

CMBS 2.0: Springing Escrows (and Springing Recourse)

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The Line will periodically examine post-recession loan origination, servicing and securitization practices in a series we'll call "CMBS 2.0."

Let's talk about springing escrows at the outset, because experience has proven to be a stern taskmaster. The notion behind springing escrows is that if an unhappy event occurs after the loan is made—say a key tenant decides not to renew its lease or the loan's debt service coverage ratio (DSCR) drops below a certain threshold—the borrower is required to fund an escrow account serving as additional security for the loan. This way the loan is still more or less in balance—when funded, the borrower has more skin in the game to offset drops in value. In the usual CMBS 1.0 configuration, the borrower's failure to fund would constitute a loan default and expose the loan sponsors as guarantors to personal liability under the loan's non-recourse carve-outs.

So what's the problem?

Notice that I used the words "when funded" above. At the very point when the lender needs the escrow funded, the borrower is least able to perform. Loan servicers have observed during this cycle that springing escrows have been largely ineffective. The unprecedented peak-to-trough declines in value undoubtedly have much to do with this, since many commercial borrowers see their equity as having dissipated beyond hope of revival. The threat of recourse to the sponsor can certainly make a difference, but for reasons we'll examine later, carve-out liability can be problematic, too.

The best practice? If the contingency that the escrow is aimed at mitigating is essential to the integrity of the loan underwriting, there should be an up-front escrow. Ideally funded with cash, although a properly structured letter of credit from a well-regarded bank can also suffice. (But borrowers should be forewarned that letters of credit are not so readily obtained now as in pre-recessionary times.) Lenders are likely to find that getting investors to give "credit" in a secondary market transfer for escrows that are not funded is a difficult proposition in this cycle.

There is a structural alternative to up-front funding that, while not equal, is credible: making the borrower's failure to fund the escrow a spring recourse event for the borrower and guarantor.

Some aspects of this require explanation. First, changes to REMIC regulations have made loan provisions that modify the recourse character safe in virtually all circumstances. All that is now required is either that the loan be principally secured by real estate (meaning that the property value be at least 80% of the loan amount at the time of the modification—a "VTL" test) or that the fair market value of the loan be greater after the modification than before. Where the change is from non-recourse to recourse, satisfying the latter test should be self-evident. Before the recent REMIC changes, effecting springing recourse in a REMIC-compliant way involved a structural workaround that was not always practical.

Second, as the example of the General Growth Properties bankruptcy reminds us, a guarantor that is neither a warm body nor financially well-off is of little benefit. Better to have a warm body guarantor that has financial wherewithal. Underwriting CMBS 2.0 loans will require additional scrutiny of the guarantor's other obligations, too, since those can dilute the value of the guaranty.

Third, since recourse carve-outs impose personal liability upon the borrower and guarantor only for losses suffered as a result of breach, there can be proof problems in establishing causation and sizing damages that can undermine the effectiveness of the remedy. For this reason the lender's incentive of choice is springing recourse—in other words, the borrower's failure to fund the springing escrow when required would result in the loan being a full recourse obligation of the borrower and sponsor. For the sponsor, this is beyond doubling down on the escrow funding. There are draconian consequences if the escrow is not funded that dwarf the escrow amount itself, including severe tax consequences if a subsequent foreclosure results in a proceeds shortfall.

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While a reasonable approximation of fully-funded, up-front escrows is possible with the "springing escrow/springing recourse" approach, borrowers and sponsors may yet prefer the funded, up-front escrows because of the devastating and disproportionate consequences associated with springing recourse.

Then again, isn't that the point?

Reposted from Andrews Kurth At the Line Blog - which examines the Economic Recovery, Real Estate Finance and the Capital Market - for more info. - kindly click: http://aktheline.com/CMBS_2_0

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Peter has extensive experience in:

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- Legal risk evaluation methodology, including the development of proprietary data-capturing and processing tools that identify loan information that is foreseeably relevant to secondary market transaction requirements
- Securitized lending programs, including the development of program guidelines, form loan documentation, and "best practices" protocols
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