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In this issue

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Hurricane Katrina: One Year Later, Effects on CMBS Industry Largely Unknown

By **David G. Fine**

Hurricane Katrina made landfall inside the Louisiana/Mississippi border just after 6:00 AM on August 29, 2005. By the time it dissipated near the Great Lakes three days later, the Federal Emergency Management Agency (FEMA) had declared 48 counties in Louisiana, Mississippi, and Alabama as "severely impacted," with another 43 counties receiving FEMA aid. Industry analysts estimated that existing CMBS transactions contained loans secured by approximately 600 properties with an aggregate outstanding principal balance of over $3 billion located within the "severely impacted" counties, with another 1,400 properties ($10 billion aggregate outstanding principal balance) located in counties receiving FEMA aid.

Initially, industry experts predicted that the effects of Hurricane Katrina on the CMBS industry would match past hurricanes. Short-term delinquen-

cies related to affected properties were expected to rise. However, since CMBS transactions typically provide for advancing of principal and interest, these short-term delinquencies were not expected to adversely affect CMBS certificate holders. Further, borrowers are required to obtain "all-risk" property insurance (which would provide for coverage against damage done by "windstorms," such as hurricanes) and business interruption insurance (which would provide for temporary income—typically, 12 to 18 months—to replace income lost to damage preventing the operation of the property). As these insurance policies were expected to cover the costs of restoring the affected properties, losses to CMBS transactions were expected to be minimal. Although the windstorm damage caused by Hurricane Katrina was similar to past hurricanes, the resultant flooding in the wake of Hurricane Katrina was unique to this storm.

The type of damage caused by Hurricane Katrina has spawned significant litigation that will affect the CMBS industry. In addition to the damage done to properties by the strong winds of Hurricane Katrina, properties in Louisiana (due to the failed levee system), Alabama, and Mississippi (due to storm surges and coastal waves) suffered significant flood damage. Insurance appraisers cited a significant amount of damage that they identified as not being caused by Hurricane Katrina's winds but rather by resulting flooding.

Typically, CMBS loans required windstorm insurance (as a component of hazard or "all risk" insurance coverage) in the amount of the replacement cost of the damage. Flood insurance (which is specifically excluded from such "all risk" insurance coverage) is only required if the property is located in a federally-designated high risk flood zone. Further, even if required, flood insurance is typically capped under the loan documents at the lesser of the outstanding principal balance of the loan or the maximum amount available under the National Flood Insurance Program—currently $500,000. Therefore, the determination by the applicable insurance appraiser as to whether the property was damaged by Hurricane Katrina's winds or the resulting floods directly (and significantly) affected the amount of insurance proceeds that would be available for restoration of the applicable property. A significant amount of litigation between property owners (and their lenders) and insurers is currently being waged over this issue.

It should be noted that Hurricane Rita affected a greater number of properties securing loans in CMBS transactions and caused greater short-term damage. However, the areas affected the most by Hurricane Rita (such as Dallas, Texas) did not suffer from the same flooding risk as those affected by Hurricane Katrina. As a result, losses to CMBS transactions resulting from Hurricane Rita will track industry predictions more closely and should be greatly mitigated by windstorm insurance coverage required under typical loan documents.

Meanwhile, the CMBS industry still has largely yet to feel the effects of Hurricane Katrina. The presence of continuing FEMA assistance, business interruption insurance, forbearance agreements, and delayed payments of property and income taxes at the local, state, and federal level have kept delinquency levels low. However, each of these measures is temporary (and, in the case of business interruption insurance and delayed tax payments, has already begun to expire). As a result, there will inevitably be losses to CMBS transactions due to the devastation caused by Hurricane Katrina. The extent of those losses will largely be determined by the litigation over the nature of damage (flood vs. windstorm) to various properties and the ability of the region to rebuild prior to the exhaustion of these temporary financial factors that have artificially lowered delinquency rates to date.

More importantly, however, Hurricane Katrina illustrates the vulnerability of CMBS transactions to significant natural disasters. While loan originators could have reasonably predicted Hurricane Katrina (or a similar disaster) in making their insurance determinations, they could not have predicted the unusual levels of flooding that Hurricane Katrina caused. As a result, the failure of standard loan documents to provide for significant amounts of flood insurance potentially expose CMBS transactions to largely unanticipated risk. As with the terrorism events of September 11, 2001, and the proliferation of terrorism insurance, lenders need to revise their loan documents to give them flexibility in requiring additional flood insurance (or insurance for similar natural disasters). Combined with heightened awareness in connection with the underwriting of future loans, these revisions can reduce the exposure of CMBS transactions to likely natural disasters in the wake of Hurricane Katrina.

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RMBS Update:
SEC Releases Additional Regulation AB Telephone Interpretations

By **Steven J. Molitor**, **Ralph R. Mazzeo**, and **Laurie J. Nelson**

Throughout 2006, parties to residential mortgage-backed securities ("RMBS") transactions have been navigating through a new regulatory regime courtesy of Regulation AB. Regulation AB sets forth disclosure requirements and periodic reporting requirements for RMBS registered with the Securities and Exchange Commission ("SEC"). On August 7, 2006, the SEC Division of Corporate Finance released additional guidance as to compliance with Item 1122 of Regulation AB (compliance with applicable servicing criteria) in its Manual of Publicly Available Telephone Interpretations. One of the more noteworthy interpretations offered by the SEC concerns the clarification of Item 1122(d)(4)(i), which should prove helpful to RMBS parties in planning and performing Item 1122 engagements.

Item 1122(d) of Regulation AB affects a number of parties to RMBS transactions, including originators, servicers, master servicers and trustees, by providing four detailed categories of servicing criteria for assessing servicing compliance: General Servicing Considerations; Cash Collection and Administration; Investor Remittances and Reporting; and Pool Asset Administration. Additionally, Regulation AB broadly defines a servicer to include "any person responsible for the management or collection of the pool assets or making allocations or distributions to holders of the asset-backed securities." Certain RMBS trustees may fall within the definition of "servicer" under Regulation AB, as the applicable servicing criteria address cash flow calculation and distribution as well as loan-level servicing. Each annual report on Form 10-K must include a separate assessment report for each party "participating in the servicing function."

Item 1122 of Regulation AB, in addition to requiring the above-mentioned assessments of compliance by various parties, requires an attestation report on each party's assessment of compliance by a registered public accounting firm. Prior to August 7, accounting firms could not be certain that they would not have to hire separate legal counsel to verify assessment reports, or that they were not being asked to physically verify that collateral properties underlying the securitized mortgages were being maintained properly. As a result of the August 7 telephone interpretations, Item 1122(d)(4)(i), which states that collateral or security on pool assets is maintained as required by the transaction agreements or related pool asset documents, has been clarified to require "an assessment of whether the mortgage and related documents, rather than the physical properties underlying the mortgages, are maintained as required by the transaction agreements or related pool asset documents." Also, "an auditor attesting to an assertion regarding the Item 1122(d)(4)(i) criterion is only required to verify that the mechanics of performing the loan perfection or loan defeasance prescribed in the transaction agreements or related pool asset documents have been performed. The auditor is not required for this or any other criterion to make a legal determination, such as whether the loan perfection and loan defeasance were successfully performed."

Although these telephone interpretations provide much-welcomed additional guidance on certain issues, there are other areas of continued concern as to which the SEC declined to provide further interpretation. For example, the SEC provided no additional guidance as to when servicers should obtain Item 1122 assessments from third-party "subcontractors" to whom certain activities covered by Item 1122 may be delegated. Regulation AB subjects to reporting compliance any third party that performs any Item 1122 activity with respect to more than five percent of pool assets. This requirement has created a "gray area" for market participants where third party vendors are used for specific subcontracted activities; nevertheless, the SEC has indicated that it is the responsibility of each servicer to make its own determination as to whether to require Item 1122 reports from third parties, based on a "facts and circumstances" analysis of each particular servicing arrangement.

In addition, the SEC declined to provide guidance on the meaning of "material" non-compliance. Regulation AB requires that any material non-compliance during the reporting period be disclosed on Form 10-K, and market participants have been struggling to establish an appropriate threshold for determining "materiality" in this context. As it did with the subcontractor issue, the SEC has chosen to have each market participant make its own independent judgment as to materiality, without additional guidance from the SEC.

The SEC's August 7 telephone interpretations incorporate the new comments within the set of interpretations originally posted by the SEC in December 2005. Although intended by the SEC as general guidance only, these additional published interpretations will be heavily relied upon by market participants as they seek to comply with the reporting requirements of Regulation AB. Despite their silence on certain issues, the SEC has provided additional helpful guidance on the issues addressed in these latest telephone interpretations.

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Dechert Launches European CMBS Book

In conjunction with Sweet & Maxwell (a division of the *Thomson Financial* group), Dechert will launch on November 8, 2006, the first European book dedicated to European CMBS entitled *Commercial Mortgage-Backed Securitisation: Developments in the European Market*. The launch will take place during the CMSA-Europe Conference 2006 (November 8–10, 2006), at the Hotel Cavalieri in Rome.

The book's editor, Andrew V. Petersen of Dechert, has brought together a collection of leading structured finance lawyers at Dechert, investment bankers, industry specialists, and ratings agencies that have considerable experience in the securitization market in the U.K. and Europe and in work that covers the legal, investment, issuer, arranger, trade association, servicer, and ratings agency perspectives to offer real insight into current practice.

The book examines the CMBS process from start to finish, starting with the emergence of the asset, its economic environment and marketplace, via the ratings process, and the structuring of major deals, including the use of technological innovations and credit enhancement products such as synthetic swaps and property derivatives, moving onto origination, structuring, and issuance of CMBS deals. Following that, there is detailed coverage of subordinated debt structures, intercreditor agreements, servicing, CRE CDOs, and the European laws on market abuse and investor reporting. Analysis of the current European CMBS market follows, with an in-depth examination of the pan-European CMBS markets, including Germany, France, Spain, Italy and Portugal, from leading structured finance lawyers within those jurisdictions. Finally, new innovations and potential developments are covered in the role of CMBS in Islamic finance, title insurance, and more.

This book will prove an essential guide to all participants in the CMBS industry. If you would like additional information on this publication, please contact Andrew V. Petersen at +44 20 7184 7390 or andrew.petersen@dechert.com.

Pension Protection Act Provides New Definition of Plan Assets

By **Susan M. Camillo**

On August 17, 2006, President Bush signed the Pension Protection Act of 2006 (the "Act"). In addition to much publicized changes in the funding and tax law requirements for employee benefit plans, the Act also contains a favorable new definition of "plan assets" that will provide greater flexibility to issuers of asset-backed securities ("ABS") that are, or may be considered, equity interests for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). This new definition of plan assets became effective for transactions on or after August 18, 2006.

U.S. retirement plans subject to ERISA or Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code") (collectively, "ERISA Plans") are a significant source of investment capital. The fiduciary duty provisions of ERISA, and the prohibited transaction provisions contained in ERISA and Section 4975 of the Code, apply when assets of an ERISA Plan are invested in any asset, including ABS. The U.S. Department of Labor has issued a number of prohibited transaction exemptions that might apply to facilitate an ERISA Plan's acquisition of ABS, including the so-called "underwriter's exemptions" and "investor-based exemptions" (e.g., the QPAM exemption, the INHAM exemption, and exemptions for insurance company general accounts, insurance company separate accounts, and bank collective funds).

However, when an ABS is not debt for ERISA purposes, and the issuer of an ABS is not covered by an underwriter's exemption or by the exemption for mortgage pool investment trusts (PTE 83-1) (such ABS, "ERISA-restricted ABS"), it is possible that the issuer's underlying assets could be deemed to include ERISA Plan assets under ERISA and applicable regulations (the "plan asset rule") if ERISA Plans are permitted to invest in such ABS. If this were to occur, the panoply of ERISA rules would apply to the issuer and the management of its portfolio assets. One way to avoid this result under the plan asset rule is to limit participation by "benefit plan investors" in *each* class of equity interests in the issuer to less than 25% (the "25% test").

Until enactment of the Act, the term "benefit plan investor" was defined broadly to include not only ERISA Plans, but also other plans such as non-U.S. plans and governmental plans. The Act significantly modifies the definition

of "benefit plan investor" to include only an employee benefit plan that is subject to the fiduciary responsibility provisions of Title I of ERISA, a plan to which Code section 4975 applies (this includes IRAs), and any entity whose underlying assets include plan assets by reason of such a plan's investment in such entity. Thus, the definition no longer includes governmental and non-U.S. benefit plans.

Further, the Act provides that an entity (such as a hedge fund or other investment fund, which might be an ABS investor) will be considered to hold plan assets "only to the extent" of the percentage of the equity interests in the entity held by benefit plan investors. Formerly, if an entity became a plan assets fund, 100% of its assets counted as plan assets when it invested in another fund (such as an ABS issuer) for purposes of the plan asset rule 25% test.

These changes are favorable for ABS issuers for several reasons. Issuers now have access to a greater number of plan investors. They now will be able to place ERISA-restricted ABS with governmental and non-U.S. benefit plans without limitation, and will not run the risk that their assets will be deemed to be plan assets for purposes of ERISA. In fact, such non-ERISA Plan investors will be treated the same for the 25% test as other non-plan investors in the sense that they will be added to the denominator (but not the numerator), thus increasing the amount of "benefit plan investor" assets that can be accepted by an ABS issuer without breaching the 25% limit.

Also, it is now easier for an issuer of ERISA-restricted ABS to take advantage of the 25% test. Formerly, an issuer of ERISA-restricted ABS could market the ABS freely to non-U.S. and governmental plans, but then would have to prohibit any ERISA Plan or ERISA plan asset fund from investing in the ABS. Another alternative was for such an issuer to prohibit non-U.S. plans from investing in the ABS (relying on deemed representations, since non-U.S. markets generally are paperless electronic markets), and permit ERISA Plans to invest; this requires issuing physical certificates to the ERISA Plans to enable the issuer to monitor for the 25% test. Another variation on this last scenario is to permit only insurance company general accounts to invest, giving a representation (or deemed representation if the ABS are not in physical form) that their benefit plan investor percentage would always remain below 25%.

Under the new rule, an issuer still may prefer to prohibit benefit plan investors (as more narrowly defined) from acquiring ERISA-restricted ABS. Now, however, it is easier to apply the 25% test. An issuer of ERISA-restricted ABS would only have to issue physical certificates to, and track the ownership of interests by, ERISA Plans and ERISA plan asset funds to be able to monitor the percentage of each class of ERISA-restricted ABS owned by benefit plan investors, and to prevent such investors from acquiring 25% or more of any class of such ABS. Further, it is possible that only a portion of the investment by ERISA plan asset funds will be benefit plan investor assets.

Issuers likely will have to revise their disclosure and other documents (including representations and legends) to reflect these changes in the law.

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B Note Purchases


By **David M. Linder** and **Hilary M. Roxburgh**

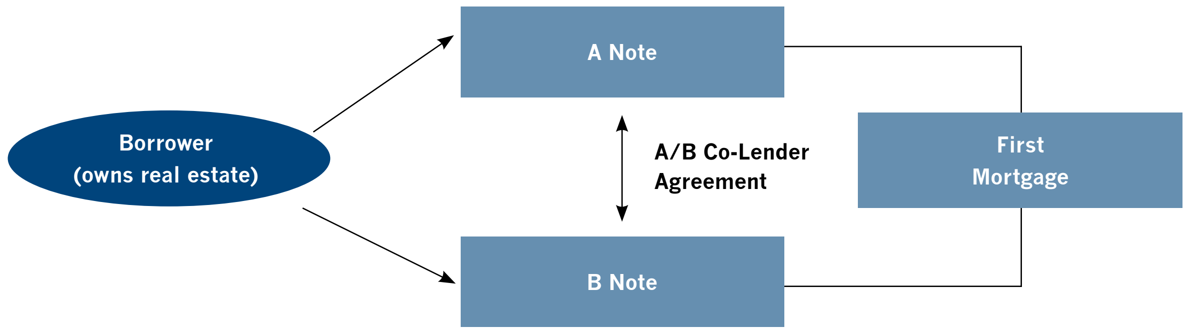
Over the past several years, the A/B loan structure has become prevalent in the CMBS market in connection with large commercial mortgage loan originations. This article summarizes the major features of the A/B loan structure in CMBS transactions, and addresses several issues that may be important to B note buyers when negotiating a B note purchase. While many variations of the A/B loan structure exist, and the structure is also used in non-CMBS transactions, this article only addresses the A/B loan structure in the CMBS context.

Major Features of the A/B Loan Structure Used in CMBS Large Loan Originations

The figure on page 7 (Figure 1) presents the general A/B loan structure used in large commercial mortgage loan originations in the CMBS market.

The A/B Loan Structure. As set forth in Figure 1, an A/B loan is evidenced by two promissory notes: an A note and a B note. Both of these notes are secured by the same first mortgage on the underlying commercial real estate, and each of these notes evidences the same commercial mortgage loan to the underlying borrower. The A note is generally senior to the B note and is intended to be deposited into a CMBS securitization. The B note is

Figure 1. General A/B Loan Structure



generally subordinated to the A note and is intended to be sold to a third party.

The A/B Co-Lender Agreement. In connection with an A/B loan, the A note holder and B note holder enter into an A/B co-lender agreement which provides for the relative rights and obligations of the two note holders.

This agreement generally:

- Addresses how payments are allocated between the A note and B note
- Provides the B note holder with consent rights over certain major decisions when the B note holder has a significant economic stake in the deal
- Gives the B note holder a purchase option on the A note under certain circumstances
- Gives the B note holder the right to cure certain events of default on the A/B loan under certain circumstances
- Places transfer restrictions on the B note
- Addresses many other issues between the A note holder and B note holder

Servicing. The A note holder usually engages a commercial mortgage loan servicer to service the entire A/B loan in accordance with a servicing standard, and without regard to various conflicts that the A note holder or servicer may have. This servicing standard, among other things, requires the A note holder, or the related servicer, to service the A/B loan on behalf of both note holders, as a collective whole, taking into account that the B note is subordinate. After the A note is securitized, servicing is generally governed by the pooling and servicing agreement for the A note securitization.

Issues that May Be Important to B Note Buyers

There are many things to consider when purchasing a B note. Some of the more important things to consider are addressed below.

Payments on the Notes. Payments made by the borrower on the A/B loan usually flow through one of two, separate payment waterfalls set forth in the A/B co-lender agreement. The first payment waterfall applies prior to certain specified events of default on the underlying A/B loan. In this waterfall, the A and B note holders are both generally paid at their respective interest rates and in accordance with their percentage interests, although the A note holder receives its interest and principal entitlements before the B note holder receives its principal and interest entitlements. The second payment waterfall applies after certain specified events of default on the underlying commercial mortgage loan. In this waterfall, the A note holder is generally paid in full before the B note holder receives any further payments. In both waterfalls, the servicers and other parties to the A note securitization are typically paid off the top before any payments are made to either note holder.

Some things a B note purchaser might want to consider about the payment waterfalls are:

- Have the defaults that trigger a change in the payment waterfalls been limited to a subset of material events of default, such as defaults that cause the loan to be serviced by a special servicer?
- Do the payment waterfalls switch even if the B note holder's cure period with respect to the underlying event of default has not expired?

- Has the compensation payable to the servicers and other parties to the A note securitization been limited in the A/B co-lender agreement since they are paid off the top?
- Is the trustee's fee in the A note securitization payable only out of payments allocated to the A note holder?
- Have any payments by the borrower (such as exit fees) been excluded from the payment waterfall and retained by the A note holder?
- Are default interest, late charges, prepayment fees, and similar amounts paid *pari passu* or sequentially to the A note holder and B note holder?
- Where in the payment waterfalls does the B note holder get reimbursed for any cure payments it has made to the A note holder?
- Does the B note holder get reimbursed in the payment waterfalls for any realized losses allocated to the B note?

Major Decisions. The A note holder is generally responsible for servicing the A/B loan and dealing with all borrower requests in accordance with the servicing standard. The B note holder, however, is generally given consent rights over certain major decisions. These consent rights burn off, however, when a control appraisal event occurs. In addition, the servicer can usually override the B note holder's decision if the decision is inconsistent with the servicing standard or if immediate action is necessary. A control appraisal event generally occurs when the value of the B note has dropped to 25% or less of its original value.

Some things a B note purchaser might want to consider about major decisions and control appraisal events are:

- Is the list of major decisions that the B note holder has consent rights over comprehensive enough?
- Does the B note holder have consent rights or non-binding consultation rights?
- If the B note holder's consent is deemed given under any circumstance, has a reasonable procedure been established to obtain its consent?
- Can the B note holder appoint an operating advisor to represent it in connection with major decisions?
- Are the events which give rise to the A note holder's ability to order an appraisal that could result in a control appraisal event sufficiently limited?
- Can the B note holder delay the A note holder's right to order an appraisal if the related B note holder cure period has not expired?
- Does the B note holder have the right to challenge the A note holder's appraisal?
- Can the B note holder regain control if the appraised value of the underlying real estate increases, and is there a sufficient procedure for ordering appraisals after a control appraisal event?
- Can a control appraisal event occur prior to the securitization of the A note?
- When determining the value of the B note for appraisal purposes, is all collateral for the A/B loan (including escrows and reserves) considered?
- Can the B note holder post additional collateral (such as cash or a letter of credit) to avoid a control appraisal event, and if so, when can the A note holder access such collateral?
- Could ordinary amortization, in and of itself, result in the B note holder losing its consent rights over major decisions?

Purchase Option. The B note holder is usually given the right to purchase the A note (generally at par plus accrued interest and unreimbursed servicing expenses) while certain specified events of default on the A/B loan are continuing. Some things a B note purchaser might want to consider when assessing the purchase option provisions in the A/B co-lender agreement are:

- Has the purchase price been sufficiently limited (for example, does the price exclude default interest, late charges, yield maintenance, prepayment premiums, exit fees, liquidation fees to a special servicer, or regular interest on the A/B loan beyond the date of purchase)?
- If the B note holder has made cure payments to the A note holder, are those cure payments deducted from the purchase price?
- When does the B note holder's purchase option trigger (for example, is the trigger event sooner or later than the trigger event for the payment waterfalls)?
- Is the time period that the B note holder has to exercise the purchase option too limited?
- Does the B note holder purchase the A note free and clear of any participations and on a servicing released basis?
- Do any other parties to the transaction have purchase options on the A note, and if they do, is the B note holder's purchase option senior, and do the other purchase options terminate if the B note holder exercises its option?
- Does the B note holder have the purchase option after a control appraisal event?

Cure Rights. The B note holder is typically given the right to cure events of default on the A/B mortgage loan during specified time periods. Some things a B note purchaser might want to consider about its cure rights in the A/B co-lender agreement are:

- Does the B note holder have cure rights over all events of default, or just monetary events of default?
- For monetary defaults, is the amount of the cure payment sufficiently limited (for example, does the cure payment exclude default interest, late charges, yield maintenance, prepayment premiums, and exit fees)?
- Does the B note holder have sufficient time to cure monetary and non-monetary events of default?
- For a non-monetary event of default, is the B note holder given additional time to cure if the B note holder is diligently pursuing the cure?
- If the B note holder is curing or the cure period has not expired, do the payment waterfalls switch, can a control appraisal event occur, can the A/B loan be transferred to special servicing, and/or can the A/B loan be accelerated?
- Are the limits on the number of consecutive cures or the number of cures over the life of the A/B loan too restrictive?
- Does the B note holder have cure rights after a control appraisal event?

Transferability. The B note holder is typically given the right to transfer up to 49% of its interest in the B note without the A note holder's consent. For transfers of greater than a 49% interest, generally the B note holder must either transfer to a qualified transferee or obtain a no-downgrade letter from each rating agency that rated the A note securitization. Qualified transferees include entities that satisfy certain financial tests, certain securitization vehicles (including CDOs that satisfy certain requirements), and certain investment funds.

Some things a B note purchaser might want to consider about the transfer provisions in the A/B co-lender agreement are:

- Does the definition of "qualified transferee" properly accommodate the B note holder's contemplated exit strategy?
- If the B note holder is contemplating a CDO, does the qualified transferee definition work for the contemplated CDO structure, and is the B note in registered form for the CDO?
- If the B note holder is contemplating a sale to an investment fund, do the fund and the fund manager meet the tests in the A/B co-lender agreement, or do the fund or its manager need to be pre-approved?
- What notices and documents need to be signed in connection with a transfer, and does the overall procedure seem reasonable?
- Can either note holder transfer any interest in its note to the underlying borrower or its affiliates?
- Can the B note holder finance the B note on a warehouse line or a repurchase facility, and, if so, do the relevant provisions in the A/B co-lender agreement satisfy the B note holder's lender's requirements?

Servicing. The A note holder usually engages a commercial mortgage loan servicer to service the entire A/B loan. Some things a B note purchaser might want to consider about the servicing of the A/B loan are:

- Has the B note holder been given the right to appoint and replace the special servicer for the A/B loan prior to a control appraisal event?
- Does the A/B co-lender agreement have self-contained servicing provisions that work properly even if the A note is never securitized, such as servicing provisions that apply after a foreclosure?
- What information is the servicer required to provide to the B note holder, and is that information sufficient?
- Has the servicer agreed to reasonably cooperate with the B note holder in connection with a sale or financing of the B note?
- Has the B note holder been provided with a copy of the interim servicing agreement with any pre-securitization, interim servicer, and should the B note holder require a separate agreement with any such interim servicer?
- Does the B note holder have any approval rights over the pooling and servicing agreement for the A note securitization (the "PSA")?
- How are conflicts between the PSA and the A/B co-lender agreement resolved?
- Has the A note holder agreed that the PSA will not adversely affect the B note holder, and cannot be materially amended without the B note holder's consent?
- Has a model PSA been attached to the A/B co-lender agreement?
- Does the PSA contain servicing compensation consistent with any caps in the A/B co-lender agreement and consistent with the B note holder's expectations?
- Can or does the PSA change the date upon which the B note holder receives payments on the B note?

- Can or does the PSA provide any party with the right to retain default interest, late charges, prepayment premiums, or other amounts payable on the B note?
- Can or does the PSA contain any material definitions that differ from those negotiated in the A/B co-lender agreement (such as definitions relating to when a control appraisal event occurs and when the A/B loan goes to special servicing)?
- Can or does the PSA contain purchase options and cure rights that differ from the A/B co-lender agreement, and if so, how will those rights be reconciled?
- Can or does the PSA provide any party the right to buy the B note without the B note holder's consent?
- Can or does the PSA give the B note holder the right to purchase the A note at fair value under certain circumstances?
- Can or does the PSA require payments on the A/B loan to be made to a separate account and can amounts in such account be used for anything unrelated to the A/B loan?
- Will the servicer under the PSA be required to obtain the consent of anyone else with respect to major decisions other than the B note holder?

Other Considerations. Some other things a B note purchaser might want to consider prior to purchasing a B note are:

- Does the A/B co-lender agreement provide that it is non-recourse to the B note holder except for payments received in error, to the extent of future distributions to the B note holder from the payment waterfalls or for breaches of the agreement by the B note holder?
- Is the A note holder (or the servicer) responsible for all advances with respect to the A/B loan, or does the A/B co-lender agreement obligate the B note holder to make certain advances?
- Does the B note holder have the right to file documents in a bankruptcy of the underlying borrower if the A note holder or the relevant servicer fails to do so in violation of the servicing standard?
- If the B note holder is a venture capital operating company, has it been given sufficient rights to satisfy any related requirements?
- Has the effect on the B note holder of any REMIC taxes imposed on the A note securitization trust been limited?
- Is the A note holder providing the B note holder with sufficient representations and warranties in connection with the sale of the B note, and are those representations consistent with any subsequent representations the B note holder may need to give in any contemplated sale or financing of the B note?
- How will record title to the A/B loan be held?
- Has the B note holder received proper assignments with respect to its interest in the B note, and is the B note holder assuming any liabilities prior to the date it purchases the B note?

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Amendments to FASB Statement No. 140 Still in Process

By **Martin G. Gorham**

In August 2005, the Financial Accounting Standards Board (FASB) proposed amendments to FASB Statement No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* by issuing three exposure drafts:

- Accounting for Transfers of Financial Assets
- Accounting for Servicing of Financial Assets
- Accounting for Certain Hybrid Instruments

While FASB had intended to issue final statements with respect to the three exposure drafts concurrently, there were substantive issues in the *Transfers* exposure draft that were identified in comment letters that required redeliberations that made it unfeasible to issue a single statement in early 2006. Consequently, FASB decided to proceed with the issuance of final statements on *Servicing and Hybrid Instruments* as stand-alone documents.

In February 2006, FASB issued FASB Statement No. 155 *Accounting for Certain Hybrid Financial Instruments*, which amended FASB Statement No. 140 by eliminating the prohibition on a qualifying special-purpose entity (QSPE) from holding a derivative financial instrument pertaining to a beneficial interest other than another derivative financial instrument.

FASB Statement No. 156 *Accounting for Servicing of Financial Assets*, issued in March 2006, amended FASB

Statement No. 140 to, among other things, permit entities to choose to either subsequently measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur, or amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss, and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.

Amendments to FASB No. 140 proposed in the *Accounting for Transfers of Financial Assets* exposure draft are still under discussion. At the FASB meeting on July 26, 2006, FASB decided to:

- Proceed with redeliberations on the proposed guidance related to rollovers of beneficial interests
- Address issues pertaining to the permitted activities of a QSPE jointly by combining discussions and decisions related to the servicer discretion project (which previously had been a separate FASB project) with the transfers project
- Redeliberate the issues of initial measurement of interests that continue to be held by the transferor and passive derivative financial instruments held by a QSPE that pertain to a transferor's beneficial interests (reversing the previous decision made at the June 7, 2006, meeting to delete consideration of these issues)
- Defer making a decision regarding participating interests (paragraph 8(a)) and transferability requirements (paragraph 9(b)) until completion of redeliberations on the permitted activities of a QSPE and the effects of continuing involvements on isolation

Given the importance of accounting treatment in the securitization market, industry groups such as The Capital Consortium continue to work with FASB staff on the amendments to FASB Statement No. 140. For example, any changes in the servicer discretion interpretation that could result in commercial mortgage-backed securities trusts no longer qualifying for QSPE status would have a significant impact on the large U.S. CMBS market.

FASB will address issues related to permitted activities of a QSPE and isolation in the third and fourth quarters of 2006, and expects to issue a final Statement in the second quarter of 2007.

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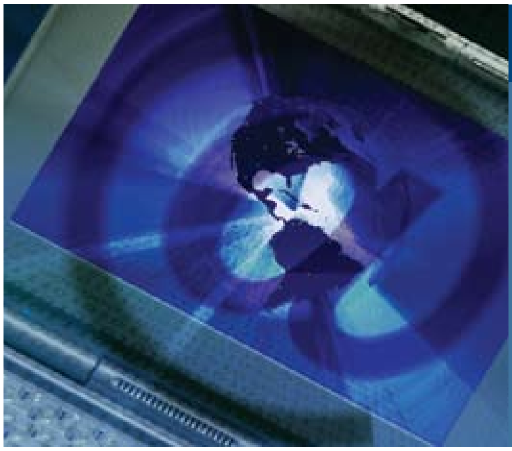

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