

The Andrews Kurth Difference

Evaluating legal risk is essential in times of economic stress. At Andrews Kurth, we have a 4-step process that aligns loan origination practices with “best execution” secondary market outcomes:

- *Step 1:* Loan summaries trap information potentially relevant to internal quality control and secondary market information requirements.
- *Step 2:* Loan-level diligence includes Q and A with business and legal closing participants to assure that loan presentation is seamless, and that problems with structure, documents or property diligence are addressed.
- *Step 3:* Overview memoranda incorporate loan pool data topically, so that pool-wide decisions can be examined in context and readied for disclosure, reps/warranties compliance and investor follow-up.
- *Step 4:* Takeaways identify decision-making tendencies and procedural or substantive issues, with an eye toward evaluating program-wide actions and institutionalizing best practices.

Our legal risk processes have been developed and continually refined since 1995. In the past three years, we have applied this approach to nearly 3,000 loans in 45 CMBS securitizations involving eight different shelves and to a variety of portfolio transactions.

If you would like more information, please contact **Peter McKee** at 214.659.4507 or petermckee@andrewskurth.com.

Real Estate Finance/Capital Markets Contacts

David Barbour, Partner

214.659.4444, davidbarbour@andrewskurth.com
Capital Markets

Chris Boehler, Partner

713.220.4421, chrisboehler@andrewskurth.com
Loan Origination

Michael Boyd, Partner

713.220.3921, michaelboyd@andrewskurth.com
Loan Origination

Chuck Jacaman, Partner

214.659.4433, chuckjacaman@andrewskurth.com
Loan Origination

Jong Kim, Partner

214.659.4483, jongkim@andrewskurth.com
Loan Origination

Brigitte Kimichik, Partner

214.659.4441, brigittekimichik@andrewskurth.com
Loan Origination

Charles Marshall, Partner

214.659.4509, charlesmarshall@andrewskurth.com
Program Counsel/Loan Origination

Peter McKee, Partner

214.659.4507, petermckee@andrewskurth.com
Legal Risk Evaluation/Capital Markets

Tom Popplewell, Partner

214.659.4480, tompopplewell@andrewskurth.com
REMIC Matters

Patrick Sargent, Partner

214.659.4430, patrickssargent@andrewskurth.com
Program Counsel/Capital Markets

Kathleen Wu, Partner

214.659.4448, kathleenwu@andrewskurth.com
Loan Servicing

AUSTIN

111 Congress Avenue, Suite 1700
Austin, Texas 78701
512.320.9200

BEIJING

Room 2007, Capital Mansion
No. 6 Xinyuang Nanlu
Chaoyang District
Beijing, China 100004
86.10.8486.2699

DALLAS

1717 Main Street, Suite 3700
Dallas, Texas 75201
214.659.4400

HOUSTON

600 Travis, Suite 4200
Houston, Texas 77002
713.220.4200

LONDON

Level 16, City Tower
40 Basinghall Street
London EC2V 5DE
England
44.20.7382.0550

LOS ANGELES

601 South Figueroa, Suite 3700
Los Angeles, California 90017
213.896.3100

NEW YORK

450 Lexington Avenue
New York, New York 10017
212.850.2800

THE WOODLANDS

Waterway Plaza Two
10001 Woodloch Forest Drive, Suite 200
The Woodlands, Texas 77380
713.220.4801

WASHINGTON, DC

1350 I Street, NW, Suite 1100
Washington, DC 20005
202.662.2700

The Counselor

REAL ESTATE FINANCE/CAPITAL MARKETS

A publication of the Andrews Kurth Real Estate Finance/Capital Markets Practice Group

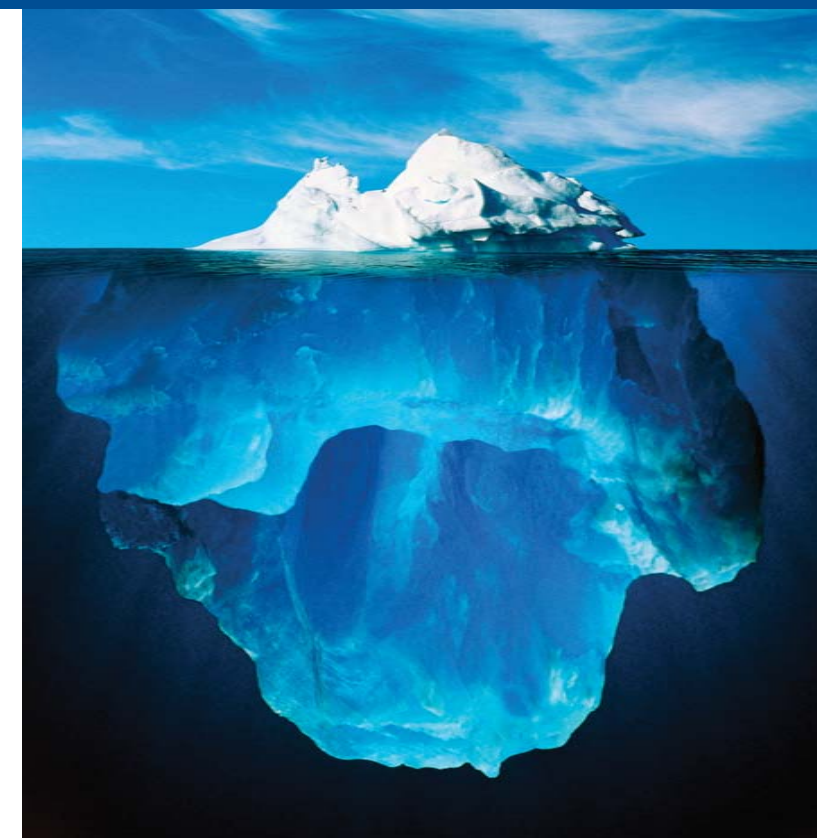
Steering Clear of Trouble: *Responding to Current Market Trends*

Uncharted and icy waters confront today's real estate finance industry. Previously non-observable risks, obscured by rising rents and cap rates that are melting away, now loom ahead. This edition of *The Counselor* addresses some of the problems presented by these emerging risks, and how to chart the best course through them.

The current “credit crunch” has been attributed to a variety of causes. Most prominent is the perception that pre-July 2007 lender underwriting practices were lax. Inevitably, returning to normalcy requires a response that allays investor concerns. How this process plays out will doubtless impact how CMBS originators do business.

In the Year Ahead, Expect to See:

Loan Selection More Rigorous. In absolute terms, loan kick-outs by b-buyers have increased demonstrably over the last year. Beyond getting comfortable with basic underwriting, the current philosophy is to remove a fixed percentage of loans, irrespective of overall loan quality. While previously a loan with a seasoning issue might have been accepted with structural safeguards, that's less true today if it's perceived as among the weakest percentage of the loans being sold. Consequently, an individual loan seller has to look both at its other loans and the loans of co-sellers to calibrate kick-out risks. On balance, this makes taking a flyer on a loan with a story less likely.



Loan Disclosure More Intense. Transparency is the catchphrase of the moment. Where lender underwriting has indulged pro forma or other aggressive assumptions, disclose such items in offering materials and discuss the related rationale in the asset summary.

Refinancing or “Balloon” Risk More Critical. Liquidity problems and cap rate compression combine to put downward pressure on commercial real estate values in many markets. Newly-originated loans are expected to have low leverage and amortization, and to be supported by stabilized income streams. Pay attention to sources of contingent liability or disruptions to income, such as tenant or third-party remedies (e.g., lease or CCR-derived), lease rollover risks, or sponsor funding risks (e.g., springing escrows) that could be particularly problematic in an economic downturn.

(Continued on Page 2)

Copyright © 2008 by Andrews Kurth LLP. All Rights Reserved.

This newsletter has been prepared by Andrews Kurth LLP for informational purposes only and does not constitute legal advice. This information is not intended to create (and receipt of it does not constitute) an attorney-client relationship. Readers should not act on this information without seeking professional counsel. Prior results do not guarantee a similar outcome and depend on the facts of each matter.

ANDREWS
ATTORNEYS KURTH LLP

andrewskurth.com

ANDREWS
ATTORNEYS KURTH LLP

STRAIGHT TALK IS GOOD BUSINESS.®

Steering Clear (from Page 1)

Less Leniency for Self-Inflicted Problems. For 2008, expectations are that there will be fewer securitizations and fewer loans in each deal. Loans tainted by having been kicked out of previous pools are harder to sell. Accordingly, loans that do close should be as issue-free as possible. Some frequently encountered or otherwise important issues:

- *Document Changes.* Some changes are contemplated by existing documentation (e.g., ownership transfers prior to pool closing), but corrective changes, particularly to accounting tape-related matters such as payment or prepayment terms, can require immediate attention. Not identifying corrective changes in a timely fashion can either delay the loan sale or result in potential liability.
- *Post-Closing and Interim Servicing Event Risk.* Put simply, nothing of a material nature should be pushed to post-closing unless there is an absolute assurance it will be satisfactorily performed within the time available. The key word is "material." Closing with only a temporary certificate of occupancy, for example, would be defensible if the conditions to issuance of a permanent C/O were routine, and escrows or carve-outs backstop the undertaking, but not if there is a potential risk that the project could be shut down or tenant remedies would be triggered. Likewise, watch for underwriting contingencies that can occur prior to pool closing (e.g., springing escrow trigger events), and be prepared to act if triggered. Often the loan presentation has to be trued up to the current situation.
- *Insurance Tie-Out.* Where underwriting relies upon insurance to mitigate special risks (e.g., coverages for building law and ordinance, flood, earthquake, or rent loss with an extended period of indemnity), confirm that such insurance is in place as prescribed. Where property due diligence identifies the related risk or insurance requirements are imposed late in the loan closing process, this can fall through the cracks. Insurance matters are among the most stringent and detailed reps and warranties.
- *REMIC Issues.* Escrows that approach 10% of the underwritten property value should be flagged for REMIC scrutiny. Overbroad "lender discretion" release criteria, while more frequently encountered with partial releases and collateral substitutions, create REMIC problems if release criteria for

super-sized escrows are not carefully drafted. Watch for large performance holdbacks and hotel-type property improvement plan escrows, for example.

Beware Hidden Retail Risks: *Co-Tenancy Impacts*

In an economic downturn, the interplay of retail lease provisions can create surprising risks that would be viewed as remote in more buoyant circumstances. The impact of "go dark" and co-tenancy provisions are particularly important, since physical vacancy frequently precedes economic vacancy. A major tenant's right to go dark (particularly where the landlord has not negotiated the right to regain control), in combination with co-tenancy remedies, can be devastating. Thorough lease due diligence is required to identify co-tenancy triggers, the extent of available tenant remedies, and current compliance status. All are important to underwriting and assessing rollover risk and related escrow sizing. Shadow anchors are particularly troubling: due diligence access is limited and no ability to cure defaults by the shadow anchor's landlord exists. To mitigate co-tenancy risks, a landlord must have latitude in obtaining replacement tenants to deflect tenant remedies. Where co-tenancy risks are apparent, underwriting adjustments should be considered to account for the greater-than-usual impact of lease rollovers.

Scanning the Horizon: *Anticipating Servicing Actions*

Loan servicing and surveillance have assumed greater prominence in the current economic cycle. Servicing initiative and flexibility are derived from the governing loan documents; "look beyond the forms" to anticipate information demands that might serve as an early warning device for loan-level stress, and pay attention to process and action triggers that can impact secondary market transactions. Some pointers:

- *Watch for Special Compliance Requirements.* Wherever a regulatory overlay exists (e.g., Section 8 housing, Land Use Restriction Agreements, Industrial Development Authority-based incentives), assure ongoing compliance by requiring that the borrower include compliance-related certifications or other comfort as part of its usual financial reporting.

Non-compliance can result in potentially severe remedies, including cessation or even disgorgement of the related benefit originally conferred, upsetting underwriting assumptions.

- *Remember to Backstop Special Covenants with Information.* Monitoring and enforcing financial or special performance-related covenants likewise necessitates that related information be provided (e.g., sponsor net worth and liquidity updates). Include these types of information requests among routine quarterly or annual reporting requirements.
- *Interim Servicing Considerations.* The time between loan closing and pool closing can be rife with risks for the loan originator and servicer. In addition to payment monitoring, changes in tenants, litigation, casualty or condemnation, late payments, guarantor issues, and even routine servicing actions like assumptions or releases create disclosure, reps and warranties compliance, or other liability-related issues that need to be monitored continually as a securitization moves to market.
- *Push. Don't Pull.* Given servicer workload, it's more effective to require a borrower to push special issue-type information than to merely retain the right to pull it from them. Also, consider appropriate behavioral incentives (escrows or fees) if borrowers do not comply.
- *Be Careful of "Deemed Approved" Mechanisms or Tight Turnarounds.* Assumption applications are increasing. Absent special and compelling circumstances, loan documents should not commit to specific timeframes for lender/servicer responses, including provisions that equate non-action with approval after a specified interval. Specify the contents of the information package required to process a servicing request, so that time is not wasted with undue back-and-forth.

Legislative Update: *Terrorism Insurance*

In December, President Bush signed the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA), extending the Terrorism Risk Insurance Act which was set to expire. TRIPRA addresses significant lender concerns by extending the program seven years, covering domestic acts of terrorism, and providing for a study on coverage for nuclear, biological, chemical and radiological attacks.

Borrower Expectations: *Loan Assumptions*

With the change in financial markets and heightened scrutiny of borrowers and loan structures, borrowers hoping to sell properties via assumptions should smooth the process with detailed preparation. For loans that are included in securitizations, the servicer will require items set forth in its own assumption checklist and any related pooling and servicing agreement. Borrowers should notify the lender/servicer of its proposed sale/assumption and begin early to organize and prepare all required items, including:

- Review loan documents for sale/assumption requirements, transferee criteria and approvals (typically the lender has sole discretion in approving the new borrower).
- Make sure all property information, schedules, reports and financials have been timely provided and the borrower is in compliance with loan obligations.
- Provide detailed information on the proposed new borrower/assumptor; note that the lender/servicer must evaluate the creditworthiness of the borrower and its principals (net worth, background checks, relevant experience, Patriot Act compliance, adequacy of proposed guarantor/indemnitor, property management and insurance).
- New borrower/assumptor organizational documents, opinions and assumption documents meeting applicable requirements should be included in submission package; remember that modifications to loan terms are not likely to be permitted.
- The submission package should be complete, and make it evident that the new borrower/assumptor will not negatively affect the expected performance on the loan; since the lender/servicer typically has substantial discretion in granting approval and, if the loan has been securitized, has a duty to the trust in granting approval, a strong positive case should be made for why approval should be granted.

Fortunately the assumption process has improved in recent years due to improved servicer procedures, published rating agency criteria, and publications and efforts by two key industry associations, the Commercial Mortgage Securities Association and the Mortgage Bankers Association, which often work together to provide borrower and lender/servicer tools and information.