

# CMBS OPPORTUNITIES & PROBLEMS

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*Peter S. Goodman, Principal, McKool Smith, P.C.  
David W. Prager, Managing Director, Goldin Associates, LLC<sup>1</sup>*

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## Overview of CMBS

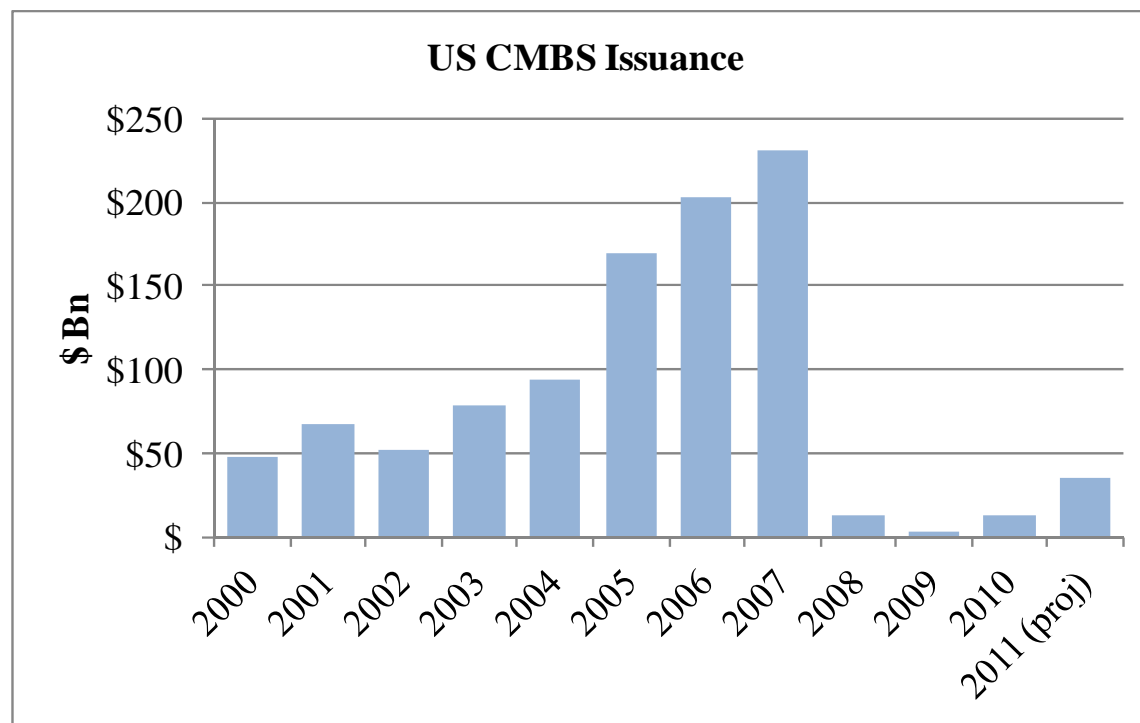
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- Until the 2007 financial crisis, an increasing percentage of commercial real estate was financed efficiently through the packaging of commercial mortgages into commercial mortgage backed securities sold into the capital markets. After 2007 CMBS, volume fell to virtually zero, and has now recovered to about \$35 billion annually, still just 15% of the peak levels.
  - In a typical CMBS structures, one often sees a diversified pool of 50-300 commercial real estate loans (backed by shopping centers, office buildings, apartment complexes, etc.) or a few concentrated mega-loans with more concentrated risk but better-regarded collateral. The loans are placed in a REMIC trust and securitized.
    - Underlying loans may themselves be apportioned to multiple CMBS pools.
  - In a CMBS structure, tranches of prioritized securities are sold to investors.
    - The tranches typically are sequentially paid (principal payments) with the senior most tranche being retired before any pay down of the next most senior tranche (all tranches receive interest, until defaults occur).
    - Losses are incurred in reverse order of seniority.
    - However, complex structures often have esoteric securities, such is I/O strips, prepayment penalty strips, etc.
  - Upon formation of the CMBS, certain rights to administer the transactions are delegated to the trustee, servicer and special servicer. Other rights are retained by the investors, the control party of the class of investors, or the most junior surviving class.

## Current State of Play in the CMBS Market

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- The CMBS “boom” has not returned since 2007:



- However, dollar volume in the first half of 2011 was \$25.7 billion, which was more than double of all of 2010.
- But, 2011 is still expected to close at about \$35 billion given uncertainties with the European economies and a fragile U.S. economy.

- Moody's said recently that for CMBS it is a "delay of game, not game over," and that CMBS issuance could be \$200 billion-plus as seen in 2006/2007. However, according to a recent study from FTI Consulting, Inc., CMBS issuance was predicted not to return anywhere close to the 2007 level for the next 5 years.
- According to Moody's, in the third quarter of 2011, multi-borrower, floating rate CMBS deals returned to the market for the first time in 4 years.
- CMBS issuance in 2012 is widely expected to mirror 2011.
- CMBS has rebounded better than non-agency RMBS given the handful of RMBS deals planned in 2011. The size of individual CMBS deals are now around \$1 billion, less than half the size of 2007 CMBS deals, and with fewer loans with higher loan balances.
  - Structures are much simpler. Certificate classes are fewer and thicker. Subordination levels are higher.
  - Disclosure for CMBS transactions continue to be highly detailed.
- The passage of "Dodd-Frank Wall Street Reform and Consumer Protection Act" ("Dodd-Frank") in July 2010 ushers in "CMBS 2.0"
  - Dodd-Frank was passed on July 21, 2010, and according to a study from the law firm Davis Polk, it required regulators to create 243 new rules, conduct 67 studies, and issue 22 periodic studies. As a general matter, it changed the existing regulatory structure, increased oversight of certain institutions, and provided increased standards and supervision.

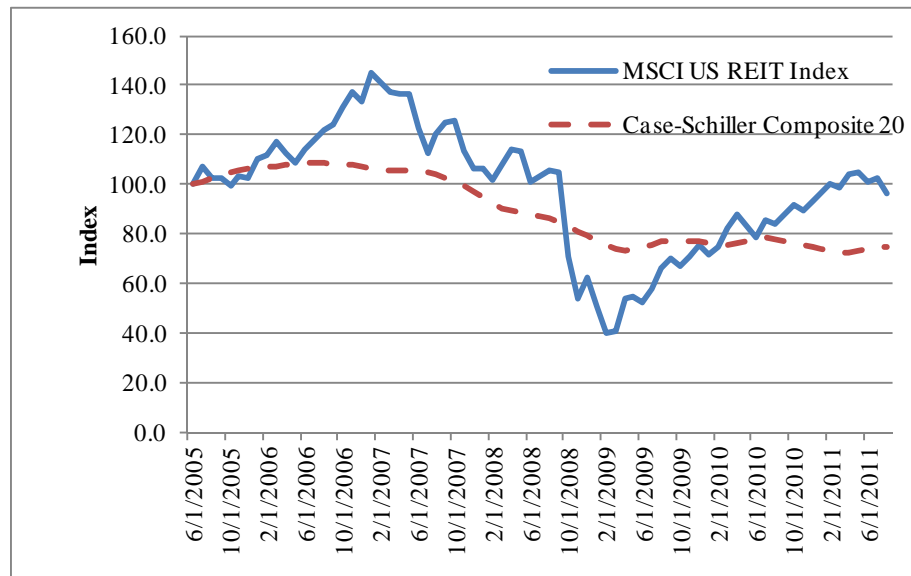
- According to HousingWire.com, six Federal agencies were required to implement the CMBS components of Dodd-Frank’s securitization risk-retention framework, in particular, according to the *Wall Street Journal*, a requirement that all issuers of asset-backed securities, including CMBS, keep at least 5% of the pool’s risk on their balance sheets.
  - “Risk retention” is intended to add stability to the securitization sector (i.e. for CMBS and RMBS). Specifically, if banks are required to keep a portion of the loans that they are selling off, then the banks may have incentive for making better loans.
  - However, banks and other issuers (in both RMBS and CMBS) are pushing for alternatives that would exempt them from the 5% risk retention requirement if they satisfy certain conditions.
  - But, some take the view that there should not be a “one size fits all” approach, and that CMBS and RMBS should be treated differently, even though the risk retention rules apply to both.
    - As just one example, if issuers are required to hold additional risk, it would limit the overall volume issued given that certain issuers would be wary of having too much commercial mortgage debt on their balance sheet.
- The CRE Finance Council, a trade group that represents the commercial real estate industry, has maintained (according to HousingWire.com) that investors and other market participants would prefer a package of reforms that include robust disclosures and reps and warranties.
- Currently, banks and other issuers are issuing safer loans now, as opposed to the loose underwriting standards and other factors that led to so many issued loans defaulting in large numbers.
- Groups such as the CRE Finance Council and other trade organizations are working with regulators (Office of the Comptroller of Currency and the Federal Reserve) to implement Dodd-Frank’s proposed rule changes, which are not scheduled to take effect until 2013.

## Remediation of CMBS, Comparison to RMBS, and the Role of Monoline Insurers

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- The pain has been slower in CMBS compared to RMBS.
  - Pundits for years have been speculating that it's the next shoe to drop, but it hasn't.
- At the end of October 2011 (3<sup>rd</sup> Quarter of 2011):
  - Trepp (an analytics firm that measures CMBS) and Fitch Ratings reported that CMBS defaults are half of what they were for all of 2010. The fall in CMBS defaults is said to benefit from tightening spreads, and a slowing loan default rate.
    - Fitch concluded that this could signal a “newfound level of stability in the markets within the CMBS segment.”
  - Trepp stated that commercial loans remain the chief reason why U.S. banks fail.
    - Trepp stated that in October, commercial real estate loans were up to \$401 million, or 65.1% of total, nonperforming loans at failed banks.
  - According to HousingWire.com, Bank of America recently commented in a research note that the quarter was steady and predictable, but continues down a recovery path that is “choppy” at best.
    - Bank of America further stated that commercial real estate is tied to the overall economy, which itself is shaky because of unemployment, uncertainties at the big banks, and the European debt crisis.
    - Bank of America added in its research note that commercial loans tied to properties located in major metropolitan areas were faring better than loans tied to secondary or tertiary markets.

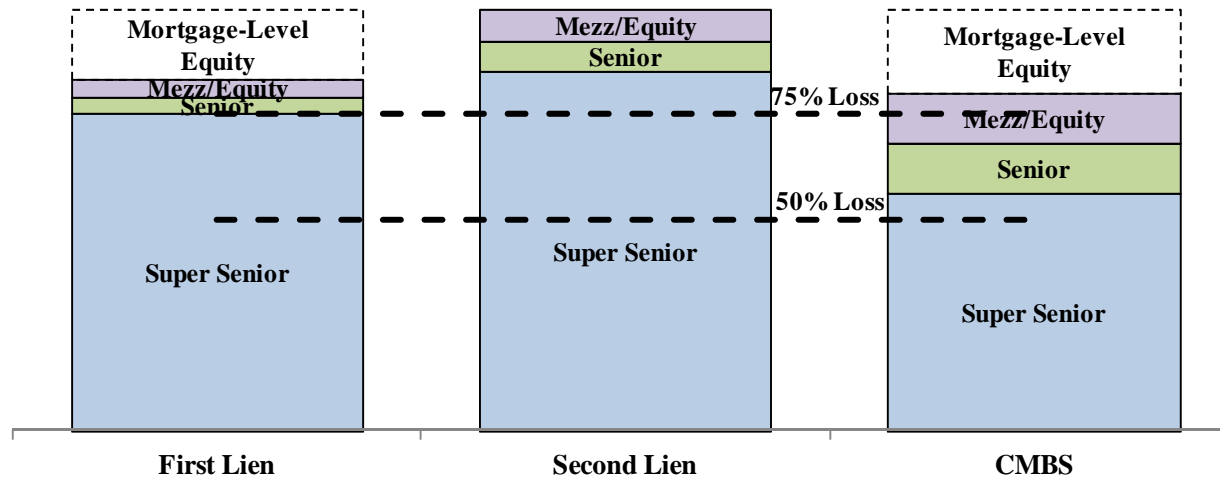
- Questions to consider:
  - Will the CMBS market collapse?
  - Why has it not already collapsed?
  - How do monoline insurers, special servicers, certificateholders, and others address risks of default?
  - Is the risk of default greater for CMBS than RMBS?
- There are some similarities between RMBS and CMBS.
  - Multiple loan real estate collateral.
  - The underlying collateral is tied to macroeconomic factors, and has been subject to similar declines.



- Structural Differences between CMBS and RMBS:
  - CMBS structures provide greater protections for investors (particularly the most senior tranches) than RMBS.

	<u>RMBS</u>			<u>CMBS</u>
	<u>First Lien</u>		<u>Second Lien</u>	
<b>Number of Loans</b>	1,000-3,000		1,000-3,000	50-300
<b>Collateral Represented by Top 10 Loans</b>	~1%		~1%	30%-50%
<b>Loan Level Subordination</b>	20%		0%-10%	20%-30%
	Subordinate position often second lien debt		Loans typically only cover up excess beyond 80% first lien	Subordinate position is often equity
<b>Info Available on Borrowers</b>	As obtained by originator (no identifying information) No (or limited) updates on credit quality		As obtained by originator (no identifying information) No (or limited) updates on credit quality	Identifying information, including primary tenants Quarterly or annual updates

- As a result, CMBS structures can withstand greater collateral losses than RMBS.



- Super senior tranches that were narrower on CMBS. These tranches had a very low yield, “double wrapped” (i.e. double AAA ratings), and no capital charge.
  - Generally, super senior tranches were held by major investment banks.
- Senior tranches (next level down) are held by insurance companies.
- Monoline insurers were mostly insuring the super senior tranches of CMBS and both super senior and senior RMBS tranches.
  - However, to the extent CMBS were included in CDOs, monolines may indirectly guarantee less senior tranches.

- Monoline insurers (i.e., the insurance companies that provide financial guarantees to issuers, often in the form of credit wraps, enhance the credit of the issuers) face significant risk on their insured CMBS portfolios.
  - Nearly all of these insurers have restructured or are in the process of doing so. While many of these restructurings were premised on little to no CMBS losses, continued deterioration of the commercial real estate market challenges this assumption.
    - According to an article from the Commercial Real Estate Development Association of Massachusetts, the CMBS market remains overleveraged with over \$1 trillion in loans maturing over the next 5 years, with \$100 million coming due this year alone. Huge drops in valuation are predicted.
    - According to a quarterly report from UBS, in recent years, there has been a decline in the fair value of the underlying assets in a CMBS, and a corresponding increase in the risk of potential claims against the monoline insurers.
- Generally, the underwriting and investment criteria for CMBS differed significantly from RMBS. As a result, remediation (loss mitigation) efforts also differ significantly.
  - RMBS
    - In RMBS, there are a large number of small credits that were not individually disclosed to (or identifiable through diligence by) investors, the loan underwriting standards were poor, and investment decisions were made on pool (rather than loan level) characteristics.
      - On a cost-benefit basis (or as a result of statutory non-recourse), there is little to be gained by litigating against residential borrowers.

- RMBS investment and underwriting were based on a review of loan and borrower *characteristics as represented*.
  - The primary source of recovery is breach of representation and warranty (or “R&W”)/putback litigation, which focuses on recoveries from securitization sponsors or loan originators.
- CMBS
  - CMBS investors more closely examined the underlying borrowers, had clarity on their credit quality and there was greater credit risk concentrations (e.g., the top 10 borrowers are 30-50% of the issuance of the CMBS).
  - As a result, CMBS remediation is less focused on R&W claims.
    - Rather, remediation of CMBS is more akin to a traditional corporate loan workout.
    - However, very often the Pooling & Servicing Agreement (“PSA”) has limiting language with respect to what the special servicer can agree to and what standards it must use to evaluate a proposed workout. For example, it might have to do what is “in the best interests of all certificate holders”—but is that even possible given the often conflicting objectives of senior and junior certificate holders—or might be required to maximize the present value---but doesn’t that just beg the question of what discount rate to use? Further, the PSA might limit the duration of a potential loan modification or other terms.
    - DIP financing is also very problematic. The tax code usually requires REMICs to be a fixed pool of assets--protective advances might be made, but a new, DIP loan, or proceeds used for something other than direct collateral preservation might be prohibited.
  - With CMBS defaults only recently emerging, it is also unclear how much the monoline insurers are providing in their loss reserves with respect to CMBS. The general view is that they are under-reserving. If losses exceed such reserves, some of the recent monoline restructurings may be in jeopardy.

- Key Issue: Who is the control party?
  - Monoline insurers are the control party in insured RMBS and CMBS to the extent losses extend into the insured tranches.
    - Where the credit protection was written as a CDS contract, the monoline may not possess even putative control rights despite bearing substantial economic risk.
  - However, if the monoline insurer's control rights do NOT prevail, it will be difficult for the monoline to remediate its exposure.
  - Several in the industry have commented that there can be conflicts in CMBS documents respecting the responsibilities for the relevant parties (e.g., conflicting information regarding the duties of the special servicer, the trustee, the directing certificateholder, etc.) --- or even mechanical/practical difficulties determining who is the control party, when valuations are ordered to cause a change, how to deal w/ brain-dead CDOs that own control positions, special servicers with common ownership of specific tranche holders, special servicer "rights" to purchase mortgages from trusts at "fair market value," etc.

## CMBS Certificateholders' Standing and Rights in Chapter 11 Bankruptcies: *In re Innkeepers USA Trust, et. al.* (Bankr. S.D.N.Y., April 1, 2011)

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- Key Themes
  - CMBS certificates may not give certificateholders standing to assert claims in a chapter 11 bankruptcy.
  - Unlike typical bond indentures where investors in bond debt have established standing as a party-in-interest, but in a chapter 11 bankruptcy, CMBS certificateholders may not have standing, and may need to rely on the special servicers/ REMIC trustees to assert their rights.
- Background
  - The Bankruptcy Court for the Southern District of New York ruled that a substantial CMBS certificate holder had no standing as a “party in interest” under Section 1109 of the Bankruptcy Code<sup>2</sup> to be heard in connection with the bankruptcy proceeding of the borrower on the underlying mortgage loan. It is the first case to specifically address the standing of a CMBS certificateholder in a chapter 11 case.
  - The borrower (Innkeepers) owned and operated a portfolio of hotels, but most of its properties were secured by mortgage debts, which were transferred to CMBS trusts, which in turn issued certificates of different priorities to investors. After defaulting on several loans, Innkeepers filed for chapter 11 in July 2010. Innkeepers sought to conduct an auction under Section 363 of the Bankruptcy Code to determine which party would be the Plan of Reorganization sponsor. Innkeepers identified potential purchasers, and filed a motion for approval of new equity commitment with bidding procedures, including a “stalking horse” bid that would maximize value to the estate. However, the equity commitment provided for a substantial reduction in debt held by the CMBS trusts, which the special servicer had agreed to.

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<sup>2</sup> Section 1109(b) provides that a “party in interest” may raise, appear and be heard on any issue in a bankruptcy proceeding. The Bankruptcy Code does not define “party in interest,” but provides a list that includes the debtor, a trustee, the creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee.

- The certificateholders objected to the proposed bidding procedures on the basis that they inhibited competitive bidding, and that the special servicer was placing its own financial interests above those of the certificateholders.
  - The Bankruptcy Court denied standing to the certificateholder because the holder had a derivative connection to the Debtors, and was merely a creditor of the CMBS trust (i.e. the right to payment was from the trust’s assets, not the debtors as the originator of the assets in the trust).
    - The Court relied on previous cases that deny standing to “creditors of a creditor,” i.e. no direct financial (or any other) relationship with the Debtors. *Krys v. Official Comm. Of Unsecured Creditors (In re Refco Inc.)*, 505 F.3d 109 (2d Cir. 2007) (holding that a creditor of a creditor is not a party in interest within the meaning of section 1109(b)).
    - In addition, the Court relied on cases with similar, but not identical, structures; *In re Shilo Inn*, 295 B.R. 726 (Bankr. D. Or. 2002) (denying standing to certificateholders of a pooled real estate loan similar to a CMBS trust); *Bank of America, N.A. v. PCV ST Owner L.P.*, Case No. 10-1178 (S.D.N.Y. Apr. 30, 2010) (CMBS certificateholder denied standing to intervene in non-bankruptcy foreclosure action).
  - The Bankruptcy Court also found that the certificateholders had violated the express language of a “no action” clause in the applicable servicing agreements of the mortgage loan, and that neither of the two exceptions to the clause was met such that the certificateholders could circumvent the contractual duties of the special servicer to achieve their own independent standing. Even if standing was granted, the certificateholders’ objections were still meritless.

- Analysis & Implications
  - A servicing agreement’s “no action” clause that prohibits certificateholders from instituting any suit or action relating to the loan may completely bar the certificateholders from standing and/or asserting their claims.
    - The Court stated that the “no action” clause (barring any suit or action) in the applicable servicing agreement here was standard, and that its express language barred the certificateholders from standing because it would otherwise alter the terms and risks that investors undertook in purchasing the certificates, and encourage other certificateholders to challenge a special servicer’s authority and advance individual and conflicting interests.
    - Otherwise, the Court stated, it would “dramatically alter the CMBS landscape and render the delegation to a special servicer meaningless” and require litigation with parties who “previously were contractually obligated to speak with one voice, that of the special servicer.”
    - The Court found neither of the two conditions precedent to a “no action” clause to have been met:
      - The certificateholder provides the trustee with written notice of default; AND
      - “Certificateholders entitled to at least 25% of the voting rights have made a written request to the trustee to institute such a suit, action, or proceeding and the trustee has neglected to take such action for at least 60 days.”
  - The “no action clause” could limit the ability of CMBS certificateholders to meaningfully participate in a borrower’s bankruptcy proceeding, including where the certificateholders’ interests diverge from the special servicer.
    - However, it will depend on the voting percentage owned by the certificateholder. In this instance, the certificateholders had an insufficient voting percentage (less than 25% of the face value of the certificates) to direct the special servicer.

- Still, such requirements such as the “no action” clause could impede the ability of distressed investors from taking an active role in a bankruptcy proceeding.
- A borrower debtor may be protected where a special servicer has provided support such that a proposed restructuring is not thwarted by disgruntled certificateholders.
  - Under the applicable servicing agreement, the Court stated that the special servicer’s duties arise upon an event of default under the mortgage loan, and in which case the special servicer is appointed to represent the interests of all certificateholders with respect to that loan.
  - The Innkeepers Court found the presence of an active special servicer significant. As a contrast, in the Extended Stay bankruptcy in the Southern District of New York, the CMBS certificateholders were permitted to appear and be heard and the Court did not even rule on whether they were parties in interest within the meaning of Section 1109. However, in that case, the special servicer was not appointed until the Extended Stay bankruptcy was filed (whereas for Innkeepers, the special servicer was appointed two months prior and became actively involved immediately).
- But, a special servicer who is contractually bound to consider the interests of all certificateholders as a collective whole may have breached its duties and could face liability.
  - The certificateholders may believe that the special servicer has breached the applicable servicing agreement by violating certain servicing provisions therein.
  - Special servicers may have less comfort because a dispute between the special servicer and the certificateholders may be brought in a non-bankruptcy forum.
  - Often the controlling class can appoint the special servicer and the threat of replacement (and the subsequent loss of monthly fee income and the typically large resolution fee) is often an attempt to influence the special servicer.