

# Must Investors Rush in Where Cops Fear to Tread?

By: Peter K. McKee, Jr.

A client sent me a news article entitled "Bid to Make Banks Fix Crumbling Bronx Properties." In prose that evokes images out of *Fort Apache the Bronx* (the 1981 movie that titillated audiences with the tagline "15 minutes from Manhattan there's a place where even the cops fear to tread!"). The writer describes an apartment property gone horribly wrong: no hot water, gaping holes in ceilings, a "shattered window refracting light across graffiti that cursed management." There are reports of over 900 open violations affecting just one building (and some 4,600 violations across the 10 property complex) that once upon a time secured a \$35 million loan originated in 2007 by Deutsche Bank.

What happened after the loan was made? The loan was sold to a trust in a securitization transaction (a related article appearing on the *Globe St.* website identifies the pool as COMM 2006-C8, though that reference doesn't square with a 2007 loan closing). The borrower subsequently defaulted. Then the special servicer, on behalf of the securitization trust, initiated a foreclosure action and had a receiver appointed by the court to oversee the property. There are some tactical judgments implicit in the special servicer's actions, but let's continue with the story, or, rather, the punch line:

**On behalf of the tenants, New York City's Legal Services Agency has announced its plan to file a motion with the trial court seeking to force the securitization trust (i.e., investors) to repair the buildings.**

So what are to make of this?

Here are a few observations:

The *Globe St.* article mentions that the units are rent-controlled. In the 2007 time frame, it's possible that when the bank that made the loan (Deutsche Bank, in this instance) sized the loan proceeds based on the optimistic expectation that the rent control regime would be changed, and that higher rents could be charged at some point over the life of the loan (i.e., through conversion to condominiums). If that were the underwriting assumption, the units continuing to be rent-controlled would not bode well. With substantial maintenance expenses and fixed rental rates, the borrower's owner's profit incentive diminished. And, since the loan was likely non-recourse to the borrower and its sponsors (except for bad boy carve-outs), the downside risk was largely shifted to the lender. If the lender bought into the borrower's strategy to reposition the property and lent too much money, that may retrospectively appear ill-judged, but it is not by itself an indication of the lender's venality.

If Deutsche did base their loan underwriting on higher rents (so-called "pro forma underwriting") it would have to disclose that in the prospectus supplement accompanying its sale of the loan in the securitization. Further, Deutsche would have to make representations and warranties regarding the mortgaged property's condition and its compliance with local laws. These representations benefit the securitization trust, and give investors in the trust remedies (i.e., curing the breach or repurchasing the loan) when there has been a material breach that adversely affects the value of the loan.

If the reported conditions existed when the loan was made, there's clearly a breach of those representations, right? Not so fast. Assuming Deutsche Bank was aware of the situation and expected the code violations to be remedied, they'd have taken an exception to those reps, described the extent of the problem and provided assurances to investors (and the rating agencies rating the securitization) that any risks would be mitigated. For example, the loan documents might include specific borrower covenants, or there might be a funded repair escrow sized to address the problem. The loan guarantors might even have personal liability for failure to make the repairs as required.

The investor that stands to suffer loan losses first, the so-called "b-buyer," would have to get comfortable with the extent of the problem and proposed mitigants. If not, they could remove the loan from the pool or discount their price. So we can indulge the notion that when the loan was securitized, either things were not that bad or there was a credible plan to fix the problems that then existed.

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And even if there were an actionable breach, there is no direct remedy for the tenants arising from the loan sale documents. The tenants' remedies would have to be based specifically on their lease (unlikely, since residential leases are usually on a landlord's form), or more generally on consumer legislation and case law aimed at tenant protection. Ordinarily, the tenants would be incentivized to move to a better maintained property, but rent controls distort this incentive. Forcing the subsequent owner (the securitization trust) to bear the repair costs solves the tenants' problems, but it adds to the trust's already significant losses on the loan itself.

Between the securitization and today, we know that the borrower defaulted on its loan. New York is a judicial foreclosure state, so there's a protracted process if the lender decides it wants to take the property back. While the judicial foreclosure was pending, the special servicer had a receiver appointed by the Court to manage the property after the borrower defaulted. This looks like "by the book" servicing. You certainly don't want the borrower handling rents after it's defaulted. But this scenario comes with a real twist: the extent of property condition problems are such that the existing cash flow doesn't even begin to cover the related repair costs. For the trust, the risk is that merely directing that a receiver be appointed for the property creates the specter of having responsibility for all the property's problems.

This is exactly where the NYC Legal Services motion is headed. Who's really responsible? At least up to the point it was in control, the borrower, of course. It's not like it didn't spend the money (whether on the property or otherwise). It just ceased being profitable for the borrower to operate the property, so they mailed in the keys. The borrower's downward economic spiral leads to the property deteriorating, and that process doesn't improve with time. It can take time for the servicer, who is acting on behalf of the trust, to assess how bad things really are and estimate the cost to cure the problems. The judicial foreclosure and receivership processes in New York only compound the pain. In the case where the risk of taking over the property are greater than the benefit, the harsh reality may be that the "lender" (whether securitization trust or not) is better off abandoning the property back to the borrower. Not exactly the result the investors expected.

What of the policy consequences associated with making the investors responsible? As reported, this is ostensibly an example of failed loan underwriting or failed loan surveillance. Post-recession CMBS, in particular, must address these types of issues head-on. There has to be skin in the game from the borrower and its sponsor (low LTVs and high DSCRs). There has to be real net worth behind the sponsor group. Escrows have to be conservatively sized and fully funded. Post-closing undertakings have to be monitored, with real consequences (springing recourse, for example) to the sponsor for non-performance of essential property covenants. Once funded, servicer surveillance of the properties is critical in pinpointing deteriorating properties. Financial reporting must be rigorously enforced, since that is often an early warning of problems. Post-closing fraud and failure to provide financial information should potentially have recourse consequences as well.

If investors ultimately have liability for deteriorating properties even where they have avoided active control, loss severities will increase and costs of future lending will go up. Securitized lending conduits provided abundant and cheap financing to many B and C properties between 2005 and 2007, and even the GSEs may have a few projects that fall into that category. Increasing investor liability will certainly serve to chill lending activity to that sector unless substantial risk premiums exist. It's a vicious cycle that probably results in housing stock of a certain vintage deteriorating even further. NYC Legal Services may win the battle but lose the war. Let's see what the Court decides to do.

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Peter has extensive experience in:

- Commercial mortgage-backed securities, including representing loan sellers and issuers in representations and warranties compliance, disclosure, and other matters related to the aggregation of loans for securitization
- 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
- Structured finance transactions, including mezzanine, pari passu, A/B and other split loan structures, as well as re purchase transactions and loan participations
- Various other real estate transactions, including planning and zoning matters, development and leasing

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