

8 FAQs of CMBS loan restructuring

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During the early 2000's, hotel owners, like the owners of virtually all property types, turned increasingly to Wall Street to finance and refinance their properties, attracted by the higher leverage and lower rates offered in comparison to more conventional lenders. These loans were packaged with a wide variety of other loans and turned into securities, known as commercial mortgage-backed securities.



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Since 2004, about US\$100 billion of hotel CMBS loans have been issued across all hotel sectors and markets. They range in size from US\$5 million to US\$1.4 billion, including more than 30 single or portfolio CMBS loans each in excess of US\$200 million, according to Realpoint.

Surprisingly, many of the post-2005 CMBS loans have been made on midscale hotels in amounts averaging US\$15 million-US\$20 million.

Nearly 1,000 CMBS hotel loans are maturing within the next two years. Such a huge volume of maturing loans involving a debt class that has not yet gone through a serious hotel industry

downturn is even more sobering when looking at the explosion of CMBS hotel delinquencies during the past 12 months. Said delinquency rate has jumped from less than 0.5 percent in the fall of 2008 to 6-8 percent with predictions that the delinquency rate will exceed 10 percent in the months ahead, according to Realpoint.

What will be the result of such large upcoming maturities and increasing delinquencies on CMBS hotel lenders and borrowers in such a severe industry downturn? While politicians may trumpet the end of the "Great Recession," current hotel performance trends, combined with an almost total absence of new CMBS issuances and a lack of lending capacity from more traditional lenders, would seem to point to a large number of defaults in the CMBS hotel arena during the next few years. More specifically, with the industry's revenue per available room projected to decline 17 percent to 18 percent in 2009 and an additional 1 percent to 5 percent in 2010, hotel owners and lenders cannot rely on an improving economy to bail out distressed loans.

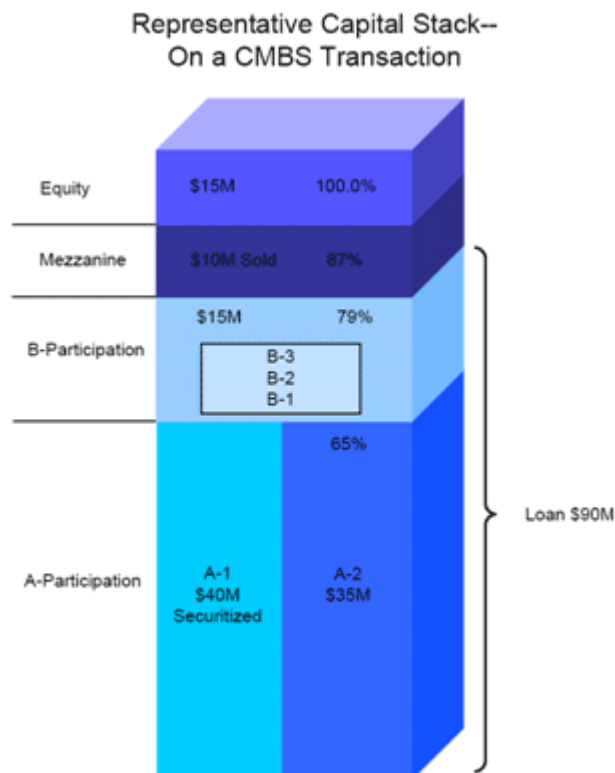
Because of such an unprecedented decline in industry revenue fundamentals, hotels' average net operating income and asset values have declined 35 percent to 40 percent, according to Realpoint, which in turn has caused or will cause many owners to lose their equity investment and, in many instances, the cash to meet ongoing debt service payments or covenants.

Finally, the growing loan refinance and balloon default risk facing many hotels, when combined with the lack of financing and very stringent loan underwriting standards, even places hotel owners with performing assets at great risk should they have debt maturing in the next one to two years.

While such problems are not unique to CMBS-financed hotel properties, the complexities of pursuing and securing a restructuring with CMBS debt often are far greater than hotels with other forms of financing. To understand why CMBS loan restructurings are likely to be more

challenging even to hotel owners with previous downturn experience, this article will answer common questions regarding the structure of typical CMBS loans and highlight some of the issues unique to CMBS loans that hotel owners likely will confront when dealing with a workout.

1. How are CMBS loans typically structured and what are the main governing documents?



One of the main differences between CMBS loans and conventional loans is that CMBS loans are transferred by the originating lender into a trust together with many other loans, with the original lender having no ongoing relationship with the borrower. The document governing this pool of loans is called the Pooling and Servicing Agreement, or PSA. Though this agreement can be the single most important document governing the workout, the borrower is not a party and is generally not even entitled to see a copy.

Another basic difference is that CMBS loans often are tranching into multiple classes, both within the mortgage and sometimes also including one or more classes of mezzanine loans. An example of such a multitranche structure is shown in chart form. The relationships among these various classes of lenders are set forth in Participation Agreements and Intercreditor Agreements. This multiplicity of players, each with a differing interest, can result in a much more contentious workout than borrowers might expect, with the disagreements among lenders being greater than those with borrowers.

2. Because there are so many players, with whom will the borrower deal?

While the loans technically are held by a trustee, the PSA appoints a loan servicer, usually called the master servicer, to act on behalf of the trust and administer the loans on a day-to-day basis, including collecting and applying debt-service payments. The PSA also typically appoints another party, called the special servicer, to deal with situations outside the ordinary course. In most securitizations, only the special servicer has the right to waive defaults or modify the loan, so that is the party the borrower almost certainly will deal with in any workout situation.



3. What standards do the servicers apply in administering the loans?

The servicers must act in accordance with accepted servicing practices and administer the loans “giving due consideration to the customary and usual standards of practice of prudent institutional commercial mortgage lenders servicing and administering mortgage loans for third parties.” In the context of a workout, the servicer usually is charged with “maximization of recovery to the [H]olders as a collective whole, taking into account their relative priority.”

This means the servicer must consider the interests of the holders of subordinate tranches outside the trust (though not separate mezzanine loans) in addition to acting for the trust itself, which becomes interesting in light of the fact that the special servicer typically is appointed by one of such subordinate holders and may have an economic interest in the pool of loans being serviced. Furthermore, the special servicer is required to undertake on each CMBS loan an analysis of the net present value, or NPV, of projected income/sale proceeds less costs of pursuing certain business and legal restructuring options; i.e., the special servicer is charged with analyzing whether the projected NPV of pursuing a loan forbearance/modification will yield a higher NPV than a real-estate owned sale.

4. How does a loan get transferred into special servicing?

The rules governing a transfer to special servicing are contained in the PSA. The typical conditions for transfer include such objective items as loan maturity or a payment or other event of default which has continued for a certain period of time, as well the more subjective standard that the master servicer believes there is “an imminent risk of an event of default.”

A borrower cannot simply request a transfer into special servicing, which has been a great source of frustration to many borrowers since, as stated above, only the special servicer has the authority to enter into loan amendments. This has led some borrowers to intentionally default to precipitate a transfer, which generally speaking is a bad idea. The better course, if possible, is to try and convince the master servicer that a default is imminent, but that also entails a certain degree of risk to the borrower, including a potential risk of triggering recourse in certain instances.

5. Are the servicers restricted from taking certain actions in a workout?

One of the most common statements regarding CMBS loan workouts is that there are actions the servicer cannot take because of tax restrictions. While there is truth to that statement, in most workout situations, the restrictions that exist will not be meaningful.

The mortgage pools of CMBS loans are creations of the tax code known as a Real Estate Mortgage Investment Conduit or REMIC. While the REMIC rules do prohibit a loan servicer from entering into a “material modification” of a loan prior to an event of default, most workouts will occur after such an event has occurred, negating the effect of the restriction. There are no specific restrictions against such common borrower requests as forbearance, forgiveness of loan principal, reduction of interest rate or (generally speaking) a maturity extension.

The servicer may also be granted rights pursuant to the loan documents to change property managers and possibly even to change flags, but in reality there are usually direct non-disturbance agreements with the manager and/or comfort letters from the franchisor in place which will prohibit such action.



Furthermore, recently issued regulations by the I.R.S. appear to provide further flexibility under REMIC rules to CMBS servicers in situations “where the holder or servicer believes that there is a significant risk of default of the loan” and “based on all facts and circumstances, the holder or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modification loan.” In such situations, the regulations list types of modifications not likely to cause REMIC qualifications to be at risk, and also states that discussions between a servicer and borrower concerning a modification may occur before a loan default.

6. Who controls the servicer during a workout (i.e., which party is the real decision maker)?

Though the special servicer is the party who has primary authority for running the workout, there are certain actions it cannot take without the consent of the “controlling (or directing) holder.” The party that is the controlling holder is typically the holder of the most junior interest in a loan, though there are typically provisions to shift to another party upon certain triggers if such interest no longer has economic value. This junior interest can be outside the trust, but cannot be in the form of a separate mezzanine loan.

Among the decisions that require consent are loan extensions, interest-rate reductions and principal forgiveness. A controlling holder might more appropriately be called a “vetoing holder,” because while it has the power to veto a servicer’s request to take such actions, it cannot typically affirmatively force a servicer to take action.

In any event, if the servicer and the controlling holder cannot agree on a course of action after a specified amount of time has passed, the servicer is authorized to take action in accordance with accepted servicing practices. While this may sound like a drastic action, in practice it will almost never happen because the special servicer is appointed by the controlling holder.

7. What borrower actions can trigger recourse?

In virtually all CMBS loans, the loan documents provide that upon the happening of certain specified events (the “non-recourse carve outs”) a principal of the borrower, typically an individual, will become personally liable for any loss or damage that the lender suffers or, in some cases, for the entire loan amount. While many of these events are obvious “bad-boy” type events such as fraud, misappropriation or non-permitted subordinate debt, others are more subtle and can be triggered by an unwitting borrower experiencing cash flow issues.

For example, many loans contain a carve out if the borrower “admits its inability to pay its debts as they mature.” A borrower facing a cash flow shortage might think it is being proactive by sending a letter to the servicer detailing when cash will run out, but in several instances we’ve seen, servicers have responded by declaring the borrower in default and threatening recourse. Worse still, that item is often lumped together with other bankruptcy or insolvency type carve outs in the full recourse (as opposed to loss or damage) section.

Another item to watch is failure to pay real-estate taxes. While most loans provide for escrows to pay such amounts and typically provide first payment priority in the cash flow waterfall, most loans also state that after the occurrence of an event of default, the lender may apply cash flow in any order it chooses, as well as apply reserves to payment of the debt. Thus even an unrelated technical event of default (e.g., a failure to deliver required interim financial statements) could



permit the lender to use monies previously earmarked for real estate taxes to repay principal and then pursue the carve-out guarantor for real-estate tax payments going forward.

8. So what can a borrower facing a CMBS hotel workout do to prepare for dealing with the servicer?

Due to the above described CMBS complexities and “tranche” interests, it is essential that a borrower facing a distressed CMBS loan:

- understands the CMBS servicing parties and holders, constraints, rules and alternatives applicable to its loan, as well as the rights and roles of the hotel’s franchisor and manager;
- works through the master servicer to connect with the special servicer as early as possible with a comprehensive plan and all needed financial and property information , and without having the loan going into default;
- demonstrates to the servicer an ability to provide some form of financial commitment to add value to the asset underlying the loan and its collateral;
- and starts such process at least six-nine months ahead of the loan’s scheduled maturity.

Concluding remarks

Trying to predict whether or not the complexities of hotel CMBS loans, including the potential liability of special servicers to tranches with divergent interests, will make CMBS loans more susceptible to further “extending and pretending” or to consensual workouts versus foreclosures, and REO sales should best be left to a soothsayer. Nonetheless, with the “flood” of CMBS hotel loans now moving to the special servicer, we will begin to get some answers to the questions and issues raised in this article. While each CMBS hotel loan involves unique facts, the economic condition of the hotel industry, the availability and cost of debt and equity capital, and the role regulators will play in assessing the valuation of hotel loans on lenders’ financial statements will all be critical to the outcome of how distressed CMBS hotel loan situations are resolved. Stay tuned!

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