

UNDERSTANDING MODIFICATION OPTIONS UNDER PORTFOLIO AND CMBS LOAN STRUCTURES

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If you are the borrower with a commercial loan that was originated after 2005 or that is maturing during the next 24 months, chances are that you are not sleeping as well as you once did. That's because there is a substantial likelihood that deteriorated market conditions have undermined your property's performance and value to the point that you are no longer able to service your debt, or if your loan is maturing, there is no realistic source of capital to re-finance the maturing debt (even if your property is otherwise performing). In either case, the question is "what can I do"?

There is no cut and dried answer to that question and the potentially available alternatives to you may vary dramatically, depending upon whether your loan remains in a lender's 'on book' portfolio or has been securitized. If the loan remains in a portfolio, that means it is actually owned and servicing is controlled by the actual lender (a "Portfolio Loan"). If, on the other hand, your loan was securitized (which was the most pervasive form of commercial loan origination during the 2 year period preceding the current, on-going, real estate crisis and represents approximately 21% of all commercial mortgage loans outstanding as of the end of 2008), your loan is no longer held by the lender that originated it and is now serviced by a Master or a Special Servicer (a "CMBS Loan"). Often times, the Master Servicer and Special Servicer have no relationship whatsoever to the lender that originated the loan. In addition, a CMBS Loan is subject to complex REMIC tax regulations and stringent restrictions imposed by the applicable Pooling and Servicing Agreement that your loan is subject to through the securitization (this is the mammoth guide that dictates what the Master or Special Servicer can do with your loan). This article discusses the potential work-out options that are available to borrowers of both Portfolio Loans and CMBS Loans.

Whether you have a Portfolio Loan or a CMBS Loan, one thing is equally applicable; be prepared. Do not expect your lender (or Master or Special Servicer, if applicable) to find the proper solution to your specific problem(s). Whatever type(s) of relief you are requesting, your request must be in writing and must carefully detail the reasons why the resolution you are proposing is in the best interest of the note holder – in short why modifying the loan is a better alternative for the note holder, than simply declaring an event of default, accelerating the loan and foreclosing on the underlying property.

If you have a Portfolio Loan, as opposed to a CMBS Loan, you will have considerably more flexibility in structuring a modification. That is because your lender is not constrained by REMIC tax rules and the Pooling and Servicing Agreement and its primary goal will generally be to maximize asset value and increase the likelihood that the loan will be repaid by you. The modification options available to a Portfolio Loan borrower are so far superior to those available to a CMBS Loan borrower, that if your loan was originated after 2006 and was intended to be securitized (and thus, become a CMBS Loan), it is worth double checking whether the securitization actually occurred. Due to the rapid deterioration of investors' appetite for CMBS Loans, many commercial loans that were originated in 2007 and 2008 as intended CMBS Loans, never achieved securitization and thus, remain to this day Portfolio Loans.

Unlike a Portfolio Loan, a CMBS Loan is no longer held by the lender that originated the CMBS Loan. Instead, third party Master and Special Servicers service the CMBS Loan for the benefit of a REMIC (or a Real Estate Mortgage Investment Conduit) trust (the investors in which receive the cash flow generated by a pool of CMBS Loans). For all intents and purposes, a Master Servicer has no ability to discuss or facilitate a modification of a CMBS Loan. It is instead the Special Servicer that has the power, subject to compliance with REMIC tax rules and the Pooling and Servicing Agreement, to consent to a modification of a CMBS Loan. However, a Special Servicer has no ability to take any action with respect to a CMBS Loan until that CMBS Loan has been transferred to the Special Servicer for handling. Transfer from the Master Servicer to the Special Servicer takes place only if the CMBS Loan is actually in default or faces “imminent” default. Accordingly, unless your CMBS Loan is in default or the CMBS Loan borrower notifies the Master Servicer that it intends to default (which notice should be in writing), there is no meaningful way for a CMBS Loan borrower to even talk to anyone associated with the loan about potential modification scenarios.

Even after a CMBS Loan has been transferred to the Special Servicer, it may be very difficult to engage the Special Servicer in meaningful dialogue regarding potential modification scenarios. This is due, in large part, to the fact that the current real estate crisis has overwhelmed most Special Servicers, few of whom are sufficiently staffed to handle the volume of CMBS Loans presently in default. By April of 2009, many of the individual asset managers responsible for handling specially serviced CMBS Loans who work for the nation’s largest Special Servicers were each handling 30 or more defaulted CMBS Loans. This is considered more than double the historic capacity for a single asset manager.

In addition to the problems caused by understaffing, Special Servicers are less likely to agree to a modification due to the “servicing standard” imposed upon them by the Pooling and Servicing Agreement. Unlike the Portfolio Loan lender who generally looks to maximize asset value, the Special Servicer is required to maximize recovery for the REMIC trust’s bondholders on a “present value basis”. The Special Servicer also usually holds the “first loss” piece of the trust and will be the first class to suffer loss on a defaulted loan. Many experts contend that the Special Servicer is much more likely to foreclose than work-out a defaulted loan, since it is difficult to demonstrate that a modification will result in a greater “present value” recovery to the trust than would foreclosure. That said, it is possible to work-out a modification of a defaulted CMBS Loan, even with the presences of these actual and perceived hurdles.

With the foregoing considerations in mind, the following modification strategies are potentially available to Portfolio Loan and CMBS Loan borrowers:

Maturity Date Extension. Whether you have a Portfolio Loan or a CMBS Loan, a maturity date extension is generally the most readily available type of modification. This is particularly true when your loan is otherwise performing. That is, the impending default is due solely to the maturity of the loan and the borrower’s inability to obtain replacement financing in the current capital market environment. As a general rule, most lenders are not equipped and do not want to foreclose on and take back your property (and thus, become “REO” (or real-estate owned) on the lender’s books). Accordingly, if the loan is otherwise performing and you are

perceived to be a “good” borrower, many lenders are willing to grant maturity date extensions of up to 24 months for a Portfolio Loan and up to 12 months for a CMBS Loan, with an option to extend an additional 6 to 12 more months, all (of course) subject to certain negotiated conditions.. In most instances, the lender will request a fee for accommodating such an extension and/or option.

Interest Rate Reduction. Fortunately, we are living in time of historically low interest rates. This means your lender’s own costs of funds are low and it is more palatable for Portfolio Loan lenders to grant temporary interest rate reductions, including interest-only payments (where normally monthly principal (or amortization) payments would be payable monthly along with the applicable interest payments). If the borrower can demonstrate that its property will cover operating expenses and debt service at a lower interest rate, we have seen Portfolio Loan lenders agree to downward adjustments of the interest rate to as low as the “prime rate” on a temporary basis; generally for a period of up to 24 months. Interest rate reductions are very rare in CMBS Loan modifications. However, in some instances, the Special Servicer may agree to temporarily allow monthly payments to be made on an interest-only basis and we have seen a few instances when the Special Servicer allowed a reduction of the interest rate on a CMBS Loan in exchange for a partial principal reduction payment by the borrower.

Principal Balance Reduction. This is far and away the most difficult type of a modification to achieve. However, if your Portfolio Loan lender can be convinced that the market value of the collateral has fallen significantly below the outstanding principal balance of your loan (and your lender believes that, notwithstanding such valuation erosion, you remain a competent operator), we have seen Portfolio Loan lenders agree to reduce the principal balance of their loan to not less than the market value of the property. In almost every instance however, the lender will require to see some equity or other benefit to the property infused by the borrower (or its principals). However, it should be noted that principal balance reduction is virtually unheard of in a CMBS Loan modification; especially since it is the Special Servicer who will typically absorb the principal reduction loss.

Additional Funding. In some instances, the value of the lender’s collateral can be significantly increased by an influx of additional capital. While it is very unusual in today’s environment for this to occur, in some instances a Portfolio Lender may be willing to advance additional funds to enhance the value of the property. However, it is a virtual certainty that the lender will require the borrower also to infuse additional capital as the price for funding additional loan proceeds. If the borrower is unable or unwilling to fund that additional capital, a more likely solution is sometimes achieved by convincing the lender to agree to allow a reallocation of reserves to other sources (such as covering debt service or operating shortfalls). For example, a capital expenditure reserve might be made available for payment of operating expenses at the property or for debt service on the loan. Since Special Servicers are not lenders, additional funding is not available in a CMBS Loan modification, although Special Servicers can, in appropriate situations, agree to allow a reallocation of reserves to other sources as previously described.

White Knight. A hybrid of the Principal Balance Reduction modification described above is a so-called “White Knight” transaction. This is a transaction in which the lender agrees to

substitute the original Portfolio Loan sponsor (the underlying company or person comprising the single asset entity borrower) with a new sponsor (a “White Knight”) that is perceived by the lender to have superior financial and/or operational capacity to that of the original sponsor. In this scenario, the principal balance and/or interest rate of the Portfolio Loan is typically reduced to a current market level in exchange for the influx of new capital (or new capital commitment or partial recourse guaranty) by the White Knight. The original sponsor is released from liability, but may be allowed to retain passive participation. For the same reasons that principal balance reductions don’t generally take place on the CMBS Loan side of things, White Knight transactions are structured very differently in CMBS Loan modifications. The White Knight contributes capital and takes a partial ownership in the Borrower typically in the form of preferred equity. In this scenario, the original Borrower/sponsor is not released from liability.

Short Sale. A so-called “short sale” is a scenario in which the lender allows the property to be sold for an amount less than the outstanding debt and nevertheless releases its lien against the loan collateral. Assuming the loan is no longer performing and the lender can be convinced that the market value has deteriorated to the amount sought in the short sale, both Portfolio Loan lenders and CMBS Loan lenders may consent to short sales. The incentive to the note holder is the generally accepted supposition that the property can be sold for more by the current borrower, than as REO by the lender (the property will have been tainted by foreclosure and there will be significant associated sales costs to the selling lender). Typically the lender will not allow any sale proceeds to leak to the borrower. However, we have seen Portfolio Loan situations where institutional borrowers with captive real estate brokers are allowed to retain a sales commission where the broker’s efforts are instrumental to facilitating the short sale. Short sales have not occurred to date on CMBS loans.

Deed-in-Lieu. A deed-in-lieu of foreclosure (a “Deed-in-Lieu”) is a deed to the property given to the lender (or to the lender’s affiliate) rather than (in lieu of) taking the property back through foreclosure. In some instances the lender will work with the borrower to structure the Deed-in-Lieu to look more like a sale, which arguably may allow more favorable tax treatment and less perceived “taint” to the sponsor. From both a Portfolio Loan lender and a CMBS Loan lender’s perspective, a Deed-in-Lieu is generally more expedient than foreclosure, less of a taint to the value of the property (when it is ultimately sold) and potentially less costly. A Deed-in-Lieu does not eliminate liens and encumbrances that are subordinate to the senior loan, so in instances in which there are junior mortgages or mechanic’s liens, any lender is going to be less inclined to accept a deed-in-lieu. In some instances these concerns may be overcome by having the property conveyed to an affiliate of the lender, which allows the lender the ability to foreclose the loan in the future, thereby eliminate junior liens and encumbrances. In this scenario, it is essential to include so-called “non-merger” language to make sure that the lender’s security interest and the owner’s fee interest have not merged by reason of the Deed-in-Lieu.

Relief from Personal Guaranty. If the lender can be convinced that the borrower does not have meaningful financial resources or liquidity (or both, as they often go hand in hand), both Portfolio Loan lenders and CMBS Loan lenders will often agree to reduce or eliminate personal guaranties in exchange for a borrower cooperation in a “friendly foreclosure” or deed-in-lieu transaction.

Equity Participation. If a Portfolio Loan lender can be convinced that the borrower is the best operator for the property and has a realistic opportunity to reposition a property in the market, we have seen Portfolio Loan lenders convert debt to preferred equity participation in the Portfolio Loan borrower. This is particularly true in connection with the resolution of mezzanine or subordinate debt held by Portfolio Loan lenders. Conversely, CMBS Loan lenders are precluded from taking equity participation interests, so this is not an option the CMBS Loan world.

CONCLUSION

We are living in unprecedented times. The financial crisis has wrecked havoc on commercial mortgage loans and capital markets have evaporated. The once omnipresent CMBS originator no longer exists as a source of financing. That said, borrowers facing the prospect of foreclosure and/or personal liability for recourse obligations have reason for hope in many instances. However, if you want to work-out a troubled Portfolio Loan or CMBS Loan it is important to plan ahead, imperative to plan carefully and most important of all, to be reasoned and purposeful in your planning.

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