New Rules of Engagement for Workouts: REMICs & Distressed Real Estate Loans

by James R. Butler, Jr. & Jeffrey E. Steiner

ABOUT THE AUTHORS

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THE CMBS MARKET IS HUGE . . . AND LARGELY A MYSTERY

The CMBS (Collateralized Mortgage Backed Securities) market has fundamentally changed the landscape in the United States for commercial real estate finance—the legal structure, ownership, management, and rules of the game. Securitization[1] has also forever altered the behavior of the participants and consequences that follow in the mortgage default dance.[2]

By 2000, the Federal Reserve estimated that 19 percent, or almost one-fifth, of all outstanding commercial mortgage debt in the United States was securitized. This amounts to almost $281 billion in mortgage loans. The amount has been growing at more than $50 billion per year and is expected to continue growing at this rate for a decade or more.

Since the early 1990s, CMBS-financed loans may have been the most attractive and available loans for many borrowers, such as hotel owners and operators. They almost certainly have provided better execution than competing portfolio lenders, but the servicing and other restrictions on handling troubled loans will present many problems for borrowers in the next downturn as their loans get into trouble.

Given the pervasive "success" of CMBS financing, it is nothing short of amazing that so many borrowers and their advisors appear to have little

understanding of the process, structure, and practical implications of their securitized debt or how to deal with it when times get tough. This article looks at a number of these issues and offers some explanations.

Given the strong sudden downdraft in the hospitality industry, this background may be particularly valuable for owners of hospitality properties financed with securitized debt.

HOW CMBS BECAME SO DOMINANT

Although securitization of residential real estate is both well-defined and mature, securitization of commercial real estate is a relatively new phenomenon and virtually untested by recession or other economic distress.

For years, commercial real estate was primarily financed by banks, thrifts, life insurance companies, and pension funds. But all this changed in the late 1980s, when the nation faced protracted economic downturn and a banking and S&L crisis of historic proportions. A virtual collapse in commercial real estate finance ensued in the early 1990s.

Taking a page from an earlier test balloon,[3] and faced with billions of dollars of troubled commercial real estate loans, the RTC helped launch the secondary market for this product. By 1993, the RTC's commercial real estate loan pools aggregated almost $14 billion. The rest is history.

Take note! This market has never been tested by the very economic stress that gave it birth. We expect many business and legal developments to evolve when it is. And the time may be close at hand. According to a recent PKF study, 36 percent of the hotels in the United States are expected to default in meeting debt service in 2002. Many of these loans have been financed from CMBS-driven sources.

NEW PARADIGMS REPLACE OLD ONES—THE FUNDAMENTALS

In contrast to traditional, non-securitized commercial real estate loans, the structure for CMBS loans is far more complex. A bank, mortgage banker, or other loan originator makes a loan secured by a mortgage on commercial real estate. The originator holds the loan until it accumulates a sufficient number of loans for securitization.[4] Then the originator sells the mortgages to a depositor.[5] The depositor transfers the loans to an entity that will pay no federal income taxes. Normally, to assure this tax transparency, the entity will be a Real Estate Mortgage Investment Conduit (REMIC).[6]

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The sellers and underwriter, working with the rating agencies,[7] decide the makeup of the ideal pool—what loans, how many, and other such factors. The rating agencies determine how the pool will be tranched or divided into classes for requested ratings. The underwriters, working within the rating levels, design multiple classes of securities (bonds) to be sold at various interest rates, expected maturities, yield, payment characteristics, and other factors to satisfy market conditions—determining how many securities will be offered at each rating and maturity. There may be both fixed and variable yield tranches.

Typically a Pooling and Servicing Agreement or PSA establishes the management structure of the CMBS pool. This complex document provides extensive detail governing the duties of the servicers in handling the loans and allocation of cash flows to different classes of investors. It is designed to protect the REMIC status and resulting tax treatment of the trust, and to balance the sometimes-conflicting interests of the various classes of bondholders, as well as those of the issuer, servicers, and others. The parties to this agreement usually include the Trustee and the Custodian for the trust holding the mortgages, a Master Servicer, and a Special Servicer.

The Master Servicer is responsible for collecting and monitoring all mortgage payments and ensuring that all payments are made to the security holders. In most cases, the Master Servicer must also advance payments to the bondholders unless it can show that the advance will not likely be recoverable, in which case servicing is transferred from the Master Servicer to the Special Servicer.

The Special Servicer is usually the holder of the lowest rated or unrated tranche of the offering—the first loss or "B-piece."[8] The Special Servicer is the

party who handles the workouts, and is otherwise charged with servicing the loans when they default. The other two parties to the pooling and servicing agreement are the Trustee and the Custodian.[9] The Trustee acts on behalf of the bondholders in relaying information between the bondholders and the Master Servicer. The Custodian is the party with the actual possession of the underlying mortgage loan documents that comprise the pool.

The entire securitized transaction relies on the income stream produced by the mortgages in the pool. The overwhelming importance of the income stream reduces the real estate to a fungible commodity. It is not the real estate that is securitized, it is the cash flow. And the CMBS market depends upon the rating agencies' assessment of the likelihood of default within the income stream drives the sizing of the tranches and the subordination levels of the offering.[10]

SOME PRACTICAL IMPLICATIONS OF REMICS FOR TROUBLED LOANS

The practical implications of securitization can be profound. Compared to traditional pre-CMBS models, securitized loans invoke different players, documentation, structures, and inflexible tax rules. These differences affect the incentive, ability, and willingness to workout or liquidate troubled loans.

Structurally speaking, on the borrower side, the collateral assets securitizing the loan will be transferred to an SPE (Special Purpose Entity). In the case of larger loans, this entity will also be a so-called bankruptcy remote vehicle—designed to prevent the borrower from filing bankruptcy, or at least to make it more difficult for the borrower to file bankruptcy. And, conversely it is intended to make the bankruptcy process faster and simpler for the lender.

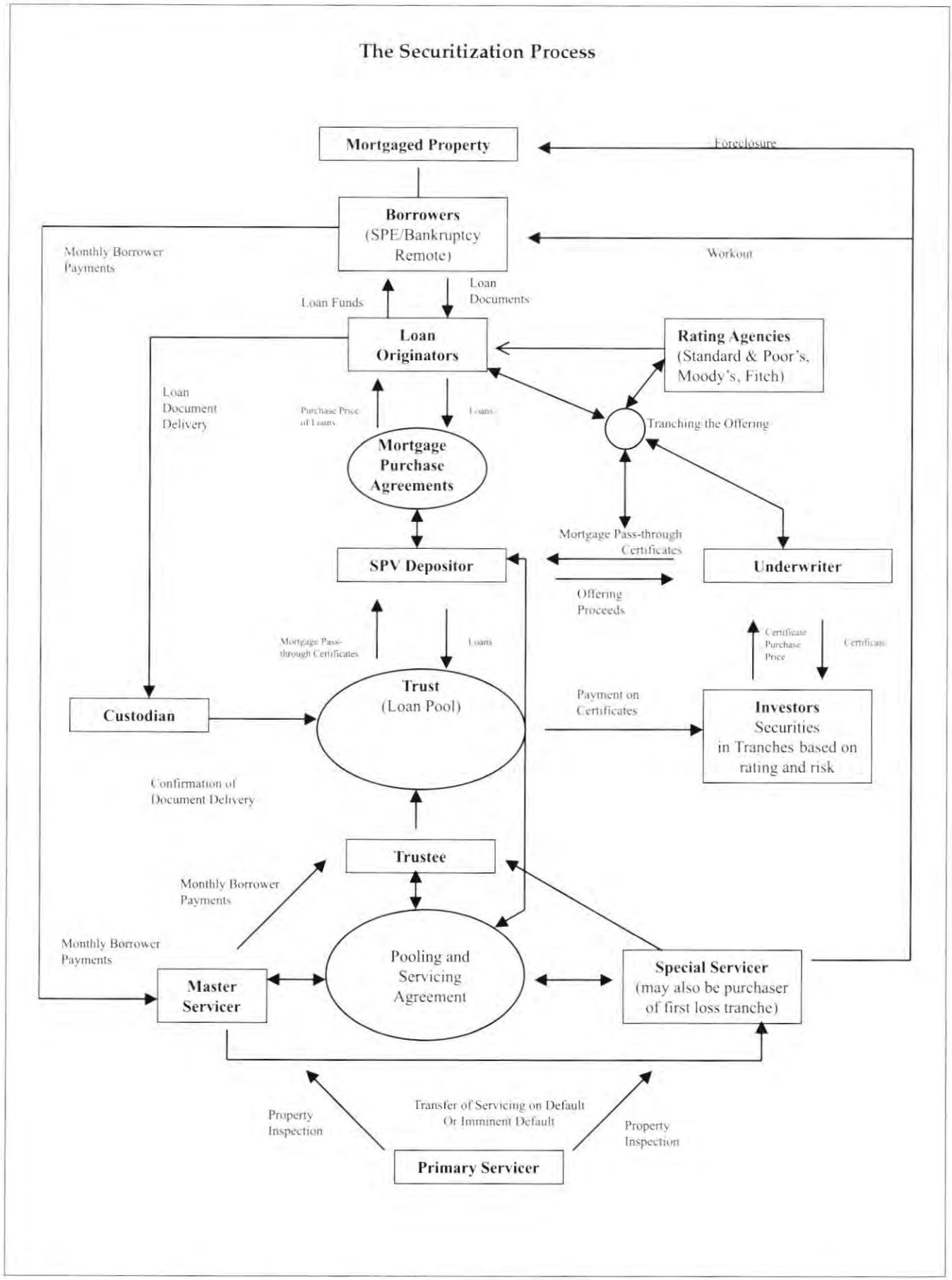
On the lender side, as noted above, most CMBS vehicles are REMICs. "REMIC" status is crucial to the securitization market, because it assures bondholders that the trust will be a pass through entity for tax purposes, avoiding a devastating double tax if the loan pool or trust were to be taxed as well. REMIC status is gained by compliance with complex and rigid rules that prohibit prepayments (unless executed in accordance with defeasance procedures) and sales or exchanges of mortgages in the trust, including modifications to the mortgages, (unless in compliance with very strict guidelines). These tax-driven mandates severely limit when and what a Special Servicer can do when a loan gets into trouble.

The REMIC rules, pooling and servicing agreement and loans documents (rating agency guidelines and accounting standards such as FASB 140)[11] together provide a strict regimen for securitized troubled debt. The REMIC rules require that REMIC pools be static—subject to very limited exceptions, they cannot be expanded, or significantly altered once formed. Failure to strictly observe these rules is the tax equivalent of Armageddon for REMIC investors, servicers and other participants, because the loss of REMIC status is a cataclysmic event in terms of double taxation, and even penalty taxes, on pool income. The REMIC rules thus limit substitution of collateral and significant modifications of existing loans prior to default. Even after default, the pooling and servicing agreement severely restricts the servicer's authority to make modifications.

Where a traditional whole loan lender would have attempted to preserve the value of the asset, REMIC regulations attempt to preserve the integrity of the trust. And borrowers find themselves dealing with multiple parties representing diverse interests that in non-CMBS loans are all typically held by the whole loan lender. Unlike more flexible, traditional portfolio lenders, borrowers will find that Servicers and Special Servicers will follow the loan documents, pooling and servicing agreement, and REMIC rules to the letter in order to comply with contractual and fiduciary duties to the trustee and ultimately the bondholders.

1. The loan will be serviced by several companies with whom the borrower probably has no relationship. The friendly, local banker or mortgage banker looking to future business with the borrower will have little or nothing to do with the securitized loan.
2. Servicers will follow and enforce precisely the strict letter of the loan documents. Servicers will also administer the loan in strict conformance with other agreements or standards that the borrower may never have seen such as the pooling and servicing agreement, REMIC rules, and accounting standards (FASB 140).
3. Multiple servicers confuse many borrowers who often have trouble finding out who to talk to, what authority the Master Servicer and Special Servicer may have, and when to talk to each. In addition to the Master Servicer and Special Servicer, there may be sub-servicers.
4. Releasing any collateral is problematic once the loan is securitized.[12]
5. Additional advances are impossible unless specifically provided for in the original loan documents

Exhibit 1


The Securitization Process
Mortgaged Property
Foreclosure
Borrowers (SPE/Bankruptcy Remote)
Monthly Borrower Payments
Workout
Loan Funds
Loan Documents
Loan Originators
Rating Agencies (Standard & Poor's, Moody's, Fitch)
Loan Document Delivery
Purchase Price of Loans
Loans
Tranching the Offering
Mortgage Purchase Agreements
Mortgage Pass-through Certificates
SPV Depositor
Underwriter
Offering Proceeds
Mortgage Pass-through Certificates
Loans
Certificate Purchase Price
Certificate
Trust (Loan Pool)
Payment on Certificates
Custodian
Investors Securities in Tranches based on rating and risk
Confirmation of Document Delivery
Trustee
Monthly Borrower Payments
Monthly Borrower Payments
Pooling and Servicing Agreement
Master Servicer
Special Servicer (may also be purchaser of first loss tranche)
Property Inspection
Transfer of Servicing on Default Or Imminent Default
Property Inspection
Primary Servicer

(and by an objective standard or schedule). A cornerstone of REMICs is that the pool is fixed and cannot be expanded after formation.

6. Once put in the pool, loans cannot be materially modified before default.[13] A Special Servicer may be able to approve a loan modification that a Master Servicer cannot approve for its most reliable and creditworthy borrower—only after a default or imminent default.
7. Servicers will enforce financial, data, and other seemingly technical requirements of the loan documents. They may impose a fee for failure to deliver data on time and ultimately may declare a default. When the data is required to be in electronic form, and on the lender's form, the borrower better comply.
8. Generally speaking, a lender will not have the discretion to permit a borrower to substitute alternate mortgage or real estate collateral.[14]
9. If permitted by the loan documents, transfers of the underlying property and assumption of the mortgage may be permitted, but usually only on one occasion and pursuant to a clearly defined process and set of conditions.[15]
10. Further encumbrance is usually prohibited in securitized loans without the consent of the lender, and is likely to be prohibited altogether. And where prohibited, the REMIC will have virtually no flexibility to accommodate the further encumbrance of the property.[16]
11. Unless specifically authorized in the loan documents, prepayments on debt held by REMICs are generally prohibited, and when permitted will be conditioned on defeasance.[17] This limits release of collateral, and complicates workouts. Defeasance is expensive and time-consuming.
12. REMICs are likely to favor foreclosure over workouts. Foreclosure will be the relatively safe alternative for servicers charged under the pooling and servicing agreement with a standard of care, preservation of the REMIC status, and choosing the alternative that will maximize net present value (without using subjective judgments and input). With the REMIC's loan documentation, lock box, SPV structure, limitations on transfer, and yield maintenance, it may be difficult to establish clearly that a workout would produce a larger net present value than a foreclosure.

CONCLUSION

REMICs have changed the landscape of commercial real estate finance forever. We are now about to see how they will change the processing of troubled loans as we experience the next real estate downturn. The complexities of the structure make it imperative for all parties to the loan to know what they are doing. If borrowers are to succeed in workouts or bankruptcies, they will need to solve the maze to find the right party to talk to at the right time, and know how to present options that are within the power and prerogatives of the servicer. Servicers will face interesting challenges in dealing with practical issues of hotels and other operating assets, protecting value, and avoiding unnecessary taxes and costs. REI

NOTES

1. Securitization is the process of pooling assets such as mortgage loans, enhancing the credit rating, and issuing new securities to investors based upon the underlying assets in this pool.
2. Using the rating agencies' historic default rate (18 percent) and severity of loss factor (28 percent), applied to $1.3 trillion of outstanding commercial mortgage debt, experts predict that during the next economic downturn, the holders of U.S. commercial real estate debt may lose up to $65.5 billion.
3. In one of the earliest commercial real estate securitizations, Olympia & York obtained a $970 million loan in 1984 secured by 3 Manhattan office buildings. The loan was securitized in a private placement to 40 institutional investors. But the technique did not become popular at the time, because, among other things, there were abundant alternate financing sources.
4. Securitized pools usually range from a minimum of $300 or $400 million up to $4 billion.
5. The depositor is a special purpose vehicle ("SPV") formed to minimize the possibility of a voluntary bankruptcy. Rating agencies insist that the transfer of the mortgages by the depositor must quality as a "true sale" for bankruptcy purposes and isolate the mortgage from a bankruptcy of the originator. As noted later in this article, under financial accounting standards, satisfying this test also imposes limits on the discretion that the Special Servicer will have in disposing of the loans. See the discussion regarding FASB 140, *infra*.
6. The Tax Reform Act of 1986 authorized the creation of real estate mortgage investment conduits or REMICs as the exclusive vehicle for holding fixed pools of mortgages and issuing multiple classes of interests to investors. Entities meeting the six statutory requirements for a REMIC will not be treated as a separate taxable entity. Rather, the income of a REMIC will be allocated to, and taken into account by, the holders of the residual interests.
7. The rating agencies are independent private parties that are paid to analyze the creditworthiness of the pool. The major rating agencies are Standard & Poor's, Moody's, and Fitch.
8. The "B-piece" refers to all certificates below investment grade (rated BBB and below), but in mortgage securitizations, it is the usual practice for one investor to buy the entire B-piece.
9. Sometimes, the Master Servicer or Special Servicer will engage a party known as a Primary Servicer or sub-servicer. Although such entities are not signatories to the pooling and servicing agreement, they enter into contracts with the Master Servicer or Special Servicer to assist with various functions such as property inspection, working with the borrowers on requests for assignments, assumptions, defeasance, and similar matters.

10. The rating agencies are essential in evaluating the creditworthiness of the securitized income stream from the issuer. A credit rating is an assessment of the likelihood of ultimate receipt of principal and the timely receipt of interest. This is an evaluation of default risk and does not reflect other risks, such as interest rate risks, event risks, or other informational risks. Without participation from the rating agencies, there would be no CMBS market.
11. FASB 140 restricts the role of the Special Servicer in workouts by limiting discretion. As noted earlier, it is critical to the rating agencies that the transfer of mortgages by the depositor to the trust be viewed as a "true sale" to insulate the trust from bankruptcy issues that might affect the depositor. FASB 140 provides, in essence, that for transfers after April 1, 2001, a transfer to a trust will not quality as a sale if the trust or its agents (such as the Special Servicer) can decide when and how to dispose of assets. In other words, if the Special Servicer is given substantial discretion in disposition of assets, then the transfer to the trust might be rendered a "financing" instead of a "sale." This results in severe restriction of the flexibility that the Special Servicer has in working out the loan. It is particularly noteworthy that the FASB rejected certain arguments from the financial community that the Special Servicer should be permitted to exercise "a commercially reasonable and customary amount of discretion."
12. It may be possible to release unimproved land with a value of less than 10 percent of the value of the entire parcel, but even this will take time, require a REMIC opinion, and cost money.
13. Prior to default, any material modification may be deemed a sale or exchange of a mortgage that jeopardizes the REMIC status, but minor modifications may be permissible as an "insignificant change." For example, modifications that are not significant include: (1) extensions of the loan term that are the lesser of five years or one half of the original loan term; (2) adjustments in interest rate that are less than the greater of 25 basis points or 5 percent of the annual yield of the original loan; (3) waiver of customary accounting or financial covenants; or (4) assumption permitted by the original loan documents or due-on-sale clause.

    However, even minor modifications are likely to be complex and require considerable analysis by the servicer. Undoubtedly, REMIC opinions will be required to confirm that a change is not a "significant modification" within the meaning of the REMIC rules. Such opinions can be time-consuming and involve an additional expense.
14. While there may be many reasons that a borrower would prefer to substitute one collateral property for another, it will not be possible even if everyone were to agree that the substitute collateral is more valuable, because it would violate the REMIC's requirement to avoid sales or exchanges of its mortgage pool. It would be possible if the specific exchange or substitution was provided in the loan documents (and without discretionary lender consent), but that is usually quite problematic.
15. As with most conduit loan terms, if the loan documents do not specifically authorize the transfer and assumption, it will not be permitted.
16. A violation of this restriction is probably a material default under the loan, and is likely to trigger personal liability of the borrower and its guarantors under the carve-out provisions that create personal liability for the otherwise nonrecourse debt in certain specified situations.
17. Defeasance avoids termination of the debt by substituting, after a lock out period, an over-collateralized package of U.S. government securities that are not callable or prepayable. Defeasance is somewhat cumbersome and expensive because the borrower will normally have to purchase securities for the defeasance with a face value in excess of the mortgage amount in order to match each of the payment obligations of the original mortgage. In addition, the borrower will also be burdened with the inevitable transaction costs for legal fees, REMIC opinions, and the like for itself, as well as the rating agencies, brokers, accountants, trustees, servicers, and others who are involved in or must execute the substitution of collateral.