DechertOnPoint

Slicing and Dicing: A Primer on Selected Legal and Structuring Issues

by David W. Forti and William C. Stefko
Dechert LLP

CMBS World, Spring 2005

Published in Vol. 7, No. 1 of *CMBS World*, Spring 2005
Re-published with permission from Commercial Mortgage Securities Association, Inc.

Slicing and Dicing: A Primer on Selected Legal and Structuring Issues

David W. Forti and William C. Stefko

Forti

Stefko

Subordinate debt–be it in the form of second mortgage loans, junior interests in first mortgage loans, or mezzanine financing–has long been a feature on the landscape of "conventional" (i.e., non-capital markets) commercial real estate finance. Commercial mortgage loans with related subordinate debt (and, to a lesser degree, *pari passu* debt) have been included in commercial mortgage-backed securities transactions ("CMBS Securitizations") since the inception of the market. Recent years, however, have witnessed the proliferation of highly complex subordinate and *pari passu* debt structures tailored to comply with the requirements (legal, ratings and otherwise) applicable to CMBS Securitizations. As a consequence, whole commercial mortgage loans (particularly, large balance commercial mortgage loans) are being broken down into *pari passu* and senior-subordinate components–"sliced and diced"–in ever increasing frequency.

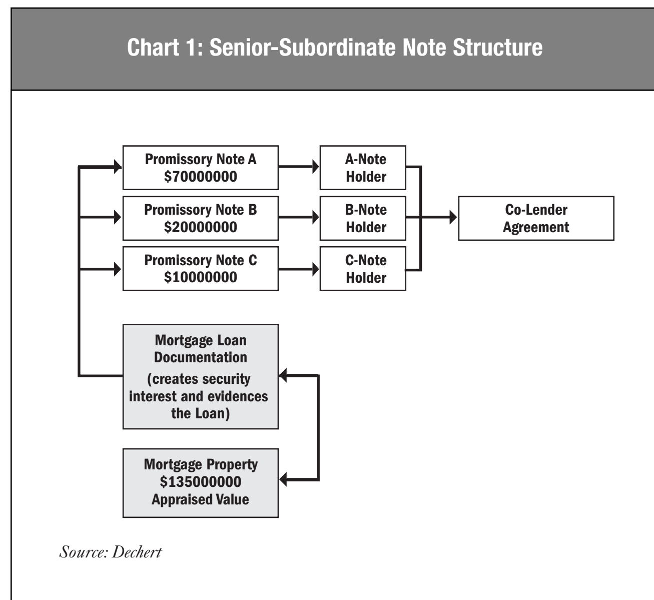
Indeed, it has become a rare exception for a CMBS Securitization not to contain multiple commercial mortgage loans that are structured with some form of *pari passu* or subordinate debt, be it *pari passu* notes, *pari passu* participation interests, subordinated notes, subordinated participation interests, "rake" securities, mezzanine financing, or preferred equity financing. In fact, many large commercial mortgage loans are structured with multiple separate *pari passu* and subordinate components. Recent transactions have, on a single financing, included multiple *pari passu* participations, several subordinate B-notes and up to five tiers of mezzanine debt. It is clear that "slicing and dicing" adds a significant level of intricacy to transactions in the real estate capital markets.

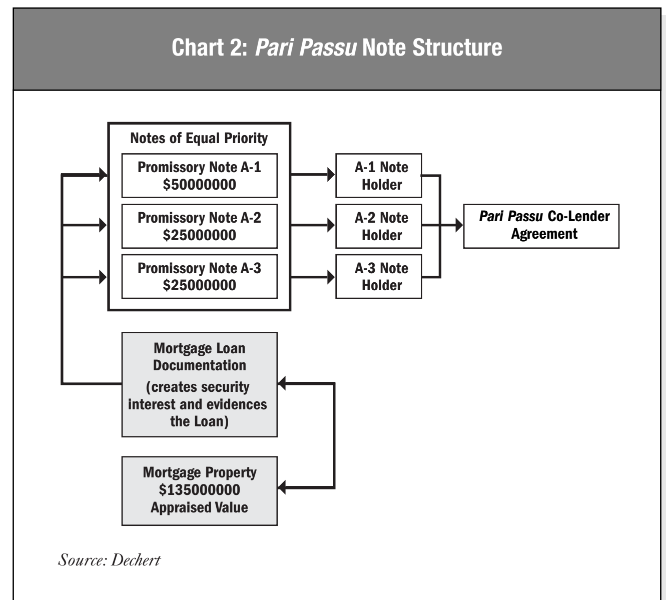
First we examine some of the driving forces that have come to shape this phenomenon in the real estate capital markets. We then present an overview of the types of senior-subordinate and *pari passu* debt structures employed in originating and structuring commercial mortgage loans destined for securitization ("Loans"), namely (1) senior-subordinate interests in Loans and (2) *pari passu* interests Loans, and the documentation governing these structures,[1] describing in general fashion the salient features of each.

Motives for Slicing and Dicing Commercial Mortgage Loans

Given the additional complexity caused by all of this slicing and dicing, it is appropriate to examine the motivations to incorporate subordinate and *pari passu* debt structures into CMBS Securitizations. One factor is the desire of borrowers to maximize leverage. Investors in CMBS Securitizations have widely varying risk tolerances. As such, lenders originating commercial mortgage loans were faced with having to devise a means of packaging the added leverage related to Loans destined for CMBS Securitizations in a way that would be palatable to investors across this risk-tolerance spectrum. Originating lenders soon discovered that splitting a Loan into multiple components enabled them to create a variety of debt instruments which would appeal to a broad array of investors, while meeting the demand of their borrowers for greater leverage. On a highly-leveraged property for instance, the related financing might be structured so that only an investment-grade portion of the debt is included in a CMBS Securitization with the remaining portion of the financing split into one or more subordinated classes, often tailored to meet the requirements of the anticipated purchaser (e.g., a certain investor's risk and return preference might cause such investor to prefer a slice of the debt that represents 65%-75% of the "all-in" leverage of the financing; other investors with more aggressive risk and return tolerances may prefer more deeply subordinated, higher-yielding components of the financing).

Even where borrower debt-maximization is not a driving factor, investor disfavor of concentration risk (significantly heightened after the events of September





11), and the desire for more diversified portfolios of Loans being included in CMBS Securitizations has lead to a decline in the number of stand-alone securitizations. Instead, large Loans which might otherwise have been included in stand-alone CMBS Securitizations are more typically being split on a *pari passu* basis with the various *pari passu* components being included in multiple CMBS Securitizations, in an effort to reduce the concentration of any single loan in a given pool.

Yet another reason for the slicing and dicing of Loans is the marked increase in the number of players in the real estate capital markets that desire to purchase higher-yielding, subordinate debt. As subordinate debt instruments have become more commonplace, a number of financing and warehousing sources have developed. One rapidly-evolving financing and exit strategy for the holders of subordinate debt is the collateralized debt obligation (CDO) market.[2] Using CDOs, subordinate debt investors can move their debt instruments off balance sheet, or take arbitrage profit from favorable interest rate movements. Indeed, in the last few years, the appetite for CDOs which are backed in whole, or in part, by whole commercial mortgage loans, subordinated notes, subordinated participation interests and mezzanine financing has been robust. This growth seems to have, in turn, fueled the desire for the players in the subordinated debt markets to acquire appropriate and sufficient collateral for inclusion into these vehicles, which has spurred increased competition for these subordinate debt pieces.

Overview of Senior-Subordinate Debt Structures

In a senior-subordinate loan structure (sometimes called an A/B loan structure), a Loan is split into one or more senior components, and one or more subordinate components, each of which is secured by the same mortgage lien on the property or properties which secures the Loan. In senior-subordinate loan structures where multiple senior interests are created, the senior interests are typically structured as *pari passu* components in the Loan in the manner discussed below.

There may be more than one subordinate component. Where there are multiple subordinate interests created in the Loan, such interests may either be *pari passu*, or, as is more commonly encountered, structured in multiple subordinate tranches. In the example illustrated in Chart 1, a $100,000,000 commercial mortgage loan has been split into (1) a $70,000,000 A-note; (2) a $20,000,000 B-note, which is subordinate to the A-note; and (3) a $10,000,000 C-note, which is subordinate to both the A-note and the B-note.[3]

The Co-Lender Agreement

The holders of each component of the Loan in a senior-subordinate loan structure will typically enter into a co-lender or intercreditor agreement (a "Co-Lender Agreement") which sets forth the relative rights and obligations of the holders of the senior components in respect of the Loan *vis-à-vis* the holders of the subordinate components in the Loan. Unlike the co-lender and intercreditor agreements in a *pari passu* loan structure where there is relative parity among holders of the components, there is a fundamental tension in a Co-Lender Agreement—namely, the senior component holder's need to preserve the relative seniority of its position, and the subordinate component holder's need for tools which it may use to protect and preserve its subordinate investment in the Loan. Co-Lender Agreements typically establish (among other things) the relative priority of distribution of amounts received in

respect of the Loan among the holders of the components and the allocation of losses and expenses realized in connection with the Loan among the holders of the components; the ground rules for the servicing and administration of the Loan (including the rights of the holders of the subordinate components to appoint the special servicer for the Loan, and to consent to and/or be consulted on, various servicing matters); the conditions for transfer by the holders of the components of all or a portion of their interest in such components; and certain protective rights, which may be exercised by the holders of the subordinate components, which frequently include an option to purchase at par the components in the Loan which are more senior to such subordinate component, and certain rights granted to the holders of the subordinate components to cure both monetary and certain non-monetary defaults in respect of the Loan.

Payment Priorities and Allocation of Losses

The Co-Lender Agreement provides for the relative payment priorities among the holders of the senior and subordinate components in the Loan. Collections on the Loan are usually first applied to the payment of administrative expenses, then due in connection with the Loan (e.g., servicing and trustee fees). The order and priority of distribution of the remaining collections on the Loan most typically depend upon whether certain "trigger events" then prevail. While these triggering events vary from transaction to transaction, in general, at any time when no monetary event of default or material non-monetary event of default is continuing in respect of the Loan, the holders of the senior components and subordinate components will generally receive their full proportionate share of interest, principal and other amounts payable in respect of the Loan concurrently. During the continuance of a monetary event of default or material non-monetary default in respect of the Loan, however, the payments in respect of the components are made sequentially in order of seniority, with the holders of the most senior components generally receiving payments of all amounts received on the Loan until the most senior component is paid in full, and following such payment in full, to the holders of the next most senior component until paid in full, and so on. Since the subordinate components in the Loan provide credit enhancement for the more senior components in the Loan, the Co-Lender Agreement will generally provide that any realized losses, and costs and expenses (e.g., servicing fees, additional trust fund expenses in a securitization) in respect of the Loan, including losses due to the modification of the Loan in connection with a work-out of the Loan, will be borne first and fully by the most subordinate component of the Loan, then to the next most subordinate component in a like manner, and so on. In addition, all fees that might be payable to the special servicer in the event the default in respect of the Loan is cured (e.g., work-out fees) will thereafter typically be allocated first to the most

> **"The Co-Lender Agreement provides for the relative payment priorities among the holders of the senior and subordinate components in the Loan."**

subordinate component in the Loan, unless the borrower under the mortgage loan documentation is required to pay these fees.

A discussion of loss allocation to subordinate components in the Loan would not be complete without a word on interest rate "creep." In some senior-subordinate arrangements, the holders of the subordinate components may suffer shortfalls in interest payments on their component due to the phenomenon known in industry jargon as "rate creep." One example of how rate creep may arise in a senior-subordinate structure occurs where, following an event of default which triggers the post-event of default distribution priorities described above, the most senior component is hyperamortized for a period of time, and following the cure of the event that triggered the post-event of default payment priorities, the conditions giving rise to the pre-event of default payment priorities described above again prevail. For example, assume a $100,000,000 Loan is evidenced by a single promissory note requiring the borrower to make payments of interest at 8.00% per annum, and such Loan is split into an $80,000,000 senior participation interest with a stated interest rate of 6.50% per annum and a $20,000,000 subordinate participation interest with a stated interest rate of 14.00% per annum[4]. If an event occurs which would, pursuant to the Co-Lender Agreement, trigger the post-event of default payment priority causing the senior participation interest to be hyperamortized in the aggregate amount of $2,000,000, and subsequently, the events giving rise to the post-event of default payment priority are corrected, the borrower (under its promissory note) would thereafter be obligated to make payments on $98,000,000 at 8.00%, but the weighted average interest rate on the now $78,000,000 senior component and the $20,000,000 subordinate component would "creep" up to 8.03% per annum.

The obvious result is that the amount of interest proceeds required to be paid in by the borrower would, for each payment period thereafter, be 0.03% short of the amount needed to pay current interest on the Loan components. This shortfall would typically be borne by the subordinate components.

Servicing and Administration of the Loan

Most Co-Lender Agreements provide that the holder of the most senior component will act as "lead lender" with respect to the administration and servicing of the Loan, and in the usual course of events, the holder of the most senior component will sell such component into a CMBS

Securitization. Prior to inclusion of the Loan into a CMBS Securitization, the Loan will typically be serviced pursuant to an interim servicing arrangement. Transactions vary widely in respect of interim servicing of the Loan. Some participants have standing interim servicing arrangements with third-party servicers. Others will negotiate *ad hoc* interim servicing agreements with the holders of the other components in the Loan.

Since the potential impact of decisions made in servicing the Loan is great, the subordinate component holders will often negotiate the parameters which govern the form and substance of the servicing arrangements for the Loan post-securitization. While approaches vary, some Co-Lender Agreements attach a form pooling and servicing agreement (PSA) and limit deviations from that form to items that do not have a material and adverse impact on the rights of the holder of the subordinate component.[5] Other Co-Lender Agreements do not attach a specific form, but instead will permit the holder of the senior component to enter into successor servicing arrangements for the Loan provided there is no material adverse effect on the rights and obligations of the holder of the subordinate component. Remedies of the subordinate component holder for a breach of these provisions vary as well, ranging from the right of the subordinate component holder to put the subordinate component back to the holder of the senior component, to money damages.

"The related subordinate components of the Loan are typically not included in the CMBS securitization into which the senior components are sold."

Once sold into the securitization, the servicing and administration of the whole Loan will, in many cases, be performed by the servicers retained by the holder of the senior component in connection with the inclusion of the senior component in the CMBS Securitization trust. The bundle of servicing rights usually includes (among other things) the power to provide for the day-to-day administration of the Loan, to transact with the borrower under the Loan, and to act for and on behalf of the senior component holder and the subordinate component holder in the event of a bankruptcy proceeding involving the related borrower, subject in many cases to the consent and consultation rights granted to the holders of the subordinate components (as described below).

The related subordinate components of the Loan are typically not included in the CMBS Securitization into which the senior component is sold.[6] Instead, the subordinate components will continue to be held outside of the CMBS Securitization trust. Nonetheless, the whole Loan (including the subordinate components) will be serviced by the servicers for the related CMBS Securitization for the benefit of the holders of the senior components and the holders of the subordinate components, as a collective whole. Counterbalancing the rights of the senior component holder to appoint the master servicer for the Loan, the most subordinate component holder is sometimes granted the right (subject to certain conditions described below) to terminate any existing special servicer for the Loan, and appoint a new special servicer for the Loan. It is important to note that the subordinate component holder's right to replace the special servicer extends only to the particular Loan in which it holds a subordinate component, and does not permit the subordinate component holder to terminate the special servicer for other commercial mortgage loans included in the CMBS Securitization containing the senior component in the Loan.[7]

In addition (and while generally the subject of negotiation between the senior component holder and the subordinate component holder), major servicing decisions and certain other actions proposed to be taken with respect to the Loan (e.g., changes in the monetary terms of the Loan, approval of waiver of due-on-encumbrance and due-on-sale clauses, actions to bring the mortgage property in compliance with environmental laws, sales of the Loan when it is a defaulted mortgage loan, and certain other fundamental items) are generally subject to the consent and/or consultation rights of the holders of the most subordinate component. As a check on the ability of the subordinate component holders to thwart action in respect of the Loan which might benefit the holders of the Loan as a collective whole (but which might not result in the most favorable outcome for the subordinate component holder) the consent rights of the subordinate holder may be overridden by the servicer, if the servicer determines following the course of action proposed by the subordinate holder would otherwise violate the servicing standards set forth in the related CMBS Securitization PSA.

As further protection against a tyranny of the minority, the subordinate holder may only exercise such consent rights and may only appoint a special servicer for the Loan when it has enough "skin in the game"—which is usually measured by a form of "control appraisal test." While Co-Lender Agreements may vary on the formulation of the control appraisal test, most provide that a subordinate component holder is divested of its consent rights and the ability to appoint a special servicer where (1) the initial principal balance of the most subordinate component less any principal payments received on that component, any appraisal reductions and realized losses allocated to such component, is less than (2) a certain percentage (typically, 25%) of (a) the initial principal balance of such component less (b) principal payments received on such component. On and after the date that the control appraisal test would

apply to the most subordinate component holder, the next most subordinate component holder would succeed to such rights. There are several measures of protection that subordinate component holders typically attempt to negotiate into the Co-Lender Agreement which are designed to forestall or mitigate the effects of the control appraisal test being triggered (and the loss of control rights attendant thereto). One such measure is the right of the subordinate component holder to deliver a "challenging" appraisal to the servicer charged with computing the appraisal reduction amounts under the CMBS Securitization PSA—if the servicer determines in accordance with the servicing standard that the subordinate component holder's appraisal is a more accurate barometer of mortgaged property value than appraisals obtained by the servicer, the appraisal reduction amount based on the challenging appraisal may be reduced, and consequently, the applicability of the control appraisal test averted. Another measure sometimes negotiated by the holders of the components in the Co-Lender Agreement would permit the subordinate component holder to post highly-liquid collateral (e.g., cash or a letter of credit from highly-rated providers) with the senior component holder, that when added to the outstanding principal balance of the subordinate component will meet or exceed the thresholds set out in the control appraisal test.

Transfers of Interests in Loan Components

The Co-Lender Agreement will typically provide that while holders of the senior component are generally free to transfer all or a portion of their interests in their senior component, the holders of a subordinate component in the Loan may not transfer all or more than a certain specified percentage (usually greater than 49%) of their respective interests in such component except to certain classes of large financial institutions or their closely-held affiliates (known as "qualified transferees"[8]) or, if the senior component of the Loan has been included in a CMBS Securitization, the holder of the senior component receives written confirmation from each rating agency which rates any securities issued pursuant to the CMBS Securitization, that such transfer will not result in the downgrade, qualification or withdrawal of the ratings assigned to such securities. Many Co-Lender Agreements do, however, provide that the holders of the related subordinate components may pledge their interests in the Loan as collateral (e.g., in connection with a warehouse financing of such interest), provided certain conditions are satisfied. In general, no holder of a component in the Loan may transfer its interest in the component to the borrower under the Loan or any affiliate of such borrower.[9]

Purchase Option and Cure Rights

Other protective measures which holders of the subordinate components in the Loan will typically negotiate into Co-Lender Agreements include (1) the right to purchase each of the more senior components in the Loan (generally, following an event of default in respect of the Loan) in order to gain sole control of the Loan and the work-out and foreclosure process, and (2) cure rights in respect of certain borrower defaults under the Loan.

In general, the most subordinate component holder would be granted priority rights in exercising the purchase option, and would be required to purchase each component which is senior to it at par (i.e., a price equal to the aggregate outstanding principal amount of each more senior component outstanding, plus accrued and unpaid interest thereon and all other amounts then due and payable in respect of the Loan, including any advances made in respect of the Loan and interest on such advances). The holders of the components will typically negotiate whether or not the purchase price to be paid by the subordinate component holder will include prepayment premiums and yield maintenance charges. Especially in larger Loans, senior component holders will attempt to include these amounts in the purchase price for the defaulted Loan as a means of protecting the yield to the holders of interest only strips in the CMBS Securitization, who sometimes are compensated for loss yield with prepayment premiums. Subordinate holder purchase options are typically triggered by a monetary default (which remains uncured for a given period of time) or a material non-monetary default under the Loan. Some Co-Lender Agreements also provide that the purchase option may be triggered immediately prior to the subordinate component holder losing its control rights as a result of the applicability of the control appraisal test.

Cure rights are also usually available to the holders of the subordinate component in the Loan. In general, subordinate component holders are given a few business days to cure monetary defaults and time frames which generally mirror borrower cure periods for non-monetary defaults. Most Co-Lender Agreements include a limit on the number of consecutive months that a subordinate component holder may avail itself of its right to cure, as well as a limit on the number of cure events that may occur over the life of the Loan.

Overview of *Pari Passu* Debt Structures

A *pari passu* or "A/A" loan structure involving a Loan is not unlike a "traditional" syndicated loan in which several lenders each own a proportionate share of a commercial mortgage loan. In a typical *pari passu* structure, a Loan is split into two or more components each having equal priority, and each of which is secured by the same mortgage lien on the property or properties which secure the Loan. In the example illustrated in Chart 2, a $100,000,000 commercial mortgage loan has been split into three *pari passu* components: (1) a

$50,000,000 A-1 note, (2) a $25,000,000 A-2 note, and (3) a $25,000,000 A-3 note, each of equal priority.[10]

Once the Loan is split into its constituent parts, the holders of the various components typically enter into a co-lender agreement, or intercreditor agreement (a "*Pari Passu* Co-Lender Agreement"), which sets forth the relative rights and obligations of the holders of the components in respect of the Loan.

In general, the *Pari Passu* Co-Lender Agreement will provide that each component of the Loan (1) receives its proportionate share of interest, principal and other amounts payable in respect of the Loan at the same as each of the other components in such Loan (both prior to and following an event of default under the Loan), and (2) is allocated its proportionate share of any losses, costs or expenses realized in respect of the Loan.

In some cases the *Pari Passu* Co-Lender Agreement will require that major actions with respect to the Loan be subject to the consent and/or consultation rights of all or some specified portion of the holders of each component, with voting rights in proportion to the interest in the Loan represented by such component. In other cases, the rights to administer the Loan and make routine decisions reside in the holder of the component of the loan designated as "lead lender," subject to overriding consent and/or consultation rights with respect to major actions granted to the holders of the components of the Loan who are "non-lead lenders." Historically, the lead lender in a *pari passu* structure exercised control subject to very limited consultation rights. The thinking at the was that since each interest was of equal priority, and further, since the *pari passu* structure lacked the fundamental tension inherent in senior-subordinate debt structures, the motivation and interests of the lead lender in exercising its control rights should more or less be aligned with the interests of each other *pari passu* component holder. This approach is evolving, and becoming the focus of increased negotiation. The ability to appoint the special servicer is an especially hot topic and CMBS Securitizations vary greatly in this regard. Some transactions permit the holders of the *pari passu* components to replace the initially-appointed special servicer only for cause; other transactions allow a majority (or supermajority) of the holders of the *pari passu* components to replace the special servicer at any and for any reason. Indeed, there is some discussion in the industry about creating a type of "first-loss" piece out of the aggregate *pari passu* components of the Loan, and to provide the holder of such first-loss piece in the *pari passu* structure with most of the control rights typically afforded the lead lender.

Similar to restrictions found in the Co-Lender Agreements for senior-subordinate loan structures, the *Pari Passu* Co-Lender Agreements will typically provide for constraints on the ability of any holder of a component in the Loan to transfer all or more than a certain specified percentage (usually 49%) of its interest in such component except to certain classes of qualified transferees[11].

> **"Cure rights are also usually available to the holders of the subordinate component in the Loan."**

Many of the issues which are frequently encountered in the context of *pari passu* loan structures arise from the complexities that this structure introduces to the CMBS structure. In particular, servicing of the Loan and principal and interest advancing in respect of the Loan become more complicated.

Using the sample structure in Chart 2, the A-1 component would most likely be the first of the components of the Loan included in a CMBS Securitization, followed by the A-2 and A-3 component in succession. The whole Loan would most commonly be serviced by the master servicer and special servicer for the CMBS Securitization of the A-1 component (i.e., each of the other components, though not included in the CMBS Securitization of the A-1 component, would nonetheless be serviced by the master servicer and special servicer for the CMBS Securitization in which the A-1 component has been included), and the servicing activities of the servicers retained in connection with the CMBS Securitization of the A-2 and A-3 components with respect to the Loan would generally be limited to making payments and passing along reports.

Where the *pari passu* structure is employed, advancing on all or portions of the Loan across several CMBS Securitizations is also impacted. For instance, servicing advances in respect of the whole Loan would be made by the master servicer (or special servicer or trustee, if applicable) for the CMBS Securitization in which the A-1 component of the Loan is included. In contrast, principal and interest advancing in respect of each component of the Loan would most typically be retained by the applicable master servicer for the CMBS Securitization in which such component resides (in the above example, the master servicer for the CMBS Securitization including the A-1 component would make principal and interest advances solely with respect to the A-1 component, the master servicer for the CMBS Securitization including the A-2 component would make principal and interest advances solely with respect to the A-2 component, and so on). Determinations of non-recoverability in respect of servicing advances would, in our example, be made by the servicer for the CMBS Securitization which includes the A-1 component. With respect to non-recoverability determinations involving outstanding principal and interest advances, however, in the most common formulation, if any one of the servicers for any CMBS Securitization in which any one of the components of the Loan is contained makes a non-recoverability determination, each other servicer

making principal and interest advances in respect of the other components of the Loan is generally bound by such determination. Recovery of non-recoverable servicing advances is also made more complicated, in some cases, requiring the reimbursement of advances to be made across CMBS Securitization pools.

Pari passu notes included in multiple CMBS Securitizations also create certain rating agency issues, since not all of the rating agencies typically assign ratings to all of the CMBS Securitizations in which each *pari passu* component is included. For instance, with respect to a large Loan having two *pari passu* components, one of the major rating agencies may not rate the CMBS Securitization which includes the first component to be sold (and which typically controls the servicing of the remaining components of the Loan), but such rating agency may rate the CMBS Securitization which includes the second component. In this circumstance, the rating agency will not have had the opportunity to ensure that the servicing of the Loan complies with such rating agency's criteria, and that other issues important to such rating agency (and which may impact its rating of the second CMBS Securitization) and protective of investor interests may not have been adequately addressed in the documentation for the initial CMBS Securitization which controls servicing of the whole Loan (e.g., does the initial CMBS Securitization documentation contain rating agency "no downgrade" provisions over actions that such rating agency would typically require in rating the transaction?). In order to address this situation, many *Pari Passu* Co-Lender Agreements (as well as the related lead-securitization documentation) provide for rating agency confirmation over the initial CMBS Securitization documentation and that rating agency provisions contained in the initial CMBS Securitization documentation are applicable to any rating agency which may rate any other *pari passu* component of the Loan included in future CMBS Securitizations.

A Word on the Mechanics of Participation Interests and Separate Notes

Mechanically, the slicing and dicing of Loans occurs in two main ways. If the originating lender is aware of the appropriate "splits," the Loan may be structured at closing with all of the various components in place. This does not occur very often as it would require the originating lender to know at the of the closing of the Loan the most likely exit strategy and sizing for each component of the Loan. The more usual method involves a post-closing slicing of the Loan. Loan documentation typically provides the originating lender broad rights to accomplish post-closing Loan splits, provided that the aggregate financial terms to the borrower are not altered when the Loan is split into its constituent components. Many originating lenders also reserve the right to split the Loan into multiple senior-

(continued on p. 68)

"Given the chance, we strongly prefer to do business with a servicer like Prudential.

They have the nicest, most knowledgeable people in the business. Our servicing representative is fantastic—very responsive and timely in getting back to us with information."

Andrew Juster, Treasurer, Simon Property Group, Indianapolis, Indiana

A Superior Borrowing and Servicing Experience

Capital Markets Lending
Life Company/Portfolio Lending
Fannie Mae and FHA-Insured Loans
Structured Financing
Mezzanine Lending
Interim/Bridge Lending
Affordable-Housing Loans
Forward Commitments

Flexible servicing for your loan. Here's a pleasing pledge from Prudential Mortgage Capital Company: prompt, personal attention from our very own servicing subsidiary, Prudential Asset Resources. No hassles, paper chases or unreturned phone calls. Just a single point of contact and a staff well-versed in a broad range of loan types from all capital sources. Our experienced management team is always working on your side, quickly addressing any concerns and customizing solutions to tailor-fit your specific needs.

Join our roster of satisfied clients. Contact Prudential Mortgage Capital for more information on our loan origination and servicing capabilities:

1-888-263-6800 prudential.com/mortgagecapital

Prudential Financial

subordinate components or to create a separate mezzanine loan post closing. In practice, many originating lenders will close the Loan with the most likely senior-subordinate debt structure in place, and reallocate amounts among the components as necessary—it is much easier to reallocate amounts between an existing first mortgage loan and mezzanine loan post-closing than it is to create a new mezzanine loan after the borrower has received the Loan proceeds. For the most part, borrower cooperation is required in post closing restructuring; participation interests (discussed below), however, do not generally require borrower cooperation and thus are favored by some originating lenders.

From a legal perspective, a participation interest and a promissory note are two very different legal interests. Generally speaking, however, there is significant overlap in the material terms of co-lender agreements for multiple promissory notes and participation agreements for multiple participation interests, and subordinate participants and subordinate noteholders are generally afforded identical rights (i.e., the priority of payment, servicing consent and consultation rights, cure rights, purchase options, etc., are generally consistent across debt structures which employ participation interest and those which employ separate promissory notes), and for this reason (as well as for ease of discussion), we did not differentiate between debt structures which employ participation interests, and those which employ separate notes in our discussion of subordinate and *pari passu* debt structures above.

Participation interests are generally easier to structure as borrower involvement is usually not necessary. Also, rating agencies rating CMBS Securitizations where one or more subordinate debt components exist tend to prefer the participation structure since the subordinate participants will have no direct, contractual privity with the borrower and various bankruptcy waivers and assignments of rights contained in participation agreements are more likely to be enforced. This absence of contractual privity makes a subordinate lender's bankruptcy of less concern with respect to loan enforcement issues during the subordinate participant's bankruptcy and makes it less likely that the subordinated participant will be able to interfere in a borrower bankruptcy. Additionally, certain investors prefer having a direct note from the borrower instead of a participation interest. The promissory note structure also avoids the complexity associated with the insolvency of the entity that granted the participation interest (this is typically not a significant concern when the senior participation is held by a securitization trust).

The manner in which the CMBS will be offered for sale may also be a factor in whether a separate note or participation debt structure is used. In public CMBS offerings, for example, current securities laws favor the use of separate promissory notes for *pari passu* components to be included in multiple CMBS Securitizations, while private CMBS securitizations of *pari passu* components generally employ a participation structure.

Conclusions

It is apparent that intensive Loan slicing ultimately creates a variety of interested parties (whose interests are often divergent) having a variety of consent and approval rights over both "routine" borrower actions such as alterations and lease approvals as well as more complex issues such as work-outs or material financial modifications. For instance, if a borrower seeks approval of a material lease at the mortgaged property, it is possible that all of the component holders will have some sort of a say. In a Loan with multiple *pari passu* notes, subordinate notes and mezzanine loans, it is easy to see how a once relatively easy process quickly becomes extremely complicated and convoluted, and will likely require more and effort to process, which inevitably leads to increased costs. While certain deemed consent rights are becoming much more commonplace in an effort to streamline this process, work-outs and liquidations are bound to be infinitely more complex, and the potential for large-scale conflict among the various interest holders, huge. In the end, only will tell what other impact further slicing and dicing will have on borrowers, originating lenders, CMBS executions, and commercial mortgage loan servicing in general. ❑

David W. Forti, Esq., is a Partner, and William C. Stefko, Esq., is a Senior Associate, in the Finance and Real Estate practice group at Dechert, LLP.

Copyright © 2005 Dechert LLP. All rights reserved. This article is for educational and illustrative purposes only and should not be construed as legal advice. Materials should not be considered as legal opinions on specific facts or as a substitute for legal counsel.

[1] *As the intended focus of this article is pari passu and senior-subordinate structures employed in structuring commercial mortgage loans, we have excluded from our discussion as beyond the scope of this article, both mezzanine financings and certain other commonly-encountered pari passu and subordinate debt devices which are typically created in the related PSAs or analogous documentation (e.g., "rake" bonds).*

[2] *Generally speaking, a CDO transaction involves an off-shore (usually Cayman Islands) or domestic special purpose entity issuing notes to investors which are collateralized by certain assets. CDO transactions vary greatly depending on the asset types to be included in the CDO, the motivation for the CDO transaction (e.g., arbitrage or balance sheet CDOs), and whether the CDO investors are looking through to the market value of the asset (a "market-value" CDO) or the future income stream to be generated by the assets (a "cash flow" CDO). Commercial real estate CDOs (RE CDOs) typically involve either a static pool of assets (with some period for a "ramp-up" of assets to be included in the CDO vehicle), or, unlike a REMIC for a CMBS Securitization, a pool of actively-managed assets (where trading of assets in and out of the pool over all or a*

(continued on p. 69)

portion of the term of the CDO may occur under certain circumstances). Assets included in RE CDOs may include (among other things) CMBS securities, REIT debt securities, other CDO securities and, more recently, whole commercial mortgage loans, B-notes, subordinate participation interests and mezzanine loans.

[3] *The related mortgage loan might also be "componentized" using a senior-subordinate participation structure, discussed under heading, "A Word on the Mechanics of Participation Interests and Separate Notes," p. 23."*

[4] *The weighted average interest rate of the $80,000,000 senior component at 6.50% per annum and the $20,000,000 subordinate component at 14.00% per annum is 8.00% per annum on the entire $100,000,000 participation, which is equal to the 8.00% per annum the borrower is required to pay under its $100,000,000 promissory note.*

[5] *In some Co-Lender Agreements, certain changes are expressly permitted to be made to the form PSA. These may include, for example, changes to comply with federal income tax and accounting rules and regulations, and changes which may be requested by the rating agencies which may rate the securities issued in connection with the CMBS Securitization in which such Loan is included.*

[6] *In some circumstances, one or more of the related subordinate components may be included in the CMBS Securitization trust.*

For instance, if the subordinate component in the Loan has been created prior to securitization, the subordinate component of the Loan (e.g., a B-note) may be sold to the CMBS Securitization trust together with the senior component (e.g., an A-note). In this variant (somes called a "B-note Rake"), the A-note would be "pooled" together with the other mortgage loans in the CMBS Securitization and payments and losses on the Loan allocable to the A-note would be allocated to the "pooled" certificates (i.e., those certificates which are backed by the general pool of mortgage loans, including the A-note) issued by the CMBS Securitization trust. The B-note would also be included as an asset of the CMBS Securitization trust, but payments and losses on the Loan allocable to the B-note would be allocated only to certain special classes of certificates (i.e., the "rake certificates") issued by the CMBS Securitization trust. The rake certificates would be generally subordinated to the pooled certificates, but would only be allocated losses with respect to the particular Loan generally in the manner described in this article. It should be noted that the post-event of default payment priorities applicable to this B-note may differ from those described herein—since these rake certificates are usually assigned a rating as to the ly receipt of interest by one or more of the rating agencies, the Co-Lender Agreement would likely provide that interest payments on the B-note would be kept current and have the benefit of interest advancing even after an event of default under the Loan (which, in turn, would usually have the effect of keeping interest on the rake certificates current).

In another example, if the subordinate component had not yet been created in the Loan, the whole Loan might be sold into the CMBS Securitization trust, with provisions included in the related PSA to "synthetically" create the senior-subordinate structure, even though there is only one promissory note and no Co-Lender Agreement in place. In this variant, the PSA would typically provide for the Loan to be componentized notionally (i.e., a senior "pooled" component in the Loan might be created, and a subordinate "non-pooled" component in the Loan created), including provisions which emulate some of the protective features granted to the subordinate component holders in a Co-Lender Agreement. The senior "pooled" component would support the "pooled" certificates issued by the CMBS Securitization, and the subordinate "non-pooled" component would support the classes of rake certificates. Generally speaking, losses in respect of the Loan would be applied first to the subordinate "non-pooled" component (and in turn, to the rake certificates in reverse sequential order), and following the reduction of the notional amount of the subordinate "non-pooled" component to zero, would be applied to the senior "pooled" component. The payment priorities would generally work in the manner described in the preceding example, with interest being kept current on the rake certificates even following an event of default under the Loan.

[7] *The right granted to the subordinate component holder to replace the special servicer for the particular Loan in which the subordinate component holder owns its interest somes leads to CMBS Securitizations which have more than one special servicer (i.e., the special servicer appointed by the subordinate component holder for the particular Loan may be different than the special servicer for the other loans in such CMBS Securitization).*

[8] *While formulations in Co-Lender Agreements may vary, generally speaking, qualified transferees fall into three broad categories: (1) large financial institutions having a minimum amount of capital/statutory surplus or shareholders' equity (usually $250,000,000 or more) and, with certain exceptions, a minimum amount (usually $600,000,000 or more) in total assets in name or under management, which is regularly engaged in the business of making or owning commercial real estate loans or commercial loans and their closely-held affiliates; (2) certain financially-sound and/or regulated trustees in connection with a securitization of the related component; and (3) investment funds controlled by certain permitted fund managers which invest through a fund with a certain minimum amount of committed capital (usually $250,000,000 or more), and acts as the fund manager responsible for the day-to-day management and operation of such investment vehicle.*

[9] *Some Co-Lender Agreements do permit transfers of subordinate interests to the related borrower or a borrower affiliate provided that, among other things, upon such transfer, the broad consent and consultation rights, cure rights and purchase options will be of no force and effect while such interest is owned by a borrower or a borrower affiliate.*

[10] *As noted above in our example of a senior-subordinate loan structure, the related mortgage loan might also be "componentized" using a pari passu participation structure, discussed under heading, "A Word on the Mechanics of Participation Interests and Separate Notes, p. 23."*

[11] *Ibid.*