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Q&A With Dechert's Richard Jones

Law360, New York (February 01, 2012, 1:45 PM ET) -- Richard D. Jones is a partner in Dechert LLP's New York and Philadelphia offices, where he co-chairs the firm's finance and real estate practice. He focuses his practice on capital markets and mortgage finance. Jones recently received the Commercial Mortgage Securities Association's Founders Award for his leadership. He has also received the Distinguished Service Award from the Mortgage Bankers Association of America.

Q: What is the most challenging case or deal you have worked on and what made it challenging?

A: Certainly, one of my most memorable transactions was the first commercial real estate collateralized debt obligation on which I acted as issuer’s counsel. It was done on the cusp of the late credit interregnum, and, in some ways, it could serve as the poster child for the excess of exuberance in credit markets at the height of the bubble.

I’ve been thinking about this deal a lot recently, as I’m now working on a transaction which is, in large measure, a 2.0 redo of the CRE CDO. We were representing CBRE Realty Finance, a specialty finance company. The company had concluded, rightly enough, that the CRE CDO was the best darn tool ever invented to lever a portfolio of mortgage assets while earning lucrative fees in the process.

The CRE CDO was a device by which rated debt was sold to investors to finance the acquisition and, ultimately, the trading of pools of high-yield, illiquid, commercial real estate loans, B pieces, participations and the like. Breathtaking in the originality of its conception, incredibly complex in structure and ultimately flawed in design, these transactions became the greatest “thing,” ... just before they became the worst thing.

The CRE CDO had all the customary complexity of a securitization, including innumerable parties, application of multiple rating agency criteria and enumerable bilateral contracts; all the things that make herding cats an apt description of most structured finance transactions. Moreover, it was new and untested and we were building this particular jet aircraft while flying it.

Both rating agency criteria and banker design notions were morphing continuously. The urge to lard more “functionality” into an already dauntingly complex structure to provide even more flexibility to the issuer could not be denied. Barely a week went by when new features were not added. How about a bucket for synthetics? Other CRE-CDO bonds (remember CDO-squared)? Why not put construction loans into the vehicle? To the lawyers: You can make all this work, right? The documentation became so complex and, in consequence, so turgidly opaque, we wrote users' manuals at the same time we closed the deals.

Regrettably, there were fundamental design flaws in the structure. The risks of cascading default flowing from very high-yield debt was not fully understood, and, in the crucible of a credit crunch and a commercial real estate depression, the structures flamed out spectacularly.

So mistakes were made, but the structure remains so alluring. As we look forward into 2012, the CRE CDO is due for a comeback. From something akin to a kind of financial pornography, whispered about only in the dark, the CRE CDO is being actively redesigned and refloated, albeit in much more conservative and robust structural clothing.

Q: What aspects of your practice area are in need of reform and why?

A: Structured finance is not suffering from an unmet need for reform, but from too much reform. We are roiled by a continuous drumbeat of policymakers' "good ideas" rushed into legislation and regulations. Capital formation, in the miasma of uncertainty created by such gargantuan pieces of legislation as Dodd-Frank and its regulatory progeny has been degrading.

The regulators, together with industry participants, are working hard to make some sense out of all this. My team and I recently authored the comment letter on the SEC reproposal of Regulation AB on behalf of the CRE Finance Council, and we remain deeply involved in the regulatory conversation around much of the major legislation affecting the commercial real estate capital markets.

Q: What is an important issue relevant to your practice area and why?

A: Skin in the game. A centerpiece of the policymakers' response to the late credit crisis was the notion that bankers who retain risk in credit exposures they originate will do a better job on making good loans than those who do not. That a banker who originates a loan with the intended purpose of selling that asset and reaping an immediate trading profit is likely to be less serious about credit quality and underwriting than one who will retain that financial asset in its portfolio. Lovely idea, intuitively obvious and fundamentally unsound.

The data suggests a limited causative relationship between the level of skin in the game and credit quality. Witness that the investment and commercial banks that failed over the past few years failed not because they laid off too much risk, but because they kept it. The dodgiest loans made in the years leading up to the credit collapse were building and construction loans, where 100 percent of the risk, "skin in the game," was retained by the originating lenders.

Nonetheless, skin in the game, as a policy nostrum, is now received wisdom, and we're stuck with it. The industry is struggling to mitigate the damage it will cause, and continue deliver capital to the credit markets in its shadow.

Q: Outside your own firm, name an attorney in your field who has impressed you and explain why.

A: Pat Quinn of Cadwalader Wickersham & Taft. Pat has been a major player in the commercial real estate capital markets for a decade and a half, and is associated with many of the innovations in securitization. He is a consummate professional and always a pleasure to do business with. A lawyer who doesn't play "gotcha," who focuses on getting the deal done. He gives of his time freely to help the industry in its engagement with the policy establishment.

Q: What is a mistake you made early in your career and what did you learn from it?

A: It's funny how you remember your mistakes much more vividly than your victories. As a very young lawyer, and well out over my skis, I was asked to prepare the truth and lending disclosure documentation for the Connecticut Student Loan Program. Truth in lending was new then. We were in a hurry. I read the statute and regs and started drafting. Seemed pretty straightforward. I dove in and, I was pretty proud of the work product.

The client took my documents, thanked me for a job well done, declared victory and printed thousands of loan applications, which were promptly distributed to banks throughout the State of Connecticut. I missed something, which I would have figured out if I had taken the time to read the commentary that had already been written by some very smart lawyers about TIL disclosure in other states.

When I discovered the problem, sheer panic set in. I confessed my sins and ultimately worked out a fix with the Connecticut banking commissioner, which, blessedly, had the ability to conclude that whatever the disclosure was, was, in fact, correct. The banking commissioner decided that the disclosure worked, and I moved on. It taught me to avoid the cheap answer, to spend the extra time to get it right. "Ready, fire, aim" should be used sparingly.