



May 2009

## REAL ESTATE UPDATE

**CMBS Servicing Alert: Frequently Asked Questions**

2008 was an unprecedented year in many respects. The list of devastating financial events affecting all areas of the economy was extraordinary and the carnage continues. The mortgage meltdown in the residential market has stretched across all sectors. The lack of liquidity and the credit crunch have caused a virtual standstill in the issuance of commercial mortgage backed securities (CMBS) and in new commercial real estate transactions.

The lack of liquidity and credit availability affect non-CMBS maturities and transactions as well, but CMBS loans offer new challenges for all involved. From the beginning of the secondary real estate market for commercial loans in the 1990s, comparisons of traditional and CMBS loans highlighted “the lenderless loan” and, as the structures evolved and became more complex, some did warn of the likely difficulties borrowers would face when and if a loan hit troubled waters. Now, with CMBS debt maturities looming, loan delinquencies on the uptick, virtually no new capital available from the capital markets and more traditional lenders on the sidelines, the reality of the complications inherent in CMBS loans is becoming even more striking. Borrowers have a more pressing need to better understand the unique challenges inherent in CMBS loans.

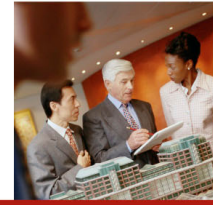
Moreover, not only borrowers, but also CMBS loan servicers and investors are asking more questions. The discussion below covers only some of the unique issues facing the parties with a direct stake in administering, restructuring and enforcing the complex financing structures now commonly affecting CMBS loans.

The questions below are posed from the perspective of the borrower, but the discussion is a useful starting point for any party involved in working out a securitized loan transaction.

**FREQUENTLY ASKED QUESTIONS**

**Borrower: I obtained my loan from Originator Bank, NA (“Originator”). I knew that the Originator planned to sell the loan into a securitization, but who is my lender after the securitization, and what rights and obligations does the loan servicer have with respect to my loan?**

In effecting securitization of a particular CMBS or “conduit” loan, the Originator sells the loan to a real estate mortgage investment conduit (REMIC or “Trust”). The Trust typically holds scores or even hundreds of commercial loans in a pool and issues various tranches of bonds to fund the purchase of such loans. Pursuant to a Pooling and Servicing Agreement (PSA), the trustee of the Trust (“Trustee”) engages a master servicer and a special servicer to service all the loans in the pool for the benefit of the bond/certificate holders (“Investors”).



The master servicer is the point of contact between the Trustee and the borrowers while the loan is not in default. The master servicer also collects mortgage payments and passes the funds through to the Trustee and advances any late payments to the Trustee. The master servicer may subcontract some of its duties to the Originator, as a primary servicer, to allow the Originator to maintain a working business relationship with the borrower. Although the master servicer or the primary servicer is the borrower's initial point of contact, these servicers will have little or no ability to make any material modifications to the terms of a loan.

The special servicer takes over servicing of the loans in the Trust during a "special servicing event." Typically, the special servicer is also the owner of the most subordinated class of bonds issued by the Trust.

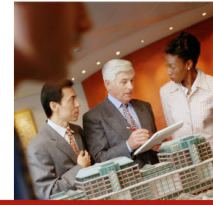
**Borrower: Since my loan has been closed, my debt service and reserve payments have flowed in and occasionally I have worked with the master servicer on contemplated releases, etc. Now, just because one of the anchor tenants is rumored to be having some problems or I have a few vacancies, the master servicer is calling me and asking for lots of information. What's going on? Do I have to provide this information?**

In this case, the master servicer may be trying to determine if a default has occurred or if a default is likely to occur. A borrower, or its attorneys, should review the loan documents to determine what special obligations, if any, exist with respect to providing information outside of the typical annual (or quarterly) operating reports. Regardless of any contractual obligation (under the loan agreement) to provide the information requested, a borrower should also consider the pros and cons of cooperating with the servicer. A lack of cooperation by a borrower may be viewed by the master servicer as a signal that the situation is worse than it appears.

**Borrower: In discussions with me, the servicer has referred to the requirements of a PSA that have to be met. What is a PSA? I did not sign a PSA. How does it affect me as a borrower? How can I obtain a copy of it?**

The PSA is the principal CMBS securitization document. The PSA sets forth the terms and descriptions of the loans being pooled and the rights and obligations of the servicers of the certificates and loans.<sup>1</sup> The borrowers as to the CMBS loans in the pool are not parties to the PSA, but the PSA nevertheless applies to the loans and governs the authority of the servicers. For instance, the PSA's requirements as to loan modifications typically are much more stringent and inflexible than those that balance sheet lenders typically would impose. This approach is due to both the REMIC rules (discussed below) and the preferences of the Investors and the rating agencies. PSAs may be obtainable from the servicer, but if not otherwise publicly available, the servicer may be reluctant to make them available.

**Borrower: Why and when does a loan's servicing move from a master or primary servicer to a special servicer?**



A loan's servicing will move from a master servicer to a special servicer upon the occurrence of a "special servicing event." A special servicing event typically occurs when there is a payment default, a borrower bankruptcy or a determination by the master servicer that a loan default is reasonably foreseeable and would likely remain uncured. Special servicers usually specialize in loan workouts, foreclosure, bankruptcy and management of REO properties. They must set a strategy that maximizes the recovery of principal and interest to the Investors on a net present value basis. The special servicer has some discretion, but ultimately must act within the bounds of the PSA and comply with REMIC rules.

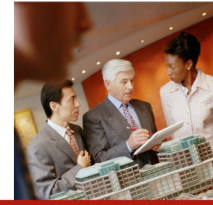
The special servicer is also involved in the approval process when the lender's consent is required by the loan documents. The PSA also generally delineates material requests that would be shifted to a special servicer either specifically or by category. For example, a special servicer will usually be involved for any loan modification that may extend the maturity date of a loan. In general, however, any modification that would be deemed material, and is not expressly pre-approved in the loan documents, will not be permitted by the servicers, except in connection with a special servicing event.

**Borrower: My special servicer now tells me he is the lead special servicer, but there are a few other servicers involved with my loan, plus a controlling certificate holder. How did that happen, what do all these servicers do and how do they interact? What is a controlling certificate holder?**

When a loan is securitized, particularly if the loan is large, the single initial Originator may morph into multiple parties. These lender parties may include holders of interests in various tranches of the securitized loan or, if the loan has been split among separate pools or in an A/B structure, they may include holders of interests in the different securitizations or loan components. In such a case, each loan pool or component may have its own separate set of servicers (master and special). The most subordinate certificate holder (often referred to as the "B-piece holder") among Investors in a securitization is typically the "controlling certificate holder." The controlling certificate holder usually is the Investor most at risk if a loss occurs. Pursuant to the PSA, the controlling certificate holder may have the right to replace the special servicer.

**Borrower: My loan is maturing in 60 days. I have an extension option, but it looks like I will be just under the DSCR test that I need to pass to qualify. Can the servicers—any of them—work with me on this, to modify the test so I can obtain my extension?**

Pursuant to the REMIC rules and the PSA, the master servicer cannot consent to a significant modification of a loan, which would include an unanticipated extension. If, as in this circumstance, there is an extension option permitted under the loan documents, the master servicer may have discretion to allow the DSCR test to be modified. However, unless the borrower meets all of the extension criteria in the loan documents, the master servicer is not required to extend the loan. Moreover, approval may require input from several parties. If, however, the master servicer anticipates that the borrower will not be able to meet its payment obligation if the extension is not



granted, it may determine that default is reasonably foreseeable and declare a special servicing event, in which case the special servicer and the other parties involved with the loan will have the right to decide whether to approve an extension.

**Borrower: My loan is maturing in 60 days. I have no extension option remaining. I have been beating the bushes to find a refinancing source, with no luck. Can the servicers—any of them—work with me on this, so I can obtain an extension? The project cash flow is just fine, but I can't refinance.**

In the current financing environment, borrowers certainly should seek refinancing early. If efforts to refinance are unsuccessful, the borrower's paper trail, showing that serious efforts were made to obtain refinancing, should be helpful in working with the servicer.

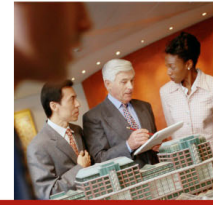
In the situation described above, the extension will probably be considered a significant loan modification. The REMIC rules prohibit such a significant loan modification unless the PSA contains a provision that allows the master servicer to extend the loan to facilitate a borrower's refinance activities. Additionally, however, the master servicer generally is permitted to extend a loan on its existing terms if the borrower has substantiated an exit plan that provides for payment of all proceeds due within 90 days of maturity. As noted above, if the master servicer anticipates that the borrower will not be able to meet its payment obligation if the extension is not granted, it may determine that default is reasonably foreseeable and declare a special servicing event. If a special servicing event exists, the special servicer will have some greater discretion as to whether to extend the loan, even if the PSA does not expressly contemplate an extension.

**Borrower: Does the existence of a loan default change the answers to what the servicer can do to extend or modify the loan?**

If there is a default or a significant deterioration of the performance of the collateral for the loan, the master servicer will transfer the loan to the special servicer, who has broader discretion to grant an extension when a default exists. The special servicer must uphold the servicing standard set forth in the PSA, which generally dictates that the special servicer administer the loan in a manner that maximizes the recovery of principal and interest to the Investors on a net present value basis. In addition, the special servicer will also need to ensure that the extension (or modification) would not cause an adverse REMIC event. That assurance often comes in the form of a REMIC legal opinion issued to the lender, which the borrower must obtain, at its expense.

**Borrower: There seem to be a lot of parties stacked up on the lender side of my loan, and multiple parties among them with approval rights. Who calls the shots if the loan is in default? How does it affect me and the loan's guarantors if the Investors and mezzanine lenders don't agree on what to do?**

This is an excellent question. The foundation of the CMBS markets is the splitting of a pool of loans into many tranches, with varying risk levels. The junior tranche (controlling certificate



holder) takes the first loss. As noted above in item 4, the special servicer must follow the servicing standard, which calls for maximizing the recovery of principal and interest to *all* of the Investors on a net present value basis. By contrast, the controlling certificate holder is *not* obligated to take into account the interests of other Investors. It is not hard to think of situations like this in which the different Investors will clash. Unfortunately, sometimes the documents are not clear as to who controls decisions. Disputes involving such “tranche warfare” already have been reported.<sup>2</sup>

**Borrower: Everyone knows we are in an unprecedented credit crisis. I hear news reports about across-the-board loan modification programs, but are the programs just for homeowners or can commercial borrowers take advantage of these programs too? Why can't servicers just institute blanket modifications?**

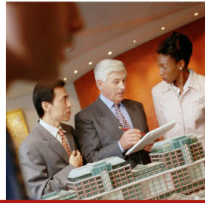
The loan modifications discussed by regulators, politicians and consumer advocacy groups are directed toward *residential* mortgages. So far, there has not been any legislation proposed to provide widespread relief for *commercial* mortgage borrowers. In either the residential or commercial MBS context, there are significant challenges to imposing a modification, due to REMIC rules and contract rights.

**Borrower: You have referred many times to REMICs and REMIC rules. What is a REMIC and how do REMIC rules affect my loan?**

A REMIC is a real estate mortgage investment conduit (also referred to as a “Trust”). The REMIC rules are established by the Internal Revenue Code and must be followed to ensure that the Trust is treated as a pass-through entity, thus avoiding double taxation of the income of the Trust (similar to a partnership or limited liability company). This favorable tax treatment presumes that the REMIC is a passive investor in mortgages and does not conduct any business activity. In order to maintain the tax treatment, the Trust must comply with numerous rules to maintain REMIC status. For instance, because the REMIC rules require that the pool remain static, the rules limit loan modifications and restrict substitution of new loans into the pool (except in a few circumstances).

## CONCLUSION

The issues surrounding loan extensions or modifications are very fact-specific, so all parties involved in CMBS loans and any proposed modifications of them will need to carefully review the loan documents, the PSA and the facts surrounding the distressed loan. Legal counsel that is familiar with CMBS loans and the constraints on servicers can be invaluable to borrowers facing refinancing, default or loan extension or modification issues. Thompson Hine's Distressed Loan Group is available to help borrowers, lenders, servicers and investors address these issues. For more information about our Distressed Loan Group, please go to [www.ThompsonHine.com/practices/realestate\\_distressedresponse.php](http://www.ThompsonHine.com/practices/realestate_distressedresponse.php).



## FOR MORE INFORMATION

If you have questions on this topic, please contact:

Marci P. Schmerler      404.541.2982      [Marci.Schmerler@ThompsonHine.com](mailto:Marci.Schmerler@ThompsonHine.com)  
Linda A. Striefsky      216.566.5733      [Linda.Striefsky@ThompsonHine.com](mailto:Linda.Striefsky@ThompsonHine.com)

If you do not wish to receive future communications by e-mail, please send e-mail with the word “unsubscribe” as the subject line to [Georgene.Davison@ThompsonHine.com](mailto:Georgene.Davison@ThompsonHine.com).

This advisory may be reproduced, in whole or in part, with the prior permission of Thompson Hine LLP and acknowledgement of its source and copyright. This publication is intended to inform clients about legal matters of current interest. It is not intended as legal advice. Readers should not act upon the information contained in it without professional counsel.

This document may be considered attorney advertising in some jurisdictions. Some of the design images and photographs in this document may be of actors depicting fictional scenes.

© 2009 THOMPSON HINE LLP. ALL RIGHTS RESERVED.

---

<sup>1</sup> Georgette C. Poindexter, “Subordinated Rolling Equity: Analyzing Real Estate Loan Default in the Era of Securitization,” 50 EMORY L.J. 519 (Spring 2001), at 538.

<sup>2</sup> Kineling Wei and Alex Frangos, “Hancock at Center of Tranche Warfare,” *Wall Street Journal*, January 21, 2009, Page C1.