

## **EVERYBODY INTO THE POOL!**

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### **What Borrower's Counsel Needs to Know About Securitizeable Mortgages**

If you have acted as borrower's counsel in traditional commercial mortgage transactions, you are already familiar with typical loan terms, covenants and representations, and have a sense of what you can negotiate and which provisions the lender considers sacrosanct. Once you venture into the world of securitized lending and the commercial mortgage-backed securities or "CMBS" market, you will find that this sector of the commercial mortgage industry has a number of significant differences that set it apart from traditional commercial mortgage lending. As borrower's counsel, you will do both yourself and your client a service by educating yourself about these distinctions.

The growing presence of Wall Street's rating agencies in mortgage financing has caused many lenders to modify their mortgage loan documents to conform to CMBS requirements, even if they do not immediately intend to pool their loans in a securitization. By documenting the transaction initially in a form acceptable to the rating agencies, lenders preserve an option to deposit their loans into a pool of securitized mortgages at some time in the future. You can better represent your borrower clients in future transactions by understanding the requirements of the securitized market, and knowing which terms are and which terms are not negotiable. What makes a CMBS loan different from a traditional commercial mortgage?

#### **The Money Source**

First and foremost, it is the source of funds used to make the loan to the borrower. The traditional commercial mortgage lender is a bank, insurance company or other financial institution that often relies on its own assets to advance monies to its borrowers. This segment of the mortgage lending industry contains a limited number of players, most of whom are highly regulated. By contrast, a securitized mortgage lender acts as a "conduit" to other parties in the capital markets to make mortgage capital available. The securitization process involves a large number of players – the loan originator who identifies the borrower and performs the initial credit analysis, the depositor who deposits the loans into a pool for securitization, the investors who purchase the securities and thereby provide the ultimate source of funds for the loan, and the trustee who distributes periodic payments to the investors or "certificate holders." Once securitized, these loans are then administered by one or more servicers throughout the life of the issued securities.

Because capital markets are larger, they are often more efficient, and the securitized mortgage lender is frequently able to offer better pricing than a traditional

lender. But part of the price a borrower pays for its favorable interest rate is a reduction in the flexibility of the loan's terms and conditions. In contrast to the relative flexibility that is afforded to borrowers by traditional lenders, a securitized mortgage lender must maintain strict uniformity in its loan documents. This uniformity is essential for the loan, and the loan pool collateralizing the issued securities, to be deemed a sound investment by the rating agencies and investors.

Rating agencies have specific requirements in rating "securitizeable" mortgages. In order to rate an investment instrument accurately, Wall Street seeks two imperatives: maximum information and maximum predictability. Lenders require comprehensive information about the borrower, the mortgaged property and the likelihood of extraordinary events occurring during the loan's term (such as prepayment or bankruptcy), to ensure the security and predictability of the loan investment for the lender, the trustee and the certificateholders.

### **Risk Analysis**

In a traditional commercial mortgage loan origination, the lender conducts its own credit analysis of the borrower and has the option to accommodate some loans with unusual risks, subject to its own internal lending guidelines and the regulatory regimen by which it is governed. By contrast, the securitized commercial mortgage lender conducts its credit analysis with the knowledge that one or more rating agencies will be looking over its shoulder and doing the same analysis as well. With its eye on the rating agency microscope, the CMBS originator focuses on conforming each loan to a set of industry standards so that a uniform pool is created which can then be securitized and sold to investors.

### **Bankruptcy Remote Entities**

While traditional loan underwriting seeks to minimize risk by ensuring that the loan amount can be easily recovered, securitized lenders focus on managing risk by maintaining the cash flow of the property and by isolating the collateral property so that it can be easily transferred to the lender in the event of default. To achieve this isolation, the borrowing entity must be a single-purpose entity ("SPE") whose sole business is the ownership and operation of the mortgaged property. This requirement is necessary to prevent other assets of the borrower from prolonging a borrower bankruptcy. This structure also helps to prevent the bankruptcy court from declaring substantive consolidation of the borrower's assets with one of its affiliates, which could further delay and complicate the bankruptcy proceeding. Another advantage of the SPE's simple structure is that it can be more easily described to investors in the prospectus that discloses relevant information about the collateral for the CMBS pool. Although the SPE is often a newly-formed entity, "recycled" SPEs are sometimes allowed provided that they do not currently own property other than the collateral property.

The SPE entity holding the collateral property must adopt certain charter or bylaw restrictions and special governing clauses which are intended to restrict its ability to file

for bankruptcy to the greatest degree possible. These provisions may include appointing independent members of its board of directors, requiring a voting supermajority for certain major events such as mergers or bankruptcy filings, or establishing trust arrangements which restrict the freedom of stockholders to approve such events. The borrower's attorney must provide for these restrictions in the entity's formation documents.

In addition to the restrictions required in the SPE's formation documents, the loan documents also seek to reinforce the separateness of the SPE from its affiliates and reduce the risk that it might become entangled in an affiliate's bankruptcy proceeding. Securitized mortgage loan documents are designed to insure that the collateral property will remain available to the secured lender if a court seeks to include it as part of a parent's or affiliate's bankruptcy proceeding. However, the bankruptcy waivers often seen in CMBS loan documents have not been fully tested by the courts despite their widespread use, and the public policy which disfavors such waivers continues to cast some doubt on their enforceability.

If a loan comprises a certain percentage of the overall loan pool or a non-SPE affiliate controls the SPE borrower, borrower's counsel may be asked to provide a non-consolidation opinion that analyzes the relationship between the borrower and its controlling entity and concludes, with reasonable certainty, that a substantive consolidation would not be ordered by a bankruptcy court.

### **Loan Covenants**

Another significant difference between traditional commercial mortgage loans and CMBS loans is the purpose and inclusion of certain borrower covenants in the loan documents. Securitized mortgage lenders seek to avoid variations in the anticipated cash flow generated by the loan pool since investors are expecting a given rate of return over a given time period on their mortgage-backed securities. The securitized mortgage lender's focus on protecting the property's income stream is evident in the loan document's financial covenants designed to insure property cash flow. The borrower will be required to deliver periodic reports of the operating results for the mortgaged property, prepared in accordance with generally accepted accounting principles, sometimes quarterly and at least on an annual basis. Failure to deliver the reports may constitute a default under the loan, or may trigger full or limited recourse liability on a loan that is otherwise non-recourse. The SPE borrower in a securitized loan can also expect stricter covenants on late rents and tenant vacancies, and a CMBS lender may be more likely to stress the debt service coverage ratio over the property's loan-to-value ratio.

If a loan doesn't meet certain CMBS guidelines, or the loan covenants do not provide expected collateral protections such as financial reporting, and this oversight goes undetected by the loan originator, the result may be a poorer set of ratings for the levels of securities, or "tranches", in the loan pool by the rating agencies, or the securitization sponsor may reject the loan from the pool altogether. As a result, securitizable loan documents include fairly broad "further assurance" undertakings which

require the borrower to take reasonable additional steps to assist in the qualification of the loan for securitization after closing.

### **Transferability**

Unlike “portfolio” mortgage loans in which a lender may commit to holding a loan on its own books throughout its term, securitized loans must be transferable by the originating lender to the trustee for the benefit of the investors. SPE borrowers are required to acknowledge this anticipated transfer and sometime to execute additional documentation to facilitate it. Borrower’s counsel’s opinion must include reliance language that allows investors, rating agencies and others the benefit of its opinions regarding the transferability of the loan as well as the validity of the lending documents and their conformance to law.

While the loan must be transferable by the lender, the mortgage and collateral property are usually restricted from transfer by the borrower. Many CMBS loans will allow a limited right to transfer to a new owner upon full assumption of the loan, replacement of guarantors, a review of the background and credit of the replacement borrower, and payment of an assumption fee. But transfers outside of those that are expressly permitted by the loan documents are strictly prohibited. Such a prohibited transfer could violate the Internal Revenue Code provisions governing Real Estate Mortgage Investment Conduits or “REMICs”, thereby robbing the entire mortgage pool, of which the transferred mortgage is a part, of its tax benefits.<sup>1</sup>

### **Diversification and Reporting**

Another contrast between traditional and securitized commercial loans is that in traditional loans, lenders are subject to relatively stringent internal and external regulation of their mortgage loan portfolios. For example, a traditional lender will often cap its exposure to a particular borrowing group, property type or geographical area in an effort to maintain a diverse, and more risk-protected, portfolio. Securitized loans, however, are not subject to these same limitations since they are not held in the originating lender's portfolio and diversification can be assured by depositing different borrower, property type or geographical loans into different pools. However, CMBS loans are governed by securities laws which require that arrangers produce detailed disclosure statements or prospectuses for investors. Because of this pressure to provide extensive disclosure, securitized loans must be documented in a standardized, uniform and formulaic way. For example, the requirement that the borrower must provide periodic reports concerning the operating results for the mortgaged property continues to insure the transparency of the investment for the certificateholders once they make the decision to invest in the pool.

### **Reserves, Insurance Proceeds and Casualty Awards**

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<sup>1</sup> An exhaustive discussion of the REMIC rules under the Internal Revenue Code is beyond the scope of this article. The reader may review the IRC’s REMIC regulations at 26 C.F.R. §1.860A -G.

Because an SPE borrower has no assets other than the collateral property, a securitized mortgage lender will require reserves for future operating costs including tenant turnover expenses, capital improvements, taxes and insurance premiums. Securitized lenders are also more likely than traditional lenders to require that the borrower obtain insurance to cover operating risks such as rental value insurance, business interruption insurance and law and ordinance coverage. Because it is essential to a securitized investment that the underlying collateral remain in good condition and income-producing, securitized mortgage loan documents usually provide that insurance proceeds from a casualty or condemnation awards be made available for restoration of the property. By contrast, some traditional mortgage loans may provide that such funds will or may be used to reduce the loan balance. If these funds were applied to reduce the loan balance of a CMBS loan, the payments available to investors in the pool of securitized mortgages would be subject to much greater volatility. Once again, predictability is the key.

### **Guaranties**

Traditional lenders often require additional collateral in the form of guaranties from third parties to address certain risk contingencies. By contrast, in a securitized lending transaction, investors rely primarily on the collateral and the SPE which serves as the principal obligor for payment, and third party guarantors are viewed with greater caution. Credit enhancements such as guaranties create a risk of nonpayment from a new party, necessitating investigation and disclosure of the creditworthiness and risks associated with the guarantor, which could prove to be a significant obstacle to meeting investor disclosure requirements. In addition, if repayment relies on outside parties, the rating agencies will not give the securitized pool as “clean” a rating as they would if repayment were a function only of the mortgaged property’s operations. A lower rating lowers the price investors are willing to pay and therefore increases the cost of funds, making the securitization transaction less attractive.

Guaranties and similar credit supports also detract from the asset isolation sought from the SPE and may serve as evidence that the SPE is not economically independent, risking exposure of the SPE to its affiliates’ credit risks. Securitized commercial mortgage lenders regard certain limited guaranties, such as environmental indemnities, to be beneficial despite the legal risks. However, for the CMBS lender, cash reserves and over-collateralization are as a safer form of credit enhancement that carry no legal risk of veil-piercing.

### **Prepayment**

While prepayment may be available, or available with restrictions, in traditional mortgage loans, securitized mortgage loans are usually closed to prepayment or prepayment may be available only with the payment of a prepayment fee sufficient to compensate the investor for its opportunity loss. Because investors in CMBS buy into a particular “tranche” of the mortgage pool in anticipation of a given rate of return,

variations in the anticipated cash flow from the pool can wreak havoc on the structured payments of the securities.

CMBS loan documents generally prohibit prepayment but permit defeasance under certain circumstances. A defeasance option permits the borrower to substitute U.S. government securities for the underlying real estate collateral for the loan once it is in the pool. The borrower then transfers the loan and assigns this substitute collateral to an unaffiliated SPE that is established solely for the purpose of handling the defeased loan. Defeasance options require that the substituted collateral must produce sufficient cash flow to cover the original debt service obligation. In connection with the defeasance, the borrower and its counsel may be asked to provide a non-consolidation opinion, an enforceability opinion and a REMIC opinion stating that the defeasance will not affect the tax-exempt status of the pool.

### **The Lender/Borrower Relationship**

Some traditional loan borrowers may seek assurances that they will be able to continue to deal with the relationship-oriented loan officer who originated their loan. In the securitized loan market this is not an option, since the loan is designed to be sold, and then serviced by whichever CMBS loan servicer signs on to the pooling and servicing agreement. The good news for borrowers and all borrowers' counsel is that CMBS servicers have become more customer-oriented over the years as the industry has matured. Borrower and borrowers' counsel would be well-advised to negotiate all the flexibility they can in the original loan documents, since REMIC rules prohibit releases or substitutions of collateral, changes to the loan's economics and other "substantial" changes once the loan is in a pool. If the originator approves of a partial release of excess acreage that doesn't adversely affect property cash flow and the loan documents set out the steps required to secure that release, then the servicer will be able to accommodate the borrower to facilitate the release. Otherwise, the borrower is simply out of luck.

### **Subordinate Financing**

While a traditional lender may allow a provision in the loan documents that permits subordinate financing, securitized lenders prohibit subordinate financing secured by a lien on the mortgaged property. This prohibition furthers the securitized lender's goal of isolating the property and its income stream and preventing a junior lender from entangling the property in foreclosure and impeding timely payments to investors.

### **On the Horizon**

The REMIC Modernization Act, currently under consideration by Congress, is designed to relax some of the existing rules governing which loan terms can and cannot be modified once a mortgage loan is securitized. If this legislation is enacted, the CMBS marketplace is likely to experience a shot of adrenaline as borrowers and investors seek new opportunities produced by the relaxed rules.

Many other factors, in addition to those discussed above, are considered when a commercial mortgage loan is placed under Wall Street's microscope of rateability. Though commercial mortgage financing is a long way from the standardization seen in the residential mortgage market, it certainly appears to be moving in the direction of greater standardization and uniformity. Today's lenders and borrowers are well-advised to keep CMBS requirements within their peripheral vision as public ownership of the nation's commercial mortgages kicks into high gear.

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