

REAL ESTATE

FINANCE

Volume 27, Number 1

June 2010

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

By Timothy A. Stafford, David M. Linder,
and Richard D. Jones

Timothy A. Stafford is a partner at Dechert LLP in New York, NY. He may be reached at timothy.stafford@dechert.com. David M. Linder is a partner at Dechert LLP in San Francisco, CA. He may be reached at david.linder@dechert.com. Richard D. Jones is a partner at Dechert LLP in Philadelphia, PA. He may be reached at richard.jones@dechert.com.

The ongoing crisis in the credit markets and the continuing deterioration of commercial real estate have significantly increased 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 10 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 certificate holders (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, unless the borrower submitted an acceptable refinancing commitment to the Master Servicer, in which event the special servicing transfer event date may be extended for an additional period to allow the refinancing to occur.

3. *Imminent Payment Default:* A Servicer determines that a payment default on the loan is imminent and is likely to remain unremedied beyond the grace period set forth in the loan documents.
4. *Other Material Defaults:* A non-monetary default occurs that materially adversely affects the certificate holders 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.
6. *Foreclosure:* The Servicer receives notice of a foreclosure of another lien affecting the mortgaged property.

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 certificate holders (and any other holders of interests in the loan, such as a B-Note holder or a *pari passu* ANote holder), as a collective whole.
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?

Typically, the PSA specifies that the relevant discount rate for determining maximization of recoveries on a net present value basis for a loan in default is the interest rate for the particular loan, not a “current market rate” that can be inferred from current market conditions. If the PSA is silent as to the discount rate, it appears that some Servicers may be using the loan interest rate as the discount rate.

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), and PSAs therefore require Servicers to service mortgage loans in a manner consistent with the REMIC tax rules. REMIC 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 rules do not permit significant modifications. If the loan is not in default but a default is reasonably foreseeable, the REMIC tax regulations permit the Servicer broad discretion to modify the loan.

However, many PSAs do not expressly give the Servicers such broader authority unless the loan is a specially serviced loan. If a loan is not in default, a special servicing transfer event typically does not occur unless a default is imminent (not reasonably foreseeable). Thus, there may be situations, although free from the constraints of the REMIC rules limiting significant modifications, the default is reasonably foreseeable (but not imminent), the Special Servicer may be reluctant to effect a modification in the absence of express authority in the PSA allowing for significant modifications of a loan that is not yet a specially serviced loan. However, if the Special Servicer determines that the PSA and the REMIC regulations permit it to modify a loan that is not in default but as to which a default is reasonably foreseeable or imminent, the PSA provisions governing modifications of defaulted mortgage loans (discussed below) generally will apply.

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

In general, both the REMIC 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 certificate holders (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 payment 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 payment date.” In order to rate receipt of principal by the rated final payment 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 and fusion 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 two 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 and fusion deals.

Rating agencies usually have used a different methodology for determining the rated final payment date for “large loan floaters” and single loan “stand-alone” securitizations from the methodology used for fixed rate conduit and fusion 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), and sometimes the limits on extensions are even more severe. In fact, some older stand-alone deals may prohibit any extensions unless all or substantially all of the certificate holders consent to the extension.

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. If the practice of the Servicer and prudent institutional commercial mortgage lenders is not to grant borrowers under defaulted loans long-term extensions, Servicers might not grant an extension of the maturity date of a defaulted loan in a securitization in a single large increment, although Servicers may determine to grant additional extensions in relatively small increments if the loan remains unpaid after an extension has been granted.

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.³ The control party also typically has the right to replace the Special Servicer without cause.⁴ 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 certificates that has not experienced realized losses in excess of 75 percent of the initial principal balance of that class (the “controlling class certificate holder”). For large loans with B-Notes or junior participations, the initial control party is typically the holder of the B-Note or junior participation, but if “appraisal reduction amounts” for the related whole loan exceed 75 percent of the principal balance of the B-Note or junior participation, control usually shifts to the controlling class certificate holder.⁵ Note that, except with respect to loan specific “rake bonds” and some single loan stand-alone securitizations, appraisal reduction amounts typically are not used for the

purpose of shifting control among classes of certificates within the securitization. Changes in control among such classes usually are determined by allocation of actual realized losses.

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."

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 certificate holder or a holder of a B-Note or junior participation is permitted to consult with the Special Servicer or approve major actions with respect to a defaulted loan. Often the controlling class certificate holder (and sometimes the holder of a B-Note or junior participation) 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 certificate holders 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.

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 certificate holders) 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 certificate holders 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, which might be helpful in the current environment where new financing for commercial real estate is scarce.⁶

NOTES

1. For purposes of this article: (i) commercial mortgaged-backed securities are referred to as CMBS, (ii) a CMBS pooling and servicing agreement is referred to as a PSA, (iii) the 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.
3. For a more detailed analysis of consultation and consent rights in CMBS transactions, see our article entitled "Frequently Asked Questions Regarding B-Note Holder Consent and Consultation Rights," *DechertOnPoint*, Issue 15 (March 2009).
4. For a more detailed discussion of the right of a control party to replace the Special Servicer, see our article entitled "B-Notes Under Pressure: Frequently Asked Questions Regarding B-Note Holder's Right to Replace a Special Servicer," *DechertOnPoint*, Issue 16 (March 2009).
5. For a more detailed discussion of appraisal reduction amounts, see our article entitled "B-Notes Under Pressure: Frequently Asked Questions Regarding Control Appraisal Events and Loss of Control," *DechertOnPoint*, Issue 18 (April 2009).
6. Some groups are pressing for changes to the REMIC rules to allow a securitization trust to provide seller financing to a buyer of REO property.

Reprinted from *Real Estate Finance* June 2010, Volume 27, Number 1, pages 3-6,
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