to the borrowers. In order to afford the investors this protection and the borrowers the better pricing, many CMBS loans prohibit voluntary prepayment at any time. Even if a borrower agrees to an absolute restriction on prepayment, it should be sure that the restriction terminates at least 60, but preferably 120 days (a CMBS lender is unlikely to agree to more than 120 days), prior to the maturity date. Otherwise, a borrower will face the difficult task of ensuring that any refinancing or repayment of the CMBS loan occurs exactly on the maturity date if it wants to avoid the event of default, default interest and late fees that typically accompany a payment made after the maturity date.

### *Defeasance*

If a loan prohibits prepayment, then defeasance is usually the only option available to a borrower if it needs to repay the loan in advance of the maturity date (e.g., in connection with a sale of the property or refinance of the loan).

Defeasance is the process by which a securitization trust releases the real property collateral from the loan and in exchange receives a pledge of government securities (e.g., U.S. treasury bills).[54] The government securities are specially selected to generate cash flow that mirrors the amount and timing of the loan payments exactly so that there is no interruption or change in the amount and timing of the payments that any investor receives.

In connection with the defeasance, a newly-formed special purpose entity, commonly referred to as the successor borrower, will assume the borrower's obligations under the loan documents, and the original borrower and guarantors will be released from their respective obligations under the loan documents (other than the typical liabilities that survive the repayment of a loan). Effectuating the defeasance is complicated and precise work. It is also time-consuming and may take 30 days (or more). There are various consultants who specialize in defeasance, and it is advisable for a borrower to retain one to handle the process.

Defeasance can be an expensive process. In addition to buying the substitute government securities, a borrower will incur numerous other costs and fees, including the costs of forming the new special purpose entity and the fees of attorneys, accountants, the defeasance consultant and the servicers. If a borrower wants to reduce these costs, it should pay close attention to the defeasance provisions in the loan documents and take the time to negotiate them before the loan closes.

Lenders are often amenable to modifications of the defeasance provisions as long as the fundamental framework remains unchanged. There are several changes that a borrower can make to the defeasance provisions that will significantly improve its position without altering the fundamentals that are a lender's concerns. First, a borrower should make sure that any duplication of payments is eliminated from the loan documents. Second, a borrower should seek to minimize the notice that it must provide prior to defeasance (while remaining cognizant of the time it will actually take the borrower to accomplish the securitization). Third, a borrower will benefit from ensuring that the terms of the defeasance in the loan documents grant the borrower the following rights:

(i) the right to purchase substitute treasury securities that make payments through the earliest date for prepayment without a penalty (e.g., 90 days prior to the maturity date) rather than through the loan maturity date;

(ii) the right to select the substitute securities; and

(iii) the right to designate the successor to the borrower.

A borrower should be aware that the REMIC rules prohibit defeasance until after the second anniversary of the issuance of the securitization of that REMIC.[55] This means that for a minimum of two years after a loan closes, a borrower will have an absolute lockout on prepayment regardless of the circumstances.

### *Yield Maintenance*

Although CMBS lenders generally prefer to eliminate any right that a borrower has to prepay the loan, a borrower may be able to negotiate a prepayment right. Any prepayment right will come at a cost to a borrower. First, a borrower will be required to pay a yield maintenance fee to compensate the lender (or, in the CMBS context, a bond investor) for the loss in yield and the disruption of the income stream that an investor will incur if the loan is prepaid. Second, since a bond investor will want a higher yield to compensate it for the risk that its payment stream will be interrupted, in addition to a yield maintenance fee, CMBS lenders often charge a borrower a higher interest rate on the loan than they would charge if prepayment on the loan and defeasance were the borrower's only exit option.

Yield maintenance formulas in CMBS loans are similar to those in portfolio loans; however, CMBS lenders are often more amenable to changes in the yield maintenance provisions (as they are with defeasance provisions) than a balance-sheet lender. A CMBS lender, unlike a portfolio lender, does not expect to be affected by the prepayment. Nor does a CMBS lender expect any prepayment right granted to a borrower to affect the lender's ability to sell bonds because the bond investor will be compensated by the higher interest rate on the loan. Accordingly, a borrower should seek to modify the yield maintenance premiums as follows:

(i) increase the replacement rate in the yield maintenance formula, which will result in a lower yield maintenance premium;

(ii) make sure the monthly payment calculations are based on an amortizing (and not interest-only) loan so that the monthly loss in yield gradually decreases;

(iii) eliminate any floor on the interest rate; and

(iv) exclude casualty and condemnation payments, partial prepayment resulting from permitted lien releases, principal paydowns necessary to satisfy financial covenants and prepayments during an event of default from the prepayments subject to the yield maintenance premium.

Whether defeasance or yield maintenance is better for a borrower will depend upon various facts. Yield maintenance generally occurs faster than defeasance. A loan that prohibits prepayment and only releases a borrower and the collateral through defeasance generally has a lower interest rate than a loan that permits prepayment but requires payment of a yield maintenance premium.

In theory, a borrower should incur the same cost whether it elects defeasance or payment of a yield maintenance premium because both are intended to provide the lender with the same amount of money as it would have received if the loan had not been repaid. In reality, this is not always the case. There are minimal costs to yield maintenance beyond the premium itself, whereas there can be substantial costs associated with defeasance beyond the cost of acquiring the substitute securities. Additionally, any material variance between the treasury rate and the coupon rate will result in substantial cost differences between defeasance and yield maintenance. For example, if the treasury rates increase significantly relative to the increase in the coupon rate, then the price of treasuries will fall, and a borrower will be able to acquire the treasury securities necessary for defeasance at a price that is lower than the yield maintenance amount. Defeasance offers a borrower a greater potential for gain or loss than yield maintenance.

## *Loan Assumption*

Unlike portfolio loans, CMBS loans typically permit the loan to be assumed under specified circumstances. Depending upon the circumstances, a loan assumption may be much cheaper than either defeasance or prepayment with yield maintenance, but it will take significantly longer (easily 90–120 days, if not more) to accomplish.

CMBS lenders are more flexible in permitted loan assumptions than portfolio lenders because of the restrictions on prepayment and the long term of the CMBS loan. Common CMBS loan assumption requirements are the following:

(i) payment of an assumption fee;

(ii) lender's approval of the transferee;

(iii) the execution of assumption documents by the new borrower and new guarantees by a replacement guarantor; and

(iv) the trust's receipt of a rating agency confirmation.

Typically the loan assumption fee in a CMBS transaction is one percent; however, lenders frequently agree to reduce it to 0.5 percent. It is generally not in a borrower's best interest to reduce the fee too much below 0.5 percent, except on a large loan. Loan assumptions require a lot of time and effort by the special servicer. If the assumption fee is too low, the special servicer may put the loan assumption on the bottom of its "to do" pile, resulting in delays that are significant enough to enable a prospective buyer/borrower to walk away from the transaction.

In order to streamline the assumption process, a borrower should seek to include the concept of "Qualified Transferee" in the loan documents. A Qualified Transferee would be an SPE that is owned or controlled by an entity that meets specified financial conditions (e.g., net worth and liquidity), and, depending upon the nature of the real estate, specified experience (e.g., 10 years' experience managing resort hotels). If the new borrower is a Qualified Transferee, a lender may be willing to waive the assumption fee (though for the reasons noted above, payment of some fee is advisable), lender approval and/or the requirement for a rating agency confirmation.

It is likely that any new borrower will want to modify certain provisions of the loan documents (e.g., transfer provisions) to address its specific needs and sensitivities. To facilitate such changes, it is advisable for the initial borrower to ensure that the loan assumption provisions in the loan documents obligate the lender to permit reasonable modifications to the loan documents provided that such modifications do not constitute a "significant modification."

It generally takes a special servicer a substantial amount of time (at least 90 days) to process a loan assumption, no matter how simple the loan assumption may seem. Since it is very unlikely that a lender will accept a "deemed approval" for a loan assumption, a borrower should be sure that the purchase agreement to which the loan assumption relates allows sufficient (ideally unlimited) time for the lender to approve the loan assumption. The purchase agreement should also obligate the buyer to provide any information requested by the lender within a specified (and very short) time after the lender's request.

It is not inconceivable that a property could sell two or three times over a 10-year period. Accordingly, borrower should make sure that there is no limit on the number of loan assumptions permitted during the term of the loan. Most lenders are willing to agree to this.

### *Mezzanine Financing*

The last, and much less common, alternative to defeasance is mezzanine financing. If a property appreciates significantly in value following the securitization, and the borrower wants to increase its loan proceeds, it may be able to procure mezzanine financing at a lower cost than defeasance.

Although the standard CMBS loan documents prohibit mezzanine financing, many lenders will agree to permit it under certain circumstances. Common lender requirements are the following:

(i) the property satisfies specified financial tests (e.g., debt yield and loan to value);

(ii) the maturity date of the mezzanine loan is no earlier than the maturity date of the mezzanine loan;

(iii) the mezzanine lender is not affiliated with the borrower;

(iv) the mezzanine lender executes an intercreditor agreement acceptable to the lender; and

(v) the borrower delivers a rating agency confirmation. It is advisable that a borrower address its right to obtain mezzanine financing in the term sheet.

Any borrower's counsel who understands the CMBS framework, the differences between what a lender cannot do and what a lender does not want to do, and the most common problems that arise for borrowers in a CMBS context is well-positioned to advise and assist her client efficiently and effectively with a loan, from the term sheet through repayment, in whatever form that may take.

## NOTES:

[1]Many of the primary sources that dictate the structure of CMBS loans, including publications of the Commercial Real Estate Finance Council and the national rating agencies, are only available for purchase. This article includes many references to these publications (noted in this article as only available for purchase) because the author was unable to find comparable publicly-available resources.

[2]Commercial Mortgage-Backed Securities (CMBS) Finance: Overview, Practical Law Practice Note Overview (2018) (only available for purchase).

[3]CRE Finance Council, CRE Finance Council CMBS E-Primer: A Comprehensive Overview Of Commercial Mortgage Backed Securities, § 1.11 (2015), *available at* https://www.pathlms.com/crefc/courses/1226 (only available for purchase).

[4]26 U.S.C. § 860A(a); 26 U.S.C. § 860D(a).

[5]CRE Finance Council, *supra* note 3, at § 1.4.

[6]U.S. and Canadian Multiborrower CMBS Rating Criteria (Fitch Ratings) (May 18, 2018), Appendix F, https://www.fitchratings.com/site/re/10028210; CMBS: Rating Methodology And Assumptions For Global CMBS (Standard & Poor's, 2015) p. 1. https://www.standardandpoors.com/en_US/web/guest/ratings/ratings-criteria/-/articles/criteria/structured-finance/filter/cmbs (only available to registered users).

[7]CRE Finance Council, *supra* note 3, at §§ 6,3, 8.3.

[8]*Id.* at §§ 6.3, 8.4.

[9]*Id.* at § 4.5.

[10]Commercial Mortgage-Backed Securities (CMBS) Finance: Overview, Practical Law Practice Note Overview, *supra* note 2.

[11]*Id.*

[12]CRE Finance Council, *supra* note 3, at § 3.2.

[13]Final Rule Implementing Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Credit Risk Retention) (Oct. 21, 2014), https://www.sec.gov/rules/final/2014/34-73407.pdf.

[14]CRE Finance Council, *supra* note 3, at § 6.3.8.3.1.

[15]*Id.* at § 6.3.8.4.1.

[16]*Id.* at § 6.3.8.4.3.5.3.

[17]U.S. CMBS Legal and Structured Finance Criteria (Standard & Poor's, 2003) p. 32; CMBS: Rating Methodology And Assumptions For Global CMBS, *supra* note 6, at p. 4.

[18]CRE Finance Council, *supra* note 3, at § 2.7.1.

[19]*Id.* at §§ 6.3.4, 6.3.5.

[20]*Id.* at § 6.4.1.6.

[21]Commercial Mortgage-Backed Securities (CMBS) Finance: Overview, Practical Law Practice Note Overview, *supra* note 2.

[22]CRE Finance Council, *supra* note 3, at § 4.2.

[23]*Id.* at § 4.10.

[24]*Id.* at § 1.4.

[25]*Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, 295 Mich. App. 99, 812 N.W.2d 799 (2011).

[26]*Wells Fargo Bank, NA v. Cherryland Mall Ltd. Partnership*, 295 Mich. App. 99, 812 N.W.2d 799, 816 (2011).

[27]CRE Finance Council, *supra* note 3, at § 3.7.

[28]18 CCR § 104.1.

[29]Legal Criteria for U.S. Structured Finance Transactions: Special Purpose Entities (Standard & Poor's, 2006) p. 4 (only available to registered users).

[30]Samuel Lichtenfeld, *A Guide to Commercial Mortgage-Backed Securities: What You Should Know about the "New" Environment*, Freeborn & Peters Whitepaper, 6 (2014), https://www.freeborn.com/assets/white_papers/freeborn_peters_white_paper_a_guide_to_commercial_mortgage-backed_securities_0.pdf.

[31]Legal Criteria for U.S. Structured Finance Transactions: Special Purpose Entities, *supra* note 29.

[32]U.S. and Canadian Multiborrower CMBS Rating Criteria, *supra* note 6, at p. 1–3; CMBS: Rating Methodology And Assumptions For U.S. and Canadian CMBS (Standard & Poor's, 2012) at p. 7 (only available to registered users).

[33]Legal Criteria for U.S. Structured Finance Transactions: Special Purpose Entities, *supra* note 29, at p. 2.

[34]CRE Finance Council, *supra* note 3, at §§ 6.3.8.3.3.8 to 6.3.8.3.3.9; California Real Estate Finance Practice: Strategies and Forms, CEB (2018) § 1.45; Cash Management for Commercial Real Estate Loans, Practical Law Practice Note (2018); Basics of Secured Commercial Real Estate Financing, Practical Law Practice Note (2018).

[35]CRE Finance Council, *supra* note 3, at §§ 6.3.8.3.3.8 to 6.3.8.3.3.9.

[36]*Id.* at § 6.4.1.2.8.

[37]*Id.* at § 3.12.4.

[38]*Id.* at § 6.3.5; CMBS: Rating Methodology And Assumptions For U.S. and Canadian CMBS, *supra* note 32 at p. 7.

[39]CRE Finance Council, *supra* note 3, at §§ 6.3.8.3.1, 6.5.

[40]26 C.F.R. § 1.860F-4; CRE Finance Council, *supra* note 3, at § 6.3.8.1.

[41]Commercial Mortgage-Backed Securities (CMBS) Finance: Overview, Practical Law Practice Note Overview, *supra* note 2.

[42]26 C.F.R. § 1.860G-2(b); U.S. CMBS Legal Structured Finance Criteria, *supra* note 17, at p. 10.

[43]CMBS: Rating Methodology And Assumptions For U.S. and Canadian CMBS, *supra* note 32 at p. 2.

[44]CRE Finance Council, *supra* note 3, at §§ 6.3.5, 6.6.3.

[45]CMBS Large Loan Rating Criteria (Fitch Ratings) (July 27, 2018), at p. 18 (only available to registered users).

[46]26 C.F.R. § 1.860D-1.

[47]26 U.S.C. § 860F(a)(1).

[48]26 C.F.R. § 1.860G-2(b).

[49]*Id.* § 1.860G-2(b)(3), (4).

[50]The principally secured test is typically tested only once. 26 C.F.R. § 1.860G-2(a)(1). The principally secured test will be deemed satisfied if the fair market value of the real property securing the loan is at least 80 percent of the loan's adjusted issue price at origination or on the REMIC's start-up day. The adjusted issue price is generally the adjusted issue price of a debt instrument at the beginning of the first accrual period. *Id.* § 1.1275-1

[51]26 C.F.R. § 1.860G-2(b)(3).

[52]CRE Finance Council, *supra* note 3, at § 6.3.3.

[53]*Id.* at §§ 6.3.8.3.3.17, 6.3.8.4.3.2, 6.5.

[54]*Id.* at § 6.3.8.3.3.18; California Real Estate Finance Practice: Strategies and Forms, *supra* note 34 at § 1.45; Fisch and Berg, The Role of Defeasance in Real Estate Finance, *New York Law Journal*, (July 8, 2015); Weinstock, Defeasing CMBS Loan, Commercial Investment Real Estate (2014); Jacob and Jahnke, Putting the Fees in Defeasance, Michigan Real Property Review (Fall 2008).

[55]26 C.F.R. § 1.860G-2(a)(8).