

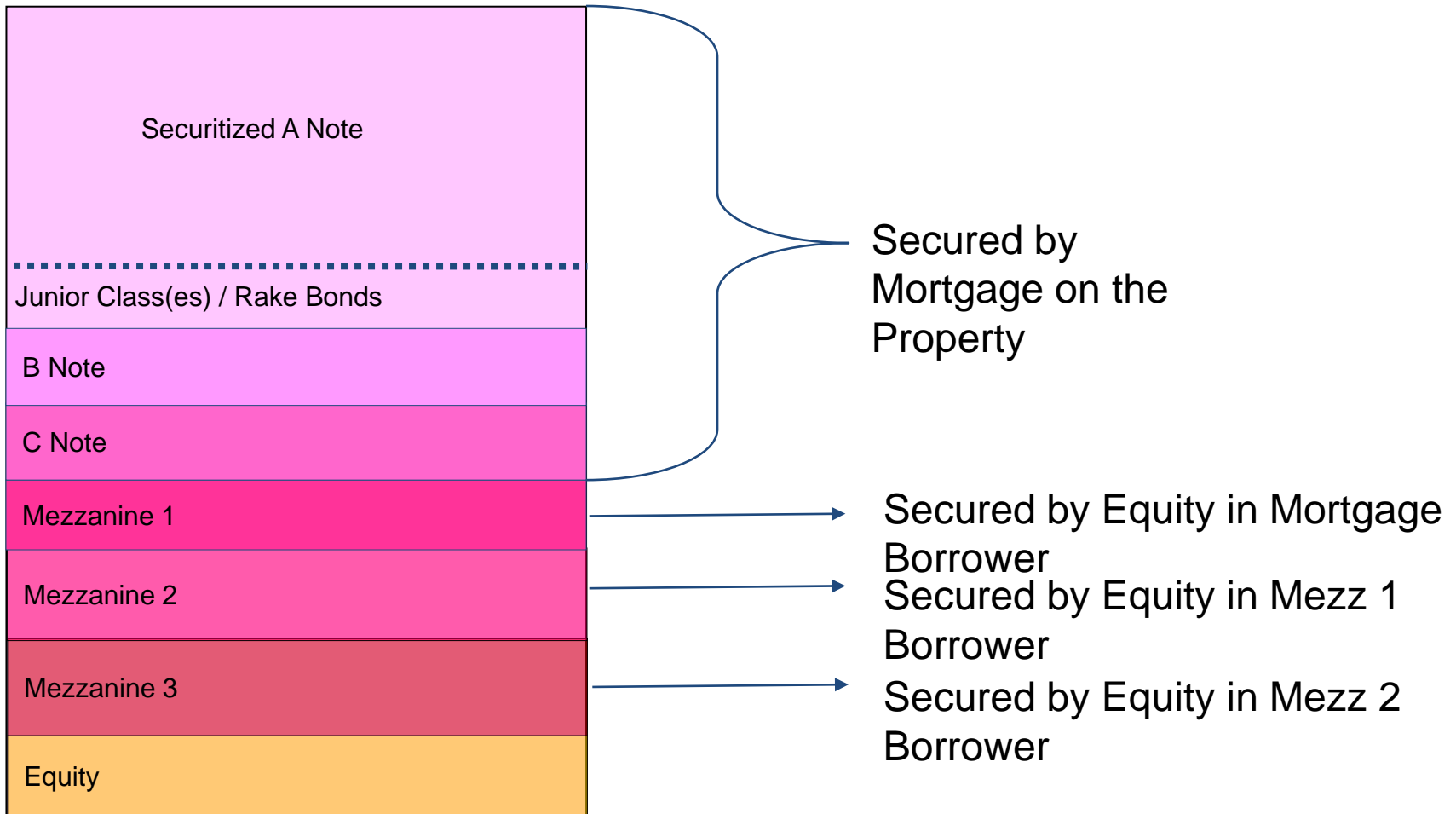
**CMBS Workout
and Structural Issues involving
B-Notes, Rake Bonds and
Mezzanine Notes**

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OVERVIEW OF REAL ESTATE
CAPITAL STACK STRUCTURES
AND
PARTICIPANT ROLES / RIGHTS / LIMITS

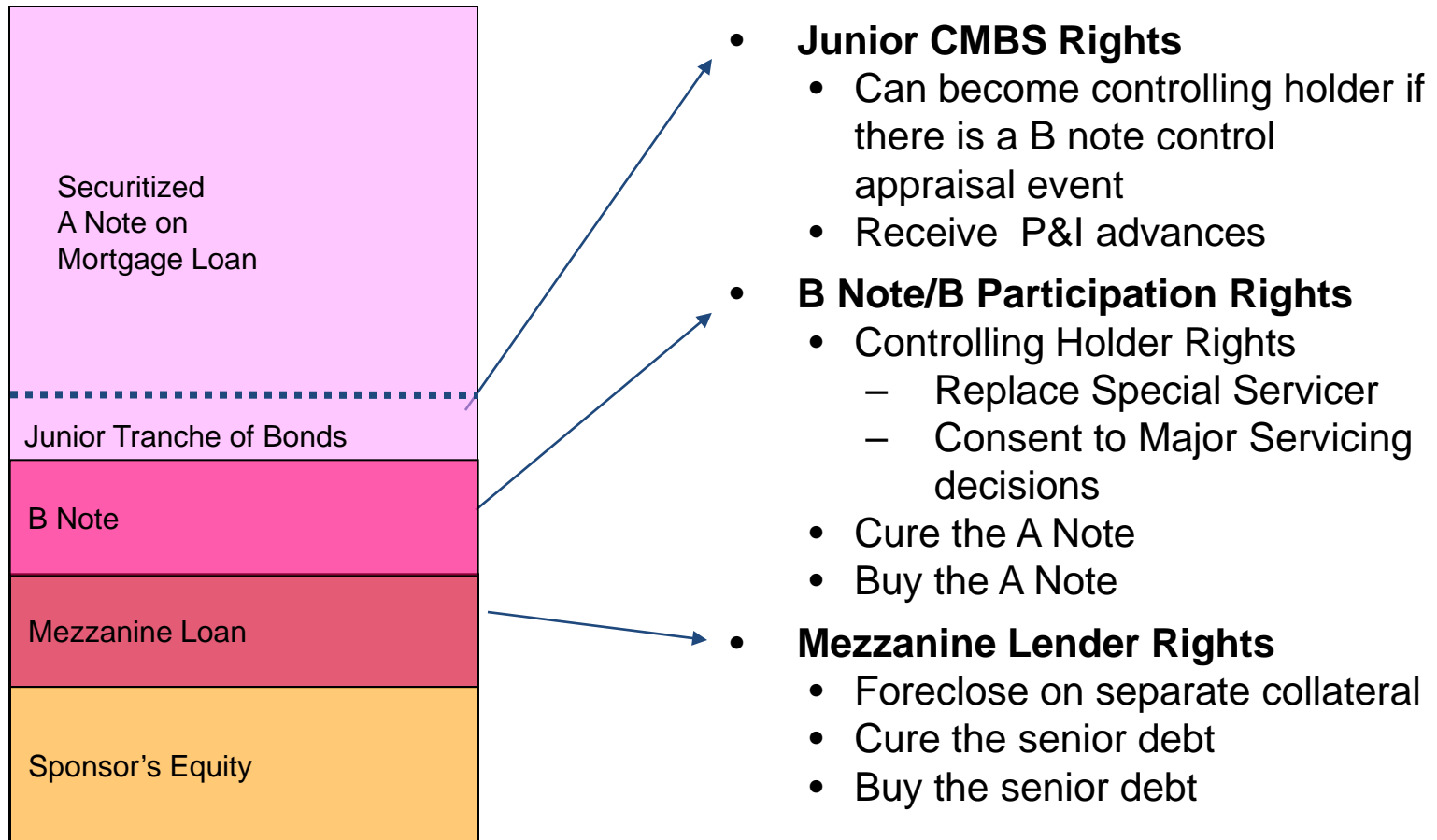
Representative Commercial Real Estate Capital Stack



Various Parties to Commercial Real Estate Capital Stack (CMBS)

- **Trustee**
 - Lender of record of mortgage loan
- **Master Servicer**
 - Services loan prior to “specially serviced” designation
 - Handles cash
 - Responsible for advancing
- **Special Servicer**
 - Takes over active servicing of loan once it becomes “specially serviced”
- **Controlling Holder**
 - Has consultation and consent rights over major servicing actions
 - Has the right to replace the special servicer
- **Mezzanine Lender**
 - Holds a separate loan with separate collateral
 - Party to inter-creditor agreement with mortgage lender

Rights of Junior Lenders in Capital Stack



Refer to Appendix for Comparison of Principal Differences between B-Note and Mezzanine Loan

Types of Junior CMBS

- **Conduit CMBS**
 - Generally fixed rate
 - Larger pools
 - Tranched down to unrated
 - Junior CMBS often purchased by special servicer affiliates
- **Large Loan CMBS**
 - Generally floating rate
 - Most junior CMBS is often “BBB” rated
 - “Controlling Holder” is usually the B Note
- **“Rake Bonds”**
 - Essentially a securitized B Note
 - No “rainy day” waterfall
 - Usually receive P&I advances

Rights of Certain Members in CMBS Capital Stack

- **B Note Holder**

- Is the controlling holder prior to a Control Appraisal Period
- Has limited cure rights
- Has par purchase option post-default
- Has right to remove and replace special servicer
- Has consent and consultation rights, including:
 - foreclosure
 - modification of a mortgage loan resulting in a discounted pay-off
 - modification of a monetary term of the mortgage loan
 - approving any bankruptcy plan of the borrower
 - waiver of a due on sale or due on encumbrance provision

- **Majority Subordinate CMBS Certificate holder** (i.e., most subordinated class of certificates not subject to a Control Appraisal Period)

- Is the controlling holder when B note is in a Control Appraisal Period
- May have fair value purchase option under pooling agreement post-default
- Has right to remove and replace special servicer

- **Other CMBS Certificate holders**

- No independent right to take action with respect to the mortgage loan
- Can obtain the names of other certificate holders upon request

Overview of B-Notes (Subordinate Loan Participations)

B-Notes and Subordinate Loan Participation Overview

B-Notes / Loan Participations

Formation / Structure



Observations

- Created when first mortgage loan split into one or more credit tranches interests (e.g. A/B/C)
- Most junior C-note absorbs first loss on loan
- Driven off disparity between market cap rates and rating agency cap rates

Similarities to Mezzanine Loans (1)



- B-Note lenders share some of same rights as mezzanine lenders
- Upon default, two fundamental rights:
 - Right to cure loan
 - Right to purchase loan

B- Note Holder Impact on Securitization Trust



- Controlling party is most junior note holder
- Receives similar (some times more extensive) consultation, approval purchase and cure rights
- Can direct special servicing decisions on specific loan; impacts entire bondholders

Investor Motivations



- Motivated by desire to take single asset, property or portfolio risk that they can underwrite and carefully monitor
- May view downside as an option to own entire asset / portfolio at their debt level

(1) Refer to Appendix for Principal Differences between B-Notes and Mezzanine Loans

B-Note Holders – Additional “Control Rights”

B-Note Holders often receive an additional bundle of control rights that allow it to approve major workout / other decisions that impact all the bondholders with respect to that loan

Although each deal is specific and detailed in either an inter-creditor agreement or loan participation agreement; some common rights include the following:

- **Pre- and Post- Default Control Rights**

- Right to appoint the special servicer of the mortgage loan;
- Right to approve or reject a proposed lease at the property (in accordance with the lease approval provisions of the mortgage loan documentation);
- Right to approve the annual budget submitted by the borrower;
- Right to approve a new property manager for the property (in accordance with the provisions of the mortgage documentation);
- Right to approve a transfer of the property by the borrower.

- **Post-Default Control Right**

- Right to approve the workout plan for a defaulted loan (often referred to as an “asset status report”)

Refer to Appendix for a detailed description of B-Note holder’s consultation rights and approval rights

B-Note Holders - Limitations to Control Rights

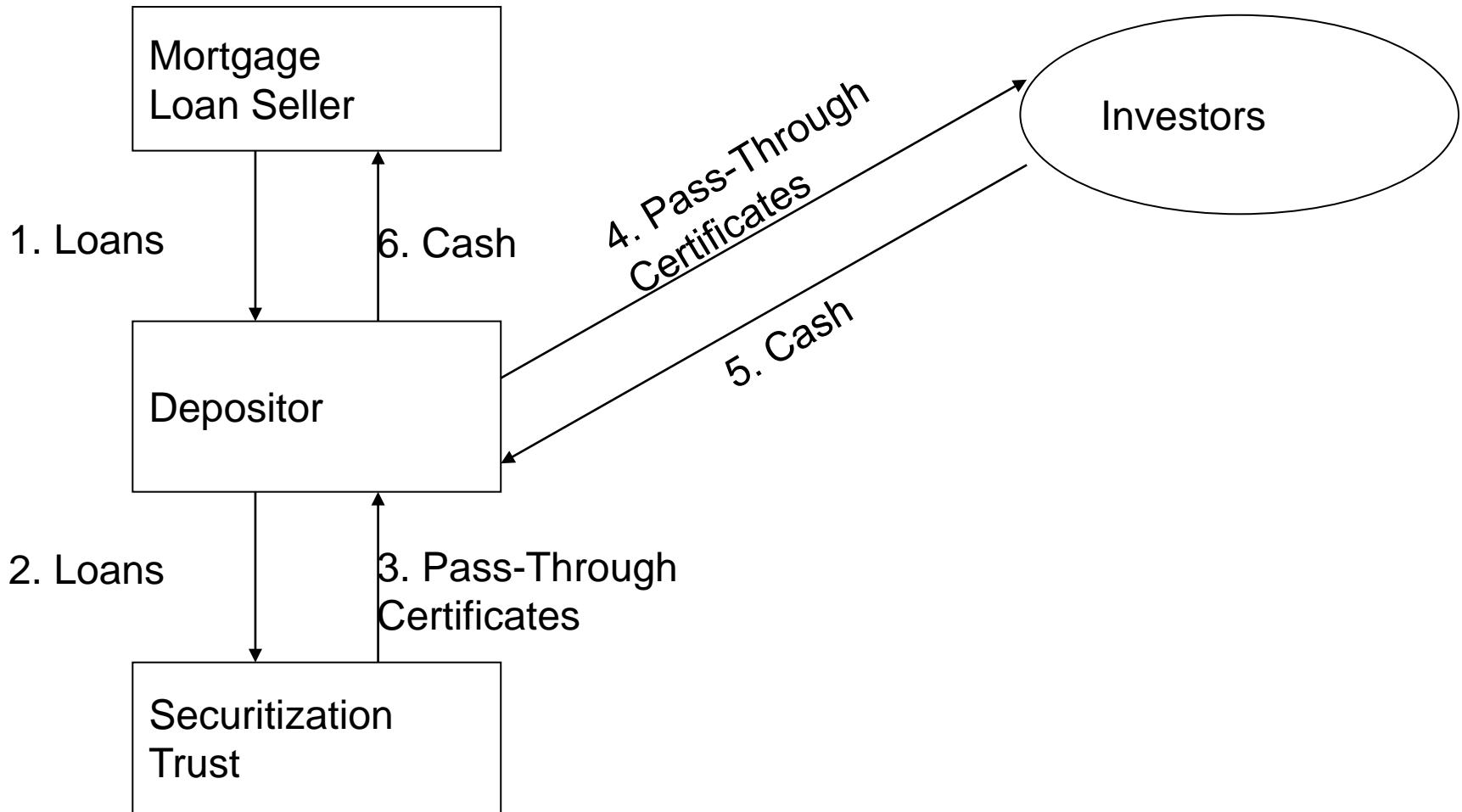
A B-Note holder has much broader rights than a mezzanine lender; therefore constraints are in place to make sure the B-Note holder does not abuse its power at the expense of senior bondholders

There are two forms of protections

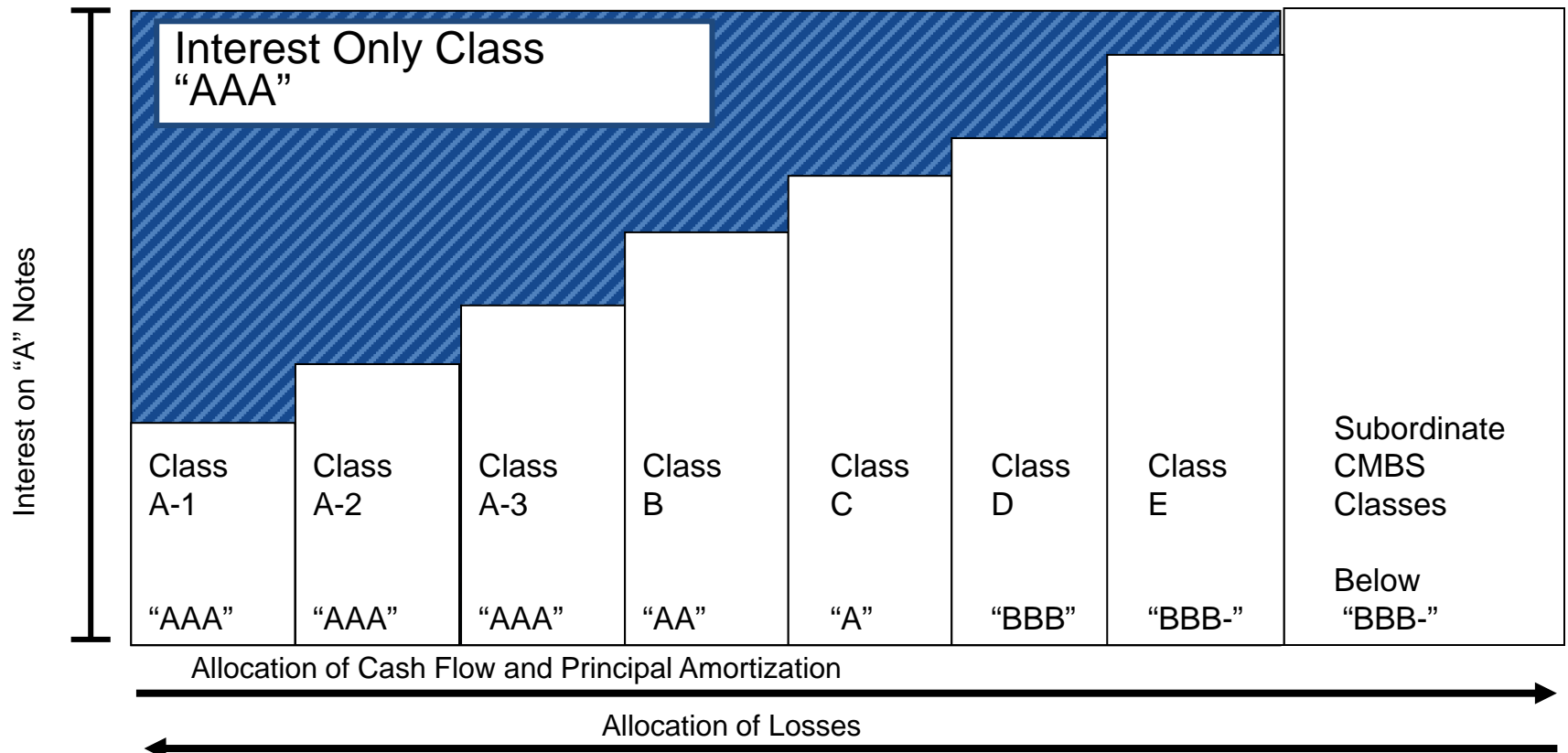
- **Standard of Care that places limitations on powers granted to B-Note holder**
 - Servicer or special servicer required to service and administer loan in accordance with Servicing Standard, or Accepted Servicing Practices
 - Creates a fiduciary relationship between bondholders and servicer
 - Servicer has the ability to reject or trump any approval / rejection of the B-note holder's rights if the exercise of those rights would violate servicing standard
 - B-Note Holder can protect its interest by buying out the A-note pursuant to its purchase option
- **Confirmation of Meaningful Financial Interest (via Control Appraisal Period / Reduction)**
 - Control Appraisal Period test can be triggered if value of property has dropped to level that causes B note holder to have less than 25% equity in its position
 - Refer to Slides on Control Appraisal Period / Reduction for further computational details

**CMBS STRUCTURAL IMPACTS
FROM LARGE LOAN FLOATERS
AND RELATED
JUNIOR LOAN PARTICIPATION / “B-
NOTES”**

Typical CMBS Structure – Transaction Level



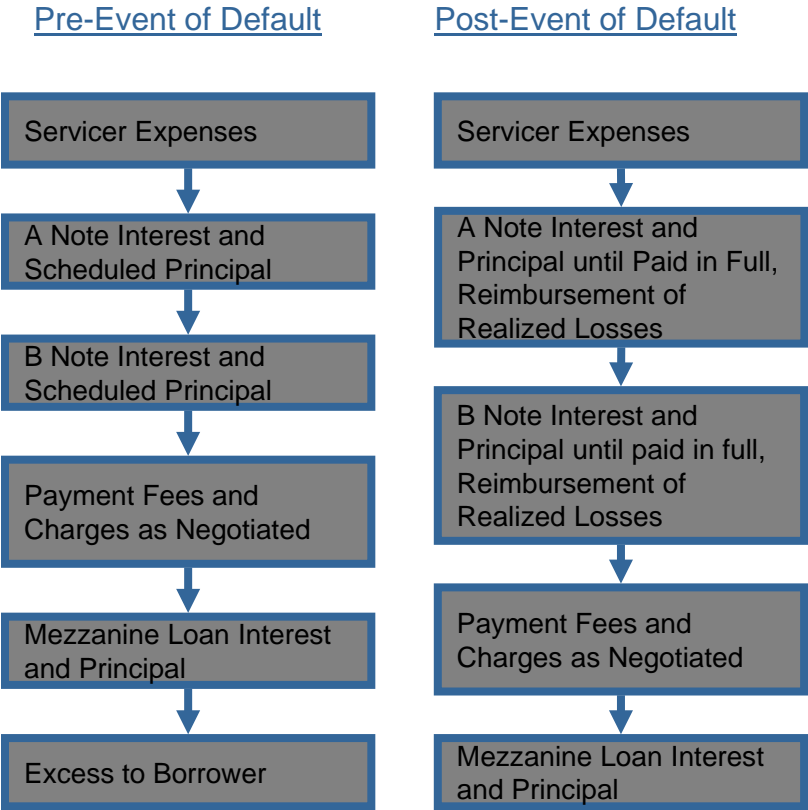
Representative CMBS Structure – Bond Level



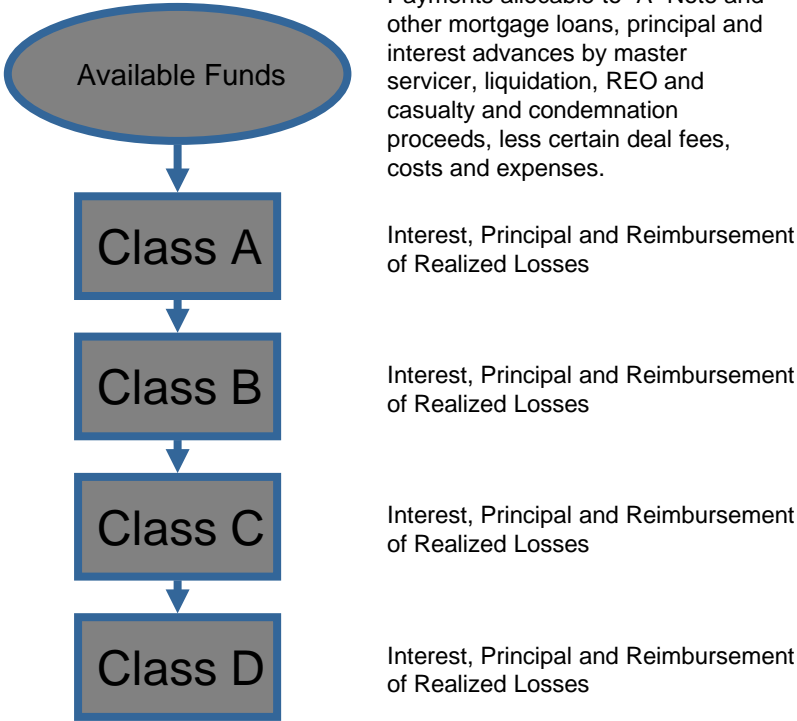
Cash Flow from "A" Note in the Mortgage Loan is pooled with other mortgage loans and further divided in Securitization Trust

Payment Waterfall

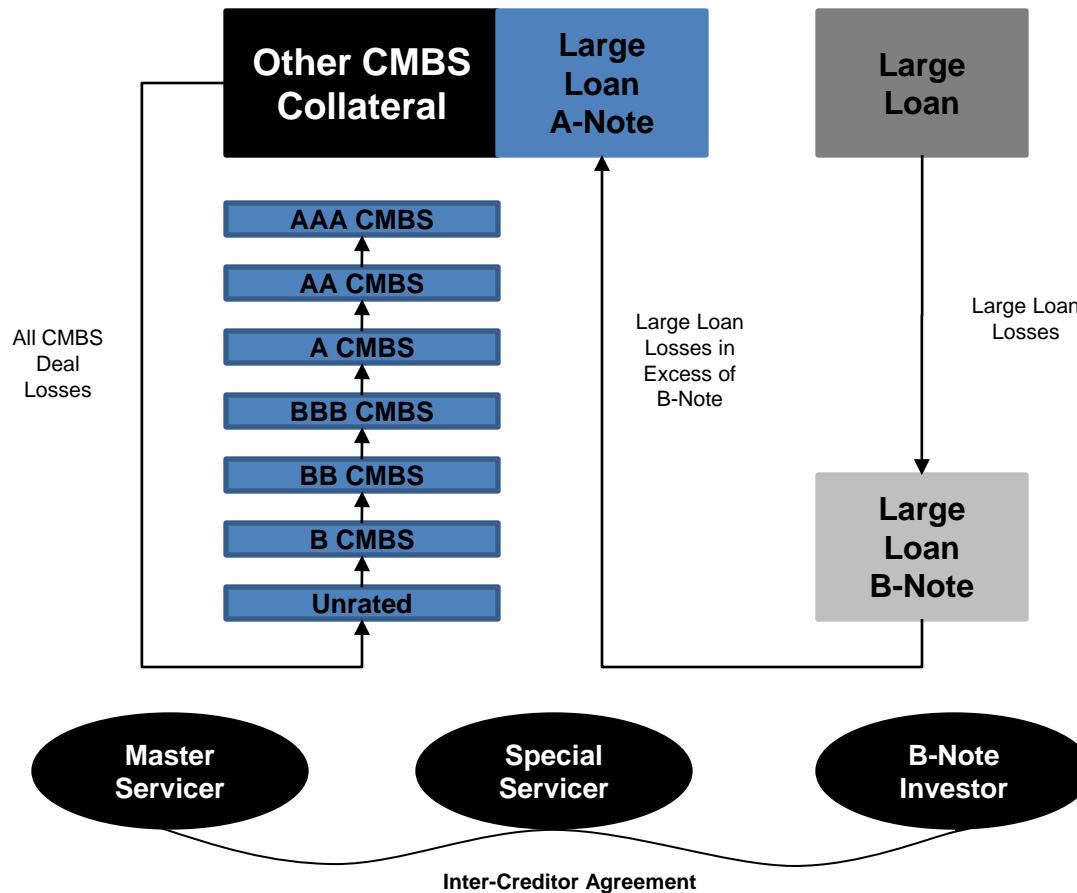
Loan Level



Securitization Level (Amounts allocable to "A" Note and other mortgage loans)



Large Loan Losses (inside CMBS)



In some cases, the B-Note is further credit tranching to include a C-Note, D-Note or otherwise delineated (e.g. B-1, B-2 etc) to reflect first loss. In those cases, the most junior note absorbs first loss up to their loan balance, before higher rated positions would.

CMBS SPECIAL SERVICING AND WORKOUT IMPLICATIONS

Loan Level Implications of Specially Serviced Status

Triggering Special Servicing status increases focus on work-out options, escalates fees and could activate other control rights within the structures

What Triggers Special Servicing?

Objective Criteria:

- Payment default at maturity
- Monthly payment 60 days or more delinquent
- Borrower bankruptcy
- Borrower admits that it is insolvent

Subjective Criteria:

- Master servicer or special servicer determines payment default is imminent
- Master servicer or special servicer has notice of default (other than P&I) that materially and adversely affects certificate-holders

What Happens Once in Special Servicing?

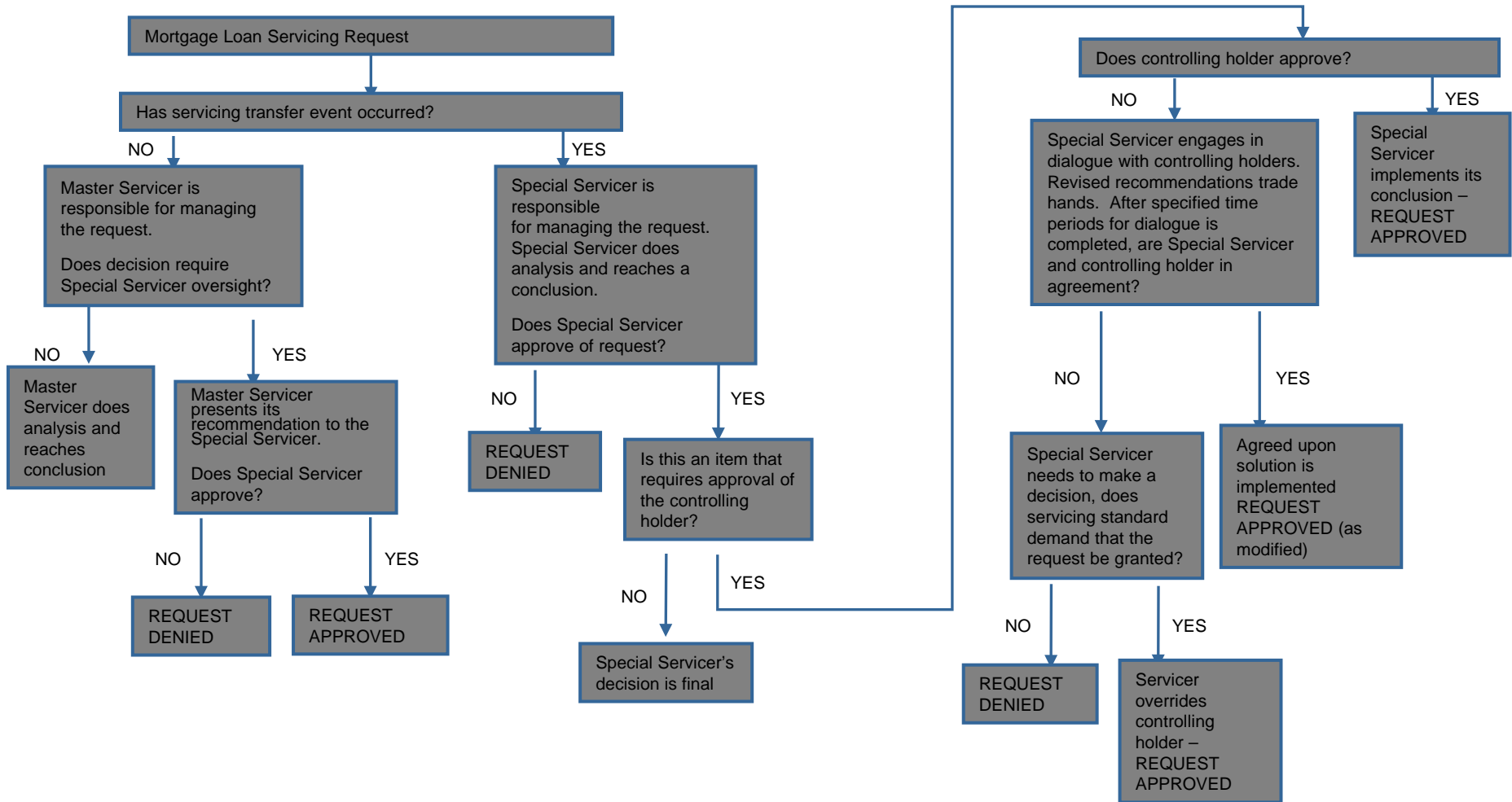
- Special servicer becomes active
- Special servicing fees become payable
 - Special servicing fee (typically 0.25% per annum, payable monthly)
 - Liquidation or workout fee (often 1.0% of all amounts collected)
- Appraisal is ordered
- “Rainy day” waterfall comes into place for B notes (not junior bonds)
- Cash trap starves mezzanine lenders (triggered by mortgage default; not special servicing)

Servicing Standard

The Servicing Standard generally requires the servicer to:

- Diligently service and administer the mortgage loans in the best interest of, and for the benefit of, the Certificate-holders and the holders of serviced companion loan (as a collective whole) in accordance with the terms of the mortgage loan documents
- Service with the same care, skill, and diligence as is customary in the Servicer's activities
- Service with a view to the timely collection of scheduled payments of principal and interest
- Service without regard to any pre-existing relationship with a related borrower
- Service without regard to ownership of any certificates by it or any of its affiliates
- Service without regard to its obligations to make advances or incur servicing expenses
- Service without regard to the adequacy of its compensation or its right to receive reimbursement of costs

Servicing Request Decision Tree



Contractual Limitations on Workouts and Modifications

– **Pooling and Servicing Agreement Restrictions**

- “Net Present Value” test
- Can’t extend the maturity into the “tail period” (typically 2-7 years prior to rated final distribution date)
- Some agreements have specific limits (e.g. up to 3 one-year extensions)
- Can’t extend the maturity beyond the date 10 years prior to expiration of applicable ground lease
- Requires consent of controlling holder

– **REMIC Restrictions**

- Modifications that are “significant” for tax purposes cannot be entered into unless mortgage loan is in default or default is reasonably foreseeable
- “Significant” modifications for tax purposes include:
 - Changes in yield
 - Reductions of principal
 - Substitution of collateral
 - Waiver of prepayment penalties
 - Extension of maturity date by more than the lesser of (a) 5 years and (b) 50% of the original term (without extension rights)

– **Mezzanine Inter-creditor Agreement Restrictions**

- Can’t increase financial burden on mortgage borrower
- Can’t extend lock-out period or yield maintenance period

Appraisal Reductions

Appraisal reduction events may shift control of Controlling Party (whether it's a subordinate CMBS holder, or a B-Note holder on Large loan participation)

Calculation of Reduction Amount

The Appraisal Reduction Amount will equal the excess, if any, of the sum of:

1. the principal balance of the loan on the date of determination, plus
2. all unpaid interest on the Note through the most recent Due Date, plus
3. all accrued but unpaid Servicing & Trustee Fees, Property Protection Advances and other Trust Fund expenses, plus
4. all due unpaid real estate taxes, insurance premiums and ground rent

— over,

1. an amount equal to 90% of the appraised value.

Appraisal Reduction Amounts are allocated to the Loan to determine (1) if a Control Appraisal Event has occurred or (2) whether P&I Advances must be reduced.

Control Appraisal Period Event

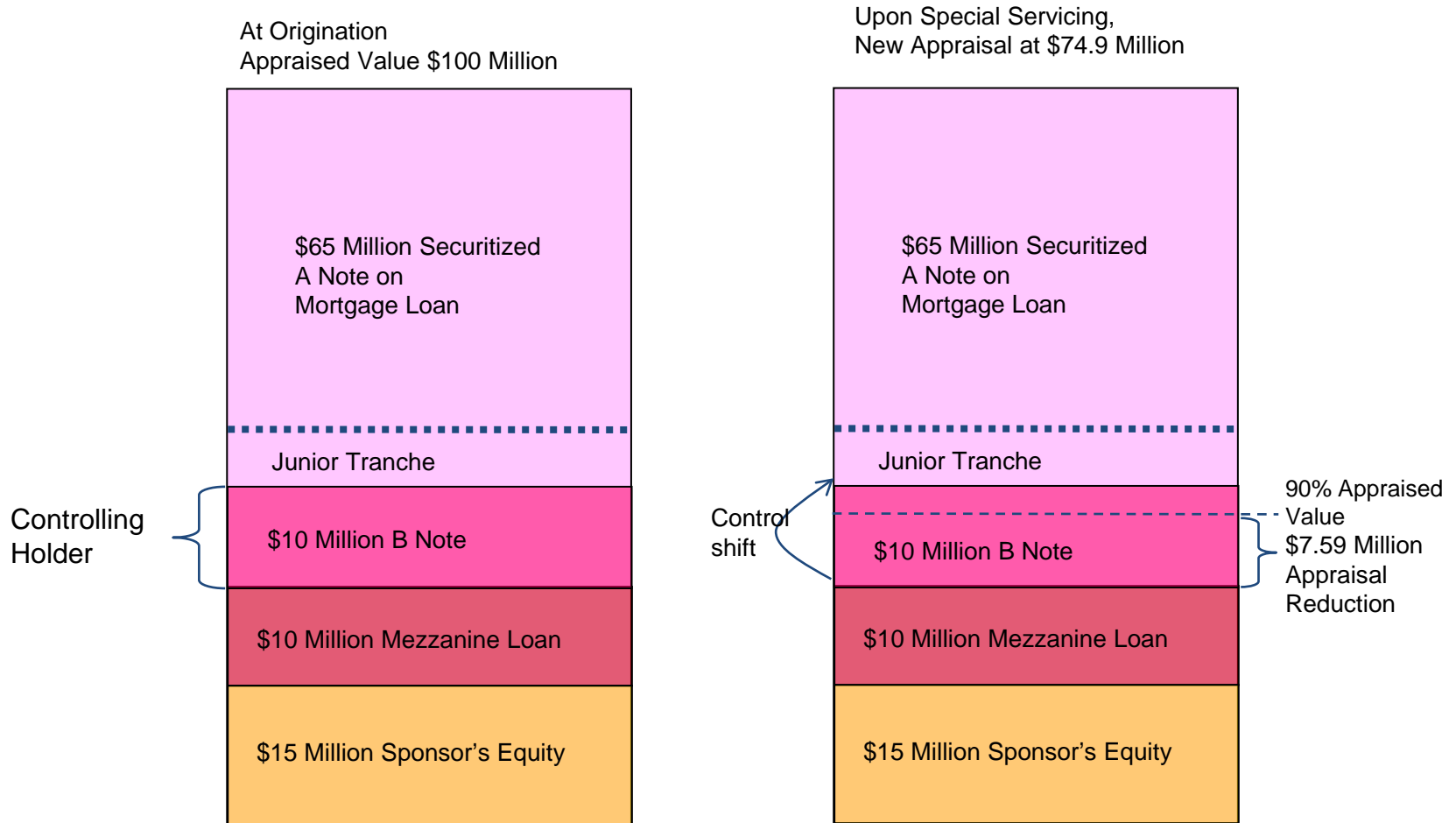
A Control Appraisal Period will exist if the initial principal balance for a Class of Certificates minus the sum of:

1. all payments of principal received on such class, plus
2. the Appraisal Reduction Amount, plus
3. losses allocated to such Class of Certificates

is less than 25% of the excess of:

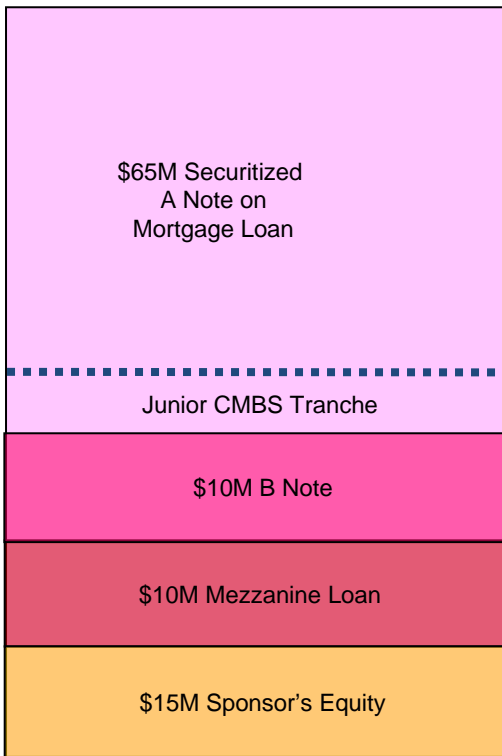
1. the initial principal balance of such Class of Certificates, over
2. all payments of principal allocated to such Class of Certificates.

Appraisal Reductions

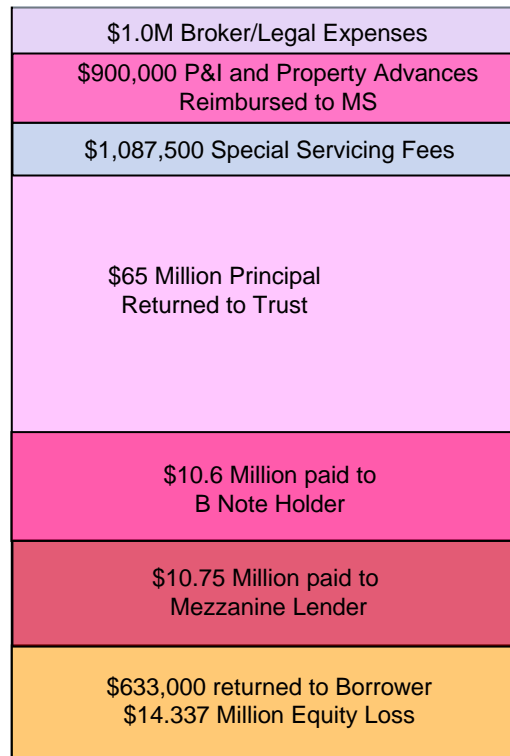


Application of Liquidation Proceeds In Foreclosure

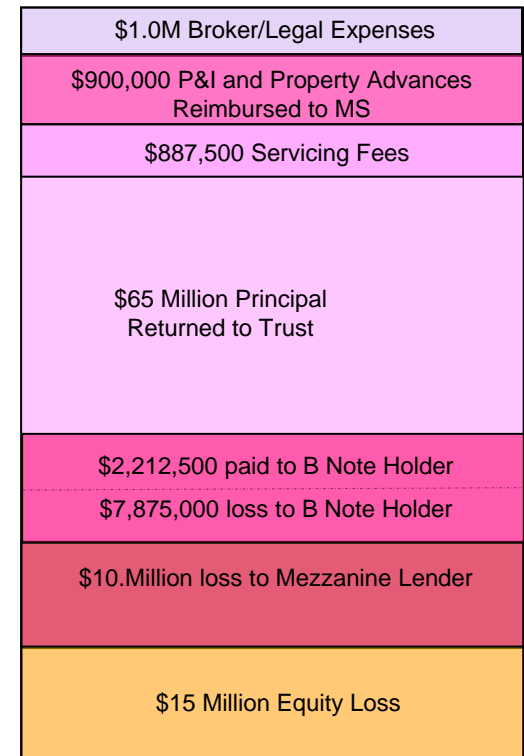
At Origination,
\$100 Million Appraised Value



Foreclosed,
Sold For \$90 Million



Foreclosed,
Sold For \$70 Million



Source: UBS CMBS Research (modified)

APPENDIX ITEMS

Pre- and Post-Default Control Rights for B Notes

Principal Differences between B Notes and Mezzanine Loans

Pre-Default B-Note Control Rights

Pre-Default

<p>Consultation Rights</p>	<p>The servicer will generally be required to consult with the junior participant in connection with</p> <ul style="list-style-type: none"> a) Any adoption or implementation of a business plan submitted by the borrower with respect to the related mortgage property b) The execution or renewal of any lease to the extent lender approval is required in the related mortgage loan documents c) The release of any escrow held in connection with the mortgage loan not expressly required by the terms of the related mortgage loan documents d) Material alterations on the related mortgage property e) A material change in any ancillary loan documents f) The waiver of any notice provision related to prepayment g) Proposals to take any significant action with respect to the mortgage loan or the related mortgaged property <p>The servicer is also required to consider alternative actions recommended by the junior participant that are related to the foregoing.</p>
<p>Approval Rights</p>	<p>The servicer will generally be required to obtain the approval of the junior participant before taking certain significant actions including, but not limited to,</p> <ul style="list-style-type: none"> a) Any modifications or waivers of any monetary term of the mortgage loan relating to the timing and amount of payments of principal or interest b) Any substitution or release of collateral for the mortgage loan to the extent not permitted by the related mortgage loan documents c) Any action to bring the mortgaged property into compliance with environmental laws d) Certain waivers of “due-on-sale” or “due-on-encumbrance” clauses under the loan documents e) Any release of the borrower or any related guarantor from liability with respect to the mortgage loan f) Any material changes to, or any waivers of, any of the insurance requirements g) Approval/replacement of the property manager

Pre-Default B-Note Control Rights (cont.)

Termination of Special Servicer	<p>Generally , the junior participant is permitted to terminate the special servicer at any time, with or without cause, with respect to the related mortgage loan and to appoint a replacement special servicer</p>
Rights to Reports and Information	<p>The junior participant is generally entitled to certain reports and information relating to the mortgage loan, including, but not limited to,</p> <ul style="list-style-type: none"> a) Any noncompliance on the part of the related borrower relating to the requirements in the mortgage loan documents regarding the borrower's organization and existence b) A report of account balances in all escrow accounts and a reconciliation statement of all subaccounts c) Copies of all operating statements, financial statements or budgets delivered by the borrower, together with notification of any determination by it that a cash trap exists under the related mortgage documents d) Any adverse changes in any operating statements, financial statements and budgets, or any apparent violation of the provisions of the mortgage loan documents shown by the information set forth on such statements and budgets e) A statement on or before each remittance date reflecting the calculation of the payment due to the junior participant f) Accounting records that reflect the current and correct outstanding principal balance of the mortgage loan and each participation interest, the applicable interest rate during each participation interest, the applicable interest rate during each interest, the applicable interest rate during each participation interest, the applicable interest rate during each interest accrual period relating to the mortgage loan g) Notification of any deficiencies in the required cash management accounts

Post-Default B-Note Control Rights

Post-Default

Pre-Event of Default Rights	All of the rights described previously in a pre-event of default scenario continue in a post-event default scenario.
Cure Rights	<p>The servicer is obligated to give notice of any monetary default or nonmonetary default under the related mortgage loan documents to the junior participant (each, a “cure option notice”) and must typically permit the junior participant an opportunity to cure such default. If the default is a monetary default, the junior participant will typically have until five business days after the receipt of the cure option notice to cure such monetary default. Cures must include all past due amounts, reimbursement of advances and other trust fund expenses. If the default is a nonmonetary default, the junior participant will typically have until 30 business days after the receipt of the cure option notice to cure such nonmonetary default.</p> <p>The junior participant’s right to cure a monetary default or nonmonetary default is often limited to a certain number of cure events over the life of the mortgage loan, and the agreements provide a limit on the number or consecutive months a cure can take place. The number of total cures over the life of a mortgage loan is generally limited to 4-6, and the limit on the number of consecutive cures is generally 3-4. The rating agencies, although not monolithic on this point, have recently expressed that the number of cures over the life of a mortgage loan can be limited to five, with no more than three consecutive cures.</p>
Purchase Option Rights	<p>Following an event of default, the junior participant will have the right to purchase the senior participant interest at a price equal to the principal balance of the senior participation, together with accrued and unpaid interest thereon up to the purchase date (or through the end of the interest accrual period if the mortgage loan has been securitized), plus some or all of the following:</p> <ul style="list-style-type: none"> a) Any unreimbursed servicing advances with respect to the mortgage loan b) Any reasonable costs and expenses with respect to the senior participation that have not been reimbursed to the senior participant c) Servicing fees payable pursuant to the related pooling and servicing agreement d) Certain additional trust fund expenses in respect to the related mortgage loan

Post Default B-Note Control Rights (cont.)

<p>Additional Approval Rights</p>	<p>After an event of default, the servicer will generally be required to obtain the approval of the junior participant before taking any action in foreclosure or any comparable conversion of the ownership of the mortgaged property by deed-in-lieu of foreclosure.</p>
<p>Rights to Additional Reports and Information</p>	<p>After the servicing of a mortgage loan is transferred to a special servicer (which generally follows a default), the junior participant is entitled to an “asset status report,” which generally sets forth the following:</p> <ul style="list-style-type: none"> a) A summary of the status of the specifically serviced mortgage loan and any negotiations with the related borrower b) A discussion of the legal and environmental considerations reasonably known at such time by the special servicer that are relevant to the exercise of remedies with respect to the specially serviced mortgage loan c) The most current rent roll and income or operating statement available for the related mortgaged property d) Recommendations on how the specially serviced mortgage loan might be returned to performing status and returned to the servicer for regular servicing e) The appraised value of the related mortgaged property f) The status of any foreclosure actions or other proceedings undertaken, any proposed workouts and the status of any negotiations with respect to the workouts, and an assessment of the likelihood of additional events of default g) A summary of any proposed actions and an analysis of whether taking such action is reasonably likely to produce a greater recovery on a present value basis than not taking such action h) Other information as the special servicer deems relevant <p>The junior participant has the right to approve or disapprove the actions proposed by the asset status report unless such approval or disapproval would be inconsistent with the servicing standard.</p>

Principal Differences Between B-Notes and Mezzanine Loans

	B-Notes	Mezzanine Loans
Collateral	<ul style="list-style-type: none"> •First Mortgage •Assignment of rents and leases 	<ul style="list-style-type: none"> •Partnership ownership interests in the mortgage borrower
Priority	<ul style="list-style-type: none"> •Subordinate to the A-Note, but still part of the first mortgage 	<ul style="list-style-type: none"> •Subordinate to the entire first mortgage but senior to preferred equity and equity
Perfection of Security Interests	<ul style="list-style-type: none"> •Recorded mortgage 	<ul style="list-style-type: none"> •UCC filing
Foreclosure	<ul style="list-style-type: none"> •Property foreclosure – Judicial or non-judicial (6-18 months, state dependent) 	<ul style="list-style-type: none"> •UCC foreclosure (60-90 days)
Subordination	<ul style="list-style-type: none"> •Achieved through Participation Agreement 	<ul style="list-style-type: none"> •Achieved through inter-creditor Agreement
Rights on Default	<ul style="list-style-type: none"> •Significant consent and consultation rights •Input on modifications and workout •Purchase option right •Cure option 	<ul style="list-style-type: none"> •Management kick-out •Purchase option •Cure option
Limits to Keep Current	<ul style="list-style-type: none"> •Three to four months of consecutive cure 	<ul style="list-style-type: none"> •Unlimited provided mezzanine lender is exercising equity foreclosure remedies