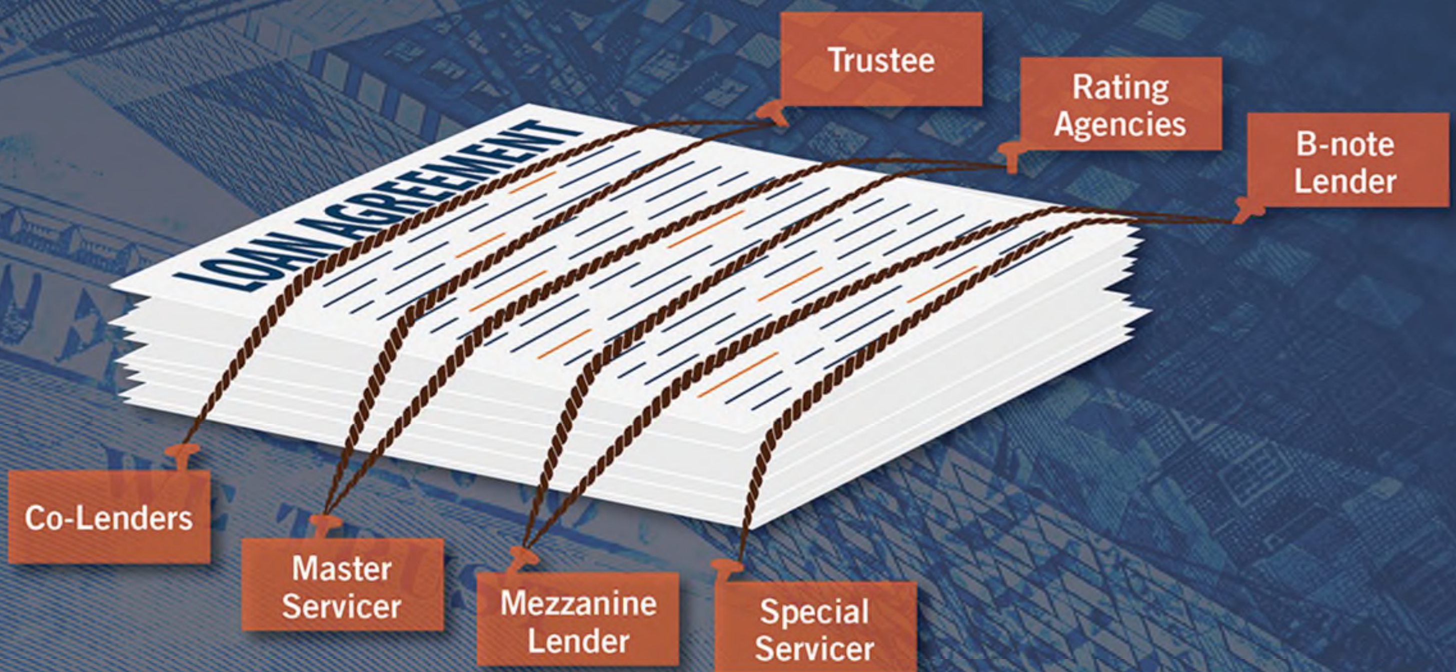
The Ties That Bind: Distressed Debt in a Structured World

Information Sheets and Thought Pieces

May 8, 2023



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Alphabet Soup – Common Acronyms and Select Terms in Structured CRE Loans and Workouts

A/B Loan or A/B Co-Lender – An "A/B Loan" refers to a loan structure with a senior note (the "A-Note") and a subordinate note (the "B note"). "A/B Co-Lender" refers to the agreement that sets forth the respective rights of the holders of the A-Note and B note.

B-Piece – Refers to the classes or tranches of CMBS that are below investment grade (i.e., BB+ and lower), including any non-rated tranche.

BK (Bankruptcy) – Commonly used shorthand for the word "bankruptcy."

CCR (Controlling Class Representative) – Party in a CMBS transaction with the right to consent to, or cause, certain actions of the special servicer. May also be referred to as a "Controlling Class Certificate Holder" or "Directing Certificateholder". In an A/B structure, the B note holder will play the role of CCR as the "Controlling Noteholder" or similar term.

CLO (Collateralized Loan Obligation) – A securitization vehicle that funds the purchase of a loan portfolio with the issuance of rated debt securities and an equity piece. May refer to both corporate CLOs or CRE CLOs.

CMBS (Commercial Mortgage Backed Securities) – A securitization structure in which a single loan (in the case of a SASB) or a pool of loans secured by mortgages on commercial real estate is tranched and sold to investors. A PSA or TSA will govern how future income and losses on the pooled assets backing the securities are to be treated.

COD (Cancellation of Debt Income) – Phantom income on which a borrower must pay taxes due to the forgiveness or cancellation of debt. Certain loan modifications may trigger COD income. Borrowers may structure workouts to avoid COD. May also be referred to "**COI**" (Cancellation of Indebtedness) income.

CRE CLO (Commercial Real Estate Collateralized Loan Obligation) – A securitization vehicle used to finance pools of commercial mortgage loans not using a REMIC structure. Bonds issued in CRE CLOs tend to be backed by "bridge" or "transitional" first mortgage loans (and sometimes "stapled" mezzanine loans) with the issuer retaining the most subordinate tranches.

DCH (Directing Certificateholder) – See "CCR".

DIL (Deed in Lieu) – A transaction in which a borrower deeds a mortgaged property to the lender or its designee in lieu of the lender conducting a foreclosure. An "assignment in lieu" would be the counterpart for a mezzanine loan.

DIP or DIP Loan (Debtor in Possession Loan) – A loan provided to a party in a bankruptcy (the "debtor in possession") to provide operational cash for such party's restructuring. DIP loans are given superpriority in the bankruptcy, may be secured by liens on unencumbered assets, second liens on already encumbered assets and in rare occasions may prime existing secured creditors.

EOD (Event of Default) – A default beyond notice and cure periods under a credit agreement, which permits the underlying obligation to be accelerated and/or remedies enforced by the lender.

Hope Note – A B note (or other subordinate note) that is structured as part of a workout of a loan. The hope note is contractually subordinated to a specified amount of borrower equity—typically a limited amount of "new money" introduced by the borrower as part of a turnaround plan, together with a specified rate of return on such equity.

Alphabet Soup – Common Acronyms and Select Terms in Structured CRE Loans and Workouts (ct.)

ICA (Intercreditor Agreement) – An agreement setting forth various rights and obligations between the mortgage lender(s) and mezzanine lender(s) with respect to a specific transaction. Not to be confused with a "co-lender" agreement, which sets forth the rights and obligations of the mortgage lenders amongst themselves or the mezzanine lenders amongst themselves.

OPB (Outstanding Principal Balance) – The outstanding principal balance of a loan.

P&I Advance (Principal and Interest Advance) – An advance, by the applicable servicer, of delinquent principal and interest payments to bondholders of a securitized loan product.

PA (Protective Advance) – Advances made by a lender to protect the value of its collateral. These advances tend to be unpaid taxes, insurance, condominium assessments, ground lease payments or similar payments.

PIK (Payment in Kind) – Generally refers to a structure in which interest on a loan is not "paid current" but instead is added to the OPB of the loan on each "payment" date. The "PIKed" interest then accrues interest and interest is therefor compounded on each "payment" date. A "**PIK Toggle**" feature may be used to allow the borrower elect to either PIK its interest payments or pay interest in cash (or some combination of the two) and thus "toggle" between PIK and paid-current interest payments.

PNA (Pre-Negotiation Agreement) – An agreement entered into between the borrower and lender in a transaction in anticipation of workout negotiations. This agreement will govern the relationship between the borrower and lender in the course of workout negotiations.

PSA (Pooling and Servicing Agreement) – An agreement that sets forth the rights of various parties to a CMBS transaction, including application of future income and losses on the pooled assets backing the securities, and whether a servicer is required to make advances to the bondholders. The PSA will also (i) govern which parties are in control of workout negotiations or need to consent to (or be consulted in connection with) modifications to loan documents, (ii) set forth limitations on modifications to loans and (iii) dictate procedures for foreclosures on underlying assets and exercising remedies under the loan documents. "PSA" tends to refer to such agreement in connection with a "pooled" or "conduit" loan transaction, while "**TSA**" tends to refer to such agreement in connection with a SASB.

QT (Qualified Transferee) – When used in connection with loan transfer restrictions, an entity to which a loan may be transferred (especially a mezzanine loan or other subordinate loan). May also be referred to as a "Qualified Lender", "Qualified Institutional Lender" or other similar term.

RAC (Rating Agency Confirmation) - A requirement to obtain a letter from rating agencies that a specific action will not result in a downgrade or withdrawal of a rating it has given. RACs are often required for modifications to mortgage loans in CMBS or CRE CLO transactions.

REMIC (Real Estate Mortgage Investment Conduit) – A pass-through structure through which mortgage loans are often securitized. REMICs must satisfy a number of complex rules to benefit from the pass-through treatment which may impact mortgage loan structuring, loan workouts and enforcement of remedies by lenders.

REO (Real Estate Owned) – Real estate that has been acquired by a lender through foreclosure or a DIL. Some banks will refer to this as "***OREO***" (Other Real Estate Owned) to differentiate between REO properties acquired due to foreclosure or DIL and typical corporate real estate assets.

Alphabet Soup – Common Acronyms and Select Terms in Structured CRE Loans and Workouts (ct.)

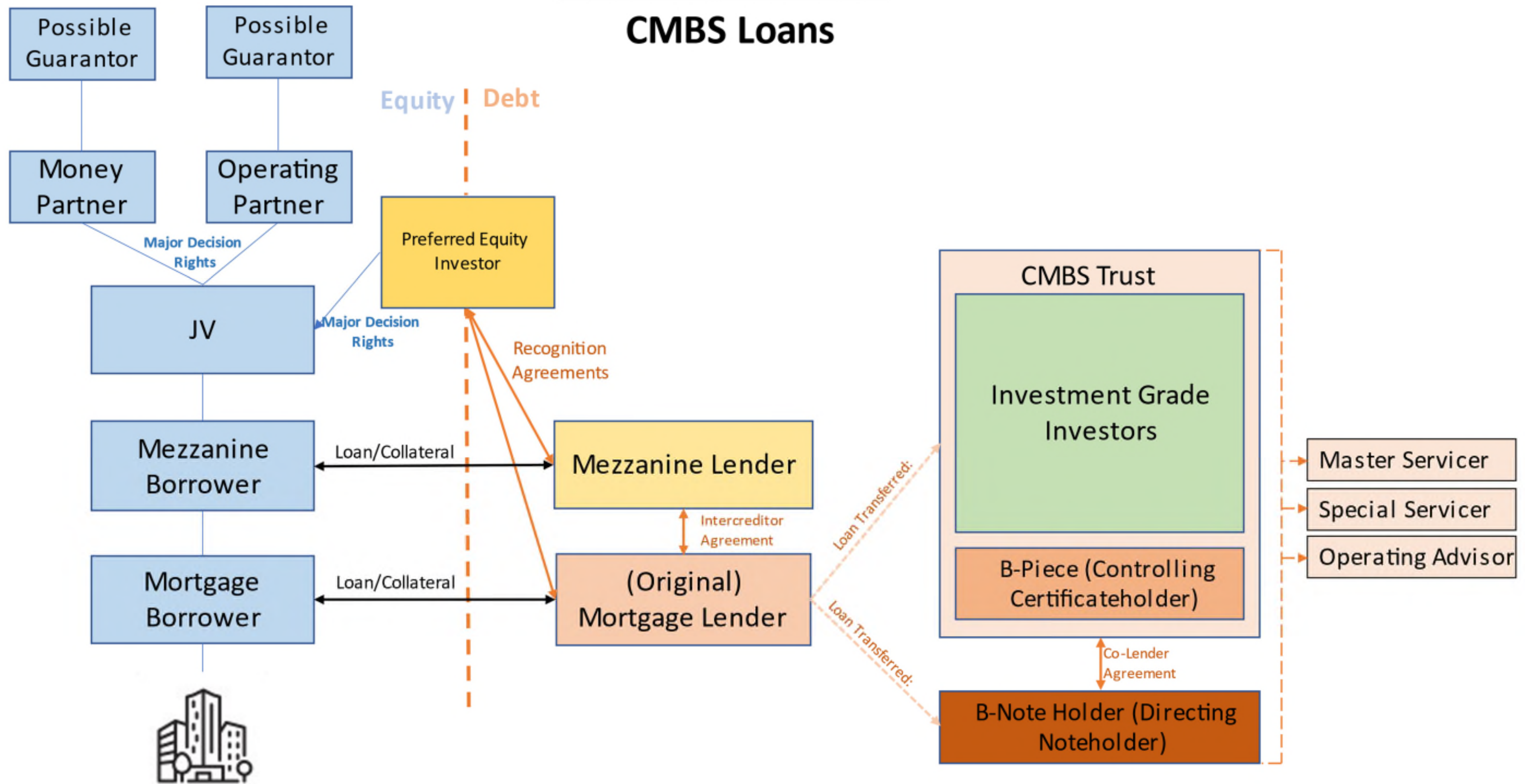
ROR (Reservation of Rights Letter) – A letter sent by a lender in connection with a default by a borrower under a loan. Such letter reserves the rights of the lender to call a default, accelerate the loan or begin foreclosures or other remedies.

SASB (Single Asset, Single Borrower) – A CMBS transaction where a single loan has been securitized (as opposed to a "pooled" or "conduit" CMBS transaction). SASBs may include multiple properties, multiple mortgages and multiple mortgage borrowers, so long as such SASB securitizes a single cross-defaulted and cross-collateralized loan.

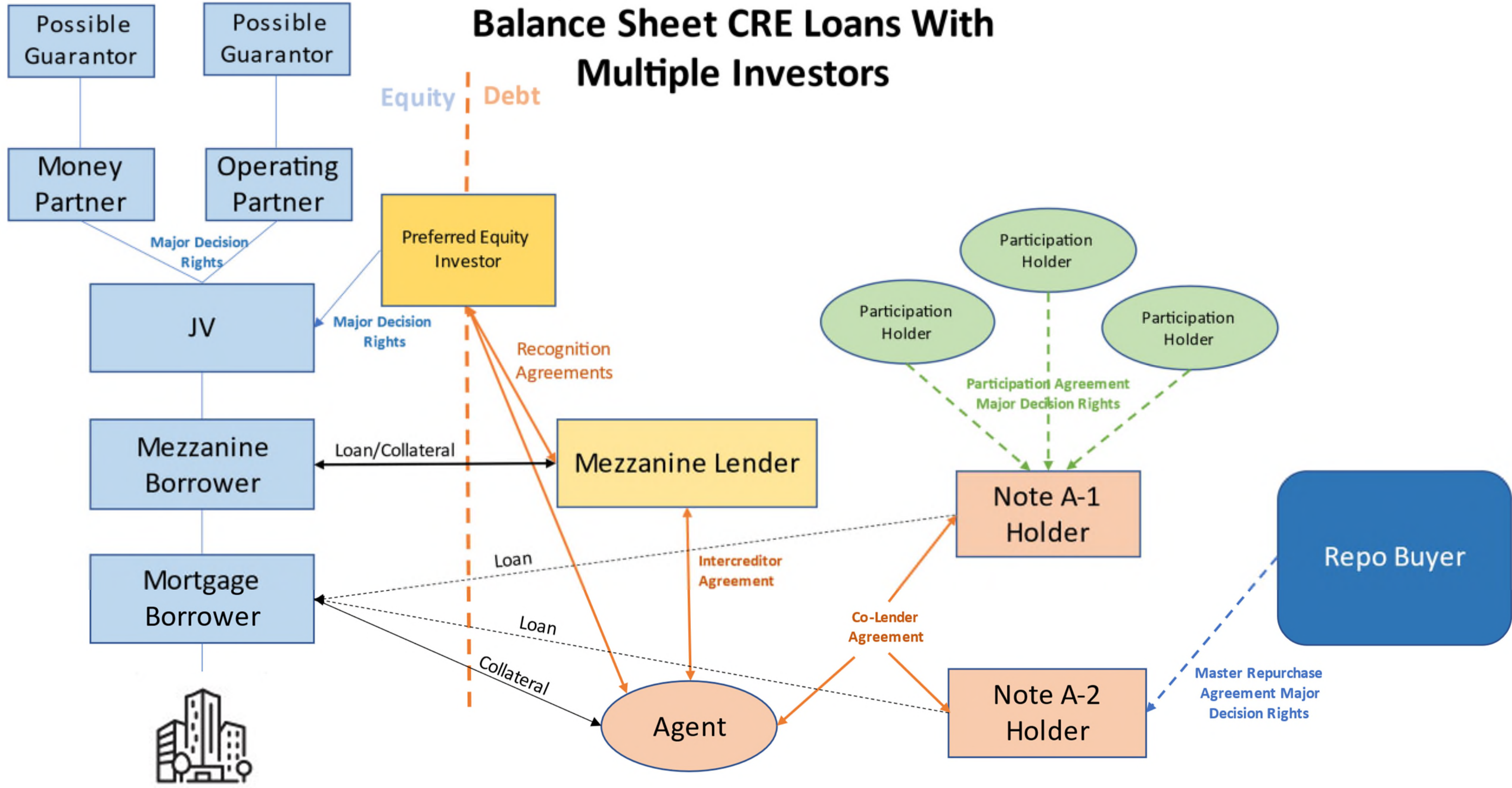
TSA (Trust and Servicing Agreement) – See "PSA".

UCC (Uniform Commercial Code) – The UCC governs the rights of a lender in certain non-real estate collateral, including security interests in the equity of property owners that secure mezzanine loans. The UCC also governs mezzanine foreclosures, which are sometimes referred to as "UCC foreclosures" or "UCC-9 foreclosures".

Parties at the Table – CMBS Loans



Parties at the Table – CMBS Loans (ct.)



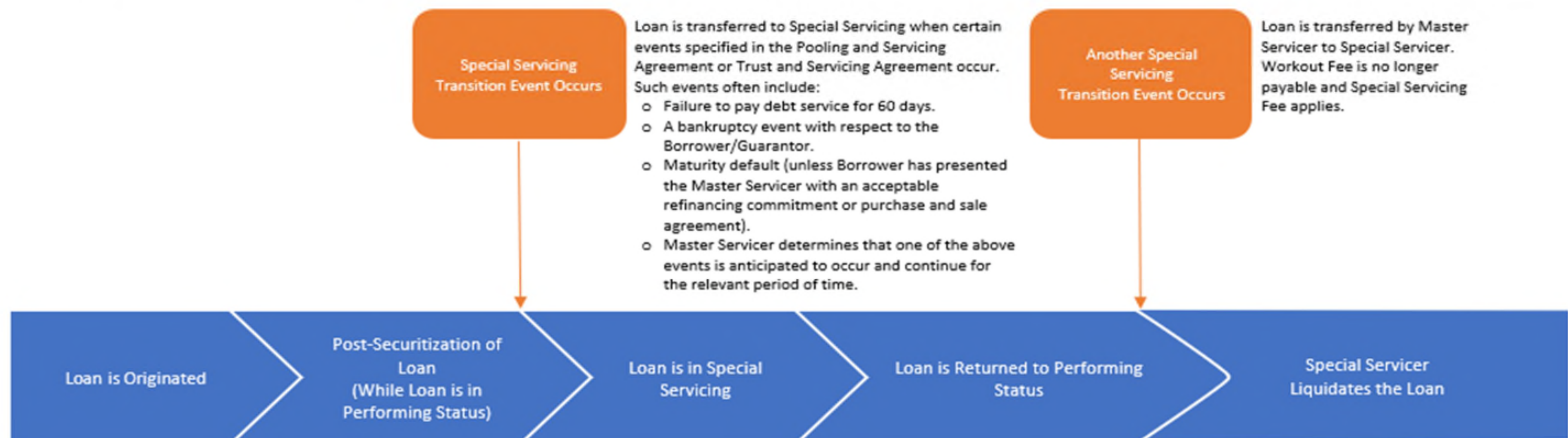
	WHEN TO USE?	WHAT DOES IT DO?	ITEMS TO KEEP IN MIND
PRE-NEGOTIATION AGREEMENT	A default is anticipated to occur (or has occurred) and borrower wants to discuss modifying (or otherwise deviating from) the existing loan terms.	Written agreement among borrower, lender and guarantor addressing the terms of workout negotiations. Makes clear that no discussions will become binding agreements until evidenced by an executed agreement among all parties. Borrower agrees to pay lender's costs and expenses, provide information requested by lender, and may acknowledge the existence of a default or Event of Default. Borrower may agree to release lender from claims relating to the loan. Preserves lender's enforcement rights and remedies under the loan even though discussions are taking place.	If there are multiple levels of debt (i.e., mortgage loan and one or more subordinate loans), the lenders may enter into a pre-negotiation agreement among themselves. Ideally should be executed before discussions start. If not, then pre-negotiation agreement should specifically cover any prior discussions.
EVENT OF DEFAULT NOTICE	An Event of Default has occurred under the loan agreement.	Expressly terminates rights of borrower under the loan agreement which are conditioned upon the absence of an Event of Default. May allow lender to apply amounts held in reserves as it sees fit (i.e., for debt service, operating expenses, capex for the property). Triggers interest accruing at the Default Rate. Triggers various lender rights and remedies (i.e., the ability to spring hard cash management, budget approval rights, etc.)	Will there be an impact to the lender's balance sheet due to a loan being formally in default? Will the Event of Default Notice trigger any provisions under any repo financing (i.e., margin calls, de-levering payments)? There may be specific consequences of declaring an Event of Default in certain states or for certain assets (i.e., purchase agreements for condominium units in NY may be subject to recission in certain default situations).

PNAs vs. EOD Notices vs. ROR Letters vs. Acceleration Notices in Commercial Real Estate Finance (ct.)

	WHEN TO USE?	WHAT DOES IT DO?	ITEMS TO KEEP IN MIND
RESERVATION OF RIGHTS LETTER	If there is a breach of loan document terms, but the lender is not yet ready to declare a formal Event of Default. **Example**: Borrower misses a reporting deadline, lender doesn't want to declare an Event of Default, but also doesn't want to lose the right to do so in the future. If lender is granting a waiver of specific conditions under the loan documents, but not amending the loan document or waiving defaults. **Example**: Making advances or releasing reserve funds when a disbursement condition has not been satisfied (e.g., construction milestone failure or payment default).	Allows flexibility for lender without waiving rights. Prevents borrower from claiming lender waived defaults or modified loan requirements when accommodating borrower requests.	Repeat use of RoR Letters may evidence a pattern that can be used against a lender in litigation. RoR Letters do not let the lender affirmatively take remedies.
ACCELERATION NOTICE	An Event of Default has occurred under the loan agreement and lender desires to declare the loan immediately due and payable in full (i.e., the maturity date is being "accelerated").	Accelerating the loan is a pre-requisite to the lender exercising material remedies, such as foreclosure.	A lender has the ability to decelerate or reinstate the loan if circumstances change or as lender may elect.

Distressed Fees Throughout the Life of a CMBS Mortgage Loan

There are five primary servicing-related fees that may apply during the life of a CMBS loan: (1) pre-securitization interim servicing fee, (2) post-securitization servicing fee, (3) special servicing fee, (4) workout fee, and (5) liquidation fee. The below example assumes that a loan becomes defaulted, goes back into good standing, and then a second default occurs which results in liquidation.



- If there is a period between origination and securitization, the Loan is serviced by the originating lender and/or an interim servicer hired by the Lender.
- Lender may or may not have the right to pass through to Borrower the periodic servicing fee charged by its interim servicer on a deal-by-deal basis.
- Borrower is often charged processing fees in connection with Borrower requests for approvals/ waivers/ amendments pursuant to the Loan documents.

- Loan is serviced by Master Servicer while in performing status.
- Master Servicer is paid a servicing fee out of the collections received by the securitization trust.
- Borrower may or may not be responsible for payment of servicing fee before the Loan is transferred to Special Servicing on a deal-by-deal basis.
- Borrower is often charged processing fees in connection with Borrower requests for approvals/ waivers/ amendments pursuant to the Loan documents.

- Special Servicing Fee is due monthly in amount equal to 1/12th of a set percentage of the outstanding principal balance of the Loan which varies on a deal-by-deal basis.
- Often, the Special Servicing Fee is passed through to be paid by Borrower pursuant to the Loan documents.
- If Borrower does not pay, the Special Servicing Fees are taken out of collections received by the securitization trust.

- If the Special Servicer successfully negotiates a modification of the Loan with Borrower/Sponsor or the default is otherwise cured and Borrower has made 3 consecutive monthly payments as and when due, the modified Loan is transferred back to be serviced by Master Servicer.
- A monthly Workout Fee is due to Special Servicer in an amount equal to a set percentage of each principal and interest (including the balloon payment at maturity) payment due from Borrower until the Loan is repaid in full or another default under the Loan occurs which varies on a deal-by-deal basis.
- Workout Fee is often passed through to be paid by monthly by Borrower at the time that the debt service is paid pursuant to the Loan Agreement. If Borrower does not pay, the Workout Fee will be paid out of the collections received by the securitization trust.

- If the Special Servicer determines that a modification of the Loan to put the Loan back into good standing is not in the best interests of the certificateholders, then it may pursue liquidation of the Loan.
- Special Servicer may either sell the defaulted Loan or foreclose on the property and subsequently sell the foreclosed property.
- Upon sale of the Loan, sale of foreclosed property or other final liquidation of the Loan, the Special Servicer is paid a one-time Liquidation Fee in an amount equal to a set percentage of the total liquidation proceeds from the liquidation which varies on a deal-by-deal basis.
- Liquidation Fee is paid out of the proceeds from the liquidation of the Loan.

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences

Preferred equity is when an investor makes a capital contribution directly or indirectly to a mortgage borrower in exchange for a direct or indirect equity share in such mortgage borrower. It is a priority equity position, with a higher rate of return than that of the common equity.

Preferred equity is subordinate to all debt, but does possess various rights with respect to common equity. The most material of these rights are: to receive a preferred distribution on the preferred equity investment, to approve certain major decisions, and (in some cases) to take control of the entity in which preferred equity investor is investing. Although preferred equity investors have priority claim on equity distributions equal to a designated percentage of their investment, there is no guarantee that such distributions will be made in the event that the underlying project fails. Preferred equity investors may receive a higher return than a mortgage or mezzanine lender (whose return is capped by the applicable interest rate). Preferred equity investors do not benefit from the capital appreciation of an investment (unless they are in the common equity, which is unlikely).

A **mezzanine loan** is a loan to the equity holder of a mortgage borrower secured by a pledge of equity interests in such mortgage borrower. The mezzanine lender has the ability to foreclose on the equity collateral in the event of default under the mezzanine loan, and in doing so assumes ownership and control of the mortgage borrower and the mortgaged property. Upon such foreclosure, the pledging equity holder is "cut off" and its rights with regard to the underlying property are severed.

Since the rating agencies and certain mortgage lenders disfavor subordinate debt, borrowers and lending investors seek to disguise "gap" funding behind mortgage debt as anything other than subordinate debt, hence the utilization of preferred equity. But, making a determinative legal analysis that such "gap" funding/preferred equity is debt or equity in any one circumstance is difficult. The legal distinctions between preferred equity and mezzanine debt are blurred; each shares degrees of similarity (e.g. structurally subordinate to mortgage loan; investment is evidenced by/collateral is equity interests). However, there are distinct differences between the two. Factors which are more debt-like are: (a) a stated principal amount, (b) a fixed or determinable rate of interest, (c) a fixed or determinable maturity date, (d) absolute payment of the principal, (e) no participation in management and (f) seniority to general creditors. None of such factors is determinative and the courts will apply a balancing test, favoring substance over form in characterizing (or recharacterizing) an investment for bankruptcy and other purposes.

A mortgage loan can be structured with senior/subordinate tranches of debt, evidenced by notes, that are secured by the same collateral, the underlying property. The **B note** is subordinate to the A note. While the mortgage loan is performing, this subordination has minimal impact, as both noteholders will be paid current. However, in the event of a default, the A note will receive its interest and full principal prior to any payment under the B note. Should the mortgage be foreclosed, the holders of the A note and the B note would take title to the property as co-owners, with similar senior/subordinate rights.

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences (ct.)

The following table below compares some key differences of preferred equity, mezzanine debt and a B note in commercial real estate finance.

	Preferred Equity Investment	Mezzanine Debt	B Note in an A/B Mortgage
Documents	Operating agreement; possibly ancillary documents like guaranty/environmental indemnity	Customary loan documents; intercreditor agreement	Customary mortgage loan documents; co-lender agreement between A noteholder and B noteholder
Inter-lender documentation	For "hard" (debt-like) pref equity, possibly a recognition agreement with mortgage lender or recognition provisions in a mortgage loan agreement For "soft" (equity-like) pref equity, likely no separate recognition agreement, but possibly notice rights in mortgage loan agreement	Intercreditor agreement	Co-lender agreement
Security	Typically, unsecured	Secured by pledge of 100% of mezzanine borrower's equity interest in the owner of the property	Secured by mortgage on the real property and related improvements, same as the A note
Priority	Payable after mortgage debt and mezzanine debt	Payable after mortgage debt but before preferred and common equity	B note is subordinate to the A note; both A note and B note are senior to any subordinate debt and/or preferred equity Payment waterfall shifts after a continuing event of default such that B note will not receive payments until A note is paid in full
Interest	Paid preferred return from available cash flow for "soft" pref equity or periodic distribution date for "hard" pref equity	Paid interest on monthly basis at interest rate in mezzanine loan agreement	B note interest rate likely higher than A note interest rate to compensate for subordinate/higher risk position
Maturity	May be open ended for "soft" pref equity or have a mandatory redemption date for "hard" pref equity	Maturity date set forth in mezzanine loan agreement	Maturity date set forth in mortgage loan agreement

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences (ct.)

	Preferred Equity Investment	Mezzanine Debt	B Note in an A/B Mortgage
Consent Rights (over borrower actions)	For "hard" pref equity, consent rights over management and control of property can be substantial (comparable to those of a mortgage or mezzanine lender, if not more involved in material day to day matters) For "soft" pref equity, decisions usually limited to a handful of fundamental matters (e.g. bankruptcy, material loan modifications, sale of all assets)	Mezzanine lender will have its own consent rights detailed in the mezzanine loan agreement generally consistent with those of the mortgage lender	Depending on size and whether the B note is in the controlling position, consent (and consultation) rights can range from many (substantial) to few (fundamental) B noteholder typically loses consent rights if it is "appraised out" (i.e. if, based on a current appraisal of the mortgaged property after certain adverse events, servicer determines that the total of the outstanding amounts under the mortgage loan and all servicing fees and protective advances exceeds 90% of the appraised value of the property and the "excess" or projected losses on the B note exceed a certain level, typically 75%, of the principal amount of the B note) B noteholder can avoid being appraised out by posting additional collateral

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences (ct.)

	Preferred Equity Investment	Mezzanine Debt	B Note in an A/B Mortgage
Loan modification rights	Pref equity investor should have consent rights to any modifications of the joint venture/pref equity documentation, and may have consent rights for any material loan modifications	Mezzanine lender will have consent rights over material mortgage loan modifications as set forth in both the mezzanine loan documents (relative to the borrower) and the intercreditor agreement (relative to the mortgage lender) Intercreditor agreements typically provide that if the mortgage loan is in default or bankruptcy and mezzanine lender has not cured, then consent rights of a mezzanine lender to mortgage loan modifications will be limited to a handful of fundamental decisions (e.g. converting mortgage loan indebtedness to equity)	B noteholder will typically have consent rights over material mortgage loan modifications, provided it has not been appraised out

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences (ct.)

	Preferred Equity Investment	Mezzanine Debt	B Note in an A/B Mortgage
Cure rights	For “hard” pref equity, separate notice and cure rights may be negotiated in separate recognition agreement, but typically, pref equity investor does not have any additional cure rights beyond those available to the borrower For “soft” pref equity, usually no separate cure rights	Due to risk of being foreclosed out by the mortgage lender, mezzanine lender negotiates for cure rights Monetary cures – cure period is typically 10 business days after the later of (A) the receipt of the mortgage loan default notice and (B) the expiration of borrower’s cure period provided in the mortgage loan documents; capped at 4-6 consecutive months or a certain number of months in a 12 month period unless the mezzanine lender is continuing to diligently pursue its rights against the equity collateral Non-monetary cures – cure period is typically 30 days after the later of (A) the receipt of the mortgage loan default notice and (B) the expiration of borrower’s cure period provided in the mortgage loan documents; typically no cap on the number of non-monetary cures and the cure time period may be extended as long as mezzanine lender is pursuing foreclosure, keeping the mortgage loan current and there is no material impairment to the property	The exercise of cure rights enables the B noteholder to stop the shift in payment waterfall from pro-rata to senior/sequential Monetary cures – cure period is typically 10 business days after the expiration of borrower’s cure period provided in the mortgage loan documents; capped at 4-6 consecutive months or no more than 4-6 months within a negotiated time period Non-monetary cures – cure period is 30 days after the expiration of borrower’s cure period provided in the mortgage loan documents; typically no cap on the number of non-monetary cures and the cure time period may be extended as long as pursuing cure and no material impairment to A note
Special servicer appointment	N/A	N/A – mezzanine loan will have its own servicing arrangements	B noteholder usually has the right to appoint and/or replace the special servicer for the mortgage loan, provided B noteholder is not appraised out

Preferred Equity, Mezzanine Debt and B Notes in CRE – Primary Differences (ct.)

	Preferred Equity Investment	Mezzanine Debt	B Note in an A/B Mortgage
Mortgage Loan purchase option	For "hard" pref equity, occasionally standalone right of the pref equity investor to "buy" (or pay off) the mortgage loan	Mezzanine lender typically has the right to purchase the mortgage loan upon certain triggers (e.g. event of default, bankruptcy or transfer to special servicing)	B noteholder typically has the right to purchase the A note to avoid being appraised out
Enforcement rights	Set forth in joint venture/preferred equity documentation, subject to compliance with any recognition agreement requirements For "hard" pref equity, enforcement rights may range from an increase in preferred return to the ability to control the day to day management to "acceleration" of a mandatory redemption date For "soft" pref equity, usually limited to loss of voting rights, subordination of payment or equity dilution of operating member Pref equity investor is at risk of being foreclosed out by any debt directly or indirectly secured by the property (mortgage or mezzanine)	Separate enforcement rights under the mezzanine loan agreement and applicable UCC, subject to compliance with any intercreditor agreement requirements	Separate enforcement rights under the mortgage loan (e.g. foreclosure on the real property); B noteholder usually has enforcement decision-making rights as long as it is not appraised out; even if appraised out, B noteholder cannot be foreclosed out and maintains an interest in the investment post-foreclosure
Primary enforcement remedy	Remedies set forth in operating agreement; no statutory framework for remedies; no foreclosure rights	UCC foreclosure, subject to terms of any intercreditor agreement with mortgage lender	Mortgage foreclosure; A note and B note foreclose and take title to the property together as co-owners

CMBS Under Stress – Frequently Asked Questions about Key Provisions in CMBS Pooling and Servicing Agreements Addressing Mortgage Loan Modifications

Authored by: Timothy Stafford and Edward J. Stack IV

The current rising interest rate environment and deterioration in the value of certain types of commercial real estate properties threaten to significantly increase the number of distressed commercial real estate loans. In this environment it is critical for investors in commercial mortgage-backed securities (CMBS) to have a clear understanding of how the pooling and servicing agreements (PSA) for CMBS affect a Servicer's approach to dealing with troubled commercial real estate loans.[1] This article addresses ten frequently asked questions about key provisions in PSAs that govern modifications of commercial mortgage loans by Servicers with a focus on distressed commercial mortgage loans.[2]

1. Which Servicer Is Responsible for Servicing a Distressed Commercial Mortgage Loan?

When a loan is transferred to a trust in connection with a securitization, the Master Servicer under a PSA initially assumes the responsibility to service the loan. If an event of default with respect to the loan occurs that materially adversely affects the interests of the certificateholders (or such an event of default is imminent) or certain other adverse events affecting the loan occur, a "special servicing transfer event" will exist with respect to the loan and the servicing of the loan will be transferred to the Special Servicer. Thus, the Special Servicer usually is the party that has primary responsibility for determining how to address distressed loans.

2. What Are the Typical Events that Cause a Loan to Be Transferred to Special Servicing?

Typical special servicing transfer events under a PSA include the following:

1. Monthly Payment Default: The borrower fails to make a monthly payment when due and such failure continues for 60 days.
2. Maturity Default: The borrower fails to pay the loan in full on its maturity date (or in some cases within 30 or 90 days following the related maturity date), unless the borrower submitted an acceptable refinancing commitment or purchase and sale agreement to the applicable Servicer, in which event the special servicing transfer event date may be extended for an additional period to allow the refinancing or sale to occur.
3. Imminent Default: A Servicer determines that a payment or other material default on the loan is imminent and is likely to remain unremedied beyond a period specified in the PSA.
4. Other Material Defaults: A non-monetary default occurs that materially adversely affects the certificateholders and such default is not remedied within the applicable cure period set forth in the loan documents.
5. Bankruptcy and Related Events: A borrower bankruptcy occurs, the borrower consents to the appointment of a receiver, or the borrower admits in writing its inability to pay its debts when they become due.

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[1] For purposes of this article: (i) commercial mortgaged-backed securities, whether issued in connection with a multi-asset pool or a single-asset single borrower transaction are referred to as CMBS, (ii) a CMBS pooling and servicing agreement and/or trust and servicing agreement is referred to as a PSA, (iii) the servicer or master servicer appointed under a PSA is referred to as the Master Servicer, (iv) the special servicer under a PSA is referred to as the Special Servicer, and (v) references to the Servicer mean the Master Servicer or the Special Servicer, as applicable.

[2] This article is of a general nature and is being provided for informational purposes only. Not all PSAs are alike. CMBS investors (and their counsel) should carefully review the applicable PSA and other relevant documents to determine their rights in any specific case.

6. Foreclosure: The Servicer receives notice of a foreclosure of another lien affecting the mortgaged property.
7. Some "single-asset single-borrower" deals (known as SASBs) include as a servicing transfer event the Servicer making three consecutive debt service advances.

Some PSAs will contain additional or slightly different special servicing transfer events or will allow for the passage of a longer period before a default-related event becomes a special servicing transfer event. A loan that has been subject to a special servicing transfer event is commonly referred to as a "specially serviced loan."

3. What Is the Servicing Standard?

The Servicer is required to service the loans in accordance with the PSA, the applicable loan documents, applicable law, and a standard of conduct known as the "Servicing Standard."

Typically, the Servicing Standard has the following components:

1. Standard of Care: The Servicer must act in accordance with the higher of the standard of care it applies to loans held for its own account and the standard it applies to servicing loans held by third parties (giving due consideration to customary practices of prudent institutional commercial mortgage lenders).
2. Collective Whole: The Servicer must take into account the interests of the certificateholders (and any other holders of interests in the loan, such as a B note holder or a pari passu A-Note holder), as a collective whole, taking into account the subordinate or pari passu nature of such other interests in the loan.
3. Timely Recovery on a Net Present Value Basis: The Servicer must service the loan with a view to the timely collection of all principal and interest payments or, with respect to a loan in default, the maximization of recoveries on such loan on a net present value basis.
4. Conflicts: The Servicer must service the loan without regard to conflicts of interest, such as other business relationships with a borrower, ownership of certificates in the securitization, or any subordinate or pari passu debt relating to a loan in the securitization, any obligation to make advances on any of the loans, the right of the Servicer to be paid, or the ownership or servicing of loans or properties outside of the securitization pool.

4. How Is Net Present Value Calculated in the Context of the Servicing Standard?

PSAs in more recent deals specify that the relevant discount rate for determining maximization of recoveries on a net present value basis for a loan in default is the highest of (x) the interest rate determined by the applicable Servicer that approximates the market rate that would be obtainable by the related borrower on similar non-defaulted debt as of such date of determination, (y) the interest rate that would be applicable to the loan in question in the absence of a default and (z) the yield on 10-year U.S. treasuries as of the date of such determination. PSAs in older deals may not specify the methodology to use for calculating net present value, but we expect the modern approach to be used on most of those deals.

5. Is a Servicer Permitted to Modify a Commercial Mortgage Loan That Is Not in Default?

Most commercial mortgage loan securitizations are structured as Real Estate Mortgage Investment Conduits (REMICs) or as grantor trusts, and PSAs therefore require Servicers to service mortgage loans in a manner consistent with the REMIC and/or

grantor trust tax rules. REMIC and grantor trust tax rules severely limit the Servicer's ability to modify a loan if the loan is not in default or a default is not reasonably foreseeable. Generally, in such circumstances, the REMIC and grantor trust rules do not permit significant modifications. If the loan is not in default but a default is reasonably foreseeable, the REMIC and grantor trust tax regulations permit the Servicer broad discretion to modify the loan.

6. How Much Discretion Is the Servicer Given to Modify a Commercial Mortgage Loan That Is in Default?

In general, both the REMIC and grantor trust tax rules and the PSA allow the Servicer broad latitude to modify a mortgage loan that is in default, including extending the maturity date, changing the interest rate, reducing the principal amount of the loan and accepting a discounted pay-off. The primary constraint usually will be the Servicing Standard, which requires the Servicer to seek to maximize recovery to the certificateholders (and any related holder of a subordinate or *pari passu* note) as a collective whole on a net present value basis. However, as discussed in more detail below, the Servicer typically will need to obtain the approval of a "control party," and the PSA imposes some other limits on the Servicer's ability to extend a loan.

7. Does the PSA Contain Limitations on the Servicer's Right to Extend a Defaulted Commercial Mortgage Loan?

The limitations on the Servicer's right to extend a defaulted loan typically revolve around the "rated final distribution date" for the securitization and the Servicing Standard.

In most CMBS deals, rating agencies are rating not only the likelihood of timely receipt of interest, but also ultimate receipt of principal by a specified date. This date generally is known as the "rated final distribution date." In order to rate receipt of principal by the rated final distribution date, the rating agencies typically need the PSA to prohibit the Servicer from extending any loan past a specified date preceding the rated final payment date to allow a sufficient period for foreclosure of mortgages securing any remaining unpaid loans and liquidation of any resulting REO properties. For most fixed rate conduit securitizations, the rated final payment date is 32 years or later after the securitization closing date, and Servicers are permitted to extend a loan up to the date that is five years prior to the rated final payment date. Because most loans in CMBS trusts have terms of 10 years or less, this limitation on extensions is not likely to come into play for most loans in most fixed rate conduit deals.

Rating agencies usually have used a different methodology for determining the rated final payment date for SASB securitizations from the methodology used for fixed rate conduit deals. As a result, the limitations on extensions for these deals typically are much more constraining. Often a Servicer may not be able to extend a loan (in the aggregate) for more than two or three years past the contractual maturity date of the loan (after giving effect to any borrower extension options).

The Servicing Standard also will impact the Servicer's ability to extend. Although a strict mathematical approach to interpreting the Servicer's obligation to maximize recovery on a net present value basis might suggest that extending a defaulted loan for the longest period permissible is what the PSA requires, other elements of the Servicing Standard might lead to the Servicer extending a mortgage loan in increments of one year or less. As noted above, the Servicing Standard requires the Servicer to act in a manner consistent with the higher of the standard of care it applies to loans held for its own account and the standard it applies to servicing loans held by third parties, giving due consideration to customary practices of prudent institutional commercial mortgage lenders. In in the current environment, where many commercial mortgage loans are having difficulties getting refinanced even if they have solid financial metrics, we might see balance sheet lenders and Special Servicers more open than in past periods of distress to grant longer extension packages to matured commercial mortgage loans that have good financial metrics.

8. Which Parties Typically Have Approval Rights over a Servicer's Actions with Respect to a Defaulted Commercial Mortgage Loan?

Most PSAs give a "control party" the right to consult with the Special Servicer and consent to significant modifications to a defaulted loan. The control party also typically has the right to replace the Special Servicer without cause. Thus, a control party has significant influence over the direction of a loan workout. For most loans, the control party will be the holders of a majority of the principal amount of the most subordinate class of control-eligible certificates (typically the classes rated below investment grade at issuance) that has not experienced realized losses in excess of 75 percent of the initial principal balance of that class (the "controlling class certificateholder"). For large loans with B notes, the initial control party is typically the holder of the B note, but if "appraisal reduction amounts" for the related whole loan exceed 75 percent of the principal balance of the B note, control usually shifts to the controlling class certificateholder.[3] Appraisal reduction amounts are also used for the purpose of shifting control among classes of control-eligible certificates within a securitization.

Although the control party may have the right to approve a Servicer's proposed actions with respect to a defaulted loan, the approval right is not absolute. The PSA generally will require the Servicer to disregard any direction from a control party, even with respect to an action otherwise requiring the control party's consent, if acting on such direction would violate the Servicing Standard. This often is referred to as the "servicing standard override."

Most PSAs give several "consultation parties" the right to non-binding consultation with the Special Servicer with respect to significant modifications to a defaulted loan. Typically, control eligible classes that have lost control because of the appraisal reduction process will have consultation rights. In securitizations where the related securitization sponsors satisfied all or a portion of their risk retention obligation through the holding by the sponsor and/or one or more originators of the mortgage loans, such retaining sponsors and retaining originators are usually entitled to appoint a consultation party. In addition, the operating advisor appointed pursuant to the related PSA is entitled to consult with the Special Servicer with respect to significant modifications to a defaulted loan.

9. If I Hold an Investment Grade Certificate, Which Gives Me No Rights to Approve a Special Servicer's Actions with Respect to a Defaulted Commercial Mortgage Loan, What Checks Are There on the Special Servicer's Conduct?

As noted above, typically only the controlling class certificateholder or a holder of a B note is permitted to consult with the Special Servicer or approve major actions with respect to a defaulted loan. Often the controlling class certificateholder (and sometimes the holder of a B note) is the Special Servicer itself or an affiliate. Even if the control party is not the Special Servicer or an affiliate, it may have the right to replace the Special Servicer, which gives the control party significant influence over the Special Servicer.

A significant check on the Servicer's conduct is the Servicing Standard. The Servicing Standard requires the Special Servicer to consider the interests of all the certificateholders as a collective whole and without regard to conflicts of interest inherent in the CMBS structure. If a Servicer violates the Servicing Standard, it has potential liability for breaching its contractual duty under the PSA.

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[3] For a more detailed discussion of appraisal reduction amounts, see our article entitled "B notes in CMBS A/B Loans Under Pressure: Frequently Asked Questions Regarding Control Appraisal Events and Loss of Control."

Another check on the Special Servicer's conduct that exists for conduit securitizations and most SASB securitizations is the ongoing review of the conduct of the Special Servicer by the operating advisor. The operating advisor is obligated to review certain servicing actions taken by the Special Servicer and file an annual report detailing the operating advisor's view on the Special Servicer's compliance with its obligations under the PSA, including its obligation to act in accordance with the Servicing Standard. If the operating advisor determines that the Special Servicer is not complying with its obligations under the PSA and that replacement of the Special Servicer would be in the best interests of the certificateholders as a collective whole, the operating advisor has the right to call for a vote of all of the certificateholders on its recommendation to replace the Special Servicer. While it may be difficult to assemble the requisite percentage of certificateholders to vote in favor of such a recommendation, the potential damage to a Special Servicer's reputation that would result from such a recommendation being proposed or approved is another deterrent against the Special Servicer taking actions that violate the Servicing Standard.

Moreover, rating agencies provide an additional check on the Servicer's conduct. Servicers are evaluated and monitored by the rating agencies. PSAs generally provide that a Special Servicer can be terminated (by the election of the securitization trustee or by the securitization trustee at the direction of a specified percentage of the certificateholders) if it does not meet the applicable standards of an "approved" Servicer for any rating agency rating the securitization. Improper conduct by a Servicer could lead a rating agency to determine that the Servicer no longer meets that rating agency's standards. The consequences of that event potentially are severe for the Servicer, as it may lose not only its servicing rights for the securitization affected by the Servicer's conduct, but it also is at risk of losing its servicing rights on all CMBS transactions rated by that rating agency.

10. Can a CMBS Trust Offer Financing to a Buyer of a Mortgaged Property?

The securitization structure and the REMIC tax rules prohibit a securitization trust from making a new loan to finance a buyer's purchase of a mortgaged property. Thus, if a mortgage is foreclosed and the collateral is taken as REO property, the underlying loan is legally extinguished and the Special Servicer may not offer seller financing to a buyer of the REO property. However, if a buyer that is willing to purchase the mortgaged property on terms the Special Servicer considers favorable to the certificateholders under the Servicing Standard emerges prior to completion of foreclosure, the Special Servicer might be able to permit the buyer to assume the existing defaulted loan and modify the loan to adapt it to terms necessary to facilitate the sale of the property. This strategy might be helpful in the current environment where new financing for certain types of commercial real estate is more difficult to obtain.

B Notes in CMBS A/B Loans – Frequently Asked Questions regarding Control Appraisal Events and Loss of Control

Authored by: Timothy Stafford and Edward J. Stack IV

The current rising interest rate environment and deterioration in the value of certain types of commercial real estate properties threaten to significantly increase the number of distressed commercial real estate loans. In this environment it is critical for B note Holders[4] to have a clear understanding of their legal rights. This article discusses Control Appraisal Events and the rights a B note Holder may have to avoid, delay or mitigate the impact of a Control Appraisal Event.[5]

What is the purpose of the Control Appraisal Event test?

A fundamental principal of CMBS structures is that the party which is in the "control position" (i.e. the party which has consent and consultation rights and the right to replace the Special Servicer) should have a meaningful economic stake in the outcome of any action that is subject to its consent or approval rights. With an A/B Loan, this concept is implemented through a mechanism commonly known as a Control Appraisal Event. As will be discussed in more detail below, when certain adverse events occur with respect to an A/B Loan ("Appraisal Trigger Events"), the Servicer is required to obtain a current appraisal of the mortgaged property and determine whether the principal amount of the A/B Loan and unpaid interest thereon (as well as amounts owed the Master Servicer for debt service and property protection advances and certain unpaid property-related expenses) exceed 90% of the current appraised value of the mortgaged property. If there is such an excess (commonly referred to as an "Appraisal Reduction Amount") and it is greater than a specified level (typically 75% of the then outstanding principal amount of the B note), a "Control Appraisal Event" has occurred and the control position shifts to the A-Note Holder.

Additionally, a change in control will usually occur if the B note Holder becomes an affiliate of the related mortgage borrower. For transactions that involve both an A/B Loan and a mezzanine loan, if the B note Holder is an affiliate of the mezzanine lender, a change of control will often result if the mezzanine loan is accelerated in connection with a mezzanine loan event of default or if the mezzanine lender commences the exercise of remedies to realize on its collateral.

When is the Servicer required to obtain an appraisal?

The Appraisal Trigger Events are usually specified in the PSA, although sometimes they may be contained in the Co-Lender Agreement. Although there is variation from deal to deal, particularly between conduit and SASB (single asset, single borrower) transactions, typical Appraisal Trigger Events include the following:

- a delinquency in a monthly payment that continues for 60-90 days or more

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[4] For purposes of this article (i) subordinate notes and subordinate participations are referred to as "B notes," (ii) the holders of B notes are referred to as "B note Holders," (iii) senior notes and senior participations are referred to as "A-Notes," (iv) the holders of A-Notes are referred to as "A-Note Holders," (v) co-lender agreements and participation agreements are referred to as "Co-Lender Agreements," (vi) the whole loan to which a B note relates is referred to as the "A/B Loan," (vii) a pooling and servicing agreement is referred to as a "PSA," (viii) the master servicer appointed under the PSA is referred to as the "Master Servicer," (ix) the special servicer of the A/B Loan is referred to as the "Special Servicer" and (x) references to the "Servicer" means the Master Servicer or the Special Servicer, as applicable.

[5] Please note that this article relates solely to B notes associated with A/B Loans where one or more of the A Notes is in a CMBS securitization trust and the B note is held outside of the securitization trust. This article does not cover balance sheet A/B Loans, mezzanine loans or any class of securities issued in connection with a CMBS securitization. This article is of a general nature and is being provided for informational purposes only. B note Holders (and their counsel) should carefully review any applicable Co-Lender Agreement, PSAs and other relevant documents to determine their rights in any specific case.

- the borrower fails to pay the loan in full within 90 days of its maturity date, unless the borrower submitted an acceptable refinancing commitment to the Servicer, in which event the Appraisal Trigger Event may be delayed for an additional period to allow the refinancing to occur
- 60 days after the A/B Loan is modified in a manner that reduces monthly payments
- 60 days after an extension of the mortgage loan, other than an extension the borrower was entitled to pursuant to the loan documents as of right
- a receiver is appointed with respect to the mortgaged property
- the borrower is subject to bankruptcy proceedings
- the mortgaged property becomes REO property

The Servicer is typically required to obtain a new appraisal (or an update to an existing appraisal) promptly after the occurrence of an Appraisal Trigger Event, although many transactions do not require a new or updated appraisal if the Servicer has already obtained an appraisal within nine or twelve months prior to the occurrence of such Appraisal Trigger Event and it believes no material change has occurred with respect to the mortgaged property that would draw into question the validity of such existing appraisal. The Servicer is also typically required to obtain a new appraisal or an update to an existing appraisal every nine or twelve months after the Appraisal Trigger Event. As discussed in more detail below, many PSAs and Co-Lender Agreements also require the Servicer to obtain a new appraisal upon the request of the B note Holder.

How is the Appraisal Reduction Amount calculated?

The Appraisal Reduction Amount is calculated by the Servicer each time it receives an appraisal or appraisal update. The Servicer will take 90% of the current appraised value (i.e., it will apply a 10% "haircut" to the appraised value) and subtract specified property-related debt and liabilities. Although there are some differences from deal to deal, the specified property-related debt and liabilities typically include the following items:

- the outstanding principal amount of the A/B Loan
- accrued and unpaid interest on the A/B Loan (at the non-default rates)
- unpaid property protective advances made by the Servicer with respect to the A/B Loan
- unpaid interest (typically accruing at a rate equal to the prime rate) on such property protection advances and on any outstanding debt service advances made by the Master Servicer with respect to the A/B Loan
- unpaid real estate taxes, ground rents and insurance premiums currently due with respect to the mortgaged property (net of any escrows or letters of credit held by the Servicer for such items)
- any liens against the mortgaged property which are senior to the mortgage securing the A/B Loan

In some transactions the specified property-related debt may include other items, such as unpaid fees due to the Special Servicer with respect to the A/B Loan and unreimbursed expenses of the CMBS trust related to the A/B Loan.

If the specified property-related debt and liabilities exceed such 90% of the appraised value of the mortgaged property, the resulting excess is the Appraisal Reduction Amount.

How is a Control Appraisal Event determined?

If the Appraisal Reduction Amount exceeds the threshold specified in the Co-Lender Agreement or PSA, an Appraisal Reduction Event occurs and the control position shifts to the A-Note Holder. This threshold is typically 75% of the outstanding principal amount of the B note.

Additionally, if the holder of the B note is an affiliate of certain borrower parties or a defaulted mezzanine loan lender as described above, the control position will shift to the A-Note Holder regardless of whether a Control Appraisal Event has otherwise occurred.

Can a B note Holder obtain an appraisal?

Many Co-Lender Agreements or PSAs give the B note Holder rights to arrange for a second appraisal (at the B note Holder's expense) if the B note Holder is dissatisfied with the results of an appraisal or appraisal update obtained by the Servicer in connection with an Appraisal Reduction Event. The second appraisal usually must be ordered from an appraisal firm selected by the Servicer or from an appraisal firm selected by the B note Holder and approved by the Servicer. If there is a significant difference between the appraised value reflected in appraisal or appraisal update, the Servicer obtained in connection with the Appraisal Trigger Event and the second appraisal obtained on behalf of the B note Holder, the Co-Lender Agreement or PSA will specify a process for resolving the discrepancy, such as taking the average of the first and second appraisals or retaining a third appraiser to resolve the difference.

Can a B note Holder avoid or delay an Appraisal Trigger Event?

Most Co-Lender Agreements or PSAs give the B note Holder the right to cure A/B Loan defaults. If an uncured A/B Loan default would immediately or with the passage of time result in an Appraisal Trigger Event (as is the case with most monetary defaults), the cure of such default will generally delay the related Appraisal Trigger Event. If the underlying A/B Loan default is resolved during the period the B note Holder is exercising its cure rights, the Appraisal Trigger Period may end up being avoided entirely.

The B note Holder typically has the right to cure a monetary default on the A/B Loan within five to 10 business days after the end of the borrower's grace period (if any), and the right to cure a non-monetary default within thirty days after the end of the borrower's cure period. Some Co-Lender Agreements allow for the non-monetary cure period to be extended for an additional period (typically 60-90 days) if the B note Holder diligently pursues such cure and the A-Note Holder is not adversely affected. Cure payments made by the B note Holder must include any interest on advances made by the Servicer in connection with such default and related expenses, but the B note Holder is often not required to pay late charges, default rate interest or other penalty fees. Recovery of any cure payments by the B note Holder will be subordinate to any principal and interest then due to the A-Note Holder. Because the exercise of the cure rights can prevent the Special Servicer from implementing a default resolution strategy on an asset which may be in distress, most Co-Lender Agreements limit the B note Holder's right to cure defaults with respect to an A/B Loan. Limitations vary, but a common formulation is that a B note Holder is not permitted to cure more than four consecutive monthly payment defaults, and the total number of cure episodes over the life of the A/B Loan is often limited to six such periods.

The B note Holder will need to assess a number of factors in determining whether to exercise its cure rights if the borrower defaults on an A/B Loan, including the likelihood that (a) a current appraisal would result in a Control Appraisal Event, (b) the B note Holder will be able to recover any cure payments and (c) the default can be resolved (by the borrower on its own or as part of a workout implemented by the Special Servicer while the B note Holder is still in control) before the limits on the B note Holder's cure rights come into play.

How can a B note Holder avoid a Control Appraisal Event?

Some Co-Lender Agreements or PSAs allow the B note Holder to avoid a Control Appraisal Event by posting, as collateral, cash or cash equivalents or a letter of credit in an amount sufficient to avoid a Control Appraisal Event within a short period after receiving notice that a Control Appraisal Event has occurred. This collateral is commonly referred to as "Threshold Event Collateral." If the B note Holder posts Threshold Event Collateral, it will remain in the control position unless a future appraisal obtained in connection with an Appraisal Reduction Event leads to a higher Appraisal Reduction Amount, in which event the B note Holder will lose control unless it posts additional Threshold Event Collateral.

Threshold Event Collateral is held as credit support for the A-Note, so the B note Holder has the risk of increased losses on its investment if it elects to post Threshold Event Collateral. Threshold Event Collateral is held by the Servicer and used to pay any deficiency in amounts due to the A-Note Holder and the Servicer upon a final liquidation of the A/B Loan or the mortgaged proper-ty. If such losses do not exceed the Threshold Collateral, any remaining Threshold Event Collateral is returned to the B note Holder at that time. The B note Holder might also get back some or all of its Threshold Event Collateral if circumstances improve. If a subsequent appraisal obtained in connection with an Appraisal Trigger Event (or at the request of the B note Holder, if permitted under the Co-Lender Agreement or PSA) results in a lower Appraisal Reduction Amount, the Servicer is usually required to return any excess Threshold Event Collateral.

My B note was subject to a Control Appraisal Event, now what?

Even if control shifts to the A-Note Holder, all is not lost. The Co-Lender Agreement and PSA still require the Servicer to act in accordance with the servicing standard, which, among other things, generally requires the Special Servicer to seek to maximize recovery on the whole A/B Loan (not just the A-Note) on a net present value basis. In addition, unlike a mezzanine loan, a B note is not "wiped out" if the mortgage securing the A/B Loan is foreclosed and the mort-gaged property becomes REO property. The B note Holder will retain a subordinate interest in the REO property, and if the proceeds from the ultimate sale of the REO property exceed the amounts due to the A-Note Holder and the Servicer under the Co-Lender Agreement, the B note Holder may get a partial (or even full) recovery. In addition, if the value of the mortgaged property subsequently improves and the Appraisal Reduction Amount is reduced, it is possible that a Control Appraisal Event may no longer exist and the control position may shift back to the B note Holder.

The B note Holder may also effectively regain control of the A/B Loan by exercising an option to purchase the A-Note. A Co-Lender Agreement or PSA typically gives the B note Holder an option to purchase the A-Note at its "par price" if a material event of default exists with respect to the A/B Loan. The par price typically includes the sum of the following:

- the outstanding principal balance of the A-Note
- accrued and unpaid interest on the A-Note (to the extent not advanced by the Master Servicer) at the non-default rate of interest

- any unreimbursed property protection and debt service advances made by the Servicer, together with interest thereon
- any unpaid special servicing fees

The par price may or may not include items such as prepayment premiums or yield maintenance and the Special Servicer's workout or liquidation fees, depending on the transaction.

The B note Holder's purchase option typically expires upon the foreclosure of the mortgage securing the A/B Loan or the Servicer's acceptance of a deed-in-lieu of foreclosure. Some Co-Lender Agreements also limit the option exercise period to a specified number of days (typically 90 days) after the B note Holder receives from the Servicer notice of an A/B Loan default. Upon receiving a notice of default, the B note Holder should review the Co-Lender Agreement and the PSA to determine whether its purchase option is triggered, when and if its purchase option expires and what the par price is. Once the B note Holder gives notice of its intent to exercise the purchase option, the B note Holder will typically have 10-15 business days to complete the purchase of the A-Note.

Mezzanine Lender Rights: Before a mortgage lender can exercise remedies, a mezzanine lender will have the benefit of the following protections under the intercreditor agreement:

1. Mezzanine Lender Cure Rights – Mezzanine lender is entitled to receive notices of default under the mortgage loan and is afforded an opportunity to cure before the mortgage lender can exercise remedies
    a. Monetary Cures:
        i. Cure period is typically 5-10 business days after the later of (x) mezzanine lender's receipt of the mortgage loan EOD notice and (y) the expiration of the mortgage borrower's cure period under the mortgage loan documents
        ii. Cure payment may include reimbursement of mortgage lender's costs and expenses in connection with the mortgage loan default
        iii. Cure payment generally excludes late charges and default interest
        iv. Typically limited to 6 consecutive monthly monetary cure payments or 6 cures in a 12-month period unless mezzanine lender is pursuing a foreclosure on the equity collateral under the mezzanine loan
    b. Non-Monetary Cures:
        i. Cure Period is typically the longer of (x) 15-30 business days from mezzanine lender's receipt of the mortgage loan EOD notice and (y) mortgage borrower's cure period under the mortgage loan documents
        ii. Longer cure period is provided for a non-monetary default which is either susceptible to cure but cannot be cured within the provided cure period or is not susceptible to cure without ownership of the equity collateral, provided that the mezzanine lender is pursuing a foreclosure on the equity collateral (sometimes an overall cap of 180-360 days total)
        iii. Certain non-monetary defaults which are not susceptible of cure by the foreclosing mezzanine lender are typically waived as long as there is no material impairment to the value, use or operation of the property
2. Mezzanine Lender Purchase Option:
    a. Triggers:
        i. Acceleration of the mortgage loan
        ii. Exercise of remedies by the mortgage lender
        iii. Bankruptcy proceeding commenced by or against mortgage borrower
        iv. Material non-monetary or monetary mortgage loan event of default
        v. Mortgage loan is transferred to special servicing
    b. Expiration:
        i. Event giving rise to the purchase option ceases to exist

Jumping Through Hoops – Intercreditor Considerations for Distressed CRE Debt (ct.)

ii. Upon a foreclosure, sale by power of sale or mortgage lender's acceptance of a deed in lieu (mezzanine lender is typically guaranteed a certain amount of time (generally 30 days) to first exercise purchase right before a deed in lieu may be accepted by mortgage lender)

c. Purchase Price:

i. The sum of:

1. Mortgage loan outstanding principal balance

2. All accrued and unpaid interest

3. Unreimbursed advances made by the mortgage lender (including protective advances) and interest thereon

4. If the mortgage loan is securitized, any applicable workout, special servicing or liquidation fees (subject to certain limitations, including no liquidation fee if the purchase option is exercised within 90 days after the triggering event)

5. Mortgage lender's costs and expenses

ii. Typical exclusions: late fees, default interest, prepayment fees, yield maintenance premiums and exit fees

3. Standstill Period:

a. If the mortgage borrower fails to pay the mortgage loan on the maturity date and to meet the applicable extension conditions, the mortgage lender agrees not to commence any enforcement action for a period of time (typically 60-90 days) if certain conditions are met, including:

i. No other mortgage loan default is continuing

ii. Mezzanine lender promptly commences an equity collateral enforcement action upon maturity default

iii. Mezzanine lender timely makes (or causes to be made) all debt service payments and any other amounts due under the mortgage loan (excluding any late charges, late fees, and default interest)

iv. All extension conditions set forth in the mortgage loan agreement are satisfied (other than the maturity default)

Mezzanine Loan Foreclosure: Before a mezzanine lender can foreclose, it must satisfy all conditions set forth in the intercreditor agreement:

1. Foreclosure on Equity Collateral:

a. Transferee taking title to the equity collateral must be a "Qualified Transferee" which meets certain minimum financial and experience requirements

i. the originating mezzanine lender and initial purchaser are typically pre-approved

b. Property must be managed by a "Qualified Manager" after foreclosure

Jumping Through Hoops – Intercreditor Considerations for Distressed CRE Debt (ct.)

        i. "Qualified Manager" test varies by asset type and size
        ii. Management company typically must (x) not be in bankruptcy and (y) satisfy certain size and experience tests
    c. Prior to foreclosure, transferee must generally cure all remaining monetary defaults except for the mortgage borrower's failure to repay the mortgage loan in full
    d. Transferee must deliver a replacement guarantor and replacement guaranties and environmental indemnity to mortgage lender
    e. Transferee must provide a new non-consolidation opinion to mortgage lender
    f. If the above conditions are not satisfied, mezzanine lender must obtain mortgage lender's approval to the foreclosure or, if the mortgage loan is securitized, a rating agency confirmation
2. Foreclosure on Separate Collateral: Mezzanine lender may foreclose on its separate collateral (including any accounts and other collateral for the mezzanine loan except for the equity collateral) at any time
3. Payment Subordination in Guaranties: Mezzanine lender's right to recover under any mezzanine loan guaranty may depend upon whether:
    a. Mortgage lender is simultaneously exercising its rights against the same guarantor under any mortgage loan guaranty
    b. The mortgage loan remains outstanding

Multi-Tier Mezzanine Loan Structure Intercreditor Considerations:

1. A junior mezzanine lender has similar consent, purchase and cure rights with respect to the senior mezzanine loan(s) as the senior mezzanine lender has with respect to the mortgage loan:
    a. Cure rights with respect to non-monetary defaults may be sequential (most junior mezzanine lender is given first opportunity to cure) and cure rights with respect to monetary defaults and purchase rights are contemporaneous with the rights of the senior mezzanine lender
    b. If a junior mezzanine lender elects to exercise its cure right with respect to the mortgage loan, it must also cure any senior mezzanine loan defaults
    c. If a junior mezzanine lender elects to exercise its right to purchase the mortgage loan, it must also purchase any senior mezzanine loans
2. Multi-tier structure does not affect the rights of any mezzanine lender to foreclosure on its separate collateral (except with respect to pursuing common guarantors)

What Can You Really Do in 90 Days? Sample UCC Foreclosure Timeline for a CRE Mezzanine Loan

WHAT CAN YOU REALLY DO IN 90 DAYS?*
SAMPLE UCC FORECLOSURE TIMELINE FOR A CRE MEZZANINE LOAN

Days 1-30+			Days 31-60+			Days 61-90+		
Notices	**Diligence**	**Sale Preparation**	**Notices**	**Diligence**	**Sale Preparation**	**Notices**	**Diligence**	**Sale Preparation**
Notices of default and acceleration	• UCC searches • Title searches • Lien searches • Appraisal, if applicable • Phase I environmental report, if applicable • Review Construction Documents, Sales Contracts, Condominium Documents, if applicable	• Review loan document (including pledge agreement) requirements • Engage broker and negotiate broker agreement • Develop marketing plan and materials • Engage auctioneer • Engage court reporter • Determine method, location, time of sale	Notices of disposition of collateral by public sale to borrower, guarantor and any senior lenders, as applicable	• Update UCC searches • Update title searches • Update lien searches	• Establish data room for prospective purchasers and prepare confidentiality agreements requirements • Prepare terms of public sale, UCC public sale notices and advertisements • Prepare auctioneer script, instructions for bidders, bidding certificate	• Supplemental notices of disposition of collateral by public sale, as applicable • Notices to other UCC creditors of record	• Final UCC searches to identify other UCC creditors • Update title searches • Update lien searches • Diligence any mechanics liens or other issues at the property that the winning bidder at the sale will be stepping into	Determine Credit Bid amount and plan for, file appropriate forms with respect to, and pay Transfer Taxes (and perhaps hire tax counsel)

Other Considerations *(Ongoing)*

- Review and abide by intercreditor agreement requirements
- Mortgage lender coordination must be addressed throughout entire process
- Borrower cooperation may be required to properly diligence the property
- Borrower remedies, such as filing for bankruptcy or filing for a temporary injunction (i.e., TRO) of the sale, may delay the marketing process and/or sale date

Begin to Plan for Ownership After a Successful Sale

- Prepare Statement of Accounts and send notices of consummation of sale to applicable parties
- Amend organizational documents of foreclosed-upon entity
- Terminate affiliate property agreements and enter into replacement agreements
- Remove and replace borrower affiliates on condominium boards, etc., as applicable
- Amend loan documents and deliver replacement guaranties, legal opinions, revised organizational documents
- Comply with other requirements of mortgage lender in accordance with the intercreditor agreement, as applicable

* **Not as much as you may think… this timeline assumes a 60 day UCC sale is commercially reasonable (and practically feasible). All UCC sales must be commercially reasonable, which must be assessed independently for each deal based on its facts and related timing.**

Crisis Averted? Close Calls and Lessons for CRE Lenders After Recent Bank Shutdowns (Parts I-V)

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Overview

This series of articles from Dechert's Global Finance Group reviews various aspects of loan documents and market practices relating to commercial real estate lending in light of the takeover of several banks earlier this month. Topics range from breaking up with your DACA bank to reviewing default provisions - with a focus on practical analysis and suggestions for navigating loan documents in a post-shutdown world.

Part I - What's In A Name? – The Impact of Titles on Cash Management Accounts (released March 15, 2023)

Shakespeare may have thought that a rose by any other name was still a rose…but would an FDIC regulator see things the same way? Don't bet on it.

This past weekend while the FDIC was taking over Signature Bank, many lenders (and their lawyers) were busy trying to understand the impact of the shutdown on the multitude of reserve accounts, cash management accounts and lockbox accounts set up at Signature Bank relating to hundreds of commercial real estate loans. It turns out – names matter.

Before the FDIC announced late on Sunday, March 12, 2023, that all depositors at Signature Bank would be made whole, many lenders were grappling with the FDIC regulations regarding deposit insurance coverage. As many recent articles have already described in great detail, the FDIC insures the balance of a depositor's account up to $250,000. However coverage amounts depend on how accounts are owned, including the application of certain distinct ownership categories recognized by the FDIC (e.g., individual accounts, joint accounts, trust accounts, retirement accounts, etc.). It came as a surprise, even to some highly sophisticated parties, that the maximum $250,000 of insurance is aggregated across all accounts in each ownership category at a failed bank that are owned by the same party.

It is common practice for commercial real estate loan documents to require deposits of property revenues directly into a lockbox account, which then sweeps on a daily basis into a cash management account. In addition, reserve accounts (for taxes, insurance, FF&E, etc…) are a customary feature. These accounts -- lockbox, cash management and reserve -- are usually required to be "lender controlled" accounts, or accounts "in the name of a lender" or "for the benefit of the lender". While that nomenclature may have been designed to describe a lender's security interest in and control over the accounts, that wording could have unintended consequences when dealing with a bank receivership. The FDIC rules focus on the owner of the deposits and regulators start with the presumption that ownership is determined by the deposit account records of the failed bank (12 C.F.R. § 330.5). If an account is entitled ***in the name of the lender or f/b/o the lender***, and the FDIC were to consider such lender to be the owner of the account, then the deposit insurance would be payable to that lender. So, what's the problem with that outcome? Well, it turns out that lenders were often using Signature Bank for accounts on multiple loans at the same time. Under the aggregation rules, the FDIC would only allow a single $250,000 insurance claim across all of a lender's accounts at Signature Bank, notwithstanding that the accounts related to completely different loans and unrelated borrowers.

So, what's a lender to do? Most complex commercial real estate loan documents require lender- controlled accounts, and some even contain boilerplate language stating that such lender-controlled accounts are not the property of

borrower and should be excluded from the estate of any borrower who files for bankruptcy. But then, many loan agreements may also contain statements requiring borrower to report any interest earned on an account as borrower income, suggesting that the accounts are owned by borrower. It's clear that for purposes of the FDIC insurance regulations, both lender and borrower benefit from making sure that **borrower** is considered the owner of the accounts and related deposits and gets the benefit of the FDIC insurance in the event of a bank failure. With that in mind, it would be prudent for commercial real estate lenders to:

i. include in the loan agreement an express statement regarding the ownership of any required accounts, including specifically for purposes of 12 C.F.R. § 330.5 (*Recognition of deposit ownership and fiduciary relationships*);
ii. require that borrower's name also appear in the title of every account established in connection with a loan that is lender-controlled or f/b/o lender;
iii. require that any accounts maintained by a servicer (or custodian) clearly indicate that such account is being held in a servicing or custodial capacity only (See 12 C.F.R. § 330.7 – *Accounts held by an agent, nominee, guardian, custodian or conservator*);
iv. use the borrower's tax ID number when establishing each required account; and
v. ensure that the account records at the bank consistently reflect that the account is owned by borrower.

The FDIC's late night decision on March 12th to provide insurance above the $250,000 cap saved lenders with cash management accounts at Signature Bank from having to wade through the details of how their accounts were named and owned (and avoided the need to explain these complex arrangements to regulators). However, a future bank takeover might turn out differently. So, lenders take heed and remember that a rose smells sweetest when you simply call it a rose.

Part II – Breaking up is hard to do… or so they say. And with a bank in receivership, it's even harder (released March 17, 2023)

In the immediate wake of the Signature Bank takeover, commercial real estate lenders undertook swift inventory of their loan files to identify where they may have had exposure due to funds on deposit with Signature Bank. This meant identifying each deposit account control agreement (commonly called a lockbox agreement, or clearing account agreement, or deposit account agreement, and referred to in this article as a "DACA") and each cash management agreement with Signature Bank as a counterparty.

Further, most lenders have been evaluating whether there should be changes to their lockbox and cash management arrangements, and many borrowers have been contacting their lenders and insisting that their funds be transferred to accounts at banks other than Signature Bank.

How does a lender break up with a DACA or cash management bank in financial distress? This article will walk through some relevant considerations, whether for this breakup or a future one.

Let's start with what the relevant documents say:

Loan Agreement –

- The loan agreement will usually contain eligibility requirements that must be satisfied in order for a bank to be used for cash management accounts and lockbox accounts (also sometimes called clearing accounts or deposit accounts). Often, the concept of an "Eligible Institution" is specifically detailed, with eligibility tied to a bank's ratings.
- The loan agreement often provides for the right of a lender to select the cash management account bank (including the unilateral ability to replace such bank from time to time).
- However, loan agreements often are silent on the ability of a lender to select, or to cause the borrower to replace, a lockbox bank, unless such bank no longer meets the Eligible Institution criteria.
- Even if the loan agreement provides for Eligible Institution criteria, and allows for the replacement of a bank, it generally is not so granular as to detail the specific replacement process should a bank no longer satisfy the relevant criteria (such as borrower cooperation, costs and expenses, etc.).

DACA –

- Typically, DACAs provide for unilateral termination by a lender upon 30 days' notice to the lockbox bank and borrower.
- Most DACAs do not address, either expressly or implicitly, what happens if the lockbox bank is taken into receivership or shut down (or downgraded or placed on any sort of watch list, for that matter).
- However, simply because a DACA may require 30 days' notice for termination to be effective, that does not mean that funds must continue to be deposited with the lockbox bank during the interim period. Although it will require the cooperation of both borrower and lender, tenants and other relevant parties can be directed to make their payments into a different account while the notice period for termination is running.

Cash Management Agreement –

- A cash management agreement is similar to a DACA, in that it provides for lender control over a specific bank account. Like with a DACA, generally a lender will have the unilateral right to terminate a cash management agreement upon notice to both borrower and cash management bank, usually 30 days.
- As with the interim period after sending a termination notice on a DACA, a lender can prevent funds from going into the cash management account by sending a redirection notice to the lockbox bank, instructing it to send daily sweeps to a different account.

Practically then, what is a lender to do? The documents described above provide a number of provisions that – even when taken as a whole – do not fully contemplate a sudden distress event, such as the shutting down of a lockbox bank or cash management bank, or the transfer of accounts to a successor bridge bank as part of receivership.

What we are seeing right now, in light of current banking concerns, is a combination of the following:

- Many lenders and/or their servicers preemptively moved funds out of Signature Bank, with or without following the technical provisions of relevant loan documents.

- Some lenders have delivered redirection letters to their lockbox banks, instructing them to cease daily sweeps into cash management accounts at Signature Bank/Signature Bridge Bank.
- Some lenders are working with their borrowers to divert funds from going into Signature Bank/Signature Bridge Bank lockbox accounts.
- Many lenders are setting forth action plans with their borrowers to implement new lockbox and/or cash management regimes at banks other than Signature Bank/Signature Bridge Bank.

All of the above actions rely, to a certain degree, on borrower cooperation and/or after the fact loan modifications.

What could make this process easier, or at least more clear, for a lender should there be a next time?

1. Consider using a definition for “Eligible Institution” in the loan agreement and any other relevant document, such as the servicing agreement, that specifically details as additional criteria that a bank taken under control of the FDIC or other relevant authority is no longer an Eligible Institution.
2. In each of the loan agreement and DACA, consider whether a lender should have an express unilateral right to direct borrower to terminate and/or replace a lockbox bank relationship upon such bank no longer being an Eligible Institution. Note here that any such termination should not be automatic – rather at lender’s option so that cushion time (e.g., 30 days) can be utilized to identify and implement a replacement DACA. To have a DACA automatically terminate may not be enforceable (and/or raise ipso facto issues) and, from a practical perspective, could leave cash management matters in an even more abrupt state of limbo where funds could be rejected.
3. In connection with any termination or replacement of a lockbox bank or a cash management bank, thought should be given to including a covenant (most practically in the loan agreement) requiring borrower to cooperate with the process and detailing related action steps.
4. In each of the DACA and the cash management agreement, a lender may want to eliminate provisions that require the bank being terminated to affirmatively acknowledge receipt of the termination notice as a condition to the effectiveness in the case of a termination triggered by bank distress. A shut down bank or a bank in distress may not have the administrative processes in place to handle such acknowledgement.
5. Similarly, lockbox banks often require written notice, then written acknowledgement back from the bank, and then the passing of a few business days before implementing any change in its daily or weekly sweep protocol to a new cash management bank. Given the importance of expediency in a shut down or receivership situation, lenders may seek an exception to that process allowing for a shorter timeframe and electronic delivery methods if the bank to which the funds are being swept is under FDIC control.

Breaking up may be hard to do, but at least with a clearer path, it might be just a little bit easier.

Part III – The Emperor Has No Clothes – The Impact of Recent Bank Closures on Loan Guarantees (released March 22, 2023)

While our other articles have focused on the nuts and bolts (and bumps and grinds) of lockbox accounts and cash management arrangements in the wake of the recent bank shutdowns, there is more of concern for lenders than the logistics of claiming insurance proceeds and the location of cash management accounts. Let’s talk about loan guarantees.

Almost every commercial real estate loan has at least one guaranty as part of its collateral package. Depending on the type of loan, multiple guarantees may be required to cover various aspects of the transaction (i.e., recourse guarantees,

completion guarantees, carry guarantees, replenishment guarantees, etc.). Lenders take great care to negotiate financial covenants with respect to the creditworthiness of the party providing the guaranty. The most common covenants are net worth and liquidity requirements. Not every loan has both covenants, so they are addressed individually below.

Net Worth Covenants – Here is a typical net worth covenant:

> *At all times until the Loan has been indefeasibly paid in full, Guarantor shall maintain Net Worth in the aggregate of not less than $XX (excluding any equity or value attributable to the Property securing the Loan).*
>
> *"Net Worth" shall mean, as of any given date, (i) Guarantor's total assets as of such date less (ii) Guarantor's total liabilities (taking into account contingent liabilities) as of such date.*

Some loan documents will contain additional details and restrictions on the calculation of Net Worth, such as excluding non-US assets or intangible assets or adding in a concept of lender discretion.

Liquidity Covenants – Here is a typical liquidity covenant:

> *At all times until the Loan has been indefeasibly paid in full, Guarantor shall maintain Liquid Assets in the aggregate of not less than $XX.*
>
> *"Liquid Assets" shall mean cash and cash equivalents, but only to the extent owned freely, free of security interests, liens, pledges or any other encumbrance; provided that Liquid Assets shall not include any asset that is part of the collateral for the Loan.*

Again, some loan documents will be more detailed and may specifically define "cash and cash equivalents" in a manner similar to this:

> *"**Cash and Cash Equivalents**" shall mean: (i) United States dollars and (ii) any of the following which may be liquidated without restrictions within five (5) Business Days or less: (a) securities issued or directly and fully guaranteed or insured by the United States government or any agency or instrumentality thereof having maturities of not more than six (6) months from the date of acquisition; (b) certificates of deposit and Eurodollar time deposits with maturities of six (6) months or less from the date of acquisition, bankers' acceptances with maturities not exceeding six months and overnight bank deposits, in each case, with any domestic commercial bank having capital and surplus in excess of $500 million and an S&P Certificate of Deposit Rating (short term) of A-1 or better or the equivalent by Moody's; (c) repurchase obligations with a term of not more than seven (7) days for underlying securities of the types described in clauses (ii)(a) and (b) above entered into with any financial institution meeting the qualifications specified in clause (ii) (b) above; (d) commercial paper having the highest rating obtainable from Moody's or S&P, and in each case maturing within six months after the date of acquisition; and (e) money market funds substantially all the assets of which are comprised of securities and other obligations of the types described in clauses (i) and (ii)(a) through (d) above.*

What's The Impact of the Bank Shutdowns on Guarantees?

What is common across these covenants is that there is nothing which would expressly pick up an FDIC takeover of a bank. As a reminder, absent the extraordinary steps taken last week with respect to Signature Bank and SVB, depositors are only insured up to the first $250,000 of funds in each account meeting the FDIC's recognized ownership categories. As an example, a guarantor with a $2,000,000 cash deposit account at a bank that gets taken over is insured for $250,000, but will only have a receivership certificate for the $1,750,000 balance. What might that mean in terms of compliance with the Net Worth and Liquid Asset covenants described above? As drafted, things might be better for the guarantor than for the lender…

- If a Net Worth definition includes a concept of lender discretion, perhaps the lender has an argument to discount the value of the $1,750,000 receivership certificate.
- If a Liquid Asset covenant doesn't have a specific definition for "cash and cash equivalents", a guarantor is likely to insist that the receivership certificate counts as a full cash equivalent.
- If there is a detailed definition of cash and cash equivalents, a lender may be in a better position to exclude the receivership certificate – however, if the guarantor's original asset was a certificate of deposit (rather than cash), and the bridge bank assumed the CD obligation, a lender may still face a fight with its borrower as to whether the CD counts towards the liquidity requirements.

Clear language, rather than an argument with a borrower, is always preferred. Lenders should review their existing financial covenants (and related definitions) and consider whether changes to those provisions going forward could prevent a situation where a lender may have to live with the pretense that a guarantor is wearing clothes.

And, lenders, beware -- your own closet may have some invisible garments in it. The same kind of financial covenants often appear in repurchase, warehouse and note-on-note facilities that lenders use to leverage their assets.

Part IV – The Lag is a Drag (released March 31, 2023)

In our prior three articles, we discussed the potential impact of the recent bank shutdowns on cash management arrangements and guarantor financial covenants in commercial real estate lending. The issues we identified could make it appear that loan documents have no protection in the event a lockbox bank or cash management bank suffers distress. But, that is not the case. Loan documents generally contain a requirement that accounts be "Eligible Accounts" and that the accounts be held at "Eligible Institutions". These definitions are meant to be the primary protection for both lenders and borrowers that all funds flowing through the cash management system are held in a safe manner.

Let's look at sample definitions of "Eligible Account" and "Eligible Institution".

> *"Eligible Account" shall mean a separate and identifiable account from all other funds held by the holding institution that is either (x) an account or accounts maintained with a federal or state- chartered depository institution or trust company which complies with the definition of Eligible Institution, or (y) a segregated trust account or accounts maintained with a federal or state chartered depository institution or trust company acting in its fiduciary capacity that has a rating of at least "[XX]" and which, in the case of a state chartered depository institution or trust company, is subject to regulations substantially similar to 12 C.F.R. §9.10(b), and having in either case a combined capital*

and surplus of at least $[XX]. An Eligible Account will not be evidenced by a certificate of deposit, passbook or other instrument.

"Eligible Institution" shall mean (a) a depository institution or trust company insured by the Federal Deposit Insurance Corporation (i) the short term unsecured debt obligations or commercial paper of which are rated at least "[XX]" (or its equivalent) from each of the Rating Agencies (in the case of accounts in which funds are held for thirty (30) days or less) and (ii) the long term unsecured debt obligations of which are rated at least "[XX]" (or its equivalent) from each of the Rating Agencies (in the case of accounts in which funds are held for more than thirty (30) days) or (b) such other depository institution otherwise approved by Lender from time-to-time. The key qualifying criteria for both definitions are the minimum ratings required for the institution holding the relevant account.

So, how do those ratings work?

Ratings are issued by nationally recognized statistical ratings organizations (NRSROs) such as Fitch, Inc., Moody's Investors Service, Inc., S&P Global Ratings, and others. NRSROs communicate their ratings to the general public through announcements, which are distributed to major financial newswires, and by publication on NRSRO websites. Many NRSROs also issue periodic ratings reports. Banks often include these ratings on their own websites.

An NRSRO can update or withdraw its ratings at any time. A material a negative (or positive) credit event is likely to trigger a ratings reassessment. In advance of such a credit event, an NRSRO may issue an anticipatory statement, such as a downgrade (e.g., from "stable" to "negative") or an upgrade, or place a rated entity "on watch". These predictive actions put parties on notice that something may happen.

As we know from recent experience, however, credit events can be sudden, with little or no advance warning. And, no NRSRO can predict the certainty of a credit event occurring. Consequently, many updates to ratings are reactive, and not proactive. Hence, a lag. Recently closed banks had high ratings at the time of shutdown, and the ratings for each were not updated until after the FDIC had intervened. In those cases, the update was that the ratings for each were withdrawn.

Did the ratings requirement in the customary Eligible Account / Eligible Institution definitions provide the protection as intended in this instance? No, and it is not clear that they could have. NRSRO ratings are not always able to serve as a canary in the coal mine. So, what is a lender to do? While this may be an issue without a definitive fix, here are some things to consider:

- Should the financial criteria used in "Eligible Account" definitions be adjusted?
- Should the ratings used for assessing "Eligible Institutions" be modified?
- Should additional criteria be added to "Eligible Institution", such as requiring that no receivership or insolvency proceedings exist?
- Should a lender have the right to take action based on a negative credit event, such as a downgrade, even if a bank's minimum rating requirements remain satisfied?

- Some loan documents pre-approve specifically named banks. Should a specifically named bank still be subject to minimum ratings and/or not under receivership criteria?

Lots to think about here, and likely no right answers – but definitely some wrong answers, and maybe some better answers. In sum, ratings serve a variety of watchdog purposes in financing transactions, but they do come with the risk of a lag. And, when the monetary lifeblood of a commercial real estate deal is at stake, the lag really can be a drag.

Part V – Not It! (released April 6, 2023)

In the wake of the FDIC bank shutdown actions taken last month, we have written about cash management arrangements, account naming conventions, financial covenants and rating requirements in typical commercial real estate loans with 20/20 hindsight. Our prior analyses often required connecting the dots across multiple defined terms, various provisions and more than one loan document to try to fully understand the implications of a bank closure. In this article, we've delved into a much more direct topic: *what do customary commercial real estate loan documents say about liability with respect to funds in various deal-required bank accounts?* Here's a hint – probably less than you think!

We reviewed a wide sampling of commercial real estate loan agreements – from balance sheet loans, to SASB deals to conduit paper – and here is what we found:

- Many loan agreements are completely silent regarding who is liable with respect to amounts on deposit in the various accounts set up under a loan (which we will call, generically, "Reserve Funds" for purposes of this article).
- Some loan agreements, however, do contain indemnity language similar to these two examples:

  Ex. 1 - *Borrower shall indemnify Lender and hold Lender harmless from and against any and all Losses arising from or in any way connected with the Accounts, the sums deposited therein or the performance of the obligations for which the Accounts were established.*

  Ex. 2 - *Borrower shall indemnify and hold Lender harmless from and against any and all actions, suits, claims, demands, liabilities, losses, damages, obligations and costs and expenses (including attorneys' fees and expenses) arising from or in any way connected with the Reserve Funds Account and/or the Reserve Funds Lockbox Agreement (unless arising from the gross negligence or willful misconduct of Lender) or the performance of the obligations for which the Reserve Funds Account was established.*

  An indemnity from the borrower – that's good, right? Lenders are covered, right? Well, an indemnification obligation from borrower to lender doesn't directly get at the issue of who is liable in a situation where there is a bank shutdown and FDIC insurance is insufficient to cover the full amount of Reserve Funds. If the Reserve Funds are the property of the borrower, and it is the borrower who suffers the "loss", then query what it means for a borrower to indemnify the lender from losses…?

  In the second example, above, note the carveout for gross negligence of the lender. This is fairly typical language.

- Some loan agreements contain clear language that the lender is not liable for certain kinds of losses:

Ex. 1 - *Lender shall not be liable for any loss sustained on the investment of any funds constituting the Reserve Funds.*

Ex. 2 - *Lender shall not be liable for any loss sustained on the investment of any funds constituting the Reserve Funds so long as such investment was not expressly prohibited by this Agreement or the Reserve Funds Agreement.*

While these and similar provisions protect lenders from claims relating to losses sustained by the investment of Reserve Funds, they still do not address a situation where there is insufficient FDIC insurance.

- The best provisions we found were better at limiting a lender's liability for risk of loss relating to Reserve Funds more generally, although they were still not completely on point. Below are two of these more protective examples:

Ex. 1 - *In no event shall Lender be liable either directly or indirectly for losses or delays relating to the Reserve Funds resulting from any event which may be the basis of computer malfunctions, interruption of communication facilities, labor difficulties or other causes beyond Lender's reasonable control or for special, consequential, treble or punitive damages except to the extent of Lender's gross negligence, willful misconduct, fraud or illegal acts.*

Ex. 2 - *Except as otherwise provided in this Agreement or as required by applicable law, Lender will have no duty as to any Reserve Funds, as to ascertaining or taking action with respect to calls, conversions, exchanges, maturities, tenders or other matters relative to any Reserve Funds, whether or not Lender has or is deemed to have knowledge of such matters, or as to the taking of any necessary steps to preserve rights against any parties or any other right pertaining to any Reserve Funds.*

Given the banking industry events of last month, and the potential losses that depositors were facing due to the cap on FDIC insurance proceeds, loan documents should be clear as to the allocation of liability when Reserve Funds are at risk. (From a lender's perspective, the answer to who's on the hook is, of course, "not it"!)

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