A Borrower's Guide to Doing Business With a Securitizing Lender

Once the current market turmoil subsides, the benefits of borrowing from these lenders can outweigh the difficulties.

STEPHEN P. LIESKE AND GLENN D. BLUMENFELD

Because this article appears after a traumatic spasm in the securities marketplace, we preface our discussion with a brief description of the recent turbulence and assert our belief that the market will ultimately return to some semblance of its former self, albeit with some different players and perhaps more conservative underwriting. In response to disruptions in markets far from this country, an unprecedented flight to quality occurred in the fixed income debt marketplace resulting in a massive diminution in the value of commercial mortgage-backed securities and of commercial mortgage loans in the portfolios of lenders who were holding loans for securitization.

During some days in the fall of 1998, it was impossible to sell commercial mortgage-backed bonds at virtually any price and, consequently, commercial mortgage lenders who made mortgage loans intended for the capital markets were simply unable to price their loans. Loans that had priced during the summer of 1998 between 100 and 200 basis points over corresponding U.S. Treasuries could be had, if at all, 200 basis points wide of those midsummer prices. The consequent rapid deterioration of loan values brought margin calls on the warehousing lending lines of many conduit lenders who had built their businesses on significant leverage. Many of these conduits had to scramble for cash. The least of their problems was their inability to make new loans; many were facing potential insolvency.

Many market observers and market makers agree that what happened was not a death blow to commercial real estate mortgage securitization, but merely a disruption of that market. This blip punished those who ignored interest rate risk while playing the game of leverage with limited capital and rewarded those who did not. Although the authors are attorneys who serve this roiling marketplace and not specialists in its pathology, we agree with those who assert that the credit crunch of late 1998 will ease, leaving a functional capital market in its wake. Functional it may be, but certainly somewhat less amiable for the aggressive borrower. But, to return to the proper beginning of this article, what is securitization and what are the capital markets?

WHAT IS SECURITIZATION?

The ease with which bankers now use the terms *conduit* and *securitization* might suggest that these concepts have been a part of the world of banking and finance since the deMedici's were financing the wars of fifteenth century kings and princes. Actually, the business of accumulating real estate mortgage loans into pools of loans and ultimately creating securities evidencing ownership interests in such pools, the sale of which securities fuels the business of making new loans, is a relatively new form of commercial lending. Moreover, when viewed against the backdrop of traditional methods of lending, it is not always possible to ascertain the requirements

Stephen P. Lieske is an associate with the San Francisco office of Allen, Matkins, Leck, Gamble & Mallory LLP. Glenn D. Blumenfeld is a partner in the real estate department of Dechert Price & Rhoads in Philadelphia, Pennsylvania. Special thanks to Richard D. Jones, Chairman of the Real Estate Practice Group at Dechert Price & Rhoads, for his assistance in writing this article.

imposed on borrowers seeking to tap this new source of capital.

However, borrowers and legal counsel who understand the basics of conduit lending and securitization can 1) avoid spending costly hours attempting to negotiate provisions for which the strictures of the securitization process leave the lender little or no flexibility, and 2) harvest the opportunities that securitized lending affords.

What Is a Conduit?

The term *conduit* is shorthand for a banker's program, or pipeline, of loans that are destined for securitization.[1] In other words, in a conduit program, from the first day of the underwriting process the lender intends to sell the loan into a securitization, rather than to retain the loan for its own investment portfolio. Typically, the sale does not occur until after a warehouse period during which the lender holds the loan while it is accumulating enough loans to create a pool large enough to securitize economically. During the first half of 1998, several pools that moved to the market contained over $3 billion.

The Securitization Process

Securitization is simply the process of creating a security. In the commercial mortgage loan securitization industry, the security typically takes the form of a certificate representing an interest in a trust that is created to hold a pool of mortgage loans.

The securitization process is a six-step process that is summarized below and is shown graphically in Exhibit 1.

Step 1 Lender makes mortgage loans to borrowers.

Step 2 Lender warehouses the loans until the Lender accumulates a sufficient volume of loans to securitize economically.

Step 3 Lender sells the loans to an accommodation party called a *depositor*, which transfers the loans to single-purpose trust.

Step 4 The trust acquires the loans with the proceeds of the simultaneous sale to investors of certificates representing ownership interests in the mortgage loans held by the trust. Certain classes of the certificates may be rated by one or more of the nationally recognized Rating Agencies (Standard & Poor's Ratings Services, Fitch IBCA, Inc., Moody's Investors Service, Inc., and Duff & Phelps Credit Rating Co.).

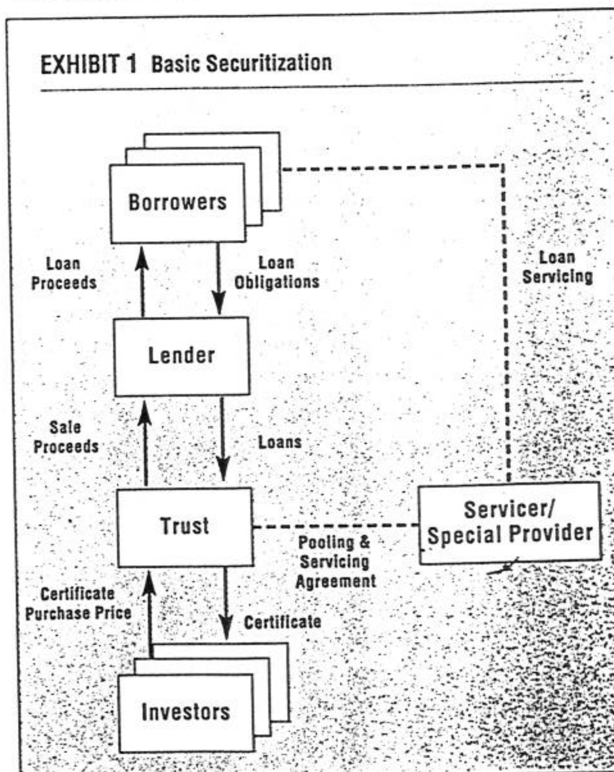
Step 5 The trust engages a "master servicer" to service the loans in the trust, and a "special servicer" to service problem loans (e.g., delinquent or defaulted loans). The relationship among the servicers, the trustee, and other parties to the transaction are described in a document known as a *Pooling and Servicing Agreement*.

Step 6 After a borrower's loan is securitized, the borrower is instructed to make loan payments and direct all inquiries to the servicer. Except for this requirement, which is no different from other situations where a loan is sold, the actual securitization process is almost completely transparent to the borrower.

ECONOMIC EFFICIENCIES AND THE RATING PROCESS

By pooling mortgage loans and repackaging them into securities in a more or less standardized format, conduit lenders are able to create multiple securities with varying economic characteristics that can be sold to a range of investors, each with different investment needs and different toler-

EXHIBIT 1 Basic Securitization



ances and appetites for risk. The loan originator realizes profits upon the sale of the loans if, because of yield efficiencies created by multiple classes of securities, the weighted average yield on all classes of securities that are sold is lower than the weighted average interest rates on the underlying loans in the pool. The fact that the sum of the parts is worth more than the whole has enabled lenders to sell the pool of loans at a premium over the face value of the underlying loans.[2] The lender can earn additional profits by generating origination and servicing fees, which are activities that do not tie up capital in long-term investments.

In the borrower community, the institution of conduit lenders has had its proponents and detractors.

As the securitization market has developed, a critical component of almost every deal structure is that the resulting securities (or at least most of them) are rated by one or more of the nationally recognized Rating Agencies.[3] Rating is a process by which the Rating Agencies analyze the credit risk of a particular pool of mortgage loans.[4] If the pool contains very large loans or a combination of large and small loans (known as a fusion deal), the Rating Agencies may actually visit the properties securing the largest loans and perform an underwriting and a legal analysis of these loans. On the other hand, in pools consisting of only smaller loans, because the risk of loss is spread across a diverse collection of assets, individual loans may receive relatively little Rating Agency scrutiny.

In order to assign a rating to securities, Rating Agencies perform due diligence on the pool of loans. The analysis of any particular loan depends on its size relative to the size of the overall pool. However, it may include an analysis of the lender's underwriting, the quality of the collateral, the structure of the loan, the reputation of the originator, and the legal documentation for an individual loan vis-a-vis guidelines established from time to time by the individual Rating Agencies. Based on its diligence and modeling of the frequency and magnitude of losses, the Rating Agencies assign subordination levels to the pool. Subordination as to any specific security refers to the amount or value of securities that are junior in right (i.e., in right of payment) or "subordinate" to the class of securities in question. In a hypothetical pool of loans, perhaps 25–30% of the securities may be "subordinate" to the AAA rated securities. Thus, for example, 70–75% of the securities may be rated AAA, 10% of the securities may be "subordinate" to the AA rated securities, and so on, until, at the bottom of the subordination pyramid, one finds the securities that the Rating Agencies cannot rate, which are the most subordinate of all classes. These more risky securities are sometimes called the "B Piece."

Each class of securities is paid in the order of its subordination (i.e., the AAA are paid first, then the AA and so on).[5] Accordingly, losses on defaulted loans are first applied to the unrated securities and then to each class of rated securities in inverse order of subordination. Thus, with respect to any individual class of securities, the unrated and lower-rated classes effectively serve as a collateral cushion for the higher rated classes; this is sometimes referred to as overcollateralization. The size of the collateral cushion has a corresponding effect on pricing because the interest rates on each certificate bear an inverse relationship to their rating (i.e., the higher the rating, the lower the risk, the lower the interest rate, and vice versa).

CHARACTERISTICS OF CONDUIT LENDERS

In the borrower community, the institution of conduit lenders has had its proponents and detractors. Although the line between portfolio lenders and securitized lenders is blurring, there are, nonetheless, factors that distinguish the conduit community from the portfolio lending community. Although conduit lenders are diverse, it is possible to generalize to a certain extent.

Uniformity of Documentation

One of the factors that characterizes conduit lending is the external imposition of a significant level of uniformity in the structure and documentation of the loans destined for the securitization process. Simply put, loans that are not homogenous in size, terms, condition, structure or loan documentation challenge both Rating Agencies and investors who wish to assess credit, quality, yield and return on securitized pools of loans. Consequently, these non-homogenous loans are worth "less" to the marketplace. This makes it possible to contrast a conduit lending execution generically with the typical portfolio product by making the following assumption: for a portfolio lender, virtually everything is negotiable; for

the securitized lender some things simply are not.[6]

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Advantaged Pricing

If securitized lenders are inflexible, why have they, until recently, become such a popular source of funds? One reason is that securitized lenders have been able to provide more proceeds at lower interest rates. For significant periods during the five years prior to the early fall of 1998, it was possible to obtain more proceeds at a lower all-in interest rate from many securitized lenders because the strong demand for mortgage-backed securities caused the lending community to structure and price loans more and more aggressively.

However, as evidenced by the recent turmoil in the capital markets, a securitized lender's pricing advantage may rapidly become a disadvantage. When demand for the resulting securities slackens, pricing widens (i.e., investors demand higher returns) and underwriting tightens. As noted, when this article was being written, market volatility caused some conduit lenders either to leave the market entirely or to suspend operations temporarily because they were unable to determine how to price their loans.[7]

Non-recourse Lending

Conduit lending is almost uniformly non-recourse to the borrower and its principals. In other words, the lender agrees that if the borrower defaults, it will look solely to the value of the property to recover the debt. The lender further agrees that it has no right to recourse against the borrower or the borrower's principals. Many portfolio lenders, on the other hand, insist that the loan documents provide not only recourse to the borrower, but also include a guaranty from affiliates and/or principals. Although there are typically carve-outs to the non-recourse provisions in conduit loan documents (fraud, breaches of environmental representations, misuse or misapplication of funds permit the lender to proceed against the borrower and/or its guarantors) many of the carve-outs are circumstances wholly within the borrower's control. Moreover, there may be flexibility in negotiating carve-outs and, in many cases prior to the recent turmoil, securitized lenders agreed to limit the carve-outs to the borrower and not to require joinder of the borrower's principals. This limitation, of course, renders the carve-outs fundamentally meaningless because most borrowers are single-purpose entities (see discussion below) with no assets other than the mortgaged property.

Borrowers and their counsel should, however, take special care when they review carve-out provisions, and they should make sure that the borrower is actually getting a non-recourse deal.

In addition to non-recourse carve-outs, the lender, if it has concerns about the environmental condition of the property, may require that a third party deliver an environmental guaranty. Lenders address this on a deal-by-deal basis, and they have no universal requirement that such an indemnity be delivered.

Alleged Closing Speed

According to their own representatives, conduit lenders are quicker to close than most portfolio lenders. The proof of the pudding is, of course, in the eating, and it behooves the prudent borrower to test such assurances by talking to other borrowers or to the mortgage banking community before making a decision based upon alleged speed to close. Because there is nothing intrinsically speedier about the conduit process than the portfolio lending process, any sort of global claims to speediness by the securitization industry may be viewed with a certain degree of cynicism. Instead, the track record of the individual specific lender should be researched by the prospective borrower.

On a more solid, analytic footing is the assertion that conduit lenders rarely have to be concerned that problems of borrower product type or geographic concentration will interfere with the processing of the loan. Portfolio lenders often encounter significant restrictions in their ability to make certain loans because either internal or regulatory restrictions limit their activity to lend in some locations or to some industries. For example, if a portfolio lender has already reached its limit on loans secured by a specific type of property within a specific geographic region, it may be prohibited from lending even to a borrower that has approached the lender with a high-quality asset. The typical securitized lender has no such limitation.

As can be gleaned from this analysis, borrowers find securitized lenders are more attractive when the deal gives the borrower more money or if alternatives appear to be recourse. What drives some borrowers away from what would otherwise be a good execution in the securitization market is what we will call the "securitization baggage."

Securitization baggage is, of course, the bad news.

SECURITIZATION BAGGAGE: THE BAD NEWS

The baggage is, of course, the bad news. There may be costs and structural constraints in the securitized lending world that some borrowers may find unpalatable. As indicated above, the documentation, structure, and diligence requirements of securitized loans tend to be more homogenous than those of portfolio loans. These factors may be problematic for individual lenders with idiosyncratic organizations or needs. As the securitization industry has matured during the last five years, investor and Rating Agency expectations and requirements have solidified, creating steady pressure on the originators to conform to industry modalities. If the Rating Agencies or the investor community look less favorably at variations in structure, underwriting or diligence, originators whose loan applications vary will receive less proceeds upon the sale of their loans in the securitization process. This may occur because the Rating Agency displeasure may translate into unfavorable subordination levels, or the investor community will require higher yields to purchase the bonds. Alternatively, if such variations are regarded as material, the loans may be ineligible for the pool and the originator will be stuck with those loans. Recent evidence indicates that when a significant percentage of the loans (in terms of value) in a pool deviate significantly from industry and Rating Agency norms, there is a concomitant and significant reduction in the securitization value of the loans. Faced with this reality, prudent lenders will, of course, rigorously resist borrower requests for accommodation or require those borrowers to pay with price proceeds or other deal terms in exchange for accommodation.

For this reason, it is useful to summarize some of the most significant structural requirements imposed upon borrowers by the Rating Agencies and by the expectations of the bond investor community.

The Bankruptcy Remote Single-Purpose Entity

Perhaps the most famous hallmark (some say, the idiosyncrasy) of securitization is the requirement that the borrower and its general partner or managing member be a single-purpose entity. There has been, and there still is, enormous confusion regarding the requirements for being a "single-purpose entity" (in shorthand, SPE). The genesis of the SPE requirement lies in the nature of the rating process. The rating of any type of asset-backed security depends upon a number of assumptions made by the Rating Agency. One of the most important is that the analyst can determine the size and certainty of the underlying income stream derived from the assets that back the securities without regard to external credit concerns. In other words, the analyst can safely assume that only the quality of an underlying asset affects the value of the securities and that the borrower has no other businesses and no other obligations and liabilities that might interfere with the economics of the rated asset. The concept of the bankruptcy remote single-purpose entity arose from this fundamental need to isolate the rated asset.

Starting at the beginning, the Rating Agencies uniformly require that loans above a certain size must be made to an SPE borrower.[8] If loan size exceeds the designated threshold, the requirement that the borrower and the borrower's general partner or corporate member be single-purpose entities is virtually non-negotiable.

Not only must the borrower, general partner and/or managing member, if applicable, be a single-purpose entity, but if the entity in question is a corporation, it must also have an independent director.[9] In contrast, a portfolio lender typically does not require that a borrower be formed solely for the purpose of owning and operating the mortgaged property, much less require that the borrower be a single-purpose entity. This is due, in part, to the fact that, in many instances, the portfolio lender may have recourse against the borrower or a creditworthy guarantor and, therefore, is not limited to recovery solely against the underlying asset.

Each lender makes individual judgments about how much compliance the market will require.

Single-purpose entity requirements are so comprehensive that they go well beyond merely requiring that the borrower be organized solely for the purpose of owning and operating the property or properties to be mortgaged in favor of the lender. Rather, they establish a detailed set of criteria, or separateness covenants, driven primarily by the need to make the borrower bankruptcy remote (i.e., that it is unlikely that the borrower will file for bankruptcy protection if the lender has properly underwritten the loan). This set of criteria has developed over the years based on various bankruptcy cases and also on cases addressing the issue of "piercing the corporate veil where corporate or partnership formalities are ignored or misused."

The basic premise of the SPE criteria is that not only must the borrower be organized solely for the purpose of owning and operating the property, but also that the borrower must affirmatively conduct its business activities completely separate and apart from the business of any other entity or individual. Typical separateness covenants include requirements that the borrower have no assets other than real and personal property related to the operation of the real property collateral, utilize separate stationery and invoices, have separate books and records, have a sufficient number of employees, and maintain sufficient capitalization for its business activities. An additional requirement of securitized lenders, which many borrowers consider problematic, is a requirement that the borrower have no other indebtedness other than trade payables that the covenants limit to some relatively small percentage of the overall loan amount, all of which must be paid within a relatively short time after they are incurred.[10]

Borrowers of loans whose size falls below the thresholds set by the Rating Agencies may not need to adhere to the full panoply of structural elements and obligations required of borrowers of larger loans in order to be bankruptcy-remote single-purpose entities. However (and this has already added to industry confusion about these issues), the Rating Agencies are likely to give higher ratings to borrowers that are at least single-asset entities, meaning that the borrowers carry on no business other than owning the mortgaged asset and have no liabilities or obligations other than those arising out of the operation of the mortgaged asset. Moreover, investors, particularly buyers of the subordinate securities, view single-purpose entity status as quite important and, to a somewhat uncertain extent, show significant preference for loans that are structured as closely as possible to the Rating Agency model of the bankruptcy-remote SPE. As each conduit tries to read the Rating Agencies' minds about at what size level the Rating Agencies will begin to care about conformity to full blown SPE requirements, they may arrive at different conclusions and thus vary substantially in their own requirements. In this area, there is substantial variability amongst conduits, and there is some room for negotiation. The size level may also vary depending on the average loan size in the pool as compared to the overall loan pool. No one can, with any confidence, define the "cost" of deviation from full SPE compliance and, therefore, each lender makes individual judgments about how much compliance the market will require. It is, however, fair to say that, except for very small loans, the borrower will be required to conduct no business other than the operation of the mortgaged property, and will be required to incur no debts or obligations other than those incurred in connection with the operation of the mortgaged property. If the borrower fulfills these basic requirements, it may find room for a fair amount of horse trading on the subject of borrower organization. It is important to note that if the prospective borrower is not an SPE, it could be prohibitively expensive to obtain a conduit loan if the asset must first be transferred into an SPE compliant entity because of the imposition of transfer taxes or other similar transaction costs. As a result, attorneys should plan ahead when creating borrowing entities in order to facilitate the possibility of future conduit borrowings.

Transfers of Equity Interests; Non-Consolidation

Another requirement of conduit lenders that may affect some borrowers significantly is the restriction on the transferability of equity interests in the borrower and in the borrower's general partner or corporate member. Typically, securitization lenders prohibit transfers of equity interests (direct or indirect) aggregating more than 49 per-

cent without the lender's consent, and they permit such transfers following securitization only upon the satisfaction of certain requirements (e.g., only if Rating Agencies confirm that the transfer will not have an adverse effect on the securities). This requirement increases the cost of and may delay the transfer. The reason for the transfer restrictions, like the reasons for the other single-purpose entity requirements, is Rating Agency concerns about a bankruptcy doctrine known as *substantive consolidation*. Substantive consolidation is an equitable doctrine of the bankruptcy courts. If the court views two or more separate entities as effectively one entity for the purpose of dealing with their respective creditors, the court may order the consolidation of the assets and liabilities of the entities. This could happen, for example, in a situation where the sole shareholder of a company does not observe corporate formalities (i.e., such as shareholder minutes and director votes) and treats the assets of the corporation as her own. If, as the consequence of substantive consolidation, the creditors of the borrower's affiliate can reach the borrower's assets, the security for the repayment of the loan obligations would be impaired, and the economic effects on the certificateholders/investors could be catastrophic.

In addition to requiring the borrower and its general partner (if the borrower is a limited partnership) or its corporate member (if the borrower is a limited liability company) to be single-purpose entities, the Rating Agencies require borrower's counsel to deliver a legal opinion on the issue of substantive consolidation. Because the law is not consistent, and because of the fact-specific nature of the application of the law, this opinion is typically issued as a "reasoned" opinion that can exceed thirty pages in length. Many lawyers are reluctant to render such opinions and those who do may charge accordingly. As a result, borrowers discover that delivering the opinion may be very expensive.

If a particular loan is not large compared to the size of the total pool, and if the ownership makeup of the borrower is favorable, the lender may be willing to relax the requirement that borrower's attorney deliver a non-consolidation opinion. Borrowers, therefore, should inquire in advance about the lender's requirement for an opinion in connection with a particular loan. If the lender will forego its requirement that the borrower deliver a substantive non-consolidation opinion, the lender may impose cost elsewhere (say, by means of additional interest rate spread) if it believes that the absence of the opinion will have an adverse effect on the lender's ability to securitize the loan or the loan pool.

Cash management provisions address the desires of the Rating Agencies and investors to limit the borrower's access to the cash flow from the mortgaged property.

Cash Management Requirements

Another significant feature in conduit loans is the so-called cash management provision, which addresses the desires of the Rating Agencies and investors to limit the borrower's access to the cash flow from the mortgaged property. The creditors want the money to be devoted first to service debt, to pay taxes and insurance, and to maintain the property. When real estate is performing well, cash management is not an important creditor concern (absent fraud on the part of the borrower). But these clauses are not concerned with the good times. Rather, typical cash management provisions are designed to ensure that when cash inflow is limited, the money first goes to satisfy the items listed above before any dollars flow into the borrower's pocket. This is especially important in conduit loans because the lender's recourse is limited to the mortgaged asset.

The management of asset cash for securitized loans typically takes one of three forms:

- **A "hard lockbox" into which all cash receipts from the property are paid by the tenants and trapped in a lender account.** The lender releases portions of the cash to the borrower only after debt service payments have been made and all required reserve accounts (e.g. debt service, capital replacements, insurance, taxes, and tenant improvement or commission reserves) have been funded;
- **A "soft lockbox" that requires all cash receipts from the property to be deposited into a lender controlled account.** However, until the occurrence of a "cash trap event" (e.g. default, low debt service coverage ratio or failure to satisfy certain other deal-specific conditions), the borrower either has direct access to the account or the account balance is swept daily into a borrower-controlled account; and

- A "springing" account in which all lease payments are made to an account controlled by the borrower, until the occurrence of an event of default or other "cash trap" event. If that happens, the lockbox "springs" shut, and the tenants are then directed to pay directly into a lender-controlled account.

Like most requirements in the world of securitized lending, the form of the cash management required by a lender depends on how the lender believes the Rating Agencies and the prospective investors will perceive the loan.

> Because reserves relate to the preservation of the collateral (including future cash flow), they are popular with investors and the Rating Agencies.

Not surprisingly, hard lockboxes are the most popular with Rating Agencies and potential investors. When cash flow moves into a hard lockbox, there is little or no risk that, so long as tenants are making their monthly lease payments, there will be insufficient cash to pay debt service and expenses for the property. On the other hand, the "springing" cash management account provides in large measure illusory protection, because when it springs, the lender is unlikely to have needed borrower cooperation. The soft lockbox appears to be a viable compromise as the lender's maximum risk is the loss of one month's rents should the borrower abscond with or misapply rent payments. (If an event of default has occurred, the lockbox goes completely "hard," and the lender subsequently controls all cash.)

Although a lockbox account is not an absolute requirement for a securitized loan, cash management does increase the value of the loan to the lender. Of course, borrowers generally abhor any device that gives the lender control over the life blood of the borrower's business and provides the lender with a powerful tool to control the borrower's project in the event of a default or other cash management event. Their conflicting interests must be resolved by a negotiation in which rate, loan proceeds, recourse, the absence of reserves and the quality of conformity of the transaction structure with SPE requirements all play a role. The borrower should understand that the issue of cash management is negotiable, but that there are actual, if somewhat difficult to define, costs associated with buying flexibility. Sometimes some of those costs can be reduced with the use of other deal features like reserves and the like.

Requirements for Reserves

The lender's requirement for reserves is a corollary issue to cash management. The requirements are ultimately a function of the type, condition, and nature of property and the size of the loan involved, but they minimally include requirements that upon loan origination and/or periodically thereafter a borrower fill reserve "buckets" for taxes and insurance. Other typical reserves that lenders require are earmarked for deferred maintenance (i.e., funds to cover existing maintenance or repair requirements that must be completed shortly after the closing), capital expenditures, and leasing expense/rollover reserves.

As expected, because reserves relate to the preservation of the collateral (including future cash flow), they are popular with investors and the Rating Agencies. This does not mean, however, that all reserves are always required in every deal. Moreover, there are always two issues with respect to each reserve: The first is, will there be a reserve, and the second, how much will be in the reserve account. In some cases, the lender is most interested in simply having a reserve but is less concerned with the size of the reserve. This is particularly true when the lender is building a middle market or relatively small securities deal, which the Rating Agencies and investors are likely to assess by virtue of the aggregate data rather than by analysis of particular loans. In such deals, the fact that a large percentage of loans in the pool include reserves can be extremely important, but the actual magnitude of particular reserves is likely to be negotiable because the individual loans are not likely to be analyzed in the securitization process.

As negotiations over reserves open, the borrower should have a clear understanding of the financial strength and physical condition of the property and have access to all the third-party reports that the lender has obtained. Borrowers and their counsel should also carefully consider the mechanism for obtaining release of the reserve funds and the requirements that the lender will impose to effect a release of funds. Also open for negotiation is whether or not the reserves will be invested in interest bearing accounts.

Obviously, the longer the amortization period, the greater the refinancing risk to the lender.

Mezzanine and Subordinated Indebtedness

Occasionally, either the appraised value of a borrower's property or its cash flow will not support the level of first priority indebtedness that a borrower may wish to borrow. Because conduit loan documents absolutely prohibit the inclusion of subordinated indebtedness in the pool, a borrower would seemingly be left with no viable source of additional funds other than additional capital contributions if the first mortgage loan is insufficient to fund its capital requirements. One possible solution to this dilemma is mezzanine financing.

A mezzanine loan is made to an equity owner of the borrower other than the single-purpose entity general partner or corporate member.[11] That entity may then contribute the proceeds of the mezzanine loan to the borrower's capital.[12] Typically, the equity borrower secures the mezzanine loan by a pledge of its ownership interest in the borrower. (See previous discussion regarding equity transfers and non-consolidation.)

Because of Rating Agency concerns regarding equity ownership and substantive consolidation, the Rating Agencies will require that certain restrictions regarding transfers of the mezzanine indebtedness and foreclosure on the equity interests be built into the mezzanine loan. The requirements include restrictions that before the mezzanine lender transfers the loan to a new mezzanine lender or forecloses upon the equity and becomes an equity owner in the borrower, 1) the Rating Agencies confirm that there will not be an adverse impact on the securities and 2) a new substantive non-consolidation opinion is rendered. Complex intercreditor negotiations between the conduit lender and the mezzanine lender will often be required in order to balance the concerns and requirements of these parties.

Insurance Requirements

Like any other borrower of real estate secured funds, the borrower of funds from a securitizing lender is required to obtain and maintain various types of insurance; typically hazard, casualty, liability, and business interruption insurance. The minimum amounts and maximum deductibles are set by the lender based on standard underwriting criteria and the type and location of the property.

One wrinkle of which borrowers should be cognizant is the requirement by certain Rating Agencies that the insurance carrier meet or exceed a minimum rating. The Rating Agencies' reason is that the real property and the income that the real property generates is the sole credit support for the loan. Accordingly, if the property is damaged or lost, or if the business is interrupted, the security for the loan becomes the financial strength and wherewithal of the insurance carrier. In a typical pool transaction, Rating Agencies may require that the insurance carrier have a AA rating, a requirement that limits choices among insurance carriers and may increase the borrower's insurance costs.

An insurance item that is sometimes the subject of negotiation is the required number of months of business interruption insurance that the borrower must carry. The current industry norm is twelve to eighteen. As one would expect, the Rating Agencies and potential investors would prefer a larger number, sometimes requiring as much as twenty-four months coverage for certain specialized assets. Borrowers must weigh the cost savings of carrying a lesser amount of business interruption insurance against the increase in interest rates or decrease in loan proceeds that the lender may offer because of the lighter load of business interruption insurance.

If the borrower's tenant has the right to terminate a material lease in the event of a casualty, the Rating Agency may require the borrower to obtain special coverage that insures the lender for an amount equal to the outstanding debt upon the occurrence of a casualty, regardless of the actual cost to restore the property. Thus, if a major tenant is entitled to terminate a lease based on damage of $1 million but where the loan balance is actually $2.5 million, the trustee will have adequate funds for repayment of the loan.

SPECIAL PROVISIONS

The provisions discussed above are essentially extensions of traditional real estate underwriting requirements. However, loan documents for securitized loans may also include elements and concepts that are entirely characteristic of securitized transactions.

Hyperamortization

The typical term for a securitized loan in today's market is ten years (longer for certain asset types). Because of cash flow concerns, most borrowers prefer a longer amortization schedule. Obviously, the longer the amortization period, the greater the refinancing risk to the lender. Rating Agencies dislike both long maturities and bullet loan structures in which a significant principal balance overhangs at maturity.

With characteristic creativity, some lenders have responded to the opposing interests of 1) Rating Agency concerns about refinancing risk, and 2) borrower pressure for longer amortization, with what is commonly known as a *hyperamortization* feature. The typical hyperamortization arrangement includes a long-term (possibly 25-30 year), fully amortized loan. However, after a much shorter period, typically ten years, the interest rate significantly increases (typically rising between two and five percent) so that the lender begins trapping all cash flow from the property and applying the monies to the repayment of the loan. (This date is sometimes called the hyperamortization date because at that date the loan begins to amortize rapidly.) Sometimes it is called the optional prepayment date or the anticipated repayment date because the conditions imposed on the borrower at this date are so unpalatable that a refinancing at that point is almost a certainty. In effect, the loan is really a ten-year loan.

During 1998, all four of the major Rating Agencies indicated that they did not believe hyperamortization solves their dual concern about long maturity and bullet structures, and they indicated that they will treat a hyperamortization loan as a bullet loan of the same maturity. Nonetheless, hyperamortization appear to continue to have vitality in the marketplace. Some participants in the capital markets see a hyperamortization feature as, in essence, a prepackaged workout or restructure with a loan at the effective balloon date. Some investors purportedly find this an attractive feature.

Affiliated Property Managers

The Rating Agencies realize that many properties are managed by affiliates of the borrowing entity. Although this is acceptable to the Rating Agencies, their view is that the affiliated property manager should not continue to receive management fees under circumstances in which the certificateholders are not receiving payment or are receiving less than full payment. Accordingly, and particularly on larger loans, lenders often insist on a right to terminate the manager upon the occurrence of certain events (e.g., cash trap events; debt service coverage ratio reductions; events of default).[13] The justification for this requirement is that if income falls below established benchmarks or some other event occurs that impairs the borrower's ability to service the debt, it is the fault of the property manager who is responsible for day-to-day operations.[14] Obviously, the negotiation dynamics for a management kickout right by the lender will differ if the manager is a bona fide third party.

> Lenders often insist on a right to terminate the manager upon the occurrence of certain events.

Prepayment Rights

If the investor can be certain that the borrower will continue to make payments until the security matures, the security is worth more than if those payments can be cut off by borrower prepayment. Consequently, restrictions on prepayment of securitized loans is an extremely important issue for the value of those loans in the hands of the securitizing lender. On the other hand, all borrowers want flexibility and the right to prepay a loan either to refinance or sell mortgaged property.

Virtually all loans intended for securitization are either absolutely closed to prepayment (at least for a certain period of time) or require the borrower to make a *yield maintenance* payment in connection with prepayment. Often both concepts will be incorporated into the loan.[15] A yield maintenance payment is an amount calculated under a formula that will afford to the loanholder a return which, on a discounted basis, is equivalent to the yield that the lender would have earned if the loan continued until its natural maturity, or, in a hyperamortization loan, until the hyperamortization date.

Over the years there has been a fair amount of flexibility in the methods by which various lenders calculate yield maintainance fees. One of the most highly contested issues is the discount rate at which the prepaid amount would be deemed reinvested by the lender until the original maturity of the loan. Virtually all lender yield maintainence formulas assume that the proceeds will be reinvested in a corresponding maturity U.S. Treasury, which carries a rate far below the coupon of the loan. Borrowers often seek to adjust

that rate to something more akin to the coupon of the loan. Generally, the lenders win these arguments.

Defeasance

Quite recently, the concept of *defeasance* has emerged as an alternative to yield maintenance and has obtained some acceptance. In this structure, the loan is absolutely closed to prepayment during its entire term. However, after a two-year delay or lock-out period, a delay that is required by restrictions of the United States Tax Code applicable to the tax structure of virtually all securitizations, the loan can be defeased. Defeasance is a mechanism by which the underlying loan remains outstanding, but the borrower discharges the mortgage lien on its property by substituting other qualified collateral. Essentially, qualified collateral must be U.S. Treasury securities, and the amount of the securities must be sufficient to generate payments exactly matching the monthly debt service payments under the loan and, ultimately, paying the principal of the debt.

What sounds simple is actually a complex and transactionally expensive process. Obviously, because the interest rate on U.S. Treasuries is significantly less than the interest rate on most mortgage loans, the principal amount of U.S. Treasuries needed to defease the loan is significantly larger than the principal balance of the loan. Also, the mechanism of providing the securities and creating a security interest in them, satisfying the lender or, after securitization, the servicer and the Rating Agencies, is complex. Setting up the defeasance is, therefore, an expensive and time-consuming process. To date, defeasance has actually been implemented in only a handful of cases. Nonetheless, as the market continues to mature and if investors continue to pay top dollar for pools of loans with comprehensive defeasance, defeasance is likely to become the norm.

The Problem of Loan Documents

The sheer volume of paper that the lender's lawyers usually place on the borrower's doorstep may be an area of concern for those borrowing from a conduit lender. Although competition has somewhat reduced the complexity of loan documents, the often daunting stack of documents still typically includes a significant loan agreement, a somewhat less weighty mortgage, deed of trust or deed to secure debt, an assignment of leases and rents, an assignment of management agreement and agreements affecting real estate, a manager's consent and subordination agreement, and Uniform Commercial Code financing statements. In addition to the basic business points and the typical requirements that a borrower would expect of any real estate lender, the securitization lender's loan documents address (or address in more detail) the areas described above, all of which are critical to Rating Agency analysis of the loan.

The sheer volume of paper usually demanded by the lender's lawyers usually may concern those borrowing from a conduit lender.

Loan Servicing

The significance for borrowers of servicers and the notion of loan servicing was mentioned only briefly at the beginning of this article In a typical portfolio deal, a borrower establishes a relationship with a lending officer and probably goes back to that individual for modifications and to address issues throughout the life of the loan. In a securitized loan, however, after the securitization occurs and the loan is transferred to a trust, the borrower needs to go to a servicer for modifications and issue resolution. That servicer will have no personal familiarity with the borrower and the loan and, in addition, will be constrained by the Pooling and Servicing Agreement and Rating Agency requirements in the actions that the servicer may permit. Consequently, dealing with a servicer may be time-consuming, frustrating, and expensive, especially for borrowers accustomed to the perhaps more personal service offered by a portfolio lender.

CONCLUSION

Borrowing from a securitization or conduit lender can, in some respects, be complicated and frustrating because of the sheer volume of documents and the complexity of the various requirements. However, once the current market turmoil subsides, the pricing efficiency and other benefits of borrowing from these lenders can often outweigh the difficulty of dealing with these complex requirements. Generally speaking, if a securitized loan is not competitive on the economics, it is not competitive. However, if a securitized loan provides more proceeds at a lower

interest rate with less recourse than other loans, it ought to be the securitized lender's loan to lose. Only if the burdens and obligations of meeting the requirements of the securitized structure represent an unacceptable burden to the borrower should the borrower turn from the securitized marketplace to the portfolio lender.

In order to make the most of the securitized market, the borrower must approach the conduit lender with as full and complete an understanding as possible of the requirements of securitized lending and, indeed, of the conduit lender's position in the marketplace. With this homework done, a borrower is in the best position possible to successfully negotiate with the securitized lender. While there are clearly areas of inflexibility resulting from the Rating Agency process or the norms and expectations of the securitized marketplace, there are still issues to be negotiated and negotiated aggressively. The well-informed borrower will waste neither its time nor its counsel's time in an effort to negotiate issues that are fundamentally non-negotiable, but should focus on those where there is real negotiating room. ■

ENDNOTES

[1]The term "conduit" is also tied to the "real estate mortgage investment conduit" or "REMIC," which is a creation of the Internal Revenue Code, and the preferred vehicle to hold a pool of securitized mortgage loans. If the entity holding the pool, typically a trust, makes a "REMIC election" and satisfies a number of complex criteria, there will be no entity level taxation. In other words, the trust will not be taxed on the income it derives from holding the mortgage loans. Thus, all of the income from the pool of mortgage loans can be distributed to the beneficial owners of the trust (certificateholders), who will be taxed on their share of the income at their individual or applicable corporate marginal tax rates. The reasons for doing this are essentially the same as the reasons for using a limited partnership, limited liability company or "S" corporation as a real estate investment vehicle. The REMIC rules and regulations are complex and complicated, and a detailed discussion of these requirements goes beyond the intended scope of this article.

[2]This was true through the summer of 1998. As mentioned at the beginning of this article, rapidly rising bond yields during the early fall of 1998 turned this notion on its head, delivering losses to originators.

[3]There is no legal or other requirement that a securitization be rated. However, many investors (e.g., insurance companies) may be permitted by regulatory requirements or internal policies to purchase only rated securities. By having a transaction rated, lenders dramatically increase their pool of potential investors and, accordingly, also increase their potential securitization profits.

[4]The offering materials (e.g., prospectus, prospectus supplement, or private placement memorandum) will typically contain the following disclosure about what a rating is and what it is not:

> Ratings on mortgage pass-through certificates address the likelihood of receipt by [the applicable] certificateholders of all distributions on the underlying mortgage loans. These ratings address the structural, legal and issuer-related aspects associated with such certificates, the nature of the underlying mortgage loans and the credit quality of the guarantor, if any. Ratings on mortgage pass-through certificates do not represent any assessment of the likelihood of principal prepayments by mortgagors or of the degree by which such prepayments by mortgagors or of the degree by which such prepayments might differ from those originally anticipated. As a result, certificateholders might suffer a lower than anticipated yield, and, in addition, holders of stripped interest certificates in extreme cases might fail to recoup their initial investments.
>
> A security rating is not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the assigning rating organization. Each security rating should be evaluated independently of any other security rating.

[5]A typical securitization also contains an interest-only class of securities, usually called the "Class X," which may be paid simultaneously with the AAA or other senior classes of securities. The Class X is a derivative of the other classes in a "notional" amount equal to the principal balance of the other classes. The holder of the Class X, or interest-only "strip," is not entitled to receive any principal payment, but, rather receives payments of interest based on the amount of outstanding principal of each other class. Thus, as principal payments are made, losses are incurred, or prepayments made, the Class X holder receives a smaller interest payment.

[6]The authors are not suggesting that in reality everything about a portfolio loan is negotiable. Obviously, for example, no matter how aggressive the negotiation, the borrower must always sign a mortgage or deed of trust. However, the notion of flexibility versus inflexibility between conduit and portfolio lenders has enough analytic utility to make this comparison useful.

[7]As noted above, conduit lenders price loans based on a spread over U.S. Treasury rates. Between the date the loan is closed and the date on which the loan is securitized, Treasury rates may change, and the securitization spread (i.e., the excess interest over U.S. Treasuries that investors demand) may change. Recently, while 10-year U.S. Treasury rates have declined significantly because of investor fears about the riskiness of real estate investments, securitization spreads have gone up by more than such decline. As a result, some pools which were originated at a time when securitization spreads were lower have sold at a discount over the face amount of the underlying loans. Those conduit lenders who have relied on third party warehouse lines of credit to originate the mortgage loans have been especially hard hit, because the value of the collateral (i.e., the lesser of the "market value" or the "securitization value" of the warehoused loan) for the warehouse line of credit may be less than monies advanced, thereby causing margin calls or defaults under the line of credit facility.

[8]There is no hard and fast rule, and borrowers are simply advised to ask their lender if the single-purpose entity requirements are absolute in their deal.

[9]A typical definition that satisfies current Rating Agency criteria is as follows:

> "Independent Director" means a duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment, at any time after appointment, or at any time in the preceding five (5) years, (i) a direct or indirect legal or beneficial owner in such entity or any of its affiliates, (ii) a creditor, supplier, employee, officer, director, manager or contractor of such entity or any of its affiliates, (iii) a person who controls such entity or any of its affiliates, or (iv) a member of the immediate family of a person defined in (*i*), (*ii*), or (*iii*) above.

[10]A complete list of typical single-purpose entity requirements is included as Appendix A at the end of this article.

[11]Although certain types of mezzanine financing (i.e., direct or indirect loans to an equity owner that are contributed to the capital of the borrower and which are subject to special conditions), are permitted, because the Rating Agencies are virtually unanimous in their opposition to subordinated indebtedness, the borrower will not be permitted to incur other debt, even if it is unsecured and/or deeply subordinated.

[12]In some multi-tiered ownership structures, the mezzanine loan is made to an upper tier owner and the funds are contributed downward until they reach the operating entity. Mezzanine indebtedness should not be confused with "subordinated" debt, which is debt incurred by the borrower and, as noted above, is absolutely prohibited by the SPE provisions.

[13]Provisions incorporating these mechanisms are referred to in shorthand as "kickout" clauses.

[14]Under certain circumstances, a borrower may be permitted to defease a portion of the loan to increase the debt service coverage ratio to an acceptable level.

[15]One significant conduit lender, which recently filed for bankruptcy protection, attempted to split the baby by offering borrowers a "no-lock" program, in which borrowers were permitted to prepay by paying a more typical prepayment penalty, which was a percentage of the principal amount and reduced over time.

APPENDIX

Typical Single-Purpose Entity Provisions

Borrower shall continue to be a Special Purpose Bankruptcy Remote Entity. A "Special Purpose Bankruptcy Remote Entity" means a corporation, limited partnership or limited liability company which at all times since its formation and at all times thereafter:

(i) was and will be organized solely for the purpose of (A) owning the Property or (B) acting as a general partner of the limited partnership that owns the Property or member of the limited liability company that owns the Property;

(ii) has not engaged and will not engage in any business unrelated to (A) the ownership of the Property, (B) acting as general partner of the limited partnership that owns the Property or (C) acting as a member of the limited liability company that owns the Property, as applicable;

(iii) has not had and will not have any assets other than those related to the Property or its partnership or member interest in the limited partnership or limited liability company that owns the Property, as applicable;

(iv) has not engaged, sought or consented to and will not engage in, seek or consent to any dissolution, winding up, liquidation, consolidation, merger, asset sale (except as expressly permitted by this Agreement), transfer of partnership or membership interests or the like, or amendment of its limited partnership agreement, articles of incorporation, articles of organization, certificate of formation or operating agreement, as applicable;

(v) if such entity is a limited partnership, has and will have, as its only general partners, Special Purpose Bankruptcy Remote Entities that are corporations;

(vi) if such entity is a corporation, has and will have at least one Independent Director, and has not caused or allowed and will not cause or allow the board of directors of such entity to take any action requiring the unanimous affirmative vote of 100% of the members of its board of directors unless all of the directors and all Independent Directors shall have participated in such vote;

(vii) if such entity is a limited liability company, has and will have at least one member that has been and will be a Special Purpose Bankruptcy Remote Entity that has been and will be a corporation and such corporation is the managing member of such limited liability company;

(viii) if such entity is a limited liability company, has and will have articles of organization, a certificate of formation and/or an operating agreement, as applicable, providing that (A) such entity will dissolve only upon the bankruptcy of the managing member, (B) the vote of a majority-in-interest of the remaining members is sufficient to continue the life of the limited liability company in the event of such bankruptcy of the managing member and (C) if the vote of a majority-in-interest of the remaining members to continue the life of the limited liability company following the bankruptcy of the managing member is not obtained, the limited liability company may not liquidate the Property without the consent of the applicable Rating Agencies for as long as the Loan is outstanding;

(ix) has not, and without the unanimous consent of all of its partners, directors or members (including all Independent Directors), as applicable, will not, with respect to itself or to any other entity in which it has a direct or indirect legal or beneficial ownership interest (A) file a bankruptcy, insolvency or reorganization petition or otherwise institute insolvency proceedings or otherwise seek any relief under any laws relating to the relief from debts or the protection of debtors generally, (B) seek or consent to the appointment of a receiver, liquidator, assignee, trustee, sequestrator, custodian or any similar official for such entity or for all or any portion of such entity's properties, (C) make any assignment for the benefit of such entity's creditors or (D) take any action that might cause such entity to become insolvent;

(x) has remained and will remain solvent and has maintained and will maintain adequate capital in light of its contemplated business operations;

(xi) has not failed and will not fail to correct any known misunderstanding regarding the separate identity of such entity;

(xii) has maintained and will maintain its accounts, books and records separate from any other Person and will file its own tax returns;

(xiii) has maintained and will maintain its books, records, resolutions and agreements as official records;

(xiv) has not commingled and will not commingle its funds or assets with those of any other Person;

(xv) has held and will hold its assets in its own name;

(xvi) has conducted and will conduct its business in its name,

(xvi) has maintained and will maintain its financial statements, accounting records and other entity documents separate from any other Person;

(xvii) has paid and will pay its own liabilities, including the salaries of its own employees, out of its own funds and assets;

(xviii) has observed and will observe all partnership, corporate or limited liability company formalities, as applicable; (xx) has maintained and will maintain an arm's-length relationship with its Affiliates;

(xix) (a) if such entity owns the Property, has and will have no indebtedness other than (A) the Loan or (B) unsecured trade payables incurred in the ordinary course of business relating to the ownership and operation of the Property which unsecured trade payables do not exceed in the aggregate, at any time, a maximum amount of one percent (1%) of the Loan Amount (2) and are paid within thirty (30) days of the date incurred (unless Borrower is in good faith contesting Borrower's obligation to pay such trade payables in a manner satisfactory to Lender (which may include Lender's requirement that Borrower post security with respect to the contested trade payable(s), or (b) if such entity acts as the general partner of a limited partnership which owns the Property, has and will have no indebtedness other than unsecured trade payables in the ordinary course of business relating to acting as general partner of the limited partnership which owns the Property which (1) do not exceed, at any time, $10,000.00 and (2) are paid within thirty (30) days of the date incurred, or (c) if such entity acts as a managing member of a limited liability company which owns the Property,

has and will have no indebtedness other than unsecured trade payables in the ordinary course of business relating to acting as a member of the limited liability company which owns the Property which (1) do not exceed, at any time, $10,000.00 and (2) are paid within thirty (30) days of the date incurred;

(xx) has not and will not assume or guarantee or become obligated for the debts of any other Person or hold out its credit as being available to satisfy the obligations of any other Person except for the Loan;

(xxi) has not and will not acquire obligations or securities of its partners, members or shareholders;

(xxii) has allocated and will allocate fairly and reasonably shared expenses, including shared office space, and uses separate stationery, invoices and checks;

(xxiii) except in connection with the Loan, has not pledged and will not pledge its assets for the benefit of any other Person;

(xxiv) has held itself out and identified itself and will hold itself out and identify itself as a separate and distinct entity under its own name and not as a division or part of any other Person;

(xxv) has maintained and will maintain its assets in such a manner that it will not be costly or difficult to segregate, ascertain or identify its individual assets from those of any other Person;

(xxvi) has not made and will not make loans to any Person;

(xxvii) has not identified and will not identify its partners, members or shareholders, or any Affiliate of any of them, as a division or part of it;

(xxviii) has not entered into or been a party to, and will not enter into or be a party to, any transaction with its partners, members, shareholders or Affiliates except in the ordinary course of its business and on terms which are intrinsically fair and are no less favorable to it than would be obtained in a comparable arm's-length transaction with an unrelated third party;

(xxix) has and will have no obligation to indemnify its partners, officers, directors or members, as the case may be, or has such an obligation that is fully subordinated to the Debt and will not constitute a claim against it in the event that cash flow in excess of the amount required to pay the Debt is insufficient to pay such obligation; and

(xxx) will consider the interests of its creditors in connection with all corporate, partnership or limited liability actions, as applicable.