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### Adjusting to the Down-Cycle: Insurance and Loan Surveillance Issues Take Center Stage

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The events of 2001 promise far-reaching changes in mortgage lending best practices, not least in the CMBS industry. The emerging recession and the aggravating impacts of the terrorist attacks of September 11 represent new challenges:

**First Stresses on CMBS Structures Expected.** The U.S. economy has been in recession since March 2001, and some economists posit that real estate, which typically lags a year or so beyond a technical recovery as absorption catches up, will feel like a recession for 2002. Loss frequency and severity will be closely watched, particularly to see how bond structures hold up where loan losses are suffered. The impact of SPEs on the time needed to recover delinquent assets will also provide an interesting point of comparison with prior recessionary cycles.

**Insurance: Premiums Up and Coverage Down.** September 11-related claims reportedly wiped out three years of insurance industry profits. Insurers have responded by (i) inserting terrorism exclusions; (ii) refusing to write or renew policies for various property segments; and (iii) raising premiums across the board by 20%-70%. Trophy properties are particularly susceptible to non-renewal risk, because re-insurers are threatening to abandon the market, but any property segment with a claims history is endangered. The consequences are staggering: (i) underwriting issues arising out of premium increases (i.e., lower DSCRs); (ii) loan document troubles: non-delivery of required insurance, downgrading of insurance providers, activation of DCSR-triggered lockboxes, and other incipient defaults mandating action under servicing agreements; and (iii) reduction in new commercial mortgage lending originations, including the possible flight of pension fund investors (having a low appetite for risk) from CBD office properties or other trophy assets. The totality of the fallout will depend in part on Congress, which failed to address such insurance market shocks in its last session, and on rating agencies, to the extent they impose terrorism coverage requirements across all property types.

**Financial Reporting: Stringent Expectations.** CMBS servicers and investors have a shared view on the importance of timely and sufficient financial information as an early warning sign of property troubles. Not surprisingly, borrowers can be less forthright at the very moment when servicers and investors have the greatest need to know what's going on. Meaningful loan document requirements and incentives, including audit rights for loans that are large or have sponsor history issues, are now expected. Servicer surveillance efforts will intensify to identify and mitigate troubled loans.

**Tenant Risk-Related Information.** Whether at origination, securitization or servicing, tenant risk-related information has not been consistently collected or interpreted. As tenant credit quality is threatened, however, the market will insist on it. Trends include greater scrutiny of major lease terms and story tenants, more stringent loan-level representations, and more detailed watch list criteria for lease issues.

**OFAC Watch List Screening Procedures.** The U.S. Treasury's Office of Foreign Assets Control has the responsibility for implementing the Executive Order aimed at curtailing anti-terrorist activities. The scope of these measures is potentially broad enough to impact loan proceeds or property income coming from or passing through blacklisted individuals or organizations. Some lenders have already added blacklist searches to their loan application processes.

**Other Loss Severity Issues.** Information that correlates to loss frequency or severity will be increasingly valuable to the market, as it searches to distinguish factors that improve risk assessment. With increased delinquencies, jurisdictional differences in exercising lender remedies may be more systematically apparent and, once discerned, pricing or terms changes may not be far behind.

Lease Issues: What's On The CMBS Radar?

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*The borrower's shopping center is anchored by a supermarket and sub-anchored by a national drug store. The supermarket lease provides for low base rent (with percentage rent expected), gives the tenant the right to terminate or abate rent if the drug store is no longer operating (a co-tenancy remedy), and does not restrict the use of the premises. The drug store lease gives the drug store an exclusive use to operate as a drug store, but there is no covenant to operate.*

*The drug store decides to develop its own shopping center on the opposite side of the intersection. It ceases to operate at the borrower's shopping center, but it keeps its lease alive to preserve the exclusive. Then the supermarket treats the drug store's closing as a breach of the co-tenancy clause, ceases operating and assigns its lease to a local drug store.*

**The result:** The borrower has lost both its anchor and sub-anchor, is being sued by the national drug store for breach of the drug store exclusive, and is left with a local drug store as its anchor having little drawing power and insufficient revenues to hit percentage rent hurdles.

For reasons of complexity, search cost or lack of leverage with uncooperative tenants, lease issues can go unidentified or unresolved. But, as the example above illustrates, the interplay of lease provisions can pose risks that are frequently below the radar screen. In an economic downturn, potential loss severity is important to all CMBS participants. Lease provisions can create remedies or other tenant leverage that upset the revenue expectations of landlords and their lenders, as well investors in such loans.

Lease risks are aggravated by transaction factors: (i) lease abstracting fees can be high and the number of reviews limited to reduce costs; (ii) anchor or national tenants are unlikely to embrace lender friendly changes (such as expansions of notice/cure rights or successor liability limits) unless required to do so in the underlying lease; and (iii) The time and cost of pursuing customized agreements with all but the key tenants can be prohibitive.

How should loan processes adapt? Focus on how well lease abstract forms track CMBS issues. Make sure lease reviewers are trained and know which lease provisions have underwriting or CMBS implications. Make lease abstract information readily accessible to underwriters, closers and deal counsel, so that risks are identified and mitigants considered.

**Lease issues can arise stealthily.** Lenders should consider the scope of loan seller representations and disclosure obligations in considering such issues in CMBS transactions. Be particularly alert to these types of lease issues for securitization impacts:

**Covenants to Operate, Go-Dark and Co-Tenancy Clauses.** Physical vacancy frequently precedes economic vacancy, so a major tenant's right to go dark (particularly where the landlord has not negotiated the right to regain control) is, in combination with co-tenancy remedies, important. Look for co-tenancy triggers, the extent of available tenant remedies and current compliance status: all are critical to underwriting, particularly in assessing lease rollover risk and related escrow sizing. As for mitigants, landlords should have latitude in obtaining replacement tenants to deflect tenant remedies otherwise arising out of co-tenancy provisions.

**Conflicting Exclusives.** The rights given to various tenants for exclusive uses or products cannot conflict, or the lender will be facing an incipient landlord default that can trigger serious tenant remedies. On an ongoing basis, exclusives (particularly product exclusives), can be difficult to monitor, and can create lease approval issues for servicers. Get comfort from estoppels that no exclusives have been violated.

**Options and Rights of First Refusal.** Options and ROFRs can be embedded in lease provisions, particularly for separate parcel tenants. Left unsubordinated, these would constitute exceptions to the title matters representation at securitization. Lenders cannot always rely upon such matters being reflected in title-related documents.

**Common Area Conflicts.** Lease requirements can be more stringent as to parking than zoning ordinances, and can impose affirmative obligations for signs, common area improvements and the like that are frequently not examined during due diligence or not adequately comforted in tenant estoppels. Landlord defaults can result, often providing an ongoing tenant remedy. Augment service review by noting such lease issues.

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**Expansion Rights.** Grocery stores or major retailers can require expansion rights, often with the requirement that the landlord bear the cost of construction. The problem? Subordinate debt (i.e., the landlord's obtaining financing for the expansion from a third party) is likely prohibited by the loan documents, and the failure to construct the improvements can result in a landlord default.