

Outside Counsel

Expert Analysis

Borrower's Guide to Navigating Loan Workouts: Who Decides What?

The number of distressed commercial real estate loans continues to grow substantially with the credit crisis entering its third year and as the underlying fundamentals of commercial real estate continue to deteriorate. Foresight Analytics estimates delinquencies on commercial real estate loans by banks will rise to 9.47 percent in the fourth quarter of this year, up from 5.49 percent a year earlier.¹ In such an uncertain environment, in advance of an imminent loan default or following a loan default, it is critical for borrowers to have a clear understanding of their legal rights as well as to know the limits and motives of the players with whom they will be negotiating or litigating.

As the adage goes, "forewarned is forearmed." A borrower's success in negotiating a favorable workout is heavily influenced by not just whether it makes business sense for the lending group to enter into a workout, but whether a special servicer or "operating advisor," as the case may be, has the authority to act and the factors which may motivate their decisions.

The focus here will be on commercial real estate loans which have been securitized, those being loans which have been transferred to a pool of loans made to different borrowers generally secured by a wide range of property types. That pool takes the form of a trust, which then issues certificates entitling each holder to a certain interest rate and priority of payment from the cash flow of the loan pool, depending upon the tranche represented by the certificate, with the tranche in the "first loss" position generally receiving the highest interest rate and the inverse being the case for the safest tranche.

The relationship between the tranches is governed by a pooling and servicing agreement,² which delegates various duties to, and bestows certain authority on, the servicer. However, before taking certain prescribed major actions, the servicer must consult with, and obtain consent from, an "operating advisor" selected by (or which may be the same as) the holder of the certificate for the most subordinate "first loss" tranche, which will be described in greater detail below.

That tranche is generally referred to as the



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"controlling class," which may shift, with respect to a particular loan, upon a "control appraisal event" (e.g., a certain period of time after a foreclosure or bankruptcy or maturity default) to the holder of the certificate representing the next class if the value of the certificate as it relates to that particular loan falls by more than a certain percentage, typically 75 percent. Not only must the special servicer answer to the operating advisor, but typically may be replaced by the operating advisor at will with any other qualified special servicer of its choice.

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The Players

In the context of a traditional mortgage loan, a loan is serviced by the mortgage lender which originates and continues to own the loan, or by a loan correspondent that originated the loan. However, once a loan is securitized, the responsibility for trust matters is divided, in accordance with the terms of the pooling and servicing agreement, among a master servicer, a special servicer, and a trustee.³

In general, a servicer is required to service a loan in accordance with not only the pooling and servicing agreement, but also with the applicable loan documents, applicable law and a standard of servicing known as the "Applicable Servicing Practices." Typically, the servicing standard requires the servicer to act in accordance with the higher of the standard of care it applies to loans held for its own account or the standard it applies to servicing loans held by third parties, taking into account the interests of all holders of interests in the loans as a collective whole, and with the goal of maximizing of recovery on the

loan on a net-present-value basis.

The master servicer is responsible for collecting the loan payments and passing the funds to the trustee, the enforcement of loan terms for loans that are performing and providing performance reports to the certificate holders. In addition, the master servicer may enter into immaterial modifications without permission or consent from the controlling class.

Transfer of Loan Servicing

The master servicer usually must transfer loan administration of defaulted loans or loans at risk of imminent default to the special servicer who will either "workout" the loan or exercise remedies, subject to the approval of the controlling class. More specifically, a "special servicing period" generally commences when: a borrower fails to make any monthly payment for 60 days after its due date; the master servicer or special servicer reasonably believe that there is an imminent risk of failure to make a monthly payment, which is likely to remain unremedied for 60 days; a borrower files a petition for protection under the U.S. Bankruptcy Code; an event of default occurs under the applicable loan documents, which materially and adversely affects the certificate holders; there is a foreclosure or threatened foreclosure of any lien on a mortgaged property; or a maturity default occurs (or within 120 days thereafter if a borrower fails to close a refinancing based upon a written loan commitment delivered to the lender prior to the date of maturity).

Special Servicing

Once a loan is in special servicing, a borrower usually will propose to the special servicer some type of loan modification. Prior to a recent IRS Revenue Procedure, special servicers felt their hands were tied, since prior to an actual default any substantial loan modification risked a trust losing its REMIC⁴ status—with calamitous tax consequences. Some borrowers deliberately defaulted on their loans merely to qualify their loans for modification.

Now, as a result of the recent Revenue Procedure, if a default is foreseeable even beyond a year from the time of determination, servicers are permitted to make a substantial modification.⁵ In addition, with the new guidelines, a default is reasonably foreseeable if the holder or servicer "reasonably believes that there is a significant risk of default" either upon maturity or at an earlier date.⁶ So now, a default need not be "certain," so

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long as there is a significant risk of default.

The determination as to whether there exists a "significant risk of default" must be based on "a diligent contemporaneous determination... which may take into account credible written factual representations made by the [borrower under] the loan."⁷ Thus, for example, the REMIC servicer could rely on a borrower's representation that it had unsuccessfully pursued various alternatives for refinancing prior to the loan's upcoming maturity, and based on that representation, that a loan default upon maturity is reasonably foreseeable.

Once the REMIC considerations are satisfied, then the pooling and servicing agreement should be consulted to determine whether the special servicer is authorized to make the contemplated changes. Typically, the special servicer must approve any material modification, including: an extension of the maturity date of the loan (but generally for a period not exceeding two years); a reduction in the loan's interest rate, monthly payment amount (meaning amortization) or prepayment premium; the deferral or forgiveness of interest or principal; modification or waiver of any monetary or material non monetary term, whether or not to offer or accept a discounted pay-off or modification; or waiver of any due-on-sale clause.

Even with the approval of the special servicer, the operating advisor's approval is required prior to any material modification, any foreclosure or deed-in-lieu, any sale of either a mortgaged property or a foreclosed-upon property, any release of a borrower, guarantor or other obligor, any determination not to enforce a due-on-sale or due-on-encumbrance clause, any substitution or release of collateral, approval of any bankruptcy plan, execution, termination or renewal of what is usually defined in the loan documents as a "major lease," a change in the named property manager, or a change in the alterations or insurance standards.

Obviously, following a default, the special servicer is paralyzed unless the operating advisor gives the green light to either workout (and modify) the loan or foreclose.

Even with the operating advisor's consent, aside from a waiver of late payments, default interest, prepayment premiums or liquidated damages, pursuant to the typical pooling and servicing agreement, no modification, waiver or amendment of a loan which would affect the amount or timing of any payment or materially impair or alter the security or collateral (other than construction of improvements) may be entered into *except* (i) during a special servicing period and (ii) *only if* in the reasonable good faith judgment of the special servicer (a) a material mortgage event of default has occurred or a default in payment is reasonably foreseeable and (b) such modification, waiver or amendment or other action is reasonably likely to produce a greater recovery to certificate holders and, in the case of a participated mortgage loan, the related participants on a present value basis, than would the foreclosure or other liquidation of the subject property. As stated earlier, the duration of any loan extension is usually limited to a total of two years.

Operating Advisor

Whether or not an operating advisor consents to a particular modification may largely depend

upon who is its appointing controlling class.

1. Is the special servicer also the controlling holder/operating advisor or an affiliate thereof? If the special servicer or its affiliate holds the controlling class, then the controlling holder/special servicer may be less apt to negotiate an extension if the mortgaged property is worth more than the debt, and prefer to foreclose on the property. On the other hand, if the mortgaged property is worth less than the debt, then, for fear of being wiped out, the controlling holder/special servicer may be more likely to extend.

2. Is the operating advisor representing a controlling holder afraid of a control appraisal event and thereafter losing control? When the property is worth less than the mortgage debt, a controlling holder may prefer to modify a loan rather than foreclose, since a foreclosure would lead to the ceding of control to the next most junior tranche, which may then look to quickly dispose of the property post-foreclosure, thereby potentially wiping out the current controlling class.

3. Does the operating advisor represent a certificate holder who also holds larger senior positions in the same pool? Depending upon the relative value of the respective more senior and junior controlling interests, the controlling holder with a larger senior piece may be less patient and unwilling to extend or otherwise modify the loan, preferring foreclosure and sacrificing full recovery of its junior piece in exchange for

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a quicker recovery of its more senior position, especially if the yield on the senior position is well below market.

4. Is the operating advisor representing a certificate holder which is a CDO? Since managers of collateralized debt obligations (CDO) are subject to removal for cause, including for failure to maintain certain over-collateralization ratios (requiring that the collateral underlying a CDO be worth more than the CDO note or obligations), selling assets in a CDO (or accepting less than full repayment) may require their replacement with substitute collateral worth at least as much and having at least as high a rating. This is not necessarily easy to do.

Therefore, the CDO manager may be more apt to modify the loan, thereby avoiding a default which would otherwise have an adverse effect on the ability of the manager to retain its management of the CDO. Of course, the smaller the percentage that the subject loan represents of the overall pool, and the smaller the percentage that the controlling class represents of the entire CDO, the lower the chance that the holder of the controlling class being a CDO will matter.

5. Is the operating advisor representing a certificate holder who bought the certificate at a discount and would rather "loan to own" the various assets secured by loan in the pool? A fund which has purchased its position at a deep discount in the secondary market may be more interested in the borrower defaulting in order to

force a foreclosure, making a quick profit on the portion of the pool comprised by the borrower's loan following a post-foreclosure resale of the mortgaged property.

6. Is the operating advisor representing a certificate holder which hasn't marked to market its interest in the loan and would rather extend, especially if the loan is performing? For some holders of controlling class certificates, accounting rules promote a "pretend and extend" posture, which benefits borrowers wishing to extend and modify the loan. The Financial Accounting Standards Board has changed its interpretation of FAS 115-2 and FAS 124-2, making it easier to avoid recognizing losses to current value by providing that a holder of a debt security should use its best estimate of the present value of expected cash flows from the debt security to determine the presence of a credit loss.⁸

7. Is the mortgaged property a hotel or substantially vacant office building or a hotel in need of a multi-million dollar upgrade or Property Improvement Program? A servicer might be more willing to modify the loan to the extent that a borrower is willing to contribute the needed capital, since the special servicer's access to funds is usually limited strictly to the cash flow generated by the mortgaged property and the capital required is far greater than what the property's cash flow is able to yield.

Conclusion

Successfully navigating the gauntlet of a securitized commercial real estate loan workout requires the borrower to carefully plan and strategize ahead of a looming maturity default or other anticipated default. If, as Bismarck said, "politics is the art of the possible," then the same may be said of securitized loan workouts. A borrower should understand the limitations of a servicer's and operating advisor's authority and propose a modification which is possible, taking into account, and perhaps capitalizing on, the potential motivations of the controlling class certificate holder. Only then may a borrower maximize its chances for modifying its loan on favorable (or at least tolerable) terms.

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1. Lingling Wei & Mike Spector, Tishman Venture Abandons Stuyvesant, Wall St. J., Jan. 25, 2010.

2. While there is no universal form of pooling and servicing agreement, many terms of the agreement used in recent securitizations are relatively standard, and this article reflects the authors' experience with the pooling and servicing agreements they have dealt with.

3. The trustee's duties include holding the mortgage collateral, distributing funds collected by the master servicer to the certificate holders, supervising the master servicer and special servicer, ensuring that the servicers comply with the terms of the pooling and servicing agreement and appointing new servicers if those terms are materially violated.

4. Most commercial mortgage loan securitizations are structured as Real Estate Mortgage Investment Conduits (REMICs), governed by 26 U.S.C.S. §§860A through 860G, which treats REMICs as pass-through entities for tax purposes.

5. Rev. Proc. 2009-45 issued on Sept. 15, 2009.

6. *Id.* §5.03.

7. *Id.*

8. Contributing factors may include, among other things: the length of time and the extent to which the fair value has been less than amortized cost; payment structure of the debt security and the likelihood of the issuer's ability to make payments in the future; failure of the security issuer to make scheduled interest payments; and any subsequent events to the balance sheet date which impact fair value.