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The Fungus Among Us—Mold Becomes Growing Issue *Written by **Patrick Sargent** at 214.659.4430*

Mold has been around, naturally, forever. Recently, however, it has caused high profile problems for real estate owners (commercial and residential) and insurance companies. Lawsuits in California and Texas have generated multimillion dollar awards against insurance companies. A hotel in Hawaii had to close several hundred rooms, and a New York office building has suffered significant mold contamination. New mold legislation is popping up in many states.

What is the problem? First, many types of building materials when combined with moisture (leaking pipes/equipment/HVAC, excessive humidity, condensation) create an ideal environment for mold growth. Once it flourishes, cleanup, repair and remediation costs ensue, as well as potential tenant revenue stoppage. Second, some types of mold may create a health hazard to tenants, or at least a basis to claim damages for health problems. Third, there are no established standards or procedures for dealing with this "toxic" substance and, given the circumstances that lead to mold growth, there is no guarantee that once it has been cleaned up it will not resurface. Consequently, property owners could incur significant costs and revenue losses that may or may not be covered by insurance, and may be subjected to protracted litigation. Not surprisingly, insurance companies, facing mounting claims, are moving to exclude mold from coverage, or offering it only as an expensive rider.

What to do? Lenders, buyers, and owners must be diligent in determining whether a mold risk or potential risk exists. Since the typical phase I environmental site assessment ("ESA") does not address mold, the ESA scope of review should be expanded specifically to include mold conditions. Upon discovery, remediation should be required and if not completed prior to closing, then either insurance, reserves, an operations and maintenance plan or principal/sponsor guarantees, or a combination of these, should be implemented. Lenders should also consider updating their loan documents and underwriting criteria with specific mold references in the borrower reps and warranties, lender inspection rights, monitoring, and insurance requirements to deal with the mold problem. Fitch has already issued a report ["Are Phase 1s Getting Moldy?" 9.16.02] stating that they expect to see specific reference to mold inspections in ESAs for loans included in rated securitizations. Property owners should proactively implement monitoring practices and every effort should be made to allocate the risk of loss caused by mold to tenants and to require tenants provide immediate notice to property owners of circumstances which could result in mold growth.

Having been warned, owners and lenders need to take preventative measures to keep from getting blindsided by this potentially costly problem.

Best Practices Summary

- Expand scope of Phase 1 ESA to include mold conditions
- Update loan documents to include mold issues in reps / warranties, inspections / monitoring and insurance
- Update underwriting criteria, borrower questionnaires and loan applications
- Owners should add mold condition monitoring to property management agreements and leases

**For additional information, see www.moldupdate.com sponsored by the NAMIC.*

Got Proceeds? Mezzanine and B Note Structures More Popular *Written by **Peter McKee** at 214.659.4507*

As first mortgage underwriting standards tighten in response to the perception of heightened market risk, borrowers can be left short of loan proceeds. To fill that gap, borrowers are finding that it is cheaper to seek additional debt than it is to raise additional equity. The additional debt market continues to evolve and develop, and, while previously seen only for trophy properties, is increasingly available for conduit-type loans. Where the additional debt may not be in place at the time of the first mortgage closing, borrowers are best served by pre-wiring the first mortgage loan documents to anticipate such additional financing. Accommodating additional debt for CMBS loans on an after-market basis will be difficult in the face of

pooling and servicing agreement requirements.

Beyond the economic risks arising out of increased leverage, the interaction between first mortgage debt and additional debt creates unique legal risks depending on the structure. Listed below is a glossary of terms and basic distinctions between mezzanine, B Note and subordinate debt structures (in order of impact on first mortgages- least to greatest):Mezzanine Debt

Debt owed by owner of borrowing entity, usually secured by a pledge of the owner`s interest in the borrower; there is no lien on the property, nor is there any other structural attribute that would cause the first mortgage borrower to violate its special purpose entity covenants. Pursuant to intercreditor provisions, the mezzanine lender`s rights are limited to notice and cure rights on borrower defaults, and the ability to take control of the borrower (by foreclosing on the pledge of the ownership interest), subject to the first lien debt. The mezzanine noteholder must be pre-approved by the first mortgage lender as an approved successor control party to sidestep due-on-sale conditions, and, from a rating agency standpoint, pass muster based on management expertise and financial wherewithal. In general, the mezzanine lender has greater control and flexibility in the exercise of remedies than does the B Noteholder or subordinate lender. Rating agencies prefer mezzanine debt to B Note structures.B Note Debt

Debt owed by the borrower, evidenced by a separate note (B Note) but secured by the same mortgage as the first lien note (A Note). The A Note is intended to be securitized, while the B Note (representing additional leverage) often is not. Payments are allocated first to the A Note, and then to the B Note. Typical intercreditor provisions leave the B Noteholder with the remedy to purchase the A Note as the chief means of protecting its interest. Otherwise, it is subject to standstill requirements. Some role advising the special servicer in workout strategy may also be also be allowed the B Noteholder, but B Noteholder rights adversely impact the treatment the A Note receives in securitization. Yield expectations on B Notes are higher than on mezzanine debt.Subordinate Debt

Debt owed by borrower (other than a limited amount of trade payables) that is behind the first mortgage debt in priority. Such debt can be secured (second lien) or unsecured. Subordination and standstill protections are expected by CMBS first mortgage lenders that (i) allow subordinate lenders to be paid only out of excess cash flow, (ii) forestall the exercise of remedies by subordinate lenders until after the first lien has been satisfied and bankruptcy preference periods have lapsed; and (iii) contain a non-petition covenant and an assignment of rights to vote in bankruptcy.

CMBS Document Delivery Defects: Rethinking The Problem *Written by* ***Peter McKee*** *at 214.659.4507*

What lenders took to be a routine back office function -- collecting and delivering complete mortgage files -- has assumed new found importance in light of increasing anecdotal evidence of missing documents, inadequate follow up and adverse impacts on loan administration and servicing. CMBS participants, as a consequence, are looking at fractured relationships or potential liability. What happened, and what can be done?

One of the key documents in the securitization of a pool of loans is the pooling and servicing agreement (PSA), which includes provisions dealing with the delivery of mortgage files to the trustee, and the remedies available to investors in the trust for noncompliance. Frequently, certain elements of that mortgage file are not available at closing: the final title policy, recorded mortgage and assignment of leases and rents and filed UCC`s being the usual suspects. Moreover, underlying recordation or filing information for the documents evidencing the assignment of the loan to the trust at securitization (e.g., Assignment of Mortgage, Assignment of ALR, and UCC-3`s) is unavailable. Then there are more interesting variations: transferring letters of credit (which involves tackling the issuing bank`s administrative processes), locating documents that have vanished, or fixing document inconsistencies with borrowers or title companies that are not always cooperative.

The problem is compounded by the historic inattention this function has received. Institutional memory is lost with turnover of key personnel, loan originators are off to the next deal, and loan servicers don`t think they`re compensated to wade into the issue. Trustees can be concerned with their liability to the trust for straying from the letter of the PSA. As a result, such document or other loan defects show up on the trustee`s "exception report" that is delivered to loan sellers and investors

several months after securitization, and can involve literally hundreds of items requiring follow up. Investors are alarmed at the prospect of the trust (i.e., them) bearing costs they view as being incurred only because loan sellers didn`t do what they were supposed to do. Loan sellers, in turn, target their service providers, and so on.

Enter the Commercial Mortgage Securities Association (CMSA), and its Document Integrity Task Force, chaired by LaSalle`s Mary Anne Ashmore. A CMSA-sponsored loan document checklist provides a closing checklist template for loan originators, and at least gets lenders and trustees on the same page. But, in the CMSA`s most recent assessment, only about half of loan originators were actually using the checklist, making document intake for trustees more difficult and heightening the prospect of exceptions that could otherwise have been cleared. What`s on the horizon? Expect PSA`s to require that the CMSA checklist accompany loan files.

Current generation PSA`s include features that begin to address investor concerns, including tight "core document" delivery guidelines and related buy-back remedies, provisional delivery of final title policies and recorded/filed documents, and more detailed protocols for addressing defects. Because the stakes are higher with stringent investor remedies, it is clear that lenders will have to deploy greater resources to assure compliance going forward, not to mention tending to the shortcomings of the past. Loan origination procedures, particularly post-closing, should be harmonized with foreseeable document delivery requirements, for example, to save time and money later. Effectively discharging this function is a key component to the overall perception of loan originator quality and credibility.

- Use the CMSA Checklist, or a variation adapted to your loan document platform.
- Involve the trustee in your loan origination process so that special features can be anticipated. Be proactive in describing any document variations on the CMSA checklist.
- Become conversant with what constitutes "provisional delivery" of certain loan file components in the PSA so that you can that buy time to comply with requirements for late-arriving final title policy and recorded/filed documents. Build that into closing protocols.
- Request previews of the exceptions checklist so that obvious inaccuracies can be cleared away early. Schedule periodic conference calls with the trustee to tie-out exceptions so that there is a strategy for clearing them and responsibility is clear.
- Always include a trustee receipt and acknowledgment with document transmittals, and make sure it`s returned by the trustee in timely fashion, so that you can establish a compliance record. Trustees can misplace documents, too.
- CMBS issuers should consider selecting their trustee based on the trustee`s reputation for dealing with document defect issues responsively.

Tenant Bankruptcy Risks In CMBS Deals *Written by* ***Steve Smith*** *at 214.659.4449*

Tenants have increasingly sought relief from landlords due to the slumping economy by attempting to negotiate lease buyouts, reduced space commitments and/or reduced rental rates. A popular negotiation tactic is to threaten bankruptcy and rejection of the lease, leaving the landlord with potentially nothing but a large unsecured claim. Typically, CMBS loan documents require a lender`s consent to major lease modifications, buyouts, or unscheduled terminations. In evaluating the borrower`s (landlord`s) request to approve a lease modification or buyout, a Servicer must examine, among other things, both the likelihood that a particular tenant will seek bankruptcy protection and the possible impact of such bankruptcy proceeding on the borrower`s (landlord`s) ability to pay the loan. The likelihood that a tenant may file bankruptcy is usually tied to a tenant`s overall financial well-being and its ability to maintain its business without resorting to bankruptcy. Assuming a tenant is a bankruptcy candidate, it has essentially four options with respect to its lease obligations:

- reject the lease,
- assume the lease,
- assume and assign the lease, or
- renegotiate the lease and then assume or assume and assign the lease.

Implementation of the first three options is typically within a tenant`s control subject to certain protections afforded a landlord under the Bankruptcy Code in connection with an assumption or an assumption and assignment. Renegotiation of a lease will require a landlord`s active participation and may even require approval by landlord`s lender.

Rejection
If the lease is rejected, it is in effect terminated and the landlord is left with its security deposit or letter of credit proceeds, if any, and the right to file an unsecured claim in the tenant`s bankruptcy proceeding for the sum of any prebankruptcy unpaid rent and the rent reserved under the lease for the balance of the lease (not to exceed the greater of one year`s rent or fifteen percent of rent reserved under the lease not to exceed three years` rent). Although unsecured claims in most bankruptcy proceedings do not usually result in significant recoveries, the Servicer should make sure that the borrower or lender, if the loan documents permit, files a proof of claim for the allowable rejection claim. The cost of filing such a claim is nominal, and there are situations when a bankruptcy proceeding, even in a liquidation context, can produce significant distribution to unsecured creditors. Typically, tenants seek rejection (i) when a lease is no longer viable at its current terms, (ii) a tenant may be withdrawing from that particular market, or (iii) a tenant has a more attractive alternative.

Assumption of Lease
A tenant can assume a lease without modifications provided it cures all existing defaults and provides adequate assurance of future performance. An assumption usually occurs where a lease has favorable terms and the assumption is beneficial to the tenant`s overall restructuring in bankruptcy.

Assumption and Assignment
A tenant can assume and assign a lease without modification provided it cures all existing defaults and the third party assignee provides adequate assurance of future performance to the landlord. This option usually occurs if the tenant is selling part or all of its business or in the unlikely event that the lease is a below market lease and the tenant can make a profit on such assignment.

Renegotiation
Unless a particular lease is a clear rejection candidate (i.e., a retail tenant is exiting the particular market, it is a highly unprofitable store, or a tenant can consolidate operations at a more favorable location), a tenant in bankruptcy will typically attempt to a renegotiate on the threat of rejection. Renegotiation is not required by bankruptcy but a bankruptcy proceeding is by its nature an ongoing negotiation of a debtor`s liabilities. If successful in such renegotiation, a lease will be then assumed or assumed and assigned.

A Servicer`s task in evaluating the relevant bankruptcy risks and likely impact upon the borrower`s (landlord`s) performance under the loan can be complicated. This is particularly true if a tenant has multiple locations and opportunity to consolidate operations or move operations to a more attractive location. Additionally, a tenant`s bankruptcy exit strategy may not be clear or may change over time. A tenant`s restructuring proposal may be accompanied by or tied to a borrower`s request for modification of a loan to accommodate the loss of a tenant or the reduced rental rate. Obviously, in such context the Servicer has to comply with the applicable Pooling and Servicing Agreement and satisfy any REMIC requirements with respect to a proposed loan modification. Unfortunately, the Servicer is typically unable to modify a loan under REMIC rules unless there is a default. This highlights a flexibility problem that challenges Servicers of CMBS deals in a declining market environment.

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