

Defaults in Securitized Real Estate Loans

*Changes in the commercial
mortgage-backed securities
market may affect the
rights and obligations of
the parties in the event
of a real estate downturn.*

GEORGETTE C. POINDEXTER

AS THE REAL estate market enters its first downturn in a decade, the structure of the ownership and management of commercial mortgage debt has been fundamentally altered by the advent and transforming success of Commercial Mortgage Backed Securities (CMBS) in the financing of commercial real estate. The question is, will CMBS affect the downturn? Will the transformation of the real estate mortgage market imposed by securitization materially change the behavior of market participants and, hence, the outcome of mortgage defaults?

Two factors have changed the pattern of loan participants' behaviors and market

outcomes in the commercial mortgage loan arena. First, the securitized ownership of commercial real estate mortgage debt has been structurally transformed: the investor pool has vastly expanded to include participants investing in only a discrete portion of the cash flow of the loan. Second, this investor pool has expanded to include participants with very different expectations and risk-responses than 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 drastically changes traditional bilateral workout negotiations by including many participants with divergent outcome goals.

As the old paradigms fall and new ones have yet to take form, there is substantial uncertainty about how the CMBS 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 volume of mortgage defaults. This article identifies and analyzes changed structures, and speculates on the behavior of players in the new structure who are reacting to a significant real estate recession.

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 — that is hard to price, trade, manage, and value — into a liquid asset marked to market. This asset can be bought, sold, and owned like other securities because investors can assess its value and risk with relative ease.

Debt servicing is potentially more efficient in a securitized environment. 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, as well as an elaborate origination structure to generate product. This was expensive and capacity could not be easily adjusted to meet market conditions. It was, in large measure, a sunk fixed investment that could not easily be shrunk or ballooned as the institution’s demand for mortgage debt waxed or waned. A 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 ameliorates these limitations by permitting limited participation. This allows investors in mortgage loans to react to market fluctuations and permits more efficient debt market participation. Furthermore, the structure facilitates

greater specialization in origination, capital provision, servicing, and foreclosure.

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 real estate to a fungible commodity. For the most part, it is not the real estate that is being securitized, but rather the cash flow. This aspect of securitization has critical implications when default becomes a possibility, as cash-flow impairment affects different investors in different fashions. In turn, how that cash flow is rehabilitated or recouped affects investors in distinct manners.

The year 1999 saw the emergence of a more active and vocal participation by the lowest rated buyers in the securitized commercial mortgage market. Their impact has been felt as they increasingly influence the composition of loan pools by successfully excluding loans that they believed heighten the potential for losses to the most junior tranches. Market analysts agree that the investor market for low-rated (thus high-risk) securities remains thin. Hence, these buyers drive pool composition, language in the documents, and overall pool quality.

While today's CMBS market is the child of the massive defaults of the real estate depression of the early 1990s, it has

yet to be tested and stressed by the very factors that gave it birth. 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 seventeenth century, the lender took possession of the land, collected its income (with no responsibility for an accounting), enjoyed the rights of land ownership, and kept the land in the event of default — regardless of the land's value in relation to the debt. Strict foreclosure, now abandoned in all but a few states, bars the borrower from redeeming the property once the lender has foreclosed. In modern times, whole loan remedies have focused 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 if the expected asset value after the workout was greater than the present value of the asset (minus foreclosure costs). At that point the lender foreclosed.

Since securitization, investors engage in

a sequential approach to default. Creditors' rights are 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 affected by the investor's stake in the asset pool.

In terms of default, perhaps the biggest change wrought by securitization is the increase in the number of parties who now have an interest and voice in the workout, and the sometimes conflicting goals of those parties. Whereas in the pre-securitization era the workout was bilateral (between the lender and the borrower), now a myriad of parties with differing agendas may be involved in the negotiation.

THE SECURITIZATION MODEL

It's useful to review the basic structure of a securitized transaction. In the securitization model, a loan *originator*, either through its direct sales force or through customary mortgage banking arrangements, provides 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 efficient securitization. When a suffi-

ciently large pool has been accumulated for securitization, the loans are securitized. The *underwriter* agrees to purchase the securities for resale on either a full underwriting or a good faith basis. Traditionally, large securitizations have been done 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 warehoused.

The originators are ultimately mortgage sellers who sell loans to a *depositor*. This depositor is a special purpose vehicle (SPV) that minimizes the possibility of a voluntary bankruptcy for reasons unrelated to the performance of the assets. 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. Rating agencies insist on a "true sale."

The depositor transfers the loans into a vehicle, normally a trust, which is tax-transparent (that is, not subject to tax at the pool of the trust or other entity). The sellers, working with the underwriter, decide how many and which 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 others. One or more rating agencies then review the pool. This review provides preliminary

Table I Hypothetical \$1 Billion Mortgage Loan Pool

Class	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 or Unrated	\$150 million	800bp	11 years

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 (see Table I).

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 capital 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 investors, the underwriter and seller/accumulators will also pre-sell the lowest-rated tranche of the offering. The lowest-rated 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. These parties, known in the market as “B-piece buyers” are almost uniformly also the parties who agree to service the loans in the pool in the event any loan defaults. As a result, the party charged with workouts 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, in particular, 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, under some circumstances, the payment of principal and interest on the underlying securities) in the event the underlying mortgage borrowers fail to pay. If there is a default in the pool, investors are not affected if the master servicer advances the money. However, master servicers are not obligated to advance if they can show that the advance is nonrecoverable. At this point the loan servicing moves from the master servicer to the *special servicer*.

A special servicer is generally charged with servicing the loans if the loans are more than 60 days in default. 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.

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 parties to a contract with the master and special servicer. Primary servicers 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.

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.

The trust is exempted from the Investment Company Act of 1940, but depending on the offering, may have to register with the Securities and Exchange Commission under the '33 Act. 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 resale to a range of investors. In the average transaction there may be more than two dozen 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 that can be traded.

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 the borrower's equity but also by a security's subordination level. In other words, the risk of default is felt disproportionately by the most subordinated classes.

Let's go back to our hypothetical issuance of \$1 billion (Table I). In this offering, the securities rated BBB and above are referred to as investment grade securities, while those rated below are classified as non-investment grade. Certain institutions such as pension funds and life insurance companies are severely limited by regulation from purchasing non-investment grade securities. As a result, the market for non-investment grade tranches is thin. The subordination cushions flow up the rating chart. Therefore, the B-piece is the first to absorb all and any reductions in income due to default or delinquency. Accordingly, the most subordinate tranche requires a substantial yield premium to take on the greater credit risk exposure.

In the \$1 billion case, for example, there would have to be a default in the pool of at least 15 percent of the value of the pool (\$150 million) before the BBB participants suffer any reduction in payment. Likewise, there would have to be defaults or delinquencies amounting to 30 percent of the value of the pool (\$300 million) before the AAA-rated securities are impaired. In other words, a reduction in

income payable on a security is limited to the extent that loss exceeds its subordination level.

At the core of the CMBS market is 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. Rating is an assessment of default risk and does not reflect other risks such as interest rate, event, or informational risks. Rating agencies (primarily Moody's, Standard & Poor's, Fitch) are independent private parties paid to analyze the creditworthiness of the pool. In rating the pool, the agencies size it into discrete risk categories (tranches) and label those categories accordingly. It is difficult to overstate the importance of rating agencies in the CMBS market. In the absence of rating agencies, few originators could accumulate a sufficiently large portfolio of loans that are relatively homogeneous in underwriting standards, credit quality documentation, and historical loss information, to quantify the investment risk for purchasers. While some commentators have decried the profound influence of rating agencies, there is general agreement that without rating agencies there could be no CMBS market.

The rating agencies' assessment of payment safety within the income stream drives the sizing of tranches and the subordination levels of the offering. In tranching

the pool and rating the securities, the rating agency considers, among other factors, default and delinquency rates and loss severity, combining large-scale statistical analysis with micro loan-by-loan analysis. Since there is a likelihood that some loans in each pool will default, the job of the rating agency is to underwrite how many, and how badly.

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 entire risk. Although such risk is generally mitigated by a limit on the loan-to-value ratio (theoretically requiring a borrower to have an equity cushion), once that cushion is exhausted the lender loses.

Vertical tranching, based on subordination and also known as credit tranching, is a form of internal credit enhancement. Through tranching, securitization segregates the risk of loss in the pool. The rating agency sizes each tranche to meet rating hurdles; that is, it signals 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 losses suffered by the pool's lower-rated securities. Of course, the lower the risk of loss, the lower the yield on the tranche. Now, instead of buying the whole risk, investors select only the part of the risk

that matches their risk/return appetite. Hence, the debt is priced to reflect a more accurate risk of loss.

DOCUMENT ARCHITECTURE

Securitization produces not only new players in the transaction, but also major changes in both document architecture and the structure of ownership and management of mortgage loans. In contrast, the structure of loans and ownership patterns prior to securitization highlight potential default issues and the likely impact on the behavior of the parties. The changes affect the ability and willingness to choose workout or liquidation in the event of default. While these changes may not be strictly tied to default, they do have a significant affect on the ability to workout a loan in distress.

Key among the changes are 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. Most securitized transactions have prepayment conditioned upon defeasance, so the debt is not terminated. Rather, the borrower substitutes a package of non-callable and non-prepayable U.S. government obligations for the mortgage. 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. Another feature is the use of an SPV to protect the lender and, ultimately, the certificate holders of a security from having the underlying property involved in bankruptcy proceedings against the borrower on the property. In order to ensure isolation, a “true sale” of the mortgage loan must be effected into a bankruptcy-remote entity established by the borrowers at the loan level and the issuer at the securities level, whose sole asset is the property or properties being financed. The isolation of the asset further attenuates the borrower from the lender in the event of default.

Whereas 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 consensual workout.

Along with modifications in the underlying documents, changes in the legal and business landscape affect how parties react to a default situation. Real Estate Mortgage Investment Conduit (REMIC) and tax structures are perhaps the most important aspect of this 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 its start-up. After that, government securities are the only allowable substitute collateral. Except for precisely defined “defective obligations,” no mortgage may be substituted for another originally included in the REMIC pool. Hence, the flexibility to respond to defaults is relatively limited.

So-called put-back rights provide that if the special servicer indicates that a representation of the originator has been breached, 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 a paydown, substituted collateral, or a variety of other solutions. Put-back rights give the servicer more options, as 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 on substitution of collateral.

The security holders in the most subordinate class are the *controlling class*, which in turn 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 shepherding loans in default, all important decisions are made in consultation with the operating advisor.

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. Master servicers and special servicers earn their fees only when they are servicing the loan, which creates a conflict 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).

Taken together, these many adjustments affect the behavior of the owners of commercial real estate debt. Lenders no longer act solely in their creditor capacity, but work to preserve their position, not in the asset as a whole, but rather in their tranche of the trust. Holders of the different tranches do not have the same interests in resolving defaults. The importance of a bondholder's equity-like interest increases as the subordination cushion evaporates, creating subordinated rolling equity.

SUBORDINATED ROLLING EQUITY

The following example of a default scenario for a whole loan situation will clarify the concept of subordinated rolling equity. Imagine a defaulted \$1 million non-recourse loan secured by a property currently valued at \$1 million. The lender could foreclose immediately and recoup \$1 million. However, there are significant transaction costs associated with foreclosure. Alternatively, the lender could work with the borrower for a year to attempt to rehabilitate the loan. Let's say there is a 50 percent chance the workout will be successful at the end of the year and that the value of the asset will rebound above \$1 million. Alternately, if the workout is unsuccessful, there is a 30 percent chance the asset will depreciate to \$850,000, and a 20 percent chance that the asset will depreciate to \$800,000.

In deciding whether to foreclose immediately or attempt to workout the loan, the lender will theoretically 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.

In the scenario above, the present value of the asset to the lender is \$1 million less the foreclosure costs (\$1,000,000 – FC).

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

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

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

$$\begin{aligned}
 \$1,000,000 - FC &< \$915,000 - FC/2 \\
 \$85,000 &< FC/2 \\
 \$170,000 &< FC
 \end{aligned}$$

It turns out that, for the risk assumptions mentioned above, the whole loan lender will only workout the loan if the foreclosure costs are greater than \$170,000. If the foreclosure costs are less than \$170,000, the whole loan lender will foreclose.

Table II shows a \$1 million pool using the same subordination levels as in the previous example. Consider the perspective of the special servicer who holds the B piece in

deciding whether to foreclose or workout.

Leaving aside servicing fees for the 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:

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

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 foreclosure costs are less than \$75,000, the special servicer will foreclose; if the foreclosure costs exceed \$75,000, the special servicer will choose to attempt to workout the loan.

These two scenarios demonstrate the greater incentive for a special servicer to

Table II Hypothetical \$1 Million Mortgage Loan Pool

Class	Worth	Yield (over 10 Year Treasury)	Average 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

workout a loan. For a whole lender to have incentive to workout the loan, the foreclosure costs have to be greater than \$170,000. For the special servicer the costs have to be only \$75,000. The gap is even starker when the servicing fees are taken into consideration, as the special servicer stands to earn a workout fee that would be lost once the loan was foreclosed.

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-out the loan for, say, \$85,000 may make economic sense to the special servicer, it is not in the best interest of the BBB holders. The risk of loss has rolled up into the next tranche while the decision-making ability (whether to foreclose or workout) remains 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 exercise their legal rights for the benefit of the whole loan, as all the gains accrue to the decision-maker. In the securitized transaction, the special servicer allocates benefits and losses to the other tranches. At first blush, this situation presents a confounding mixture of equity and debt considerations, as the objectives shift from security interest to equity interest as the bondholders' subordination

cushion decreases. Will the holders of the trust certificates act as traditional creditors seeking repayment of debt, or will they act more like shareholders wishing to preserve value in the company? Tying repayment strictly to the value of an asset blurs the line between debt and equity even more.

The web starts to untangle if, instead of conceptualizing the investors as holders of mortgage debt, we analyze them as equity investors in a trust. Debt traditionally has been defined as "an unqualified obligation to pay a certain sum at a reasonably close fixed maturity date along with a fixed percentage in interest payments regardless of the debtor's income or lack thereof." Courts explain the conceptual difference between lenders and equity holders by contrasting shareholders, who place their money at the risk of the business, with lenders, who seek a safer return. In other words, a loan is made upon the reasonable assumption that it will be repaid whether the business venture is successful or not, while equity's return reflects the risk of the business.

One of the hallmarks differentiating debt from equity is investors' expectation of repayment. Because the owners of the lower rated tranches in the transaction have a notably lower expectation of repayment (and compensating higher yield) they are effectively the equity owners of the trust. As the loan pool experiences greater loss severity, this expectation of repayment is

compromised. Therefore, the tranche standing to lose its entire investment reacts as the trust equity investor, attempting to keep assets out of foreclosure.

Another salient difference between equity and debt is the right to participate in corporate governance. Negotiated covenants 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. In matters of corporate governance, the lowest-rated tranche governs foreclosure decisions, again acting like the trust's equity holders.

The party that stands to experience the greatest betrayal of expectations in the \$1 million example cited above is the BBB tranche. The AA and AAA tranches enjoy subordinations of 20 percent and 30 percent respectively. Thus, not only must all property level equity be wiped out, but also the lower tranches. For a pool with 30 percent equity, the property values would have to decline by 38.5 percent before the 20 percent AA subordination tranche experiences losses. This loss is comparable in severity to the last real estate recession. In contrast, the BBB tranche with a 15 percent subordination begins to experience losses at only a 35.6 percent reduction. This loss severity fits with industry projections of implied loss rates if the economy were to experience

high stress. However, unlike the B piece, the BBB holders have no voice in composition of the pool and, absent a reappraisal reduction, have no voice in the servicing of the pool.

CONFLICTS OF INTEREST

The challenge is to craft the trust so that the decision-makers enjoy the benefits and incur the costs of their decisions. The concept of subordinated rolling equity views the trust as the touchstone for delineating the roles of differing parties. A major issue is the conflict of interest faced by the master servicer. The master servicer holds no equity stake in the trust; rather, its obligation to the trust is defined by fiduciary duty. The master servicer 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 creates 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 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.

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, which holds the servicer 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 that the servicer uses for loans which the servicer owns.

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 to 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.

An appraisal reduction in the pool, as the mechanism is generally used, does not require a change in the controlling class; it

is triggered by 120-day delinquencies, borrower bankruptcy, and other events. At the point of appraisal reduction, 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 percent 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, because as long as they are the controlling class they choose the operating advisor. Since the actions taken in the event of default in a securitized transaction depend on how quickly and under what circumstances the equity stake in the transaction rolls up into the next class of security, linking controlling class with appraisal reduction is based on default, not liquidation.

Even if the parties to the transaction reject the proposal to link appraisal reduc-

tion with default (rather than liquidation) there are still several ways to achieve risk/responsibility parity. One method is to give a right to 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. 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.

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. This limitation of liability expressly states that the operating advisor may take action that

favors 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 model is to create a rebuttal presumption of self-dealing on the part of the special servicer when they are the controlling class — and thereby elect the operating advisor.

CHANGES IN LOAN DOCUMENTATION

The next step in applying the subordinated rolling equity model is to analyze the different default sensitive provisions and to reconceptualize them from an equity viewpoint. We start with the assumption that in the transformation from whole loan to securitized loans, the lenders' ability to workout 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 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.

The party not 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 workout the troubled loan. At this point notions of market efficiency and expediency collide with traditional property notions such as clogging the equity of redemption. While acknowledging the importance of such property rights, the borrowers in securitized transactions are sophisticated parties who, 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.

This is an exciting time for commercial real estate financing. Long relegated to the sidelines of market finance, real estate is now securely established 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 financing; more

capital than ever is flowing into real estate. The bad news is that the CMBS market has opened up Wall Street capital to real estate financing; traditional two-party lending transactions are rapidly being retrofitted to accommodate new players and new roles.

Underlying all of this is the specter of market downturn. We can only speculate as to who the losers and winners will be. However, applying the model of subordinated rolling equity charts a rough map of how the transactions should be structured to ensure that the parties on the losing end are those with the decision-making power.

A different version of this article appeared in the spring 2001 issue of the *Emory Law Journal*.