New York Law Journal
Real Estate Trends
Wednesday, November 19, 2008
©2008 ALM Properties, Inc. An incisivemedia publication

The Enigma Of Special Servicers

Loan Agreements Grant Experts Broad Discretion

BY JEFFREY B. STEINER AND ZACHARY SAMTON

Jeffrey B. Steiner *Zachary Samton*

FINANCING

In this age of specialization, many institutional lenders, especially those on Wall Street, have allocated the various elements of loan administration to third-party experts rather than undertaking the process themselves. In the context of a loan which has been pooled into a securitization while title is nominally held by a trustee, administration of the loan pool is conducted by a party known as servicer. Further, when a securitized loan goes into default, or a material default is imminent, the administration is transferred from the jurisdiction of a master servicer to that of a so-called special servicer, which has particular expertise in default and workout situations. To many in the industry, however, the authority, rights and obligations of a special servicer remain an enigma. In this article we will focus on what lender's, borrower's and investor's attorneys should know about the rights, obligations and authority of special servicers in the context of securitized loans.

Special servicers, as well as master servicers, are retained by securitization trusts pursuant to a pooling and servicing agreement or other similar agreement and the authority, rights, duties and obligations of such special servicer are contained therein. Although such agreements can be heavily negotiated (borrowers, for the most part, are not privy to such negotiations), most contain many common provisions which require a special servicer to perform certain obligations while still permitting some flexibility to account for changing conditions and the particularities of individual loans. These provisions include standards for when a loan is transferred from a master servicer to the authority of the special servicer, the scope of actions the special servicer may take, and standards for determining the appropriate remedy for a loan in default. Additionally, servicers, including special servicers, may be limited in their authority by certain sections of the Tax Code known as the REMIC (Real Estate Mortgage Investment Conduit) rules.[1] Violating REMIC rules could have a significant adverse economic effect to the trust (or certificate holders, as applicable) and special servicers are careful to avoid such a situation.

Pooling and servicing agreements normally grant authority to the special servicer when (a) a borrower fails to make a monthly payment for a specified period after its due date, (b) in the reasonable business judgment of the master servicer there is an imminent risk of a default that is likely to impair the use or marketability of the property secured by the subject mortgage loan, (c) the master servicer has received notice that the borrower has become the subject of an insolvency proceeding, (d) the master servicer has received notice of a foreclosure or threatened foreclosure of a lien on a mortgaged property, (e) a borrower is in default beyond any grace or cure periods in the performance or observance or any obligation under the loan documents, the failure of which to cure may materially and adversely affect the interests of the lender or (f) the loan matures and the borrower fails to make the final payment.[2] Additionally, there may be other instances where the consent or approval of a special servicer is required, even though the subject loan itself remains under the jurisdiction of the master servicer.

Typically, the special servicing provisions of a pooling and servicing agreement require the special servicer to employ a "servicing standard" (sometimes known as "accepted servicing practices") when carrying out its duties and obligations. The servicing standard is defined as a level of care that the special servicer must employ when making decisions on behalf of the lender (be it a trust, bank, certificate holders or participants). Generally, the servicing standard requires the special servicer to apply the higher of the following two levels of care: (i) the same care, skill, prudence, and diligence with which the special servicer administers and services similar mortgage loans for third parties, and (ii) the same care, skill, prudence, and diligence with which the special servicer services or administers similar mortgage loans for its own account. Irrespective of the applicable level of care, the servicing standard further requires the special servicer to act in accordance with all applicable laws and the terms of the subject mortgage loans, and to exercise reasonable business judgment with a view towards the "maximization of timely recovery of principal and interest" without regard to (a) any relationship or conflict the special servicer (or any affiliate thereof) may have with the borrower or a certificate holder,[3] (b) the obligation of the special servicer to make advances or (c) the right of the special servicer to receive compensation under the pooling and servicing agreement. The rights and obligations of a special servicer are further restricted by the fiduciary duty owed to the trustee, who in turn has a fiduciary duty to the certificate holders.

Jeffrey B. Steiner *is a member of and* **Zachary Samton** *is counsel to DLA Piper LLP (US).* **Brandon Douglass***, an associate of the firm, assisted in the preparation of this article.*

Once a loan is under its authority, a special servicer typically has broad discretion to modify, amend, or waive its terms, subject to the servicing standard and provided such amendment, modification or waiver would likely produce a greater recovery for the certificate holders and would not otherwise violate REMIC rules, where applicable. One such modification is the establishment of a workout plan for the borrower. A workout aims to convert the defaulted mortgage loan back into a performing loan. Foreclosure (or a deed-in-lieu) is another option that a special servicer may consider. Foreclosure, however, is usually a last resort, saved for borrowers who refuse to cooperate with the special servicer or loans with little prospect of economic viability.

As part of a workout plan, a special servicer may, in certain circumstances, extend the term of a loan in default. By extending the term of the loan, the borrower is given more time to find appropriate take-out financing in order to refinance the loan or reduce the size of the balloon payment. While the special servicer is commonly given broad discretion to extend a maturity date, I.R.C. §860F(a)(4) prevents the extension of the term of a loan held in a REMIC beyond the date such REMIC liquidates its assets and the proceeds thereof are credited or distributed to the certificate holders. The limits of an extension period may also be restricted by the terms of the pooling and servicing agreement.

In the context of a securitized mortgage loan, insolvency of a borrower is a relatively rare occurrence, although with the current economic climate we may see an increasing number. Most securitized loan borrowers, if not all, are single/special purpose entities (and many are additionally bankruptcy remote) and own only the real estate collateral for the loan and business located thereon. Generally, a pooling and servicing agreement grants authority to the special servicer to act on behalf of the lender/certificate holders with respect to any bankruptcy of a borrower. Even so, disputes may still arise. In *In Re Shilo Inn*, the certificate holders of a REMIC made a motion for an order to determine the procedures for voting on a debtor's proposed plan of reorganization after obligors on multiple loans in the REMIC went into default.[4] The certificate holders alleged that each was entitled to vote the trust's claims and not the special servicer. The court denied the certificate holders' motion based on the finding that the pooling and servicing agreement gave the special servicer broad authority "to do or cause to be done any and all things in connection with such servicing and administration of the … Mortgage Loans which they may deem necessary or desirable," provided it observes the proper servicing standard.[5] The certificate holders argued that the pooling and servicing agreement limited the special servicer's ability to take certain actions without the approval or consent of the certificate holders. The court concluded that "even assuming that the restrictions contained in the PSAs effectively preclude [the special servicer] from voting in favor of the debtor's proposed plan of reorganization, that fact does not lead to the conclusion that the certificate holders must therefore be allowed to vote the trusts' claims."[6] The court continued, "the agreement does not restrict [the special servicer] from voting on the proposed plan; it merely restricts how [the special servicer] may cast that vote."[7] The court determined that the special servicer was the correct party to vote, but that it must cast its vote in line with the wishes of the certificate holders. In this particular case, the certificate holders did not approve the debtor's reorganization plan and consequently the special servicer was required to vote against it.

Although the special servicer often is given broad discretion to determine the solution for a loan in default, there are instances when the special servicer is not permitted to modify the loan documents without the express consent of the controlling certificate holder or trustee. In such a situation, the borrower may find it more difficult to negotiate a modification as the controlling certificate holder may be self-interested. The controlling certificate holder may see foreclosure as the best option as it removes a bad asset and guarantees a more immediate financial return for the certificate holders. Regardless of who makes the final determination, one influential factor is the economic viability of the borrower. If the property is no longer generating sufficient income to pay debt service in addition to expenses, then extending the life of the loan would not alleviate the problem and a special servicer may be reluctant to extend the maturity date.

Investors should be aware that special servicers are generally entitled to several different fees, paid from the monthly debt service payments, depending on the services rendered and the course of action taken. Such fees include: (a) the special servicing fee, which is a monthly payment, based on the product of a negotiated percentage rate and the outstanding balance of the loans under the special servicer's authority; (b) a workout fee, which is earned in connection with the successful workout of a loan in default and is generally calculated as the product of an agreed upon percentage and the total collection of principal and interest during the balance of the loan term; (c) a liquidation fee, which pertains to loans that have been the subject of a foreclosure or deed-in-lieu and therefore are no longer part of the trust and is frequently calculated as a percentage of any realized liquidation proceeds, and (d) a determination or evaluation fee earned in connection with an evaluation of a loan in default. Workout fee payments are often terminated if the loan goes back into default, but the special servicer is then eligible for a new workout fee if a subsequent workout is successfully negotiated. An evaluation of a loan consists of a review of the financial condition and stability of the defaulting party. A special servicer must determine whether the defaulting loan generates the requisite proceeds or has the potential to continue making debt service payments and paying the expenses of the subject property if the loan is modified or amended. The analysis is intended to determine the course of action that will most likely maximize the benefits to the trust as a whole. Lastly, a special servicer is entitled to be reimbursed for any reasonable costs and expenses incurred during the servicing of a loan. The definition of reasonable expenses and costs is defined in each pooling and servicing agreement and typically excludes all overhead costs (such as office space, supplies, employees' salaries, and similar internal costs).

In the current economic environment, special servicers are likely to play an increasingly larger role in the commercial real estate finance market. Consequently, understanding their rights, duties and authority (both legal and contractual) has become more significant for all parties to a securitized mortgage loan and should not be overlooked or underestimated.

1. I.R.C. §860A-G
2. Such occurrences may be referred to "special servicing events"
3. *Teachers Ins. & Annuity Ass'n v. CRIIMI MAE Servs. L.P.*, 2007 U.S. Dist. LEXIS 28279 (S.D.N.Y. Mar. 20, 2007).
4. *In re Shilo Inn*, 285 B.R. 726 (Bankr. D. Or. Oct. 12, 2002).
5. Id. at 731.
6. Id. at 732.
7. Id.

Reprinted with permission from the November 19, 2008 edition of the NEW YORK LAW JOURNAL © 2008 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact 877-257-3382 or reprints-customerservice@incisivemedia.com. ALM is now Incisive Media, www.incisivemedia.com. # 070-11-08-0029