

What Lurks Beneath

Think you know the risks? Check out the long-term issues in securitized loans.



BY STEVEN P. BLONDER

The past decade has brought about unprecedented growth in the levels of home ownership. Much of this was generated by low interest rates and myriad new financing vehicles. For those who already owned residential real estate, valuations rose, allowing any equity to be tapped for alternate uses. On the commercial side, low interest rates and available credit provided access to capital that enabled owners and developers to finance or refinance various projects seemingly at will.

This year, however, a different story emerged. Mortgage defaults (both commercial and residential) continue to rise. Foreclosures are proceeding at record rates. Credit has tightened, residential real estate valuations have stalled or even declined, and the “piggy banks” that homeowners had counted on are often illusory. Multifamily housing projects of all sizes are under water. Phrases such as “subprime mortgages” and the “subprime crisis” have entered the public vernacular.

Recent headlines suggest that the subprime mortgage crisis is the catalyst of current economic concerns and the decline in the stock markets. Financial companies continue to take huge write-offs to adjust for their subprime exposure. One need only peruse the recent headlines to learn that the credit markets are in a tailspin.

Amid all of this turbulence, holders of securitized loans—whether in commercial mortgage-backed securities (CMBS), collateralized debt obligations (CDOs), or some other structure—are staring risk in the face. These are a few of the more transparent effects of the over-extension of credit. The real and more frightening issue is what dangers remain unseen, lurking below the surface.

THOSE WERE THE DAYS

One generation ago, purchasing real estate was much simpler and more predictable. A real estate purchaser or developer would enter the local bank with his longtime

lawyer, visit with a banker he probably knew, and after a conversation or two, leave with a commitment for funding a project. At the closing, documents would be signed, money exchanged, and the deal completed.

With very few exceptions, real estate deals today no longer come together that way. Even local transactions now involve multinational lending sources and often employ complex financing structures that require seemingly endless underwriting and other due diligence. Cross-collateralizations and escrows are common. Real estate investment trusts and other vehicles typically hold the ownership, while the loans themselves are bundled, securitized, and sold on the public market.

Yet the lengthy documents that accompany these real estate transactions merely mask the increased uncertainty in the new forms of ownership and complex financing structures. In fact, the underwriting process merely identifies a host of other issues that may not come to light until years after a transaction is consummated. But the underwriting process has no bearing on the risks inherent in the structure of the financing vehicle. These new, relatively untested financing structures are unpredictable in a downturn, which adds a layer of complexity in dealing with troubled or defaulted loans. This uncertainty is exacerbated by the lack of discretion and judgment common among the servicers of these financing structures when they are called upon to work out issues with particular loans or borrowers.

WHAT HAPPENED IN OREGON

The perfect example was a case in Oregon in which a bankruptcy filing affected a company’s CMBS debt in unforeseen ways and raised a number of serious issues. The case involved a franchise and management company operating 27 hotels under a single brand. When the hotels experienced a series of operating challenges, all of the non-CMBS loans were driven into bankruptcy, even though the borrowers had negotiated various forbearance arrangements with the non-CMBS lenders. The control-

ling owner, the management company, the franchisor, and the other hotels did not enter bankruptcy.

The 27 hotel loans were each made to a different special-purpose entity (ownership structure) and then allocated among three pools, each of which contained other loans as well. The loans included cross-collateralization (when the collateral for one loan is also used as the collateral for another loan) and cross-default provisions (which put the borrower in default if it defaults on another obligation) within the separate pools. At least one pool was structured to expressly permit the release of the primary debtor from the loan, provided the property was sold to a buyer that would assume any outstanding debt. The properties were operated by a management company affiliated with the borrower. Although the hotel revenues were pledged to the lender, the loan documents allowed that money to be used to cover operating costs as long as the existing management company continued to operate the property.

One pitfall of this complex structure arose from the interplay between the servicer for the CMBS pool holding the 27 mortgages and the post-default special servicer (the entity that takes over once a loan falls into default). Before the bankruptcy filing, the servicer refused to consent to a workout or forbearance, claiming that it needed the consent of the special servicer.

However, the special servicer refused to involve itself in a loan that was not in default. As a result, the borrower attempted to trigger a technical default by making a late mortgage payment. Even then, the special servicer maintained that it could release the first lien but not effect the cross-collateralization lien, and still refused to make concessions prior to any actual default. Once the loan truly fell into default, the special servicer began foreclosure and receivership procedures, with an ultimate goal of liquidating the properties. In short, the roles of the different servicers—which were a creation of the CMBS structure—led to additional complexities and problems.

After the non-CMBS loans entered bankruptcy, these dominoes fell:

- The management affiliate was allowed to use hotel revenues for continuing operations and apply excess funds to reserves and capital projects. That meant the holders of the various CMBS tranches got nothing.
- The special servicer initiated litigation that claimed mismanagement and commercial defamation, requiring the holders of the CMBS tranches to incur even more legal fees.
- The special servicer also claimed that the borrower had guaranteed the entire debt via a "bad acts" guarantee (in other words, one that becomes effective upon a borrower committing certain "bad acts," including defaulting on a loan). As a result, the borrower was cornered.
- Because hotel management kept vendors paid, employees paid, the hotels operating and the traditional lenders happy, the CMBS investors were left holding the bag.

THE LESSONS

There are important lessons here. First, the anticipated benefits of the separate special-purpose entities did not happen and,

therefore, provided no effective defenses in the bankruptcy. For example, the fact that employee relationships and vendor contracts were handled by a special-purpose entity (an affiliate of the borrower, rather than the borrower itself) meant very little under the bankruptcy code. Also, the inclusion of cross-collateralization requirements in the loan documents directly undercut all other efforts to separate the various entities and minimize the associated risks.

Second, it seems fairly clear that the inherent conflicts of interest in the CMBS servicing structure led to this bankruptcy. Consider this: Some reports show that the default rate for securitized loan pools is higher than that of a comparable pool of institutional loans. In all likelihood, the higher default rate is a result of the unique CMBS structure and the awkward interplay between the servicers. In the Oregon case and others like it, the performance of the non-CMBS loans after a negotiated forbearance provides further evidence that the CMBS structure caused additional problems.

Third, the powers of the post-default special servicer were held under a microscope by the court and strictly construed. On what issues were the various note holders entitled to speak or to vote? What were the restrictions on the special servicer's powers? Although the special servicer may have claimed authority to act under certain circumstances, the intersection of typical servicing agreements and the bankruptcy code leads only to confusion and differing answers concerning the rights and powers of all involved.

In Oregon, the parties thought they had considered all the likely ramifications from the underlying transaction when the loans were made. But the Oregon case underscores the fact that these increasingly complex financing and ownership structures do not provide the protections that most borrowers expect, particularly when it comes to troubled loans. With billions of dollars of bundled and securitized real estate mortgages, borrowers should prepare themselves for a range of problems. Borrowers should carefully watch the grant of power to and the restriction of power on a CMBS servicer, as well as the structuring constraints on a borrower's ability to work out a troubled loan.

Particularly problematic, however, is today's lack of predictability in this market. This uncertainty means inherent risk for those active in the market as well as those sitting on the sidelines. For a borrower, for example, even the most carefully crafted plans may need to be rethought because the expected protections may not exist. For a lender, even careful underwriting and monitoring may not be sufficient to safeguard your interests.

For those sitting on the sidelines, the write-offs being taken by public companies and the tight credit markets, together with the inverted yield curves, underscore the prudence of caution. Whatever one's position, do not count on the expected protections to help weather the storm.

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