[Legal & Regulatory]

Working Out Right

What to Expect from Pooling and Servicing Agreements

By Michael Hamilton & Scott Weinberg

Borrowers have experienced uncertainty over the past three years as CMBS workout procedures have been tested for the first time in a recession. Familiarity with the ins and outs of these procedures, as defined in the typical pooling and servicing agreement, or PSA, will make it easier to avoid the risks and implications such situations can produce. The PSA defines the roles and authority of the master and special servicers, when and how the servicers must act, prohibited actions and the standard of care required.

Transfer from Master to Special Servicer

While the master servicer is responsible for collecting monthly payments and responding to borrower requests for consent, typically it is the special servicer that has the authority to work out a loan.

A loan will undergo a servicing transfer to the special servicer upon certain events, including (1) a monetary or material nonmonetary default, (2) a bankruptcy of the borrower; (3) a borrower's admission in writing of an inability to pay debts as they come due; and in certain cases, (4) a determination that a material event of default is imminent.

Imminent defaults are frequently encountered today, as maturing debt is not refinanceable due to loss in values and corresponding needs for additional equity. If the maturity date is more than six to nine months away, the default will not be "imminent enough" for a servicing transfer.

To trigger a transfer to special servicing, borrowers may also elect to intentionally default (for instance, fail to make an interest payment, or terminate a management agreement). The default must be significant enough to trigger a servicing transfer but not trigger recourse liability under the nonrecourse/bad act carveouts.

Borrowers must tread cautiously in these areas and consider the wider implications of any admission of imminent default or actual default.

The Asset Status Report

When a servicing transfer event occurs, the loan file is transferred to the special servicer. The special servicer is then obligated to obtain a new appraisal and prepare an "asset status report" summarizing its recommendations for the loan, such as foreclosure or restructuring of the debt. A prudent borrower will seek to influence the contents of the asset status report early in the process.

The Controlling Class

The most junior certificate in the CMBS pool is initially the "controlling class." The controlling classholder is often an affiliate of the special servicer. Generally, if the value of the controlling class certificate is at least 25 percent of its initial balance, then its holder will remain the controlling classholder. If not, then the next most junior certificate holder becomes the controlling classholder.

The controlling classholder has approval rights over the asset status report. In addition, without the consent of the controlling classholder, the special servicer may not undertake certain loan modifications, including those that affect the amount or timing of any payment or extend the maturity date (beyond a certain period).

The special servicer's authority to undertake loan modifications is also limited by REMIC tax rules (which are beyond the scope of this article) and the "Servicing Standard."

The Servicing Standard is the standard of care required of the servicers in the PSA. In essence, the servicer shall seek maximization of timely recovery of principal and interest on a net present value basis for the benefit of all certificateholders. There is a dearth of case law regarding the Servicing Standard, and servicers will generally interpret their authority conservatively to reduce their potential liability.

Likely Outcomes

- If the appraised value of the property is greater than the loan amount and revenues cover debt service and operating expenses, the servicer will likely not extend or work out the loan. Servicers are increasingly more willing to foreclose, especially on properties that do not require any particular operational expertise.
- If the appraised value of the property is less than the loan amount but revenues cover debt service and operating expenses, the servicer will likely entertain an extension of between 12 and 24 months, for a fee of 50 to 100 basis points. Principal paydown requirements vary among servicers. Cash management techniques are almost uniformly imposed.
- Operational expenses receive priority over debt service when cash flow is insufficient.
- Write-downs have been few and minimal. Other variables are highly negotiable.

With this information in hand, borrowers should have a better understanding of the servicer's needs and limits, providing them with greater certainty and more predictable workout solutions to the challenges that lie ahead. CPE

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