

**Subordinated Rolling Equity:**  
*Analyzing Real Estate Loan Default in the Era of Securitization*

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The Commercial Mortgage Backed Securities market has changed the legal structure of commercial real estate finance in the United States. Not only have the players changed in the holding of real estate debt but also the documents underlying the transaction have evolved. This article analyzes how these changes may affect the rights and obligations of the parties in the event of a real estate downturn. The new structure decouples traditional debt oriented rights from risk of investment loss. The article suggests several methods to minimize such a disjunction.

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During the next economic downturn the holders of US commercial real estate debt may possibly lose approximately \$65.5 billion.<sup>1</sup> The importance of this observation does not lie in the amount. Such losses would not be inconsistent with the experience of the market in post-war recessions and, indeed, such a multibillion dollar loss would be less than the severe losses of the 1990-92 recession.<sup>2</sup> Rather the significance is **who** will be experiencing this loss.<sup>3</sup> When the real estate market next experiences a downturn of this magnitude, the structure of the ownership and management of commercial mortgage debt will have been fundamentally altered by the advent and transforming success of the Commercial Mortgage Backed Securities (“CMBS”) market in the financing of commercial real estate.<sup>4</sup>

The question then, which is the focus of this article, how will the next recession be different? Will the transformations of the real estate mortgage market imposed by securitization materially change the behavior of market participants and, hence, the outcome of mortgage defaults?

The process of “securitization” reassembles the principal and interest cash flows of the underlying loans into securities, differentiated by interest rate, duration and subordination to meet the investment needs of a wide class of investors. The pooling of commercial mortgage loans creates tradable debt securities backed by that pool of loans. Previously, the only players in

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<sup>1</sup> This amount was calculated estimating a 18% default rate, the rating agency standard severity of loss factor of 28% multiplied by \$1.3 trillion of outstanding commercial mortgage debt. For default rate and severity of loss see, Howard Esaki, Steven L’Heureux and Mark Snyderman, Commercial Mortgage Defaults: An Update, Spring 1999. For outstanding commercial debt see, Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States, Annual Flow and Outstandings 1991-1999, June 9, 2000, chart F. 220.

<sup>2</sup> From 1991 to 1993 the net change in assets for commercial mortgages was \$89 billion. Board of Governors of the Federal Reserve System, supra n. 1

<sup>3</sup> The biggest losers during the last recession were Savings Institutions (\$48.4 billion) and Life Insurance companies (\$36.7 billion). After the Savings and Loan crisis Savings Institutions are no longer major players in the commercial mortgage market. Life Insurance companies not only hold whole debt as they did before the recession but also now are more likely to hold CMBS securities.

the commercial mortgage debt marketplace were those willing and able to hold whole loans.<sup>5</sup>

Now the CMBS marketplace has vastly expanded the investor pool brings the commercial real estate mortgage investment business into the mainstream of institutional investment.

By transforming the market from one based on holding illiquid whole loans to one based on securities backed by loans, the economic/legal goals and limitations in the event of borrower default, likewise, are transformed. As a response to this transformation, this article sets forth the thesis that in addition to the debt based contractual strictures of loan workout and foreclosure, holders of subordinated CMBS debt will also act as if they were equity holders in the issuing entity. The concept of subordinated rolling equity refers to the fact that in the event of default in the mortgage pool, each class of security holders, from the bottom class upwards, will limit their debt related work out efforts to the point where their contractual right to receive income from the pool is extinguished. At this point they will abandon their traditional legal role of lender and behave as would an equity investor. Equity rolls upward through the levels of subordination.

Market forces demand this reconceptualization of mortgage lending. By the middle of 2000, nearly \$300 billion of outstanding commercial mortgage loans have been securitized.<sup>6</sup> This represents about 19% of all commercial mortgage loans outstanding. If the CMBS marketplace continues to grow as expected at a level of approximately \$50 billion per year, the CMBS marketplace will soon represent a substantial slice of a commercial mortgage loans outstanding.<sup>7</sup>

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<sup>4</sup> CMBS falls under the broad category of “asset backed securitization” that look primarily to cash flow from specific pools rather than general corporate operations for repayment. See, Richard Mendales, *Looking Under the Rock: Disclosure of Bankruptcy Issues Under the Securities Laws*, 57 OHIO ST. L. J. 731, 776 (1996).

<sup>5</sup> While subordinated participations certainly were structured, generally, when an investor purchased a mortgage participation, this was participation in the whole loan, not a subordinated investment as in today’s securitized market.

<sup>6</sup> Moody’s Investor Services, Commercial Mortgage Alert, April 10, 2000, p. 14.

<sup>7</sup> Moreover, the growth of this marketplace has had a powerful impact on the so-called portfolio market, or the market for mortgage loans that continue to be held as whole loans by traditional mortgage investors. First, even

The confluence of two factors will change the pattern of loan participants' behaviors and market outcomes in the commercial mortgage loan arena in the next significant recession. First, as stated before, the structural metamorphosis of securitizing ownership of commercial real estate mortgage debt comes into play. The investor pool has vastly expanded to include participants only investing in a discrete portion of the cash flow of the loan. Secondly this pool of investors in real estate debt has expanded to include participants with very different expectations and risk-response modalities from traditional whole loan portfolio lenders. Now the Master Servicer, the Special Servicer, the Trustee and, ultimately, the investor, have a role, a voice and legal rights in the event of default. This multiparty situation eviscerates a bilateral workout negotiation by including many participants with divergent outcome goals.<sup>8</sup>

As the old paradigms fail and new ones have yet to take form, there is substantial uncertainty in how this new marketplace will react to significant stress. We must observe the structural changes that have taken place in the market and extrapolate the likely legal response of the parties when confronted with a substantial number of mortgage defaults. This article identifies and analyzes changed structures and speculates on the behavior of players in the new structure reacting to a significant real estate recession. To do so this article will study the default sensitive provisions of securitized real estate transactions in an effort to construct a default paradigm that will guide the industry in the event of a market downturn.

To lay the groundwork for our model of subordinated rolling equity, first the article will offer a brief history of the securitization of commercial real estate loans. In this section the article will sketch a historical benchmark in order to situate future real estate losses against the

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mortgage loans not currently destined for securitization have begun to mimic the loan documentation characteristics of the securitized marketplace. Second, the old paradigm of assessing the value of mortgage loans on a gross yield basis has been displaced by the securitization paradigm of market value. The impact of the growth of securitization is leveraged as the conduct of whole loan investors begins to mimic the CMBS investor.

severe real estate recession of 1990-1992. The next part of the article will introduce the new parties to a real estate transaction and compare the workout and enforcement provisions as applied in the eras before and after securitization. Then, to frame the potential problem of loan default, the article will examine the issues of default risk in the current real market based on rate of loss and loss severity. This discussion will generally describe the critical elements of rating in the securitization market structure with emphasis on default response structures. Finally the last part of the article will construct a new default paradigm based on the theory of subordinated rolling equity. This section will offer suggestions to address the concerns of investors, servicers and borrowers faced with the predicament of loan default.

## **I. The Dawn of the Era of Securitization**

Real estate loan securitization creates a secondary market for loans secured by mortgages on real property. Lenders originate loans and then sell a group of loans as a pool to an entity that will issue securities. The income from the underlying mortgage debt supports securities sold to market investors. Securitization of commercial mortgage loans transforms an inherently illiquid asset (which is hard to price, trade, manage or value) into a liquid asset. As such the asset can be bought, sold and owned like other securities because investors can assess its value and risk with relative ease.

The securitized market is both well defined and mature in the residential real estate market.<sup>9</sup> The success of this residential market had a two-pronged effect (later emulated in the

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<sup>8</sup> For example, previously negotiable issues such as restrictions on transfer and lock out/yield maintenance/defeasance requirements are now generally non-negotiable.

<sup>9</sup> Government National Mortgage Association (GNMA or Ginnie Mae), created by Congress in 1968, guarantees pas-through mortgage backed securities that are issued by HUD approved mortgagees. Its securities are backed by the full faith and credit of the US government. Federal National Mortgage Association (FNMA or Fannie Mae), created as a government corporation in 1938 but spun off to private ownership in 1968, issues guaranteed Mortgage Backed Securities which are backed by loans in its own portfolio as well as by participations in loans that are pooled or packaged through other lenders. Although a private corporation FNMA securities are subject to the regulatory authority of HUD and the Secretary of the Treasury has the discretionary authority to purchase up to \$2.25 billion of

commercial market). First of all, it infused the market with new sources of funds for financing real estate. Secondly, it shifted the relationship between the borrower and the lender from the parties' local concerns to a concern for the objectives and business standards of unrelated market investors.<sup>10</sup>

a. collapse of the commercial whole loan market

Unlike the residential market, the success of the commercial real estate loan securitization is a relatively recent phenomenon. One reason securitization of commercial loans failed to take hold was that until the late 1980s owners of commercial real estate almost exclusively financed the asset through mortgage loans made by life insurance companies, pension funds, thrifts and banks.<sup>11</sup> Before the market downturn of the 1990s borrowers enjoyed access to a deep capital pool with relaxed underwriting criteria.<sup>12</sup>

In contrast to previous real estate downturns, both real estate and overall economic factors contributed to the collapse of the commercial real estate market in the late 1980s and early 1990s.<sup>13</sup> Overbuilding and stricter environmental measures contributed to high vacancy rates and increased cost of management. To exacerbate the vacancy problem, a severe credit

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FNMA debt. See, [www.fanniemae.com/markets/debt/w21804.html](http://www.fanniemae.com/markets/debt/w21804.html). As a result credit markets price these securities as having "agency status." Congress created the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) to provide mortgage lenders liquidity for conventional residential mortgages. FHLMC sell mortgage backed securities, issues other debt securities secured by conventional mortgages and operates a guarantor program. Freddie Mac stock is openly traded. See, [www.freddiemac.com/corporate/about/twlvquest.html](http://www.freddiemac.com/corporate/about/twlvquest.html). In addition to the governmental pioneers in the market, there are now a host of private players. For an in-depth examination of the creation of the residential secondary market, see, Robin Malloy, *The Secondary Market: A Catalyst for Change in Real Estate Transactions*, 39 SOUTHWESTERN L.J. 991 (1986).

<sup>10</sup> See Malloy, supra n. 9 at 1018.

<sup>11</sup> See Joseph P. Forte, *A Capital Markets Mortgage*, 31 REAL PROP. PROBATE & TR. J. 490, 496 (1996)

<sup>12</sup> Greenspan, Alan. "Credit Situation Part of a Cycle Extending Back Ten Years." *The American Banker*. December 12, 1991:11

<sup>13</sup> During the 1950s, 1960s, 1970s, and much of the 1980s, collapses in the real estate property markets were largely precipitated by a tightening of monetary policy by the Federal Reserve in response to an increasing rate of inflation. Although aggressive property development did precede diminutions in real estate value, over development was not the crucial blow to the property markets. Rather, those crises are more closely connected with the non-real estate related curtailment in the pace of economic growth. Peter Kozel, Ratings Transition Study: Sources of Risk Revealed for CMBS Transactions, Standard & Poor's Structured Finance Special Report 1, 10 (January, 2000). [www.standardpoor.com/ratings/index.htm](http://www.standardpoor.com/ratings/index.htm).

crunch (due to the economic recession in the United States) and a further shift from a manufacturing-based market to a technologically-based market gutted demand.

Although there are many hypotheses as to what precipitated the crash, there is general agreement that the primary industry-specific cause of the collapse was excess supply caused by overbuilding. The development boom in the 1980s was the largest in US history. By its completion, office space had doubled to 2.5 billion square feet and new commercial space in total was increased by 12.5 billion square feet.<sup>14</sup> The 1980s started with a vacancy rate of 5%, which had increased to 18% by the end of the decade.<sup>15</sup> By 1989, rents had declined more than 26% since 1984.<sup>16</sup>

The flow of easy money in the 1980s partially explains this supply increase. The percentage of total loans devoted to real estate consistently increased throughout the decade, from 12.1% in 1984 to 18% at the end of 1989.<sup>17</sup> During this decade, commercial banks had increased the percentage of commercial real estate loans in their portfolio to nearly 40% - capturing 64% of all new commercial real estate loans during this time.<sup>18</sup> Over-enthusiasm was a product of the “go-go 80s” and some financial institutions, particularly the Savings and Loan Associations consistently underwrote real estate loans at an 80% (or greater) loan-to-value ratio.<sup>19</sup> Such free flow of cash led developers to keep building even as vacancy rates were rising.

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<sup>14</sup> Freeman, Tyson. “The 1980s: (Too) Easy Money Fuels a New Building Boom.” *National Real Estate Investor*. 41 (11): 40-44. September 30, 1999.

<sup>15</sup> Freeman, n. 14.

<sup>16</sup> Neustadt, David. “Study Projects Further Woes for Real Estate.” *The American Banker*. October 26, 1989: 2.

<sup>17</sup> Kleege, Stephen. “Loans for Real Estate Grow Twice as Fast as Business Loans in 1989.” *The American Banker*. June 19, 1999: 1.

<sup>18</sup> Brady, Shaun M. “Trends in Commercial Real Estate Finance.” *Commercial Lending Review*. 4(4): 45-56. 1989 Fall. In 1988 life insurance companies invested 16.3% of their assets in commercial mortgages. *Real Estate and the Credit Crunch: Proceedings of a Conference Held in September 1992*. Lynn Browne and Eric S. Rosengren, editors. Federal Reserve Bank of Boston, Conference Series No. 36, p. 67

<sup>19</sup> Brady, supra n. 18.

Overbuilding was also a by-product of the passage of the Economic Recovery Act in 1981.<sup>20</sup> Under this legislation, depreciation schedules were shortened and losses generated from real estate could be used to offset other income. Real estate soon became a favored tax shelter and investors flooded the market. When the tax code was revised in 1986,<sup>21</sup> and depreciation schedules were extended and passive losses were limited, the real estate market values fell precipitously.<sup>22</sup>

A second real estate related element contributing to the collapse of the market was the tightening of environmental standards for commercial real estate towards the end of the 1980s.<sup>23</sup> Although this factor did not have nearly as profound an impact as that of overbuilding, it did contribute to the woes of both lenders and borrowers in the late 1980s. As environmental assessments became mandatory, it became very difficult for potential borrowers with contaminated properties to obtain financing.<sup>24</sup>

Fundamental economic issues enveloped the real estate quagmire. The economic recession in the United States in the late 1980s – early 1990s with its increased level of mergers and corporate downsizing<sup>25</sup> decreased consumer demand, and, hence, dampened demand for all sectors of commercial property.<sup>26</sup> This decrease in demand, coupled with the increase in supply, led to plummeting values of commercial real estate in the early 1990s.

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<sup>20</sup> Freeman, supra n. 14. Economic Recovery Act of 1981, PL 97-34 1981 (HR 4242)

<sup>21</sup> Tax Reform Act of 1986.

<sup>22</sup> For example, TRA of 1986 had a “significant and negative effect” (ranging from 10.1% to 17.1 in different regions) on value of office buildings throughout the United States. Stanley Smith, Larry Woodward and Craig Schulman, *The Effect of the Tax Reform Act of 1986 and Overbuilt Markets on Commercial Office Property Values*, 19 J. REAL EST. RESEARCH 301, 317 (2000).

<sup>23</sup> Uncertainty as to lender liability for environmental contamination was fueled by the decision in *United States v. Fleet Factors Corp.*, 901 F. 2d 1550 (1991).

<sup>24</sup> Brady, supra n. 18.

<sup>25</sup> Webb, R. Brian. “Real Estate Markets.” *Indiana Business Review*. 66(5) 12-13, 1991-1992 Winter

<sup>26</sup> Scotchie, Joe. “NMN This Week Presents its Annual Section on the outlook for the Mortgage Industry in the Year Ahead.” *National Mortgage News*. December 31, 1990: 11.



As banks experienced increased charge-off and delinquency rates on all types of loans, including real estate, their capital positions were weakened.<sup>27</sup> As of December 1993, 16.2% of banks' commercial mortgage portfolios were either delinquent or foreclosed real estate.<sup>28</sup> At the same time, stricter regulations were imposed on the banks.<sup>29</sup> Real estate funding dried up because lenders were reluctant to refinance or restructure existing commercial real estate loans as they feared regulators and securities analysts would view such actions negatively.<sup>30</sup> The process was a vicious cycle, compounded by the Savings and Loan crisis, which further diminished sources of capital for many developers and caused others to default on their loans.

This mix of real estate and non real-estate factors combined in at the end of the 1980s to eventually caused the collapse of the commercial real estate market. The effects of overbuilding, environmental regulations, the credit crunch, decreasing demand and uncertainty in the economy took their toll on the market and, by the beginning of the 1990s had resulted in one of the worst real estate collapses in history.

Lenders, faced with borrowers' defaults, responded by imposing the legal remedies afforded by the loan documents. A lenders' arsenal of rights included: default interest increases, late fees, tax and insurance escrow requirement, right to receive tenant rents, mortgagee-in-possession rights, and ultimately, foreclosure. All of these tools were crafted to a) ensure prompt payment of sums due under the mortgage note, and b) allow the lender to recoup its investment by selling the property and applying the proceeds of sale to the outstanding note.<sup>31</sup> As will be

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<sup>27</sup> Cantor, Richard and John Wenninger. "Perspective on the Credit Slowdown." *Federal Reserve Bank of New York Quarterly Review*. 18(1): 3-36. 1993 Spring.

<sup>28</sup> Han, Jun. "1994: The End of the Credit Crunch." *Real Estate Finance*. 11(1): 29-38. 1994 Spring.

<sup>29</sup> Dennis J. Block et al., *Current Trends in the Market For Corporate Control*, PLI, January 1999, pp. 30-31.

<sup>30</sup> Bates, James. "Regulators Told of 'Credit Crunch'." *Los Angeles Times*. September 30, 1992: D2.

<sup>31</sup> If one compares loan documentation from the era before securitization and documentation used now in a securitized transaction the same remedies would be included. However, as discussed, *infra*, the difference is who uses them. For example, there is no longer the waiving of late fees or default interest because the Servicer prices their services on collecting these fees.

discussed later, once the value of the asset dips below the borrower's equity (assuming a non-recourse loan) a whole loan lender takes on the role of equity holder. The lender's goal is to fashion a work out that will, hopefully, push the asset value once more above the loan value and recoup lender's investment. What differentiates a whole loan from a securitized loan is the point at which the lender takes on this equity stake.

b. origins of the commercial secondary market

The dearth of capital that crippled the real estate market in the early 1990s forced the real estate community to search for alternate methods of financing commercial real estate. Actually, one of the first securitized financings occurred in 1984, before the market collapse. Olympia & York financed three Manhattan office buildings with a private placement to forty institutional investors of \$970 million secured by a mortgage on the three properties.<sup>32</sup>

Despite such a massive undertaking by Olympia & York, the secondary securitization market for commercial real estate failed to take hold. Several major impediments held back the market. First of all, there was no impetus to seek out funding alternatives given the abundance of what would later be characterized as underpriced debt.<sup>33</sup> Additionally, as shown by the residential market, loan documentation must be standardized in order to accurately assess (and hence price) borrower's credit risk. Commercial loan documentation tended to be highly individualized and loan specific. Furthermore, Wall Street did not understand the "dirt" of the

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<sup>32</sup> Olympia & York pooled the financing of three of its buildings (1290 Avenue of the Americas, 2 Broadway and the Park Avenue Atrium) into one new vehicle and then sold fifteen year bonds backed by liens against the properties to 40 investors. For a description of this transaction along with a history of Olympia & York see Anthony Bainco, *The Reichmanns: Family Faith Fortune and the Empire of Olympia & York*, 1997

<sup>33</sup> As will later be discussed, this debt should be characterized as mispriced because it was priced as though it only included AAA risk when in fact it was whole loan debt risk.

real estate transaction. The market was unfamiliar with the economic functioning of the underlying real estate and regarded it as an illiquid investment.<sup>34</sup>

However, by the early 1990s an absence of lenders and the tightening of credit requirements forced a new look at the creation of a secondary market for commercial loans.<sup>35</sup> Just as a credit crunch precipitated the governmental creation of a secondary market for residential loans, the response of the government in creating the Resolution Trust Company (“RTC”) spurred the secondary market for commercial loans.<sup>36</sup> The inundation of non-performing loans that surfaced during the Savings and Loan crisis led to the formation of the RTC which forever changed the way Wall Street looked at real estate.<sup>37</sup> In October 1990, the RTC’s oversight Board approved a plan that allowed the RTC to bundle and securitize its huge portfolio of mortgage loans acquired from insolvent thrifts.<sup>38</sup> In August 1991 the RTC completed its first multifamily securitization followed by the first non-multifamily securitization in February 1992.<sup>39</sup> By July 1993 the RTC had securitized close to \$14 billion in commercial mortgages.<sup>40</sup>

Taking their cue from the government, private investment companies began to purchase pools of mortgages for purposes of securitization. The RTC created market acceptability of commercial real estate loan securitization. The pump was primed to establish a new market for

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<sup>34</sup> Another obstacle was the lack of governmental intervention in the market (as it intervened and created the residential secondary market). See, Joseph Shenker, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369,1398 (1991). See also, Michel Schill, *The Impact of Capital Markets on Real Estate Law and Practice*, 32 J. MARSHALL L. REV. 269, 271-274 (1999) (discussing why commercial real estate secondary market was slower to develop than residential market).

<sup>35</sup> Frantz, James B. “Some Traditional Lenders Coming Back, Mortgage Securitization Gains Momentum.” *National Real Estate Investor*. 34(11): 36-50. 1992 October

<sup>36</sup> Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73 §501, 103 Stat. 183, 184 (1989) (codified 12 U.S.C. 1831 et seq.)

<sup>37</sup> Frank J. Fabozzi, *The Handbook of Mortgage Backed Securities* 4<sup>th</sup> ed. 1995 p. 418. (Hereinafter referred to as “Fabozzi Handbook”)

<sup>38</sup> Shenker supra n. 34 at 1404. At that time the RTC owned \$77 billion in various types of securitizable assets.

<sup>39</sup> Fabozzi, Handbook supra n. 37 at 492

<sup>40</sup> Fabozzi Handbook, supra n. 37 at 492

commercial debt with underwriting discipline. Whereas before securitization, cost of funds to the borrower tended to be borrower specific and somewhat idiosyncratic, securitization of the debt imposes the concept of single cost of funds at the market clearing price.

Securitization also prompted more efficient debt servicing. Before securitization, an investor intent on holding real estate debt made whole loans and needed a “full service” real estate mortgage department to make and manage loans, and an elaborate origination structure to generate product. This was (and is) expensive and capacity could not be easily adjusted to meet market conditions. It was, in large measure, a sunk, fixed investment which could not easily be shrunk or ballooned as the institution’s demand for mortgage debt waxed or waned. A fairly large structure was needed to make one loan or a hundred, and the need to preserve functionality led to structural overcapacity whenever demand for mortgage debt diminished. Securitization addresses and ameliorates these limitations by permitting limited participation. This permits investors in mortgage loans to nimbly react to market fluctuations and permits more efficient debt market participation.

The creation of the new capital market not only created supply in the wake of the collapse of traditional lending sources but also spoke to borrower demand. Borrower demand for securitized products proved strong due to lower interest rates, availability of non-recourse financing, and higher loan to value ratios.

Underlying the entire securitized transaction is the income stream produced by the mortgages in the pool. Not surprisingly, preservation of the income stream is critical to the success of the securitization. The overwhelming importance of the income stream reduces the real estate to a fungible commodity. It is not the real estate being securitized, it is the cash-

flow.<sup>41</sup> This aspect of securitization has critical implications when default becomes a possibility. Cash flow impairment will affect different investors in different fashions. How that cash flow is rehabilitated or recouped likewise affects investors in distinct manners.

It is a whole new age for commercial real estate finance for borrowers, lenders and investors. Lenders reduce the amount of required capital holdings while earning income from servicing and originating fees.<sup>42</sup> Borrowers enjoy access to cheaper capital on a non-recourse basis. Investors can participate in the real estate market with a minimal capital investment and structured risk.<sup>43</sup>

c. Today's CMBS market

From a market of \$3 billion in 1990,<sup>44</sup> by 1998 domestic CMBS issuance had reached \$78 billion.<sup>45</sup> In 1999, after a significant credit hiccup, CMBS issuance dropped to \$59 billion.<sup>46</sup> In 2000 domestic analysts expect CMBS to stabilize at about \$50 billion.<sup>47</sup> While various market analysts differ, most agree that CMBS originations will remain in the \$50 billion range through the early parts of this decade and perhaps begin to increase again with the overall growth of the refinancing market expected in 2003.<sup>48</sup> In addition to domestic issuance, internationally

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<sup>41</sup> See, Alan Kronovet, *An Overview of Commercial Mortgage Backed Securitization: The Devil is in the Details*, 1 N.C. Banking Inst. 288, 299-300, 304 (1997).

<sup>42</sup> Stephen J. Cosentino, *Swimming in New Water: Bank Participation in Securitized Loan Pools*, 65 UMKC L. REV. 543, 546 (1997)

<sup>43</sup> Quite naturally there are disadvantages to the securitized era. Loss of personal contact, homogenization and complication of transactions, loss of local input due to nationalization (even internationalization) of markets all are effects of the shift. These issues are raised in any asset securitization. See, Amy C. Bushaw, *Small Business Loan Pools: Testing the Waters*, 2 J. SMALL & EMERGING BUS. L. 197, 226-227 (1998)

<sup>44</sup> Commercial Mortgage Alert, supra n. 6.

<sup>45</sup> Moody's Investors Service, 1999 Year in Review and 2000 Outlook: CMBS-The View From the Peak of the Real Estate Cycle, January 2000.

<sup>46</sup> Commercial Mortgage Alert supra n. 6

<sup>47</sup> Moody's Investors Service, CMBS Third Quarter 1999 and Outlook: Conduit Loan Quality Improves as Market Slowdown Approaches, October 1999.

<sup>48</sup> Moody's Investors Service, CMBS Second Quarter 2000: Rent Spikes Pose Major Credit Challenges, July 2000.

issuance will be \$12 billion, up dramatically 33% from 1999.<sup>49</sup> While analysts differ on the specifics, all commentators generally agree that securitization has become a mature and stabilized part of the real estate mortgage finance marketplace and is likely to represent between a third and a half of commercial mortgage issuance for the foreseeable future.

### CMBS ISSUANCE SUMMARY<sup>50</sup>

	US (\$Bil.)	Non-US (\$Bil.)	Total (\$Bil.)
1990	\$3.4	\$1.4	\$4.8
1991	\$7.6	\$0.6	\$8.2
1992	\$14.0	\$0.0	\$14.0
1993	\$17.2	\$0.3	\$17.5
1994	\$17.5	\$2.8	\$20.3
1995	\$17.9	\$1.1	\$19.0
1996	\$28.8	\$0.9	\$29.7
1997	\$40.4	\$3.6	\$44.0
1998	\$77.7	\$0.6	\$78.4
1999	\$58.5	\$9.3	\$67.8
2000 YTD	\$8.2	\$5.0	\$13.2

With the commencement of private label securitization in the early 90's (following the RTC issuances) securitization began modestly not only in aggregate volume, but also in structure. At the outset, securitization was mostly limited to well-recognized property types (multi-family, office and industrial) with homogeneously structured loan terms and conditions. Loans were at a fixed rate, with terms ranging from 7 to 10 years. Securitization pools were usually constructed from several dozen to perhaps a hundred of these relatively homogenous loans, with the occasional appearance of a much larger single asset securitization in which a

<sup>49</sup> *Standard & Poor's Structured Finance Special Report, 2* (January 2000). <http://www.standardpoor.com/ratings/structuredfinance/index.htm>. The rate of new issuances is also impacted by lack of a refinance window which is closed for about the next 3 years because few 10 year loans were made during the recession of 1990-93. In addition increase in interest rates adversely affect any discretionary refinance activity.

single mortgage loan is securitized. Over the past decade, securitization has spread across a wide range of asset classes and experimented with a wide range of structures.

Individual loans have, particularly in recent years, begun to include mezzanine functions<sup>51</sup> priced to include floating rate interest provisions. Principal balance of pools hover between \$600 million to \$3 billion range.<sup>52</sup> Pools are now found composed of both one single asset class (typically credit tenant loans) and also loans that include both large and small loans in a single pool (fusion deals).

Of special relevance to any discussion of default, 1999 saw the emergence of a more active and vocal participation by the B-piece (lowest subordinated security) buyers in the securitized commercial mortgage market.<sup>53</sup> Their impact has been felt in the market as they increasingly influenced the composition of loan pools by successfully excluding loans that they believed heightened the potential for losses to the junior certificates. Market analysts agree that the investor market for B-pieces remains thin.<sup>54</sup> Hence, these buyers drive pool composition, language in the documents, and overall pool quality.<sup>55</sup>

## **II. Old Dogs, New Tricks**

While the CMBS market of today may have been the child of the massive defaults during the real estate depression, it has yet to be tested and stressed by the very factors that gave it

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<sup>50</sup> Commercial Mortgage Alert, *supra* n. 6.

<sup>51</sup> Mezzanine financing is financing subordinate to the mortgage that is sold into the pool. See discussion, *infra*, note 80.

<sup>52</sup> Moody's, CMBS Third Quarter 1999 Review, *supra* n. 47.

<sup>53</sup> The "B piece" refers to all of the certificates below investment grade. It is usual practice for one investor to buy the entire B piece (all certificates rated BBB and below including the ungraded certificates).

<sup>54</sup> Sally Gordon, Moody's, SD75 ALI-ABA 171, 178 (March 1999). These certificates bear a higher risk (with correlative yield) and require more real estate expertise. See also, Moody's Investor Service, *The CMBS Market Learns a Lesson*, November, 1998.

<sup>55</sup> Gordon, *supra* n. 54 at 5. See also, Jeffrey Lenobel and Gregory Pressman, *Mortgage Backed Security Process Undergoes Change*, 3/29/99 NYLJ s1.

birth.<sup>56</sup> The legal relationships constructed in this new market are grafted onto the contractual structure of previous eras. While default provisions of loan documentation may continue to include the familiar provisions of assignment of rents, late fees, default interest and foreclosure they also include new mechanisms such as put backs and prepayment limitations such as defeasance.

A lender's right to protect its investment in the event of a borrower's default has evolved as a lender's relationship to the encumbered land has shifted. Until the early 17<sup>th</sup> century the lender took possession of the land, collected its income (with no responsibility of an accounting), enjoyed the rights of land ownership and kept the land in the event of a borrower default—regardless of the land's value in relation to the debt.<sup>57</sup> Strict foreclosure, now abandoned in but a few states, bars the borrower from redeeming the property once the lender has foreclosed.<sup>58</sup> In our more modern times, whole loan remedies focus on preservation of capital to pay the underlying debt. Lenders utilized the legal rights of a creditor in order to maintain value in the asset only while the expected asset value after the workout was greater than the present value of the asset (minus foreclosure costs).<sup>59</sup> At that point the lender foreclosed. Now, with securitization, investors engage in a sequential approach to default. Creditors rights are

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<sup>56</sup> Fitch analyzed CMBS transactions issued from January 1990 to December 1999 to develop a historical perspective of bond performance. From a total issuance amount of approximately \$240.6 billion only 12 rated classes of certificates in six transactions defaulted or experienced losses. The rated bond default rate was 0.21% of the original principal balance amount. See, Diane Lans and Aaron Jaffee, "Rated CMBS Exhibit Low Defaults," [www.fitchratings.com](http://www.fitchratings.com), July 14, 2000. There have been, though, market participants with their share of problems. Most notably Criimi Mae, the largest purchaser of B piece securities filed for bankruptcy in 1998. See, *In re Criimi Mae, Inc.*, 251 B.R. 796 (Bkrcty. D. Md. 2000). Note that the CMBS market was not the causative factor. Rather, a margin call prompted by Asian and Russian economic crises threw the company into bankruptcy. See, *What's Happening in the Mortgage Backed Securities Market?*, 33 No. 6 Bankr. Ct. Dec. (LRP) 1, October 27, 1998 ("There have been no collapses of these securitized vehicles. The are performing as the rating agencies and surety companies wanted them to in terms of what the investors in those pieces of paper are getting"). See also, Lenobel and Pressman, *supra* n. 55; Gregory Weston, *The CMBS Market: a 1998 Review and the Top Ten Trends for 1999*, 67 PL/INY 793 (December 1999)

<sup>57</sup> Ann M. Burkhart, *Lenders and Land*, 64 MO. L. REV. 249, 249 (1999)

<sup>58</sup> Boyer, Hovernkamm & Kurtz, *The Law of Property*, 4<sup>th</sup> ed. 1991 at 640.



attenuated from the investors' equity stake. This transformation forces new delineations of rights and responsibilities. The willingness and legal ability to work toward preservation of income stream and asset value are impacted by the investor's stake in the asset pool.

a. Old Dogs

As property law shifted focus away from the feudal importance of the land and towards the modern importance of the debt, lender's rights in the event of default likewise took on a more contract-oriented remedy. The goal of the modern remedies is to give the lender the benefit of its bargain by making it financially whole in the event of a borrower's default.<sup>60</sup> While vestiges of land-oriented rights remain (such as mortgagee-in-possession provisions) they are reconceptualized into preservation of asset provisions designed to safeguard the asset value in order to pay the lender.

During a workout period the lender and borrower attempt to fashion a solution that will rehabilitate the loan to where the borrower can continue repayment until the maturity date. Although limited by legal restrictions on loss of priority and certain regulatory limits,<sup>61</sup> borrower and lender work relatively unconstrained. Workout possibilities include collateral substitution, capitalization of interest, interest forgiveness, partial forgiveness of debt and relaxation of subordinate financing restrictions. Borrower and lender are relatively free to fashion an acceptable agreement toward the goal of preserving the value of the property and continuing the income stream.

The largest bat the lender can swing in the event of borrower default is foreclosure. The borrower loses title to the asset in satisfaction of the debt. However, whether through legal

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<sup>59</sup> The term "workout" has been defined as "A negotiated compromise between lender and borrower relaxing borrower's loan obligations." Barry C. Ross, *Real Estate Workouts: A Lender's Primer*, 21 REAL EST. REV. 16 (1991). Workouts signify the attempt to restructure the loan in order to avoid foreclosure.

<sup>60</sup> E. Allan Farnsworth, *Contracts* at 756 (3d ed 1999)

limitations (borrower's equitable right of redemption), through procedural limitations (such as notice and opportunity to cure) or policy limitations (such as anti-deficiency statutes and one-action rules), a lender's rights upon foreclosure are linked to ensuring repayment of the underlying debt. Limited or no recourse to the borrower for repayment of the debt further reduces the real estate to nothing more than a debt repayment vehicle. As such, the contractual default provisions afford the lender latitude only insofar as necessary to preserve asset value to repay the debt.<sup>62</sup>

Furthermore, as most commercial real estate owners are single asset entities (even in the era before securitization), default provisions tended to focus even more on the preservation of capital to ensure repayment of the debt. Once the value of the asset is depleted nothing is left to repay the creditor. A clear example of this arises when a single asset entity declares bankruptcy. Far from the "normal" bankruptcy scenario with various lenders staking a multitude of claims, real estate bankruptcies are more likely to be primarily two party affairs—the borrower and the lender. Some commentators have, correctly, noted that bankruptcy courts generally do not focus on the fact that these affairs are primarily two party disputes.<sup>63</sup> However, the limited scope of the proceedings permits the lender to focus on the land without the distraction of competing claims on the only asset of the bankrupt.

#### b. New Tricks

In so far as default is concerned, perhaps the biggest change in the securitization era is the increase in the number of people who now have an interest and voice in the work out and the

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<sup>61</sup> For example the ERISA limitations on life and pension company investments discussed *infra*. See also, Michael G. Frankel, et al., *Real Estate Workouts—A Step by Step Analysis*, 466 PLI/Tax, June 2000.

<sup>62</sup> For example, the impairment of security test in the law of waste limits the lender's damages as to the amount of the mortgage, however great the injury to the property may be. See, Grant Nelson, Dale Whitman, *Real Estate Finance Law*, §4.4.

<sup>63</sup> See, James L. Lipscomb & Alan J. Robin, *Impact of Bankruptcy on Workouts and New Investments*, 31 REAL PROPERTY, PROB. & TR. J. 671, 681 (1997).

sometimes conflicting goals of those parties. Whereas in the pre-securitization era the work out was bilateral (between the lender and the borrower) now a myriad of parties with differing agendas can be involved in the negotiation.

In order to set the stage to discuss the transformation to the structure of ownership and management of mortgage loans, it's useful to review, in a very summary way, the structure of a securitized transaction.<sup>64</sup> In the securitization paradigm, a loan originator (the "Originator"), either through its direct sales force or through customary mortgage banking arrangements, originates a loan to a borrower secured by a mortgage on commercial real estate. The Originator then holds that loan on its balance sheet or finances temporary ownership of that loan through some form of warehouse credit facility in order to accumulate a sufficient number of loans for securitization.<sup>65</sup>

When a sufficiently large pool has been accumulated for securitization (which is a number ranging from a low of \$300-\$400 million in specialized cases up to as much as almost \$4 billion), the loans will be securitized.<sup>66</sup> An underwriter that agrees to purchase the securities for resale under either a full underwriting basis or a good faith basis normally drives the process of securitization. Traditionally, large securitizations have been done on a public basis with full underwriting from an investment bank. In recent years, it has become customary for multiple accumulators to pool loans for securitization in order to shorten the period during which the loans must be accumulated and held on balance sheet or financed.<sup>67</sup>

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<sup>64</sup> See, Kronovet, *supra* n. 41 at 299-300.

<sup>65</sup> In some cases, the Originator does not hold the loans. Rather, the Originator immediately sells loans as originated to another party, which will use its balance sheet to accumulate loans for securitization. Typically, these accumulators have been investment banks and a handful of very large commercial banks and life insurance companies.

<sup>66</sup> This amount assumes a public offering. Private placements can be much smaller (in the \$25-50 million range).

<sup>67</sup> When loans are assets intended for sale, accumulation represents a significant risk due to market fluctuations and value. Although outside the scope of this article, a complex of hedging arrangements has become the norm to stabilize the value of the loans during the warehouse or accumulation period for securitization. The need to deal

The originators or accumulators now become mortgage sellers who sell loans to a depositor. This depositor is a special purpose vehicle (“SPV”) which minimizes the possibility of a voluntary bankruptcy for reasons unrelated to the performance of the assets.<sup>68</sup> Sale of the loans by the originator to the SPV constitutes a “true sale” for bankruptcy purposes as it isolates the assets from a bankruptcy of the originator.<sup>69</sup> Rating agencies insist on a “true sale.”<sup>70</sup>

The depositor transfers the loans into a vehicle, normally a trust, which is tax transparent (e.g., not subject to tax at the pool of the trust or other entity), and usually a REMIC or sometimes a FASIT.<sup>71</sup> The sellers, working with the underwriter, decide how many loans and what loans should be accumulated to create the best pool, taking into account such factors as geographic and product type diversity, size, interest rate, loan-to-value and other factors. One or more rating agencies then review the pool. This review provides preliminary indications of how the pool would be tranching for any requested rating. A typical recent transaction might result in the following allocations of loan amount to the various rating levels:

Hypothetical \$1 Billion Mortgage Loan Pool

Class <sup>72</sup>	Principle Balance	Yield (over 10 Year Treasury)	Average Life
AAA (Aaa)	\$700 Million	120bp	9 years
AA (Aa)	\$100 Million	135bp	10 years
BBB (Baa)	\$50 Million	300bp	10.5 years
B	\$150 Million	800bp	11 years

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with the risks to the market value of trade assets during the accumulation period has greatly reduced the number of players in the marketplace.

<sup>68</sup> Although a voluntary bankruptcy of an SPV was upheld in *In re Kingston Square Associates*, 214 B.R. 713 (S.D. NY 1997).

<sup>69</sup> Tamar Frankel SECURITIZATION: THE CONFLICT BETWEEN PERSONAL AND MARKET LAW (CONTRACT AND PROPERTY) 18 Ann. Rev. Banking L. 197, 211 (1999)

<sup>70</sup> See, Mendales, supra n. 4 at 777.

<sup>71</sup> REMICs: 26 USCA § 860a et seq. FASITs: 26 USCA § 860h et seq. See also, *Michael S. Gambro, Scott Leichtner, Selected Legal Issues Affecting Securitization*, 1 N.C. Banking Inst. 131, 155-161 (1997) for a discussion of choice of vehicle.

<sup>72</sup> Different rating agencies utilize unique, but comparable, designations to their ratings. The different designations are noted within the example.

Working within these rating levels, the underwriter and the seller/accumulator design bonds with the securities to be sold in terms of interest rate, expected maturity, yield, payment characteristics and many other factors based on market conditions. By way of example, there may be two AAA, or highest rated, classes of securities one with a long maturity and one with a medium maturity. Also within the same pool there may be both fixed and variable couponed tranches of securities.

While working with the rating agencies and holding preliminary price talks with certain investors, the underwriter and seller/accumulators will also sell the lowest rated tranche of the offering. The first loss tranche of the deal is often sold to one of the handful of investors who specialize in purchasing such high-yielding but high risk paper. The parties who purchase this paper, known in the market as the “B-piece Buyer” are almost uniformly also the parties who agree to service the loans in the pool in the event any loan defaults.<sup>73</sup> As will be discussed, *infra*, this practice creates an interesting scenario when a default occurs. The party charged with special servicing and workout holds the first loss piece.

To service the loans the trust contracts with entities known as Servicers. The rights and responsibilities between the trust and the servicer may stand alone in a separate Servicing Agreement. However, these contractual obligations are more likely bundled with the Trust Agreement in the Pooling and Servicing Agreement. The Pooling and Servicing Agreement is the master plan for the pool of loans, including the applicable tax elections or tax treatment of the pool, the allocation of cash flows, the duties of the various parties in the transaction, and particularly the arrangements regarding servicing.

One entity, generally known as a Master Servicer, is responsible for collecting and tracking all mortgage payments and ensuring that all payments are made to all the security

holders. In most CMBS transactions, the Master Servicer also has an advancing function. By undertaking this obligation, the Master Servicer agrees to advance monies for various costs (including the payment of principal and interest on the underlying securities under some circumstances) in the event the underlying mortgage borrowers fail to pay. If there is a default in the pool the investors are not affected if the Master Servicer advances the money.<sup>74</sup> However, Master Servicers are not obligated to advance if they can show the likelihood that the advance is nonrecoverable.<sup>75</sup> At this point the loan servicing moves from the Master Servicer to the Special Servicer.

The Special Servicer is generally also a party to the Pooling and Servicing Agreement. A Special Servicer is the entity charged with servicing the loans if the loans are over 60 days in default.<sup>76</sup> Unlike Master Servicers, Special Servicers have no advancing obligation. Therefore, the income from the loans in default does not flow through the pool until the loans are either rehabilitated or liquidated. As mentioned above, the Special Servicer is typically, although not always, also the buyer of the first loss bonds.

Finally, the Master Servicer and Special Servicer often will retain parties known as Primary Servicers (sometimes called sub-servicers). These participants are not parties to the Pooling and Servicing Agreement but are in contractual privity with the Master and Special Servicer. Primary Servicers are the parties who discharge the traditional mortgage banking function of property inspection and direct interaction with the underlying mortgage borrowers on requests for assignments, assumptions, defeasance and the like.<sup>77</sup>

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<sup>73</sup> See, Lenobel and Pressman *supra* n. 55

<sup>74</sup> Frank Fabozzi and Chuck Ramsey, *Collateralized Mortgage Obligations: Structures and Analysis*, 3<sup>rd</sup> Ed. 115

<sup>75</sup> Fabozzi, *supra* n. 74 at 116. Conceptually this is because the master servicer's advancing obligation is a liquidity support not a credit support.

<sup>76</sup> Other non-monetary events (such as failure to provide documents) may also trigger a default.

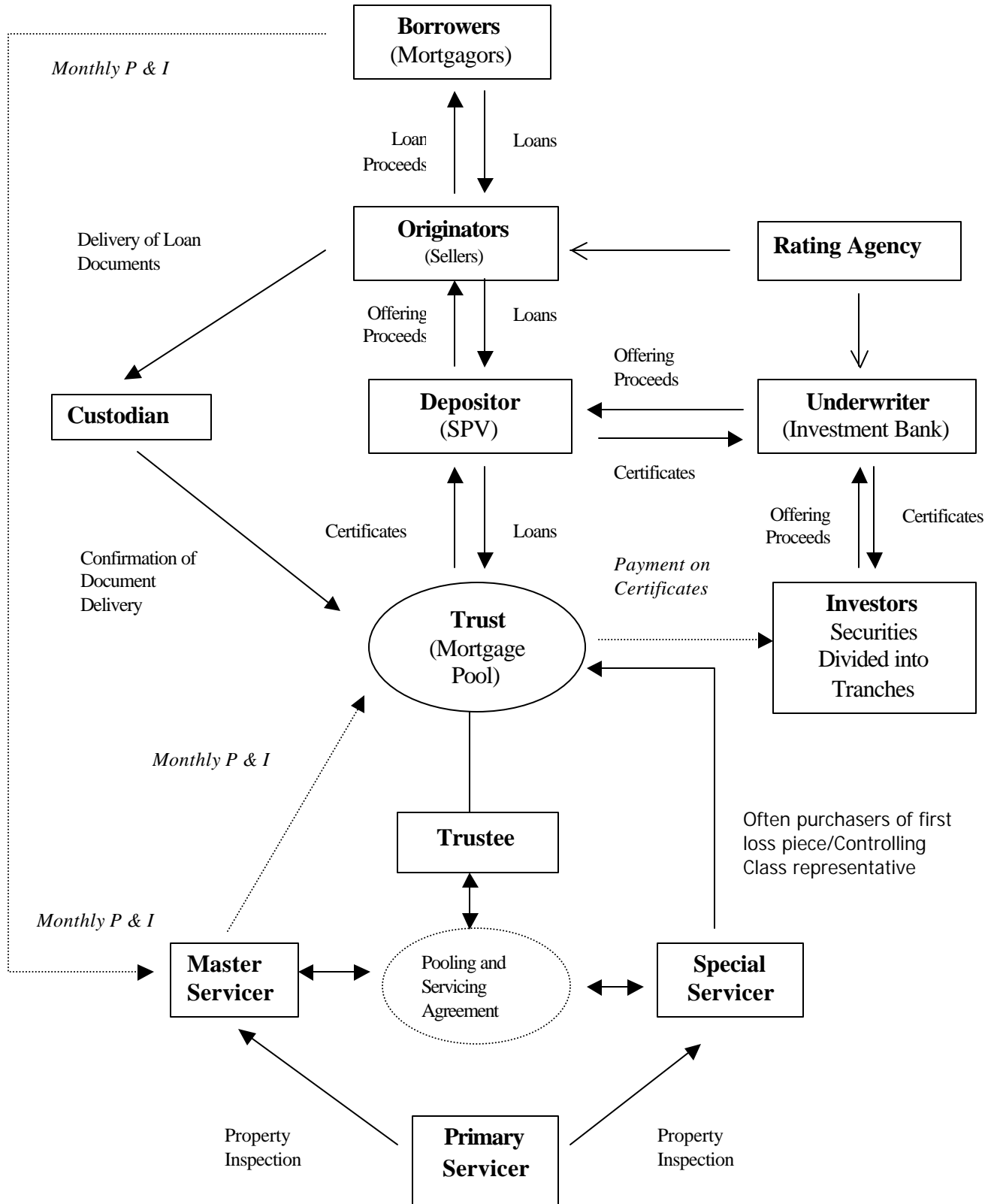
<sup>77</sup> Recently, the contractual relationship between primary and master servicer has been somewhat in flux as primary servicers (often the original lender or a mortgage banker) have tussled for more control over dealings with the

The two additional customary parties to the Pooling and Servicing Agreement are the Trustee and the Custodian. The Trustee acts on behalf of the bondholders and essentially funnels information between the bondholders and the Master Servicer. The Custodian is the party charged with possession of all of the underlying mortgage loan documents that constitute the pool.

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borrower. While initially, primary servicers were strictly ministerial agents for the master servicer, terminable at will, many primary servicers have recently gotten a substantial share of the master servicer's duties and powers, albeit leaving the master servicer with the legal responsibility for its performance under the Pooling and Servicing Agreement and somewhat beholden to the performance of the primary. Such robust primary servicers are not terminable at will by the master servicer, but only "for cause". This development is likely to further change the dynamics of loan workouts as it continues to spread through the marketplace.

The parties can be diagrammed like this:





The trust is exempted from the Investment Company Act of 1940<sup>78</sup> but, depending on the offering, may have to register with the Securities and Exchange Commission under the '33 Act.<sup>79</sup> After regulatory clearance has been granted from the Securities and Exchange Commission and relevant state agencies (Blue Sky), the bonds are sold to the underwriter for re-sale to a range of investors. In the average transaction there may be as many as 30 investors in a transaction who will buy one or more of the various securities offered for sale with the proceeds of the purchase repaying the underwriter for the underwriter's purchase of the bonds from the depositor. Once a transaction is closed, and depending on the identity of the underwriting investment bank, the size of the pool and a number of other factors, there often is a secondary market for the bonds which can be and are regularly traded.

Finally, a regular adjunct to the actual securitization process in recent years has been the growth of mezzanine financing. Because securitization has been characterized by relatively conservative loan-to-value ratios (less than 70%) and borrowers seem to have a never-ending appetite for greater leverage, lenders have discovered ways of providing additional financing to mortgage borrowers even when the loan is primarily destined for securitization. These structures, generally known as mezzanine loan structures, provide additional proceeds to the borrower.<sup>80</sup>

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<sup>78</sup> §3(c)(5)(c) of the Investment Company Act exempts companies primarily holding real estate interests such as mortgages. Primarily is defined as 55%. An interesting situation can occur if, due to defeasance, the trust ends up holding 54% mortgages and 46% Treasuries.

<sup>79</sup> For a discussion of the relevance of the '33 Act see J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, § 14.01 (1996)

<sup>80</sup> Several mezzanine structures can be used. One method makes loans to entities which own mortgage borrowers. These loans are secured by pledges of the mezzanine borrower's equity ownership interest in the mortgage borrower. Another structure relies on the issuance of "D equity." D equity is debt structured as preferred equity in the mortgage borrower. Most recently, mezzanine debt has been issued in the form of so-called "A/B" loan structures. A/B loan structures are accomplished by segmenting, on a senior subordinate basis, a single mortgage loan with the senior tranche (typically called the A piece) sold into the securitization and the B tranche retained by the seller or sold to an unrelated third party. These transaction structures create complex intercreditor issues in securitized lending. For a complete description of mezzanine structures, see, Nicholas J. Levidy, *CMBS: Moody's Approach to A/B Notes and Other Forms of Subordinate Debt*, Moody's Investors Services, February 4, 2000

c. Effect of subordination

Subordination, or payment prioritization, starkly differentiates whole loan lending from securitized lending. In making a whole loan, the lender undertakes the risk for everything above the borrower's equity stake. In a securitized loan risk is buoyed not only by borrower's equity but also by a security's subordination level.<sup>81</sup> In other words the risk of default is shared disproportionately among the classes.<sup>82</sup>

Let's go back to our hypothetical issuance of \$1 billion.<sup>83</sup> In this offering the securities rated BBB and above are referred to as investment grade securities, while those rated below are non-investment grade.<sup>84</sup> Certain institutions such as pension funds and life companies are severely limited, by regulation, from purchasing non-investment grade securities.<sup>85</sup> This regulatory limitation thins the market of B piece purchases considerably. The subordination cushions flow up the rating chart. Therefore, the B piece is the first to absorb a reduction in income due to default or delinquency.<sup>86</sup> Accordingly this tranche requires a yield premium to take on the greater credit risk exposure.<sup>87</sup>

Under this hypothetical there would have to be a default in the pool of at least 15% of the value of the pool before the BBB participants suffer reduction in payment.<sup>88</sup> Likewise there would have to be defaults/delinquencies amounting to 30% of the value of the pool before the

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<sup>81</sup> A tranche's subordination level refers to the percentage of value of the pool that must be compromised before a holders of that tranche can experience a loss on their investment.

<sup>82</sup> Fabozzi Handbook, supra n. 37 526.

<sup>83</sup> See page 21.

<sup>84</sup> Lenobel and Pressman supra n. 55

<sup>85</sup> Employee Retirement Income Security Act of 1974 §4975

<sup>86</sup> Fabozzi Handbook, supra n. 37 526

<sup>87</sup> Fabozzi and Ramsey, supra n. 74 at 119.

<sup>88</sup> The B piece is \$150 Million or 15% of the mortgage pool.

AAA rated securities are impaired.<sup>89</sup> In other words, a reduction in income payable on a security is limited to the extent loss exceeds its subordination level.<sup>90</sup>

### III. Gradable and Tradable: the Importance of Rating

At the core of the CMBS market lies the ability to rate the creditworthiness of the security. A credit rating is generally defined as an assessment of the likelihood of ultimate receipt of principle and the timely receipt of interest.<sup>91</sup> Rating is an assessment of default risk and does not reflect other risks such as interest rate risks or event risks or informational risks.<sup>92</sup> Rating agencies (such as Moody's, Standard & Poor's, Fitch) are independent private parties that analyze the creditworthiness of the pool. In rating the pool the agencies sizes the pool into discrete risk categories (tranches) and label those categories accordingly.<sup>93</sup>

It is difficult to overstate the vital role of rating agencies in driving the CMBS market. In their absence, few originators could accumulate a sufficiently large portfolio of loans that are relatively homogeneous in underwriting standards, credit quality documentation, and historical

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<sup>89</sup> The sum of the B, BBB and AA tranche values is \$300 million or 30% of the pool. Therefore the AAA piece is said to have a subordination level of 30%, the AA piece has a subordination level of 20% and the BBB- has a subordination level of 15%. From an issuer's perspective the lower the level of subordination in a securitization the better. A low level of subordination means that fewer securities are rated as having a high risk of default and delinquency. This is beneficial to the issuer because these high risk securities have high yield requirements. In addition to the sale of the interest only strip, an issuer makes its profit in the spread between what the mortgagors pay on the underlying mortgage notes and what the issuer must pay to the certificate holders. Obviously, as risk/yield decrease profitability increases.

<sup>90</sup> Lenobel and Pressman, *supra* n. 55

<sup>91</sup> [www.fitchibca.com/info\\_center/rating\\_definitions](http://www.fitchibca.com/info_center/rating_definitions).

<sup>92</sup> It is not a recommendation to buy. 50 Bus. L. 527, 535 (1995) Richard Leftwich, *Evaluating Bond Rating Agencies*, in *The Complete Finance Companion*, George Bickerstaff (ed.) at 233. Event risks are extraordinary changes in the financial or operating characteristics of a business. Financial companion p. 237. Furthermore, a rating does not substitute for disclosure of bankruptcy issues. Rating agencies are primarily concerned with the risk of default itself rather than the complication that occur during bankruptcy reorganization. See, Mendales, *supra* n. 4 at 751.

<sup>93</sup> Ratings serve both a legal purpose and a market purpose. For example, many regulated industries (such as pension funds) are limited in purchasing non-investment grade (defined as BB and below) bonds. Further more, ratings convey information to the capital market because the agencies have access to confidential data about an issuer's financial health and prospects. See Leftwich, *supra* n. 92 233.

loss information to quantify the investment risk for purchasers.<sup>94</sup> While some commentators have decried the profound influence of rating agencies (without the correlative regulatory oversight),<sup>95</sup> there is general agreement that without participation from the rating agencies, there would be no CMBS market.<sup>96</sup>

As stated previously, the issuer is securitizing the income stream. Therefore, the agencies' assessment of the likelihood of default within the income stream drives the sizing of the tranches and the subordination levels of the offering. In tranching the pool and rating the securities the rating agency, among other factors, considers default/delinquency rates and loss severity.<sup>97</sup> This analysis combines large scale statistical analysis with micro loan by loan analysis. Out of each pool there is the likelihood that some loans will go into default. The job of the rating agency is to estimate how many and how badly.<sup>98</sup>

a. Default/delinquency rates

Both default and delinquency rates are important to a discussion of default. Default rate is the percent of loans in the loan portfolio that are non-performing. Delinquency rate is the percent of the portfolio value that is non-performing. In a study of mortgages held by life insurance companies originated between 1972 and 1992, the cumulative default rate as of 1997 for loans originated before 1987 was 18.1%. The cumulative default rate for loans originated in 1985

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<sup>94</sup> Loss coverage is determined by foreclosure frequency times loss severity. See, Kenneth G. Lore, *Mortgage Backed Securities*, Clark-Boardman (1985) at 9-9. For a discussion on this issue in relation to loans outside of real estate, see, Bushaw supra n. 43 at 247-248.

<sup>95</sup> In his article *A Conceptual Framework for Imposing Statutory Underwriter Duties on Rating Agencies Involved in the Structuring of Private Label Mortgage-Backed Securities*, 70 ST. JOHN'S L. REV. 779 (1996), Gerard Uzzi submits that rating agencies should be regulated, asserting that there is a correlation between less stringent credit enhancement requirements and a greater rating agency market share. Uzzi at 790.

<sup>96</sup> However, rating a security is not an exact science. Issuers and their securities are often rated by more than one agency and sometimes with inconsistent results. See, Mendales, supra n. 4 at 751(1986). Absent a complete portfolio due diligence though, they are the closest thing an investor has to a plausible default proxy.

<sup>97</sup> For a discussion of how different rating agencies analyze a pool of mortgages see, Tamara Adler & Robyn Ballard *Mortgage Pool Technology Test New Frontiers* 639 PLI Corp 221 (1989).

<sup>98</sup> Fabozzi & Ramsey supra n. 74 at 133.

jumped to 28%, testimony to the severity of the last recession.<sup>99</sup> Furthermore, since approximately half of these loans were restructured rather than liquidated the true cumulative default rate was likely much higher.<sup>100</sup>

The default rate in securitized transactions has been much lower. Since the US economy has not faced a severe economic downturn during the era of securitization it is unclear whether the lower default rate can be attributed to the nature of the loans in the securitized pool, better loan servicing or simply the current wave in the real estate cycle. According to Fitch, fixed rate loans securitized between 1991 and 1996 had an average annual default rate of 3.5%. Floating rate loans during the same period had a default rate of 5.4%.<sup>101</sup> Fluctuations in interest rates can have a significant impact on property level stresses and hence on default rates, even during a period of relatively stable and low interest rates.<sup>102</sup>

Fully amortizing loans defaulted less than half as often as balloon loans. The fully amortizing loan default rate was 2.6%, while the balloon loan default rate was 6%.<sup>103</sup> Approximately 59% of the defaulted balloon loans defaulted at the balloon date.<sup>104</sup> This result illustrates the problem posed by refinance risk and the need for offsetting that risk through the use of refinance constants and servicer flexibility. The higher risk of default at the balloon date takes on particular relevance in the present economic environment. While default rates may be low during the amortization period of the loan (whether in a stable or in a stressed economic

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<sup>99</sup> Eskai, et al supra n. 1

<sup>100</sup> Eskai, et al, supra n. 1. If a loan is restructured rather than liquidated the loss is never actually realized and therefore does not go into the cumulative default rate.

<sup>101</sup> FitchIBCA, Trends in Commercial Mortgage Default Rates and Loss Severity –1997 Update, July 20, 1998. [www.fitchibca.com](http://www.fitchibca.com) at 9

<sup>102</sup> Fitch supra n. 101 at 9. Furthermore, fixed rate loans are more generally backed by more seasoned, non-transitional properties thus tending toward lower default tendencies.

<sup>103</sup> Fitch supra n. 101 at 10

<sup>104</sup> Fitch supra n. 101 at 10

environment) the specter of default sharpens at the refinance window. Loans entered into at the inception of the securitization era are rapidly approaching their refinance window.

Delinquency rates rose as high as 7.53% during the real estate depression of the early 1990's.<sup>105</sup> Today, mortgage delinquencies are at historically low levels. For example, the American Council of Life Insurers reported that the delinquency of life insurance commercial mortgage loans is 0.39%, a record low.<sup>106</sup> Standard & Poor's reported that of its \$92.4 billion CMBS issuance, the total amount delinquent was \$708.6 million, a 0.77% delinquency rate as of May 2000.<sup>107</sup> From May 1999 to May 2000 delinquencies trended higher.<sup>108</sup> Even with a good real estate environment, analysts assert that this type of trending is to be expected as transactions season and weaker properties begin to experience problems after mortgage origination.<sup>109</sup>

b. loss severity

While default and delinquency measure the number of loans that are non-performing, loss severity measures the value of each loan that is compromised. Hence while a pool may have a relatively high default rate the ability to recoup most of the investment is not compromised if the value of the loans in default remains fairly constant. Conversely, a low default rate may mask a sharply increased risk on impairment if the loans in default have dropped in value severely. As most securitized loans are generally underwritten with a 70% loan to value ratio, loss severity in excess of 30% affects return on investment in the lower tranches.

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<sup>105</sup> Fabozzi, Handbook, supra n. 37 at 495.

<sup>106</sup> Peter Kozel, *Ratings Transition Study: Sources of Risk Revealed for CMBS Transactions*, Standard & Poor's Structured Finance Special Report, 1, 9-10 (January 2000). [www.standardpoor.com/ratings/index.htm](http://www.standardpoor.com/ratings/index.htm)

<sup>107</sup> Larry Kay, Delinquency Rates Edge Upwards, CMBS Quarterly Insights, Standard & Poor's, [www.standardpoor.com/ratings/structuredfinance](http://www.standardpoor.com/ratings/structuredfinance). July 20, 2000

<sup>108</sup> Kay, Delinquency Upward July 20, 2000

<sup>109</sup> Larry Kay, *CMBS Secondary Market Rating Activity: Upgrade and Away*, Standard & Poor's Structured Finance Report, 1, 6-7 (January 2000). [www.standardpoor.com/ratings/structuredfinance/index.htm](http://www.standardpoor.com/ratings/structuredfinance/index.htm) In fact 1995 transactions experience a 2.33% delinquency rate as of May, 2000. See also, Kay, Delinquency Upward.

The severity of loss from defaults 1992-1997 (as the market pulled out of the recession) was 43.8%.<sup>110</sup> Since the major losses were from RTC and “thrift product” transactions, these findings were likely due to a combination of high leverage, fair to poor collateral quality, and limited servicer flexibility.<sup>111</sup> Rating agencies today continue to use a 28% loss severity as the average severity when calculating implied loss rates.<sup>112</sup>

c. Default and structured risk

A defining feature of the securitization of commercial mortgages is the ability of the CMBS market to segregate risk into tranches. In an unsecuritized transaction the lender (the bank, pension fund or life insurance company) takes on the whole risk of loss. Although such risk is generally mitigated by a limit on the loan to value ratio (requiring a borrower to have an equity cushion), once the cushion is exhausted the lender’s investment is open to loss.

Vertical tranching, also known as credit tranching, is a form of internal credit enhancement.<sup>113</sup> Through tranching the pool, securitization structures the risk of loss. The rating agency sizes each tranche to meet rating hurdles, i.e. signaling rating as a proxy for expected loss. The higher rated securities are buffered from risk of loss not only by the borrower’s equity but also by the lower rated securities. Hence they receive higher ratings. Of course, the lower the risk of loss, the lower the yield on the security and vice versa. Now, instead of buying the whole risk, AAA through non-investment grade (also known as “high yield,” “junk” and “toxic

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<sup>110</sup> Moody’s CMBS: Review of Updated Commercial Default Study, June 11, 1999 p. 2

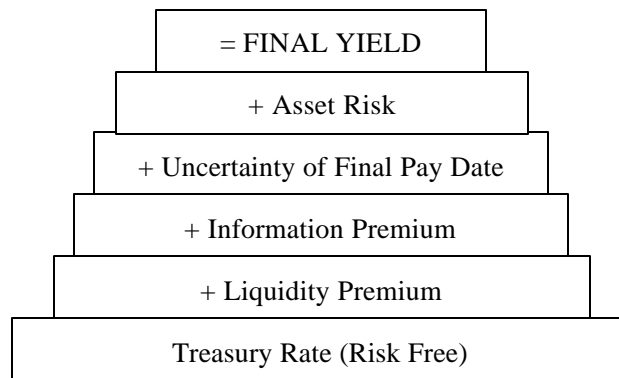
<sup>111</sup> Fitch, *supra* n. 101 at 2.

<sup>112</sup> Moody’s Review *supra* n. 110 at 3.

<sup>113</sup> Fabozzi and Ramsey, *supra* n. 74 at 119. Vertical tranching can be analogized to the vertical redistribution of risk by reinsurance or vertical exhaustion of excess insurance policies. See, Charles F. Corcoran, III, REINSURANCE LITIGATION: A PRIMER, 16 W. New Eng. L. Rev. 41 (1994); William P. Shelley, Richard C. Mason and, Nancy C. Thome, FUNDAMENTALS OF INSURANCE COVERAGE ALLOCATION, 14 NO. 9 Mealey’s Litig. Rep.: Ins. 25 (2000)

waste”), an investor buys only the piece of the risk that matches her risk/return appetite. Hence the debt is priced to reflect a more accurate risk of loss.<sup>114</sup>

Although the primary focus of this article is default, it is not the only risk that affects price. The pricing of risk (or required yield) of a security can be analogized to a multi-tiered cake:<sup>115</sup>



While the default risk inherent in the “Uncertainty” layer carries significant importance, the information premium is, likewise, a crucial layer. As will be discussed below, the new players in a securitized transaction (such as the master servicer and special servicer) guide and advise the pool in the wake of borrower default. Their actions directly affect the risk of loss of the lower rated securities. Information as to conflicts of interest, contractual limitations and self-dealing should be modeled into the price. Although such economic modeling is beyond the scope of this article, the legal response to the economic situation will be addressed, *infra*.

#### **IV. Old Dogs Learning New Tricks**

In addition to the new players in the transaction, there are major changes in both document architecture and the structure of ownership management of mortgage loans. These

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<sup>114</sup> Contrast this with the “mispriced debt” of the pre-securitized era which was priced to reflect only the AAA risk but was subject to the risk face by what is now the unrated tranche.

<sup>115</sup> Sally Gordon, *supra* n. 35. Although for clarity this example prices off of Treasury, the market often prices off of LIBOR, swaps, spreads and other more dynamic baselines and benchmarks.



changes can be contrasted the with the structure of loans and ownership patterns prior to securitization to highlight potential default issues and the likely impact on the behavior of the parties. The changes affect the ability and/or willingness to choose workout or liquidation in the event of default.

a. Document architecture

Within the loan documents that underlie a mortgage transaction changes have been made to accommodate the new securitized structure. While these changes may not be strictly tied to default they do have a significant impact on the ability (or lack thereof) to workout a loan in distress.

- Yield maintenance and limitations on prepayment. Prior to securitization prepayments (whether voluntary or involuntary) were generally subject to a yield maintenance requirement that a lender could choose to impose or waive.<sup>116</sup> Because most securitized transaction use a REMIC vehicle,<sup>117</sup> prepayment is now conditioned upon defeasance. Using defeasance the debt is not terminated. Rather the borrower substitutes a package of noncallable and nonprepayable US government obligations for the mortgage.<sup>118</sup> This restriction impedes the workout by giving the lender less latitude in fashioning a solution to a default such as a partial prepayment or waiving of yield maintenance.
- SPV Structures. Use of a SPV protects the lender and, ultimately, the certificate holders of a security, from having the underlying property involved in bankruptcy

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<sup>116</sup> The most common method was to require all prepayments to be accompanied by the difference between the contract rate and the treasury rate discounted to present value. For general discussion of prepayment of mortgages see, Dale A. Whitman, MORTGAGE PREPAYMENT CLAUSES: AN ECONOMIC AND LEGAL ANALYSIS, 40 UCLA L. Rev. (1993); Frank S. Alexander, MORTGAGE PREPAYMENT: THE TRIAL OF COMMON SENSE 72 Cornell L. Rev. 288 (1987)

<sup>117</sup> Discussed *infra*.

proceedings against the borrower on the property. In order to ensure isolation a “true sale”<sup>119</sup> of the mortgage loan must be effected into a bankruptcy-remote entity established by the borrower(s) at the loan level and the issuer at the securities level whose sole asset is the property or properties being financed.<sup>120</sup> The isolation of the asset further attenuates the borrower from the lender in the event of default.

- **Lock Box.** Where borrowers previously paid their monthly payments directly to the lender, most securitized transactions require a lock box deposit. Under this arrangement, the tenants deposit rental payments directly into an account in the name of the trustee or an account that is immediately wired to the trustee. The borrower is entitled to payments or rent in excess of operating expenses and debt service. This scenario reduces borrower flexibility by bypassing the landlord altogether. While this may work to decrease the possibility of borrowers collecting rent more than 30 days in advance or not applying rent to debt service payment, it decreases the interpersonal relationship that may promote a satisfactory workout situation.

#### b. Changes in the Structure of Ownership and Management of Mortgage Loans

Along with the modifications in the underlying documents, the changes in legal and business landscape affect how parties will react to a default situation.

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<sup>118</sup> George Lefcoe, *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Prepayment*, 28 Real Est. L. J. 202, 203 (2000)

<sup>119</sup> Sally Gordon, Glossary of Terms, SE76 ALI-ABA 673, April 6, 2000.

<sup>120</sup> Robert Dean Ellis, SECURITIZATION VEHICLES, FIDUCIARY DUTIES, AND BONDHOLDERS' RIGHTS, 24 J. Corp. L. 295 (1999).

- Tax and REMIC regime.<sup>121</sup> This structure is, perhaps, the most important change of the new environment. A REMIC allows for a single level of taxation. However, to qualify as a REMIC the trust cannot have a change in the pool until two years after start up. Even then, only government securities can be substituted for collateral.<sup>122</sup> Except for precisely defined “defective obligations” no mortgage may be substituted for another originally included in the REMIC pool.<sup>123</sup> The flexibility to respond to default is therefore limited by exogenous regulations.
- Put back rights. If the Special Servicer indicates that a representation of the Originator has been breached the special servicer has the right to put the loan back to the Originator. The originator must repurchase the loan or (within the parameters of REMIC requirements) substitute another loan. Previously a lender had the flexibility of determining whether the breach would be resolved by e.g. a paydown, substituted collateral or other solutions. Now the servicer in some fashion has more options and in some fashion less. A defective loan obligation can be resolved without a default. The credit of the originator is substituted for the credit of the borrower in requiring a repurchase from the pool. However, if the originator does not repurchase the loan the servicer is bound by the REMIC restrictions which limit substitution of collateral.

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<sup>121</sup> Virtually all of current securitizations utilized the REMIC pass through tax structure which provides tax transparency. There are other structures available, but seldom used, such as FASIT or grantor trusts. Each of the alternatives has its own burden of inflexibility but are not discussed herein because the REMIC is the dominant structure in the market.

<sup>122</sup> 26 CFR pt. 1 §1.860G-2(a)(8).

<sup>123</sup> George Lefcoe, *supra* n. 118. See also, George Lefcoe, Prepayment Disincentives in Securitized Commercial Loan, 13-Oct Prob. & Prop. 6 (1999)

- Controlling Class (or Directing Class) and Operating Advisor. The security holders in the most subordinate class are the Controlling Class. The Controlling Class elects the Operating Advisor. The Operating Advisor works with the Special Servicer when a loan is being specially serviced. While the Special Servicer is charged with the obligation of sheparding loans in default important decisions are made in consultation with the Operating Advisor.
- Outsourcing of servicing. As stated above, in the era before securitization loans were, generally, serviced in house. Now a complex dance between the Master Servicer, Special Servicer and borrower ensues in the event of a default. Along with the outsourcing of the servicing goes the issue of servicer compensation. Master Servicers and Special Servicers earn their fees only when they service the loan. This creates a conflict for both in deciding whether to send the loan to the special servicer (in the case of the Master Servicer) and whether to liquidate the loan (in the case of the Special Servicer).

#### **IV. Modeling the Paradigm**

Taken together, the adjustments wrought by pooling, subordination and securitization ultimately affect the behavior of the owners of commercial real estate debt. Whether it is a new business or legal stricture now imposed on the process, lenders no longer act solely in their creditor capacity. Now they act to preserve their equity not in the asset but rather in the trust. For example, as stated above REMIC restrictions severely limit the substitution of collateral. Whereas the whole loan lender would have attempted to preserve the value of the asset, REMIC regulations attempt to preserve the integrity of the trust.

However, there is a fundamental conflict inherent in the situation caused by the effect of subordination. The bondholders do not act as one. Rather, the importance of a bondholder's equity-like interest increases as the subordination cushion evaporates. This creates subordinated rolling equity.

#### a. Drafting the Model

In order to sketch the idea of rolling subordinated equity we can begin with the default scenario in a whole loan situation. Imagine a \$1 million non-recourse loan secured by a property valued at \$1.3 million. The loan goes into default and the underlying real estate is valued at time of default at \$1 million. The lender can foreclose immediately and recoup \$ 1 million. However, there are significant transaction costs associated with foreclosure. Alternatively the lender can work with the borrower for a year to attempt to rehabilitate the loan. Suppose there is a 50% chance the work out will be successful at the end of the year and the value of the asset will rebound above \$1 million. However, if the workout is unsuccessful there is a 30% chance the asset will depreciate to \$850,000 and a 20% chance and the asset will depreciate to \$800,000.

In deciding whether to foreclose immediately or attempt to work out the loan the lender will determine the workout value and the present value. If the present value is greater than the workout value then the lender will foreclose. Otherwise the lender will enter into a workout.

The present value of the asset to the lender is 1,000,000 minus the foreclosure costs or \$1,000,000 - FC.

The workout value can be derived as follows (assuming risk neutrality):

$$\begin{aligned} &.5[(1,000,000) - 0 \text{ (no foreclosure)}] \\ + &.3[(850,000) - FC] \\ + &.2[(800,000) - FC] \\ = &915,0000 - FC/2 \end{aligned}$$

As previously stated the lender will workout the loan if the value today minus foreclosure costs is less than the workout value. Therefore the loan will be worked out if:

$$1,000,000 - FC < 915,000 - FC/2$$

$$85,000 < FC/2$$

$$170,000 < FC$$

Therefore the whole loan lender will only workout the loan if the foreclosure costs are more than \$170,000. If the foreclosure costs are less than \$170,000 the whole loan lender will foreclose.

Now let's consider the perspective of the Special Servicer (who holds the B piece) in deciding whether to foreclose or workout. Using the same subordination levels as in the previous illustration we can tranche a \$1 million pool as follows:

Class	Worth	Yield (10 Year Treasury)	Aver. Life
AAA	\$700,000	120bp	9 years
AA	\$100,000	135bp	10 years
BBB	\$50,000	300bp	10.5 years
B	\$150,000	800bp	11 years

Leaving aside servicing fees for a moment, the Special Servicer will decide to workout the loan as long as the workout value is greater than the present value minus foreclosure costs. For the Special Servicer (as holder of the B piece), though, the workout has no value if the asset is worth less than \$850,000. Therefore the workout value to the Special Servicer is as follows:

$$\begin{aligned}
 &.5[(150,000) - 0] \\
 &+ 0 \\
 &+ 0 \\
 &= 75,000
 \end{aligned}$$

The present value of the asset to the Special Servicer (as holder of the B piece) is \$150,000 – FC. The workout value is \$75,000. Therefore if the FC are less than \$75,000 the special servicer will foreclose. Once the foreclosure costs exceed \$75,000 the Special Servicer will choose to attempt to workout the loan.

Taken together these two scenarios show the incentive for a Special Servicer to workout a loan when the foreclosure costs are much lower. For a whole lender to have incentive to workout the loan the foreclosure costs had to be greater than \$170,000. For the special servicer the costs only had to be \$75,000. The gap is even starker when the servicing fees are taken into consideration. The Special Servicer stands to earn a fee<sup>124</sup> during a workout that would be lost once the loan was foreclosed.<sup>125</sup>

Consider now the position of the holders of the BBB tranche. If the loan is liquidated immediately they will be in the money until foreclosure costs exceed \$150,000. While working the loan out for say, \$85,000 may make economic sense to the special servicer it is not in the best interest of the BBB holders.<sup>126</sup> The risk of loss has rolled up into the next tranche while the decision-making ability (whether to foreclose or workout) is stuck below. The equity considerations implicit in the whole loan lender's decision are subordinated in a securitized transaction and roll up the pipeline as the value of the underlying pool is compromised.

Whole loan owners operate according to traditional debt principles. The legal rights exercised are for the benefit of the whole loan. All of the gains of the benefits and the

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<sup>124</sup> Generally the fee is 25bp of the principal balance of the specially serviced loans. Furthermore, there is a workout fee of 1% of all future income off of a rehabilitated loan.

<sup>125</sup> The fee on a liquidated loan is generally 1% of the liquidation proceeds. The counterpoint to this argument is that if a Special Servicer determines it could manage the property better than the present owner (thus adding value) it may be incentivized to foreclose on the property on behalf of the trust and bury the property for its own behalf. This scenario begs the conflict of interest provision that is standard in Pooling and Servicing Agreements and further strengthens the argument for more control by the Trust and other security holders over the acts of the Special Servicer.

minimization of losses accrue to the decision making party. In the securitized transaction the special servicer is taking on the role of allocating benefits and losses to the other tranches.

#### b. Debt versus Equity

At first blush this situation presents a confounding mixture of equity and debt considerations. The objectives of bondholders shift from debt/security interests to an equity interest as their subordination cushion decreases. Are the holders of the trust certificates expected to act as traditional creditors seeking repayment of debt or are their actions more like shareholders wishing to preserve value in the company?<sup>127</sup> Furthermore, the debt is non-recourse to the borrower. Tying repayment strictly to the value of an asset blurs the line between debt and equity even more.<sup>128</sup>

The webs starts to untangle if, instead of conceptualizing the investors as holders of mortgage debt we analyze them as equity investors in the trust. Debt traditionally has been defined as “an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payments regardless of the debtor's income or lack thereof.”<sup>129</sup> Courts explain the conceptual difference between lenders and equity holders by contrasting shareholders who place their money at the risk of the business while lenders seek a more reliable return. In other words, a loan is made upon the reasonable assumption that it will

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<sup>126</sup> These security holders would favor workout only if foreclosure costs were more than  $\$90,000; .3(50,000-FC) + 75,000$ . Would favor workout if  $FC > \$90,000$ .

<sup>127</sup> Note that this discussion is in no way meant to address the tax issues of whether the securities are equity or debt. We simply speak to the corporate governance and behavioral issues embedded in the analysis. As CMBS transactions deliberately use a tax transparent vehicle such as a REMIC the distinction does not affect the issuer. For the tax implications in other arenas see, Stephen F. Cappelli Robert A. Santangelo THINKING ABOUT THE CORPORATE TAX BASE: CERTAIN CAPITAL MARKET TRANSACTIONS 50 Tax Law. 65 (1996). For a review of tax issues see, Margaret A. Gibson, The Intractable Debt/Equity Problem, 81 Nw. U. L. Rev. 452 (1987)

<sup>128</sup> David P. Hariton DISTINGUISHING BETWEEN EQUITY AND DEBT IN THE NEW FINANCIAL ENVIRONMENT 49 Tax L. Rev. 499, 513 (1994).

<sup>129</sup> Gilbert v. Commissioner, 248 F. 2d 399,402 (2d Cir. 1957).



be repaid no matter whether the business venture is successful or not, while capital is put to the risk of the business.<sup>130</sup>

One of the hallmarks, then, differentiating debt from equity is the investor's expectation of repayment.<sup>131</sup> Because the lower rated pieces of the transaction have a lower expectation of repayment (and compensating higher yield) they are closer to equity than are the higher rated tranches.<sup>132</sup> As more of the loan pool experiences greater and greater loss severity this expectation of repayment is further compromised. Therefore, the tranche standing to lose its entire investment reacts as the equity investor, attempting to keep assets out of foreclosure. The upper tranches, their investment intact with an immediate foreclosure, favor immediate liquidation, as would any fully secured creditor.<sup>133</sup>

Another salient difference between equity and debt is the right to participate in corporate governance. Negotiated covenants can enable debt holders to monitor the financial health of the firm and review major business decisions. However, these contractually based rights are not equivalent to an internal role in firm governance.<sup>134</sup> In matters of corporate governance the lowest rated tranche decides the workout/foreclose dilemma. They act as the equity holders of the trust.

The party that stands to experience the greatest betrayal of expectations in this scenario is the BBB tranche. The AA and AAA tranches enjoy subordinations of 20% and 30% respectively.

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<sup>130</sup> *Slappey Drive Industrial Park v. US* 561 F 2d 572, 581 (5th Cir. 1977); see also *Midland Distribus. Inc. v. US* 481 F 2d 730, 733 (5th Cir. 1973). The seminal case making this dichotomy stated the case most eloquently: "The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them." *US v. Title Guarantee & Trust Co.* 133 F 2d 990, 993 (6th Cir. 1943).

<sup>131</sup> See, Margaret A. Gibson, *The Intractable Debt/Equity Problem*, 81 NW. U. L. REV. 452, 467 (1987)

<sup>132</sup> By stating this I do not mean to imply that there are no high yield bonds or low yield equities. Certainly both exist. Rather, I am drawing a comparison of the changing expectations of investors with a securitized transaction.

<sup>133</sup> See, Douglas G. Baird, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests*, 51 U. CHI. L. REV. 97, 106 (1984).

<sup>134</sup> See, Deborah A. DeMott, *Agency and the Unincorporated Firm*, 54 WASH. & LEE L. REV. 595, 610 (1997).

From the hypothetical, the value of the asset would have to decline from 1,300,000 to 800,000 or 38.5% before the AA tranche experiences loss. This is the loss severity is comparable to the last real estate recession.<sup>135</sup> In contrast, the BBB piece would begin to experience loss at \$850,000 or only a 35.6% reduction. This loss severity comports to industry projections of implied loss rates if the present economy were to experience high stress.<sup>136</sup> However, unlike the B piece the BBB holders had no voice in composition of the pool and, absent a reappraisal reduction, have no voice in the servicing of the pool.

While there are certainly financial instruments that are treated legally as both debt and equity for different purposes,<sup>137</sup> we need not exact a fine line on the distinction between debt and equity. With the development of capital markets, the characterization of capital investments has become more difficult.<sup>138</sup> The important point lies in how the characterization affects workout/foreclosure decisions. For this we should look deeper than the simple debt/equity dichotomy and dissect the financial and corporate governance features of the security.<sup>139</sup> When there is diverse ownership of the firm, as there is by creating the subordinated tranches of the trust, individual owners have the incentive to take action that will increase their share even if to the detriment of other classes. No single group, if left legally unconstrained, will make a decision that is in the best interests of the owners if all were considered together.<sup>140</sup>

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<sup>135</sup> Last recession there was a 43% loss severity. Esaki et al supra n. 1

<sup>136</sup> See, CMBS Review of Updated Commercial Mortgage Default, supra n. 110, table 2 p.3. Loss severity assuming high stress was estimated to be 33%.

<sup>137</sup> E.g. capital securities issued by banks. These are long-term corporate bonds that qualify as debt instruments under existing tax law, but are treated as equity for non-tax purposes, including bank holding company regulatory capital requirements. See, John J. Madden FINANCING SMALL BANK HOLDING COMPANIES: SECURITIZATION OF CAPITAL SECURITIES 54 Bus. Law. 93 1998

<sup>138</sup> Hariton, supra n. 128

<sup>139</sup> Alexander J. Triantis, George G. Triantis 72 Wash. U. L.Q. 1231 CONVERSION RIGHTS AND THE DESIGN OF FINANCIAL CONTRACTS (1994)

<sup>140</sup> Baird, supra n. 133 at 107.

### c. Applying the Model

The task, then, becomes how to craft the rights and responsibilities so that the decision makers enjoy the benefits and incur the costs of their decisions. Using the theory of subordinated rolling equity, we treat the trust as the touchstone for delineating the roles of differing parties.

#### i. Conflicts of interest- Master Servicer

The first issue is to address conflict of interest faced by the Master Servicer. The Master Servicer holds no equity stake. Rather, fiduciary duty defines their obligation to the trust. The Master Servicer, as indicated above, has the duty to advance funds it deems “recoverable.” If the funds are not “recoverable” then the loan is transferred to the Special Servicer (and the Master Servicer forgoes the servicing fees for that loan). This sets up an incentive for the Master Servicer to deem the advance “recoverable.” The right of the Master Servicer to recoup advances made from the trust strengthens this incentive. Therefore, the ability of the Master Servicer to recoup advances that are subsequently may not be recoverable impairs the value of the trust. Restricting repayment of advances would tighten the Master Servicer’s fiduciary duty to the well being of the trust.

#### ii. Conflict of interest-Special Servicer

The conflict of interest between a Special Servicer’s role as a servicer and its role as holder of the lowest piece of the securitization is specifically addressed in the Pooling and Servicing Agreement. The servicer is given express permission to hold securities. However, it is held to a servicing standard the higher of:

1. the same manner in which and with the same care, skill, prudence and diligence with which the servicer services and administers similar mortgage loans for other third party portfolios, giving due consideration to customary and usual standards of practice of prudent institutional commercial mortgage lenders servicing their own loans and to the maximization of net present value of the mortgage loans; or

2. the same care, skill, prudence and diligence which the servicer uses for loans which the servicer owns.<sup>141</sup>

As a preliminary matter, if we are to match risk with responsibility, teeth must be inserted into the standard by imposing sanctions for actions adverse to the well being of the trust. One way to do this is redefine the concept of controlling class. While there is an argument that the first loss holders should determine what happens when their money is on the line, this argument loses validity when the loss is greater than that tranche's subordination level. As shown in the above example, because of subordinated rolling equity other bondholders must have a voice when their interests are threatened.

At the point of an appraisal reduction<sup>142</sup> where defaults in the pool exceed a security's subordination level, the holders of the security should lose their position as Controlling Class to the next higher tranche. This investor class should forgo its status as a manager of the pool to the next higher class and remain with only a residual claim on the assets of the trust. Only when this appraisal reduction and shifting of Controlling Class occurs does subordinated rolling equity pair the limitation of risk with a limitation on rights.

Most transactions now are drafted to shift the Controlling Class only when the lowest tranche has lost 75% of its value as determined by liquidation and expense losses. Waiting until liquidation to shift the Controlling Class (and implicitly the Operating Advisor) provides further incentive for a Special Servicer to favor workouts over liquidation. Since the actions taken in the event of default in a securitized transaction depend on how quickly and under what

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<sup>141</sup> Standard & Poor's Structured Finance Ratings, Legal and Structured Finance Issues in Commercial Mortgage Securities, [www.standardpoor.com/ratings/structuredfinance.index.htm](http://www.standardpoor.com/ratings/structuredfinance.index.htm) at 54.

<sup>142</sup> An appraisal reduction, as the mechanism is generally used, does not require a change in the Controlling Class. An appraisal reduction in the pool is triggered by 120 day delinquencies, borrower bankruptcy and other events.

circumstances the equity stake in the transaction rolls up into the next class of security linking Controlling Class with appraisal reduction based on default, not liquidation.<sup>143</sup>

Even if the parties to the transaction reject the proposal to link appraisal reduction with default (rather than liquidation) there are still several ways to endeavor the risk/responsibility parity. One method imposes a right of the higher rated securities holders to appoint a representative of their own in matters of mortgage modification and liquidation. Alternatively the documents could prohibit the Special Servicer (when it is also the holder of the first loss piece) from voting on certain matters of modification or extension of a mortgage loan.<sup>144</sup> The difficulty raised in these alternatives is that they dilute decision making power at a time when swift action may be necessary to preserve maximum value in the asset. A better solution might be to require the out of the money controlling class to back up its actions with a reserve fund. The class would establish a reserve fund (with its own money) sufficient to cover any risk of loss that might be suffered by upper tranches when the lowest tranche decides to workout the loan rather than foreclose.<sup>145</sup>

At a minimum, the Pooling and Servicing Agreement should acknowledge a presumption of self-dealing that the Special Servicer can rebut. Standard language in most Pooling and Servicing Agreements limits the liability of the Operating Advisor to the Trust or to other Certificate Holders for actions taken in good faith using reasonable business judgment.<sup>146</sup> This

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<sup>143</sup> In adopting this new structure, however, care must be taken to precisely define the events that could trigger such an appraisal reduction. One method is to limit appraisal reductions upon notice that a threshold percent of the principal balance of the pool is in default.

<sup>144</sup> Standard & Poor's Structured Finance Ratings, Legal and Structured Finance Issues in Commercial Mortgage Securities, [www.standardpoor.com/ratings/structuredfinance.index.htm](http://www.standardpoor.com/ratings/structuredfinance.index.htm) at 63.

<sup>145</sup> See, standardpoor supra n. 144 at 62.

<sup>146</sup> For example: **Limitation on Liability of Operating Adviser.** The Operating Adviser shall have no liability to the Trust or the Certificate holders for any action taken, or for refraining from the taking of any action, in good faith and using reasonable business judgment pursuant to this Agreement, or using reasonable business judgment. By its acceptance of a Certificate, each Certificate holder (and Certificate Owner) confirms its understanding that the Operating Adviser may take actions that favor the interests of one or more Classes of the Certificates over other Classes of the Certificates and that the Operating Adviser may have special relationships and interest that conflict

limitation of liability expressly states that the Operating Advisor may take action that favor interests of one class or the other. Furthermore the limitation acknowledges that no action can be taken against the Operating Advisor as a result of any special relationship between the Special Servicer and the Operating Advisor. As the Operating Advisor is chosen by the holders of the Controlling Class (the lowest tranche), in effect the Operating Advisor and the Special Servicer are immune from liability for actions of conflict of interest. A better paradigm would be to create a rebuttal presumption of self dealing on the part of the Special Servicer when they are the Controlling Class and hence elect the Operating Advisor.<sup>147</sup>

### iii. Changes in Loan Documentation

The next step in applying the model is to analyze the different default sensitive provisions and reconceptualized them from an equity –like viewpoint. We can start with the basic assumption that in the transformation from whole loan to securitized loans the lender’s ability to work out a defaulted loan is greatly constricted. From the perspective of the higher rated tranches this works to preserve their stake in the trust. Most notably, the REMIC restrictions that limit collateral substitution limit the change in composition of the trust. The other modifications from the whole loan scenario (limitations on transfer, yield maintenance, SPV structure, and lock

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with those of Holders of some Classes of the Certificates and each Certificate holder (and Certificate Owner) agrees to take no action against the Operating Adviser based upon such special relationship or conflict. Notwithstanding any term in this Agreement, the Special Servicer shall not be entitled to indemnification from the Trust for any action taken by it at the direction of the Operating Adviser, which is in conflict with the Servicing Standard.

<sup>147</sup> For example: **Liability of Operating Adviser.** If the Special Servicer shall be entitled to elect the Operating Adviser by the terms of this Agreement or have special relationships and interest that conflict with the of Holders of some Classes of the Certificates, the Operating Adviser shall have liability to the Trust or the Certificate holders and shall indemnify the same from its own funds for any action taken, or for refraining from the taking of any action, if the Operating Adviser cannot show the action to be in good faith and using reasonable business judgment pursuant to this Agreement, or using reasonable business judgment. By its acceptance of a Certificate, each Certificate holder (and Certificate Owner) acknowledges that the Operating Adviser may take actions that favor the interests of one or more Classes of the Certificates over other Classes of the Certificates. However if the actions taken or refrain from favor the interest of the Class of Certificates held by the Special Servicer, or and each Certificate holder (and Certificate Owner) such special relationship or conflict creates a rebuttal presumption of self dealing. Notwithstanding any term in this Agreement, the Special Servicer shall not be entitled to indemnification from the

boxes) limit workouts and thus favor disposition of defaulted loans through foreclosure. Taken as a whole the new document architecture favors swifter disposition or liquidation and thus works well under the model of subordinated rolling equity.

#### iv. Borrower's perspective

The party not heretofore specifically considered in this discussion is the borrower. While changes in documents, new regulations and more vocal upper tranches may work to preserve the value of the principal balance of the loan pool, such mechanisms may disadvantage the marginal borrower who, with time and indulgence could work out the troubled loan. At this point notions of market efficiency and expediency collide with traditional property notions such as clogging the equity of redemption.<sup>148</sup> While acknowledging the importance of such property rights, the borrowers in securitized transactions are sophisticated parties whom we can assume understand the nuances of the transaction. Hence, if a choice must be made, market efficiency should win out over borrower's rights.

### **V. Conclusion**

It is an exciting time for commercial real estate financing. Long relegated to the sidelines of market finance, real estate is now thoroughly entrenched in the capital markets. Of course, this is a good news, bad news scenario. The good news is that the CMBS market has opened up Wall Street capital to real estate financings. More capital than ever is flowing into real estate. The bad news is that CMBS market has opened up Wall Street capital to real estate financings.

Traditional two party lending transactions must be retrofitted to accommodate the new players.

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Trust for any action taken by it at the direction of the Operating Adviser, which is in conflict with the Servicing Standard.

<sup>148</sup> To fully protect the right of the borrower to redeem property after default the lender cannot exact agreements or concessions that interfere with or "clog" the equity of redemption. See, Boyer, Hoverkampp & Kurtz, *The Law of Property*, 4<sup>th</sup> ed. 1991 at 640.

Underlying all of this is the specter of market downturn. Until the next recession we can only speculate as to who the losers (and winners?) might be. However, applying the model of subordinated rolling equity charts a rough map of how the transactions should be structured to insure that the parties on the losing end are those with the decision making power.