CMBS Newsletter—February 2000

Patrick Sargent/Peter McKee

February 3, 2000 **CMBS Market Drives Changes in Loan Info Methods** *Written by **Peter McKee** at 214.659.4507*

- How many anchor tenants have termination rights?
- What mitigation was obtained for loans with nonconforming uses or improvements to provide "no violations" and rebuild comfort?
- Which title policies don't have access, zoning or usury endorsements (and why)?
- Do all loans require lender consent to a change of borrower control?

Rating agencies and investors are asking increasingly detailed loan-level questions as they evaluate CMBS pools, and issuers and loan sellers must consider changing market precedent as it affects disclosure detail and the representations and warranties they give. The trapping and presentation of relevant loan-level information to respond to these various needs is what we call the "collateral review" process. The ability to respond quickly, accurately and persuasively impacts the perception of how rigorous a lender's underwriting actually is and how well its loan processes function. As this perception is reinforced, brand identity is established for good or ill. Delivering legal issue-related information is now an essential part of a lender's overall CMBS marketing and execution, because it is particularly rich in content.

Effective risk management in light of existing and foreseeable market conditions (particularly the increasing demand for information) requires a rethinking of the law firm's role. Legal issues-related information can be used not only for liability avoidance, but also to support a lender's approach to underwriting and overall risk management. Beyond identifying legal risks or features that are relevant in the CMBS market, it is now important to capture mitigating or contextual information that reflects how that risk was managed. And such information should be immediately available across an entire loan pool.

Andrews & Kurth has developed a new methodology to address the need for legal risk information:

- CMBS-related information is trapped at the time of loan origination, and formatted clearly in anticipation of retrieval and presentation needs at securitization;
- Legal due diligence time is compressed, and costs are managed within defined parameters;
- Database systems are used to provide information retrieval times closer to real time, and protected client access and separate search capability are afforded;
- Information filters for future deals are trued-up in light of market precedent; and
- Feedback loops are established to identify and institutionalize best practices.

The benefits of this approach are considerable. Risk allocation decisions (particularly those involving loan level reps and warranties) can be made more quickly and confidently. Back-end legal costs are more predictable and better managed. And better quality information capture opens up opportunities for other best practices that can positively affect overall execution.

Spotting REMIC Problems in Loan Originations *Written by **Tom Popplewell** at 214.659.4480*

Problems that affect an issuer's compliance with Real Estate Mortgage Investment Conduit (REMIC) requirements can be time-consuming, expensive or even disastrous. Compliance issues should be identified before securitization, when the consequences are less dire. Loan originators are well-served by being aware of common pitfalls.

Defeasance Loans Must have at Least 2 Years of Lockout Protection at the REMIC Start-Up Date.

When defeasance provisions started making their way into loan documents in early 1998, the standard language prohibited the borrower from defeasing the loan prior to the earlier of (i) 2 years after the REMIC start-up date (i.e., the closing date of the securitization) or (ii) 3 years from the closing date. No one envisioned that loans would be held for longer than one year before they were securitized, so the lockout burn-off seemed safe enough. Enter the global financial crisis (and its CMBS

counterpart) in fall 1998. Holding loans for longer than one year became a painful reality with a twist: some defeasance lockouts were suddenly inadequate for REMIC purposes.

For new loans, a logical response was to modify the standard lockout provision to extend up to 4 years from closing (this works, although recent market trends seem to indicate a reversion back to the 3 year standard). For existing loans, though, a fix became necessary: either (i) drop the loan into a separate REMIC (a mini-REMIC) which can be rolled up into the principal REMIC at the time of securitization, or (ii) obtain the borrower's consent to modify the loan to extend the lockout. Otherwise, if the borrower gives notice of defeasance within 2 years of the REMIC start-up, the REMIC election can be jeopardized. (In certain cases, the issuer or loan seller may be able to repurchase the loan from the trust to avoid invalidating the REMIC election).

The mini-REMIC approach only works if the REMIC declaration is made 2 years prior to the lockout burn-off.An example:

09.15.98 - Loan closes; defeasance language provides that loan may not be defeased prior to (i) 2 years after REMIC start-up or (ii) 3 years from closing (09.15.2001). Defeasance can only be effected on first day of month, so the first opportunity to defease the loan is 10.01.2001.

09.30.99 - Last day that lender can make mini-REMIC declaration (assumes that loan has not already been securitized). Data Capture

The key, under any circumstances, is knowing when your defeasance loans have their lockout burn-off, so that you can plan accordingly. If loans get kicked out of one pool and rolled into future ones, this can get tricky. For defeasance loans that are purchased, loan purchasers should remember that a loan seller's REMIC representations given at the time of the loan sale may be true, but that there may yet be REMIC problems when the loan is intended for securitization. Loan purchasers should consider representations as to the earliest defeasance date for the loans being purchased. Check the mini-REMIC deadline to identify possible compliance issues or related transaction expenses, so that risks and responsibilities can be allocated appropriately.Partial Release Provisions Cannot Rely on Typical Lender Discretion-Type Criteria.

Partial release provisions represent a trap for the unwary, because the effects of REMIC compliance in this context are counter-intuitive. A partial release provision that would be appropriate and well-drafted from a portfolio lender's viewpoint may trigger REMIC noncompliance problems for the securitized lender. Here's the problem: If the conditions that must be satisfied for the partial release to occur are discretionary or subjective, the IRS could take the position that such a provision would result in a prohibited collateral substitution. Most loan forms are peppered with lender's sole discretion-type criteria for partial releases, so a re-write of those forms is necessary to avoid potential REMIC problems.

In particular, lenders should not assume that partial releases for excess land (i.e., where undeveloped property is included in the mortgaged property until it can be separately subdivided) could not pose REMIC issues. Prior to securitization, loan amendments are usually possible to fix the problem. After all, the borrower generally benefits by narrowing the release criteria. If the problem comes to light after securitization, though, the lender may be in a difficult position: processing the partial release may imperil the REMIC election, while refusing to process it may result in an unhappy or litigious borrower. Earn-out and IDOT Issues.

Earn-out loans must be fully funded before they are REMIC-eligible. In addition, a loan involving an indemnity deed of trust (IDOT) structure, which results in a loan that is secured only by a guaranty that is itself secured by an interest in real property, may raise questions that must be resolved concerning the loan's creating a qualified mortgage for REMIC purposes (a loan secured by an interest in real property).

Cautionary Tales from the B-Piece Front *Written by **Peter McKee** at 214.659.4507 and **Pat Sargent** at 214.659.4430*

Price talk and levels on your upcoming pool look good and you expect to close in 2 to 3 weeks. Then, after several days of due diligence, your B-piece buyer presents a list of hundreds of collateral questions. Your loan underwriting and closing practices are pilloried. And after several weeks of back-and-forth regarding the appropriate mix of loan kick-outs, tighter

reps and pricing changes (none of which you find appealing), you still haven't closed. You've incurred over $100,000 in extra transaction costs. If the deal busts, you may have to pick up an even bigger tab to cover the B-piece buyer's costs. And then you get to start over again with another B-piece buyer...

The marketing of the unrated class of securities (the so-called "B-piece") has always been important to the overall economics of a CMBS deal. But B-piece buyers have recently had significant influence on pool composition and structure issues. B-piece buyers are aggressively seeking to reduce loan-level risk exposure. They are asking more loan-level questions, and looking for mitigants to perceived problem areas.

For the loan seller or issuer, better loan-level information is an essential element of deal management, risk management and marketing. Legal risk-related information is becoming an ever larger part of information demand because it can provide valuable insights into overall risk management practices. An understanding of market precedent is also critical.

Licenses and Permits Comfort
(Certificates of occupancy and, for hotels and nursing homes in particular, applicable operating permits have been obtained). If C/O's cannot be obtained, look for (i) confirmation from locality that the absence of the permit will not result in any enforcement action; and (ii) supporting evidence that there are no zoning or other local law violations. For temporary C/O's, assure that any conditions remaining to be satisfied must be susceptible of being timely performed (and check leases to confirm that rent obligations are not impacted if the permanent C/O is delayed).

Specific B-piece buyer hot button areas that have gotten recent attention in industry conferences include:

- "Bad borrower" information, such as bankruptcy, loan default, criminal or securities law violations or other "bad act" information about borrower or principals (also a rating agency issue)
- Loan document provisions focused on borrower information compliance (i.e., is there a stiff penalty for borrower's failure to provide updated financial information, and, upon breach of these loan covenants, is there the right to audit the borrower's books?)
- Loan document assurances that all defeasance, modification, transfer and assumption-related transaction costs (including attorneys' fees and rating agency review costs) will be borne by the borrower and not by the trust

Adapting Tenancy-in-Common Structures to SPE Requirements *Written by **Patrick Sargent** at 214.659.4430 and **Charlie Marshall** at 214.659.4509*

Borrowers often present lenders with structuring challenges, such as when their tax advisors suggest the use of a tenancy-in-common (TIC) structure to accommodate a like-kind exchange (IRC §1031). Lenders are then asked: “Is this a problem?”

Where the lender requires that the borrower be a single purpose entity (SPE), a TIC structure presents special concerns: (i) how to deal with multiple TIC borrower parties in bankruptcy; (ii) how to address each TIC party’s rights of partition; and (iii) how to manage contacts between the lender and multiple borrower parties. Mitigating TIC risks involves the following:

- Requiring that each TIC party be an SPE (typically a single member limited liability company SPE, which is disregarded as an entity separate from its owner for federal income tax purposes);
- Requiring that each TIC party enter into a TIC management agreement: (i) appointing one TIC party as the manager for all; (ii) authorizing the managing TIC party to be the sole contact and notice party for purposes of the loan; (iii) authorizing the managing TIC party to otherwise act on behalf on the borrower in connection with the loan; (iv) stipulating in the TIC management agreement that the property may not be partitioned; and (v) providing that if a TIC party becomes a debtor in a bankruptcy proceeding, any one or more of the other TIC parties have the right to purchase the bankrupt TIC party’s interest at fair market value based on an independent appraisal – this is designed to lessen the potential negative impact of the trustee's power of sale pursuant to Sec. 363(h) of the Bankruptcy Code.

Failing to properly structure and document a TIC loan will affect the SPE characterization of the loan and may impact pricing. Even with these mitigants in place, TIC loans may be viewed less favorably than loans having more typical SPE structures, and, accordingly, could merit a slight spread increase to the borrower.

The court held that the junior lender would be allowed to vote its claim in the confirmation proceeding, notwithstanding the contractual language assigning those rights to the senior lender.