

Blog Post

Moving Forward

Posted on **October 20, 2010** by Charles T. Marshall

Over the past year, we have looked far and wide for answers to how we got in this real estate finance and capital markets mess and how to get out of it. We have listened to real estate industry leaders and economists. We have examined rating agency delinquency reports and downgrades. We have looked for comparative solace from the experience of the Dust Bowl, the carnage of the First World War and the 1980s bust. We have even consulted with Dr. Strangelove, Ferris Bueller, and Willy Loman.

But we're tired of being amateur economists and historians. We're ready to move forward. With the VIX down and the CMBX up, with issuers dusting off their shelves and real estate lenders tuning up their forms, the time is right to focus on the transitional requirements and limitations of CMBS 2.0.

One of the features of 2.0 that has caught our eye right off the bat is a renewed appreciation for the interplay of document provisions.

Take a recent loan secured by a retail center. The anchor tenant had delivered a notice of landlord default for failure to repair the roof and highlighted the issue in its estoppel letter. The lender dutifully required a typical 1.0 solution: an escrow and a covenant to complete the repair within 120 days. However, the loan document escrow provisions did not otherwise address the existing lease default or true-up the loan and lease documents. The lease obligated the landlord to commence curing the default within 30 days after notice, which had expired by the time of closing. In the loan agreement, the borrower represented that no material landlord defaults existed under any leases. Consequently, the CMBS securitization representations and warranties had to include an exception for a material loan default, a bad result. In addition, no documented effort was made to square the proposed repair and timing with the tenant, potentially permitting an anchor to have a termination or self-help right.

In 2.0, particularly with heightened focus and disclosures regarding leases, a mere escrow will not be a cure-all. The underlying issue and documentation, particularly when an anchor tenant's involved, must be cleanly reconciled in the loan documents.

Another issue we've noticed: with the yawning equity gap, mezzanine financing will likely be a common feature at the outset of 2.0, but the various documents will need to be tuned up. For example, typical intercreditor provisions permit the mezz lender to cure and/or purchase the senior loan after default but does not normally address the timing of exercise of the purchase option. Pooling and servicing agreements provide that the special servicer receives a 1% fee when the senior loan is transferred to special servicing, which usually occurs once the loan is 90 days past due. The problem created by the document interplay is that the purchase price for the senior loan documents has not included the servicer's 1% fee. The result: a disclosure issue, since the trust would be obligated to pay the fee under these documents, an unhappy investor, and possible loan kick-out unless the documents' provisions are amended or waived (with little incentive for servicer or mezz lender to do so).

The transition to 2.0 will present many document tune-up and reconciliation opportunities.