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CMBS Counselor - Winter 2009

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Specialty-Serviced Loans: What Investors Need to Know

By Pat Sargent and John Tucker

Given the current economic climate, investors in securitized pools of mortgage loans want to understand the impact a "specially-serviced" loan has upon their investments. For the investment grade investor in particular, whose loan-level diligence and deal participation are less substantial than below-investment grade investors, what does it mean when one or more of the mortgage loans underlying the trust securities become "specially-serviced"?

In general, a specially-serviced loan is one in which a payment is 60 days past due or a payment or other default is imminent or likely to occur within a specified time, which default the servicer determines in good faith is reasonably likely to materially and adversely affect the interests of the certificateholders.

What happens to a specialty-serviced loan?

When one of these conditions is met, the master servicer transfers the servicing authority to the special servicer.

The trust pooling and servicing agreement ("PSA") requires the special servicer to service the loans with the same skill, care and diligence as is normal and customary for similar loans in the industry, or as it would for loans it holds for its own account, with a view to the maximization of the recovery of principal and interest on the specialty-serviced loan for the certificateholders as a collective group on a net present value basis, but without regard to any relationship with the borrower or affiliates, any certificates the servicer may own, or any fees or reimbursements it may be entitled to receive. This obligation is known as the "servicing standard."

Since the special servicer is frequently also the B-piece or junior certificate investor, and as such its investment is exposed to the "first loss" on the underlying loans arising from loan performance problems, it typically has a vested interest in the performance of the loan. This economic interest, however, is checked by the servicing standard.

The special servicer first physically inspects the property and prepares an asset summary report ("ASR"). The ASR describes the property condition and the special servicer's strategy for dealing with the troubled loan. The special servicer must consult with the representative of the junior certificateholders (if another party owns the certificates) before implementing the strategy set forth in the ASR. However, the special servicer is ultimately responsible for the course of action chosen.

Options in Dealing with Specialty-Serviced Loans

What options are available to the special servicer in dealing with troubled loans?

The PSA generally provides the servicer significant leeway in dealing with defaulted loans, subject to the servicing standard. For example, after assessing the local market, tenant status and estimated economics for operation of the property, the special servicer may determine that the best prospect for recovery to certificateholders is to amend or modify the loan by extending the maturity date, reducing the interest rate, and/or deferring or forgiving certain payments and charges such as prepayment premiums, yield maintenance fees and late charges. Additionally, the special servicer may decide to allow a discounted payoff of the mortgage loan by the borrower. Another option is to conduct a sale of the defaulted mortgage note. Finally, the special servicer could pursue foreclosure proceedings resulting in either a sale of the property if an adequate bid is offered or the trust owning the property pending an ultimate sale to another user. In exercising its judgment, the servicer will weigh the economic benefit to the trust of owning and operating the property temporarily against the benefits expected to be gained from exercising the other options described above.

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Through this process, certificateholders may derive comfort from the servicing standard, the reputation of the servicer in the industry and the requirement that the servicer meet rating agency criteria. The PSA's arrangement of rights and responsibilities is intended to align and balance varying economic interests. The construct is sure to be tested in this recessionary period, but special servicers may well prove that this principled flexibility is both necessary and effective to mitigate mortgage losses and protect the interests of investors.

Legal Due Diligence Strategies in Loan Pool Transactions

By Peter McKee

In his book, *Blink*, Malcolm Gladwell describes how accurate decisions can be made quickly. Through a process Gladwell terms "thin-slicing", the human mind can examine a situation and skim the information necessary to make correct judgments and develop effective problem-solving strategies. Not unexpectedly, these skills are acquired with accumulated experience, training and judgment in the related subject matters. Still, the message of the book speaks to how information is assimilated, parsed, and used, which suggests its relevance to examining the topic of legal due diligence.

Assessing risk has never been more important. Legal risk is an essential subset of that exercise, particularly for the commercial and multi-family lending industry that is the focus of this article. More properties are stressed, and defaulted non-residential loans, while under 2% currently, are becoming more numerous. In the present market new sources of anxiety seem to emerge daily, and both property and loan valuations are unsettled. For holders, sellers and purchasers of mortgage loans, having a reliable and clear understanding of loan features and loan risks is critical to both valuation and strategy. To extrapolate from Gladwell's thesis, effective legal due diligence includes an aspect of separating the useful information from the less relevant, and above all, recognizing data patterns that belie the choices made and risks taken, consciously or not, by lenders and servicers.

As the difference between loan sellers' and buyers' pricing expectations narrows, loan trades will become more numerous. In the first of a series of articles on distressed and performing loan pool issues, we focus on guiding principles involved in establishing an appropriate scope and output for legal due diligence review, and best practices.

1. Integrate legal diligence with credit diligence to achieve a balanced composite of legal and business risk.

For loan pool sales, the purchaser uses a combination of information from its due diligence and risk-shifting through representations and warranties or other structural devices (such as guarantees) to arrive at a price. From the outset, then, the loan purchaser should assess the relative value of the available information, the cost to extract and evaluate it, and the availability and adequacy of other risk-shifting measures.

Assuming that a substantially complete mortgage and credit file is available for each loan, the loan purchaser can assign roles and responsibilities for the legal and credit due diligence functions, but it must also assure that the results of legal and credit due diligence are eventually fused into a composite picture of transactional risk. The scope of the legal due diligence function typically includes loan documents and opinions, entity documents, applicable third-party agreements (e.g., intercreditor agreements, SNDAs) and property-level due diligence (title, survey, zoning and/or leases), and is the province of in-house or outside counsel. What we would term "credit due diligence", by contrast, deals with matters such as third-party reports (e.g., appraisal, Phase I environmental, property condition report), credit information, and underwriting information such as property income and expense information, budgets, and the like. Typically, internal or third-party analysts and underwriters with real estate experience perform the credit due diligence function. Considerations such as available information, time, cost and expertise also drive how roles are configured. Ultimately, counsel's ability to be part of the integrated process is its principal "value-added" opportunity, because legal risk information provided without consideration of the deal's context is of scant value.

Beyond assessing each loan on the basis of loan-level legal and credit considerations, the loan purchaser and its counsel have to consider the effect of loan-related representations and warranties (and any other credit-enhancing features) that mitigate loan-level risk. Is the loan pool being sold "as-is" (frequently the case for distressed loan sales) or with loan seller

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representations and warranties? What are the nature and extent of any representations and warranties, and the indemnitor's financial condition?

As to the scope and depth of representations and warranties, there is greater variability than might be expected, even among comparable transactions. Loan representations are comprised of multiple elements and are qualified or conditioned to varying degrees that frequently reflect accommodations from past transactions that have been carried forward. Understanding the present deal context and the past practices associated with loan representations becomes an important aspect of evaluating their fitness for the particular purposes of the deal. Rather than assuming that the scope of the loan seller's representations and warranties is "market" or not, it is more valuable to understand where the actual holes are, and whether, taken in conjunction with the available loan information, some other mitigant exists to offset such risks.

The financial strength of the loan seller or other related indemnitor and the contractual basis for asserting claims and exercising remedies are also part of this assessment. High-quality loan information and broad diligence can abate the need for stringent loan representations and warranties, while poor-quality loan information renders stringent loan representations (and a strong indemnitor) virtually essential, or at least subject to substantial price adjustments. One problem that arises is a mismatch of perceptions concerning the quality of loan information, particularly since that occurs after a terms sheet has been signed, and re-trading the deal terms can be contentious.

"Best Practice" Suggestions

- **Selecting Counsel.** Both loan origination and secondary market transactional experience are critical differentiators in selecting outside counsel to perform what is essentially a forensic function. Understanding the risk management choices made at loan origination and appreciating the impact of secondary market expectations on value, including discounts for uncertainty, are at the heart of an effective due diligence process.
- **Evaluating Loan-Level Representations and Warranties.** Andrews Kurth has developed composite assessments of loan-level representations and warranties based on many of the most active CMBS shelves and other secondary market information. This provides a benchmark for comparison of proposed representations and warranties, and identifies gaps that are candidates for further mitigation.
- **More Detailed Terms Sheet Requirements.** The parties' agreeing to more detailed requirements concerning information deliverables can lessen sources of later contention. For institutional purchasers, this also can serve to systematize loan sale requirements.

2. Extract information from loan file and property diligence that is material to core business judgments affecting the deal. Be cognizant of price and risk exposure. Anticipate how loan-level information has to be processed by the transaction parties.

There should be a shared sense of what is material to the deal and what is not. The surest way of getting this right is to have an agreed form of due diligence review output to memorialize the results of the loan review and assure consistency in approach. Beyond starting with a review form, this is also a matter of right-sizing the diligence to the deal and the perceived risks it presents. Counsel should avoid incurring search costs for information that the client does not care about. But this presents at least two complications: Counsel has to know what the client cares about, and counsel has to know when the context could be different enough to change that result. In addition to agreeing on a loan review format at the outset, reviewing and discussing loan information as it is being aggregated is important. Patterns of perceived risk can change with data, and being able to identify issues and make adjustments early is both efficient and qualitatively essential. The loan purchaser may generally be content with subordinate financing up to a stated loan-to-value ratio, for example, but what if mezzanine debt (not debt of the borrower, but its owner) is also permitted and does not technically fall within the LTV language of the documents? This is but one example of an "add-on" consideration that could complicate an otherwise straightforward choice. As new risks are identified, transaction parties have to be apprised so that risk-shifting or price discussions can be considered.

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Once the reviews have been compiled, the data should be “rolled-up” or summarized. An agreed format should be used, questions compiled and follow-up orchestrated for efficiency. The loan-level data roll-up should serve as a roadmap for the loan purchaser. Depending on the deal context, this can take different forms. Where there is a foreseeable need for loan-level disclosure, as in a securitization, a topical format can be used that mirrors information relevant to securitization participants. Where there are specific formats or protocols that an institution requires (relating, for example, to loan or investment committee approval processes), the roll-up format can be adapted to that purpose as well.

The roll-up format also presents an opportunity to pull together the results of the credit due diligence, or to corroborate loan-level information (such as an accounting tape) that is reviewed by both legal and credit teams.

Beyond the function of summarizing issues, there is also the task of specifying required curative actions or “directing traffic” so that issues are resolved or otherwise mitigated. Whether incorporated into the roll-up format or treated separately, the deal parties have to have some practical basis to winnow down the open issues.

“Best Practice” Suggestions

- **Loan Review Format/Legal Data Record.** It is both qualitatively advantageous and efficient to insist on an agreed review form that is tailored to the particular deal. This avoids search cost for information that does not have material relevance, and assures that essential inquiries are covered. Andrews Kurth has a proprietary form called a Legal Data Record that includes different topic-based modules, and so is readily adapted to varying needs and circumstances. One virtue of this approach is that it provides a snapshot of legal features (including borrower/guarantor information, loan document provisions and property due diligence) that can be used for later reference by loan servicing or in connection with the sale or financing of the loan.
- **Roll-Up Format for Loan-Level Information.** The loan purchaser and counsel should choose a format that anticipates how the summary information will be used. Whether the format has to satisfy counsel-driven protocols (i.e., 10b-5 comfort letter) or institutional protocols (i.e., loan committee or investment committee approvals), or the parties simply have the practical need to have a list of open items to identify and resolve, the roll-up format should anticipate and satisfy these various purposes.
- **Takeaways Sessions.** Review both substantive issues and process efficiencies periodically. This fosters a shared sense of what is material and what can be improved.

3. *Manage both internal and external cost and timeliness.*

Given the scale and labor-intensive nature of the due diligence process in loan pool transactions, the involvement of multiple parties with different responsibilities, the frequently unpredictable nature of the quality or quantity of available information, and the logistical challenge of processing huge amounts of information, managing costs is a crucial aspect of counsel's effectiveness. Too often, however, there is limited appreciation for how internal resources could be used to advantage, and how information setup and subsequent delivery impact costs.

The loan purchaser should take stock of available internal resources and consider ways that those resources could complement the outside counsel's role and responsibilities. Certainly the nature and frequency of status-type communications, while a necessary attribute of imposing order on the process and keeping parties informed, can impact costs substantially. Establish interim milestone dates to measure progress and provide status updates. Conference calls must be tightly managed to avoid becoming time-consuming and unproductive.

How loan information is assembled and updated makes a huge difference to overall efficiency. Counsel can achieve greatest efficiency by using a “touch-it-once” approach to loan file review, which means that the file is reviewed one time, all relevant information is extracted for roll-up, and curative action is identified. Time and cost efficiencies are lost where the loan file is missing documents that are material, where there are changes in the scope of review or where there are “special issue” searches. Since the process of clearing open issues is by necessity a “rolling” process, incomplete loan files create an ongoing drag on efficiency and a potential source of confusion as the parties spar over what has been sent and/or should

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have been approved. The roll-up format has to record precisely what has been received and processed (and what action remains) to minimize these types of issues. The loan seller has a tremendous effect on the efficiency of this process, beginning with the state of the loan files that are delivered, how well they are organized, and how follow-up deliverables are managed.

Though it may appear counterintuitive, deals that have a short fuse create cost pressures that more routinely paced deals do not. First, time-compressed deals can impose inefficient staffing patterns (i.e., more people are required) and entail more internal communication. Second, time-compressed deals put a premium on logistics and organization, and if either is lacking, time is frequently lost. Third, time-compressed deals invariably mean more matters get pushed to post-closing, which presents its own set of process challenges.

Managing costs is most readily achieved where the loan purchaser and its counsel have a shared understanding of material risk and the review formats that are used mirror this understanding as closely as possible. There is a cost-benefit comparison to evaluating loan information that it is useful to review from time to time, particularly if the search cost is high or the benefit merely tangential to the perceived business risks of the transaction.

“Best Practice” Suggestions

- **Evaluate How Internal Resources Can Help.** Look for constructive ways to manage costs by adapting the due diligence process around the loan purchaser’s internal resources. Perhaps the review output can obviate formal reporting, or the scope of review can be reduced in reliance on in-house lawyers, or housekeeping aspects of the deal (tracking deliverables and the like) can be internalized. Look for ways to reduce upward pressure on legal fees.
- **“Touch-It-Once” Approach Works Best, But Efficiency Depends on Loan Seller.** Time permitting, delay legal review until the loan file is complete. Having loan file information dribble out wastes time and potentially creates confusion about deliverables status. This is largely within the loan seller’s control.
- **Short Fuse Deals Create Unique Legal Fee Pressures.** Time-compressed deals can create fee pressures arising from staffing patterns, lapses in organization and logistics, and more issues getting pushed to post-closing resolution. More routinely paced deals can avoid these pressures.
- **Review Output Formats for Cost Benefit.** Loan purchaser and counsel should evaluate the related legal review formats where information is difficult to obtain or the perceived benefit is only marginal given the deal context.

4. Anticipate servicing and/or re-sale requirements after the loan purchase.

The end result of a loan purchase transaction is, after all, the ownership of the mortgage loans. So anticipating loan servicing requirements is an important aspect of the loan pool due diligence process, as is assuring that the exit strategy for the loan assets is viable, whether that involves holding the loan to maturity, financing or re-sale.

As noted above, the loan review format can help the servicer become acquainted with the loan documents and key property issues. Indeed, recurring servicing issues should be highlighted by the loan purchaser so that the review format can flag them. The servicing ledger, which reflects actions take by the servicer respecting the loan or communications involving the borrower or third parties, can provide an indication of problems to come or issues that are unresolved. Particularly with respect to distressed loan pools, the servicing ledger may represent the most reliable chronology of borrower default and the status of the exercise of remedies. Since distressed loan values are heavily dependent on determinations of loss severity, this is critical information to the loan purchaser. For example, notices of code violations could be an indication that the property condition has declined and that owning the loan could expose the loan purchaser to contingent liabilities that, notwithstanding loan seller representations, make the asset unattractive.

Similarly, the loan purchaser must consider its exit strategy for the asset. If this includes financing or re-sale to a third party, then the loan purchaser has to be attentive to current or foreseeable market expectations both as to adequacy and availability of loan information and the legal and credit features of the loan. Depending upon the durability of loan seller representations and warranties, the loan purchaser may be exposed to fresh risks when it wishes to re-sell the loan. Thus,

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even if a loan purchaser were predisposed to view certain risks as benign, it should still be mindful of the possibility that the market at time of loan re-sale could be less forgiving.

“Best Practice” Suggestions

- **Use the Legal Review Format/Legal Data Record and Servicing Ledger to Tie-In Servicing-Related Information and Evaluate Loan or Collateral Issues.**
- **Evaluate Market Requirements for Financing or Re-Sale of Loans.** Where a loan purchaser wants to preserve the option of financing or re-selling the loan, it must be mindful of current or foreseeable market requirements, even where it is predisposed to view a related risk as unimportant.

Conclusion

Deal context should shape the parties' decisions regarding the scope, function and budget of legal due diligence in loan pool transactions. A “one-size-fits-all” approach risks mismatching the end and the means, which can prove costly both in terms of transaction cost and/or retained liability. There are a variety of ways to tailor the legal review output to better serve both the requirements contemplated by the deal and the loan purchaser's long-term servicing needs and exit strategy, and to manage costs and deal timing in the bargain. A key component in achieving these objectives is using a legal review format that aligns client diligence requirements with counsel's role. If well-executed, the legal due diligence process can identify behavioral or systemic approaches to origination and servicing decisions, and offer insights that are critical to informed business judgment.